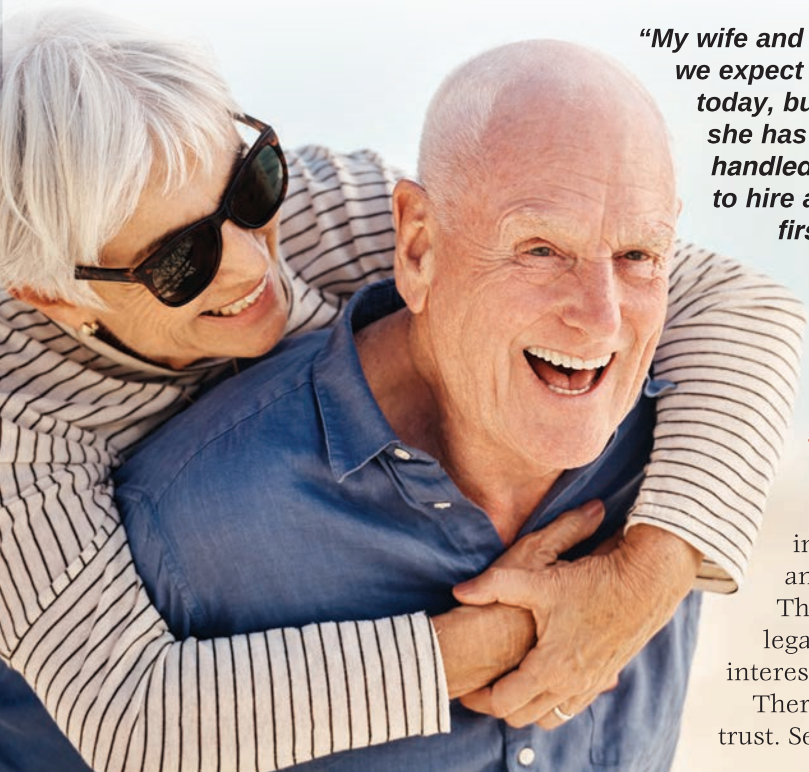
IN THIS ISSUE

Trust UPDATE
CITIZENS BANK
A Bank Built For You

February 2020

How to protect a surviving spouse

Widowhood is hard enough; it should not be a financial catastrophe as well.



A fictionalized recent question we received:

"My wife and I are about to move into a senior living complex, where we expect to spend the rest of our lives. This may sound sexist today, but throughout our 55 years of a pretty happy marriage she has handled the cooking and the housework, while I have handled the money. If she dies before I do, I know I'll be able to hire a cook and household help. But what happens if I die first? Who will handle the money? I don't mean the daily routine stuff like the groceries, she's fine with that. I mean managing our retirement portfolio, seeing to it that the taxes are paid, the major considerations. Is there a service that can provide lifetime financial protection for my wife if she survives me?"

We're pleased to report that a thoughtfully designed trust should resolve the issues presented by this individual. A marital trust will provide the surviving spouse with income for life. If the trust contains life insurance policies, the trustee will see to claiming the proceeds. The investment portfolio will be managed prudently under the legal standards associated with "fiduciary duty"—that means the interests of the trust beneficiary are paramount.

There are a number of choices to review when designing a marital trust. See the table "Choices for marital trusts" for a capsule review.

Choices for marital trusts *These are the most common types of trusts for surviving spouses.*

Trust type	*Estate tax exposure at spouse's death?*	*All income to spouse?*	*Spouse can direct remainder?*	*Comment*
Traditional marital deduction trust	Yes	Yes	Yes	Best for larger estates, paired with a credit shelter trust
Qualified Terminable Interest Property (QTIP) Trust	Elective	Yes	No	Best for multiple-marriage situations
Credit shelter trust	No	Elective	No	Appropriate by itself for smaller estates, but may be paired with traditional or QTIP trust
Qualified Domestic Trust (QDOT)	Yes	Yes	Elective	For a spouse who is not a U.S. citizen

Source: Internal Revenue Code; M.A. Co.

Tax considerations

Married couples have two privileges under the federal estate tax, privileges intended to treat them as a single economic unit. First, there is the unlimited marital deduction for property that passes to a surviving spouse. Second, if one spouse doesn't use up his or her federal estate tax exemption ($11,580,000 for 2020), the surviving spouse will inherit the unused portion. In layman's terms, the exemption itself has become "portable" and is inheritable. In IRS lingo, it is a Deceased Spousal Unused Exemption Amount (DSUEA). Together, a married couple may protect over $23 million from the federal estate tax (provided they both die before 2026, when the amount exempt is scheduled to be cut in half).

For example, say that Husband dies in 2020, leaving his entire estate to Wife in a marital deduction trust. Whether the estate is $1 million or $50 million, there will be no federal estate tax, thanks to the unlimited marital deduction. Husband will not use any of his exemption, so Wife may also inherit a DSUEA of $11,580,000 to use at her future death, which will be combined with her own estate tax exempt amount.

However, as welcome as the portability of unused exemption amounts between spouses may sound, in many cases it may make estate administration somewhat more complicated. To preserve the unused exemption, the executor for the first spouse to die must file a federal estate tax return, even if no estate tax is due, even if the estate is well under the $11.58 million basic exclusion amount. Even if the surviving spouse doesn't appear to be a candidate for paying federal estate taxes, one cannot know how long the spouse will live and what other assets he or she might come into. Therefore, the number of estates filing federal estate tax returns will have to grow in the coming years to preserve this opportunity.

Another issue is that the statute of limitations for the estate of the first spouse to die will remain open until the death of the second spouse, when the DSUEA will be claimed. This could be decades later.

Finally, the DSUEA does not extend to the generation-skipping transfer tax. Relying on this approach "wastes" the exemption of the first spouse to die.

On the other hand, there is the income tax to consider, especially for estates that appear likely to dodge the federal estate tax bullet. The tax basis of inherited assets is "stepped up" to fair market value at the date of a decedent's death. Assets in a bypass trust enjoy no such step-up when the trust terminates, so the heirs could be facing a large tax on built-up capital gains.

The table "Portable exemptions versus credit shelter trusts" sums up the pros and cons. There is no answer that will be best for everyone. Many experts suggest that portability is a good back-up for those who fail to plan, but less than ideal as a first choice. In many cases, especially for smaller estates, the better course will be to rely on a bypass trust to consume the first spouse's exclusion. This allows for finality in that spouse's estate; it offers flexibility in providing for other heirs; and appreciation in bypass trust assets will not be subject to estate tax at the second spouse's death.

Has your estate been planned?

Estate planning today is highly personalized. Don't expect to buy a plan "off the shelf." With dozens of planning approaches to choose from, you and your advisors will need to do some careful analysis of your estate, your family situation, and your goals.

At your request, one of our trust specialists will be glad to assist. Call on us! ☐

Portable exemptions versus credit shelter trusts

This table illustrates the pros and cons of credit shelter trusts and reliance on the new portability provisions.

	PORTABLE EXEMPTION	CREDIT SHELTER TRUST
Inflation protection	None	Inflationary growth in trust assets avoids future estate taxation (an "asset freeze").
Basis step-up at surviving spouse's death	Yes	No
Estate planning simplicity	Easily understood, meets most couples' expectations, but will require estate tax filings by nontaxable estates.	Somewhat more complicated; harder for couples to understand, but existing estate plans do not require redrafting.
Asset protection upon future remarriage and divorce	No	Yes
Preservation of inheritance for children	No	Yes
Generation-skipping transfer tax exemption	Lost	Preserved

Source: Internal Revenue Code; M.A. Co.

Suddenly *in*secure

In December, as part of the budget deal, Congress passed the SECURE Act (Setting Every Community Up For Retirement Enhancement Act), and the President quickly signed it. The new legislation included liberalization of retirement plan rules for small employers, repeal of the old rule that those over 70½ are barred from contributing to a traditional IRA, and permission to use up to $10,000 of 529 plan money to repay student loans (lifetime cap, not per year), among other things.

According to the bipartisan Joint Committee on Taxation, the costliest change in terms of lost revenue is an increase in the age at which Required Minimum Distributions (RMDs) must begin. The new age is 72, up from the familiar 70½. This change will "cost" the federal treasury an estimated $737 million in 2020, some $8.8 billion over the next ten years.

The Congress decided to look to those who inherit IRAs and other qualified retirement plan assets to pick up this tab.

An end to stretching

Those who inherit an IRA from someone who died in 2019 or earlier have had the option of taking RMDs over their lifetime, a strategy called the "stretch IRA" by estate planners. This was a great plan for heirs who had no immediate need for the funds, because it maximized the period of tax deferral while it tended to push the largest distributions into retirement, when the heir was likely in a lower tax bracket.

The new rule, when decedents die in 2020 or later, requires that the inherited IRA be paid out in ten years, not over a lifetime. In 2020 this single change is projected to increase federal tax revenue by $212 million. The serious money comes in down the road, because in 2029 federal revenue will be increased by $2.5 billion. Over the ten-year budget window, this change raises $15.7 billion, more than enough to offset the "costs" of taxpayer breaks.

Exceptions

There are important exceptions to this new rule. These designated beneficiaries will be permitted distribution periods longer than ten years:

- a surviving spouse;
- a minor child or children;
- a disabled beneficiary;
- a chronically ill individual; and
- beneficiaries who are less than ten years younger than the account owner (such as a brother or sister).

The exception for the minor child lasts only until he or she reaches the age of majority (18 or 21, depending upon state law), because then the ten-year rule kicks in. For the other categories of designated beneficiaries, the exception ends at death, when a ten-year distribution must begin.

Action plan

In a recent legal webinar, estate planning expert Natalie Choate called the elimination of the lifetime payout rules "a sucker punch" to taxpayers who relied upon long-settled tax law in crafting their estate plans. The new law "affects not only people who are already dead, it affects the written estate plans that our clients have already made," she said. The impact of the change will vary among families depending upon circumstances. "It's definitely not one-size-fits-all, and there's no one thing you can tell everyone to do," Choate concluded.

For married couples who plan to leave each other their retirement assets, the SECURE Act changes little. A surviving spouse who inherits an IRA may treat the account as his or her own. In that case, penalty-free distributions are generally not permitted before age 59½, and RMDs will commence when the spouse reaches age 72. Alternatively, the surviving spouse may take the role of beneficiary instead of owner, which calls for an immediate program of RMDs geared to the spouse's age.

For nonspouse beneficiaries, a conduit trust has been a popular tool to turn an inherited IRA into a lifetime financial resource. That protection now will last only ten years. An alternative to consider is making a charitable remainder trust the IRA beneficiary. There is no income tax when the IRA money goes to the charitable trust, so the entire resource is available to create an income for the private beneficiary. The income may be expressed as a fixed annual dollar amount (an annuity interest) or as a fixed percentage of the value of the trust assets (a unitrust interest).

If you inherited an IRA before 2020, the new rules don't affect your payouts. But if an IRA makes up a substantial portion of your estate, you should consider scheduling an appointment with your estate planning advisors soon this year. ☐

Start-up costs not deductible

James Primus purchased 266 acres of property for farming in 2011. The land included 200 acres of mature maple trees suitable for making syrup, as well as overgrown pastures and hay fields. Primus thinned the maple trees in 2011 through 2013. In 2015 he installed piping for collecting the maple sap, and in 2016 the barn needed modification to house the evaporator for making the syrup. In 2017 Primus sold 18,000 pounds of maple syrup.

He also planned to grow blueberries on the property. In 2012 and 2013 Primus cleared the area for the blueberry bushes. He ordered 2,000 blueberry bushes in 2014 and planted them in 2015.

This sounds like a lot of work, but it was secondary to Primus' real job as an accountant. For the 2012 tax year, Primus claimed farming expenses in excess of $200,000, and $118,503 for 2013.

The IRS disallowed the deductions, and the Tax Court agreed. The expenses incurred in 2012 and 2013 were start-up costs, and as such are not deductible. The business of selling maple syrup and blueberries had not yet commenced in those years.

Recycling not deductible

Chad and Dana Loube purchased a house for $795,000 with the intention of tearing it down and building a new one. Instead of a simple demolition of the old building, the Loubes contracted with Second Chance, Inc. to deconstruct it. The fixtures and other materials were salvaged to the extent possible and then resold. Second Chance was a charity that used the deconstruction process to teach marketable skills to persons facing barriers to employment ranging from limited education to criminal records, while environmentally reusing materials that would otherwise end up as landfill debris.

The Loubes made a cash donation to Second Chance to get the process started. They obtained a professional appraisal of the value of the house before proceeding. The cost to reproduce the house was determined to be $674,000, and after adjustments and depreciation the appraiser determined that the materials cost of the house was $297,000. The Loubes took a charitable deduction for that amount.

No deduction is allowed, said the IRS, and the Tax Court agreed. There was no evidence of the value actually received by the charity. The appraisal did not satisfy the very strict rules that apply to deductions for gifts to charity worth more than $5,000. In particular, it was missing the basis and the acquisition date of the donated property. Providing the appraisal was not "substantial compliance" with this requirement. "Congress specifically passed DEFRA's heightened substantiation requirements so that the Commissioner could efficiently flag properties for overvaluation from the face of appraisal summaries." ☐