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Estate Planning newsletter

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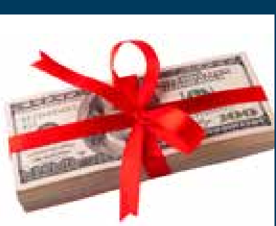

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LAW UPDATE: THE SECURE ACT MAKES SIGNIFICANT CHANGES TO RETIREMENT PLANNING

Congress recently passed—and the President signed into law—the SECURE Act, landmark legislation that may affect how you plan for your retirement. Here is a look at some of the more important elements of the SECURE Act that have an impact on individuals and their IRA's. For detailed advice related to your particular situation please contact one of our estate planning attorneys or your tax advisor.

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LAW UPDATE: THE SECURE ACT MAKES SIGNIFICANT CHANGES TO RETIREMENT PLANNING

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Key provisions affecting individuals and IRA's:

Repeal of the maximum age for traditional IRA contributions.

Before 2020, traditional IRA contributions were not allowed once the individual attained age 70½. Starting in 2020, the new rules allow an individual of any age to make contributions to a traditional IRA, as long as the individual has compensation, which generally means earned income from wages or self-employment.

Required minimum distribution age raised from 70½ to 72.

Before 2020, retirement plan participants and IRA owners were generally required to begin taking required minimum distributions, or RMDs, from their plan by April 1 of the year following the year they reached age 70½. The age 70½ requirement was first applied in the retirement plan context in the early 1960s and, until recently, had not been adjusted to account for increases in life expectancy.

For distributions required to be made after Dec. 31, 2019, for individuals who attain age 70½ after that date, the age at which individuals must begin taking distributions from their retirement plan or IRA is increased from 70½ to 72.

Partial elimination of stretch IRAs.

For deaths of plan participants or IRA owners occurring before 2020, beneficiaries (both spousal and non-spousal) were generally allowed to stretch out the tax-deferral advantages of the plan or IRA by taking distributions over the beneficiary's life or life expectancy (in the IRA context, this is sometimes referred to as a "stretch IRA").

However, for deaths of plan participants or IRA owners beginning in 2020 (later for some participants in collectively bargained plans and governmental plans), distributions to most non-spouse beneficiaries are generally required to be distributed within ten years following the plan participant's or IRA owner's death. So, for those beneficiaries, the "stretching" strategy is no longer allowed.

Exceptions to the 10-year rule are allowed for distributions to (1) the surviving spouse of the plan participant or IRA owner; (2) a child of the plan participant or IRA owner who has not reached majority; (3) a chronically ill individual; and (4) any other individual who is not more than ten years younger than the plan participant or IRA owner. Those beneficiaries who qualify under this exception may generally still take their distributions over their life expectancy (as allowed under the rules in effect for deaths occurring before 2020).

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INCOME TAXATION OF TRUSTS

With the federal estate tax exemption currently at $11.58 million for individuals ($23.16 Million for married couples) and the Minnesota estate tax exemption at $3 million, non-tax considerations generally prevail when selecting a particular trust arrangement for the transfer of wealth from one generation to the next. However, income taxation is still an important and often overlooked issue in the trust context. Whether you own assets individually or through a trust, the income on those assets will be subject to state and federal income tax. The tax liability of yourself, your beneficiaries, and/or your trust can differ drastically depending on the type of trust you create and whether or not that trust retains income or distributes income to trust beneficiaries.

Types of Trusts

A trust is a separate taxable entity that comes into existence when a "grantor" transfers assets to a trustee for the purpose of protecting and conserving those assets for the beneficiaries. The assets can be transferred in trust during your life under a written declaration known as a trust agreement or after your death in accordance with your will. A trust created during the grantor's life is known as an *inter vivos* trust. A trust created under a will following a person's death is known as testamentary trust.

Trusts are also commonly described as being either revocable or irrevocable. Revocable trusts can be amended or revoked at any time by the grantor without the consent of another person, including the trustee. The grantor usually retains unrestricted control over the trust assets during his or her life and for so long as he or she is mentally competent. In comparison, irrevocable trusts typically cannot be changed, amended, or revoked by anyone after they are established. *Inter vivos* trusts can be revocable or irrevocable, but testamentary trusts are always irrevocable.

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TAX RETURN FOR
Form 1040
Department of the Treasury—Internal Revenue Service
(99)
U.S. Individual Income Tax Return
For the year Jan. 1–Dec. 31, 2014, or other tax year beginning
Your first name and initial
Last name
Last name
Home address
City, town or post office,
Foreign country name
Filing Status
Check only one box.
Exemptions
Yourself.
Spouse
Dependents:
(1) First name
Last name
(2) Dependent's social security number
If more than four dependents, see instructions and check here
Total number of exemptions claimed
Wages, salaries, tips, etc. Attach Form(s)
Taxable interest. Attach Schedule B if required
8b
MRC
M–
C1
C2
C/CE
+/–
ELECTRONIC

INCOME TAXATION OF TRUSTS

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Taxation of Grantor Trusts

The income tax consequences of a trust depends on whether that trust is a grantor or non-grantor trust under the Internal Revenue Code ("IRC"). Grantor trusts are disregarded as a separate taxable entity to the extent the grantor or another person is treated an owner of any portion of a trust asset. All items of income, deduction and credit pass through to the grantor and are reported on the grantor's individual tax return.

A grantor is treated as an owner for income tax purposes if he or she has sufficient control over the trust. Examples of control include: (1) a reversionary interest retained by the grantor or grantor's spouse exceeding five percent of the value of the transferred property; (2) the power of the grantor or a non-adverse party to affect beneficial enjoyment of trust assets or income; (3) the power of the grantor or non-adverse party to revoke the trust or return the trust property to the grantor; or (4) the power of the grantor or a non-adverse party to distribute income to or for the benefit of the grantor or the grantor's spouse. As you would expect, revocable trusts are by definition a grantor trust.

Income from grantor trust is taxed at the individual rate of the grantor. As will be discussed below, trusts are taxed using less favorable tax brackets with higher tax rates applying to lower amounts of income. As a result, income from a grantor trust is taxed less than a non-grantor trust and it usually makes the most sense to hold property in a grantor/revocable trust if the trust will be accumulating income.

Taxation of Non-Grantor Trusts

A non-grantor trust is treated as a separate taxable entity that is taxed in substantially the same manner as an individual taxpayer; however, these trusts only pay taxes on the income they accumulate. A trust that distributes income to beneficiaries is treated as a conduit passing the income to the recipient who reports it on his or her individual tax return. The character of the income, such as ordinary income, qualified dividend, etc., remains the same in the hands of the beneficiary. Beneficiaries are never taxed on more than their share of distributable net income. Distributable net income is a special calculation used to allocate income between the trust and its beneficiaries. This calculation is designed to prevent double taxation of trust income.

To the extent that the trust has accumulated income during a given year, it will be taxed on separate schedule applicable only to trusts and estates. The schedule is adjusted for inflation each year. A comparison of the tax rate schedule for trusts and individuals is as follows for the tax year beginning in 2019:

TRUST

Income	Tax Rate
Under $2,600	10%
Over $2,600 to $9,300	24%
Over $9,300 to $12,750	35%
Over $12,750	37%

INDIVIDUAL (single)

Income	Tax Rate
Under $9,700	10%
Over $9,700 to $39,475	12%
Over $39,475 to $84,200	22%
Over $84,200 to $160,725	25%
Over $160,725 to $204,100	32%
Over $204,100 to $510,300	35%
Over $510,300	37%

The fact that non-grantor trusts are taxed at a progressively higher rate than individuals and grantor trusts does not mean a non-grantor trust will automatically have a large tax liability. Often, these types of trusts spray out the income to beneficiaries who may be taxed at a lower individual rate than the grantor. Also, non-income producing assets will not be subject to tax until sold.

Determining Trust Income for Federal and State Taxes

A trust's income, as determined by generally accepted accounting principles, is not necessarily the same thing as its income for tax purposes. Instead, a trust's income under the Internal Revenue Code is determined by the terms of the trust agreement and applicable law. Minnesota's Uniform Principal and Income Act ("UPIA") authorizes the trustee, in absence of contrary terms in the trust agreement, to allocate receipts and expenses between income and principal to ensure that both income beneficiaries and remainder beneficiaries are treated impartially and fairly under the terms of the trust.

As a result, even though receipts of dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of assets are generally allocated to principal, a different allocation of these amounts will be respected by the IRS if the allocation is a reasonable apportionment between the income and remainder beneficiaries of the trust's total return for the year.

Minnesota also taxes income earned by trusts under the rates applied to married individuals filing separate returns. Resident trusts are taxed on all income earned by the trust with credit given in most circumstances for taxes paid to another state. Minnesota also taxes non-resident trusts on income sourced from within the state. Two examples include income derived from carrying on a trade or business conducted wholly within this state, and income or gains from tangible property located in this state that is not used in a business.

Tax Liability and Tax Returns

For non-grantor trusts, both Minnesota and federal law impose an obligation on the trustee to compute and pay for the taxes of the trust. The trustee is required to complete and file an income tax return—Form 1041. The trustee will be liable for any tax liability that he/she had notice of or could have determined with "due diligence". Beneficiaries may also be required to pay for an uncollected tax liability of the trust to the extent they received trust assets.

In comparison, the grantor or other person deemed an owner must pay taxes on the income produced from assets held by a grantor trust. Instead of using the Form 1041, the trustee will report items of income, deduction, and credit on separate statement identifying the grantor. The grantor then reports these items on his or her individual tax return. In some circumstances, the trustee can elect an alternative reporting method. Under one such method, the trustee doesn't need to file a return with the IRS if the trustee provides all payors of income with the trust's address and the grantor's name and tax identification number. The trustee must also provide the grantor with additional information unless the grantor is acting as the trustee.

Conclusion

Estate planning attorneys often advise clients about the benefits of various trust arrangements. One important consideration during this conversation is the income tax consequences that occur during the life of the trust. With the estate and gift tax exemptions at their highest value ever, income tax will have a greater impact on most individuals' ability to maximize the transfer of wealth to their heirs and should be considered as part of every estate plan.

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DONOR-ADVISED FUNDS: HOW TO STAY PHILANTHROPIC UNDER CURRENT TAX LAWS

While the 2017 Tax Cuts and Jobs Act (the "Tax Act") introduced new tax rules affecting high net worth individuals and multimillion-dollar companies, one major change directly affects the rest of us: the increased standard deduction. This article explores the impact of the increased standard deduction on return filing and charitable giving and further explains how you can use tools like donor-advised funds and bunched charitable contributions to minimize your taxes.

The Standard Deduction

The Tax Act nearly doubled the standard deduction to $12,000 per individual (or $24,000 for married couples filing jointly). The standard deduction is the deduction every individual can apply toward and reduce his or her taxable income. Compare this with itemized deductions, providing a higher reduction of taxable income when the taxpayer's eligible deductions (e.g., charitable contributions, state and local taxes, and home mortgage interest) are greater than $12,000.

This increased standard deduction has led many taxpayers, who previously filed itemized returns and utilized the charitable deduction, to take the standard deduction because their itemized deductions were less than $12,000. This article is directed at those taxpayers taking the standard deduction yet still making annual, charitable contributions.

For the remainder of this article, I will refer to the following example:

- Jane is an unmarried individual who makes $85,000 each year;
- Jane pays $5,000 in home mortgage interest each year;
- Jane pays $2,000 in state and local taxes each year;
- Jane generously gives $5,000 to a local non-profit organization each year

Based on the numbers in the example, Jane has total itemized deductions of $12,000, equal to the standard deduction. Jane decides to take the standard deduction and avoid filing the somewhat daunting itemized tax return. Unfortunately, this strategy ignores the opportunity for Jane to utilize bunched charitable contributions and a donor-advised fund to increase her itemized deductions, lower her taxable income, and even place her in a lower tax bracket.

Bunched Charitable Contributions

Bunched charitable contributions involve a taxpayer making a charitable contribution every other year, or more periodically, while maintaining the same annual average. For example, instead of giving $4,000 to a charitable organization on an annual basis, a taxpayer would give $8,000 every other year.

Bunching charitable contributions allow taxpayers to increase their itemized deductions in the year the contribution is made and take advantage of other itemized deductions with the goal of exceeding the standard deduction.

In our example, Jane's itemized deductions are equal to the standard deduction. Instead of making annual charitable contributions of $5,000, she would be better off utilizing bunched contributions and instead giving $10,000 every other year. Using this method would give Jane itemized deductions of $17,000 in contribution years and allow her to take the $12,000 standard deduction in non-contribution years. Overall, Jane's tax liability decreases in contribution years and sacrifices less itemized deductions in non-contribution years ($7,000 instead of $12,000).

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DONOR-ADVISED FUNDS: HOW TO STAY PHILANTHROPIC UNDER CURRENT TAX LAWS

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What should Jane do when the charity expresses concern that this plan decreases its capital in non-contribution years?

[enter donor-advised funds]

Donor Advised Funds

A donor-advised fund (DAF) is an investment account used to make charitable contributions to the organization of your choice. Essentially, a DAF allows a donor to irrevocably contribute assets to an investment account, take the deduction for the contribution in the year such assets are placed into the account, and control the timeline of distributions to the organization(s) of choice.

Paired with bunched charitable contributions, DAFs enable a taxpayer to take increased deductions available under the bunched contributions method, ensure the charitable organization receives annual distributions, and also increase the value of the money donated by placing assets in an investment account. DAFs also provide the opportunity for taxpayers to avoid capital gains taxes on highly-appreciated, low basis assets because taxpayers generally do not have to pay capital gains taxes on charitable contributions but still get to take the asset's fair-market value as a deduction.

Conclusion

Taxpayers making contributions to charitable organizations but only utilizing the standard deduction should consult a financial advisor, tax preparer, or attorney about incorporating bunched charitable contributions and DAFs into their financial plan to take advantage of itemized deductions and decrease their total tax liability.

Gislason & Hunter Estate Planning Services

Estate Planning is important to ensure the orderly transfer of family assets, as well as to protect those assets from unnecessary taxation. The Gislason & Hunter Estate Planning Practice Group offers a variety of services to assist you in creating the best plan for you, your family, your business or your farm.

Some of the many services our attorneys offer include the following:

- Drafting wills, trusts, codicils and powers of attorney
- Preparing health care directives and living wills
- Creating family business succession plans with emphasis on each family's particular goals and values
- Farm estate and succession planning
- Evaluating estate and gift tax issues and structuring planning options to minimize tax obligations
- Administering and assisting clients with probate proceedings, conservatorships and guardianships
- Advising on Medicaid, Medicare, nursing home and elder law issues
- Handling disputed estate and probate matters in litigation, arbitration or mediation formats

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