Volume 2 11th Edition

AICPA

The Adviser's Guide to

Financial and Estate Planning

Sidney Kess, CPA, JD, LLM
Steven G. Siegel, JD, LLM

Use this guide and other PFP Section resources noted throughout these pages to help you stay current, communicate with your clients, and reinforce your role as trusted adviser during this time of uncertainty.

About the AICPA Personal Financial Planning Section

The AICPA's Personal Financial Planning (PFP) Section is the premier provider of content and tools to help you deliver the most valuable and competent advice to your clients in the areas of estate, tax, retirement, risk management, and investment planning. Visit our website for more information on many of the topics covered in this publication, such as the AICPA PFP Section homepage at aicpa.org/pfp, Proactive Planning Toolkit (updated for the Setting Every Community Up for Retirement Enhancement [SECURE] Act, the Coronavirus Aid, Relief, and Economic Security [CARES] Act of 2020, the American Rescue Plan Act, and more), PFP Learning Library with 24/7 on demand access to top experts, Broadridge Advisor (3,000+ client facing tools), Bob Veres Inside Information (cutting edge planning & practice ideas), and Advanced PFP Conference recordings.

Long-term trends in client demographics, needs, and expectations are now compounded with valid concerns about the impact on financial plans related to the COVID-19 pandemic. With myriad questions and complexities, clients need the professional, objective, and trusted advice of the CPA Personal Financial Specialist (CPA/PFS) more than ever to sort things out. Learn more about the CPA/PFS credential at aicpa.org/pfs.

The CARES Act of 2020, the Consolidated Appropriations Act of 2020 (CAA), and the American Rescue Plan Act of 2021 have made additional changes in the tax law in response to many unexpected issues raised by the pandemic. The changes raised by these acts are discussed throughout the 4-volume series where relevant. In addition, there may be sweeping reform ahead with the Biden administration and other proposals being discussed. There are far too many in play to cover here, though we will include in future 2021 volumes of the guide if proposals become law. In the meantime, the best place to get ongoing updates on these proposals is the PFP Learning Library.

DISCLAIMER: *This publication has not been approved, disapproved, or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors and the publisher are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.*

About the Authors

Sidney Kess, Esq., CPA, JD, LLM
Of Counsel, Kostelanetz & Fink, LLP
Senior Consultant, Citrin Cooperman & Company

Sidney Kess, Esq., CPA, JD, LLM, was the recipient of the AICPA's Gold Medal Award for Distinguished Service to the Accounting Profession. This award is the highest award granted to a CPA by

© 2021 AICPA. All rights reserved.

the Institute. *CPA Magazine* selected him as "Most Influential Practitioner." He is author and co-author of hundreds of tax books on financial, tax, and estate planning. He is one of the nation's best-known lecturers in continuing professional education (CPE), having lectured to more than 1,000,000 practitioners. Mr. Kess is consulting editor of CCH's *Financial and Estate Planning Reporter*. Mr. Kess was Chairman of the Advisory Board of the Tax Hotline and is a member of the PPC, Tax Action Panel. He has edited a column, "Tax Tips," for the *New York Law Journal* for the past 50 years.

Mr. Kess edits the AICPA's *CPA Client Bulletin* and *CPA Client Tax Letter*. He is Executive Editor Tax of *CPA Magazine*, is on the editorial board of the New York State Society of Certified Public Accountants' *The CPA Journal*, and is coeditor of that journal's Financial Planning section. He has also written hundreds of AICPA tax workshops, audio and video programs, and is the recipient of the AICPA Distinguished Lecturer Award. Mr. Kess is often quoted in *The Wall Street Journal*, *The New York Times*, and other national publications. He was included in *Accounting Today's* "100 Most Influential CPAs in the U.S." for several years. Mr. Kess was the National Director of Tax at KPMG Main Hurdman and a tax partner at KPMG Peat Marwick. Mr. Kess is the recipient of the AICPA's "Special Recognition Award" for his many years of contributions to the AICPA's CPE program and was elected to the Estate Planning Hall of Fame by the National Association of Estate Planners & Councils for his distinguished service to the field of estate planning. Mr. Kess is also a member of the AICPA's Personal Financial Planning Executive Committee. Mr. Kess was the recipient of the AICPA's 2015 Personal Financial Planning Distinguished Service Award.

The AICPA established the Sidney Kess Award for Excellence in Continuing Education to recognize individual CPAs who have made significant and outstanding contributions in tax and financial planning and whose public service exemplifies the CPA profession's values and ethics. Sidney Kess was the first recipient of this award. Mr. Kess was selected as one of "125 People of Impact in Accounting" by the *Journal of Accountancy* in its June 2012 issue celebrating the AICPA's 125th anniversary. Mr. Kess was inducted into the New York State Society of CPA's Hall of Fame. He recently received the New York State Society's Outstanding CPA in Education Award.

He received his JD from Harvard University School of Law, LLM from New York University Graduate School of Law, and BBA from Baruch College.

Steven G. Siegel, JD, LLM
The Siegel Group

Steven G. Siegel, JD, LLM, is president of The Siegel Group, which provides consulting services to attorneys, accountants, business owners, family offices, and financial planners. Based in Morristown, New Jersey, the group provides services throughout the United States.

Mr. Siegel is the author of many books, including *The Grantor Trust Answer Book* (2020 Leimberg Information Services, Inc.); *The Adviser's Guide to Financial and Estate Planning* (AICPA 2021; formerly *The CPA's Guide to Financial and Estate Planning*); co-author of *Income Taxation of Trusts and Estates* (Carolina Press 2020), *Federal Fiduciary Income Taxation* (Foxmoor 2020); and *Federal Estate and Gift Taxation* (Foxmoor 2016).

In conjunction with numerous tax planning lectures he has delivered for the National Law Foundation, Mr. Siegel has prepared extensive lecture materials on the following subjects: *The SECURE Act, Planning for the 99%; Planning for An Aging Population; Business Entities: Start to Finish*; *Preparing the Audit-Proof Federal Estate Tax Return*; *Business Acquisitions: Representing Buyers and Sellers in the Sale of a Business*; *Dynasty Trusts*; *Planning with Intentionally-Defective Grantor Trusts*;

© 2021 AICPA. All rights reserved.

Introduction to Estate Planning; *Intermediate-Sized Estate Planning*; *Social Security, Medicare and Medicaid: Explanation and Planning Strategies*; *Subchapter S Corporations: Using Trusts as Shareholders*; *Divorce and Separation: Important Tax Planning Issues*; *The Portability Election*; and many other titles.

Mr. Siegel has delivered hundreds of lectures to thousands of attendees in live venues and via webinars throughout the United States on tax, business, and estate planning topics on behalf of numerous organizations, including The Heckerling Institute on Tax Planning, The Notre Dame Tax Institute, CCH, AICPA, Investments and Wealth Institute, Yale School of Management, Chicago Booth Business School, Western CPE, CP America; the National Society of Accountants, Cohn-Reznick, Foxmoor Education, many state accounting societies and estate planning councils, as well as in-house training on behalf of private companies.

He is presently serving as an adjunct professor of law in the Graduate Tax Program (LLM) of the University of Alabama and has served as an adjunct professor of law at Seton Hall and Rutgers University law schools.

Mr. Siegel holds a bachelor's degree from Georgetown University (magna cum laude, Phi Beta Kappa), a JD from Harvard Law School, and LLM in taxation from New York University Law School.

Contents

Chapter 8: Annuities

- 801 Overview
- 805 Commercial Annuities
- 810 The Private Annuity
- 815 Qualified Longevity Annuity Contracts

Chapter 9: Employee Benefits

- 901 Overview
- 902 The SECURE Act of 2019 Creates Far-Reaching Changes in the Law
- 905 Primer on Qualified Retirement Plan Rules
- 910 Employee Stock Ownership Plan Opportunities
- 915 Individual Retirement Account IRA Opportunities
- 920 Profit-Sharing Plans
- 925 Cash or Deferred (401[k]) Arrangements
- 930 Pension Plans
- 935 Thrift and Savings Plans

© 2021 AICPA. All rights reserved.

940 Borrowing from the Plan

945 Group-Term and Group Permanent Life Insurance

950 Death Benefits

955 General Financial Planning Factors for Qualified Plan and IRA Benefits

960 Employee Awards

965 Health Plans

970 Below-Market Loans to Employees

975 Cafeteria Plans

980 Employer-Provided Dependent Care Assistance

985 IRC Section 132 Fringe Benefits

990 The “myRA”

Chapter 10: Transfers Includible in the Estate at Death

1001 Overview

1005 The Costs of Transfer

Chapter 11: Wills

1101 Overview

1105 What a Will Can and Should Do

1110 Will Forms and Provisions

1115 Execution of the Will

1120 Joint, Mutual, and Reciprocal Wills

1125 Instructions and Data Sources Outside the Will

1130 Digital Estate Planning

Chapter 12: The Marital Deduction

1201 Overview

1205 Qualifying for the Marital Deduction

1210 Qualifying Terminable Interest Property (QTIP)

© 2021 AICPA. All rights reserved.

1215 To What Extent Should the Marital Deduction Be Used?

1220 How to Make a Marital Deduction Bequest

1225 Use of Trusts in Marital Deduction Planning

1230 Alien Surviving Spouses — Qualified Domestic Trusts (QDOTs)

1235 Use of Disclaimers

1240 Common Disaster, Survivorship, and Equalization Provisions

Chapter 13: Powers of Appointment

1301 Overview

1305 General and Special Powers

Chapter 14: Selection and Appointment of Fiduciaries

1401 Overview

1405 Selecting an Executor or Personal Representative

1410 Alternate or Successor Fiduciaries

1415 Selection of Guardians

Chapter 15: Postmortem Planning

1501 Overview

1505 Income Tax Savings on Decedent’s Final Return

1510 Planning for the Estate’s Liquidity

1515 Handling Administration Expenses, Casualty Losses, and Estimated Taxes

1520 Selecting the Valuation Date for Estate Assets

1525 Changing the Testator’s Plan

1530 QTIP Election

Chapter 16: Planning for the Executive

1601 Overview

1605 Executive Compensation

1610 Lifetime and Estate Planning for Executive Benefits

© 2021 AICPA. All rights reserved.

1615 Use of Standard Planning Techniques

1620 Total Financial Counseling for the Executive

1625 The Migratory Executive

Chapter 17: Planning for the Professional

1701 Overview

1705 What Makes the Professional Special?

1710 Side Businesses

1715 Corporate and Non-Corporate Practice

1720 Problems and Pitfalls in Corporate Operation

1725 Planning for Shareholder-Professionals

1730 Withdrawal and Expulsion

Chapter 18: Closely Held Businesses — Choice of Business Entity

1801 Overview

1805 Tax Factors

1810 Nontax Factors

1815 Disposition of the Business Interest

1820 Conclusions: Evaluating the Choices Among the Available Entities

Chapter 19: Planning for the Owner of the Closely Held Corporation

1901 Overview

1905 Initially Planning the Business Structure

1910 Recapitalization and Post-Organizational Planning

1915 Obtaining Money from the Corporation via Stock Redemptions

1920 Using an Employee Stock Ownership Plan in Estate Planning for the Business Owners

1925 Qualifying for Installment Payment of the Estate Tax

1930 Keeping the Business in the Family

1935 Buy-Sell Agreements — Questions and Answers

© 2021 AICPA. All rights reserved.

1940 How Shares in Closely Held Corporations Are Valued

1945 Electing S Corporation Status

1950 Corporate-Owned Life Insurance and the Estate of a Controlling Shareholder

© 2021 AICPA. All rights reserved.

Chapter 8

Annuities

¶801 Overview

¶805 Commercial Annuities

¶810 The Private Annuity

¶815 Qualified Longevity Annuity Contracts

¶801 Overview

Life insurance provides financial security for family members and other beneficiaries in the event of a premature death. However, life insurance does not provide very well for those who live beyond their life expectancy. The insurance industry offers annuities as the solution to this concern. Annuities offer protection against consuming financial resources before death. Particularly in times of low interest rates and low returns on all investments, clients are becoming increasingly concerned about outliving their resources. The financial planner should consider annuities as part of the client's financial plan.

An individual who buys an annuity is known as the *annuitant*. All annuities guarantee the annuitant payments annually (at the very least) for life or for a specified period. These payments include two parts — a return of capital and a return on capital in the form of interest or investment income. An annuity is essentially a systematic capital-consuming vehicle meant to provide the annuitant with an income for life or for a specified period.

Planning Pointer.

The annuitization feature that life insurance policies carry should be compared to a traditional commercial annuity. Because there is no additional sales load, individuals who have significant cash values in their life insurance policies and no longer require their coverage, or a portion thereof, should consider converting their existing life insurance coverage to an annuity in lieu of purchasing a traditional commercial annuity.

¶805 Commercial Annuities

An individual can buy a commercial annuity in a variety of forms. Two basic kinds of annuities are the fixed annuity and the variable annuity. A fixed annuity pays the annuitant fixed payments for life or for a specified period. A variable annuity is essentially an annuity tied to a mutual fund. A variable annuity pays the annuitant payments that vary with investment results for life or for a specified period.

An equity-indexed annuity is a hybrid annuity. It pays the annuitant a minimum fixed rate of return along with a percentage of the increase, if any, in a related stock market index.

© 2021 AICPA. All rights reserved.

A major weakness of the fixed annuity is that the annuity payments may not keep pace with inflation. In times of high inflation, the annuitant sees constantly rising prices, but the annuity payments remain fixed. During periods of low inflation, this factor is less important. When inflation was high, insurance companies developed variable annuities for individuals who were concerned about inflation eroding the purchasing power of fixed annuities. Insurance companies invest money in variable annuities in stocks, bonds, and money market instruments. Under the anticipated skilled management of the insurance company's investment advisers, the annuitant can expect a variable annuity to grow and keep ahead of inflation. However, variable annuities have more risk and may not achieve the desired result.

The advantage of equity-indexed annuities is the low risk because of the minimum guaranteed return. The disadvantage is that the potential return is less than the potential return on a variable annuity. The annuitant receives only a portion of the increase in the stock market index to which the annuity is linked. The participation rate determines how much of the increase in the related stock market index will be credited as interest to the annuitant. For example, if the participation rate was 75% and the related stock market index increased by 10%, the annuitant would receive an interest rate of 7.5% (.75 ×.10) for that period. The features, benefits, and limitations of equity-indexed annuities vary across insurance companies.

According to the National Association of Securities Dealers (NASD), sales of equity-indexed annuities have increased significantly in recent years. Equity-indexed annuities do have some risks. The minimum guaranteed rate of return is usually 90% of the premiums paid plus 3% annual interest. The guarantee is only as good as the insurance company that sells the annuity. Charges for an early surrender of an equity-indexed annuity may be high. Because of the growing popularity of these annuities, they are coming under increased scrutiny from regulators. Financial planners should examine equity-indexed annuities and particularly the surrender charges carefully before recommending them to clients.

Unless an investor has some way of retaining capital and investing it in a way that beats inflation, the annuity deserves consideration. Individuals who have reason to believe that they will outlive the life expectancies in annuity mortality tables should seriously consider annuities. One of the best ways to evaluate variable annuities is to compare them to mutual funds. A financial planner should look at the various kinds of annuities in the market for clients who want to invest in an annuity.

One obvious advantage of the annuity for some individuals is that the guaranteed payments from an annuity protect a person from the inability to manage money. An annuity can also be attractive to a person who wants to provide an assured income for the life of another person.

Straight annuities pay a specified amount periodically for the life of the annuitant. Other kinds of annuities provide payments for 5, 10, 15, or 20 years. Another type of annuity pays a cash refund to the annuitant's beneficiaries if the annuitant does not recover at least the initial investment.

The straight annuity provides the largest payment per dollar invested because the insurance company's obligation ceases on the annuitant's death. The longer the period of guaranteed payments, the smaller the periodic annuity payments will be. The cash refund type of annuity does not guarantee a fixed number of payments. Instead, it gives the annuitant's beneficiaries, upon the death of the annuitant, the difference (if any) between the annuitant's investment in the contract and the amount received.

An insurance company computes the payments on joint and survivor annuities by taking into account the life expectancies of the annuitant and the survivor. Obviously, life expectancies of two individuals will be greater than that of one individual. Accordingly, the periodic annuity payments will be smaller.

© 2021 AICPA. All rights reserved.

.01 Deferred Annuities

Some annuities (immediate annuities) begin paying immediately. Deferred annuities are another type of annuity. In deferred annuities, the annuitant makes a current investment in an annuity contract in return for annuity payments that begin in the future.

Withdrawals from a deferred annuity before the annuity start date and partial surrenders or distributions in the nature of dividends are subject to immediate income taxation.[1]

In addition, a 10% additional excise tax generally applies to premature distributions.[2] Although a taxpayer can ask the IRS to abate tax penalties for reasonable cause, the taxpayer must find a specific exception in the IRC to avoid this additional tax. The IRC allows the taxpayer to avoid the additional tax for distributions under certain conditions. This additional tax does not apply to taxable amounts received after age 59½[3] or because of the annuitant's death[4] or disability.[5] Substantially equal periodic payments made over the life expectancy of the taxpayer, or over the joint lives of the taxpayer and the designated beneficiary, are not subject to the additional tax.[6] The 10% additional tax does not apply to investments in annuity contracts made before August 14, 1982.[7] Early withdrawals may also be subject to insurance company surrender charges, which are typically substantial.

Individuals may turn to annuities for additional tax-sheltered retirement savings after exhausting their limits on qualified plans (for example, 401(k) plans) and IRAs. Contributions to deferred annuities are not deductible and are not subject to limits, as are contributions to IRAs or qualified plans.

Deferred annuities may be especially useful for individuals who assume they will outlive their life expectancies contained in the annuity mortality tables. Annuity mortality tables assign longer life expectancies than life insurance tables. This difference is because of the selection process involved in buying one product or the other. Annuitants are generally concerned with outliving their financial reserves. Life insurance policyholders are generally concerned with premature death and leaving their dependents in a financial bind.

---

[1] IRC Section 72(e).

[2] IRC Section 72(q)(1).

[3] IRC Section 72(q)(2)(A).

[4] IRC Section 72(q)(2)(B).

[5] IRC Section 72(q)(2)(C).

[6] IRC Section 72(q)(2)(D).

[7] IRC Section 72(q)(2)(F).

© 2021 AICPA. All rights reserved.

If the owner of a deferred annuity dies before the annuity start date, the surviving beneficiary must receive the entire interest in the annuity generally within five years after the contract holder's death.[8] Alternatively, the beneficiary may receive the annuity over a period not more than the life expectancy of the beneficiary.[9] When the beneficiary receives payments based on life expectancy, the payments must begin within one year of the contract holder's death.[10] If the beneficiary is a spouse, the spouse may continue the contract in the spouse's name and defer income tax.[11]

If the contract holder dies on or after the annuity start date, the beneficiary must receive any remaining portion of the annuity interest as rapidly as under the method of distribution in effect at the contract holder's death.[12]

These rules do not apply to an annuity contract provided by a qualified pension plan, profit-sharing plan, stock bonus plan, IRC Section 403(b) tax-sheltered annuity, or an annuity purchased in an IRA.

Deferred annuities may be considered in connection with the 3.8% net investment income tax. Annuity payments are classified as investment income for purposes of this tax under IRC Section 1411. Funds invested in a deferred annuity while the purchaser is working have their investment income yield deferred. If the payments begin when the purchaser has retired, the payments will be net investment income when received, but perhaps the adjusted gross income (AGI) of the purchaser has fallen short of the threshold for the net investment income tax by that time, keeping the payments free of that tax.

.02 Variable Annuities Versus Mutual Funds

Variable annuities generally offer the advantages of mutual funds plus the opportunity to defer taxes. However, the commissions, fees, and other charges of variable annuities and unfavorable taxation at death or lifetime sale are disadvantages.

Variable annuities and mutual funds are similar in many ways; both provide professional management of a securities portfolio and neither offers a guaranteed cash value. Rather, the amount the investor receives depends on the performance of the portfolio. Both charge the investor a sales charge and the costs of investment management and administration. Both allow several transfers between funds each year without charge.

The chief advantage of variable annuities over mutual funds is the opportunity for tax deferral. Investors in variable annuities do not pay tax on the dividends and the capital gains until they withdraw the money. The amount received over the taxpayer's basis in the annuity is subject to tax as ordinary income

---

[8] IRC Section 72(s)(1)(B).

[9] IRC Section 72(s)(2)(B).

[10] IRC Section 72(s)(2)(C).

[11] IRC Section 72(s)(3).

[12] IRC Section 72(s)(1)(A).

© 2021 AICPA. All rights reserved.

at a tax rate of up to 37% for 2021. The 3.8% net investment income tax will also apply to this income. However, the holder of a mutual fund held outside of the variable annuity pays taxes on any income or gain from the mutual fund in the year earned, along with the net investment income tax, even if the taxpayer reinvests the money in the mutual fund. The taxpayer can avoid paying current taxes on the income and gain if the mutual fund investments are in a qualified pension or profit-sharing plan, a traditional IRA, a Roth IRA, a 401(k) plan, or a 403(b)(7) plan.

Other factors also may favor the annuity. First, a transfer between funds is not a taxable event for annuities, but it is for mutual funds. Second, investment advisory fees on variable annuities reduce the gross income received from the annuities, thereby providing a tax benefit for such fees. Investment fees on mutual funds are miscellaneous itemized deductions and not tax deductible after 2017 through 2025 as the result of the 2017 Tax Cuts and Jobs Act (TCJA). Third, loans may be available against annuity balances, although they are generally taxable distributions.[13]

The IRC also treats most loans on annuities in qualified plans (for example, a 403(b) plan) as distributions.[14] However, the IRC allows loans for annuities in a qualified plan, including a 401(k) plan, up to $50,000, or the greater of one half of the value of the taxpayer's vested benefit (or $10,000).[15] The terms of the loan must require the borrower to repay the loan within five years,[16] unless the borrower used the proceeds of the loan to purchase a principal residence.[17] There must be a level amortization schedule with payments not less frequently than quarterly. The loan must be evidenced by an enforceable agreement. If the borrower defaults on a loan payment, the entire loan balance, including accrued interest, is a deemed distribution that will subject the borrower to tax at ordinary income rates. The 10% additional excise tax also applies to the deemed distribution, unless the taxpayer meets an exception. The plan administrator may allow the borrower a grace period (a "cure period") to cure the default on the loan. The grace period may not extend beyond the last day of the calendar quarter following the calendar quarter in which the required payment was due.[18]

The Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020 (H.R. 748) created a special rule for qualified plan loans to be taken in 2020. If there is a COVID-19 virus-related illness or hardship, plan loan dollar limits are increased to the lesser of (a) $100,000 (prior law had a cap of $50,000) or (b) the greater of $10,000 or 100% of the present value of the participant's vested benefit. The loan must be taken within 180 days of the enactment of the law (by approximately September 22, 2020, unless extended by subsequent laws). Also, for plan loans falling due between March 27, 2020 and December 31, 2020, the term for those loan repayments is extended by one year. The terms *illness* and *hardship* are

---

[13] IRC Section 72(e)(4)(A).

[14] IRC Section 72(p)(1).

[15] IRC Section 72(p)(2)(A).

[16] IRC Section 72(p)(2)(B)(i).

[17] IRC Section 72(p)(2)(B)(ii).

[18] Regulation Section 1.72(p)-1 Q&A 10.

© 2021 AICPA. All rights reserved.

broadly defined to include any COVID-19 related illness as well as adverse financial consequences relating to job, reduced work hours, business loss, childcare, and more.

The maximum tax rate of 20% (effective for 2021)[19] for most long-term capital gains and qualified dividends is an advantage that mutual funds have over variable annuities. Income recognized from variable annuities is ordinary income subject to tax rates of up to 37% effective in 2021.[20] Both annuities and long-term capital gains (as well as qualified dividends) are subject to the 3.8% tax on net investment income if the taxpayer's applicable threshold is met. Annuity balances also receive unfavorable tax treatment at death because the beneficiary must recognize the appreciation as ordinary income under the income in respect of a decedent rules.[21] There is no basis step-up for an annuity. The appreciation of mutual funds escapes income tax at death because the beneficiaries receive a tax-free step up in basis unless the special carryover basis rules for persons who died in 2010 were elected.[22]

Additionally, the poor liquidity and increased annual charges of variable annuities may offset the tax deferral advantages of variable annuities. Variable annuities are generally illiquid because of the 10% additional excise tax and insurance company-imposed surrender charges for early withdrawals.

.03 How Annuities Are Taxed

Annuity payments under a commercial annuity received after the annuity start date are partly a return *of* capital and partly a return *on* capital in the form of interest or investment earnings. Interest and investment earnings are taxable, but the annuitant's return of capital is not taxable. For annuitants whose annuity contributions were tax sheltered when made, such as in a 403(b) plan, all of the annuity payments received will be taxable.

The annuitant must separate each payment received. The amount not taxable is equal to an exclusion ratio multiplied by the payment. The taxable amount is equal to the payment minus the amount not taxable. The exclusion ratio is equal to the annuitant's investment in the contract divided by the total expected return for the life of the contract.[23] To compute the expected return, the annuitant multiplies the annual return by a multiple supplied by the appropriate Treasury table in Regulation Section 1.72-9.

> **Example 8.1.** Howard, age 62, purchased a fixed annuity for $100,000 with funds that were not tax sheltered. The annuity will pay him $7,000 per year for life. According to the table in Regulation Section 1.72-9, Howard's life expectancy is 22.5 years. Howard's exclusion ratio is 63.49% ($100,000 ÷ [22.5 × $7,000]). When Howard receives a $7,000 payment, he will treat $4,444 ($7,000 ×.6349) of the payment as a tax-free recovery of basis. He will include the difference of $2,556 in his gross income as ordinary income. The annuity may also be subject to

[19] IRC Section 1(h).

[20] IRC Section 1(i).

[21] IRC Section 691(A)(1).

[22] IRC Section 1014(a).

[23] IRC Section 72(b)(1).

© 2021 AICPA. All rights reserved.

the 3.8% tax on net investment income if Howard's modified AGI is over the threshold amount for imposing this tax.

For individuals whose annuity start date is after 1986, the total amount that the annuitant may exclude from gross income is limited to the investment in the contract.[24] Thus, when the annuitant reaches the point where the investment in the contract is fully recovered, all remaining payments are fully taxable.

> **Example 8.2.** Assume the same facts in example 8.1 apply. If Howard lives for 25 years, he will recover $97,768 (22 × $4,444) of his $100,000 basis in the annuity after 22 years. In year 23, Howard will treat $2,232 of the $7,000 payment as a tax-free recovery of basis. His gross income from the annuity payment will be $4,768 ($7,000 – $2,232). In years 24 and 25, Howard will include all $7,000 of each payment in his gross income.

If the annuitant dies before recovering all of the investment in the contract, the IRC allows an itemized deduction on the annuitant's final income tax return for the remaining basis in the annuity.[25] The deduction is not a suspended miscellaneous itemized deduction,[26] so it should remain available after 2017. For purposes of computing a net operating loss, the IRC treats this deduction as though it were attributable to a trade or business.[27]

> **Example 8.3.** Using the same facts as example 8.1, assume that Howard died after receiving 15 annuity payments rather than living for 25 years. Howard's basis in the annuity would be $33,340 ($100,000 – [15 × $4,444]). The executor of Howard's estate may take a deduction of $33,340 on Howard's final income tax return.

The taxpayer includes payments received before the annuity start date that are less than or equal to the increase in cash value[28] after August 13, 1982,[29] in gross income.[30] Amounts received that are greater than the increase in cash value after August 13, 1982, are a tax-free recovery of basis.[31] The taxpayer includes all additional payments in gross income after recovering all of the basis in the contract.

The IRC provides a simplified method for assigning basis to monthly annuity payments received under a qualified plan.[32] If the primary annuitant has reached age 75 by the annuity start date, the taxpayer may

---

[24] IRC Section 72(b)(2).

[25] IRC Section 72(b)(3)(A).

[26] IRC Section 67(b)(10).

[27] IRC Section 72(b)(3)(C).

[28] IRC Section 72(e)(3)(A).

[29] IRC Section 72(e)(5)(B).

[30] IRC Section 72(e)(2)(B).

[31] IRC Sections 72(e)(2)(B) and 72(e)(3)(B).

[32] IRC Section 72(d).

© 2021 AICPA. All rights reserved.

not use the simplified method unless the annuity has fewer than five years of guaranteed payments.[33] The part of the annuity payment attributable to the taxpayer's basis is equal to the basis in the contract divided by the number of anticipated payments. Based on the age of the annuitant at the annuity start date, the annuitant assigns basis to the payments based on the number of anticipated monthly payments. The following table from IRC Section 72(d)(1)(B)(iii) applies to employee annuities with an annuity start date after December 31, 1997.

Age of the Annuitant on the Annuity Start Date	The Number of Monthly Anticipated Payments
Not more than 55	360
More than 55, but not more than 60	310
More than 60, but not more than 65	260
More than 65, but not more than 70	210
More than 70	160

Example 8.4. Debra retires at age 62 and begins receiving monthly payments of $2,000 as a life annuity from her employer. Debra had contributed $130,000 to the annuity with after-tax funds. Her employer also contributed to the annuity. Debra will recover her basis over 260 months by treating $500 ($130,000 ÷ 260) of each payment as a tax-free recovery of basis. She will include the remaining $1,500 of each payment in her gross income. After she has recovered all her $130,000 basis, she will include all of the $2,000 monthly payment in her gross income. She should also determine whether the annuity is subject to the 3.8% tax on net investment income based on her threshold of modified AGI.

The number of anticipated payments is different if the annuity is payable over the lives of more than one individual. The following table from IRC Section 72(d)(1)(B)(iv) shows the number of anticipated payments based on the combined ages of the annuitants for annuities with a start date after December 31, 1997.

Combined Ages of the Annuitants	The Number of Anticipated Payments
Not more than 110	410
More than 110, but not more than 120	360
More than 120, but not more than 130	310
More than 130, but not more than 140	260
More than 140	210

Example 8.5. Dave and Gwen are ages 65 and 63, respectively. Dave has a basis of $124,000 in an annuity. His employer also contributed to the annuity. Dave begins receiving monthly payments of $4,000. The payments are for Dave's life and will continue for Gwen's life if she survives him. Dave will allocate $400 ($124,000 ÷ 310) of basis to each $4,000 payment until he recovers the $124,000 investment in the contract.

[33] IRC Section 72(d)(1)(E).

© 2021 AICPA. All rights reserved.

.04 Providing Essential Liquidity: Comparing Systematic Withdrawals and Immediate Annuities

When the financial planner considers recommending an annuity for a client to address the need for long-term liquidity, before addressing specific products, there should be a broader inquiry, namely whether the annuity contract, with its guaranteed payment but lack of any investment growth is the appropriate choice, or whether the recommendation should be for the client to more actively manage assets and systematically withdraw funds as needed for liquidity. There is no "one size fits all" correct answer. The analysis often turns on the client's tolerance for risk and on the investment expertise of the client or the client's advisers. It is certainly a case-by-case determination. A comparison of these approaches follows.

A. Spreading Income Over the Client's Life

Systematic withdrawal allows money to be withdrawn whenever desired. The risk is the client may run out of money if the financial plan does not work out as planned or if the client outlives the funds. If the planning is too conservative, the client may live at a level less than that otherwise affordable. If investments do well, or if the client lives only a relatively short time, it is likely there will be funds left for heirs.

An immediate annuity spreads income over the client's future lifetime, regardless of longevity or the performance of the economy. If assets are converted to an annuity, the likelihood is there will be little or nothing of those assets to leave to heirs unless there is a principal guarantee which could reduce the amount of the available annual annuity payment.

B. Protection from Inflation

The systematic withdrawal method suggests a blend of investments, including common stocks, which have proven over time to be the best strategy to combat inflation. Such investments involve a higher tolerance for risk and the possibility of market declines. Treasury bonds indexed to inflation may provide a hedge against some of the risk presented by common stocks but at the cost of currently low interest rates.

Fixed annuity payments lose their purchasing power when there is inflation. If the annuity chosen is a variable annuity, stock market performance will influence and vary the annuity payments, which may keep up with inflation or cause a loss of money depending on the performance of the market.

C. Flexibility for the Client

The systematic withdrawal method gives the client control over investments and the withdrawal of funds. This can vary depending on the specific circumstances of the client and changes in economic conditions. Bear in mind that funds in IRAs in all cases and those in qualified retirement plans unless the participant is still employed and not a 5% or more owner of the employer must be withdrawn beginning at age 72, as extended from age 70½ (as provided in the Setting Every Community Up for Retirement Enhancement [SECURE] Act of 2019). If an annuity is desired, it can be purchased at any time.

The annuity is a contract that is locked in once it is issued. Terminating the contract early typically incurs costly surrender charges. The contract can be chosen to provide for lifetime payments, payments for a minimum number of years, or payments to the annuitant and a survivor. Whatever flexibility is available is in the initial choice of the annuity arrangement. Once purchased, its terms are established.

© 2021 AICPA. All rights reserved.

D. Management, Record Keeping, and Compliance Concerns

When systematic withdrawals are made, the client is responsible for the management of investments and staying current with bill payments. The success or failure of annual investments may cause tax liabilities to fluctuate from year to year. The client must be sure to address annual minimum distribution requirements when applicable.

The purchased annuity relies on the insurance company to invest the funds and see to their management. Scheduled monthly payments are typically direct deposited into the client's account. Taxable income varies little, if any, from year to year if the annuity is fixed; it may vary if the annuity is a variable annuity. The annuity will automatically address minimum distributions at age 72.

E. Which is the Best Plan for the Client?

The systematic withdrawal method works best for the independent client who is comfortable being in control of the situation and has the good health to remain in control. The client is responsible for investment decisions and withdrawal decisions. If the client is uncomfortable or timid with respect to management and asset allocation, this method may not be the recommended choice for such a client.

The fixed annuity method works best for an older person who does not want to deal with investment and management issues. A younger person may be able to structure a portfolio of stocks and bonds to hedge against risk that will perform as well as or better than an annuity; or, if market conditions decline, there will be time to recover in a later investment cycle. A person in poor health may not live long enough to collect all of the contractual annuity payments.

There is clearly no right or wrong choice here. The financial planner needs to understand the client and assist in designing a plan that is comfortable and appropriate for each individual client.

.05 Viable Income Options for Choosing an Annuity Plan

If the financial planner's recommendation and the client's decision is to proceed with an investment in an annuity product, the analysis is not over. In some respects, it has just begun. Does the client want a maximum return of funds with no concern about heirs? Does the client want to preserve an inheritance for heirs? Should a lesser immediate payment be taken to protect the interest of a surviving spouse? A comparison of some of the broad options facing the annuity investor follows.

A. Lifetime Income Only

The client receives income payments for life. The payments cease upon the client's death. This choice provides the most income for the client based on the amount invested in the annuity or plan. It may be particularly attractive to single individuals without great concern for leaving an inheritance to heirs because there is no back-end payment or guarantee.

B. Life with Period Certain (Lifetime Income with a Minimum Number of Payments)

The client receives income for life. If the client dies before receiving a specified amount or a specified number of payments, the client's beneficiaries will receive the balance of payments provided under the annuity contract or plan. This plan is typically chosen by clients who want a stream of income for life, but do not want to risk the loss of a portion of their annuity investment in the event of a premature death. When the client has concerns about leaving an inheritance for heirs, this plan is often selected.

© 2021 AICPA. All rights reserved.

C. Life with Refund Certain (Lifetime Income with a Minimum Number of Guaranteed Payments)

The client receives income for life. If the client dies before receiving the total invested in the annuity contract or plan, the beneficiary will receive a continuing stream of payments until the total payments are made equal to the amount invested in the contract or plan. This plan provides a guaranteed return of principal to the client or the client's family in addition to life income for the client. This plan is often chosen by clients who may not be in good health and who want to assure an inheritance for their heirs.

D. Joint and Survivor Provisions (Lifetime Income for Two People)

The client names two individuals as beneficiaries and income continues to be paid as long as either is alive. The annual payment is typically less than it would be if only one life was involved, but the income stream is now designed to protect two persons. At the first death, the payments continue to the survivor, generally (but not necessarily) at a reduced percentage of the original amount. This joint and survivor option is often selected by couples. If there is not much other income available to them, the option selected after the first death may be to continue 100% of the payments being made when both persons were alive. If this is done, the overall payments from inception will be reduced below what a lower percentage option after the first death may have yielded.

Once again, the role of the financial planner here is to first understand the needs and desires of the client, examine other available assets and sources of income and then present and recommend the various options that will best suit the client's personal and family situation.

E. The Medicaid Compliant Annuity

An annuity may be used in Medicaid planning. It is used to support the well spouse ("community spouse") while the other spouse is in a care facility. Properly structured it can be viewed as an exempt asset for Medicaid eligibility purposes. For the annuity to be exempt, it must be an immediate (not deferred) annuity. It must be irrevocable. The annuity contract payment amount and term cannot be altered, and the parties to the contract cannot be changed. In addition, the annuity must be non-assignable and be actuarially sound. The annuity must provide equal monthly payments to the annuitant, and must name the state Medicaid agency as beneficiary when the annuitant dies to recover funds paid on behalf of the ill spouse.

¶810 The Private Annuity

The private annuity resembles a commercial annuity that an insurance company might issue. However, parties other than insurance companies issue this type of annuity. Instead of making a cash payment to acquire the annuity, a person can acquire a private annuity in exchange for a transfer of property. The party making the promise to pay the private annuity is the obligor. The obligor is usually a member of the annuitant's family. However, the obligor can also be someone outside the family.

Historically, a transfer of property in exchange for a private annuity had offered the tax advantage of income tax deferral. Under the so-called "open transaction approach," courts have allowed the deferral of any recognition of gain from the annuity payments until the basis of the property has been recovered

© 2021 AICPA. All rights reserved.

when the amount realized from the sale cannot be determined with certainty.[34] In a long-standing revenue ruling, the IRS had adopted an approach referred to as ratable recognition.[35] Under this approach, the capital gain (i.e., the difference between the basis in the property transferred and the fair market value (FMV) of the annuity received) was recognized ratably over the life expectancy of the transferor.

However, the IRS changed its position and concluded that neither the open transaction approach nor the ratable recognition approach clearly reflects the income of the transferor of property in exchange for an annuity contract. Contrary to the premise underlying these authorities, the IRS now believes that an annuity contract — whether secured or unsecured — may be valued at the time it is received in exchange for property. Consequently, the IRS has proposed regulations that eliminate the income tax deferral for private annuities.[36] The regulations were proposed to be effective for exchanges after October 18, 2006, but deferred for exchanges made after April 18, 2007, for transactions in which (1) the issuer of the annuity contract is an individual; (2) the obligations under the annuity contract are not secured, either directly or indirectly; and (3) the property transferred in the exchange is not subsequently sold or otherwise disposed of during the two-year period beginning on the date of the exchange.

The proposed regulations provide a single set of rules that leave the transferor and the transferee in the same position as if the transferor had sold the property for cash and used the proceeds to purchase an annuity contract. If an annuity contract is received in exchange for property other than money, (1) the amount realized attributable to the annuity contract is the FMV, (as determined under IRC Section 7520) of the annuity contract at the time of the exchange; (2) the entire amount of the gain or loss, if any, is recognized at the time of the exchange, regardless of the taxpayer's method of accounting; and (3) for purposes of determining the initial investment in the annuity contract under IRC Section 72(c)(1), the aggregate amount of premiums or other consideration paid for the annuity contract equals the cost attributable to the annuity contract.

Planning Pointer.

Notwithstanding the proposed regulations, one situation when the private annuity would remain viable would be when the transferor has a high basis in the property (perhaps as the result of acquiring it from a deceased spouse with a stepped-up basis). If the property has further appreciation potential, its transfer in exchange for a properly calculated private annuity would freeze the value of the property in the hands of the transferor and avoid gain recognition at the time of the transfer.

Private annuities remain an attractive estate planning tool if the income tax consequences can be overcome. Because the annuity terminates at the death of the annuitant, there is no asset to include in the deceased annuitant's estate. If valuable property was transferred in exchange for a private annuity and the transferor died within a relatively short time of the transfer (having lived at least more than one

[34] *D.J. Lloyd*, 33 B.T.A. 903 (1936).

[35] Revenue Ruling 69-74, 1969-1 C.B. 43.

[36] Proposed Regulation Section 1.72-6(e); Proposed Regulation Section 1.1001-1(j); IRS News Release IR 2006-161 (October 17, 2006).

© 2021 AICPA. All rights reserved.

year), the transferred property is not part of the decedent's estate; and possibly only a small number of annuity payments were made, thus removing value from the decedent's ultimate estate calculation.

Another weapon the IRS may use to challenge a private annuity is the "source of payments test." If the annuity payments can be made to the transferor only from the transferred property, the IRS may take the position that the transferor has retained a life estate in the transferred property and argue for a full estate inclusion of the value of the property at the transferor's date of death under IRC Section 2036. If possible, having the transferee of the property pay the annuitant from funds or assets not associated with the transferred property is certainly a better planning choice.

¶815 Required Minimum Distribution Rules Revised to Permit Qualified Longevity Annuity Contracts (QLACs)

A common theme in retirement planning discussions is that people are not saving enough money for their retirement. The combination of lack of savings, increased expectation of longevity and the required minimum distribution rules that force withdrawals of retirement funds have led to pressure on the Treasury to allow some alternative investments in retirement plans that will address these concerns. In 2014, the IRS issued final regulations (T.D. 9673) to allow the purchase of deferred annuities within retirement plans that begin at an advanced age and that do not count in the plan participant's account balance when determining required minimum distributions.

The regulations address annuity contracts that are called "qualified longevity annuity contracts," or QLACs. The term refers to annuity contracts issued on or after July 2, 2014, that satisfy a variety of requirements described next. Before the annuity payments commence, the value of these contracts is excluded from the account balance of the participant used to determine required minimum distributions.

In order to be considered a valid QLAC, the contract must provide that distributions begin no later than a specified annuity starting date as provided in the contract. The regulations require that the specified annuity starting date may be no later than the first day of the month following the date on which the participant attains age 85.[37] (Unless otherwise indicated, the Q&As referred to here are issued under Regulation 1.401(a)(9)-6). The contract may permit a participant to elect an earlier annuity starting date than the one specified but is not required to provide an option to do so. The regulations also provide that the maximum age may be adjusted to reflect changes in mortality in the future. This is left to IRS future publications.[38]

The regulations provide that the amount of the premiums paid for the contract under the plan on a given date may not exceed the lesser of $135,000 (in 2021) or 25% of the IRA or qualified plan account balance of the participant on the date of payment.[39] For those with at least $540,000 in an IRA or 401(k), the maximum amount that can be contributed to a QLAC is $135,000. For those with less

---

[37] Regulation 1.401(a)(9)-6; Q&A-17(a)(2).

[38] Q&A-17(d)(2)(ii).

[39] Q&A-17(b).

© 2021 AICPA. All rights reserved.

than $540,000 in an IRA or 401(k), the maximum amount that can be contributed to a QLAC is 25% of their December 31, 2020, balance.

This limitation is applied with respect to the account balance of the participant under a qualified plan as of the last valuation date preceding the date of a premium payment, increased for contributions allocated to the account and decreased for distributions made from the account after the valuation date but before the date on which the premium is paid.[40] While the value of the QLAC is excluded from the account balance of the participant used to determine required minimum distributions, the value is included in the account balance of the participant for purposes of applying the 25% limitation.[41]

Circumstances might arise where the annuity contract failed to be a QLAC because premiums paid for the contract exceeded the premium limits. If that is the case, the contract will not fail to be a QLAC if the excess premium is returned to the non-QLAC portion of the participant's account by the end of the calendar year following the one in which the excess premium was paid. The excess premium may be returned to the non-QLAC portion of the participant's account either in cash or in the form of an annuity contract that is not intended to be a QLAC. Should an excess premium (including the FMV of an annuity contract that is not intended to be a QLAC) be returned to the non-QLAC portion of the participant's account following the last valuation date for the calendar year in which the excess premium was originally paid, the participant's account balance as of that valuation date must be increased to reflect the excess premium. The good news here is that any such return of excess premium will not be treated as a violation of the rule that a QLAC must not provide a commutation benefit.[42]

The regulations also provide that if a contract at any time fails to be a QLAC for any reason other than exceeding the premium limitations, the contract will not be treated as a QLAC, nor as a contract that is intended to be a QLAC, beginning on the date of the first premium payment for that contract.[43] An inflation adjustment to the dollar limitation specified in IRC Section 415(d) provides that any increase that is not a multiple of $10,000 will be rounded to the next lowest multiple of $10,000.[44]

A QLAC may include a return of premium feature guaranteeing that, should the annuitant die before receiving payments at least equal to the total premiums paid under the contract, an additional payment can be made to make up the difference.[45] The QLAC may offer a return of premium feature that is payable before and after the participant's annuity starting date. This enables the QLAC to provide for a single-sum death benefit to be paid to a beneficiary in an amount equal to the excess of the premium payments made with respect to the QLAC over the payments made to the participant under the QLAC. In the event that a QLAC is or will provide a life annuity to a surviving spouse, it may also provide a similar return of premium benefit after the death of both the participant and the spouse.

---

[40] Q&A-17(d)(1)(iii).

[41] Q&A-3(d).

[42] Q&A-17(d)(1)(iii).

[43] Q&A-17(d)(3).

[44] Q&A-17(d)(2)(i).

[45] Q&A-17(c)(4).

© 2021 AICPA. All rights reserved.

Where a return of premium payment is involved, it must be paid no later than the end of the calendar year following the one in which the participant dies or the one in which the surviving spouse dies, whichever is applicable.[46] If the participant or the surviving spouse dies after the required beginning date, the return of premium payment is then treated as a required minimum distribution for the year in which it is paid and is therefore not eligible for rollover treatment.

If the sole beneficiary of a participant under the contract is the surviving spouse of the participant, the only benefit permitted to be paid after the death of the participant other than a return of premium is a life annuity payable to the surviving spouse that does not exceed 100% of the annuity payment payable to the participant.[47] A special exception specifies that a plan may comply with any applicable requirement to provide a qualified preretirement survivor annuity. If the surviving spouse of the participant is one of multiple designated beneficiaries, the special rules for a surviving spouse may be applied as if there were separate contracts for each of the separate beneficiaries, so long as separate account requirement conditions are satisfied.[48] If the participant's surviving spouse is not the sole beneficiary under the contract, the only benefit permitted to be paid after the death of the participant other than a return of premium is a life annuity payable to the designated beneficiary.[49]

A QLAC cannot include a variable annuity contract or an indexed annuity contract. This was presumably decided to maintain consistency with the view that an annuity contract should be eligible for QLAC treatment only if the income under the contract is primarily derived from contractual guarantees. Variable annuities and indexed contracts may provide an unpredictable level of income, making these contracts inconsistent with the new regulations. However, if the contract provides for the payment of dividends or a cost-of-living adjustment, the contract will not be treated as a variable or indexed contract.[50] To qualify as a QLAC, a contract may not include a commutation benefit, cash surrender value, or other similar feature because inclusion of such a feature would reduce the benefit of mortality pooling under the contracts.[51]

When the annuity contract is issued, a participant must be notified that the contract is intended to be a QLAC. This requirement will be satisfied if appropriate language is included either in the contract or in a rider or endorsement with respect to the contract.[52] This requirement may also be satisfied if a certificate is issued under a group annuity contract and the certificate states that the interest of the participant under the group annuity contract is intended to be a QLAC.[53] A transitional rule provides

---

[46] Q&A-17(c)(4)(iii).

[47] Q&A-17(c)(1)(i).

[48] Q&A-17(c)(1)(ii) and Q&A-17(c)(5).

[49] Q&A-17(c)(2).

[50] Q&A-17(d)(4)(ii).

[51] Q&A-17(a)(4).

[52] Q&A-17(a)(6).

[53] Q&A-17(d)(5).

© 2021 AICPA. All rights reserved.

that an annuity contract issued before January 1, 2016, will not fail to be a QLAC merely because the contract does not satisfy this requirement.

The opportunity to create and use a QLAC is also extended to IRAs. The amount of the premiums paid for the contract under an IRA on a given date may not exceed $135,000.[54] The amount of the premiums paid for the contract under an IRA on a given date may not exceed 25% of the individual's IRA account balance. Because required minimum distributions (RMDs) from an IRA may be satisfied with a distribution from another IRA, a QLAC that could be purchased under an IRA within these limitations may be purchased instead under a different IRA. This means that the amount of the premiums paid for the contract under an IRA may not exceed 25% of the sum of the account balances (as of December 31 of the calendar year before the one in which a premium is paid) of all the IRAs (but not Roth IRAs) that an individual owns.

Because Roth IRAs are not subject to the required minimum distribution rules before the death of the IRA owner, the regulations provide that an annuity purchased under a Roth IRA will not be treated as a QLAC.[55] The dollar and percentage limitations on premiums that apply to a QLAC will not take into account premiums paid for a contract that is purchased or held under a Roth IRA, even if the contract satisfies the requirements to be a QLAC. Should a QLAC be purchased or held under a plan, annuity, contract, or traditional IRA that is later rolled over into or converted into a Roth IRA, the QLAC would cease to be a QLAC after the date of the rollover or conversion. Additionally, the premiums paid would then be disregarded in applying the dollar and percentage limitations to premiums paid for other contracts after the date of the rollover or conversion.[56]

The final regulations do not apply to defined benefit plans. These plans are generally required to offer annuities that are designed to provide longevity protection.

When an IRC Section 403(b) plan is involved, the rules relating to qualified plans, not IRAs, are applied. The 25% limitation on premiums is separately determined for each IRC Section 403(b) plan in which a person participates. The regulations provide that if the sole beneficiary of a participant is the surviving spouse of the participant and the participant dies before the annuity starting date under the contract, a life annuity payable to the surviving spouse after the death of the participant may exceed the annuity that would have been payable to the participant to the extent necessary to satisfy the requirement to provide a qualified preretirement survivor annuity. IRAs are not subject to this requirement, but IRC Section 403(b) plans are.[57]

When an IRC Section 457(b) plan is involved, QLACs are limited to eligible government plans. IRC Section 457(b)(6) requires eligible IRC Section 457(b) plans that are not eligible government plans to be unfunded so that the purchase of an annuity contract under that type of plan would be inconsistent with the requirement that such a plan be unfunded.

---

[54] Regulation 1.408-8; Q&A-17(b)(2).

[55] Reg. 1.408A-6; Q&A-14(d).

[56] Regulation 1.408-8; Q&A-12(e).

[57] Regulation 1.403(b)-5(e).

© 2021 AICPA. All rights reserved.

The advantage of a QLAC is the opportunity to create a fixed income hedge against longevity. The disadvantage is the loss of potential long-term growth if the funds had been retained in a more aggressively invested (and presumably successful) investment account.

The regulations provide for annual reporting rules under IRC Section 6047(d). They state that any person issuing a contract intended to be a QLAC must file annual calendar-year reports with the IRS and provide a statement to the participant regarding the status of the contract.[58] The purpose of this reporting is to inform the plan administrators and the participants that the contract is intended to be a QLAC, to make certain that the dollar and percentage limitations applicable to QLACs can be applied, and to make certain that the IRS is in coordination with the QLAC exception to the required minimum distribution rules. The IRS has issued Form 1098-Q and accompanying instructions for this purpose. The issuers of the annuity who will be subject to the annual reporting requirements will have to comply with these requirements for each calendar year, beginning with the year in which premiums are first paid and ending with the earlier of the year in which the participant attains age 85 or dies. In a situation where the participant dies and leaves the participant's spouse as the sole beneficiary, it will be necessary to continue the annual reporting requirement until the year in which the distributions to the spouse begin or, if earlier, the year in which the spouse dies.

Planning Pointer.

For a more in-depth review of planning with annuities, read The Adviser's Guide to Retirement Planning, included with your PFP/PFS member benefits.

[58] Regulation 1.6047-2.

© 2021 AICPA. All rights reserved.

Chapter 9

Employee Benefits

¶901 Overview

¶902 The SECURE Act of 2019 Creates Far-Reaching Changes in the Law

¶905 Primer on Qualified Retirement Plan Rules

¶910 Employee Stock Ownership Plan Opportunities

¶915 Individual Retirement Account IRA Opportunities

¶920 Profit-Sharing Plans

¶925 Cash or Deferred (401[k]) Arrangements

¶930 Pension Plans

¶935 Thrift and Savings Plans

¶940 Borrowing from the Plan

¶945 Group-Term and Group Permanent Life Insurance

¶950 Death Benefits

¶955 General Financial Planning Factors for Qualified Plan and IRA Benefits

¶960 Employee Awards

¶965 Health Plans

¶970 Below-Market Loans to Employees

¶975 Cafeteria Plans

¶980 Employer-Provided Dependent Care Assistance

¶985 IRC Section 132 Fringe Benefits

¶990 The “myRA”

© 2021 AICPA. All rights reserved.

¶901 Overview

Cash is the quintessential employee benefit, but cash alone is not sufficient to attract the best employees in today's competitive economy. Employees have come to expect a wide range of benefits as part of their total compensation package. Employers can provide many such benefits to employees on a tax-free or tax-deferred basis. The tax-favored treatment also works to the advantage of the employer. The employer can often provide benefits at a lower cost than additional cash compensation. The employee benefits by having more after-tax compensation than the employee would have solely from cash compensation.

Tax-free employee benefits generally escape payroll taxes. Another advantage is that the employer can provide such benefits to employees without raising the employee's AGI. This benefit is important because some tax benefits and credits are phased out after AGI reaches certain levels.[1] Some other deductions are permitted only to the extent that they exceed a certain percentage of AGI. Medical expenses are allowed as a deduction only to the extent that they exceed 7.5% for 2021 of AGI.[2]

This chapter covers, in some detail, what is perhaps the biggest employee benefit of all — the qualified retirement plan. Among other things, this chapter examines the various types of plans, distribution rules, factors in borrowing from plans, and financial planning for plan benefits. This chapter also addresses other popular benefits including health plans, cafeteria plans, and dependent care assistance.

Many of the benefits addressed in this chapter are equally suitable for both highly compensated employees and non-highly compensated employees. However, benefits of a character primarily for highly compensated employees, such as deferred compensation and stock options, are not considered in this chapter. They are discussed in ¶1605.

¶902 The SECURE Act of 2019 Creates Far-Reaching Changes in the Law

The SECURE Act was signed into law December 20, 2019. It creates a wide range of employee benefit and retirement plan changes. In some respects, it alters rules that have been in place for over 20 years. Some of the changes will enhance a person's ability to save for and protect one's retirement. Other provisions in the law will change long-standing rules that may force taxpayers to revisit and revise their estate planning choices that they may have believed were already well-settled.

The following discussion highlights the most important provisions of the SECURE Act.

.01 Required Minimum Distributions

The SECURE Act changes the start date for RMDs from age 70½ to age 72. The age change applies to distributions required to be made after December 31, 2019, with respect to individuals who attain age 70½ after such date.

---

[1] IRC Sections 68 and 151(d)(3).

[2] IRC Section 213(a).

© 2021 AICPA. All rights reserved.

For those who turned 70½ in 2019, their first RMD would have been required to be taken by April. 1, 2020. However, the provisions of the CARES Act of 2020 suspended all 2020 RMDs until 2021. Anyone who turned 70½ in 2020 will not have to take their RMD until they turn 72.

.02 IRA Contributions After Age 70½

Beginning in 2020, the age limit for contributions to an IRA has been eliminated. In prior years, contributions to an IRA were not allowed beginning for the year the taxpayer turned 70½. The IRA contribution must still be based on compensation or self-employment income received by the taxpayer.

.03 The Qualified Charitable Distribution (QCD) Rule

Moving the age for RMDs to age 72 does not change the qualified charitable distribution (QCD) rule. Thus, a taxpayer who is 70½ or older may make a QCD and reduce his or her RMD. However, because IRA contributions are now deductible for those who qualify for the QCD provision, the SECURE Act reduces the allowable QCD by the IRA deductions allowed for a taxpayer over 70½. Charitable contributions of amounts that were IRA deductible contributions made beyond age 70½ will be treated as "regular" taxable IRA withdrawals and "regular" charitable contributions deductible on Schedule A as itemized deductions. If a person wishes to utilize the QCD opportunity, the transfer from the IRA to the charity should take place *before* any other RMD is withdrawn; that will allow the RMD obligation to be satisfied by the QCD without having a direct withdrawal be treated as (or part of) the RMD.

.04 Reduction of "Stretch-Out" of RMD Rules for Many Taxpayers

The "stretch-out" distribution period for the inherited IRAs for many taxpayers is reduced to a 10-year maximum, from a lifetime distribution. Within the 10-year period, there are no required distributions. But the entire inherited retirement account must be distributed by the end of the 10-year period following the participant's year of death. Note that the IRS issued Publication 590-B in April 2021, which contains examples (on page 12) that appear to suggest level payments over 10 years may be required. This is contrary to what was understood after passage of the SECURE Act, so clarification and guidance from the IRS may be necessary. The examples in the publication may be just illustrative of alternative circumstances, but their issuance has caused concern.

For persons who died prior to 2020 and named a designated beneficiary of their plans, the designated beneficiary can continue to use his or her life expectancy (following the pre-SECURE Act law), **but** when the designated beneficiary dies, the 10-year payout rule becomes effective. Prior to the SECURE Act, the "remaining life expectancy" of the deceased designated beneficiary was used for distributions to the successor beneficiary. Now, the 10-year rule will apply.

The SECURE Act creates a special group of beneficiaries to which the 10-year distribution limit does not apply. This group is called Eligible Designated Beneficiaries. Persons in this group may use their life expectancy to claim RMDs. These include:

- A surviving spouse. The spousal beneficiary may still rollover the deceased spouse's IRA or retirement account into his or her own IRA.
- A minor child of the plan participant. The minor child must take RMDs based on his or her life expectancy until the child reaches majority (and then the 10-year rule applies). Note that the minor designation only refers to minor children of the participant. Grandchildren of the participant and other minor beneficiaries may not use the life expectancy rule.

© 2021 AICPA. All rights reserved.

- A disabled individual[3] or a trust for such person.
- A chronically ill individual[4] or a trust for such person.
- An individual who is not more than 10 years younger than the deceased participant or IRA owner.

These changes apply to distributions to a non-spouse beneficiary from retirement plans and IRAs if the plan participant or IRA owner's death occurs after December 31, 2019. These changes suggest that all advisers review their clients' plans to determine if the required 10-year payout is acceptable, or whether an alternative plan of distribution timing should be considered.

.**05 Additional Amounts Treated as Compensation for IRAs**.

Certain taxable non-tuition fellowship and stipend payments to graduate and post-doctoral students will now be treated as compensation for IRA purposes. This change is effective for taxable years beginning after December 31, 2019. Also, excluded difficulty of care payments[5] are treated as compensation for determining non-deductible IRA contributions. This change is effective for contributions made after December 20, 2019.

.**06 Plan withdrawals for birth and adoption expenses.**

Plan withdrawals for the birth or adoption of a child of up to $5,000 per individual are penalty-free withdrawals from an IRA and a qualified pension plan. To meet the requirements of the qualified birth or adoption distribution, the individual must take a distribution during the one-year period beginning on either the date of birth of the child, or the date of the final adoption of the child (under age 18). An individual taking a distribution for the birth or adoption of a child may make an additional contribution back to the plan from which the distribution was made or to an IRA. The IRS will need to provide timing rules for the repayment. Spouses may each take a $5,000 distribution if each has a retirement account.

To be eligible for this benefit, the taxpayer must include the name, age, and TIN of such child or eligible adoptee on the taxpayer's tax return for the taxable year. This change is effective for distributions made after December 31, 2019.

.**07 401(k) Rule Changes for Part-time Employees**

401(k) plans are now required to offer participation to long-term, part-time employees. Employers with 401(k) plans must offer employees who work between 500 and 1,000-hours a year an additional means to participate in the plan. The rule change only affects 401(k) cash or deferral arrangements, and no other qualified plans. A part-time employee is eligible to participate in the employer's 401(k) plan if the employee has at least 500 hours of service in three consecutive 12-month periods.

The change applies to plan years beginning after December 31, 2020, except that the 12-month periods beginning before January 1, 2021 are not taken into account. Thus, the earliest that a part-time employee will be able to participate in the 401(k) plan is 2024.

---

[3] IRC Section 72(m)(7).
[4] IRC Section 7702B(c)(2).
[5] IRC Section 131(c).

© 2021 AICPA. All rights reserved.

.08 Automatic Enrollment Credit and Percentage Enhanced

A new tax credit of $500 for a three-year credit period is allowed for small employers adding an auto-enrollment provision to their plans. The new credit applies for taxable years beginning after December 31, 2019. Beginning in 2020, the SECURE Act allows the plan to set the automatic enrollment percentage to as high as 15% (previously 10%).

.09 Credit to Encourage Small Employers to Offer Retirement Plans

The credit for a small employer starting a retirement plan, such as a 401(k), 403(b), SEP IRA or SIMPLE IRA, has been increased for taxable years beginning after December 31, 2019. For the first credit year and each of the two taxable years immediately following the first credit year, the credit is the greater of—

(A) $500, or
(B) the lesser of

> (i) $250 for each employee of the eligible employer who is not a highly compensated employee and who is eligible to participate in the eligible employer plan maintained by the eligible employer, or
>
> (ii) $5,000.

.10 Encouragement of Multiemployer Plans

Small employers of two or more employees may come together to participate in a new class of pooled multiple employer plans (MEPs). An MEP essentially allows small employers to join together to offer retirement plans with (presumably) lower administrative costs. A critical factor that made employers skeptical of the MEP was the IRS's "bad apple" rule. The IRS said that if one employer in the plan defaulted, the whole plan was disqualified. The SECURE Act now provides that if a single employer defaults, the remaining plan maintains its qualified status. The MEP must be administered by a "pooled plan provider." Generally, changes apply to plan years beginning after December 31, 2020.

.11 Timing Change to Establish a Retirement Plan

Beginning in 2020, employers may adopt retirement plans that are entirely employer funded up to the due date of the tax return, including extensions. Current law requires the employer to establish their plan by December 31 (or the last day of their fiscal year).

Planning Pointer.

Proactive Planning Toolkit

Legislation like the TCJA, SECURE Act, CARES Act, the CAA, and the American Rescue Plan Act have added more complexity to financial planning. Technical content, tools, and other resources are available to PFP Section members in the Proactive Planning Toolkit to help you get up to speed on all of the intricacies so that you can educate your clients and proactively help them meet their life goals and give them peace of mind while navigating the complex financial landscape.

© 2021 AICPA. All rights reserved.

¶905 Primer on Qualified Retirement Plan Rules

An understanding of the basic qualified retirement plan rules is essential for every financial and estate planner. First, the planner should note that the law does not require that an employer furnish employees with any retirement benefits. However, if the employer offers a qualified retirement plan, the employer and the employees will receive significant income tax benefits. The employer receives a current income tax deduction for contributions to the plan.[6] The plan's earnings accumulate free of current income tax. Employees are generally taxed on their stake in the plan only when their share is distributed to them.

Although the law in this area consists of both tax and labor law provisions, the focus of this chapter is on the tax provisions though the two sometimes overlap. The labor provisions cover notice requirements, plan administration, nondiscrimination, fiduciary responsibility, and other matters.

.01 Fundamental Aspects of Qualified Plans

Defined contribution versus defined benefit plans. Although a detailed discussion of different types of retirement and benefit plans appears in ¶910 and the paragraphs that follow, an introduction to the two basic types of qualified plans will be helpful in understanding fundamental concepts. Defined contribution and defined benefit plans are the two basic types of qualified plans. All other qualified plans essentially are hybrids of these forms.

A defined contribution or individual account plan involves a fixed employer contribution.[7] The employer's contributions, together with earnings thereon, yield a retirement benefit to the employees. In this type of plan, the contribution is fixed or defined. However, the actual retirement benefit is indeterminable at the outset because the earnings on the contributions ultimately determine the retirement benefit amount. A defined contribution plan formula would be expressed, for example, as 10% of employee compensation. The employer would contribute that amount annually to the plan, and the plan would credit the contribution to a separate account maintained for a plan participant. Upon retirement, the participant is entitled to receive the amount in the account. A participant who separates from service with the employer before retirement would be entitled to receive the vested interest, if any, in the account.

The other basic plan variety is a defined benefit plan. A defined benefit plan is one in which the amount of the benefit, and not the amount of contribution, is determinable at the outset.[8] Benefit formulas under defined benefit plans are generally stated either as a percentage of final or average pay, or as a percentage of pay for each year of service. For example, an employee might retire with a benefit equal to 50% of final pay or average pay. Alternatively, an employee might receive 2% of pay for each year of participation up to a maximum of 20 years, yielding a maximum retirement benefit of 40% of pay. The contribution required to produce the benefit is determined actuarially and will vary depending on several factors. These factors include the amount of the benefit, the employee's age and projected length of

---

[6] IRC Section 404.

[7] IRC Section 414(i).

[8] IRC Section 414(j).

© 2021 AICPA. All rights reserved.

service with the employer, and the plan's history of gains and losses (that is, the investment success of employer contributions).

Ceilings on benefits and contributions. IRC Section 415 limits benefits and contributions under qualified plans. If an employer maintains more than one defined benefit plan, all the defined benefit plans will be treated as one defined benefit plan for purposes of determining the limitation on benefits.[9] If an employer maintains more than one defined contribution plan, all the defined contribution plans will be treated as one defined contribution plan for purposes of determining the limitation on contributions and other additions.[10] IRC Section 415 limits governing benefits and contributions are different from the limit on the amount that an employer may deduct. IRC Section 404 prescribes limits on the deductibility of employer contributions. Although the two limits are interrelated, different rules apply to both determinations.

The IRC Section 415 limit for defined contribution plans is expressed in terms of the maximum annual addition. The limit for 2021 is the lesser of 100% of compensation or $58,000[11] The dollar limit is indexed to inflation in $1,000 increments.[12] Annual additions include employer contributions, employee contributions, and reallocated forfeitures.[13]

For 2021, the maximum annual benefit payable under a defined benefit plan is limited to the lesser of $230,000 or 100% of the participant's average compensation for the three highest consecutive years worked.[14] The dollar limit is indexed to inflation in $5,000 increments.[15] Adjustments to the dollar limit apply for early and late retirement.[16] Also, the dollar limit is based on 10 years of plan participation.[17]

Nondiscrimination rules. A plan may not discriminate in favor of highly compensated employees as to benefits or contributions.[18] Generally, all benefits, rights, and features of a qualified plan must be made available in a nondiscriminatory way. However, a plan is not discriminatory merely because benefits or

---

[9] IRC Section 415(f)(1)(A).

[10] IRC Section 415(f)(1)(B).

[11] IRC Section 415(c)(1).

[12] IRC Section 415(d).

[13] IRC Section 415(c)(2).

[14] IRC Section 415(b)(1).

[15] IRC Section 415(d).

[16] IRC Sections 415(b)(2)(C) and 415(b)(2)(D).

[17] IRC Section 415(b)(5).

[18] IRC Section 401(a)(4).

© 2021 AICPA. All rights reserved.

contributions bear a direct relationship to compensation.[19] Certain disparities are permitted,[20] as discussed in the "Plan Integration" section that follows.

The nondiscrimination rules are extremely technical, and plans are always required to be in compliance with them. However, the IRS allows plans to be tested on one representative day of a plan year using simplified methods that do not always require total precision.[21] If the plan does not change significantly, testing only needs to occur once every three years.[22] In addition, certain plans can avoid regular nondiscrimination testing if they satisfy certain design-based safe harbors.

Coverage. The coverage rules require that the plan meet one of the following criteria:[23]

- At least 70% of the non-highly compensated employees are covered by the plan.
- The percentage of non-highly compensated employees covered by the plan is at least 70% of the percentage of highly compensated employees covered by the plan.
- The plan benefits such employees who qualify under a classification set by the employer and found by the IRS to not discriminate in favor of highly compensated employees. The average benefit under the plan for non-highly compensated employees is at least 70% of the benefit available for highly compensated participants.

IRC Section 401(a)(26) requires qualified plans to benefit at least 50 employees or 40% of all employees of the employer, whichever is less. This rule applies separately to each qualified plan of the employer and the employer may not aggregate plans to satisfy this requirement. In certain cases, a single plan may be treated as comprising separate plans.

Participation and eligibility. Generally, an employee may not be excluded from plan coverage if the employee is at least 21 years old and has completed a year of service.[24] However, a plan may require, as a condition of participation, that an employee complete up to two years of service with the employer if the plan also gives each participant a nonforfeitable right to 100% of the accrued benefit under the plan when the benefit is accrued.[25] Generally, an employer may exclude part-time workers, defined as those who have worked less than 1,000 hours during a year of service.[26]

---

[19] IRC Section 401(a)(5)(B).

[20] IRC Section 401(a)(5)(C).

[21] Revenue Procedure 93-42, 1993-2 Cumulative Bulletin (CB) 540.

[22] Ann. 93-130, Internal Revenue Bulletin (IRB) 1993-31 (September 28, 1993).

[23] IRC Section 410(b).

[24] IRC Section 410(a)(1)(A).

[25] IRC Section 410(a)(1)(B).

[26] IRC Section 410(a)(3)(A).

© 2021 AICPA. All rights reserved.

Benefit accrual. Benefit accrual is a general concept that refers to the amount a participant earns under a qualified plan. In a defined contribution plan, a participant's accrued benefit is the amount set aside in a bookkeeping account. In a defined benefit plan, the accrued benefit is the present value of the retirement benefit being funded.

Revised rules for developing alternative mortality tables. Private sector defined benefit pension plans generally must use mortality tables prescribed by the U.S. Treasury for purposes of calculating pension liabilities. Plans may apply to Treasury to use a separate mortality table.

For plan years beginning after December 31, 2015, the Bipartisan Budget Act of 2015 provides that the determination of whether the plan has credible information to use a separate mortality table is made in accordance with established actuarial credibility theory. In addition, the plan may use tables that are adjusted from Treasury tables if such adjustments are based on a plan's experience, and projected trends in such experience.[27]

Vesting. All qualified plans must confirm that participants have a nonforfeitable right to fixed percentages of their accrued benefits after a prescribed period. Employees must always be 100% vested in their own contributions.[28] Since 2006, all employer contributions to defined contribution plans must vest as rapidly as (1) 100% vesting after three years of service, or (2) 20% after two years and 20% each year thereafter to achieve 100% vesting after six years of service.[29] All years of service with an employer, after the employee has attained age 18, are taken into account.[30] Special rules apply to a plan maintained pursuant to a collective bargaining agreement.

Employers may always provide more rapid vesting than the minimum vesting requirements.

Two special rules apply in the vesting area. First, top heavy plans are subject to different vesting requirements, as discussed in subsequent paragraphs.[31] Second, 100% vesting is triggered upon both normal retirement age[32] and plan termination, irrespective of the plan's regular vesting schedule.[33]

Funding. In a defined benefit plan, technical rules govern the manner in which benefits must be accrued and funded to ensure that requisite funds will be available when the promised benefit becomes payable.[34] These technical rules apply to a lesser extent to defined contribution (also known as money

---

[27] Bipartisan Budget Act of 2015, Section 503.

[28] IRC Section 411(a)(1).

[29] IRC Section 411(a)(2)(B) as amended by PL. 109-280.

[30] IRC Section 411(a)(4).

[31] IRC Section 416(b).

[32] IRC Section 411(a).

[33] IRC Section 411(d)(3).

[34] IRC Section 412.

© 2021 AICPA. All rights reserved.

purchase) pension plans. Failure to satisfy the prescribed funding rules subjects the employer to a non-deductible excise tax.[35] The employer must make the required plan contributions quarterly to satisfy the minimum funding rules.[36]

Fiduciary responsibility. Both labor and tax law provisions contain a number of rules concerning fiduciary responsibility. The term *fiduciary* is broadly defined to include most persons who have an administrative or investment role in connection with a plan. Fiduciaries are subject to a knowledgeable, prudent man standard, a duty to diversify investments, and detailed rules forbidding transactions between a plan and parties in interest, referred to as *prohibited transactions*. Actions must be taken in accordance with the best interests of the clients. IRC Section 4975 imposes excise taxes on disqualified persons engaging in prohibited transactions. In addition, elaborate reporting and disclosure rules govern fiduciaries both in their dealings with plan assets, governmental agencies, and plan participants.

Plan integration. Qualified plans are permitted to take into account certain benefits derived from employer contributions to Social Security when determining whether benefit or contribution levels discriminate in favor of the prohibited group.[37] The rationale for this rule is that a greater percentage of a non-highly compensated employee's retirement benefit will be covered by Social Security.

Automatic survivor benefits. Defined benefit plans and certain defined contribution plans must provide for automatic survivor benefits for married participants. A qualified joint and survivor annuity (QJSA) must be provided for a participant who retires. In addition, a qualified preretirement survivor annuity (QPSA) must be provided to the surviving spouse when a vested participant dies before the annuity start date.[38]

The participant may waive the joint and survivor annuity or the preretirement annuity for a spouse, but only if certain notice, election, and written spousal consent requirements are satisfied.[39] Consent contained in a prenuptial agreement does not satisfy the consent requirement. The waiver of either type of annuity by a nonparticipant spouse is not a taxable transfer for gift tax purposes.[40] Plans subject to the survivor annuity rules must offer a qualified survivor optional annuity (QSOA) to participants who waive the QJSA or QPSA.[41]

---

[35] IRC Section 4971.

[36] IRC Section 412(m)(3).

[37] IRC Sections 401(a)(5)(C), 401(a)(5)(D), and 401(l).

[38] IRC Section 401(a)(11)(A)(ii).

[39] IRC Section 417.

[40] IRC Section 2503(f).

[41] IRC Section 417(a)(1)(A).

© 2021 AICPA. All rights reserved.

A plan generally is not required to treat a participant as married unless the participant and the participant's spouse have been married throughout the one-year period ending on the earlier of the participant's annuity starting date or the date of the participant's death.[42]

Planning Pointer.

The preretirement annuity for the surviving spouse of a participant who dies at a young age or with a very small amount of vested accrued benefits is likely to be small. If the plan provides a lump-sum preretirement benefit, the combined value of the lump sum and the annuity may not exceed the amount of death benefits permitted under the incidental death benefit rule.[43]

The preretirement annuity is no substitute for life insurance. A tax-free, group-term life insurance benefit[44] might be worth much more to the surviving spouse (and the family) than a small preretirement annuity that might not commence until the survivor reaches early retirement age (55) or later.

Top heavy plans. More stringent rules apply for top heavy plans, basically defined as plans in which *key employees* have more than 60% of the benefits.[45] The important additional requirements are that such plans must provide more rapid vesting[46] and minimum benefits for non-key employees.[47]

Since 2006, fewer plans will be deemed to be top heavy. Adjustments to the minimum benefit or contribution rules reduce the cost to employers. A safe harbor applies to 401(k) plans that meet certain requirements for the actual deferral percentage nondiscrimination test[48] and that meet the requirements for matching contributions.[49] Such 401(k) plans are specifically excluded from the definition of a top heavy plan.[50] A special rule for 401(k) plans not deemed to be top heavy but that belong to an aggregation group that is a top heavy plan allows the 401(k) plan's contributions to be taken into account in determining whether any other plan in the group meets the IRC Section 416(c)(2) minimum distribution requirements.[51]

---

[42] IRC Section 417(d).

[43] Revenue Ruling 85-15, 1985-1 CB 132.

[44] IRC Section 79.

[45] IRC Section 416(g)(1)(A).

[46] IRC Sections 416(a) and 416(b).

[47] IRC Sections 416(a) and 416(c).

[48] IRC Section 401(k)(12).

[49] IRC Section 401(m)(11).

[50] IRC Section 416(g)(4)(H)

[51] IRC Section 416(g)(4)(H).

© 2021 AICPA. All rights reserved.

The rule for computing the present value of a participant's accrued benefit or a participant's account balance applies for purposes of determining whether the plan is top heavy. Under this provision, the accrued benefit or account balance is increased for distributions made to the participant during the one-year period ending on the determination date.[52] However, a five-year lookback rule applies for distributions made for a reason other than separation from service, death, or disability. For such distributions, the accrued benefit is increased for distributions made during the five-year period ending on the determination date.[53]

A *key employee* is an employee who at any time during the year was one of the following:[54]

- An officer with annual compensation exceeding $185,000 (for 2021 and indexed for inflation in $5,000 increments)
- A 5% owner of the employer
- A 1% owner with annual compensation exceeding $150,000 (for 2021)

No more than 50 employees may be treated as officers. If the employer has fewer than 50 employees, the number of officers may not exceed the greater of three employees or 10% of the employees. Note that the family attribution rules of IRC Section 318 apply in determining if a person is a 5% owner.

Employer-matching contributions are considered when determining whether the employer has satisfied the minimum benefit requirement for a defined contribution plan. Any reduction in benefits that occurs because the employer may take matching contributions into account will not cause a violation of the contingent benefit rule of IRC Section 401(k)(4)(A). This provision overrides a provision in Regulation Section 1.416-1, Q&A M-19, which states that if an employer uses matching contributions to satisfy the minimum benefit requirement, the employer may not use such matching contributions for purposes of the IRC Section 401(m) nondiscrimination rules. Thus, employers can take matching contributions into account for purposes of both the nondiscrimination rules and the top heavy rules.

Another provision applies for determining whether a defined benefit plan meets the minimum benefit requirement. Under this provision, any year in which the plan is frozen is not considered a year of service for purposes of determining an employee's years of service. A plan is frozen for a year when no key employee or former key employee benefits under the plan.[55]

---

[52] IRC Section 416(g)(4).

[53] IRC Section 416(g)(3)(B).

[54] IRC Section 416(i)(1) and IR 2014-99 (October 25, 2014).

[55] IRC Section 416(c)(1)(C)(iii).

© 2021 AICPA. All rights reserved.

Definition of highly compensated. A highly compensated employee for 2021 is one who, during 2020, was in the top 20% of employees by compensation for that year and who

- was a 5% or more owner of the employer, or
- received more than $130,000 in annual compensation (indexed in $5,000 increments) from the employer.[56]

The threshold for being a highly compensated employee is indexed to inflation.[57]

Compensation cap. A $290,000 (for 2021) cap applies to the amount of compensation that may be taken into account for purposes of determining contributions or benefits under qualified plans and simplified employee pension (SEP) plans.[58] This limit is indexed to inflation in $5,000 increments.[59]

Credit for plan startup costs of small employers. Employers with no more than 100 employees who received at least $5,000 of compensation from the employer for the previous year may claim a tax credit for some of the costs of establishing new retirement plans.[60] The credit is 50% of the startup costs the small employer incurs to create or maintain a new employee retirement plan.[61] Prior to the SECURE Act, the maximum amount of the credit was $500 in any one year, and an eligible employer may claim the credit for qualified costs incurred in each of the three years beginning with the tax year in which the plan becomes effective.[62] This has been enhanced as described below. The employer may elect to claim the credit in the year immediately before the first year in which the plan is effective.[63] In addition, an eligible employer may elect not to claim the credit for a tax year.[64] A new employee retirement plan includes a defined benefit plan, a defined contribution plan, a 401(k) plan, a savings incentive match plan for employees (SIMPLE), or a SEP plan.[65] The plan must cover at least one employee who is not a highly compensated employee.[66] Qualified startup costs include any ordinary and necessary expenses incurred to establish or administer an eligible plan or to educate employees about retirement planning.[67]

---

[56] IRC Section 414(q) and IRS Notice 2018-83, 2018-47 IRB 774 (November 19, 2018).

[57] IRC Sections 414(q)(1) and 415(d).

[58] IRC Sections 401(a)(17)(A) and 404(l).

[59] IRC Sections 401(a)(17)(B) and 404(l)

[60] IRC Sections 45E(c)(1) and 408(p)(2)(C)(i).

[61] IRC Section 45E(a).

[62] IRC Section 45E(b).

[63] IRC Section 45E(d)(3).

[64] IRC Section 45E(e)(3).

[65] IRC Section 45E(d)(2).

[66] IRC Section 45E(d)(1)(B).

[67] IRC Section 45E(d)(1)(A).

© 2021 AICPA. All rights reserved.

The credit allowed reduces the otherwise deductible expenses to prevent a double tax benefit.[68] The credit is allowed as a part of the general business credit.[69]

The SECURE Act permits an eligible small business to claim a tax credit for adopting a new 401(k) plan and/or a new automatic enrollment feature.

- *Qualified startup costs*. Before the SECURE Act, a small business could claim a tax credit equal to 50% of its "qualified startup costs," up to a $500 limit. Now the limit is the greater of
  - — $500, or
  - — the lesser of
    - $250 multiplied by the number of non-highly compensated employees eligible for plan participation, or
    - $5,000.

This credit is available for up to three years.

- *Automatic enrollment.* Small businesses can earn an additional $500 tax credit by adding an automatic enrollment feature to a new or existing 401(k) plan. The credit is available for each of the first three years the feature is effective.

When combined, these credits can total up to $5,500 per year ($16,500 for three years).

Credit for elective deferrals and IRA contributions. An eligible individual may claim a nonrefundable tax credit for elective deferrals and IRA contributions.

An eligible individual means an individual who is at least 18 years old at the end of the tax year, is not a student as defined in IRC Section 152(f)(2), and who cannot be claimed as a dependent on another taxpayer's return.[70]

The credit is in addition to any allowable deduction or exclusion from gross income. Its purpose is to encourage taxpayers with low or moderate incomes to establish and maintain retirement savings plans. The credit will not reduce a taxpayer's basis in an annuity, endowment, or life insurance contract. The credit is equal to the applicable percentage (described as follows) multiplied by the amount of qualified retirement plan savings contributions for the year up to $2,000.[71]

---

[68] IRC Section 45E(e)(2).

[69] IRC Section 38(b)(14).

[70] IRC Section 25B(c).

[71] IRC Section 25B(a).

© 2021 AICPA. All rights reserved.

A taxpayer must reduce the contribution amount by any distributions received from a qualified retirement plan, an eligible deferred compensation plan, and a Roth IRA (other than qualified rollover contributions) during the testing period.[72] Distributions received by a taxpayer's spouse are treated as received by the taxpayer for purposes of computing the credit if the couple files a joint return.[73] However, certain distributions such as loans from annuities, distributions of excess contributions, and rollover distributions from traditional IRAs are not considered distributions for purposes of computing the credit.[74] The testing period includes (1) the current tax year, (2) the two preceding tax years, and (3) the period after such tax year and before the due date for filing the income tax return for the year, including extensions.[75]

The maximum credit is 50% of the elective deferral or IRA contribution up to $2,000. However, the credit percentage is reduced or eliminated for taxpayers with modified AGI (computed without regard to the exclusions for foreign earned income, foreign housing, and income from possessions of the United States or Puerto Rico) greater than certain limits.[76]

In 2021, the credit rate is completely phased out when AGI exceeds $66,000 for joint return filers; $49,500 for head of household filers; and $33,000 for single and married filing separately filers. The applicable percentage is the percentage determined in accordance with the following table.[77]

AGI Limitation						
Joint Return Over		Head of Household		All Other Cases		Applicable Percentage
$ 0	$39,500	$ 0	$29,625	$ 0	$19,750	50%
39,500	43,000	29,625	32,250	19,750	21,500	20%
43,000	66,000	32,250	49,500	21,500	33,000	10%
66,000		49,500		33,000		0%

.02 Distributions From Qualified Plans

Generally, distributions must commence no later than April 1 of the year following the year in which the employee attains age 72. An employee who is still working past age 72 may choose to delay receipt of a qualified plan distribution until April 1 of the calendar year following the calendar year of retirement.[78]

---

[72] IRC Section 25B(d)(2).

[73] IRC Section 25B(d)(2)(D).

[74] IRC Section 25B(d)(3)(C).

[75] IRC Section 25B(d)(2)(B).

[76] IRC Section 25B(b).

[77] Notice 2020-79 (January 1, 2021).

[78] IRC Section 401(a)(9)(C)(i).

© 2021 AICPA. All rights reserved.

This alternative is not available to plan participants who are at least 5% owners of the company, nor does it apply to required distributions from IRAs.[79]

Planning Opportunity: A person who has an IRA and is an employee (not a 5% or more owner) covered by an employee plan can transfer the IRA to the employee plan (if the plan accepts such transfers) and delay the required minimum distributions. Similarly, a person who is a 5% or more owner of one company (Company 1) and an employee of another company owning less than 5% of that company (Company 2) can transfer the plan interest from Company 1 to Company 2 and delay the required minimum distributions. If RMDs are already required in the year this is done, those distributions must be taken in the year of transfer before the transfer is completed.[80]

The required distribution requirements generally applicable to retirement plans were suspended for 2009 with respect to defined contribution arrangements.[81] The required minimum distribution rules returned in 2010 were suspended for 2020 by the CARES Act and remain in effect going forward.

IRC Section 457 plans need only satisfy the minimum distribution rules applicable to qualified plans.[82] Amounts deferred under an IRC Section 457 plan sponsored by a state or local government are includible in the employee's gross income only when paid, rather than when otherwise made available to the employee.[83] This rule applies only to governmental IRC Section 457 plans and not to plans sponsored by tax exempt organizations.

If an employee chooses to delay receipt of distributions until commencement of a post-age 72 retirement, the employee's accrued pension benefit must be actuarially adjusted to reflect the value of the benefits that the employee would have received if the employee had chosen to retire at age 72 and then began receiving benefits.[84] This actuarial adjustment rule does not apply to defined contribution plans, governmental plans, or church plans.[85]

Distributions are to be made, in accordance with regulations, over a period that does not extend beyond the life expectancy of the employee and the employee's designated beneficiary.[86]

The SECURE Act has made a number of changes in the RMD area, including limiting the life expectancy rule for many beneficiaries to a 10-year payout. In addition, the CARES Act of 2020 has

---

[79] IRC Section 401(a)(9)(C)(ii).

[80] PLR 200453015

[81] IRC Section 401(a)(9)(H), as added by the Worker, Retiree, and Employer Recovery Act of 2008 (Public Law No. 110-458).

[82] IRC Section 457(d)(2).

[83] IRC Section 457(a)(1)(A).

[84] IRC Section 401(a)(9)(C)(iii).

[85] IRC Section 401(a)(9)(C)(iv) and Conference Report to the Small Business Job Protection Act of 1996 (Public Law No. 104-188).

[86] IRC Section 401(a)(9)(A).

© 2021 AICPA. All rights reserved.

provided relief to taxpayers who are required to take minimum distributions as well as opportunities to take certain plan withdrawals without being subjected to the 10% excise tax and to repay those withdrawals to the plan over three years and deduct the repayments when made. These provisions are covered in other areas of this guide.

Planning Pointer.

IRS is offering relief to some taxpayers who are required to take minimum distributions from their tax-deferred retirement accounts (401(k), 403(b), 457, and individual retirement accounts). Here's what you need to know:

- If you are normally required to take mandatory distributions, you did not have to in 2020. This also applied if you are the beneficiary of an inherited tax-deferred or Roth account. If other sources of income or savings are sufficient to meet some or all of your cash flow needs for 2020 and you did not need to take your RMD, it made sense to skip it for 2020 and lower your overall tax liability.

- Roth conversions were advantageous in 2020 if you were temporarily in a lower tax bracket. This strategy allows you to pay the taxes now at the lower rate and convert to a Roth, where funds grow tax-free and minimum distributions are not required.

Minimum distributions must comply with requirements of IRC Section 401(a)(9) and the lengthy regulations issued thereunder.[87]

Although delaying distributions may be the preferred route for many, some employees may want to begin receiving distributions while still working. Pension benefits may commence at age 62 even though an employee continues to work. A pension plan will not fail to be a qualified retirement plan solely because the plan stipulates that a distribution may be made to an employee who has attained age 62 and who is not separated from employment at the time of the distribution.[88]

Under final IRS regulations, a pension plan may begin the payment of retirement benefits after the participant has reached the plan's normal retirement age, even if the participant has not separated from service. In general, a plan's normal retirement age must not be earlier than the earliest age that is reasonably representative of the typical age for the employer's industry. As a safe harbor, a normal retirement age of at least age 62 will meet the requirement. If a plan's normal retirement age is between ages 55 and 62, then the determination of whether the normal retirement age meets the general rule is based on all of the relevant facts and circumstances. A normal retirement age that is lower than age 55 is presumed to be earlier than the earliest allowable age, unless the IRS determines otherwise.[89]

---

[87] Regulation Sections 1.401(a)(9)-0 through 1.401(a)(9)-9.whit

[88] IRC Section 401(a)(36).

[89] Regulation Section 1.401(a)-1(b)(2).

© 2021 AICPA. All rights reserved.

Calculating the required minimum distribution. The Commissioner may waive the 50% excise tax imposed under IRC Section 4974 for a tax year if the payee assures the Commissioner that the failure to distribute the required minimum distribution was due to reasonable error and that reasonable steps are being taken to correct the error.[90] Under the regulations, plan participant taxpayers must calculate the required minimum distribution using the Uniform Lifetime table in all situations, regardless of the beneficiary, unless the participant's spouse is the only beneficiary and is more than 10 years younger than the participant. In cases when the spouse of the participant is the sole plan beneficiary named by the participant and is more than 10 years younger than the participant, the RMDs are calculated by using the Joint and Last Survivor table.[91] This table is used to give the younger spouse, who will presumably be the survivor, an opportunity to collect some of the older spouse's retirement plan benefits. Starting in 2022, the various tables used to calculate RMDs from retirement plans will be updated. To reflect longer life expectancies, these tables will be expanded to allow RMDs to be drawn out over a greater length of time. The benefit here is twofold: First, more drawn out RMDs means retirees can rest assured knowing that even if they live significantly longer than the average life expectancy, smaller withdrawals allow more money to sit in those accounts and potentially grow. Secondly, it means the amount of money required to take from each distribution shrinks, potentially lessening the tax burden.

The following are reproductions of the Uniform Lifetime table:

Uniform Lifetime Table Effective January 1, 2022	
Age	**Distribution Period (Years)**
72	**27.4**
73	**26.5**
74	**25.5**
75	**24.6**
76	**23.7**
77	**22.9**
78	**22**
79	**21.1**
80	**20.2**
81	**19.4**
82	**18.5**
83	**17.7**
84	**16.8**
85	**16**

[90] Regulation Section 54.4974-2, Q&A 7.

[91] Regulation Section 1.409(a)(9)-9, Q&A 2.

© 2021 AICPA. All rights reserved.

Uniform Lifetime Table Effective January 1, 2022	
Age	**Distribution Period (Years)**
86	**15.2**
87	**14.4**
88	**13.7**
89	**12.9**
90	**12.2**
91	**11.5**
92	**10.8**
93	**10.1**
94	**9.5**
95	**8.9**
96	**8.4**
97	**7.8**
98	**7.3**
99	**6.8**
100	**6.4**
101	**6**
102	**5.6**
103	**5.2**
104	**4.9**
105	**4.6**
106	**4.3**
107	**4.1**
108	**3.9**
109	**3.7**
110	**3.5**
111	**3.4**
112	**3.3**
113	**3.1**
114	**3**
115	**2.9**
116	**2.8**
117	**2.7**
118	**2.5**
119	**2.3**
120	**2**

© 2021 AICPA. All rights reserved.

Uniform Lifetime Table Effective through December 31, 2021			
Age	**Distribution Period**	**Age**	**Distribution Period**
70	27.4	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115 and older	1.9

To calculate the required minimum distribution, the taxpayer finds the distribution period in the table based on his or her age at the end of the year. The taxpayer then divides the account balance as of December 31 of the previous year by the distribution period to determine the required minimum distribution. The taxpayer returns to the table each year to determine the new distribution period to use to calculate the required minimum distribution. Because the table has a distribution period of 1.9 years even for someone who is more than 115 years old, the regulations never require a taxpayer to deplete the entire account balance. Thus, the account holder will not outlive his or her benefits and may always leave some portion of the retirement plan to a beneficiary as long as voluntary withdrawals do not deplete the retirement account.

Planning Pointer.

The IRS provides an IRA Required Minimum Distribution Worksheet to calculate RMDs for the current year.

© 2021 AICPA. All rights reserved.

Example 9.1. Simon had $500,000 in his defined contribution pension plan on December 31, 2020. On December 31, 2021, Simon will be 73 years old. The distribution period for a person age 73 in 2021 is 24.7 years. His required minimum distribution for 2021 is calculated as follows: $500,000 ÷ 24.7 = $20,242.91. If, on December 31, 2021, Simon has $560,000 in his defined contribution pension plan, his required minimum distribution for 2022 (when he will be 74 years old) would be calculated as follows: $560,000 ÷ 25.5 (the new factor for age 74) = $21,960.78.

The account holder does not have to designate a beneficiary or select a distribution method to compute the minimum required distribution. Only one required distribution method applies to all participants unless the more than 10-year younger spousal exception applies. As illustrated in the following example, if the designated beneficiary is the account holder's spouse and the spouse is more than 10 years younger than the account holder, the account holder may use the longer of the period determined under the Uniform Lifetime table or the couple's actual joint life expectancy using the Joint and Last Survivor table in Regulation Section 1.401(a)(9)-9, Q&A 3 to calculate the required minimum distribution.[92]

Example 9.2. Ron has a defined contribution pension fund with a balance of $340,000 on December 31, 2020. His wife, Gladys, is 15 years younger. On December 31, 2021, Ron will be 75 years old and Gladys will be 60 years old. If Ron used the Uniform Lifetime table, his required distribution period would be 22.9 years. His required minimum distribution for 2021 would be computed as follows: $340,000 ÷ 22.9 = $14,847.16. However, using the couple's actual joint life expectancy, the distribution period is 26.5 years from Joint and Last Survivor table in Regulation Section 1.401(a)(9)-9, Q&A 3. The required minimum distribution is calculated as follows: $340,000 ÷ 26.5 = $12,830.19.

Beneficiary selection. The term *designated beneficiary* has special meaning with respect to retirement distributions. Although the law allows a trust designated as a beneficiary to be looked through to its actual individual beneficiaries, generally, only an individual may be a *designated beneficiary*.

The regulations provide a flexible approach to the designation of a beneficiary. They allow for the selection or change of a beneficiary after the plan participant's required beginning date without penalty in terms of the required minimum distribution amount. The rules allow for a designation of beneficiary to be recognized up until September 30 of the calendar year following the calendar year of the account holder's death.[93] Accordingly, not only may the account holder change beneficiaries after the required beginning date, but a postmortem beneficiary change motivated by estate planning strategies may be accomplished through a disclaimer. In a case in which the account holder has selected multiple beneficiaries and one of them is not an individual (for example, a charity), the regulations allow for buying out a beneficiary who is not an individual by paying the beneficiary all benefits due before September 30 of the calendar year following the calendar year of the account holder's death. Thus, a charity could be disregarded in determining a designated beneficiary for purposes of the distribution rules.

---

[92] Regulation Section 1.401(a)(9)-5, Q&A 4(b).

[93] Regulation Section 1.401(a)(9)-4, Q&A 4.

© 2021 AICPA. All rights reserved.

The rule allowing a post-mortem beneficiary change requires that any change be made to a beneficiary designated by the decedent through available post-mortem planning, such as by means of a qualified disclaimer under IRC Section 2518. Fiduciaries cannot appoint new plan beneficiaries not authorized by the decedent.

Naming a charity or one's estate or certain disqualified trusts does not constitute naming a designated beneficiary. If there was no designated beneficiary as of September 30 of the calendar year following the calendar year of the employee's death and the employee died before his or her required beginning date (the April 1 following the year in which the employee turned age 72), the five-year rule withdrawal applies automatically.[94]

The application of this rule means that the participant's plan benefit must be withdrawn from the plan by the end of the fifth year following the participant's year of death. If the participant died after reaching his or her required beginning date, the required period of withdrawal, if there was no designated beneficiary, would be the remaining actuarial life expectancy of the deceased participant beginning in the year following the year of the participant's death. For each year after the participant's death, the distribution period is reduced by one year.[95] Note that a person's estate is *not* considered a designated beneficiary under these rules. Accordingly, naming one's estate as a designated plan beneficiary will likely result in a faster required withdrawal of plan assets than if an individual beneficiary or a qualified trust for individual beneficiaries is named.

Planning Pointer.

The rule allowing a change in beneficiary until September 30 of the calendar year following the calendar year of the account holder's death is very beneficial. The rules allow a disclaimer to be coupled with the naming of a younger contingent beneficiary. However, the rules of the 2019 SECURE Act changed the opportunity to use the life expectancy of the younger beneficiary for RMDs to the new rule requiring plan benefits to be distributed to beneficiaries by the end of the 10th year following the death of the plan participant, thereby eliminating the advantages of the lifetime stretch out of the RMDs for many beneficiaries. The financial planner should not interpret the regulations to mean that an account holder no longer needs to select a designated beneficiary. The flexibility provided by the potential to change beneficiaries by a disclaimer is welcome, but the account holder should still designate a beneficiary and also successor beneficiaries in case the disclaimer opportunity proves advantageous.

Trust look-through rules. The regulations provide that only individuals may be designated beneficiaries for purposes of determining the required minimum distribution.[94] However, the regulations also provide that if a trust is named as a beneficiary of a retirement plan, the beneficiaries of the trust and not the trust itself will be treated as beneficiaries of the participant under the plan for purposes of determining the distribution period under IRC Section 401(a)(9).[95] The trust must be valid under state

[94] Regulation Section 1.401(a)(9)-3, Q&A 4.

[95] Regulation Section 1.401(a)(9)-5, Q&A 5.

[96] Regulation Section 1.401(a)(9)-5, Q&A 5.

[95] Regulation Section 1.401(a)(9)-4, Q&A 5.

© 2021 AICPA. All rights reserved.

law, irrevocable upon the participant's death, and the trust beneficiaries must be individuals ascertainable at the time of the decedent's death. The trustee of the trust named as beneficiary must provide the administrator of the plan with a final list of beneficiaries of the trust, including information on contingent beneficiaries and remaindermen, as of September 30 of the calendar year following the calendar year of the participant's death. The trustee must provide other administrative information to the plan administrator by October 31 of the calendar year following the calendar year of the participant's death.[96]

Qualified domestic relations order. As provided under IRC Section 401(a)(13), retirement assets may be assigned pursuant to a qualified domestic relations order (QDRO). A QDRO is an order, judgment, or decree that relates to child support, alimony, or property rights of a spouse or former spouse, child, or dependent of the participant made pursuant to a state domestic relations law.[97] The regulations provide that a former spouse to whom all or a portion of the participant's qualified retirement plan benefit is payable pursuant to a QDRO will be treated as a "spouse" (including a surviving spouse) of the participant for purposes of IRC Section 401(a)(9), regardless of whether the QDRO specifically provides that the former spouse is treated as the spouse for purposes of IRC Sections 401(a)(11) and 417.[98] This rule applies regardless of the number of former spouses a participant has who are alternate payees with respect to the participant's qualified retirement benefits.

In addition, if a QDRO divides the individual account of a participant in a defined contribution plan into separate accounts for the participant and for the alternate payee, the required minimum distribution to the alternate payee during the participant's lifetime must still be determined using the same rules that apply to distributions to the participant. Thus, RMDs to the alternate payee must commence by the participant's required beginning date. The required minimum distribution for the alternate payee during the lifetime of the participant may be determined using the Uniform Lifetime table. Alternatively, if the alternate payee is the participant's former spouse and is more than 10 years younger than the participant, the required minimum distribution is determined using the joint life expectancy of the participant and the alternate payee.

QDRO-based rules also apply to distributions, transfers, and payments from IRC Section 457 deferred compensation plans.[99] For purposes of determining whether a distribution from an IRC Section 457 plan is made pursuant to a QDRO, the special rule of IRC Section 414(p)(11) for governmental and church plans will apply. A distribution or payment from an IRC Section 457 plan will be treated as made from a QDRO if the plan makes the payment pursuant to a domestic relations order and the order creates or recognizes the existence of an alternate payee's rights to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable to the participant in the plan.[100] Rules similar to IRC Section 402(e)(1)(A) will apply to a distribution or payment pursuant to a QDRO.

---

[96] Regulation Section 1.401(a)(9)-4, Q&A 6.

[97] IRC Section 414(p).

[98] Regulation Section 1.401(a)(9)-8, Q&A 6.

[99] IRC Sections 414(p)(10), 414(p)(11), and 414(p)(12).

[100] IRC Section 414(p)(11).

© 2021 AICPA. All rights reserved.

If a QDRO orders a distribution of funds from a participant's plan to a spouse or former spouse as the alternate payee, those funds will not represent taxable income to the plan participant. The spouse or former spouse will be responsible for the income tax due on the payment. The 10% early withdrawal penalty will not apply.

If the alternate payee is a child or dependent of the participant (rather than a spouse), then the distribution will be taxed to the plan participant. In such a case, the 10% early withdrawal penalty will still not apply.

If there is no QDRO between the spouses, and retirement plan assets are distributed to a spouse (or anyone else), then the distribution will be taxed to the plan participant. The 10% early withdrawal penalty may apply as may income tax withholding requirements.

If the alternate payee is the spouse or former spouse, the taxable part of any distribution received by such person will qualify as an eligible rollover distribution. Thus, it can be rolled over into an IRA. If the alternate payee is a child or other dependent, the money may not be rolled over into an IRA.

Timing of distributions. If a participant in pay status dies before his or her entire interest has been distributed, the balance must be distributed to the participant's beneficiary at least as rapidly as it would have been distributed under the method in effect at the participant's death, subject to several exceptions described next.[101]

If distributions have not commenced before the participant's death, the balance must be distributed in five years,[102] subject to the following exceptions. First, if the participant has designated a beneficiary other than a spouse, distributions may be made over not more than the 10-year period required by the SECURE Act.[103] Second, if the designated beneficiary is the participant's spouse, distribution need not commence until the date on which the participant would have attained age 72 or, if the spouse is younger than the participant and rolls over the participant's benefit to the spouse's own IRA, distributions from the spouse's IRA need not commence until the year the surviving spouse attains age 72.[104]

The distribution rules present opportunities for clients who have no present need for distributions to take them over longer periods. By deferring the receipt of payments, the clients derive the benefit of deferred payment of taxes and continued tax-free buildup of the funds during the deferral period. In addition, if the client or his or her beneficiary is in a lower tax bracket when the plan distributes the money, the recipient will realize further benefits. Conversely, if a person expects to be subject to higher tax brackets once RMDs must begin, planning suggests taking distributions sooner to "flatten out" income reporting.

---

[101] IRC Sections 72(s)(1)(A) and 401(a)(9)(B).

[102] IRC Sections 72(s)(1)(B) and 401(a)(9)(B)(ii).

[103] IRC Sections 72(s)(2) and 401(a)(9)(B)(iii).

[104] IRC Sections 72(s)(3) and 401(a)(9)(B)(iv).

© 2021 AICPA. All rights reserved.

Retirement plan distributions are not considered as net investment income under the 3.8% net investment income tax rules. However, the receipt of taxable retirement benefits will increase the taxpayer's modified AGI, potentially causing other income to be subjected to the net investment income tax.

In figuring the amount that must be distributed each year under the regulations, a participant's life expectancy must be recalculated annually using the Uniform Lifetime table. The joint life expectancy of a participant and his or her spouse who is more than 10 years younger than the participant must also be recalculated annually using the Joint and Last Survivor table in Regulation Section 1.409(a)(9)-9, Q&A 3.[105]

An individual who fails to take a required distribution must pay a 50% non-deductible excise tax on the excess of the minimum required distribution over the amount actually distributed.[106] This is sometimes called the *excess accumulations tax*. The IRS can waive this penalty on a case-by-case basis if the payee can establish that the shortfall in the required distribution was due to reasonable error and reasonable steps are being taken to remedy the shortfall.

In order to waive the penalty, it is not necessary to request a private letter ruling and pay the required user fee. Reasonable cause to avoid the penalty includes proof of serious illness, mental incapacity, financial institution error, natural disaster, or seizure of funds by a court pending the outcome of litigation over who was entitled to the account.

Form 5329 should be filed for each year that reflects a shortfall in the required payment. Form 5329 can be attached to Form 1040 if that form has not yet been filed. Otherwise, for years when the income tax return has already been filed, file Form 5329 for each shortfall year as a separate stand-alone return. The client should take the missed required distribution(s) as soon as possible.

It is suggested that the client take a separate withdrawal check for each year that a required distribution was missed, that the check not be combined with any other distribution, and that the client not have any taxes withheld from the "shortfall" check.

Additional tax on premature withdrawals. Early withdrawals from qualified plans (as well as from IRC Section 403(b) annuities and IRAs) are subject to a 10% additional excise tax.[107] Early withdrawals generally are distributions made before age 59½ or in the absence of the plan participant's death or disability.[108] This additional tax is often called a penalty, but it is technically an additional tax. Unlike penalties, which a taxpayer may avoid for reasonable cause, a taxpayer must meet a specific statutory exception to avoid this additional tax. The following are recognized exceptions to the additional tax[109]

---

[105] IRC Section 401(a)(9)(D).

[106] IRC Section 4974(a).

[107] IRC Section 72(t)(1).

[108] IRC Section 72(t)(2)(A).

[109] IRC Section 72(t)(2).

© 2021 AICPA. All rights reserved.

- A distribution that is part of a scheduled series of substantially equal periodic payments based on the life of the participant (or the joint lives of the participant and the participant's designated beneficiary) or the life expectancy of the participant (or the joint life expectancies of the participant and the participant's designated beneficiary). Such periodic payments must last at least five years or until the participant attains age 59½, whichever occurs later.
- A distribution from a qualified plan to an employee after separation from the employer's service and after attainment by the employee of age 55.
- A distribution that does not exceed the amount allowable as a medical expense deduction (that is, expenses in excess of 7.5% in 2021 of AGI determined without regard to whether the taxpayer itemizes deductions).
- Payments made from a qualified plan to or on behalf of an alternate payee pursuant to a QDRO.
- Certain distributions of excess contributions to and excess deferrals under a qualified cash or deferred arrangement.
- Withdrawals by a public safety employee age 50 or older from a government plan.
- Dividend distributions under IRC Section 404(k).

In the case of distributions from IRAs, the post-age 55 and QDRO exceptions do not apply.

The 10% additional tax on early distributions will not apply to distributions from an IRA that are used to pay for the following:

- Health insurance premiums of an unemployed individual after separation from employment[110]
- Qualified higher education expenses[111]
- First-time homebuyer expenses (a lifetime cap of up to $10,000 or $20,000 for a married couple) and expenses for persons called to active duty in the military[112]
- A one-time transfer from an IRA to fund a health saving account contribution
- The exception for a series of substantially equal periodic payments described previously applies to IRAs
- Withdrawals by a reservist called to active duty
- IRS levy

---

[110] IRC Section 72(t)(2)(D).

[111] IRC Section 72(t)(2)(E).

[112] IRC Section 72(t)(2)(F) and (G).

© 2021 AICPA. All rights reserved.

- As added by the 2019 SECURE Act, withdrawals of up to $5,000 for qualified birth or adoption expenses

The qualified higher education expense exception covers amounts withdrawn and used to pay qualified higher education expenses (tuition, fees, books, and supplies) of the taxpayer, spouse, children, and grandchildren. The amount of qualified educational expenses is reduced by payments received for a student's education that are excludable from gross income (such as a qualified educational scholarship, educational allowance, or payment).[113]

Planning Pointer.

The amount that can be withdrawn from the IRA without imposition of the 10% additional tax is generally reduced by excludable educational payments.[114] However, this rule does not apply to excludable payments arising from a gift, bequest, devise, or inheritance.[115] Thus, planned or unplanned gratuitous payments for the student's education will not cause an otherwise qualifying educational early withdrawal to be subjected to the 10% additional tax. The IRA withdrawal for educational expenses must be made at the same time the payment for the education expense is required.

An additional exception to the 10% excise tax for early withdrawals was added by 2015 legislation. This exception is for distributions from an IRC Section 414(d) defined benefit governmental plan made to a "qualified public safety employee" who has separated from service after attaining age 50.[116]

Under the Trade Preference Extension Act of 2015 (TPA Act), effective for distributions made after December 31, 2015, the term *qualified public safety employees* for IRC Section 72(t) purposes is broadened to allow younger workers to collect sooner and includes specified federal law enforcement officers, customs and border protection officers, federal firefighters, and air traffic controllers,[117] and the types of plans from which distributions eligible for the exception can be made is broadened to include defined contribution plans and other types of governmental plans.[118] Additionally, the fact that a federal public safety worker takes such newly permissible distributions will not constitute a modification of otherwise qualifying substantially equal periodic payments under IRC Section 72(t)(4)(A)(ii).[119]

Hardship distributions. There is no general hardship exception to the 10% early withdrawal penalty. In order to qualify for relief, a taxpayer must fit within one of the enumerated statutory exceptions or use the series of substantially equal periodic payments exception. The courts have not been sympathetic to

---

[113] IRC Section 72(t)(7).

[114] IRC Section 72(t)(7)(B).

[115] IRC Sections 72(t)(7)(B) and 25A(g)(2)(C).

[116] IRC Section 72(t)(10).

[117] IRC Section 72(t)(10)(B).

[118] IRC Section 72(t)(10)(A), as amended by TPA Act Sec. 2(b).

[119] IRC Section 72(t)(4)(A)(ii), as amended by TPA Sec. 2(c).

© 2021 AICPA. All rights reserved.

claims of relief from the penalty in situations in which funds have been withdrawn to pay for subsistence living or to avoid jail for failure to pay child support.[120] Several cases have imposed the penalty tax when the taxpayer withdrew the funds from a qualified plan claiming exceptions for which only IRA withdrawals are permitted as penalty-free. Had the taxpayer rolled over the plan distribution to an IRA and then withdrew the funds from the IRA to pay such expenses, the IRA withdrawal would have satisfied the exception, and the penalty tax would not have been imposed.[121]

The hardship withdrawal rules from plans such as 401(k) plans, 457 plans, and certain nonqualified deferred compensation plans are more generous. The rules now extend permitted withdrawals for hardships and unforeseen emergencies not only to the participant and his or her dependents, but also to *any* beneficiary named under the plan, regardless of the beneficiary's relationship to the participant. This new provision certainly underscores the importance of paying attention to one's beneficiary designation forms and keeping them updated.

The IRS issued new guidelines (February 23, 2017) addressing hardship withdrawals from 401(k) plans. Unlike a loan from the plan, participants do *not* have to repay the funds accessed via a hardship withdrawal. Absent proof of hardship, however, the withdrawal may be subject to income tax and the 10% excise tax. The plan participant must prove there is a serious and immediate need for the money and that the distribution is necessary to satisfy that need.

Items that qualify as hardships include expenses related to medical care, purchase of a principal residence, tuition, prevention of eviction from a principal residence, burial or funeral expenses, and repair of damages to a principal residence. The IRS requires verification that a distribution is for one of the foregoing reasons. IRS auditors are instructed to look for "source documents" such as estimates, statements, and receipts addressing the hardship or a summary in paper or electronic format or telephone records verifying the information contained in the source documents. It is important for the participant to retain these documents and make them available to the plan sponsor or administrator upon request.

The Tax Court has determined that a retired police officer who received two distributions from his retirement accounts while suffering from a major depressive disorder and failed to roll them over into another qualified retirement account within the requisite 60-day period was entitled to a hardship waiver under IRC Section 402(c)(3)(B). (*Trimmer v. Commissioner*, 148 T.C. # 14 (2017).)

The CARES Act included a special rule for 2020. The 10% early-withdrawal penalty was waived for COVID-19-related distributions between January 1, 2020 and December 31, 2020 for up to $100,000 from qualified retirement plans or IRAs. A COVID-19-related distribution is one made during the 2020 calendar year to an individual who is diagnosed with COVID-19 by a CDC-approved test, whose spouse or dependent is diagnosed with COVID-19, or who experiences adverse financial consequences as a result of being quarantined, furloughed, laid off, having work hours reduced, being unable to work due to lack of childcare due to COVID-19, or closing or reducing hours of a business owned or operated by the individual. Such distributions are subject to regular income tax, but any taxable income from an

---

[120] *Robertson v. Commissioner*, TC Memo 2000-100; *Czeipel v. Commissioner*, TC Memo 1999-289.

[121] *McGovern v. Commissioner*, TC Summ. Op. 2003-137 (higher education expenses); *Joseph v. Commissioner*, TC Summ. Op. 2003-153 (first-time homebuyer expenses).

© 2021 AICPA. All rights reserved.

early withdrawal can be included in income ratably over a 3-year period. The withdrawn amount can also be recontributed over three years without regard to annual contribution limits.

The CARES Act rule permits in-service distributions from qualified retirement plans, even if such amounts are not otherwise eligible for distribution under the federal tax rules, and exempts the distribution from the otherwise mandatory 20% federal income withholding applicable to eligible rollover distributions from qualified retirement plans, and exempts such distributions from the IRC Section 402(f) notice requirement and the direct trustee to trustee rollover requirement.

Tax treatment of distributions. Amounts distributed from qualified plans are subject to being taxed as annuities or as lump-sum distributions or may qualify for tax-free rollover treatment.[122] Each is separately discussed in the following sections. Early withdrawals are subject to a 10% additional tax, as previously discussed. Failure to take a large enough required distribution may result in a 50% penalty, as previously discussed.

Annuity rules. As a general rule, qualified plan distributions are taxed under the annuity rules of IRC Section 72. Under these rules, a portion of each payment is treated as a tax-free return of employee contributions, if applicable, and a portion of each payment is taxable. The annuity rules are discussed in detail in chapter 8, "Annuities."

Lump-sum distributions. Ten-year averaging and pre-1974 capital gain treatment for lump-sum distributions continue to apply only to individuals who attained age 50 before January 1, 1986.

An individual who attained age 50 before January 1, 1986, and who receives a lump-sum distribution from a qualified plan, is permitted to use 10-year averaging to report the distribution and to elect capital gain treatment with respect to the pre-1974 portion of a lump-sum distribution, with the capital gain being taxed at a flat rate of 20%. This special rule may be used by any individual, trust, or estate in regard to a lump-sum distribution with respect to an employee who had attained age 50 by January 1, 1986. Form 4972 is used to report these distributions.

A lump-sum distribution is a distribution made within one taxable year of the receipt of the plan balance to the credit of the participant in the plan or any plan of the same type on account of the employee's death, after the employee attains age 59½, on account of the employee's separation from service (except in the case of a self-employed individual), or on account of disability in the case of a self-employed individual.[123]

Net unrealized appreciation (NUA) attributable to that part of a lump-sum distribution that consists of employer securities (other than appreciation attributable to deductible employee contributions) is excluded in figuring the tax on the lump sum. The unrealized appreciation attributable to the employer securities is taxable only on a disposition of the securities in a taxable transaction. Ordinary income tax is paid on the cost basis of the stock when a distribution is taken, but the appreciation is taxed at capital gains rates (long or short, depending on the holding period) when the stock is sold. The NUA does not receive a basis step-up upon death, it is treated as income in respect of a decedent.

---

[122] IRC Section 408(d)(3).

[123] IRC Section 402(d)(4)(A).

© 2021 AICPA. All rights reserved.

Tax-free rollovers. No current income tax is owed on eligible rollover distributions from plans that are rolled over to an eligible retirement plan. An eligible retirement plan that can accept tax-free rollovers is (1) a traditional IRA, (2) a qualified plan, (3) an annuity plan, (4) an IRC Section 403(b) annuity, or (5) a governmental IRC Section 457 plan.[124]

An eligible rollover distribution is any distribution to an employee of part or all of his or her account balance in a qualified trust, except for the following:

- Distributions that are part of a series of substantially equal periodic payments
- Required distributions, such as a minimum distribution required because the taxpayer has reached age 72 [125]

Rollover-eligible distributions can avoid current tax when the employee uses a direct rollover to another eligible retirement plan or, in limited circumstances, takes the distribution personally and rolls it over into another eligible retirement plan within 60 days.[126] However, if a direct rollover is not used, the distribution is subject to 20% withholding, making it difficult for the recipient to roll over the entire amount and thereby fully avoid tax on it.[127] Any part of an eligible rollover distribution that is not timely rolled over is subject to current taxation.[128] The financial planner should always recommend direct trustee-to-trustee rollovers, which will avoid withholding issues as well as the client's failure to complete the rollover transaction within the required 60-day period. Transfers to an "inherited IRA" by any nonspouse beneficiary can be accomplished successfully only if there is a trustee-to-trustee transfer.

A surviving spouse who is the named beneficiary of an employee's retirement plan may roll a distribution over to a qualified plan, annuity, or IRA in which the surviving spouse participates, either in a trustee-to-trustee rollover or via a rollover into an IRA within 60 days of receipt of the funds.[129] Distributions to a beneficiary other than a surviving spouse can be rolled over into an inherited IRA for the beneficiary.[130] The IRA receiving the rollover is treated as an inherited IRA. Benefits must be distributed in accordance with the required minimum distribution rules that apply to inherited IRAs of nonspouse beneficiaries, in accordance with the distribution requirements of the SECURE Act.

---

[124] IRC Section 402(c)(8)(B).

[125] IRC Section 408(d)(3)(E).

[126] IRC Section 408(d)(3).

[127] IRC Section 3405(c)(1).

[128] IRC Section 408(d)(1).

[129] IRC Section 408(d)(3)(C).

[130] IRC Section 402(c)(11).

© 2021 AICPA. All rights reserved.

IRS provides relief from the 60-day rollover rule. Late rollovers may now be accepted.

The IRS issued Revenue Procedure 2016-47 to provide relief for many late 60-day rollovers to IRAs. A self-certification procedure is now available. Clients may use the procedure to roll over distributions from both company plans and all IRAs. The client treats the transaction as a rollover. Nothing need be reported or attached to the client's tax return. A self-certification letter must be provided to the plan administrator or IRA custodian. The administrator or custodian is not required to accept the late rollover to an IRA. No late fee is required from the client, thereby avoiding the cost of a private letter ruling, which had previously been the only avenue for relief. Misapplied funds must be deposited into an IRA account. The IRS is not required to accept the self-certification if the criteria for allowance have not been met.

The Revenue Procedure lists 11 acceptable reasons for a late rollover, including financial institution or postal error, misplacing and never cashing the distribution check, depositing the check into an account mistakenly believed to be a retirement account, not obtaining needed information from the distributing company despite attempts to do so, personal misfortune (illness, death of a family member, damage to principal residence, incarceration, problem in a foreign country, or IRS levy).

The revenue procedure does not apply to situations in which multiple rollovers in one year are not allowed or where anything other than a trustee-to-trustee rollover is prohibited (such as in the case of an inherited IRA).

The best advice: Avoid the problem by using direct trustee-to-trustee transfers in all cases.

Eligible rollover distributions are subject to mandatory 20% federal income tax withholding,[131] unless the recipient elects to have the distribution paid directly to another eligible retirement plan in a trustee-to-trustee transfer.[132] Withholding is not required if only employer securities are distributed or if $200 or less in cash is disbursed instead of fractional employer securities.[133] Distributions that are not eligible rollover distributions are excused from mandatory 20% withholding. The CARES Act also excused 20% withholding from certain permitted 2020 withdrawals attributed to the coronavirus.

A direct rollover can be accomplished by any reasonable means, including a wire transfer or a check from the old plan to the trustee (or custodian) of the transferee eligible retirement plan designated by the taxpayer. The check can be mailed to the transferee eligible retirement plan, or it can even be given to the participant for delivery to the eligible retirement plan if it is made out properly to the new plan's trustee or custodian. Distributing plans must offer a direct rollover option to participants eligible to receive eligible rollover distributions; however, plans are not required to accept rollover contributions.

A plan participant may decide that only part of an eligible rollover distribution be transferred via a direct rollover to another plan. In that case, only the part that is not directly rolled over is subject to 20% withholding.

---

[131] IRC Section 3405(c)(1).

[132] IRC Section 3405(c)(2).

[133] IRC Section 3405(e)(8).

© 2021 AICPA. All rights reserved.

Plans are permitted to limit distributees to a single direct rollover for each eligible rollover distribution.[134] Therefore, a retiree who wants a large distribution to be transferred to more than one IRA institution may not be able to accomplish this directly. However, the retiree can achieve this goal by a direct transfer of the entire distribution to one traditional IRA. Trustee-to-trustee transfers can then be made tax-free from that IRA to the others.

A qualified plan may provide for mandatory distributions to employees with small accrued benefits who terminate employment if the present value of the employee's benefit is $5,000 or less. Mandatory distributions must be transferred to an IRA of a designated trustee or issuer if (*a*) the distribution is more than $1,000 but not more than $5,000 and (*b*) the employee receiving the distribution does not elect a direct rollover to another plan or IRA and does not elect to receive the distribution.[135] The plan must notify the employee of the option to have the distribution transferred without cost or penalty to a different IRA.

¶910 Employee Stock Ownership Plan Opportunities

Employers will want to consider the advantages an employee stock ownership plan (ESOP)[136] provides. The ESOP from the employer's standpoint is considered in some detail in ¶1920.

Although employers receive significant benefits under ESOPs, the main focus here is on the benefits that employees can expect to derive from an ESOP. Like most employee benefit plans, an ESOP (under Employee Retirement Income Security Act (ERISA) rules) is designed to benefit participating employees — generally, those who stay with the employer the longest and contribute the most to the corporation's financial success. All cash and employer stock contributed to the ESOP are allocated each year to the accounts of the participating employees under a specific formula.[137] These amounts are held in trust and administered by a trustee who is responsible for protecting the interests of the participants and their beneficiaries.

An employee's ownership generally depends on the vesting schedule adopted by the company within the limits prescribed by IRC Section 411(a), which are the same as those available to other qualified plans (¶905).

In general, unless a participant elects otherwise with any required spousal consent, payment of benefits must commence no later than one year after the later of the close of the plan year (1) in which the participant retires, becomes disabled or dies, or (2) that is the fifth year following the plan year in which the participant otherwise separates from service.[138] Unless the participant elects otherwise, distribution is to be made in substantially equal installments (not less frequently than annually) over a period not

---

[134] IRC Section 408(d)(3)(B).

[135] IRC Section 401(a)(31)(B).

[136] IRC Section 4975(e)(7).

[137] IRC Section 409(b).

[138] IRC Section 409(o)(1)(A).

© 2021 AICPA. All rights reserved.

longer than five years.[139] Additional time to distribute is provided if the account balance is over $1,165,000 for 2021.[140] This amount is indexed annually to inflation in $5,000 increments.[141]

Distribution of an employee's vested benefits must normally be made in cash or in shares of employer stock as determined by the administrator of the plan, subject to the distributee's right to demand stock, unless the charter or bylaws restrict ownership of stock to employees.[142]

The following questions and answers are designed to help in further apprising employees of ESOP rights.

Q. May an ESOP provide for the purchase of incidental life insurance whose proceeds are payable to beneficiaries of employees participating in the ESOP?

A. Yes, provided the aggregate life insurance premiums for each participant do not exceed 25% of the amount allocated to his or her ESOP account at any particular time. This 25% limit applies, regardless of the type of life insurance purchased (for example, ordinary life or term insurance).[143]

Q. May the employer be required to purchase the securities distributed to a participant?

A. Yes, if the securities are not readily tradable on an established market. The price is to be determined by a fair valuation formula.[144] The requirement of a put option is satisfied if the option exists for at least 60 days following distribution of the stock and if it is not exercised within such 60-day period for an additional period of at least 60 days in the following plan year.[145] An employer that is required to repurchase employer securities distributed as part of a total distribution under the put option requirements must pay the employee in substantially equal payments over a period not exceeding five years. In the case of a put option exercised as part of an installment distribution, the employer is required to repay the option price within 30 days of exercise. These last two rules apply to distributions attributable to stock acquired after 1986.

Q. Must an employee be permitted to direct account diversification?

A. Effective with respect to stock acquired after 1986, ESOPs must allow qualified participants (those who have attained age 55 and have completed 10 years of participation in the plan) to

---

[139] IRC Section 409(o)(1)(C).

[140] IRC Section 409(o)(1)(C)(ii).

[141] IRC Section 409(o)(2).

[142] IRC Section 409(h).

[143] Revenue Ruling 70-611, 1970-CB 89.

[144] IRC Section 409.

[145] IRC Section 409(h)(4).

© 2021 AICPA. All rights reserved.

direct diversification of up to 25% of their account balances over a six-year period (50% in the sixth year). The election period generally begins with the plan year during which the participant attains age 55 unless the participant has not yet completed 10 years of service, in which case the period begins in the year in which such service is completed.[146] In addition, more generous diversification rights for defined contribution plans that permit the divestiture of all employer securities may apply to certain ESOPs.[147]

Q. May an employee who receives employer stock from an ESOP trust be required to offer to sell the stock to the employer before offering to sell it to a third party?

A. Yes.

Q. What are some of the problems or disadvantages of an ESOP?

A.

1. In a closely held corporation, the major disadvantage of using an ESOP is that a large number of minority shareholders may be created unless stock ownership is restricted to employees or the ESOP.

2. A closely held corporation might have problems with the expense of annual appraisals to determine fair valuation. However, the corporation can overcome these problems by a specific valuation provision or formula.

3. The corporation might have problems of compliance with SEC rules on offerings, disclosure, and stock restrictions.

4. ESOPs are intended to motivate employees and to give them a share of the ownership in their employer-corporation. In a declining market, employees might not be motivated by the potential for appreciation in the value of the stock.

¶915 Individual Retirement Account Opportunities

This section examines the rules and applicable planning strategies related to traditional IRAs — deductible and non-deductible as well as SEP plans, SIMPLE plans, and Roth IRAs.

[146] IRC Section 401(e)(28).

[147] IRC Section 401(a)(35), as added by Public Law No. 109-280.

© 2021 AICPA. All rights reserved.

.01 In General

For tax year 2021, subject to certain phase outs subsequently discussed, every employee or self-employed individual may contribute the lesser of 100% of his or her earnings or $6,000 to his or her own IRA.[148] The $6,000 limit is adjusted for inflation in $500 increments. In addition, a taxpayer who is age 50 or older may contribute an additional "catch-up" amount of $1,000 through 2021. The earnings on the contributions increase tax-free until withdrawn. Tax liability will be due when the taxpayer starts making withdrawals (required when age 72 is reached).

However, IRC Section 219(g) limits the deductibility of IRA contributions in the case of an active participant in a qualified retirement plan, SEP, IRC Section 403(b) annuity, or government plan whose AGI exceeds certain levels. For 2021, if an individual who files a single or head of household return is covered by a qualified retirement plan, his or her IRA deduction begins to phase out when AGI reaches $66,000 and is completely eliminated once AGI reaches $76,000. For 2021, the phase out begins at $105,000 for a married individual who is covered by a qualified plan and is complete when AGI reaches $125,000. The phase out range is higher for a married individual who is not covered by a qualified plan, but whose spouse is covered. For 2021, the individual's deduction phases out if income is between $198,000 and $208,000. For married individuals filing separately, the phase out range is $0–$10,000. These dollar amounts are indexed annually for inflation.

Individuals denied deductions may make non-deductible IRA contributions and achieve deferral of tax on the IRA earnings.[149]

Planning Pointer.

The phase out amounts will reduce or eliminate IRA deductions for many individuals and families. If the taxpayer faces this situation, the advisability of non-deductible investments in a traditional IRA should be seriously considered in light of the availability of the Roth IRAs. Roth IRAs do not provide a deduction for contributions, but they do give the benefit of both income tax-free buildup (like a traditional IRA) and receiving the IRA funds income tax-free on retirement (¶915.04).

Spousal IRAs. Note: Spousal IRAs have been now renamed "Kay Bailey Hutchison Spousal IRAs" in honor of the retired Texas senator. A spouse who does not have earned income or who has only a small amount of earned income can still make the maximum contribution for the year, provided the other spouse's earnings are sufficient to support the contribution. Thus, a spouse with no earned income may contribute as much as $6,000 to an IRA for 2021.[150] However, if the spouse who has earned income is an active participant in an employer-sponsored retirement plan and the couple's AGI is greater than the amount at which the phase out begins, the maximum amount of the spousal IRA contribution that will be deductible will be proportionately reduced in the same way that a nonspousal IRA is reduced.[151]

---

[148] RC Section 219(b)(1).

[149] IRC Section 408(o)(2)(B).

[150] IRC Section 219(c).

[151] IRC Section 219(g).

© 2021 AICPA. All rights reserved.

The $6,000 limit will be adjusted for inflation annually, but may increase only in $500 increments. In addition, a spouse who is age 50 or older may contribute an additional catch-up contribution of $1,000 through 2021.

Additionally, an individual will not be considered to be an active participant in an employer-sponsored plan merely because the individual's spouse was a participant. Thus, most spouses who are not actually participants in an employer plan will be able to make the maximum deductible contribution to an IRA. The maximum deduction for such nonparticipant spouses, however, is phased out for couples with AGIs between $198,000 and $208,000 for 2021.[152]

Deemed IRAs. If a qualified plan allows employees to make voluntary contributions to a separate account or annuity established under the plan, and under the terms of the plan the account or annuity meets the requirements for a traditional IRA or a Roth IRA, the account or annuity will be treated as an IRA and not as a qualified plan for all purposes under the IRC.[153] In addition, a qualified plan will not lose its qualified status solely because it establishes and maintains a deemed IRA program. This provision effectively allows employers to set up traditional IRAs or Roth IRAs for their employees without affecting any other qualified plan. The deemed IRA and contributions to it are subject to ERISA's exclusive benefit and fiduciary rules to the extent otherwise applicable to the plan. However, they are not subject to the ERISA reporting and disclosure, participation, vesting, funding, and enforcement requirements applicable to the eligible retirement plan.

Distributions. Distributions from traditional IRAs must commence by April 1 of the year following the year in which the IRA owner attains age 72.[154] For 2009, the required distribution requirement applicable to IRAs was suspended.[155] The required distribution rules were reinstated prospectively for 2010 and subsequent years. However, for 2020, the required distribution rules were suspended as the result of the pandemic.

Failure to take a required distribution results in a 50% excise tax.[156] Treasury regulations[157] that govern RMDs from qualified plans also apply to IRAs with some modifications.[158] Taxpayers with IRAs may use the uniform distribution rules without revising their governing documents. The Uniform Lifetime table and more details on the distribution rules are discussed in ¶905.02.

---

[152] IRC Section 219(g)(7).

[153] IRC Section 408(q)(1).

[154] Section 401(a)(9)(C).

[155] IRC Section 401(a)(9)(H), as added by the Worker, Retiree, and Employer Recovery Act of 2008 (Public Law No. 110-458).

[156] IRC Section 4974(a).

[157] Regulation Sections 1.401(a)(9)-0 through 1.401(a)(9)-9.

[158] Regulation Section 1.408-8.

© 2021 AICPA. All rights reserved.

Trustees, custodians, or issuers of IRAs must provide account holders with information regarding the minimum amount required to be distributed from the IRA each year.[159] An IRA trustee must provide a statement to the IRA owner by January 31 following the end of the calendar year if the IRA owner is living and subject to a minimum required distribution.[160] The trustee must inform the IRA owner of the required minimum distribution in accordance with two alternatives.

Under the first alternative, the IRA trustee must provide the IRA owner with a statement of the amount and date of the required minimum distribution with respect to the IRA for the calendar year. The trustee may calculate the amount of the required minimum distribution, assuming that the only beneficiary of the IRA is not the spouse of the IRA owner who is more than 10 years younger than the IRA owner. The trustee may also assume that no amounts received by the IRA after December 31 of the previous year are required to be taken into account to adjust the value of the IRA as of December 31 of the previous year for purposes of calculating the required minimum distribution with respect to rollovers and trustee-to-trustee transfers.

Under the second alternative, the trustee must provide a statement to the IRA owner that a minimum distribution is required for the IRA for the calendar year and the date by which the distribution must occur and offer to provide the IRA owner, upon request, a calculation of the amount of the required minimum distribution. If the IRA owner makes a request for the calculation, the trustee must make the calculation and provide it to the IRA owner.

Under both alternatives, the trustee must inform the IRA owner that the trustee will report to the IRS and the IRA owner must receive a required minimum distribution for the calendar year. The trustee may provide the statement to the IRA owner, along with the statement of the FMV of the IRA as of December 31 of the previous year by January 31 following the end of the calendar year. The trustee must report to the IRS on Form 5498, "IRA Contribution Information," that a minimum distribution is required. The trustee does not have to report the amount of the required minimum distribution to the IRS. The trustee does not have to file any reports for deceased owners of traditional IRAs or for any Roth IRAs.

The IRS clarified this guidance by providing that IRA trustees may use the first alternative for some IRA owners and the second alternative for other IRA owners. In addition, the IRA trustee may transmit the required statement electronically. The electronic transmission must comply with a reasonable and good faith interpretation of the applicable law. The trustee may provide the information electronically only if the trustee satisfies the procedures applicable to the electronic transmission of Forms W-2, including the consent requirement described in the regulations under IRC Section 6051.[161]

Requiring custodians to inform the IRS that the IRA owner has a required minimum distribution obligation allows the IRS to easily determine whether account holders have taken the required minimum distribution. Account holders who do not take the required minimum distribution are subject to a 50%

---

[159] Regulation Section 1.408-8, Q&A 10.

[160] Notice 2002-27, Internal Revenue Bulletin (IRB) 2002-18, 814 (April 16, 2003).

[161] Notice 2003-3, IRB 2003-2 (December 20, 2002).

© 2021 AICPA. All rights reserved.

excise tax on the difference between the required minimum distribution and the actual distribution.[162] The law treats taxpayers with multiple IRAs as having one account.[163] The required minimum distribution must be calculated separately for each IRA. However, taxpayers may take distributions from their choice of one or more of their IRAs as long as they take total distributions greater than or equal to the total required minimum distribution.[164] This rule allows holders of multiple IRAs to use lower-yielding IRAs to satisfy the minimum distribution requirements. However, distributions from Roth IRAs or IRC Section 403(b) accounts may not be used to satisfy the required minimum distribution from IRAs.

> **Example 9.3.** Peter is 76 years old. He has two IRAs. On December 31, 2020, the balance in the first IRA is $180,000 and the balance in the second IRA is $120,000. His required minimum distribution for 2021 is ($180,000 + $120,000) = $300,000 ÷ 22 = $13,636.36. (22 is the factor from the 2021 Uniform Lifetime table for persons age 76.) Peter may take all of the required minimum distribution from either account or receive a partial distribution from each account as long as the total distribution is at least $13,636.36.

The regulations provide that the election by a surviving spouse eligible to treat an IRA as the spouse's own IRA may be accomplished by redesignating the IRA with the name of the surviving spouse as owner rather than as beneficiary.[165] This election allows the surviving spouse to wait until reaching age 72 to take required minimum distributions. If making this election, the spouse should then immediately name a new designated beneficiary.

If the surviving spouse contributed to the IRA or did not take the required minimum distribution for a year under IRC Section 401(a)(9)(B) as a beneficiary of the IRA, the regulations treat the surviving spouse as having made a deemed election to treat the IRA as the surviving spouse's own IRA. The deemed election is permitted only if the spouse is the sole beneficiary of the account and has an unlimited right of withdrawal from it. This requirement is not satisfied if a trust is named as beneficiary of the IRA, even if the spouse is the sole beneficiary of the trust, unless the spouse obtains a private letter ruling treating the spouse as having all rights in the trust and permitting the spouse to be recognized as owner of the IRA.[166]

Distributions are to be made over a period that satisfies the requirements of the SECURE Act. Attention must be paid to whether the beneficiary is an Eligible Designated Beneficiary, entitled to use life expectancy for RMDs, or whether the beneficiary is subject to the ten year withdrawal rule.[167] If an owner in pay status dies before his or her entire interest has been distributed, the balance must be

---

[162] IRC Section 4974(a).

[163] IRC Section 408(d)(2).

[164] Regulation Section 1.408-8, Q&A 9.

[165] Regulation Section 1.408-8, Q&A 5(b).

[166] Regulation Section 1.408-8, Q&A 5(a) and (b).

[167] IRC Section 401(a)(9)(A).

© 2021 AICPA. All rights reserved.

distributed to the beneficiary subject to the SECURE Act rules for rollover IRAs by a spouse and inherited IRAs by other named beneficiaries.[168]

If required distributions have not commenced before the participant's death prior to age 72, the balance must be distributed in five years subject to the following exceptions.[169] First, if the owner has designated a beneficiary who is not the spouse of the owner or another Eligible Designated Beneficiary, the plan benefits are subject to the ten year distribution rule.[170] Second, if the designated beneficiary is the owner's spouse, distribution need not commence until the later of the date on which the spouse attains age 72 or the deceased owner would have attained age 72.[171]

If an individual has made no non-deductible contributions to any IRA, the entire amount of any distribution is taxable as ordinary income. If an individual has made a non-deductible contribution to any IRA, special rules apply. Under the special rules, any withdrawal will be taxable on a pro rata basis, taking into account the ratio of the non-deductible contributions to the entire amount in the account.

> **Example 9.4.** If non-deductible contributions over five years add up to $10,000 and earnings thereon equal $5,000, there is $15,000 in the account. Two thirds of the account represents non-deductible contributions. Accordingly, on a withdrawal of $1,200, the tax-free recovery of basis would be two thirds of the withdrawal (that is, $800 and $400 would be taxable).

Another pro rata rule applies if the individual also has a deductible IRA as shown by the following example.

> **Example 9.5.** The non-deductible IRA is as previously described in example 9.4. The taxpayer also has $35,000 in a deductible IRA, for a total of $50,000 in both IRAs. On a withdrawal of $1,000 from the non-deductible IRA, only one fifth, or $200, would be deemed to come from the non-deductible IRA. To compute the taxable versus nontaxable amounts, first divide the total nontaxable amount by the total in both accounts (in this case, $10,000 ÷ $50,000 = 0.2 = 20%). Then multiply the resulting percentage by the amount of the withdrawal ($1,000 × 0.2 = $200). The result is that $800 is taxable as ordinary income and $200 is a tax-free recovery of basis.

The larger the deductible IRA in relation to the non-deductible IRA, the larger the amount of the withdrawal subject to tax. In general, withdrawals taken before attaining age 59½ or resulting from other than death or disability are subject to an additional 10% excise tax.[172] The exceptions to this rule are discussed in ¶905.02, under the heading "Additional tax on premature withdrawals."

State law considerations. The income tax treatment of IRA contributions and distributions by individual states varies widely and can present problems for the financial planner and the client.

---

[168] IRC Section 401(a)(9)(B).

[169] IRC Section 401(a)(9)(B)(ii).

[170] IRC Section 401(a)(9)(B)(iii).

[171] IRC Section 401(a)(9)(B)(iv).

[172] IRC Section 72(t).

© 2021 AICPA. All rights reserved.

Most states that have an income tax give their residents a deduction equivalent to the federal deduction for IRA contributions. However, some states limit the deduction to amounts less than the federal maximum deduction, and other states (for example, New Jersey) bar a deduction altogether.

As to distributions, although most states follow the federal approach, in many states the income tax treatment of IRA distributions is more complex. The financial planner should check applicable state law, especially in states where the deduction is denied, and the client receives a 1099 from the plan administrator when distributions are made. At least some part of that distribution has already been taxed by the state disallowing the deduction, and a complex calculation may be necessary (along with adequate records from the client reporting the previously taxed contributions) to separate the federal taxable amount from the amount already taxed by the state.

Selecting IRA investments. The two most common types of IRA investments or approaches to IRA investments are (1) individual retirement accounts with a bank or other qualified person as trustee and (2) individual retirement annuities (nontransferable annuities issued by a life insurance company).

That formal listing does not do justice to the investment opportunities open to the IRA investor. There is intense competition within the financial services industry for IRA dollars. The competition among financial institutions to provide products aimed at the IRA market has spawned an array of investment choices. The best advice is to choose investments with the best combination of expected return and risk.

The following paragraphs include a brief summary of some types of investments offered by various entities marketing IRAs.

Thrift institutions. The investment options that may be offered by savings and loan associations and mutual savings banks for IRA accounts are limited to fixed and variable rate certificates of deposit of varying maturities and money market accounts. The investments are protected by FDIC insurance, up to $250,000 per institution. The fees, if any, charged for opening and maintaining an IRA are relatively small.

Brokerage houses. Brokerage houses, including some that offer self-directed IRAs, offer the widest range of investment options, with some offering everything from money market funds, stocks, bonds, and mutual funds to limited partnership interests in real estate.

As long as the self-directed IRA holder keeps the same brokerage house as custodian, the IRA assets can be moved among different investments to get the best return. The ability to reallocate assets offers an important advantage over investments in bank certificates of deposit, which the investor cannot dispose of prior to maturity without suffering interest penalties.

Most IRA custodians accept and allow only approved stocks, bonds, mutual funds, and CDs. A self-directed IRA custodian allows those types of investments in addition to real estate, notes, private placements, tax lien certificates, and much more. Self-directed IRAs appear to be gaining increased popularity for their greater investment flexibility; they must still follow rules addressing prohibited IRA investments, including collectibles (such as artwork, stamps, rugs, antiques, and gems), certain coins, and life insurance.

Self-directed IRAs may not engage in transactions with *disqualified persons* — individuals with whom or entities that an IRA is prohibited (absent a special exception) from engaging in any direct or indirect sale or exchange or leasing of any property; lending of money or other extension of credit; furnishing goods, services, or facilities; or transferring to or permitting the use of IRA income or assets.

© 2021 AICPA. All rights reserved.

Disqualified persons include fiduciaries (which, in the case of a self-directed IRA, includes the IRA owner) as well as the following family members of the IRA owner: spouse; parents; grandparents and great-grandparents; children (and their spouses); grandchildren and great-grandchildren (and their spouses); service providers of the IRA (for example, IRA custodian, CPA, financial planner); an entity (such as a corporation, partnership, limited liability company, trust, or estate) of which 50% or more of that entity is owned directly or indirectly or held by a fiduciary or service provider and, also, a partner who holds 10% of a joint venture of such entity.

Self-directed IRAs may not provide an indirect benefit to the participant. It is considered an "indirect benefit" if the IRA is engaged in transactions that, in some way, can benefit the participant currently. Some examples of prohibited transactions include personally using property held in the IRA, such as an office, personal residence, vacation home, or retirement home; or receiving personal benefits from the IRA, such as lending yourself money from the IRA or compensating the participant, or a company that the participant owns, to do work on property purchased by the IRA. Caution must be exercised to avoid having a self-directed IRA receive unrelated business taxable income from conducting a trade or business activity or engaging in debt financing. Such activity could lead to taxation of the IRA income, additional tax return filing requirements (Form 990-T), income tax on the IRA receipts at the trust tax rate, and possibly disqualification of the IRA entirely.

The IRS has focused on valuation issues involving self-directed IRAs. The instructions for Form 5498 and Form 1099-R require the reporting of non-publicly traded stock and notes, partnership and LLC interests, real estate options, and other hard to value assets. For example, if real estate is the only asset owned in a self-directed IRA and the account owner is subject to minimum required distributions (RMDs), where does the owner get the cash to pay the required withdrawal? How are real estate taxes and expenses paid? Must there be an annual appraisal of the hard to value assets? Presumably yes.

A number of cases have supported IRS challenges of self-directed IRAs where the taxpayers are dealing with the assets in their own personal accounts,[173] or using an LLC in the IRA to pay wages to the account holder — a prohibited transaction.[174] A taxpayer successfully withstood an IRS challenge to a self-directed IRA[175] where he was able to prove he never controlled funds that were used to purchase stock that his custodian refused to purchase.

Generally, an investor will pay a price for the flexibility offered by brokerage houses, especially if a self-directed IRA is used. There may be a fee for opening the account, as well as custodial fees, possibly based on a percentage of the amount in the account, with a fixed-dollar minimum.

Zero coupon bonds. Zero coupon bonds based on underlying U.S. Treasury issues, which are often marketed by brokerage houses under such names as certificates of accrual on Treasury securities (CATs) or Certificates of Government Receipts (COUGRs), can serve to lock in good interest rates and maximize returns on IRAs. The zero coupon bond provides the investor with a means to avoid the problem of reinvesting periodic income payments at lower yields if interest rates fall. Of course, with

---

[173] *Vandenbosch v. Commissioner*, TCM 2016-29.

[174] *Ellis v. Commissioner*, 8th Cir. 2015-1 USTC para. 50,328.

[175] *McGaugh v. Commissioner*, 7th Cir. 2017-2 USTC para. 50,272.

© 2021 AICPA. All rights reserved.

interest rates on bonds and certificates of deposit at or near record lows in 2021, the client may urge the financial planner to suggest investments that may generate higher returns. Here, the financial planner must determine the risk tolerance of the client and the need for long-term financial security in making appropriate recommendations.

U.S. Treasury Separate Trading of Registered Income and Principal Securities (STRIPS) are federally sponsored zero coupon bonds. The STRIP program allows the IRA owner to purchase zero coupon bonds guaranteed by the U.S. government.

The zero coupon bond's failure to produce any current income prior to maturity makes such bonds more volatile than ordinary bonds. Also, brokers may charge steep fees for zero coupon bonds based on underlying Treasury securities.

Mutual funds. Mutual funds are often used for IRAs. Mutual funds offer a range of investment options almost as broad as those offered by brokerage houses. Families of mutual funds range from conservative to very aggressive growth funds, index funds, exchange traded funds, and money market funds. The IRA investor may move from one fund to another without penalty so long as it is within the same family and maintains the same manager or trustee. FDIC insurance is lacking, but funds are available that invest in government securities. These funds might require fees and charges. The financial planner may want to consider a blended portfolio of equities, bonds, and cash that is tailored to the client's risk tolerance and mindful of longevity issues.

Commercial banks. Commercial banks may offer certificates of deposit and FDIC insurance of up to $250,000 on principal and interest, as can thrift institutions. They may market and manage common funds for IRA customers, giving them broad investment options and flexibility. They might also offer other conveniences, such as transfers from checking accounts and direct payroll deductions.

Insurance companies. In a bid for IRAs, some insurance companies have set up stock equity funds, fixed-dollar or bond funds, and money market funds in addition to their more conventional annuity plans. State regulation of insurance companies can be counted upon to provide some element of safety, but FDIC insurance, which is provided to banks, is lacking. The financial planner should check the fees and other charges.

Investment choices in times of low interest rates. IRA contributions should not be put off in anticipation of higher interest rates, but investment choices should be made accordingly. The earlier in a given year the taxpayer makes a contribution, the sooner earnings on the contribution begin to accrue on a tax-deferred basis for traditional IRAs or on a tax-free basis for Roth IRAs. Earlier contributions lead to a greater compounding of interest. Over the life of the IRA, the additional compounding can mean thousands of extra dollars.

Individuals who are conservative in their investment philosophy and who anticipate a rise in interest rates might consider non-fixed-income investments for the short term, such as money market funds or money market-type bank accounts. When interest rates climb, the individuals can move the money to a higher yielding fixed-income vehicle such as a CD.

Collectibles. IRC Section 408(m) penalizes an IRA participant who directs his or her investments into collectibles (art works, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages, and any other tangible personal property so characterized by the IRS). It also assumes that if any IRA assets are used to acquire a collectible, the amount is treated as a distribution taxable to the participant. However, IRA investments are permitted in state-issued coins and the following U.S. gold and silver coins — one-

© 2021 AICPA. All rights reserved.

ounce, half-ounce, quarter-ounce, and 10th-of-an-ounce gold bullion coins, and a one-ounce silver bullion coin. Also, IRA investments are allowed in certain platinum coins and in gold, silver, platinum, and palladium bullion. However, the bullion must be in the physical possession of the IRA trustee.

Rollovers and *Bobrow v. Commissioner* — The rules to be followed. Qualified plan distributions may be rolled over tax-free into an IRA only within 60 days of distribution (¶905.02).[176] However, the IRS may waive the 60-day rollover period if the failure to roll the funds over within 60 days is due to good cause, such as a casualty, a disaster, or an error by a bank or other custodian.[177] A taxpayer-directed IRA-to-IRA rollover under the so-called 60-day rollover rule, where the taxpayer withdraws funds from one IRA and returns them to another IRA within 60 days of the withdrawal, may be made without tax penalty only once a year.[178] (See the preceding discussion regarding Revenue Procedure 2016-47 and the relaxation of the 60-day rollover rule by the IRS in Section ¶905).

The Tax Court held in *Bobrow v. Commissioner,* T.C. Memo 2014-21 (contrary to the IRS's previous published example in Publication 590, page 25) that, regardless of how many IRAs a taxpayer maintains, there may be only one nontaxable withdrawal and rollover contribution within each one-year period. The IRS has indicated that they will follow the holding in this case but will not apply it to transactions that occurred before January 1, 2015.[179] However, an unlimited number of direct transfers from one IRA trustee to another, (i.e., with no withdrawal by the taxpayer) even if it is the same trustee, may be made without tax penalty. In either case, depending on the particular IRA, the individual might incur interest penalties for premature withdrawals and might not be able to recover prepaid fees. The rules will also apply to Roth IRAs, but a conversion to a Roth IRA is not considered a rollover for purposes of these rules.

The *Bobrow* case is a game-changer in the IRA rollover field. The IRS changed its rules as a result of the case in a manner unfavorable to taxpayers. Practitioners should be aware of these rules so they can protect their clients against the imposition of possible tax issues and penalties. For many years, the IRS rollover guidance found in Publication 590 provided that if a person had multiple IRAs, it was permissible to do multiple IRA rollovers.

Following the guidance from the IRS in Publication 590, prior to *Bobrow*, a taxpayer with multiple IRAs could accomplish multiple IRA rollovers during a one-year period because the one-year limitation rule was applied on an IRA-by-IRA basis. Each IRA maintained by an IRA owner would have its own one-year period within which a rollover could occur. The rules of Publication 590 were widely known by financial planners and their clients. They were used as an income tax planning technique to provide a short-term, tax-free loan with no cost or penalty to a taxpayer if the taxpayer had multiple IRAs. Planning, in fact, encouraged clients to maintain multiple IRAs for this very purpose.

---

[176] IRC Section 408(d)(3)(A).

[177] IRC Sections 402(c)(3) and 408(d)(3).

[178] IRC Section 408(d)(3)(B).

[179] Notice 2014-15.

© 2021 AICPA. All rights reserved.

In the *Bobrow* case, the taxpayer — a tax lawyer — used multiple IRA rollovers from multiple IRAs to take advantage of the opportunity of tax-free loans which Publication 590 appeared to permit. However, the Tax Court determined that, notwithstanding the IRS guidance, the "clear" reading of the statute required that the one-year limitation rule under IRC Section 408(d)(3)(B) applied on an aggregate basis and not on an IRA-by-IRA basis. The IRS determined it would follow the Bobrow holding and issued new rules effective January 1, 2015.

The IRS explained its new IRA rollover rules in Publication 590-A:

> Beginning in 2015, you can make only one rollover from an IRA to another (or the same) IRA in any one-year period regardless of the number of IRAs you own. The limit will apply by aggregating all of an individual's IRAs, including SEP and SIMPLE IRAs as well as traditional and Roth IRAs, effectively treating them as one IRA for purposes of the limit. However, trustee-trustee transfers between IRAs are not limited and rollovers from traditional IRAs to Roth IRAs (conversions) are not limited.

The IRS provided a new example in the revised Publication 590-A[180]referring to a taxpayer named John who has three traditional IRAs: IRA-1, IRA-2, and IRA-3. "On January 1, 2015, John took a distribution from IRA-1 and rolled it over into IRA-2 on the same day. For 2015, John cannot roll over any other 2015 IRA distribution, including a rollover distribution involving IRA-3. This would not apply to a conversion."

In addition to revising its Publication 590, the IRS issued two announcements involving the application of the one-rollover-per-year limitation in IRA rollovers — Announcements 2014-15 and 2014-32. The IRS determined that the new rules for administrative purposes should become effective as of January 1, 2015, and should not be applied on a retroactive basis. IRS Announcement 2014-32 was fairly comprehensive and made the following points:

- Amounts received from an IRA will not be included in the gross income of a distributee to the extent that the amount is paid into an IRA for the benefit of the distributee under the 60-day rollover rule. Publication 590-B indicates that certain distributions are not eligible for rollover, such as amounts that must be distributed (required minimum distributions) during a particular year.

- IRC Section 408(d)(3)(B) is the key section involved under the one-rollover-per-year limit on IRA rollovers.

- An individual receiving an IRA distribution on or after January 1, 2015, cannot roll over any portion of the distribution into an IRA if the individual has received a distribution from any IRA in the preceding one-year period that was rolled over into an IRA.

- The IRS, in Publication 590 and its proposed regulations, had previously provided that the IRA rollover rules were based on an IRA-by-IRA basis. However, in *Bobrow v. Commissioner*, the

[180] The guidance from the IRS has now been split into Publications 590-A and 590-B.

© 2021 AICPA. All rights reserved.

Tax Court held that the one-rollover-per-year limit applied to taxpayers on an aggregate basis and not on an IRA-by-IRA basis.

- A rollover from a traditional IRA to a Roth IRA (a conversion) is exempt from the one-rollover-per-year rule. It is not considered in applying the one-rollover-per-year rule to other rollovers.

- A rollover from a Roth IRA to any Roth IRA (including the same Roth IRA) would preclude any other Roth IRA rollovers to any Roth IRA under the one-year rule. It would also preclude any rollovers from one traditional IRA to a traditional IRA (including the same traditional IRA) under the one-year rule.

- A rollover from a traditional IRA to any traditional IRA (including the same traditional IRA) would preclude any other traditional IRA rollovers under the one-year rule. It would also preclude any rollover from any Roth IRA to a Roth IRA (including the same Roth IRA) under the one-year rule.

- For purposes of Announcement 2014-32, the term *traditional IRA* includes a simplified employee pension (SEP) under IRC Section 408(k) and a SIMPLE-IRA under IRC Section 408(p).

- The one-rollover-per-year limitation does not apply to a rollover to an IRA from a qualified plan. In addition, the one-rollover-per-year limitation does not apply to a rollover to a qualified plan from an IRA.

- The one-rollover-per-year limitation rule does not apply to trustee-to-trustee transfers.

Violations of the one-rollover-per-year-limit on IRA rollovers can be costly to the taxpayer. The violation of the rollover limitation rule may trigger a taxable event (possible income tax, accuracy penalties, and early distribution penalties), and it could also be treated as an excess contribution that was made to the receiving IRA. An excess contribution to an IRA is subject to a 6% penalty tax that is ongoing on the excess amount that remains in the IRA at the end of each tax year. A special correction rule, withdrawing the penalty, applies to the first year in which an excess contribution is made if the contribution is withdrawn.

A cautionary note here involves spousal IRAs. Where a taxpayer dies and a surviving spouse inherits the decedent's IRA, the surviving spouse becomes the IRA owner.[181] It would appear that the revised rollover rules would arguably prohibit a spouse from taking a withdrawal from his or her own IRA and rolling it over into another IRA and then, within the same taxable year, taking a withdrawal from the deceased spouse's IRA and rolling it into the survivor's IRA. This would violate the "one-rollover-per-year rule" and subject the spouse to income tax on the second rollover and possibly to the 6% excess contribution tax. This potential problem may be avoided by having the surviving spouse accomplish a direct trustee-to-trustee transfer of the decedent's IRA account to the surviving spouse's IRA account.

[181] Revenue Procedure 89-52.

© 2021 AICPA. All rights reserved.

.02 Simplified Employee Pension (SEP) Plans Using IRAs

A SEP plan offers employers a simplified way of providing employees with pensions. SEPs make use of IRAs.

Although a SEP takes the form of an IRA, employees can set up their own IRAs. Participation in the SEP will cause deductions for contributions to the IRA to be phased out for participants with AGIs greater than certain levels (¶915.01).[182]

Employer contributions to a SEP are excluded from the employee's federal gross income (and that of some, but not all, states) and are not subject to employment taxes. Elective deferrals and salary reduction contributions are also excluded from gross income, but they are subject to employment taxes.

Contributions must not discriminate in favor of highly compensated employees. Not more than $290,000 (for 2021) of compensation may be taken into account.[183] This amount is indexed to inflation in $5,000 increments.[184]

Basic advantages. SEPs offer the following advantages:

- Low startup costs
- Low administration costs
- No requirements for yearly contributions to the SEP
- Portability of benefits
- Reduced fiduciary responsibility on the part of the employer

Disadvantages. Possibly, the biggest disadvantage of the SEP for an employer is the required inclusion of part-time or seasonal employees — those short-term employees who arguably provide the least contribution to the company's success.[185]

Also, the employer should be made aware of the SEP provisions related to vesting, withdrawals, employee coverage, and the tax consequences on distribution, all of which are separately discussed in the following paragraphs.

IRS model SEP agreement. The IRS model Form 5305-SEP may be used by employers in establishing SEPs. However, employers who currently maintain any other qualified plan, or who have ever maintained a defined benefit plan, may not use Form 5305-SEP. The advantage of using the model form

---

[182] RC Section 219(g).

[183] IRC Section 408(k)(3)(c).

[184] IRC Sections 401(a)(17) and 404(l).

[185] IRC Section 408(k)(2).

© 2021 AICPA. All rights reserved.

is that the employer is assured that the SEP meets applicable requirements without the need for an additional ruling, opinion, or determination letter from the IRS. Use of this form simplifies ERISA reporting and disclosure requirements. Basically, all the employer has to do is provide copies of the completed form to participants and statements showing contributions made on their behalf.

Coverage. The employer must make contributions on behalf of each employee who has attained age 21, has performed services for the employer during at least three of the immediately preceding five years, and who has received at least $650 (for 2021 and indexed to inflation in $50 increments)[186] in pay during the year.[187]

Full vesting and withdrawals. All employer contributions to a participant's SEP are fully (100%) vested; the employee takes immediate ownership and may withdraw the contributions at any time with the understanding that such withdrawals are subject to income tax and a special penalty tax on a premature withdrawal.

Employer deductions. The contributions made by the employer under a SEP are deductible by the employer for the year in which they are made. The amount of the deduction is limited to 25% of compensation paid during the SEP's plan year. An employer may use its taxable year for purposes of determining contributions to a SEP. The excess of the employer contribution over the 25% limit is carried forward and deductible in future tax years in order of time and is also subject to the 25% limit in each succeeding tax year.[188]

Distributions. SEP distributions are subject to the regulations applicable in determining the required minimum distribution from qualified plans and IRAs. See more details and the Uniform Lifetime table in ¶905.02 and the IRA rules discussed in ¶915.01.

SEPs for persons past age 72. A sole proprietor, partner, or corporate employee who is past the age of 72 may make SEP contributions even after reaching that age. With the SECURE Act, previous limitations on contributions to traditional IRAs beyond age 70 ½ were removed. Age is no longer a limitation to traditional IRAs. It had not been a limitation previously for contributions to SEPs. However, when the SEP holder reaches age 72, minimum distributions must commence at that time. The SEP holder may stretch out the payments by using the Uniform Lifetime table for minimum distributions (shown and discussed in ¶905.02). Under the Uniform Lifetime table, an individual's life expectancy from year to year is never reduced by a full year. Therefore, SEP distributions may be stretched out far beyond the individual's life expectancy, as computed when distributions first commenced.

Salary reduction simplified employee plans. In plan years beginning before January 1, 1997, an employer could establish a salary reduction (cash or deferred) arrangement as part of a SEP. Such arrangements may not be established in plan years beginning after December 31, 1996. However, salary reduction simplified employee plans (SARSEPs) set up before 1997 may continue to operate after 1997,

---

[186] IRC Section 408(k)(8).

[187] RC Section 408(k)(2).

[188] IRC Section 404(h)(1)(C).

© 2021 AICPA. All rights reserved.

subject to the same conditions and requirements that were previously in place. Further, new employees hired after December 31, 1996, may participate in a SARSEP of their employer established before January 1, 1997.

The maximum annual elective deferral under a SARSEP is the lesser of $19,500 for 2021 or 100% of the participant's compensation. The $19,500 limit is indexed for inflation in $500 increments. This limit applies to total elective deferrals under all plans.

The election to have amounts contributed to a SARSEP or received in cash is available only if at least 50% of the employees of the employer who are eligible to participate elect to have amounts contributed to the SARSEP.[189] In addition, the election is available only to employers that did not have more than 25 employees who were eligible to participate (or who would have been required to be eligible if a SARSEP was maintained) at any time during the prior taxable year.[190]

The highly compensated employees may not defer more than 1.25 times the average deferral percentage for all other employees who participate.[191]

For purposes of meeting the participation requirements as to elective (salary reduction) arrangements, an individual who is eligible is deemed to receive an employer contribution.

The attractive feature of a SARSEP, from the employer's standpoint, is that the cost to the employer is limited to the cost of administering the plan. To the extent that owners are able to participate, their tax savings through elective deferrals can help offset the after-tax cost of administration. The latter involves a minimal amount of paperwork and bookkeeping.

Elective contributions are excludable from employees' gross income, but they are subject to Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes.

The employer is deemed to make the contributions that are produced by salary reductions. Accordingly, the employer receives a deduction.

.03 SIMPLE Retirement Accounts

The Savings Incentive Match Plans for Employees (SIMPLE) plans (¶925.02) are intended to encourage employers who currently do not maintain a qualified plan for their employees to set up a SIMPLE plan. These plans can either be set up as an IRA (discussed here) or as a 401(k) cash or deferred plan (discussed in ¶925).

Employers with 100 or fewer employees who received at least $5,000 in compensation from the employer in the preceding year may adopt a SIMPLE plan if they do not maintain another qualified plan. A SIMPLE plan allows employees to make elective contributions of up to $13,500 in 2021 or 100% of

---

[189] IRC Section 408(k)(6)(A)(ii).

[190] IRC Section 408(k)(6)(B).

[191] IRC Section 408(k)(6)(A)(iii).

© 2021 AICPA. All rights reserved.

the participant's compensation.[192] The limit is indexed for inflation in $500 increments. Employers must make matching contributions.[193] Assets in the account are not taxed until they are distributed to an employee, and employers generally may deduct contributions to employees' accounts. In addition, a SIMPLE plan is not subject to the nondiscrimination rules (including top heavy provisions) or other complex requirements applicable to qualified plans. SIMPLE plans allow annual catch-up contributions of $3,000 in 2021 for participants age 50 and older.

SIMPLE plans must be open to all employees who meet the $5,000 compensation qualification,[194] and all employer contributions to an employee's SIMPLE account are immediately vested.[195]

Employees covered by a SIMPLE plan may make elective contributions in greater amounts than they could contribute to traditional IRAs. Unlike contributions to a traditional IRA, the employee's SIMPLE elective contributions must be set up as a percentage of compensation rather than a flat dollar amount.[196]

Employers must use one of two contribution formulas. First, under the matching contribution formula, the employer is generally required to match employee contributions, on a dollar-for-dollar basis, to a maximum of 3% of the employee's compensation for the year. (However, if the employer satisfies certain notice requirements to employees in two out of five years, the employer may choose to match only a maximum of 1% of each employee's compensation.)[197] Alternatively, the employer may make a non-elective contribution of 2% of compensation for each eligible employee who earned at least $5,000 in compensation for the year.[198]

SIMPLE accounts may accept rollovers from an expanded list of retirement plans.

Effective for contributions made after December 18, 2015, rollover contributions to an employee's SIMPLE retirement account are permitted from

- a traditional IRA, under the rollover rules of IRC Section 408(d)(3),
- a qualified trust, under the rollover rules of IRC Section 402(c),
- a qualified annuity, under the rollover rules of IRC Section 403(a)(4),

---

[192] IRC Section 408(p)(2)(A).

[193] IRC Section 408(p)(2)(A)(iii).

[194] IRC Section 408(p)(4).

[195] IRC Section 408(p)(3).

[196] IRC Section 408(p)(2)(A)(ii).

[197] IRC Section 408(p)(2)(C).

[198] IRC Section 408(p)(2)(B).

© 2021 AICPA. All rights reserved.

- a 403(b) tax-sheltered annuity, under the rollover rules of IRC Section 403(b)(8), and
- a governmental IRC Section 457 plan, under the rollover rules of IRC Section 457(e)(16).

However, no rollover contribution is permitted to be made to the SIMPLE retirement account until after the two-year period described in IRC Section 72(t)(6), which is the two-year period beginning on the date that the employee first participated in a qualified salary reduction arrangement maintained by the employer.[199]

Planning Pointer.

Although the SIMPLE IRA plan may be an attractive alternative for a small employer that wants to avoid the administrative complexity associated with other types of qualified plans, those other qualified plans allow greater yearly elective contributions ($19,500 in 2021).[200]

Clearly, having a qualified retirement plan is a good thing for employees. However, employees need to be aware that they will incur a 25% additional excise tax if they withdraw funds from the SIMPLE plan during their first two years of participation.[201]

A participant in a SIMPLE plan may use the minimum required distribution rules that apply to other qualified plans. See ¶905.02 for the Uniform Lifetime table and ¶915.01 for how these rules affect distributions from IRAs.

.04 Roth IRAs

Although the maximum permissible contribution to a Roth IRA is not deductible,[202] distributions from the account are received tax free if certain requirements are met.[203] The maximum amount that a taxpayer may contribute to a Roth IRA is $6,000 for 2021. The $6,000 limit may be adjusted annually for inflation in increments of $500. In addition, taxpayers who are at least 50 years old may contribute an additional $1,000 through 2021. With a traditional IRA, distributions related to deductible contributions are fully taxed as ordinary income, and distributions related to non-deductible contributions are taxed in the same manner as annuity payments (nontaxable return of contributions or ordinary income tax on earnings).

---

[199] IRC Section 408(p)(1)(B).

[200] IRC Section 402(g)(1)(B).

[201] IRC Section 72(t)(6).

[202] IRC Section 408A(c).

[203] IRC Section 408A(d).

© 2021 AICPA. All rights reserved.

Distributions from a Roth IRA are tax-free to the extent that they represent non-deductible contributions to the account. To qualify for tax-free distribution treatment of earnings, the Roth IRA distributions must satisfy a five-year holding period and must also meet one of the following requirements:[204]

- The distribution is made on or after the date the individual attains age 59½.
- The distribution is made to a decedent's beneficiary (or the decedent's estate) on or after the decedent's death.
- The distribution is attributable to the individual being disabled.
- The distribution is a qualified special purpose distribution defined as a qualified first-time homebuyer distribution.[205]

Nonqualifying distributions are treated as coming first from non-deductible contributions, then from previously taxed rollovers and conversions. Thereafter, distributions representing earnings become taxable, if at all, only after all contributions, rollovers and conversions have been recovered.

Unlike a traditional IRA, distributions from a Roth IRA do not have to commence by April 1 in the calendar year in which the individual reaches age 72.[206] In fact, there are no minimum distribution requirements of any kind imposed on the person who contributed to a Roth IRA.

Contributions. An individual may contribute to a Roth IRA after reaching age 72, as is now the case for traditional IRAs following the SECURE Act.[207]

An individual's ability to contribute to a Roth IRA is phased out in 2021 for single individuals and heads of households with modified AGI between $125,000 and $140,000; for joint filers with AGI between $198,000 and $208,000 ; and for a married individual filing a separate return between $0 and $10,000.[208]

Rollovers and conversions. Amounts in a traditional IRA may be rolled over into a Roth IRA and, after the income tax is paid, these amounts may be entitled to future tax-free distributions under the Roth IRA rules.[209]

The 10% excise tax will not apply to the IRA rollover distribution.

---

[204] IRC Section 408A(d)(2)(A).

[205] IRC Sections 408A(d)(2)(A)(iv), 408(d)(5), and 72(t)(2)(F).

[206] C Section 408A(c)(5).

[207] IRC Section 408A(c)(4).

[208] IRC Section 408A(c)(3).

[209] IRC Section 408A(c)(3)(B).

© 2021 AICPA. All rights reserved.

Since 2010, anyone can convert a traditional IRA to a Roth IRA, regardless of the amount of AGI reported and irrespective of their filing status.

Pros and cons of Roth IRAs. Roth IRAs offer financial planners and their clients attractive tax benefits and a good measure of flexibility. However, Roth IRAs also have disadvantages. The following list notes the advantages and disadvantages of Roth IRAs, as contrasted with those of traditional IRAs.

Advantages of Roth IRAs

- If the relevant qualifications are met, qualified distributions from Roth IRAs are not taxable.[210]

- If the accumulation period is long, the benefit from the tax exempt treatment of the Roth IRA distributions should outweigh the tax deductions allowed for contributions to a traditional IRA. This possibility will be enhanced when high-appreciation-potential investments (such as growth-oriented stocks and certain mutual funds) are housed in the Roth IRA.

- The primary tax benefit flowing from the Roth IRA (contributions that will later produce tax-free distributions) does not begin to be phased out until single individuals have modified AGI (for 2021) of at least $125,000 and married taxpayers filing jointly have modified AGI of at least $198,000. The primary benefit associated with traditional IRAs (deductible contributions that will later produce taxable distributions) begins to be phased out for taxpayers who are active participants in a qualified plan when income (for 2021) reaches $105,000 for joint filers ($0 for married persons filing separately) or $66,000 for singles, heads of households, and surviving spouses.[211]

- Unlike a traditional IRA, the law does not require that distributions from a Roth IRA begin in the year in which the individual participant attains age 72.[212]

- Contributions to a Roth IRA may continue after the individual reaches age 72. [213] The Roth IRA contributor is never forced to take required minimum distributions.

- If a Roth IRA distribution has met the requirements to be tax-free when received, the distribution would not increase the AGI base for taxation of Social Security benefits or for the 3.8% tax on net investment income, or with respect to the cost of Medicare parts B and D, unlike distributions from a traditional IRA.[214] Depending on the amount of income that the individual receives in addition to the Social Security benefits (¶3505), this advantage could be significant.

---

[210] IRC Section 408A(d)(1).

[211] IRC Section 219(g).

[212] IRC Section 408A(c)(5).

[213] IRC Section 408A(c)(4).

[214] IRC Section 86.

© 2021 AICPA. All rights reserved.

- Under the ordering rules that determine taxation of withdrawals from Roth IRAs that are not qualified distributions, amounts that do not exceed the individual's accumulated contributions in the account may be withdrawn tax-free.[215] These ordering rules differ from the rules applicable to ordinary IRAs that require early withdrawals to be taxed as income and are subject to the 10% additional tax. Consequently, Roth IRAs give the owner the flexibility to meet unexpected financial emergencies without an immediate tax disadvantage. However, withdrawing money from a tax-advantaged IRA is not something to be done lightly. Taking the money out early forfeits the tax-free buildup on the contributions. Additionally, once accumulated Roth IRA contributions are withdrawn, the taxpayer may not contribute them back to the account. However, the individual may continue to make the maximum yearly contributions to the account while still eligible to do so. Eligibility to make contributions to a Roth IRA requires that the taxpayer earn income in an amount that is at least equal to his or her Roth IRA contribution.

- A traditional IRA may be converted to a Roth IRA. The conversion is an income taxable event, but the subsequent growth of the account and its withdrawal can be free of further income tax. Roth conversions done prior to 2018, could be "undone" by declaring a recharacterization of the Roth IRA to the traditional IRA by October 15 of the following year, and no taxable event will be deemed to have occurred. However, the 2017 TCJA eliminated the recharacterization opportunity for Roth conversions done in 2018 and beyond.

- The Roth IRA presents an interesting planning opportunity in the context of IRC Section 199A. If the taxpayer is eligible to claim a qualified business income (QBI) deduction, but taxable income is less than QBI (possibly due to a generous retirement plan contribution deduction) consider doing a Roth conversion to increase taxable income to more closely approach — or even exceed — QBI. The 20% deduction will then be computed on a larger number, the lesser of QBI or taxable income, giving the taxpayer a larger deduction. This larger deduction will help offset the impact of the taxable income from the Roth conversion. When all is done, the taxpayer will have a Roth IRA, an IRC Section 199A deduction, at the cost of some taxable income, but not as much as would have been the case if the Roth conversion was done without the IRC Section 199A deduction in the same year, or if the IRC Section 199A deduction was smaller due to reduced taxable income without the Roth conversion.

- The political risk of higher income taxes in future years suggests that 2021 may be the ideal year to recommend a Roth IRA conversion. Disadvantages of Roth IRAs

- No current deduction is allowed for amounts contributed to a Roth IRA.[216] This compares unfavorably with a traditional IRA deduction, which reduces the initial cost of the contribution.[217]

---

[215] IRC Section 408A(d)(4)(B).

[216] IRC Section 408A(c)(1).

[217] IRC Section 219(a).

© 2021 AICPA. All rights reserved.

- The advantage to be gained from the tax-free distributions from Roth IRAs might not outweigh the lost deductions for contributions, particularly if the number of years to accumulate the benefits is not great. In addition, the individual might be in a lower tax bracket at retirement than when the individual made the contributions. If the individual is a conservative investor, it may take a long time to earn back the required income taxes paid on the conversion from the traditional IRA to the Roth IRA.

- Although new contributions to Roth IRAs are likely to be advantageous, the same might not be true of rollovers from traditional IRAs to Roth IRAs. A taxpayer must pay tax on the rollover to the extent that the amount exceeds the taxpayer's basis, if any, in the traditional IRA.[218] The higher the tax bracket a taxpayer is in, the less likely the conversion will be beneficial, unless there is a long time span after the conversion with tax-free buildup and appreciation in the Roth IRA.

- Some individuals might not feel comfortable with trading the upfront tax advantage available with a traditional, deductible IRA for the future tax benefit promised by a Roth IRA. Congress may amend the tax law, and nothing can prevent a later Congress from reducing or eliminating the benefits of a Roth IRA.

- The SECURE Act changed the time period over which the Roth IRA's plan participant's designated beneficiaries must withdraw the funds in the plan. For most designated beneficiaries (other than Eligible Designated Beneficiaries) the plan funds must be withdrawn by the end of the tenth year following the year of the plan participant's death.

Planning Pointer.

Given the income tax rates in effect for 2021 on high-income-earning taxpayers and the risk of higher future tax rates to be enacted, Roth conversion advice must be considered. The future growth of the Roth IRA will be tax-free in times of possibly higher income tax rates. If a Roth conversion is done, and if the value of the IRA account declines following the conversion, the taxpayer will no longer have until October 15 of the following tax year (after 2018) to recharacterize the conversion of the traditional IRA to the Roth IRA back to the traditional IRA, with no resulting adverse tax consequences. The "hedge" opportunity of the Roth IRA conversion has been eliminated.

Proactive Planning Toolkit

Legislation like the TCJA, SECURE Act, CARES Act, the CAA, and the American Rescue Plan Act have added more complexity to financial planning. Technical content, tools, and other resources are available to PFP Section members in the Proactive Planning Toolkit to help you get up to speed on all of the intricacies so that you can educate your clients and proactively help them meet their life goals and give them peace of mind while navigating the complex financial landscape.

Bear in mind that as distinguished from the Roth IRA rules, amounts held in a Roth 401(k) account are subject to the required minimum distribution rules. Although a traditional 401(k) plan may now be

[218] IRC Section 408A(d)(3)(A)(i).

© 2021 AICPA. All rights reserved.

converted to a Roth 401(k) plan, the participant must begin withdrawing minimum distributions from the Roth 401(k) plan at age 72. Planning here suggests converting the Roth 401(k) plan to a Roth IRA (a tax-free conversion) prior to age 72. If this is done, no minimum distributions will be required from the Roth IRA, under current law.

¶920 Profit-Sharing Plans

Profit-sharing plans offer very attractive tax advantages:

- The employer makes contributions to the plan for the future benefit of employees, but the employer receives a current deduction.
- Employer contributions are not taxable to the employee when made, which means all of the contribution is invested for the benefit of the employee.
- Income earned on invested contributions (by both employer and employee), earnings on earnings, and realized appreciation are not taxed while they are in the plan.
- When the employee receives distributions on retirement, the employee receives favorable tax treatment under the annuity rules (or, if eligible, the lump-sum distribution rules), as discussed in ¶905.02. If the employee takes a distribution in employer stock that has appreciated in value over the stock's basis in the plan, no tax at all is paid on the appreciation (the net unrealized appreciation) until the employee sells the employer stock (unless the employee elects otherwise).

From the employer's standpoint, one of the key features of a profit-sharing plan is that it allows excellent cost control. Also, contributions are permitted to be made by the employer, even in the absence of profits.

.01 Making Plans Effective

Financial planners do not have to be pension and profit-sharing experts. However, they should be legitimately concerned with measures that can serve to make profit-sharing plans more effective instruments for attaining both company and employee objectives. Some of the ideas the financial planner should explore are described in the following paragraphs.

Individual investment choice. The law recognizes individual account plans in which the participant is permitted to exercise independent control over the assets in his or her individual account. In these cases, the individual is not regarded as a fiduciary, and the other fiduciaries are not liable for any loss that results from control by the participant or beneficiary. With this approach, the employee is placed in essentially the same position as if the employee received cash and was left to invest it. However, the employee has the enormous benefit of the tax shelter offered by the plan.

Under Department of Labor regulations, a plan sponsor can be held liable for imprudent investment decisions by participants of individual retirement account plans unless the plan offers a broad range of investment alternatives.

Choice of funds. Typically, different investment funds are set up within the plan, and the plan gives the participant a choice among various funds. The employee might have a choice of bonds, common stock, balanced or venture funds, mutual funds, or some combination of these funds.

© 2021 AICPA. All rights reserved.

Access to cash. A profit-sharing plan may make benefits available to participants after a relatively brief deferral period (as little as two years). However, a 10% additional tax is imposed on early withdrawals by the participant from the plan.[219]

Pension floor. A supplemental defined benefit pension plan can be used to provide a floor for retirement benefits. This defined benefit plan puts part of the risk of the profit-sharing plan's poor performance on the company. However, this will only work when the company is able and willing to assume the risk. The use of a SEP plan is another possibility to be considered.

Minimum guarantees by company. In lieu of adopting a supplemental defined benefit plan, some companies guarantee a minimum annual contribution to the profit-sharing plan out of accumulated earnings in years in which the company has no profits.

Another possibility is for the company to guarantee investment performance of the plan up to a set amount.

.02 Incidental Insurance

Profit-sharing plans are looked upon primarily as a source of benefits for the participant while living. However, the trust created by the plan may buy insurance on the life of the participant, provided that the insurance is merely incidental. The insurance is considered incidental in the case of a profit-sharing plan if the aggregate life insurance premiums for each participant are less than one half the total contributions standing to his or her credit at any specific time. The plan must require that, on retirement, the policy either be distributed to the participant or be converted by the trustee into cash to provide periodic payments.

The premiums paid by the company for incidental insurance are deductible by the company and only the pure insurance portion of the premiums, determined under a special rate table, is taxable to the participant.[220] The participant may be able to exclude the insurance proceeds from his or her gross estate if the policy meets the requirements of IRC Section 2042. This usually requires the participant to remove the life insurance policy from the plan and transfer it to an irrevocable life insurance trust more than three years prior to the participant's death.

¶925 Cash or Deferred (401(k)) Arrangements

IRC Sections 401(k) and 402(a)(8) permit employers to establish cash or deferred arrangements (often referred to as 401(k) plans) as part of a qualified plan. Under a 401(k) plan, the employee is given a choice of receiving cash or making a contribution (or having one made by the employer) to a qualified plan and deferring tax on the amount contributed to the plan.

---

[219] IRC Section 72(t).

[220] Regulation Section 1.79-3(d)(2).

© 2021 AICPA. All rights reserved.

.01 In General

The plan may be in the form of a salary reduction agreement. For example, under such an agreement, an employee could elect to reduce current compensation or forego a raise and have the amounts foregone contributed to the plan on his or her behalf. This particular feature makes the 401(k) very attractive to employers. Employers may adopt a 401(k) plan without added payroll costs other than the costs of setting up and administering the plan.

The 401(k) plan also has advantages for the employee. A 401(k) plan permits employees to provide for their own retirement with pretax dollars, rather than with after-tax dollars. The income generated by their contributions also avoids current taxation. The employees who choose contributions to the plan receive less current cash, but they pay correspondingly lower taxes. By choosing a contribution, employees who would have saved a like amount in the absence of a plan can receive more spendable cash. The employee may change the choice of cash or contribution annually, as the employee's needs and circumstances change.

Note that a plan contribution can be the default option for a 401(k) plan. Employees who do not wish to contribute (or who wish to make a smaller or larger contribution) must make an affirmative election.

401(k) plans may allow participating employees to designate all or part of their elective deferrals to the plan to be treated as after-tax Roth contributions.

IRC Section 402A. The designated Roth contributions are generally treated in the same manner as pretax elective deferrals for purposes of limitations and nondiscrimination requirements, except that the plan must account for the Roth contributions separately. Although the employee is required to include the Roth contributions in gross income, the distributions from a Roth 401(k) are subject to rules similar to those applicable to Roth IRA distributions. Section 457 plans are now permitted to include a designated Roth contribution program.

A traditional 401(k) plan can be converted to a Roth 401(k) plan. However, use caution because a Roth 401(k) plan requires the participant to begin withdrawing minimum distributions upon attaining age 72. If the Roth 401(k) plan is converted (tax free) to a Roth IRA, no minimum distributions to the participant are required from a Roth IRA.

Planning Pointer.
The financial planner should consider recommending that a client who is participating in a Roth 401(k) plan convert that plan to a Roth IRA plan. There is no tax consequence on making that conversion because the contributions to the Roth 401(k) plan were already included in the client's gross income. If the conversion to the Roth IRA is accomplished, the client will be free of the rule of the Roth 401(k) requiring minimum distributions from the plan. Participants will not be required to take required minimum distributions from the Roth IRA.

Cap on deferrals. An aggregate cap applies to elective deferrals for all plans in which an employee participates. The cap is $19,500 for 2021. The limit is indexed for inflation in $500 increments. This cap does not bar matching contributions by the employer up to maximum contributions in the aggregate of

© 2021 AICPA. All rights reserved.

$58,000 in 2021 by the employer and employee.[221] This limit is indexed for inflation in $1,000 increments.[222]

Qualification requirements. In general, an IRC Section 401(k) arrangement must be part of a plan that meets the general requirements for being a qualified plan. It must also meet special tests that prevent income deferrals made by highly compensated employees from exceeding a certain level determined with reference to deferrals by non-highly compensated employees.

Hardship withdrawals. Hardship withdrawals are permitted only if the participant or beneficiary of the plan has an immediate and serious financial need and other resources are not reasonably available to meet the need. The plan or other legally enforceable agreement must prohibit the employee from making any contribution to the plan or any other plan maintained by the employer for at least six months after the employee receives a hardship withdrawal.[223]

The IRS issued guidelines on February 23, 2017, addressing hardship withdrawals from 401(k) plans. Unlike a loan from the plan, participants do not have to repay the funds accessed via a hardship withdrawal. Absent proof of hardship, however, the withdrawal may be subject to the 10% excise tax. The plan participant must prove there is a serious and immediate need for the money and that the distribution is necessary to satisfy that need.

Items that qualify for hardships include expenses related to medical care, purchase of a principal residence, tuition, prevention of eviction from a principal residence, burial or funeral expenses, and repair of damages to a principal residence. The IRS requires verification that a distribution is for one of the foregoing reasons. IRS auditors are instructed to look for "source documents," such as estimates, statements, and receipts, addressing the hardship or a summary in paper or electronic format or telephone records verifying the information contained in the source documents. It is important for the participant to retain these documents and make them available to the plan sponsor or administrator upon request.

Wide availability. Tax exempt organizations may establish 401(k) plans for their employees.[224]Rural cooperatives and Indian tribal governments may also establish 401(k) plans, but state and local governments (and their political subdivisions) still may not set up cash or deferred plans.[225]

A rule referred to as the *same desk rule* for distributions from 401(k) plans, 403(b) plans, and 457 plans has been repealed. Under the same desk rule, the law formerly treated a participant as not having separated from service if the employee retained the same job for a new employer following a liquidation, merger, or acquisition. Under current rules, an employee will not be prevented from

---

[221] IRC Section 415(c)(1) and Notice 2020-79 (January 1, 2021).

[222] IRC Section 415(d).

[223] Regulation Section 1.401(K)-1(d)(3)(iv)(E)(2).

[224] IRC Section 401(k)(4)(B)(i).

[225] IRC Sections 401(k)(4)(B)(ii) and 401(k)(4)(B)(iii).

© 2021 AICPA. All rights reserved.

receiving distributions from a plan if continuing in the same job for a different employer following a liquidation, merger, or acquisition.[226]

.02 SIMPLE 401(k) Plans

An employer that does not employ more than 100 employees or maintain another qualified plan may set up a SIMPLE plan as part of a 401(k) arrangement. SIMPLE plans in the form of an IRA are discussed in ¶915.03.

Under a SIMPLE 401(k) plan, the nondiscrimination rules (including the top-heavy rules) do not apply, provided that each of the following three requirements is met:[227]

1. Elective deferrals made by the employee in a year do not exceed $13,500 in 2021. This limit is indexed for inflation in $500 increments. These deferrals must be computed as a percentage of compensation, not as a fixed-dollar amount.

2. The employer makes contributions matching the employee's elective deferrals up to a maximum of 3% of employee compensation. Alternatively, the employer may make a nonelective contribution of 2% of compensation for each eligible employee who earned at least $5,000 from the employer for the year.

3. No other contributions are made under the arrangement.

Employer contributions must be immediately vested in the employees' accounts.

Planning Pointer.

SIMPLE 401(k) plans may be an attractive alternative for small employers who want to set up a qualified plan because they lack the administrative complexity that is normally present. However, under a regular 401(k) plan, participants may contribute a greater amount each year than under a SIMPLE plan.

Employers should also note that unlike SIMPLE-IRA plans, SIMPLE 401(k) plans are not allowed to reduce matching contributions less than 3% by reason of the two-of-five year rule (¶915.03).

If the SIMPLE plan rules encourage the establishment of retirement plans by employers that otherwise would not have done so, the SIMPLE plan will certainly be advantageous to employees. However, employees should know that they will incur an additional excise tax of 25%[228] if they withdraw funds from the SIMPLE plan during their first two years of participation.

---

[226] IRC Sections 401(k)(2)(B)(i), 403(b)(7)(A)(ii), 403(b)(11)(A), and 457(d)(1)(A)(ii).

[227] IRC Section 401(k)(11).

[228] IRC Section 72(t)(6).

© 2021 AICPA. All rights reserved.

.03 Single (Individual) 401(k) Plans

These plans are available to sole proprietors or partners who have no common law employees. The plan can be funded by both employer and employee contributions on behalf of the individual participant. The maximum deductible employer contribution is 25% of compensation for 2021, capped at $58,000. An employee contribution can be made either as a pretax or Roth employee deferral contribution for up to $19,500 for 2021 ($26,000 in 2021 for employees age 50 or older). The total contributions (the combined amount of employer plus employee contributions) may not exceed $58,000 for 2021 ($64,500 for employees age 50 or older). A plan participant can borrow from a 401(k) plan as long as the applicable borrowing rules are observed.

¶930 Pension Plans

The three basic types of pension plans are as follows:

- A defined benefit plan, which promises fixed or determinable benefits
- A target plan, which aims at providing a certain benefit (the target benefit) but does not promise it
- A money purchase plan, in which there are fixed employer contributions and the participant gets whatever benefit his or her pension account will ultimately buy

All three may be viewed as a way of spreading an employee's compensation over his or her lifetime, including the period after retirement. A tax-qualified pension plan offers all the well-known tax advantages of any qualified plan:

- The employer receives a current tax deduction for contributions to the plan.
- The employee is not currently taxed.
- The pension fund grows in a tax-sheltered deferred environment and certain benefit distributions may receive favorable tax treatment.

From the employer's point of view, pension plans have always involved a long-term commitment to support the plan financially in good times and bad times so long as the plan continues. A financially healthy employer with confidence in future strength is most likely to make the commitment. Terminating pension plans is difficult. The excise tax on reversions of plan funds to the employer is generally 50%.[229] This tax is reduced to 20% if a qualified replacement plan is set up and maintained.[230] These cost factors encourage the adoption of nonguaranteed arrangements, such as profit-sharing plans and cash or deferred plans, including salary reduction plans, stock bonus plans, ESOPs, thrift plans, and IRAs. However, none of these plans offers a perfect solution to satisfy the needs of both the company and the employee.

---

[229] IRC Section 4980(d)(1).

[230] IRC Section 4980(a).

© 2021 AICPA. All rights reserved.

The defined benefit plan still has an important role in some situations; it can provide a benefit based upon 100% of average compensation for the employee's highest three earning years, whereas a profit-sharing plan is basically a plan based on average earnings over the employee's career. This benefit of a defined benefit plan might be especially attractive to shareholder executives in closely held corporations.

The future of defined benefit plans must rest on holding costs in check. The vital element in pension planning remains the same — keeping a balance between costs and benefits on a scale the company can financially support. In recent years, many companies have determined that the cost of their defined benefit plans was too high, and the plan benefits were either reduced or eliminated (or converted into a defined contribution plan or an employee deferral plan). Currently, the largest use of defined benefit plans is for employees of state and local government bodies, where cost restraint seems less of a concern.

The factors to be taken into account and the methods of holding down costs will vary from company to company. These factors and methods depend on the nature of the operation, the character of the work force, its age and composition, turnover, and union affiliations.

A company might decide to participate in a ready-made, master or prototype plan sponsored by a trade association, insurance company, mutual fund, or bank. If a substantial number of employees are involved, the company should most likely call in plan design experts to tailor a plan to the company's own situation and that of its employees. The experts will marshal the facts, make the projections and actuarial assumptions for various alternatives, and leave the final decision to the company. The company might want to check what the competition is doing or has done. The following is a list of factors that will affect the costs and benefits of a defined benefit plan:

- *Coverage and participation*. A plan may exclude certain employees (¶905). Use of independent contractors and leased employees can also hold down costs. Although rules can cause leased employees to be treated as actual employees for employee benefit plan purposes, it is generally not the case if a leased employee works for the employer for less than one year.[231]

- *Type of plan*. Money purchase and target plans, as distinguished from defined benefit plans, can limit costs.

- *Benefit formula*. A formula using a career average compensation yields lower cost to the employer than a final pay formula.

- *Incidental benefits*. A no frills approach obviously keeps costs down. Incidental benefits include disability insurance, death benefits, and health and accident benefits for retired employees.

- *Integration with Social Security*. An integrated plan begins with a few Social Security benefits as its base and then has the employer supplement these benefits so that a coordinated retirement plan results. This integration with Social Security also can help reduce costs.

[231] IRC Section 414(n).

© 2021 AICPA. All rights reserved.

- *Employee contributions*. Mandatory contributions can cut costs. Voluntary contributions permit an employee to increase his or her benefits.

- *Vesting formula*. Which minimum standard (¶905) will produce lower costs, taking into account age, composition of employees, and expected rates of turnover? This answer will vary from company to company, often depending on the type of business being done.

- *Retirement age*. The older the retirement age (up to age 65), the lower the cost of providing specific benefits. If the plan allows early retirement, reduced benefits on a sound actuarial basis might reduce cost.

- *Investment and actuarial assumptions*. All costs, liabilities, rates of interest, and other factors under the plan must be determined on the basis of actuarial assumptions and methods. Each of these assumptions must be reasonable, taking into account the experience of the plan and reasonable expectations. Alternatively, in the aggregate, the assumptions must result in a total contribution equivalent to the contribution that would be obtained if each assumption was reasonable. Further, the actuarial assumptions and methods must, in combination, offer the actuary's best estimate of anticipated experience under the plan.

- *Past service*. Providing benefits for service before the adoption of the plan obviously adds to cost. Nevertheless, providing benefits for past service might be necessary because of practical considerations, such as attracting desirable employees. IRC Section 415 bars the use of such service in determining the maximum benefit allowable.

- *Speed of funding*. Generally, the faster funding takes place, the lower the cost, because income of the fund accumulates tax-free inside the plan and would be taxable outside the fund. However, a cap applies to the deductible amount. In addition, a 10% excise tax applies to non-deductible contributions.[232]

.01 Money Purchase Plan

A money purchase pension plan calls for a specified contribution by the employer, such as a percentage of compensation of each covered employee. The plan promises no specific benefit. The employee receives whatever benefits the aggregate contributions will buy at retirement, plus the income and gains realized. This approach, by itself, gives no recognition to past service. For this reason, employers sometimes supplement it with a unit-benefit approach that may give credit for past service.

.02 Target Plan

A target benefit plan can be described as a hybrid of a defined benefit plan and a money purchase plan. It resembles a defined benefit plan in that annual contributions are based on the amount necessary to buy specified benefits at normal retirement. However, it differs from a defined benefit plan in that it does not promise to deliver the benefits, but merely sets the specified benefit as a target. Therefore, as in a money purchase plan (and a profit-sharing plan), the ultimate benefit depends on investment experience.

---

[232] IRC Section 4972(a).

© 2021 AICPA. All rights reserved.

A contribution to a target plan, once made, is allocated to the separate accounts of the participants, as are increases or decreases in trust assets. Decreases in the trust assets are at the risk of the participants, rather than the employer. In a defined benefit plan, the employer must make greater contributions if trust assets decrease in value. Likewise, gains in asset value are for the benefit of the participants and do not reduce the employer's contributions.

.03 Incidental Life Insurance

Pension plans are primarily for retirement benefits, but they may include incidental life insurance benefits.[233] Under regular pension plans, coverage under an ordinary plan (for example, a whole life policy) is considered incidental so long as the face amount of the policy does not exceed 100 times the projected monthly benefit. With money purchase pension plans, the same limitation applicable to profit-sharing plans is used. The aggregate premiums for an ordinary policy must be less than one half of the amount standing to the credit of the participant at any specific time.[234]

The company may deduct the premiums paid for incidental life insurance. The pure insurance portion of the premium, determinable under a special table,[235] (see ¶945.01) is taxable to the participant. The participant may exclude the insurance proceeds from his or her gross estate if the policy satisfies the requirements of IRC Section 2042.

¶935 Thrift and Savings Plans

Thrift plans may possess the predominant characteristics of a profit-sharing plan, a pension plan, or a stock bonus plan. All forms of thrift plans, however, have one common characteristic: the employee-participants contribute some percentage of their compensation to the plan and the employer matches their contributions dollar-for-dollar, or in some other way spelled out in the plan. The plan may or may not be tax qualified.

When the plan is tax qualified, the employer receives a current income tax deduction for its contributions to the plan, and the employee is not currently taxed on such contributions. The employee's own contribution is not tax deductible but comes out of after-tax dollars. Both employer and employee contributions are free to grow within the plan tax deferred, and withdrawals and distributions are subject to the same taxation rules applicable to pension, profit-sharing, and stock bonus plans.

In the typical plan, the employee is required to contribute a percentage of compensation if the employee is to participate in the plan. If too high of a percentage was required, the lower paid employees would be unable to participate in the plan, and only the highly compensated employee would benefit. Special, complex nondiscrimination rules contained in IRC Section 401(m) prevent this situation.

A savings plan differs from the type of thrift plans previously discussed in that it may simply be an adjunct plan to an otherwise qualified pension, profit-sharing, or stock bonus plan, with the employee

---

[233] Regulation Section 1.401-1(b)(1)(i).

[234] Revenue Ruling 66-143, 1966-1 CB 79 (January 1, 1966); Revenue Ruling 61-164, 1961-2 CB 99.

[235] Regulation Section 1.79(3)(d)(2).

© 2021 AICPA. All rights reserved.

permitted to make voluntary contributions out of after-tax dollars in order to receive the tax shelter of deferring income tax liability on the growth of the plan assets that the plan affords. IRC Section 401(m) limits the amount of voluntary contributions the highly compensated may make, depending on the contributions made by other employees. The more generous the contribution opportunity offered for the rank-and-file employees, the greater the benefits that become available to the highly compensated.

A thrift plan may permit an employee to suspend contributions temporarily without losing the right to participate in the plan. Most plans permit withdrawals while the employee is still on the job, usually with some conditions attached. Some thrift plans provide for periodic distributions at specified intervals (for example, five years). On retirement, death, or disability, the entire amount in the employee's account usually becomes payable, although the plan may provide for other types of distributions.

¶940 Borrowing From the Plan

The terms of a qualified plan may permit the plan to lend money to participants without adverse income or excise tax results, if certain requirements are met.

In general, the law treats loans from qualified plans as distributions.[236] However, a loan will not be treated as a distribution to the extent aggregate loans to the employee do not exceed the lesser of (1) $50,000 or (2) the greater of one half of the present value of the employee's vested accrued benefit under such plans, or $10,000. The $50,000 maximum sum is reduced by the participant's highest outstanding loan balance during the preceding 12-month period.[237]

Plan loans generally must be repaid within five years,[238] unless the funds are used to acquire a principal residence for the participant.[239]

In addition, plan loans must be amortized in level payments and loan repayments must be made on no less than a quarterly basis over the term of the loan.[240] The deduction of interest on all loans from qualified plans by the employee is subject to the general interest deduction limitations, which generally deny a tax deduction for personal interest paid.[241] However, interest on loans secured by elective deferrals and interest on loans to key employees are not deductible in any event.[242]

---

[236] IRC Section 72(p)(1)(A).

[237] IRC Section 72(p)(2)(A).

[238] IRC Section 72(p)(2)(B)(i).

[239] IRC Section 72(p)(2)(B)(ii).

[240] IRC Section 72(p)(2)(C).

[241] IRC Section 163(h).

[242] IRC Section 72(p)(3).

© 2021 AICPA. All rights reserved.

An unreasonable rate of interest may cause the plan to be disqualified.[243]

Repayments of loans, including those treated as distributions, are not considered employee contributions under the rules limiting employee contributions or limiting additions to defined contribution plans.

The CARES Act of 2020 has increased the loan limitation from qualified plans and provided coronavirus related relief for the timing of repayments. The Act temporarily increases the plan loan dollar limits for qualifying individuals (i.e. persons who suffered either an illness or a family or economic hardship as a result of the virus) to the lesser of (1) $100,000 or (2) the greater of $10,000 or 100% of the present value of the participant's vested benefit. This relief provision only applies to loans taken out within 180 days of enactment of the Cares Act (March 27, 2020). If the due date of an existing loan occurred between March 27, 2020 and December 31, 2020, it will be delayed for one year.

A pledge of the participant's interest under the plan or an agreement to pledge such interest as security for a loan by a third party, as well as a direct or indirect loan from the plan itself, is treated as a loan.[244]

The plan administrator is subject to loan reporting requirements. In addition, the employee must furnish the employer plan with information on loans.

Loans to S corporation shareholders, partners, and sole proprietors qualify for the statutory exemption to the excise tax under the prohibited transaction rules of IRC Section 4975. The prohibited transaction rules still apply to loans from IRAs.

If a participant fails to make a loan payment when it is due, the plan administrator may allow a cure period. The IRS limits the cure period to the last day of the calendar quarter after the calendar quarter in which the loan payment was due. If the participant does not cure the default, the entire loan balance, including any accrued interest, is treated as a deemed distribution to the participant, subject to income tax and possibly to the 10% excise tax as well.[245]

¶945 Group-Term and Group Permanent Life Insurance

.01 In General

Group-term life insurance has been a valuable tax-favored employee benefit for many years. An employer may provide up to $50,000 of group-term life insurance coverage, on a tax-free basis to employees, under a plan that meets the requirements of IRC Section 79 and the regulations thereunder. An employer may make amounts of life insurance in excess of $50,000 available on favorable terms.

---

[243] Revenue Ruling 89-14, 1981-1 CB 111.

[244] IRC Section 72(p)(1)(B).

[245] Regulation Section 1.72(p)-1, Q&A 10.

© 2021 AICPA. All rights reserved.

The plan may not discriminate in favor of key employees. If the plan discriminates in favor of key employees, the $50,000 exclusion will not apply to the key employees.[246]

The cost of employer-provided group-term life insurance is treated as wages for FICA purposes to the extent the cost is includible in gross income for income tax purposes.[247]

Retired and disabled employees. The amount of group-term life insurance coverage that an employer may provide tax-free to a disabled employee who has terminated employment is unlimited.[248] The same has been true of retirees. However, retirees are generally subject to the $50,000 ceiling, subject to a grandfather rule for those retirees covered under a plan in existence on January 1, 1984 (or any comparable successor plan), who attained age 55 on or before that date and who either (1) were employed by the company during 1983 or (2) retired on or before January 1, 1984, and who, when they retired, were covered by a group-term life insurance plan of the employer (or a predecessor plan).

Tax treatment to employer and employee. If the employer is not a direct or indirect beneficiary of the policy and all other IRC Section 79 requirements are met, the employer receives a deduction for the insurance premiums paid.[249]

Insurance Provided on or After July 1, 1999, Five-Year Age Bracket Cost-per-$1,000 of Protection for One-Month Period	
Under 25	$.05
25 to 29	.06
30 to 34	.08
35 to 39	.09
40 to 44	.10
45 to 49	.15
50 to 54	.23
55 to 59	.43
60 to 64	.66
65 to 69	1.27
70 and over	2.06

[246] IRC Section 79(d)(1)(A).

[247] IRC Section 3121(a)(2)(C).

[248] IRC Section 79(b)(1).

[249] IRC Sections 162(a) and 264(a)(1).

[250] IRC Sections 79(a) and 79(c).

© 2021 AICPA. All rights reserved.

These cost-per-$1,000 figures are arbitrary and are not related to the actual premiums paid for the coverage. To illustrate how to use the premium tables, consider a key employee who is age 45 and covered by $150,000 of group-term life insurance. The employee's gross income attributable to the insurance coverage over $50,000 is calculated as follows:

> Step 1: Cost of insurance per $1,000 for an individual age 45 for one year ($.15 × 12) = $1.80
>
> Step 2: Amount to be included in the employee's gross income for the insurance coverage over $50,000 is $180 = (100 × $1.80).

This sum is added to the employee's gross income.

Note that state law may decrease the $50,000 ceiling; the amount of tax-free coverage to the employee may not exceed a state ceiling.[251]

.02 Effect of Changing Insurers or Policies

Often, an employer may cancel a group-term policy with one insurance company and purchase a new policy with a new carrier, possibly one offering better service or lower rates.

Two important questions arise as the result of such change:

1. If, following the change, the insured makes a new assignment of incidents of ownership in the new policy to the assignee of the old policy, does the new assignment start a new three-year period for purposes of IRC Section 2035? This IRC section includes all gifts of life insurance made within three years of death in the gross estate of the transferor.

2. Is an assignment of all rights in a current group-term policy and of rights under any arrangement for life insurance coverage provided by the employer effective as a present transfer of rights under a policy issued by a new carrier?

The IRS in Revenue Ruling 79-231[252] answered yes to the first question and no to the second. In 1980, the IRS revoked this ruling and gave a conditional no answer to the first question but seemed to adhere to the prior no answer to the second question.[253]

The facts in both Revenue Ruling 79-231 and Revenue Ruling 80-289 were identical. They were as follows:

> In 1971 an employee who was insured under a group-term life insurance policy, the premiums for which were paid by the employer, assigned to his spouse all rights under the policy and under any arrangement of the employer for life insurance coverage. In 1977, the employer terminated the arrangement with one insurance carrier and entered into an arrangement with a new carrier

---

[251] Regulation Section 1.79-3. IRS Publication 15-B.

[252] 1979-2 CB 323.

[253] Revenue Ruling 80-289, 1980-2 CB 270.

© 2021 AICPA. All rights reserved.

> identical in all relevant respects to the prior arrangement. Shortly thereafter and within three years of death, the employee executed an assignment of all his rights under the new policy to his spouse.

Rev. Rul. 80-289 states:

> The Internal Revenue Service maintains the view that the anticipatory assignment was not technically effective as a present transfer of the decedent's rights in the policy issued by Z [the new carrier]. Nevertheless, the IRS believes that the assignment in 1977 to D's (deceased employee's) spouse, the object of the anticipatory assignment in 1971, should not cause the value of the proceeds to be includible in the gross estate of the decedent under IRC Section 2035 where the assignment was necessitated by the change of the employer's master insurance plan carrier and the new arrangement is identical in all relevant aspects to the previous arrangement with Y [the prior carrier].

Thus, the ruling appears to be based on fairly narrow grounds. Consequently, prudence suggests that assignments of group-term insurance in situations where the employer has changed carriers should follow the requirements of this ruling to the letter:

1. Following a change of carriers, the insured should make a new assignment, spelling out his or her interests in the new policy. The sooner this takes place, the better.

2. The assignee should be the same person or legal entity, such as a trust, in both assignments.

3. The new group-term arrangement should be identical in all relevant respects to the prior arrangement. The ruling leaves unanswered the question of whether added amounts of coverage would affect the result. If coverage is added, the insured might make separate assignments to the same assignee of the old and new coverage, lest the new coverage be deemed to taint the entire assignment.

4. All premiums should be paid by the employer.

5. Although the ruling appears to deny the effectiveness of the anticipatory assignment, it may be a good idea to arrange for, in the original assignment, an assignment of the assignor's interest in a new policy necessitated by a change of insurance carriers. Under the facts disclosed in the ruling, the anticipatory assignment was of "rights under any arrangement for life insurance coverage of the employees" of the corporation. In those terms, it was broad enough to cover both employer-provided permanent life insurance and group-term insurance. Although the ruling does not state that this factor is the basis for the assignment's ineffectiveness, greater specificity might possibly obtain a favorable result in situations where the insured, following a change of carriers, does not get around to making a new assignment. Such anticipatory assignments are apparently not harmful, except possibly when the insured, after making the anticipatory assignment, has a change of heart and wants to make the assignment to another person.

Revenue Ruling 79-231, which contains a fairly detailed discussion of anticipatory assignment under local law, indicates that it is to be treated as a contract to assign insurance policies subsequently obtained and may be enforceable if and when a new policy is acquired. In this view, the promise becomes enforceable when the employer acquires a master policy from the new carrier.

© 2021 AICPA. All rights reserved.

If the insured has not made an anticipatory assignment, when a new carrier is substituted, the insured should be free to make an assignment to a different assignee. However, in doing so, the insured runs the risk of having the proceeds includible in his or her gross estate if the insured dies within three years of the new assignment.[254] The risk of that happening might, in some circumstances, be preferable to having the proceeds go to the first assignee, particularly if the taxpayer will not be subject to federal estate tax liability.

.03 Use of a Trust for a Group-Term Policy

Use of an irrevocable trust to hold a group-term policy and its proceeds can be an effective way of keeping the proceeds out of the gross estate of the insured,[255] provided the insured is able to avoid the problems associated with IRC Section 2035 (transfers within three years of death) and its special application to group-term life insurance.

If a trust is to be used, the premiums paid by the employer (and any paid by the insured) will be deemed to be gifts from the insured to the trust beneficiaries. These transfers will be deemed gifts of future interests for which the gift tax annual exclusion for gifts of present interests will not be available.[256] However, the annual exclusion may be made available if the trust contains a Crummey power that gives the beneficiary the right to withdraw trust contributions of up to the annual exclusion amount ($15,000 for 2021, indexed annually for inflation) each year on a noncumulative basis. The IRS has ruled that when an irrevocable life insurance trust contains a Crummey power, the premium payment made by the employer for a group life insurance policy constitutes a direct payment by the employee that qualifies for the present interest exclusion as a result of the unrestricted demand right held by the beneficiaries.[257]

If the trust is set up to provide the surviving spouse a life interest in the proceeds, with limited powers of invasion of principal at the survivor's death, the proceeds may pass to those given remainder interests without being included in the gross estate of the survivor.[258]

.04 Group Permanent Life Insurance

Permanent life insurance, standing by itself, is not within the tax shelter provided by IRC Section 79 for group-term life insurance. However, regulations permit a policy of group-term insurance to include permanent benefits, provided a great many conditions are satisfied. Complex formulas are provided for determining the amount taxable to the employee under such policies.[259]

---

[254] IRC Sections 2035(a) and 2042.

[255] IRC Section 2042.

[256] IRC Section 2503(b).

[257] Revenue Ruling 76-490, 1976-2 CB 300.

[258] IRC Section 2041(b).

[259] Regulation Section 1.79-1(b).

© 2021 AICPA. All rights reserved.

¶950 Death Benefits

Financial planning considerations for qualified retirement plan and IRA benefits are considered in ¶955. This section focuses on death benefits payable outside of formal retirement plans. These death benefits might consist of payments that the employer has contracted to make or may be in the nature of extra compensation for services performed. The payments are generally taxable income to the recipient.[260]

The employee may name the beneficiary of the death benefit. The employee might also be in a position to control the type and form of payment to be made to the beneficiary. The employee will want to consider the means of control available. The employee should also consider the income tax on the beneficiaries to be selected, along with federal and state estate tax effects. Should the executor be named as the beneficiary of all or part of the death benefit, or should beneficiaries other than the executor be named? Will enough funds be available to the executor to satisfy any liquidity requirements the estate may have? Other questions include the steps, if any, needed to protect the interests of the beneficiary. Will a trust be needed to protect his or her interests? Will a trust limiting the primary beneficiary to a life interest be desirable only as a means of avoiding estate taxes on the death of the primary beneficiary? Contractual death benefits are not includible in the employee's estate as annuities within the reach of IRC Section 2039(a).

The more than 5% reversionary interest rule of IRC 2037 may be a concern if there is a possibility that the beneficiary might die before the employee dies under conditions that will result in the benefits going to the employee's estate. The value of the interest is measured by IRS tables in the first instance. The values given by the tables are presumptively correct. The value varies with the age of the beneficiary. In a low interest rate environment, it is difficult to create any reversionary interest that will avoid the estate inclusion 5% test.

The IRS has taken the position that when a nonqualified death benefit is combined with a plan offering disability benefits for the employee, the death benefits are includible in the employee's gross estate as an annuity, subject to IRC Section 2039(a). The IRS lost this argument in *W. Schelberg Est.*,[261] but won under the same facts in *J. Looney*.[262] However, for undisclosed reasons, the IRS, after its victory in *J. Looney*, moved to vacate the district court's opinion, thereby providing the taxpayer in that case with a victory by default.

The resulting victory accorded the taxpayer offers an opportunity to escape the annuity pitfall, at least in factual situations identical to those in the two cited cases.

The IRS developed another technique for extracting revenue from a contractual death-benefit-only arrangement. The underlying theory is that, when an employee designates a beneficiary of the death benefit, the employee makes a gift that is perfected and complete when death occurs.[263]

---

[260] IRC Sections 61(a) and 691(a).

[261] 612 F.2d 25 (2d Cir. 1979).

[262] 569 F. Supp. 1569 (D.C. Ga. 1983).

[263] Revenue Ruling 81-31, 1981-1 CB 475.

© 2021 AICPA. All rights reserved.

The U.S. Tax Court, in *A. DiMarco Est.*,[264] expressly rejected the gift-on-death theory advanced by the IRS in Revenue Ruling 81-31.[265] In *DiMarco*, the decedent was employed by IBM and participated in its death-benefit-only plan. Under the plan, the death benefit could only be paid to a spouse, minor children, or dependent parents. The decedent-employee had no control over the beneficiary designation or the amount or timing of the payment of the death benefit, all of which were predetermined by the plan and subject to the employer's control. The court found that the decedent possessed no interest in any fund established to pay the death benefit. Indeed, the death benefit became payable out of the employer's general assets. Subsequently, the IRS conceded this issue. It revoked Revenue Ruling 81-31[266] and acquiesced in *DiMarco*.[267] However, the acquiescence applies only under the following conditions: (1) the employee is automatically covered by the benefit plan and has no control over its terms, (2) the employer retains the right to modify the plan, and (3) the employee's death is the event that first causes the value of the benefit to be ascertainable.

Planning Pointer.

A carefully structured death-benefit-only plan, following the outlines of the IBM plan previously described, might present a major planning opportunity. The death payments will escape both estate and gift tax, although the recipient of the death benefit will be liable for income tax on the full amount of the payments. In any event, planning should avoid naming the decedent's estate as either a primary or even a default beneficiary of the death benefit. Having a list of alternate or successor beneficiaries other than the estate will avoid a possible reversionary interest claim.

¶955 General Financial Planning Factors for Qualified Plan and IRA Benefits

Financial planning for qualified plan and IRA benefits should take into account income and estate tax considerations, the gift tax consequences of choosing various forms of distributions, the treatment of life insurance provided under a qualified plan, and possible liquidity concerns. Commencement of payment to a spouse of a required joint and survivor annuity automatically qualifies for the estate and gift tax marital deductions,[268] as discussed in greater detail in subsequent sections. Apart from the required survivor annuity situation, irrevocably designating any beneficiary will constitute a gift. On the other hand, a nonparticipant spouse's consent to the naming of another beneficiary does not constitute a gift by the spouse.[269] These various factors are explored in the following sections.

---

[264] 87 T.C. 653 (1986) (Acq.).

[265] 1981-1 CB 475.

[266] Revenue Ruling 92-68, 1992-2 CB 257.

[267] 1990-2 CB 1.

[268] IRC Sections 2056 and 2523.

[269] IRC Section 2503(f).

© 2021 AICPA. All rights reserved.

.01 Gift Tax Factors

The gift tax consequences of a spouse's qualified plan annuity rights and of naming nonspousal beneficiaries are discussed in the following paragraphs.

Spouses. As a general rule, a qualified retirement plan (but not an IRA, which is a retirement plan but not a qualified retirement plan) must provide a qualified joint and survivor annuity (QJSA) in the case of a married participant who retires, unless the participant's spouse consents to some other form of distribution. Plans generally must also provide a qualified preretirement survivor annuity (QPSA) in the case of a vested participant who dies before the annuity start date and who has a surviving spouse.[270] The spouse's written consent is needed in such a case to waive the annuity.[271] Plans subject to the survivor annuity rules must offer a QSOA (Qualified Successor Only Annuity) to participants who waive the QJSA or QPSA.[272]

The participant will generally not be treated as making a gift to his or her spouse by virtue of the spouse's right to receive an annuity. No gift occurs provided that the spousal joint and survivor annuity automatically qualifies for the estate and gift tax marital deductions[273] and will do so as long as only the spouses have the right to receive any payments before the death of the last spouse to die. Although the provision applies automatically, the executor or donor may elect not to have it apply.

The lack of transfer tax applicability also applies to a joint and survivor annuity payable to a spouse under an IRA.

IRC Section 2503(f) makes it clear that a nonparticipant spouse does not make a gift by virtue of a waiver of his or her qualified plan annuity rights.

Nonspousal beneficiary. Irrevocably designating a nonspousal beneficiary of a qualified plan annuity will constitute a gift for gift tax purposes. The gift will be of a future interest and will not qualify for the gift tax present interest annual exclusion.[274]

.02 Estate Tax

Qualified plan and IRA benefits are fully includible in a participant's gross estate[275] (except for certain very limited grandfathered benefits).[276] A survivor annuity paid to a participant's surviving spouse who

---

[270] IRC Section 401(a)(11).

[271] IRC Section 417.

[272] IRC Section 417(a)(1)(A).

[273] IRC Sections 2056 and 2523.

[274] IRC Section 2503(b).

[275] IRC Section 2031.

[276] IRC Section 2039.

© 2021 AICPA. All rights reserved.

is a United States citizen automatically qualifies for the estate tax marital deduction,[277] as long as only the spouses have the right to receive any payments before the death of the last spouse to die (for further details, see the previous discussion in section 955.01 in connection with the gift tax). The same would be true of an annuity payable under an IRA.

.03 Life Insurance Proceeds

If a qualified plan provides participants with cash value life insurance, the cash value of the policy immediately before death is not excludable from gross income under IRC Section 101(a). However, the remaining portion of the proceeds paid to the beneficiary is excludable under IRC Section 101(a).[278] Life insurance proceeds paid under a qualified plan would be includible in the gross estate under IRC Section 2042, dealing with life insurance policies rather than under IRC Section 2039.[279] Therefore, the participant may be able to exclude the insurance proceeds from the gross estate by removing any incidents of ownership that the participant had in the policy more than three years before death.[280] An actual distribution of the cash value of the policy to the participant might be the best way for the participant to begin the process of having the proceeds excluded from the gross estate. The insured must recognize gross income, if any, to the extent that the cash received exceeds the adjusted basis in the policy.[281]

¶960 Employee Awards

An item of tangible personal property (not cash or cash equivalents, gift cards or gift certificates, vacations, meals, lodging, or tickets) transferred to an employee for length of service or safety achievement is excludable from gross income, subject to dollar limitations subsequently discussed.[282] The item must be awarded as part of a meaningful presentation and under circumstances that do not create a significant likelihood of the payment of disguised compensation.[283]

Length-of-service awards qualify only if made after a minimum of five years of service.[284] Managers, administrators, clerical workers, and other professional employees are precluded from receiving qualifying safety awards because their positions do not involve safety concerns.[285]

---

[277] IRC Section 2056.

[278] Regulation Section 1.72-16(c)(2)(ii).

[279] Regulation Section 20.2039-1(d).

[280] IRC Sections 2035(a) and 2042.

[281] IRC Section 72(e).

[282] IRC Sections 74(c)(1), 162(a) and 274(j)(2).

[283] IRC Section 274(j)(3)(A).

[284] IRC Section 274(j)(4)(B).

[285] IRC Section 274(j)(4)(C).

© 2021 AICPA. All rights reserved.

The employer's deduction for all awards of tangible personal property provided to the same employee generally is limited to $400.[286] The limit is $1,600 in the case of a qualified plan award,[287] defined as an award provided under an established written plan or program that does not discriminate in favor of highly compensated employees.[288] The $1,600 limit also applies in the aggregate to both types of awards.

If the award is fully deductible by the employer, (a non-wage business expense) then the full FMV of the award is excludable by the employee.[289] If the deduction limit prevents a portion of the cost from being deducted by the employer, then the employee receives only a partial exclusion. In such cases, the employee must include in his or her gross income the greater of (1) the portion of the cost that is not deductible or (2) the amount by which the item's FMV exceeds the deduction limitation.[290]

¶965 Health Plans

An employer may provide medical benefits to employees either without charge to the employees or on an employee contribution basis. The benefits may include payment or reimbursement of medical (including dental) expenses of the employee and his or her dependents. In addition, the employer may provide payment of or reimbursement for premiums for accident and health insurance, including major medical and dental insurance, for the employee and his or her dependents. That said, there are a number of issues arising under the Affordable Care Act (ACA) that limit how an employer may reimburse an employee for healthcare benefits, including penalties imposed on an employer where reimbursement to employees for healthcare costs may constitute an impermissible group health plan. This issue was addressed in legislation enacted in late 2016 and is discussed in ¶1605.01 and in chapter 39.

The amounts the employer pays or reimburses for medical expenses may be completely tax-free to employees[291] (including those who are retired[292]and those who have been laid off)[293] and the payments are fully deductible by the employer, assuming that total compensation is not unreasonable.[294]

---

[286] IRC Sections 162(a) and 274(j)(2)(A).

[287] IRC Section 274(j)(2)(B).

[288] IRC Section 274(j)(3)(B).

[289] IRC Section 74(c)(1).

[290] IRC Section 74(c)(2).

[291] IRC Sections 105 and 106.

[292] Revenue Ruling 82-196, 1982-2 CB 53.

[293] Revenue Ruling 85-121, 1985-2 CB 57.

[294] IRC Section 162(a).

© 2021 AICPA. All rights reserved.

The benefit is especially valuable to employees because medical expenses paid by employees are deductible only to the extent that they exceed 7.5% of AGI[295] in 2021 and because itemized deductions of any kind operate to reduce tax liability only to the extent that they exceed the standard deduction.

Self-insured medical reimbursement plans are subject to special nondiscrimination rules.[296]

One type of health plan is worthy of particular note because it combines the ability to cover health costs on a tax-favored basis with the opportunity for tax-favored savings.

IRC Section 223 permits eligible individuals to establish health savings accounts (HSAs). An HSA is a tax exempt trust or custodial account established exclusively for the purpose of paying out-of-pocket medical expenses of the account beneficiary who, for months in which contributions are made to an HSA, is covered under a high-deductible health plan (HDHP).[297] HSAs can receive tax-favored contributions by or on behalf of eligible individuals, and amounts accumulated in an HSA may be distributed on a tax-free basis to pay or reimburse qualified medical expenses.

In the case of an HSA established for an employee, the employee, the employer, or both may contribute to the HSA. Employer contributions to an employee's HSA are treated as employer-provided coverage for medical expenses under an accident or health plan and are excludable from the employee's gross income. The employer contributions are not subject to withholding from wages for income tax or subject to payroll taxes. An individual's own contributions to his or her HSA are deductible in determining AGI (that is, they are deductible above the line, whether or not the employee itemizes deductions). An employee's own contributions can be made through a cafeteria plan, in which case they are treated as employer contributions that are excludable from the employee's income. Employer-provided coverage under a HDHP is treated like other health plan coverage for tax purposes.

The HDHP supporting an HSA may be either an insured plan or an employer-sponsored self-insured medical reimbursement plan. For 2021, the minimum annual deductible is $1,400 for self-only coverage and $2,800 for family coverage. The annual out-of-pocket expense limit is $7,000 for self-only coverage and $14,000 for family coverage. These amounts are indexed annually for inflation.[298]

Employees or their employers (or a combination) can contribute one-twelfth of the maximum annual contribution for each month of eligibility.

For 2021, the maximum annual contribution is $3,600 for self-only coverage and $7,200 for family coverage.[299]

---

[295] IRC Section 213(a).

[296] IRC Section 105(h).

[297] Notice 2004-2, 2004-2 IRB 269 (December 22, 2003).

[298] Revenue Procedure 2018-30, May 10, 2018.

[299] Notice 2020-79 (January 1, 2021).

© 2021 AICPA. All rights reserved.

Planning Pointer.

The elimination of the plan deductible limit can significantly increase the maximum deduction, especially for individuals covered by an HDHP with a relatively low annual deductible.

> **Example 9.6.** Sherman has self-only coverage under an HDHP and contributes to an HSA. His HDHP has the lowest permitted deductible — $1,400 for 2021. He can contribute up to the maximum contribution limit of $3,600, even though that's more than double the amount of his deductible.

Individuals age 55 or older can make catch-up contributions in addition to their regular contributions for the year. Catch-up contributions may also be made on behalf of a spouse who is covered under an individual's HDHP and who meets the age requirements (the catch-up contribution limit is $1,000 for 2021 and later years).

An individual is generally eligible for HSA contributions for a given month only if covered by an HDHP as of the first day of the month. However, an individual who establishes an HSA partway through the year can contribute the full annual amount. For purposes of calculating the maximum annual contribution, an individual who is an eligible individual for the last month of the tax year is treated as (*a*) having been an eligible individual during each of the months in that tax year and (*b*) having been enrolled in the same HDHP in which the eligible individual is enrolled for the last month of the tax year.[300]

Planning Pointer.

Only those part-year enrollees who begin HSA participation during the year and are covered by an HDHP at year end are eligible to make the maximum annual contribution. Contributions by or for an individual who ceases to be eligible during the year continue to be limited to one-twelfth of the maximum contribution for each month of eligibility.

Another option for funding an annual HSA contribution is to use funds in a traditional or Roth IRA. An individual who is eligible for an HSA can make one lifetime qualified HSA funding distribution from an IRA or Roth IRA. Any amount that would otherwise be included in gross income on account of the distribution will be excluded if applicable requirements are met.[301] A qualified HSA funding distribution is not subject to the 10% tax on early withdrawals of IRA funds. However, no HSA deduction is allowed for the amount contributed to the HSA from a traditional IRA or from a Roth IRA. Moreover, the annual limit on other HSA contributions is reduced by the amount of a qualified HSA funding distribution. A qualified HSA funding distribution must be made by means of a direct trustee-to-trustee transfer. Once made, a qualified HSA funding distribution is irrevocable.

To ensure tax-free treatment for a qualified HSA funding distribution, an individual must remain eligible for HSA coverage during a 12-month testing period beginning with the month the qualified HSA

---

[300] IRC Section 223(b)(8)(A).

[301] IRC Section 408(d)(9).

© 2021 AICPA. All rights reserved.

funding distribution is made. If an individual is not eligible for HSA coverage (for example, if the individual is not covered by an HDHP) at any time during a testing period, the amount of the qualified HSA funding distribution must be included in gross income for the tax year that includes the first month in which the individual is not eligible. In addition, a 10% penalty tax may apply to the included amount. Note, however, that if an individual ceases to be eligible because of death or disability, the addition to gross income and the penalty tax do not apply.

An HSA distribution that is used exclusively to pay qualified medical expenses (that is, medical expenses that are not covered by insurance or otherwise, including expenses for nonprescription drugs) of the account holder and his or her spouse or dependents is excludable from income. The exclusion applies even if the account holder is not eligible to make HSA contributions at the time of the distribution (for example, if the account holder is no longer covered by an HDHP or has reached age 65 and is enrolled in Medicare). Also, the exclusion applies to distributions for qualified expenses of a spouse or dependent who is not covered by the high-deductible plan.

The receipt of medical care for armed service-connected disability does not affect HSA eligibility. Eligible individuals may, subject to statutory limits, make deductible contributions to an HSA. Other persons (for example, family members) also may contribute on behalf of eligible individuals. Eligible individuals are those who are covered under an HDHP and are not covered under any other health plan which is not an HDHP, unless the other coverage is permitted insurance (i.e. insurance for worker's compensation, torts, ownership and use of property such as auto insurance, insurance for a specified disease or illness, or providing a fixed payment for hospitalization) or coverage for accidents, disability, dental care, vision care, or long-term care. There is **no** deduction for an HSA contribution for any month an individual is eligible for and enrolled in Medicare.

For months beginning after December 31, 2015, an individual will not fail to be treated as an eligible individual solely because of receiving hospital care or medical services under any law administered by the VA for a service-connected disability.[302]

In general, payments for health insurance premiums are not qualified payments for purposes of HSA withdrawals, with several exceptions. Payments for four types of health insurance are qualified HSA medical expenses. These include the following:

1. Premiums for long-term care insurance

2. Health insurance premiums during periods of continuation coverage required by federal law (for example, COBRA coverage)

3. Health insurance premiums during periods that the individual or spouse is receiving unemployment compensation

4. For persons age 65 or older, any health insurance premiums, including Medicare Part B and Part D premiums, other than a Medicare supplemental policy

[302] IRC Section 223(c)(1)(C).

© 2021 AICPA. All rights reserved.

Planning Pointer.

An individual can receive distributions from an HSA at any time and for any purpose. A distribution that is not used to pay qualified medical expenses is includable in the gross income of the account holder. In addition, such a distribution generally is subject to a 20% penalty tax. However, the penalty tax does not apply to a distribution that is made after the account holder's death or disability, or after the account holder reaches age 65. In other words, funds in an HSA that are not needed for medical expenses can serve as a tax-deferred savings account for retirement.

An employer with more than 19 employees must meet the COBRA continuation coverage requirements of IRC Section 4980B.

To improve the portability of health insurance coverage, the Health Insurance Act of 1996[303] placed restrictions on the ability of certain group health plans to exclude individuals from coverage based on preexisting conditions or health status. Group health plans, other than government and small employer plans (plans with fewer than two current employees at the beginning of the plan year) that fail to comply with these restrictions face stiff fines.

Broadridge Advisor offers a comprehensive Health Care Reform Resource Center to help financial planners answer questions such as the following: If I already have health insurance, can I keep my existing coverage? Do small businesses have to offer health insurance to employees or face a penalty? How does the law affect seniors and Medicare? What are health exchanges? AICPA PFP and PFS members have access to Broadridge Advisor (a $499 value) as part of their membership.

¶970 Below-Market Loans to Employees

Below-market interest loans made by the employer offer an attractive benefit to those employees to whom the loans are extended. An employer may offer loans to employees on a selective basis without meeting the nondiscrimination rules that apply to many other benefits. The loans may serve needs related to the borrower's employment or solely personal needs. For example, an employer may provide a loan to finance the purchase of company stock under a stock purchase plan or stock option. Employer loans might also provide funds for investment, college, a home purchase, or a family emergency.

.01 Demand Loans Versus Term Loans

The tax treatment of these loans is largely favorable for both the employer and the employee.[304] The law draws a distinction between demand loans and term loans.[305]

---

[303] Public Law No. 104-191.

[304] IRC Section 7872.

[305] IRC Sections 7872(a) and 7872(b).

© 2021 AICPA. All rights reserved.

In the case of a demand loan, the employee-borrower is treated as having paid to the employer-lender imputed interest for any day the loan is outstanding. The employer-lender is treated as having received the amount so paid as interest and as having transferred an identical amount to the borrower as wages.[306]

The employee has gross income in the amount of the value of the use of the money loaned.[307] and a possible interest deduction for the imputed interest.[308] However, deductions for personal interest are generally disallowed.[309] The employer receives the imputed interest as gross income and has an equivalent deduction for imputed compensation paid, if any, subject to reasonable compensation limits.[310] The employer's real cost is the loss of the use of the money loaned.

In the case of a term loan, the employer is treated as transferring to the employee, on the date of the loan, compensation in an amount equal to the excess of the amount of the loan over the present value of principal and interest (if any) due under the loan. This excess is then treated as original issue discount, and the employer and the employee are respectively treated as receiving and paying interest over the life of the loan.[311] The employee is taxed upfront, but the employee's interest deductions, if any, are spread out over the term of the loan. The situation is just the opposite for the employer. Interest deductions are subject to various limitations and restrictions, including the fact that personal interest paid by the employee is not deductible.[312]

A compensation-related term loan is to be treated as a demand loan if the benefit derived by the employee from the interest arrangement is (1) nontransferable and (2) conditioned on the future performance of substantial services by the employee.[313]

.02 Factors to Consider

Loans of $10,000 or less. For any day on which the amount of the loan outstanding does not exceed $10,000, no amounts are deemed transferred by the employer to the employee-borrower and retransferred by the employee to the lender.[314]

Imputed interest rates. If the loan is for less than four years or is a demand loan, the imputed interest rate is the federal short-term rate. If the loan is for over four years, but not over nine years, the federal

---

[306] IRC Section 7872(a)(1).

[307] IRC Section 61(a).

[308] IRC Section 163.

[309] IRC Section 163(h).

[310] IRC Section 162(a).

[311] IRC Section 7872(b).

[312] IRC Section 163(h).

[313] IRC Section 7872(f)(5).

[314] IRC Section 7872(c)(3)(A).

© 2021 AICPA. All rights reserved.

mid-term rate is to be used. If the loan is for over nine years, the federal long-term rate applies.[315] The rates are revised monthly.[316]

Advantage of loan secured by residence. If a no-interest loan from an employer is secured by the employee's residence and otherwise meets the IRC Section 163(h) rule for qualified residence debt, the employee may deduct the imputed interest as an itemized deduction. The deduction for the interest would provide the employee with a tax benefit to the extent that the employee's total itemized deductions exceed the standard deduction. The imputed interest deemed received is extra compensation income.

¶975 Cafeteria Plans

Under an IRC Section 125 cafeteria plan, a participant may choose between two or more benefits, consisting of cash and qualified benefits. Cafeteria plans that reimburse health and dependent care costs are sometimes called flexible spending accounts. A plan must be in writing,[317] be maintained for the exclusive benefit of employees,[318] and must also meet various nondiscrimination requirements. First, the plan must not discriminate in favor of highly compensated employees for eligibility to participate.[319] Second, the plan must meet a concentration test under which qualified benefits provided to key employees may not exceed 25% of aggregate qualified benefits provided to all employees.[320] Third, each type of benefit available or provided under a cafeteria plan is subject to its own applicable nondiscrimination rules and to any applicable concentration test.[321]

Failure to meet the eligibility discrimination tests results in highly compensated employees being taxed on the value of available taxable benefits.[322] Similarly, failure to meet the 25% tests results in key employees being taxed on the value of available taxable benefits.[323] Failure to meet individual nondiscrimination requirements generally results in highly compensated employees being taxed on the discriminatory excess.

A cafeteria plan may offer the following nontaxable benefits: group-term life insurance up to $50,000 (¶945), coverage under an accident and health plan (¶965), coverage under a dependent care assistance

---

[315] IRC Section 1274(d)(1)(A).

[316] IRC Section 1274(d)(1)(B).

[317] Proposed Regulation Section 1.125-1(c).

[318] IRC Section 125(d)(1).

[319] IRC Section 125(b)(1).

[320] IRC Section 125(b)(2).

[321] IRC Section 125(f).

[322] IRC Sections 61(a) and 125(b)(1).

[323] IRC Sections 61(a) and 125(b)(2).

© 2021 AICPA. All rights reserved.

program (¶980), adoption assistance (¶3450), and 401(k) plan participation (¶925). Any such benefits chosen and received will be nontaxable if the requirements of the applicable IRC sections are met.[324] A plan may also offer, as a qualified benefit, group-term life insurance in excess of $50,000.[325]

The most popular nontaxable benefits under cafeteria plans are health insurance, other medical costs, and dependent care assistance. Some cafeteria plans are known as premium-only plans (POP). A POP allows the employee to pay the employee's portion of group health insurance for the employee or for the employee's family with tax-sheltered dollars. Many cafeteria plans allow dependent care assistance in addition to the cost of group health insurance. Reimbursements from cafeteria plans are excluded from gross income and excluded from wages for employment tax purposes.

The IRS has ruled that a health flexible spending account cafeteria plan may reimburse employees for the cost of nonprescription drugs.[326] The reimbursement is nontaxable to the employee. By contrast, if an individual incurs nonprescription drug costs, except insulin, that are not reimbursed under an employee benefit plan, such costs are not deductible as an itemized deduction under IRC Section 213.[327] The cost of food supplements, such as vitamins, that an employee takes to maintain good health is not eligible to be reimbursed under a cafeteria plan.[328]

A plan may offer benefits that are nontaxable by reason of employee after-tax contributions. For example, a plan may offer participants an opportunity to purchase health coverage with their own after-tax contributions.[329]

A plan may not offer a benefit that defers the receipt of compensation,[330] subject to certain exceptions. One exception is that an employer may offer participants the opportunity to make elective contributions under an IRC Section 401(k) arrangement.[331]

A salary reduction feature is permitted, but the employee must choose the salary reduction in advance and forfeit any unused benefits. For instance, assume an employee takes a salary reduction of $2,000 in exchange for medical reimbursements in a like amount. However, the employee incurs medical expenses of only $1,500. The employee must forfeit the unused $500. In the past, this use-it-or-lose-it rule strictly applied on a year-by-year basis. However, IRS rules now permit a cafeteria plan to be amended to allow a grace period of up to 2½ months for tapping unused benefits from the prior plan year. If a grace period

---

[324] IRC Section 125(f) and Proposed Regulation Section 1.125-1.

[325] Revenue Ruling 2003-102, IRB 2003-38 (September 22, 2003).

[326] Revenue Ruling 2003-102, IRB 2003-38 (September 22, 2003).

[327] Revenue Ruling 2003-58, IRB 2003-22 (May 15, 2003).

[328] IRC Sections 79(a) and 125(f).

[329] Proposed Regulation Section 1.125-1(h).

[330] IRC Section 125(d)(2)(A).

[331] IRC Section 125(d)(2)(B).

© 2021 AICPA. All rights reserved.

is adopted, qualified expenses incurred during the grace period may be paid or reimbursed from funds remaining in an employee's account at the end of the prior plan year.[332] A 2½ month grace period may, for example, be adopted for a health or dependent care flexible spending arrangement under a cafeteria plan.

The IRS now allows tax-free payment or reimbursements for medical costs under a cafeteria plan to be made by debit cards, credit cards, and other electronic media. However, the employer must have adequate controls in place to assure that such payments or reimbursements are for medical costs only.[333]

For 2021, the flexible spending arrangements contribution limits are generally a minimum of $25 and a maximum of $2,750, with the dependent care limit of a minimum of $25 and a maximum of $5,000 for married persons filing joint returns and single parents, and $2,500 for married persons filing separately.

In response to the coronavirus, the IRS has issued Notice 2020-29 that provides greater flexibility for taxpayers by:

- extending claims periods for taxpayers to apply unused amounts remaining in a health FSA or dependent care assistance program for expenses incurred for those same qualified benefits through December 31, 2020.
- expanding the ability of taxpayers to make mid-year elections for health coverage, health FSAs, and dependent care assistance programs, allowing them to respond to changes in needs.
- applying earlier relief for high-deductible health plans to cover expenses related to COVID-19, and a temporary exemption for telehealth services retroactively to January 1, 2020.

Notice 2020-33 directs the Secretary of the Treasury to "issue guidance to increase the amount of funds that can carry over without penalty at the end of the year for flexible spending arrangements." The notice increases the limit for unused health FSA carryover amounts from $500, to a maximum of $550, as adjusted annually for inflation. For 2021, the maximum remains $550.

¶980 Employer-Provided Dependent Care Assistance

IRC Section 129 provides that employees may exclude up to $5,000 of employer-provided dependent care assistance from their gross income.[334] The $5,000 limit is not indexed to inflation. For highly compensated employees to be allowed the exclusion, the employer must provide the benefits under a written nondiscriminatory plan.[335]

The dependent care may be directly provided by the employer or by a third party. Payments made to a person for whom the employee or his or her spouse may take a dependency exemption, and payments

---

[332] Notice 2005-42, 2005-23, IRB 1 (May 18, 2005).

[333] Revenue Ruling 2003-43, IRB 2003-21 (May 6, 2003).

[334] IRC Sections 129(a) and 129(d).

[335] IRC Section 129(d).

© 2021 AICPA. All rights reserved.

made to children under age 19, are not eligible for the exclusion.[336] A child attains age 19 on the 19th anniversary of the date on which the child was born. For example, a child born on January 1, 2002, attained age 19 on January 1, 2021.[337]

The amount excluded from gross income reduces the amount of expenses that qualify for the credit available under IRC Section 21 for payments for household and dependent care services.[338]

Payments made by the employer are deductible under IRC Section 162(a) to the extent that they are ordinary and necessary business expenses.

IRC Section 129 plans can be tested for nondiscrimination under the IRC Section 129 rules. The penalty for failing the IRC Section 129 test is that all highly compensated employees must include the value of any benefits they receive from the plan in their gross income.[339]

There is a tax credit for employers that provide childcare benefits to employees. The credit is part of the general business credit. The credit for the employer is equal to the sum of 25% of qualified childcare expenditures and 10% of qualified childcare resources and referral expenditures.[340] The employer credit is limited to a maximum amount of employer-provided childcare credit of $150,000 per year.[341] The employer may not receive a deduction for any expenditures used as a base for the credit.[342] In addition, the employer must reduce the basis of the qualified property for expenditures claimed as a base for the credit.[343] The credit is subject to recapture if an employer terminates the childcare benefits.[344] This credit has been permanently extended. Recall from above that IRS Notice 2020-29 provides flexibility in making changes to dependent care savings accounts.

¶985 IRC Section 132 Fringe Benefits

IRC Section 132 excludes certain categories (discussed in the subsequent sections) of employer-provided benefits from an employee's gross income and from employment taxes.

---

[336] IRC Section 129(c).

[337] Revenue Ruling 2003-72, IRB 2003-33 (July 18, 2003).

[338] IRC Section 129(e)(7).

[339] IRC Sections 61(a) and 129(d)(1).

[340] IRC Section 45F(a).

[341] IRC Section 45F(b).

[342] IRC Section 45F(f)(2).

[343] IRC Section 45F(f)(1)(A).

[344] IRC Section 45F(d).

© 2021 AICPA. All rights reserved.

.01 No-Additional-Cost Service

The entire value of any no-additional-cost service provided by an employer to an employee (including an employee's spouse or dependent children) or a retiree is excludable from the employee's or retiree's gross income. The exclusion is available to highly compensated employees only if the employer meets nondiscrimination requirements.[345] The employer may incur some additional cost or loss of revenue, provided it is not substantial.[346]Also, another business with which the employer has a reciprocal written agreement may provide the services.[347] For example, two airlines may provide seats for each other's employees.

Examples of such excluded services include airline, railroad, bus, or subway seats if customers are not displaced. Hotel rooms provided to employees working in the hotel business would also be excluded. Utilities may also qualify if excess capacity is available (for example, phone services provided to phone company employees).

.02 Employee Discounts

An employee may exclude a qualified employee discount from gross income.[348] The value of a discount on services provided to an employee is excluded from the employee's gross income to the extent that it does not exceed 20% of the selling price of the services to customers.[349] In the case of goods, the discount may not exceed the gross profit percentage of the price at which the employer offers the property for sale to customers.[350]

In either case, the property or service must be of the same type that is ordinarily sold to the public in the line of business in which the employee works. The discount must go to a current employee or retiree, the spouse or dependent child of either, or the surviving spouse or dependent child of a deceased employee.[351]

The discount is not excluded from the gross income of highly compensated employees unless the employer meets certain nondiscrimination requirements.[352] Also, discounts on the sale of real estate or personal property held for investment (for example, stock) do not qualify for exclusion. If an employee receives a discount on such property, the employee must include the discount in gross income.[353] For

---

[345] IRC Section 132(j)(1).

[346] IRC Section 132(b).

[347] IRC Section 132(h)(3)(i).

[348] IRC Section 132(a).

[349] IRC Section 132(c)(1).

[350] IRC Section 132(c)(2).

[351] IRC Section 132(h).

[352] IRC Section 132(j)(1).

[353] IRC Sections 61(a) and 132(c)(4).

© 2021 AICPA. All rights reserved.

example, if a real estate broker allows a discount on the sale of real estate to a real estate salesperson, the salesperson must include the discount in gross income.

To some extent, employee discounts on merchandise can be a substitute for cash compensation. The law does not limit the aggregate value of the discounts that an employee may exclude from gross income.

.03 Working Condition Fringe Benefits

The FMV of any property or services provided to an employee is excluded from the employee's income to the extent that the cost of the property or services would be deductible as ordinary and necessary business expenses if the employee had paid for such property or services.[354] The nondiscrimination requirements do not apply to working condition fringe benefits.[355] Thus, a highly compensated employee may exclude working condition fringe benefits from his or her gross income even if the employer provides such benefits only for certain employees.

Examples of working condition fringe benefits include the following:

- Use of a company car or airplane for business purposes
- Subscription to publications useful for business purposes
- Use of a car by full-time salespersons
- Certain consumer product testing by employees
- A bodyguard or a car and a driver provided for security reasons
- On-the-job training
- Business travel
- Under certain circumstances, outplacement services[356]

.04 *De Minimis* Fringe Benefits

Property or services not otherwise tax-free are excluded from an employee's gross income if their value is so small that they make accounting for the benefits unreasonable or administratively impracticable. The frequency with which similar fringe benefits (otherwise excludable as *de minimis* fringes) are provided by the employer is to be taken into account, among other relevant factors, in determining

---

[354] IRC Sections 132(a) and 132(d).

[355] IRC Section 132(j)(1).

[356] Revenue Ruling 92-69, 1992-2 CB 51.

© 2021 AICPA. All rights reserved.

whether the FMV of the property or services is so small that accounting would be unreasonable or impracticable.[357]

Examples of *de minimis* fringe benefits include occasional use of copying machines, supper money, taxi fare because of overtime, and holiday gifts with a low FMV.

Subsidized eating facilities operated by the employer on or near the employer's business premises are considered *de minimis* if revenue from the facilities equals or exceeds direct operating costs. The employer may restrict the use of the facilities to a reasonable classification of employees, as long as the employer does not discriminate in favor of highly compensated employees.[358]

.05 Qualified Transportation Fringe Benefits

Certain employer-provided transportation fringe benefits are tax-free to employees.[359] These benefits include transit passes or vouchers worth up to $270a month (for 2021); commuting in a commuter highway vehicle worth up to $270 a month (for 2021; employer-provided parking worth up to $270 (for 2021) a month at or near the employer's premises, or a place from which the employee commutes by mass transit. For 2018 and beyond, as the result of the 2017 TCJA, these benefits are no longer deductible by the employer and the employee exclusion for bicycling is repealed, even if provided by the employer.[360] The aggregated tax-free amounts for transit passes and highway vehicle commuting may not exceed $270a month (for 2021).[361] Commuters can receive both the transit and parking benefits (that is, up to $540 per month in total). Employers can allow employees to use pretax dollars to pay for transit passes, vanpool fares, and parking, but not for bicycle benefits. These amounts are indexed for inflation.[362] Employer-provided benefits greater than these amounts are taxable to the employee.[363]

What will likely happen is that many employers desiring to continue this program will increase the employee's taxable compensation to take into account the benefit of the transportation fringe, thereby allowing the employer a compensation deduction for what is paid.

These qualified transportation fringe benefits may not be provided on a tax-free basis to partners, 2% S corporation shareholders, sole proprietors, or independent contractors.[364] However, the IRS stated in

---

[357] IRC Sections 132(a) and 132(e)(1).

[358] IRC Section 132(e)(2).

[359] IRC Section 132(f)(2).

[360] IRC Sections 132(f)(1) and 132(f)(2); Revenue Procedure 2008-66, 2008-45 IRB 1107, as modified by Revenue Procedure 2009-21, 2009-16 IRB.

[361] IRC Section 132(f)(2)(A) and Revenue Procedure 2007-66, 2007-45 IRB 960 (October 18, 2007).

[362] IRC Sections 132(f)(6). IRS Publication 15-B, 2016.

[363] IRC Sections 61(a) and 132(f)(2).

[364] IRC Sections 132(f)(5)(E), 401(c), 1372(a), and Regulation Section 1.132-9 and Regulation 1.132-6(d)(1).

© 2021 AICPA. All rights reserved.

Notice 94-3[365] that the *de minimis* and working condition fringe benefit rules apply to partners, S corporation shareholders, and independent contractors. Therefore, these taxpayers may still exclude from their gross income employer-provided transit passes, valued at no more than $21 a month, and employer-provided business-transportation-related parking (but not commuter parking) under the preexisting rules.

.06 On-Premises Athletic Facilities

The value of any on-premises athletic facilities (gym or other facilities) provided for employees, their spouses, or their dependent children is not includible in the employees' gross income.[366]

.07 Moving Expenses

As the result of the TCJA, employer reimbursements of qualified job-related moving expenses are no longer deductible by the employer or received tax free by employees.[367]

.08 Qualified Retirement Planning Services

An exclusion for qualified retirement planning services allows employees and their spouses to exclude from their gross income the value of qualified retirement planning services provided by employers that sponsor qualified retirement plans.[368] Qualified retirement planning services include retirement planning advice and information.[369] The exclusion applies to highly compensated employees only if the employer offers the retirement planning services to all employees of the group who normally receive information and education about the plan.[370] The exclusion does not extend to related services such as tax return preparation. This exclusion has been made permanent.

¶990 The "myRA"

The myRA has been suspended by the Treasury because it did not gain the following or popularity that had been intended. The intent of the myRA ("my retirement account") was to enable small-dollar savers to establish an after-tax Roth IRA contribution through payroll deduction with a Treasury-designated custodian without paying fees or start-up costs.

---

[365] 1994-1 CB 327; T.D. 8933.

[366] IRC Section 132(j)(4).

[367] IRC Sections 132(a); 217.

[368] IRC Section 132(a)(7).

[369] IRC Section 132(m)(1).

[370] IRC Section 132(m)(2).

© 2021 AICPA. All rights reserved.

Exhibit 9-1: Annual Limits for Retirement Plans

Annual Limits 2021

Type of Limit	2020	2021
Elective deferral limit for 401(k), 403(b), 457, and salary reduction simplified employee plans (SARSEP)	$19,500	$19,500
Catch-up amount for 401(k), 403(b), and 457(b) plans for age 50 and over	$6,500	$6,500
Elective deferral limit for savings incentive match plan for employees (SIMPLE)-IRA and SIMPLE-401(k) plans	$13,500	$13,500
Catch-up amount for SIMPLE-IRA and SIMPLE-401(k) plans for age 50 and over	$3,000	$3,000
Limit on annual additions to defined contribution plans, including 401(k), profit-sharing, and money purchase plans	$57,000 or 100% of pay	$58,000 or 100% of pay
Limit on annual benefits under defined benefit plans	$230,000 or 100% of pay	$230,000 or 100% of pay
Maximum compensation for qualified plans, simplified employee pension plans (SEPs), and 403(b) plans	$285,000	$290,000
Minimum compensation for SEP plans	$600	$650
Highly compensated employee definition benefit	$130,000	$130,000
Key employee compensation in top heavy tests	$185,000	$185,000
ESOP payout limits (five-year threshold amount and one-year extender amount)	$1,155,000 ÷ $230,000	$1,165,000 ÷ $230,000
FICA taxable wage base	$137,700	$142,800
IRA and Roth IRA contribution	$6,000	$6,000
IRA and Roth IRA catch-up for age 50 and over	$1,000	$1,000
IRA deductibility, active participant, single tax filer	MAGI $65,000 $75,000	MAGI $66,000 – $76,000
IRA deductibility, active participant, married joint tax filer	MAGI $104,000– $124,000	MAGI $105,000 – $125,000
IRA deductibility, active participant, married separately tax filer	MAGI $0 – $10,000	MAGI $0 – $10,000
IRA deductibility, spouse of active participant	MAGI $196,000 – $206,000	MAGI $198,000 – $208,000
Roth IRA contribution, single tax filer	MAGI $124,000 – $139,000	MAGI $125,000 – $140,000
Roth IRA contribution, married joint tax filer	MAGI $195,000 – $205,000	MAGI $198,000 – $208,000
Roth IRA contribution, married filing separately tax filer	MAGI $0 – $10,000	MAGI $0 – $10,000

© 2021 AICPA. All rights reserved.

Chapter 10

Transfers Includible in the Estate at Death

¶1001 Overview

¶1005 The Costs of Transfer

¶1001 Overview

A fundamental consideration in estate planning is how the decedent will make transfers of property owned at death and to whom. If the decedent did not make any arrangements for such transfers, state laws of intestacy will determine the distribution of the individual's estate.

An individual's main financial and estate planning concern will be giving favored heirs as much as possible and holding transfer costs and taxes to a minimum. The toll takers along the line of transfer include federal and state tax collectors, executors or personal representatives, trustees, attorneys, appraisers, accountants, guardians, probate and court clerks, and others. Those who perform services are entitled to the fees and charges, which the law and reasonable compensation allow them.

Historically, the federal estate tax has caused practitioners and their clients the greatest concern. The 2017 TCJA significantly increased estate tax exclusion will eliminate concerns (at least until the law sunsets after 2025 or until law changes that may occur sooner) with the federal estate tax for almost all taxpayers. The unlimited marital deduction and unlimited charitable deduction[1] can completely offset estate tax liability, as discussed in ¶1005. In addition, for the unmarried and the married who do not make full use of the unlimited marital deduction, an applicable credit amount (unified credit) is available to offset or reduce the federal estate tax liability. This credit has the effect of excluding from tax the first $11,700,000 in 2021, indexed annually for inflation (see ¶405).[2] The top marginal federal estate tax rate is 40% for 2021.

If the client is wealthy enough to be a taxpayer at death, the federal estate tax toll has the financial planner looking for escapes through lifetime planning. The financial planner may want to change forms of ownership of assets, unwind joint ownership arrangements, develop family gift programs, set up living trusts, plan life insurance coverage and employee benefits, and use family income-splitting and other techniques. Practical considerations limit what the financial planner can do or should do. The planner might not be able to get consent to the unwinding of joint ownership. A client's individual

[1] IRC Section 2056(a); 2055.

[2] IRC Section 2010(c).

© 2021 AICPA. All rights reserved.

circumstances and the law also may shackle the financial planner. There may be reluctance to retitle assets. Family businesses or professional license arrangements may make lifetime asset transfers impossible. The death of a spouse will deprive the client of the marital deduction unless the client remarries. Charitable intentions may be present, but may not be substantial. Business owners typically are reluctant to yield control.

.01 Portability

Portability allows the unused federal estate tax exclusion of a deceased spouse to be used by a surviving spouse. The effect of portability is to permit a married couple to transfer $23,400,000 million to their heirs (in 2021) without imposition of federal transfer taxes. Obviously, portability is a game-changer for financial planners. (See the detailed discussion of portability in chapter 37.)

Inevitably, transfers at death will occur and the client must address the costs of transfer, which consist primarily of probate costs and federal and state death taxes in those states that continue to impose an inheritance tax or an estate tax. The sections that follow explain how the federal estate tax works, discuss other transfer costs, and compare different modes of transfer in terms of cost.

Although this chapter, and the ones immediately following it, will discuss effective ways to reduce estate taxes, the best way for many clients to deal with the tax consequences of increased wealth will be through increased reliance on lifetime gifts, which are discussed in chapter 4, "Lifetime Gifts to Individuals," but be mindful of the fact that income tax considerations are essential, and the basis to heirs is a crucial consideration, especially where donees may pay no federal estate tax, but will be income tax payers.

¶1005 The Costs of Transfer

For very wealthy individuals the biggest cost of transferring property at death is the federal estate tax, despite the relief for married individuals provided by the unlimited marital deduction.[3] The use of the marital deduction defers taxation for the wealthiest families, but may not eliminate it. However, not every individual is married, and not every married individual is prepared to take full advantage of the unlimited marital deduction or, alternatively, the unlimited charitable deduction. For persons who are not married, the portability election is not available.

As a result, the federal estate tax is something to be reckoned with not only by those currently with estates within its reach, but also by those who in the foreseeable future may have estates subject to its bite. The generous exclusion of $11.70 million (indexed for inflation) available in 2021 sunsets at the end of 2025, and possibly sooner due to political risk. Once the decedent has exhausted possible deductions and the unified credit, the effective federal estate tax rate is a flat 40% for estates of decedents who die in 2021. A problem for the financial planner and his or her clients is the uncertainty of the law. When will the client die? What will be the law in the client's year of death? Will the estate tax be repealed, and if it is, will the repeal be permanent or temporary? Will exclusions be reduced? Because these questions cannot be answered, planning is uncertain, so the key element to any plan is flexibility.

---

[3] IRC Section 2056(a).

© 2021 AICPA. All rights reserved.

The estate tax is neither a tax on the estate nor a tax on the property in the estate. It is an excise tax, a tax on the right or privilege of a deceased person to transfer property to beneficiaries of the decedent's own selection or, in the absence of any plan created by the decedent, to those beneficiaries that state law (applying the laws of intestacy) may select for the decedent. The estate tax is measured by the value of the taxable estate. Property subject to the estate tax may include items that few would think of as property owned or controlled by the decedent. Taxable property may include some property that the decedent disposed of long before death.

All the property that the decedent owned is valued at the date of death, or six months later if the executor or administrator elects the alternate valuation date, provided that use of the later date reduces the value of the decedent's estate and the estate tax payable. This value of the property is the decedent's gross estate.[4] The estate then may deduct funeral expenses; debts or obligations of the estate; administration and probate costs; the fees of the personal representative (executor or administrator); accounting fees; attorney's fees; casualty losses during the administration of the estate; state death taxes; and certain other taxes, including income taxes due at the death of the decedent and property taxes accrued, but not paid, before death.[5] The decedent's gross estate is further reduced by the amount of any bequest made to the decedent's spouse that qualifies for the marital deduction.[6] Finally, the estate may deduct any qualifying bequests to charity.[7]

The difference between the gross estate and the allowable deductions is the taxable estate.[8] Determining the estate tax under the unified estate and gift tax rate schedule is more complicated. The complication comes about primarily because the estate tax takes into account (by adding to the value of assets owned at death) certain lifetime transfers plus, under some circumstances, gift tax payable on those transfers. The estate tax is determined by applying the rate schedule to the aggregate of certain lifetime transfers plus the taxable estate, and then subtracting the gift taxes payable on those lifetime transfers. The lifetime transfers to be taken into account are all of those made in excess of the available present interest gift tax exclusion after 1976 (these transfers are referred to as "adjusted taxable gifts") and the gift tax subtraction, or offset, is limited to the gift tax paid on post-1976 gifts.[9]

For gifts made after August 5, 1997, the gift tax statute of limitations bars the IRS from revaluing any gift made by the decedent for estate tax computation purposes, as long as the gift was originally adequately disclosed. However, for gifts made prior to August 5, 1997, the U.S. Tax Court has held in *F. Smith Estate*[10] that the gift tax statute of limitations provision of IRC Section 2504(c) applies only to revaluation of lifetime gifts for gift tax purposes but did not bar the revaluation of lifetime gifts for

---

[4] IRC Section 2031(a).

[5] IRC Sections 2053 and 2054 and the regulations thereunder.

[6] IRC Section 2056(a).

[7] IRC Section 2055(a).

[8] IRC Section 2051.

[9] IRC Section 2001(b).

[10] 94 T.C. 872 (1990).

© 2021 AICPA. All rights reserved.

estate tax purposes. The same result was reached by the U.S. Court of Appeals for the Eighth Circuit in *C. Evanson*.[11] As a result, the value of gifts made prior to August 6, 1997, that do not have a readily determinable market value (unlike publicly traded securities) should be supported by appraisals and other documents establishing fair market value at the time of transfer. Amended gift tax returns may need to be filed. The failure to satisfy the adequate disclosure standards means that the statute of limitations for gift tax purposes does not run out, and the IRS has the further opportunity to revalue the gift and include it in the value of the decedent's estate as an adjusted taxable gift when the taxpayer dies.[12]

What about transfers includible in the decedent's gross estate under one or more IRC provisions, which include lifetime transfers with certain retained interests, rights, or powers by the decedent, as subsequently detailed? Certainly, counting such transfers twice would be unfair, once as a taxable lifetime transfer within the gift tax rules and again as part of the decedent's gross estate. Hence, the gift tax values of these transfers are not to be ultimately counted as lifetime transfers in determining the decedent's federal estate tax liability. The gift tax that may have been paid on such transfers is available as a subtraction or offset in determining the estate tax.

In addition, the gift tax paid by a spouse can be subtracted when the transfer subject to tax is included in the decedent's gross estate and is considered to have been a transfer made in part by the surviving spouse under the gift-splitting provision.[13] However, if the spouse's gift tax was offset by the unified credit (discussed in the following paragraphs), the credit used will not be restored to the surviving spouse because the transfer involved is included in the decedent's gross estate.

One further factor affects transfers subject to the gift tax made within three years of death. Generally, the value of the transferred property itself is not includible in the gross estate, but the amount of the gift tax paid on the transfer is includible. This is the so-called "gross-up" rule under IRC Section 2035(b). The gift tax subject to the rule includes the tax paid by the decedent or his or her estate on any gift made by the decedent or his or her spouse within three years of death. It does not, however, include any gift tax paid by the spouse on a gift made within three years of death that is treated as having been made one half by the spouse, because the spouse's payment of such tax would not reduce the decedent's gross estate.

These are the basic rules. The following illustration explains how they might apply in a specific situation.

> **Example 10.1.** Jeff Jones' estate at his death in 2021 is valued at $26,000,000. He made total taxable gifts of $2,500,000 since 1977 and paid no gift taxes because of the unified credit. Items deductible under IRC Section 2053 amount to $500,000 and the state death tax deduction is also $500,000. His estate has no losses. There are no charitable deductions. His wife, Mary, is given a marital deduction bequest of $10,000,000.

---

[11] *Estate of Evanson v. Commissioner,* 30 F.3d 960 (8th Cir. 1994).

[12] Regulation 301.6501(c)-1.

[13] IRC Section 2513.

© 2021 AICPA. All rights reserved.

Gross estate	$26,000,000
Administration expense	500,000
State death taxes	$500,000
Adjusted gross estate	$25,000,000
Marital deduction	10,000,000
Taxable estate	$15,000,000
Taxable gifts	2,500,000
Tentative tax base	$17,500,000
Estate tax on tentative tax base	$7,000,000
Credit for gift taxes paid	0
Tax before applicable credit amount	$7,000,000
Applicable credit amount	4,625,800
Estate tax payable [14]	$2,374,200

In the preceding example, if the marital deduction had been increased to take into account the property owned by the decedent at death, the tax liability could have been reduced to zero.

In general, the estate tax is figured by applying the unified rates shown in Exhibit 10-1 to the total of transfers both during life and at death, and then subtracting the gift taxes paid, if any, as refigured based on the date-of-death rates.

Exhibit 10-1: Unified Rate Schedule for Transfers in 2021 and Later

(A) Amount Subject to Tax Equal to or More Than—	(B) Amount Subject to Tax Less Than—	(C) Tax on Amount in Column (A)	(D) Rate of Tax on Excess Over Amount in Column (A)
—	$ 10,000	—	18%
$ 10,000	20,000	$ 1,800	20
20,000	40,000	3,800	22
40,000	60,000	8,200	24
60,000	80,000	13,000	26

[14] Although the applicable credit amount (unified credit) against the estate tax is reduced to the extent that the applicable credit amount is used against the gift tax, in order to preserve the applicable credit amount taken in computing gift taxes, it is necessary for the applicable credit amount to appear in the estate tax computation before computing the total tax liability. The total taxable gifts are added to the taxable estate in computing the tentative tax base, but the applicable credit amount used against the gift taxes is reflected as a reduction of the gift taxes payable. If the applicable credit amount did not appear in the estate tax computation, the effect would be to cancel out the effect of taking the credit in computing the gift tax.

© 2021 AICPA. All rights reserved.

(A) Amount Subject to Tax Equal to or More Than—	(B) Amount Subject to Tax Less Than—	(C) Tax on Amount in Column (A)	(D) Rate of Tax on Excess Over Amount in Column (A)
80,000	100,000	18,200	28
100,000	150,000	23,800	30
150,000	250,000	38,800	32
250,000	500,000	70,800	34
500,000	750,000	155,800	37
750,000	1,000,000	248,300	39
1,000,000	—	345,800	40

The applicable exclusion amount was $5,450,000 in 2017. Due to the TCJA, it was $11,180,000 in 2018, was $11.4 million in 2019, was $11,580,000 in 2020 and is $11,700,000 in 2021, indexed for inflation. The increased exclusion amount is scheduled to sunset after 2025 and return to the 2017 level, indexed for inflation, pending political developments.

.01 Other Credits Against the Estate Tax

IRC Section 2012 allows a credit for gift taxes paid on pre-1977 gifts of property includible in the donor's gross estate. This credit does not apply to post-1976 gifts. As previously noted, gift taxes paid on such gifts are subtracted in computing the estate tax.

IRC Section 2013 provides a credit for federal estate taxes paid on prior taxable transfers to the decedent included in the decedent's estate by persons who died within 10 years before or two years after the decedent's death. The amount of the credit allowed depends on how many years by which the transferor predeceased the decedent.

A credit is also available for foreign death taxes paid on the decedent's assets (upon proof of the foreign tax being paid), as described in IRC Section 2014.

.02 What Is Included in the Federal Gross Estate?

The federal estate tax does not allow any property exemptions as some state death taxes allow for a homestead or for household goods or for life insurance proceeds.

Everything that normally is considered property is included in a person's federal gross estate. Stocks, bonds, mutual funds, notes, mortgages, bank accounts, cash, jewelry, personal effects, real estate, automobiles, furniture and furnishings, works of art, collectibles, patents, copyrights, trademarks, life insurance proceeds, annuities, retirement plan benefits, business interests, and limited partnership investments are a part of the gross estate. In short, all property is included to the extent of the decedent's interest at the time of death.[15]

[15] IRC Section 2033.

© 2021 AICPA. All rights reserved.

Also includible are various rights and claims. A claim for an income tax refund, a leasehold interest, certain interests in a trust, a judgment that the deceased may have held against someone, a debt owed to the decedent, and other like items are included.

The estate tax provisions include other items that one may not normally think of as being owned by the decedent. A brief listing of these items follows:

- The value of any property that a person has given away during in a lifetime in which that person retains (1) the right to enjoy the income or use of the property for life, (2) the right to designate who is to enjoy the income or the property itself, or (3) the right to vote transferred stock in a controlled corporation (that is, where the decedent or his or her relatives own 20% or more of the stock).[16]

- The value of any property that a person has given away during lifetime, but which transfer is to become effective in possession and enjoyment by the donee only upon the donor's death or in which the donor at the time of death retains a reversionary interest worth more than 5% of the value of the property at that time.[17]

- Property that the decedent transferred during lifetime, in trust or otherwise, without adequate and full consideration, in which the decedent retained the right to revoke, alter, amend, or terminate the enjoyment of the property transferred.[18] This provision applies to revocable living trusts created by the decedent.

- Annuities providing a death benefit, a refund, or survivor income.[19]

- The *full value* of property held by the decedent as a joint tenant with any other person (other than his or her spouse), except as it may be shown that someone else contributed part or all of the consideration for its acquisition. If it is a joint tenancy with a right of survivorship between spouses, in general, only one half of the value is includible in the gross estate of the first spouse to die.[20]

- The value of property subject to a general power of appointment possessed by the decedent at death that is, generally, property which the decedent may not have actually possessed and enjoyed, but which the decedent could direct to be transferred to the decedent, the decedent's estate, the decedent's creditors, or the creditors of the decedent's estate.[21]

---

[16] IRC Section 2036.

[17] IRC Section 2037.

[18] IRC Section 2038.

[19] IRC Section 2039.

[20] IRC Section 2040(b).

[21] IRC Section 2041.

© 2021 AICPA. All rights reserved.

- Insurance policies on the decedent's life payable to his or her estate or about which the decedent is deemed to possess an incident of ownership, such as the right to name the beneficiary, to borrow against the cash surrender value or otherwise control the economic benefits of the policy, including, in some cases, the power to control a corporation that owns the policy.[22]

- The value of any interest of the surviving spouse as dower or curtesy or any statutory substitute.[23]

- Property from which a qualified terminable interest property income interest was payable.[24]

- A catchall provision that brings property in which the decedent has any interest at the time of death, to the extent of the decedent's interest, into the gross estate.[25]

IRC Section 2033 includes everything that normally is considered property. The regulations under this section note that a cemetery lot owned by the decedent is part of the gross estate, but its value is limited to the salable value of that part of the lot which is not designated for the interment of the decedent and family members. Notes or other claims held by the decedent are likewise included even though they may be canceled by the decedent's will.[26]

IRC Section 2035(d) provides that the value of property transferred within three years of death for an adequate consideration in money or money's worth is generally not includible in the gross estate of the transferor. However, the decedent's gross estate will include interests in property transferred within three years of death that would otherwise have been included in the decedent's estate under IRC Sections 2036, 2037, 2038, or 2042 if the decedent had retained such interest.[27] For example, under IRC Section 2042, the proceeds of life insurance policies on the decedent's life transferred within three years of death would be included in the decedent's gross estate, regardless of the motive or circumstances of the transfer.

In addition, under IRC Section 2035(c), the value of all property transferred within 3 years of death (other than gifts eligible for the annual gift tax exclusion) is included in the decedent's estate for purposes of determining the estate's qualification for certain special IRC provisions, including redemption of stock to pay death taxes, special use valuation, and 14-year deferral of payment of estate tax.[28]

---

[22] IRC Section 2042.

[23] IRC Section 2034.

[24] IRC Section 2044.

[25] IRC Section 2033.

[26] Regulation Section 20.2033-1(b).

[27] IRC Section 2035(a).

[28] IRC Sections 303, 2032A and 6166.

© 2021 AICPA. All rights reserved.

IRC Section 2035(b) includes in the gross estate any gift tax paid by the decedent, or the decedent's estate, on any gift made by the decedent, or his or her spouse, within three years of the decedent's death.

What must surely come across from this recital of IRC provisions is that the estate tax collector is well armed. Careful planning is required to reduce or avoid the estate tax.

.03 Administration and Probate Costs

Executor's commissions may account for a significant part of the cost of transferring property on death. The testator may attempt to fix the amount of commissions or provide that no commissions are to be paid, so long as the person or persons named as executors are willing to work on that basis.

Some states have a statutory fee schedule for executors or personal representatives that applies, unless the will or an agreement of the parties provides otherwise. Some states call for reasonable compensation to be determined by the probate court. The statutory fees vary among the several states. Fees are usually a percentage of the estate inventory or receipts and disbursements, or probate estate, with higher percentages at lower brackets, ranging from 5% to 7% or so on for the first $5,000 to $200,000, down to 2% to 3% on amounts greater than, say, $200,000, with still lower percentages on larger estates. The probate court might sometimes award additional compensation for extraordinary or especially complex services.

Attorneys' fees, although usually not fixed by statute and no longer guided by bar association fee schedules, may parallel those allowed the personal representative or executor, or be based solely on hours worked. However, special services will call for special compensation and general rules for valuing an attorney's services will apply. An attorney's compensation will take into account, among other things, customary fees, complexity of required services, the time spent, the amount involved, and the results obtained.

Other miscellaneous expenses include court filing fees, probate fees, bonding fees, and costs of appraisals and accounting services. These expenses, however, are generally a relatively small part of the cost of administration. To be on the safe side for planning purposes, as a very broad rule of thumb, and depending on the complexity of the assets, a financial planner can figure on probate and administration expenses of roughly 9% on an estate of $50,000, down to 5% on a $1 million estate, and probably 2% to 4% on the very largest estates. When possible, attorney fees should be determined by the complexity of the work required and the time spent, not by the application of a flat percentage fee of the decedent's estate.

The IRS, in Technical Advice Memorandum 8838009 (June 17, 1988), ruled that for an administration expense to be deductible, the expense must be found to be reasonable for purposes of both state probate law and federal estate tax law. Hence, the IRS may independently determine the reasonableness of an expense allowed by a state probate court. The IRS successfully advanced this point of view in *J. White*.[29]

[29] CA-2, 88-2 USTC ¶13,777, cert. granted 2/27/89, cert. dismissed 110 S.Ct. 273.

© 2021 AICPA. All rights reserved.

Chapter 11

Wills

¶1101 Overview

¶1105 What a Will Can and Should Do

¶1110 Will Forms and Provisions

¶1115 Execution of the Will

¶1120 Joint, Mutual, and Reciprocal Wills

¶1125 Instructions and Data Sources Outside the Will

¶1130 Digital Estate Planning

¶1101 Overview

The coronavirus pandemic has highlighted both the importance and the need for individuals and families to have an estate plan in place. CPAs are perfectly positioned to work with clients and their team of advisers to put together a plan that meets their financial and life goals. Recent legislation and leveraging technology have provided flexibility in accomplishing this important planning opportunity when there is a need to be compliant with physical distancing requirements.

Every individual has a legal plan in force for the disposition of property upon death. A will sets forth the testator's plan for the disposition of probate property at death. The testator might own some property that will be disposed of outside of probate. The testator's interest in property owned as joint tenants with right of survivorship will pass to the other joint tenants. Pension funds, other retirement plans, life insurance policies, and property in a living trust will pass to the named beneficiaries, all outside of a will. A living trust can do many of the same things as a will, but not everybody has a will or an effective trust. If a person does not have either, the law of the decedent's state of residence steps in and disposes of the individual's property at death as it assumes the decedent would have wanted, in the light of existing family relationships. As far as a particular individual is concerned, the law's assumptions may or may not be well founded. Even when the beneficiaries selected by law are the same as those that the individual would have chosen, there is no advantage in simply allowing the law to take its course. This is referred to as the law of intestacy. There are costs associated with intestacy (administration fees, court fees, fiduciary bonds) that can be avoided when the decedent has a will or trust.

Having a will offers many advantages. A will enables an individual to decide both the type and the amount of property to be distributed to selected primary beneficiaries. A will can also specify the terms and conditions governing the distribution of property to contingent beneficiaries. Naming contingent beneficiaries is important in case the primary beneficiaries predecease the testator (that is, the person who makes the will) or the primary beneficiaries choose to disclaim property. The will should state how

© 2021 AICPA. All rights reserved.

the testator wants any disclaimed property to be distributed. A will also allows an individual to address other estate administration matters, such as appointing a guardian for minor children, selecting an executor, compensating the executor, and directing which beneficiaries will bear the burden of the estate's debts and taxes. Provisions can be made to address persons with special needs or lifestyle concerns.

An individual might be perfectly willing to have any property owned at death divided equally between the individual's surviving spouse and surviving children, if that is what applicable state law provides. However, the idea of a court-appointed guardian stepping in to control the children's share might be objectionable. The person might prefer to set up a trust, with an independent trustee, to make investments and distribute income and principal, as circumstances dictate, without having the fiduciary required to go to court for approval and without making formal judicial accountings. Similarly, the individual might feel that a surviving spouse's interest deserves the protection of a trust. Such provisions can be accomplished only by a properly drafted will or living trust.

Estate planning involves a great deal more than arranging for the transfer of property on the death of the owner, which is the fundamental purpose of a will. The financial planner has to do several things to help a client plan a will. The financial planner will want to look at the existing forms of ownership of property, the possibilities of lifetime personal and charitable giving, the use of living trusts, existing life insurance arrangements, qualified retirement plan and IRA benefits and beneficiary designations, and other property interests that may or may not pass under the will. If the estate owner has interests in a closely held business, the financial planner will want to examine those interests carefully in terms of their legal and tax structure and the planning opportunities and pitfalls present in those interests. The financial planner should also consider and address issues of family business succession planning. All of this planning must be considered in the context of whether federal or state estate or inheritance taxes are involved.

When the financial planner has the complete picture of the individual's assets and liabilities, as well as any plans for heirs and other intended beneficiaries, then the planner can begin thinking about preparing the outline or financial plan for the client's will, desires, and intent and then engaging the attorney to draft the necessary documents. The intent is most important. When a financial planner or a court looks at a will with a view to interpret it, if there is any ambiguity in the language used, the objective is to find out what the person who made the will (the testator) intended. The objective of the will draftsman should be to put into clear language and explain what the testator really wants.

The testator's intent must be an informed intent. The testator will know better than anyone else about the chosen heirs and the desires for them. The testator will also know better than anyone else about various property interests and their economic potential. However, chances are the testator will know little, if anything, about estate planning.

Some estate planning matters may be beyond the competence of the financial planner. In that case, the financial planner has to seek expert counsel. The point is that a will cannot adequately reflect a client's intent and consent to transfer property on death unless it is an informed consent. It cannot be an informed consent unless the financial planner tells the client what is possible and why certain will provisions are necessary. There are shorthand terms used in wills that have become encrusted with legal meanings. Many of these terms escape the layman unless the financial planner explains them.

© 2021 AICPA. All rights reserved.

¶1105 What a Will Can and Should Do

A will is a legal declaration of what an individual wants done with his or her probate property or estate upon death. From a legal standpoint, any sensible person can do almost anything with probate property through a will. However, there are limitations on such things as disinheriting a spouse, the duration of a trust, and possible other restrictions that vary from state to state.

The important thing is not so much what the client can do but what the client should do. What should the testator think about in terms of will provisions? What types of things do not belong in a will?

A will should not merely express the testator's hopes and wishes; it should also make positive directions and positive dispositions of property. Hopes and wishes tend to confuse things. Beneficiaries and family members might question the interpretation of a provision in the will, such as whether the testator's wish is to be taken as a command. Even if a court should conclude that the wish in question is still a wish, the parties might prefer that the dispute had never arisen.

Courts and lawyers refer to this sort of wishing type of language as precatory language. Precatory may also connote something stronger than a wish, but less than a command or direction. In any case, wishes and precatory language are generally to be avoided, unless the wish expressed is clearly only a wish. It should not be a direction or command used to dilute or in any way modify positive directions or commands. Ambiguity is what often leads to lawsuits seeking interpretations of documents after a person dies, just the opposite of what the testator wants to accomplish in addressing the preparation of a will.

The will can cover a wide variety of details about what is to be done about the testator's estate and property. Following are some of the key areas the client and financial planner should consider.

.01 Family Income During Administration

Getting a stream of income flowing out of an estate or trust takes time. In the meantime, the family, whose income may have been shut off or reduced by the death of the family member, may suffer unless some special provision has been made or is available. If the surviving spouse already has enough cash or liquid assets, together with life insurance proceeds, then income from the estate or trust during administration is less important. A joint account is almost as good a source of ready cash as a separate account, except that in most states the survivor will not be able to access the entire joint account until state tax waivers are presented. This process may involve only a short delay, from a few days to several weeks, or may involve a much longer process, depending upon state and local rules. The surviving spouse will not have a liquidity problem if a living trust has been set up to deliver family income on the death of the settlor. Nor is there a liquidity problem if, under state law, the surviving spouse is given an adequate allowance. Alternatively, the will can provide that the surviving spouse is to receive a specified amount each month, commencing with the testator's death and continuing until the estate makes a distribution of a total specified amount, or until trust income begins to flow. If a trust is to be used, another approach might be to provide that the estate may advance income, which accrues to the trust, to the surviving spouse as the trust is being set up.

.02 Funeral Arrangements

Funeral arrangements are best left to the discretion of the family or in special instructions expressed and addressed to the family (such as a specific instruction involving cremation, burial, entombment, or anatomical gifts) or to the executor independent of the will. The testator should leave some discretion to

© 2021 AICPA. All rights reserved.

the family, which allows the family to accommodate unusual circumstances. If the testator inserts desired funeral arrangements into the will, the executor and surviving family members might not discover the will with the instructions until after making funeral arrangements, or possibly until after the funeral has occurred. In addition, a problem could arise in regard to the force and effect of the instructions, if they are included in the will, because in most states a will is not effective until probated, and there may be a minimum 10-day waiting period after death before a will can be probated.

.03 Tangible Personal Property

Tangible personal property includes jewelry, furniture and furnishings, cars, works of art, clothing, and basically any moveable item. Disposing of tangible personal property in a separate will provision is best, for two reasons:

1. If the testator does not dispose of such property in a separate will provision, it will generally go into the residue of the estate (that is, what is left after debts, administration expenses, and specific bequests have been paid). The executor or personal representative might then be obligated to sell these items. Selling the items could create a variety of problems, such as failure to realize true value, loss of sentimental value, and mechanics and expenses of sale.

2. If the tangible personal property is left in the residue and passed on to the legatee or legatees without a separate, specific will provision, the recipients might have to pay income taxes on the personal property distributed to them to the extent that the estate has distributable net income. This income tax rule does not apply to distributions of specific bequests of property, which by statute (IRC Section 663) do not result in income taxation to the beneficiaries.

The testator should make specific bequests of the more valuable items to named individuals and include a catchall provision to address miscellaneous items. The testator may give the person named in the catchall specific bequest outright ownership or instruct the division of the items among family members. If the testator anticipates problems among beneficiaries cooperating regarding the disposition of personal effects, consideration should be given to either very clear enumeration of bequests or to creating a mechanism (such as a plan of alternating choices) to avoid unpleasantness among the beneficiaries, or to order a sale of all personal effects and a division of the proceeds.

In some cases when there are numerous items of personal property to be bequeathed, the financial planner may suggest that the testator include a list clause in the will that states that a list of items and their designated beneficiaries will accompany the will. If that is done, the list can be periodically revised by the testator without the need to create a new will or a codicil to the existing will each time a new item is added or the testator changes his or her mind about a particular bequest. The financial planner must, however, check state law, as some states (such as New York) do not permit a list clause incorporation by reference provision in a will.

.04 Legacies

There are four types of legacies to be considered: (1) gifts of specific property, (2) general gifts of money, (3) gifts of money payable out of a particular source, and (4) gifts payable out of the residue or what remains after other legacies, expenses, and debts have been paid.

Different rules apply to different types of bequests, which the estate owner will want to take into account. If a bequest is of specific property, and the testator sold or otherwise disposed of the property before death, the legatee will get nothing, unless the testator makes some other provision in the will. The

© 2021 AICPA. All rights reserved.

legatee's loss is technically known as an ademption. Similarly, if the estate owner, after having made a specific bequest of property, puts a mortgage on the property, the legatee generally takes the property subject to the mortgage. In that case, there is a partial ademption.

The estate owner needs to know what the law provides in the situation where the estate assets are insufficient to satisfy all of the estate's debts, costs, and bequests. State law provides an order of priority in reducing bequests, unless a will provision (an abatement clause) directs otherwise. The bequests made from the residue of the estate are the first to be reduced or abated. If there is still a deficiency, the general money bequests are cut, followed by the money bequests payable out of specific sources, and finally the bequests of specific property.

The estate owner should also consider the effects of inflation, deflation, and other factors resulting in growth or shrinkage of the estate, because these may affect the various legatees. If, for example, the estate is smaller than expected, those beneficiaries given cash bequests do relatively better than the residuary legatees, who are often the testator's prime concern. On the other hand, if the estate proves to be larger than anticipated, the residuary legatees do better.

One way of handling the shrinkage problem is to confirm that the executor is to pay cash bequests only if the estate is valued at more than a set minimum. Another way is to not allow the cash bequests (not stated in terms of fixed dollars, but in fractions or percentages of the estate) to exceed a fixed amount. If the testator is concerned about the specific legatees losing out because of inflation, the testator could use the fractional bequest approach, with any fixed-dollar limitation high enough to compensate for possible inflation. Alternatively, if an initial dollar amount is used, the testator could provide that a cost-of-living factor be added from the date the will is signed through the date of the testator's death.

.05 Real Estate

Real estate can present special questions. For example, will the real property be retained by the executor or sold? If it is to be sold, when and how is it to be sold? What if the real estate market at the time is soft? May the executor mortgage the property? The surviving spouse may have certain interests in real estate acquired during marriage by virtue of the common law rights of dower or curtesy or modern statutory substitutes under applicable state law. There are other considerations if an individual owns real estate outside the state of residence where the will is to be probated. Problems may arise regarding rights in the property under laws of other states or foreign jurisdictions, the power of the executor to deal with it, and the need for ancillary probate proceedings in the jurisdiction where the real estate is situated. The estate would also incur the added expense of such proceedings. These factors invite consideration of alternatives such as lifetime gifts, sales of the out-of-state or foreign real estate, and the use of living trusts or limited liability companies to hold title to the real estate.

The law usually defines real estate to include not only land but also the improvements on the land. Property law has many complex rules and exceptions. Often, the family residence is the subject of a specific bequest to the surviving spouse. The client might want to know whether to gift the residence during life, leave it to the spouse outright in the will, or leave it in a trust. Another issue is whether the surviving spouse is to be given an interest that will qualify for the marital deduction, including a qualified terminable interest property (QTIP) interest, or a more limited interest. A more limited interest could be a nonqualifying (that is, not qualifying for the marital deduction) term interest, with a remainder interest left to other family members. The testator might also leave the remainder interest to a charity to take advantage of the special rules that apply to charitable gifts of a remainder interest in a personal residence or farm (¶515.03). Also, the financial planner should remind the client of the income

© 2021 AICPA. All rights reserved.

tax exclusion for some or all of the gain on the sale of a residence by the surviving spouse.[1] See chapter 12, "The Marital Deduction," for a full discussion of the marital deduction.

Condominiums and cooperative apartments merit many of the same considerations as any other type of family residence. However, their precise status as real or personal property may depend on applicable state law.

Certain farm or other business real property includible in the estate may require special attention. Generally, property includible in the gross estate is valued at its fair market value on the decedent's date of death (or on the alternate valuation date) for estate tax purposes. However, IRC Section 2032A provides that an executor may elect to value qualified real property used for farming or business based on its special value for current use, rather than on its highest and best use. Details of this provision are discussed in ¶2210.

.06 Gifts of Income

The will may provide for periodic payments of income to named beneficiaries. The will may direct the executor to buy annuities or to set up a trust for this purpose. The principal of the trust might go to others on the death of the income beneficiaries or at some earlier date fixed in the trust.

.07 Disposing of the Bulk of the Estate

After payment of debts, administration expenses, taxes, and specific legacies, the executor must dispose of the bulk of the estate called the residue or remainder. All, or a good portion, of the remainder will usually go to the surviving spouse of a married testator. If it is to be shared, the executor will be directed to divide it into the shares indicated for the named beneficiaries. There may be problems in making a physical division of some types of property, and there will be uncertainties of valuation if the assets are to be distributed in kind to the beneficiaries and values have changed after their valuation for estate tax purposes. Provisions for the sale of properties to permit equal division and to avoid valuation problems are available.

Providing for contingent beneficiaries of the residuary portion of the estate if the primary beneficiaries do not survive the testator is important. Usually, the children of the primary beneficiary will be named contingent beneficiaries. The testator could have two or more primary beneficiaries, each of whom have children. In such a case, the will should specify whether the children of each primary beneficiary are simply to take their parent's share, divided up equally among the children of that particular parent, or whether all of the children of all of the deceased primary beneficiaries are to share equally in the combined shares of their deceased parents. The first described disposition is known as a per stirpes distribution; the latter is called a per capita distribution. The following example illustrates how each works.

> **Example 11.1.** The residue is to go to Adam and Bob in equal shares and, if either or both die before the testator, to their children then living per stirpes. Adam and Bob both die before the testator. Their children survive them and the testator. Adam has one child, Carla, and Bob has

[1] IRC Section 121.

© 2021 AICPA. All rights reserved.

two children, Debra and Earl. Carla gets half of the residue. Debra and Earl each get one quarter. If a per capita distribution were called for, then Carla, Debra, and Earl would each get one third.

.08 Protecting Minor Beneficiaries

A testator could make a bequest to a beneficiary who is a minor at the time of payment. In such a case, the bequest to the minor may require a guardian to be appointed by the probate court to hold and manage the bequest during the period of minority. In some states, a will designation of a guardian of the property would be acceptable. Guardianship entails expense and usually requires judicial accounting. The age of majority for most purposes has been lowered from the formerly universally accepted age 21 to age 18. A trust is usually preferred over a guardianship because it offers greater flexibility, control, and avoids unnecessary red tape and expense. Provision may be made for use of trust income or principal for the benefit of the minor. The trust may terminate on the minor's attaining majority or continue until a later age or for the lifetime of the minor, if desired.

.09 Protecting Adult Beneficiaries

If a testator has an adult beneficiary who is incompetent, the testator has a choice between some form of guardianship (the form varies in different states) and a trust, with the latter generally being preferable. A special needs trust may also be suggested by the financial planner. Such a trust could prohibit use of the trust funds for those basic expenses payable by public assistance, and at the same time allow use of the trust funds for the special needs of the beneficiary. If the adult is competent, then the choices are an outright bequest of the full amount, a bequest payable in installments over a limited period, or the use of a trust. A trust is favored if the testator feels a trustee is needed to supply one or more attributes missing in the beneficiary. These missing attributes could include lack of money sense, lack of investment management experience or judgment, and inability to resist the demands of other family members or friends. Trusts are often used to protect a beneficiary who may be involved with substance abuse, gambling issues, and the like, to protect the beneficiary's inheritance. A trust may also be a good idea to provide asset protection from all types of creditors, including matrimonial claimants.

.10 Trust Provisions

Trusts are flexible instruments and the testator, in creating a trust under a will to dispose of property, has a great deal of leeway in deciding how and when the trust is to distribute income or principal, how long the trust is to last, what the trust is to do with income or principal left in the trust on termination, and many other details. In a sense, a trust may permit a testator to "rule from the grave." If the trust is created for the benefit of the surviving spouse and is to qualify for the marital deduction, it will have to take the form of a general power-of-appointment trust, a QTIP trust, or an estate trust. The subject of trusts is treated more thoroughly in chapter 6, "The Use of Trusts," and the marital deduction is covered in chapter 12, "The Marital Deduction."

.11 Choice of the Executor or Trustee

One should look for trustworthiness, competence, availability, and cost factors when choosing an executor or trustee. Selection of trustees is discussed in chapter 6, "The Use of Trusts," and selection of executors is discussed in chapter 14, "Selection and Appointment of Fiduciaries."

© 2021 AICPA. All rights reserved.

.12 Business Interests

If the estate includes business interests such as a sole proprietorship, a partnership interest, a limited liability company, an interest in a closely held corporation or in a professional corporation, many different planning opportunities and pitfalls arise. These opportunities and pitfalls are considered in separate chapters of this guide devoted to planning for each form of business interest. See also ¶1105.05 in reference to business real estate.

.13 Life Insurance Interests

The will provisions, if any, dealing with life insurance should be integrated with existing life insurance arrangements, including irrevocable life insurance trusts (chapter 7, "Life Insurance"). Generally, life insurance does not pass by will, so typically it does not specifically need to be addressed in the will document.

.14 Payments of Death Taxes

The testator can allocate the burden of federal estate taxes and state death taxes and provide that they are to be borne by the estate or by the shares of the individual beneficiaries. If the will contains no provision for the allocation of death taxes, the executor must check state law. Many states have apportionment statutes allocating the death taxes proportionately to the items generating the taxes and to the beneficiaries receiving those items. If the gross estate for federal estate tax purposes will consist solely of probate assets, placing the burden on some specific portion of the assets might be desirable. If the gross estate will include both probate and nonprobate assets, the testator may allocate the tax burden to the probate assets or some portion of them, to the nonprobate assets, or to both. IRC Section 2207B provides a right of recovery of taxes paid from persons who received property that is includible in the gross estate under IRC Section 2036.

IRC Section 2207A contains a presumption that the taxes charged against QTIP property at the death of the surviving spouse shall be paid from the QTIP property. A will provision of the surviving spouse may waive this right of recovery provided the survivor's will specifically indicates this result and contains a specific reference to QTIP property or a QTIP trust.[2] Such a provision that reverses the presumption generally is not advisable, as it may serve to increase the estate tax burden on the separate assets of the surviving spouse, which may not pass to the same persons named as beneficiaries of the QTIP property.

A bequest to the surviving spouse that qualifies for the marital deduction reduces the burden of federal estate taxes. Therefore, the marital deduction bequest will normally not be called upon to share in the burden of federal estate taxes under the tax apportionment provisions of the will. The testator should also consider the burden of death taxes on the shares of the estate that pass to other beneficiaries. If taxes will come from a charitable share, the charitable deduction will be reduced and the tax increased, requiring a circular algebraic calculation.

[2] IRC Sections 2044 or 2207A.

© 2021 AICPA. All rights reserved.

.15 Survivorship

Occasionally, determining in what order the person making the will and his or her spouse died or in what order two or more beneficiaries died will be important. This issue is readily manageable if there is clear evidence of the order of deaths. Sometimes such clear evidence does not exist. The problem becomes most acute when spouses die at or near the same time and the availability of the marital deduction is an issue (this topic is discussed in chapter 12, "The Marital Deduction"). Some consideration should also be given to the broader aspects, such as when a bequest is contingent on the testator's survival or on that of a primary beneficiary. Most states have adopted the Uniform Simultaneous Death Act, which provides that if two persons die under circumstances such that one cannot tell who died first, each is presumed to be the survivor for the passage of personal property. However, that provision applies only when one cannot tell the order of deaths and it does not apply if a will suggests a different presumption. Apart from the simultaneous death situation when the order of deaths cannot be determined, one should consider situations in which deaths of the individuals involved occur within a relatively short time of one another. In such a case, to avoid two (or more) probate proceedings (and possibly two or more taxable estates) within a short time, the financial planner might want to suggest provisions that require survivorship for a specified period of time (such as 30 or 60 days) as a condition of the bequest. A marital deduction bequest conditioned on survivorship of up to six months may still qualify for the marital deduction if the spouse survives that long. Another consideration is portability. There must be a surviving spouse if a portability election is to be effective.

.16 Investment Powers

The executor has very limited power to invest unless it is provided for by the will. The executor's basic job is to marshal assets, liquidate them, and distribute them as fast as possible. If the executor holds on to an asset beyond a reasonable time and the estate suffers a loss, the executor can be held liable. The executor also runs a risk of liability for holding on to cash too long without putting it in an interest-bearing account. If large sums are involved beyond the current FDIC $250,000 insurance limit, maintaining many separate accounts might be inconvenient. The executor might choose to keep all the funds in one account if the financial institution provides collateral for the account. Investment in short-term government paper may be permitted as an exception to the general rule against consolidating investments. However, if the maturity dates of such paper do not conform to the estate's cash requirements, the executor may not be able to invest in such instruments. The testator will want to consider these potential problems facing the executor and might want to give somewhat greater freedom than state law otherwise allows by including broader investment powers in the will. Such broad powers are typically granted in most wills.

A trustee is in a different position. The trustee has implied investment powers if the trust does not provide them. Some states limit trustees to a list of approved investments of a generally conservative nature. In others, the trustee is subject to the prudent investor rule, which establishes criteria for determining the prudence of investments by a trustee. The American Law Institute promulgated the prudent investor rule as a part of the Restatement (Third) of Trusts in 1992. Under this rule, the trustee is to evaluate the prudence of an investment based on its impact on the total investment portfolio rather than as a single investment. The trustee must consider the risk and potential return of any investment, and the trustee may invest in any asset consistent with the objectives of the trust. In addition, the trustee may delegate the investment and management functions under certain conditions. The prudent investor rule is a part of the Uniform Prudent Investor Act (UPIA) promulgated by the Uniform Law Commissioners in 1994. The District of Columbia and a majority of the states have enacted the UPIA.

© 2021 AICPA. All rights reserved.

The UPIA is a change to the "prudent man rule" that allows investments that a prudent man would make in the management of his own affairs with the objective of preserving the corpus. The American Law Institute promulgated the prudent man rule as a part of the Restatement (Second) of Trusts in 1959. The prudent man rule is more restrictive than the prudent investor rule. The prudent man rule may still be the standard in some states. The settlor can free a trustee of these restrictions by a provision in the trust, giving the trustee broad investment discretion. How much power is given necessarily depends on the trustee selected and his, her, or its abilities. If the trustee is strong on integrity and weak on investment experience, the trustee should consider permitting employment of a professional investment adviser. If there is any hesitancy about conferring broad investment powers, setting out investment guidelines is better than restricting the trustee unduly. The trustee needs to be able to respond to changing market conditions. Flexibility is again a key planning concept.

¶1110 Will Forms and Provisions

There is no single or standard form of will. Individuals differ and individual wills differ. The basic objective of all wills is the same — to transfer the probate property from the estate of the testator to the chosen beneficiaries. To this end, wills tend to follow a common structure, with variations, additions, and subtractions appropriate for the testator and the testator's estate. A checklist of common components of a will, and some not so common components, follows.

.01 Testator's Identity

Some wills not only identify the testator by name, but also indicate family relationships, persons named in the will, and family members, if any, who are intentionally omitted as beneficiaries.

.02 Domicile

The will declares the testator's domicile in a certain state or jurisdiction. Domicile is important in determining such things as the formal requirements of a will and its execution, property rights, rights of the surviving spouse, taxation, and other important matters. The declaration made in a will is some evidence of domicile at the time of its execution and at the time of death, but it is not controlling. Still, including a declaration is a good idea, if it is made with due regard for the legal ramifications. If an individual has two or more residences in different probate court districts, or in different states, the will should indicate the principal residence and district of probate. Because different states have different estate tax and inheritance tax laws, as well as other tax law and property succession differences, choice of domicile may become a serious issue for the financial planner to consider. If the domicile is uncertain, the financial planner can assist the client to take the necessary steps to conclusively establish domicile in one jurisdiction or another (for example, demonstrate physical presence, register to vote; obtain a driver's license; join religious institutions, clubs, and other social entities; establish the location of key personal items, including pets; change address for important mail; or obtain a safe deposit box).

.03 Revocation of Prior Wills and Codicils

The testator revokes prior wills and codicils with each new will executed. (Codicils are instruments executed with the formality of a will amending, modifying, or adding to a prior will and are legally considered as forming a part of the prior will.)

© 2021 AICPA. All rights reserved.

.04 Funeral Directions and Disposition of Body

Funeral and burial or cremation directions are best handled outside the will, if for no other reason than that they may come too late if family members or the executor do not immediately consult the will. The same is true of any plans the testator might have for the disposition of body parts or organs for the use of others because of the added factor of legal complications in the disposition of the body by will. All states have adopted the Uniform Anatomical Gift Act of 1968 that sets out the rules. Almost half the states have adopted the Revised Uniform Anatomical Gift Act of 1987. Another revision occurred with the 2006 Revised Uniform Anatomical Gift Act. The testator should obtain forms for such gifts from the intended donee organization. The willingness to be an organ donor is listed on a driver's license in some states.

.05 Cemetery, Monument, Memorials

The testator might make provision for perpetual care and bequests made for masses or other religious services. Designating the individual by title who holds a position in a named institution as the recipient of the bequest (for example, the then-serving pastor of St. Mary's, rather than a specific, named individual) is better. The named individual might not be at the institution at the time of the testator's death.

.06 Payment of Debts

This will provision directs the payment of debts, funeral expenses, the costs of administration, and possibly indicates the source from which such amounts are to be paid. The testator might also want to establish debt items that might not otherwise qualify as valid debts. For example, a loan from a child might have been made on an informal basis and the testator might wish to make formal acknowledgment. However, because debts are deductible for estate tax purposes, the IRS might suspect that the testator is using the debt to get an estate tax deduction for what is really a bequest, especially when family members are involved. The will might state that the executor is directed to use estate assets to pay all of the testator's just debts that are not barred from enforced collection by the statute of limitations.

.07 Payment of Taxes

This will provision establishes the source of payment of death taxes as well as the source of payment of other expenses of estate administration. Often death taxes will be made payable out of the residue instead of being apportioned among all the assets includible in the taxable estate, whether passing under the will or outside the will. Examples of assets that pass outside the will are life insurance, jointly held property, retirement plan benefits, and revocable living trusts. If a marital or charitable deduction gift is payable out of the residuary estate, the testator might not want the marital or charitable deduction portion of the residue to bear the tax burden, especially insofar as the marital or charitable deduction portion has not contributed to the tax burden. Also, if the tax burden is to be borne by the marital or charitable share of the assets, the tax burden will operate to reduce the marital or charitable deduction and possibly increase estate taxes. By the same token, the testator might not want other assets qualifying for the marital or charitable deduction and passing to the surviving spouse or charity under other portions of the will or outside the will (but includible in the adjusted gross estate) to bear the burden of taxes not attributable to the transfer to the surviving spouse or charity.

If the residue is divisible into a marital or charitable deduction portion and a nonmarital or noncharitable deduction portion, then the latter may be given the burden of all of the death taxes. However, the testator

© 2021 AICPA. All rights reserved.

may not want to do so if such a provision would seriously distort or impair the testator's intent to benefit the beneficiaries of the nonmarital or noncharitable share. The financial planner should discuss the tax allocation issues with the client. As a general rule, the marital and charitable shares should be protected, if possible, from sharing the tax burden. Having these shares contribute to that burden is likely to result in reducing the deductions available to the estate, with a corresponding increase in the estate tax liability, as well as increased complexity, as a circular algebraic calculation must be done to determine tax liability when it is borne by a marital or charitable share of the estate.

.08 Administration Expenses

A clause addressing payment of administration expenses identifies the source for payment of expenses incurred in collecting, maintaining, and distributing an estate. Examples of such expenses include executor and attorney's fees, court costs, probate fees, storage costs, accountant's fees, and appraiser's fees. Administration expenses are often paid out of the residue of the estate; however, payment can be apportioned among all the assets includible in the estate. As in the case of the tax payment clauses previously discussed, the attorney who drafts the will must take special care to avoid erosion of the marital and charitable deduction, and possibly increase estate taxes when drafting an apportionment clause for administration expenses. In the absence of an apportionment clause for administration expenses in the governing instrument, state law governs.

The U.S. Supreme Court ruled in *O. Hubert Estate*.[3] that an estate did not have to reduce its marital and charitable deductions by the amount of administration expenses paid out of income generated during administration by assets allocated to a marital or charitable trust. Pursuant to *Hubert*, an executor could use the income generated by the marital or charitable assets to pay administration expenses if the use of such income was not a material limitation of the right of the surviving spouse or charity to the income and if the executor had been granted the discretion to use such income for that purpose. To pass the material limitation test of *Hubert*, the expenses paid had to be properly chargeable to the income generated by the marital or charitable assets under applicable state principal and income allocation rules.

However, after the decision in *Hubert*, the Treasury modified the regulations governing the calculation of the deduction for administration expenses and the marital and charitable deductions. Regulation Section 20.2055-3(b), which applies to estates of decedents dying on or after December 3, 1999, states that the charitable deduction is reduced by the amount of *estate transmission* expenses paid from the charitable share. Estate transmission expenses are expenses arising from the decedent's death and the necessity to transfer the decedent's property to his or her beneficiaries. The charitable deduction is also reduced by *estate management* expenses paid from the charitable share, but attributable to a property interest that is not a part of the charitable share. However, the charitable deduction is not reduced for the estate management expenses attributable to property that is part of the charitable share and paid from the charitable share. Estate management expenses are expenses incurred in connection with the investment or maintenance of estate assets during the period of administration.

In addition, Regulation Section 20.2056(b)-4(d), which applies to estates of decedents dying on or after December 3, 1999, states that transmission expenses paid from the marital share reduce the marital deduction. The marital deduction is not reduced for estate management expenses attributable to and paid

[3] 520 U.S. 93 (1997), *aff'g* 63 F.3d 1083 (1995).

© 2021 AICPA. All rights reserved.

from the marital share unless the executor deducts such expenses as an administration expense on the estate tax return. However, the marital deduction is reduced by estate management expenses paid from the marital share but attributable to a property interest that is not a part of the marital share.

A well-drafted will should include language addressing these *Hubert* issues, identifying and distinguishing estate transmission and management expenses and indicating the permitted and prohibited sources of their payment to protect the marital and charitable deductions.

.09 Personal Property

Disposing of personal property in a separate will provision is always best for the reasons mentioned in ¶1105. The will should note that some categories or specific items of personal property do not belong to the testator, even though they may be in the testator's possession. For example, the property might already belong to the testator's spouse. In that case, one might want to confirm such ownership in the will. If the testator lives in a community property jurisdiction, the attorney who drafts the will may use a clause recognizing the community property interest of the surviving spouse in one half of the tangible personal property owned by the community.

.10 Legacies

Legacies fall into four basic categories: (1) bequests or devises of specific property, (2) general money bequests, (3) money bequests payable out of specific property, and (4) residuary bequests. If the testator does not own the specific property intended to be given at the time of death, the legatee takes nothing, unless the testator makes some other provision in the will. This is known as ademption. The testator can guard against ademption of a specific legacy or against ademption, generally, by providing for a cash legacy equal to the value of the property bequeathed at the time of its disposition, the proceeds (if sold), or some other amount of cash. If estate assets are insufficient to pay all legacies, the law provides an order of priority — an order of abatement of legacies, depending on the particular types of legacy involved (see ¶1105). The testator may change this order by a provision in the will. Gifts of the residue abate first and residuary legatees are usually the testator's primary concern. Therefore, the testator should protect against some beneficiaries receiving nothing because of an unforeseen shrinkage in the estate. The will may state that the legacies of those less favored by the testator are to abate first.

.11 Residuary Bequests

In most cases, residuary bequests are very important. The transfer may be of the entire residue to one named beneficiary or of fractional shares to two or more named beneficiaries. The bequest of the residue of the estate can be outright or in trust. The trust or trusts can be those created by the will. Alternatively, a living trust created during the testator's lifetime can receive the residuary bequest. Bequests of the residue frequently involve the marital deduction, which is discussed in chapter 12, "The Marital Deduction."

.12 Lapsed Legacies

What happens if a legatee is unwilling to accept a legacy, dies before the testator, or dies after the testator, but before a gift vests? For example, what if a gift of a remainder interest is contingent on surviving the holder of a life estate? State law will furnish an answer if the testator's will does not address this contingency. As a general rule, the lapsed legacy becomes a part of the residuary estate. If the lapse is in the residuary estate, and no successor beneficiary is named, then the property may pass under the laws of intestacy, as it would pass if there was no will. Many states have special anti-lapse

© 2021 AICPA. All rights reserved.

statutes dealing with bequests to descendants or siblings of the testator. In any event, the possibility of lapse exists, and some provision, for or against, is advisable to control the situation to the testator's liking. The financial planner should always encourage the client to consider several "what if" scenarios, various contingencies and unexpected developments and address them accordingly in the will.

.13 Power of Appointment

The testator may possess a power of appointment exercisable solely by will. This is typically the case when a power of appointment marital deduction trust has been set up for the benefit of a surviving spouse. The holder of a power exercisable by will should take great care to make sure that the requirements for exercise are fully satisfied. If the holder of the power does not wish to exercise it, that should be stated explicitly in that person's will. The will of the person who created the power will include a "default clause" disposing of the property if the power of appointment is not exercised.

.14 Gifts to a Class

Gifts to a class are gifts made to persons not individually named who fit a general description or class, such as children or grandchildren. The testator may include unborn persons in the class. Generally, membership in the class is determined as of the date the gift is intended to take effect. This date might be the date of the testator's death or some later date. Good planning suggests avoiding having a class remain open indefinitely, (such as a gift to grandchildren whenever they may be born) as that will delay the closing of the class and the distribution of property to those beneficiaries otherwise entitled to take the property that is available.

.15 Appointment of the Fiduciary

The testator appoints the person, individual, or corporation who is to serve as executor and any successors or substitutes. The testator also includes a provision waiving the posting of a bond or other security, if that waiver is deemed prudent. A special provision for compensation of the executor may be included, usually on terms mutually agreed upon in advance by the testator and the executor. The testator may appoint more than one executor. The testator should name successors or substitutes to fill in the gaps if an executor is unable or unwilling to serve.

Chapter 14, "Selection and Appointment of Fiduciaries," discusses the selection and appointment of fiduciaries in detail.

.16 Survivorship

Will provisions can address two potential problems concerning survivorship: (1) establishing the order of deaths of the testator and his or her spouse or other beneficiary where there is no proof of the order of deaths, and (2) avoiding the expense of double administration where two parties, one inheriting from the other, die within a short time of one another (see ¶1105.15 and ¶1240, which review the area and suggest solutions). Bear in mind that portability requires identifying a surviving spouse, so that one spouse should be deemed to survive the other if there is a simultaneous death.

.17 Disinheritance

In most states, the testator cannot completely disinherit a spouse. A spouse is given the right to elect against the testator's will and receive a share of the testator's property (an "elective share," often one third under the laws of most states) even if the spouse is omitted from the testator's will, whether

© 2021 AICPA. All rights reserved.

intentionally or accidentally. Careful attention should be paid to formula clauses, especially with the substantial exclusions currently available from transfer taxes. Use of a well-intentioned formula clause could end up inadvertently disinheriting a spouse, resulting in an election against the will by the spouse. Children who are not mentioned or provided for may, in some states, be entitled to what they would inherit if there was no will. In other states, this rule is limited to children who are born after the will is executed. Some states have similar restrictions if the testator makes charitable bequests and makes no mention of particular classes of heirs. The person or persons being disinherited need not be named; a class designation will do. However, naming the individual and the reason, tactfully stated, for the disinheritance is good practice. Will provisions that explicitly address disinheritance along with the testimony of the scrivener of the will can help provide a defense later to charges of fraud, undue influence, or lack of capacity to make a will.

.18 Powers Clauses

State law will give an executor certain powers without benefit of a will provision. A testator may add to or subtract from those powers given. One of the possible problems involved in relying on state law is that one cannot always rely on the testator to remain in that state so that the right state law powers will be read into the will. The better way may be for the attorney who drafts the will to select carefully the powers appropriate to the particular estate and spell them out in the will. Many administration powers can have substantial dispositive effects. No power should be included unless the testator knows what it means and what the possible effects might be, and that it is consistent with his or her basic intentions. The testator should give the fiduciary broad enough powers to be able to handle the variety of situations that can arise in the way the testator might want them handled if still alive. Instead of limiting the fiduciary with direct limitations, the better way will often be for the testator to set forth guidelines in a particular area, intended as suggestions and not commands, making such intent crystal clear. Investment powers are most important, as is apparent from the discussion in ¶1105.16.

If a trust is created, dealings between the trust and the estate become another important place in which the powers of the executor and the trustee need to be structured to assure a smooth working relationship. One may want to permit the trust to lend money to the estate or to purchase estate assets. This provision might be of particular importance in supplying estate liquidity. If the trust is to be the recipient of life insurance proceeds, one must be mindful of the adverse estate tax consequences that can result if the trustee is required to use life insurance proceeds to pay estate expenses. In any case, the powers of the estate and the trust must be coordinated. For example, the power of the trust to lend has to be matched by a power of the executor to borrow from the trust. Special types of assets call for special types of powers. Business assets, for instance, are of this type, and the whole subject of planning for business interests is developed later in this publication (see chapters 19–22).

If real estate is involved, a variety of powers might be appropriate, including power to foreclose, improve, manage, subdivide, insure, borrow, or, perhaps, abandon the property. If there are minor or incompetent beneficiaries, the financial planner should consider other special powers, including a power to accumulate income and to make direct payments to or on behalf of the beneficiary. In short, the powers need to be commensurate with the duties and responsibilities of the fiduciary and adequate to meet the situations that might arise.

.19 Disclaimers

If there is a possibility that a disclaimer might be a useful postmortem strategy, the testator should make provision for it in the will (see ¶1525 for a discussion of disclaimers).

© 2021 AICPA. All rights reserved.

.20 Digital Assets

It is becoming increasingly important for persons to address their digital assets, especially if the internet is the place where much of their vital and confidential information is maintained. Identifying user names and passwords in a separate trust or in a will or document in safe keeping and referenced in a will or trust can provide heirs with essential information that might otherwise require significant effort and expense to obtain.

¶1115 Execution of the Will

A will speaks when its maker can no longer speak, so the voice heard must be identified as that of the maker. Property rights and human rights depend on it. To safeguard those rights, the law surrounds the execution of a will with formal requirements, which need to be carefully observed and satisfied.

The requirements might vary somewhat from state to state, but they all are intended to establish the will's validity. Specifically, these formalities establish that the testator executed the instrument in question with full and complete knowledge that it was the testator's will, the testator meant it to be his or her last will, signed it or placed his or her mark at the end of the instrument on a certain date, and had it duly witnessed and attested. Although some states might give effect to unwitnessed or self-written (holographic) wills, for practical purposes, one should ignore this possibility.

The following is a more detailed model of how these general formalities break down into specifics, subject to some variations in state law that might require special attention.

.01 Declaration of Will

In the past, many wills started out with the testator saying that, "I make, publish, and declare this to be my Last Will and Testament." All three verbs are important, but today many wills leave only the "declare" part up front. The recital of "make" and "publish" is not essential so long as the testator executes the will and the witnesses can attest that it is the will of the testator.

.02 Signature or Mark

The testator should sign the will. If unable to sign the will, the testator should place a mark where the signature should be or ask someone else to sign the will on his or her behalf and in his or her presence. The signing should be located immediately at the end of the will proper.

.03 Witnesses

At least two, preferably three, disinterested witnesses should be on hand to witness the execution of the will. Two witnesses may be all that are legally required in most states, but some may require three. Even when only two are needed, a third witness will facilitate proof of proper execution if one is later unavailable for any reason.

The witnesses generally should not be any of the following: (1) a beneficiary, executor, or trustee under the will, or the spouse or business partner of any such person; (2) an officer, director, or shareholder of a corporation that is an executor or trustee under the will, or a beneficiary.

Most states now permit the use of a self-proving affidavit. If the will is signed in the presence of the appropriate number of witnesses and a notary public, the will can be admitted to probate without the

© 2021 AICPA. All rights reserved.

necessity of having the witnesses come forward. This method of will execution is always recommended, as witnesses may die, move away, or become difficult to locate.

.04 Publication and Attestation

The witnesses should be told that the instrument that they are called upon to witness is the testator's will, and the testator should specifically ask them to witness the execution of the will.

Each witness must either see the testator sign or hear the testator acknowledge that the testator's signature is already on the will. This signature should be pointed out to the witnesses and actually be seen by them. If the testator is unable to sign and someone else signs on the testator's behalf, the witnesses should observe that the person signing does so at the request of the testator and in the presence of the testator.

The witnesses, at the request of the testator and in his or her unobstructed view, should sign their names and write their addresses on the will. In some states, the witnesses may do so independently of the attestation clause that follows. In other states, the witnesses' signatures and addresses appear only once following the attestation clause.

Each witness, the testator, and the person, if any, signing for the testator should all be present throughout the entire proceedings for execution of the will.

.05 Date and Place

The will should fully and correctly state the date and place of its execution.

.06 Page Numbering

As a matter of practice, if not a legal requirement, the attorney should number the pages of the will consecutively, bind them together, and have the testator and witnesses initial each page. When the will is stapled or bound, do not remove the staples or binding until the original will is presented for probate. Some states (notably, New York) may object to admitting to probate a will that has been unbound or unstapled, fearing possible tampering.

.07 Attestation

Either as the vehicle for the attesting witnesses' signatures or as an additional provision following their signatures, an attestation clause should be set out that recites all the formalities of publication and attestation referred to in ¶1115.04, the date of the execution of the will, and the number of pages of the will.

In some states, provision is made for an affidavit of the witnesses to be executed at, or about the time of, the will's execution. The probate court may accept this affidavit in lieu of the witnesses' making an affidavit or appearing personally when the will is probated. This affidavit eliminates difficulties of proof that might arise if, at the time of probate, one or more of the attesting witnesses is not available. This affidavit, called a self-proving affidavit, should be notarized.

In some instances, the will itself and the attestation clause might contain recitals about the testator's competence. One attestation clause recites, for example, that the testator appeared to be of sound mind and memory and was in all respects competent to make a will. Some practitioners question whether this clause adds anything useful. If a will is to be executed by someone who is seriously ill and, perhaps,

© 2021 AICPA. All rights reserved.

hospitalized, obtaining the opinion of the attending physician about competency before the execution of the will would be prudent. The attorney might want to get a written statement, preferably in affidavit form, supporting the competency of the testator at the precise time of the execution of the will.

The formalities surrounding the execution of a will are of great importance and should not be regarded lightly. Each state has its own requirements, which should be followed to the letter. Once the testator has died, any technical error may invalidate the will, or at least cause unnecessary expense and delay.

¶1120 Joint, Mutual, and Reciprocal Wills

Sometimes two related individuals, such as spouses, have a common plan for the disposition of their property. Special problems can arise because of the marital deduction, and that aspect of joint or mutual wills is discussed in chapter 12, "The Marital Deduction."

One should be able to distinguish between joint, mutual, and reciprocal wills. A joint will is a single will executed by two or more individuals. A mutual will is one made pursuant to an agreement between two or more individuals to dispose of their property in a special way. In such a case, the will might be a joint will or there could be separate wills. Reciprocal wills are those in which each testator names the other as his or her beneficiary, either in a joint will or in separate wills.

Joint wills are a popular alternative for spouses in a number of states, particularly community property states. When they are used, be careful that upon the death of the first spouse, the rights and separate property of the surviving spouse and any other heirs are clearly addressed and explained.

¶1125 Instructions and Data Sources Outside the Will

A will is a marvelous device for doing the basic job it is intended to do — transferring probate property on death. It is a legal document and it is almost invariably written by a lawyer for a layman. It tends to be in formal terms. Although some people might prefer to have it written in less formal terms, there is often a real danger in departing from tried and tested legal language. There is also a danger in expressing general wishes or offering precatory guidance regarding particular matters, lest they be taken as commands or create doubts and uncertainties about portions of the will. Some things that the testator might want to say are not appropriate. Once the will is submitted for probate, it becomes a public document, which anyone can read. For these and other reasons, instructions outside the will — whether in the form of a letter or a memorandum from the testator or perhaps a trust which is not a public document open to possibly unwanted scrutiny — make more sense assuming, of course, that the testator trusts the recipients of the instructions to follow them.

Some examples of suggestions outside the will that might be appropriate include the following:

- Suggestions as to investment and whether to sell or hold securities
- Suggestions as to special assets of the estate (works of art, jewelry, stamp and coin collections, etc., in which the testator's judgment might be better than that of anyone else in the family or one charged with the administration of the estate)
- Suggestions as to the selection of insurance options
- Explanations of the reasons for some of the will provisions (for example, the testator might explain the use of a marital and nonmarital trust.)

© 2021 AICPA. All rights reserved.

- An investment philosophy for the guidance of trustees or others
- Identification of pets and direction for their care

In addition, the financial planner should assist the client in preparing a data source list, which will facilitate understanding the client's situation for his or her own periodic review, assisting power of attorney holders in the event of the client's incapacity, and aiding fiduciaries in the administration of the client's estate. Once completed, this information should be kept in a safe, accessible place and be periodically reviewed and updated (preferably annually). Exhibit 11-1 includes forms that the client can use. Any data list should include a person's user names and passwords to access any sites that involve financial information or other data, including program rewards that may be of importance to a person's family and heirs.

Exhibit 11-1: Estate Owner's Confidential Data Bank

KEY ADVISERS: PERSONAL, BUSINESS, FINANCIAL, AND PROFESSIONAL

Adviser	Name	Address	Phone Number
Attorney			
CPA			
Financial planner			
Banker			
Stockbroker			
Insurance agent			
Funeral director			
Doctor			
Dentist			
Clergy			
Employer or business associates			
Appraiser			
Other			

© 2021 AICPA. All rights reserved.

KEY PERSONAL PAPERS

Name		Location
Certificates:	Birth	
	Adoption	
	Baptismal	
	Marriage	
Will (original copy)		
Brokerage statements		
Income tax returns		
Gift tax returns		
Household inventory		
Military service records		
Social Security number and cards; Medicare cards		
Employment records		
Educational records (diplomas, transcripts)		
Medical and health records (medication, vaccinations)		
Cemetery site deed		
Divorce decree or separation agreement		
Passport		
Citizenship papers		
Organizations:	Professional	
	Religious	
	Fraternal	
	Union	
	Other	
Powers of attorney		
Living wills (medical directives)		
Trusts		
Others (including computer usernames and passwords)		

© 2021 AICPA. All rights reserved.

MEMBERS OF FAMILY

(List spouse, children, grandchildren, parents, siblings, and others who may be involved in your estate or in caring for your family after your death.)

Name	Address	Relationship	Date of Birth	Place of Birth	Marital Status	Date of Death	Place of Death

BANK DATA

	Name of Bank or Credit Union	Address	Name of Account	Account Number	Online Credentials	Location of Bank Statements, Checkbook, or Key
Savings accounts						
Checking accounts						
Money market accounts						
Certificates of deposit						
Safe deposit box						

U.S. SAVINGS BONDS

Serial Number	Names Registered	Purchase Date	Purchase Price	Maturity Date	Maturity Value	Location

© 2021 AICPA. All rights reserved.

STOCKS, BONDS, MUTUAL FUNDS, AND OTHER INVESTMENTS

Broker _____ Address _____
Telephone _____ Email_____

Issuer	Owner (Indicate Whether Registered or Bearer)	Description	Date of Purchase	Number of Shares	Purchase Price	Location
Stocks						
Bonds						
Mutual funds						
Other						

OTHER TANGIBLE PERSONAL PROPERTY

(auto, jewelry, art, and so on)

Type of Property	Location	Insured		Other Comments*
		Yes	No	

* Include cost basis of items which may have appreciated in value and date acquired.

REAL ESTATE

(Include cemetery plot, condominium, and cooperative apartment)

Description and Location	Date of Purchase	Purchase Price	Title in Name of	Mortgage: Amount and Holder	Location of Records
List separately lot and block, date, cost, and nature of improvements.					

© 2021 AICPA. All rights reserved.

OTHER ASSETS

Company Benefits	Company	Beneficiary	Administrator
Pension			
Profit-sharing			
Traditional IRA			
Roth IRA			
Annuity			
Medical savings account			
Health savings account			
Other			

INSURANCE

Broker _____ Address _____
Telephone _____

Company and Address	Policy Number	Location of Policy	Type of Insurance Beneficiary	Value on Natural Death	Value on Accidental Death
Life insurance					
Health insurance					
Disability income insurance					
Long-term care insurance					
Home and car insurance					
Other (umbrella policy; personal contents policy, malpractice insurance)					

© 2021 AICPA. All rights reserved.

DEBTS

(Bank, mortgage, broker, and insurance loans, installment contracts, consumer loans, credit card debt, automobile leases)

Creditor's Name and Address	Amount	Collateral	Location of Records and Documents

¶1130 Digital Estate Planning

As more and more clients become immersed in the technology of the digital age, a new frontier of planning has emerged — digital estate planning. A digital estate plan is a plan for disposition of all of the online accounts of the client upon the client's death.

Estimates suggest that the average adult with internet access has more than 25 active accounts. Aside from photos, social media, and emails, the bank accounts and investment accounts of many clients are entirely online. If the client dies, how can these accounts be accessed? If the client's family wants the accounts and information removed from the internet, how is this done?

Access to another person's account — even after death — is extremely difficult. There is a federal law, the Stored Communications Act of 1986 (18 USC 2701 et seq.), that protects a person's electronic data from access by anyone else. Some sites have decided to interpret the privacy rules strictly, even if there has been a death. Only a handful of states have addressed legislation to help recover the online data of a decedent. Idaho, Indiana, and Oklahoma have addressed social media and blogging accounts, and Connecticut and Rhode Island have addressed email accounts. This list can change as awareness of the importance of access to digital assets increases.

The legislation — even in states where there are laws — remains largely untested in the courts, and each website and online service has addressed the issue independently.[4]

Most U.S. states have enacted legislation to adopt in some form the Uniform Fiduciary Access to Digital Assets Act (UFADAA). There are sometimes concerns expressed by internet and

[4] This is still an evolving area. For Facebook's latest policies on Facebook pages after death, see www.facebook.com/help/408583372511972/.

Google's policies are listed here: https://support.google.com/accounts/contact/deceased?hl=en&rd=1.

To see how Yahoo treats an account after the owner's death, click here: https://help.yahoo.com/kb/SLN2021.html.

For Twitter's policy, visit https://support.twitter.com/articles/87894-how-to-contact-twitter-about-a-deceased-user#.

© 2021 AICPA. All rights reserved.

telecommunications companies that the act raises privacy questions, conflicts with federal law, and undermines contract rights.

The UFADAA is a comprehensive law proposed by the National Conference of Commissioners on Uniform State Laws (NCCUSL) that provides access to a wide range of digital assets, including electronic documentation of financial accounts, on par with access to traditional tangible assets.

As of May 2019, nearly all states have introduced or enacted some type of law on this topic. To illustrate how important it is to keep up with changes to the law in this area, in 2017, Virginia adopted its version of the UFADAA. The law would allow fiduciaries to manage digital property, including computer files, web domains, and virtual currency, but restricts a fiduciary's access to electronic communications such as email, text messages, and social media accounts unless the original user consented to such access in a will, trust, power of attorney, or other record. The law also repeals the Privacy Expectation Afterlife and Choices Act (Article 3 sections 64.2-109 through 64.2-115), Chapter 1, Title 64.2 of the Code of Virginia, which was enacted in 2015. What can the financial planner do to be helpful here? Most importantly, encourage the client to create a digital estate plan. This would involve the listing of all relevant online accounts of the client, including the name of the account, its contents, the URL address, the username, and the password, along with instructions for the disposition of the account and identification of the person to undertake or supervise the disposition. As technology advances and a person's information becomes stored in the cloud, or wherever else technology may lead us, we do not want important information to die with the client and be unavailable or, at worst, unknown to loved ones. Determine what laws (if any) your state has adopted dealing with digital assets.

The key factor here is to get the client to do something. Whether a paid service is used, or the client keeps a clear and updated record of these items, if the issue is addressed, the family will be better protected. It is increasingly ironic that clients will pay thousands of dollars to prepare a traditional estate plan which may only transfer a small percentage of their assets yet minimize or ignore the importance of addressing their digital accounts, where much or most of their financial life is recorded and stored.

Make a list of all online accounts and how to access them. This is the core of any digital estate plan. List *all* relevant online accounts, from banking and investment websites to social media, smartphone sync sites such as iTunes, photo-sharing sites, rewards programs, and even home utilities. Document the following information:

- Name of the account
- Contents of the account
- URL address
- User name
- Password
- Instructions for the account's disposition, as well as which person is to undertake or supervise the disposition

Write out instructions. This can be as simple as creating a list of what to do with all of a client's online accounts. Consider a Facebook account, for example. Does the profile remain online as an historical timeline or tribute, or both, or does the client want the account deleted?

© 2021 AICPA. All rights reserved.

Name a digital executor or trustee. Designate a person to carry out the digital plan, name this person in the will, and ensure the designee knows how to access the digital estate. Give the digital executor power of attorney over digital accounts in order to access them. Consider a living trust dedicated exclusively to addressing issues arising in connection with digital assets.

Store information in a safe place. With digital estate planning gaining more traction, planning services are starting to pop up that will allow your clients to store all their pertinent information in one place. This resource enables them to better protect their most sensitive information. One company is Password Box, which allows a client to enter usernames, passwords, and directives for each and every digital asset, even deciding which heir gets what account.

Be an advocate for your clients. Although these steps may seem like a lot of hoops to jump through, either in your own life or when encouraging clients to take these steps, the best way to preserve anyone's legacy is to make sure all details are completely documented. Present clients with some real-world examples and show them just how important digital estate planning can be. Perhaps most importantly, leave instructions that make it easy to locate and access this digital information.

.01 Digital Planning Checklist

- Create an Inventory of Your Digital Assets and Social Media Accounts.
    - — Begin by identifying all computers and other pieces of hardware that may contain information. This may include home and office computers, cell phones, laptops, tablets, USB flash and hard drives, cameras, iPods, and so on.
    - — Software programs and file folders and their locations are next.
    - — List online accounts (banking, shopping, Amazon), online sites where you may keep photos, documents, and so on, and social media accounts.
- List Passwords
    - — Although it goes against all the security measures we have been taught, a list of login IDs, passwords, and PIN numbers should be kept and *regularly updated*.
    - — This can be either a written list that is kept in a secure location or it can be an encrypted electronic list (web-based or software-based) that needs only a master password to access. No matter which "virtual vault" is selected, it is important that a trusted individual have access to the list and instructions. To avoid any unforeseen issues, the Terms of Service contracts should be reviewed before a family member or representative attempts to access your accounts.
- Select a "Digital Executor" or "Digital Representative"
    - — Although it is probable that your state does not legally recognize a "Digital Executor" (most states do not), it is still advisable to name a person or persons who should manage your digital assets upon your death or incapacity. This could be done in your will for death, a power of attorney for a life event, or by a separate written appointment that could cover both lifetime and death.

© 2021 AICPA. All rights reserved.

— The person selected should be tech-savvy and experienced with the internet and should also be someone who will be trusted to follow your instructions.

— Certain social media sites such as Facebook have their own rules and restrictions. For example, Facebook will now allow a user to appoint a "legacy contact" (described in the following section) to a Facebook account. This appointed contact will have limited access to manage a Facebook account after a user's death.

.02 Facebook Legacy Contacts

Facebook now allows you to appoint a "legacy contact" for your Facebook account after you die. Previously, after a user died, Facebook would not allow anyone else to access or modify the deceased user's Facebook account, but the account could be closed or "memorialized." Facebook also allows you to set your account so that it's permanently deleted when you die.

A Facebook account legacy contact can (1) download a copy of what the deceased user shared on Facebook (photos, videos, wall posts, profile information, contact information, events, and the deceased user's list of friends); (2) write a pinned post for the deceased user's profile to share a remembrance or final message on behalf of the deceased user; (3) respond to new friend requests with the deceased user; and (4) update the deceased user's profile picture and cover photo.

However, a Facebook account legacy contact cannot (1) read or download the messages that the deceased user sent to friends (or photos that the deceased user automatically synced with Facebook but didn't post); (2) remove friends of the deceased user; (3) change photos, postings, or other items shared on the decedent's timeline; or (4) log in to the deceased user's account. Although a legacy contact cannot read or download messages that the deceased user sent to friends, Facebook may provide a copy of the deceased user's messages if the deceased user expressed clear consent to allow this in the decedent's will or another legal consent document.[5]

As our digital world evolves and becomes a greater part of many people's lives, all of these rules and laws involving access and privacy will grow in importance and will likely change quickly. Monitoring this area and keeping clients advised may be a significant role for the financial planner.

[5] See footnote 4.

© 2021 AICPA. All rights reserved.

Chapter 12

The Marital Deduction

¶1201 Overview

¶1205 Qualifying for the Marital Deduction

¶1210 Qualifying Terminable Interest Property (QTIP)

¶1215 To What Extent Should the Marital Deduction Be Used?

¶1220 How to Make a Marital Deduction Bequest

¶1225 Use of Trusts in Marital Deduction Planning

¶1230 Non-Citizen Surviving Spouses — Qualified Domestic Trusts (QDOTs)

¶1235 Use of Disclaimers

¶1240 Common Disaster, Survivorship, and Equalization Provisions

¶1201 Overview

The estate of a decedent may claim a deduction, called the marital deduction, for qualifying bequests or transfers of property to a surviving spouse.[1] The deduction is unlimited. The gift tax marital deduction for transfers of property to a spouse during lifetime (¶405) is also unlimited.[2] The surviving or donee spouse must be a United States citizen for the unlimited estate tax and gift tax marital deductions to be applicable, unless special provisions are included in the transfer of property to the spouse.

The use of this unlimited marital deduction is the primary focus of this chapter. The actual requirements for qualifying for the deduction are discussed in ¶1205. The special requirements for qualified terminable interest property (QTIP)[3] are discussed in ¶1210. The extent to which a married individual should use the marital deduction is covered in ¶1215. The proper forms of expressing a marital deduction disposition and the advantages and disadvantages of each are listed in ¶1220. The use of trusts

[1] IRC Section 2056(a).

[2] IRC Section 2523(a).

[3] IRC Section 2056(b)(7).

© 2021 AICPA. All rights reserved.

in marital deduction planning, including the bypass nonmarital trust, is considered in ¶1225. Disclaimers (¶1235) and common disaster, survivorship, and equalization bequests (¶1240) are additional important elements to consider in marital deduction planning.

Bequests to spouses who are not citizens of the United States generally are not eligible for the estate tax marital deduction unless they are in the form of a qualified domestic trust (QDOT) as defined in IRC Section 2056A. Such trusts are discussed in detail in ¶1230. Noncitizen donee spouses who receive lifetime gifts may also receive an enhanced annual exclusion gift, but not one that is unlimited.

The federal gift and estate tax marital deductions are allowed for transfers to a same-sex spouse in exactly the same manner that these deductions are allowed for opposite-sex spouses (*Windsor v. United States, 133 S.Ct. 2884 (2013); Obergefell v. Hodges, 135 S. Ct. 2071 (2015).)*

¶1205 Qualifying for the Marital Deduction

IRC Section 2056 sets forth the rules that govern the allowance of the estate tax marital deduction. It allows an estate tax deduction equal to the value of property included in the deceased spouse's gross estate that actually passes to the surviving spouse and that is not a nonqualified terminable interest.

A married individual can qualify for the marital deduction easily when the spouse designated as a beneficiary is a citizen of the United States. A married individual whose will that gives everything to his or her spouse outright without restrictions if the spouse survives and, if not, to the children, creates no marital deduction problem for his or her estate. The estate will receive the full marital deduction if the spouse survives. Other problems could occur, however, which are addressed in the following paragraphs.

A married person who wants a spouse to have everything but is concerned about what the surviving spouse might do with the property might have difficulty qualifying for the marital deduction. The individual might be concerned the surviving spouse might remarry, and the new spouse could receive a portion of the accumulated wealth. The individual cannot eliminate that risk completely and still take advantage of the marital deduction if the decedent's property is to be left outright to the surviving spouse. In this situation, planning would suggest the use of a marital deduction trust.

Property bequeathed to one's spouse without restrictions qualifies for the marital deduction. However, if a testator burdens the bequest with restrictions under which the interest in the property conveyed to the surviving spouse can be revoked and transferred to someone else upon the occurrence or nonoccurrence of a contingency, the bequest will not ordinarily qualify for the marital deduction.

In legal terms, the bequest without restrictions is an absolute bequest of an absolute interest. The bequest with restrictions is a terminable interest. Generally, an interest is terminable if it will end or fail by reason of lapse of time or the occurrence or nonoccurrence of a specified event. An interest given to a spouse that will terminate on the spouse's remarriage is terminable. A terminable interest will not qualify for the marital deduction if another interest in the same property passed from the decedent to another person, and that person may possess the interest after termination of the spouse's interest, such as when the spouse gets an interest in the property for a period of years or until remarriage, after which time it passes to others. The reason for this rule is to prevent a deduction at the death of the first decedent spouse for property that will not be included in the surviving spouse's estate.

© 2021 AICPA. All rights reserved.

.01 Exceptions to the Terminable Interest Rule

The terminable interest rule that would deny the marital deduction has five exceptions. These exceptions, when applicable, allow the marital deduction to be claimed because they ensure that the property will still be included in the surviving spouse's estate. Thus, the marital deduction is essentially a tax deferral mechanism giving the estate of the first spouse to die a deduction for the property passing to the survivor, but requiring inclusion of what remains of that property at the survivor's death in the surviving spouse's estate. Whether or not there will be an actual tax liability at the death of the surviving spouse will depend on the applicable exclusion from federal taxation available at the second death and the use of the portability election at the death of the first spouse.

The most important and most popular exception to the terminable interest rule is the QTIP exception.[4] It is separately discussed in ¶1210.

A second exception, found in IRC Section 2056(b)(5), is the general power of appointment exception. This provision permits a life interest arrangement to qualify for the marital deduction, whether it is in trust or not. The surviving spouse must be entitled to all the income from the entire transferred property interest or from a specific portion thereof (payable at least annually) and must have the power to appoint the property to himself or herself (that is, in the case of a trust, power to direct the trustee to pay him or her all of the principal) or the power to appoint the property to his or her estate or his or her creditors or the creditors of his or her estate (that is, a general power of appointment).

A third exception to the terminable interest rule relates to a survivorship condition. IRC Section 2056(b)(3) states that if the only condition of a bequest to the surviving spouse is that the spouse survive the decedent spouse for a period not exceeding six months, the marital deduction is allowable, if the spouse actually survives for the period specified.

A fourth exception to the terminable interest rule is contained in IRC Section 2056(b)(6) and states that a right to the payment of life insurance or annuity proceeds held by an insurer, coupled with a power of appointment in the surviving spouse exercisable in favor of such spouse or his or her estate, will qualify for the marital deduction.

The fifth exception is for a bequest to the spouse of an income interest in a charitable remainder unitrust or charitable remainder annuity trust when the surviving spouse is the only noncharitable trust beneficiary (¶515).[5]

.02 The Joint and Mutual Wills' Disqualifying Pitfall

Sometimes spouses execute joint and mutual wills under the terms of which the survivor is obligated to make bequests to certain persons. If, under state law, the survivor may not revoke the will or make a different disposition, the bequest to the surviving spouse will be regarded as falling short of a general

---

[4] IRC Section 2056(b)(7).

[5] IRC Section 2056(b)(8).

© 2021 AICPA. All rights reserved.

power of appointment and consequently be treated as a terminable interest not qualifying for the marital deduction.[6]

To safeguard the marital deduction for an outright transfer, each spouse must trust the other. Usually, no legal obstacle prevents the survivor from disposing of the property received outright under the decedent's will. Consequently, the safest procedure is for each spouse to execute a separate will, with no provision or other agreement restricting the survivor's freedom of disposition. For further safety, in unusual and somewhat extraordinary circumstances, a cautious financial planner might recommend that each spouse execute the will out of the presence of the other. The financial planner might even have each spouse state affirmatively that the will is being executed freely without any compulsion or undue influence of the other and without any understanding, agreement, or obligation that either may or may not change the will at any time in the future. In a really troublesome situation, both spouses might be asked to sign a statement to that effect. However, this procedure is rare and unusual. It should not be used without considering its possible negative impact. The procedure might possibly invite inquiry as to whether the couple in fact had an understanding or agreement.

¶1210 Qualifying Terminable Interest Property (QTIP)

IRC Section 2056(b)(7) allows a special form of life income interest in a trust arrangement given to a surviving spouse to qualify for the marital deduction. This interest has come to be known as a QTIP. As discussed in ¶1205, a life income interest accompanied by a general power of appointment in the surviving spouse will also qualify for the marital deduction. However, that requirement presents a married individual with the choice of (1) surrendering control of the ultimate disposition of the marital bequest property or (2) surrendering the tax benefit of the marital deduction in order to assure that, on the death of the surviving spouse, the property will pass to children or other chosen objects of bounty of the first decedent. With a QTIP arrangement, the testator can control the disposition of the remainder interest after the spouse's death and gain the benefit of the marital deduction while retaining ultimate control of the transferred property, essentially having it both ways.

[6] *D. Siegel Est.*, 67 T.C. 662 (1977).

© 2021 AICPA. All rights reserved.

Exhibit 12-1: Comparison of Forms of Qualifying Marital Bequests

Point of Comparison	Outright	Power of Appointment Trust	Estate Trust	Qualified Terminable Interest Property Trust
Survivor's freedom to use and manage assets	Yes	No	No	No
Cost savings: Trustee's fees, accountings	Yes	No	No	No
Right to elect to take against will may be barred	Yes	Yes	No	Yes
Protection Against				
Survivor's improvidence	No	No	No	Yes
Survivor's lifetime creditors	No	Yes	Yes	Yes
Survivor's creditors at death	No	Yes	No	Yes
Provides flexibility in distributions of income based on need	No	No	Yes	No
Provides flexibility in distributions of principal based on need	No	Yes	Yes	Yes
Limitation on survivor's right of disposition	No	No	No	Yes
Lifetime assignments	No	Yes	Yes	Yes
Mandatory distribution of income (at least annually)	No	Yes	No	Yes
Income distributions terminable on survivor's remarriage	No	No	Yes	No
Avoidance of probate on survivor's death	No	Yes	No	Yes
Availability of assets to survivor's executor	Yes	No	Yes	No
Retention of non-income-producing property in marital deduction share	Yes	No	Yes	No

For a life income interest to qualify for the marital deduction as a QTIP, the following conditions must be met:

- The surviving spouse must be entitled to all of the income from the property payable at least annually for life.
- A QTIP interest in property not placed in trust must provide the survivor with rights to income that are sufficient to satisfy the rules applicable to marital deduction trusts.
- No one (including the spouse) may have any power to appoint any part of the property to any person other than the spouse during the spouse's life.
- The executor must elect to have the interest treated as a QTIP.

© 2021 AICPA. All rights reserved.

QTIP treatment is elective. Therefore, the decision as to whether to take advantage of the marital deduction can be deferred until the testator's death. The QTIP election is generally irrevocable.[7] However, if the estate provides sufficient evidence that the QTIP election was not necessary to reduce the estate tax liability to zero, the IRS will disregard the QTIP election and treat it as null and void.[8]

Revenue Procedures 2001-38 and 2016-49 Revenue Procedure 2001-38 provided relief from an unnecessary QTIP election by treating it as null and void for federal estate, gift, and generation-skipping transfer tax purposes. It was based on the idea that an executor would not make a QTIP election if it was not needed to reduce the decedent's estate tax liability.

When the federal estate tax exclusion was significantly increased and portability entered the law, planning considerations changed. An estate may want to make both a portability election and a QTIP election for a nontaxable estate even if the QTIP election had no effect on federal estate tax liability. Making the QTIP election would reduce the value of the decedent's taxable estate and increase the amount of the deceased spouse's unused exclusion (DSUE) passing to the surviving spouse. Planning suggested having a nontaxable estate file a portability-only return to claim the maximum DSUE amount and gain a possible basis increase when the QTIP property is included in the future nontaxable estate of the surviving spouse.

Another reason a QTIP election might be desired to be made in a nontaxable estate involves state estate taxes. Some states may have a lower estate tax exclusion amount than the federal exclusion and do not allow a state-only QTIP election. Some states provide that the state QTIP election can be made only if a QTIP election is also made on a federal estate tax return. The problem here was that if the value of the estate was less than the federal exclusion amount, there was concern that a federal QTIP election would not be recognized as the result of Revenue Procedure 2001-38.

These issues were addressed by the IRS in Revenue Procedure 2016-49 (IRB 2016-42, September 27, 2016). Revenue Procedure 2001-38 was modified and superseded to provide that the IRS will continue to disregard unnecessary QTIP elections *only* if the executor did not make a portability election. Revenue Procedure 2016-49 treats a QTIP election as *void* if *all* of the following requirements are satisfied:

- The federal estate tax liability of the estate was zero, making the QTIP election unnecessary.
- No election to claim portability was made by the executor of the estate.
- Several procedural requirements must be observed, including filing a supplemental Form 706 for the estate of the predeceased spouse or a gift tax return (Form 709) for the surviving spouse or Form 706 for the estate of the surviving spouse (upon death) and entering at the top of the return, "Filed pursuant to Revenue Procedure 2016-49." (Note that a private letter ruling and accompanying user fee is not required to gain this result).

---

[7] IRC Section 2056(f)(7)(B)(v).

[8] Revenue Procedure 2001-38, Internal Revenue Bulletin 2001-24, 1335, (June 11, 2001). Modified by Rev. Proc. 2016-49. See the following discussion.

© 2021 AICPA. All rights reserved.

- Identifying the QTIP election that was made and providing an explanation of why the QTIP election should be treated as void (that is, affirming that no portability election was made in the estate of the predeceased spouse).

Assuming that the QTIP election is meant to be valid, Revenue Procedure 2016-49 treats a QTIP election as *valid* (and *not* void) in the following situations:

- A partial QTIP election was required to reduce the estate tax liability and the executor made the election with respect to more trust property than was necessary to reduce the estate tax liability to zero.

- The QTIP election was stated as a formula designed to reduce the estate tax to zero.

- A protective QTIP election was made.

- The executor of the estate made a portability election even if the decedent's DSUE amount was zero.

- The procedural requirements described previously were not satisfied.

The primary advantages of Revenue Procedure 2016-49 are the following:

- Married taxpayers no longer have to choose between the benefits of portability and the benefits of making a QTIP election. Estates can make a portability election and gain the benefit of the DSUE and a possible basis increase at the death of the surviving spouse.

- Estates with values between the federal estate exclusion amount and the state exclusion amount in a state that does not allow a state-only QTIP election should now be able to obtain QTIP treatment for state tax purposes.

- Unnecessary QTIP elections can still be nullified if portability was not elected.

Annuity issues. Annuities may qualify for the marital deduction under regulations to be prescribed.[9] The final marital deduction regulations (discussed in the following paragraphs) do not address the qualification for the marital deduction of annuities created by decedents dying after October 24, 1992.

Also, a spousal joint and survivor annuity automatically qualifies for the estate and gift tax marital deductions as long as only the spouses have the right to receive any payments before the death of the last spouse to die.[10] Although the provision applies automatically, the executor or donor may elect not to have it apply.[11]

---

[9] Regulation Section 20.2056(b)-7(f).

[10] IRC Section 2056(b)(7)(C).

[11] IRC Section 2056(b)(7)(C)(ii).

© 2021 AICPA. All rights reserved.

Taxation of the QTIP property. Property subject to the QTIP election will be subject to transfer taxes at the earlier of the date (1) on which the surviving spouse disposes (either by gift, sale, or otherwise) of any part of the qualifying income interest,[12] or (2) of the surviving spouse's death.[13]

If the donee spouse makes a lifetime disposition of any part of the life income interest, that will be treated as a deemed transfer of the remainder interest and will trigger a tax on the entire remainder [14] that is actuarially valued[15] and without benefit of the gift tax annual exclusion because the remainder is not a present interest in property.[16] The transfer of the life income interest will be subject to the ordinary gift tax rules and will be eligible for the annual gift tax exclusion ($15,000 for 2021, indexed annually for inflation).[17]

If the qualifying income interest is not disposed of before death, the fair market value (FMV) of the property remaining in the QTIP trust is includible in the decedent's gross estate and receives a basis equal to the FMV of the property at the death of the surviving spouse. This is an increasingly valuable adjustment, especially in light of the taxes on ordinary income, qualified dividends, and long-term capital gains and the imposition of the 3.8% tax on net investment income for wealthier taxpayers[18] These taxes may be reduced or avoided by the basis adjustment.

The estate taxes attributable to the taxation of the qualifying interest in the estate of the second spouse to die are presumptively borne by the QTIP trust property. The surviving spouse's estate has a right to recover estate tax attributable to inclusion of the property in the gross estate of the second spouse to die, unless the second spouse to die otherwise directs by a clear and specific statement by will.[19]

.01 All Income for Life Requirement

Federal courts[20] have held that the requirement that the surviving spouse receive all of the income for life will not cause disqualification of a QTIP trust that distributed stub income (income that a trust accumulates between the date of the last distribution to the surviving spouse and the death of the surviving spouse) to someone other than the surviving spouse.

---

[12] IRC Sections 2511 and 2519.

[13] IRC Section 2044.

[14] IRC Section 2519(a).

[15] IRC Section 2702.

[16] IRC Section 2503(b) and Regulation Section 25.2503-3.

[17] IRC Section 2503(b).

[18] IRC Sections 2044 and 1014.

[19] IRC Section 2207A.

[20] *L. Shelfer Est.*, 86 F.3d 1045 (1996).

© 2021 AICPA. All rights reserved.

The IRS takes the position[21] that the surviving spouse will not be deemed to receive all of the income for life if the QTIP trust contains unproductive assets and the surviving spouse does not have the power to direct the trustee to convert such assets into productive assets. Such a power must be included in the language of the document creating the QTIP interest.

IRC Section 2056(b)(7)(B)(ii) defines a qualifying income interest for life to include property in which the surviving spouse has a usufruct interest under Louisiana law, which refers to a life estate in property.

Regulation Section 20.2056(b)-7(d)(1) provides that a power under applicable state law that allows a trustee to adjust the amounts of income and principal in accordance with the trustee's duty to remain impartial between income beneficiaries and remainder beneficiaries (or the allowance of a 3% to 5% unitrust interest to the surviving spouse as how the lifetime interest of the spouse is described) will not be considered a power to appoint the trust property to someone other than the surviving spouse, so the presence of such powers will not disqualify QTIP treatment. An executor may make the QTIP election with respect to an IRA payable to a trustee as named beneficiary if the surviving spouse can force the trustee to withdraw all of the income from the IRA at least annually (even beyond required minimum distributions) and pay all the income to the surviving spouse.[22]

.02 Other QTIP Issues

Annuities. IRC Section 2056(b)(10) supports that, for QTIP purposes, a specific portion of property must be determined on a fractional or percentage basis. This limitation makes the treatment of annuities uncertain, because the specific portion of a trust to which an annuity relates would be identified in terms of the fixed sum payable to the surviving spouse.

The IRS has delayed issuing guidance on the deductibility of spousal annuities to which IRC Section 2056(b)(10) applies (in general, annuities created by individuals dying after October 24, 1992).[23]

With respect to commercial annuities, a commercial annuity purchased by the decedent spouse's executor pursuant to a directive of the decedent does not qualify as QTIP. Such an annuity would be a non-deductible terminable interest.[24]

Severance of elective portion. Regulation Section 20.2056(b)-7(b)(2)(ii) expressly permits the elective and nonelective portions of QTIP property to be severed and held as separate trusts.

Remarriage. An individual considering using the QTIP exception to the terminable interest rule might have second thoughts because the interest will not qualify if it is made terminable on remarriage. Instead, consider creating a trust maximizing the use of the unified credit[25] and providing the surviving

---

[21] IRS Technical Advice Memorandum 9717005, December 18, 1996.

[22] Revenue Ruling 2000-2, 2000-1 C.B. 305(January 18, 2000); Revenue Ruling 2006-26 I.R.B. 2006-21, 939 (May 30, 2006).

[23] Regulation Section 20.2056(b)-7(f).

[24] IRC Section 2056(b)(7)(C).

[25] IRC Section 2010.

© 2021 AICPA. All rights reserved.

spouse with income for life or until remarriage, with the remainder to the couple's children or other designated beneficiaries. The large federal estate tax exemption may give decedents more flexibility in protecting their assets from potential unwanted future beneficiaries without jeopardizing exposing their assets to higher tax rates.

Contingent interests. The previous version of Regulation Section 20.2056(b)-7(d)(3) took the position that an income interest that is contingent on the executor making a QTIP election is not a qualified income interest for QTIP purposes, regardless of whether the QTIP election is made. The IRS's rationale for denying the deduction was that if the executor could choose not to make the QTIP election, the executor could effectively appoint the property to someone other than the surviving spouse. However, having lost its argument in the U.S. Tax Court[26] and three U.S. Courts of Appeals,[27] the IRS issued a revised Regulation Section 20.2056(b)-7(d)(3) that states that a surviving spouse's income interest for life, which is contingent upon the executor's proper QTIP election, will not fail to qualify as a QTIP. This planning has become known as the use of the "Clayton QTIP."

¶1215 To What Extent Should the Marital Deduction be Used?

The marital deduction is in the IRC to be used, but it does not have to be used. Whether it is used, and to what extent, depends primarily on tax factors and secondarily on nontax factors. The testator should consider the needs and legal rights of the potential surviving spouse. At common law, a wife had dower rights and a husband had curtesy rights to the income for life from one third of the real estate owned by the decedent spouse.

Now, most states provide a spouse with a statutory right of election to take against the will unless the decedent leaves a certain portion of the family's real estate to the surviving spouse. Many states also allow the right to take against the will for personal property. Some states gross up all of the family property and test whether the surviving spouse has received an appropriate share (often one third). The rules can vary from state to state, but they are factors the testator should consider when deciding how much to devise and bequeath to the surviving spouse and in what form. This decision in turn may control the availability of the marital deduction. Eliminating a spouse as a beneficiary (absent a prenuptial agreement) is not something that will generally withstand appropriate legal challenge.

The nontax factors that influence the use of the marital deduction include, but are not limited to, the following:

- Love and affection, or the lack thereof
- Confidence or lack of confidence in the judgment or management ability of one's spouse
- Fear or lack of fear of the spouse's remarriage or involvement in another relationship
- Survivor's resources, both material and in terms of talent (management, investment, and so on)

---

[26] *W. Clack Est.*, 106 T.C. 131 (1996) Acq.

[27] *W. Robertson Est.*, 15 F. 3d 779 (8th Cir. 1994); *A. Clayton Jr., Est.*, 976 F.2d 1486 (5th Cir. 1992); *J. Spencer Est.*, 43 F.3d 226 (6th Cir. 1995).

© 2021 AICPA. All rights reserved.

- Possibility of inheritance from other sources
- Presence or absence of young children and their financial needs

If the only consideration were tax savings in the estate of the first spouse to die, the testator historically would want to use the marital deduction to the fullest extent possible. Thus, the testator would consider bequeathing everything to his or her spouse in a marital deduction bequest. The testator should also consider the estate situation of the surviving spouse because it will be affected by the use of the marital deduction. A potential tax on property which qualifies for the marital deduction is only deferred until the death of the surviving spouse (to the extent that the property is not consumed or given away). If the survivor has a significant separate estate, it will affect the survivor's estate tax situation.

Using the marital deduction at the first spouse's death will result in the inclusion of the remaining property at the second spouse's death resulting in an FMV basis of property at the second death passing to heirs. If there is not likely to be a federal estate tax at the second death, the income tax planning anticipating a higher basis is very advantageous here.

The financial planner should analyze how the use of the marital deduction affects the aggregate estate taxes of both spouses and should consider the availability of the portability election to save the use of the unified credit available to both spouses (discussed in the following section) until the death of the surviving spouse. Portability is an estate planning game-changer in that it allows very significant wealth to pass transfer tax-free through the two estates of a married couple and permits a possibly stepped-up income tax basis at both deaths. Portability is discussed further in chapter 37.

.01 Unified Credit Amount (the Applicable Exclusion from Transfer Tax)

The unified applicable credit amount (unified credit)[28] against estate tax liability is an important factor in financial planning as it relates to marital deduction planning. The corresponding applicable exclusion amount for the estate tax is shown here for the years indicated:

Applicable Exclusion Amount
$2,000,000 in 2008
$3,500,000 in 2009
$5,000,000 in 2010, unless the decedent's estate elected to opt out of the federal estate tax
$5,000,000 in 2011
$5,120,000 in 2012
$5,250,000 in 2013
$5,340,000 in 2014
$5,430,000 in 2015
$5,450,000 in 2016
$5,490,000 in 2017
$11,180,000 in 2018, $11,400,000 in 2019, $11,580,000 in 2020, $11,700,000 in 2021

[28] IRC Section 2010.

© 2021 AICPA. All rights reserved.

and thereafter (indexed annually for inflation subject to the sunset of the 2017 Tax Cuts and Jobs Act after 2025 and the return of the 2017 exclusion amount, adjusted for inflation). Also subject to legislative change before 2026.
Note: For 2008 and 2009, the applicable estate tax rate above the exemption amount was 45% and the estate tax rate above the exemption amount for 2010-2012 was 35%.[29] The estate tax rate for 2021 is 40%.

These amounts assume that no lifetime use has been made of the unified credit to offset gift taxes. The lifetime applicable exclusion amount for gift tax purposes was $1,000,000 through 2010; $5 million through 2011; $5,120,000 for 2012; $5,250,000 for 2013; $5,340,000 for 2014; $5,430,000 for 2015; $5,450,000 for 2016; $5,490,000 for 2017; $11,180,000 in 2018, $11,400,000 in 2019, $11,580,000 in 2020, $11,700,000 in 2021, indexed annually for inflation.[30]

The financial planner must take into account the value of the exclusion to the client, to the client's estate, to the surviving spouse, and to the estate of the surviving spouse, along with the effect of the use in whole or in part of the portability election. The availability of portability serves to avoid a major estate planning problem that previously existed, namely the prior law that failure to take into account and use the applicable exclusion at the first of the spouse's deaths resulted in its waste and caused higher taxes than might otherwise have been incurred at the second death (taking into account the aggregate tax liabilities of both estates).

Combining the optimal use of the exclusion and the marital deduction, could be the key to estate tax savings. Portability allows a decedent spouse who died in 2011 or thereafter to leave his or her entire unusedtransfer tax exclusion to the surviving spouse. This is referred to as the Deceased Spouse's Unused Exclusion (DSUE). The surviving spouse then has his or her own exclusion available, as well as the unused exclusion from the decedent spouse. Portability is a permanent part of the transfer tax law. The availability of established DSUE will not be "clawed back" or eliminated in the event the transfer tax exclusion amount is reduced in the future. See additional discussion of portability in chapter 37.

> **Example 12.1.** Charles died in March 2021 with an estate of $16,000,000 after payment of debts, funeral, and administration expenses. His spouse, Valerie, is without assets of her own. If he bequeaths the $16,000,000 to Valerie with a qualifying marital deduction bequest, his estate will incur no estate tax. If Valerie dies in 2021 after receiving such a bequest, her estate tax would be zero (as the result of her own exclusion of $11,700,000 and $11,700,000 of the DSUE obtained from Charles as the result of portability). If instead Charles had used his own exclusion in full during his lifetime or at his death so that portability was not available, Valerie's assumed $16 million estate would be taxable on $4,300,000 and her estate would incur a federal tax of $1,720,000 ($4,300,000 × .40).

A significant amount of federal estate taxes on the estate of the first spouse to die can be avoided by a combined use of the marital deduction[31] and the applicable exclusion amount (unified credit), subject to making appropriate decisions about portability. A more conservative planning approach would suggest

---

[29] IRC Section 2001(b)(2).

[30] IRC Section 2505(a)(1).

[31] IRC Section 2056(a).

© 2021 AICPA. All rights reserved.

not relying on portability and making certain that the unified credit is used at the death of the first spouse to ensure that the estate of the surviving spouse is not overfunded by a too-generous marital deduction that would result in tax at the second death, especially if marital deduction assets appreciate substantially, when such tax may be avoided.

Combining the marital deduction with a bypass trust geared to the applicable credit amount could produce better tax results for the estates of both spouses in the aggregate than full use of the unlimited marital deduction by the first to die, again depending on the effects, if any, of portability, and the future appreciation of the family assets because the portability election does *not* provide for indexing for inflation. If the surviving spouse will live many years after the first decedent, there could be concern about long-term appreciation of the first decedent's property. A bypass trust will allow that appreciation to avoid being taxed at the second death.

Be aware of the "planners' dilemma" here. If the unified credit is used, the appreciation on the property in the unified credit trust will not be taxed at the death of the surviving spouse, but it will pass to beneficiaries without a further basis step up at the death of the surviving spouse. What should the financial planner be more concerned with — avoiding tax on appreciation at the second death, or getting a basis step up to the ultimate heirs? The answer will vary on a case-by-case basis.

The applicable credit amount approach deprives the surviving spouse of the use of principal that would be available if the testator had made an outright marital deduction bequest. However, the testator may give the spouse a limited power to invade the corpus of a trust designed to take advantage of the applicable credit amount. (These trusts are also known as *credit shelter* or *bypass trusts*.) A power of invasion limited by an ascertainable standard related to health, support, and maintenance will not make the trust property includible in the gross estate of the surviving spouse.[32]

The preceding example assumed that the surviving spouse lacks other assets. If the surviving spouse possesses separate assets, the financial planner should take that factor into account in planning the use of portability and the marital deduction over two deaths.

Four essential points emerge on the use of the unlimited marital deduction viewed strictly from the standpoint of tax factors, and assuming a portability election is not relied upon: (1) it should never be used without regard to taking into account, to at least some extent, the available applicable exclusion amount (unified credit); (2) it should never be used without regard to the size of the survivor's estate; (3) consideration should be given to the possibility of the survivor's ability and willingness to reduce the size of his or her estate; and (4) attention should be paid to income tax basis issues over two deaths, as discussed in subsequent paragraphs.

Another concern to be raised about outright transfers to take advantage of portability is that, although it certainly embraces an estate plan featuring simplicity, it does not take into account such things as persons with multiple marriages and blended families when the surviving spouse may not be the parent of the decedent's children, and possibly unlikely to benefit them at the second death; asset protection concerns that a trust may provide; rapidly appreciating property that could result in tax liability at the second death; or management and control of property issues. Given these factors, financial planners

[32] IRC Section 2041(b)(1)(A).

© 2021 AICPA. All rights reserved.

should be cautious in recommending the use of outright transfers to take advantage of portability. The use of the marital deduction is an excellent opportunity in the right planning circumstances (such as when a QTIP trust is used where asset protection, tax deferral, and basis increase are all possible coupled with control over the ultimate disposition of the property), but its unlimited use is certainly not appropriate in every case. Portability is discussed further in chapter 37.

The unlimited marital deduction applies to both lifetime gifts and to devises and bequests at death. If a spouse dies with unused unified credit and portability is elected, the surviving spouse may add the unused unified credit of the decedent to his or her own credit for lifetime gifting purposes (so long as the death of the first decedent occurred in 2011 or later). The subject of interspousal lifetime gifts has already been discussed in chapter 4, "Lifetime Gifts to Individuals." As a general rule, lifetime interspousal gifts offer no special advantage over testamentary transfers and could result in a disadvantage if the gifted property has a low income tax basis. However, a lifetime gift might serve to make available the marital deduction even though the donee spouse may predecease the donor or might aid in enabling the donor's estate to qualify for special benefits for certain business interests.

This result may be accomplished by a gift *to* a donee spouse on his or her deathbed. If the gift to the dying spouse consists of appreciated property, the property will receive a stepped-up basis[33] upon the spouse's death that will eliminate any income tax liability for pre-death appreciation if the property is devised or bequeathed by the donee spouse to the couple's children, and not returned to the donee's spouse who made the gift. If the property is transferred by the donor spouse to the donee spouse and then willed back to the donor spouse by the donee, it will not receive a stepped-up basis if the donee spouse dies within one year of the gift.[34] If a donor gives appreciated property to an individual, and the donor or his or her spouse reacquires the property on the death of the donee within one year of the gift, the donor's basis in the property will be the decedent's adjusted basis in the property immediately before his or her death (which is likely to result in the donor receiving the property with the same basis it had when it was given).[35]

Where a stepped-up basis is desired, consider "upstream" gifting of low basis property to a senior family member and "hedge" against death within one year and return of the gifted property to the donor by having the senior family leave the property to someone other than the donor, such as a grandchild, if death occurs within one year from the date of the gift.

.02 Transfer of Insurance to Spouse

Before the unlimited marital deduction,[36] one of the standard estate planning techniques was for the insured to transfer life insurance policies to the spouse, along with all incidents of ownership. The objective of this transfer was to keep the insurance proceeds out of the gross estate of the insured

---

[33] IRC Section 1014(a).

[34] IRC Section 1014(e).

[35] IRC Section 1014(e)(1).

[36] IRC Section 2056(a).

© 2021 AICPA. All rights reserved.

transferor-decedent.[37]That technique may no longer be necessary. If the decedent retains the policy and the proceeds are includible in the gross estate of the insured, no estate tax will be due in any case if the spouse is the beneficiary of the proceeds in a marital deduction bequest. A better strategy might be to retain the policy and incidents of ownership as a valuable asset in case of divorce or some other circumstance that makes retention desirable, such as the need to access the cash value of the policy. Transfers of life insurance within three years of death are includible in the gross estate of the transferor-decedent.[38] As a recommended planning alternative, the financial planner may suggest transferring the life insurance policy to an irrevocable trust with the surviving spouse as the primary lifetime beneficiary. The trust can be drafted to allow for a QTIP election only if the insured dies within three years of the transfer; otherwise, no QTIP election should be made. If the insured lives three years from the date of the transfer, the properly drafted irrevocable life insurance trust will keep the life insurance proceeds free from federal estate tax in the estates of both spouses.

.03 Spousal Second-to-Die Insurance

The loss of the marital deduction by reason of the spouse predeceasing the estate owner is a factor to be considered. Portability of the decedent's available exclusion will mitigate potential tax liability. Second-to-die insurance is another consideration here. (¶705).

.04 Possible Reduction of the Survivor's Estate

As previously discussed, one of the key considerations involved in the use of the marital deduction is the probable impact on the estate tax liabilities of the survivor's estate.

The probable impact will depend in part on the extent to which the survivor consumes or otherwise disposes of the funds available. This consumption and disposition of the estate depends in part on the estimated time within which the survivor can make dispositions.

With these factors in mind, the use of the gift tax annual exclusion ($15,000 for 2021,indexed annually for inflation)[39] offers one way of reducing the size of the survivor's gross estate without transfer tax cost.

> **Example 12.2.** Harry is a surviving spouse with three married children. Each married child has two children. Therefore, Harry has a total of 12 potential donees to whom he could give tax-free gifts up to the annual exclusion amount each year. Thus, Harry could give a total of $180,000 to his children, their spouses, and his grandchildren in 2021 without incurring a gift tax liability or using any part of his lifetime gifting exemption. He could also give anyone else $15,000 without incurring a gift tax liability because the annual gift tax exclusion is not limited to gifts to family members. Moreover, he could make equivalent gifts subject to indexing adjustments in succeeding years. He could also pay tuition and medical expenses directly to the providers of the

---

[37] IRC Section 2042.

[38] IRC Section 2035(a).

[39] IRC Section 2503(b).

© 2021 AICPA. All rights reserved.

education and medical services on behalf of anyone he wishes without having such payments be treated as a gift.

Indeed, the process of reduction of a spouse's gross estate through the use of the annual exclusion may begin before the death of the first spouse by lifetime gifts to children or others. With gift splitting,[40] such reductions may take place at an accelerated pace per donee per year until the time of death of the first spouse. For 2021, the annual present interest exclusion for split gifts is $30,000. In a community property state, all gifts of community property by spouses are deemed made one half by each spouse. In other states, the consenting spouse must affirmatively agree (and sign Form 709) to split a gift.

The intrafamily installment sale is another possibility for reducing the survivor's gross estate. The sale of property in exchange for a note has the effect of freezing the value of the seller's property at the amount of the note. All future appreciation in the property will belong to the purchasers of the property.

.05 Disclaimers

From a planning standpoint, one might want to provide in the will that the surviving spouse may refuse to accept any part of the marital bequest. A qualified disclaimer (¶1525) treats the interest disclaimed as if it had never been transferred to the disclaimant. Hence, no gift occurs from the disclaimant to the person acquiring the property as a result of the disclaimer. If the surviving spouse does not make a qualified disclaimer, the surviving spouse will then need to weigh the cost of making a lifetime gift against the cost of retaining the property and having it included in his or her gross estate. To the extent that the surviving spouse uses the annual gift tax exclusion ($15,000 for 2021, indexed annually for inflation)[41] or the gift is of property with potential appreciation, lifetime giving generally results in less transfer taxes than including the property in a decedent's gross estate. However, if lifetime giving will result in actual payment of tax, the value of tax deferral resulting from leaving the property in the decedent's estate needs to be weighed. The $11,700,000 lifetime gift tax exclusion opportunity available in 2021 (indexed annually for inflation) should be considered here.

In addition, the income tax basis issue should also be considered. Lifetime gifts result in acquiring a carryover basis from the donor,[42] and transfers at death result in acquiring a date-of-death value basis from the decedent.[43] Given the likelihood of many income taxpayers and few estate taxpayers, income tax basis is a very important planning consideration.

---

[40] IRC Section 2513.

[41] IRC Section 2503(b).

[42] IRC Section 1015.

[43] IRC Section 1014.

© 2021 AICPA. All rights reserved.

.06 Lifetime Interspousal Gifts to Qualify for Special Benefits

The unlimited marital deduction allows the use of lifetime interspousal gifts made more than three years before death as a means of qualifying the donor's estate for benefits that depend on the size and composition of the estate.[44]

> **Example 12.3.** This example is intended to illustrate possible tax planning when the estate tax exclusion is much less than the current $11,700,000 level. Glenda has a gross estate valued at $7,000,000, which includes stock in a closely held corporation valued at $2,210,000. She plans to bequeath one half of her estate to her spouse and the other half to her children. Under these circumstances, the closely held stock would not meet the 35% test[45] for an IRC Section 303 redemption. However, if she were to make a lifetime gift of $700,000 to her spouse more than three years before her death, reducing her gross estate to $6,300,000 at her death, the 35% test would be satisfied (.35 × $6,300,000 = $2,205,000). Of course, given the existing exclusion, this estate would not be taxable in any event, so that the opportunities of IRC Section 303 are not necessary to pursue here — at least under current law.

Such gifts, if made long enough before death, will also be useful in terms of qualifying an estate for special use valuation under IRC Section 2032A and for the benefits of IRC Section 6166, providing a 14-year extension of time for the payment of the portion of estate taxes attributable to the inclusion of closely held business interests in the decedent's gross estate.

Although gifts made within three years of death will not, as a general rule, be included in the gross estate of the donor (except for transfers of life insurance policies), such gifts will be included for the purpose of determining eligibility for the benefits of IRC Sections 303, 2032A, and 6166.[46]

.07 Home and Personal Effects

In a marital bequest, tax considerations are not the sole factors involved. The financial planner must always consider the human elements of estate planning. Each spouse might want the other spouse to have certain household and personal effects, regardless of tax considerations. Usually, the spouses will want their residence to go to the survivor. The client and the financial planner should consider these human elements.

.08 State Death Taxes

To the extent that federal estate and gift taxes take on relatively less importance, state death taxes (and, in Connecticut, gift taxes) can take on relatively greater importance in planning. Many states have repealed all transfer taxes previously due at death.

Historically, state death taxes have fallen into three major categories: (1) inheritance tax, (2) estate tax, and (3) estate pick-up tax to make maximum use of the federal credit for state death tax allowance under

---

[44] IRC Section 2035(c).

[45] IRC Section 303(b)(2)(A).

[46] IRC Section 2035(c).

© 2021 AICPA. All rights reserved.

the federal estate tax. The federal credit for state death taxes was permanently repealed for decedents dying after 2004. Instead, Congress changed death taxes to a deduction in computing the federal taxable estate for decedents dying in 2005 and thereafter. The deduction for state death taxes is permanent. Many states have taken steps to decouple their death taxes from the federal system to continue to derive revenue from the deaths of their residents.

An inheritance tax is levied on the right to receive property by inheritance. Beneficiaries are divided into classes according to their closeness to or remoteness from the decedent, with different exemptions and tax rates applicable to each class. In general, the closer the relationship, the lower the tax. These rules will vary from one state to another.

Several states levy an estate tax similar to the federal tax, giving a flat exemption to the estate as a whole. However, some states provide exemptions to beneficiaries by classes, totaling the exemptions and applying them to the estate as a whole.

Some states do not tax retirement plan benefits, others tax them in full, and some provide exemptions before taxing these benefits. In certain cases, life insurance proceeds will enjoy substantial exemptions or be free entirely of state death taxes. Use of life insurance in these states might be indicated as a means of reducing taxes even though the proceeds are includible in the gross estate for federal estate tax purposes, unless there is planning in place to remove the insurance proceeds from the policy owner's estate.

State death taxes can also be avoided in states that do not tax a power of appointment in the hands of the donee unless it is exercised. In those states, a power of appointment trust that qualifies for the federal marital deduction would escape state death taxes if the surviving spouse does not exercise the power given to him or her.

The essential point is that a financial planner should examine state death taxes when considering marital deduction and other estate planning and check state laws for conformity or lack of conformity to federal rules. When the client favors leaving his or her entire estate to a surviving spouse, planning to use the available state death tax exclusion at the first death is especially important, even if that requires using a bypass trust with a "formula clause" to hold just the right amount of the state exclusion at the first death. Often, the surviving spouse is given the opportunity to exercise a disclaimer power to fund just the exact amount of a state death tax exclusion. This planning should be considered even when there is no concern for federal estate tax liability. At the present time, only Hawaii and Maryland allow portability of their estate tax exclusions.

¶1220 How to Make a Marital Deduction Bequest

There is more than one way to make a spousal bequest that will qualify for the marital deduction. A testator may make the bequest outright as a direct transfer to the surviving spouse. The testator can also transfer property to a trust for the surviving spouse's benefit, provided the trust meets certain requirements.

Whether outright or in trust, the bequest will usually fall into basic patterns:

- *Bequest of specific property*. Outright, the bequest might state, "I give my spouse the 5,000 shares of IBM common stock which I own." In trust the bequest might state, "I give the 5,000 shares of IBM common stock which I own to the Fidelity Trust Company of Boston, Massachusetts, as trustee under an agreement dated January 6, 2021,for the benefit of my spouse."

© 2021 AICPA. All rights reserved.

- *Bequest of money*. "I give my spouse $500,000." This type of bequest is known as a pecuniary bequest because it refers to an amount of money rather than specific property or a percentage of one's estate.

- *Straight fractional share of net estate*. The net estate is technically known as the residue. It is what is left after payment of debts, administration expenses, specific bequests, and other charges not imposed on the residue. It might be worded, "I give one-third of my residuary estate, outright, to my spouse."

- *Formula marital deduction bequests*. Maximizing the unified credit to which each spouse is entitled in many circumstances might produce greater estate tax savings for the estates of both spouses than bequeathing everything to one's spouse in a marital deduction bequest. The preferred way to set aside the largest amount that can pass free of federal estate tax by way of the applicable credit amount (unified credit) is by means of a formula marital deduction bequest.

Three formula clauses are commonly used: (1) the pecuniary marital deduction formula, (2) the pecuniary unified credit formula, and (3) the fractional residuary formula. These formulas have numerous variations and refinements. The basic formulas, their advantages and disadvantages, and their planning implications, are as follows:

- *Pecuniary marital deduction formula*.

  "I give my spouse the smallest sum of money that will minimize the federal estate tax payable with respect to my estate, provided, however, that in determining this sum, the provisions of any treaty or convention of the United States or provision of the IRC of 1986, as it may be amended, other than the unified credit [applicable credit amount] provisions of Section 2010 of said Code, shall not be taken into account to the extent that taking such provisions into account would increase state death taxes payable with respect to my estate."

  The foregoing marital deduction bequest can be made to the spouse outright or in a marital deduction trust (¶1225). After using this provision, the testator will dispose of his or her residuary estate, which will generally correspond to the exclusion equivalent provided by the available applicable credit amount.[47] In some cases, the testator may then dispose of the residuary estate to a nonmarital trust (which may have the surviving spouse as its exclusive beneficiary for life, or as one of several beneficiaries, or excluded entirely as a beneficiary) or outright or in trust for beneficiaries other than his or her surviving spouse, for the full benefit of this provision to be realized.

- *Pecuniary unified credit formula (usually in trust form)*.

  "I give my trustee, in trust, the largest amount that may pass free of federal estate tax, pursuant to the unified credit [applicable credit amount] allowable to my estate, after taking account of the value of property passing to beneficiaries under this will or otherwise that is includible in my gross estate and does not qualify for the marital or charitable deduction."

[47] IRC Section 2010.

© 2021 AICPA. All rights reserved.

This provision also can be used to make an outright bequest to persons other than the surviving spouse. The residuary estate, under such a formula, will constitute the marital deduction amount. This disposition of the residuary estate can be outright or in a marital deduction trust (¶1225).

- *Fractional residuary marital deduction formula*.

  "I give my spouse the smallest fractional share of my residuary estate that will minimize the federal estate tax payable with respect to my estate, provided that, in determining the size of such share, the provisions of any treaty or convention of the United States or provision of the IRC of 1986, as amended from time to time, providing for a credit against the federal estate tax, other than the unified credit [applicable credit amount] provisions of Section 2010 of said Code, shall not be taken into account to the extent that taking such provisions into account would increase state death taxes payable with respect to my estate."

  This type of bequest may be made outright to the surviving spouse or to a marital deduction trust (¶1225). Should this bequest be made, the balance of the residuary estate will be composed of the exemption equivalent provided by the available applicable credit amount, left in trust or outright, as desired.[48]

A formula marital deduction bequest is the only way the testator can fix precisely the exemption equivalent and obtain the optimum amount of marital deduction. Experts engage in an ongoing debate as to which of the formulas to choose. In this connection, the financial planner should consider these factors:

- Pecuniary formulas are easier to express and explain.
- Pecuniary formulas may offer greater opportunities for postmortem estate planning if the fiduciary is given authority to select and allocate assets.
- An outright pecuniary bequest (whether it be a pecuniary marital or a pecuniary unified credit) generally freezes the value of the pecuniary share. The share of the estate that is not part of the pecuniary bequest generally obtains the benefits of appreciation and bears the risks of decline in estate values.
- If appreciated property is distributed in satisfaction of either of the types of pecuniary marital deduction bequests, the estate realizes gain measured by the difference between the estate's basis in the property and its FMV at the date of distribution.[49]
- A fractional residuary marital bequest will cause the surviving spouse to participate in the appreciation or depreciation of estate values during administration.
- No gain (or loss) is recognized by the estate upon a distribution in satisfaction of a fractional residuary marital deduction.[50]

---

[48] IRC Section 2010.

[49] Regulation Section 1.1014-4(a)(3); *Kenan v. Commissioner*, 114 F.2d 217 (2nd Cir. 1940).

[50] Regulation Section 1.1014-4(a)(3).

© 2021 AICPA. All rights reserved.

- The fractional residuary marital deduction can present serious administrative problems for the fiduciary in that the fraction of the residuary estate constituting the marital deduction share must be recomputed upon every distribution of the estate assets. In many cases, the actual amount of estate principal and income due the marital share cannot be ascertained until the final accounting of the executor, and then only after what is often a difficult calculation.

The ultimate choice of one formula or another rests on several factors, including

- careful analysis of the testator's assets and their gain and loss potential;

- the testator's preferences about his or her spouse receiving the benefits from estate appreciation (or suffering a loss from estate value declines);

- whether the benefits and risks are to be shifted to the nonmarital share of the estate, with the hope of allocating possible asset appreciation to the nonmarital disposition where it will escape estate taxation at the death of the surviving spouse; and

- testator's family relationships.

If, in the testator's projected estate, the realization of gains is not probable because the assets are unlikely to fluctuate in value, or if selection of assets to be distributed to satisfy a pecuniary bequest can avoid gain, a pecuniary bequest of either kind previously described may be favored.

However, if there is a good possibility of appreciation, and family relationships and other circumstances are such that a sharing of the appreciation seems desirable, the use of a fractional share marital deduction might be indicated, despite the administrative difficulties.

If the surviving spouse is to receive the income of the nonmarital share for life, the use of a pecuniary marital deduction formula and the transfer of the appreciation potential to the nonmarital share might be beneficial. The loss of appreciation potential by the marital share may be offset by the gain to the nonmarital share, which will pay its income to the spouse for life and will escape estate taxation at the spouse's death. However, this leverage of the nonmarital share by the frozen marital share might not be advantageous if the estate significantly declines in value, as then the nonmarital share will not convey the anticipated benefits to its ultimate beneficiaries.

The choice of a marital deduction formula requires a careful analysis of all of the foregoing factors. In addition, the financial planner must pay attention to the relationship between the formula chosen for particular beneficiaries and the amount of the applicable exclusion as it changes from year to year. The formula allocation between spouse and children, when the plan is signed, may differ widely from what will actually happen as the result of increased or decreased exclusion amounts in the year of the decedent's death. For example, an estate plan signed in 2002 and not subsequently revised, leaving the maximum exclusion amount to children and the balance to the surviving spouse, would have left the children $1 million had the testator died in 2002 and $11,700,000 if the testator died in 2021. This could entirely eliminate the spouse's share of the estate, forcing the spouse to consider a statutory election against the decedent's will.

© 2021 AICPA. All rights reserved.

The formulas included in estate planning documents could lead to unintended consequences, as previously indicated, suggesting the need for ongoing vigilance by the financial planner on behalf of a wide range of clients to address the frequent changes in the estate and gift tax laws.

Portability presents another complicating factor here. Should the unified credit be used at all after the first death, used in part, or used in full? There are many conflicting considerations surrounding portability for the financial planner to review with the client, including maximizing income tax basis adjustments. Portability is discussed further in chapter 37.

.01 Special Handling of Life Insurance Proceeds

Many individuals retain incidents of ownership in life insurance policies on their lives for any number of reasons. When the policy proceeds payable upon death are intended to benefit the surviving spouse, the estate tax marital deduction will be allowed if the disposition meets the requirements for the marital deduction.[51]

There are 10 suggested ways of disposing of life insurance proceeds, to or for the benefit of a surviving spouse. Each of these ways will qualify for the federal estate tax marital deduction.

1. Lump-sum payment to the spouse.

2. Lump-sum payment to a trust, the terms of which are such that any property included in the gross estate and passing to this trust will pass to the spouse and qualify for the federal estate tax marital deduction.

3. Lump-sum payment to the spouse, but only if the spouse survives the decedent for a stated period of time, which cannot exceed six months. If the spouse does not survive, the proceeds are payable to someone else and do not qualify for the marital deduction.

4. Lump-sum payment to the spouse, but if the decedent and the spouse die as the result of a common disaster, then the proceeds are payable to someone else. Of course, under (3) or (4), if the spouse does not survive (actually or presumptively) to become entitled to the proceeds, then the marital deduction will not be allowed.

5. Proceeds left on deposit with the insurance company, with the interest payable to the spouse for life, at least annually. The first interest payment would be made no later than 13 months after the decedent's death, with the principal fund eventually payable to the spouse's estate.

6. Same as (5), except that instead of the principal fund being payable to the spouse's estate, the spouse has the power to direct that the principal fund be paid to the spouse's estate. If this power is not exercised, then the principal fund is payable to someone else.

7. Same as (5), except that instead of the principal fund being payable to the spouse's estate, the spouse has the power to withdraw the entire principal fund at any time during his or her lifetime. Any amounts not withdrawn by the time of the spouse's death are payable to someone else.

---

[51] IRC Section 2056(b)(6); Regulation Sections 20.2056(b)-1(d)(3) and 20.2056(b)-6.

© 2021 AICPA. All rights reserved.

8. Proceeds payable only in annual or more frequent installments to the spouse for life, with the first installment payable no later than 13 months after the decedent's death. A specified number of payments or a minimum total amount is guaranteed. If the spouse dies before the guaranteed number of payments or minimum total amount has been paid out, then the unpaid balance is payable to the spouse's estate.

9. Same as (8), except that instead of the insurance company having the obligation to pay the unpaid balance to the spouse's estate, the spouse has the power to withdraw the value of the remaining guaranteed payments or amount in a lump sum at any time during his or her life. If the spouse does not receive the guaranteed payments or amount before death, and does not exercise the power to withdraw the lump sum, then the unpaid balance of the guaranteed payments or amount is payable to someone else.

10. Same as (8), except that instead of the insurance company having the obligation to pay the unpaid balance to the spouse's estate, the spouse has the power to direct that the unpaid guaranteed balance be paid to the spouse's estate. If this power is not exercised, that balance is payable to someone else.

Planning Pointer.

The financial planner should read all of the client's life insurance policies. All policies are not the same and contain different settlement options with different financial arrangements. In addition to tax aspects, such as the marital deduction, the financial planner should address the financial aspects. How much will the beneficiary receive under each of the alternatives? Will this amount meet the beneficiary's needs? When working with life insurance policies, a knowledgeable life insurance professional should be consulted. Professional expertise can solve many complex life insurance problems in estate planning. See exhibit 7.2 in chapter 7, "Life Insurance," for a life insurance audit plan.

.02 Special Handling of Personal Effects

The testator should usually make a specific bequest to the surviving spouse of the personal and household items to assure their availability for the marital deduction. Sometimes these items, although includible in the gross estate, will pass outside the will. Either way, a marital deduction fractional share formula bequest applied to the residuary estate may call for an adjustment to take into account the value of other property passing to the surviving spouse by bequest or otherwise. This other property would include personal and household items. Their value is not easily established. The surviving spouse might want the lowest possible value put upon them, but other beneficiaries might strive for the highest values.

.03 Foreign Property

If the testator holds foreign property used to satisfy the marital bequest, the foreign taxes paid will not be available as a credit to reduce the U.S. estate tax.[52] The testator should not use such property for the marital bequest. Rather, the testator should use it for nonmarital bequests when the credit for foreign

[52] IRC Section 2014(b)(2).

© 2021 AICPA. All rights reserved.

death taxes is available.[53] The will often states that a marital deduction share should not be funded with foreign assets which qualify for the foreign tax credit.

¶1225 Use of Trusts in Marital Deduction Planning

The marital deduction bequest may be outright or in trust. A trust may be used in any situation when significant assets are involved, and the testator feels that professional management and administration of the property to be bequeathed to the surviving spouse will be in the spouse's best interest. Also, a trust can provide protection against the demands of children, relatives, creditors, and others. It can be protective of family assets if the surviving spouse remarries. It can also be used to assure that the first spouse to die will be able to control the ultimate disposition of his or her property after the death of the surviving spouse. This last point is especially important when the family is a "blended family" of several marriages and children from different spouses.

Marital deduction trust planning often involves the coordination of a marital deduction bequest with the unified credit portion. Depending on what the needs of the surviving spouse are, the estate plans of both modest and sizeable estates often make use of trusts to carry out a marital deduction plan (¶1220).

The most commonly used trust in marital deduction planning is not a marital deduction trust at all. Instead, it is a bypass trust to hold that portion of the gross estate that is exempt from tax upon the testator's death by reason of the unified credit.[54] (Note that such historical use was the "planning norm" before portability became the law which may now result in a shift of thinking and planning for many families, as the bypass trust becomes less necessary for estate tax savings where estates are of moderate size.) Frequently, this bypass trust (also known as a credit shelter bypass trust or a unified credit trust) is designed to pay the surviving spouse all of its income. However, it may also be a sprinkling discretionary trust created for the benefit of the surviving spouse and other family members.

The bypass trust is designed with two purposes in mind, either or both of which may be realized. First, if the surviving spouse is to be a beneficiary, the assets of this trust will be exempt from federal estate taxation upon the surviving spouse's death. Second, even if the spouse is not a beneficiary of the trust, the trust can be designed to take maximum benefit of estate appreciation when the testator desires that the spouse not benefit from it.

The bypass trust often is used with an outright formula marital deduction bequest. However, it can also be used in conjunction with a formula marital deduction trust, as follows:

- *Pecuniary marital deduction trust and residuary unified credit trust*. Such an arrangement allocates all of the risk of gain or loss during estate administration to the residuary unified credit trust.

- *Pecuniary applicable credit amount (unified credit) trust and residuary marital deduction trust*. Such an arrangement protects the unified credit portion from erosion resulting from declining values, but it will not help the testator achieve the goal of allocating any gains in estate values to the nonmarital portion. All of the gains must pass to the residuary marital portion.

---

[53] IRC Section 2014(b).

[54] IRC Section 2010.

© 2021 AICPA. All rights reserved.

- *Fractional residuary marital deduction trust and balance of the residuary (the amount exempted from tax by the available applicable credit amount) also in the trust*. As previously stated, this method is complicated, but it also protects the two-trust shares from the wide variations in valuation that can occur if the pecuniary formulas (marital or unified credit) are used.

The following discussion assumes that the estate owner will wish both the marital and nonmarital portions of the estate to be held in trust.

In most cases, the choice of a marital deduction trust to include in the estate plan will be between a power of appointment trust and a QTIP.[55] Before creation of the QTIP in the 1981 tax law changes, the power of appointment trust was the most widely used alternative to an outright distribution. The QTIP has become the most widely used marital deduction trust since 1982. A planning technique known as an estate trust also may be used (see the following discussion).

The QTIP has the basic advantage of obtaining the marital deduction when the first spouse dies and enabling the settlor-testator to control the ultimate disposition of the property on the surviving spouse's death.

The exercise of that right when the married testator has children from a prior marriage to protect along with a surviving spouse (the so-called "blended family") is understandable and should be explained to the testator's spouse. If not so explained, or when such explanation is inapplicable, the QTIP may be construed as a statement to the surviving spouse of the following: (1) the settlor-testator believes that because the property involved is his or hers, the settlor-testator is not willing to give the spouse any more than a life income interest (and such peripheral rights to principal as the settlor-testator chooses to confer); (2) the settlor-testator is unwilling to entrust the ultimate disposition of the trust property to the surviving spouse; and (3) the settlor-testator is better able to make the decision as to ultimate disposition of the property than is the surviving spouse.

These assumptions may be open to challenge on several grounds:

- The fact that the settlor-testator held title to the trust property does not necessarily mean that the surviving spouse is without rights in the property. For example, the surviving spouse might have rights that would be recognized on principles of equitable distribution in divorce proceedings, were a divorce to occur.

- If the ultimate takers are joint lineal descendants of the spouses, the settlor-testator's capability of making a fairer or more appropriate distribution than the survivor might be an issue.

- If the ultimate disposition is to take place long after the settlor-testator has died, another issue might be whether the settlor-testator is better able to make a more appropriate disposition than the survivor.

[55] IRC Section 2056(b)(7).

© 2021 AICPA. All rights reserved.

If a second marriage is involved and the settlor-testator has children or other beneficiaries from a prior marriage, a so-called "blended family," the QTIP provides a useful way of safeguarding their interests and preserving the marital deduction.

The settlor-testator using a QTIP need not deprive the surviving spouse of all voice in the ultimate disposition. The survivor may be given a broadly-drafted limited power of appointment to select among specified classes of beneficiaries that stops short of a general power of appointment. This power may limit possible challenges along the lines previously suggested.

Using a trust for the marital disposition also provides asset protection for the surviving spouse against possible claims of his or her creditors, children, or claims of a new spouse if the survivor remarries.

The choice should be a rational one, taking into account a wide range of circumstances and alternatives, addressing not only what may be done under the law but also what is likely to produce the better end result. The financial planner can be of assistance to the client in identifying and discussing these various issues.

.01 QTIP Trusts

If certain conditions are met, a so-called QTIP trust, providing a surviving spouse with a life income interest, may qualify for the marital deduction.[56] The IRC requirements are discussed in ¶1210.

The most important difference between a QTIP trust and the power-of-appointment trust, described in the following paragraphs, is the ability of the first decedent spouse to control the disposition of the remainder interest in the trust after the surviving spouse's death. This consideration is much more a personal decision than a tax decision on the part of the creator of the QTIP interest. Some of the considerations connected with this have already been described.

The income payment provisions of the QTIP trust are governed by IRC Section 2056(b)(7) and the regulations promulgated thereunder. In virtually all respects, the income to be paid to the surviving spouse must meet the same criteria as those set up with respect to power-of-appointment trusts.

Once the testator has created the dispositive pattern of a QTIP trust, the most important planning issue connected with the QTIP trust lies in the election to be made by the executor on the federal estate tax return.

The QTIP election can take place in the following contexts:

1. The testator makes a bequest of his or her entire estate (other than tangible personal property, which is generally left outright) in trust for the benefit of the surviving spouse. The executor may elect to qualify the entire trust for the marital deduction, or the executor can make a partial election and qualify only part of the principal of the trust for the marital deduction. In this case, the testator does not care about the niceties of formula bequests. The task of preserving the

[56] IRC Sections 2056(b)(7)(A) and 2056(a).

© 2021 AICPA. All rights reserved.

applicable credit amount[57] and addressing portability is left to the executor as part of the QTIP election.

2. The testator makes a formula marital deduction bequest in which the estate is divided into an applicable credit amount trust portion (or outright bequests to persons other than the surviving spouse) and a trust portion, which is eligible for the marital deduction, as the executor elects, under the QTIP provision to so qualify it. The testator has already taken steps to reduce the estate tax to zero in the most efficient way through an applicable credit amount disposition separate from the marital deduction (absent the use of the portability election). The executor's task is to decide whether to engage in further estate planning and to qualify the entire QTIP trust for the marital deduction, or only part of it, with the hope of avoiding greater estate tax at the surviving spouse's death. A sense of "balancing" taxes between the two estates of the spouses should be considered here.

3. The testator makes a pecuniary nonformula bequest (for example, $5 million) or a straight fractional bequest (for example, one third of his or her residuary estate) in trust for the surviving spouse. This type of bequest is frequently made in second marriage situations where there is a "blended family" and the testator wishes to control the disposition of the trust remainder after the spouse's death. The testator gives the executor the power under IRC Section 2056(b)(7) to make a QTIP election as to this trust.

After the testator's death, the executor should determine whether to elect the full marital deduction under the QTIP rule.

In cases 2 and 3, the executor has received directions from the testator. When the testator has selected a formula marital deduction, the executor normally will wish to qualify the entire QTIP trust for marital deduction treatment. The reason is that the testator's will that contains the formula has already reduced the estate by the amount exempted under the available unified credit. On the other hand, when the testator has made a straight pecuniary bequest or fractional bequest, the testator's usual intent is also clear. The testator would want the executor to elect the entire principal of the trust to qualify for the marital deduction as QTIP.

A more difficult case is posed by the facts of case 1. If, for example, the testator's gross estate (exclusive of tangible personal property) is $16 million upon his or her death in 2021, how much should the executor elect? The executor can qualify the entire $16 million for the marital deduction as QTIP, but that will only defer taxation until the spouse's death. Instead, the executor, within the confines of the marital deduction trust, should consider making a partial election. The effect of a partial election is that only the amount of marital deduction necessary, after the application of the unified credit (again, leaving portability aside), will be elected. The applicable exclusion amount of the unified credit is $11,700,000 (equivalent to a unified credit of $4,625,800) in 2021. Therefore, the marital deduction needed to reduce the estate tax to zero here is $4,300,000 ($16,000,000 − $11,700,000). In such a case, the QTIP partial election will be made as to 26.875% of the trust assets (or $4,300,000 ÷ $16,000,000).

[57] IRC Section 2010.

© 2021 AICPA. All rights reserved.

Consider, however, if such a division is a sufficient bequest to address the needs and lifestyle of the surviving spouse. It is important to balance the desire for tax savings over two deaths with appropriate concerns for the ongoing support and health of the surviving spouse. If the surviving spouse feels shortchanged by the amount left in the marital share by the first decedent that could prompt an election against the will. Alternatively, if the surviving spouse has significant assets in his or her own name, a reduced marital share at the first death may be completely appropriate. If the surviving spouse is the exclusive life beneficiary of a large credit shelter trust, that may mitigate concerns about the size of the marital bequest. Once again, there are significant issues here — including how portability should be handled and how income tax basis issues should be addressed — that the financial planner should discuss with the clients.

The executor need not make the QTIP election for the sole purposes of preserving the applicable credit amount and minimizing the amount of estate tax to be paid on the decedent's death. In some cases, a full QTIP election would be disadvantageous. For example, when the spouse has died shortly after the testator (or is in imminent danger of death at the time the testator's executor is faced with the election), the executor should consider the potential federal and possibly state estate tax and administration costs on the estate of the surviving spouse, and other relevant facts and circumstances, at the time the election is to be made. Consideration should also be given to a possible conflict of interest if the surviving spouse is named the executor.

Another important concern to be addressed is the income tax basis. When the bypass trust is used, there is no basis adjustment at the death of the surviving spouse — as there is when a marital deduction plan is used. With the reduced impact of the estate tax for most taxpayers, (but subject to the risk of political change) and increased income tax concerns with the advent of higher tax brackets and the net investment income tax, this presents another issue for the financial planner to analyze.

Complicating all of these planning options is the fact that the large exemptions created by the TCJA are scheduled to sunset after 2025 and return to the 2017 levels indexed for inflation. There is also the political risk that the change of administrations in 2021 could see changes come sooner. Flexible planning is the key to addressing these concerns. It is not realistic to expect all clients to change documents with every change in the political climate, so creation of a flexible plan that can be adapted to changes in the law is a worthwhile objective. This can be accomplished with drafting alternatives within the documents, or providing trustees or trust protectors with the opportunity to make favorable elections to address appropriate planning opportunities.

Another issue to consider is state law. Some states (notably New York) may not view a QTIP Trust as an "adequate" share of the deceased spouse's will for the surviving spouse. An elective share may still be available.

.02 Power-of-Appointment Trusts

The most widely used trust in marital deduction planning before the creation of QTIPs was the power-of-appointment trust. As commonly used, it has four essential components:

1. It gives the surviving spouse a life income interest in the trust property.

2. It gives the trustee or the surviving spouse the right to use trust principal for designated purposes.

3. It gives the surviving spouse the right to provide by will who is to receive the trust assets (that is, a general power of appointment exercisable by will).

© 2021 AICPA. All rights reserved.

4. It states that if the surviving spouse fails to take advantage of the right to name the beneficiaries of the trust assets, they are to go to the beneficiaries named in the trust by the spouse who is the first to die (sometimes referred to as the "takers in default").

The following discussion provides some general comments on these typical components.

The survivor must have the right to all the income from the trust, and such income must be paid to the survivor at least annually. The survivor or the trustee may, but does not have to, receive the lifetime right to use principal. To hasten consumption during the lifetime of the surviving spouse, if desirable, consider a provision that authorizes the surviving spouse to use the trust principal to make gifts to children and grandchildren and to pay any gift tax on such gifts.

The surviving spouse must be given a general power of appointment exercisable in favor of the surviving spouse or his or her estate, or his or her creditors or the creditors of the estate, but the power need not be limited to exercise by will. There is a good reason why it is frequently so limited; it avoids having the capital gains of the trust taxable to the surviving spouse, as they would be if the survivor had a general power exercisable during the survivor's lifetime. However, higher capital gain tax rates are imposed at much higher thresholds for individuals than for trusts. Therefore, it may actually be advantageous to have capital gains taxable to the spouse, rather than to the trust. Similarly, with the 3.8% tax on net investment income applicable to trusts at a very low threshold ($13,050 for 2021), another reason can be cited for favoring allocating capital gains to individuals rather than to trusts. Consider recommending that the trustee have the discretion to distribute principal to address possible capital gain tax issues.

The regulations say that the power of appointment must be exercisable by the surviving spouse "alone and in all events."[58] This requirement is probably not to be taken literally because no power would be exercisable by an incompetent. If the spouse is an incompetent, the IRS will allow the marital deduction.[59] Nevertheless, the "alone" part must be heeded, and the "in all events" part as well, except where mental incompetence might arise.

The surviving spouse might have a general power of appointment that he or she fails to exercise or chooses not to exercise. In that case, the trust assets are includible in his or her gross estate for tax purposes, but they are not included for the purpose of calculating executor's fees. An exception would be if under the terms of the trust, the trust assets, in default of appointment, go to the survivor's estate.

.03 The Estate Trust

The estate trust is a bit unusual. It is a trust that will qualify for the marital deduction, even though it is designed so that the surviving spouse receives none of the income or principal while alive. The trust ends on the surviving spouse's death and the trust assets and accumulated income are to be paid to his or her estate at that time. Because the trust assets are part of the surviving spouse's estate, the surviving spouse can control the disposition of the trust assets by will. It is not a terminable interest and so is not required to satisfy the life interest and power of appointment exception to the terminable interest rule

[58] Regulation Section 20.2056(b)-5(g).

[59] Revenue Ruling 75-350, 1975-1, Cumulative Bulletin (CB) 115.

© 2021 AICPA. All rights reserved.

previously discussed. It qualifies for the marital deduction under the same provision as property given outright.

The description of an estate trust in the previous paragraph is an extreme form. The surviving spouse does not have to be denied income or principal while alive. The trustee may be given discretion to make such distributions, but the surviving spouse has no right to demand them.

The estate trust is for the surviving spouse who really does not need income. The surviving spouse has either sufficient income to sustain himself or herself, or the trust could distribute more income than the surviving spouse will need to live comfortably. It is also useful when the trust assets are valuable but illiquid and the testator does not want to allow the survivor to have the right to make the assets productive of income (that is, have the right to require the assets to be sold).

Distributions of income to the survivor may be based upon need, taking into account other sources of income and the survivor's standard of living. The stream of income can be terminated upon the survivor's remarriage. Nothing prevents an estate trust from holding non-income-producing property with good growth potential. Holding such property would very likely present problems with a power of appointment trust and a QTIP trust, given the absence of income distributions.

The financial planner should confirm that the applicable state law recognizes the estate trust as a valid trust and does not convert it into some other type of legal entity that will not give the surviving spouse an interest that qualifies for the marital deduction.

On the survivor's death, the estate trust encounters some other challenges. In addition to the potential estate tax, possible appreciation in the value of the trust assets may have occurred, and there may be accumulated income. This may cause additional administration expenses and executor's commissions, which are avoided with a power-of-appointment trust if the power is not exercised.

Another possible disadvantage of the estate trust is that if the surviving spouse remarries, on the surviving spouse's death, the second spouse may be able to claim part of the value of the trust assets as a surviving spouse electing against a will because the assets are now included in the estate of the deceased spouse. Still, another disadvantage is the compressed income tax rates that apply to the income realized by a trust that is not distributed.

After defining the marital share, by formula or dollar amount, language similar to the following can be used in the creation of an estate trust:

> The trustee shall hold the marital share as the principal of a new, separate, and distinct trust for [spouse's name]'s sole benefit. This trust will be known as the marital trust.
>
> The trustee may pay over and distribute as much (including all or none) of the income and principal of the marital trust to [spouse's name] as the trustee, in its sole discretion, considers advisable to enable [spouse's name] to maintain the standard of living which [he, she] enjoyed during my lifetime. The trustee shall add any undistributed income to the principal of the marital trust annually. The trustee shall have no obligation to make any of the assets of the trust productive of income.
>
> Any principal, including accrued and undistributed income, remaining in the marital trust at [spouse's name]'s death is called the distributive property. The trustee shall pay over and

© 2021 AICPA. All rights reserved.

distribute the distributive property to the executors or administrators of [spouse's name]'s estate to be held, administered, and distributed in all respects as a part thereof.

.04 The Nonmarital Trust

As previously stated, the nonmarital bypass trust has become a common means of using the unified credit available at the testator's death. Instead of leaving everything in a marital deduction bequest to one's spouse, the testator can provide a separate trust to pay all of its income to the surviving spouse for life, with the remainder paid to the testator's children or grandchildren. The surviving spouse will not possess a general power of appointment over this trust. In addition, the QTIP election is not made with respect to a nonmarital trust. Therefore, no part of the principal of this trust will be includible in the gross estate of the surviving spouse at death. The advantage here is that appreciation of the property during the lifetime of the surviving spouse is not taxed at the survivor's death.

When weighing the advisability of a full gift of the decedent's property to the surviving spouse and the use of portability against the use of the nonmarital bypass trust, consider the expectations of the property appreciating and the life expectancy of the surviving spouse. Bear in mind that the portability election is not indexed for inflation. Consequently, significant appreciation in property over time could be taxed when the surviving spouse dies if full portability is used and the value of the estate of the surviving spouse exceeds the amount of the DSUE plus the surviving spouse's available exclusion.

The nonmarital trust is not dependent upon whether the testator has selected a marital trust for the benefit of his or her spouse or, if a marital trust has been selected, what type of trust it is. The value of the nonmarital trust lies principally in its ability to provide the surviving spouse (and other family members, if desired) with a continuing source of income and limited rights to principal of the trust during the spouse's lifetime. Even if the surviving spouse's income from the marital bequest is adequate for his or her needs, a nonmarital trust for the benefit of younger family members can be structured so that the trustee can pay the spouse some, all, or none of the income or principal of the trust as the testator directs or, as the trustee in its discretion, determines. Thus, the nonmarital trust can be a highly effective backup measure.

The nonmarital trust generally will be structured with the following two prime objectives:

1. Meeting the current and long-term needs of intended beneficiaries

2. Avoiding the inclusion of trust assets in the gross estate of the surviving spouse on his or her death

The testator can write virtually whatever provisions he or she wishes into the nonmarital trust. The income interest of the spouse can be terminated upon remarriage. It need not even exist at all, and the testator's children (or others) can be made beneficiaries of the trust to the exclusion of the surviving spouse. The nonmarital trust (or its non-trust equivalent, the outright disposition of the unified credit exemption equivalent available at death to nonspouse beneficiaries) is one of the few instances in estate planning when the testator can act free from the constraints of estate and gift taxes.

When planning for couples who live in states that still have a death tax, a formula nonmarital trust is often used, designed to be funded at the first death with assets equal to the state's available death tax exclusion (typically less than the federal exclusion). This assures that the couple will benefit from the state exclusion at both deaths, rather than only upon the death of the surviving spouse. Currently, only Hawaii and Maryland make their death tax exclusions portable.

© 2021 AICPA. All rights reserved.

.05 The Portion Trust

A surviving spouse may be given a qualifying income interest in a portion of a single trust for QTIP or general power of appointment trust purposes. The testator might do so in situations when the administrative costs of a two-trust plan do not justify its use. Another reason might be if the estate assets, if divided into two trusts, would be insufficient to induce a professional trustee to accept appointment as trustee of one or both of the trusts.

IRC Section 2056(b)(10) limits the term *specific portion* to a fractional or percentile share of the property. It overrules case law holding that a specific portion could be identified in terms of a fixed amount of income or principal, which caused appreciation in certain marital deduction property to be includible in neither spouse's gross estate.[60]

¶1230 Noncitizen Surviving Spouses — Qualified Domestic Trusts (QDOTs)

No marital deduction is allowed under IRC Section 2056(d) if the surviving spouse is not a U.S. citizen, unless certain special requirements are met. The marital deduction is allowed if the surviving spouse becomes a U.S. citizen before the federal estate tax return is filed and was a resident of the United States at all times after the decedent's death and before becoming a citizen. The marital deduction also is allowed for property passing to a surviving spouse who is not a U.S. citizen if the property passes in a QDOT.[61] Property passing to the surviving spouse is treated as passing in a QDOT if it is transferred or irrevocably assigned to a QDOT before the decedent's federal estate tax return is filed.

A QDOT is a trust that satisfies the following conditions:

- The trust instrument must require that at least one of the trustees of the trust be an individual U.S. citizen or a domestic corporation. The IRS has authority to waive this requirement if local foreign law prohibits a trust from having a U.S. trustee.

- The trust instrument must state that no distribution, other than a distribution of income, may be made from the trust unless a trustee who is an individual U.S. citizen or a domestic corporation has the right to withhold from the distribution the federal estate tax due on the distribution.

- If the assets passing or deemed to pass under the QDOT exceed $2 million, the trust must meet certain additional technical requirements (See ¶1230.04) to ensure collection of the federal estate tax.[62]

- The executor must make an election on the federal estate tax return. Once made, the election is irrevocable.[63] To allow the estate of a decedent with a nonresident alien spouse to qualify for the

---

[60] Northeastern Pennsylvania National Bank and Trust Co., 387 U.S. 213 (1967); C. Alexander Est., 82 T.C. 34 (1984), aff'd without opinion, 760 F.2d 264 (4th Cir. 1985).

[61] IRC Section 2056A.

[62] Regulation Section 20.2056A-2(d).

[63] Regulation Section 20.2056A-3.

© 2021 AICPA. All rights reserved.

marital deduction in those situations when the use of a trust is prohibited by local foreign law, the IRS has been given the authority to treat as trusts legal arrangements that have substantially the same effect as a trust.[64]

Under Regulation Section 20.2056A-2(b)(1), an interest passing in a QDOT must otherwise qualify for the marital deduction as a life estate with power of appointment, QTIP, estate trust, or lifetime beneficial interest of a charitable remainder trust (¶1205).

.01 Protective Election

Under Regulation Section 20.2056A-3(c), an executor may make a protective QDOT election if there is a bona fide legal controversy that would create difficulties with making the election at the time the return is filed. Regulation Section 20.2056A-3(b) bars a partial QDOT election.

.02 Reformation and Transfers

If property passes to a trust that otherwise qualifies for the marital deduction but for the fact that the surviving spouse is not a U.S. citizen, under Regulation Section 20.2056A-4(a), the property is treated as passing to a QDOT if the trust is reformed to meet the QDOT requirements. The reformation may occur pursuant to the decedent's will or trust agreement, or a judicial proceeding.

In addition, under Regulation Section 20.2056A-4(b), property that passes to a noncitizen surviving spouse outside of a QDOT is treated as passing to a QDOT if the surviving spouse either transfers or irrevocably assigns the property to a QDOT pursuant to an assignment that is enforceable under local law before the estate tax return is filed and at a time when the QDOT election may still be made. However, the property is treated as passing from the decedent to the QDOT solely for purposes of qualifying for the marital deduction. For all other purposes, such as income, gift, estate and generation-skipping transfer tax purposes, the proposed regulations treat the surviving spouse as the transferor of such property to the QDOT.

.03 Tax on QDOT Property

Federal estate tax is imposed on the value of the property remaining in a QDOT at the time of the death of the surviving spouse.[65]

Estate tax is also imposed under the following conditions:

- There is a distribution of trust principal to the surviving spouse before the surviving spouse's death.[66]
- No trustee is an individual U.S. citizen or a domestic corporation.[67]

---

[64] IRC Section 2056A(c)(3).

[65] IRC Section 2056A(b)(1)(B).

[66] IRC Section 2056A(b)(1)(A).

[67] IRC Sections 2056A(a)(1)(A) and 2056A(b)(4).

© 2021 AICPA. All rights reserved.

- The trust ceases to meet the requirements prescribed in Regulation Section 20.2056A-2(d).[68]

Any portion of the tax imposed on a distribution that is paid out of the QDOT is treated as an additional distribution to the noncitizen spouse and thus is itself subject to additional federal estate tax.[69]

No federal estate tax is imposed on any distribution to the surviving spouse of income or of trust principal on account of hardship.[70] Under Regulation Section 20.2056A-5(c)(1), a distribution is made on account of hardship if the distribution is in response to an immediate substantial financial need relating to the noncitizen spouse's health, maintenance, education, or support, or the health, maintenance, education, or support of any individual whom the surviving spouse is legally obligated to support. A distribution is not considered made on account of hardship to the extent that the amount distributed may be obtained from other sources that are reasonably available to the noncitizen spouse. Assets such as closely held business interests, real estate, and tangible personal property are not considered sources that are reasonably available to the noncitizen surviving spouse.

In addition, the following distributions from the QDOT are exempt from the federal estate tax under Regulation Section 2056A-5(c)(3):

- Payments for ordinary and necessary expenses of the QDOT;
- Payments to government authorities for income or other taxes, but not the deferred federal estate tax imposed on the QDOT;
- Dispositions of trust assets by the trustees;
- Payments by the QDOT to the surviving spouse to reimburse the spouse for income taxes attributable to amounts received from a non-assignable annuity or other arrangement transferred from the spouse to the QDOT.

The federal estate tax does not apply (that is, the marital deduction is allowed) after the surviving spouse becomes a U.S. citizen under the following conditions:

- The surviving spouse was a U.S. resident at all times after the date of the decedent's death and before becoming a U.S. citizen.
- No tax was imposed on any distribution before the surviving spouse became a U.S. citizen.
- The surviving spouse elects to treat any taxable distribution as a taxable gift. The surviving spouse may also treat any reduction in the tax imposed on a distribution because of the unified credit allowable against the decedent's estate[71] as a credit allowable to the surviving spouse for the purposes of determining the amount of the unified credit against the gift tax on gifts made by

---

[68] IRC Section 2056A(a)(2).

[69] IRC Section 2056A(b)(11).

[70] IRC Section 2056A(b)(3).

[71] IRC Section 2010.

© 2021 AICPA. All rights reserved.

the surviving spouse in the year he or she becomes a U.S. citizen or any later year. (The applicable exclusion amount for gifts is $11,700,000 for 2021.)

The amount of the federal estate tax due on a distribution is the amount equal to the tax that would have been imposed on the decedent spouse's estate if the decedent spouse's taxable estate had been increased by the sum of

1. the amount involved in the taxable event and

2. the aggregate amount involved in previous taxable events with respect to QDOTs of the decedent, reduced by

3. the tax that would have been imposed on the decedent's estate if the decedent's taxable estate had been increased by the amount in paragraph two, immediately preceding.

For purposes of computing the amount of federal estate tax due, a credit is allowed for state or foreign death taxes paid by the spouse's estate.

The federal estate tax imposed because of a distribution during the noncitizen surviving spouse's life is due on the 15th day of the fourth month following the calendar year in which the distribution occurs. The tax imposed because of a distribution in the year in which the surviving spouse dies is due on the date nine months after the surviving spouse's date of death.

The trustee is personally liable for the amount of tax imposed. A lien attaches to the property giving rise to the tax for a period of 10 years after the taxable event.

.04 QDOT Security Rules

The IRS has issued regulations[72] regarding the security requirements that apply to QDOTs with assets in excess of $2 million. Under these rules, if the FMV of the assets of the QDOT at the death of the first decedent exceeds $2 million, the trust instrument must require the following: (1) at least one U.S. trustee be a bank or (2) the U.S. trustee furnish a bond or security to the IRS in an amount equal to 65% of the FMV of the trust corpus, computed as of the decedent's date of death. For purposes of this $2 million threshold, the value of the surviving spouse's principal residence (to a maximum of $600,000) is excludable.

If the FMV of the QDOT assets is $2 million or less, the QDOT does not have to meet the bank or bond requirements if, in the alternative, the trust instrument expressly provides that no more than 35% of the FMV of the trust assets, determined annually, may be invested in real property that is not located in the United States.

[72] Regulation Section 20.2056A-2(d)(1)(iv)(A).

© 2021 AICPA. All rights reserved.

¶1235 Use of Disclaimers

Disclaimers, discussed in detail in chapter 15, "Post-Mortem Planning," are effective postmortem estate planning tools. The subject is discussed here because disclaimers may be used in connection with marital deduction bequests. The disclaimer would serve to keep any property initially bequeathed to the spouse but then disclaimed by the spouse out of the surviving spouse's estate and, at the same time, shift the property to a credit shelter trust possibly designed to use a state death tax exclusion or outright to younger generation beneficiaries without incurring gift tax liability for the disclaiming spouse. A disclaimer by the surviving spouse is valid even if the will directs that the property disclaimed passes to a trust in which he or she has an income interest limited by an ascertainable standard.

Disclaimers may also be used in favor of the surviving spouse. If the surviving spouse is given less than the unlimited marital deduction allows, the children might disclaim some or all of their legacies to permit the parent to receive a larger deductible amount. Any estate tax savings generated might ultimately benefit the children.

¶1240 Common Disaster, Survivorship, and Equalization Provisions

A financial planner should also consider whether to use the marital deduction in situations when both spouses die within a short time of one another, when they die in a common disaster, or when one cannot determine the order of survivorship.

Survivorship provisions remain relevant in marital deduction planning. A portability concern requires that there be a surviving spouse in order for the decedent's unused exclusion to pass to a surviving spouse. A clause saying that no spouse survives the other could defeat a desirable portability election, especially when one spouse has significantly more assets than the other and whose estate could be helped by receiving DSUE from the first spouse to die. Accordingly, it is suggested that a simultaneous death clause include the presumption that one of the spouses is deemed to survive the other.

Survivorship provisions should also be included in cases in which individuals who are not spouses need protection against the consequences of dying within a short time of each other to avoid being subjected to multiple costly estate administrations.

.01 Common Disaster Provisions

IRC Section 2056(b)(3) also makes the marital deduction available if the bequest to the surviving spouse is contingent on the spouse surviving a common disaster that takes the life of the decedent. If at the time of the final audit of the estate tax return for the decedent's estate a possibility exists that the surviving spouse might be deprived of the marital bequest by operation of the common disaster provision as given effect by local law, the marital deduction will be denied.[73] Although local law could conceivably save the marital deduction by providing a presumption of survival of a common disaster for a specified period, a financial planner might be unwise to rely on local law. Many state statutes addressing common disasters are more focused on property transfer issues than taxation issues.

[73] Regulation Section 20.2056(b)-3(c).

© 2021 AICPA. All rights reserved.

From a planning standpoint, making the marital bequest available to the survivor to meet his or her actual needs and medical expenses might be desirable. Indeed, that factor might be of greater importance than possible savings in transfer costs. From this point of view, a presumption of survivorship of the common disaster that would permit the estate to provide the survivor with funds would merit consideration. Alternatively, a testator might consider a specific money bequest, not contingent on survival for any specified period.

Another important factor in connection with a common disaster provision is that it does not provide for the situation in which the spouses die within a short time of each other, but not as a result of a common disaster. Accordingly, the common disaster provision may be coupled with a provision requiring survival for a period of six months or less.[74]

As discussed previously, another concern here is the effect of portability. For portability to be applicable, there must be a surviving spouse. If the presumption in a will is that neither spouse survives the other in a common disaster, portability may arguably not be available. This could be a concern if one spouse had a relatively large estate and the other spouse a small estate, and portability, if available, could allow a zero tax result. This suggests drafting common disaster clauses for married persons to be sure there is a deemed surviving spouse.

.02 Equalization Provisions

When one spouse has a significantly larger estate than the other, the financial planner should consider a tax equalization clause. The objective is to have the estates of the two spouses pay the lowest aggregate amount of estate taxes by maximizing the exclusions available over two deaths. This planning is less necessary than in prior years because the estate tax rate structure is no longer truly progressive, as a 40% tax rate applies to all taxable estates, and portability allows the entire tax liability (at the 40% rate) to be deferred until the second death.

> **Example 12.4.** Gordon dies in 2021 and has a taxable estate of $16,000,000 (before application of the marital deduction). Everything is to go to Beverly, his wife, if she survives him; otherwise, it goes to their children. Beverly also dies in 2021 with no assets of her own. The availability of portability and the marital deduction should result in no federal estate tax here on either estate, regardless of the order of deaths.

[74] Regulation Section 20.2056(b)-3(d), example 2.

© 2021 AICPA. All rights reserved.

The IRS, by acquiescing in *C. Smith Est.*[75] and other cases, has allowed risk-free equalization of tax liability by estates. This equalization of tax includes the cases of the largest estates, when the exclusion amounts may be exceeded, or where portability is unavailable as the result of prior transfers.[76] *Smith* involved an inter vivos pour-over trust which did not contain a six-month survivorship provision. The following is the language of the *Smith* equalization provision:

> (b) There shall be allocated to the marital portion that percentage interest in the balance of the assets constituting the trust estate which shall, when taken together with all other interests and property that qualify for the marital deduction and that pass or shall have passed to Settlor's said wife under other provisions of this trust or otherwise, obtain for Settlor's estate a marital deduction which would result in the lowest federal estate taxes in Settlor's estate and Settlor's wife's estate, on the assumption Settlor's wife died after him, but on the date of his death and that her estate was valued as of the date on (and in the manner in) which Settlor's estate is valued for federal estate tax purposes; Settlor's purpose is to equalize, insofar as possible, his estate and her estate for federal estate tax purposes based upon said assumptions.

An equalization clause containing a six-month survivorship clause for inclusion in a will might provide as follows:

> If my said spouse shall have survived me, but shall not have survived me by six (6) months, I give to [her, him] that fraction of my residuary estate which shall, when taken together with all other interests and property that qualify for the marital deduction and that pass or shall have passed to my said spouse under other provisions of this will or otherwise, obtain for my estate a marital deduction which would result in the lowest federal estate taxes in my estate and in my said spouse's estate, on the assumption that my spouse died after me, but on the date of my death and that my said spouse's estate were valued as of the date on (and in the manner in) which my estate is valued for federal estate tax purposes; my purpose is to equalize, insofar as possible, my estate and [her, his] estate for federal estate tax purposes, based upon said assumptions.

The foregoing clause will accomplish exact equality between the estates of the testator and the surviving spouse. However, this exact equality might not be necessary, because exact equality requires that the estate of the predeceasing spouse transfer sufficient assets to the estate of the surviving spouse to equalize federal estate taxes.

Despite the victory of the taxpayer in *Smith* and the acquiescence of the IRS in that (and similar) decisions, the benefit of equalization clauses can only be obtained (like the marital deduction itself) when the wealthier spouse dies first. Furthermore, because of the unlimited marital deduction, the real usefulness of equalization between spouses may be limited to situations when the wealthier spouse (testator) leaves an outright legacy, and not a trust legacy, to the surviving spouse. An equalization provision is not necessary in a will creating QTIP interests. The only provision needed in such a will is a simple reversal of the ordinary survivorship presumption provided under the Uniform Simultaneous Death Act. In addition, as previously indicated in this chapter and in chapter 37, the effects of portability may negate many of these concerns, allowing for a far simpler handling of these issues.

---

[75] 565 F.2d 455 (7th Cir. 1977).

[76] Revenue Ruling 82-23, 1982-1, CB 474.

© 2021 AICPA. All rights reserved.

Chapter 13

Powers of Appointment

¶1301 Overview

¶1305 General and Special Powers

¶1301 Overview

An individual has a power of appointment if he or she has the legal right to determine who will become the beneficial owner of property. The individual who has a power of appointment is the holder of the power. A power of appointment is not an interest in property. Therefore, the gross estate of an individual who dies holding a power of appointment does not include the value of the property subject to the power under IRC Section 2033. However, the gross estate may include property subject to a power of appointment under IRC Section 2041 when the power is deemed to be a general power of appointment.

Financial planners use powers of appointment to give flexibility to an estate plan. When setting up an estate plan, a financial planner acts on the basis of what seems sensible at the time and as far down the road as he or she can see. However, financial planners, through no fault of their own given the changes in the law and the changing circumstances of their clients, cannot be expected to predict uncertain future developments.

Suppose a financial planner is planning an estate for a couple with young children. The spouses know what their current needs are and can estimate their future needs. They also know whether either one can handle money. They may have some ideas about the children's needs and abilities, but the children's needs and abilities are more uncertain.

The couple could place their children's future entirely in the hands of the surviving spouse, leaving everything to him or her, in full faith and confidence that the survivor will adequately provide for the children. Each spouse may feel that the other will make sensible judgments about the children. However, one or both spouses may not be too sure of the survivor's ability to handle an investment portfolio. Each spouse may have concerns about the impact on the children of a possible remarriage by the surviving spouse. The solution to any uncertainty could be a trust that provides the surviving spouse with a power of appointment.

> **Example 13.1.** Ben sets up a testamentary trust to be funded with $1 million in cash and securities. If his wife Jennifer survives him, the trust provides that she will receive the income from the trust for her life. At Jennifer's death, the remainder of the trust will go to their children, David and Sara, in equal shares. Ben also gives Jennifer the power to vary distribution of the trust corpus as she sees fit to provide for the needs of David and Sara.

The power given can be as broad or as narrow as the grantor desires. The power could allow the surviving spouse to exercise it only in favor of the children. Alternatively, the power could allow the

© 2021 AICPA. All rights reserved.

surviving spouse to exercise the power in favor of other classes of relatives such as parents, grandparents, nieces, and nephews. In its broadest terms, the power may allow the holder to appoint the trust corpus in favor of the holder, the creditors of the holder, the holder's estate or the creditors of the holder's estate. Tax considerations, which vary depending on the nature of the power chosen, may affect the choice of the extent of the power. In addition, the holder of the power does not necessarily have to be the surviving spouse.

Example 13.2. Assume the same facts as in example 13.1, except that Ben gives Jennifer the power to vary distribution of the trust corpus as she sees fit not only for the children's benefit, but also to appoint it for Jennifer's own support.

¶1305 General and Special Powers

Powers of appointment are divided into two broad categories: general and special. With certain exceptions, a general power of appointment "means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate."[1] General powers of appointment are considered essentially similar to outright ownership of property. Hence, a decedent's gross estate includes the value of property over which he or she held a general power of appointment at death.[2] Generally, a decedent's gross estate does not include the value of property over which he or she held a *special* (also referred to as a *limited*) power of appointment.

The IRC does **not** consider a power to be a general power of appointment if it contains one of the following provisions:

- An ascertainable standard relating to the holder's health, education, support, or maintenance that limits the holder's power to consume, invade, or appropriate the property.[3]
- The holder cannot exercise the power except in conjunction with the creator of the power.[4]
- The holder cannot exercise the power except in conjunction with a person having a substantial adverse interest in the property involved.[5]

Example 13.3. Wendy grants her husband, Arnold, a power of appointment over property in a trust. However, Arnold may not exercise the power without the consent of Wendy. Arnold's power is not a general power of appointment because it may only be exercised in conjunction with Wendy, who created the power.

---

[1] IRC Sections 2041(b)(1) and 2514(c).

[2] IRC Section 2041(a).

[3] IRC Section 2041(b)(1)(A).

[4] IRC Section 2041(b)(1)(C)(i).

[5] IRC Section 2041(b)(1)(C)(ii).

© 2021 AICPA. All rights reserved.

Example 13.4. Anthony grants a power of appointment to his wife, Antonia, over property in a trust. Antonia may invade the trust corpus only to provide for her health, education, support, or maintenance. Antonia's power is not a general power of appointment because her power is limited by an ascertainable standard.

Property subject to a general power of appointment is includible in the gross estate of the holder of the power at its fair market value (FMV) at the time of the holder's death.[6] In addition, for gift tax purposes, the IRC treats the exercise or release of a general power of appointment as a transfer of the property subject to the power by the holder. IRC Section 2514(e) treats the lapse of a power of appointment as a release of the power. However, the IRC does not treat a disclaimer of such power as a release.[7]

Example 13.5. Don holds a general power of appointment over $500,000 of property in a trust. At Don's death, his gross estate includes the $500,000 in the trust.

Example 13.6. Debra holds a general power of appointment over $525,000 of property in a trust. Debra releases the general power of appointment during her lifetime. Debra has made a $525,000 taxable gift.

The financial planner can incorporate a power of appointment in a power-of-appointment trust. This trust, discussed in detail in ¶1225, may be written so as to qualify for the marital deduction. In order to qualify for the marital deduction, the power of appointment granted to a spouse must be a general power of appointment. (With a QTIP discussed in ¶1210, the grantor does not have to give a spouse any power of appointment.)

Financial planners may also use a power of appointment in an IRC Section 2503(c) trust for a minor, as discussed in ¶425, and in other trusts that do not provide for the mandatory distribution of income. Such powers may allow gifts to the trust to qualify for the annual exclusion ($15,000 for 2021, indexed annually for inflation) from taxable gifts.[8]

Powers of appointment that do not meet the IRC's definition of a general power of appointment are special (limited) powers of appointment. The possession of special powers of appointment generally is not taxable to the holder either for estate or gift tax purposes.

Example 13.7. Patricia holds a power of appointment over $780,000 in a trust. She may invade the corpus of the trust to provide for her health and education only. At Patricia's death, the value of the trust is not included in her gross estate.

Example 13.8. Marsha holds a power of appointment over $500,000 in a trust. At her death, she may appoint the trust property among her then living children and grandchildren. This is not a general power of appointment, and the trust property will not be included in her estate, regardless of whether she exercises the power.

---

[6] IRC Section 2041.

[7] IRC Section 2514(b).

[8] IRC Section 2503(b).

© 2021 AICPA. All rights reserved.

The financial planner can create the widest possible **special** power of appointment by using the IRC definition of a general power of appointment as a guideline. The financial planner does so by providing for a power of appointment that the holder can exercise in favor of any one or more individuals, corporations, organizations, or entities. However, the holder cannot exercise the power in favor of himself or herself, the holder's estate, the holder's creditors, or the creditors of the holder's estate unless the power meets one of the exceptions in the IRC.

The IRC provides a very helpful rule for the financial planner who is designing or reviewing a will or trust agreement. IRC Section 2041(b)(1)(A) provides that if an ascertainable standard relating to health, education, support, or maintenance limits the holder's power to consume or appoint the property, the power is not a general power of appointment.

The use of any one or more of these four statutory standards (sometimes referred to as the "HEMS" standard – for health, education, maintenance and support) will cause the power to be sufficiently limited for estate tax purposes. Regulation Section 20.2041-1(c)(2) contains examples of other limited powers that are not general powers of appointment. These examples include powers exercisable for the following benefits of the power holder:

- Support in reasonable comfort
- Maintenance in health and reasonable comfort
- Support in his or her accustomed manner of living
- Education, including college and professional education
- Medical, dental, hospital and nursing expenses, and expenses of invalidism

Regulation Section 20.2041-3(b) provides that "... a power which by its terms is exercisable only upon the occurrence during the decedent's lifetime of an event or contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent's death." The regulation provides three examples of such contingencies: attaining a certain age, surviving someone, and dying without issue.

In one case, *E. Kurz Est.*,[9] an individual was the beneficiary of two trusts, a marital trust and a nonmarital trust. During her life, she was entitled to all the income from both trusts and had an unlimited right to demand the entire principal from the marital trust. She also had a right to demand payments of up to 5% of the principal from the nonmarital trust if the principal of the marital trust had been completely exhausted. At the time of her death, each trust had assets of over $3 million.

The estate tax return for the individual's estate did not include any of the assets of the nonmarital trust, arguing that no power existed at the time of death under Regulation Section 20.2041-3(b). The U.S. Tax

[9] 101 TC 44, AICPA Dec. 49,166, aff'd, CA-7, 95-2 USTC Section 60,215.

© 2021 AICPA. All rights reserved.

Court disagreed and included the value of those assets to which the power to withdraw 5% of the principal applied in her estate after adopting and applying the following standard for contingent powers:

> [I]f by its terms a general power of appointment is exercisable only upon the occurrence during the decedent's lifetime of an event or contingency that has no significant nontax consequence independent of the decedent's ability to exercise the power, the power exists on the date of the decedent's death, regardless of whether the event or contingency did in fact occur during such time.

When a person receives a general power of appointment and may exercise it during that person's lifetime, subject to certain exceptions discussed in the text that follows, the exercise during lifetime in favor of someone other than oneself takes the property out of his or her gross estate. The exercise of a general power during lifetime will be treated as a gift of the underlying property. The exercise of the power reduces the potential estate tax even if the holder exercises the power within three years of death. A power exercisable during lifetime, as well as by will, imparts greater flexibility than if the holder could exercise the power only by will. Some individuals may oppose such flexibility. They might fear, for example, that the children of the power holder would pressure the holder to exercise the power. In addition, they may feel that limiting the exercise of the power to appointments by will is more likely to achieve their estate planning goals.

The exercise or release of a power of appointment, even if within three years of death, will ordinarily not draw the property subject to the power into the gross estate of the decedent. However, the IRC provides an exception if the power relates to property that would be includible in the decedent's gross estate under IRC Section 2035 (transfer of life insurance within three years of death) or IRC Section 2038 (revocable transfers). In such cases, the exercise or release of the power within three years of death will cause the property subject to the power to be includible in the decedent's gross estate.

In this connection, financial planners may design some powers to lapse if the holder does not exercise them within a specified period, often the calendar year. The lapse of the power is a release of the power. However, this rule applies only to the extent the holder could have appointed property in excess of the greater of $5,000 or 5% of its aggregate value.[10] The exception to this rule, allowing for a limited withdrawal or lapse without gift tax consequences, is referred to as a *five-and-five power*.

Financial planners often use a five-and-five power with a nonmarital trust. In this situation, one spouse desires to give the surviving spouse or other life beneficiary an annual noncumulative power to invade corpus without drawing the trust corpus into the gross estate of the power holder.

A Crummey power of invasion allows the beneficiary of a trust to withdraw a contribution made to the trust.[11] A Crummey power converts what would otherwise be a gift of a future interest in property to a present interest in property. Only present interests in property qualify for the annual exclusion ($15,000 for 2021, indexed annually for inflation) from taxable gifts.[12]

---

[10] IRC Section 2514(e).

[11] *Crummey*, 397 F.2d 82 (9th Cir., 1968), *aff'g in part and rev'g in part* 25 T.C.M. 772 (1966).

[12] IRC Section 2503(b)(1).

© 2021 AICPA. All rights reserved.

A lapse of a Crummey power of invasion may pose an estate tax problem if the Crummey power allows the withdrawal of the full annual exclusion or any amount in excess of $5,000. The gross estate of the holder of the Crummey power may be required to include the excess over $5,000 unless the 5% rule provides for withdrawal of a lesser amount.[13]

.01 Power-of-Appointment Checklist

- ❒ Does the will or trust clearly state how the holder of the power may exercise it?

  In many states, the law presumes a residuary clause in a will is the place to exercise all powers of appointment. Financial planners should consider providing that a person may exercise testamentary powers only if the will specifically refers to them. Because of differing requirements of state law, a lifetime power over real estate should be exercised in the form of a deed under the law of a specific state.

- ❒ Does the instrument create any "disguised" powers?
  - Can any beneficiary, acting as a trustee, pay principal to himself or herself unrestrained by an ascertainable standard?
  - Does the trustee have to discharge a beneficiary's legal obligations?

- ❒ May the holder exercise the power to appoint to another trust?

  Under the law of some states, a holder must exercise special powers outright unless the holder has specific authority to create a trust.

- ❒ Does a provision for a gift terminate if the holder does not exercise the power?

- ❒ May the holder appoint unequally among the objects of the power?
  - May he or she exclude any or all of the objects?

- ❒ Is a clear provision made for the payment of estate taxes on property subject to a general power?

  The IRC provides that unless a contrary provision exists, the executor may recover the pro rata portion of the estate tax from the person receiving the appointive property.[14]

- ❒ May the holder disclaim all powers?
  - May the holder release or reduce the powers from general to special?

  IRC Section 2518, as discussed generally in ¶1525, governs disclaimers. It specifically allows qualified disclaimers of powers to be made free of gift tax. The document creating the power should provide for a method of disclaimer and for a beneficiary of a disclaimed power to limit the objects of a power to make it nontaxable.

- ❒ If a trust provides for both a five-and-five power and a Crummey power, does it coordinate them?

- ❒ Can a power be exercised to create another power to extend the term of a trust?

  Such a power may invoke the provisions of IRC Section 2041(a)(3), the so-called "Delaware Tax Trap," and result in an estate inclusion for the person exercising such a power.

---

[13] IRC Section 2514(c).

[14] IRC Section 2207.

© 2021 AICPA. All rights reserved.

.02 Matters to Consider Before Exercising a Power of Appointment

The effective exercise of a power of appointment depends on careful observance of the requirements of the instrument creating the power. The financial planner may deliberately structure these requirements to discourage exercise or decrease the possibility of ineffective exercise, thus permitting the creator's plan of disposition to take effect. If a power of appointment is made available but not exercised, the financial planner should make certain there is an alternative disposition of the property to appropriate beneficiaries. This is called a *default clause* — it disposes of the property in default of the exercise of the power of appointment.

Before exercising a power of appointment, the holder should carefully review the requirements of the will, trust, or other instrument conferring the power. The holder may want to consult an attorney for advice and counsel in interpreting the conditions under which he or she may exercise the power, especially if the holder wants to exercise the power for the holder's own benefit. Allowing the holder to invade the corpus of a trust for the holder's health, education, support, or maintenance meets the requirements of the IRC for avoiding classification as a general power of appointment. However, this standard may be sufficiently vague to invite controversy with the other beneficiaries of the trust or estate. The holder must strictly comply with the requirements of the power.

The holder should keep good records to document that the holder used the appointive property in accordance with the terms of the power. The holder wants to avoid controversy with beneficiaries of the trust or estate. In addition, the holder wants to be sure that the exercise of the power does not violate the limits of the power that keep the appointive property out of the holder's gross estate.

If the holder of the power can exercise the power only in conjunction with one or more individuals who have an adverse interest in the property, the holder will need to secure their approval. If the adverse parties will not consent to the exercise of the power, the holder may want to explore ways of settling the dispute, including the use of a mediator.

Be aware of the date the power of appointment was created. General powers created prior to October 21, 1941, must be exercised if they are to be included in the estate of the possessor of the power. General powers created after that date are included in the estate of the possessor of the power just by virtue of the deceased power holder's possessing them. Be careful if the financial planner allows a pre-October 21, 1941, power to be inadvertently exercised. It could result in an expensive and unnecessary tax bill.

.03 Estate Planning With Limited Powers of Appointment

The financial planner should consider the possibility that a typical estate plan will transfer all the decedent's property to the surviving spouse at the death of the first spouse and then equally to children at the death of the surviving spouse. Although there is nothing wrong with such a plan, consider the possibility that the surviving spouse will survive the deceased spouse by many years. Perhaps there will be information known to the surviving spouse about the children over the years that could not have been known by the deceased spouse, such as disability, bad marriages, creditor problems, substance abuse, financial need, financial success, special needs, health issues, and so forth.

Giving the surviving spouse a limited power of appointment to appoint property at death among children and grandchildren adds flexibility to an estate plan that otherwise may be lacking. The default clause (providing for disposition of the property if the limited power is not exercised) can still provide for equal

© 2021 AICPA. All rights reserved.

distribution to the children of the marriage, so that inaction by the survivor will do no harm, but the limited power of appointment is worth contemplating by the financial planner in this situation.

.04 Powers of Appointment and Income Tax Basis

With the increased exclusion from transfer taxes ($11,700,000 in 2021, indexed annually for inflation), relatively few persons will be transfer taxpayers at death. This suggests allowing more assets to be included in the estates of persons whose assets will fall below the transfer tax threshold. This will result in the basis of property to heirs being equal to the date of death value of the decedent's property under IRC Section 1014.

One way to accomplish this is to grant beneficiaries a general power of appointment over property left to them in a trust. This will require an estate inclusion for the beneficiaries and result in the desired basis adjustment. The possible downside of this planning is giving control over the property to the persons to whom the general power of appointment might be granted. The financial planner should consider this trade off. Is the risk of control worth the benefit of the income tax basis adjustment? This is likely a case-by-case determination, but certainly one worth exploring with clients.

In some situations, the only general power granted to a beneficiary is the power to appoint property to creditors of the beneficiary. This reduces the possible appointees of the beneficiary but exposes the property subject to the power to potential creditors.

A possible way to hedge this planning is to name a *trust protector* who can be given the right to grant a beneficiary of a trust a general or limited power of appointment. This can be especially useful when the trust grantor dies and the beneficiary survives for a long period of time. Perhaps the grantor was reluctant to grant a general power to the beneficiary at his or her death. The trust protector can have, in a sense, the "last word," allowing for the understanding of changes in the tax and inheritance laws over time as well as issues in the life of the beneficiary to whom the power may or may not be granted, as well as issues in the lives of the persons the beneficiary may select as heirs should the power be granted.

Such a power is often made available in the context of the generation-skipping tax. If it appears that transfers in trust for children for life and then to grandchildren will result in an amount passing to grandchildren that would exceed the transferor's generation-skipping tax exclusion ($11,700,000 in 2021, indexed for inflation), a trust protector can grant the child of the grantor a general power of appointment over the trust property. That will result in the property being included in the child's estate (possibly with no estate tax consequences) and will avoid any generation-skipping issues, which could be far more costly than the inclusion for estate tax purposes in the child's estate.

If there is concern about using the general power of appointment to create an estate inclusion, a more sophisticated plan may consider giving a decedent the opportunity to exercise a power of appointment (a limited power can work here) to create another power of appointment that postpones or suspends the vesting of property for a period of time that is ascertainable without regard to the date of creation of the first power. When this is done, the exercise of such a power has the effect of what is sometimes referred to as "springing the Delaware Tax Trap" (this refers to a Delaware statute that caused IRC Section 2041(a)(3) to be enacted), resulting in the inclusion of the property subject to the exercised power in the estate of the person who exercised it. Where estate inclusion and upward basis adjustment is desired — with no resulting transfer tax — this planning may also be considered. The Delaware Tax Trap refers to a situation where a person exercises a power of appointment created after October 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or

© 2021 AICPA. All rights reserved.

power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power. This can be used intentionally by a power holder to create an estate tax inclusion of the property subject to the power in an estate that will still not be taxable even with the inclusion of this additional property. This is especially helpful with the current estate tax exclusion in 2021 of $11,700,000, since the estate inclusion will result in the heirs of the property receiving a basis adjustment equal to the FMV of the trust property at the death of the person who "sprung" the Delaware Tax Trap. A note of caution here is that if the trust is a grandfathered trust that is exempt from the generation-skipping tax rules, (created prior to September 25, 1985) extending the term of the trust beyond the statutory rule against perpetuities may result in loss of the grandfathered status and subjecting the trust to the generation-skipping tax.

© 2021 AICPA. All rights reserved.

Chapter 14

Selection and Appointment of Fiduciaries

¶1401 Overview

¶1405 Selecting an Executor or Personal Representative

¶1410 Alternate or Successor Fiduciaries

¶1415 Selection of Guardians

¶1401 Overview

Chapter 6, "The Use of Trusts," discussed the selection and appointment of trustees. This chapter focuses on the selection and appointment of executors and guardians, as well as a broader use of the term *fiduciary*.

¶1405 Selecting an Executor or Personal Representative

Executors are now known in some states as *personal representatives*. When choosing an executor, the first concern must be to find someone who is trustworthy, responsible, and capable of handling the job. The executor should also be free of possible conflicts of interest with the beneficiaries. If any potential conflict exists, the financial planner should clearly inform the client of the potential conflict. Conflicts may arise with respect to children who do not get along; persons whose financial interests in the decedent's estate may be adverse to those of other persons; step-parents and step-children; and so forth. In some situations, the client may still decide to name that person as an executor. If the client's attorney can find no legal impediment, then he or she should implement the client's wishes. When a potential conflict of interest exists, a wise client should look for another candidate. Beyond avoiding potential conflicts of interest, the client should look to state statutory qualifications. A nonresident individual not related to the decedent may not be able to serve as executor. The financial planner should check state law on this point. An executor should command respect and confidence among the beneficiaries and not favor one beneficiary over another. Available time is another important factor in selection. Before a client nominates an executor in a will, the client should specify the job requirements and ask for the person's consent.

A client should have a general idea of what an executor's job involves. An executor is responsible for the following:

- Gathering the assets of the estate
- Paying debts and claims against the estate
- Filing the federal and state estate and inheritance tax returns (when applicable) and the estate's federal and state income tax returns and paying the taxes

© 2021 AICPA. All rights reserved.

- Filing any required unfiled income or gift tax returns of the decedent and paying any tax due from the decedent's funds
- Paying the estate's administration expenses
- Liquidating assets as required
- Distributing money and assets to beneficiaries
- Settling the estate
- Accounting to the beneficiaries

The executor must carry out all these duties and comply with legal and tax requirements, exceptions, and limitations.

An executor's job begins even before it is official. Between the testator's death and the probate of the will, the executor should be available to help the family as circumstances dictate, take steps to protect assets, and prepare for probate.

After the probate court or Surrogate's office admits the will to probate, letters testamentary will be issued that give the executor the power to act on behalf of the estate. The executor must gather the assets of the estate and preserve them. The job may require detective-like skills to locate all the assets. Is there a "trail" to locate the decedent's digital assets? The executor will want to pay the debts of the estate as quickly as possible. The executor may want to take advantage of discounts for prompt payment and avoid additional charges for interest and penalties. It may be possible to negotiate with creditors to reduce the amount due from the decedent's estate. If the estate has business interests, the executor must do many other things, including protecting the ongoing business and possibly preparing it for sale. At the same time, the executor will be handling all the details of administering the estate, including the following:

- Obtaining appraisals
- Scheduling cash needs
- Filing for probate
- Preparing for sales
- Setting up the federal and state estate tax returns, if required
- Choosing the valuation date
- Filing any necessary gift tax returns, including those left unfiled by the decedent
- Filing the estate's income tax returns and any unfiled personal income tax returns of the decedent
- Resolving any ambiguities in the will

© 2021 AICPA. All rights reserved.

Next, the executor makes distributions to beneficiaries. The executor must face the problems often associated with distributions, such as even-handed asset distribution, making an allocation of tax burdens, avoiding interest payments on cash legacies, and safeguarding distributions to minors, incompetents, charities, and others.

The will may contain a provision for a qualified terminable interest property (QTIP) interest for the surviving spouse.[1] If so, the executor will have to make a timely election[2] for the interest to qualify for the marital deduction.[3] This election may call for the judicious exercise of discretion, taking into account several factors, including projected tax results. The need for a QTIP election may have a direct bearing on the selection of the executor.

The executor has help administering the estate. The estate attorney can provide guidance. The attorney for the estate may prepare the estate tax return (Form 706), with assistance from an accountant. The accountant usually prepares the fiduciary income tax return (Form 1041). The accountant may also prepare schedules showing distributions to beneficiaries and allocations of estate taxes to them. Although the attorney and accountant provide valuable help, the executor retains the primary responsibility. If anything goes wrong, the court will likely hold the executor responsible. In lawyer's language, the executor is "surcharged."

The executor has plenty of room for honest error. In addition, fraud is always a possibility. Because of the possibilities of error and fraud, the court will usually require a bond for the executor. The bond usually requires that other individuals sign as sureties. Even if the will states that the executor is to serve without bond (as wills typically do), in a rare instance, the probate court may require the executor and sureties to sign an unsecured paper bond.

Bear in mind that the executor may be held personally liable for taxes due from the decedent's estate. The executor must address tax obligations before making distributions to beneficiaries.

Clients often consider a spouse or close family member as an executor. The spouse or close family member may be willing to serve without pay. However, nominating an inexperienced family member may be more problematic than nominating a professional fiduciary who will charge a fee.

The importance of filing Form 706 to obtain the benefit of portability when there is a surviving spouse must also be considered. Be certain that the chosen executor has the best interests of the surviving spouse and his or her family in mind. Be careful of a vindictive child or stepchild refusing to make the portability election to avoid benefiting the heirs of the surviving spouse. Consider having clients include a direction in their wills or in a prenuptial or postnuptial agreement insisting that the portability election be made. Failure to make a portability election could subject an executor to personal liability if the failure results in tax liability at the death of the second spouse to die, which could have been avoided via a portability election.

---

[1] IRC Section 2056(b)(7).

[2] IRC Section 2056(b)(7)(B)(v).

[3] IRC Section 2056(a).

© 2021 AICPA. All rights reserved.

.01 Corporate or Individual

The corporate fiduciary may have the better qualifications based on financial management experience. A corporate fiduciary specializes in the handling of estates, has experience, and is (presumably) responsible. It has no emotional bias, is fair and impartial, is never sick, is never on vacation or abroad, and never dies. However, in reality, the corporate trustees are represented by employees that do retire, die, and change jobs. Corporate trustees may also be involved in mergers and takeovers.

The edge that an individual might have to be selected as a fiduciary is familiarity with the family. It is hard to quantify the importance of personal trust, comfort, and understanding of a family's dynamics — but these are often the characteristics of a fiduciary most important to an individual, particularly an heir or a beneficiary. How long will a trust last? If beyond the reasonably anticipated life expectancy of an individual, the corporate trustee, at least in the role of successor, may have a necessary and important place. In any event, successors should always be considered and provided for, whether individuals or corporations.

Consider the possibility of naming a corporate trustee as the investment fiduciary and a family member or other familiar individual as a distribution trustee. Include provisions allowing beneficiaries to remove and replace a fiduciary if performance is not satisfactory.

.02 Co-executors

Co-trustees may be more common than co-executors. However, sometimes, a testator will feel more comfortable with two executors (an idea akin to having a cosigner on a loan). Co-executors might possibly make sense when one executor has special knowledge about the handling of certain estate assets, such as business interests, works of art, or other items requiring special handling. Objections to co-executors are as follows:

- Divided authority holds the possibility of deadlocks.
- There may be delays getting together and approving actions to be taken.
- Possible double fees and added costs.

Unless there is a strong reason for having co-executors, such as children who do not get along well and may not trust just one child serving as executor, one executor is generally preferable.

.03 Fees

Fees payable to executors vary in different states. Some states allow a percentage of the probate estate as a fee; others limit the fee to time spent; still others have no limiting guidelines other than "reasonable." When a testator names two or more executors, the total fee may be larger. In some states, if the estate is over a certain size, the law entitles each executor to a full statutory fee. However, if the estate has more than three executors, they must share the total fee. Thus, adding another executor may both increase the estate administration expenses and reduce the amount that each executor would otherwise receive. Occasionally a will directs an executor to serve without a fee. In such cases the nominee has a right to decline to serve. Many trust companies will decline the appointment unless the estate assures them a certain amount in fees. It is certainly possible for persons to negotiate an acceptable executor's fee while they are living and selecting the executor.

© 2021 AICPA. All rights reserved.

For federal estate tax purposes, administration expenses allowable by state laws, including executors' fees, are deductible from the gross estate.[4] An executor's fee is includible in the executor's gross income.[5] In many instances, the executor's income tax bracket will be lower than the 40% estate tax bracket. In such cases, the combined tax liability of the estate and the executor will be lower by paying the executor the statutory fee, rather than leaving the person named as the executor an equivalent bequest as an heir. The estate saves more in estate taxes than the executor pays in income taxes. An equivalent bequest would not be subject to income tax, but it would not be deductible from the gross estate when computing the taxable estate.

An estate must also file an income tax return (Form 1041) and pay income tax. The executor's fee is a deductible administration expense.[6] To prevent a double deduction, the income tax deduction is not allowable unless the estate files a statement that it has not taken the same amount as an estate tax deduction. Thus, the executor should compare the tax saved by deducting administration expenses on the estate tax return to the tax saved by deducting administration expenses on the estate's income tax return, assuming that a federal estate tax return will be required to be filed. Given the significant increase in the federal estate tax exclusion ($11,700,000 in 2021, indexed annually for inflation) it is likely that there will be relatively few taxable federal estate tax returns and more claims of fiduciary fees on the estate's income tax return.

The IRS may disallow the deduction for executors' fees if they are unreasonable.[7] Approval by a state court of competent jurisdiction is not determinative of the reasonableness of the fee for federal income tax purposes. The IRS may independently determine the reasonableness of an expense allowed by a state probate court.[8] Not every state requires formal approval of the executor's fee by a judge or probate administrator as a condition precedent for paying the fee.

¶1410 Alternate or Successor Fiduciaries

The executor the client names may be unable or unwilling to serve when the time comes to accept the appointment. Even if the executor accepts, the executor may later be unable or unwilling to continue to serve. Hence, a client should provide for a successor or alternate.

If the testator fails to act and name successors, the probate court will appoint someone as the administrator when that becomes necessary. Having an administrator, rather than an executor, may result in less effective performance and higher costs. A testator who names a successor or alternate can dispense with bonding if the testator so elects. Conceivably, a will could provide that any court-appointed administrator is to serve without bond. A court may or may not give effect to this provision. The proceedings for the judicial appointment of an administrator involve court costs and legal expenses.

---

[4] IRC Section 2053(a)(2).

[5] IRC Section 61(a).

[6] IRC Sections 212 and 641(b).

[7] Regulation Section 1.212-1(d).

[8] *J.M. White, Exr.*, 853 F.2d 107 (2nd Cir. 1988).

© 2021 AICPA. All rights reserved.

When considering trustees, a number of important decisions must be made. If trusts will last for a long time, careful consideration must be given to naming successors to the original trustees. Trusts designed for multiple generations of beneficiaries need to address a mechanism for selecting successors. Perhaps the adult beneficiaries select. Perhaps trustees name their own successors. When the trust assets include a family business, will the selected trustees understand both how to address the management of the business and the personal needs of the beneficiaries? That may be the case, but consider naming one trustee as the "management" trustee who is the business expert, and another trustee as the "distribution" trustee to address issues that affect the personal needs of the beneficiaries. Such a division of responsibility may prove to be helpful in the appropriate cases.

¶1415 Selection of Guardians

Individuals with minor children or incapacitated adult children should include a provision in their wills nominating a guardian for their children. If one parent dies or becomes incapacitated, the surviving parent usually will have custody of the children. Even if the surviving parent is a noncustodial parent, the surviving parent usually receives custody of the children upon the custodial parent's death. However, in some cases, the surviving parent may not receive custody if a court determines that such custody would not be in the children's best interest. Parents should also plan for the possibility that they could both die at the same time (for example, in a common accident). If parents die without naming a guardian for their children, the court will decide on a guardian without knowing the parents' wishes. In such cases, the guardian the court chooses may not share the parents' values. Although the court does not have to appoint the guardian nominated by the parents, courts generally give great weight to the parents' wishes.

Parents should think carefully about whom they would want as the guardian for their children. In many cases, the parents will want a family member to be the guardian. In other cases, the parents may prefer a close friend. The parents should talk to the potential guardians to learn if they would be willing to serve. Usually, the parents will want to nominate an individual who shares their basic values. The guardian should get along well with the children and set a good example for them. The guardian should be healthy, both physically and emotionally. In some cases, the children's grandparents may not be physically capable of caring for small children. In short, the individual or individuals nominated should be able to act as a parent to the children.

An attorney should prepare a will, or a codicil to an existing will, to nominate a guardian. The parents should also nominate an alternate or successor in case the primary guardian is unable or unwilling to serve or continue to serve.

In most cases, the parents should set up a trust to provide financial support for the minor children. Parents should not ask the guardian to bear the financial burden of supporting the children. In addition, parents will want the children to have adequate financial resources for their support, healthcare, and education. Life insurance is a common way to provide the financial resources for the children's support in case of the parents' deaths. An alternative is to leave a bequest to the guardian or name the guardian as the beneficiary of a life insurance policy, provided the designated guardian accepts that role.

The will can provide for a waiver of the bond normally required of a guardian. It can also provide for compensation to the guardian(s).

© 2021 AICPA. All rights reserved.

Chapter 15

Postmortem Planning

¶1501 Overview

¶1505 Income Tax Savings on Decedent's Final Return

¶1510 Planning for the Estate's Liquidity

¶1515 Handling Administration Expenses

¶1520 Selecting the Valuation Date for Estate Assets

¶1525 Changing the Testator's Plan

¶1530 QTIP Election

¶1501 Overview

The objective of estate planning is to improve the financial circumstances of the individuals involved and protect their interests. Postmortem planning is, strictly speaking, not estate planning. However, to the extent that the objective of minimizing estate taxes and fulfilling the wishes of the decedent can be achieved by postmortem planning, postmortem planning is part of the same process.

Because of the uncertain climate of the federal tax laws, a decedent cannot predict what the law will be at the time of his or her death. It may be left to postmortem planning techniques and decisions to complete the process and bring about the desired outcomes. The financial planner should establish and maintain a good working relationship with the client's heirs so that postmortem planning discussions can be easily and productively conducted as a logical continuation of the client's planning.

Moreover, the financial planner needs to be aware of things that he or she can do while the client is alive that will facilitate postmortem planning. Often, the most effective post-mortem planning flows directly from effective pre-death planning that creates flexible options for postmortem planning. In this chapter, the focus is on the executor's postmortem planning strategies to reduce estate taxes, income taxes, and otherwise improve the situation of the estate and its beneficiaries. This chapter also considers decisions that a decedent's survivors might make that will have the effect of changing the decedent's or the executor's plan.

¶1505 Income Tax Savings on Decedent's Final Return

Following are some questions a financial planner may want to consider as part of a decedent's final income tax return checklist.

© 2021 AICPA. All rights reserved.

.01 Should a Joint Income Tax Return Be Filed With the Surviving Spouse?

The executor or administrator may file a separate return for the decedent or elect to file a joint return with the surviving spouse if the surviving spouse has not remarried before the end of the tax year.

Planning Pointer.

Generally, a joint return results in tax savings because of the tax rate schedule's income-splitting benefits. In addition, some tax credits, such as the earned income credit and the credit for child and dependent care services, are not allowed on a separate return filed by a married person.

If the surviving spouse has not remarried and has a dependent child, the surviving spouse may file an income tax return using the filing status of "surviving spouse" (also known as widow(er) with dependent child) for the two years following the death of a spouse.[1] This filing status allows the surviving spouse to use the same tax rates as a married couple filing jointly.[2]

An unabsorbed capital loss in the year of death might influence the election decision. Such a loss cannot be carried forward to the decedent's estate's income tax return. On a joint return, however, it can be applied against the surviving spouse's income. The same is true of losses suspended under passive activity rules (see chapter 31, "Investment and Financial Planning Strategies and Vehicles"). The suspended passive losses are allowed on the decedent's final Form 1040 to the extent that the losses are greater than the excess (if any) of the basis of such property in the hands of the transferee over the adjusted basis of such property immediately before the death of the decedent.[3] The unused passive losses may not be carried to the estate's income tax return or the estate's beneficiaries.

The decedent's tax year closes on his or her date of death. The surviving spouse's tax year does not close at the decedent's death; it continues to its normal closing period. This rule affords an opportunity for the survivor to realize gains or losses and accelerate or postpone income or deductions to minimize income taxes.

The liability on a joint return is joint and several.[4] Therefore, the election to file a joint return with the surviving spouse may subject the estate, and the surviving spouse, to additional income tax liability. However, in some cases, the innocent spouse rules[5] provide relief from joint and several liability. If a surviving spouse has concerns that the decedent spouse was not entirely forthright about income and deductions that may be indicated or claimed, the financial planner should encourage the surviving spouse to avoid filing a joint return. The innocent spouse rules are useful in the right circumstances, but the IRS often rejects an innocent spouse claim when the surviving spouse's lifestyle suggests the spouse

---

[1] IRC Section 2(a).

[2] IRC Section 1(a).

[3] IRC Section 469(g)(1)(C)(2).

[4] IRC Section 6013(d)(3).

[5] IRC Section 6015.

© 2021 AICPA. All rights reserved.

knew, or should have known, about incorrect tax return representations and is not appropriately "innocent." Where there is a concern, the surviving spouse should file as married filing separately, which then forces the tax return of the decedent spouse to also be filed as married filing separately. Neither a surviving spouse nor a deceased married person may file as a single person for the year of the deceased spouse's death.

.02 Should Commissions of Surviving Spouse-Executor Be Waived?

A frequent question is whether an executor who is the surviving spouse should waive commissions.

The surviving spouse-executor should usually waive commissions because they are subject to income tax, particularly when (1) he or she will otherwise receive an equivalent amount as a bequest or legacy (not treated as taxable income) and (2) the estate tax marital deduction exempts the estate from estate tax so that a deduction for the commissions is not needed (or the estate is not taxable as it falls below the amount of the applicable exemption).

An exception to the general rule for a survivor spouse-executor to waive commissions may occur when there is an opportunity to accelerate income to the final joint return by paying partial commissions from the estate before the close of the year in which the decedent died, assuming offsetting deductions are available that would be lost because the return is the decedent's final income tax return.

.03 Were the Decedent's Medical Expenses Paid within One Year After Death?

As a general rule, medical expenses are deductible for income tax purposes only in the year paid.[6] However, medical expenses incurred before death and paid within one year after death may be claimed as medical expense deductions on the decedent's final income tax return.[7] Moreover, medical expenses unpaid at death may be an estate tax deduction as a debt of the decedent. To prevent a double deduction and to be entitled to claim expenses as a deduction on the decedent's final income tax return,[8] the executor or administrator must file a waiver of the right to claim the estate tax deduction.[9] Before deciding where to claim these medical deductions, the executor should compare the tax results of each approach. It may be advisable to extend the filing dates of Forms 1040 and 706 in order to get a more complete picture of the medical bills that will be received by the decedent's estate.

---

[6] IRC Section 213(a).

[7] IRC Section 213(c)(1).

[8] IRC Section 2053(a).

[9] IRC Section 213(c)(2).

© 2021 AICPA. All rights reserved.

Planning Pointer.

Medical expenses are deductible for income tax purposes only to the extent they exceed 7.5% of AGI for 2021[10] The amount deductible on an estate tax return is not subject to any percentage limit.

The executor should not claim the medical expenses on the estate tax return when no estate tax is payable because of the unlimited marital deduction or unified credit. In any event, no medical expenses may be claimed on the income tax return (Form 1041) filed for the decedent's estate.

.04 Did the Decedent Constructively Receive Any Income Before Death?

One of the chief problems encountered when filing the decedent's final income tax return is the determination of what income items to include in it. For a cash-basis taxpayer, all income, actually or constructively received up to the time of death, must be reported.[11] (The decedent's gross income reported on his or her final return includes income constructively received before death, although actually received thereafter.) Income earned by a decedent but not included in the final income tax return because it was not actually or constructively received before death is known as *income in respect of a decedent*.[12] Such income is reported on the recipient's income tax return (beneficiary or estate).

Planning Pointer.

Determining what income the decedent constructively received before death and what items constitute income in respect of a decedent is important. Determining that items of income were constructively received before death is advantageous if the decedent's marginal income tax rate is lower than the marginal rate of the beneficiary or of the estate.

.05 Did the Decedent Own Any U.S. Savings Bonds?

Series EE, and Series I bonds might constitute part of the decedent's assets. The interest income on U.S. Series EE, and Series I bonds is usually reported upon the bonds' redemption (or on redemption of Series H or HH bonds received in exchange for Series EE bonds). However, IRC Section 454(a) permits an election to report as income in any one year the total increase in the value of Series EE bonds to date (or unreported income reflected in Series HH bonds received in an exchange). If the election is not made, the accrued income will be income in respect of a decedent and eventually reportable by the heir to the bonds.[13] Series I bonds are issued at their face amount. They pay a fixed interest rate plus an additional amount of interest based on the rate of inflation. A cash-basis taxpayer may defer the recognition of interest income on the Series I bonds until the earlier of their maturity date or date of disposal. A taxpayer must use the same accounting method to account for Series EE and Series I bonds.

---

[10] IRC Section 213(a).

[11] IRC Section 451(a) and Regulation Section 1.451-2(a).

[12] IRC Section 691(a).

[13] IRC Section 691(a).

© 2021 AICPA. All rights reserved.

Note: Series EE and Series HH bonds replaced Series E and Series H bonds as of January 1, 1980. Series HH bonds are available only on exchange for eligible Series E and Series EE savings bonds.

Planning Pointer.

Reporting all of such accrued and previously unreported income on the decedent's final income tax return might be advantageous. This method is particularly advantageous if death occurred early in the final tax year before receipt of substantial taxable income. Even if the election results in the imposition of federal income taxes (interest on these bonds is exempt from state and local income taxes), the tax liability is deductible on the estate tax return if the return results in a taxable estate.[14] Electing to report the accrued income on bonds may also be advantageous if the decedent had large deductible expenses in the year of death (such as medical expenses) that might otherwise be unused. Offsetting the reported income with such expenses may result in little or no tax on that income and avoid it being taxed in the future to the successor owner of the bonds as *income in respect of a decedent* (IRD).

.06 Does the Survivor Qualify as a Surviving Spouse?

A qualifying surviving spouse[15] is eligible to use the joint return tax rates[16] for two years following the year of death if (1) a dependent child resides in the survivor's household, (2) the survivor was entitled to file a joint return with the decedent for the year of death, and (3) the survivor was not remarried in the taxable year in issue.

Planning Pointer.

Compare the income tax brackets of the surviving spouse and the estate and strive to maximize the benefits and advantages of joint return rates. The estate might be able to accelerate income to the surviving spouse by making distributions during the two-year period. When making the comparison, a financial planner should remember that the income tax brackets of estates are highly compressed. For example, for tax years beginning in 2021, the 0 rate applies to an estate's taxable income up to $2,650, the 24% rate applies to taxable income between $2,650 and $9,550. The 35% rate applies to taxable income between $9,550 and $13,050. Finally, the 37% rate applies to taxable income over $13,050.

.07 Are There Any Bad Debts or Losses for Worthless Securities to Be Claimed?

If there are any debts or stocks that are worthless at the date of death, the executor should determine whether worthlessness occurred during the year of death or in a prior open tax year.

---

[14] IRC Section 2053(a).

[15] IRC Section 2(a).

[16] IRC Section 1(a).

© 2021 AICPA. All rights reserved.

Planning Pointer.

If worthlessness occurred during prior open years, the executor should consider a refund claim. The statute of limitations for claiming a refund is seven years from the due date of the return for a claim arising from a worthless debt.[17]

¶1510 Planning for the Estate's Liquidity

The estate will need cash or cash equivalents for many purposes, such as payment of debts, taxes, cash legacies, and administration expenses. With good advance planning and favorable market conditions, the estate's liquidity needs will have been provided for. If these elements are missing, the estate could be in trouble. Listed in this section are five ways in which the executor may be able to solve the estate's liquidity problem.

.01 Distributions in Kind

If the executor can distribute assets instead of cash, the cash needs of the estate will be reduced. Thus, the client's will should give the executor the required authority to make such in-kind distributions. The executor might be able to distribute assets in kind without express authority with the consent of all beneficiaries. However, the consent of all beneficiaries might not be sufficient grounds for a distribution in kind in the case of a cash bequest. Unless the will provides specific authority covering the cash bequest as well as all others, a single beneficiary may hold up the distribution in kind and compel a forced sale of assets at an inopportune time. If the estate would be allowed a marital deduction and the executor is planning to make a distribution in kind, special rules apply that demand attention. These rules are discussed in ¶1220. Under IRC Section 643(e), the general rule provides that the beneficiary receives the estate's basis in property distributed in kind, and the estate's distribution deduction is limited to the lesser of the property's basis or its fair market value (FMV) on the date of distribution. However, the executor may elect to have the gain on appreciated property recognized by the estate. In this case, the beneficiary receives a stepped-up basis, and the estate receives a distribution deduction equal to the FMV of the distributed property. If the estate makes this election, it applies to all distributions of appreciated property made during the taxable year.

An executor must look very closely at the comparative income tax situations of the estate and the beneficiaries. If the estate has capital losses, the executor should consider making the IRC Section 643(e) (3) election, so the estate could use the losses to offset the gain. Capital losses may be carried forward but may only be distributed to beneficiaries in the final year of the estate. When making the comparison, the executor should remember that the income tax brackets of estates are highly compressed (see ¶1515.06). For example, for tax years beginning in 2021, the top 37% rate applies to an estate's taxable income in excess of $13,050. Long-term capital gains and qualified dividends are taxed at the rate of 20% when the taxable income of the estate (or a trust) exceeds $13,250. By comparison, the 37% rate on ordinary income applies to single taxpayers with taxable income over $523,600, and married filing jointly taxpayers with taxable income over $628,300. The 20% rate on long-term capital gains and qualified dividends applies to single taxpayers with taxable income over $445850 and

[17] IRC Section 6511(d)(1).

© 2021 AICPA. All rights reserved.

married taxpayers filing jointly with taxable income over $501,600 for 2021. These thresholds will be indexed annually for inflation.

Moreover, the 3.8% net investment income tax impacts trusts and estates with taxable income over $13,050. The threshold for imposition of this tax for individuals (not adjusted annually for inflation) is $200,000 of AGI for single filers, $250,000 of AGI for married persons filing jointly, and $125,000 of AGI for married persons filing separately.

.02 Putting Depressed Assets in Trust

A will often creates a trust, and the executor encounters a variety of assets. Some of these assets are marketable, but others are not marketable or are temporarily depressed in value. Under these circumstances, the executor should consider selling the marketable assets (for example, listed securities) and transferring the other assets to the trust. In turn, the trust would be in a better position to hold out for a sale at FMV or for a lesser amount justifying retention. If a living trust created by the testator is in existence and is funded, a sale of estate assets to the trust might be advisable. Such a sale is especially advisable if both the trust instrument and the will contemplate and authorize the sale.

.03 Borrowing from a Beneficiary or Trust

The estate can raise cash by borrowing from a beneficiary or a trust. The trust may be a living trust created by the testator. Although authorization in the will or trust is not required for an executor to borrow from a beneficiary or trust, express authorization in the will and trust instruments will make such borrowing easier. If the proceeds of a life insurance policy payable to the trust will be the source of the borrowed funds, the financial planner should take care to avoid an arrangement calling for mandatory lending of the policy proceeds to the estate to assure their exclusion from the gross estate.[18] It may be advisable to stipulate that any borrowing be discretionary and require adequate interest and adequate security.

.04 Business Interests

The gross estate might include an interest in a closely held business. If such an interest represents more than 35% of the adjusted gross estate, a C corporation or an S corporation may use a tax-favored stock redemption under IRC Section 303 to provide the estate with liquidity. In addition, if the same percentage test is met for either a corporation, or other forms of closely held businesses, (proprietor, partnership or LLC) an installment payment of estate tax liabilities attributable to the business interest under IRC Section 6166 (over 14 years) will help ease the estate's liquidity problem. These provisions are discussed in detail in chapter 19, "Planning for the Owner of the Closely Held Corporation."

.05 Minimizing Income and Estate Taxes

Techniques for minimizing income and estate taxes by the judicious use of deductions for administration expenses and losses are discussed in ¶1515. To the extent that these techniques save taxes, they reduce liquidity needs.

---

[18] Regulation Section 20.2042-1(b)(1).

© 2021 AICPA. All rights reserved.

¶1515 Handling Administration Expenses

An executor may choose to deduct administration expenses and casualty losses either on the estate tax return[19] or the estate's income tax return.[20] If the executor takes these deductions on the estate tax return, they reduce the estate tax at the expense of a higher income tax liability. The reverse is true if the executor takes the deductions on the income tax return.

Usually, the choice made by the executor will be based on comparing the income tax effect and the estate tax effect of claiming the deduction, often by comparing the relative tax brackets of each potential situation (that is, claiming the deduction on the income tax return or on the estate tax return). In estates not subject to the estate tax either by reason of the unified credit or the marital deduction or charitable deduction, the executor should take the deduction on the income tax return.

If the estate is subject to estate tax, the executor should compare the applicable estate and income tax rates. For 2021, the top income tax rate is 37%, which applies to taxable income over $13,050 for an estate. In addition, an estate is subject to the 3.8% tax on net investment income when it has taxable income over $13,050. That can raise the effective tax rate to 40.8% on ordinary income and short-term capital gains and to 23.8% on long-term capital gains and qualified dividends. The top estate tax rate is 40% for 2021. Therefore, in many instances, the income tax deduction will now produce greater savings, especially assuming the estate does not reach the threshold to be a taxable estate — which is $11,700,000 in 2021, indexed annually for inflation. In making this comparison, take into account the impact, if any, of state income or transfer taxes (or both).

Nevertheless, the choice between deducting these items on the income or estate tax return often involves more sophisticated analysis than just a comparison of the relative tax brackets and working out the arithmetic, as discussed below.

.01 Beneficiaries

An election one way or the other between the estate tax return or the estate's income tax return might adversely affect some estate beneficiaries and favor others. When this occurs, if the adverse effect or favoritism is substantial, costly litigation might ensue unless the parties can resolve the conflict by an adjustment.

.02 Distributions – Where to Claim Deductions

If the estate makes distributions to beneficiaries, the comparison should be between the effect of taking the deduction on the estate tax return and analyzing the effective estate tax bracket (40% in 2021) and taking the deduction on the income tax returns of the beneficiaries, and analyzing their respective income tax brackets, rather than analyzing the income tax bracket of the estate, which will not come into play. In this connection, the income tax brackets of individuals are not nearly as compressed as those that apply to estates. For example, for tax years beginning in 2021, an estate hits the top bracket of 37% for taxable income over $13,050, whereas a single individual is taxed at a rate of 10% on taxable income

---

[19] IRC Sections 2053 and 2054.

[20] IRC Section 642(g).

© 2021 AICPA. All rights reserved.

up to $9,950, at a rate of 12% on taxable income between $9,950 and $40,525, at 24% between $40,525 and $86,375, and at higher rates on taxable income greater than that amount.

.03 Marital Deduction

The choice of returns for the deduction can affect the marital bequest. If the will provides for a marital deduction[21] formula bequest, a deduction taken on the estate's income tax return, rather than on the estate tax return, would increase the marital deduction. Again, whether the estate is liable for federal estate tax is a key consideration here. Claiming deductions on the estate tax return may reduce the amount of the unified credit needed to reduce or eliminate tax liability, thereby creating more DSUE for the surviving spouse.

.04 Effect on Beneficiaries of a Trust

If the estate property is placed in a trust, the executor must consider the effect of the election as to where to claim expenses on the income beneficiaries and the remaindermen. Administration expenses and estate taxes paid are ordinarily charges against principal and the remaindermen. Therefore, the deduction of administration expenses on the estate tax return, to the extent that the deduction reduces the estate tax, benefits the remaindermen. Deduction of those items on the income tax return of the trust benefits the income beneficiaries, at the expense of the remaindermen. When the income beneficiaries and remainder beneficiaries are the same persons, these concerns do not arise. When they are different persons, possible conflicts could arise.

Accordingly, under local law, if the executor takes the deductions on the income tax return of the trust, the income account might be required to compensate the principal account in an amount equal to the increased estate taxes resulting from deducting the expense items against income. If a charity is the remainderman, the amount credited to the principal account would give rise to an additional charitable contribution deduction.[22]

.05 Special Estate Tax Factors

In some cases, the election of where to claim administration expenses can affect estate taxes, even when the estate makes full use of the unlimited marital deduction.[23] There might be estate tax liability if the administration expenses are deducted on the income tax return, resulting in certain other items exceeding the available applicable exclusion amount of the unified credit.[24] These other asset items are (1) the decedent's post-1976 adjusted taxable gift amount;[25] (2) debts that, although enforceable, are not deductible for estate tax purposes because they were not incurred for consideration in money or money's

---

[21] IRC Section 2056(a).

[22] IRC Section 2055(a).

[23] IRC Section 2056(a).

[24] IRC Section 2010(c).

[25] IRC Section 2001(b)(1).

© 2021 AICPA. All rights reserved.

worth;[26] and (3) lifetime transfers to persons other than the decedent's spouse that are includible in the decedent's gross estate.[27]

.06 Interest Deductions

Two prime issues regarding the deductibility of interest paid or incurred by an estate are (1) deductibility against income and (2) deductibility as an administration expense against the estate tax.

As for the first issue, the disallowance of the deduction for personal interest contained in IRC Section 163(h) applies to estates ("all taxpayers other than corporations"). *Personal interest* is any interest other than interest incurred in connection with a trade or business, investment interest, interest taken into account in computing income or loss from a passive activity, qualified residence interest, and interest payable on unpaid estate taxes during which an extension of time for the payment of such tax is in effect under IRC Section 6163 (payment of estate tax on the value of a reversionary or remainder interest in property).

Note that interest paid in connection with IRC Section 6161 (which allows the discretionary extension of time to pay estate taxes) is not exempt from the definition of personal interest. In addition, the estates of decedents may not deduct interest paid on the 14-year extension for the payment of estate taxes under IRC Section 6166.[28] The denial of the interest deduction in such cases, as well as no deduction for personal interest on any other borrowing by the estate, obviously adds to the cost of such borrowing.

If the gross estate includes a trade or business, incorporated or unincorporated, any interest paid or incurred in connection with the estate's operation of the business would be deductible.[29]

Investment interest is deductible,[30] but deductibility is limited to the net investment income received by the estate for the year.[31] Investment income does not include qualified dividends unless the taxpayer elects to include them as investment income and forego the reduced tax rate of 15% or 20% (0% if the estate is in the 12% bracket for ordinary income) on such qualified dividends. Long-term capital gains are not included in investment income unless the taxpayer elects to include them in investment income. Any long-term capital gains included in investment income must be taxed as ordinary income.[32]

Qualifying interest paid or accrued by an estate is treated as qualified residence interest if paid in connection with a home used as a qualified residence by a beneficiary who has a present or residuary

---

[26] IRC Section 2053(c)(1)(A).

[27] IRC Sections 2036 and 2038.

[28] IRC Section 163(h) and Committee Reports on P.L. 105-34 (Revenue Reconciliation Act of 1997).

[29] IRC Sections 162(a) and 163(h)(2)(A).

[30] IRC Sections 163(a) and 163(h)(2)(B).

[31] IRC Section 163(d)(1).

[32] IRC Section 163(d)(4)(B) and Temporary Regulation Section 1.163(d)-IT.

© 2021 AICPA. All rights reserved.

interest in the estate.[33] The 2017 TCJA has placed a cap of $750,000 on the qualified residence indebtedness for loans taken out after December 15, 2017, for which the interest paid will be deductible.

Regarding the issue of allowable deductibility against the estate tax, deductibility basically hinges on the benefit to the estate.

As previously noted, an estate may not deduct the interest paid for the 14-year deferral of estate taxes under IRC Section 6166 as an administration expense on the estate tax return.[34] Interest payable by an executor electing to pay estate tax in installments under *other* applicable IRC provisions is deductible as an administration expense.[35] However, as a general rule, the interest is deductible only when it accrues, and the estate claims the deduction. At that time, the estate tax is recomputed, and a refund may be due. No refund will be made until the entire tax liability has been paid; interest on the refund accrues daily.[36]

In *C. Graegin Est. v. Commissioner*,[37] the U.S. Tax Court recognized an exception to the preceding rule and allowed an estate to deduct currently as an administration expense the full amount of interest due 15 years later. The federal estate tax amounted to $204,000. The estate had only about $20,000 in liquid assets, and the executor decided the best course was to borrow to pay the estate tax. The lender was a wholly owned subsidiary of the closely held corporation in which the decedent held stock. It agreed to loan the estate the needed $204,000 on an unsecured note bearing interest at 15%, the prime rate at that time, with principal and interest in a single payment due 15 years later. Prepayment of interest or principal was barred. The key elements allowing the *Graegin* deduction were the prohibition of any prepayment, thus assuring that the full amount of the interest would be paid, and the estate's proof that the lack of sufficient liquidity made the loan necessary. The IRS will challenge the deductibility of interest on loans to pay the federal estate tax on the grounds that the estate did have sufficient liquidity, and the loan was voluntary, not mandatory. When other sources of funds to pay the tax may be available, the IRS opposes the interest deduction on what it sees as "elective" borrowing. These cases turn on the particular facts and circumstances of each. It is difficult, but not impossible, for the taxpayer to succeed in these cases. *J. Koons Est.,* CA-11, 2017-1 USTC ¶60,700.

Tax exempt income presents a special situation. Interest paid on funds borrowed to earn tax exempt income is not deductible, and the expenses of earning tax exempt income are not deductible for income tax purposes[38] but may be deducted for estate tax purposes.[39]

---

[33] IRC Section 163(h)(4)(D).

[34] IRC Section 2053(c)(1)(D).

[35] *C.A. Bahr Est.*, 68 T.C. 74 (1977) (Acq.); Rev. Rul. 78-125, 1978-1 CB 292.

[36] Revenue Ruling 80-250, 1980-2 CB 278.

[37] 56 T.C.M. 387 (1988). See also *Duncan v. Commissioner*, T.C. Memo 2011-255.

[38] IRC Section 265(a).

[39] IRC Section 2053(a).

© 2021 AICPA. All rights reserved.

.07 Distributions and Miscellaneous Itemized Deductions

The executor will also want to take into account the effect on the income beneficiaries of the estate of an election when the executor is required to make current distributions of income under the terms of the will or applicable state law. Although the estate receives an income tax deduction for the amounts of income distributed,[40] the amount of income received by beneficiaries is taxable.[41] Thus, their tax brackets become a factor in the choice to be made.

The IRS released proposed regulations on May 8, 2020 (IR 2020-90) clarifying that the following deductions allowed to an estate or non-grantor trust are not miscellaneous itemized deductions:

- Costs paid or incurred in connection with the administration of an estate or non-grantor trust that would not have been incurred if the property were not held in the estate or trust
- The personal exemption of an estate or non-grantor trust
- The distribution deduction for trusts distributing current income
- The distribution deduction for estates and trusts accumulating income

These deductions are not affected by the suspension of the deductibility of miscellaneous itemized deductions for tax years beginning after December 31, 2017 and before January 1, 2026. The proposed regulations also provide guidance on determining the character, amount, and allocation of deductions in excess of gross income succeeded to by a beneficiary on the termination of an estate or non-grantor trust. Specifically, the proposed regulations clarify that the character of the deductions does not change when succeeded to by a beneficiary on termination of the estate or trust and require the fiduciary to separately identify deductions that may be limited when claimed by the beneficiary. These proposed regulations affect estates, non-grantor trusts (including the S portion of an electing small business trust), and their beneficiaries.

The proposed regulations address the guidance the IRS said it would provide in Notice 2018-61[42] The proposed regulations make it clear that excess deductions incurred by a trust or estate in the year of termination for items such as accounting fees, legal fees, fiduciary fees, cost of appraisals, probate, accountings, fiduciary bonds, and others may be carried over to the beneficiaries and deducted by the beneficiaries on Form 1040 without being termed miscellaneous itemized deductions on an individual's tax return.

Though the proposed regulations are said to be effective when they become final, they also state that taxpayers may rely on them for tax years ending after December 31, 2017. Accordingly, those who may now file amended tax returns to gain the benefit of these deductions are as follows:

- An estate or non-grantor trust that did not claim these deductions in 2018 or 2019
- or those who did not pass them to beneficiaries on the final returns for 2018 and 2019
- and the beneficiaries of these estates or trusts that did not receive the benefit of the allocation of excess deductions in the year of termination.[43]

---

[40] IRC Section 661(a).

[41] IRC Sections 661(a) and 662(a).

[42] IRC Section 67(g).

© 2021 AICPA. All rights reserved.

Note that the final income tax return of the estate is the only opportunity afforded the estate to pass *capital losses* and net operating losses through to the beneficiaries. This rule was not affected by the limitations imposed by the TCJA.

During the administration of a trust or an estate, the only deductions that may be passed to beneficiaries prior to the final year of the entity's administration are the deductions allowed for depreciation, depletion, and amortization. These deductions follow the income. That is, if income is distributed to beneficiaries, the deductions for these items may pass to them as well. If income remains with the entity, so do these deductions. The only exception to this rule is when state law or the governing instrument requires that a depreciation or depletion reserve be maintained. Where that is the case, the amount of the reserve is allocated to the entity. If there are any further depreciation or depletion amounts, they follow the income.

A decedent's estate has the right to take advantage of the 65-day rule for distributions. Therefore, for purposes of computing the estate's income tax liability, the executor may elect to treat distributions made within 65 days after the close of its tax year as if they were made on the last day of the tax year.[43] The executor must make the election by the due date of the estate's income tax return, including extensions. The election is irrevocable.[44] The fact that the election may have been made for one tax year does not bind the executor for any other tax year.

.08 Timing

The executor should also consider the timing of the payments of expenses. If the estate is on a cash basis, the executor might want to advance the date of payment of certain expenses. Giving the executor discretion in the will about when payments may be made is helpful here.

.09 Selling Expenses of the Estate

The selling expenses of the estate are deductible against the estate tax or the income tax, but not against both. This rule is made clear by IRC Section 642(g), which bars not only double deductions for selling expenses but also the use of an expense as an offset against the sales price for income tax purposes, unless a statement is filed assuring that such expenses have not been claimed as estate tax deductions.

.10 Deductions against IRD

IRD generally refers to those amounts the decedent was entitled to receive as gross income but were not includible in his or her final income tax return (or in the return for any prior year) under the accounting method used. IRD is taxable to its recipient under IRC Section 691(a).

IRC Section 691(c) allows a deduction for the federal estate tax attributable to the inclusion of an item of IRD on the income recipient's income tax return because the item is then double taxed (for estate and income tax purposes). IRC Section 691(b) allows the IRD recipient deductions for unpaid business expenses, interest, state and local income and property taxes (the tax deduction for state and local taxes

---

[43] IRC Section 663(b).

[44] Regulation Section 1.663(b)-2(a)(1)N.

© 2021 AICPA. All rights reserved.

is limited to $10,000 beginning in 2018 as the result of the TCJA) and the foreign tax credit that are not allowable on the decedent's final return. These IRC Section 691(b) deductions are known as *deductions in respect of a decedent*. The IRC Section 642(g) bar on double deductions does not extend to deductions in respect of a decedent; they may be taken as both estate tax deductions and income tax deductions. The IRD deduction is not considered a miscellaneous itemized deduction and is allowed to pass to the beneficiary of a trust or estate and be deducted in determining taxable income.

.11 Selecting a Tax Year

Although a trust must generally use the calendar year as its tax year,[45] an estate may choose a fiscal year or the calendar year as its tax year.[46] If the estate's first income tax return is for a period of less than 12 months, the estate does not have to annualize its income.[47] The executor should choose the tax year of the estate carefully. The executor should consider the timing of the estate's expected revenues and expenses and choose the tax year that will minimize the estate's income tax liability and open the possibility of deferred income tax reporting by the estate's beneficiaries. A decedent's qualified revocable trust eligible to make an IRC Section 645 election may file Form 8855 to do so and then be entitled to choose a fiscal year for a period of at least two years from the decedent's date of death.

.12 Estimated Payments of Income Tax

An estate must make estimated income tax payments for any taxable year of administration ending more than two years after the date of the decedent's death.[48] A short estate tax year counts as a year of the estate's administration. An estate is subject to the same penalty for underpayment of estimated taxes as is an individual.[49] Underpayment of estimated taxes could possibly subject the executor to a surcharge because the executor is personally liable for the penalty. Note that a trust is required to make estimated income tax payments from its inception when the trust's tax liability exceeds $1,000. A qualified revocable trust that makes an IRC Section 645 election can wait the same two years as an estate before estimated income tax payments may be required.

Making intelligent projections of an estate's taxable income is often difficult because it requires a projection of net capital gains that may be realized, as well as deductible distributions to beneficiaries. The conscientious executor needs to know the income tax picture of the beneficiaries, which may only become clear fairly late in the estate's tax year.

---

[45] IRC Section 644(a).

[46] IRC Section 441(b) and Temporary Regulation Section 1.441-1T(b)(2).

[47] Regulation Section 1.443-1(a)(2).

[48] IRC Section 6654(l)(2).

[49] IRC Section 6654(l)(1).

© 2021 AICPA. All rights reserved.

Planning Pointer.

Wills should be drafted to include exonerations for executors who cause the estate to pay the penalty for underpayment of estimated tax by reason of incorrect estimation of quarterly tax payments. This exoneration should be effective if the fiduciary undertakes to discharge his or her duty in good faith. This provision will prevent beneficiaries from taking fiduciaries to task for failure to discharge duties that are exceedingly difficult to perform.

For estate tax purposes, administration expenses may be paid at any time during the course of the administration. Frequently, an estate will have its highest taxable income in its first full year. If so, the executor should pay these expenses during the first year in order to claim them against high income. The executor should claim any expense that is not deductible for income tax purposes (for example, funeral expenses or an expense relating to tax exempt income) on the estate tax return.

¶1520 Selecting the Valuation Date for Estate Assets

In general, estate assets are valued at the date of death.[50] However, an executor may elect on Form 706, the federal estate tax return, to value all the property included in the decedent's gross estate six months later (or as of the date of the earlier disposition after death of any particular assets) (called "the alternate valuation date") under IRC Section 2032(a) only if the election will decrease both the value of the gross estate and the sum of any estate and generation-skipping transfer tax (after credits) imposed.[51] Higher values on the alternate valuation date may not be selected to give the heirs a higher basis in the decedent's property. A nontaxable estate may not select the alternate valuation date.

The purpose of this election is to reduce the tax liability when there has been a decline in value following death.[52] The estate may use date-of-death valuation or the alternate valuation date only. This choice may not be made on an asset-by-asset basis. Valuation of all the estate assets must be made either as of the date of death or as of the alternate valuation date. A return electing the alternate valuation date must also report date-of-death values.

.01 Use of Qualified Terminable Interest Property to Qualify for Alternate Valuation

Despite the rule in IRC Section 2032(c) limiting use of the alternate valuation date, the opportunity might still exist to elect the alternate valuation date when estate assets have declined in value, and no estate tax ordinarily would be due by reason of the marital deduction.[53]

The idea would be to take steps to make sure that a small estate tax would become due before election of the alternate valuation date. The permitted election of the alternate valuation date would then reduce the gross estate and the small estate tax. Thus, it would satisfy both conditions in IRC Section 2032(c).

---

[50] IRC Section 2031(a).

[51] IRC Section 2032(c).

[52] Regulation Section 20.2032-1.

[53] IRC Section 2056(a).

© 2021 AICPA. All rights reserved.

How can the estate achieve this result? If the marital deduction bequest qualifies for a qualified terminable interest property (QTIP) election,[54] the executor can make a partial QTIP election to generate a small estate tax. If the gross estate has decreased in value during the six months following the decedent's death, the alternate valuation election would then reduce the gross estate and, thereby, reduce the small estate tax resulting from the partial QTIP election.

Accordingly, a QTIP pecuniary marital deduction provision (with the residuary estate to pass to a nonmarital trust or to nonspouse beneficiaries) might be an attractive option. If the estate appreciates in value, date-of-death values can be chosen so that all appreciation can be allocated to the nonmarital share. If the estate declines in value, the use of the alternate valuation date will allocate all the assets that declined in value to the marital deduction share, thus, reducing assets to be ultimately subject to tax on the surviving spouse's death.

The executor should carefully analyze the decision to pay a small amount of estate tax. Depending on the state of the decedent's domicile, the payment of a small amount of federal estate tax might have to be accompanied by a much larger amount of state inheritance or state estate tax — or none, depending on applicable state law. In addition, reporting the assets of an estate at a lower value results in a lower income tax basis to the heirs. Given the high income tax rates and the 3.8% tax on net investment income, higher, rather than lower, income tax basis adjustments will typically be favored. In addition, creating a taxable estate where portability may be available and with the enhanced $11,700,000 applicable exclusion for 2021 may prove to be quite difficult. For an in-depth discussion of portability, see chapter 37.

.02 Late-Filed Returns

IRC Section 2032(d) provides that the alternate valuation date is permitted if elected on a late-filed estate tax return that is filed no more than one year after its due date, including extensions. The alternate valuation date must be elected on the first estate tax return filed.

¶1525 Changing the Testator's Plan

Sometimes, the best laid plans do not work out. Something happens. Assets appreciate or depreciate in value. A loss occurs. An unexpected gift is received. A new family member arrives while an old one departs. Often, events move faster than one can adjust plans to the new situations. Sometimes, the testator is simply neglectful. Death comes, and it is too late to change the testator's estate plan. However, those who survive can make certain changes in the plan of disposition through disclaimers, settlements, and the election to take against the will.

.01 Disclaimers

Beneficiaries are not forced to accept property bequeathed to them under another person's will. They can disclaim a bequest. No one is likely to disclaim a sizable bequest unless some benefit comes from the disclaimer, if not for the disclaimant, then for others who will benefit by the disclaimer. If someone who does not wish to accept an interest in property makes a qualified disclaimer, the interest disclaimed

[54] IRC Section 2056(b)(7).

© 2021 AICPA. All rights reserved.

will be treated for federal transfer tax purposes as if it had never been transferred to that person.[55] The disclaimant will not be treated as having made a gift, for either gift or estate tax purposes, to the person to whom the interest passes by reason of the disclaimer.[56]

A beneficiary may make a qualified disclaimer of a beneficial interest in a decedent's IRA under IRC Section 2518, even though, before making the disclaimer, the beneficiary received the required minimum distribution for the year of the decedent's death from the IRA. The beneficiary may make a qualified disclaimer under IRC Section 2518 with respect to all or a portion of the balance of the account, except for the income attributable to the required minimum distribution that the beneficiary received. At the time of the disclaimer, the disclaimed amount and the income attributable to it must be paid to the beneficiary entitled to receive the disclaimed amount or segregated in a separate account.

An individual who disclaims his or her entire remaining interest in an IRA will not be considered a designated beneficiary of the IRA for purposes of IRC Section 401(a)(9), if the individual makes the disclaimer on or before September 30 of the calendar year following the calendar year of the decedent's death. In addition, on or before September 30, the disclaimant must be paid the income attributable to the required minimum distribution amount, so that the disclaimant is not entitled to any further benefit in the IRA after September 30 of the calendar year following the calendar year of the decedent's death.[57]

Note the distinction between a "qualified disclaimer," which must be made within nine months of death under IRC Section 2518 and allows the disclaimant to avoid gift tax liability, and a "disclaimer" of an IRA interest by September 30 of the year following the year of the decedent's death. If the latter disclaimer occurs more than nine months after the decedent's date of death, the disclaimant will be treated as having made a gift.

Extending the time to file the federal estate tax return (Form 706) does **not** extend the time for making a qualified disclaimer beyond the nine-month period following the decedent's date of death.

By the surviving spouse. If the surviving spouse's qualifying marital deduction bequest gives the spouse more than he or she might need or consume, the unconsumed amount will be includible in the surviving spouse's gross estate. If the survivor's estate is taxable, this situation could result in the survivor's beneficiaries receiving less than they might otherwise receive. In this type of situation, the surviving spouse might wish to disclaim all or part of the bequest. If the disclaimer will result in the bequest passing to those he or she wishes to benefit (for example, the survivor's children), the property will not be included in the survivor's gross estate and will pass to the intended beneficiaries without gift tax liability and possibly without any added transfer expenses. The surviving spouse may also make a valid disclaimer, allowing the property disclaimed to go to a trust in which the spouse has an income interest. Regulation Section 25.2518-2(e)(2) requires that this result occur without the surviving spouse's direction (that is, it must occur as a result of a provision in the decedent's will directing the disposition of any disclaimed property, rather than by having the surviving spouse direct the disposition of the disclaimed property). In addition, the surviving spouse's power to receive the income (or any

---

[55] IRC Section 2518(a).

[56] Regulation Section 25.2518-1(b).

[57] Revenue Ruling 2005-36, Internal Revenue Bulletin 2005-26 (June 27, 2005).

© 2021 AICPA. All rights reserved.

other property) from a trust funded as the result of the spouse's own disclaimer must be limited by an ascertainable standard.

Any disclaimer of a marital deduction bequest might increase the estate tax liability of the decedent's estate unless it is in favor of a charity[58] or if a sufficient amount of unified credit[59] is available to offset the liability. Even if the estate incurs additional estate tax, the disclaimer might possibly reduce the estate tax and administration costs of the disclaimant's own estate. These factors should be considered. A qualified disclaimer has been held to override a QTIP election.

Planning Pointer.

Many estate plans are intentionally designed to leave property to the surviving spouse with a pathway created that leads to a disclaimer trust. Depending on the amount of the decedent's assets, the available unified credit in the year of death and the needs of the surviving spouse, a disclaimer may be made to whatever extent deemed appropriate. This planning allows important flexibility to address the uncertainty of future estate tax laws. It is also a useful plan to give the surviving spouse the opportunity to disclaim just enough property to fund a bypass trust at the first spouse's death to cover the state estate tax exclusion that may be available (assuming, of course, that the decedent's state of domicile at death had an estate or inheritance tax). This can ensure the use of the state death tax exclusion in the estates of both spouses.

Disclaimer in favor of surviving spouse. Sometimes when the surviving spouse is to receive a marital deduction bequest[60] that might be deemed less than adequate and there are bequests to children or other persons, the executor might want to have the other beneficiaries disclaim their bequests, in whole or in part. The effect will be to increase the marital deduction and so reduce potential estate taxes at the death of the first spouse. IRC Section 2056(a) permits an estate tax marital deduction for property disclaimed by a third person that passes in favor of the surviving spouse. Children might do this for a variety of reasons, including concern for the surviving spouse's needs. They might also do so with the reasonable hope that gifts in the amount of their disclaimed bequest will later be forthcoming. There should not be any financial commitment made to induce a disclaimer. Such gifts to the children could be made in installments to take advantage of the annual gift tax exclusion.[61] Also, the children might ultimately benefit by any resulting estate tax savings.

Disclaimers by others without regard to the marital deduction. Occasionally, a legatee will not need a legacy and prefer to have it go to others. A disclaimer may accomplish this purpose without incurring gift tax liability, while keeping the legacy out of the legatee's gross estate.

---

[58] IRC Section 2055.

[59] IRC Section 2010.

[60] IRC Section 2056(a).

[61] IRC Section 2503(b).

© 2021 AICPA. All rights reserved.

Powers of appointment. A general power of appointment may be the object of a disclaimer. If a decedent holds a general power of appointment at death, all the property subject to the power will be includible in his or her gross estate under IRC Section 2041. (See chapter 13.)

If an individual is given or bequeathed a general power of appointment, any exercise of that power, even within nine months, is not treated as a qualified disclaimer. Rather, it is considered an acceptance of the power's benefits. Moreover, a release of a general power of appointment is treated as a gift or bequest of the property subject to the power. However, a qualified disclaimer of the power does not trigger any transfer tax consequences.

If the surviving spouse is the beneficiary of a power-of-appointment marital deduction trust, circumstances might exist in which he or she might wish to disclaim the power of appointment. The disclaimer in such case would result in the loss of the marital deduction and increase estate taxes (or the use of the unified credit) for the decedent's estate. The survivor's interest would be converted to a life estate and would not be includible in the surviving spouse's gross estate. Depending on factors such as the survivor's age, health, the relative size of the survivor's gross estate, the availability of the advantages of portability, the decedent's gross estate, and most importantly, the amount of the available unified credit, the disclaimer of the power could produce favorable tax results. However, the life estate of the surviving spouse would not obtain a basis adjustment when the surviving spouse died, which is another factor to take into account in making this disclaimer decision.

Joint tenancies and tenancies by the entirety. The rules for disclaimers of interests in joint tenancies with right of survivorship and tenancies by the entirety made on or after December 31, 1997, are contained in Regulation Section 25.2518-2(c)(4)(i). These rules provide that a disclaimer of an interest received in a joint tenancy with right of survivorship or tenancies by the entirety must be made no later than nine months after the creation of the tenancy. Similarly, if a person receives a joint interest in property by operation of law upon the death of the first joint tenant to die, a disclaimer of the survivorship interest must be made no later than nine months after the death of the first joint tenant to die. The survivorship interest is generally deemed to be a one half interest in the property, regardless of the consideration provided by the individual making the disclaimer and regardless of the amount included in the decedent's gross estate under IRC Section 2040. In general, with the exception of joint interests held by spouses, the entire amount of a joint interest in property is included in a decedent's gross estate, except to the extent of consideration provided by another person.[62] The disclaimer rules under Regulation Section 25.2518-2(c)(4)(i) apply, regardless of whether the joint property interest can be unilaterally severed under local law. See the discussion of joint property in chapter 3.

For interests in real estate held by spouses as joint tenancies with right of survivorship or as tenancies by the entirety created on or after July 14, 1988, the surviving spouse may disclaim any part of the joint interest that is includible in the decedent's gross estate under IRC Section 2040.[63] Under IRC Section 2040(b), only one half of the value of a joint interest in property held by a married couple with right of survivorship or as tenants by the entirety is included in the decedent's gross estate. In addition, a special rule applies to joint bank accounts, brokerage accounts, and other investment accounts in which the

[62] IRC Section 2040(a).

[63] Regulation Section 25.2518-2(c)(4)(ii).

© 2021 AICPA. All rights reserved.

transferor may unilaterally withdraw his or her own contributions without the consent of the other joint tenant.[64] Such contributions, when made, are revocable and, therefore, are not completed gifts for purposes of the gift tax.[65] For such accounts, the transfer creating the survivor's interest in the decedent's share of the joint account occurs on the date of the decedent's death. Thus, to be effective, a qualified disclaimer of such a joint account must occur no later than nine months after the date of the decedent's death. However, a surviving joint tenant may not disclaim any part of the account attributable to any consideration that he or she provided.

Planning Pointer.

When a client did not have the benefit of pre-death estate planning, financial planners frequently confront the problem of applicable credit amount (unified credit) bequests that are underfunded by reason of the ownership of substantial joint property by a spouse. Postmortem planning might be necessary to salvage a defective estate plan and produce a larger nonmarital disposition. With the consent of the surviving spouse, the survivorship interest (that is, the half interest deemed to belong to the predeceasing joint tenant) may be divested to other persons.

However, the availability of the portability election may eliminate this concern. The transfer of significant joint property by a decedent to his or her spouse will not absorb any of the applicable exclusion, allowing it to be portable to the surviving spouse without loss of any applicable exclusion. This is an important change in estate planning perception, especially for smaller and mid-sized estates, which previously were planned to maximize the use of the applicable exclusion at the first death. Keep in mind the income tax basis issue, however. With joint property, there is only a one half date-of-death value basis adjustment passing to the survivor. Separately owned property gets a full basis adjustment. Both halves of community property get a full basis adjustment. See chapter 37, "Portability: An Estate Planning Game-Changer" for an in-depth discussion of portability.

The availability of the enhanced applicable exclusion and portability suggest an opportunity for long-term planning for grandchildren and more remote descendants. Consider using direct bequests or the disclaimer planning technique to make certain that the generation-skipping exclusion of each family member is used to the greatest extent appropriate. This can create multi-generational "Dynasty Trusts" that, if properly drafted, can avoid transfer taxation as it exists today for literally hundreds of years.

Disclaimer to favor charity. IRC Section 2055(a) allows a deduction for a charitable transfer resulting from a disclaimer. If a decedent's will provides that a charity would receive a disclaimed bequest, a disclaimer might reduce estate taxes, while at the same time taking the bequest out of the disclaimant's estate. However, the beneficiary should consider income tax consequences before disclaiming a bequest. If the bequest is accepted and then given to charity, the legatee-donor will be entitled to an income tax deduction.[66] The value of the beneficiary's potential income tax deduction must be weighed against any

[64] Regulation Section 25.2518-2(c)(4)(iii).

[65] Regulation Section 25.2511-1(h)(4).

[66] IRC Section 170(a).

© 2021 AICPA. All rights reserved.

higher estate taxes resulting from the acceptance of the bequest and the effect of such higher estate taxes on the legatee and others with whom he or she is concerned.

Basis concerns. An important consideration in any discussion of disclaimers is the income tax basis to the heirs of the disclaimed property. If there is a disclaimer, the heirs take the basis of the transferor, either the carryover cost basis if the transfer is *inter vivos* or the date of death value of the transferred property if the transfer is the result of a death. If the person contemplating disclaiming is unlikely to have a federal taxable estate, perhaps the best plan, at least from an income tax standpoint, would be to allow the original heir to receive property, forego the disclaimer, and allow the property to be included in the future estate of the would-be disclaimant.

Income interest. Family income tax savings might play a part in motivating a disclaimer. For example, a family member in the highest income tax bracket who is given an income interest under a trust may wish to disclaim his or her interest if it places more income in the hands of family members in lower income tax brackets. Also, diversion of income to family members in lower income tax brackets might prevent loss of deductions or other tax breaks that are reduced or eliminated as AGI hits certain thresholds.

Mechanics of disclaimers. IRC Section 2518 provides a single set of definitive rules for disclaimers for purposes of the estate, gift, and generation-skipping transfer taxes.

To be effective for tax purposes, a disclaimer must be qualified. A *qualified disclaimer* is an irrevocable and unqualified refusal to accept an interest in property. It must satisfy the following four requirements:

1. The refusal must be in writing.

2. The written refusal must be received by the transferor, his or her legal representative, or the holder of legal title to the property no later than nine months after the day on which the transfer is made (however, in any event, the period will not expire until nine months after the day on which a young person contemplating a disclaimer attains age 21).

3. The person who disclaims must not have accepted the interest, or any of its benefits, before making the disclaimer.

4. The interest disclaimed must pass to someone other than the person making the disclaimer without any direction on the part of the person making the disclaimer. (A valid disclaimer by a surviving spouse may be made even though the interest passes to a trust in which he or she has an income interest subject to an ascertainable standard for withdrawals and distributions.)

If any possibility exists that a disclaimer might be a useful postmortem tool, the financial planner should advise the client to make provision for disclaimers in the will. This provision might include such details as the following:

- Disclaimers in whole or in part

- The requirement of a written statement to be delivered to the executor within the time limits imposed

© 2021 AICPA. All rights reserved.

- Provision for the disposition of the disclaimed bequest and details about what is required to assure an effective disclaimer for federal tax purposes, even though it may be ineffective under local law

The provision in the will that disposes of the disclaimed bequest is important to the one who is going to disclaim. The disclaimant cannot disclaim property in favor of just anyone; the disclaimant can only refuse to accept the bequest and allow it to pass under that provision of the will to the next designated beneficiary, or if there is no designated beneficiary, to the intestate heirs of the decedent. Creating a disclaimer "pathway" that will be comfortable for a client contemplating disclaiming is an essential element of good postmortem planning that must be addressed *before* anyone has died.

.02 Election Against the Will

In many states, when a person's will does not give the surviving spouse a prescribed share of the testator's estate, the surviving spouse is given a right to take against the will. If the surviving spouse makes the election, he or she will receive a larger share of the estate. At the same time, the election might have the effect of increasing the marital deduction,[67] thereby reducing estate taxes.

In some circumstances, the election can also result in the allowance of a charitable deduction[68] not otherwise allowable. For example, the decedent's will puts the residue in trust to pay the income to the surviving spouse for life, with the remainder to a charity. The trust is not, however, in the form of an annuity trust or unitrust, and, therefore, does not qualify for an estate tax charitable deduction. Assume that the surviving spouse's life interest does not qualify for a marital deduction. On the survivor's election to take against the will, the life income interest fails, and the charity receives an immediate interest that qualifies for an estate tax deduction.[69]

.03 Will Contest or Settlement

A will contest or settlement can result in a shift of property interests under the will from one beneficiary to another or from a beneficiary named in the will to a person not named. If the contest or settlement is bona fide and at arm's length, no gift occurs.[70]

The IRS does not challenge the estate tax deductibility of immediate payments to a charity in settlement of a bona fide will contest solely on the grounds that the payments were made in lieu of a trust remainder interest that would not have been deductible because of failure to meet IRC Section 2055(e)(2) requirements.[71] However, the IRS cautions that it will scrutinize settlements to ensure that they do not represent a collusive attempt to circumvent IRC Section 2055(e)(2).

---

[67] IRC Section 2056(a).

[68] IRC Section 2055.

[69] Revenue Ruling 78-152, 1978-1 CB 296, modified by Revenue Ruling 89-31, 1989-1 CB 277.

[70] *R.S. Righter, Exr.*, 258 F. Supp. 763 (W.D. Mo. 1966), *rev'd and rem'd on another issue*, 400 F.2d 344 (8th Cir. 1968).

[71] Revenue Ruling 89-31, 1989-1 CB 277.

© 2021 AICPA. All rights reserved.

A 1993 U.S. Tax Court decision[72] addressed the impact on the marital deduction of a will clause permitting the executor to allocate administrative expenses between income and principal. The surviving spouse challenged the will on the ground of undue influence. The parties reached a settlement. The executor then claimed a marital deduction for the portion of the estate passing to the spouse under the agreement. The IRS argued that the agreement should be disregarded, and the marital deduction should be equal to the amount passing to the spouse under the terms of the will. The U.S. Tax Court emphasized that the settlement was reached in the context of a bona fide adversarial proceeding and allowed a marital deduction for the amount passing under the agreement.

¶1530 QTIP Election

An exception to the non-deductible terminable interest rule permits QTIPs to qualify for the marital deduction if the executor so elects.[73] Because the decision of whether to set up a QTIP trust to qualify for the estate tax marital deduction is a pre-mortem one, which does require postmortem action by the executor, the factors to be taken into account when deciding whether to make the election are discussed in ¶1210, when QTIP requirements are discussed generally.

Planning Pointer.

As this chapter indicates, the important opportunities for postmortem planning may be as, or even more, important in some estate plans than the pre-mortem planning issues. The financial planner should be certain to follow through with any case in which there has been a death to make certain that the estate plan has been carried out and that all appropriate and available postmortem options and decisions have been addressed. Poor pre-mortem planning can be significantly repaired by thoughtful and timely postmortem planning. It may be said that for many plans, the death of the decedent is the beginning, and not the end, of the financial planning process.

[72] *O. Hubert Est.*, 101 T.C. 314 (1993), *aff'd* 63 F.3d 1083 (11th Cir. 1995), *aff'd* 520 U.S. 93 (1997).

[73] IRC Section 2056(b)(7).

© 2021 AICPA. All rights reserved.

Chapter 16

Planning for the Executive

¶1601 Overview

¶1605 Executive Compensation

¶1610 Lifetime and Estate Planning for Executive Benefits

¶1615 Use of Standard Planning Techniques

¶1620 Total Financial Counseling for the Executive

¶1625 The Migratory Executive

¶1601 Overview

Many corporate executives have a personal financial planning and estate planning position quite different from that of other individuals. They have pay packages that are bulging with fringe benefits, many of which they cannot take with them if they terminate employment. Some fringe benefits, such as stock options, are often burdened with restrictions on current enjoyment. Other fringe benefits, including generous retirement plans, become available only on retirement or death.

Much of corporate executives' estates might be tied up in the stock of their employers. They are in need of diversification, but for tax and personal reasons, may be locked into their employer's stock. Without adequate life insurance, their estates are likely to suffer liquidity problems.

In addition, corporate executives are often highly mobile, residing in different states or countries in the course of their careers. Rights and liabilities acquired in community property jurisdictions, for example, will frequently need to be examined. Different common law rights also could be called into question.

With compensation income taxed at a top income tax rate of 37% in 2021, and with higher net investment income tax and capital gains rates as well, executives are always looking for fringe benefits that will enable them to live better and enjoy more without tax cost to them. If they are wise, they will favor fringe benefits with low after-tax cost to the employer.

Some executives have little sense of capital or of saving. For them, the company provides, and will continue to provide, financial security. However, many executives are becoming less sanguine in the face of takeovers, mergers, downsizings, business slowdowns, and adjustments.

An executive always faces business and social pressures to spend. Many executives have children who need or will need educating, often in private schools. Some children might already be in college or graduate schools.

© 2021 AICPA. All rights reserved.

These and other factors tend to create a great need for personal financial and estate planning on the part of corporate executives.

The emphasis in this chapter is on building the compensation package and developing a feasible estate plan for the corporate executive. To help put things in focus, here is what a typical mid-level executive's numbers might look like and how his or her estate's balance sheet might shape up if the executive were to die today. The executive is 45; married; has three children ages 14, 17, and 19; and has a salary of $250,000.

Sample Executive Estate Balance Sheet

Assets	
Checking account	$3,000
Savings account (money market type)	20,000
Savings account (joint with spouse)	10,000
Money market instruments	10,000
Listed stock	55,000
Company stock (restricted)	900,000
Unexercised stock options, 1,000 shares at $40 and current price $40	0
Home (joint with spouse)	625,000
Vacation condominium (joint with spouse)	280,000
Unimproved land	25,000
Tangible personal property	15,000
Deferred compensation payable over 10 years after retirement or on death or termination of employment, present value	75,000
Vested rights in pension plan	40,000
Vested rights in profit-sharing plan	554,000
Vested rights in a traditional IRA	6,000
Insurance	
Life insurance (permanent — cash value $10,000, face value $50,000)	50,000
Group life	100,000
Travel accident insurance ($50,000, but not figured in gross estate projection because there is no way of knowing if the executive will die as a result of an accident)	
Total Assets	**$2,768,000**
Liabilities	
Home mortgage	$220,000
Vacation condominium mortgage	60,000
Unimproved land mortgage	10,000
Company stock purchase loan	100,000
Total Liabilities	**$390,000**
Net Worth	**$2,378,000**

© 2021 AICPA. All rights reserved.

The executive's spouse has no substantial assets of his or her own, except for a one half interest in jointly held property of a value of $915,000. Without the $250,000 salary, the family's financial position, although not bad by the average person's standards, is not necessarily good. Without going into a detailed analysis, a few things are readily apparent. As far as the estate tax is concerned, the insurance policies are listed as part of the executive's assets so that $150,000 is includible in the gross estate (assuming $50,000 is not collected on the travel accident policy). The insurance policies might have been excluded from the gross estate if the executive had assigned the policies to a beneficiary other than the estate so that the executive retained no incidents of ownership at death. However, that may become a concern in the future if assets grow greater than the current exemptions for federal purposes (assuming the client doesn't live in a state with a state inheritance tax or estate tax).[74] Under IRC Section 2040(b), only half of the jointly held property is includible in his or her gross estate.

With a gross estate of $2,310,500 (total assets of $2,768,000 minus one half of the joint assets of $915,000 under IRC Section 2040(b)) in 2021, and assuming the mortgage debts and stock purchase debt are personal, amounting in all to $390,000 and adding say, $50,000 for administration expenses, the taxable estate is $1,870,500 (before application of the marital deduction). No federal estate tax is due as a result of the marital deduction[75] and the applicable exclusion amount of $11,700,000 (unified credit equivalent for 2021 under IRC Section 2010, indexed annually for inflation). But the estate needs $440,000 to pay administration expenses and retire debts. State death tax, if applicable, could be an added debt of the estate. It has $150,000 in life insurance proceeds and must gather the rest from the remaining assets available. The joint property is not available to the executor. The deferred compensation, if payable over a period of 10 years, will not be of much immediate value, unless the company could be persuaded to pay the present value in a lump sum. The real estate does not appear to be a good source of ready cash, and the company stock might present some problems in view of the assumed restrictions. Spousal rights in the retirement benefits render them unavailable for the payment of immediate expenses. Even if the savings account is drained and the listed securities sold, the estate does not have enough cash to pay off all the debts and expenses. The family's position leaves much to be desired if existing living standards are to be maintained, and the three children sent to college and graduate school.

A checklist of executive payroll benefits that a financial planner should consider as executive wealth builders follows. Special estate planning considerations and techniques for the executive are explored in this chapter.

This chapter addresses the financial planning aspects of business owners, some of which may qualify as a small business. The Small Business Association relief programs are beyond the scope of this guide, but visit the AICPA's Payroll Protection Program page for more resources to help your clients (www.aicpa.org/sba). Access COVID-19 planning strategies and client facing resources from the PFP Section.

[74] IRC Section 2042.

[75] IRC Section 2056(a).

© 2021 AICPA. All rights reserved.

¶1605 Executive Compensation

Salaries come first. To attract and retain good people, a company must pay competitive salaries. Indeed, to entice a good executive from another firm, a better-than-competitive salary, plus bonuses, are ordinarily required.

Salaries and cash bonuses are not everything. Capital-building benefits, such as qualified profit-sharing plans and stock bonus plans with built-in capital accelerating mechanisms, are particularly attractive to executives. Executives are usually in high tax brackets and can benefit the most from the tax shelter. Tax-free current benefits, such as medical insurance and life insurance, for example, are also popular. The executive whose company pays the premium on a $50,000 group-term life insurance policy receives the benefit tax-free.[76] If the company is a C corporation, in a 21% tax bracket,[77] as the result of the changes made by the 2017 Tax Cuts and Jobs Act (TCJA), its after-tax cost of the group-term life insurance is 79% of its cost.

.01 Checklist of Executive Benefits

The following is a list of executive benefits and their income tax status, along with an added cost/benefit analysis in many cases.

Qualified pension and profit-sharing plans and traditional IRAs. Executives are not taxed on employer contributions when made. Such plans also shelter the income from tax as long as it remains in the plan (see ¶905 for a detailed discussion of the qualified plan rules). Executives who are participants in qualified plans may also make contributions to traditional or Roth IRAs,[78] but the contributions are subject to income limitations and may not be allowed, and, even if allowable, may not be deductible (¶915).[79]

Qualified cash or deferred arrangements (401(k) plans). Employers are permitted to establish cash or deferred arrangements (CODAs) as part of a qualified plan (often referred to as 401(k) plans). Under a CODA, the executive and other employees have the choice of (1) having the employer pay all (or part) of the employee's share of employer contributions in currently taxable cash or (2) having payment made to the executive's or employee's account in a qualified plan, with resulting income tax deferment. However, maximum annual elective deferrals are limited to $19,500 for 2021. In addition, individuals who are age 50 or older may contribute an additional $6,500 for 2021 (see ¶925 for details).[80] These contribution limits are indexed annually for inflation in $500 increments.

---

[76] IRC Section 79(a).

[77] IRC Section 11(b).

[78] IRC Section 408.

[79] IRC Section 219(g).

[80] IRC Sections 402(g)(1) and 402(g)(5) and IR 2014-99 (October 23, 2014).

© 2021 AICPA. All rights reserved.

Employee Stock Ownership Plans (ESOPs). ESOPs generally take the form of a straight qualified stock bonus plan or one coupled with a qualified money purchase pension plan (see ¶910 for a fuller discussion).[81]

As a tax-qualified plan, an ESOP enjoys all the tax advantages that qualified pension and profit-sharing plans enjoy. Although there may be distributions of employer stock invested in an ordinary qualified profit-sharing plan, an ESOP must make a distribution of such stock if the participant or a beneficiary demands it.[82] However, an ESOP does not have to make a distribution of the stock if the charter or bylaws of the corporation or the ESOP plan itself restrict the ownership of substantially all outstanding employer securities to employees or the ESOP.[83] In that case, cash payments are made to a retiring employee or to his or her estate. The unrealized appreciation in the employer securities is not taxable to the executive on distribution, but only on a subsequent taxable transaction.

ESOPs offer added advantages to the company and its shareholders in that they may be used to raise capital by having the plan borrow to purchase stock from the company or its shareholders. Often, the sellers of stock to the ESOP are the company's executives, who then gain diversification of their assets. The ESOP typically borrows the funds to pay the executive for the stock, with the loan guaranteed by the company. The company's tax-deductible contributions to the plan enable it to pay off the loan. In effect, the company funds the executive's diversification of assets and pays off the loan with tax-deductible dollars. The ESOP can provide an important market for stock held by company shareholders, thus allowing them to diversify their holdings away from the company stock. Other possible advantages of an ESOP to the company include its use as a financing vehicle in acquisitions, sales of part of the business, and buying out dissident shareholders, and, of course, creating an incentive for all company employees to grow the success of the company.

ESOPs offer an opportunity to diversify tax-free under a provision providing for nonrecognition of gain on a sale of company stock to an ESOP in which the sale proceeds are invested by the seller in stocks of publicly held companies. The investment must occur within a certain time frame (generally within 90 days of the close of the plan year), the employee must have completed 10 years of participation under the plan and have attained age 55, and at least 25% of the participant's account must be involved in the transfer. Certain other technical requirements also must be met.[84]

In addition, a C corporation may deduct, at the election of plan participants or their beneficiaries, dividends paid to an ESOP and reinvested in qualified employer securities.[85]

If the ESOP plan is to work, the company must be healthy, the employees must be interested in acquiring company stock, and the company and its shareholders must be willing to suffer the possible

---

[81] IRC Section 409.

[82] IRC Section 409(h)(1).

[83] IRC Section 409(h)(2)(B).

[84] IRC Section 401(a)(28)(B).

[85] IRC Section 404(k)(2)(A).

© 2021 AICPA. All rights reserved.

dilution of control. The latter might be especially important if the company is closely held, but might be manageable through the development of an acceptable repurchase plan.

ESOPs have received some negative publicity. Some well-known corporations abused ESOPs. In addition, the values of some ESOPs have decreased significantly. The IRS has identified certain transactions by S corporations involving ESOPs as abusive tax shelters[86] Although an ESOP may be a shareholder in an S corporation, IRC Section 409(p) prevents an S corporation from using an ESOP as a tax shelter for a small group of owners and executives. Rather, the ESOP must provide a meaningful benefit to rank-and-file S corporation employees.

The IRS allows an ESOP to direct a rollover of distributions of the S corporation stock to a participant's IRA without risking termination of the S election, as long as the rollover meets all the following conditions:

- The ESOP must provide that the S corporation must repurchase the stock once the ESOP distributes the stock to the participant's IRA.
- The S corporation must actually repurchase the stock on the same day of its distribution to the IRA.
- No income, deduction, credit, or loss attributable to the stock is allocated to the participant's IRA.[87]

Because of the requirement for the S corporation to repurchase the stock the same day the ESOP distributes it to the participant's IRA, financial planners should urge the ESOP to make the distribution early in the day.

In addition, a regulation[88] addresses abusive situations in which former S corporation owners receive (1) deferred compensation from a management company related to the S corporation or (2) special rights to acquire assets from the S corporation. These arrangements dilute the value of the S corporation stock in the ESOP. This type of deferred compensation and such special rights are treated as "synthetic equity" (i.e. rights to acquire or receive S corporation stock in the future) under the regulation. Treatment as synthetic equity results in income tax liability and excise tax liability for the recipients.

Incentive stock options. Incentive stock options (ISOs) are often granted to key employees. ISOs are taxed in a favorable manner.[89] The granting of the option and its exercise are not taxable events for regular income tax purposes, but the exercise of the option is a taxable event for purposes of the alternative minimum tax (AMT).[90] Proceeds from the sale or exchange of the stock will be taxed as a

---

[86] Revenue Ruling 2003-6, 2003-1 C.B. 286.

[87] Revenue Procedure 2003-23, 2003-1 C.B. 599.

[88] Regulation Section 1.409(p)-1.

[89] IRC Section 422.

[90] IRC Sections 421(a) and 422(a); IRC Section 56.

© 2021 AICPA. All rights reserved.

capital gain, provided the stock is sold or exchanged after it has been held for at least two years from the date the option was granted *and* one year from the date it was exercised. If the stock is not held for the required period, the sale or exchange is treated as a disqualifying disposition, and the employee is taxed at ordinary income tax rates on the difference between (1) the option price paid for the stock and (2) the lesser of the fair market value (FMV) at the time of the option exercise or the sale price.[91] A number of requirements must be met for stock options to qualify as ISOs.[92] In addition, an annual $100,000 exercise limit applies.[93]

IRS regulations[94] have clarified the tax treatment of disqualifying dispositions and made it clear that any entity classified as a corporation for federal tax purposes is eligible to grant incentive stock options.[95]

Generally, an ISO must express the following:

- An offer to sell at the option price
- The maximum number of shares acquirable under the option
- The time allowed to exercise the option

The corporation must grant the ISOs under a shareholder-approved plan, which specifies the number of shares to be issued and the class of employees who will receive the stock. The regulations allow ISOs to be in either paper or electronic form. The corporation must grant an option within 10 years of the date the corporation adopts the ISO plan or the date of its approval by the corporation's shareholders. The grantee must exercise the option within 10 years from the date of grant.

The option price must be at least equal to the FMV of the stock when the corporation grants the option. The regulations explain that the corporation may determine the option price in any reasonable manner as long as the minimum price is not less than the FMV of the stock on the date of grant.

Generally, the grantee may not transfer the options to another party and keep the special tax treatment. The regulations carve out a limited exception. Grantees may transfer options to a trust if they remain the beneficial owners. However, when a grantee transfers options under a divorce agreement, they lose their special tax status.

---

[91] IRC Section 422(c)(2).

[92] IRC Section 422(b).

[93] IRC Section 422(d).

[94] Regulation Sections 1.422-1, 1.422-2, 1.422-4, and 1.422-5.

[95] TD 9144 (August 2, 2004).

© 2021 AICPA. All rights reserved.

The regulations also identify three provisions that the corporation may include in an incentive stock option, which do not render it defective. An ISO may

- provide for a cashless exercise,
- give the grantee the right to receive additional compensation when the option is exercised, and
- be subject to certain permissible conditions.

The regulations expand the definitions of option, corporation, and stock. Options now include warrants. *Statutory option* means an incentive stock option or an option granted under an employee stock purchase plan. Corporation now includes a limited liability company treated as a corporation for tax purposes.

When a grantee makes a disqualifying disposition of stock, the profit is treated as compensation income and not as capital gain. The compensation income generally equals the FMV of the stock on the date the option was exercised minus the exercise price.

A special rule applies if the amount realized on a disqualifying disposition is less than the FMV of the stock at the time the option was exercised. The amount included in the gross income of the grantee will not exceed the excess, if any, of the amount realized on the sale over the adjusted basis of each share. This rule applies only to dispositions where a loss (if sustained) would be recognized to the grantee. Thus, it does not apply if the stock is disposed of in a nonrecognition transaction or by gift.

For AMT purposes, stock acquired by exercise of an ISO is treated as though it were taxable under the IRC Section 83 rules governing taxation of property given for services, rather than under the IRC Section 421 rules that govern ISOs for regular income tax purposes.[96] Under the IRC Section 83 rules, the difference between the value of ISO stock and the price paid for it by the employee on exercise is includible in AMT income when the stock is freely transferable or not subject to a substantial risk of forfeiture.[97] Under this rule, if a taxpayer acquires and disposes of ISO stock in the same tax year, the tax treatment under both the regular tax and the AMT is the same.[98] However, if a disqualifying disposition occurs in a year after exercise, an AMT adjustment must be made in the year of exercise based on the spread between the option price and the stock's FMV (determined under IRC Section 83 rules).[99] Gross income is recognized for regular tax purposes in the year of disposition.

The TCJA tightened the limitations on the deduction for excessive employee compensation paid by publicly held companies to the five highest paid employees, now including the principal executive officer and financial officer[100]. The exceptions that had been allowed in the previous law for commissions and performance-based compensation are repealed. For tax years beginning in 2018,

---

[96] IRC Sections 56(b)(3) and 83.

[97] IRC Section 83(a).

[98] IRC Sections 422(c)(2) and 56(b)(3).

[99] Regulation 1.422-1(b)(2)(i).

[100] IRC Section 162(m)(1).

© 2021 AICPA. All rights reserved.

applicable employee remuneration includes any cash and noncash benefits paid for services, including commissions- and performance-based compensation, but not income from employee trusts, annuity plans or pensions, benefits expected to be tax-free, income payable under a written binding contract in effect on February 17, 1993, and compensation paid before a corporation became publicly held.[101, 102]

Nonqualified stock options. Nonqualified stock options can be granted at bargain rates, unlike ISOs, which must be priced at 100% of FMV at the time of grant. No tax consequences for either the executive or the company occur at the time of the grant of nonqualified options unless the option has a readily ascertainable value. The option has a readily ascertainable value if the stock is actively traded on an established market or its FMV can otherwise be measured with reasonable accuracy.[103] Assuming that is not the case, on exercise of the option, the difference between the FMV of the stock at the time of exercise and the option price (that is, the bargain element) is taxable to the executive as ordinary income, with a corresponding deduction allowed to the company, unless the stock acquired is not transferable and is subject to a substantial risk of forfeiture.[104] In the latter case, the executive is taxed (and the company is allowed a deduction) when the stock becomes transferable or the risk of forfeiture ends,[105] unless the executive has elected to include the value of the stock in gross income in the year of the transfer.[106] If the executive makes the election to include the value of the stock in income, and the executive later forfeits the interest in the stock, no deduction is allowed for the loss.

Planning Pointer.

It is often advisable to have the employee make a Section 83(b) election and include the value of stock in income when the option is granted, especially in cases in which the company is a start-up venture, and the initial value of the stock is low. If there is a later public offering of the stock, the Section 83(b) election allows the employee who made the election to establish a basis in the stock and a holding period at the time such election is made, thereby allowing the employee's subsequent sale of the stock to be considered a long-term capital gain, if the required holding period rules are met, rather than ordinary income, which would result if the Section 83(b) election was not made. The Section 83(b) election must be filed no later than 30 days after the property was transferred and may be filed prior to the date of transfer. The election is made by filing a written statement with the IRS office where the person performing the services files his or her return. The IRS no longer requires a copy of the statement to be attached to the person's tax return for the year the election is made. The Section 83(b) election may be used in connection with restricted stock awards as well as in connection with compensatory stock options.

---

[101] IRC Section 162(m)(4)(C).

[102] IRC Section 162(m)(4)(C).

[103] Regulation Section 1.83-7(b).

[104] IRC Section 83(a).

[105] IRC Section 83(a).

[106] IRC Section 83(b)(1).

© 2021 AICPA. All rights reserved.

The IRS provided sample language that may be used for making an election under IRC Section 83(b) and provided examples of the income tax consequences of making such an election. When properly completed and signed by the service provider, the sample election would satisfy the requirements of Regulation Section 1.83-2 with respect to shares of common stock subject to a substantial risk of forfeiture. For the election to be valid, the service provider must also satisfy all the other applicable requirements, including timely filing the election with the IRS and providing a copy to the service recipient. A Section 83(b) election must contain all the information required by Regulation Section 1.83-2(e), but need not use the exact format or language of the sample election.[107] This is certainly an area where the financial planner can make an impact, both by bringing the Section 83(b) election opportunity to the attention of the client and making certain that the Section 83(b) election is properly made.

The TCJA added a new IRC Section 83(i) which provides that a qualified employee of a privately held company may elect to defer including in income the amount of income attributable to qualified stock transferred to the employee by the employer. This election is an alternative to being taxed in the year in which the property vests under IRC Section 83(a) or in the year it is received under IRC Section 83(b). The election to defer income inclusion for qualified stock must be made no later than 30 days after the first date the employee's right to the stock is substantially vested or is transferable, whichever occurs first. If this deferral election is exercised, the employee must include the income for the tax year that includes the earliest of

- the first date the qualified stock becomes transferable or
- the date the employee becomes an excluded employee (i.e., is a 1% owner of the corporation or is or was the CEO or CFO of the corporation or is a family member of a 1% owner or a CEO or CFO or is one of the four highest compensated employees of the corporation for the current year or any of the 10 preceding tax years).

If the nonqualified stock option has a readily ascertainable value at the time of grant, the bargain element is immediately taxable to the executive as ordinary compensation income, and the company receives an equivalent income tax deduction.

On exercise of the option, the executive may need cash or deferred payment financing. The Federal Reserve Board permits *cashless exercises* of stock options. Under this procedure, a broker buys the stock from the company at the exercise price, sells enough of the stock in the market sufficient to cover the purchase from the company, plus commissions and possible margin interest, and delivers the remaining stock to the executive.

If the executive is an officer, director, or 10% shareholder of the employer, he or she will be subject to the short-swing profits provision of the Securities and Exchange Act, Section 16(b), if he or she sells the stock within six months of acquiring it.

The executive must weigh the value of this form of cashless exercise against other forms of exercise of stock options that may be available with little or no cash involved, such as a company loan at a low interest rate and swap of stock previously acquired for stock to be acquired. Both plans can be

[107] Revenue Procedure 2012-29.

© 2021 AICPA. All rights reserved.

accomplished without payment of commissions and without any current tax liability. The first approach would have no Section 16(b) involvement. The second would qualify for a Section 16(b) exemption.

IRS regulations address the identification of a substantial risk of forfeiture for purposes of the transfer of restricted property in exchange for services under Reg. 1.83-3(c)(1). The regulations provide the following:

- A substantial risk of forfeiture may be established only through a service condition or a condition related to the purpose of the transfer (except for situations noted under IRC Section 83(c)(3) and Reg. 1.83-3(j) and (k) as noted in the following text).

- In determining whether a substantial risk of forfeiture exists based on a condition related to the purpose of the transfer, both the likelihood that the forfeiture event will occur and the likelihood that the forfeiture will be enforced must be considered. For example, assume that a person is hired and given stock which is nontransferable. For the employee to retain the stock, the revenue of the employer may not decline more than 15% in each of the three years following the issuance of the stock. If it declines more than 15%, the stock is forfeited by the employee. This restriction appears to be a "condition related to the purpose of the transfer." However, the regulations do require that the likelihood of the condition occurring must be taken into account. If there is little chance it will occur, then the condition will not constitute a substantial risk of forfeiture and the stock will be taxable to the employee when it was issued.

- Except as specifically provided in IRC Section 83(c)(3) and Reg. 1.83-3(j) and (k), transfer restrictions do not create a substantial risk of forfeiture, including transfer restrictions that carry the potential for forfeiture or disgorgement of some or all of the property, or other penalties, if the transfer restriction is violated.

- Examples provided in the regulations make it clear that selling windows and lock-up restrictions to prevent insider trading liability do not result in a substantial risk of forfeiture because they are not imposed as service conditions or as conditions related to the purpose of the transfer.

- The effect of the risk of insider trading liability is left exclusively to Reg. 1.83-3(j) which provides that property, the sale of which may give rise to suit under Section 16(b) of the Securities Exchange Act of 1934, is subject to a substantial risk of forfeiture until that potential exposure is no longer the case. Reg. 1.83-3(j) provides that if the sale of property at a profit within six months after the purchase of the property could subject a person to suit under Section 16(b) of the Securities Exchange Act of 1934, the person's rights in the property are treated as subject to a substantial risk of forfeiture and are not transferable until the earlier of the expiration of such six-month period, or the first day on which the sale of such property at a profit will not subject the person to suit under Section 16(b).

- The regulations clarify that the purchase of shares in a transaction subject to Section 16(b) of the Securities Exchange Act of 1934 prior to the exercise of a stock option that would not otherwise give rise to Section 16(b) liability, would not defer taxation of the stock option exercise under Reg. 1.83-3(j).

© 2021 AICPA. All rights reserved.

- Stock received by employees who can be required to pay over to the corporation any profits realized upon the sale of stock within six months of acquisition, pursuant to the insider's trading rule of Section 16(b) of the Securities Exchange Act of 1934, is considered to be subject to a substantial risk of forfeiture.[108] If a taxpayer's property is subject to a restriction on transfer to comply with the SEC's pooling-of-interests accounting rules, the property is also considered to be subject to a substantial risk of forfeiture, and the taxpayer's interest in the property is deemed nontransferable. This defers taxation on such property until it is no longer subject to the restrictions.

Cash bonuses. Payment of year-end bonuses may be timed to fall into the following tax year, with a current compensation deduction for the employer and deferral of tax for the executive. An accrual basis corporation can take a deduction for its current tax year for a bonus not actually paid to an executive until the following tax year if all the following requirements are met:

- The executive doesn't own more than 50% in value of the corporation's stock.
- The bonus is properly accrued on the corporation's books before the end of the current tax year.
- The bonus is actually paid within the first 2½ months of the following tax year.[109]

For an executive on the cash basis, the bonus won't be taxable income until the year in which it is paid.

If deferral of tax on a year-end bonus makes sense for an executive, the executive can request in advance that the employer delay payment until early in the following year. However, if the executive waits until a bonus is due and payable to request a deferral, the doctrine of constructive receipt will be triggered, and the tax on the bonus will not be deferred. Also, if the deferral extends beyond 2½ months after the close of the taxable year, the bonus will be treated as nonqualified deferred compensation. Bonuses treated as deferred compensation are currently includible in income to the extent not subject to a "substantial risk of forfeiture" if the arrangement fails to meet certain distribution, acceleration of benefit, and election requirements (see text that follows).

Performance shares. Performance shares are a variation of a bonus plan. The plan differs, however, in that it is more likely to be geared to the long term. It attempts to match compensation with a unit of the company stock's performance and an individual's performance in relation to the unit's performance. The company sets targets. To the degree that those goals are met, the company gives awards, sometimes referred to as *phantom stock plans*. The final payout can be cash, stock, or both. Along the way, the company makes phantom awards to the executive to encourage performance without actually committing the company's shares. The executive is taxed on the final payout as compensation, and the company receives a corresponding tax deduction.

The claimed advantage over conventional stock plans is that performance shares are not so closely tied to the market; to some extent, they reflect performance, and they do not require any payment by the executive.

---

[108] IRC Section 83(c)(3).

[109] Regulation Section 1.404(b)-1TQ&A2.

© 2021 AICPA. All rights reserved.

To the extent that actual shares of company stock are awarded, the company faces dilution problems. Also, the value of the shares is a charge against earnings. Because of this factor, earnings must grow sufficiently to compensate for the charge, while at the same time, meeting the company's goals and objectives. Generally, plans of this type are not suitable for start-up companies because they have difficulty setting earnings goals.

Stock appreciation rights and phantom stock. Stock appreciation rights (SARs) and phantom stock are designed to provide the executive with a cash bonus measured by the appreciation in the value of the company's stock from the time the rights are granted over a set or determinable period. Like performance shares, SARs give an executive a stake in company growth without a cash investment. Payments made could include amounts equal to the dividends paid on the stock or amounts equal to the appreciation in value of the stock after a determined starting date. The payments are treated the same as cash bonuses. They are taxable to the executive as compensation and deductible by the company unless they are made subject to a substantial risk of forfeiture, in which case, they are taxable only when such risk lapses.

Planning Pointer.

In closely held companies in which there is reluctance by controlling shareholders to share any company stock, SARs and phantom stock plans are excellent ways to offer an incentive to allow employees to share in the growth and upside of the company without giving them any actual equity ownership. Start-up companies may offer other forms of equity-based incentive compensation, such as so-called restricted stock units that offer a true equity stake in a business subject to a variety of restrictions on sale and redemption. When the companies providing such forms of stock compensation satisfy the requirements of a company offering "qualified small business stock" (see chapter 31, "Investment and Financial Planning Strategies and Vehicles"), persons holding such stock for at least five years and eventually selling it may qualify for a tax exemption upon sale of from 50% to 100% of their realized gain, depending on when the stock was acquired.

Group-term life insurance. Group-term life insurance is tax-free to the executive on coverage of up to $50,000,[110] subject to compliance with antidiscrimination rules.[111] For higher amounts of coverage, the executive receives a break on the portion of the employer-paid premium that is taxable.[112] The company receives a deduction for premiums paid regardless of the amount, if any, taxable to the executive, subject to the rules of reasonable compensation.[113]

Group permanent life insurance. Treasury regulations accept a single policy combining term insurance with permanent life insurance as being within the scope of IRC Section 79 rules governing

[110] IRC Section 79(a).

[111] IRC Section 79(d).

[112] IRC Section 79(c).

[113] IRC Section 162(a).

© 2021 AICPA. All rights reserved.

group-term life insurance, provided many conditions are satisfied.[114] Complex formulas are provided for computing the amount taxable to the executive (¶945).

Split-dollar life insurance. Split-dollar life insurance is permanent insurance acquired under an arrangement by which the company and the executive share the premium cost. The company and the executive's beneficiaries also share the proceeds on an agreed basis. Either the company or the executive may own the policy. Under the endorsement method, the employer owns the policy and endorses an interest in the policy to the employee. Under the collateral assignment method, the employee owns the policy and assigns a security interest in the policy to the employer.

In a traditional split-dollar arrangement, the employer pays the portion of the annual policy premium that equals the increase in the policy's cash value for the year, and the employee pays the remainder of the premium. On the employee's death, the employer receives the cash surrender value of the policy (thus, recouping most or all of its cost) and the employee's estate or beneficiary receives the remainder of the death benefit.

However, under an "equity" split-dollar arrangement, the death benefit that goes to the employee's estate or named beneficiary is not limited to what is left over after the employer receives the cash value; the employee's estate or beneficiary receives a portion of the cash value as well. The employer generally recovers only an amount equal to the cumulative premiums it actually paid. The remainder of the death benefit goes to the employee's estate or named beneficiary. During the life of the policy, when the cash value buildup exceeds the cumulative premiums paid by the employer, the employee is considered to have an equity interest in the policy. If the policy is surrendered, the employee will receive a portion of the cash value.

The IRS's final regulations[115] on the treatment of all split-dollar life insurance arrangements apply to split-dollar arrangements executed or materially modified after September 17, 2003. For split-dollar arrangements entered into on or before September 17, 2003, taxpayers may continue to rely on prior revenue rulings as described in Cumulative Bulletin Notice 2002-8, Internal Revenue Bulletin 2002-4, 398 (January 3, 2002), as long as such arrangements are not materially modified.[116] Under the 2003 regulations, the amount taxable to an individual under a traditional split-dollar arrangement with a company is generally determined as under prior law. This means the individual is taxed on the value of the death benefit coverage provided by the company, based on the cost of one year of term insurance. For split-dollar arrangements entered into before January 28, 2002, this cost may be determined using the table of one-year premium rates set forth in Rev. Rul. 55-747, 1955-2 C.B. 228, commonly referred to as the "P.S. 58" rates, if a contractual arrangement between the company and the individual provides that those rates will be used.[117] For arrangements entered into on or after January 28, 2002, Table 2001 rates (IRS Notice 2001-10, 2001-5, IRB) must be used to determine the cost of current life insurance protection as the measure of the value of the current economic benefit.

---

[114] Regulation Section 1.79-1(b).

[115] Regulation Sections 1.61-22 and 1.7872-15.

[116] Revenue Ruling 2003-105, 2003-2 C.B. 696 (September 11, 2003).

[117] Notice 2002-8, 2002-1 C.B. 398 (January 3, 2002).

© 2021 AICPA. All rights reserved.

Although leaving the tax treatment of traditional split-dollar policies relatively intact, the final regulations substantially alter the tax treatment of equity split-dollar arrangements.

Under the final regulations, the tax consequences of an equity split-dollar life insurance arrangement depend on its classification under one of two alternative regimes: the economic benefit regime or the loan regime.

Under the economic benefit regime, the employer, as owner of the insurance policy, is deemed to provide economic benefits to the non-owner employee. The premiums paid by the employer are treated as compensation to the employee. In addition, any right or benefit in the insurance policy, such as an interest in the cash surrender value, is treated as additional compensation.

Under the loan regime, the employee owns the policy and the employer pays the premiums. The employer, as the non-owner of the policy, is deemed to loan the premium payments to the employee-owner of the policy. The loan regime applies when (1) the payment is made by the non-owner to or on behalf of the owner; (2) the payment is a loan under the tax law, or a reasonable person would expect the payments to be repaid; and (3) the payment is made from, or secured by, the death benefit or the cash surrender value of the policy. Each premium payment is treated as a separate loan. If the loan under the split-dollar arrangement is not a below-market loan, the general rules for loans apply. The borrower may not deduct any interest paid on the split-dollar loan because it is personal interest. If the loan under the split-dollar arrangement is a below-market loan, the provisions of IRC Section 7872 apply. However, the *de minimis* exception of IRC Section 7872 does not apply to split-dollar loans. The imputed interest on a below-market loan to an employee under a split-dollar arrangement is usually taxable compensation to the employee.

The split-dollar regulations do not affect the calculation of the amount included in an executive's gross income for group-term life insurance that exceeds $50,000. The amount included in the executive's gross income in such cases is still determined under Regulation Section 1.79-3(d)(2).

The company receives no deduction for the premiums paid in the split-dollar arrangement.[118] However, the company recovers the premiums paid tax-free when the executive dies. The company would also recover the premiums paid tax-free if and when the executive buys the policy, or if the company's lien against the policy is satisfied while the executive is still alive.

Planning Pointer.

With the enhanced federal estate tax exclusion, it becomes increasingly unlikely that many people will be estate taxpayers. This may diminish the need for life insurance, at least as a fund to be used for estate tax payment. Persons who have split-dollar life insurance policies paid for by an employer may consider buying out the employer's interest in order to obtain full control over the policy.

Medical benefits. The company can provide medical benefits to executives and their dependents. The cost of the medical benefits generally will be tax deductible by the company[119] and tax-free to the

[118] IRC Section 264(a).

[119] IRC Section 162(a).

© 2021 AICPA. All rights reserved.

executive.[120] Medical benefits include payment or reimbursement of accident and health insurance premiums, including major medical coverage and dental care, and direct payment or reimbursement of medical or dental expenses.

Executives (or employees) who pay their own medical expenses are allowed to deduct them only to the extent they exceeded 7.5% (for 2021) of the executive's AGI.[121] That floor on deductions makes employer-provided, tax-free medical benefits particularly attractive.

Prior to the Affordable Care Act (ACA), medical benefits were generally not subject to nondiscrimination requirements. An employer may provide group health insurance only for key executives or other selected employees. However, if an employer provides health benefits under a discriminatory self-insured plan, benefits paid to highly compensated employees will be taxable to the extent they constitute "excess reimbursements" over and above amounts available to non-highly compensated employees.[122] (Provisions contained in the ACA may limit or prohibit the ability of an employer to offer health insurance only to key executives or other highly compensated employees, as discussed in the following sections.)

An employer can deduct amounts paid or accrued during the tax year for medical benefits for employees, provided they qualify as ordinary and necessary expenses of the employer's business.[123]

An employee's own payments for medical benefits are generally deductible as medical expenses, subject to the 7.5% of AGI threshold in 2021. However, employee contributions may be made on a pretax basis under a cafeteria plan. A *cafeteria plan* is an employer-provided plan that offers employees a choice between cash compensation and one or more employee benefits, such as medical benefits. Employees who choose to receive medical benefits in lieu of cash compensation do not owe tax on the forgone compensation, and the forgone compensation is not treated as wages for payroll tax purposes.[124]

The ACA and employer reimbursement of employee insurance. The ACA raised some serious concerns for employers that desired to assist their employees with the payment of health insurance premiums. For several years, employers were threatened with severe penalties if they made these payments. Legislation in late 2016 finally addressed some of these concerns.

Notice 2013-54 provided that such a practice by a business owner creates a very serious problem for the owner because reimbursement of employee premium costs constitutes maintaining a "group health plan." The ACA provides that any group health plan must not provide an annual limitation on benefits, and the amount paid by the employer is deemed to be an annual limitation. Accordingly, the "plan" fails the requirement to be a "group health plan."

---

[120] IRC Sections 105 and 106.

[121] IRC Section 213(a).

[122] IRC Section 105(h)(1).

[123] Regulation Section 1.162-10(a).

[124] IRC Section 125.

© 2021 AICPA. All rights reserved.

Although the premium reimbursement to the employee is still considered a tax-free receipt under Revenue Ruling 61-146, if the company involved has at least two employee-participants, even if the plan is not considered discriminatory, it fails to meet the maximum lifetime benefit requirement of the ACA, is deemed a disqualified group health plan, and is subject to a penalty under IRC Section 4980D. What is the penalty on the employer? $100 per day, per participant.

A sole owner of a small business can pay for his or her own health insurance, exclude other employees, and not be subject to the penalty. If, however, there are multiple employees, the business may not pay for all their insurance without a group health plan. According to Notice 2013-54, paying for the cost of an employee's policy falls short of the mandated group health plan, subjecting the employer to the penalty. This includes payments provided by the employer to reimburse the employee under an IRC Section 105 medical reimbursement plan, under a Revenue Ruling 61-146 reimbursement plan, or through employee pretax contributions made through an IRC Section 125 cafeteria plan. Such plans are considered "improper" group health plans that fail to satisfy the "essential health benefits" requirements of the ACA.[125]

Employer reimbursements made on an after-tax basis avoid the per diem penalty and may be used by an employee to purchase an individual market plan both inside and outside of the ACA exchanges.

Sole proprietors without employees are not subject to the penalty. Neither are sole Subchapter S shareholders without employees.

The IRS issued limited relief in this area in Notice 2015-17. In the notice the IRS provided limited penalty relief to small employers (under 50 full-time employees) who are using certain premium reimbursement plans that the IRS had previously indicated violate the ACA. The Notice did not change the IRS's position with respect to premium-only plans. It granted a grace period through June 30, 2015, for small employers that use certain types of premium reimbursement arrangements to pay for individual coverage on the exchange, among other things. In the Notice, the IRS stated that penalties would not be assessed against small employers (under 50 full-time employees) who sponsor them until July 1, 2015.

Small business owners and their employees expressed great unhappiness with these provisions. The employer's desire to assist with health insurance payments without underwriting a full plan was being penalized, or employees were not getting employer assistance with healthcare.

The 21st Century Cures Act and Qualified Small Employer Health Reimbursement Arrangements (QSEHRAs) was signed into law on December 13, 2016, to address this issue. The law allows small employers that do not offer any group health plan to their employees to adopt a Qualified Small Employer Health Reimbursement Arrangement (QSEHRA) to reimburse employees for premiums they pay for individual insurance policies. The law became effective January 1, 2017.

[125] IRC Section 9815.

© 2021 AICPA. All rights reserved.

The law provides that a QSEHRA will not be considered a group health plan for ACA purposes, such that it will be exempt from the market reform requirements. To qualify as a QSEHRA, the program must meet the following requirements:[126]

- A QSEHRA must be funded exclusively with employer contributions; there is no provision for employee contributions (such as those made under a typical IRC Section 125 cafeteria plan).

- For 2021, reimbursements must be limited to $5,300 per year for employee-only coverage and $10,700 per year for family coverage.[127]

- A QSEHRA must be offered to all eligible employees on the same terms. (Exclusions are permitted for employees with less than 90 days of service, employees under age 25, employees covered by a collective bargaining agreement, nonresident aliens, and certain part-time and seasonal employees.)

- The employer cannot offer group health plan coverage to any of its employees.

An employer that adopts a QSEHRA must provide a written notice explaining the terms of the arrangement. The IRS will issue a model notice that can be used to comply with this requirement. Employers must issue the notice at least 90 days before the beginning of each new plan year (for example, the notice for 2021 was due October 2, 2020).

An employer desiring to offer a QSEHRA will need a written plan document setting forth the terms of the arrangement, along with supporting documents.

Wage increases in lieu of health coverage. The IRS confirmed in Notice 2015-17 that providing increased wages in lieu of employer-sponsored health benefits does not create a group health plan subject to market reforms, provided that receipt of the additional wages is not conditioned on the purchase of health coverage. Quelling concerns that any communication regarding individual insurance options could create a group health plan, the IRS stated that merely providing employees with information regarding the health exchange marketplaces and availability of premium credits is not an endorsement of a particular insurance policy. Although this practice may be attractive for a small employer, an employer with more than 50 full-time employees (in other words, an applicable large employer, or "ALE") should be mindful of the ACA's employer shared responsibility requirements if it adopts this approach. An ALE is required to offer group health coverage meeting certain requirements to at least 95% of its full-time employees or potentially pay penalties under the ACA. Increasing wages in lieu of benefits will not shield ALEs from those penalties. (See the further discussion of the ACA in chapter 39.)

Treatment of employer payment plans as taxable compensation. Some employers and commentators have tried to argue that "after-tax" premium reimbursement arrangements should not be treated as group health plans. In Notice 2015-17, the IRS confirmed its disagreement. In the Notice, the IRS acknowledges that its long-standing guidance excluded from an employee's gross income premium

[126] IRC Section 9831(d).

[127] Rev. Proc. 2020-45, November 4, 2020.

© 2021 AICPA. All rights reserved.

payment reimbursements for non-employer-provided medical coverage, regardless of whether an employer treated the premium reimbursements as taxable wage payments. However, in Notice 2015-17, the IRS provides a reminder that the ACA has significantly changed the law, including, among other things, implementing substantial market reforms that were not in place when prior guidance had been released. The result: government guidance has reiterated and clarified the view that premium reimbursement arrangements tied directly to the purchase of individual insurance policies are employer group health plans that are subject to, and fail to meet, the ACA's market reforms (such as the preventive services and annual limits requirements). This is the case regardless of whether the reimbursements or payments are treated by an employer as pretax or after-tax to employees. (This is in contrast to simply providing employees with additional taxable compensation not tied to the purchase of insurance coverage, as described earlier.) As noted previously, assuming that there is compliance with the 21st Century Cures Act, the employer plan *will* satisfy the ACA standard and not be subject to penalty. Absent such compliance, the ACA requirements will not be met.

Integration of Medicare and TRICARE premium reimbursement arrangements. Although Notice 2015-17 confirms that arrangements that reimburse employees for Medicare or TRICARE premiums may be group health plans subject to marketplace reforms, government guidance also provides for some safe harbor relief from that result. As long as those employees enrolled in Medicare Part B or Part D or TRICARE coverage are offered coverage that is minimum value and integrated with another group health plan and not solely excepted benefits, they can also be offered a premium reimbursement arrangement to assist them with the payment of the Medicare Part B or D premiums and Medigap premiums or TRICARE premiums. (The IRS appropriately cautions employers to consider restrictions on financial incentives for employees to obtain Medicare or TRICARE coverage.)

Long-term care insurance. Group long-term care insurance is treated as accident and health insurance. Therefore, the value of employer-provided long-term care coverage is excludable from an employee's income as contributions to an accident and health plan.[128]

Long-term care insurance cannot, however, be offered as a benefit under a cafeteria plan.[129] Therefore, an employee's premiums for long-term care insurance cannot be paid on a pretax basis. Moreover, an employee's deductions for long-term care insurance premiums are subject to annual dollar limits based on the employee's attained age at the end of the taxable year of payment.[130] Further, the deduction for long-term care insurance premiums is subject to the overall 7.5% of AGI floor on medical expense deductions for 2021.

Health savings accounts (HSAs). HSAs are tax exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents.[131] Contributions to an HSA can be made by "eligible individuals" or by their employers or both. Within

---

[128] IRC Section 106.

[129] IRC Section 125(f).

[130] IRC Section 213(d).

[131] IRC Section 223.

© 2021 AICPA. All rights reserved.

limits, contributions to HSAs are deductible above the line when determining AGI, if made by individuals, and are excludable from gross income and taxable wages, if made by their employers. Distributions from HSAs for qualified medical expenses are not includible in gross income. Distributions from an HSA for other purposes are includible in the account holder's gross income and are subject to an additional 20% penalty. However, the 20% penalty does not apply to distributions made after death, disability, or after the account holder attains age 65. Therefore, an HSA can serve as a tax-deferred retirement savings vehicle to the extent amounts in the account are not needed for current medical expenses.

An individual is eligible to make HSA contributions for any month if he or she (1) is covered under a HDHP as of the first day of that month and (2) is not covered under any other health plan that is not a high-deductible plan and that provides coverage for any benefit covered under the high-deductible plan.

For calendar year 2021, the limitation on deductions for an individual with self-only coverage under an HDHP (High Deductible Health Plan) is $3,600. For calendar year 2021, the limitation on deductions for an individual with family coverage under an HDHP is $7,200.

For 2021, an HDHP is defined as a health plan with an annual deductible that is not less than $1,400 for self-only coverage or $2,800 for family coverage, and with respect to which the annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but not premiums) do not exceed $7,000 for self-only coverage or $14,000 for family coverage.

If an employer provides HDHP coverage coupled with an HSA and makes employer contributions to the HSA, the employer must make available a comparable contribution on behalf of all employees with comparable coverage. Since 2007, an exception to the comparability rules enables employers to make *larger* HSA contributions for non-highly compensated employees than for highly compensated employees (as defined in IRC Section 414(q)). The rule provides that highly compensated employees are not treated as comparable participating employees for purposes of applying the comparability rules to an employer's contributions for non-highly compensated employees.[132]

Contributions are considered *comparable* if they are either of the same dollar amount or the same percentage of the deductible under the high-deductible plan. The comparability rule is applied separately to part-time employees (that is, employees who are customarily employed for fewer than 30 hours per week). No restrictions are placed on the ability of the employer to offer different plans to different groups of employees.

Archer medical savings accounts. Medical savings accounts (MSAs) were a precursor to HSAs and designed for employees of small employers and self-employed individuals.[133]

Like an HSA, an MSA is a tax exempt trust or custodial account that is set up to pay medical expenses in connection with a high-deductible health plan. Contributions to the account are deductible or excludable from an employee's income if made by an employer and amounts in the account can be withdrawn tax-free to pay for out-of-pocket medical expenses. Amounts withdrawn for other purposes

[132] IRC Section 4980G(d).

[133] IRC Section 220.

© 2021 AICPA. All rights reserved.

are taxable and subject to a 20% penalty unless the withdrawal is made after death, disability, or Medicare eligibility.

Only self-employed individuals and employees of small employers (generally, those with 50 or fewer employees) were eligible to establish MSAs.

MSAs were a pilot project that expired after December 31, 2007. Thus, starting in 2008, no new MSAs are permitted; however, qualifying MSAs remain eligible for tax benefits.

For 2021, the HDHP supporting an MSA must have an annual deductible of no less than $2,400 and no more than $3,600 in the case of self-only coverage, or no less than $4,800 and no more than $7,150 in the case of family coverage. Annual out-of-pocket expenses cannot exceed $4,800 for self-only coverage or $8,750 for family coverage.[134] For individuals with self-only coverage, the maximum annual contribution is 65% of the deductible under the high-deductible plan; the maximum is 75% of the deductible for individuals with family coverage.

An employee can make contributions to his or her own MSA or contributions may be made by the employer sponsoring the high-deductible plan, but not by both. An employer that makes MSA contributions on behalf of employees must make comparable contributions for all employees with comparable coverage.

Death benefits. Death benefits are fully taxable to the recipient. Death benefits payable outside of qualified retirement plans are discussed in detail in ¶950.

Expense accounts. Business and travel expenses paid by the executive and reimbursed by the company under an accountable plan[135] will be tax-free to the executive. However, only 50% of expenses for business meals are deductible by the company,[136] subject to a number of relatively minor exceptions of limited application.[137] The Taxpayer Certainty and Disaster Tax Relief Act of 2020, enacted as part of the CAA 2021, allows a full deduction for certain business meal expenses — an increase from the 50% deduction limit. The expenses must be paid or incurred during calendar year 2021 or 2022, and the relevant food and beverages provided by a restaurant. The TCJA repealed the deduction for entertainment expenses after 2017, including expenses for a facility used in connection with entertainment, even if directly related to the active conduct of the taxpayer's trade or business.[138] This repeal includes clubs, tickets to entertainment and sporting events, skyboxes, and charitable sporting events.[139]

---

[134] Notice 2020-79, January 1, 2021.

[135] Regulation Section 1.62-2.

[136] IRC Section 274(n)(1).

[137] IRC Section 274(n)(2).

[138] IRC Section 274(a).

[139] IRC Section 274(l)(1)(b).

© 2021 AICPA. All rights reserved.

Below-market interest loans. Below-market interest loans made by employers offer an attractive executive benefit. They can serve needs related to employment, such as the purchase of company stock under a stock purchase plan or stock option. They also can help with personal needs, such as providing college funds. However, loans to executive officers and directors of public companies are prohibited by IRC Section 402 of the Sarbanes-Oxley Act of 2002.

In the case of a demand loan, the employee has compensation income in the amount of the value of the use of the money loaned and a deemed interest payment for the imputed interest.[140] The deemed interest payment is deductible only if it meets the requirements under IRC Section 163. Generally, personal interest is not deductible.[141] The employer has imputed interest income and a corresponding compensation deduction. Term loans are less favorable to the executive, who is currently taxed on the value of the foregone interest for the entire term.[142] However, term loans can be structured to be treated as demand loans by making the benefit nontransferable and conditioned on future services.

If the executive is a shareholder, the employer is treated as having paid a dividend[143] or made a capital contribution equal to the foregone interest. The employer receives no deduction, but the shareholder is treated as having paid interest to the employer. The deemed interest payment by the shareholder will be deductible if it meets the requirements of IRC Section 163. The employer includes the deemed interest payment in gross income.

Company meals. Meals furnished by the company on its premises for its business convenience are tax free to the employees[144] and deductible by the company.[145] The deduction for employer-provided meals that are excludable from the employee's income or are de minimis fringe benefits is eliminated after 2025 as the result of the TCJA.[146]

Company lodging. Lodging furnished by the company for its business convenience that the employee is required to accept as a condition of employment is tax-free to the employee[147] and deductible by the company.[148]

Education. Company-paid, business-related education designed to improve existing skills and not to prepare for a new occupation or profession is tax-free to the employee[149] and deductible by the

---

[140] IRC Section 7872(a).

[141] IRC Section 163(h).

[142] IRC Section 7872(b).

[143] IRC Section 301.

[144] IRC Section 119(a).

[145] IRC Section 162(a).

[146] IRC Section 274(o).

[147] IRC Section 119.

[148] IRC Section 162(a).

[149] IRC Sections 132(a)(3), 132(d), 162(a) and Regulation Section 1.162-5.

© 2021 AICPA. All rights reserved.

company.[150] No dollar limit applies to this fringe benefit. Graduate courses, undergraduate courses, and noncredit courses are eligible.

In addition, an employee may exclude from gross income up to $5,250 of employer-paid educational assistance, regardless of whether the education is directly related to job performance.

To qualify for the exclusion for employer-provided educational assistance, the employer must furnish the assistance under a program described in IRC Section 127(b). The program must be a separate written plan for the exclusive benefit of the employees, and it must not discriminate in favor of highly compensated employees. No more than 5% of the educational benefits may be paid to the principal shareholders or owners. The program does not have to be funded, and the employees may not have the ability to choose other benefits instead of the educational assistance. The employer must provide reasonable notice of the availability and terms of the program to eligible employees.

Eligible expenses include tuition, fees, books, supplies, and equipment. Payments for room, board, transportation, and any equipment or supplies that a student will retain after the completion of the course are not eligible. Payments for recreational courses are not eligible for the exclusion. Whereas at one time the exclusion was limited to education below the graduate level, current rules permit the exclusion to be claimed for graduate and professional courses. Employers may provide different levels of benefits based on the grade a student earns in the class.[151] IRS Publication 970, "Tax Benefits for Education," provides additional information on employer-provided educational assistance programs.

Non-job-related education benefits in excess of the $5,250 limit are subject to income taxes and employment taxes unless the benefits may be excluded from gross income as a working condition fringe benefit under IRC Section 132(h)(8).

The exclusion for educational assistance programs was made permanent by the American Taxpayer Relief Act of 2012.[152]

Charitable contributions. Charitable contributions made by the company in the executive's name to charities designated by him or her are tax-free to the executive. They are not deductible by the executive but are deductible by the company.[153]

Financial counseling. Some companies provide legal, tax, investment, and financial and estate planning services to executives through an outside counseling firm (see ¶1620 for details on such services). The amount paid is fully taxable to the executive[154] but it is no longer deductible beginning in 2018 after the

---

[150] IRC Section 162(a).

[151] IRC Section 127(c)(5).

[152] P.L. 112-240.

[153] IRC Section 170(a).

[154] IRC Section 61(a).

© 2021 AICPA. All rights reserved.

repeal of the allowance for miscellaneous itemized deductions by the TCJA. Consider increasing employee compensation to obtain a deduction for the employer here, and allow the employee to make payments (nondeductible) for these services.[155]

Retirement planning. A tax exclusion covers any retirement planning advice or information provided to an employee or spouse if the employer maintains a qualified retirement plan. In addition to advice and information about the employer-provided plan, the services provided may include general advice and information on retirement. However, the exclusion does not apply to tax preparation, accounting, legal, or brokerage services. In addition, the exclusion does not apply to highly compensated employees unless the retirement planning services are available on substantially the same terms to each member of the group of employees who are normally provided with education and information regarding the employer's plan.[156]

Dependent care assistance. IRC Section 129 allows expenses incurred for dependent care assistance under a written nondiscriminatory plan to be excluded from an employee's gross income, subject to an annual ceiling of $5,000 ($2,500 for a separate return made by a married person). Employers may claim a credit for providing childcare benefits to their employees. This credit is a part of the general business credit. The credit is equal to the sum of 25% of the qualified childcare expenses and 10% of the qualified childcare resources and referral expenditures. The total credit to be claimed by an employer for any year may not exceed $150,000. This credit has been made permanent.[157]

Moving expenses. As the result of the TCJA, beginning in 2018, moving expenses paid by a company in connection with a job-related move are now taxable to the executive[158] and no longer deductible by the company or the executive.[159] The former definition of *qualified moving expenses* is no longer relevant, except in the case of still allowable deductions for members of the U.S. Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station.[160]

Cafeteria-style compensation. Under a cafeteria plan,[161] each executive may choose from among two or more benefits consisting of cash and qualified benefits (¶975).

Other fringe benefits. A company may provide a number of other fringe benefits tax-free to executives. Certain categories of fringe benefits are accorded tax-free treatment, in some cases, subject to antidiscrimination rules. A detailed discussion of these rules appears in ¶985.

---

[155] IRC Section 67(g).

[156] IRC Section 132(m).

[157] IRC Section 45F.

[158] IRC Section 217(g).

[159] IRC Section 162(a).

[160] IRC Section 132(g)(2).

[161] IRC Section 125.

© 2021 AICPA. All rights reserved.

.02 Overcoming Limits on Benefits and Contributions

The maximum amount of annual additions to defined contribution plans (for example, profit-sharing plans) is 100% of compensation, not to exceed $58,000 in 2021.[162] This amount is indexed for inflation in $1,000 increments. The maximum annual benefit payable under a defined benefit plan (for example, the conventional pension plan) is $230,000 for 2021.[163] The maximum amount is indexed for inflation in $5,000 increments. The dollar limit for defined benefit plans is reduced if benefits begin before age 62 and increased for benefits beginning after age 65. Those individuals adversely affected by the limitations on contributions and benefits will want to consider the following:

- Excess benefit plans (see discussion that follows).
- Being elected to the board of directors of other corporations and receiving compensation for such service that may then become the basis of a contribution to a self-employed retirement plan. However, the U.S. Tax Court has held that fees earned by inside directors are not eligible for Keogh contributions[164] because the IRS withdrew proposed regulations[165] under which such plans would have run afoul of the nondiscrimination rules.
- Setting up another plan (if the employer has only a single plan).
- Arranging for increased compensation (cash, stock, phantom stock, tax-favored fringe benefits, and so forth) to make up, in whole or in part, for the reduction in benefits or contributions.
- Arranging for post-retirement consulting services.

.03 Deferred Compensation Plans

The objective of a deferred compensation agreement is to shift income from a year in which the executive is in a high tax bracket to a year in which the executive is expected to be in a lower tax bracket. Often, the deferred compensation is expected to be paid after retirement.

Deferred compensation plans are commonly used to provide retirement benefits to highly compensated and other key employees, often through an arrangement known as an excess benefit plan. An *excess benefit plan* is defined as a plan maintained by an employer solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed by IRC Section 415. These plans are exempt from the minimum participation, funding, and vesting standards applicable to qualified plans generally.

---

[162] IRC Sections 415(c)(1) and 415(d)(1).

[163] IRC Section 415(b)(1)(A).

[164] *P.H. Jacobs*, 66 T.C.M. 1470 (1993).

[165] Proposed Regulation Section 1.414(o)-1(g).

© 2021 AICPA. All rights reserved.

Deferred compensation plans generally fall into two categories: funded and unfunded. An unfunded plan may simply involve a mere promise to pay an employee a certain amount at retirement. With a funded plan, amounts are set aside currently by the employer, typically in a trust or similar arrangement, to provide future benefits.

The American Jobs Creation Act of 2004 (Jobs Act)[166] made major changes in the tax treatment of deferred compensation arrangements, including excess benefit plans. Prior to the Jobs Act, the precise tax treatment depended on whether a deferred compensation arrangement was funded or unfunded. A bare contractual promise of an employer to pay compensation at retirement or some other time in the future did not result in current taxable income to the employee. The IRS had ruled that there was no constructive receipt of income, even if the employee's rights under the agreement were vested (nonforfeitable).[167] Accordingly, an employee promised retirement benefits was taxed on the benefits only when they were paid during retirement.

Under the prior rules for funded plans, an employee was not currently taxed on employer contributions to the plan, as long as the employee had no current access to the funds. However, an employee could be taxed on funds set aside in a trust or similar arrangement if he or she had a vested interest in the trust — even though benefits were not payable until retirement. This was known as the *economic benefit doctrine*.[168]

To avoid the economic benefit doctrine, funded deferred compensation plans were often set up in the form of a "rabbi trust" (the first IRS ruling permitting this arrangement involved a rabbi).[169] The employer created and funded a trust for the benefit of the employee, but the employee had no right to the funds until retirement. The funds remained the employer's property until that time. An employer's creditors could reach the assets of a rabbi trust. The economic benefit doctrine did not apply if the employee's control over the receipt of income was subject to substantial limitations or restrictions. The IRS ruled that trust funds were sufficiently restricted when they were subject to the claims of the employer's creditors, so that the economic benefit doctrine did not apply.

The rules under IRC Section 409A. The 2004 Jobs Act enacted Section 409A of the IRC, which imposed new restrictions on deferred compensation arrangements.

Under IRC Section 409A, all compensation deferred under a "nonqualified deferred compensation plan" is immediately includible in an employee's gross income if

- the compensation is not subject to a "substantial risk of forfeiture";
- the compensation was not previously included in gross income; or

---

[166] P.L. 108-357, 10/22/2004.

[167] Revenue Ruling 60-31, 1960-1 C.B. 174.

[168] *Sproull v. Comm'r*, 16 T.C. 244 (1951).

[169] PLR 8113107.

© 2021 AICPA. All rights reserved.

- the plan does not meet certain requirements for
  - — distributions,
  - — acceleration of benefits, and
  - — elections (see text that follows).[170]

A *nonqualified deferred compensation plan* is generally any nonqualified plan that provides for the deferral of the payment of compensation owed to an employee or other service provider to a time more than two and one half months after the end of the year in which the compensation ceases to be subject to a substantial risk of forfeiture. The term *nonqualified deferred compensation plan* does not include a qualified retirement plan, tax-deferred annuity, simplified employee pension, or savings incentive match plan for employees (SIMPLE) plan. It also does not include any bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan or Archer medical savings account, health savings account, or any other medical reimbursement arrangement.[171]

The rights of a person to compensation are subject to a "substantial risk of forfeiture" if the person's rights to such compensation are conditioned upon the performance of substantial services by any such person.[172] Once an employee's rights to the plan's benefits become vested (they are not conditioned upon the performance of future services or subject to any other substantial risk of forfeiture), the benefits will generally be taxable to the employee unless the previously listed requirements are met. If a nonqualified plan is not in compliance with, or does not operate in compliance with, these requirements at any time during a tax year, all amounts deferred under the plan for that tax year and all preceding tax years are included in gross income for that year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

The amount included in income also is subject to

- interest (at the IRS's underpayment rate plus one percentage point) on the tax underpayments that would have occurred had the compensation been included in income for the tax year when first deferred, or if later, when not subject to a substantial risk of forfeiture and

- additional income tax equal to 20% of the compensation required to be included in gross income.[173]

Avoiding income inclusion. When there is no substantial risk of forfeiture, three requirements must be met under Section 409A to *avoid* income inclusion:

1. *Distributions.* Distributions from a nonqualified deferred compensation plan may be allowed only upon an employee's separation from service or death, or at a specified time (or pursuant to a

---

[170] IRC Section 409A(a)(1)(A).

[171] Regulation Section 1.409A-1(a).

[172] IRC Section 83(c)(1).

[173] IRC Section 409A(a)(1)(B)(i).

© 2021 AICPA. All rights reserved.

fixed schedule), or upon change in control of a corporation, or upon occurrence of an unforeseeable emergency, or if the employee becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events.[174]

In the case of a "specified employee" who separates from service, distributions may not be made earlier than six months after the date of the separation from service or, if earlier, from the date of death of the employee. *Specified employees* are key employees of publicly traded corporations.[175]

2. *Acceleration of benefits.* No acceleration of distributions is generally allowed. Changes in the form of distribution that accelerate payments are subject to the rule prohibiting acceleration of distributions. However, this prohibition is not violated merely because a plan provides a choice between cash and taxable property if the timing and amount of income inclusion is the same regardless of the medium of distribution. For example, the choice between a fully taxable annuity contract and a lump-sum payment may be permitted.[176]

3. *Elections.* If a nonqualified deferred compensation plan provides that compensation can be deferred at the participant's election, the election must generally be made no later than the close of the preceding tax year.[177]

A plan may permit subsequent elections to delay or change the form of payments under the plan. If it does permit such elections, a plan must require that the new election cannot take effect until at least 12 months after it is made. A subsequent election to further defer a distribution to be made after the participant's separation from service, on a predetermined date or schedule, or upon a change of ownership of the employer must defer any payment to which it applies (not just the first payment) for at least five years. A subsequent election relating to a payment to be made on a predetermined date or schedule cannot be made less than 12 months prior to the first scheduled payment.[178]

Employer's deduction. An employer can claim a deduction for payments made under a nonqualified deferred compensation plan only in the year they are includible in the gross income of the employee.[179]

Creditor risk. When there is no substantial risk of forfeiture present, a potential "danger" of these plans is that they may be vulnerable to claims of the plan participant's creditors.

---

[174] IRC Section 409A(a)(2)(A).

[175] IRC Section 409A(a)(2)(B)(i).

[176] IRC Section 409A(a)(3).

[177] IRC Section 409A(a)(4)(B).

[178] IRC Section 409A(a)(4)(C).

[179] IRC Section 404(a)(5).

© 2021 AICPA. All rights reserved.

¶1610 Lifetime and Estate Planning for Executive Benefits

An executive's company benefits are likely to be a substantial part of the executive's total estate. This section considers the executive's lifetime choices in relation to various executive benefits and the disposition of benefits that become payable at death.

.01 Qualified Pension and Profit-Sharing Plans

The executive will often be a participant in a qualified pension or profit-sharing plan. If the company does not have a plan, the executive should press for one type or the other or for an ESOP.

Regardless of whether the executive is an active participant in a qualified plan, the executive may set up a traditional IRA and contribute up to $6,000 for 2021. The $6,000 limit may be adjusted annually for inflation in $500 increments.[180] In addition, individuals who are age 50 or older can make additional "catch-up" contributions. The additional contribution is $1,000 through 2021,also indexed for inflation in $500 annual increments.[181] A married individual who files a joint return may also contribute up to the annual limit for a spouse, assuming the spouse does not make his or her own contributions.[182] Although a contribution to a traditional IRA may be made, executives who are participants in qualified plans are disallowed deductions for traditional IRA contributions if their income exceeds certain levels.[183]

If the executive's AGI is less than certain levels, he or she may contribute up to the maximum allowed each year (plus up to the same amount for the executive's spouse) to a Roth IRA instead of a traditional IRA.[184] The amount that an executive may contribute to a Roth IRA for 2021 begins to phase out at an AGI of $125,000 if single or $198,000 if married and filing a joint return. These amounts are indexed annually for inflation. Contributions to Roth IRAs are not tax deductible,[185] but a taxpayer may make tax-free withdrawals of contributions at any time.[186] Distributions from Roth IRAs are completely tax free after the taxpayer has held the account for five years if the taxpayer is at least age 59½, the taxpayer is disabled, or the distribution is paid to a beneficiary after the taxpayer's death, or the distribution is used to pay for qualified expenses (one time only) up to $10,000 of buying a home.[187]

If the company plan allows it, and the executive's budget allows, voluntary contributions to the company plan should be made because the tax shelter afforded on the income on the executive's own

---

[180] IRC Section 219(b)(5)(A).

[181] IRC Section 219(b)(5)(B).

[182] IRC Section 219(c)(1).

[183] IRC Section 219(g).

[184] IRC Section 408A(c)(2).

[185] IRC Section 408A(c)(1).

[186] Regulation Section 1.408A-6.

[187] IRC Sections 408A(d)(2), 408A(d)(5), 72(t)(2)(F), and 72(t)(8).

© 2021 AICPA. All rights reserved.

contributions is a valuable deferred tax benefit. However, the executive should compare returns from other tax-deferred or tax-free investments to be certain that the company plan contribution is a good decision.

Profit-sharing plans, unlike pension plans, may permit in-service withdrawal of vested amounts, subject to plan rules and restrictions and tax rules. Employer contributions withdrawn before age 59½, except for disability or death, are generally taxable as ordinary income and are generally subject to a 10% additional tax.[188] Although the 10% additional tax is often called a penalty, it is really an additional excise tax. Thus, a taxpayer cannot avoid the additional tax merely on a showing of "reasonable cause" (but see the special CARES Act rules for 2020 waiving the 10% excise tax for COVID-19 related withdrawals of up to $100,000). Otherwise, the taxpayer must meet one of a number of statutory exceptions to avoid the additional tax under IRC Section 72(t). However, if a participant in a qualified plan changes jobs (or simply terminates his or her employment), a rollover-eligible distribution may be transferred directly tax free to a traditional IRA or another qualified plan that accepts such contributions. If the participant receives the distribution directly, the participant may roll over the amount tax-free to another qualified plan or to a traditional IRA within 60 days of receiving the distribution.[189] The IRS may waive the 60-day limit for hardships, such as a casualty or natural disaster or error by the plan custodian for distributions made to the participant.[190] (Note that the IRS has liberalized the 60-day withdrawal requirement in certain circumstances in Revenue Procedure 2016-47, as discussed in section 9.05 of chapter 9). If such a distribution is made to the employee, rather than directly to another plan, it is subject to mandatory 20% income tax withholding, even if the employee intends to complete a rollover. Therefore, employees who want to transfer funds to another plan or a traditional IRA should use the direct transfer method. The full amount need not be rolled over, but any amount retained will be taxable. See the discussion under the heading "Rollover of Qualified Plan Benefits" that follows.

Upon reaching the retirement age fixed in the plan, the executive usually has a choice of an annuity or a lump-sum distribution. If the executive is married and is a participant in a defined benefit plan (and under certain circumstances in the case of a profit-sharing plan), an automatic joint and survivor annuity is provided. The participant may elect out of such coverage only with his or her spouse's consent. The annuity payments will be treated for tax purposes the same as any other annuity taxable under IRC Section 72.

When choosing between an annuity and a lump-sum distribution, one must weigh the income tax impact. Also, receipt of annuity payments might cause Social Security benefits to be taxed each year, whereas a lump-sum distribution would likely subject Social Security benefits to taxation in the year of the distribution, but possibly not in other years (see "Social Security benefits and Medicare" in ¶3505). Investment factors also need to be considered. What is the projected after-tax return if the lump sum is invested by the executive? How does this return compare with the return if funds are left in the pension or profit-sharing trust? Consider the impact of the 3.8% tax on net investment income. This tax is imposed on single persons with AGI in excess of $200,000 and married persons filing joint returns with

[188] IRC Section 72(t).

[189] IRC Section 402(c).

[190] IRC Section 402(c)(3) and 408(d)(3).

© 2021 AICPA. All rights reserved.

AGI in excess of $250,000. Although withdrawals from a retirement plan do not constitute "net investment income," the withdrawals will increase the taxpayer's AGI, thereby increasing the possibility that the taxpayer will cross the threshold of becoming subject to the net investment income tax. See ¶3330 in chapter 33, "Year-End and New Year Tax Planning," for more information on the net investment income tax, as well as chapter 38, "Planning for the Medicare and Net Investment Income Taxes."

Multiple individual or trust beneficiaries are allowed without losing the advantages of the income tax-favored lump-sum distribution rule for persons born before 1936. For such persons, lump-sum distributions from qualified plans are eligible for a special income averaging rule that reduces the income tax impact of the distribution. The distribution is taxed as though made to a single recipient, and the tax liability is then allocated to the recipients in proportion to their shares.

There are special advantages and special problems if distributions from the plan are made in employer stock. Because the rules are the same as those under qualified stock bonus plans or ESOPs, these rules are explained in the paragraphs that follow specifically dealing with stock bonus plans and ESOPs.

See ¶905 for a discussion of stretched out payout opportunities.

.02 Stock Bonus Plans and ESOPs

Stock bonus plans and ESOPs generally contemplate a distribution of benefits in employer stock. However, an ESOP may bar a participant from demanding a distribution of employer securities if the employer's corporate charter or bylaws or the ESOP plan itself restricts the ownership of substantially all outstanding employer securities to employees or the ESOP. The ESOP must provide that participants denied stock have a right to receive cash.[191]

At some point, a participant might consider further holding of employer securities in an ESOP account as imprudent. Some relief is available for such a participant. ESOPs must generally allow qualified participants (those who have attained age 55 and have completed 10 years of participation in the plan) to direct diversification of up to 25% of their account balances over a six-year period (50% in the sixth year).[192] In addition, more generous diversification rights for defined contribution plans to permit the divestiture of all employer securities may apply to certain ESOPs.[193]

In the usual plan set-up, the employer securities are not publicly traded. If the employer securities are publicly traded, the market is often thin. Thus, participants must deal with a liquidity problem. The plan may not require that the distributee sell to the employer, but the distributee may have a right to sell the stock distributed to him or her to the employer at a price determined by a fair valuation formula.[194] The position of a minority shareholder in a closely held corporation in which the person is no longer

---

[191] IRC Section 409(h)(2)(B).

[192] IRC Section 401(a)(28)(B).

[193] IRC Section 401(a)(35) as added by P.L. 109-280.

[194] IRC Sections 409(h)(1)(B) and 409(h)(4).

© 2021 AICPA. All rights reserved.

employed is not usually a strong one. Therefore, the courts, and to a degree, the IRS, allow discounts in valuing such interests.

If, however, the minority position is valuable and worth maintaining, the executive who receives a distribution in the employer's securities also receives tax advantages. If it is a lump-sum distribution, the entire net unrealized appreciation attributable to the part of the distribution that consists of employer securities is excluded in figuring the tax on the lump sum (unless the executive elects otherwise). The unrealized appreciation is taxable only on the disposition of the securities in a taxable transaction. If the executive holds the securities until death, one might expect that the recipient of the decedent's stock would have his or her basis stepped up to the estate tax valuation. However, in Revenue Ruling 75-125,[195] the IRS limits the step-up. Under this ruling, the recipient receives no increase in basis to the extent of the unrealized appreciation in employer securities at the time of distribution to the executive. The ruling offers this example of how the heirs, in this case, the widow, compute gain on a sale of the securities.

> **Example 16.1.** Richard, an executive, receives from the trust employer securities with a basis to the trust of $5,000 and an FMV at the time of distribution of $10,000. The securities have a value at his death of $12,000. They are sold by his widow, Jane, for $13,000. Her basis is $7,000, which is the value at death, $12,000, less the $5,000 in unrealized appreciation at the time of distribution to the executive. Thus, she realizes a gain of $6,000 on the sale at $13,000. It is important to note here that the net unrealized appreciation is subtracted from the FMV of the decedent's stock at the time of the decedent's death.

If the executive's estate or other beneficiary receives employer securities in a distribution that qualifies for favorable lump-sum treatment, the total unrealized appreciation (attributable to both employer and executive contributions) will not be subject to income tax at that time. Rather, the gain is recognized when the securities are later disposed of in a taxable transaction (unless a contrary election is made). If the distribution does not qualify for lump-sum treatment, only the unrealized appreciation attributable to the executive's own non-deductible contributions is treated as not subject to income tax at that time. For further discussion of ESOPs, see ¶910.

.03 Rollover of Qualified Plan Benefits

The recipient of an eligible rollover distribution from a qualified plan may defer taxation of the distribution, either in whole or in part, by having all or some of the distribution transferred directly to an eligible retirement plan or by rolling over as much of the distribution as desired into an eligible plan within 60 days of the distribution.[196] Eligible retirement plans that can accept rollovers are traditional IRAs, qualified plans, annuity plans, IRC Section 403(b) annuities, governmental IRC Section 457 plans, Roth 401(k) plans, or Roth IRAs.[197] Note, however, that when the rollover is to a Roth 401(k) or a Roth IRA, the rollover is subject to income tax on the transferred funds. Also, for a rollover to be permitted from a 401(k) to a Roth 401(k), the company plan must specifically authorize such a transfer.

---

[195] 1975-1 CB 254.

[196] IRC Section 402(c).

[197] IRC Section 402(c)(8)(B).

© 2021 AICPA. All rights reserved.

As noted in detail in ¶905, mandatory 20% income tax withholding applies to eligible rollover distributions from qualified plans that are not transferred directly, trustee-to-trustee, to another eligible plan or to a traditional IRA.[198]

When property, such as employer securities, is included in the distribution, the recipient may roll it over. The recipient may also conclude a bona fide sale of such property and roll over the proceeds, including any appreciation from the time of distribution. However, the recipient may not retain the property and roll over an amount of cash equal to the FMV of the property.[199] If the distribution consists of cash and the proceeds of property or properties, and the recipient rolls over less than all, the recipient must determine the amount, if any, of the cash rollover and the extent to which property proceeds have been rolled over. The recipient makes this determination by filing a designation no later than the due date for filing an income tax return for the year of distribution. If no designation is filed, the rollover amount is allocated pro rata on the basis of the cash and the value of the property at the time of the distribution.

A surviving spouse who is the named beneficiary of an employee's retirement plan may roll a distribution over to a qualified plan, annuity, or IRA in which the surviving spouse participates.[200]

Distributions to a beneficiary other than a surviving spouse can be rolled over into an IRA for the beneficiary.[201] The IRA receiving the rollover is treated as an inherited IRA. In order to qualify for a tax-free rollover to a nonspouse inherited IRA, the rollover *must* be a trustee-to-trustee rollover. A payment to a beneficiary followed by a transfer to an inherited IRA will *not* satisfy the tax-free rollover rules. Thereafter, benefits must be distributed in accordance with the required minimum distribution rules that apply to inherited IRAs of nonspouse beneficiaries, generally for many beneficiaries a 10-year payout period as the result of the SECURE Act of 2019. The SECURE Act is discussed at length elsewhere in this guide. An inherited IRA may *not* be converted to a Roth IRA.

.04 Simplified Employee Pension Plan Using an IRA

IRC Section 408(k) provides for a simplified employee pension (SEP) plan making use of IRAs. An employee may participate in a SEP while participating in a qualified plan, subject to IRC Section 415 limits. Under a SEP, an employer makes contributions to a traditional individual retirement arrangement (called a SEP-IRA) set up by or for each eligible employee.[202] An employer does not have to make annual contributions to employees' SEP-IRAs, but if the employer does make contributions, it must not discriminate in favor of highly compensated employees. SEP-IRAs must cover all employees who have reached age 21, worked for the employer for at least three of the last five years, and received at least a

---

[198] IRC Section 3405(c).

[199] Revenue Ruling 87-77, 1987-2 CB 115.

[200] IRC Section 408(d)(3)(C).

[201] IRC Section 402(c)(11).

[202] IRC Section 408(k).

© 2021 AICPA. All rights reserved.

minimum amount of compensation for the year. The minimum compensation level is $650 for 2021, indexed annually for inflation in $50 increments.[203]

Contributions to an employee's SEP-IRA are limited to the lesser of 25% of the employee's compensation or the annual dollar limit for additions to a defined contribution plan account. The dollar limit for defined contribution plan additions is $58,000 for 2021.[204] When computing SEP contributions, no more than $290,000 (for 2021) of an employee's compensation can be taken into account.

The employee may contribute a limited amount to his or her traditional IRA or Roth IRA in addition to the contributions the employer makes to the SEP for the employee. For 2010, the limit is $6,000. The $6,000 limit may be adjusted annually for inflation. Individuals who are age 50 or older may contribute an additional $1,000 make-up contribution through 2021. However, deductions for contributions to traditional IRAs and allowable contributions to Roth IRAs are phased out at certain income levels. For more information on SEPs, see ¶915.

.05 Incentive Stock Options

ISOs are taxable in a favorable manner (¶1605). The exercise of the option by the executive while alive eliminates any problems that might be associated with the valuation of an unexercised option as part of the executive's estate. Also, exercising the option while living invites consideration of making lifetime gifts of the stock as a means of reducing the size of the executive's estate. However, the ISOs themselves cannot be the subject of lifetime gifts. As a general rule, favorable tax treatment is available for an ISO only if there is no disqualifying disposition of the stock within two years of the date of grant of the option or within one year of the date of exercise. However, the holding period requirements do not apply to an option that is exercised after an employee's death by the employee's estate or by a person who acquired the right to exercise the option by reason of the employee's death.[205] If the option is exercised by the employee, but he or she dies before the expiration of the required holding period, the employee's estate or the person who acquired the stock by reason of the employee's death qualifies for favorable tax treatment, even if the stock is sold before the expiration of the required holding period.[206]

.06 Nonqualified Options

In ¶1605, the tax treatment of nonqualified stock options is discussed at some length. That discussion is not repeated here, except to note that the executive may elect to include in gross income in the year of transfer stock acquired under an option. The executive may make this election, although the stock is not transferable and is subject to a substantial risk of forfeiture, so that tax liability is reported immediately as ordinary income at a hoped-for lower amount of taxable income than would have been the case had the tax liability been deferred. In addition to this election, the executive may be able to pay a tax on the

---

[203] IRC Section 408(k)(2)(c); Rev. Proc. 2014-61 (October 30, 2014).

[204] Rev. Proc. 2014-61, (October 30, 2014).

[205] IRC Section 421(c)(1)(A); Regulation Section 1.421-2(c)(1).

[206] Regulation Section 1.421-2(d).

© 2021 AICPA. All rights reserved.

grant of the option if the option has a readily ascertainable value at the time of grant, as defined in Regulation Section 1.83-7(b).

IRC Section 83, dealing generally with the tax on property transferred for the performance of services, provides in Subsection (c)(2) that the rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture. The wholly gratuitous transfer of an unexercised option with no readily ascertainable FMV at the time the option is granted does not give rise to any taxable income at the time of the transfer. The executive who transfers the option realizes gross income only when the option is exercised, and property is transferred to the holder. This treatment applies, although the option at the time of the grant has no ascertainable value but acquires such value before the option is transferred.[207]

The executive and an adviser might want to consider the transfer of options with no ascertainable value at the time of grant. Such a transfer would remove the option and the underlying stock from the executive's gross estate. The transfer has no current income tax consequences and low, or no, gift tax cost.

If the executive dies without having realized income from the transfer or exercise of the option, the executive's estate or beneficiary will, upon the exercise of the option or its transfer, be taxed on the income. This is treated as income in respect of a decedent,[208] and the party liable for the income tax can deduct the federal estate tax, if any, attributable to the inclusion of the option in the executive's gross estate.[209]

Financing the exercise of the option is a matter of concern both from the point of view of exercise by the executive and by the executive's executor or beneficiary. The financing raises a number of questions. What is the source of the money? How much will the exercise of the option cost? How much value does the stock itself have as collateral if subject to restrictions and substantial conditions of forfeiture? If the stock is usable as collateral, what about margin requirements? What about the executor's authority to borrow? These, and related questions, must be weighed and answered.

.07 Letter Stock

Chances are the executive who holds letter stock will be familiar with the requirements that must be met to dispose of the stock. (*Letter stock* is privately placed common stock, so-called because the SEC requires a letter from the purchaser stating that the stock is not intended for resale.) Most likely, the executive will want to dispose of it in compliance with SEC Rule 144, although that is not the only route open. Still, it is the safest route. Under SEC Rule 144, publicly available current information about the company must exist, and a limitation might apply to the number of shares that may be sold in any six-month period. Notice of intent to sell must be given to the SEC and the exchange if it is listed stock. The executive may not sell unless the stock is fully paid for and has been beneficially owned for at least two years.

---

[207] Regulation Section 1.83-7(a).

[208] IRC Section 691(a).

[209] IRC Section 691(c).

© 2021 AICPA. All rights reserved.

However, special considerations apply if the executive's estate holds letter stock. The estate is not subject to the restrictions on the number of shares that may be sold in a six-month period, unless the estate itself is in the position of a control person (that is, the person directing corporate management and policies). Also, the two-year holding period requirement is waived for the estate, unless it is a control person. If the estate is a control person, it can distribute the shares to legatees. They can sell the stock without regard to the holding period.

One must provide for full payment of the shares held because that is a condition of sale under SEC Rule 144.

.08 Deferred Compensation

An executive can do little about nonqualified deferred compensation before the right to it matures. A transfer of it will be ineffective because it is an anticipatory assignment of income. That leaves the question of what to do with the right if the executive dies before receiving the actual compensation.

Who should receive it from an income tax standpoint? Whoever receives it is going to have to report it as income in respect of a decedent.[210] The recipient may receive a deduction against the income received for the federal estate tax (if any) attributable to the inclusion of this item in the executive's estate.[211] This deduction remains available after the passage of the TCJA because it does not constitute one of the miscellaneous itemized deductions that were suspended by the TCJA effective in 2018.

The executive could bequeath the deferred compensation to his or her spouse. The executive should consider the spouse's income tax situation under the estate plan being developed and the spouse's own separate estate or earnings, if any. If the surviving spouse will be in a fairly high combined federal, state, and local income tax bracket, bequeathing this additional income to the spouse will cause a sizable amount of it to go to the tax collectors. If the executive bequeaths it to the surviving spouse and it qualifies for the marital deduction,[212] no increase in the estate tax will occur for its inclusion in the executive's gross estate. Thus, the recipient spouse will not be allowed an income tax deduction for income in respect of a decedent under IRC Section 691(c). The spouse, in addition to a marital bequest, might also receive a nonmarital deduction bequest, such as an interest in a credit shelter trust. If deferred compensation is made payable to the nonmarital deduction bequest, the benefit of IRC Section 691(c) may be available to help reduce the income tax liability, assuming, of course, that the estate will be subject to the federal estate tax.

The executive should also consider other possible beneficiaries (such as children and grandchildren). The executive should check the possible income tax consequences of a distribution to them or to a trust set up for their benefit. Another possible beneficiary is charity. Transferring a right to deferred compensation to a charity would eliminate both the estate tax and the income tax that might otherwise be imposed if the right passed to a non-charity beneficiary.

---

[210] IRC Section 691(a).

[211] IRC Section 691(c).

[212] IRC Section 2056(a).

© 2021 AICPA. All rights reserved.

An estate that has taxable income is allowed a deduction on its income tax return for distributions to beneficiaries of property in kind.[213] However, the IRS has ruled that this rule does not apply to a right to receive deferred compensation because it is not a distribution of property in kind.[214]

.09 Life Insurance

Life insurance may be provided within limits, in conjunction with a qualified pension or profit-sharing plan. The executive might be able to keep the proceeds of a life insurance policy out of his or her gross estate by transferring all incidents of ownership in the policy to a beneficiary other than the estate.[215]

However, the executive must be careful about transfers of the policy and premium payments within three years of death. Although IRC Section 2035(a), as a general rule, excludes from the donor's estate gifts made within three years of death, this exclusion does not apply to gifts of life insurance.[216]

The exception of gifts of life insurance from the three-year rule of IRC Section 2035 and whether gifts of insurance premium payments within three years of death are within the exception are discussed in ¶715. Generally, the payment of premiums within three years of death should not result in inclusion of the premiums or any portion of the policy proceeds in the decedent's estate.

Normally one will want to keep life insurance proceeds out of the estate of the insured for both asset protection and tax reasons. To do so, the insured should assign the policy and all incidents of ownership and hope that he or she lives for at least three years.

However, the insured might not always want to keep the proceeds out of his or her gross estate. The estate might have liquidity needs which, if not satisfied, might conceivably result in a greater shrinkage of the value of the estate than the estate taxes resulting from inclusion of the proceeds. It is true that the insured may make the insurance proceeds payable to a beneficiary other than the estate, who would be expected to make the proceeds available to the estate by way of a loan or to purchase assets from the estate. However, the executive might not have confidence that the beneficiary would make the proceeds available to the estate. The insured cannot burden the beneficiary with a binding obligation because that would be interpreted as though the insured had named the estate as the beneficiary.

Where the decedent's estate will be less than the amount of the federal applicable exclusion, and if state laws do not create an estate or inheritance tax concern, the insured can certainly maintain control over the life insurance policy without concern with transfer tax issues. However, directing the payment of life insurance to the decedent's estate will make it available for creditors, so this must be considered in addressing the disposition of life insurance with clients.

---

[213] IRC Section 661(a) and Regulation Section 1.661(a)-2.

[214] Revenue Ruling 68-195, 1968-1 CB 305.

[215] IRC Section 2042.

[216] IRC Sections 2035(a)(2) and 2042.

© 2021 AICPA. All rights reserved.

Planning Pointer.

The use of an irrevocable life insurance trust, which allows the trustee to purchase assets from the decedent's estate, would be a good suggestion here to couple the need for liquidity with a plan to keep the life insurance proceeds out of the decedent's estate. The trustee would be permitted, but not obligated, to purchase assets from the decedent's estate to help provide the needed liquidity.

.10 Medical Savings Accounts and Health Savings Accounts

If the executive has an Archer MSA under IRC Section 220 or an HSA under IRC Section 223, he or she does not have to withdraw anything from the MSA or HSA to pay or reimburse medical expenses incurred in the current year. Thus, the executive can use the MSA or HSA as an additional tax-qualified retirement account. The executive receives a current income tax deduction for contributions made to the account (within limits) and gains the advantage of tax-free investment build up on MSA or HSA funds not used for medical expenses. These accounts are described in detail in Section 1605.01.

.11 Contractual Death Benefits

The employer may agree to pay an executive's surviving spouse or other beneficiary a death benefit if the executive dies on the job. The death benefit will not be taxable to the executive on his or her final Form 1040 as income, but it will be taxable as income to the beneficiary. If the death benefit is includible in the executive's gross estate, the taxable portion is income in respect of a decedent,[217] and the estate tax, if any, attributable to that portion is deductible by the beneficiary.[218]

Whether a contractual death benefit is includible in the executive's gross estate depends on whether IRC Section 2037 applies. The U.S. Tax Court has held, and the IRS concedes, that IRC Section 2039(a), which would include in the gross estate an annuity or other payment receivable by any beneficiary surviving the executive, does not apply.[219] However, IRC Section 2037, which would include in the gross estate transfers taking effect at death, might apply. For this section to apply, the following requirements are essential:

- The executive makes a transfer of the benefits to a beneficiary during the executive's lifetime.
- The beneficiary can receive the benefit only by surviving the executive.
- The executive retained a reversionary interest that exceeded 5% of the value of the payments immediately before the executive's death.[220]

---

[217] IRC Section 691(a).

[218] IRC Section 691(c).

[219] *H. Beal Est.*, 47 T.C. 269 (1966) (Acq.).

[220] *S. Bogley Est.*, 514 F.2d 1027 (Ct. Ct. 1975); *H. Fried Est.*, 54 T.C. 805 (1970), *aff'd* 445 F.2d 979 (2d Cir. 1971), *cert. denied*, 404 U.S. 1016.

© 2021 AICPA. All rights reserved.

The retention of a greater than 5% reversionary interest can be a critical factor[221] and is determined under the IRS actuarial tables. The values vary with the age of the beneficiary, and the number of beneficiaries. When a single beneficiary is named, the reversionary interest of the executive in case he or she survives the beneficiary will rarely be found to be worth less than 5%. Hence, naming contingent beneficiaries is important if the primary beneficiary does not survive.

At one time, the IRS insisted that a contractual death benefit measured by an executive's salary in the year of death constituted a gift in the year of death. After losing on this argument in the courts, it has abandoned this position, but only if (1) the employee is automatically covered by the plan and has no control over its terms, (2) the employer retains the right to modify the plan, and (3) the employee's death is the event that first causes the value of the benefit to be ascertainable (see ¶950 for further discussion of this issue).[222]

.12 Voluntary Death Benefits

The employer, although not willing to commit itself contractually, may make a voluntary payment to the surviving spouse or other beneficiary of the executive. The IRS believes that any such amount would be taxable to the recipient and would not be excludable as a gift under IRC Section 102.[223] However, the U.S. Tax Court noted that the key issue is the transferor's intent based on all the facts and circumstances. The U.S. Court of Appeals for the 9th Circuit has held that payments made to the widow of an employee or stockholder were nontaxable gifts because the corporation received no economic benefits from the transfer, and the employee had been fully compensated during his life for services he provided.[224] Whether a truly voluntary death benefit to a survivor is taxable or is a nontaxable gift will depend on the facts and circumstances of each case.

¶1615 Use of Standard Planning Techniques

A financial planner should have no doubt that planning the executive's estate requires special handling. However, the situation is not so special that the executive cannot use many of the standard financial and estate planning techniques that are explained throughout this publication. Indeed, many of them take on added importance for the executive primarily because the executive's estate may be more substantial and might have more liquidity problems than most estates.

The use of the marital deduction alone,[225] or in combination with the portability opportunity or the available applicable exclusion amount (unified credit), or both,[226] can save the executive's estate from federal estate tax liability. Nontax, as well as tax, considerations bear on the extent to which the marital

---

[221] Revenue Ruling 78-15, 1978-1 CB 289.

[222] *A. DiMarco Est.*, 87 T.C. 653 (1986); and Revenue Ruling 92-68, 1992-2 CB 257.

[223] *M.L. Sweeney*, 54 T.C.M. 1003 (1987).

[224] *L.H. Harper*, 454 F.2d 222 (9th Cir. 1971).

[225] IRC Section 2056(a).

[226] IRC Section 2010.

© 2021 AICPA. All rights reserved.

deduction should be used, as discussed in ¶1215. Of course, marriage is a prerequisite of the use of the marital deduction, and not all executives are married at the time of death. Planning for two deaths before either spouse has died should be the focus of the financial planner.

Apart from federal estate tax liabilities and their discharge, the executive's estate, from the very nature of its assets, is likely to face liquidity problems. These liquidity problems might require life insurance solutions or a reordering of investments.

Gifts are often a useful way of minimizing estate tax liabilities. To minimize the estate tax through lifetime gifts, the executive should make full use of the annual gift tax exclusion ($15,000 for 2021 and indexed annually for inflation).[227] If the donor is married, spouses may also use gift splitting,[228] that is, making an election with the spouse's consent to have the gift treated as having been made half by each spouse, thus, doubling the amount eligible for exclusion. For persons in community property states, all gifts of community property are deemed to be split by law. A gift of property that appreciates in value after the gift is made, even though subject to the gift tax at the time of the gift, serves to exclude the appreciation from the gross estate of the donor. Gifts can also result in family income tax savings when income-producing property is the subject of the gift, subject to the special income tax rules (the kiddie tax) for children under the age of 19 (or under age 24 and full-time students).

When selecting property for executive giving, one must be mindful of the rule that property passing from a decedent receives a basis equal to its value at the date of death (or six months later if the alternate valuation date is allowed and is elected by the executor).[229] If the decedent's property has appreciated, the tax-free step up in basis eliminates any income tax liability on appreciation up to the time of death (or six months later if the alternate valuation date is elected by the executor). However, for property received from decedents who died in 2010 and whose estates elected to opt out of the federal estate tax system, the step up in basis for the decedent's property over its cost to the decedent is generally limited to $1.3 million for all beneficiaries, plus $3 million for property received by a surviving spouse.

No such step up in basis rule applies to lifetime gifts. Rather, a donee obtains a basis in the gifted property equal to the donor's adjusted basis in such property, plus the gift tax paid (if any) attributable to the appreciated value of the transferred property.[230] One must also be especially careful of the executive's estate's possible liquidity problems. Therefore, non-liquid assets might be prime candidates for giving. That same need for liquidity also suggests the possible use of the net gift technique in special circumstances. This technique involves having the donee pay the gift tax due as a means of preserving the executive's cash or cash equivalents (see ¶410, however, requiring exhaustion of the donor's unified credit before any gift tax is payable by the donee and on possible income tax problems arising in connection with net gifts).

---

[227] IRC Section 2503(b).

[228] IRC Section 2513.

[229] IRC Section 1014(a).

[230] IRC Section 1015.

© 2021 AICPA. All rights reserved.

Gifts of low value life insurance policies are one possibility to be explored, taking into account the possible need for the policies to supply estate liquidity. Gifts to charity are another possibility because they not only reduce the executive's gross estate, but, if made during the donor's lifetime, also provide the executive with an income tax deduction.[231]

Creation of trusts is another major consideration. Apart from tax factors, trusts may also provide protection against creditors of the grantor and the beneficiaries, control of the use of the trust funds by a fiduciary and offer professional management of investments. If created for reasons other than tax avoidance, multiple trusts for different family members may take advantage of multiple uses of the $10,000 state and local tax (SALT) deduction and possibly, if applicable, the trust's threshold in 2021 of $164,900 for purposes of the IRC Section 199A Qualified Business Income deduction.

The effect of joint ownership of property, especially as it relates to joint ownership with the executive's spouse, needs to be explored.

Regarding joint tenancies between spouses, upon the death of the first to die, only one half of the value of the property is includible in the decedent's gross estate.[232] Only that half will generally get a date-of-death value as the basis, regardless of the contributions made by either spouse.[233] For this and other reasons, spouses may want to consider termination of interspousal joint tenancies and transfer the properties into their individual names or hold them as tenants in common rather than as joint tenants. However, if the spouses hold the property as community property, such property receives a full date-of-death value as its basis to the survivor at the death of the first spouse to die.[234]

Under some circumstances, the executive might want to maintain interspousal joint tenancies or create new ones. The creation can be accomplished without gift tax consequences and removes one half of the value from the gross estate for federal estate tax purposes of the first joint tenant to die. Joint tenancy also excludes the full value of the property from the decedent's probate estate and reduces the costs of probate administration. A joint tenancy might also have some psychological benefits. An executive should not create a joint tenancy without considering long-term factors and contingencies. These factors include the potential tax impact on the estate of the survivor; the right of the survivor to dispose of the property without regard to the interests of the deceased spouse, the children, or others; the interest that the survivor's spouse might acquire in the event of a remarriage; and the possibility that the marriage of the donor and donee spouse might terminate before the death of either.

¶1620 Total Financial Counseling for the Executive

Some companies furnish financial counseling services for their top executives, often employing outside firms. The cost paid by the company will be taxable to the executive. The TCJA eliminated the possible

---

[231] IRC Section 170(a).

[232] IRC Section 2040(b).

[233] IRC Section 1014(a).

[234] IRC Sections 1014(a) and 1014(b)(6).

© 2021 AICPA. All rights reserved.

itemized deduction by the executive of a portion of the payment relating to the collection or production of income or the providing of tax advice.

> **Note:** The value of retirement planning advice or information provided to an executive or spouse is excludable from income as a fringe benefit if the employer maintains a qualified retirement plan, provided retirement planning services are available on substantially the same terms to each member of the group of employees who are normally provided with education and information regarding the employer's plan.[235]

A typical financial plan might contain the following elements:

.01 Basic Data

This includes family relationships, personal objectives and considerations, a net worth statement, and a statement of family income and expenses.

.02 Analysis of Existing Plan

Existing wills of the executive and the executive's spouse, trusts, insurance policies, employee benefit plans, matrimonial agreements, other assets, and beneficiary designations are analyzed. Property documents, bank accounts and securities holdings, and other relevant documents will be examined. Income and death tax consequences of the existing plan or documents will then be analyzed. Legal and tax weaknesses and strengths are noted. The general economic effect is set forth.

.03 General Recommendations

The financial plan will recommend improvements. It might make recommendations about lifetime gifts, with detailed suggestions about amounts, the assets to be used, their basis, and the timing of the gifts. Gift tax considerations will be spelled out, and recommendations will be made about the use of trusts or custodianships, if minors are involved. If a trust is to be used, the report will include details concerning the type of trust, such as revocable, irrevocable, testamentary, or pour-over. Consideration of appropriate fiduciaries will be discussed. Charitable giving may also be considered if that appears to be an executive objective. In appropriate cases, some of the more "sophisticated" tax and estate planning alternatives discussed later in this guide (GRATs, GRUTs, QPRTs, IDGTs, SLATs, SCINs, and so on) may be considered.

.04 Stock Options and Company Stock

The financial plan will contain information on nonqualified stock options and stock acquired by the exercise of ISOs. Recommendations will be made about their exercise, taking into account financing and tax consequences, including AMT consequences. Company stock holdings will be examined, and recommendations will be made about gifts, sales or exchanges, and bequests. Income and estate tax consequences will be noted, along with possible security law requirements.

---

[235] IRC Section 132(m).

© 2021 AICPA. All rights reserved.

.05 General Executive Benefits

The financial plan will make recommendations regarding all employee benefits. It will examine tax consequences and family considerations and make certain that all beneficiary designations are current and in accordance with the executives' wishes and sound planning.

.06 Life Insurance

The financial plan will make recommendations about existing policies. The plan will note their strengths and weaknesses and make suggestions about beneficiary designations. Liquidity, estate, and income tax considerations will be noted. The plan might also suggest assignments of ownership of policies and the transfer of incidents of ownership. Irrevocable trusts for life insurance policies should be considered. The plan might make recommendations about additional new insurance, with specifics about the type of policy, premium payments, beneficiary designations, and settlement options.

.07 New Plan

The financial plan will provide a new plan with specific details. These details will include, for example, the marital deduction bequest, with particular attention to the use of a qualified terminable interest property, powers of appointment, estate or portion trust as alternatives for the marital deduction bequest, and the use of some form of disclaimer or credit shelter trust. The plan will compare the new plan with the old plan in terms of tax and family considerations and the attainment of economic objectives. The portability election may figure prominently in the new plan.

.08 Investments

In some cases, the financial plan will review existing investments and make recommendations concerning changes or professional investment counseling. Tax-favored investments will often merit special considerations. The impact of the passive loss rules[236] and the tax on net investment income on particular types of investments should be explained.

.09 Budgets

Some financial planners become involved in the family budget and suggest areas where the family can save money or where reallocations are needed.

¶1625 The Migratory Executive

Corporate executives, particularly those working for national and multinational companies, are likely to move from one state or country to another.

The financial planner must have some appreciation of what these moves can mean and what past moves have meant in terms of property rights and any estate plan that is to be developed. Once the issues and any problems are recognized, the executive might be able to address them by marital property

[236] IRC Section 469.

© 2021 AICPA. All rights reserved.

agreements, revocable trusts, and good draftsmanship of wills. The following are some of the key problem areas and possible ways of handling them.

.01 Will Draftsmanship

Often, when drafting a will, provisions can be omitted that are read into the will by virtue of the state of domicile's statutes or case law. Fiduciary powers and administrative provisions are sometimes omitted. However, an attorney cannot afford to omit such provisions when preparing an executive's will because the executive is not certain where he or she might be located from one year or, perhaps, one month, to the next. Dispositive provisions might also be affected by a move from one jurisdiction to another. For example, if the will provides for distributions to be made to children on their attaining the age of majority, one state's age limit might be higher or lower than the limit in another state. In addition, a bequest to children might presumptively include adopted children in one state and not in another state. Therefore, the executive's will should spell out fiduciary and administrative powers in particular. The will should not use terms affecting substantive matters that might be open to different interpretations from one jurisdiction to the next, without precisely defining them.

.02 Community Property

Moves to and from community property jurisdictions involve special problems for married couples (¶325). Long after the couple has disposed of community property and acquired other property in another jurisdiction, the executive might find that the newly acquired property retains the character of community property.

To deal with many of the problems that might arise from shifting between residences in a community property state and a common law state, the financial planner should consider recommending agreements between the spouses to specifically address property rights and the use of living trusts.

Anyone engaged in estate planning in a common law state for an executive who has lived in, or might move to, a community property state, should consult with a lawyer familiar with community property law. Community property laws can vary considerably from one community property state to another.

.03 Foreign Residence

The executive who resides in a foreign country might encounter various legal and tax problems. The executive's spouse and heirs might have rights under foreign law that may not be altered or, if alterable, could be difficult to understand and assert.

In these cases, the executive should keep ownership of property in the foreign country to a minimum. The executive can do so by using a revocable trust set up in one of the states as a receptacle for assets that would otherwise follow the executive's residence. A joint account in the United States with the executive's spouse is another possibility, although joint accounts can present their own problems of inheritance, asset protection issues, and trying to determine a survivor's income tax basis.

© 2021 AICPA. All rights reserved.

An executive residing in a foreign country should have two wills: one disposing of property located within the United States and the other disposing of property located in the foreign country. A marital agreement might be helpful in these circumstances.

Under IRC Section 911, an individual meeting either a bona fide residency test or a specified physical presence test may elect to exclude up to a specified amount of foreign earned income attributable to the period of his or her residence in a foreign country for any tax year. This foreign earned income exclusion is indexed for inflation.[237] For taxable years beginning in 2021, the foreign earned income exclusion is $108,700. The maximum annual exclusion is computed on a daily basis and, therefore, is reduced ratably for each day that a taxpayer is absent from a foreign country during the tax year.[238]

[237] IRC Section 911(b)(2)(D)(ii).

[238] IRC Section 911(b)(2)(A).

© 2021 AICPA. All rights reserved.

Chapter 17

Planning for the Professional

¶1701 Overview

¶1705 What Makes the Professional Special?

¶1710 Side Businesses

¶1715 Corporate and Non-Corporate Practice

¶1720 Problems and Pitfalls in Corporate Operation

¶1725 Planning for Shareholder-Professionals

¶1730 Withdrawal and Expulsion

¶1701 Overview

Physicians, dentists, attorneys, accountants, engineers, architects, and other professionals licensed by the state to practice their professions are a privileged class. On the other hand, they are subject to governmental regulations and bound by codes of ethics to which the ordinary business person is not held. Their licenses to practice, unlike licenses to operate taxis or buses, are not transferable.

¶1705 What Makes the Professional Special?

The paradoxical combination of privilege and regulatory restrictions makes financial planning for the professional unique. The restrictions to which the professional is subject make many of the estate planning techniques available and commonly used for the handling of general business interests inapplicable. Because a professional may transfer a practice only to another professional, the professional cannot develop a family gift program involving professional business interests, as can other business owners. However, many professionals in increasing numbers are developing side businesses that make gift programs involving these side businesses applicable (¶1710).

Professionals also have much more difficulty building capital values by developing a practice because of the limitations on transferability. Professionals who own interests in side businesses are legally free to sell those business interests to the highest bidder in a non-restricted market, open to all types of bidders. A professional may usually sell an interest in a professional firm only to another professional. The buyer of a professional practice may be a neophyte who is unable to pay a good price. There also is normally no assurance that the goodwill built up by the seller will pass to the buyer, which further limits the selling price.

Because of these and other factors, the financial planning decision-making process for the professional is often more difficult than the process confronting the ordinary businessperson.

© 2021 AICPA. All rights reserved.

The job of the financial planner is to help the professional make rational choices when choice is possible and necessary. The financial planner must also guide the professional when building and preserving income and wealth and transmitting it to heirs and beneficiaries. The financial plan should save taxes and be consistent with the professional client's personality, attitudes toward risk, and fundamental interests and desires. When possible, the financial planner should encourage diversification of the professional's assets.

To incorporate or not to incorporate or, if incorporated, to continue incorporation, is a question that many professionals face. This issue is addressed in ¶1715. Licensed professionals often face liability exposure to a greater degree than many other fields of endeavor. This may lead such professionals to consider a number of planning techniques that affect the choice of business entity, as well as risk management techniques, such as special self-settled asset protection trust arrangements, especially in states like Nevada, Alaska, South Dakota, and Delaware that limit the claims of creditors, as well as a variety of liability and malpractice insurance concerns. The limited liability partnership has become a popular form of operating a professional practice. A partner in a limited liability partnership cannot escape responsibility for one's own negligence or malpractice, but is not liable for the professional negligence or malpractice of another partner.

This chapter addresses the financial planning aspects of professionals who may be business owners, some of which may qualify as a small business. The Small Business Association relief programs are beyond the scope of this guide, but visit the AICPA's Payroll Protection Program page for more resources to help your clients (www.aicpa.org/sba). For COVID-19 planning strategies and client facing resources from the PFP Section, visit www.aicpa.org/pfp/COVID19.

¶1710 Side Businesses

Many professionals might develop businesses outside their established fields of practice. In many cases, the side businesses may be related to their respective practices. A physician may, for example, establish a medical testing lab or imaging center where permitted; a dentist could set up a dental lab; accountants could begin a business consulting firm; attorneys could start an investment advisory, lobbying business, or life insurance firm. All may hold real estate outside of their professional organization that they can rent to themselves for their professional practices or their side businesses.

These side businesses, in addition to being independent of the practice in many cases, and being transferable assets, may also furnish employment opportunities for members of the professional's family.

The legal form in which these businesses operate will sometimes vary in response to state laws and, in some cases, because of issues arising under some professional codes of ethics.

If the professional practice is incorporated, these side businesses may operate as subsidiaries of the parent firm if allowed, or they may be set up as completely independent entities. They may be C corporations, S corporations, partnerships, limited liability companies, or sole proprietorships.

In many cases, in addition to functioning as separate profit centers, the side businesses may also operate to increase the profitability of the professional practices. Ethical considerations must be addressed here to be sure the professional is not violating any guidelines.

© 2021 AICPA. All rights reserved.

From a financial planning point of view, such permitted side businesses not only increase transferable wealth but may also serve to increase the sale value of the professional practice if sold as a package with the practice. They also can provide desirable diversification of the professional's investment portfolio.

¶1715 Corporate and Non-Corporate Practice

Absent state law prohibitions, professionals can choose to practice in various legal and tax forms, as a regular C corporation, S corporation (discussed in detail in ¶1945), regular partnership, limited liability partnership, or sole proprietorship. In addition, all states have adopted limited liability company acts. Some of these acts explicitly allow professionals to operate their practices as limited liability companies. The limited liability company is usually taxed as a partnership with the limited liability associated with the corporate form. However, limited liability companies may elect to be taxed as a corporation by filing Form 8832.[1] Limited liability companies are discussed in ¶2040. Some states have developed variations of these basic legal forms of organization, such as a limited liability limited partnership, a professional limited liability company, and so forth. The financial planner should be certain to become familiar with the forms of organization allowed or prohibited by local law.

Professionals should weigh a number of factors before deciding on one form of organization or another. Operating as a partnership requires at least two partners. With the other forms of organization, one can maintain a solo practice. No limit exists on the number of shareholders a C corporation may have, but an S corporation may have no more than 100 shareholders.[2] However, in counting shareholders, spouses are treated as one shareholder and lineal family members reaching over six generations may also be treated as one shareholder.[3] For an entity to be respected as a corporation, corporate formalities must be strictly observed.

The professional's decision whether to incorporate is influenced by tax factors, As the result of the 2017 Tax Cuts and Jobs Act (TCJA), C corporations (including professional corporations electing to be taxed as C corporations) pay tax at the flat rate of 21% beginning in 2018.[4] Differences between corporate and non-corporate retirement plans are no longer problematic. For a discussion of retirement plans, see ¶905. The financial planner should also consider the income tax rate that the professional may be required to pay. In 2021, the top individual tax rate is 37% — and possibly 40.8% when the 3.8% tax on net investment income applies.

An S corporation offers the opportunity for a business owner to control and regulate salary and distributions to possibly mitigate the effects of higher individual tax rates. As the result of the TCJA, the owners of certain pass-through entities (sole proprietorships partnerships, LLCs, and S corporations), may be eligible for a 20% qualified business income deduction from their taxable income. However, this deduction is not permitted for many service business activities (medicine, accounting, law, financial services, consulting, performing arts, athletes, and others) where taxable income for a married person

---

[1] Regulation Section 301.7701-3.

[2] IRC Section 1361(b)(1)(A).

[3] IRC Section 1361(c)(1).

[4] IRC Section 11(b).

© 2021 AICPA. All rights reserved.

exceeds $329,800 or for a single person exceeds $164,900, all under the complex rules of IRC Section 199A. (The 2021 numbers as adjusted for inflation.) The financial planner must determine whether a client is eligible for a pass-through deduction. Persons in these businesses are eligible for this deduction if their income falls under the applicable threshold, despite being in a profession the law identifies as a "specified service trade or business."

Using the professional corporation as a tax shelter by retaining earnings taxed at corporate rates lower than the shareholder-owners' individual rates, taking advantage of the dividends-received deduction,[5] and paying a top capital gains rate of either 15%, 18.8% (if the 3.8% net investment income tax is added), 20%, or 23.8% (if the 3.8% net investment income tax is added) — depending upon thresholds of taxable income and modified AGI[6] — for 2021 and beyond on a subsequent redemption or liquidation may provide some tax saving opportunities for very high income professionals. The income of a professional service C corporation is taxed at a flat 21% rate in 2021.[7]

Planning Pointer.

There may be some advantage to retaining income in a personal service corporation and investing it in stock that pays qualified dividends, if the shareholder intends to leave the stock and earnings there until death. The shareholder's heirs would receive a date-of-death basis,[8] (hopefully stepped up) so that they could receive much of the appreciation in the value of the dividend-paying stock tax-free. Be careful, however, because the accumulated earnings tax or personal holding company tax may be found to apply if the C corporation makes insufficient distributions.

A *personal service corporation* is defined as one substantially owned by its employees, retired employees, or their estates, the substantial activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.[9]

In the typical case, because the corporation's income usually comes almost entirely from services performed by the professional shareholders, it can generally deduct compensation and benefits to the full extent of its income without running into reasonable compensation problems.[10] Thus, the corporation itself would have little or no tax liability. Some of the income of a professional corporation with substantial investments in equipment or real estate could be attributable to those investments, but in most cases, this income is more than offset by the expenses of maintenance and operation and by depreciation deductions. However, the corporation must intend the payments to be compensation at the

[5] IRC Section 243(a)(1).

[6] IRC Section 1(h)(1)(C).

[7] IRC Section 11(b).

[8] IRC Section 1014(a).

[9] IRC Section 448(d)(2).

[10] IRC Section 162(a).

© 2021 AICPA. All rights reserved.

time of payment. If the payments were for a shareholder's personal benefit and later found not to be deductible, the corporation may be required to treat such payments as dividends and would not be able to deduct them as compensation.[11]

.01 Corporate Fringe Benefits

A regular C corporation may pay and deduct the cost of tax-favored fringe benefits for employees otherwise not deductible, or deductible only to a limited extent under other forms of business operation. These benefits include the following:

- The health and accident plan exclusion from income for amounts received under such plans[12]
- Employer payments to health and accident plan exclusion from income[13]
- Group-term life insurance exclusion from income[14]
- Exclusion of the value of meals and lodgings provided for the convenience of the employer[15]

If the fringe benefit is one that must be made available to non-owner-employees on a nondiscriminatory basis, the corporation must weigh the cost of providing it to the other employees. To the extent that the cost of covering other employees serves to hold down direct compensation costs or promotes goodwill, loyalty, and productivity, the cost of coverage may well be offset.

If a sole practitioner dies, the executor or personal representative of the practitioner should return any records that belong to clients or patients. The estate will want to retain the professional's working papers until the time for filing claims against the estate has expired. The estate might need the working papers to defend a malpractice claim. The rules of the AICPA and several state boards of accountancy do not address the issue of a CPA's working papers upon his or her death. Possibly, the state boards of accountancy in some states and the state licensing boards of other professions might address this issue. The executor of the estate should consult with the state licensing board about the disposal of the professional's working papers. If a professional in a partnership or ongoing professional corporation dies, the working papers will usually remain with the firm.

---

[11] *Neonatology Associates, P.A. et al.*, 115 T.C. 43 (2000), *aff'd* 299 F.3d 221 (3d Cir. 2002).

[12] IRC Section 105(b) and (c).

[13] IRC Section 106.

[14] IRC Section 79.

[15] IRC Section 119.

© 2021 AICPA. All rights reserved.

.02 Health Coverage for Self-Employed Professionals

By employing one's spouse and providing employees with health benefits (including coverage for spouses), a self-employed person may deduct health insurance premiums on Schedule C.[16] This deduction would reduce the professional's income tax and self-employment tax.

If the self-employed professional does not employ his or her spouse, the professional may deduct the cost of any health insurance provided to employees on Schedule C as an employee benefit program. Note, however, that the rules of the Affordable Care Act may deem employer payments for employees' health insurance a disqualifying "group health plan" and impose a costly penalty. See ¶1605 for a discussion of this issue. The self-employed person may not deduct the cost of his or her own health insurance on Schedule C. Rather, the self-employed professional may deduct 100% of one's own health insurance premiums as an adjustment to income (Schedule 1) and above-the-line deduction on page 1 of Form 1040.[17] For this purpose, health insurance premiums include eligible long-term care premiums as well as Medicare premiums. Eligible long-term care premiums are those that would otherwise be deductible as a medical expense.[18]

This deduction for health insurance premiums reduces the professional's income tax but not the self-employment tax.[19] The deduction is also limited to the professional's earned income.[20] In addition, the professional may not deduct any amount for health insurance on page 1 of Form 1040 for any month in which the professional is eligible to participate in any subsidized health plan maintained by any employer of the professional or his or her spouse.[21]

The financial planner will want to remind professionals of the need for disability income insurance. The ability of a professional to work in one's profession is often the professional's most valuable asset. Yet, professionals might overlook the need for disability income insurance. The premiums for an individual disability income insurance policy are not deductible for income tax purposes, but any proceeds received are not taxable. If an employer pays the premiums for a disability income insurance policy, the employer may deduct the premiums as an employee benefit program.[22] The premiums paid by the employer for a group disability income insurance policy are tax-free to the employee,[23] but any proceeds received will

---

[16] IRC Section 162(a), Regulation Section 1.162-10(a), IRS Coordinated Issue Paper: "All Industries, Health Insurance Deductibility for Self-Employed Individuals," UIL 162.35-02, March 29, 1999, Revenue Ruling 71-588, 1971-2 CB 91.

[17] IRC Section 162(l)(1)(A).

[18] IRC Section 162(l)(2)(C) and 213(d)(10).

[19] IRC Section 162(l)(2)(C)(4).

[20] IRC Section 162(l)(2)(A).

[21] IRC Section 162(l)(2)(B).

[22] IRC Section 162(a) and Regulation Section 1.162-10(a).

[23] IRC Section 106(a).

© 2021 AICPA. All rights reserved.

be taxable to the employee.[24] If the employer pays the premiums on the policy and treats the premiums paid by the employer as additional compensation, the employee may exclude any benefits received under the policy from gross income.[25]

.03 Corporate Considerations

Some of these tax factors (particularly the concern of double taxation of a C corporation) may tend to favor S corporation status and other available non-corporate forms of operation over the regular C corporate form of operation. Nevertheless, the opportunity to avoid the double taxation rules of C corporations by paying out all income in the form of compensation and benefits may cause many existing professional corporations to remain as such. The 21% C corporation income tax rate resulting from the TCJA is a game-changer that will have many business entities seriously considering organizing themselves as C corporations. However, if the C corporation distributes compensation to highly compensated employees, the corporation will get a deduction at 21%, and the employees may be taxed at a rate as high as 37%.

Whether the corporate operation is in C or S form, corporate limited liability applies. However, the corporate limited liability affords no protection to a shareholder-professional for a personal malpractice claim as a matter of public policy. In addition, a director or officer of a corporation is potentially subject to liability for breach of duty or wrongful acts as a director or officer. A director or officer should consider purchasing directors' and officers' liability insurance for these potential claims. The shareholder-professional should obtain malpractice insurance.

The rest of this chapter focuses on the professional corporation, that is, a C corporation, as the mode of practice. The limited liability company, partnership, and sole proprietorship forms are separately discussed in general terms in other chapters of this publication.

¶1720 Problems and Pitfalls in Corporate Operation

Professionals should consider the disadvantages, problem areas, and pitfalls involved in a corporate operation. Many areas of concern involve tax matters, but the professional should also consider practical, legal, and ethical considerations. The following list briefly outlines these various considerations, all of which are discussed in greater detail later in this section.

.01 Operating as a Corporation

To gain the tax and other advantages of corporate operation, the corporation must adhere to the formalities of corporate operation. Observing corporate formalities involves costs and expenditure of time and effort.

---

[24] IRC Section 105(a).

[25] IRC Section 105(a).

© 2021 AICPA. All rights reserved.

.02 Reasonable Compensation

A corporation may not deduct unreasonable compensation.[26] Even if the corporation believes the compensation paid is reasonable, the IRS may treat part of the payment received as a non-deductible dividend to the extent of the corporation's earnings and profits. However, the IRS may not treat the payment as a dividend solely by reason of the corporation's nonpayment of dividends out of its earnings and profits.[27]

.03 Tax Year

A personal service corporation must use the calendar year as its tax year unless the IRS consents to the use of a different year for business purposes or unless a fiscal year is elected under the rules of IRC Section 444. Corporations making the IRC Section 444 election either must make "minimum distributions" to employee-owners before the end of the calendar year or must postpone deductions for some or all distributions to employee-owners.

.04 Limits on Use of Cash Method

The TCJA has made a significant change in the law here by expanding the number of taxpayers, including C corporations, that may use cash method accounting. A single $26 million (for 2021) average annual gross receipts test (three years average) has been put in place to determine whether certain taxpayers qualify as "small taxpayers," are allowed to use the cash method of accounting, are not required to use inventories, are not required to apply the UNICAP rules, and are not required to use the percentage of completion method for a small construction contract.[28]

.05 Personal Holding Company

If services are rendered on an individual patient or client-professional basis and distributions to shareholders are not made, a C corporation may have personal holding company issues, especially in one-owner corporations. However, the issues may be manageable under Revenue Rulings 75-67, 75-249, and 75-250.[29] A C corporation that sells its assets and does not liquidate may find itself treated as a personal holding company if it has few shareholders and its ongoing income is derived from interest and dividends. An S corporation is not subject to the personal holding company tax. The personal holding company tax rate for 2021 and beyond is 20%.

.06 Allocation of Income

IRC Section 269A permits the IRS to allocate the income, deductions, and other items of a personal service corporation to more than 10% shareholders if substantially all services are performed for only one other entity. A question under this provision is about whether an individual performing services for

---

[26] IRC Section 162(a).

[27] Revenue Ruling 79-8, 1979-1 CB 92.

[28] IRC Sections 446(c), 448(b), and (c).

[29] 1975-1 CB 169, 171, and 172.

© 2021 AICPA. All rights reserved.

his or her personal service corporation is to be regarded as a separate entity to render the section applicable. Also, under IRC Section 482, the IRS is empowered to allocate income between businesses controlled by the same interests (the shareholder-employee may be considered both a business and the controlling interest).

.07 Multiple Corporation Danger

Shareholder-employees of professional corporations sometimes own related corporations (for example, a physician owns a medical service corporation and a corporation that owns his or her office building). The medical service corporation and building corporation may be a brother-sister controlled group, and only a single $250,000 accumulated earnings credit is allowed, generally to be divided equally among the corporations. Also, special qualified retirement plan rules may come into play that aggregate the income of the related entities and limit the retirement plan contributions of the owners.

.08 Accumulated Earnings Tax

An accumulated earnings tax is imposed at a flat rate of 20% on the accumulated taxable income[30] of a corporation formed or availed of to avoid income tax on dividends by permitting earnings and profits to accumulate instead of being distributed to stockholders.[31] Every corporation is allowed to accumulate a minimum of $250,000[32] ($150,000 for certain personal service corporations under IRC Section 535(c)(2)(B)) before the corporation must submit evidence that it has reasonable business needs for the accumulation. The corporation does not assess itself the accumulated earnings tax. Rather, the IRS may assess the tax on an audit of the corporation's income tax return. The accumulated earnings tax does not apply to S corporations. The accumulated earnings tax rate is 20% for 2021 and thereafter.

.09 Converting a Partnership to Corporate Form

The general rule permitting tax-free incorporation[33] of an organization previously taxed as a partnership may be jeopardized if the partnership liabilities exceed the basis of the assets transferred from the partnership to the corporation upon the corporation's formation.[34] The liabilities owed to retired or deceased partners may also create special problems.

.10 Business Expense Deductions

If the IRS disallows an expense item claimed by the corporation, corporate tax liability will be incurred or increased. If the corporation paid the amount disallowed to the professional, it may also be taxable to the professional (double taxation). The result is less corporate money for payment of compensation and, hence, a lower basis for corporate retirement plan contributions.

---

[30] IRC Section 535.

[31] IRC Section 531.

[32] IRC Section 535(c)(2)(A).

[33] IRC Section 351(a).

[34] IRC Section 357(c).

© 2021 AICPA. All rights reserved.

.11 State and Local Taxes

State and local taxes (income, gross receipts taxes, franchise taxes, and so forth) may be imposed on corporations that are not imposed on unincorporated professional practices. After the TCJA, corporations may still deduct the state and local taxes they pay arising from their business or investment activities without regard to the $10,000 cap imposed on these deductions for individuals in their personal activities.

.12 Social Security Taxes

The incorporated professional picks up both the corporate and individual liability for Social Security taxes, although the corporation gets a tax deduction for the taxes it pays, including the 1.45% Medicare tax. The self-employed individual pays twice the individual rate[35] but may deduct one half of the self-employment tax as a deduction (above the line) when computing AGI.[36] For 2021, there is an additional Medicare tax of 0.9% imposed on employees and self-employed individuals whose modified AGI exceeds $250,000 (married filing jointly), $125,000 (married filing separately), and $200,000 (single). No part of that tax is deductible by employees or self-employed persons. Employers do not pay that tax. These thresholds are not indexed for inflation.

.13 Balancing Interests of Different Professionals

If two or more professionals are shareholders, they may have different opinions on the important issues of how much income is to be deferred, what fringe benefits are appropriate, investment objectives of retirement plans, and other factors. The financial planner should recommend that the parties create a shareholders' agreement addressing these (and other) issues.

.14 Cost of Benefits

To the extent that the corporation must provide benefits on a nondiscriminatory basis and cover all employees, the tax benefits to shareholder-professionals will be offset by the after-tax cost of providing coverage to the other employees.

.15 Ethics

Some members of the legal profession perceive a question of ethics involved in a profit-sharing type of arrangement in which earnings of professionals (lawyers) are, in effect, split with nonprofessionals. However, some local bar associations have approved the status of non-lawyers as partners in law firms. Theoretically, a fee-splitting ethical question arises when younger professionals, in effect, split the amount they have earned for the corporation by way of higher corporate contributions on behalf of older shareholder-professionals participating in a defined benefit pension plan. For accountants, the AICPA's Code of Professional Conduct permits organizing a professional corporation, provided that the corporation complies with criteria spelled out in the Council Resolution contained in the Code of

---

[35] IRC Section 1401.

[36] IRC Section 164(f).

© 2021 AICPA. All rights reserved.

Professional Conduct. No serious ethical question of organizational propriety is evident in the medical profession.

.16 Accrued Bonuses and Interest Payable to Owners

A personal service corporation may not deduct an accrued bonus or accrued interest payable to an employee-owner before the time the employee-owner would include the payment in income.[37]

¶1725 Planning for Shareholder-Professionals

Financial planning for the shareholder-owner of an interest in a professional corporation involves almost everything included in planning for the owner of any other closely held corporation. Financial planning considerations include the following:

- Lifetime giving
- Lifetime income tax planning
- Estate tax planning
- Estate liquidity
- Income tax planning for the estate and family
- Life insurance planning
- Beneficiary designations
- Settlement options for life insurance and plan benefits
- Retirement plan considerations
- Lifetime and testamentary trusts
- Will dispositions and powers of appointment
- Forms of property ownership
- Eldercare considerations
- Powers of attorney and living wills
- Identification of digital assets

[37] IRC Section 267(a)(2).

© 2021 AICPA. All rights reserved.

.01 Retirement Planning and Beneficiary Designations

The big difference when planning for the shareholder-professional is in the planning for the business interest itself. In this area, the typical professional may be considered restricted in relation to the owner of a closely held business corporation. The latter has available all the techniques flowing from different forms of capitalization to programs involving gifts of shares of stock in the business to junior members of the family. Most of these planning techniques are not available to the owner of an interest in a professional corporation where family members are not similarly licensed professionals. The professional corporation generally does not have the same growth potential that a capital-oriented business corporation has. Planning for redemptions of stock to pay death taxes[38] may be ruled out in the professional corporation context by the requirement that the stock must be valued at more than 35% of the adjusted gross estate and the assumed relatively small value of shares in a professional service corporation in relation to the estate owner's other assets. Buy-sell arrangements with family members may not be available if the family members are not licensed in the same profession.

Because of some areas in which the professional shareholder may be viewed as restricted, the financial planner might need to restore some balance of nonprofessional assets to place the professional more nearly on par with the businessperson. For example, the medical building that a physician owns or would like to own should be kept outside of the professional corporation and leased to it. The physician could then use the real estate to develop a gift program, which could produce tax savings and provide junior family members with income and equity ownership.

Leasing of equipment is another area to be explored. Even relatively inexpensive items of equipment, such as personal computers and copiers, along with items such as MRI machines, may be appropriate candidates for developing an income, estate, and gift tax saving program for the professional's family. Of course, the lease arrangement must qualify as the equivalent of an arm's-length transaction. The professional should support the lease arrangement by documenting it with a valid business purpose. Given such support, it should withstand IRS scrutiny.

Tax-favored investments, particularly tax exempt bonds, may be of special interest. A key objective for the financial planner here is to promote diversification of the professional's assets and ensure that such assets not required to be associated with the professional license are held outside of the professional corporation.

.02 Shifting Income and Values Within the Professional Corporation

As a corporate practice ages and shareholders change, the way the practice divides profits might change. This change may produce tax consequences. Salary changes, although shifting income, do not have internal income tax consequences for the corporation and the group of professionals as a whole. When the practice shifts income, it may also want to shift relative ownership interests. Changes in stock ownership have tax consequences.

Usually, corporate profits will shift from senior members to junior members. This shift means that the junior members may be buying stock from the senior members. The latter may have a problem paying

---

[38] IRC Section 303.

© 2021 AICPA. All rights reserved.

tax on the gain realized, and the younger members may have the problem of financing their purchases. The senior members may sell to the juniors on an installment sale basis.

An issue that may arise at the time of a sale of stock is valuation of the stock. Valuation issues are likely for accounts receivable, work in progress, unbilled time, goodwill, and customer lists. Because the professional corporation is usually on a cash basis, it is not taxed on a receivable until it collects it. A valuation discount for the deferred tax should be allowed. Another issue is the collectability of the receivables. An additional discount should be allowed as an allowance for uncollectible accounts receivable if the stock of the professional corporation is to be fairly valued.

A professional corporation that buys the stock of a departing shareholder receives no tax deduction for the price paid. As a consequence, the corporation may prefer to pay the departing shareholder deductible severance pay or ongoing consulting fees in consideration of a conservatively valued stock price. The arrangement should not provide that the severance pay is in lieu of a higher value on the stock. The seller may object to this plan because the severance pay will be taxed at a higher rate as ordinary income, whereas the sale of stock will be taxed at lower rates as capital gain.

.03 Using Life Insurance in the Retirement Plan

A corporation can fund a qualified retirement plan partly with life insurance if the insurance is incidental to the main purpose of the plan, which is to provide retirement benefits. In the case of a pension plan, insurance is incidental if the preretirement death benefit does not exceed 100 times the monthly income to be provided by the pension plan at normal retirement age. The value of the preretirement survivor annuity required by IRC Section 401(a)(11) must be taken into account when applying this test.

In the case of a profit-sharing plan, life insurance is incidental if less than 50% of the corporation's contribution credited to each employee's account is used to buy ordinary life insurance. This treatment holds, even though the total death benefit consists of the life insurance plus the amount credited to the participant's account at the time of death.[39] However, with a profit-sharing plan, if the life insurance is purchased by funds accumulated by the plan for at least two years instead of being purchased with current contributions, no limit applies to the amount of insurance that the plan can buy.

In both the pension plan and the profit-sharing plan, corporate contributions attributable to life insurance protection result in current taxable income to the participants.

The life insurance in either type of plan can be very useful. It can provide the professional's beneficiary with cash, which can be received free of income taxes.[40] The professional may arrange to have the insurance proceeds excluded from his or her gross estate by complying with the requirements of IRC Section 2042 (such as by transferring the ownership of the policy out of the retirement plan to an irrevocable life insurance trust more than three years prior to the death of the professional).

---

[39] Revenue Ruling 73-501, 1973-2 CB 127.

[40] IRC Section 101(a)(1).

© 2021 AICPA. All rights reserved.

.04 Group-Term Life Insurance

The proceeds of a company-provided group-term life insurance policy will be includible in the professional's estate if, at the time of death, the professional possesses any of the incidents of ownership of the policy.[41] To remove the policy proceeds from an estate, the IRS requires, as provided in Revenue Ruling 69-54,[42] that (1) the policy be convertible to an individual policy on termination of the insured's employment; (2) the policy and state law permit absolute assignment by the employee of all incidents of ownership; and (3) the employee irrevocably assigns all rights in the policy, including the conversion right. Note that premiums paid in this arrangement may be viewed as taxable gifts being made by the employee.[43]

.05 Death, Disability, or Retirement

In the case of a professional corporation with more than one shareholder, provisions should be made for the sale and purchase of a professional's shares upon death, permanent disability, or retirement. The professional can do so via either a corporate redemption or via a so-called "cross-purchase agreement" with the remaining shareholders. The financial planner should strongly encourage professional clients to consider succession planning, especially if there are no family members in a position to continue the professional practice in the event of the death, disability, or retirement of the professional owner.

The choice between a corporate redemption and a cross-purchase agreement rests on the same factors that apply in the case of any closely held business corporation, as fully discussed in ¶1935.

¶1730 Withdrawal and Expulsion

Many state professional corporation statutes require that the corporation repurchase the shares of a professional shareholder who becomes disqualified. Disqualification usually means the loss of a license to practice; it does not cover the case of voluntary withdrawal or an expulsion.

The matter of withdrawal or expulsion must be covered by agreement of the parties. In either case, a termination of employment results. Determining whether an individual quit, was expelled, or was fired may be difficult. Therefore, as a practical matter, the agreement should treat withdrawal and expulsion similarly in terms of legal rights and obligations.

The corporation's board of directors will have the power to terminate the employment of any one of the professionals, with or without cause, unless the professionals are protected by employment contracts.

In two-person professional corporations, the financial planner should address what happens to the corporation, its assets, liabilities, and clients, if the shareholders no longer want to practice together.

---

[41] IRC Section 2042.

[42] 1969-1 CB 221.

[43] Revenue Ruling 76-490, 1976-2 CB 300.

© 2021 AICPA. All rights reserved.

Chapter 18

Closely Held Businesses — Choice of Business Entity

¶1801 Overview

¶1805 Tax Factors

¶1810 Nontax Factors

¶1815 Disposition of the Business Interest

¶1820 Conclusions: Evaluating the Choices among the Available Entities

¶1801 Overview

Perhaps the most important question facing an owner of an interest in a closely held business is the choice of business entity in which to operate, that is, a regular C corporation, an S corporation, partnership, LLC, or sole proprietorship. Owners of existing businesses periodically should reevaluate their form of operation. This chapter examines the tax and nontax factors to consider when choosing the business entity. Chapter 17, "Planning for the Professional," discussed choice-of-entity form considerations for professionals in ¶1715. The 2017 Tax Cuts and Jobs Act (TCJA) has dramatically changed many of the rules addressing the taxation of the various business entities. Tax rates on C corporations were reduced to a flat rate of 21%. A new 20% QBI deduction was created for certain sole proprietors, partners, LLC members, and shareholders of S corporations. Planning has taken on new challenges and new opportunities for the financial planner.

This chapter addresses the financial planning aspects of closely-held businesses, some of which may qualify as a small business. The Small Business Association relief programs are beyond the scope of this guide, but visit the AICPA's Payroll Protection Program page for more resources to help your clients (www.aicpa.org/sba). Access COVID-19 planning strategies and client facing resources from the PFP Section.

¶1805 Tax Factors

The income of S corporations, partnerships, LLCs taxed as partnerships, and sole proprietorships passes directly through to the individual owners. LLCs may elect to be taxed either as corporations or as partnerships under rules discussed briefly in the text that follows and in more detail in ¶2040. An LLC

© 2021 AICPA. All rights reserved.

owned by one individual may elect to be treated as a disregarded entity, which means it is taxed as a sole proprietorship.[1]

.01 C Corporations

When considering the tax advantages of a C corporation, the financial planner must consider the tax rate structure. The top federal individual income tax rate is 37% in 2021. The 3.8% net investment income tax may be added to the 37% rate where applicable. This rate is higher than the flat corporate rate of 21%. A C corporation may be preferable if it meets both of the following two conditions:

- The business is planning to retain earnings to fund growth.
- The business owners generally will be in higher tax brackets than would the business operated as a C corporation.

Under IRC Section 11, a C corporation is taxed at 21% beginning in 2018. This rate is made "permanent" under the TCJA, but is subject to political change. Another advantage of operating as a C corporation is that the corporate AMT has been repealed for 2018 and beyond by the TCJA (again, subject to change). Individuals (including S corporation shareholders) are subject to an AMT rate as high as 28%.[2] Any alternative minimum foreign tax credit reduces the AMT.[3]

The stock in a C corporation usually is a capital asset.[4] A gain on the sale of the shares in a C corporation results in a capital gain eligible for favorable tax treatment. If the stock is qualified small business stock acquired after 1993 and held for more than five years, the shareholder may exclude at least 50% of the gain from his or her gross income.[5] The 50% exclusion was increased to a 75% exclusion of gain from the sale or exchange of qualified small business stock acquired after February 17, 2009, and before September 27, 2010.

For stock acquired after September 27, 2010, the percentage of gain from the sale or exchange of qualified small business stock that may be excluded from gross income by a non-corporate taxpayer is increased to 100%. This increase was made permanent by the PATH Act of 2015. Eligible gain from the disposition of qualified stock of any single issuer is subject to a cumulative limit for any given tax year equal to the greater of (*a*) 10 times the taxpayer's adjusted basis in all qualified stock disposed of during the tax year or (*b*) $10 million ($5 million for married taxpayers who file separately), reduced by the total amount of eligible gain taken in prior tax years.[6]

---

[1] Regulation Section 301.7701-3(b)(1).

[2] IRC Section 55(b)(1)(A)(i).

[3] IRC Section 55(b)(1)(B).

[4] IRC Section 1221.

[5] IRC Section 1202(a).

[6] IRC Section 1202(b).

© 2021 AICPA. All rights reserved.

However, if and when applicable, any included gain is taxed at 28%. So, where the 100% exclusion does not apply, the effective rate on the gain is 14% or less.[7] For IRC Section 1202 to apply, as a general rule, the shareholder must have obtained the stock directly from the corporation in exchange for money, property, or services.[8] In addition, qualified small business stock acquired by gift or inheritance is eligible for the exclusion. A qualified small business is a C corporation funded with aggregate gross assets of less than $50 million.[9] However, certain businesses are not eligible.[10] Ineligible businesses include the following:

- Services firms, such as health, law, accounting, engineering, architecture, athletics, performing arts, consulting, brokerage services, actuarial science, financial services companies, and any trade or business where the principal asset is the reputation or skill of one or more of its employees
- Banks, investment firms, and insurance companies
- Any farming business
- Any natural resource business for which the percentage depletion deduction is available
- Hotels, motels, and restaurants

Example 18.1. On August 6, 2005, Ray invested $1 million of his own money to start Kale Corporation, a specialized manufacturing company. Ray received all of Kale Corporation's common stock in exchange for his investment. Kale Corporation was quite successful. On September 10, 2020, Ray sold all his stock in Kale Corporation to Jonah for $5 million. Ray realized a gain of $4 million ($5,000,000 – $1,000,000) on the sale of his stock. Ray invested the sales proceeds in mutual funds. Ray may exclude 50% of this $4 million gain from his gross income. Ray's tax rate on the $2 million gain included in his gross income is 28%. Had Ray acquired his stock after September 27, 2010, his entire gain would have been free from federal income taxation.

The shareholder may elect to exclude from gross income the gain on the sale of certain qualified small business stock to the extent the proceeds are reinvested in any qualified small business stock. The shareholder must have held the stock for more than six months and reinvest the sales proceeds within 60 days after the date of sale.[11] The gain not recognized reduces the basis of the new qualified business stock purchased.[12]

---

[7] IRC Section 1(h)(1).

[8] IRC Section 1202(c)(1)(B).

[9] IRC Section 1202(d).

[10] IRC Section 1202(e)(3).

[11] IRC Section 1045(a).

[12] IRC Section 1044(b)(3).

© 2021 AICPA. All rights reserved.

Example 18.2. Assume that Bob invested $2 million in the stock of a new company called Hy Performance Tools, Inc., which is qualified small business stock. Bob sold the stock to Mike for $2.5 million two years later and realized a $500,000 gain. Bob is not eligible to exclude any part of the gain, regardless of when the stock was acquired because he did not hold the stock for more than five years. Within 60 days after selling his stock, Bob invests $3 million in Bob's Building Supplies Corporation in exchange for its stock. The stock is qualified small business stock. Bob will recognize no gain on the sale of his stock of Hy Performance Tools, Inc. However, his basis in his stock in Bob's Building Supplies Corporation is $2.5 million ($3,000,000 – $500,000).

If the stock qualifies, up to $50,000 a year ($100,000 for married persons filing jointly) of a loss on the sale of closely held business stock is deductible as an ordinary loss, rather than as a capital loss.[13] The stock qualifies for ordinary loss treatment if it is IRC Section 1244 stock. The stock is IRC Section 1244 stock if the shareholder obtained it for money or other property from a corporation that was a small business corporation at the time of issue.[14] A small business corporation cannot have more than $1 million in contributed capital.[15] Any loss in excess of the $50,000 ($100,000 for married persons filing jointly) annual limit will be treated as a capital loss. Ordinary losses are fully deductible, but the maximum net capital loss deduction against ordinary income for an individual is $3,000 a year.[16]

Example 18.3. On October 5, 1998, John invested $600,000 of cash and property in JV, Inc. in exchange for its stock. JV, Inc. did not do as well as John had hoped. On June 18, 2021, John sells half of his stock in JV, Inc. to Jim for $120,000. John realizes a loss of $180,000 ($300,000 basis – $120,000 amount realized). John is married, and he files a joint return. They may deduct $100,000 as an ordinary loss. The remaining $80,000 loss is a long-term capital loss. They did not realize any capital gains during 2021. They may deduct $3,000 of the $80,000 capital loss against their other income and carry a $77,000 long-term capital loss forward to 2022 and later years.

Historically, the major disadvantage of operating as a C corporation has been that the income of a C corporation is potentially subject to double taxation. A C corporation pays taxes on its income at the corporate level. When a C corporation distributes its earnings as dividends, the shareholders pay individual income taxes on the dividends. The dividend distributions are not deductible by the corporation. However, the impact of this double taxation is somewhat minimized because qualified dividends are taxed at the long-term capital gain rate of no more than 20% (15% for individual taxpayers with taxable income less than $445,850 for single filers in 2021, $501,600 for married persons filing jointly in 2021, and 0% for taxpayers below the 22% bracket). In addition, qualified dividends may be subject to the additional 3.8% tax on the net investment income of higher bracket taxpayers. See ¶3330 in chapter 33, "Year-End and New Year Tax Planning," and elsewhere in this guide for more information on the net investment income tax.

---

[13] IRC Section 1244(b).

[14] IRC Section 1244(c)(1).

[15] IRC Section 1244(c)(3)(A).

[16] IRC Section 1211(b).

© 2021 AICPA. All rights reserved.

Combining the 21% C corporate tax rate with a dividend taxable to an individual shareholder makes the C corporation less appealing. In addition, if the C corporation pays out most of its profits as compensation, the corporation gets a deduction for the payment, but the employee may be looking at a tax rate on ordinary income of 37%, or in any event, a rate higher than 21%. C corporations that accumulate income without paying dividends may be charged with the 20% accumulated earnings tax, designed to discourage C corporations from accumulating excessive amounts of income.

.02 Personal Service Corporations

A *personal service corporation* is a C corporation that performs most of its services in such fields as health, law, accounting, engineering, and consulting. In addition, the employees performing the services must own substantially all the stock.[17]A personal service corporation is subject to the same flat tax rate of 21% as other C corporations as the result of the TCJA.[18] See the extensive discussion of personal service corporations in chapter 17, "Planning for the Professional."

.03 S Corporations

The major tax advantage of operating as an S corporation is that the corporation generally pays no income tax. The S Corporation files Form 1120S and passes its income to its shareholders. Shareholders pay taxes on their pro rata shares of the corporate income regardless of whether the corporation distributes it.[19] Shareholders of S corporations may deduct losses on their individual income tax returns to the extent of their basis in their S corporation stock and their loans to the S corporation.[20] However, an S corporation shareholder does not receive any basis for the debts of the S corporation itself or for loans which the shareholder only guarantees. The at-risk rules[21] and the passive activity loss rules[22] may also limit any deduction for losses of the S corporation.

S corporation shareholders may be eligible for the 20% QBI deduction under IRC Section 199A if the activities of the S corporation qualify for the deduction. Note that reasonable compensation paid to S corporation shareholder-employees reduces the qualified business income calculation but does count as W-2 wages. This suggests that S corporations are less advantageous when the taxpayer's taxable income is below the Section 199A thresholds where the type of business activity does not matter but more advantageous when over the thresholds and not a specified service trade or business for purposes of the QBI deduction available under IRC Section 199A.

Distributions of property from an S corporation that does not have any earnings and profits with respect to its stock are generally tax-free to the shareholders to the extent of the shareholder's basis in the S

---

[17] IRC Section 448(d)(2).

[18] IRC Section 11(b)(2).

[19] IRC Section 1366(a).

[20] IRC Section 1366(d).

[21] IRC Section 465.

[22] IRC Section 469.

© 2021 AICPA. All rights reserved.

corporation stock. If the amount of the distribution of property exceeds the shareholder's adjusted basis of his or her stock, the excess is treated as gain from the sale or exchange of property.[23] Although basis in loans to the S corporation by the shareholders allows the deduction of losses, basis in loans to the S corporation does not prevent distributions from being taxable if the basis in the stock is zero. If the S corporation was ever a C corporation with earnings and profits, distributions not out of the S corporation's accumulated adjustments account can be taxable to the shareholders as a dividend.[24] If the S corporation was previously a C corporation, realization of income or sales of assets by the S corporation attributable to the C corporation history could be subject to the built-in gains tax of IRC Section 1374, depending on how many years have passed since the conversion from a C corporation to an S corporation. The PATH Act of 2015 made permanent a five-year look back from the time the C corporation is converted to an S corporation for the built-in gains tax to be effective.

Employee-owners of S corporations are not subject to self-employment tax on the corporation's earnings. Rather, salaries paid to the employee-owners are subject to FICA taxes. Owner-employees of S corporations may not avoid all employment taxes by taking compensation solely in the form of distributions. The IRS will treat such distributions as salary to the extent of the fair market value (FMV) of the employee's services.[25] S corporation shareholder-employees must take "reasonable compensation" from the corporation. S corporations can have qualified subsidiaries for business and legal purposes. The qualified subsidiaries are not separate taxable entities for federal income tax purposes.

S corporations can have only one class of stock.[26] A division of S corporation stock into voting and nonvoting stock is not considered a second class of stock as long as the dividend and preference rights of the voting and nonvoting shares are the same. S corporations can have no more than 100 shareholders.[27] Spouses are treated as one shareholder. In addition, members of six generations of the same family may be treated as one shareholder.[28] Certain types of trusts (grantor, qualified subchapter S trusts, electing small business trusts, and voting trusts) are allowed to be S corporation shareholders. A non-resident alien may not be an S corporation shareholder.

.04 Partnerships

One of the major advantages of operating a business as a partnership is that a partnership does not pay federal income taxes.[29] However, a partnership must file an informational income tax return (Form 1065). The income of the partnership is taxed to the partners. Each partner includes his or her share of

---

[23] IRC Section 1368(b)(1) and (2).

[24] IRC Section 1368(c)(2).

[25] Revenue Ruling 74-44, 1974-1 CB 287.

[26] IRC Section 1361(b)(1)(D).

[27] IRC Section 1361(b)(1)(A).

[28] IRC Section 1361(c)(1).

[29] IRC Section 701.

© 2021 AICPA. All rights reserved.

the partnership's net ordinary income and the partnership's separately stated items of income and deduction on the partner's individual income tax return.[30]

Unlike the limits on the number of S corporation shareholders, a partnership may have an unlimited number of partners. Also, partnerships have more flexibility in allocating income to partners than do S corporations. Generally, the partnership's income and loss is allocated to each partner based on the partnership agreement.[31] The agreement may provide for special allocations among the partners to take into account varying contributions to the partnership. If the partnership has no agreement for sharing profits and losses, then the partner's distributive share of the partnership's income will be based on the partner's interest in the partnership.[32] The IRS may disregard the partnership's special allocation if it does not have substantial economic effect.[33] Special rules apply to contributed property to prevent the partners from assigning to others the gains or losses that accrued on the property before its contribution to the partnership.[34]

A partner may deduct losses from the partnership to the extent of the partner's basis in the partnership.[35] The deduction for losses from the partnership may be further limited by the at-risk rules[36] and the passive activity loss rules.[37] A partner's basis in the partnership includes the partner's share of the partnership's recourse and nonrecourse liabilities.[38] The ability to include the partnership's nonrecourse liabilities in the partner's basis in the partnership is an advantage over operating as an S corporation. However, any reduction in the partner's share of the partnership's liabilities is a deemed distribution of cash to the partner.[39] Distributions of property from the partnership to a partner are tax-free to the extent of the partner's basis in the partnership.[40]

---

[30] IRC Section 702(a).

[31] IRC Section 704(a).

[32] IRC Section 704(b)(1).

[33] IRC Section 704(b)(2).

[34] IRC Section 704(c).

[35] IRC Section 704(d).

[36] IRC Section 465.

[37] IRC Section 469.

[38] IRC Sections 752(a) and 722.

[39] IRC Section 752(b).

[40] IRC Section 731(a)(1).

© 2021 AICPA. All rights reserved.

General partners are subject to self-employment tax on their guaranteed payments and on their distributive shares of the partnership's ordinary income.[41] Limited partners are subject to self-employment tax only on guaranteed payments received for services.[42]

Liability of a general partner is a concern. A general partner is exposed to all of the liabilities of the partnership. A limited partner is only exposed to the possible loss of the limited partner's partnership investment.

Partners (general and limited) may be eligible for the 20% pass-through deduction under IRC Section 199A if the activities of the partnership qualify for the deduction or if the income of the partners is under the applicable threshold.

.05 Limited Liability Companies

LLCs operate under a charter granted by a state. LLCs have the limited liability characteristics of corporations and may have the pass-through entity tax characteristics of partnerships. Owners of LLCs are called members. Members enjoy the limited liability features of a corporation and the ability to be taxed as a partnership. Most limited liability companies with more than one member file tax returns as partnerships.

Under the check-the-box regulations,[43] an LLC with two or more members may elect to be taxed as a partnership or as an association taxable as a corporation (either a C corporation or an S corporation). An LLC with a single member may elect to be taxed as an association taxable as a corporation or to be disregarded as a separate entity. If an LLC with a single member elects to be disregarded as a separate entity, the business will be treated as a sole proprietorship for federal income tax purposes. The member will then file Schedule C of Form 1040. An LLC makes the choice of entity election by filing Form 8832, "Entity Classification Election," with the IRS. The LLC should also attach a copy of Form 8832 to its tax return for the tax year of the election. If the law does not require the LLC to file a tax return for the year of the election, the owners should attach a copy of Form 8832 to their individual income tax returns for the year of the election. Each owner must treat items of income and deduction on his or her return consistent with the election.

If an LLC elects to be treated as an association taxable as a corporation and it wants to make an S election, it does not have to file Form 8832. Filing Form 2553, "Election by a Small Business Corporation," will be deemed to be an election to be taxed as an association as well as an election to be treated as an S corporation.[44]

If a domestic LLC does not make an election, the IRS will treat the company as a partnership if it has two or more members. If the entity has one owner and makes no election, the IRS will disregard the

---

[41] IRC Section 1402(a).

[42] IRC Section 1402(a)(13).

[43] Regulation Section 301.7701-3.

[44] Regulation Section 301.7701-3T(c).

© 2021 AICPA. All rights reserved.

entity for federal income tax purposes.[45] The IRS will treat a foreign eligible entity as a partnership if it has two or more members, and at least one member has unlimited liability. However, if all members have limited liability, the IRS will treat the entity as an association taxable as a corporation. If the foreign entity has a single owner who does not have limited liability, the IRS will disregard the entity.[46]

Limited liability company members may be eligible for the 20% QBI deduction under IRC Section 199A as the result of the TCJA if the activities of the LLC qualify for the deduction.

.06 Sole Proprietorships

A sole proprietorship is the simplest business form. A sole proprietorship does not pay income taxes as an entity. Rather, a sole proprietor reports the income and deductions of a sole proprietorship on his or her own individual income tax return (Form 1040) on Schedule C. The advantage of including the net income or net loss on Schedule C is that the sole proprietor may deduct any losses of the business subject only to the amount-at-risk rules,[47] the passive activity loss rules,[48] and the hobby loss rules.[49] The disadvantage of including all the net income on Schedule C is that unlike a C corporation, a sole proprietor does not enjoy a flat 21% tax rate. The net income of a sole proprietorship is subject to tax at the owner's income tax rate.

Sole proprietors may be eligible for the 20% QBI deduction under IRC Section 199A if the activities of the sole proprietorship qualify for the deduction or if the income of the proprietor is under the applicable threshold.

Sole proprietors must pay self-employment tax on the net income reported on Schedule C.[50] However, the law allows the self-employed taxpayer to claim one half of the self-employment tax liability as a deduction when arriving at AGI (adjustment to income) on Form 1040.[51] Sole proprietors may deduct all the ordinary and necessary business expenses of operating the business on Schedule C.[52] In addition, the law allows sole proprietors special above-the-line deductions on Schedule 1 and page 1 of Form 1040 for health insurance premiums, contributions to medical savings accounts or health savings accounts, and contributions for the owner to simplified employee pension plans, savings incentive match plans for employees, and qualified retirement plans.

---

[45] Regulation Section 301.7701-3(b)(1).

[46] Regulations Section 301.7701-3(b)(2).

[47] IRC Section 465.

[48] IRC Section 183.

[49] IRC Section 469.

[50] IRC Sections 1401 and 1402(a).

[51] IRC Section 164(f).

[52] IRC Section 162(a).

© 2021 AICPA. All rights reserved.

.07 Planning Considerations

S corporations, partnerships, and personal service corporations are subject to restrictions on the use of a fiscal year for tax reporting purposes.[53] These restrictions, along with special elections allowing the use of a fiscal year for a price paid to the IRS, are discussed in the following chapters. C corporations that are not personal service corporations are not subject to these restrictions on the use of a fiscal year.

S corporations and partnerships are not subject to the AMT. However, shareholders and partners are subject to the individual AMT on their shares of pass-through items. The same is true for members of LLCs taxed as partnerships. Sole proprietors are subject to the individual AMT. A two-rate AMT structure applies to non-corporate taxpayers, subject to an exemption. The AMT exemption amounts have been permanently indexed for inflation. The 2021 exemption amounts are $114,600 on a joint return or a return of a surviving spouse; $73,900 for single or head of household; and $57,300 for married persons filing separately. For 2021, the thresholds at which the exemptions begin to be phased out are $1,047,200 for married filing jointly and surviving spouses; $523,600 for single and head of household; and $523,600 for married filing separately.

¶1810 Nontax Factors

One should also consider a number of nontax factors when evaluating the choice of form of business. Certain universal concerns are common to all business plans: risk, finance, control, and continuity. If a business is risky with respect to tort liability or contract liability, the limited liability nature of a corporation or LLC makes these business forms more attractive. The limited liability consideration is especially important if the business owners have substantial wealth outside the business. However, a sole proprietorship or general partnership might be preferable if the business is relatively risk free, easily protected with affordable liability insurance, offers little scope for expansion, and its owners have few assets. The formation, dissolution, and termination of a partnership are much easier than the comparable process for a corporation. The "red tape" required to start, operate, or terminate a non-corporate business is much less extensive than similar activities for a corporation. Nevertheless, the opportunity to avoid liability concerns by utilizing the corporation or LLC is often the most attractive choice for a client. In many cases where a partnership is used, the general partner is organized as an entity, either as a corporation or an LLC to address liability protection.

Often, a corporation can borrow money more easily than other business forms. A corporation may also find attracting and retaining talented employees and accumulating goodwill easier. A corporation can raise capital by selling shares of its stock and also use shares of stock as compensation to reward successful employees.

In a sole proprietorship, the sole proprietor controls the activities of the business. A partnership must decide how to share authority among the partners, who will make decisions, and what mechanisms the partnership will use when the partners disagree. A board of directors makes policy decisions for a corporation and delegates authority for operations to corporate officers and managers. In a corporation serious conflicts can develop over control of the board.

---

[53] IRC Sections 1378, 706(b)(1)(B), and 446(i)(1).

© 2021 AICPA. All rights reserved.

A sole proprietorship dies with its owner. The death of a partner may legally dissolve a partnership. However, with proper planning, the surviving partners can continue the business. As the result of the TCJA, a partnership no longer terminates automatically for federal income tax purposes when no business is carried on by any of the partners in a partnership or a sale or exchange of 50% or more of the total interest in the partnership occurs within a 12-month period.[54] A corporation (whether S or C) has perpetual existence, and shareholders can sell or bequeath the stock freely, subject to the professional corporation transfer limitations discussed in chapter 17, "Planning for the Professional."

¶1815 Disposition of the Business Interest

The financial planner will often need to become involved in advising a client about the tax and other issues that arise when a business interest is sold or transferred. Different considerations apply depending upon the business entity involved.

.01 Disposing of a Proprietorship Interest

A person doing business as a sole proprietor may sell or transfer the business *assets* to another person or entity. The proprietor may not, however, transfer the business *interest* to another person or entity. If the transferee of the business interest is an individual, such transferee must establish his or her own sole proprietorship and file his or her own Schedule C (or Schedule F if the business is a farming business). If assets are sold, there is no single asset referred to as the *business*. Instead, each asset is treated as if it were sold separately. The sale price must be allocated among all the assets, and the cost basis and character of each asset determines whether it has been sold at a gain or loss and whether the gain or loss is ordinary, capital, subject to recapture, and so forth. Gain or loss on the sale of the assets is reported on Form 4797 and Schedule D of Form 1040. The selling proprietor will file a final Schedule C for the last year of the business operations, as well. If the proprietor elects to simply cease doing business, such cessation of business generally does not give rise to any tax consequences, which await the sale, gifting, or other transfer of the business assets.

.02 Sale of a Partnership Interest

The general rule provides that a partner who disposes of an interest in a partnership is treated as disposing of a single asset, rather than a pro rata share of all the underlying assets of the partnership. When a partnership interest is transferred in a taxable transaction, the partner generally recognizes gain or loss measured by the difference between the amount realized and the partner's adjusted basis (the outside basis) in the partnership interest immediately before the disposition.[55]

The gain or loss is generally capital in nature.[56] Whether the gain or loss is long-term or short-term is determined by how long the partner held the partnership interest.[57] If a purchaser assumes the seller's

---

[54] IRC Section 708(b)(1).

[55] IRC Section 741; Regulation Section 1.741-1(a).

[56] IRC Section 741.

[57] IRC Section 1223.

© 2021 AICPA. All rights reserved.

liabilities or if the partnership interest is purchased subject to a liability, the amount of the liability assumed or forgiven is treated as an amount realized by the seller on the sale.[58] When a partner has a negative capital account, the sale of a partnership interest may result in a greater amount of gain being recognized than the amount of cash or other property received for the transferred partnership interest. A partner's basis in his or her partnership interest may never be negative, so that relief from a negative capital account may be viewed as a relief from liability and a distribution of cash.[59]

An important exception to the general rule that a partnership is treated as an entity when determining the tax consequences of a taxable disposition of the partnership interest arises in circumstances when, at the time of a partner's taxable disposition of a partnership interest, the partnership owns assets described in IRC Section 751 (so-called IRC Section 751 property, or "hot assets"). When this is the case, the entity theory of disposing of a partnership interest is dismissed, and the partner is taxed as though he or she sold his or her proportionate share of the partnership's IRC Section 751 property to the purchaser.[60] The portion of the purchase price received for the partner's share of the partnership's IRC Section 751 property is taxed as ordinary income or loss.[61] The remaining gain or loss on the disposition of the partnership interest is treated as capital gain or loss.[62]

Section 751 property refers to *unrealized receivables*, defined in IRC Section 751(c) as the rights to payment for goods delivered or to be delivered to the extent the proceeds therefrom would not be treated as arising from the sale or exchange of a capital asset, as well as the rights to payment for services rendered or to be rendered, such as accounts receivable. This term also refers to the amount of ordinary income that the partnership would be required to include in income under the various recapture provisions of the IRC.

Section 751 property also refers to *inventory items*, defined in IRC Section 751(d) as stock in trade or other property included in the taxpayer's inventory or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, as well as other noncapital assets. When a partnership interest is sold, all inventory is treated as a "hot asset" subject to ordinary income treatment, without regard to the relationship of its value to its cost.

.03 Exchanges of Partnership Interests

An exchange of an interest in one partnership for an interest in another partnership is a taxable event, resulting in the recognition of gain or loss, as if the transaction constituted a sale, as described previously. This rule applies even if the two partnerships have similar businesses, assets, and liabilities. IRC Section 1031, which generally provides for tax-free treatment in the case of the exchange of real

---

[58] IRC Section 752(d).

[59] IRC Sections 704(d), 752.

[60] Regulations Section 1.751-1(a).

[61] IRC Section 751(a).

[62] IRC Sections 742, 1012.

© 2021 AICPA. All rights reserved.

estate properties of like kind, is specifically inapplicable in the case of the exchange of partnership interests.[63]

.04 Non-liquidating Distributions of Partnership Property

A partner does not recognize gain upon receipt of a non-liquidating distribution of property from a partnership other than money.[64] Note that the FMV of marketable securities is considered *money* for purposes of IRC Section 731(a)(1).[65] When a distributee partner is required to recognize gain as the result of a current distribution of property, the gain is generally capital because it is viewed as arising from the sale or exchange of a portion of the partner's partnership interest. However, if the gain is attributable to IRC Section 751 assets as described above, it will be treated as ordinary income.[66] Neither the distributee partner nor the partnership may recognize a loss in connection with a current distribution of cash or property.[67]

If a partner who has contributed appreciated property to the partnership receives a distribution within seven years of that contribution, an exception to the preceding rule applies to tax the partner as if the contributed appreciated property had been sold and the partner's pre-contribution gain recognized.[68]

The partnership itself does not recognize gain on a distribution of money or other property to a partner.[69]

.05 Disposition of an LLC Interest

Similar to the preceding discussion in connection with the LLC and its tax issues on formation, the disposition of an LLC interest will be taxed in a manner commensurate with the type of entity it has elected to become. If the LLC is a single member LLC, and does not make an election to be taxed as a corporation, it will be treated as a disregarded entity, and the tax issues on disposition will be those of a sole proprietorship, as discussed previously. If the LLC has two or more members and elects to be taxed as a partnership or makes no election and defaults and is deemed to be taxed as a partnership, the tax issues on its disposition will be those of a partnership. If the LLC has one member or two or more members and elects to be taxed as either a C corporation or an S corporation, the tax issues on its disposition will be those of a corporation, as discussed in the text that follows.

---

[63] IRC Section 1031(a)(2)(D).

[64] IRC Section 731(a).

[65] IRC Section 731(c).

[66] IRC Sections 731(a) and 731(c)(6).

[67] IRC Section 731(a)(2),(b).

[68] IRC Section 737.

[69] IRC Section 731(b).

© 2021 AICPA. All rights reserved.

.06 Disposing of a C Corporation Business — Tax Considerations

The overriding consideration when there is a disposition of a C corporation interest involves the issue of double taxation and efforts to avoid it. As a general rule, a seller prefers to sell the stock of the C corporation. This allows all the attributes of the business to pass from seller to buyer, results in liabilities passing to the buyer, and avoids double taxation of the seller. The seller will have one level of taxation, generally capital gain as the result of the stock sale. In contrast, the buyer generally prefers to purchase the assets of the seller, rather than the stock. This allows the buyer to select those assets of the seller it desires to acquire and the liabilities it is willing to assume, while avoiding any responsibility for liabilities not assumed. From the tax standpoint, the buyer will prefer to purchase assets because this will give the buyer a basis in the purchased assets equal to the purchase price paid for purposes of depreciation deductions.

If the seller in an asset sale is a C corporation, there will be immediate tax liability at the corporate level. Ordinary income and capital gain are possible, depreciation recapture may apply, and a possible additional level of tax at the shareholder level could apply when the selling corporation is liquidated, and the consideration is distributed to the shareholders. The buyer of assets receives a cost basis in the assets acquired. The buyer does not, however, receive any of the tax attributes of the selling corporation, such as net operating loss carryovers. These attributes are lost if the selling corporation is liquidated and remain with the seller if there is no liquidation.

In a taxable stock acquisition, the selling C corporation shareholder(s) will realize gain or loss in a single level of taxation. The buyer in a taxable stock acquisition acquires a cost basis in the acquired stock. However, the acquired corporation is not affected by the stock acquisition. This means that the corporation's basis in its own assets and its tax attributes (that is, operating or capital losses, deductions, credits, and carryovers) are not affected by the sale. Nevertheless, as the result of complex IRC rules designed to limit "trafficking" in loss corporations, the buyer may face serious restrictions on using the acquired tax attributes, particularly if they are net operating loss carryovers.[70] Because the acquired corporation does not recognize gain or loss on the stock sale, the inherent gain in the corporation's assets remains to be taxed to the buyer.

.07 Disposition of an S Corporation Interest

In an asset sale, when the seller is an S corporation, there is usually one level of tax to the shareholder, but there also may be a corporate level tax if the built-in gain rules of IRC Section 1374 apply (if some of the sold assets are "tainted" with a C corporation history from a conversion from a C to an S corporation within five years of the sale). The buyer of assets receives a cost basis in the assets acquired. The buyer does not, however, receive any of the tax attributes of the selling corporation. These attributes are lost if the selling corporation is liquidated or remain with the seller if there is no liquidation.

In a taxable stock acquisition, the selling shareholder(s) will realize gain or loss, regardless of whether the corporation is a C or S corporation. The buyer in a taxable stock acquisition acquires a cost basis in the acquired stock. However, the acquired corporation is not affected by the stock acquisition. This means that the corporation's basis in its own assets and its tax attributes (that is, operating or capital

[70] IRC Sections 381 and 382.

© 2021 AICPA. All rights reserved.

losses, deductions, credits, and carryovers) are not affected by the sale. Nevertheless, as indicated previously, the buyer may face serious restrictions on using the acquired tax attributes, particularly if they are net operating loss carryovers.[71]

If the buyer prefers to buy assets but is forced to buy stock (perhaps the corporation must be kept alive to preserve contractual rights that may not be assignable or the corporate name is particularly valuable), IRC Section 338(h)(10) allows an election to be made for a stock purchase to be treated as a deemed purchase of assets where a corporate buyer of stock acquires at least 80% of the target company's outstanding shares within a 12-month period. It is the selling corporation that makes the election and therefore is responsible for the tax that results from the deemed liquidation of the corporate assets. The seller will likely require extra consideration from the buyer for making this election. The opportunity to use the IRC Section 338(h)(10) election also applies in the context of a C corporation.

The IRC Section 338(h)(10) election can put the purchaser of stock in the same position it would have been in with respect to the step-up in basis in the assets deemed purchased as if the transaction had been an asset acquisition. If the major asset purchased by the buyer is goodwill, it can be amortized over 15 years, which deduction should more than make up for the extra purchase price paid for the stock because the seller agreed to make the IRC Section 338(h)(10) election.

.08 Taxable Acquisitions: Allocation of the Purchase Price Among the Acquired Assets — General Rules

As a basic general rule of taxation, when a buyer acquires a group of assets in a single transaction, it is required that the purchase price be allocated among the acquired assets.[72]

Assets acquired in a business transaction typically include inventory, land, depreciable property (such as machinery, equipment, and buildings), intangible property (such as copyrights, patents, trademarks, licenses, and software), and customer lists, goodwill, or going concern value.

Historically, how the purchase price was allocated among the various assets was important to both sellers and buyers. Sellers favored allocation to capital assets that avoided or limited taxation, while objecting to allocations to depreciable assets, because this would generate ordinary income from recapture of depreciation. The buyer favored allocation to assets the cost of which could be immediately recovered as sold, such as inventory, or to those assets that were depreciable — as rapidly as possible — to use the tax system to help recover some of the cost of the acquisition. The buyer resisted allocation to assets the cost of which could not be recovered at all, except when the business was ultimately sold or terminated.

The Omnibus Budget Reconciliation Act of 1993 reduced the importance from the buyer's viewpoint of allocating the purchase price away from intangibles, notably goodwill and going concern value, by permitting the amortization of such purchased intangibles ratably over a 15-year period.[73]

---

[71] IRC Sections 381 and 382.

[72] *Williams v. McGowan*, 152 F. 2d 570 (2nd Cir. 1945).

[73] IRC Section 197; Newark Morning Ledger Co. v. United States 507 US 546 (1993).

© 2021 AICPA. All rights reserved.

IRC Section 197 intangibles include goodwill; going concern value; information-based assets, such as know-how, customer lists, workforce in place, accounting systems, and supplier lists; any government granted rights, licenses or permits; covenants not to compete entered into in connection with the acquisition of any interest in a trade or business; and any franchise, trademark, or trade name.[74]

Certain types of property are specifically excluded from the definition of an IRC Section 197 intangible, including interests in land; interests in corporations, partnerships, trusts, and estates; interests in futures contracts or other financial contracts; certain computer software; interests under tangible property leases; interests under certain existing debt; sports franchises and related items; and certain transaction costs.[75]

IRC Section 197 applies only to purchased intangibles and not to taxpayer-created intangibles, even if the value of the self-created intangibles can be estimated.

An IRC Section 197 intangible must be amortized ratably over the 15-year period beginning in the month in which the intangible is acquired. No other depreciation or amortization is permitted with respect to an IRC Section 197 intangible.

.09 Taxable Acquisitions: IRC Section 1060: Specific Rules for Allocation of the Purchase Price

IRC Section 1060 applies to what are referred to as *applicable asset acquisitions*, which are defined to include all taxable acquisitions of a trade or business, including deemed asset sales under IRC Section 338. Nontaxable asset acquisitions are not within this definition because the buyer's basis in the assets acquired in such transactions is determined by reference to the target corporation's basis in such assets.

IRC Section 1060 adopts the "residual" method of allocation, whereby the purchase price is allocated in accordance with a specified system of priorities, first to cash and then to identifiable tangible and intangible assets acquired, up to the amount of the FMV of such assets. Any remaining consideration (the residual amount) is then allocated to goodwill.

The residual method's system of priorities creates seven categories of asset classes. The allocation of the purchase price is performed by first allocating the amount to Class I assets, up to the FMV of such Class I assets, if any. Any amount of the purchase price remaining after the Class I allocation is then allocated to Class II and so on through Class VI assets. Any remaining amount of the purchase price is finally allocated to Class VII.

The seven asset classes are described as follows:[76]

- Class I: Cash and cash equivalents, including general deposit accounts (but not certificates of deposit) held in banks and other depository institutions.

[74] IRC Section 197(d); Regulation Section 1.197-2(b).

[75] IRC Section 197(e); Regulation Section 1.197-2(c).

[76] Regulation Section 1.1060-1; Regulation Section 1.338-6(b).

© 2021 AICPA. All rights reserved.

- Class II: Certificates of deposit, government securities, marketable stock and securities, foreign currency, and similar actively traded personal property.

- Class III: Accounts receivable, mortgages, credit card receivables, and debt instruments (but not those that are contingent or that were issued by related persons).

- Class IV: Inventory and dealer real property, including property held primarily for sale to customers in the ordinary course of business.

- Class V: Identifiable tangible or intangible assets not otherwise included in any of the other six asset classes. This would include items such as land, buildings, machinery used by the taxpayer in the manufacture of goods, and stock owned in closely held corporations.

- Class VI: All IRC Section 197 intangibles other than goodwill and going concern value (including covenants not to compete, regardless of their duration).

- Class VII: Goodwill and going concern value, regardless of whether they qualify as an IRC Section 197 intangible.

Allocations to the first six classes are limited to the FMV of such assets. There is no limit on the amount that may be allocated to Class VII, which is the residual category. For purposes of depreciation, the basis of an asset involved in a transaction to which IRC Section 1060 applies may not exceed the consideration allocated to that asset.[77]

IRC Section 1060 rules still leave a great deal of room for the financial planner to assist the client in negotiating with the other parties to a transaction and in disputing purchase price allocations with the IRS. There is still a significant disparity between the recovery periods of many assets. For example, most equipment costs may generally be recovered over seven years or more rapidly, whereas residential real estate costs must be recovered over 27½ years, and nonresidential real estate costs must be recovered over 39 years. Buyers acquiring the assets of a business will now favor an allocation to goodwill (with its 15-year rate of recovery), rather than to residential or nonresidential real property. Sellers will resist allocations to property requiring recapture of depreciation at ordinary income rates.

Although the assets placed in Classes I, II, and III should lend themselves to valuation without controversy, the residual method of allocation places a substantial premium on valuing Class IV and V assets. This is where the action is for the buyer. Cost recovery and amortization deductions can reduce the effective cost of an acquisition. Allocation to categories and classes more favorable can make a difference. For example, if the buyer requires the seller to accept a covenant not to compete for three years, the purchased covenant is a Class VI asset. Although it will be paid out over three years, it must be amortized over 15 years. Could the buyer and seller reach the same economic result for the seller by reducing the value of the covenant and paying the seller consulting fees, which may be deductible as an ordinary business expense as paid, rather than over a 15-year amortization period?

[77] Regulation Section 1.167(a)-5T.

© 2021 AICPA. All rights reserved.

When a transfer of assets constitutes an applicable asset acquisition, both the buyer and the seller must complete Form 8594, "Asset Acquisition Statement under Section 1060," and attach the form to each of their respective tax returns for the year of the applicable asset acquisition. Although a written agreement with respect to the allocation of consideration in an acquisition is binding on both parties, it is not binding on the IRS, which has the discretion to independently determine what it believes to be a proper allocation. Form 8594 does not require a showing of the individual asset-by-asset allocation of consideration. Instead, the consideration is allocated among the broad asset classes.

¶1820 Conclusions: Evaluating the Choices Among the Available Entities

When a planner begins to analyze which form of entity to recommend, it may be helpful to keep in mind the acronym "CABLED" to be sure to consider all the available options and criteria, as well as the advantages of one form of entity over another:

- "C" is for classes — Is it important to the entity to allow different classes of ownership? Does the recommended entity allow for such classes?

- "A" is for allocations — Does the entity allow for special allocations to the owners in a variety of circumstances?

- "B" is for basis — How is the income tax basis of an owner determined — what effect, if any, will liabilities of the entity have on the owner's basis?

- "L" is for liability — Is an owner protected from liability or exposed to liability for the actions of the entity?

- "E" is for elections — Are there required elections involved with the entity? Are there special tax elections available that can enhance the taxation of an owner?

- "D" is for distributions — Are all the distributions from the entity taxable? Are there special rules about distributions that may enhance the tax position of an owner?

Additionally, the planner should consider the impact of the additional 0.9% Medicare tax on the compensation of high earners, the 3.8% tax on net investment income, and the higher income tax rates for wealthy individuals on these decisions.

© 2021 AICPA. All rights reserved.

Chapter 19

Planning for the Owner of the Closely Held Corporation

¶1901 Overview

¶1905 Initially Planning the Business Structure

¶1910 Recapitalization and Post-Organizational Planning

¶1915 Obtaining Money from the Corporation via Stock Redemptions

¶1920 Using an Employee Stock Ownership Plan in Estate Planning for the Business Owners

¶1925 Qualifying for Installment Payment of the Estate Tax

¶1930 Keeping the Business in the Family

¶1935 Buy-Sell Agreements — Questions and Answers

¶1940 How Shares in Closely Held Corporations Are Valued

¶1945 Electing S Corporation Status

¶1950 Corporate-Owned Life Insurance and the Estate of a Controlling Shareholder

¶1901 Overview

Every owner of a substantial interest in a closely held corporation is a prime candidate for financial planning services. The founder of a closely held corporation is a candidate for such services from the inception of the corporation. A financial planner can do a great deal in the initial planning of the business structure and throughout the life cycle of the business that will yield good short- and long-term financial planning results.

This chapter addresses the financial planning aspects of closely-held businesses, some of which may qualify as a small business. The Small Business Association relief programs are beyond the scope of this guide, but visit the AICPA's Payroll Protection Program page for more resources to help your clients (www.aicpa.org/sba). Access COVID-19 planning strategies and client facing resources from the PFP Section.

.01 Value of the Stock

Stock in the business is usually the principal asset of an owner of a close corporation. Thus, the stock is often the key element in financial planning.

© 2021 AICPA. All rights reserved.

Although the stock in the close corporation can be quite valuable, it is an illiquid asset. For estate and gift tax purposes, it can present difficult valuation problems. The real value of the stock might depend on the founder's talent and drive, which are qualities that valuation experts do not necessarily consider. The value attributable to the founder's work might not be apparent until years after the founder's death. The heirs might become aware of the value of the founder to the close corporation when its earnings begin to decline, and the heirs try to sell their shares.

Special rules that apply for valuing intergenerational transfers of family businesses are discussed in chapter 23, "Impact of Estate Freeze Rules on Intrafamily Transfers."

.02 Key Areas the Financial Planner and Owner Must Address

Successor management. If the real value of the business derives from the current owner's talents, knowledge, contacts, and drive, the owner must plan to develop successor management. If successor management is not available within the family, then the owner must search outside the company or develop an employee within the company to assume management responsibilities. In any case, the financial planner must be prepared to assist in developing incentive compensation programs designed to recruit or retain talent. If the owner cannot find a suitable successor, then the owner and financial planner must formulate a plan to dispose of the business.

Building a second estate. Having virtually everything invested in a business is generally not a good idea. The financial planner and the owner should seek to build a second estate to provide a cushion if the unexpected happens, and the business fails or suffers a downturn. The financial planner must help the owner create plans to take money out of the business. Diversification of asset holdings and investments should be a central message of the financial planner to the business owner. Techniques to take money out of the business include investment in alternative assets not directly connected with the business; dividing the business into distinct enterprises; profit-sharing plans; a stock bonus plan; an employee stock ownership plan (ESOP), with sales of stock to the ESOP trust; or stock redemptions. Another possibility is to give stock to charities to generate income tax deductions. The owner could then invest the tax savings. The business owner should also consider the benefits of life insurance, especially as a source of needed liquidity.

Reserve fund for business. The financial planner should calculate how much extra cash the business may require when the owner dies, in terms of possible loss of key customers, tougher bank financing, and the need for more working capital to allow for successor management's inexperience. Accumulated earnings of a C corporation should be looked at with an eye to IRC Sections 531–537, with particular attention paid to the accumulated earnings credit of IRC Section 535(c)(2), which sets the minimum credit at $250,000 ($150,000 for certain personal service corporations), and IRC Section 537(b) before the tax on excess accumulations may be considered. The latter section permits accumulations for the purpose of IRC Section 303 redemptions in the amount of administration expenses, federal estate taxes, and state death taxes. However, it allows this accumulation only in the year in which the shareholder dies and the years thereafter. The corporation must have other reasonable business needs to justify prior accumulations.

Outside market. Does a market exist for the business? Where is the market? What can the business owner do to enhance marketability? Successor management and building funds within the business will help. What are the possibilities of a merger? Is there a possibility of going public? Should the business owner take steps to prepare the business for a possible public offering, even though only a private offering appears likely?

© 2021 AICPA. All rights reserved.

Sale to insiders. The corporation can use an ESOP to dispose of a major stock interest with highly favorable income tax results (¶1920). Other possibilities include buy-sell agreements between shareholders or business associates or with key employees capable of running the business. If a sale to associates is a possibility, and the associates are in a common age bracket with the owner-client, the financial planner should consider whether to arrange a buy-sell at a moderate bargain price or to seek a higher price. If all associates agree, a bargain price could be to the client's advantage if co-owners and associates predecease the client. The buy-sell price will aid, if not control, the valuation for estate tax purposes, provided special valuation rules contained in IRC Section 2703 and discussed in ¶2310 are satisfied. When the potential buyers and sellers are related persons, any buy-sell agreement price is viewed with permitted statutory skepticism by the IRS. If the parties are unrelated persons, the price used in a buy-sell agreement is given a presumption of fairness — neither party can be sure of being the buyer or the seller, hence, the suggestion that a "fair" price will be arrived at to protect each party's interests.

Estate taxes. What will the owner's estate tax be under the present plan? To what extent is the owner-client relying on the marital deduction[1] to reduce estate tax liabilities? What will happen if the spouse predeceases the client? What if the spouse survives and retains a significant stock interest until death? How much unified credit[2] is expected to be available? What steps are open to reduce the estate tax impact? Lifetime gifts? Charitable giving? Lifetime sale of the business? Life insurance? Fixing valuation? Is there a DSUE available through the portability rules? What may be the impact of state estate and inheritance taxes in addition to the federal estate tax? What will the transfer tax exclusion be in the year of death? These are some of the questions that the financial planner should ask before addressing planning techniques to deal with the answers to these questions.

Estate liquidity. After determining the potential federal and state estate tax impact, the financial planner should calculate how much money the estate will need to pay debts, funeral expenses, administration expenses, federal and state death taxes, and cash bequests. How will the estate obtain the money required? What liquid assets will the estate likely have? What outside resources are available? Will individual heirs or trusts be in a position to lend funds to the estate or purchase illiquid assets? To what extent can the estate rely on stock redemptions under IRC Sections 302 or 303 to meet liquidity needs? Will the business be in a position to accomplish the redemptions? If not, what steps can the business owner take to enable it to do so? Can the estate qualify for installment payments of the federal estate tax (¶1925)?

Stepped-up basis. Stock retained until death will receive, as a general rule under current law, a basis equal to its fair market value (FMV) for estate tax purposes.[3] All income tax liability for prior appreciation will be eliminated, leaving more money for the estate or heirs on a sale or redemption. This factor affects the choice between lifetime gifts of stock (when the basis carries over from the donor to the donee) and testamentary dispositions. With the 20% capital gains rate for wealthy taxpayers in 2021

[1] IRC Section 2056.

[2] IRC Section 2010.

[3] IRC Section 1014(a).

© 2021 AICPA. All rights reserved.

and subjecting capital gains to the 3.8% tax on net investment income, planning for increases in income tax basis takes on greater importance.

Valuation. What steps can the business owner take to fix the value of the stock for sale or estate tax purposes? Is discounting appropriate? The financial planner should encourage clients to use bona fide appraisals when needed to satisfy the adequate disclosure rules of the IRS.

Recapitalization and restructuring. Recapitalizing to a mix of common and preferred stock offers a number of financial and estate planning advantages. This technique is only available to a C corporation because an S corporation may not issue preferred stock. An S corporation may have voting and nonvoting stock without violating the single class of stock rule for S corporations, as long as the preferences attributable to each category of stock are identical. Some of those strategies are discussed in ¶1910.

Executive benefits. To the extent that the client occupies the position of an executive in a closely held corporation, all the planning considerations discussed in chapter 16, "Planning for the Executive," apply.

The concept of "personal goodwill" — a way to avoid double taxation in a C corporation. A decision of the Tax Court addressing the concept of "personal goodwill" suggests a strategy to avoid the double taxation to which C corporations and their shareholders are subject when the assets of a C corporation are sold.

C corporation sellers may try to avoid the double tax by suggesting a stock sale, but sophisticated buyers who agree to a stock sale will typically try to discount the purchase price because there will not be a stepped-up basis in the corporate assets.

A possible solution to the C corporation asset sale is to have the shareholders sell their personal goodwill in the business. If this planning is successful, the sellers of the goodwill pay a single level of tax at long-term capital gain rates, and the buyer obtains the same amortizable asset it would have received if it had purchased an intangible asset from the corporation.

The leading cases that support a personal goodwill argument are *Martin Ice Cream v. Commissioner*, 110 T.C. 189 (1998) (distributor relationships belonged to the seller, not to the corporation, so the buyer purchased a capital asset from the seller, rather than receiving an appreciated corporate asset) and *Norwalk v. Commissioner*, 76 TCM 208 (1998) (client relationships were the individual property of the selling accountants and shareholders, rather than the property of the corporation).

The IRS opposes this concept, and has successfully challenged it in *Muskat v. Commissioner*, 554 F.3d 183 (1st Cir. 2009) (there were no negotiations for personal goodwill, and payments for a noncompetition agreement did not qualify); *Howard v. Commissioner*, No. 10-35768 (9th Cir. 8/29/11) (a dentist had an employment agreement with his corporation, and the court concluded his services and practice were conveyed to the corporation via the employment contract, and were corporate assets); and *H & M, Inc. v. Commissioner*, T.C. Memo 2012-290 (a leading life insurance salesman sold his corporation and claimed personal goodwill based on his reputation). This was denied because there was no purchase price allocation to personal goodwill and the taxpayer entered into a covenant not to compete.

To be successful in the personal goodwill argument, it appears necessary to raise the issue early in the negotiations and allocate something valuable to it; possibly supported by an independent appraisal and

© 2021 AICPA. All rights reserved.

avoid having employment or noncompete agreements with the corporation that convert personal goodwill to a corporate asset.

The personal goodwill issue again surfaced in the U.S. Tax Court in the case of *Bross Trucking, Inc. v. Commissioner*, T.C. Memo, 2014-107. The Tax Court determined that the goodwill of a trucking business was not corporate goodwill, but personal to its owner and sole shareholder. Because the goodwill was not considered part of the assets of the corporation, the corporation did not distribute appreciated intangible assets in the form of goodwill to the owner and therefore did not recognize gain.

The court distinguished two different goodwill situations. It recognized personal goodwill developed and owned by shareholders and corporate goodwill, developed and owned by the company. In this case, the court found that the trucking business of the taxpayer may have lost its goodwill due to an investigation, so that any remaining goodwill was owned by the taxpayer personally.

Importantly, the court found that taxpayer had not transferred his goodwill to the trucking business. There was no employment contract or noncompete agreement. The taxpayer was free to leave the business and take his personal assets with him.

In another case, the taxpayer was successful in reducing the value of stock included in a decedent's estate by asserting that the personal goodwill of a valuable employee should not be attributed to the value of the corporation. In *Estate of Adell*, TCM 2014-155, the Tax Court noted the importance of a key employee to the value of a decedent's business and stated:

> A key employee may personally create and own goodwill independent of the corporate employer by developing client relationships. Although employees may transfer that goodwill by a noncompete clause or other type of contract, absent such an agreement, the employer cannot freely use the asset and the value of the goodwill should not be attributed to the corporation.

Expect the IRS to challenge a claim of personal goodwill when it is involved in a transaction involving a C corporation where the IRS can assert a double tax claim, as well as in a disputed valuation situation where the taxpayer seeks to reduce a business valuation by the personal goodwill of the key employees. However, the cases indicate that where the shareholder (or key employee) does have a reputation or special relationships (often seen, for example, in the sale of a medical practice) and significantly there is no employment agreement or noncompete agreement restricting the asset to the corporation, the shareholder (or key employee) may then be free to treat the goodwill as his or her own personal asset.

¶1905 Initially Planning the Business Structure

Placing all business operations in one corporation is not always necessary or appropriate. The financial planner should not overlook the possibility of combining the corporate form with individual, LLC, or partnership ownership of the elements of the business enterprise. The financial planner should also consider the use of multiple corporations. Multiple entities can open the door to many attractive financial planning possibilities.

For example, assume a business is engaged in the manufacture and sale of widgets. The business owner might set the business operations up as follows. The business owner uses a corporation for the operating part of the business — to do the manufacturing and selling and to carry inventory and accounts receivable. The corporation receives a certain amount of working capital. The real estate and the plant in which the corporation operates, however, are owned by the shareholders preferably in limited partnership or LLC form and are leased to the corporation. The corporation does not own the machinery

© 2021 AICPA. All rights reserved.

and equipment it uses to manufacture the widgets. A limited partnership, in which the corporation is the general partner, owns the machinery and equipment. The shareholders are limited partners, along with one or more trusts for the children of shareholders. The partnership leases the machinery to the corporation. If the business owner has extensive office equipment, computers, and fax machines, these too might be owned by the partnership or individual family members and leased to the corporation. Of course, the leasing arrangements must be fair and reasonable based on terms that might have been obtained in truly arm's-length transactions.

What has been accomplished by using this structure? The shareholders, as owners of the real estate, might incur losses in the early years to offset their other income. However, the losses are losses from passive activities, which include business activities in which the taxpayer does not materially participate and the rental of any tangible property (irrespective of material participation).[4] A taxpayer may generally only use passive losses to offset income from passive activities[5] until the taxpayer disposes of the property in a taxable transaction to an unrelated party.[6] The taxpayer carries the disallowed passive activity losses forward to the next tax year.[7]

Passive income does not include portfolio income (interest, dividends, and capital gains).[8] However, under a special exception for rental real estate in which an individual actively participates, the taxpayer may deduct annually up to $25,000 of losses against nonpassive income. The $25,000 loss allowance is phased out ratably (lose $1 deduction for every $2 of income) between $100,000 and $150,000 of AGI.[9] Another exception to the prohibition on the deduction of passive losses permits certain closely held corporations (but not including personal service corporations) to use passive losses to offset business income, but not portfolio income.[10] A special "self-rental rule" treats as active income the rental income received when a taxpayer rents property to a related entity to avoid the taxpayer manipulating positive rental income to take advantage of offsetting passive losses from other activities.[11] Self-rental income is also treated as active for purposes of the net investment income tax, so it is not subject to that tax.[12]

Assuming that the shareholders have deducted the losses from the real estate, when the real estate begins to generate a net income, the shareholders can make gifts of the real estate to trusts for their children. These gifts may produce income tax savings by moving the taxable income to persons in lower tax

---

[4] IRC Section 469(c).

[5] IRC Section 469(d)(1).

[6] IRC Section 469(g).

[7] IRC Section 469(b).

[8] IRC Section 469(e)(1).

[9] IRC Section 469(i).

[10] IRC Section 469(e)(2).

[11] Regulation Section 1.469-2(f)(6).

[12] Regulation Section 1.1411-4(g)(6).

© 2021 AICPA. All rights reserved.

brackets (if the children are not subject to the kiddie tax) while removing the real estate from the shareholders' gross estates. In addition, the gifts may provide the children with income to be used or accumulated for worthwhile purposes.

The rental income going to the limited partnership that owns the machinery and equipment could be offset, in part, by depreciation deductions. If the partnership shows losses, the benefit of the depreciation deductions would be limited under the passive activity loss rules discussed previously.

One or more of the suggested entities may be eligible for the 20% qualified business income deduction from taxable income available for owners of pass-through entities under IRC Section 199A.

The fact that the corporation does not own the real estate, the machinery, or equipment might not have a material effect on the price obtainable on an eventual sale of the corporate stock. Earnings from the business operations are more likely to be the controlling factor when determining the value of the corporation.

Planning opportunities are available when structuring the corporation itself. This chapter will not examine issues such as taxable or tax-free incorporation and other income tax factors. However, income tax factors are often related to financial planning.

Rather, this chapter will concentrate on the capital structure of the corporation. If the corporation has more than one class of stock, it cannot be an S corporation.[13] Differences in voting rights alone, however, will not create a second class of stock for S corporation purposes.[14]

Under Subchapter S, corporate profits and losses are generally passed through to shareholders.[15] Therefore, using an S corporation avoids the double taxation otherwise inherent in the C corporation form. The S corporation election is discussed in detail in ¶1945.

Also, the financial planner should give some thought to the use of multiple corporations to multiply accumulated earnings credits[16] and split income between separate entities. C corporations will be given greater consideration with the 21% flat tax rate arising under the TCJA.

¶1910 Recapitalization and Post-Organizational Planning

At one time, recapitalizing a corporation with a mix of common and preferred stock offered financial and estate planning advantages with respect to intrafamily transfers. Congress enacted IRC Section 2036(c) in 1987 largely to eliminate these advantages, but Congress repealed this provision in 1990 and replaced it with new rules for valuing transfers of interests in family businesses. These rules are contained in IRC Sections 2701 through 2704 and discussed in chapter 23, "Impact of Estate Freeze

[13] IRC Section 1361(b)(1).

[14] Regulation Section 1.1361-1(l)(1).

[15] IRC Section 1366.

[16] IRC Section 535(c).

© 2021 AICPA. All rights reserved.

Rules on Intrafamily Transfers." The following discussion is a theoretical analysis related to recapitalizations of both family-owned companies and companies owned by unrelated parties. However, family companies must apply the IRC Section 2701 rules to determine whether a recapitalization results in a gift. If a gift results, the family companies must determine the amount of the gift.

.01 Reasons for Recapitalization

Raising capital. When raising capital, one of the concerns of management is to retain control of the company. Raising capital from venture capitalists or other investors usually requires issuance of securities convertible into common stock, such as convertible debentures or convertible preferred stock. Depending on the negotiating power of each party, one possibility is to convert the common stock into separate class A voting stock and class B nonvoting stock. Management would retain the class A stock, while reserving the class B stock for issuance to the investors on conversion. A variation, when allowed under applicable state law, might be some form of weighted voting stock with each class A share having 10 votes and each class B share having one vote.

Successor management. Hiring younger management is important to the continuity of any business. Senior management is concerned about maintaining control and having minority shareholders in the event a junior executive leaves the company. These concerns may be addressed by issuing nonvoting stock to junior executives, which they may convert to voting stock over time, with a buy-back agreement for the stock in the event of termination of employment. Another alternative is to issue voting stock to junior management but restrict the voting rights of junior management for a specified period.

Retirement planning for senior management. A business owner might have a substantial portion of his or her assets invested in a closely held company. When approaching retirement, the business owner is concerned with converting the investment into a retirement fund to ensure sufficient liquidity during retirement and possibly for estate tax purposes. Advance planning is important. Such planning should include an agreement among the shareholders addressing the sale of the stock, including guidelines for computing the price of the stock, indicating how it is to be paid, and providing security for the payment. The shareholders may consider converting the common stock into preferred stock or debt, with put and call options exercisable at various times.

Dissension among the owners. A solution to any dissension among the owners can take several forms, such as a buyout, a division of the company, or a complete liquidation. Sometimes, the shareholders can provide for consequences of dissension in a buy-sell agreement. The agreement might provide a mechanism for triggering a put or call of the shares or for conversion into a nonvoting security.

Recapitalizations can take on many forms depending on the circumstances involved in each situation. A recapitalization provides management with flexibility.

.02 Sale-Leasebacks

In the initial structuring of a business, keeping the real estate and machinery out of the corporation can be desirable from a financial planning point of view. Instead of having all the assets held in the corporation, individuals through an LLC or a partnership of the shareholders or members of their families can own the real estate and machinery and lease them to the corporation. If the corporation owns the real estate and machinery from the outset, later, the corporation might be able to enter a sale-leaseback arrangement with a shareholder, partnership, or outside family members or trusts. The IRS watches such sale-leaseback transactions closely. The IRS might challenge the sale-leaseback on the grounds that it is a sham transaction. However, if the arrangement is not a sham because it has the

© 2021 AICPA. All rights reserved.

elements of an arm's-length transaction, and makes economic sense (for example, by providing additional financing for the corporation) it may withstand an IRS challenge.

¶1915 Obtaining Money From the Corporation Via Stock Redemptions

Converting stock of a closely held corporation into cash without undue sacrifice of the stock's real value can be one of the prime problems of the estate of a substantial shareholder. If the corporation has sufficient money, redemption of all or part of the stock held by the estate or its beneficiaries is a way of extracting the cash from the corporation. If the estate is not careful, however, a redemption might be at the price of a deeper discount than if the estate had sold the stock to an existing shareholder or a stranger. The tax law may treat the stock redemption as a dividend,[17] instead of as a sale qualifying for capital gain taxation, unless certain strict corporate redemption requirements of IRC Section 302 are satisfied. Although qualified dividends are taxed at the same maximum 20% rate as long-term capital gains in 2021, qualifying the redemption as a sale is still far preferable to dividend treatment. That is because a sale will allow the basis of the stock redeemed to be offset against the redemption proceeds, so that only the net difference is taxable. With dividend treatment, the entire redemption proceeds are taxable (to the extent of the corporation's earnings and profits). Also, if the stock passes from a decedent, its tax basis would be its FMV at the date of death or six months later at the alternate valuation date if the alternate valuation date is available.[18]

Thus, qualifying the redemption to be taxed as a sale or exchange and not as a dividend is important. The IRC provides two routes by which a shareholder may achieve this objective. One is IRC Section 302, which deals with distributions in redemption of stock. The other is IRC Section 303, which deals with distributions in redemption of stock to pay death taxes and funeral and administration expenses. Neither route is free from difficulty. However, IRC Section 303 is usually the easier route, assuming, of course, that there has been a death of a shareholder with a substantial interest in the corporation.

If a redemption following the death of a shareholder qualifies for sale or exchange treatment under IRC Sections 302 or 303, the amount distributed in excess of basis will be taxed as a long-term capital gain. The law deems capital assets acquired from a decedent to have been held long term, regardless of the actual holding period.[19] If a redemption does not qualify for sale or exchange treatment under either provision, the full amount received is taxed as a dividend if the corporation has sufficient earnings and profits.[20]

Qualified dividends are taxed at a maximum rate of 20% for 2021. A net capital gain is the excess of net capital gains over any net capital losses.[21] The tax rate for a net capital gain is the lower of the regular

---

[17] IRC Section 302(d).

[18] IRC Section 1014(a).

[19] IRC Section 1223(11).

[20] IRC Sections 301(c)(1) and 316(a).

[21] IRC Section 1222(11).

© 2021 AICPA. All rights reserved.

tax rate or the alternative tax rate.[22] The alternative tax rate for net capital gains consists of various layers, depending on a number of factors, including the nature of the property sold and the overall tax bracket of the seller. These layers can cause all, or part, of a net capital gain to be taxed at rates ranging from zero to 37%, depending upon the nature of the asset sold, holding period, and the income tax bracket of the seller.[23] In 2021, the maximum long-term capital gain rate and the tax rate on qualified dividends is 20% for persons with taxable income of more than $501,600 (married filing jointly) or $445,800 (single). The thresholds for these taxes are indexed annually for inflation. The additional 3.8% tax on net investment income applies for single filers with AGI over $200,000 and married joint return filers with AGI over $250,000. The thresholds for the net investment income tax are not indexed for inflation. (See ¶3330 in chapter 33, "Year-End and New Year Tax Planning," and chapter 38, "Planning for the Net Investment Income Tax," for more information on the net investment income tax). The 25% and 28% rates continue to apply to certain specialized types of gain.

To take advantage of IRC Section 303, the value of the closely held business stock in the decedent's gross estate must be more than 35% of the value of the decedent's adjusted gross estate (the gross value of the estate reduced by allowable expenses, losses, and debts).[24] The redeeming shareholder will receive capital gains treatment only to the extent that the shareholder's interest is reduced directly (or through a binding obligation to contribute) by payment of the deceased shareholder's death taxes or funeral or administration expenses.[25] Special rules apply if two or more separate corporations are involved, as noted in the text that follows.[26]

The amount that the corporation may distribute in accordance with IRC Section 303 without the distribution being taxed as a dividend is limited by the amount of estate taxes and interest thereon and the amount of funeral and administration expenses allowable as deductions for federal estate tax purposes.[27] If the corporation's distribution in redemption of stock exceeds the limits, the excess will be taxed as dividend income to the extent of the corporation's earnings and profits,[28] unless the distribution qualifies for capital gains treatment under the general corporate redemption provisions of IRC Section 302.

To qualify under IRC Section 303, the redemption must take place after the decedent's death and generally within the three-year period allowed for the assessment of estate tax. This period begins when the estate tax return is filed (normally within nine months of death), plus 90 days, or, if the estate files a petition with the U.S. Tax Court to challenge an IRS determination of estate tax, within 60 days of the court's final decision, whichever period is longer. However, if the executor has made an election to pay

---

[22] IRC Section 1(h).

[23] IRC Section 1(h).

[24] IRC Section 303(b)(2).

[25] IRC Section 303(b)(3).

[26] IRC Section 303(b)(2)(B).

[27] IRC Section 303(a).

[28] IRC Sections 301(c) and 316(a).

© 2021 AICPA. All rights reserved.

the federal estate tax in installments under IRC Section 6166 (¶1925), the time for redemption under IRC Section 303 extends to the due date of the last installment.[29] In the case of redemptions made more than four years after death absent the election to pay the federal estate tax in installments, capital gains treatment is limited to the lesser of (1) the aggregate amount of death taxes, funeral, and administration expenses remaining unpaid immediately before the redemption or (2) the total amount of such taxes and expenses paid within one year of the redemption.[30]

.01 Two or More Separate Corporations and IRC Section 303

Often, a decedent owns stock in two or more closely held corporations. For example, a decedent might own an interest in a real estate corporation that leases property to an operating corporation in which the decedent holds an interest. In such case, if the decedent's gross estate includes 20% or more in value of the stock of each of two or more corporations, then the estate may aggregate the values of the combined shares when determining whether the estate satisfies the 35% test of IRC Section 303.[31]

.02 Important Considerations Affecting Use of IRC Section 303

IRC Section 303, despite its restrictions, is a way of extracting cash (and property) from a closely held corporation in a tax-favored way. The estate can use the cash to satisfy its liquidity needs. However, the executor should consider the following negative factors.

Control of the business. If the stock to be redeemed represents the swing vote in the control of the business, the executor should weigh the loss of control against the benefits to be obtained. Revenue Ruling 87-132[32] offers a way of maintaining relative voting strength. In the case that gave rise to this ruling, a company had outstanding 300 shares of voting common stock owned equally by an estate and an individual who had no interest in the estate. The estate wanted to accomplish an IRC Section 303 redemption but did not want to lose relative voting power. A proposed solution was to issue a stock dividend of 1,500 shares of new nonvoting common to each of the two shareholders and then have the estate immediately redeem 1,000 of the new nonvoting shares in an IRC Section 303 redemption. The problem with the proposed solution was that under existing IRS rulings, a stock distribution that is immediately redeemable is taxable, rather than being tax-free under IRC Section 305. The IRS, recognizing that IRC Section 303 is remedial and the time factors involved, carved out an exception for IRC Section 303 redemptions. In such a case, the stock dividend is tax-free notwithstanding the immediate redemption.

To implement this type of solution, the redeeming shareholder might need to persuade the other shareholders to consent to the stock dividend and redemption. This consent may be necessary, even when the party seeking the solution is in control under applicable state law or corporate charter

---

[29] IRC Section 303(b)(1).

[30] IRC Section 303(b)(4).

[31] IRC Section 303(b)(2)(B).

[32] 1987-2 CB 82.

© 2021 AICPA. All rights reserved.

provisions. This plan, depending on state law, may require a greater-than-majority vote to effect such corporate action.

A corporation can use a tax-free recapitalization per IRC Section 368 to achieve similar results. If the stock dividend and recapitalization solutions are not feasible, the shareholders should consider limiting the amount redeemed so that control will not be lost or relative voting strength will not be drastically weakened. Again, the shareholders must consider the effect of state law and corporate charter provisions.

Notwithstanding the favorable result of Revenue Ruling 87-132, note that this result was only possible due to the willingness of the surviving shareholder to allow the stock dividend to avoid having the decedent's family's interest being diluted by an IRC Section 303 redemption. Not every surviving shareholder can be counted on to be as generous. The financial planner should assess the situation in which an IRC Section 303 may be likely and recommend a corporate recapitalization or stock dividend before any shareholder dies. At that time, because no shareholder will know which will be the first to die, it is likely that there will be greater cooperation in bringing about the desired corporate action.

Effect on business operations. How will taking cash or property for redemption purposes affect the operation of the business? Will working capital be depleted to an unreasonable degree? Will plans for replacement or expansion of plant and equipment be affected? What will the redemption do to the value of the shares, if any, retained? The shareholders should address these and similar questions. The IRC Section 303 redemption opportunity should not be viewed as the "Plan A" succession plan for a closely held corporate business. It is a helpful fallback if no other appropriate planning has taken place but should be viewed cautiously as a likely drain on the corporation's available assets or borrowing power, or both.

Loss of deferred payment benefits. IRC Section 6166 provides for deferred payment of estate taxes over 14 years when the estate includes a qualifying closely held business, as discussed in ¶1925. However, the estate might lose the benefits of electing installment payment of estate taxes and face an accelerated liability if the estate or heirs divest themselves of 50% or more of the value of their interest in the business before all of the installments have been paid. The shareholders must exercise caution to keep any sales or redemptions within the percentage limit, or the redemption proceeds will have to be used to pay the accelerated liability for the deferred federal estate taxes.

Nevertheless, if the distributions in redemption of stock to pay taxes to comply with IRC Section 6166 result from compliance with the provisions of an IRC Section 303 election, the redemption of stock and the withdrawal of money and other property distributed in the redemption will not be treated as a distribution or withdrawal that will cause an acceleration of the balance of the deferred tax to become due.[33]

Redemptions by different parties. Redemptions by different parties might pose some problems. As noted previously, capital gain treatment is available to a redeeming shareholder only to the extent that the shareholder's interest is reduced directly (or through a binding obligation to contribute) by any payment of death taxes or funeral or administration expenses. This requirement obviously limits the

[33] IRC Section 6166(g)(1)(B)(i).

© 2021 AICPA. All rights reserved.

number of shareholders able to take advantage of IRC Section 303. A corporation might have two or more shareholders who qualify for redemption under IRC Section 303, when the decedent's will bequeaths the stock to two or more persons. If two or more redemptions occur, the regulations take a first-come, first-served approach, regardless of whether the particular redemption might have qualified as an exchange under IRC Section 302.

If multiple redemptions occur, the corporation and the redeeming shareholders should attempt to qualify the redemptions under IRC Section 302 in order not to waste the IRC Section 303 limits. The following discussion addresses additional planning issues regarding IRC Section 303 redemptions.

Valuation of stock. The redemption price will not necessarily be the same as the value that the IRS puts on the stock for estate tax purposes. If the redemption price exceeds the value finally determined for estate tax purposes, the redeeming shareholder will realize a capital gain.

.03 Planning for IRC Section 303 Redemptions

Advance planning is often required to take advantage of IRC Section 303 in order to avoid any adverse side effects. Some of the key factors to consider are as follows.

Meeting the 35% test. In some cases, the shareholders will have no problem meeting the requirement that the stock includible in the decedent's gross estate is more than 35% of the value of the adjusted gross estate. However, if the client anticipates difficulty satisfying this test, the financial planner might consider the following strategies:

- *Lifetime gifts.* Gifts of property other than the business stock made more than three years before death will reduce the estate and help the stock interest to meet the 35% test. Gifts within the $15,000 annual exclusion limit (for 2021 and indexed annually for inflation) made within three years of death can also help in meeting the 35% test. However, other gifts made within three years of death in excess of the annual exclusion amount will be includible in the gross estate calculation for the purpose of testing availability of IRC Section 303 with respect to the 35% test.[34]

- *Transfer of property to a corporation.* A shareholder may transfer property to a corporation tax-free under IRC Section 351 in exchange for more stock. The shareholder might transfer property to the corporation that he or she has been leasing to the corporation in exchange for more corporate stock. The exchange increases the percentage of stock in the shareholder's estate.

- *Sale of nonbusiness assets.* A sale of nonbusiness assets and investment of the proceeds in the business will reduce the percentage of nonbusiness assets in the gross estate. The investment in the business will increase the value of the family member's stock.

- *Gift tax marital deduction planning.* Use of the estate tax marital deduction[35] will help in meeting the 35% test. In addition, the use of the gift tax marital deduction[36] will help if the

[34] IRC Section 2035(c)(1).

[35] IRC Section 2056.

[36] IRC Section 2523.

© 2021 AICPA. All rights reserved.

shareholder makes the gifts more than three years before death. Although gifts within three years of death are generally not includible in the gross estate of the donor, such gifts (other than those qualifying for the annual gift tax exclusion) are includible only for the purpose of determining IRC Section 303 eligibility.[37]

- *Creation of spousal joint tenancies.* An individual who is not prepared to make an outright gift to a spouse to help meet the 35% test should consider creating a joint tenancy with the spouse. An individual may create a joint tenancy with a spouse with no gift tax consequences because of the unlimited marital deduction.[38] Only one half of the property that a decedent holds in joint tenancy with a spouse is includible in the decedent's gross estate.[39] Generally, only the half that is includible in the decedent's gross estate receives a stepped-up basis at the decedent's death. However, both halves of community property receive a tax-free step-up in basis if the decedent's gross estate includes at least half the value of the property.[40]

- *Multiple corporations.* If the client holds stock in two or more corporations and is still unable to meet the 35% rule even with the multiple corporation 20% aggregation rule, a merger or consolidation of the corporations might serve to meet the qualifying tests. The client could also set up a holding company to hold the stock of the separate corporations. The stock of the holding company might then meet the IRC Section 303 tests. Establishing an independent business purpose for the holding company is important to avoid the requirement to make dividend distributions to avoid personal holding company tax under IRC Section 541. However, despite possible difficulties, the personal holding company merits consideration if other means of satisfying the IRC Section 303 tests are not feasible.

Preparing the corporation for redemptions. The corporation must have the money to redeem the stock. If the client is counting on the IRC Section 303 redemption to satisfy the estate's liquidity needs, the corporation must have cash or cash equivalents on hand. If the estate's liquidity is not a major concern, then the corporation can distribute illiquid property in redemption of the stock. The corporation could distribute property that is used in the business and plan a lease-back arrangement that permits the corporation to continue to use the property and provides liquidity to the estate through the rent payments. Note that if appreciated property is used in a redemption here, it may trigger a gain to the distributing corporation upon the distribution of such appreciated property.

In lieu of cash, the corporation may give a shareholder its note. The redemption will then be deemed to have been made when the corporation gives the note, not when it pays the note.[41] This option gives the

---

[37] IRC Section 2035(c)(1).

[38] IRC Section 2523.

[39] IRC Section 2040(b).

[40] IRC Sections 1014(a) and 1014(b)(6).

[41] Revenue Ruling 65-289, 1965-2 CB 86.

© 2021 AICPA. All rights reserved.

corporation additional time to pay for the stock. If the stock is not publicly traded, the shareholder may recognize gain, if any, realized on the redemption using the installment method.[42]

Life insurance owned by the corporation on the life of the shareholder-executive may also finance the redemption. The corporation will receive the insurance proceeds income tax-free.[43] The proceeds will be included in the decedent's gross estate if the decedent had any incidents of ownership in the policy.[44] However, incidents of ownership are not attributed to the insured solely because the proceeds are payable to a corporation that he or she controls.[45] Nevertheless, life insurance proceeds payable to the corporation will be a factor in determining the value of the stock for estate tax purposes.[46] For these reasons, allowing a member of the decedent's family or an irrevocable life insurance trust to own the policy to keep the proceeds out of the decedent's gross estate might be better. The policy owner could then lend the proceeds to the corporation in order to accomplish the IRC Section 303 redemption.

A C corporation's accumulation of earnings to meet redemption needs exposes the corporation to the risk of the accumulated earnings tax.[47] However, accumulations to meet "the reasonable needs of the business" are permissible. IRC Section 537(a) defines the quoted phrase to include IRC Section 303 needs of the business, which in IRC Section 537(b) are defined as to permit accumulation in the tax year of the corporation in which a shareholder dies, or any taxable year thereafter, of an amount needed, or reasonably anticipated to be needed, to redeem stock under and within the limits of IRC Section 303. If the corporation starts accumulating funds for an eventual redemption under IRC Section 303 in years before death occurs, it may be hit with an accumulated earnings tax (with a tax rate of 20% for 2021 and thereafter) when more than $250,000 has been accumulated ($150,000 in the case of certain personal service corporations). The corporation can reduce the risk of the accumulated earnings tax by documenting other reasonable business needs for accumulating earnings. S corporations and their shareholders are not subject to the accumulated earnings tax.

Maintaining control. When there are ownership interests in the corporation outside of the decedent's family, redemptions can shift the balance of control unless the shareholders do something about it. Be careful if a family with a 50% ownership interest transfers any of the decedent's voting shares in an IRC Section 303 redemption. Control (or "stand-off control") may be lost to the other 50% owners. If the corporation has only common stock, one of the things to consider is a recapitalization. In the recapitalization, the corporation would issue common stock and nonvoting preferred (or nonvoting common) stock. The corporation could then redeem the preferred or nonvoting common stock without affecting control. A 50% ownership family can maintain its voting power. The common stock and preferred stock are combined when applying the 35% test. If preferred stock is authorized but unissued,

---

[42] IRC Section 453.

[43] IRC Section 101(a)(1).

[44] IRC Section 2042(2).

[45] Regulation Section 20.2042-1(c)(6).

[46] Regulation Section 20.2031-2(f).

[47] IRC Section 531.

© 2021 AICPA. All rights reserved.

a simple approach would be to issue preferred stock as a stock dividend (before death). Note that preferred stock can only be issued by a C corporation, not by an S corporation. An S corporation may, however, issue voting and nonvoting common stock in a recapitalization and avoid the prohibition on S corporations having two classes of stock as long as the preferences of the voting and nonvoting shares are identical.

A dividend of preferred stock on a C corporation's common stock would constitute IRC Section 306 stock. A shareholder usually realizes ordinary income on the sale of IRC Section 306 stock to the extent of the stock's ratable share of the corporation's earnings and profits at the time the corporation distributed the IRC Section 306 stock.[48] The stock is also IRC Section 306 stock in the hands of a transferee if the transferee determines his or her basis in the stock by reference to the basis of any other person in the IRC Section 306 stock.[49] Thus, IRC Section 306 stock received as a gift retains its character as IRC Section 306 stock.

Nevertheless, IRC Section 306 stock received from a decedent that has a basis equal to its FMV at the date of the decedent's death or at the alternate valuation date will no longer be IRC Section 306 stock.[50] Therefore, the C corporation could redeem preferred stock that a taxpayer received from a decedent, and IRC Section 306 would not apply. If IRC Section 306 is applicable, any excess of the amount realized over the stock's ratable share of the corporation's earnings and profits first reduces the basis of the IRC Section 306 stock and then is treated as gain on the sale of the stock.[51] A shareholder may not recognize a loss on the sale of IRC Section 306 stock.[52] If the shareholder transfers the IRC Section 306 stock to the corporation as a redemption, the amount received in the redemption is treated as a dividend to the extent of the corporation's earnings and profits at the time of the redemption.[53] Any amount received in excess of the earnings and profits first reduces the basis in the stock[54] and then is treated as a gain on the sale or exchange of the stock.[55]

An exception to the usual rules of IRC Section 306 applies if the shareholder disposes of the IRC Section 306 stock in a sale to an unrelated party that completely terminates the shareholder's entire stock interest in the corporation.[56] If the shareholder disposes of his or her IRC Section 306 stock in a redemption, the usual IRC Section 306 rules will not apply if the redemption qualifies as an exchange

---

[48] IRC Section 306(a)(1)(A).

[49] IRC Section 306(c)(1)(C).

[50] IRC Section 306(c)(1)(C).

[51] IRC Section 306(a)(1)(B).

[52] IRC Section 306(a)(1)(C).

[53] IRC Sections 306(a)(2), 301(c)(1), and 316(a).

[54] IRC Section 301(c)(2).

[55] IRC Section 301(c)(3)(A).

[56] IRC Section 306(b)(1)(A).

© 2021 AICPA. All rights reserved.

under IRC Section 302(b)(3) as a complete termination of interest, or an exchange under IRC Section 302(b)(4) as a partial liquidation or an exchange under IRC Section 331 in complete liquidation of the corporation.[57] In addition, the usual IRC Section 306 rules will not apply when gain or loss is not recognized to the shareholder or when the transactions do not have a principal purpose of avoiding federal income tax.[58]

Limiting redemption. All redemptions qualifying under IRC Section 303 count against the IRC Section 303 limit on redemptions, including those that would qualify as exchanges under IRC Section 302. The corporation needs a plan to avoid redemptions under IRC Section 303 in excess of its limits. One approach might be a contract between the shareholders and the corporation under the terms of which the corporation is bound to redeem only as much of a shareholder's stock as the decedent's executor deems necessary, appropriate, and fair to all concerned.

.04 Redemptions under IRC Section 302

Apart from IRC Section 303, the general rule is that a corporate distribution to a shareholder out of earnings and profits, including a redemption, is to be treated as a dividend and not as a payment in exchange for stock.[59] However, four important exceptions under IRC Section 302(b) apply to redemptions that permit them to be treated as sales, not dividends:

1. A redemption not essentially equivalent to a dividend
2. A substantially disproportionate redemption
3. A complete termination of the shareholder's interest
4. Redemptions from non-corporate shareholders in partial liquidation

A redemption is not essentially equivalent to a dividend if it results in a "meaningful" reduction of the shareholder's "interest" in the corporation. Under the regulations, a determination of this issue must be made on a case-by-case basis. For this reason, the focus is usually on the second and third exceptions where there are more definitive rules. However, Revenue Rulings 75-502,[60] 75-512,[61] and 78-401[62] provide some specific guidance on the availability of the first exception.

The first ruling indicated that the factors to be considered focus on the shareholder's right to vote and exercise control, to participate in current earnings and accumulated surplus, and to share in the net assets

---

[57] IRC Sections 306(b)(1)(B) and 306(b)(2).

[58] IRC Section 306(b)(3) and (4).

[59] IRC Sections 301(c)(1) and 302(d).

[60] 1975-2 CB 111.

[61] 1975-2 CB 112.

[62] 1978-2 CB 127.

© 2021 AICPA. All rights reserved.

on liquidation. Where these rights are significantly reduced, the redemption may not be essentially equivalent to a dividend.

In the second ruling, the IRS held that a reduction of a shareholder's interest from 57% to 50%, with the remaining 50% interest being held by an unrelated party, was meaningful. Revenue Ruling 78-401 held that a reduction of a shareholder's interest from 90% to 60% was not meaningful because the shareholder retained the power to control the day-to-day operations of the company. This factor, rather than the shareholder's reduced interest in earnings and surplus or liquidation proceeds, was given controlling weight. The fact that some corporate actions might require more than a 60% vote was deemed to be of no consequence when the corporation did not show such actions to be imminent.

A *substantially disproportionate redemption* is one that reduces the shareholder's percentage of voting stock interest below 80% of what it was before the redemption and leaves the shareholder with less than 50% of the corporation's outstanding stock. The required application of the attribution or constructive ownership rules set out in IRC Section 318 complicate the matter considerably.

The thrust of these rules is that the redeeming shareholder is treated as owning not only the shares registered in his or her own name but also those owned by his or her spouse, children, grandchildren, parents, estates or trusts of which the shareholder is the beneficiary, partnerships of which he or she is a member, and corporations in which he or she owns a majority of the stock interest. Furthermore, stock owned directly or indirectly by a beneficiary of an estate is considered owned by the estate.

Because of these attribution rules, satisfying the substantially disproportionate redemption exception is often difficult before or after the death of the shareholder of a closely held family corporation.

One possible way of getting around the attribution rules after death would be if a beneficiary of the estate that holds the decedent's stock has ceased to be a beneficiary at the time of the redemption. Regulation Section 1.318-3(a) says that an individual is no longer a beneficiary when he or she has received all the property he or she is entitled to, no longer has a claim against the estate, and only a remote possibility exists that the estate will seek a return of the property or payment to satisfy claims against the estate or expenses of administration. The IRS has ruled that the interest of a residuary legatee is not terminated until the estate is closed.[63] Even with a special legatee, as long as the valuation of the closely held stock remains open, the IRS might consider the special legatee as a beneficiary.

If a shareholder completely terminates the shareholder's interest in the corporation, the redemption may qualify for sale or exchange treatment. A complete termination may also meet the disproportionate redemption rules discussed previously. In a complete termination, the constructive ownership rules of IRC Section 318(a)(1) do not apply, provided that the redeeming shareholder (1) has no interest in the corporation other than as a creditor for at least 10 years after the redemption; (2) agrees to notify the IRS of any acquisition of an interest in the corporation within the 10-year period; and (3) retains all records of the redemption for 10 years. The prohibited interests include a position as an officer, director, or employee of the corporation.[64] This provision allows the corporation to redeem all of the shareholder's stock using an installment note. If the stock is not publicly traded, the shareholder may defer the

[63] Revenue Ruling 60-18, 1960-1 CB 145.

[64] IRC Section 302(c)(2)(A).

© 2021 AICPA. All rights reserved.

recognition of any gain realized using the installment method.[65] Redeeming the stock with an installment note might be an attractive option to corporations that lack sufficient cash to pay for the stock immediately.

The shareholder will lose the benefit of the waiver of the constructive ownership rules in certain circumstances beyond those involved in the reacquisition of an interest within the 10-year period. This waiver does not apply if (1) any part of the stock redeemed was acquired from a related person within 10 years or (2) any related person owns stock at the time of the redemption, the ownership of which is attributable to the redeeming shareholder, and such person acquired any stock in the corporation from the redeeming shareholder within 10 years, and the stock so acquired is not redeemed in the same transaction. However, these limitations do not apply if the acquisition or disposition of stock does not have as one of its principal purposes the avoidance of federal income tax.[66] Thus, the IRS might not consider gifts of stock to children as part of an ongoing gift program to have tax avoidance as a principal purpose.[67]

IRC Section 302(c)(2)(C) specifically provides that entities may waive the family attribution rules. However, beneficiaries must join in the waiver and must agree to be jointly and severally liable with the entity for any deficiency resulting from an acquisition by any of them within the 10-year period discussed previously. The term *entity* includes trusts, estates, partnerships, and corporations. No provision exists for a waiver of attribution to and from entities and their beneficiaries. To the extent that these attribution rules apply, essentially the same problems and solutions exist under this exception that exist under the disproportionate exception, that is, when these rules apply, qualifying for capital gain treatment in an otherwise compliant redemption transaction is very difficult.

.05 Partial Liquidation

Under the safe harbor rule of IRC Section 302(e), a distribution is a partial liquidation for the purposes of the fourth exception to dividend treatment in these cases:

- It is not essentially equivalent to a dividend (determined at the corporate level) and occurs in the year in which the corporation adopts a plan of partial liquidation (or in the following year).
- The distribution occurs under a plan to cease conducting a business that has been actively conducted for at least five years.
- The corporation did not acquire the business in a taxable transaction within the last five years.
- The corporation is actively engaged in another trade or business.

---

[65] IRC Section 453.

[66] IRC Section 302(c)(2)(B).

[67] IRS Letter Ruling 8236023, June 8, 1982.

© 2021 AICPA. All rights reserved.

.06 Distributions of Property

The corporation recognizes gain,[68] but not loss,[69] on a distribution of appreciated property as if the corporation sold the property in exchange for the redeemed stock in a corporate redemption for its FMV. However, the FMV of the property will be treated as not less than the amount of a liability on the property to which the property is subject or which the shareholder assumed.[70] Whether the redemption is treated as a dividend or an exchange to the shareholder has no effect on the recognition of gain or loss by the corporation on a distribution of property.

.07 Dividend Distributions

If a distribution does not qualify as a stock redemption under IRC Section 302 or 303, then it is treated as a dividend paid to the shareholder. Qualified dividends are generally taxed at the same zero to 20% rates that apply to net long-term capital gains. Dividends are taxable only to the extent of the corporation's current and accumulated earnings and profits.[71] Dividends may also be subject to the 3.8% net investment income tax, depending on the recipient's AGI.

A distribution that exceeds earnings and profits is treated first as a tax-free recovery of the shareholder's basis for the stock.[72] Basis can only be reduced to zero. Any distribution that exceeds both earnings and profits and the shareholder's basis in the stock is treated as capital gain.[73]

Stock redemptions treated as dividends. A stock redemption that is treated as a dividend differs from other types of dividend distributions because the shareholder has actually surrendered stock to the corporation for which he or she had a basis. Because the redemption is treated as a dividend, the shareholder cannot use the basis to offset the redemption proceeds. Instead, the basis of the shareholder's remaining stock is adjusted to account for the basis of the stock redeemed. When the redeeming shareholder owns no remaining stock, the basis is allocated to other shareholders whose stock ownership is attributed to the redeeming shareholder under IRC Section 318.[74]

¶1920 Using an ESOP in Estate Planning for the Business Owners

ESOPs offer advantages for small business employers and their employees. ESOPs as employee benefits were discussed in ¶910. This chapter discusses ESOPs from the standpoint of their use for post-organizational planning for business interests.

---

[68] IRC Section 311(b).

[69] IRC Section 311(a).

[70] IRC Section 311 (b)(2) and IRC Section 336(b).

[71] IRC Section 316(a).

[72] IRC Section 301(c)(2).

[73] IRC Section 301(c)(3)(A).

[74] Regulation Section 1.302-2(c).

© 2021 AICPA. All rights reserved.

In ¶1915, this publication discusses the problems faced by the shareholder in a closely held corporation who undertakes to have the corporation redeem the shareholder's stock before death, as well as the problems confronting the owner's estate. The corporation itself faces a major problem. It must accumulate the funds for a redemption, and it can accumulate those funds only out of after-tax dollars. The corporation can carry life insurance on a key shareholder-executive, and the collection of the proceeds will not be taxable to the corporation.[75] However, the corporation may not deduct the premiums.[76] Insurance can help with redemptions after a shareholder's death only if the shareholder is insurable at the time of applying for life insurance.

A dramatic change takes place when a corporation uses an ESOP. The annual cash contributions a company makes to an ESOP are tax deductible. If a shareholder dies and the ESOP has sufficient cash, it purchases the shareholder's stock from his or her estate. Thus, the ESOP has acquired the stock with pretax, not after-tax dollars, because each dollar the company contributed to the ESOP was tax deductible.

.01 Tax-Free Rollover on Sale of Qualified Securities to ESOPs

When one of the founders of an ESOP-sponsoring business is ready to retire and surrender control, the founder might be concerned about lack of diversification because a disproportionate amount of the founder's net worth may be concentrated in the company stock. IRC Section 1042 permits such an individual, or his or her estate, to sell employer securities to the ESOP and defer recognition of gain by reinvesting the proceeds in securities of domestic corporations meeting certain tests. However, such deferral is available only if the holder of the company securities has held them for at least three years before the sale to the ESOP. In order to qualify for this deferral opportunity, the ESOP must hold at least 30% of the outstanding stock of each class of stock of the corporation after the sale of the owner's interest has been concluded.[77]

The basis of the stock in the domestic corporations acquired by the shareholder is reduced by the amount of the deferred gain so that if the shareholder sells the securities acquired, the shareholder will recognize the deferred gain.[78] If the shareholder holds the securities until death and they have appreciated in value, the shares receive a step-up in basis[79] and all income tax liability for pre-death appreciation is eliminated.[80]

---

[75] IRC Section 101(a)(1).

[76] IRC Section 264(a).

[77] IRC Section 1042(b)(2).

[78] IRC Section 1042(e).

[79] IRC Section 1014(a).

[80] IRC Section 1042(e)(3).

© 2021 AICPA. All rights reserved.

.02 Financing

Formerly, there was an exclusion from income for 50% of interest income received on loans made to an ESOP or to an employer-corporation, the proceeds of which are used by the ESOP to acquire employer securities (so-called "leveraged ESOPs"). The exclusion, available to banks, insurance companies, other commercial lenders, and regulated investment companies, was generally repealed for loans made after August 20, 1996.[81] However, the exclusion continues to apply to such loans made under a written binding contract in effect before June 10, 1996.[82] The exclusion also continues to apply to certain loans made after August 20, 1996, to refinance loans made before August 21, 1996. Qualified refinancing loans must meet the requirements of IRC Section 133 before repeal and not increase the outstanding principal amount of the prior loan and not extend the term of the original loan.

.03 Dividends

Dividends paid in accordance with the ESOP plan provisions on securities held by an ESOP on the record date are deductible by the corporation if paid (1) in cash to the participants in the plan or to their beneficiaries; (2) to the plan and distributed in cash to the participants in the plan or their beneficiaries; or (3) if used to make payments to repay stock acquisition loans but only if the dividends involved are on the stock acquired by the loan.[83]

¶1925 Qualifying for Installment Payment of the Estate Tax

The federal estate tax is due and payable nine months after death.[84] If the value of an interest in a closely held business exceeds 35% of the value of the adjusted gross estate (gross value of the estate reduced by allowable expenses, losses, and debts),[85] the executor may elect to pay the estate taxes attributable to the business interest (but not the estate taxes attributable to nonbusiness assets) in two or more, but not more than 10, annual installments, with interest only on the unpaid tax due for four years, and the actual installment payments of the unpaid tax due beginning in the fifth year following the decedent's date of death. A closely held business means an interest owned as

- a sole proprietorship or
- a partner in a partnership
  - — having 45 or fewer partners or
  - — in which the decedent owned 20% or more of the capital.

---

[81] IRC Section 133, repealed by the Small Business Job Protection Act of 1996 (P.L. 104-188).

[82] Small Business Job Protection Act of 1996 (P.L. 104-188, Act Sec. 1602(c)(3).

[83] IRC Section 404(k).

[84] IRC Sections 6075(a) and 6151(a).

[85] IRC Section 6166(b)(6).

© 2021 AICPA. All rights reserved.

- an owner of stock in a corporation
  - — having 45 or fewer shareholders or
  - — in which the decedent owned 20% or more of the voting stock.[86]

.01 Installment Requirements

The installment payments must be equal. If the executor makes the election to pay such estate taxes in installments, the first installment payment is due no more than five years after the prescribed date for paying the federal estate taxes. The maximum payment period is 14 years, rather than 15 years, because the due date for the last interest-only payment is the same date as the due date for the first installment payment of the tax.[87] This provision allows the estate to defer the estate taxes attributable to the business interest for up to 14 years, with a special 2% interest rate applicable to the estate taxes on the first $1 million[88] (indexed for inflation under IRC Section 6601(j)(3)) in taxable value of the closely held business. The inflation-adjusted amount for the estate of a 2021 decedent is $1,590,000. For the purpose of meeting the 20% ownership requirement, shares of corporate voting stock held by members of the decedent's family, as well as the decedent's own voting stock, are to be counted.[89] Family members are spouse, children and grandchildren, parents, brothers, and sisters.[90] These attribution rules are not applied when determining the number of partners or shareholders.

If the estate obtains this 14-year extension for payment of taxes, the estate must pay only interest annually during the first four years. The estate may pay the tax owed in annual installments with interest over the next 10 years. As indicated previously, the inflation-adjusted amount for the estate of a 2021 is $1,590,000. If the amount of the estate tax extended under IRC Section 6166 is less than this amount, only the lower amount qualifies for the special 2% rate.[91] Any amounts of deferred estate tax that are in excess of the amount that qualifies for the 2% rate (called the "2% amount") are taxed at a rate equal to 45% of the rate, determined by the IRS, that applies to underpayments of tax.[92] The interest paid on the estate tax deferred under IRC Section 6166 is not deductible on the decedent's estate tax return (Form 706) [93]or on the estate's income tax return (Form 1041) filed for the decedent's estate.[94]

---

[86] IRC Section 6166(b)(1).

[87] IRC Sections 6166(a)(3) and 6166(f)(1).

[88] IRC Section 6601(j)(1)(A).

[89] IRC Section 6166(b)(2)(D).

[90] IRC Sections 6166(b)(2)(D) and 267 (c)(4).

[91] IRC Section 6601(j)(2).

[92] IRC Section 6601(j)(1)(B).

[93] IRC Section 2053(c)(1)(D).

[94] IRC Section 163(k).

© 2021 AICPA. All rights reserved.

Example 19.1. Brenda died in 2009, when the applicable exclusion amount was $3.5 million. The estate tax value of her closely held corporate interest was $5 million and her executor elected, pursuant to IRC Section 6166, to extend the time for payment of the federal estate taxes. The amount of estate tax attributable to the value of the corporation between $3.5 million and $4,830,000 (the number for 2009 decedents) is eligible for the 2% interest rate. The 2% portion is $618,500, computed as follows: a $2,074,300 tentative estate tax on $4,830,000 minus $1,455,800 (the applicable credit amount for 2009). An interest rate of 45% of the rate applicable to underpayments of tax is assessed against the portion of the estate tax exceeding the $618,500 amount.

If the estate has undistributed net income for any taxable year after its fourth taxable year, the executor must apply it to the unpaid estate taxes.[95]

The 14-year extension can help overcome a cash squeeze, at the small price of low interest rates. In situations in which an extension of time to pay the estate tax appears to be of possible use but there is some question about whether the estate can meet the more than 35% of the adjusted gross estate attributable to closely held businesses test for installment tax payment, the financial planner should give some thought to strategies that will help satisfy the test. The client could either increase the size of the closely held corporate interest, reduce the size of the other parts of the estate through gifting, or both.

The number of shareholders for purposes of the 45-shareholder limitation is to be determined immediately before the decedent's death.[96] Spouses holding stock in any form are counted as one shareholder.[97] If a partnership, other corporation, or trust is a shareholder, the partners, other shareholders, and beneficiaries of the trust are all counted as shareholders.[98] The latter provision is designed to prevent circumvention of the 45-shareholder limitation through the use of these other entities.

The maximum amount of estate tax deferrable is the amount of estate tax attributable to the closely held business interest. This amount is determined by the ratio of the value of the closely held business interest to the adjusted gross estate.[99] In addition, if during the installment payment period, one half or more in value of the corporate voting stock (or other qualifying business interest) is sold, or if aggregate withdrawals (distributions) are made that equal one half of the value of the corporate interest (or other qualifying business interest), there is an immediate acceleration of the unpaid balance of the estate tax.[100] This rule suggests that the deferral provision has practical long-term value only in situations in which the executor or heirs will continue to hold the voting stock in the closely held corporation (or other qualifying business interest).

---

[95] IRC Section 6166(g)(2)(A).

[96] IRC Section 6166(b)(2)(A).

[97] IRC Section 6166(b)(2)(B).

[98] IRC Section 6166(b)(1)(C).

[99] IRC Section 6166(a)(2).

[100] IRC Section 6166(g)(1)(A).

© 2021 AICPA. All rights reserved.

The executor or personal representative may make the deferral election with respect to certain qualified holding companies, provided that the indirectly owned interest would meet the requirements of IRC Section 6166 had the decedent owned it directly.[101] But the 2% interest rate and five-year deferral of principal are not available to holding companies. Also, any portion of the value of the decedent's businesses attributable to clearly passive assets does not qualify.[102] When the business involves the management of passive investment assets, it may not qualify as a closely held business for purposes of IRC Section 6166. If additional services are performed, converting the activity to a service enterprise, a qualifying business interest will be found.[103] Revenue Ruling 2006-34 liberalized the availability of IRC Section 6166 deferral for persons holding real estate investments and engaging in some active management of those investments.

This 14-year extension for paying the estate tax is a good planning tool if the estate can meet the 35% test. The 14-year extension is not subject to a means test or a need test. Large estates with ample liquidity may qualify for the 14-year extension for paying the estate tax attributable to a closely held business.

To meet the 35% test in borderline situations, the business owner should consider making lifetime gifts of nonbusiness assets more than three years before death. The unlimited marital deduction for lifetime gifts[104] offers one possibility of reducing the size of the business owner's estate. Lifetime gifts to non-spouse beneficiaries taking advantage of the $15,000 annual exclusion (for 2021),[105] which is indexed annually for inflation under IRC Section 2503(b)(2), is another way to reduce the adjusted gross estate. Gift splitting with one's spouse[106] would be another way to make gifts with favorable tax consequences to help the estate qualify for the installment payment of the estate tax. The sale of nonbusiness assets and the acquisition of additional business assets with the proceeds might be another way to help the estate qualify for the installment payment of estate taxes. Administration expenses will also help meet the qualification requirements.

The amount of estate tax eligible for installment payments is reduced by the amounts distributed in an IRC Section 303 redemption in accordance with IRC Section 6166(g)(1)(B) (¶1915). This reduction is a factor in determining whether to use an IRC Section 303 stock redemption or the tax deferral offered by IRC Section 6166.

To take advantage of the installment payment of estate taxes, the executor must make the election on or before the due date of the estate tax return or any extensions. The executor should make the decision well in advance of the deadline to allow time to resolve any questions. To make the IRC Section 6166

---

[101] IRC Section 6166(b)(8).

[102] IRC Section 6166(b)(9).

[103] PLR 199929025.

[104] IRC Section 2523(a).

[105] IRC Section 2503(b)(1).

[106] IRC Section 2513.

© 2021 AICPA. All rights reserved.

election, check the applicable box on Form 706 and attach the required statement (described in the instructions for Form 706) and calculation to Form 706 when it is filed.

When measuring the federal estate tax attributable to the closely held voting stock or other qualifying business interest, one multiplies the estate tax by a fraction. The numerator is the value of the closely held voting stock or other qualifying business interest, and the denominator is the decedent's adjusted gross estate.

.02 Reasonable Cause Extension

An estate may obtain a discretionary extension of the time for payment of estate tax from the IRS for up to 10 years for reasonable cause.[107] Regulation Section 20.6161-1(a)(1) contains four examples of reasonable cause, including situations in which an estate cannot readily sell its illiquid assets to pay estate taxes, or the estate consists, in large part, of valuable rights to receive payments in the future.

¶1930 Keeping the Business in the Family

Is the business worth keeping in the family? That is an initial question to be addressed by the financial planner in the course of advising the business owner while living and ultimately by the surviving family members. The shareholders must weigh not only current earnings but also potential future earnings in the light of possible changes in the market, technology, capital requirements, competition, supplies, and labor. If patents, copyrights, licenses, leases, or other assets that can be classified as wasting assets are involved, the shareholders must also take their future expiration into account.

If the business is worth retaining, the next question is: Who will manage the business? The first place to look for management is within the family. A business owner must realize that the process of choosing and implementing a succession plan can be difficult. The owner may face issues of control, sibling rivalries, equality of treatment, love, money, and taxes, not to mention the owner's own mortality.

The overlap of family and business relationships can make the task of grooming a successor from within the family much more difficult than grooming an outsider to take over. Ideally, the business owner can take various steps to make the transition run smoothly.

The business owner might want to establish an outside board of directors or advisers who would help select and train a successor. The business owner should establish specific rules for hiring family members. The owner should go so far as to develop qualifications for positions. Anyone, even a family member, would have to meet the qualifications to be hired.

Creating a development plan for potential successors is essential. The business owner's unexpected death or sudden disability could leave the company without needed leadership in the absence of a plan. The plan must address how the successor will acquire the technical expertise and skills needed to take control. In addition, a mechanism should exist for an ongoing evaluation of the successor's performance during the transition phase.

---

[107] IRC Section 6161(a)(2).

© 2021 AICPA. All rights reserved.

The business owner must teach every aspect of the business to the successor. Before turning over the reins completely, the owner can let the successor manage a department and evaluate the successor's performance.

Sometimes, personality conflicts make grooming a child to take over for a parent extremely difficult. In such a case, the parent should consider bringing in an outside mentor. The parent would need to consider cost factors.

The family can use counseling if an absolute stalemate develops. Alternatively, the business owner can establish a family council to resolve conflicts.

To recruit and retain competent management, the corporation must arrange special compensation. Executive compensation arrangements are discussed in ¶1605. Recapitalization is one route that offers outside management an equity interest while preserving family control. On the other hand, if vesting control in management seems wiser, the corporation can give the new management voting common stock and give the family preferred stock, which can provide a steady income.

If broad-based employee participation in the ownership of the enterprise appears to afford a sounder basis for successful operation of the business, then the shareholders should consider an ESOP.

Depending on the circumstances of the particular case, efforts aimed at keeping the business in the family might be aided by the use of the special use valuation election (¶2210.01) and the election to defer payment of estate taxes (¶1925).

¶1935 Buy-Sell Agreements — Questions and Answers

The owner of a closely held corporation is naturally concerned about what will happen to the corporation upon the owner's death. Although a corporation may exist in perpetuity, many practical problems must be solved to ensure the continuity of a business. A buy-sell agreement deals with some of the problems.

A *buy-sell agreement* is a contract providing for the sale of the corporate stock upon the happening of a specified event. Generally, this event is the death of one of the stockholders. However, the agreement can also provide for a sale upon the disability, retirement, or withdrawal of one of the parties. Buy-sell agreements may establish value for transfer tax purposes if they meet the rules contained in IRC Section 2703 (discussed in ¶2310).

The following questions and answers offer guidance in the practical lifetime structuring of buy-sell agreements. Where estate tax will be due, planning before death can help avert two serious tax problems: determining the value of the stock for estate tax purposes and identifying the source of funds to pay the estate tax (this problem is particularly important because of the limited market for the stock of a closely held corporation).

Q. What are the key advantages of a buy-sell agreement?

A. In the absence of a buy-sell agreement, the corporate stock might be unmarketable. The agreement avoids a forced sale or the unwilling or unwelcome participation in the business of the decedent's surviving spouse or heirs. If the decedent's estate receives cash in exchange for the corporation's stock, funds are available for payment of federal and state estate taxes, payment of estate administration expenses, ongoing family support, and other necessary purposes.

© 2021 AICPA. All rights reserved.

The buy-sell agreement provides for corporate succession and control of the business according to the parties' desires. The agreement dispels fears that the business will terminate on the death of one of the stockholders. It is also a morale booster for key employees who otherwise might fear loss of their jobs. The agreement eliminates the risk of the corporation being barred from an S corporation election by reason of a nonqualifying or non-consenting stockholder.

Q. How does a buy-sell agreement work?

A. There are three types of buy-sell agreements:

1. The *cross-purchase agreement* is a buy-sell agreement that exists among stockholders. Example: A corporation has two stockholders, A and B. A and B both agree that, upon either's death, the decedent's estate must sell, and the survivor must purchase the decedent's stock.

2. The *stock redemption agreement* is an agreement to which the corporation and the shareholders are parties. The corporation agrees to buy (redeem) the decedent's stock. Example: A corporation has two shareholders, A and B. Both agree that their estates will sell or tender for redemption the shares they owned to the corporation (see ¶1915 for a discussion of stock redemptions generally).

3. In a *hybrid* or *combination agreement*, the corporation and the stockholders agree to buy the decedent's stock. Such an agreement consists of both a cross-purchase and a redemption agreement. Example: A corporation has two shareholders; each owns 100 shares of stock. There is a cross-purchase agreement for 50 shares of stock (or an option for a stockholder to purchase 50 shares of stock and a corporate stock redemption agreement for the remaining 50, or 100 if the option is not exercised). Unless the surviving stockholders buy their agreed portion before the redemption by the corporation, the redemption proceeds may be taxable as a dividend to the estate. Therefore, the surviving stockholders must take extreme care that the corporate redemption does not occur first.

Q. How can funds be obtained to pay for the stock?

A. Funding a buy-sell agreement with life insurance is generally advised. When the stockholders use the cross-purchase approach, each stockholder owns an insurance policy on the life of every other stockholder. If the agreement provides for redemption of the stock by the corporation, the corporation carries a life insurance policy on each stockholder whose stock is to be purchased. Upon the death of a stockholder, the corporation or the surviving stockholder (depending on the type of agreement) collects the insurance proceeds. The surviving stockholders or the corporation then use the proceeds to purchase the stock of the deceased stockholder. The stockholders can use existing policies if a stockholder becomes uninsurable. Good planning suggests acquiring insurance to fund a buy-sell agreement sooner rather than later, whereas delay suggests that issues of health and insurability could create problems. When a corporation has only two stockholders, use of a single first-to-die policy covering both stockholders should be less costly than using two separate policies (¶705).

© 2021 AICPA. All rights reserved.

Making periodic contributions to a sinking fund is a method that is particularly valuable when a stockholder is uninsurable. However, if the corporation is a C corporation, it must exercise care to avoid the accumulated earnings tax.[108]

Q. What are the tax consequences of a cross-purchase agreement?

A. Life insurance premiums paid by the stockholders are not deductible.[109] Insurance proceeds paid to the surviving stockholder are exempt from income tax if the policy is acquired directly from an insurance company.[110] If the policy is acquired from another stockholder, proceeds are excluded from income only to the extent of consideration and premiums and other amounts paid by the transferee of the policy.[111] This is the so-called "transfer for value rule," which can be avoided by having the insurance policies owned by a corporation or a partnership or a grantor-type trust, but not owned by another stockholder.[112]

Transfer of shares between the stockholders has no tax effect on the corporation.

Sale of the decedent's stock by his or her heirs or estate will result in taxable gain to the extent that the sale proceeds exceed basis[113] (that is, a basis at death equal to the value of the stock for estate tax purposes under IRC Section 1014(a)). Sellers of the decedent's stock must include in gross income any interest they receive on the deferred portion of the selling price.[114] In the typical case, the purchase price is equal to the date-of-death value of the shares sold by the seller, so the selling stockholder's estate or heirs does not realize any gain, except for the situation of estates of certain decedents that passed away in 2010, whose estates opted out of the federal estate tax system, and must follow the carryover basis rules. See ¶1005 for further details.

The basis of the surviving stockholders in the corporate shares they buy is equal to the shares' purchase price.[115]

Q. What are the tax consequences of a stock redemption agreement?

A. Life insurance premiums paid by the corporation to fund the redemption of shares are not deductible.[116] The investment of corporate funds in life insurance policies to fund a buy-sell

---

[108] IRC Sections 531-537.

[109] IRC Section 264(a).

[110] IRC Section 101(a)(2).

[111] IRC Section 101(a)(2).

[112] IRS Letter Ruling 9012063, December 28, 1989; Rev. Rul. 2007-13 (2007-11 I.R.B.)

[113] IRC Section 1001.

[114] IRC Section 61(a).

[115] IRC Section 1012.

[116] IRC Section 264(a)(1).

© 2021 AICPA. All rights reserved.

agreement does not incur the penalty on unreasonable accumulation of earnings if the accumulation serves a valid corporate purpose, rather than an individual shareholder's purpose.[117]

Insurance proceeds received by the corporation upon the death of a stockholder are not subject to regular income tax,[118] and are no longer subject to the corporate AMT which was repealed by the TCJA effective for 2018 and beyond, making a corporate redemption of a shareholder's stock a more attractive planning alternative than previously when the corporate AMT treated the life insurance proceeds as a tax preference.[119]

The premiums paid on a policy insuring a stockholder are not taxable as dividends to the stockholder if the corporation is the owner and beneficiary and retains the incidents of ownership of the policy.

The premiums paid on an insurance policy covering the life of one stockholder are not taxable as dividends to the other stockholders.

Redemption of the deceased stockholder's stock generally has no tax consequences to the surviving stockholders; the basis of the survivors' stock is unchanged. A redemption resulting in a complete termination of the deceased stockholder's interest generally results in sale or exchange treatment (¶1915).[120]

A corporation realizes no gain from the redemption of a shareholder's stock unless it distributes property in the redemption with a greater value than its adjusted basis (appreciated property).[121] A corporation may not recognize any loss on a redemption distribution of property with a value less than its adjusted basis.[122] The decedent's estate acquires a cost basis in the property distributed to it.[123] However, the estate should generally recognize little, if any, gain because the stock typically has a basis equal to its FMV at the date of the decedent's death or the alternate valuation date, except as limited for estates of certain decedents that passed away in 2010 as noted previously.[124]

---

[117] IRC Section 533 and Regulation Section 1.533-1(a).

[118] IRC Section 101(a).

[119] IRC Section 56(g).

[120] IRC Section 302(b)(3).

[121] IRC Section 311(b).

[122] IRC Section 311(a).

[123] IRC Section 1012.

[124] IRC Section 1014(a).

© 2021 AICPA. All rights reserved.

Q. Which type of buy-sell agreement should the stockholders select?

A. Each type of agreement has its advantages and disadvantages. Some key factors to consider are as follows:

Cross-purchase agreement:

1. Surviving stockholders must pay for the deceased's stock with after-tax dollars (if there is not sufficient life insurance to complete the purchase).

2. This type of agreement is relatively simple and quite satisfactory when the number of stockholders is small. It can become burdensome, however, when the corporation has many stockholders.

3. The obligation to purchase shares generally falls upon younger, minority-interest stockholders, who often are the least financially able to buy the shares or afford the life insurance premiums on older stockholders, or both.

4. This type of agreement generally results in fewer legal problems and less complicated tax consequences.

5. The purchasing stockholders obtain a basis in the purchased stock equal to what they paid for it.

6. If each stockholder must purchase a life insurance policy on every other stockholder, a large number of stockholders means a large number of life insurance policies. For example, if there are three stockholders, six policies are required. If there are five stockholders, 20 policies are required.

Stock redemption agreement:

1. Such an agreement has the virtue of simplicity when the corporation has several stockholders.

2. The corporation, not the stockholders, pays the life insurance premiums if the agreement is funded. The benefit is that the premiums are paid with money that has been taxed only to the corporation. When the stockholders pay the premiums in a cross-purchase plan, the premiums are paid with money that might have been taxed both to the corporation and the stockholders (as dividends if the corporation is a C corporation). If possible, the premiums should be paid from compensation received by the stockholders as salary or bonus to at least allow the corporation to claim a compensation deduction.

3. Despite the use of the corporation's earnings and profits for the stockholders' benefit, no dividend treatment results.

© 2021 AICPA. All rights reserved.

4. If the corporation does not use insurance as a funding device, the corporation might not have sufficient money to redeem the shares when the deceased stockholder's shares are tendered for redemption.

5. If the corporation lacks sufficient money to redeem the decedent's shares, it can use installment payments of the purchase price and still waive the family attribution rules.[125] However, the debt creates a problem of security and interest to protect the estate and heirs of the deceased stockholder.

6. There is no basis increase to the remaining stockholders when the corporation is the purchaser of the stock.

Q. How is valuation of the stock determined?

A. Generally, the parties use one of the following four methods:

1. *Book value at the date of death or at the end of the preceding accounting period.* This method is often unrealistic and not an accurate measure of value. The IRS will generally not accept book value as a proper method of valuation. It should not be used in a buy-sell agreement.

2. *Fixed price provided for in the agreement and agreed upon by the stockholders.* This method is sound only if the stockholders review and update it periodically, and it constitutes an accurate measure of FMV.

3. *Price fixed by appraisal after death.* The disadvantage of this method is the delay in choosing and then obtaining able appraisers. Consequently, the stockholders might not know the price for a significant time. Delay is a normal experience under this method.

4. *Self-adjusting formula set forth in the agreement*. The stockholders can use a variety of formulas, for example, book value at close of the preceding accounting period plus a fixed sum or a formula giving one weight to book value and another to the value indicated by the capitalization of earnings, possibly weighted to emphasize recent years. (See ¶1940 for further details on these methods and other valuation factors.)

Q. Is valuation binding for federal estate taxes?

A. For the valuation to be binding for federal estate tax purposes, the agreement must state that the stockholders cannot freely dispose of or encumber their stock during their lifetimes. In the absence of a restriction on transferability, the government will not be bound even by a bona fide valuation. The IRS generally scrutinizes the valuation provided in a buy-sell agreement. The stockholders should determine the price through arm's-length bargaining and negotiations. Agreements entered into after October 8, 1990, must meet special requirements under IRC Section 2703 in order to fix value, particularly if they involve family members. These requirements are discussed in ¶2310.

---

[125] IRC Sections 302(b)(3) and 302(c)(2)(A).

© 2021 AICPA. All rights reserved.

Q. What are disability buy-sell agreements?

A. Although buy-sell agreements generally include death provisions, disability can and does disrupt many businesses. Therefore, these agreements often contain disability buyout provisions. The stockholders can use disability insurance policies for funding and can use the disability definition in the insurance policy as the definition of disability in the buy-sell agreement. The agreement can provide for the acquisition of the stock of the disabled stockholder after a period of six months or one year of disability, for example. Normally, after this period, the stockholders will know whether the disability is permanent.

Q. What are the tax consequences of such an agreement?

A. The disabled stockholder will realize a gain or loss on the sale of stock depending upon the stockholder's basis in the shares.[126] The corporation may deduct the premiums paid on the disability income insurance policies.[127] However, unless the premiums are included in the gross income of the employee-stockholder, any disability income insurance proceeds will be included in the stockholder's gross income.[128] However, once the disability insurance proceeds are treated as payment for the redemption of the stock, the corporation may not deduct the premiums, and the stockholder will treat the payments as amounts received for the sale of his or her stock.

¶1940 How Shares in Closely Held Corporations Are Valued

For tax purposes, what are the shares of a closely held corporation worth? Many owners lack knowledge of their value. Yet, the determination of the value of the stock can have substantial tax consequences. Valuation of the shares of a closely held corporation can be especially important in the area of estate and gift taxes, but it can also have relevance for income taxes. Special valuation rules apply when a senior family member transfers common stock to junior family members while retaining preferred stock (¶2305).

How is value determined? A properly drafted buy-sell agreement is intended to provide that a disabled stockholder, or the estate of a deceased stockholder, will receive a fair price for the shares of stock. Agreements among family members entered into after October 8, 1990, must meet special requirements in order to fix value. These requirements are discussed in ¶2310. If the stockholders do not have a controlling buy-sell agreement, then the IRC, Treasury regulations, revenue rulings, and court decisions offer guidance for determining value for tax purposes.

In practice, if the IRS challenges the values used by the taxpayer, the IRS and the taxpayer arrive at the valuation by a process of negotiation and compromise. In a taxable estate situation, the taxpayer usually tries for a low valuation, whereas the IRS seeks a high valuation. However, this is not always the case. The taxpayer will want a high valuation, for example, if seeking a charitable contribution deduction, a large income tax basis, or other income tax advantages. With the significant increase in the federal

---

[126] IRC Section 1001.

[127] IRC Section 162(a).

[128] IRC Sections 61(a) and 105(a).

© 2021 AICPA. All rights reserved.

transfer tax exclusion ($11,700,000 for 2021, indexed annually for inflation), there may be more estates less concerned with low transfer tax values and more concerned with using higher values to increase basis and avoid future income tax.

Planning Pointer.

For many years, taxpayers have claimed valuation discounts to reduce the taxable values of their business interests. Minority-interest discounts and discounts for lack of marketability have been the most popular claims. With the increased transfer tax exclusions and the availability of portability, fewer taxpayers will have taxable estates. This suggests there will be fewer discounts claimed so that higher values (and higher income tax basis) will pass to heirs. It will be interesting to see if the IRS will insist in applying these discounts itself to reduce the values of the reported property and the corresponding income tax basis if the taxpayers do not claim the discounts. It is suggested that the IRS will not be taking this position in estates that do not sustain any transfer tax liability. The short-term return to the IRS to be aggressive here will be very limited, and probably not worth their effort. However, in *Estate of Warne v. Commissioner*, T.C. Memo 2021-17 (February 18, 2021), the Tax Court applied discounts in valuing interests in an LLC interest passing to charity that denied deductions for 100% of the property value because different charities were the beneficiaries, so that minority interest discount and lack of marketability concepts were applied.

If the taxpayer is unwilling to accept the valuation determined by the IRS, the taxpayer may challenge it in the U.S. Tax Court or may pay the tax and sue for a refund in a U.S. district court or the U.S. Court of Federal Claims. Generally, in tax litigation, the burden is on the taxpayer to show that the determination by the IRS is incorrect. However, the taxpayer may shift the burden of proof to the IRS by introducing credible evidence with respect to any factual issue.[129] In addition, the taxpayer must prove that he or she has complied with the requirements to substantiate any item, has maintained all records required, and has cooperated with reasonable requests by the IRS.[130]

Corporations and partnerships whose net worth exceeds $7 million or that have more than 500 employees may not shift the burden of proof to the IRS. The net worth of an estate is determined on the date of the decedent's death. The net worth of a trust is determined on the last day of the tax year, which is the subject of the dispute.[131] In practice, courts are likely to find a compromise value for the stock between the valuations of IRS experts and those of the taxpayer, assuming the court finds both experts to be credible. Valuation understatements beyond certain limits must be avoided at risk of penalty,[132] as discussed in ¶1005. The IRS has the burden of proof for the imposition of any penalty on an individual.[133]

---

[129] IRC Section 7491(a).

[130] IRC Section 7491(b).

[131] IRC Sections 7491(a)(2)(C) and 7430(c)(4)(D)(i)(II).

[132] IRC Section 6662.

[133] IRC Section 7491(c).

© 2021 AICPA. All rights reserved.

Estates often litigate disputes concerning valuation issues. Unless the potential estate tax savings exceed the expense of litigation and the executor is reasonably confident of victory, the executor should not rush to the courts. An executor who litigates and loses may be liable for a surcharge unless the executor obtains the consent and approval of the beneficiaries.

A financial planner should consider the possibility of valuation disputes in the planning stage. The financial planner should consider possibly higher valuations than originally reported when computing estate taxes and planning for the estate's liquidity needs and other related matters.

No single formula applies to all valuation situations. The IRS, however, has issued guidelines to value shares of stock in closely held businesses. (Revenue Ruling 59-60[134] enumerates factors for valuing such stocks for estate and gift tax purposes. Under Revenue Ruling 65-192,[135] these factors are equally applicable for income tax purposes.) The IRS *Valuation Training for Appeals Officers Handbook* provides a discussion of Revenue Ruling 59-60 and further insight about how the IRS values closely held securities. Because valuation is not an exact science, the financial planner should consider all relevant factors affecting FMV in the planning stage. The executor should consider these factors when resolving valuation disputes with the IRS. The IRS promulgated draft regulations for discussion under IRC Section 2704 in August 2016 that were designed to severely limit valuation discounts in intrafamily business transfers. The draft regulations were heavily criticized and were withdrawn as "burdensome" in 2017. These same draft regulations may resurface in 2021.

.01 Factors to Consider

The following discussion is an analysis of the fundamental factors for valuing shares of stock in closely held businesses.

Factor No. 1 — Nature and History of the Enterprise From Its Inception

The history of the business is important when establishing its past stability or instability, its growth or lack of growth, and its diversity or lack of diversity. These are some of the facts needed to ascertain the degree of business risk. The history should highlight the nature of the business; its products or services, or both; its operating and investment assets; its capital structure; its plant facilities; and its sales records.

Factor No. 2 — Economic Outlook and the Condition of the Specific Industry

Knowledge and consideration of overall economic conditions are essential to appraise closely held stock. The company's progress in relation to its competitors and the industry's ability to compete are significant. Although courts will undoubtedly take judicial notice of the current economic situation, information on existing business and economic conditions can be useful.

---

[134] 1959-1 CB 237.

[135] 1965-2 CB 259.

© 2021 AICPA. All rights reserved.

Factor No. 3 — Book Value of the Stock and Financial Condition of the Business

Balance sheets and necessary supplementary schedules should be obtained for at least two years preceding the appraisal date. This data usually will disclose the liquid position of the enterprise, the book value of the assets (for a discussion of valuation of business real estate, see the end of ¶1940), working capital, long-term indebtedness, capital structure, and net worth. These factors are customarily regarded as significant in evaluating a business. Separate consideration should be given to non-operating investments such as securities and real estate. Book value (assets minus liabilities) might be significant, but book value generally bears no direct relationship to FMV. Even when the IRS or the taxpayer contends that the FMV approximates the book value, the courts seldom rely on book value. However, when the taxpayer made an attempt to show a lower value by using a capitalization-of-earnings method, the Claims Court required use of a book value method.[136]

Factor No. 4 — Earning Capacity of the Company

Although determining the most significant factor affecting the FMV of stock is often difficult, earnings are generally deemed to be most important. Detailed income statements for a period (at least five years) immediately before the appraisal date are also important. (Of course, if the corporation or other business entity has been in business for less than five years, a shorter period must be used.) The use of prior earnings records is recommended because they are usually the most reliable guide to expected future earning power.

The earnings for a prior period are not merely averaged to predict future earnings. Trends (rate of growth, static earnings, declining earnings) must be taken into account. Perhaps the earnings of more recent years should be weighted more heavily than the earnings of earlier years. Clearly, if past earnings were materially affected by nonrecurring factors (for example, unusual capital gains or losses), adjustments should be made for them. Because of the unique relationship of major shareholders to their closely held corporations (these shareholders are often officers or employees of the corporation, or both), adjustments to reported earnings might have to be made for salaries or other forms of compensation. A determination should be made about whether the same salaries would be paid to non-shareholders with the same ability and performing the same duties. The loss of a key executive can have a depressing effect on value, particularly if the corporation has no trained and capable employees to succeed to the management position. Alternatively, the loss of a key employee might not seriously impair the business because of adequate life insurance coverage or the availability of competent management or the cessation of the payment of an excessive salary. Although the extent of the loss and the consequent reduction in the value of the stock are difficult to establish, the financial planner should consider the type of business and the role of the key executive.

Even when future earning power has been computed, one of the most difficult problems remains: the determination of the proper multiple to apply to these earnings. No standard table of capitalization rates applies to closely held corporations. Perhaps the best guide to finding the appropriate capitalization rate is to ascertain that of comparable companies whose shares are publicly traded, making an appropriate adjustment downward because the closely held stock is not publicly traded. The following are among the most important factors to consider when deciding on a capitalization rate in a particular case:

---

[136] *A. Luce, Jr.*, 4 Cl. Ct. 212 (1984), 84-1 USTC ¶ 13,549.

© 2021 AICPA. All rights reserved.

- The nature of the business
- The risk involved
- The stability or irregularity of earnings

Factor No. 5 — Dividend-Paying Capacity

Another important factor is the dividend-paying capacity of the business, rather than the dividends actually paid in the past. However, the dividend-paying factor is probably a less reliable indication of FMV than are other factors. In a closely held corporation, the controlling stockholder(s) can substitute salaries and bonuses for dividends, thereby reducing net income and understating the capacity of the corporation to pay dividends. In such enterprises, the payment of dividends is often based on the financial and tax needs of the controlling stockholder or group in control. The IRS acknowledges the necessity of retaining a reasonable portion of profits in the business to meet competition; therefore, it recognizes that a publicly held company has more access to credit and at more reasonable terms than does a closely held corporation.

When an actual or effective controlling interest is being valued, the dividend factor is *not* a material factor because the dividend payment is discretionary with controlling stockholders.

Factor No. 6 — Whether the Enterprise Has Goodwill or Other Intangible Value

Goodwill is based primarily on earning capacity. The presence and value of goodwill depends on the excess of net earnings over and above a fair return on net tangible assets. Elements of goodwill include the prestige and renown of the business enterprise, the ownership of a brand or trade name, and a record of successful operation over a prolonged period in a particular locality.

No single method exists for valuing goodwill. The previously mentioned factors should be considered, and when all else fails (that is, there is no better basis available), the IRS suggests a formula approach described in Revenue Ruling 68-609.[137]

Factor No. 7 — Sales of the Stock and Size of the Block to Be Valued

Prior sales of stock of closely held corporations are meaningful and useful if they were arm's-length transactions. Such sales are closely scrutinized. Forced or isolated small sales do not generally reflect FMV. Because prevailing market prices are not available, no adjustment or discount is made for "blockage." (Under the blockage theory, a blockage discount from the market price is allowable if the block of stock is so large that if it were placed on the market over a reasonable period of time, it would depress the price.) However, the size of the block of stock is relevant and should be considered. Valuing a large block of stock at a discount might be appropriate because of the general difficulty of disposing of it.

[137] 1968-2 CB 327.

© 2021 AICPA. All rights reserved.

Factor No. 8 — Market Price of Stocks of Similar Corporations

In valuing unlisted securities, the value of securities of corporations in the same or a similar line of business, listed on an exchange, should be considered with other pertinent factors. However, if sufficient comparable companies whose stocks are so listed are not available, the appraiser might use a comparison with actively traded NASDAQ stocks. Although precise comparability is generally not attainable, some stocks might be reasonably similar.

.02 Weight of Factors

Depending on the circumstances in each case, some factors might carry more weight than others. Earnings might be the most important criterion of value in some situations, whereas asset value will be more significant in others. Generally, the IRS accords primary consideration to earnings when valuing stock of companies selling products or services. Conversely, in an investment or real estate holding company, the IRS might give the greatest weight to the assets underlying the securities being valued.

Other factors considered include condition of plants and equipment; adequacy of accumulated depreciation; effect of legal restrictions and limitations; environmental hazards; contingent liabilities; union relations; employee relations; efficiency of management, employees, and plant; dependence on major customers, suppliers, and products; cash flow projections; and interest rates.

.03 Discount for Lack of Marketability

A substantial discount might be available on the basis that the stock lacks marketability (that is, an absence of a ready or existing market for the sale or purchase of the securities being valued). In its *Valuation Training for Appeals Officers Handbook*, the IRS recognizes that if owners of closely held stock should try to list a block of securities on a stock exchange for sale to the public, they probably would have to make the offerings through underwriters, incurring costs for registration, distribution, and underwriters' commissions. The courts have upheld the use of such costs to determine lack of marketability. However, when securities law restrictions on unregistered stock owned by a decedent terminated at death, the shares of stock were valued at their date-of-death value, not subject to a discount relating to the expired restrictions.[138]

.04 Minority Interests

A minority stock interest in a closely held corporation owned by a person not related to the holders of the majority of the stock will normally be valued for estate and gift tax purposes at a substantial discount from what would otherwise be its FMV.

In 1993, the IRS reversed its position that minority discounts generally are not permitted on intrafamily transfers of stock if the family, in the aggregate, has either voting control or *de facto* control at the time of the transfer. In Revenue Ruling 93-12,[139] the IRS announced its acceptance of court decisions holding that shares owned by family members are not attributed to another family member for determining the

---

[138] *C.K. McClatchy Est.*, 106 T.C. 206 (1996).

[139] 1993-1 CB 202.

© 2021 AICPA. All rights reserved.

value of that individual's shares. This position facilitates discounting of family-owned stock and the transfer of greater amounts of stock within a family at low or no gift tax cost.

The U.S. Court of Appeals for the 10th Circuit has held that a minority-interest discount and a special use valuation election (¶1005) are not mutually exclusive, provided that the minority discount is applied first.[140]

Planning Pointer.

For wealthy taxpayers likely to be subject to transfer taxes, given the availability of the significant gift tax lifetime exclusion in 2021 ($11,700,000 per donor), as well as a significant generation-skipping transfer tax exclusion (also $11,700,0001 in 2021), planning for family business interests suggests consideration of aggressive gifting plans to limit future appreciation for senior family members, including aggressive discounting while the gift tax lifetime exclusion remains at this level. So far, discounts have not been limited by legislation or regulation.

.05 Controlling Interests

The courts have recognized that an additional element of value might be present in a block of stock representing a controlling interest for valuation purposes. The taxpayer and the IRS might sometimes be at odds in the application of this rule. The IRS might be disposed to have "premium value" used when it will enhance revenue and might oppose its use when it will reduce revenue. The taxpayer, on the other hand, will favor use of the premium when it will reduce taxes and increase basis, such as when the controlling interest is shielded from tax by the marital deduction, portability, or by the unified credit, and oppose the premium when higher transfer taxes will result.

.06 Key Person Discount

The IRS recognizes the fact that, in many types of businesses, the loss of a key individual can have a depressing effect on value.[141] Some courts have accounted for this depressing effect on value by applying a key person discount.

When a taxpayer seeks a key person discount, the taxpayer should present evidence of special expertise and current significant management decisions, as well as demonstrate an actual decline in business revenue or profitability, or both, attributable to the loss of the key person.

.07 Valuation of Business Real Estate

Under IRC Section 2032A, if certain conditions are met, the executor may elect to value real property included in the decedent's gross estate which is devoted to closely held business use or farming, on the

[140] *C. Hoover Est.*, 69 F.3d 1044 (10th Cir. 1995).

[141] Revenue Ruling 59-60, 1959-1 CB 237.

© 2021 AICPA. All rights reserved.

basis of the property's value in the closely held business or farm, rather than at its FMV determined on the basis of its highest and best use.[142]

For the special valuation rule to apply, the deceased owner, while alive, or a member of the owner's family, or both, must materially participate in the operation of the business or farm, and the heirs of the owner must continue that participation in the years following the decedent's death.

For a discussion of how the provision is applied when business real estate or a farm is held directly by the decedent and of the conditions attached to the election, see ¶2110.

¶1945 Electing S Corporation Status

Many closely held corporations will want to consider electing exemption from corporate taxes by making the appropriate election under Subchapter S.[143] The S election offers these added advantages:

- Facilitating income-splitting within the family by way of gifts of stock.
- Permitting shareholders to deduct their share of the S corporation's losses against other types of income.[144] This ability is especially useful in start-up situations in which the shareholders expect losses. However, the shareholder must materially participate in the business and have basis in the corporate stock to deduct losses,[145] and the business must not consist of the rental of property.
- Reducing, but not eliminating, problems of unreasonable compensation.
- Avoiding penalty taxes on accumulated earnings or personal holding companies.

S corporations compute their taxable income in the same manner as individuals, with a few exceptions.[146] The dividends-received deduction does not apply to S corporations. Each shareholder takes into account a pro rata share of the corporation's income, deductions, and credits.[147] Basis adjustments to stock are made in accordance with a specific set of ordering rules, as specified by statute.[148] Losses that are passed through to the S corporation shareholders and unused because of their lack of basis[149] may be carried over to subsequent tax years until sufficient basis is acquired.[150]

---

[142] IRC Section 2032A.

[143] IRC Section 1363(a).

[144] IRC Section 1366(a)(1).

[145] IRC Sections 469(a) and 469(c)(1).

[146] IRC Section 1363(b).

[147] IRC Section 1366.

[148] IRC Section 1367.

[149] IRC Section 1366(d)(1).

[150] IRC Section 1366(d)(2).

© 2021 AICPA. All rights reserved.

When considering whether to operate as an S corporation, the corporate and individual tax rates under current law should be considered: The top individual rate is 37% for 2021.[151] The top individual income tax rate of 37% is greater than the top corporate rate of 21% applicable to regular C corporations.[152] But the C corporation must address the double taxation issue. If a business is planning to retain earnings to fund growth, the owners might prefer to operate it as a regular corporation as opposed to operating it as an S corporation. The decision may turn on whether the owners generally will be in higher income tax brackets than the business, if the business were operated as a regular corporation.

The TCJA also created the IRC Section 199A 20% qualified business income deduction for taxable income of pass-through entities, including the S corporation. Accordingly, planning must be done on a client-by-client basis. Which clients will be best served as a C corporation with a 21% corporate tax rate, but with a 37% top rate on compensation and a 15% to 23.8% rate on qualified dividends and long-term capital gains? Which clients would be best served as an S corporation with the 20% pass-through deduction, remembering that IRC Section 199A is not available for all business entities over certain taxable income thresholds (specified service trades and businesses) and has complex calculation issues involving W-2 income, income based on real estate asset values and the fact that IRC Section 199A will sunset after 2025 (or sooner if there is a change in the law) whereas the 21% C corporation rate is purportedly permanent, but may be changed as well?

The reasonable compensation required to be paid to S corporation owner-employees creates W-2 income, which is helpful in claiming a QBI deduction at some levels of income, but is detrimental at other levels of income. The financial planner must look at S corporations and the QBI deduction on a case-by-case basis.

An S corporation may not have more than 100 shareholders.[153] All members of a family (including multiple generations), as well as their estates and spouses, are treated as one shareholder for purposes of determining the 100-shareholder limit.[154] There is no need to make an affirmative election to have this rule apply. An S corporation may not have more than one class of stock, but differences in voting rights are permitted, as long as only the voting rights are different, that is, there are no differences involving dividend distributions, liquidation preferences, etc.[155]

New shareholders are bound by a prior S corporation election unless the holders of more than 50% of the shares of the stock consent to a revocation of the election.[156] An S corporation must use a calendar year for reporting purposes unless it can show a valid business purpose for the use of a fiscal year to the satisfaction of the IRS or unless it makes a special election under IRC Section 444. Under IRC Section

---

[151] IRC Section 1.

[152] IRC Section 11(b).

[153] IRC Section 1361(b)(1).

[154] IRC Section 1361(c)(1)(A)(ii), as amended by the Gulf Zone Opportunity Act of 2005 (P.L. 109-135).

[155] Regulation Section 1.1361-1(l)(1).

[156] IRC Section 1362(d)(1).

© 2021 AICPA. All rights reserved.

444, an S corporation that would otherwise have to adopt a calendar year under the preceding rules may elect to adopt or change to a tax year with a deferral period no longer than three months (or the deferral period of the year from which the change is made, if that deferral period is shorter than three months).

S corporations that elect fiscal years must make required payments approximating the amount of tax the shareholders would have paid on income during the deferral period if the corporation had been on a calendar year.

Tax-favored fringe benefits of any employee owning more than 2% of the stock of an S corporation are treated in the same manner as those of a partner in a partnership. Thus, such benefits are taxable to the shareholders, but the corporation receives a deduction for the payment of the benefits. This treatment is less favorable than the treatment available to C corporation shareholder-employees to whom such fringe benefit payments are not automatically taxable.

An accrual-method S corporation may not deduct interest or an expense item payable to any shareholder until it makes payment, and the shareholder includes it in income.[157] This rule applies to all shareholders;[158] it is not limited to those who own more than 2% of the S corporation's stock.

.01 Planning Opportunities

Some additional S corporation planning opportunities are discussed in the section that follows. They are not necessarily listed in their order of importance because importance can vary with the circumstances of the individuals involved.

100 shareholders. The 100-shareholder rule allows broad-based equity financing and family income-splitting, without loss of control, through the use of nonvoting common stock.

Nonvoting common. The use of nonvoting common stock enables those holding voting common stock to retain control, while at the same time, moving equity to other family members. At the same time, the use of nonvoting common stock might favorably affect valuation for gift and estate tax purposes by diluting the senior shareholders' equity interests.

Debt instruments. A debt instrument providing interest geared to an index, such as the prime rate, may be used without necessarily creating a second class of stock.[159]

New shareholders. Although new shareholders cannot terminate S corporation status by refusing to consent to the S election, they may do so by transferring stock to a nonqualified shareholder, such as a nonresident alien, or to certain trusts that do not qualify as S corporation shareholders, unless contractually barred from doing so.

---

[157] IRC Section 267(a)(2).

[158] IRC Section 267(e).

[159] IRC Section 1361(c)(5).

© 2021 AICPA. All rights reserved.

Passive income. Corporations with income that consists largely, if not entirely, of passive income are not disqualified from being S corporations. Corporations that converted to S corporation status from C corporation status with accumulated earnings and profits from regular C corporation years are subject to a 25% of gross receipts passive income limitation and possible loss of the S corporation election if the receipt of "excess" passive income persists for more than three years.[160]

Foreign source income. Corporations with gross receipts from foreign sources might want to elect S status.

Election after termination. In general, a corporation may not make a new S corporation election within five years of a prior terminated or revoked election without the consent of the IRS.[161] If the termination was inadvertent, the S corporation and its shareholders may take steps to cure the problem and ask the IRS to disregard the inadvertent termination.[162] It may be necessary for the corporation to go through the private letter ruling process including payment of the user fee to address this problem.

Gifts of stock. Shareholders can use gifts of S corporation stock to achieve family income-splitting and tax savings. Income is allocable to shareholders on a per-share, per-day basis.[163]

TCJA possible dilemma. Many S corporations are considering converting to C corporations to take advantage of the 21% flat corporate tax rate. Several concerns arise, however. If the S corporation owners have "regrets" about the conversion, they cannot return to S corporation status for five years after the conversion. Assuming they return to S status, they must address the consequences of the built-in-gains tax (having been a C corporation now converting to an S corporation) which has a five-year lookback to the corporation's C status years, forcing the activities and assets from the C status years to still be subject to C corporation tax rules during the five-year lookback period. Although the 21% C corporation tax rate is not scheduled to sunset after 2025, like most of the TCJA, "political risk" of changes long before 2026 certainly creates uncertainty for the financial planner in advising clients on these issues.

.02 Trusts as S Shareholders

As a broad general rule, trusts are not eligible S corporation shareholders, with the following exceptions.

Electing small business trusts. Stock in an S corporation may be held by certain electing small business trusts (ESBTs).[164] Any portion of such a trust that consists of S corporation stock will be treated as a separate trust[165] and taxed at the highest rate of income tax for estates and trusts. Deductions

---

[160] IRC Section 1362(d)(3).

[161] IRC Section 1362(g).

[162] IRC Section 1362(f).

[163] IRC Section 1366(a)(1).

[164] IRC Section 1361(c)(2)(A)(v).

[165] IRC Section 641(c)(1)(A).

© 2021 AICPA. All rights reserved.

of S corporation distributions are not allowed. No AMT exclusion is allowed. No capital loss carryover or offsetting $3,000 capital loss deduction is allowed.[166] For an electing small business trust to be an eligible S corporation shareholder, no interest in the trust may be acquired by purchase (that is, acquired with a cost basis).[167] Rather, the interests must be acquired by gift, bequest, or other non-purchase acquisition. An electing small business trust is permitted to either distribute or accumulate its income in the discretion of the trustees.

The TCJA allows a nonresident alien individual to be a potential current beneficiary of an ESBT without causing the loss of the S corporation election beginning in 2018. IRC Section 1361(c)(2)(B)(v). The TCJA also provided that charitable contributions from an ESBT are to be tested under the rules of IRC Section 170 rather than under the more limiting rules of IRC Section 642(c) as was the case prior to 2018.

The trustee must file an election where the corporation files its Form 1120S to have the ESBT treated as a permitted S corporation shareholder within 75 days of the ESBT becoming an S corporation shareholder.[168]

The Committee Reports to the Small Business Job Protection Act of 1996[169] note that these trusts will facilitate family financial planning by allowing an individual to establish a trust to hold S corporation stock to spread equity ownership and income among family members or other trust beneficiaries.

Grantor trusts. A trust, the grantor of which is treated as the trust owner under the rules of IRC Sections 671-678, may be an S corporation shareholder.[170] A grantor trust may remain an eligible shareholder for a two-year period following the death of the grantor, provided the entire corpus of the trust is includible in the grantor's gross estate.[171] A longer period of eligibility may be available if the trust qualifies as a qualified revocable trust and makes an election under IRC Section 645 by filing Form 8855. However, a grantor trust is an eligible S corporation shareholder only if the grantor would be eligible, that is, is a citizen or resident of the United States.[172]

Voting trusts. Voting trusts are eligible S shareholders.[173]

---

[166] IRC Sections 641(c)(1)(B) and 641(c)(2).

[167] IRC Section 1361(e)(1)(A)(ii).

[168] IRC Section 1361(e)(3).

[169] P.L. 104-188.

[170] IRC Section 1361(c)(2)(A)(i).

[171] IRC Section 1361(c)(2)(A)(ii).

[172] IRC Section 1361(c)(2)(A)(i).

[173] IRC Section 1361(c)(2)(A)(iv).

© 2021 AICPA. All rights reserved.

IRC Section 678 trusts. Trusts in which a person other than the grantor is treated as the trust owner for income tax purposes under IRC Section 678 are eligible S corporation shareholders. IRC Section 678 provides that a person other than the grantor is to be treated as the owner of a trust if such person alone has the exercisable power to vest the trust corpus or the income therefrom in himself or herself.[174]

Qualified subchapter S trust. A qualified subchapter S trust (QSST) has the following stipulations:

- It is a trust with only one current income beneficiary, to whom all of the current income of the trust is to be distributed.
- Any corpus to be distributed during the life of the current income beneficiary is to go only to such beneficiary.
- The income interest of the current income beneficiary is to terminate on the earlier of the beneficiary's death or termination of the trust.
- On the termination of the trust during the life of the current beneficiary, the trust is to distribute all of its assets to such beneficiary.[175]

The beneficiary must make an election in order to have the qualified subchapter S trust treated as a permitted S corporation shareholder within 75 days of the QSST becoming an S corporation shareholder.[176]

Certain exempt organizations. Qualified retirement plan trusts described in IRC Section 401(a) and charitable organizations described in IRC Section 501(c)(3) are allowed to be S corporation shareholders, but not charitable remainder trusts.[177] Caution, however, as business-related income received by an otherwise tax exempt trust may be deemed to be unrelated business taxable income and subjected to an unexpected large tax liability.

Many trusts commonly used in financial or estate planning will or can be made to fall within the rules allowing them to be shareholders of an S corporation, if they meet the requirements of a grantor trust, an electing small business trust, or a qualified subchapter S trust. Caution: When a grantor trust holding S corporation shares terminates, be sure the successor beneficiary is a qualified S corporation shareholder.

---

[174] IRC Section 1361(c)(2)(A)(i).

[175] IRC Section 1361(d)(3).

[176] IRC Section 1361(d)(1)(B).

[177] IRC Section 1361(c)(6).

© 2021 AICPA. All rights reserved.

.03 Other S Corporation Considerations

Time of election. The S corporation election may be made at any time during the prior tax year (to be effective at the commencement of the next tax year) or on or before the 15th day of the third month of the current tax year to be effective for the current tax year[178]

S corporations allowed to have subsidiaries. An S corporation is allowed to own 80% or more of the stock of a C corporation. However, an S corporation may not elect to file a consolidated return with its affiliated C corporations.[179] In addition, an S corporation may own a qualified S corporation subsidiary.[180]

Some financial institutions may elect S corporation status. The following types of financial institutions, which do not use the reserve method of accounting for bad debts, may elect S corporation status: domestic building and loan associations, any mutual savings bank, and any cooperative bank without capital stock organized and operated for mutual purposes and without profit.[181]

¶1950 Corporate-Owned Life Insurance and the Estate of a Controlling Shareholder

The Treasury regulations[182] provide that when the economic benefits of a life insurance policy on a decedent's life are reserved to a corporation in which the decedent is the sole or controlling shareholder, the corporation's incidents of ownership will not be attributed to the shareholder because of his or her stock ownership if the proceeds are payable to the corporation. Thus, the proceeds would not be included in the decedent's gross estate.[183] However, if the proceeds of an insurance policy the corporation owns on a sole or controlling shareholder's life are not payable to the corporation (or to a third party for a valid corporate business purpose), the incidents of ownership will be attributed to the insured through his or her stock ownership. Thus, in such a case, the proceeds would be included in the decedent's gross estate.[184]

.01 Who Is a Controlling Shareholder?

An insured will not be treated as a controlling shareholder under the regulations unless the insured owns stock possessing more than 50% of the total combined voting power of the corporation at the time of death. However, if an insured individual owns as little as 51% of the outstanding voting stock, 100% of

---

[178] IRC Section 1362(b).

[179] House Committee Report to the Small Business Job Protection Act of 1996 (P.L. 104-188).

[180] IRC Section 1361(b)(3).

[181] IRC Section 1361(b)(2)(A).

[182] Regulation Section 20.2042-1(c)(6).

[183] IRC Section 2042(2).

[184] IRC Section 2042(2).

© 2021 AICPA. All rights reserved.

the life insurance proceeds on a policy owned by the corporation and not payable to the corporation will be included in the insured decedent's gross estate.[185]

One way to avoid this result is for the controlling shareholder to make gifts of enough voting shares to reduce his or her voting power to 50% or less.

.02 Weighing the Cost of Inclusion

The controlling shareholder will normally be in a position to control whether the insurance proceeds are payable to the corporation or to another beneficiary, in whole or in part. If the proceeds are payable in their entirety to the corporation, no part of the proceeds will be includible in the controlling shareholder's gross estate. However, the insurance payable to the corporation increases the value of the insured's shares and those of all other shareholders. This result might be better for family members than if the insurance proceeds are made payable to them and includible in the controlling shareholder's gross estate, depending, of course, on the size of the controlling shareholder's estate and its relationship to the available estate tax exclusion.

If the shareholder decides to retain full control of the corporation but wants the insurance proceeds payable to a named beneficiary other than the corporation or his or her estate, and if the shareholder wants to exclude the insurance proceeds from estate taxation, the corporation must surrender all incidents of ownership in the policy.

If a shareholder wants to retain control of the policy, the shareholder might wish to purchase the policy from the corporation (or have the policy distributed as a dividend) and then transfer it, and all incidents of ownership in it, to a trust or to a family member. If the trust is an irrevocable life insurance trust, and if the insured lives three years after the date of transfer of the policy to the trust, the policy proceeds will be excluded from the gross estate of the insured shareholder.

[185] IRC Section 2042(2).

© 2021 AICPA. All rights reserved.

PPF1404D

© 11th Edition Association of International Certified Professional Accountants. All rights reserved. AICPA and American Institute of CPAs are trademarks of the American Institute of Certified Public Accountants and are registered in the United States, the European Union and other countries. The Globe Design is a trademark owned by the Association of International Certified Professional Accountants and licensed to the AICPA. 2105-48008