Mary Vandenack provides the transcript from Legal Visionaries podcast on Income Tax Considerations in Estate Planning, Part 2.

TRANSCRIPT:

Mary: On today's episode, my guest is Abbie Everist. Abbie is a senior manager at RSM in the Washington National Group. She specializes in estate planning, and we're going to talk today about income tax considerations for estate planning. We did a first episode on this covering about four tips related to this issue, and we're going to continue today talking about income tax considerations in estate planning. Thanks for joining me again today, Abbie.

Abbie: Absolutely. Glad to be here, Mary.

Mary: Last time we talked about retirement accounts and some of the issues related to pass-through entities. We'll talk a little bit further about contributions today and the context of fiduciary income taxes. Can you fill us in on whether contributions qualify for the fiduciary income tax charitable deduction?

Abbie: Absolutely. In order for a trust to get a charitable deduction, there has to be certain provisions in the trust agreement which allow charitable contributions and also that those contributions come from income, because that's where you're getting the income tax deduction. You don't want it coming from principal because then there's really no income deduction off of that. Now, a lot of people aren't aware of that or change their mind in the future. I have seen some grantor trust where we explained where it's income taxable to the grantor. And while you can get flow through treatment under 170(c) for that, you may have a liability to remainder beneficiaries on that. Because normally if they do something like that, they're at least getting the approval of current beneficiaries. But depending on the scope and size of the contribution, there could still be future liability there.

Mary: One of the things that might be considered by somebody that wants to make some charitable contributions from income, which we've seen more of with some clients who are under the estate planning limit, who were going to leave something to charity at death, but the tax brackets of trust hit the top tax rate at a fairly low threshold.

Sometimes if we don't want to have everything distributed out of trust, then there might be directions to the trustee. Does that help with that issue about the remainder beneficiaries if the settler of the trust actually says, "I direct that 10% of the income per year or an amount up to 10%, or it's my intention that some of the income," in some way that the settler of that trust provides for that?

Abbie: Absolutely. If there's a set percent or something like that, that's very easy because that isn't even trustee discretion. Trustees like things like that. And then there's no contention from the remainder beneficiaries because there's really no interpretation of that.

Mary: Let's just talk about the best way if somebody has a trust and wants to benefit charity and avoid potential issues about complaining the remainder beneficiaries, which can sometimes be really remote in today's world, what would be the best thing that could be done in creating the trust to allow for distributions from income to charity to reduce the income?

Abbie: The example you gave earlier with the set percent, that's a great way to do that. I have seen one where there's a health education maintenance support standard for beneficiaries, and then anything that the trustee doesn't distribute under that, the beneficiaries work with the trustee to appoint the remaining fiduciary income to charities.

Mary: The other thing I have seen is in your states that allow for directed trust, which is a lot of them these days, we've seen the appointment of a charitable advisor who's given authority to advise the trustee, which then can sometimes help support what is done by the trustee, which the trustee likes that, as opposed to having that potential liability to the beneficiaries. If you were to say key planning point regarding benefiting charities, reducing income taxes out of a trust?

Abbie: The key planning point is to make sure that those provisions are in the trust so that there's no ambiguity or litigation later.

Mary: Maybe don't have ChatGPT drafted trust yet. Did you see the case over the weekend on...

Abbie: We were discussing that on internal call this morning, and I want to say somebody mentioned that it made up case names.

Mary: It made up case names. I would be a person who admits to loving everything about ChatGPT, that got my attention that it would actually make up case names. I thought, well, I've been known to ask and been encouraging everybody in my office to use ChatGPT. I send that case out with caution. I'm glad to feel that we aren't going to quite be replaced by ChatGPT yet. We may still have some value yet, Abbie. Well, let's talk next about what beneficiaries might receive from a simple trust. But before I ask you exactly what they're going to receive, can you distinguish by what you mean by a simple trust versus a complex trust? I think that's the distinction you're making there?

Abbie: Yes. Simple trust has mandatory income distribution requirements, whereas a complex trust basically is everything is up to discretionary standards. It could be an ascertainable standard, it could be something else, but it's discretionary.

Mary: By way of example, a marital trust typically is required if you want to qualify for the estate tax marital deduction to be a simple trust in that it must distribute or must allocate all of the income to the beneficiary. Does that mean that the beneficiary gets all the income?

Abbie: Well, on a marital trust, they would get all of the income that's flowing through the trust. Now, when you have those flow-through entities, you're looking at fiduciary accounting income, which is what the trust gets as a distribution from that partnership or from that LLC or from that as corporation.

Mary: Can you make that, because a really good distinction, the marital trust is your basic simple trust, but you're talking about a little bit different context? If I have a partnership that's in a trust, can you explain what that fiduciary or just give an example of $100,000 of income, how does that break out?

Abbie: Right. If their share of income from the partnership is $100,000, but the managers of the partnership only distribute out $50,000, then that $50,000 is the mandatory amount going out from the trust to the beneficiary.

Mary: It's really common to have a minimum tax distribution, for example, in a partnership that says the general partner or the manager, depending on the type of entity, shall distribute a percentage of the income. Are you saying that that amount that is actually distributed is treated as the income to the trust? Let's say it's $100,000 and manager distributed $50,000, so the trust income is how much?

Abbie: The income on the tax return is the $100,000, which goes out to the beneficiary.

Mary: K-1 from partnership to trust.

Abbie: Is $100,000 but the actual cashflow is going to be the $50,000 going from the partnership to the trust to the beneficiary.

Mary: If you said, what's the planning point here, what would be the key to that? Because we have a difference between what you're getting taxed on and the cash.

Abbie: Right. The planning point is for the grantor to understand the goals of the partnership or the business entity that a trust may hold. Some partnerships are in growth mode. That's not going to provide a lot of excess cashflow to the beneficiary over an income tax liability distribution. If they maybe want to give more lenient discretion to the trustee for discretionary principal distribution to help maybe, make up whatever their anticipated or whatever they want the beneficiary to get from the trust each year.

Mary: Again, being aware of the type of entity and how it works from an income tax perspective as opposed to I think one of the things you mentioned earlier is don't look at the value of an entity just from an estate tax purposes as you're doing your estate planning. Look at each of the assets and the income tax factors that apply.

Mary: We talked in our first episode a little bit about irrevocable grantor trusts and what they are. Can we talk a little bit about how they factor into planning.

Abbie: Irrevocable grantor trusts are great types of trusts that you mentioned on the last episode talking about the burn, being able for the grantor to pay the income tax on the trust income and it's not considered a separate gift. That allows the trust to grow greater, quicker with all that benefit going to the beneficiaries in the future. It also reduces the size of his or her estate. That means when they pass away, there's smaller estate tax liability. You really get benefit on both ends.

Mary: Most people understand that they have a gift and estate tax exclusion that they can use during life or at death and an annual exclusion. One of the questions that we're often discussing with clients is what qualifies for the annual exclusion or what's going to be a gift if they go over the annual exclusion? I think what you're saying is the grantor can pay the taxes on the income of the grantor trust and it's not going to eat into the annual exclusion or the estate tax exclusion either. Correct?

Abbie: Exactly.

Mary: We can pay that tax. That's where we call it the burn and we're still paying the taxes on that. There's some other benefits to the grantor trust as well in terms of the way transactions work.

Abbie: Yes. The other main benefit of a grantor trust is the ability for the grantor to sell assets to the trust and not realize an income tax transaction. If the grantor has that dollar basis of Apple stock and it's now worth $1,000, now he still has to sell it for fair market value, but there will be no income tax liability triggered on that $999 of gain.

Mary: You put the asset in the grantor trust.

Abbie: Correct.

Mary: You have a note receivable back. No gain on the transaction. You move the growth asset into the trust, and you're keeping an asset that won't grow in value that will just have a stream of income. That's what we call the freeze, correct?

Abbie: Correct, because it's freezing the amount of exemption that you're using and the value of the asset that you're transferring into the trust. The real benefit to that as well is your growth asset, if it's growing at 8% or 10%. Now, the required interest rate, the applicable federal rate that is required to be used on that note back or the minimum amount required to be used is usually around 3%, 4%, 5%. You're getting that spread between the growth of 8% to 10% versus the note receivable interest that you're getting back.

Mary: A lot of times we structure those transactions saying as part sale, part gift based on what the cash flow we need for the grantor is and the overall liquidity of the state and looking at income tax situations. Well, we talked in the last episode about how sometimes the grantor gets tired of paying the taxes, and we talked about the strategy of changing from grantor trust status to non-grantor trust status. Could you ever have a situation instead where the trustee reimburses the grantor for the payment of taxes?

Abbie: Yes. Most states allow and most trusts are drafted where it is independent trustee's full discretion to reimburse or pay an allocable amount of income taxes based on the trust income to the grantor or to the IRS on behalf of the grantor. I definitely don't want to use that every single year because that's a big benefit of the irrevocable grantor trust. But in those years where maybe the note payments have stopped or other reasons, maybe there was a big sale of assets within the trust, absolutely. There's that flexibility there that client's love.

Mary: Let's talk about where I just change topics here to talking about divorce and estate planning. One of the topics that comes up fairly frequently is you created a trust for the benefit of your spouse while you were happily married, and then your happy marriage became less happy, and now you're going through a divorce. Can you talk about the potential impact of divorce on the trust that you've created?

Abbie: Absolutely. This one is pretty state specific on what the laws will allow of each state. My recommendation is if you think it's prudent by your legal advisor in your state would be to have it drafted with a floating spouse, which basically the beneficiary is the spouse that you're married to at that time, which obviously can change. However, sometimes that's not the most prudent based on the state that you might be in. You may be able to modify through a settlement agreement.

Mary: There are a few options, but that's definitely...I would just emphasize the concept of that being really state specific. It's rather dramatic. I was just dealing today working with a client in Maryland in a state that I hadn't dealt with and learned a whole new concept. In trust generally, the concepts vary a lot by state. South Dakota, our neighbor to the north, uses restatement too. Some states use the uniform trust code. Some use that UTC. And then there's case law that decides things based on sometimes bad facts, sometimes great facts. Any specific thoughts other than we've mentioned on contemplating a divorce and what client should consider? I guess I hate to say this part, the fact is that it's great when you get married to do all that planning, the irrevocable trusts for spouses. I know that SLATs have been a really super popular concept in recent years, but you do want to contemplate the ramifications if you do go through a divorce. Consider that floating spouse provision. Is there anything else that we should be thinking about?

Abbie: I would say floating spouse maybe if you want to concurrently create an agreement, like a postnuptial agreement in the states that allow those. That might be helpful as well to support any arguments between the spouses if there's future litigation.

Mary: I like that. Even if you're in a state, at least document the intentions and thoughts to help facilitate negotiations if a divorce situation arises. Another concept that is interesting, I remember early in my career I was often dealing with illiquid estates, and I was working with an advisor who seemed to represent only liquid estates that were coming out of business exits. Our views on what you should do for planning was entirely different. Now, I've been on both ends of that, so I have a different view, but let's talk about what type of planning considerations are really important in an illiquid estate situation.

Abbie: Absolutely, and this is actually something that we do a lot when we look at closely held businesses because they might not all be related, but really get them to understand potential cashflow implications and growth stagnation that could occur when you have a significant member or shareholder past away, and needing a state liquidity has really brought in a lot of planning for our group. If you have enough of your gross estate, the ownership being closely held business interest, there is an election that you can create an installment plan with the IRS. I never like clients to fully rely on that. I want to have a backup plan, because what if there's a change in circumstances? What if they can't buy it all back? What if instead of the 35% threshold, that's like 70% of the gross estate could be held by that deceased? Life insurance can be a good option. Sometimes the company owns it as part of maybe a cross purchase agreement, sometimes an ILIT owns it, which is a great benefit for any life insurance policy really.

Mary: Since we haven't used the term ILIT acronym yet, I'm just going to ask you to clarify that.

Abbie: Yes. An ILIT is an irrevocable life insurance trust and it's using that same gifting to trust concept where you can use your annual exclusion gifting to pay the premiums and have the trust own a life insurance policy on the grantor. Now, it's not considered the grantor's asset, so the big benefit is that you save the 40% estate tax on any death benefit proceeds, and now you have this liquidity where you can swap assets with the estate in order to provide them the liquidity to pay the estate tax. That's a good option. And then the third option, we talked about the basis step up. Maybe 70% of your estate is in a closely held entity where it can't all be bought back, or maybe it's only 30%, but in various entities as well. But you can sell marketable securities in order to pay the estate tax. Because they got the basis step up, there's not much additional income tax normally. There might be a little bit of gain from the date of death until the date of sale. Now, just a reminder, while IRAs are liquid as well, traditional IRAs will have to pay income tax before you can turn around and use the net for estate tax.

Mary: That's the income in respect of a decedent concept that goes with IRAs, which merits a whole separate podcast to discuss at some point. Using life insurance is helpful when we have an illiquid estate. That's one of the great uses of it. I do like to see somebody who really knows the different types of life insurance. Once upon a time, I tried to keep up on all the products and decided that I was going to call life insurance experts to the table when dealing with that, particularly those that are good at working with the estate planning process. Any other thoughts on that topic?

Abbie: Well, just to follow up on the life insurance, exactly, different policies are for different reasons. A lot of times newlyweds with small children will have term policies because that's when their big expenses are if something were to happen to one of them. A term policy with cross purchase might be beneficial if there's an anticipated sale event, where you know you just need to cover for a certain period of time. Otherwise, if you really need the insurance to cover through your death to help with estate tax than normally looking at permanent policies.

Mary: What I like to say is review them regularly. Because what I've found is that products change all the time and sometimes the product you had that makes sense, like you used the term as an example, early in life when you've got a lot of expenses and our income isn't that great yet, but later down the road things change. But even when you have accumulated a fair amount and your income's high, the products simply just change. Looking at those and seeing if something makes more sense makes a lot of sense.

Well, thanks for sharing with me and particularly two episodes on these topics. Do you have any last thoughts that you'd like to add on income tax planning when doing estate planning?

Abbie: I just appreciate your time and just enjoy talking about all the different things that impact an estate.

Mary: Because we love everything about tax and so we might put some people to sleep when listening to us, but we totally enjoy talking about it. I really appreciate it. As we reach the end of our episode, I want to thank our sponsors, interactive Legal, Foster Group, veterans Victory Housing and Business Centers, and Carson Private Clients. That's all for now. Thanks for listening to today's episode and stay tuned for our weekly releases.