Tulsa Estate Planning Forum
Annual Meeting
May 8, 2018

Tax Reform & the Best Ideas in 2018

Robert S. Keebler, CPA/PFS, MST, AEP
(Distinguished)

The Tax Cuts & Jobs Act

Overview

- Analysis of individual tax changes and planning going forward
- Drawdown planning after tax reform
- Charitable planning including DAFs, QCDs, CLTs AND CRTs
- Roth IRA conversions going forward
- College planning after tax reform
- Advanced income tax planning using trusts
- Contributions to defined contribution or defined benefit plans for business owners
- Overview of taxation of business entities

Key Individual Tax Reforms

Individual Rates	Overall rate decrease; 7 brackets retained
Standard Deduction	$24,000 (MFJ)
Personal Exemptions	Repealed
Child/Family Credit	Increased
AMT	Exemption increased; Exemption phaseout threshold substantially increased
SALT Deduction	Limited to $10,000 in property and state/local income taxes (except for taxes incurred in a trade or business)
Mortgage Interest Deduction	Limited to interest on up to $750,000 of acquisition indebtedness; Repeals deduction for home equity indebtedness
Pease Limitation	Repealed

Individual provisions sunset December 31, 2025

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Individual Income Tax Rates

2017

CURRENT TOP OF EACH BRACKET

	S	MFJ/QW	MFS	HOH	T&E
10.0%	$ 9,325	$ 18,650	$ 9,325	$ 13,350	
15.0%	$ 37,950	$ 75,900	$ 37,950	$ 50,800	$ 2,550
25.0%	$ 91,900	$ 153,100	$ 76,550	$ 131,200	$ 6,000
28.0%	$ 191,650	$ 233,350	$ 116,675	$ 212,500	$ 9,150
33.0%	$ 416,700	$ 416,700	$ 208,350	$ 416,700	$ 12,500
35.0%	$ 418,400	$ 470,700	$ 235,350	$ 444,500	
39.6%					

CAPITAL GAINS	0%	15%	20%

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Individual Income Tax Rates

2018

PROPOSED TOP OF EACH BRACKET

	S	MFJ/QW	MFS	HOH	T&E
10%	$ 9,525	$ 19,050	$ 9,525	$ 13,600	$ 2,550
12%	$ 38,700	$ 77,400	$ 38,700	$ 51,800	-
22%	$ 82,500	$ 165,000	$ 82,500	$ 82,500	-
24%	$ 157,500	$ 315,000	$ 157,500	$ 157,500	$ 9,150
32%	$ 200,000	$ 400,000	$ 200,000	$ 200,000	-
35%	$ 500,000	$ 600,000	$ 300,000	$ 500,000	$ 12,500
37%					

PROPOSED TOP OF EACH CAPITAL GAINS BRACKET

	S	MFJ/QW	MFS	HOH	T&E
0%	$ 45,000	$ 77,200	$ 38,600	$ 51,700	$ 2,600
15%	$ 425,800	$ 479,000	$ 239,500	$ 452,400	$ 12,700
20%					

Also, simplifies the “kiddie tax” by effectively applying ordinary and capital gains rates applicable to trusts and estates to the net unearned income of a child

§ 1, §11001

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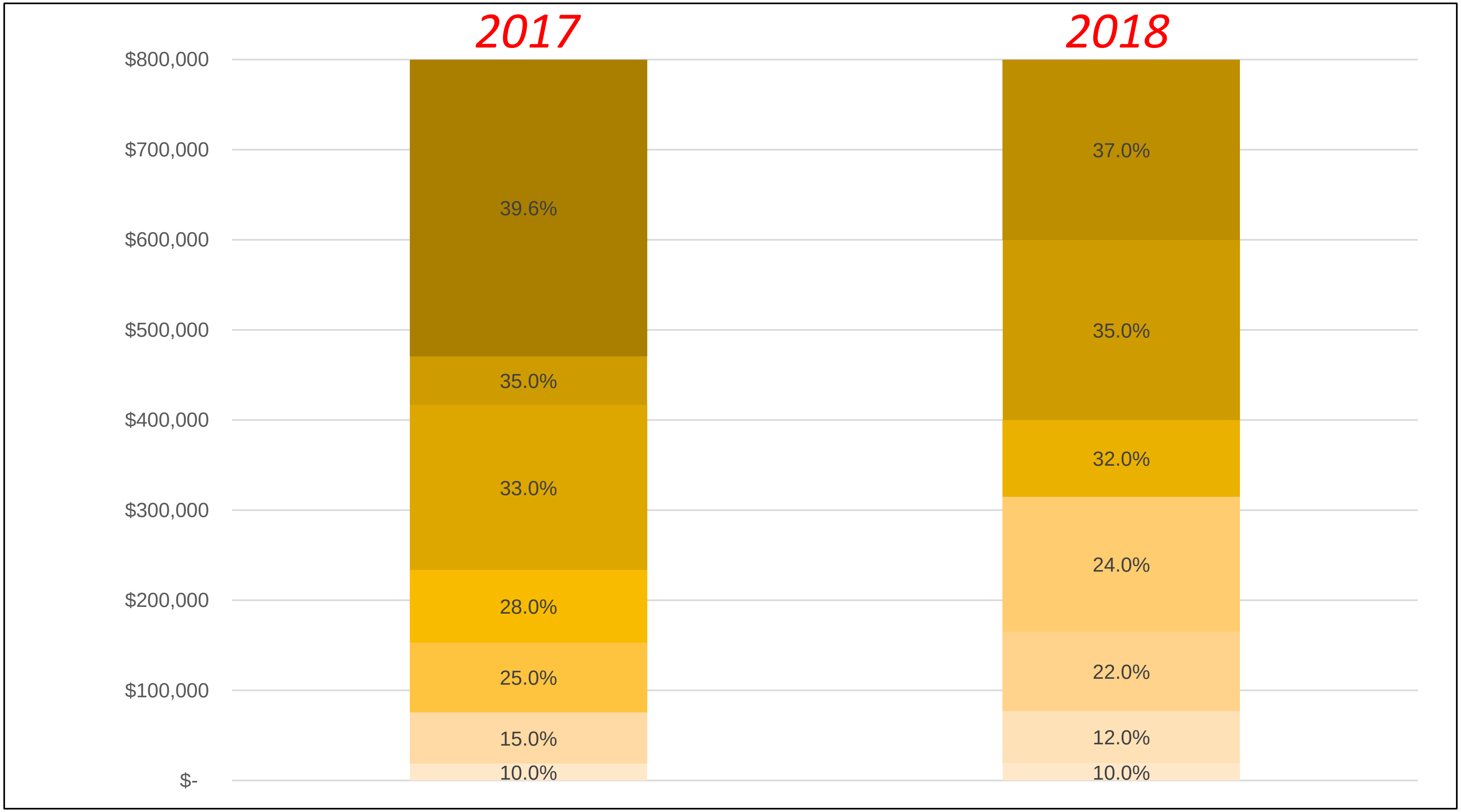
Individual Income Tax Rates

Comparison



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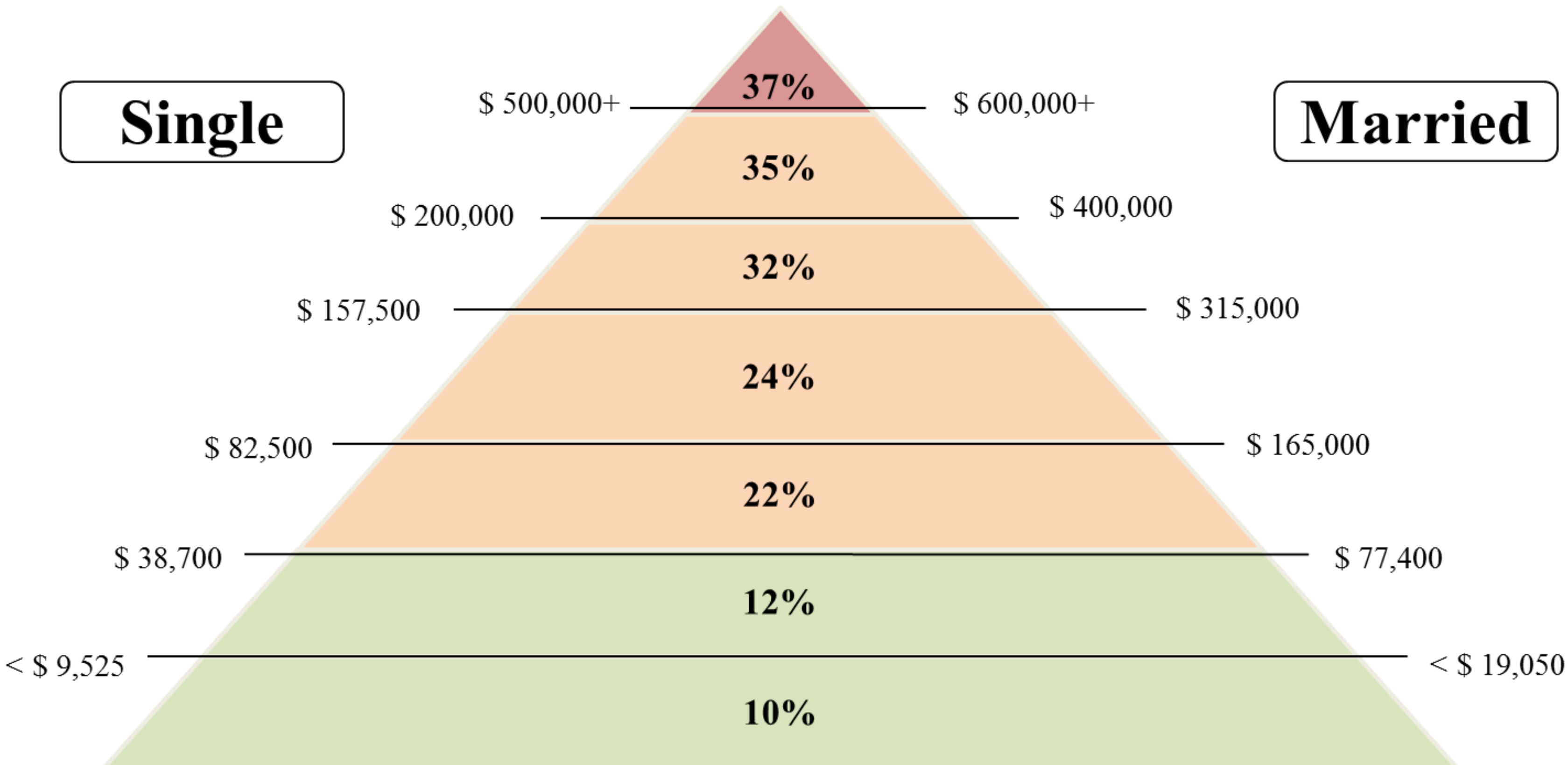
Individual Income Tax Rates



Capital Gains Rates* **0%** **15%** **20%**

*The capital gain & ordinary income brackets do not align perfectly

Tax Reform Overview for Investors

Trust & Estate Rates

2017:

Taxable income over	But not over	Is taxed at
$0	$2,550	15%
$2,550	$6,000	25%
$6,000	$9,150	28%
$9,150	$12,500	33%
$12,500		39.6%

2018:

Taxable income over	But not over	Tax Bill
$0	$2,550	10%
$2,550	$9,150	24%
$9,150	$12,500	35%
$12,500		37%

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Exemptions

- **Exemptions are completely repealed at the end of 2017**
  - Consolidated into the standard deduction
  - Expanded child tax credit and a new family tax credit designed to offset the loss for families

§ 151, §11041

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Child and Family Tax Credits

Summary

	2017	2018
Credit for Children	$1,000	$2,000
Credit for other Family Members	$0	$500
Phase-out Begins	$110,000	$400,000
Refundable Amount (credit for children only)	$1,000	$1,400

All figures for MFJ

§ 24, §11022

Tax Reform Overview for Investors

AMT Exemption Increased

	2017	2018
Single or Head of Household	$54,300	$70,300
Married Filing Jointly	$84,500	$109,400
Begin of Phaseout, Single or HoH	$120,700	$500,000
Begin of Phaseout, MFJ	$160,900	$1,000,000

Drawdown Planning After Tax Reform

DrawDown Strategies

- Basic key concepts
  - **Tax structure** – Determining the mix of taxable investments, tax-deferred investments and tax-free investments
  - **Asset location** – Determining the distribution of assets across taxable accounts, tax-deferred accounts and tax-exempt accounts to create tax advantages
  - **Tax-sensitive asset allocation** – Asset allocation done on an after-tax basis
  - **Bracket management** – Short-term timing of income and expenses on a year-by-year basis so as to minimize overall income taxes over the long-term
  - **Tax Alpha** – The improvement in portfolio returns produced by efficient income tax management

DrawDown Strategies

- Tax Structure – Key Factors
  - Age
  - Sources of income
  - Cash flow requirements
  - Current & future tax rate

- Asset location Ideas
  - Income assets in Tradition IRA
  - Growth assets in Roth IRA

DrawDown Strategies

- Tax-sensitive asset allocation

Interest Income	Dividend Income	Capital Gain Income	Tax Exempt Interest	Pension and IRA Income	Real Estate and Oil & Gas	Roth IRA and Insurance
•Money market •Corporate bonds •US Treasury bonds <u>Attributes</u> •Annual income tax on interest •Taxed at highest marginal rates	•Equity Securities <u>Attributes</u> •Qualified dividends at LTCG rate •Return of capital dividend •Capital gain dividends	•Equity Securities <u>Attributes</u> •Deferral until sale •Reduced capital gains rate •Step-up basis at death	•Bonds issued by state and local governmental entities <u>Attributes</u> •Federal tax exempt •State tax exempt	•Pension plans •Profit sharing plans •Annuities <u>Attributes</u> •Growth during lifetime •RMD for IRA and qualified plans •No step-up	<u>Real Estate</u> •Depreciation tax shield •199A deduction •1031 exchanges •Deferral on growth until sale <u>Oil & Gas</u> •Large up front IDC deductions •Depletion allowances	<u>Roth IRA</u> •Tax-free growth during lifetime •No 70½ RMD •Tax-free distributions out to beneficiaries life expectancy <u>Life Insurance</u> •Tax-deferred growth •Tax-exempt payout at death

DrawDown Strategies

- Bracket Management Principals
  - Know current & future brackets
  - Tactical timing of income and deductions
  - Understand bracket differences by filing status
  - Understand thresholds where tax benefits are lost

- Tax Alpha
  - Low-turnover strategies
  - Strategic gain & loss harvesting
  - Understand “statutory tax shelters”

Charitable Planning Including DAFs, QCDs, CLTs and CRTs

Charitable Contributions

- Outright gifts
  - Most common type
  - Gifts of cash
  - Gifts of tangible or intangible property
  - Very easy & simple
  - Some taxpayers qualify for an income tax deduction
  - Amount given will not be included in the taxpayer's estate

Charitable Contributions

- Outright gifts
  - Qualified Charitable Distributions (QCDs) from an IRA
    - Taxpayer must be age 70½ or older
    - Distribution must be direct to charity
    - Distribution cannot exceed $100,000
    - Distribution can count towards RMD
    - Distributions to Donor Advised funds & supporting organizations do not qualify

IRC § 408(d)(8)

Charitable Contributions

- Outright gifts
  - Qualified Charitable Distributions (QCDs) from an IRA
    - For many years congress renewed this provision annually and it was therefore unclear whether it was available
    - “Extenders” legislation made this provision permanent

IRC § 408(d)(8)

Charitable Contributions

- Outright gifts
  - Qualified Charitable Distributions (QCDs) from an IRA
    - Income is never recognized by the taxpayer and no deduction is claimed on the return.
    - Generally more or equally as tax efficient as a distribution from the IRA and then a contribution to charity because QCDs are not subject to the other limits on deductions for charitable contributions.

IRC § 408(d)(8)

Charitable Contributions

- Testamentary gifts
  - Very common; perhaps the most common way large gifts are made
  - Can be a:
    - Specific amount of money (pecuniary bequest),
    - Specific asset (specific bequest or devise),
    - Percentage of the estate (fractional bequest), or
    - Residual amount.
  - Reduces the taxable portion of an estate

Charitable Contributions

- **Tactical Charitable Contributions:**
  - Charitable contributions can be timed tactically
    - Reduce income in high-tax years
    - Reduce income to avoid phase-out of tax benefits
    - Avoid recognition events
    - Lump charitable contributions into a single year in order to be able to itemize (e.g. make two years of contributions each December or contribute to a DAF)

Charitable Contributions

- **Tactical Charitable Contributions (cont):**
  - Split-interest type gifts and “endowment” type gifts can allow taxpayers to concentrate years of charitable giving in a single year (e.g. DAF)
  - The AGI Limitation for cash gifts increased from 50% to 60% with tax reform
  - QCDs can avoid the limitations imposed by the standard deduction and percentage limitations and reduce taxable income due to RMDs

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Charitable Contributions

- **Tactical Charitable Contributions (cont):**
  - Gifts of highly appreciated positions can be efficient:
    - Avoids a recognition event
    - Still provides a charitable deduction
    - Limited to 30% of AGI

Charitable Contributions

- **Tactical Charitable Contributions (cont):**
  - Example of charitable giving to avoid losing a tax benefit

Tom is a married self-employed lawyer. His taxable income in 2018 will be $400,000. The practice generates $200,000 of qualified business income (QBI).

Without planning, his QBI deduction is $6,000

- Calculation: $200,000 x 20% (1 - ($400,000−$315,000)/$100,000))
- QBI Deduction Tax Savings: $6,000 x 32% = $1,920

However, with a $85,000 charitable contribution to a DAF his deduction is $40,000

- Calculation: $200,000 x 20%
- The deduction reduces his taxable income below the threshold amount (315k (MFJ)
- Additional QBI Deduction Tax savings: $40,000 x 32% = $12,800 - $1,920 = $10,880
- Contribution Tax Savings $85,000 x 32% = $27,200

Roth IRA Conversions Going Forward

Roth Conversions

- In simplest terms, a traditional IRA will produce the same after-tax result as a Roth IRA provided that:
  - The growth rates are the same
  - The tax rate in the conversion year is the same as the withdrawal year
  - Amount x growth x (1-tax rate) = Amount x (1-tax rate) x growth

Roth Conversions

	Traditional IRA	Roth IRA
Current Account Balance	$ 1,000,000	$ 1,000,000
Less: Income Taxes @ 35%	-	(350,000)
Net Balance	**$ 1,000,000**	**$ 650,000**
Growth Until Death	200.00%	200.00%
Account Balance @ Death	$ 2,000,000	$ 1,300,000
Less: Income Taxes @ 35%	(700,000)	-
Net Account Balance to Family	**$ 1,300,000**	**$ 1,300,000**

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Roth Conversions

- Reasons to convert to a Roth IRA:
  1. Special favorable tax attributes including charitable deduction carry-forwards, net operating losses (NOLs), high basis non-deductible traditional IRAs, investment tax credits, etc.
  2. Taxpayers who can pay the income tax on the IRA from non-IRA funds benefit greatly from the Roth IRA because of the ability to enjoy greater tax-free yields.
  3. Suspension of the minimum distribution rules at age 70½ provides a considerable advantage.

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Roth Conversions

- Reasons to convert to a Roth IRA (cont):
  4. Tax brackets are more favorable for married couples and therefore conversions before the first spouse's death are efficient
  5. Tax rates are currently very low and may increase in the future
  6. Taxpayers benefit from paying income tax before estate tax compared to the income tax deduction obtained when a traditional IRA is subject to estate tax

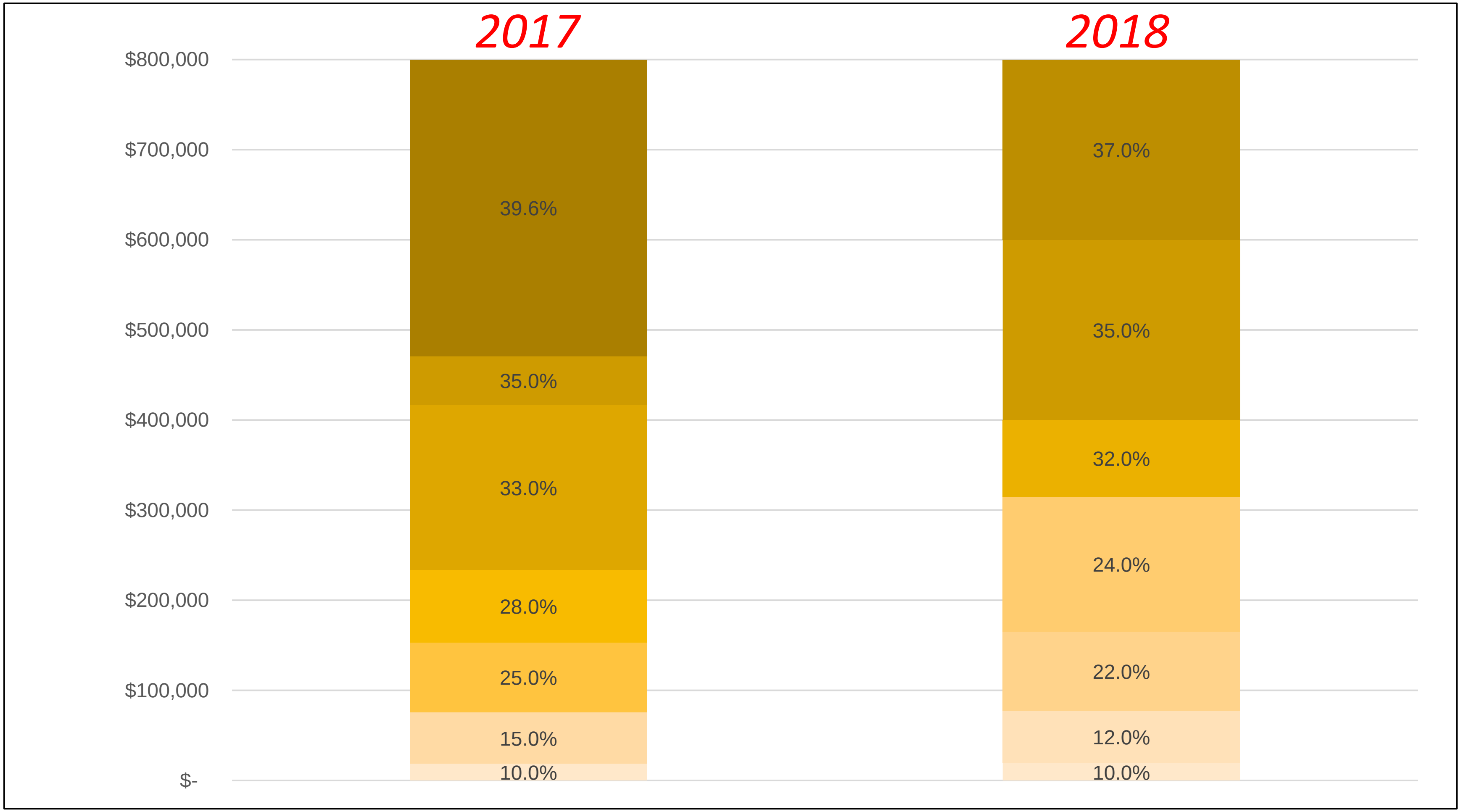
Roth Conversions

Tax Reform

TAX REFORM REPEALED THE ABILITY TO RECHARACTERIZE A ROTH CONVERSION

Roth Conversions & DrawDown

Bracket Changes – Married



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College Planning After Tax Reform

College Planning

- **Qualified Tuition Programs (QTPs/529s)**
  - Age and AGI limits of ESAs do not apply
  - Effective annual contribution limit is $15,000
    - Contributions are considered a completed gift for transfer tax purposes
    - However, 5 years of contributions can be made in an accelerated lump-sum: $15,000 x 5=$75,000
    - No further contributions during the 5-year period if you take advantage of this acceleration provision
  - Overall contribution limit varies by state
  - Most states provide contribution incentives such as tax deductions, tax credits, or matching grants.

College Planning

- **Qualified Tuition Programs (QTPs/529s)**
  - For wealthy clients:
    - Tax-free savings even more advantageous.
    - IRC §2503(e)provides gift tax exemption for tuition, which prudent, wealthy (grand)parents of students take advantage of.
    - However, it does not include "books, supplies, dormitory fees, board, or other similar expenses." Reg. 25.2503-6.
    - 529s remain useful.

College Planning

- **Qualified Tuition Programs (QTPs/529s)**
  - 2017 Tax Act changes:
    - Distributions of up to $10,000 may be used for elementary school and high school "qualified expenses"
    - Rollovers from QTP accounts to ABLE accounts allowed

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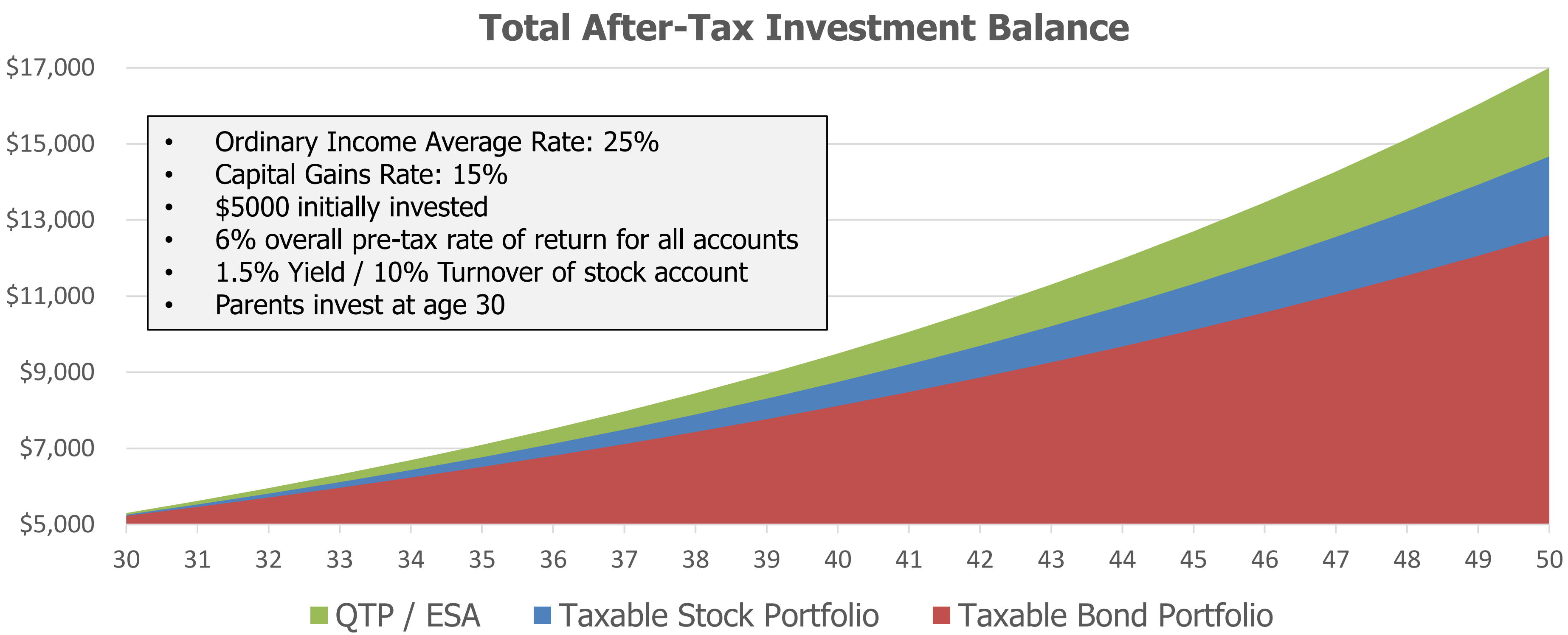
College Planning

- **Qualified Tuition Programs (QTPs/529s)**



The chart merely depicts the difference due to the income tax treatment for each option if all other variables are held constant.

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Advanced Income Tax Planning Using Trusts

Creating Trusts to Save Income Tax

Completed Gift Trusts

- Traditional estate (tax) planning
- Property generally not included in the grantor's estate (does not receive a basis adjustment at death)
- Not dependent on special provisions in the state trust code

Incomplete Gift Trusts

- Income tax and asset protection planning
- Property generally included in the grantor's estate (receives a basis adjustment at death)
- Requires the trust to be formed under the law of a limited set of states

Creating Trusts to Save Income Tax

§ **643(f) TREATMENT OF MULTIPLE TRUSTS** For purposes of this subchapter, under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust if—

(1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and

(2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter.

For purposes of the preceding sentence, a husband and wife shall be treated as 1 person.

Creating Trusts to Save Income Tax

- **Saving State Income Tax**
  - A grantor in a state with an income tax can settle a trust under the laws of a state without income tax
  - Whether its possible is dependent on the: grantor's state, beneficiary's state, trustee's state, and the state of administration

		Current	No SALT Deduction	Out of State Trust
Income		$ 100	$ 100	$ 100
State Tax	5%	(5)	(5)	
Federal Tax	37%	(35)	(37)	(37)
Net to Family		$ 60	$ 58	$ 63

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Creating Trusts to Save Income Tax

- **Qualified Business Income - § 199A**
  - The deduction is limited after the business owner's taxable income exceeds a threshold amount
  - Gifting business interests to trust can increase the amount of income which qualifies for the full deduction

TYPES OF TAXPAYERS	THRESHOLD AMOUNT
Single persons	$ 157,500
Married persons	$ 315,000
Estates	$ 157,500
Non-grantor completed gift trusts	$ 157,500
Non-grantor incomplete gift trusts	$ 157,500
Children subject to the "kiddie tax"	$ 157,500

Creating Trusts to Save Income Tax

- **State & Local Tax Deduction**
  - The deduction is now limited to $10,000 ($5,000 for MFS)
  - Settling a nongrantor trust can create an additional taxpayer and therefore an additional $10,000 SALT deduction

Contributions to Defined Contribution or Defined Benefit Plans for Business Owners

Retirement Plans

Maximum Retirement Plan Contributions

DEFINED CONTRIBUTION PLAN LIMITS	
IRA / ROTH IRA CONTRIBUTION LIMIT	$ 5,500
IRA / ROTH IRA "CATCH UP"	$ 1,000
401k ELECTIVE DEFERRAL	$ 18,500
401k ELECTIVE DEFERRAL "CATCH UP"	$ 6,000
SIMPLE IRA CONTRIBUTION LIMIT	$ 12,500
SIMPLE IRA "CATCH UP"	$ 3,000
SEP IRA EMPLOYEE PERCENTAGE MATCH LIMIT	25%
SEP IRA SELF-EMPLOYED PERCENTAGE MATCH LIMIT	20%
OVERALL LIMIT ON CONTRIBUTIONS TO DCPs	$ 55,000

Retirement Plans

Cash Balance Plans

Current Age	DC/401k Contribution	Cash Balance Allocation	Total
35	54,000	70,000	124,000
40	54,000	90,000	144,000
45	54,000	115,000	169,000
50	60,000	145,000	205,000
55	60,000	190,000	250,000
60	60,000	245,000	305,000

Please note these are 2016 figures.

A Special Thanks to Shore-Tompkins for Providing this Slide.

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Retirement Plans

Cash Balance Plans

- A Cash Balance plan is a **Hybrid Defined Benefit** plan
  – Provides a **promised** benefit by employer
  – Benefit is communicated as a **"hypothetical account"** similar to a profit sharing plan account

A Special Thanks to Shore-Tompkins for Providing this Slide.

Overview of Taxation of Business Entities

Business Taxation

Main Issues

- Corporate rate reduction
  - AET & PHC Tax
- New 199A pass-through deduction
- Accelerated cost recovery
- New interest paid deduction limit
- New loss deduction limits

Corporate Tax Rates

Current

Taxable income:	Tax rate:
$0-$50,000	15 percent
$50,001-$75,000	25 percent
$75,001-$10,000,000	34 percent
Over $10,000,000	35 percent

2018

21% flat rate

§ 11, §13001

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Personal Holding Company (PHC)

- 20% tax imposed on undistributed personal holding company income
- PHC Definition
  - 60% of adjusted ordinary gross income is personal holding company income
  - Greater than 50% of the value of outstanding stock is owned directly or indirectly by, or for, not more than 5 individuals
- Personal holding company income includes:
  - Dividends
  - Rents
  - Royalties
  - Personal service contracts
  - Trust distributions
- §§ 541-547

Accumulated Earnings Tax (AET)

- 20% tax imposed on accumulated E&P beyond the reasonable needs of the business
- Reasonable needs of the business (basically) include
  - The reasonably anticipated needs of the business (subjective test)
    - Expansion, M&A, retire debt, working capital, investments or loans to customers & suppliers
  - The amount needed for a § 303 redemption
- Purposes suggesting unreasonable accumulations
  - Loans to shareholders or relatives
  - Expenditures for the personal benefit of shareholders
  - Investments unrelated to the corporation's business
  - Retention of amounts to protect against unrealistic risks
- Designed to force distributions of amounts not needed to run the business
- Doesn't apply in addition to the PHC Tax
- §§ 531-537

IRC § 199A

- Deduction equal to 20% of domestic "qualified business income" (QBI) from a pass-through entity
- Basically, provides an effective top marginal rate of 29.6% [37% x (1 – 20%)]
- Applies to trusts & estates

§ 199A, §11011

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IRC § 199A

- For those with taxable income in excess of $415,000 (MFJ) the deduction is limited to the greater of:
  - 50% of W-2 Wages
  - 25% of W-2 Wages plus 2.5% of unadjusted basis
- Unavailable to Specified Service Business owner's taxable income in excess of $415,000 (MFJ)
- Limitations phased-in from $315,000 - $415,000 (MFJ) of taxable income

§ 199A, §11011

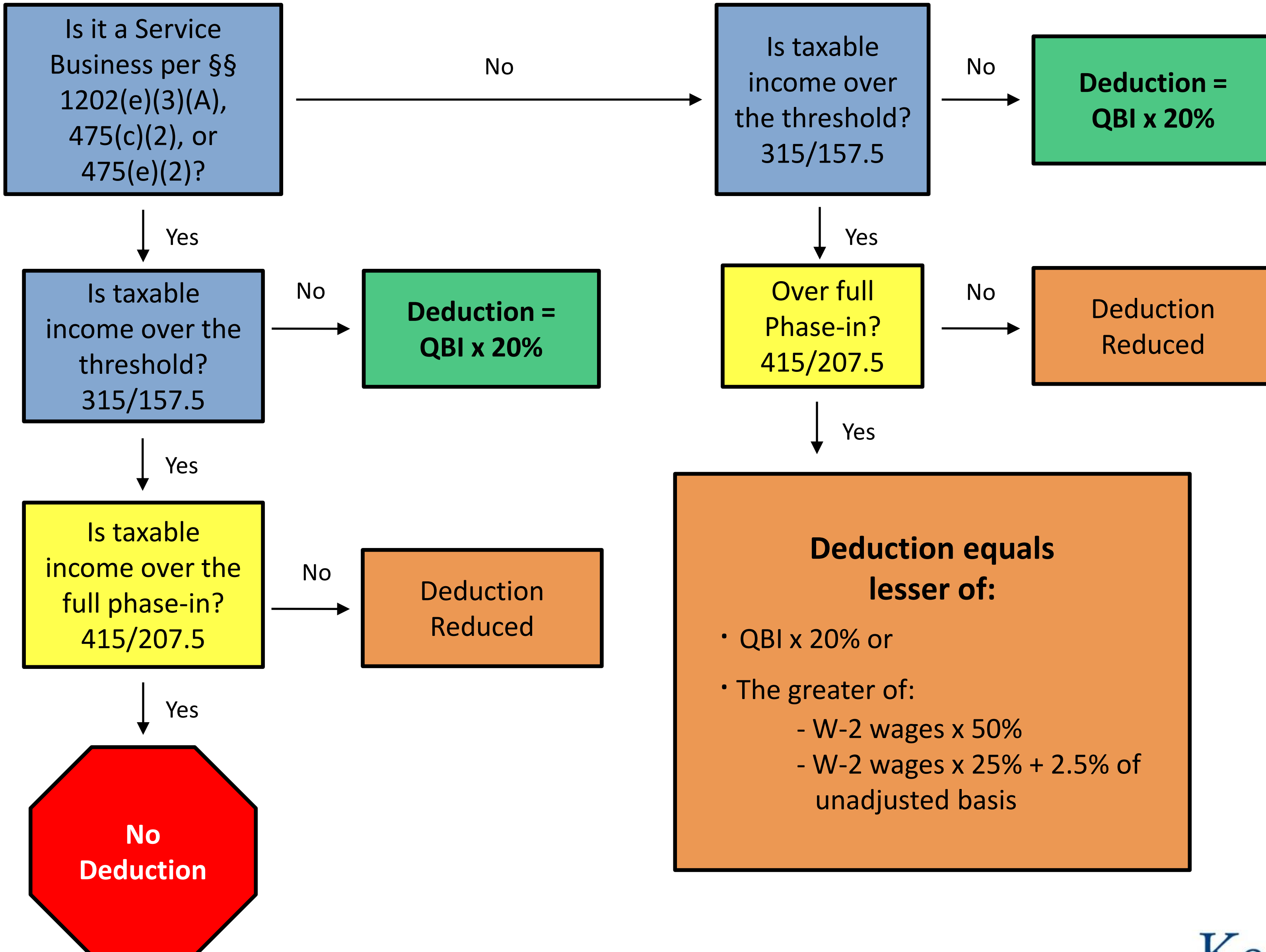
IRC § 199A

- Specified Service Business – defined in § 1202(e)(3)(A):

  "any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees"

- The final version includes new statutory language to exclude architects and engineers from the Specified Service Business definition

§ 199A, §11011


Is it a Service Business per §§ 1202(e)(3)(A), 475(c)(2), or 475(e)(2)?
No
Is taxable income over the threshold? 315/157.5
No
Deduction = QBI x 20%
Yes
Is taxable income over the threshold? 315/157.5
No
Deduction = QBI x 20%
Yes
Over full Phase-in? 415/207.5
No
Deduction Reduced
Yes
Is taxable income over the full phase-in? 415/207.5
No
Deduction Reduced
Yes
No Deduction
Yes
Deduction equals lesser of:
• QBI x 20% or
• The greater of:
- W-2 wages x 50%
- W-2 wages x 25% + 2.5% of unadjusted basis

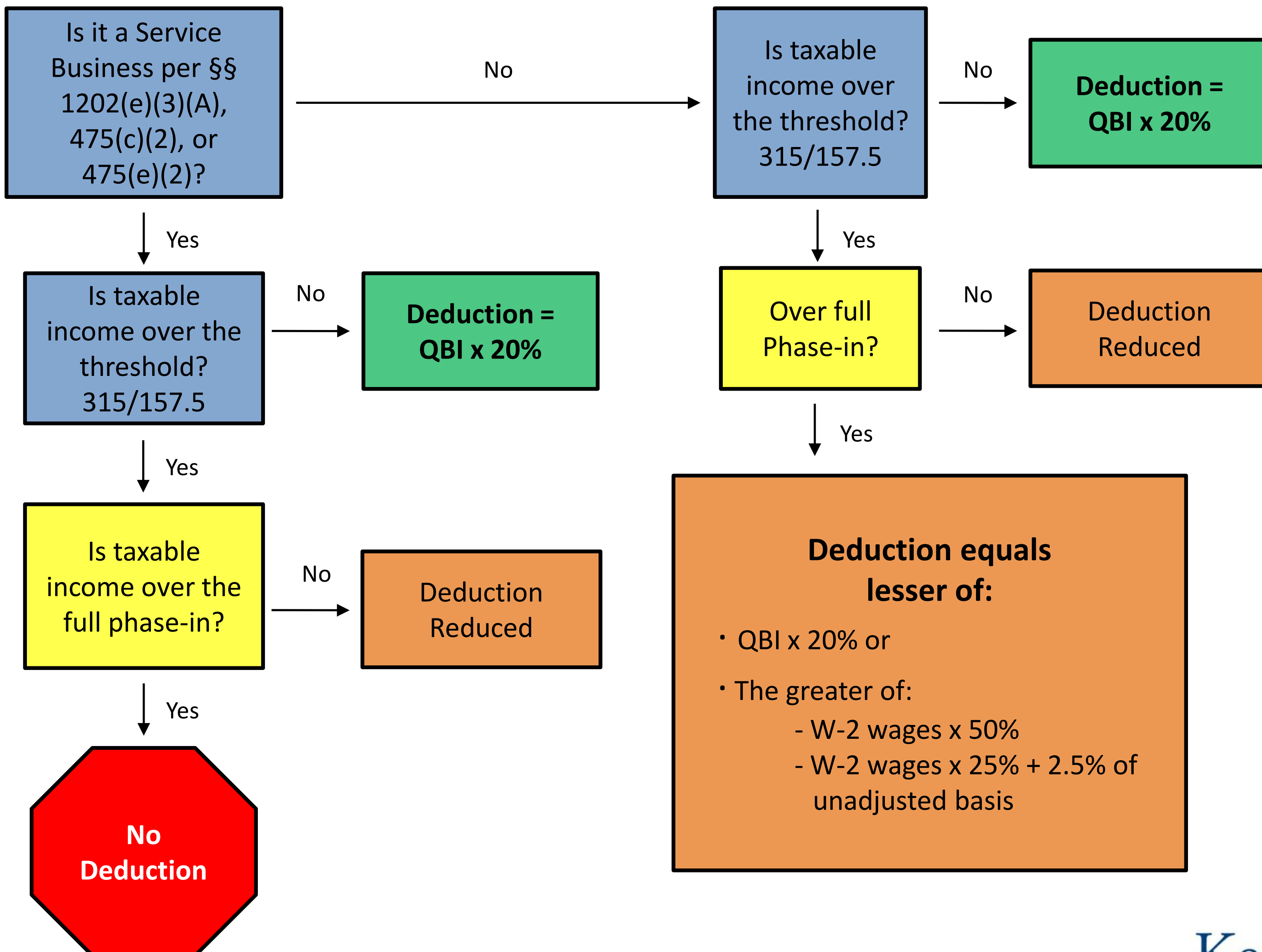
Section 199A Planning

IRC § 199A

Eligible Taxpayers

- Owners of:
  - REITs & PTPs
  - Sole proprietorships (Schedule C)
  - Sole owners (or TIC owners) of rental real estate (Schedule E)
  - S-Corporation owners (Form 1120S)
  - Partnership owners (Form 1065)

ALL QUALIFY BUT THE COMPUTATION DIFFERS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No
Yes
Is taxable income over the threshold? 315/157.5
No
Deduction = QBI x 20%
Yes
Is taxable income over the full phase-in?
No
Deduction Reduced
Yes
No Deduction
Is taxable income over the threshold? 315/157.5
No
Deduction = QBI x 20%
Yes
Over full Phase-in?
No
Deduction Reduced
Yes
Deduction equals lesser of:
• QBI x 20% or
• The greater of:
- W-2 wages x 50%
- W-2 wages x 25% + 2.5% of unadjusted basis

Four Business Classifications

And the Limitations

	Non-Service	Service
Taxable income less than $315,000 (MFJ)	**20% deduction**	**20% deduction**
Taxable income greater than $315,000 but less than $415,000	Limitation phased-in	Deduction phased-out
Taxable income greater than $415,000	**W-2/Property limit applies**	**No deduction**

THE HEART OF PLANNING IS MANAGING TAXABLE INCOME AND THE WAGE / PROPERTY LIMITATION

Eligible Taxpayers

TYPES OF TAXPAYERS	THRESHOLD AMOUNT
Single persons	$ 157,500
Married persons	$ 315,000
Estates	$ 157,500
Non-grantor completed gift trusts	$ 157,500
Non-grantor incomplete gift trusts	$ 157,500
Children subject to the “kiddie tax”	$ 157,500

Calculation of the Deduction

Simplified

- For those with taxable income in excess of $415,000 (MFJ) the deduction is limited to the greater of:
  - 50% of W-2 Wages
  - 25% of W-2 Wages <u>plus 2.5% of Qualified Property</u>

- Inapplicable to <u>Specified Service Business</u>

- Limitations for non-Specified Service Businesses phased-in from $315,000 - $415,000 (MFJ) of taxable income

- Deduction for Specified Service Businesses phased-out from $315,000 - $415,000 (MFJ) of taxable income

§ 199A, §11011

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Managing the Limitation

- **Excess Income**
  - Amount by which taxable income exceeds the threshold amount
  - Opportunity: Reducing income increases the deduction
- **Excess Limitation**
  - Amount by which the limitation imposed on high-earners exceeds 20% x QBI
  - Opportunities: Decrease wages or unadjusted basis without penalty
- **Unused Deduction**
  - Limitation imposed on high-earners reduces the deduction to less than 20% x QBI
  - Opportunities: Increase leverage without penalty, increase wages or investment to increase deduction

Trust Planning Example

Family Involved in Rental Real Estate

Richard and Delores, a married couple, purchased 500 apartment units between 1975 and 1990. These are managed by others and they pay no wages. The Qualified Business Income from this activity is about $1,900,000 and their total taxable income is about $2,200,000. The original basis of the improvements is fully depreciated so they have a minimal amount of qualified property; about $750,000. Based on these facts, below is a summary of their QBI deduction in 2018:

QBI Deduction = Lesser of:

(a) 20% of net business income: $1,900,000 x 20% = **$380,000**

(b) 20% of taxable income: $2,200,000 x 20% = $**440,000**

(c) greater of: (i) 50% of W-2 wages ($0 x 50% = $0) or (ii) 25% of W-2 wages plus 2.5% of unadjusted cost basis of assets: [$0 x 25%] + [$750,000 x 2.5%] = **$18,750**

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Trust Planning Example

Family Involved in Rental Real Estate

Richard and Delores gift interests in the entities which own the properties evenly to 15 trusts set up for each of their four children and 11 grandchildren. The Qualified Business Income and taxable income for each of these trusts is approximately $126,667. This is less than the threshold amount of $157,500 and therefore the limitation does not apply. Based on these facts, below is a summary of their QBI deduction for each trust:

QBI Deduction = Lesser of:

(a) 20% of net business income: $126,667 x 20% = **$25,333**

(b) 20% of taxable income: $ 126,667 x 20% = **$25,333**

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General Planning Ideas

- Reduce taxable income
  - Tax-free bonds
  - Life insurance & annuities
  - Real estate investments
  - Oil & gas investments
  - Charitable gifts (including CRTs)
  - Gifts to taxpayers with lower taxable income (e.g. trusts)
- Increase business income
  - Reduce leverage
  - Purchase leased equipment & real estate
- Increase W-2 Wages
  - Make S-election & pay wages
  - Increase employee wages
  - Replace contractors with employees
- Increase Qualified Property
  - Purchase leased equipment & real estate
- Spin-out or merge businesses to manage deduction
  - Separate service and non-service businesses
  - Spin-out real estate
- Recapitalize businesses to manage deduction (especially shifting leverage to service businesses)

Complete v. Incomplete Gift Trust Planning

Completed Gift Trusts

- Traditional estate (tax) planning
- Property generally not included in the grantor's estate
- Not dependent on special provisions in the state trust code

Incomplete Gift Trusts

- Income tax and asset protection planning
- Property generally included in the grantor's estate (and receives a basis adjustment at death)
- Requires the trust to be formed under the law of a limited set of states

Both create an additional taxpayer for Section 199A.

Trust Planning

§ **643(f) TREATMENT OF MULTIPLE TRUSTS** For purposes of this subchapter, under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust if—

(1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and

(2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter.

For purposes of the preceding sentence, a husband and wife shall be treated as 1 person

Decanting

with a Larger Exemption

Decanting Overview

- Definition: modifying the terms of a trust by distributing its assets to another trust

- The second trust (receiving trust) can be either new or pre-existing

- Decanting can be authorized by the terms of the original trust, state law, or perhaps even by common law

Decanting

Planning Idea

- Decant to a trust that gives beneficiary a general power of appointment
- Trust would be included in beneficiary's taxable estate. IRC Sec. 2041
- Goal: obtain step-up in basis for trust assets at death of beneficiary

Decanting

Value of the Step-Up - Example

- H dies in 2000 owning XYZ real estate with a value of $400,000. Pursuant to H's estate planning documents, the real estate goes to a credit shelter trust for the benefit of H's wife, W.

- The new basis of the real estate held in the trust is $400,000 (i.e. the value at H's death).

- Assume W dies in 2017 when the real estate has appreciated to $1,000,000. The real estate held in the family trust would still have a basis of $400,000. If the real estate is sold following W's death, the gain would be $600,000 ($1,000,000-$400,000).

- If the trust is decanted into a new trust giving W a GPOA, the trust will be included in W's estate. The real estate would then receive a step-up in basis to $1,000,000 at W's death.

- Decanting the trust property into a trust over which W has a GPOA could save $120,000 of income tax ($600,000 x 20% capital gain tax).

Uses of Decanting

Caveats

- Whether decanting can be used for the applications listed on the previous slides may depend on the applicable state's decanting statute

- Some state decanting statutes are much more favorable than others

- Some of the applications may result in unfavorable tax consequences depending on how the tax issues are resolved by the IRS and the courts

5th Annual Trust Decanting State Rankings Chart

Rank	State	Has Decanting Statute? (60% weight)	Can Decant Trust with Ascert. Standard? (7.5% weight)	Notice to Beneficiaries Required? (7.5% weight)	Can Decant Trust with Ascertainable Standard into Discretionary Trust? (7.5% weight)	Can Remove Mandatory Income Interest? (2.5% weight)	Allow Power of Appointment in Second Trust to Non-Bene? (2.5% weight)	Can Accelerate Remainder Bene's Interest? (2.5% weight)	Dynasty Trust State Ranking (7.5% weight)	Domestic Asset Protection Trust State Ranking (2.5% weight)	Total Score
1	SD	§55-2-15	Yes	No	Yes	Yes	Yes	Yes	Ranked #1	Ranked #2	99.5
2	NV	§163.556	Yes	No	Yes	Yes	Yes	Yes	Ranked #2	Ranked #1	99
3	TN	§35-15-816(b)(27)	Yes	No	Yes	No	Yes	Silent	Ranked #3	Ranked #3	93
4	NH	§564-B:4-418	Yes	No, except charitable trusts	Yes	No	Yes	Silent	Ranked #10 (tie)	Ranked #11	89.5
5	DE	12, §3528	Yes	No	No	Yes	Yes	No	Ranked #8 (tie)	Ranked #7 (tie)	86
6	OH	§5808.18	Yes	Yes	No	Yes	Yes	No	Ranked #7	Ranked #4	79.5
7 (tie)	AK	§13.36.157-159; §13.36.215	Yes	Yes	No	No	Yes	No	Ranked #4	Ranked #7	77.5
7 (tie)	IL	760 ILCS 5/16.4	Yes	Yes	No	No	Yes	Silent	Ranked #8 (tie)	Not allowed	77.5
9	IN	§30-4-3-36	Yes	Yes	Yes	No	Silent	Silent	Unranked	Not allowed	75
10 (tie)	MO	§456.4-419	Yes	Yes, only to beneficiaries of second trust	No	Yes	Silent	Yes	Unranked	Ranked #6	74

http://www.oshins.com

Steve Oshins is a member of the Law Offices of Oshins & Associates, LLC in Las Vegas, Nevada. He is rated AV by the Martindale-Hubbell Law Directory and is listed in The Best Lawyers in America®. He was inducted into the NAEPC Estate Planning Hall of Fame® in 2011 and has been named one of the 24 "Elite Estate Planning Attorneys" by The Trust Advisor and one of the Top 100 Attorneys in Worth. He can be reached at 702-341-6000, ext. 2 or soshins@oshins.com. His law firm's website is www.oshins.com.

Asset Protection Planning

With an Increased Gift Exemption

Domestic Asset Protection Trusts

Overview

- With the large estate tax exemption, many clients do not need estate tax planning
- When the estate tax exemption was lower, asset protection was merely another benefit of settling a trust
- The DAPT enables settlors to give away assets and remove future appreciation from their estate while retaining the benefit of the assets if needed
- Full faith and credit issue

Domestic Asset Protection Trusts

Overview

- A DAPT is an irrevocable trust that is set up under the laws of one of the states that allows a person to be a discretionary beneficiary of his own trust without creditors being able to access it
  - Pick a state with a short statute of limitations
  - Pick a state where no statutory exception creditors can access it
- Independent trustee has absolute discretion whether to make distributions to the settlor
- Trust has a spendthrift clause which prohibits payments to the settlor's creditors

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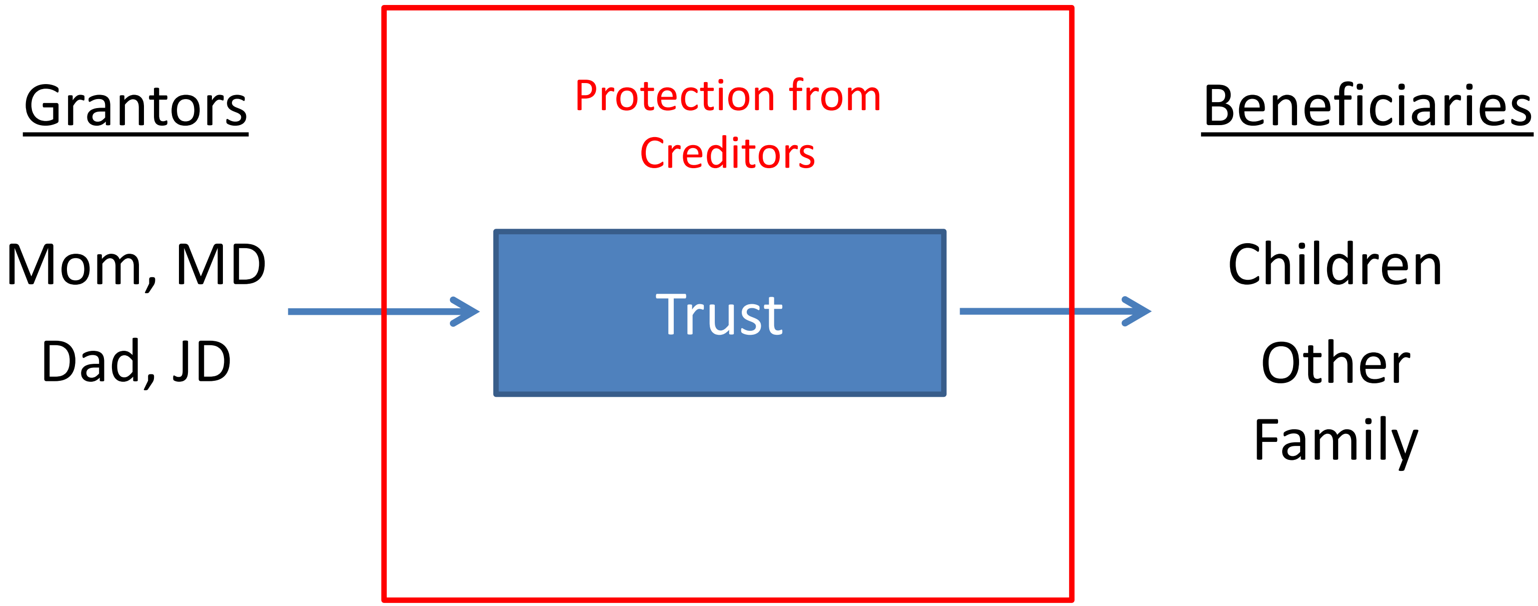
Asset Protection with Third Party Trusts

Overview

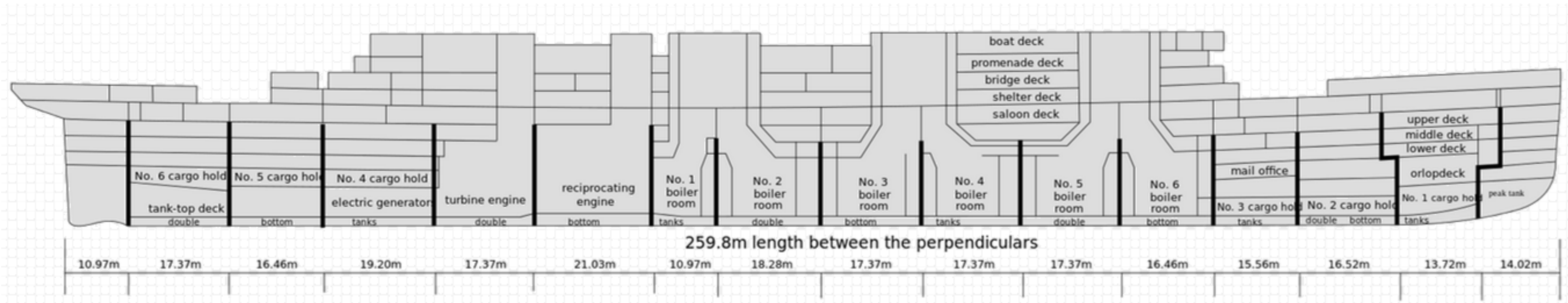
- Third Party Trusts – A trust which holds property for a beneficiary other than the settlor



Compartmentalizing Risk

Overview

- Restructure capital in various business entities to compartmentalize risk
- Expense / investment is merely additional organizational cost
- Insurance is still the "primary defense"



Compartmentalizing Risk

Overview

- Create separate business entities for
  - Different businesses
  - Real estate
  - Significant equipment
- Manage debt-to-equity ratio
- LLCs in states where a charging order is the only remedy
- Be wary of the 30% interest test

Estate Planning for IRAs

Paying IRAs to Trusts

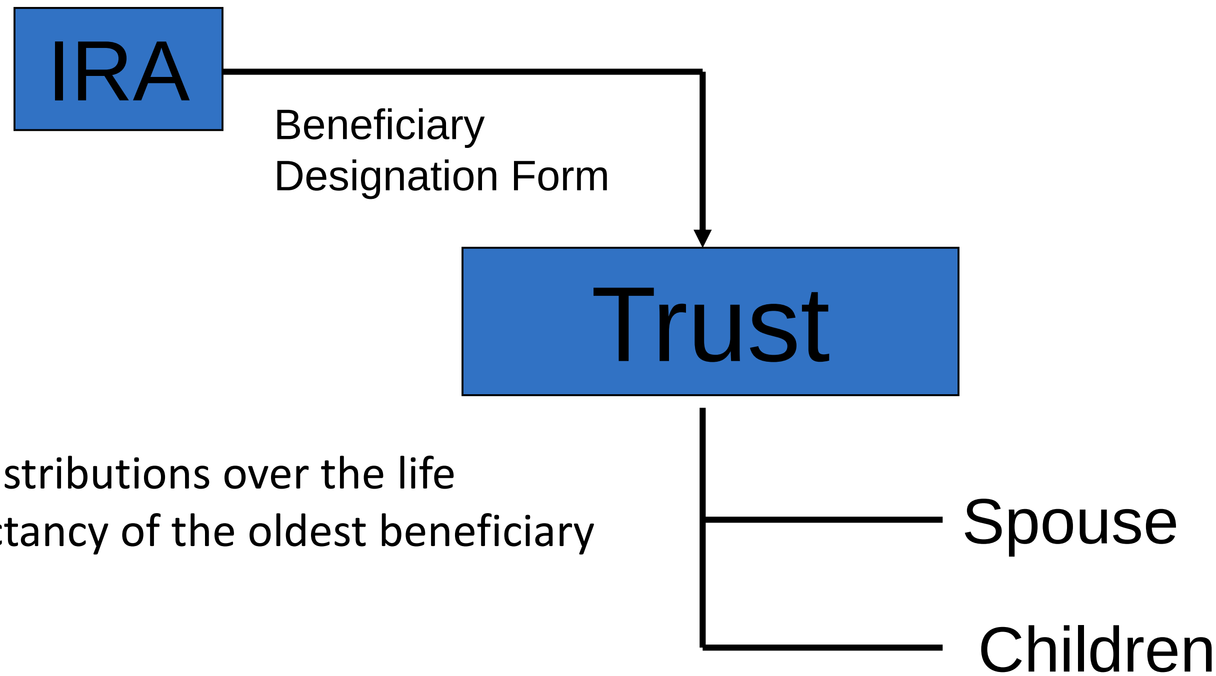
Benefits of Utilizing a Trust

- Spendthrift protection
- Creditor protection
- Divorce protection
- Special needs
- Investment management
- Estate planning
- “Dead-hand” control

Paying IRAs to Trusts

Naming a Trust as a “Designated Beneficiary”

An IRA Can Be Payable to a Trust



IRA distributions over the life expectancy of the oldest beneficiary

Paying IRAs to Trusts

Four Requirements for <u>ALL</u> Trusts

1. Trust is valid under state law
    - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(1)
2. Trust is irrevocable upon death of owner
    - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(2)
3. Beneficiaries of the trust are identifiable from the trust instrument
    - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(3)
4. Documentation requirement is satisfied
    - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(4)

Paying IRAs to Trusts

Types of Testamentary Trusts

- Unified Credit Trust
- Marital Trust
- QTIP Trust
- Generation-Skipping Trusts
- Charitable Remainder Trust

Paying IRAs to Trusts

Three Types of Trusts

- Accumulation Trusts
- Conduit Trusts
- “Payout” Trusts
- Treas. Reg. § 1.401(a)(9)-4, Q&A 5 requirements apply to both accumulation and conduit

Paying IRAs to Trusts

Conduit Trust

- A trust in which all distributions from the IRA are immediately distributed to the trust beneficiary(ies)
- Very limited asset protection

Paying IRAs to Trusts

Accumulation Trust

- A trust in which distributions from the IRA are allowed to accumulate within the trust
- Stronger asset protection than a conduit trust

Paying IRAs to Trusts

Separate Share Rule

Payable to single trust

↓

No separate shares identified in the beneficiary designation form

↓

IRA paid over oldest life expectancy

Paying IRAs to Trusts

Separate Share Rule

IRA payable to multiple trusts

↓

Each trust named in
beneficiary designation form

↓

IRA paid over each separate trust beneficiary's life expectancy

PLR 200537044

Paying IRAs to Trusts

Post-Mortem Trust Reformations

- In the past, IRS has respected post-mortem trust reformations that modified the trust to qualify as a designated beneficiary. See PLRs 200235038-41.
- IRS no longer appears to follow post-mortem reformations.

Paying IRAs to Trusts

Reforming Beneficiary Designations

- PLR 200616039-41 - Daughter's life expectancy could be used. Even though no contingent beneficiaries were named, court reformed beneficiary designation to name daughters as contingent beneficiaries of IRA.
- IRS is currently rethinking this position.

Paying IRAs to Trusts

Protection Against Claims of Creditors

	Parent's Exempt IRA	Parent's Exempt IRA	Parent's Exempt IRA	Parent's Exempt IRA	Parent's Exempt IRA	Parent's Exempt IRA
	Child	Estate[3]	Typical Revocable Trust	Stand Alone Revocable IRA Trust	SubTrusts Under Stand Alone Trust	Irrevocable Trust
Subject to claims of beneficiary's creditors	YES	YES	Possibly NO	Possibly NO	Possibly NO	Possibly NO
Subject to claims of parent's creditors	NO	YES	YES[1]	YES[1]	Possibly NO[2]	NO

[1] Depends upon state law, however, see Commerce Bank v. Bolander, 2007 WL 1041760 (Kan. App. 2007) unpublished.

[2] By naming a SubTrust that is irrevocable you may avoid the reach of the Commerce Bank Doctrine.

[3] If the Estate is the Beneficiary and an outright distribution follows, then the IRA is subject to the claims of both sets of creditors.

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Paying IRAs to Trusts

Protection Against Claims of Creditors

	Beneficiary's Level of Asset Protection	Spendthrift Protection	Tax Issues
Direct Beneficiary	Very Low or None	None	Life Expectancy
Trusteed IRAs	Low	Good	Life Expectancy
Non Designated Trust	Some	Good	5 year or ghost life expectancy rule
Conduit Trust	Low	Good	Life Expectancy
Accumulation Trust – Restatement III	Some	Excellent	Life Expectancy
Accumulation Trust – Restatement II	Excellent	Excellent	Life Expectancy

Paying IRAs to Trusts

Common Mistakes to Avoid

- Older or unidentifiable contingent beneficiary
- Estate as contingent beneficiary
- Powers of appointment
- Failure of beneficiaries clause
- Failure to provide trust document to custodian by October 31 of year following year of death
- Making lump sum distribution to trust
- General powers of appointment
- Tax issues
- Asset protection issues

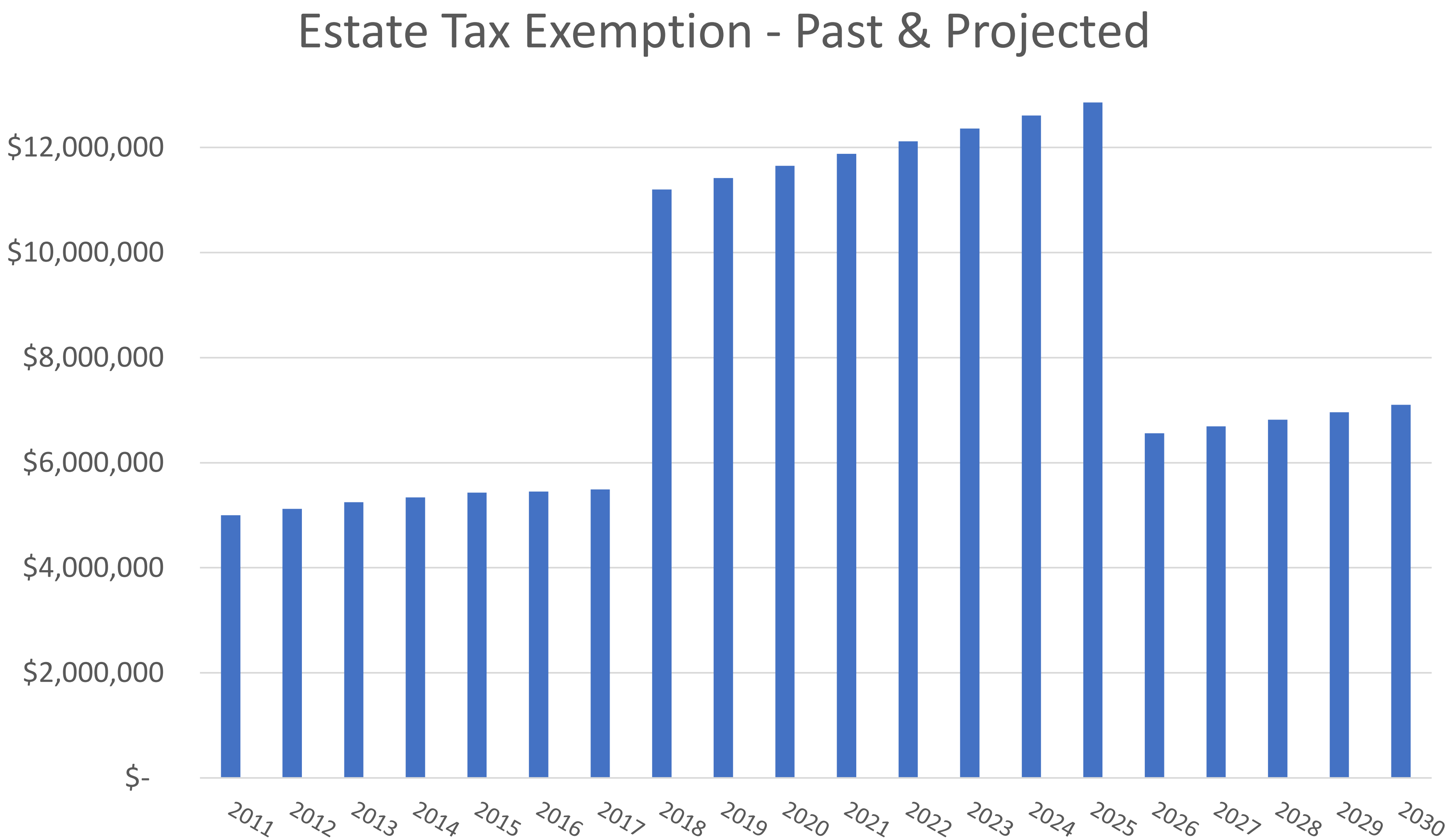
Avoiding Low Basis Traps

Estate & GST Taxes

- Doubles the Basic Exclusion Amount and GST exemption in 2018 ($10,000,000 in 2011 dollars)
- Higher exemption sunsets December 31, 2025
- Retains the § 1014(a) basis adjustment (“step-up”)

§ 2010, §11061

Estate & GST Taxes

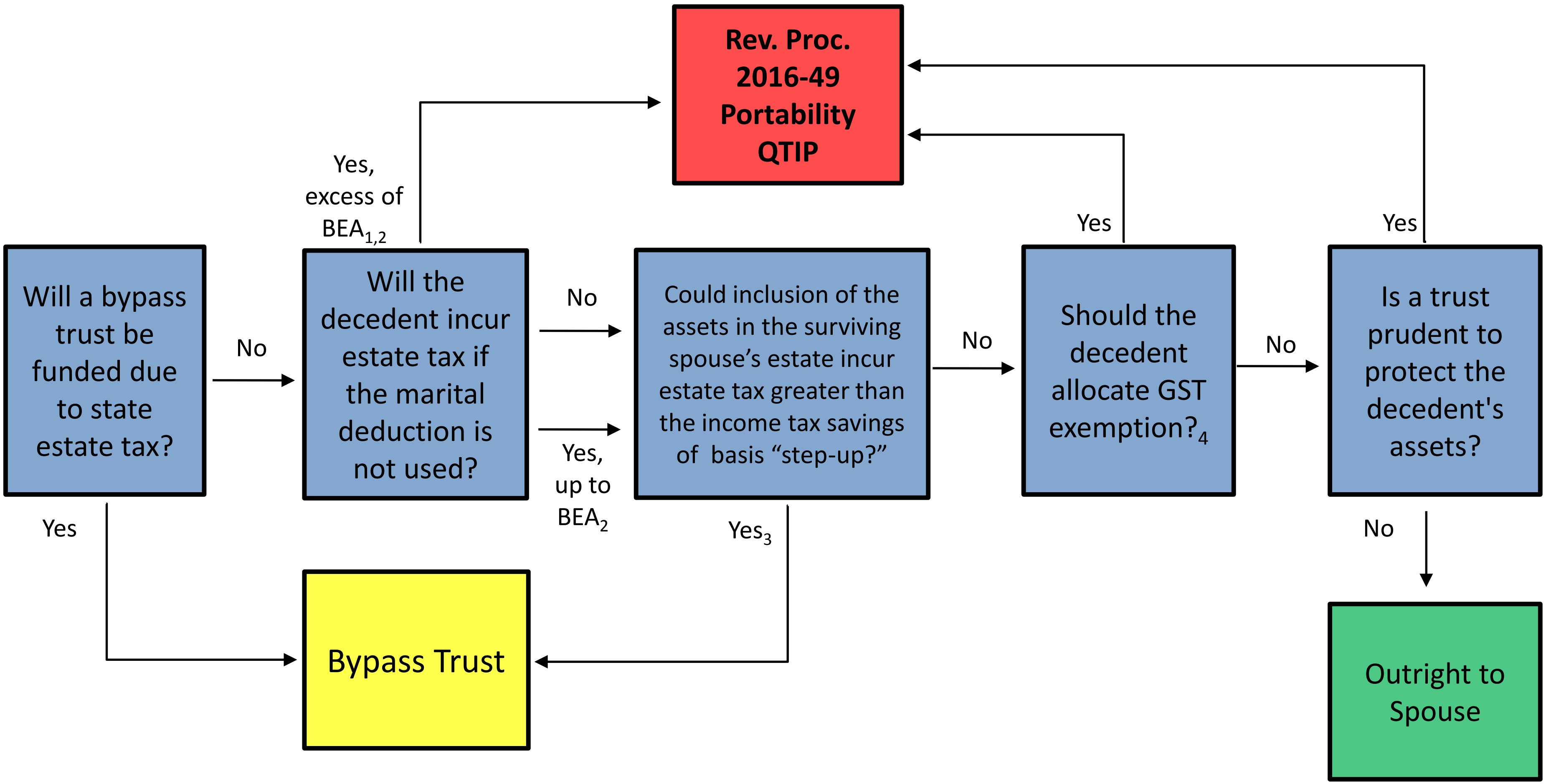


Estate & GST Taxes

Planning for a Future Congressional Reduction in the Exemption

- Tax-free gifts (to Dynasty Trusts) to use the higher exemption in anticipation of change
- IDGT Sales
- Transfers taking advantage of valuation discounts
- GST Planning
- Shifting Growth
- Four to eight-year GRATs for those “in the middle”
  - Force inclusion & obtain a “step-up” sunset in case of death
- GST grandfathered trusts/GST exempt trusts
- Portability elections
- “Springing” SLATs (i.e. SLAT with contingent GPOA provision)
- Increased ease of income shifting
- **Note, it will be difficult to decrease the exemption without creating inequitable results**

Current Testamentary Planning



1. Basic Exclusion Amount (BEA)
2. Assumes asset protection is desirable.
3. May be prudent to elect portability, give assets to the surviving spouse and then fund the trust in order to allow for a grantor trust.
4. Note that the GST exemption cannot "port" to the surviving spouse, however a "reverse-QTIP" election is available.

Estate & GST Taxes

Using a GRAT Hedge

- Using a GRAT can "hedge" the risk that a client dies early by protecting the basis step-up.
- Clients must live a significant period of time to shift post-gift appreciation out of their taxable estate for estate tax cost to exceed the income tax cost of preserving basis.
- A GRAT can hedge against the risk of early death because it forces inclusion, thereby achieving a basis increase for appreciated assets.

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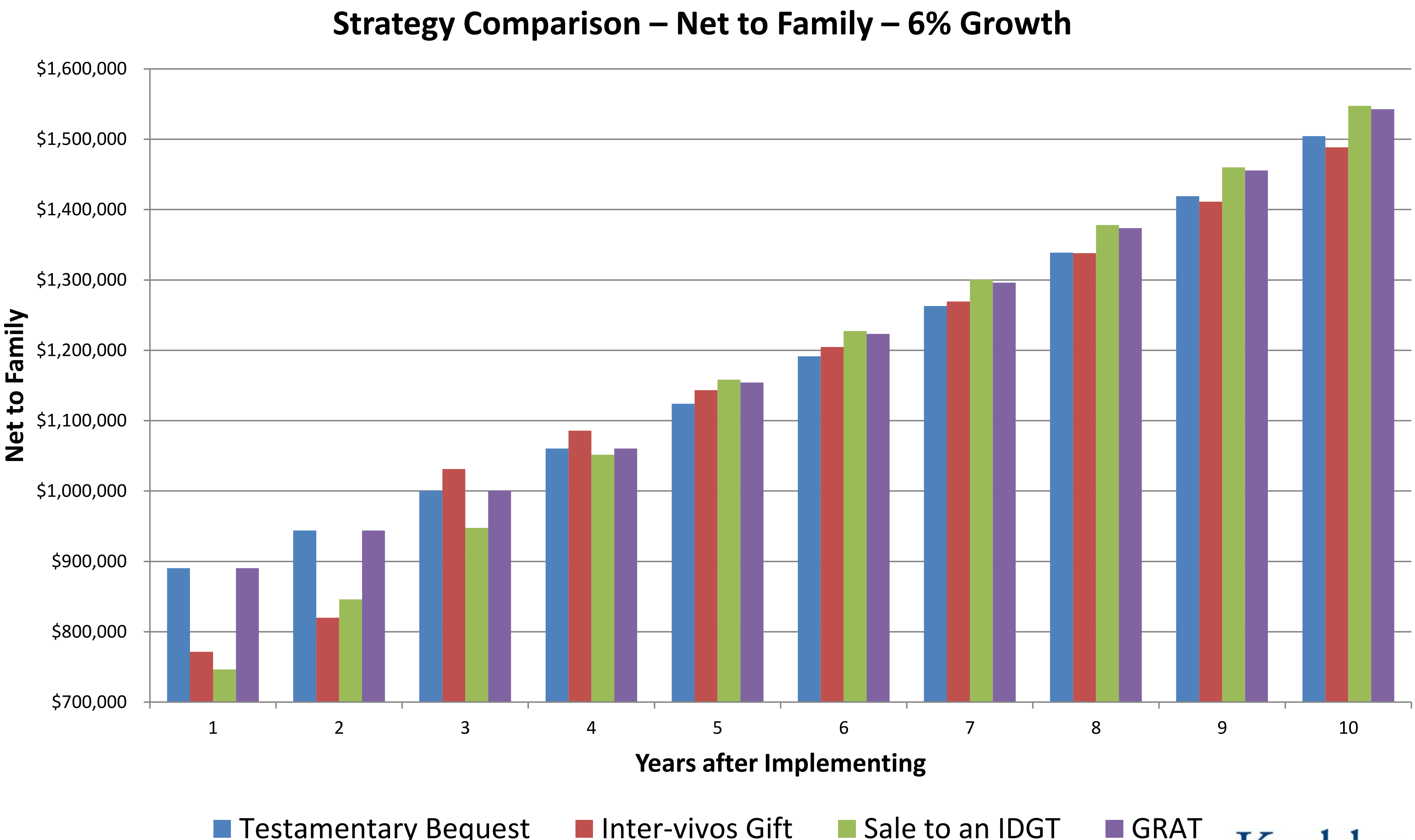
Estate & GST Taxes

Using a GRAT Hedge

- Example:
  - Client owns stock in a closely held business worth $1,000,000; basis is $200,000; rate of return is 6%.
  - The client also has $400,000 of cash available to pay gift tax.
  - The client already exhausted their lifetime exemption by funding a dynasty trust.
  - How should the client plan to transfer the stock to the next generation?
  - You should consider the following options:
    - Testamentary bequest
    - Inter vivos gift
    - IDGT Sale to the existing well-funded dynasty trust, with the note fully amortized over five years
    - **Five-year GRAT**

Estate & GST Taxes

Using a GRAT Hedge



Basis of Property Acquired from a Decedent § 1014

- Basis is generally FMV on date of decedent's death or, if elected, the alternate valuation date (IRC § 1014(a))
- Appreciated assets receive a "step-up" in basis at death – saves income tax when the property is sold by "heirs"
- Depreciated assets receive a "step-down" in basis – deprives "heirs" of the income tax benefit of claiming a loss when the property is sold
  - Less common than stepped-up basis because taxpayers have an incentive to realize losses during life

Single Client
Age 92 – Gift versus Death Analysis
Simple Breakeven

Size of Estate	$	22,400,000	$	22,400,000	$	22,400,000
Size of Gift	$	10,000,000	$	10,000,000	$	10,000,000
Basis of Gift	$	1,000,000	$	6,000,000	$	10,000,000
Built-in Gain	$	9,000,000	$	4,000,000		0
Built-in Gain taxed @ 25%	$	2,250,000	$	1,000,000		0
Appreciation needed to overcome value of step-up	$	5,625,000[1]	$	2,500,000[2]		0[3]
% of Appreciation		56.25%		25%		N/A

1. $2,250,000/40% = $5,625,000
2. $1,000,000/40% = $2,500,000
3. 40% Estate tax exceeds 25% Income tax

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Single Client
Age 92 – Gift versus Death Analysis
Interrelated Breakeven

Size of Estate	$	22,400,000	$	22,400,000	$	22,400,000
Size of Gift	$	10,000,000	$	10,000,000	$	10,000,000
Basis of Gift	$	1,000,000	$	6,000,000	$	10,000,000
Built-in Gain	$	9,000,000	$	4,000,000		0
Built-in Gain taxed @ 25%	$	2,250,000	$	1,000,000		0
Appreciation needed to overcome value of step-up	$	15,000,000[1]	$	6,666,667[2]		0[3]
% of Appreciation		150.00%		66.67%		N/A

1. $2,250,000/(40%-25%) = $15,000,000 2. $1,000,000/(40%-25%) = $6,666,667 3. 40% Estate tax exceeds 25% Income tax

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Questions

Thank You