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Fall 2020

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Feature Article

The SECURE Act: Increased Income Taxes on Inherited Retirement Accounts

By Nicholas S. Proukou, Esq.
Associate

The SECURE Act accelerated income taxation on inherited retirement accounts dramatically. This was huge news for the estate and financial planning worlds in early 2020—until it wasn't. This year continues to be full of strange and dramatic turns, many of which have overshadowed this seismic shift in retirement-account taxation under the SECURE Act. It is with some pleasure that I turn back to a topic that is pre-COVID that now feels almost normal, despite being such a dramatic change.

Under the old law (prior to January 1, 2020), individuals inheriting a retirement account on the owner's death were able to "stretch" the income tax on the account over their lifetime. For example, Nick dies and leaves a $1,000,000 retirement account to his daughter, Lilah, who for purposes of this example will be 21 years of age (she's really 2, but when she's constantly telling me "no" she seems closer to 21). The IRS gives 21-year-old Lilah a life expectancy of 62.1 years. Therefore, in the first year after my death, Lilah would be required to take out 1/62.1 of the account (approximately, $16,103) and report that amount as taxable income. Each year she ages, her life expectancy decreases and the required distribution increases until the account is either fully distributed or she dies. If she dies before full distribution, then her heirs continue to realize the income tax at the same rate as Lilah would have (i.e., using her hypothetical life expectancy under the IRS rules) until the account is fully distributed. This ability to "stretch out" the income tax on retirement accounts over a lifetime was one of the major

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benefits to saving through a retirement account prior to January 1, 2020.

The SECURE Act largely removed the stretch. The general new rule is the ten-year rule. Using the same example as above, Lilah inherits the $1,000,000 retirement account. Now, since the SECURE Act did away with her annual "required minimum distributions" she will not have to receive and report annual taxable income from the retirement account. Instead, she must fully distribute the retirement account at any time within 10 years, which is a significant acceleration in realizing the applicable income tax when compared to the 62.1 years available under the old rules.

Perhaps the most important consequence of this change relates to a specific trust type common to estate planning. Some estate plans create a trust to receive retirement accounts and pay the retirement account distributions to the beneficiary over her lifetime. These "conduit trusts" were designed to prevent the beneficiary from simply cashing in an inherited retirement account and realizing all of the income tax at once. Instead, the conduit trust made it mandatory under the old rules that the retirement account enjoy the benefit of the lifetime stretch and provide a lifetime income stream for the beneficiary.

The problem is that the law changed to eliminate the stretch, but the terms of the trust do not automatically update with the law. A retirement account payable to the same conduit trust, providing only required minimum distributions to the beneficiary, would not receive any distributions for 10 years (leaving the beneficiary high and dry) and then distribute the entire amount to the beneficiary in one giant tax event after 10 years. This result is clearly contrary to purpose of setting up such a trust under the old rules. Therefore, it is very important to review estate plans with trusts that include retirement savings to understand the consequences under the new SECURE Act rules.

There are some exceptions to the new 10-year-payout rule to note, but they are limited in scope. First, a spouse may still inherit a deceased spouse's retirement account with the special rules provided for a "spousal rollover." This favorable treatment allows for the surviving spouse to treat the retirement account as if it were always her own. Thus, contributions can still be made to the account by the surviving spouse for her lifetime (the SECURE Act now has no age limit on contributions), and the surviving spouse need only take required minimum distributions if over 72 years old (this age was also raised from its previous 70.5 by the SECURE Act).

…a spouse may still inherit a deceased spouse's retirement account with the special rules provided for a "spousal rollover." This favorable treatment allows for the surviving spouse to treat the retirement account as if it were always her own.

Another important carve out relates to Disabled and Chronically Ill beneficiaries. Individuals that fall under these categories, as defined by the IRS, are entitled to the old stretch rules. The stretch is also still available to Supplemental Needs Trusts for the benefit of a Disabled or Chronically Ill individual.

In light of these changes, there are some planning options to consider. First and foremost, it is important to review existing trusts, or Wills with trusts, to understand the new income tax consequences. Second, some are considering ROTH conversions so that when their beneficiaries distribute the retirement account(s) within 10 years, the distribution from the ROTH will not be taxable. Third, some are using retirement assets to purchase life insurance, which is inherited free of income tax by beneficiaries.

The last option that I will cover is the creation of a Charitable Remainder Trust to receive a retirement account on death. This trust is designed to pay a certain amount to an individual beneficiary for a period of years, or for their lifetime, and distribute the remainder to charity on the termination of the trust. In this case, the retirement account is fully distributed to the Charitable Remainder Trust; however, no income tax is realized because the trust has a charitable beneficiary (and satisfies some other technical requirements). The distributions to the individual beneficiary are taxable income to the beneficiary when received, and the charity receives whatever remains when the trust ends free of income tax. In the event you have charitable intentions, this can be an excellent strategy to accomplish quality income-tax planning with your retirement accounts, benefit the family, and benefit a charity all at the same time. •

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Section 1031 Exchanges: "Drop and Swaps"

Danielle B. Ridgely, Esq.
Associate

Like-kind exchanges under Section 1031 of the Internal Revenue Code are trending as taxpayers look for a way to defer their gains. Most properties are held by partnerships and LLCs. Consequently, an issue arises when only some members want to do a like-kind exchange, some members want to cash out, or the members want to split up and engage in separate like-kind exchanges. With this issue comes the popular question: "Can I do a 'drop and swap'?" And then: "What if only some of our LLC members want to 'drop and swap'?"

The term "drop and swap" refers to a partnership's distribution of proportionate shares of tenancy-in-common interests in its real property to the partners, who can either exchange the interest for replacement property or sell the interest for cash. Code Section 1031 generally provides that no gain or loss will be recognized on an exchange of real property held for business use or investment if it is exchanged solely for real property of like kind which is to be held either for business use or investment.

Nothing in the Code and regulations prohibits "drop and swaps." While the scant case law in this area shows that the IRS has a history of challenging "drop and swaps," this case law has also developed a foundation for taxpayers to take a favorable position. In Magneson v. Commissioner, the Ninth Circuit held in favor of taxpayers who dropped property received in a like-kind exchange into a partnership in exchange for a partnership interest. The IRS argued that the taxpayers failed to "hold" the property for investment purposes. The Ninth Circuit disagreed because the taxpayers effectively continued their investment in partnership form.

Relying on Magneson, the Ninth Circuit held in favor of the taxpayer in Bolker v. Commissioner who received property in tax-free liquidation from his corporation and then entered into a prearranged exchange of the property. The IRS argued that the taxpayer failed the holding requirement, but the Ninth Circuit stated that the taxpayer continued his investment "without the interposition of a corporate form" and had not cashed out of his venture.

A few years later, in Mason v. Commissioner, the Tax Court held in favor of the taxpayer in a "drop-and-swap" scenario. Two separate partnerships distributed properties in liquidation to the partners, who then exchanged the properties with each other. The IRS argued that they exchanged partnership interests, which is prohibited. The Tax Court reviewed the evidence and sided with the taxpayer because neither the transaction nor the parties' intent supported a sale of partnership interests.

These cases appear to reject a requirement that property be held for a certain length of time in favor of achieving the goal of Section 1031: If the taxpayer has not cashed out of his investment and has not converted his investment to personal use, then the taxpayer has only a paper gain and should be entitled to nonrecognition.

It has now been 35 years since Magneson. Has the IRS changed their view? No, and they added a question to the federal partnership return that makes it easier to spot a "drop and swap." However, in a recent conversation we had with the IRS National Office, the IRS informally indicated that they are not focused on this issue right now. Regardless, using the rationale afforded by the case law, taxpayers continue to structure drop and swaps, including drops to cash-out and "swapping" members. ●

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Securities Law Update: The SEC Expands the Definition of Accredited Investor

Victoria M. Conrad, Esq.
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The U.S. Securities and Exchange Commission (SEC) recently proposed amendments to its definition of accredited investor. In doing so, it is expanding the eligibility of persons who may participate in private and venture-stage investments. Under the new definition of "accredited investor," the SEC has added categories of qualified individual investors and several additional amendments. The final rule will be effective on December 8, 2020. Among other things, companies conducting private offerings will need to update their investor questionnaires and subscription and purchase agreements to include the new definition.

Additional Categories of Individuals to Qualify as Accredited Investors

1. Professional Certifications, Designations, and Other Credentials

The current definition focuses primarily on the financial condition and means of investors. The amendments, however, expand this to include persons with financial and related experience and credentials. Now representatives of broker-dealers and registered investment advisers with the following credentials may qualify as accredited investors: Licensed General Securities Representative (Series 7), Licensed Investment Adviser Representative (Series 65), and Licensed Private Securities Offerings Representative (Series 82).[1] The SEC may update the list to include additional certifications by order. These updates will be published on its website.

2. Knowledgeable Employees

The SEC also expanded the rule for investments in private-equity and venture-capital funds to include "knowledgeable employees" of those vehicles—such as an executive officer, a partner, or a board member.[2]

Other Amendments

The SEC expanded the list of entities that also qualify as accredited investors to include:

- SEC and state-registered investment advisers;
- Investment advisers exempt from registration under Section 203(l) or (m) of the Investment Advisers Act of 1940, as amended ("Advisers Act");
- Rural business investment companies;
- Limited liability companies that:
  - have total assets in excess of $5 million; and
  - were not formed for the specific purpose of acquiring the securities being offered;
- Any other type of entity that:
  - owns investments, as defined in Rule 2a51-1(b) under the Investment Company Act, in excess of $5 million; and
  - was not formed for the specific purpose of acquiring the securities being offered.
- Family Offices with at least $5 million in assets under management and their "family clients," each term defined under the Advisers Act Rule 202(a)(11)(G)-1
- Spousal Equivalents. For the purposes of pooling finances to qualify as accredited investors under the joint net worth or income thresholds in Rules 501(a)(5) and (a)(6), the amendments add the term "spousal equivalent" and define it as "a cohabitant occupying a relationship generally equivalent to that of a spouse."

This article has been prepared for general information purposes only and is not intended as legal advice, nor does it create an attorney-client relationship. These materials may be considered attorney advertising in some states. ●

If you should have questions regarding how these new rules may impact your firm, please contact Greg Gribben at 585-987-2875, Victoria Conrad at 585-987-2807, or another member of the firm's Public Companies and Securities practice group.

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[1] *Order Designating Certain Professional Licenses as Qualifying Natural Persons for Accredited Investor Status, Release No. 33-10823 (August 26, 2020).*

[2] *Accredited Investor Definition, Release Nos. 33-108-24; 34-89669 (August 26, 2020).*

Michael Blanchard named Chief Operating Officer

He replaces Paul Farnsworth who is retiring after 26 years at the firm.

Michael Blanchard
Chief Operating Officer

Michael Blanchard has joined the firm as Chief Operating Officer. As C.O.O., Mr. Blanchard will oversee all operational aspects of the firm and work closely with firm leadership in the development and implementation of firm-wide strategic goals and supporting strategies. His arrival will coincide with the retirement of Paul Farnsworth who has been an integral leader at Woods Oviatt for the past 26 years.

"We are thrilled to have someone of Mike's caliber join our team," said Woods Oviatt's Managing Partner Mitch Nusbaum. "He is an experienced strategic leader with extensive law firm knowledge, and the firm will benefit from his deep understanding of the legal industry. We look forward to the positive impact his leadership will provide our firm."

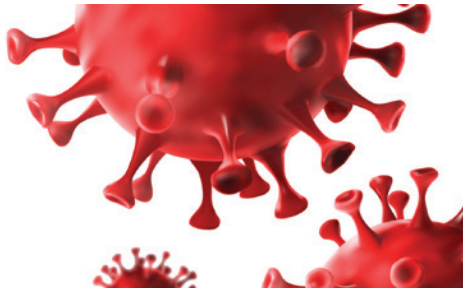
Mr. Blanchard has extensive experience in law firm strategy and management. He held several executive management positions with many of the nation's leading law firms. Most recently, he was the Managing Director of the Law Firm Advisory Group with Aon Corporation's Professional Services Group, which provides strategic management consulting services to law firm leaders throughout the U.S.

"I am excited to join Woods Oviatt as Chief Operating Officer," said Mr. Blanchard. "I have long admired the firm's commitment to providing the highest-quality legal services to its clients and its family centric culture. It's truly an extraordinary firm and I am excited to be part of it."

"Paul Farnsworth's retirement will have a great impact on the firm," said Nusbaum. "He was intimately involved in all aspects of the firm and especially instrumental in the successful move of our offices to the Legacy Tower in 2019. In the 26 years Paul has been with us, we have tripled in size and grown in to one of the preeminent law firms in Western New York. We never could have achieved these feats without the hard work and stewardship provided to us by Paul. His impact on the legal industry reached beyond the walls of Woods Oviatt Gilman. He was actively involved in the Association of Legal Administrators, serving in leadership roles for the International association for eight years, and he was its president from 2013 to 2014. We wish him a very relaxing and enjoyable retirement. He will be greatly missed!"

Paul Farnsworth

COVID-19 Multi-disciplinary Crisis Group



Woods Oviatt Gilman LLP has assembled a multidisciplinary crisis resource group of attorneys at the firm to advise clients on all aspects of the legal implications of the COVID-19 (coronavirus disease 2019) outbreak including regulatory, labor and employment, insurance, contractual, liquidity, litigation, commercial real estate and family wealth and estate issues. Our attorneys are prepared to assist clients in the successful navigation of the significant, unique, and demanding challenges they face, both now and in the days to come, as a result of COVID-19. The attorneys in our crisis-resource group practice in a variety of disciplines; working together, their relevant experience enables them to provide thoughtful, practical, proactive, and comprehensive guidance to our clients as they confront the substantial issues impacting their businesses as a result of the COVID-19 public-health emergency. Below is a partial list of the issues we know are confronting our clients and for which we have been, and will continue to be, available to provide advice:

- ❏ Business Regulation
- ❏ Labor and Employment
- ❏ Insurance
- ❏ Existing Commercial Contracts and Risk Allocation with New Commercial Contracts
- ❏ Liquidity - Credit Facilities and Capital Calls
- ❏ Commercial Real Estate
- ❏ Litigation and Disputes
- ❏ Family Wealth and Estate Planning
- ❏ Tax

For more information and to view our latest client alerts regarding COVID-19, go to: www.woodsoviattgilman.com/practices/covid-19-multidisciplinary-crisis-group

Honors and Awards

R. Thompson Gilman, Esq. has been named a 2020 ICON HONORS Recipient by the Rochester Business Journal. The ICON Honors award recognizes Greater Rochester Area business leaders over the age of 60 for their notable success and demonstration of strong leadership both within and outside of their chosen field. Tom and the other ICON recipients will be honored during a virtual ceremony on December 7th.

Tom has also been named Loyal Donor of the Year by the United Way. The United Way Loyal Donor Program recognizes and celebrates individuals who have supported the United Way for many years and, in so doing, have had an impact on the lives of many people in their community.

Robert W. Kessler, Esq. has been named a Lifetime Achievement Award Honoree by the Daily Record. The Lifetime Achievement Award recognizes lawyers whose careers have helped shape the legal landscape in the Rochester area and who have shown a longstanding commitment to the community. Bob was honored along with the other award recipients on November 11th during the 2020 Attorneys of the Year virtual celebration.

Greta K. Kolcon, Esq. is a recipient of the Rochester Business Journal's 2020 Women of Excellence Award. Greta was selected by an outside panel of judges for her professional achievement, community leadership, and mentoring. She received her award virtually on September 9th during an event hosted by the Rochester Business Journal.

David P. Shaffer, Esq. has been named a Leader in Law Honoree by the Daily Record. The Leaders in Law Award honors attorneys who have shown dedication to the legal profession and selfless, tireless commitment to the community. David was honored along with the other award recipients on November 11th during the 2020 Attorneys of the Year virtual celebration.

Jamie K. Winnick, Esq. has been named an Up & Coming Attorney by the Daily Record. The Up & Coming Attorneys award honors those who demonstrate professional accomplishment, community service, and a strong commitment to the legal profession early in their careers. To be considered, nominees must be admitted to the bar for 10 years or less. Jamie was honored along with the other recipients during a virtual event on June 24th.

From the Boardroom

Philip L. Burke, Esq. has joined the Board of the Rochester Oratorio Society.

Michael A. de Gennaro, Esq. has joined the Board of Directors at Quantum Cremations, a Pennsylvania-based start-up.

Kelly R. Gusmano, Esq. has been named the Chair of the Trusts and Estates Section of the Monroe County Bar Association.

Benjamin M. Keller, Esq. has joined the Board of Trustees of the Rochester Historical Society.

Greta K. Kolcon, Esq. has been named the President of the U-M Club of Rochester, Alumni Association of the University of Rochester.

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