delaware banker

Summer 2023
Vol. 19 No. 3

Pooled Employer Plans

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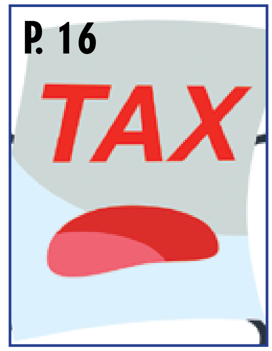

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SUBMISSIONS
Delaware Banker welcomes news items from members of the Delaware Bankers Association. The Editors reserve the right to refuse any advertising or editorial copy deemed unsuitable for publication. The Editors reserve the right to set the publication date in accordance with the Association's needs. Direct submissions to Greg Koseluk at greg.koseluk@debankers.com

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View from the Chair

by
Tarrie Miller
President & COO
County Bank

Chair
Delaware Bankers Association

"I am proud to be a community banker and an integral part of the community."

Hello. It's an honor to introduce myself, Tarrie Miller, as the current chairperson of the DBA for the 2023 calendar year. I can honestly say that I've been fortunate to be a career banker for the past 43 years. I've had the opportunity to work with some of the most talented financial minds, and well, like in any industry, some not so talented. Regardless, it's been wonderful working with people, learning, growing and helping others. As local leaders, we all have unique attributes that contribute to the growth and success of our local communities. I wanted to share a few things that are enormously important to me.

First, the DBA is a terrific partner to the financial services organizations in our State. They are committed to ensuring that we are aware of topics that may impact our business objectives at any point in time. Sarah and her team are readily available to listen to our issues and concerns and want to carry our voices forward with our legislators. Please continue to be engaged and reach out to the DBA to ensure your issues and concerns are heard.

Second, I feel blessed to be part of the State of Delaware and specifically, Sussex County. Although my early career was primarily based in southeastern Pennsylvania, Delaware banking has become, shall we say, "A Way of Life". Today, I've had the unique opportunity to share my big bank experiences with my current work family, a small, high-performing financial institution in a vibrant community of local and transplanted consumers and thriving businesses, all set on a backdrop of the Atlantic Ocean.

Third, I have a passion for community service. Like you, I've participated in many not-for-profit organizations and events over the years with a focus on CRA activities that benefit the communities in which we live. But my passion is engaged community involvement and finding activities that help my community grow. And I enjoy helping those around me learn, participate and grow at the same time.

I am proud to be a community banker and an integral part of the community. It's been said that all politics are local. What is true in the realm of government is just as valid in the field of financial services. The local bank is in the front line of financial services, and the key to their success is relationships. Bankers know their communities because that's where they live and work. The businesspeople and depositors aren't just our customers; they are our neighbors. And neighbors need to help neighbors if the local community is to thrive.

Local banks participate in their communities. We're not only there during regular business hours; we are there lending a hand in civic organizations, schools, libraries, fire companies, cultural events, scout activities, you name it! If there's something positive happening, the odds are that a local bank is there sponsoring and volunteering.

Local bankers are core contributors to a vibrant community. We're here to live; we're here to work; we're here to serve; we're here to stay.

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DIVISION OF SMALL BUSINESS

President's Report

by
Sarah A. Long
President, CEO & Treasurer
Delaware Bankers Association

"We are part of a dynamic community that strengthens our position in the financial sector and enhances the well-being of the communities we serve. "

Recently, the Writers Guild of America went on strike, demanding, amongst other things, the assurance that AI would not take their place as screenwriters in the future. Technology like ChatGPT has the potential to make people's lives easier by assisting with everyday tasks, providing effective communication, and conducting research. But there are also potential risks like data inaccuracies, privacy and confidentiality concerns, bias and discrimination, ethical considerations, and the like.

Intrigued after seeing a live demonstration of ChatGPT at a recent ABA Conference, I posed the question, "Write a 500-word column from the first person on the benefits of being a member of a state banking association from the point of view of the president of a state bankers association." Here's the response I received in less than 10 seconds (edited only for brevity).

As the President of our State Bankers Association, I often reflect on the many advantages our esteemed members enjoy by being part of this tightly-knit community. The benefits are not just limited to the financial sector; they extend far beyond, fostering growth, unity, and collaboration.

1. Strength in Numbers: An age-old adage that says, "Unity is strength." Our State Bankers Association epitomizes this saying. Together, we form a formidable force representing the interests of all member banks across our state. By pooling our resources, we wield a collective voice that echoes through legislative chambers, regulatory agencies, and the public sphere. This unity gives us the power to influence crucial policy decisions that directly impact our industry, safeguarding our future.

2. Advocacy and Influence: Being part of a State Banking Association means having a seat at the table where decisions are made. Our Association actively engages with lawmakers and policymakers to advocate for sensible banking regulations that promote stability, foster innovation, and protect the interests of both banks and customers. Our influence allows us to shape the financial sector's direction and contribute to the overall well-being of the state's economy.

3. Sharing Best Practices: Collaboration is at the core of our Association. As members, we benefit from a robust network of professionals eager to share their expertise and best practices. Whether it's tackling the challenges of digital transformation, mitigating risks, or developing sustainable growth strategies, our collective knowledge is an invaluable resource that propels our banks to new heights of success.

4. Professional Development: Our Association is committed to advancing the skills and knowledge of its members. We regularly host seminars, workshops, and conferences, inviting industry experts to share their insights on the latest trends and innovations. By investing in the professional development of our bankers, we ensure that our state's financial institutions remain at the cutting edge of the industry.

5. Fostering Community Relations: Beyond the boardrooms and financial statements, we recognize the importance of building solid relationships with the communities we serve. Our Association promotes community engagement through various initiatives, fostering a sense of responsibility and giving back to the neighborhoods that rely on us. As a united front, we make a more significant impact, creating lasting change and positive social influence.

In conclusion, being a member of our State Banking Association offers an array of tangible benefits that transcend the walls of any individual bank. We are part of a dynamic community that strengthens our position in the financial sector and enhances the well-being of the communities we serve. Unity, advocacy, collaboration, and shared resources are the cornerstones of our success as a collective force, and I am proud to lead such a remarkable association of bankers. As we continue to build upon our shared accomplishments, the future holds even greater promise for all our members and the prosperity of our state's financial landscape.

Mind-blowing. Awe-inspiring. Frightening. There is undoubtedly huge potential and possibilities for ChatGPT in banking if we leverage the strengths of both man and machine.

All Around the Hall

by
David Mench
Director, Government Affairs
Delaware Bankers Association

The first session of the 152nd General Assembly started January 10, 2023, and welcomed six new members of the House of Representatives and three new members of the Senate. Delaware continues to shade blue as Democrats picked up a seat in the Senate and more progressive-leaning candidates won seats in the House. Changes to the Delaware Legislature continue to make the DBA's role in government affairs even more critical to ensure legislators are educated on the value of the financial services industry and its importance to the health of the Delaware economy.

2023 marked the first year the General Assembly operated normally since the pandemic but with the added option of engaging in all proceedings, including the work of committees, virtually. Other changes included most committee work taking place on Wednesdays, and for the first time, the legislative session gaveled out at 5 pm on June 30th. Historically it had been 12 am.

History was made when the special session of the 152nd General Assembly convened after dinner on June 30th. Representative Valerie Longhurst was elected the first female Speaker of the House, and Representative Melissa Minor-Brown became the first black woman to be elected House Majority Leader.

The beginning of the 152nd General Assembly saw several legislative and banking issues of interest carried over from the final session of the 151st General Assembly.

Recreational Marijuana Legalization (HB 1) and Regulation of Recreational Marijuana (HB 2) were introduced in the second week of the 152nd General Assembly, and it was clear the votes were available to pass the bill and override a veto. In the end, the legislation passed with greater than a two-thirds majority in both chambers. Governor Carney did not veto the legislation, and it became law without his signature.

Data Privacy & Broker (HB 154) took a slightly different form from the previous session's bill, but the Gramm Leach Bliley exemption remained. While the 151st General Assembly bill was met with stiff resistance from the DBA and many large tech companies, the bill's sponsor, Rep. Krista Griffith, spent extensive time hearing concerns and answering questions. It eventually passed with three amendments, including the GBLA exemption.

Capping Interest Rates on Loans with Durations Under 60 days (HB 143) was again introduced and drafted identically to the original bill from the 151st General Assembly. The bill did not directly impact our members, but if passed could impact Delaware's reputation as a banking-friendly state. We collaborated closely with many constituents to ensure a united front and protect Delaware's valuable reputation. In the end, the bill was not heard in the House Banking Committee.

Several hot topics continue across the country, including climate change bills that impact most, if not all, businesses. Delaware is no exception with the passage of the Delaware Climate Change Solutions Act of 2023 (HB 99). This law creates Climate Change Officers in certain key cabinet-level departments who assist DNREC in the ongoing implementation of the Delaware Climate Action Plan. This bill met with resistance as the reporting requirements of DNREC did not include oversight from the legislature. This was addressed with House Amendment 1 to HB 99, requiring Climate Action Plan reporting to the Chief Clerk of the House of Representatives, the Secretary of the Senate, and the Chairs of the House and Senate Environmental Committees.

Financial Literacy is another hot topic across the US. Oregon passed the most recent legislation making Financial Literacy a requirement to graduate high school. Twenty-three states now have a Financial Literacy graduation requirement. Representative Jeff Hilovsky, an enthusiastic advocate for financial literacy, introduced Equity and Inclusion in Financial Literacy (HB203). The bill was debated in the House Education Committee for nearly three hours. Most legislators agreed with the idea but could not agree on whether to make it a requirement. The bill was eventually reported out of committee but was not put forward on the House floor. The DBA continues to work closely with Representative Hilovsky to make Financial Literacy education a reality for all students.

Senator Darius Brown introduced the Delaware Community Investment Venture Fund (SB83). He graciously spent time with the DBA Government Relations Committee to share his vision of the Fund. The Fund's purpose is to create opportunities for banking organizations and credit unions doing business in Delaware to better serve the needs of low- to moderate-income tracts in Delaware. The focus is innovation in small business lending to support opportunities in these tracts. The Council on Banking (comprised of Delaware bankers) will have oversight of expenditures from the fund (held by the Office of the Delaware State Treasurer) and will be charged with the adoption of guidelines or regulations to carry out the purpose of the Community Investment Venture Fund. The DBA is actively working to provide the Governor with a list of potential members for the Council on Banking … more to come.

Once again, the DBA collaborated with the Delaware Bar Association on the annual updates to the Decedents Estates and Fiduciary Relations bill (HB132) and the General Corporation Law (SB114). The diligence of the Bar Association is always appreciated and ensures Delaware continues to be a leader in these fields.

As the first session of the 152nd General Assembly ended, we were thankful for a successful year, but mindful challenges always lie ahead. DBA Government Affairs met with members of the Executive Branch, legislators, and their staff to continue to educate them on why banking is so important to sustain the Delaware Economy. This effort will require our ongoing focus in 2024 and beyond. We need to be vigilant and continue our efforts to educate, build relationships and provide innovative ideas to those that can influence Delaware's future. The Financial Services Industry provides critical financial services, invests in our communities, lends a helping hand through volunteer work, and provides opportunities for Delawareans to work and grow. The collective value to the health and wellness of the Delaware economy from DBA members cannot be underestimated. Our story needs to be shared at every opportunity.

What's New at the DBA

New Associate Members

Mayer Brown LLP

Matthew Bisanz, Partner
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Email: mbisanz@mayerbrown.com
Website: www.mayerbrown.com

Mayer Brown is a distinctive law firm that has deep experience with complex state and federal regulatory matters across industry sectors, including our signature strength, the financial services industry. We have decades of experience navigating banking, consumer financial services, and investment management issues for our clients, and our diverse teams of lawyers are recognized as cutting-edge innovators with practical commercial instincts.

Delaware Bankers Association 128th Annual Meeting

Outgoing Chair, Dominic C. Canuso, EVP & Chief Financial Officer, WSFS Bank, passes the gavel to incoming Chair, Tarrie Miller, President & COO, County Bank at the 128th DBA Annual Meeting.

Tarrie Miller, President & COO, County Bank, was elected the Chair of the Delaware Bankers Association (DBA) on May 11th at the DBA's 128th Annual Meeting in Wilmington. The DBA also elected and installed Matthew Parks, Director, Investments, CRA & Retail Banking, Discover Bank, to the position of Chair-Elect.

2023 David G. Bakerian Scholarship

(l to r) DBA President, Sarah Long, Scholarship Winners Ally Soghomonian and Megan Hamlett, President & COO, County Bank, Tarrie Miller, EVP & Chief Financial Officer, WSFS Bank, Dominic Canuso.

The Delaware Bankers Association announced the winners of the 2023 David G. Bakerian Award. The winners were Ally Soghomonian, and Megan Hamlett, both students at Caesar Rodney High School. Both students participated in the Keys to Financial Success course. Each winner received a $2,500 scholarship.

2023 Teach Children to Save Day

Delaware Governor John Carney proclaims 2023 Teach Children to Save Week as David Mench, DBA Director of Government Affairs; Sarah Long, DBA President; Colleen Davis, Delaware State Treasurer; The Great Investo, the World's Worst Money Magician; Penny, his Savvy Assistant; and, Jennifer Magaw, Administrative Specialist, Center for Economic Education and Entrepreneurship, look on.

Throughout the week of April 24 to April 28, over 100 banker volunteers taught an estimated 4,750 students in more than 200 public, private, and parochial classrooms throughout Delaware as part of the 25th annual Teach Children to Save Day. Over 90 percent of Delaware's banks participate in the Teach Children to Save Day event, the highest participation rate in the nation. Delaware Governor John Carney proclaimed the week of April 24th "Teach Children to Save Week" during an event at Clayton Elementary School in Smyrna on Tuesday, April 25th. The Delaware Legislature also approved a resolution honoring the effort.

The Delaware Financial Education Alliance created a new comic book for Teach Children to Save Day: *The Great Investo and Penny in Big Money Trouble*. The book illustrates the concept of scarcity and the benefits of saving regularly to pay for the things wanted. The book was written and illustrated by Greg Koseluk of the Delaware Bankers Association. Each student received their own copy of the comic book. The book was made possible with the support of Barclays, Sallie Mae, Smarty Pig, TD Bank, Wells Fargo, WSFS Bank, Artisans' Bank, Bank of America, Capital One, Fulton Bank, M&T Bank, Visa, Comenity Bank, First Citizens Community Bank, and Shore United Bank.

Women Connect Networking Event

Twenty-Five financial service professionals gathered at the Riverfront Hyatt Place in Wilmington on Thursday evening, May 18, for the latest Women Connect Essential Networking event. It was a great time of fun, laughter, and connection.

Delaware State Fair

The Delaware Bankers Association sponsored a booth during Kids' Day at the Fair, July 25. DBA Director of Events, Corinne Stayton and Education Coordinator, Renee Duncan (pictured above) were joined by Visa Account Executive, Alice Leonard, and gave out hundreds of Great Investo and Penny comic books, Kids Savers Kits, and other giveaway items to the fairgoers.

When it Comes to Joining a PEP, Don't be the Hot Potato

by
Maria Hurd, CPA, RPA
Belfint Lyons& Shuman, P.A.

Let's start with the Basics – What is a Pooled Employer Plan (PEP)?

PEPs were established in section 101 of the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act), which amended ERISA and the IRC, to allow unrelated employers to join a defined contribution retirement plan maintained by a pooled plan provider (PPP) acting as the plan's administrator and named fiduciary. A PEP, as defined in Section 101, is an individual account plan established or maintained for the purpose of providing benefits to the employees of two or more unrelated employers as a qualified retirement plan or a plan funded entirely with individual retirement accounts (IRA plan).

A PEP is a type of multiple employer plan (MEP) that allows unrelated employers to participate in a single, shared defined contribution plan, which is treated as a single plan for purposes of satisfying Employee Retirement Income Security Act of 1974 (ERISA) requirements. A PEP is considered to be an "open MEP" because there are no requirements that participating employers be in the same industry or location, nor are there limits to the number of participating employers in a PEP. On the other hand, in a "closed MEP," the employers must share common interests and/or organizational relationships beyond the provision of benefits. Employers have been able to join PEPs since 2021.

Pooled Plan Providers

A PEP is required to have a pooled plan provider (PPP) that is designated by the terms of the plan as a named fiduciary and plan administrator. The PPP performs certain administrative duties, including conducting proper compliance testing with respect to the PEP and the employees of each employer in the PEP. It is expected that most PPPs will be organizations such as insurance companies, banks, trust companies, consulting firms, record keepers, and third-party administrators. The PPP must register with the Department of Labor. A PEP must designate one or more trustees to be responsible for collecting contributions to, and holding the assets of, the plan and require such trustees to implement written contribution collection procedures that are reasonable, diligent, and systematic. The PPP is responsible for ensuring that all persons who handle assets of, or who are fiduciaries of, the PEP are bonded.

Together but Separate

Joining a PEP does not completely exonerate each employer from its fiduciary responsibilities. Each participating employer in a PEP generally selects from a range of plan provisions, as specified in the PEP plan document and is ultimately responsible for following the selected provisions. Except with respect to certain administrative duties of the PPP, each participating employer in a PEP is legally treated as a plan sponsor with respect to the portion of the plan attributable to employees of such employer (or beneficiaries of such employees) and retains fiduciary responsibility for the selection and ongoing monitoring of the PPP and any investment and management of the portion of the plan's assets attributable to the employees of the employer to the extent not delegated to another fiduciary by the PPP.

How is a PEP different from other multiple employer plans (MEPs) and multiemployer plans?

MEPs are maintained by two or more employers for the purpose of pooling investments and sharing administrative costs. MEPs typically maintain separate accounts for each of the employers within the plan, but they are treated as a single plan under the Internal Revenue Code (IRC). However, a MEP may or may not be treated as one plan under ERISA. The DOL has imposed a "common interest" requirement on employers adopting MEPs that must be met if the MEP is to be treated as one plan for ERISA purposes. However, with enactment of the SECURE Act, Congress loosened the common interest requirement for PEPS. Unlike the "closed" MEP ", a PEP is effectively an open MEP because it is not subject to the common interest requirement that applies to other MEPs. As such, PEPs are considered a single plan for both IRS and ERISA purposes. Multiemployer plans are similar to MEPs in that both types of plans are single plans that cover participants of more than one employer; however, multiemployer plans are subject to the terms of a collective

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Pooled Employer Plans

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bargaining agreement (CBA) between two or more contributing employers (or a group association of employers) and a labor union.

What are the DOL Financial Reporting Requirements for a PEP?

The administrator of a PEP must file an annual Form 5500, Annual Returns/Reports of Employee Benefit Plan, to which the PEP administrator must attach additional information, including a list of employers in the plan, a good faith estimate of the percentage of total contributions made by each employer during the plan year, the total of the individual account balances attributable to each employer in the plan, and the identifying information for the Pooled Plan Provider (PPP). PEPs cannot use the Form 5500-SF to satisfy their annual reporting obligations. They must file Form 5500.

PEPs that have 100 participants or more are required to have an annual financial statement audit.

The SECURE Act did not establish a new audit threshold for PEPs. Therefore, the general rule is that PEPs that cover 100 participants are more are required to have an audit.

Permission Granted Does Not Mean Action Will be Taken

Although Section 101 of the SECURE Act amended ERISA section 104(a)(2)(A) to permit the Secretary of Labor to establish simplified reporting for MEPs subject to ERISA section 210(a) with fewer than 1,000 participants in total, as long as each participating employer has fewer than 100 participants, the DOL is not currently proposing to amend the current reporting rules to establish a "simplified report" for such plans with fewer than 1,000 participants.

Unique items for auditors to consider

- **Engagement acceptance:** AU-C section 220, Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards, addresses the engagement partner's responsibilities relating to audit client acceptance. It requires the firm to obtain information considered necessary in the circumstances before accepting an engagement with a new client. An important consideration is whether the engagement team is competent to perform the PEP audit engagement and has the necessary capabilities, including time and resources.
- **Understanding the entity:** The amount of time and effort required to complete the audit will depend on many things, including the complexity of the plan and its operations. AU-C section 315, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement, requires that the auditor obtain an understanding of the entity and its environment, including the entity's internal control. The understanding of the entity should include:

  o Relevant industry, regulatory, and other external factors, including the applicable financial reporting framework. For PEPs, additional regulatory considerations will include the provisions of the SECURE Act and its regulations.

  o The nature of the entity, including:
    - Its operations. The complexity of the PEP's operations will depend largely on the plan document and plan composition, including the number of participating employers, trustees, custodians, and payroll systems, as well as the extent to which plan provisions are allowed to vary among the participating employers (e.g., definition of compensation, eligibility, vesting, etc.).
    - Its ownership and governance structures. The identification of those charged with governance for a PEP will require understanding the responsibilities of the various parties involved (which may be parties outside of the PPP) and how those responsibilities are executed.
    - The types of investments that the entity is making and plans to make, including investments in entities formed to accomplish specific objectives.
    - The way that the payroll integration is structured and how contributions are funded.

Understanding the PEPs internal control may include not only controls at the PPP, but also the controls at the participating employers that may affect the reliability of data and the design of audit procedures, such as controls over human resources information systems and payroll.

- **Audit evidence:** AU-C section 500, Audit Evidence, requires that the auditor design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. The entity's accounting records are an important source of audit evidence.

  For PEPs, audit evidence may come from various sources, depending on whether transactions are initiated at the PPP or the participating employer level. Discussions, inquiries, and information requests may need to be directed to parties other than the PPP.

  Following is an example of where transactions may be initiated in a PEP.

Source Transaction	PPP	Participating ER
Contributions		X
Participant Loan Disbursement	X	
Participant Loan Payment		X
Participant Census Data		X
Investments	X	
Distributions	X	
Expenses	X	
Opening Balances – Plan Level		X
Opening Balances – Participant Level		X

Note that it may not be possible to fully delegate payroll functions to the PPP since employers must set up new employees pay rates and hours worked on the payroll system, and participant elections may not be set up to be entered directly by participants into the payroll system.

• **Economies of Scale:** Maybe: The extent to which the PEP will result in lower audit fees per employer than if they had an individual plan will depend on how homogeneous the plan provisions adopted by the member employers are, how many different payroll companies are involved, the level of integration between the recordkeepers and the payroll softwares, the relative significance of each employer's assets, and the availability of SOC 1 reports for the relevant service providers. A PEP that mandates the same plan design and the same payroll company with full integration with the recordkeeper will have a better chance of lower audit fees than one that allows full flexibility of choice in design and payroll providers. When it comes to PEPs, individuality doesn't pay off, it makes you pay.

Discarding the Bad Apple

In the past, the "one bad apple" rule jeopardized a plan's tax qualified status when one employer had an operational failure. When things go wrong, PEP members are not jointly and severally liable for each other's actions. Under Section 101 of the SECURE Act, a PEP is not treated as failing the IRS qualification requirements solely because a single employer fails to satisfy those requirements, as long as the PEP provides for the transfer of the offending employer's plan assets to one of various specified arrangements. Noncompliant PEP members are a bad apple turned a hot potato; the PEP has to get rid of it before everybody gets burned. When it comes to PEPs, "All for one and one for all" only applies until something goes wrong.

Maria leads a team of specialized retirement plan auditors and the retirement plan audit niche at BLS, the largest locally owned CPA firm in Delaware. She is responsible for planning, supervising, and reviewing audits of single, multiemployer, and government 401(k), 403(b), and Taft-Hartley plans. Maria is known as one of the go-to auditors in the industry, which has helped her niche experience exponential growth in the number of plan audits due to the confidence of her referral sources. As a result of her team's efficient auditing and value-added services, she has a 95% client satisfaction and retention rating. Maria spearheads the firm's employee benefit audit blog – The Art of the Qualified Plan Audit. *Her blogs are frequently re-published in several national publications and she has authored white paper publications for major asset management companies.*

Using Delaware Trusts to Reduce Pennsylvania Personal Income Tax

by
Richard W. Nenno
Vincent C. Thomas
Travis G. Maurer
Young Conaway Stargatt & Taylor, LLP

In an earlier issue of the *Delaware Banker*, Mr. Nenno explained how New Jersey testators, settlors, trustees, and beneficiaries are particularly well-positioned to save New Jersey gross income tax by creating trusts in or moving them to Delaware.[1] Similarly, Pennsylvanians should consider using Delaware trusts to reduce Pennsylvania personal income tax. This article explains why.

Current Rules

In Pennsylvania, the trustee of a Resident Trust must file a return if the trust has Pennsylvania taxable income or loss; the trustee of a Nonresident Trust must file a return if the trust has Pennsylvania-source taxable income or a Pennsylvania resident beneficiary.[2] The Keystone State does not have federal grantor-trust rules for irrevocable trusts[3] but permits trustees to take a distribution deduction.[4] Starting in 2020, the Commonwealth also allows a decedent's personal representative and the trustee of the decedent's former revocable trust to make an I.R.C. § 645 election.[5]

In 2022, the Commonwealth taxed the Pennsylvania net taxable income of trustees of irrevocable trusts at 3.07%,[6] and this rate is not scheduled to change.[7] Pennsylvania defines "Resident Trust" as a trust that is created or funded by a Pennsylvania resident testator or settlor as follows:[8]

> "Resident Trust" means:
> (1) A trust created by the will of a decedent who at the time of his death was a resident individual; and
> (2) Any trust created by, or consisting in whole or in part of property transferred to a trust by a person who at the time of such creation or transfer was a resident.

In Pennsylvania, an individual is a resident for tax purposes if the individual is domiciled in the Commonwealth or if the individual maintains a permanent place of abode and spends more than 183 days there during the taxable year.[9] A "Nonresident Trust" is a trust that is not a "Resident Trust."[10]

Pennsylvania taxes trustees of Resident Trusts on the following seven specific classes of income:

- Taxable interest income
- Taxable dividend income
- Net income or loss from the operation of a business, profession, or farm
- Net gain or loss from the sale, exchange, or disposition of property
- Net income or loss from rents, royalties, patents, or copyrights
- Estate or trust income
- Gambling and lottery winnings.[11]

Trustees of Nonresident Trusts are taxed on the above classes of income attributable to Pennsylvania sources.[12] In Pennsylvania, trustees must make estimated tax payments for trusts[13] and must withhold tax from source income distributable to nonresident beneficiaries.[14]

The Commonwealth assesses a throwback tax on accumulation distributions to resident beneficiaries from Nonresident Trusts. Hence, a regulation provides:[15]

> Amounts received by a resident beneficiary from a nonresident . . . trust shall be taxable to the beneficiary in the year received to the extent that such income was not subject to tax under this article. The resident beneficiary shall be allowed a credit against the tax otherwise due under this article for his pro rata share of any income tax, wage tax or tax on or measured by gross or net earned or unearned income imposed on the . . . trust with respect to such income by another state. The credit shall not exceed the proportion of the tax otherwise due. Reference should be made to § 111.4 (relating to limitation on credit).

Safe Harbor

The Commonwealth offers a safe harbor for when a trust that meets the definition of Resident Trust will be taxed as a Nonresident Trust. Thus, according to the Pennsylvania fiduciary income tax return instructions, a trust created by a resident will not be taxed in the following circumstances:[16]

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An inter vivos trust or a testamentary trust created by a resident can become a nonresident trust if the settlor is no longer a resident or is deceased, and the trust lacks sufficient contact with Pennsylvania to establish nexus. Any one of the following conditions provides sufficient contact for a resident trust to remain a resident trust or to requalify as a resident trust:

• The trust has a resident trustee;
• Any trust administration occurs in Pennsylvania;
• Trust assets include:
• Real or tangible personal property located within Pennsylvania, or
• Stock, securities or intangible personal property, evidenced by the documents, certificates or other instruments that are physically located, or have a business situs within Pennsylvania; or
• The situs of the trust is Pennsylvania as provided in 20 PA. C.S. § 7708.

Section 7708(a) specifies:[17]

> Without precluding other means for establishing a sufficient connection with the designated jurisdiction, provisions of a trust instrument designating the situs of the trust are valid and controlling if:
> (1) a trustee's principal place of business is located in or a trustee is a resident of the designated jurisdiction;
> (2) all or part of the trust administration occurs in the designated jurisdiction; or
> (3) one or more of the beneficiaries resides in the designated jurisdiction.

Curiously, even though the safe harbor indicates that the presence of a resident trustee and § 7708(a) indicates that the presence of a resident trustee or a resident beneficiary will cause a trust to be taxed as a Resident Trust, a regulation states that in classifying a trust for income-tax purposes "[t]he residence of the fiduciary and the beneficiaries of the trust shall be immaterial."[18] It is unknown whether appointing resident advisers or protectors rather than resident trustees will be successful in escaping tax, but the safe course is to assume that it will not.

Case Law

Hope is not lost if a trust does not fall within the above safe harbor (for example, if the settlor is living or still resides in the Commonwealth) thanks to the Pennsylvania Commonwealth Court's 2013 decision in *McNeil v. Commonwealth*,[19] which saved over $500,000 of tax and which is the poster child for how Delaware trusts can save Pennsylvania tax. In 2007, two trusts, which had been established by a Pennsylvania resident settlor, had Pennsylvania resident discretionary beneficiaries, non-Pennsylvania individual trustees, and a Delaware corporate trustee. The court held that Pennsylvania's imposition of tax in the circumstances would violate the dormant Commerce Clause of the United States Constitution.[20]

The court reviewed the governing dormant Commerce Clause principles from the United States Supreme Court's 1977 *Complete Auto Transit, Inc. v. Brady* decision[21] as follows:[22]

> Commerce Clause cases are governed by *Complete Auto Transit, Inc. v. Brady*, in which the U.S. Supreme Court established a four prong test to determine whether a state tax withstands constitutional scrutiny. Those four prongs are: (1) the taxpayer must have a substantial nexus to the taxing jurisdiction; (2) the tax must be fairly apportioned; (3) the tax being imposed upon the taxpayer must be fairly related to the benefits being conferred by the taxing jurisdiction; and (4) the tax may not discriminate against interstate commerce. To pass constitutional muster, all four prongs must be satisfied and the failure to meet any one of these requirements renders the tax unconstitutional.

The court found that imposition of tax would violate prongs (1), (2), and (3); it did not address prong (4).

Regarding the first prong, the court concluded:[23]

> [W]e hold that neither Settlor's residency nor the residency of the beneficiaries provides the Trusts with the requisite presence in Pennsylvania to establish a substantial nexus and, therefore, the first prong of Complete Auto is not met and the imposition of the PIT [personal income tax] here violates the Commerce Clause of the U.S. Constitution.

Regarding the second prong, the court reasoned:[24]

> [T]he imposition of the PIT on the Trusts' income, when all of that income was derived from sources outside of Pennsylvania, is inherently arbitrary and has no rational relationship to the Trusts' business activity that occurred in Pennsylvania. Accordingly, the imposition of the PIT here does not satisfy the fair apportionment prong of *Complete Auto*.

Regarding the third prong, the court found:[25]

> In 2007, the Trusts had no physical presence in Pennsylvania, none of their income was derived from Pennsylvania sources, none of their assets or interests were located in Pennsylvania, and they were established under and were governed by Delaware law. Hence, . . . the Trusts do not benefit from Pennsylvania's roadways, bridges, police, fire protection, economic markets, access to its trained workforce, courts, and laws. We recognize that the Trusts' discretionary beneficiaries almost certainly benefit from Pennsylvania's societal and legal framework because they reside in Pennsylvania; however, they are not the taxpayer in this matter and, importantly, as discretionary beneficiaries, they have no present or future right to distributions from the Trusts. Moreover, pursuant to Sections 302 and 305 of the Tax Code the beneficiaries will pay PIT on any distributions they do receive from the Trusts, which are fairly related to the benefits they receive from residing in Pennsylvania. Similarly, Settlor, who was deceased in TY 2007, is not the taxpayer in this matter.
>
> Thus, the Department's imposition of the PIT on the Trusts' entire income is not reasonably related to the benefits Pennsylvania provides the Trusts. Therefore, the

Commonwealth's imposition of the PIT here does not satisfy the fairly related prong of *Complete Auto*.

Having held that imposition of tax would violate the dormant Commerce Clause,[26] the court did not have to decide whether it would violate the Due Process or the Equal Protection Clause of the United States Constitution or the Uniformity Clause of the Pennsylvania Constitution.[27]

The *McNeil* decision was based, in part, on the fact that the trust had no physical presence in Pennsylvania. In the meantime, the United States Supreme Court eliminated the physical-presence requirement under the dormant Commerce Clause.[28] Soon after, the Commonwealth Court of Pennsylvania disavowed *McNeil's* physical-presence test in applying Pennsylvania Personal Income Tax to a nonresident partner of a partnership that disposed of Pennsylvania real property.[29]

In our view, the elimination of the physical-presence requirement would not have changed the outcome in *McNeil* because the Commonwealth failed to meet two of the other Complete Auto criteria. Moreover, the Commonwealth might not have been able to meet the substantial-nexus prong even without the physical-presence requirement.

Establishing Trusts' Residency Status

The tax return instructions contain the following caution for trustees seeking to have a Resident Trust taxed as a Nonresident Trust:[30]

> CAUTION: Do not file an amended return to change the residency status of a trust. You must file a REV-65 Petition for Refund, with the Board of Appeals.

Planning: Federal Nongrantor Trust; Pennsylvania Nongrantor Trust

Pennsylvania testators, settlors, trustees, and beneficiaries should structure – and consider moving – federal nongrantor trusts to qualify for the above safe harbor and, where the safe harbor is not available, minimize the trusts' connections to the Commonwealth (for example, by transferring trusts to Delaware trustees) with the hope of obtaining favorable outcomes from the filing of REV-65 petitions. Although REV-65 petitions typically are denied by the Board of Appeals, numerous trustees (almost 100 as of this writing) have succeeded by appealing adverse Board of Appeals rulings to the Board of Finance and Revenue.[31] In appropriate situations, court appeals of adverse Board of Finance and Revenue decisions might be advisable.

The potential tax reduction for the trustee of a Pennsylvania Resident Trust on a $1 million long-term capital gain incurred in 2022 was $30,700. Hence, there would be $30,700 of additional assets to produce income for the beneficiaries and, through the elimination of the state-income-tax drag, to enhance the trustee's performance in that and future years. This planning is all the more important given the current $10,000 per year limitation on the federal deduction for state taxes.[32]

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Pennsylvanians also might want to create and fund Delaware revocable trusts during life to escape the Pennsylvania income tax that otherwise would be payable by their probate estates.

Planning: Federal Grantor Trust; Pennsylvania Nongrantor Trust

Given that Pennsylvania does not have grantor-trust rules for irrevocable trusts, it might be possible to design a trust to be a grantor trust for federal purposes and a nontaxable nongrantor trust for Pennsylvania purposes. Pennsylvania's treatment of all irrevocable trusts as nongrantor trusts has serious consequences. For example, the tax return instructions offer the following guidance for GRATs and GRUTs:[33]

> GRATs and GRUTs are ordinary trusts that are not exempt from PA-41 Fiduciary Income Tax Return, filing requirements or taxation. These types of trusts must file a Pennsylvania trust tax return, pay tax on any retained earnings, and report the income to the beneficiary on the same basis as any other ordinary trust.

Moreover, according to Pennsylvania practitioners, the sale of assets in exchange for a promissory note is a taxable event in the Commonwealth. Furthermore, the settlor of a Pennsylvania trust may not take a credit for taxes paid by the grantor of a trust that was treated as a grantor trust by another state "because Petitioner and the Grantor are two separate taxpayers and the same taxpayers did not pay tax on the same income in Pennsylvania and another state."[34]

Pennsylvanians who create trusts that are treated as grantor trusts for federal purposes often must pay all federal income taxes attributable to such trusts even though they do not have access to the trusts' assets. Except for trusts that give the trustee discretion to reimburse the grantor for income taxes, grantors of such trusts have the choice to pay such taxes (which might become burdensome over time), to release the powers that trigger grantor-trust treatment (which will deplete the trust fund), or to toggle between grantor-trust and nongrantor trust treatment (with its practical and tax-related challenges). Pennsylvanians might consider establishing new trusts in or moving existing trusts to Delaware, where a Delaware statute gives trustees of grantor trusts discretion to reimburse the settlor for federal, state, county, metropolitan-region, city, local, foreign, or other income tax liability unless prohibited by the governing instrument.[35] Using this statutory power, the trustee might reimburse the settlor for some taxes in one year, for no taxes in a second year, and for all taxes in a third year.

DING Trust Option

Pennsylvanians might use a type of Delaware asset protection trust (APT)[36] known as the Delaware incomplete gift nongrantor trust (DING Trust) to eliminate Pennsylvania income tax on undistributed ordinary income and capital gains. DING Trusts are designed with two goals in mind: to prevent transfers from being completed gifts; to have the trusts treated as nongrantor trusts for federal purposes. The second goal is easily accomplished because Pennsylvania treats all irrevocable trusts as nongrantor trusts. The planner then can focus on structuring transfers to be incomplete gifts so that the settlor of the DING Trust, which is a self-settled trust, might be able to receive tax-free distributions of the untaxed income in later years.

Adverse Treatment of CRTs

Pennsylvanians might want to establish their CRTs in or move them to Delaware. That's because Pennsylvania taxes CRTs at the trust level. Hence, the instructions to the Pennsylvania fiduciary income tax return provide:[37]

> CRATs, charitable remainder trusts, CRUTs and pooled income fund trusts of public charities are ordinary trusts that are not exempt from PA-41, Fiduciary Income Tax Return, filing requirements or taxation. These types of charitable trusts must file a Pennsylvania trust tax return, pay tax on any undistributed income, and report the income to the beneficiary on the same basis as any other ordinary trust.

Taxation at the trust level is undesirable when, as often is the case, a client wants to use a CRT to diversify a portfolio of low-basis securities without being taxed immediately on all capital gains.[38]

Duty to Minimize Tax

Section 108(b) of the Uniform Trust Code stipulates that "[a] trustee is under a continuing duty to administer the trust at a place appropriate to its purposes, its administration, and the interests of the beneficiaries,"[39] and § 108's comment acknowledges that a change of situs might be desirable "to secure a lower state income tax rate."[40] Pennsylvania's version of § 108[41] does not include an equivalent of § 108(b). The comment to § 7708 reports that this was done "to avoid the implication of a duty that the trustee consider the laws of all conceivable jurisdictions to which the situs of a trust may be moved and establish and re-establish situs accordingly."[42]

Trustees paying Pennsylvania tax should not relax, though, because under the duty to administer the trust in accordance with its terms and applicable law, § 76 of the Third Restatement of Trusts[43] offers the following comment:[44]

> A trustee's duty to administer a trust includes an initial and continuing duty to administer it at a location that is reasonably suitable to the purposes of the trust, its sound and efficient administration, and the interests of its beneficiaries. . . .
>
> Under some circumstances the trustee may have a duty to change or to permit (e.g., by resignation) a change in the place of administration. Changes in the place of administration by a trustee, or even the relocation of beneficiaries or other developments, may result in costs or geographic inconvenience serious enough to justify removal of the trustee.

Moreover, at least on this issue, trustees must consider the laws of as few as two jurisdictions – Pennsylvania (how to escape its tax as discussed above) and a state that will not tax the trust's income. It is generally known that nearby Delaware usually will not tax trusts created by Pennsylvanians (see below).

Delaware Considerations

Delaware taxes trustees in certain circumstances,[45] with a top rate of 6.60% on taxable income over $60,000.[46] But, trustees of trusts created by Pennsylvania residents will not have to pay Delaware income tax – or even file a Delaware return – as long as there are no Delaware resident beneficiaries.[47]

Conclusion

Pennsylvania's low flat income tax rate, its disregard of grantor-trust rules for irrevocable trusts, its adverse tax treatment of CRTs, and its other quirks distinguish the Commonwealth's tax system from those of other states. Through the discerning use of Delaware trusts, Pennsylvania testators, settlors, trustees, and beneficiaries often may greatly reduce the impact of the Pennsylvania personal income tax or eliminate it altogether. As fiduciaries, trustees that are paying Pennsylvania personal income tax, like many trustees before them, have a duty to engage in this planning to fulfill their duty to administer trusts "in accordance with . . . the interests of the beneficiaries"[48] – not the interests of the Commonwealth's Department of Revenue – and face potential liability if they fail to do so. If nothing else, it's the right thing to do.

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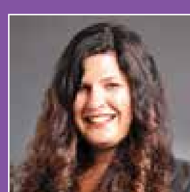
Notes:

1- Richard W. Nenno, *Using Delaware Trusts to Reduce New Jersey Income Tax*, 16 Del. Banker 22 (Fall 2020).
2- Instructions to 2022 Form PA-41 at 1.
3- *See* Instructions to 2022 Form PA-41 at 5.
4- *See* 72 P.S. § 7305.
5- *See* 72 P.S. § 7331(g).
6- 72 P.S. § 7302.
7- 72 P.S. § 7302.
8- 72 P.S. § 7301(s).
9- 72 P.S. § 7301(p).
10- 72 P.S. § 7301(n). *See David C. Matthews Fam. Tr.*, BF&R Docket No. 1917374 (Feb. 10, 2020), www.bfrcases.patreasury.gov (Petitioner was not a Resident Trust in 2016 because "Petitioner's grantor was not a Pennsylvania resident at the time Petitioner was created, and Petitioner and its grantor owned no Pennsylvania property at the time of the grantor's death or at any time during 2016.").
11- **See** Instructions to 2022 Form PA-41 at 6. See also 72 P.S. § 7302(a).
12- *See* 72 P.S. § 7302(b).
13- *See* 72 P.S. § 7325–7326.
14- *See* 72 P.S. § 7324.
15- 61 Pa. Code § 105.5(c).
16- Instructions to 2022 Form PA-41 at 4.
17- 20 Pa. C.S. § 7708(a). Section 7708(b) gives rules for determining situs when the trust instrument is silent.
18- 61 Pa. Code § 101.1.
19- 67 A.3d 185 (Pa. Commw. Ct. 2013).
20- U.S. Const. art. I, § 8, cl. 3.
21- 430 U.S. 274 (1977).
22- *McNeil*, 67 A.3d at 192 (citations omitted; emphasis in original).
23- *Id*. at 195.
24- *Id*. at 196–97 (citation and internal quotation marks omitted).
25- *Id*. at 197–98 (citations omitted). Although the opinion recites that the Settlor was deceased, he was in fact living. Courts have invalidated the taxation of inter vivos trusts whose settlors were in fact living under similar statutes of other states (*see, e.g., Fielding for MacDonald v. Comm'r of Revenue*, 916 N.W.2d 323 (Minn. 2018)).
26- *Id*. at 198.
27- *Id*. at 198 n.17.
28- *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018).
29- *Andrews v. Commonwealth*, 196 A.3d 1090, 1098 n.13 (Pa. Commw. Ct. 2018).
30- Instructions to 2022 Form PA-41 at 19. Pa. REV-65 *Board of Appeals Petition Form*, available at www.revenue.pa.gov/FormsandPublications/otherforms/Documents/rev-65.pdf (last visited July 25, 2023).
31- *See, e.g., Felger Elizabeth Y Tr. U/W*, BF&R Docket No. 2010371 (July 8, 2021), www.bfrcases.patreasury.gov ("The Department of Revenue shall issue a refund in the amount of $__ to Petitioner").
32- *See* IRC §§ 164(b)(6)(B), 641(b).
33- Instructions to 2022 Form PA-41 at 3–4.
34- *Arthur Dantchik Trust For Descendants*, BR&R Docket No. 2204243 (Jan. 26, 2023), www.bfrcases.patreasury.gov. The ruling does not give the basis on which the other state classified the trust as a grantor trust.
35- *See* 12 Del. C. § 3344.
36- *See* 12 Del. C. §§ 3570–3576.
37- Instructions to 2022 Form PA-41 at 3.
38- *See* I.R.C. § 664(b).
39- UTC § 108(b).
40- UTC § 108 cmt.
41- 20 Pa. C.S. § 7708.
42- Jt. St. Govt. Comm. Comment to 20 Pa. C.S. § 7708.
43- Restatement (Third) of Trusts § 76 (2003). Like other restatement provisions, § 76 is understood as "describing the law in a given area and guiding its development" (Black's Law Dictionary 1570 (11th ed. 2019)).
44- Id. cmt. b(2) (2003) (cross references omitted). The Reporter's Note for § 76 quotes the portion of the Comment under UTC § 108 quoted above.
45- *See* 30 Del. C. §§ 1601(8), 1631.
46- 30 Del. C. § 1102(a)(14).
47- *See* 30 Del. C. §§ 1605(b), 1636.
48- 20 Pa. C.S. § 7771.



Does California's New Law Ending the State Income Tax Benefits Associated with Incomplete Gift Non-Grantor Trusts Violate the U.S. Constitution?

by
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On July 10, 2023, California followed in the footsteps of the State of New York by adding Section 17082 to the California State Tax and Revenue Code (hereafter, "Section 17082") which establishes that income generated from Incomplete Gift Non-Grantor Trusts ("ING Trust" or "ING Trusts") created by California taxpayers will be includable in a grantor's income for California state income tax purposes.[1] ING Trusts are unique tax saving vehicles utilized by individuals residing in states with high income tax rates to eliminate or defer state income tax liabilities on the sale of low-basis, highly-appreciated assets. For federal taxation purposes, an ING Trust is treated as a non-grantor trust, however, the assets contributed to an ING Trust do not count against the grantor's federal lifetime gift tax exemption because the grantor retains certain powers over the ING Trust to cause the transfer into the ING Trust to be wholly incomplete for federal gift tax purposes.[2]

To qualify for this favorable tax treatment, an ING Trust must be created in a jurisdiction like Delaware that authorizes self-settled asset protection trusts[3] and does not impose state income tax on trust income when none of the trust's beneficiaries reside in Delaware.[4] Additionally, the grantor must avoid making a completed gift when funding the ING Trust and the ING Trust must avoid being classified as a grantor trust for federal taxation purposes.[5] The IRS has issued a series of Private Letter Rulings[6] establishing that a grantor can accomplish both of these objectives if the following requirements are met: (1) the ING Trust is a self-settled asset protection trust;[7] (2) the grantor retains a limited power of appointment over the ING Trust's assets;[8] (3) the grantor retains the power to consent to distributions directed by a majority of the distribution committee members;[9] and (4) the ING Trust has a distribution committee that has the discretion to determine whether the grantor is entitled to distributions from the ING Trust's income and principal.[10]

If these requirements are met, upon the sale of the ING Trust's assets, the ING Trust will incur a federal, but not a state income tax liability. Therefore, it is possible for individuals residing in states with high state income tax rates to eliminate their state income tax liability on assets sold by an ING Trust.

Prior to the implementation of Section 17082, the following example demonstrates how California residents were able to use ING Trusts to avoid California state income taxes on the sale of low-basis, highly-appreciated assets.

A is a resident of California that is in the highest federal and state tax bracket. A owns securities with a basis of $1 million. A believes that the securities are going to appreciate significantly in the future. To reduce state tax liability on the sale of the securities, A forms a Delaware ING Trust and funds the trust with the securities. The trustee later sells the securities for $10 million. Because the securities were owned by an ING Trust at the time of the sale, the ING Trust will owe federal tax on a $9 million gain, however, no California state tax will be due as the ING Trust was formed in Delaware where no state income tax is imposed on trust income accumulated for non-resident beneficiaries. Therefore, because A utilized a Delaware ING Trust to sell the securities, A was able to save roughly $1,197,000 in California state income taxes.[11]

Given the success that ING Trusts have had in eliminating state income tax, California enacted Section 17082 on July 10, 2023 which states:

> For taxable years beginning on or after January 1, 2023, the income of an [ING Trust] shall be included in a qualified taxpayer's gross income to the extent the income of the trust would be taken into account in computing the qualified taxpayer's taxable income if the trust in its entirety were treated as a grantor trust under Section 17731.

Section 17082 has generated controversy among wealth planning practitioners and high-net-worth individuals for two reasons. First, Section 17082 eliminates the tax benefits associated with forming ING Trusts for California residents, as income generated by an ING Trust is now includable in the grantor's income for California state income tax purposes. Second, the statute possesses a retroactive effective date. This means that income generated from ING Trusts formed between January 1, 2023, and July 9, 2023, will be subject to California state income tax even though the law was not enacted until July 10, 2023.

The use of retroactive effective dates for tax legislation is an atypical practice. Traditionally, tax laws utilize what is referred to as a "sunset provision" or a deadline for when the current

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law is set to expire. For example, I.R.C. § 2010(c) states that on January 1, 2026, the federal gift and estate exemption amount will be reduced to $5,000,000. By having this sunset provision, individuals know they have until December 31, 2025, to make the necessary gifts to take advantage of the current exemption amounts. However, the effective date used by Section 17082 does the opposite, as California residents were not afforded such notice and are now being penalized for engaging in transactions that were recognized as tax-free when they were completed.

Given the adverse tax consequences that will result from Section 17082's retroactive effective date, one might ask, "is this law even constitutional?" The initial response might be "of course not", as it is a ridiculous notion that a legislature can tax individuals for engaging in transactions that were tax-free at the time they were performed. However, like all areas of law, the answer is not so clear, as the United States Supreme Court has held that a taxpayer's reliance on the current tax law is insufficient to establish a constitutional violation.[12] As such, the remainder of this article will discuss the potential arguments that a taxpayer might raise if Section 17082 were to be challenged on constitutional grounds.

1.Ex-Post Facto Law

The first constitutional argument that might be raised is that the retroactive effective date used by Section 17082 creates an unconstitutional "Ex Post Facto Law." A law is considered an Ex Post Facto Law if a law imposes criminal liability upon an individual for engaging in an act that was legal at the time it was performed.[13]

In regard to Section 17082, it could be argued that the retroactive date used by Section 17082 creates an Ex Post Facto Law because the law imposes tax on a transaction that was exempt from California state income tax prior to Section 17082 being enacted. However, this argument will likely fail, as an Ex Post Facto Law only exists if the law imposes criminal liability for conduct that was legal at the time the act was performed.[14] Additionally, the United States Supreme Court has held that "[t] axation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must bear its burdens."[15] In this case, no criminal liability is being imposed upon California residents that created ING Trusts. Rather, ING Trusts remain legal and Californians using ING Trusts are now required to pay California income tax on income earned by ING Trusts in 2023. Therefore, any argument that the retroactive effective date used by Section 17082 creates an unconstitutional Ex Post Facto Law will likely fail.

2.Due Process

It could also be argued that Section 17082 violates Due Process because Section 17082 imposes tax upon transactions considered tax-free prior to the enactment of Section 17082. The 14th Amendment's Due Process Clause establishes that no "…State shall deprive a person of life, liberty, or property, without due process of law."[16] In the context of retroactive tax legislation, the United States Supreme Court has consistently found that retroactive tax legislation does not violate Due Process.[17] A reviewing court will find that retroactive tax legislation complies with Due Process if the law is capable of withstanding rational basis review and the period of retroactivity is deemed "modest."[18]

Rational basis review is the lowest form of judicial scrutiny that a law can face when being challenged on Due Process grounds. To survive rational basis review, the court must find that the law is rationally related to a legitimate government purpose.[19] A retroactive tax law will fail rational basis review if a court finds that the retroactive law was enacted for illegitimate or arbitrary purposes.[20] The United States Supreme Court has found that retroactive tax legislation meets the requirements of rational basis review if the law was enacted to recover or prevent the loss of tax revenue.[21] In *Carlton*, the United States Supreme Court determined that a retroactive tax law impacting the deductibility of ESOP shares sold by an estate survived rational basis review because the law was implemented to address a mistake in the tax code that could have resulted in significant and unanticipated tax revenue losses. Therefore, if a retroactive tax law was implemented to prevent the loss of tax revenue, the law will overcome rational basis scrutiny.

In addition to satisfying rational basis review, a retroactive tax law will not be found to violate Due Process if a reviewing court determines that the period of retroactivity adopted by the law is considered "modest."[22] In previous decisions, the United States Supreme Court found tax legislation possessing a retroactive effective date of slightly more than a year to be considered "modest."[23]

In this case, Section 17082 will likely be able to survive any Due Process challenges. Section 17082 satisfies rational basis review because the California legislature estimates that the implementation of Section 17082 will allow the state to recapture an estimated $17 million of previously lost tax revenue.[24] Further, a reviewing court would likely find that Section 17082's retroactive effective date of six months "modest" because the United States Supreme Court has approved retroactive effective dates spanning more than a year. Therefore, a court would likely find that the retroactive effective date used by Section 17082 does not violate Due Process.

Although Section 17082's retroactive effective date is punitive and penalizes Californians for utilizing ING Trusts to minimize their state income tax liability, any claims that the law is unconstitutional on the basis that the retroactive effective date creates an Ex Post Facto Law, or violates Due Process, will likely fail. However, given the unpredictable and ever-changing nature of constitutional jurisprudence, it is not unrealistic that a court could strike down Section 17082 as unconstitutional if the correct facts were to present themselves.

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Notes:

1- In 2014, New York eliminated the state income tax savings benefits associated with ING Trusts by adding § 612(b)(41) to the Consolidated Laws of New York which states that income from ING Trusts will be treated as if it were derived from a grantor trust and therefore includable in a grantor's income for New York state income tax purposes.

2- *See*, PLR 200612002; PLR 200502014; PLR 200247013; PLR 200148028.

3- *See*, 12 Del. C. § 3572.

4- *See*, 30 Del. C. § 1636.

5- For a more detailed discussion of the structuring requirements for ING Trusts *see*, Michael Gordon, *Use of Delaware Incomplete Gift Non-Grantor Trusts in Light of IR-2007-127* (2011), available at https://www.gfmlaw.com/sites/default/files/pdfs/Use%20of%20Delaware%20Non-Grantor%20Incomplete%20Trusts%20%2800304860%29.pdf

6- *See*, PLR 200715005; PLR 200647001; PLR 200637025; PLR 200612002; PLR 200502014.

7- Treas. Reg. § 1.677(a)-1(d) (if creditors are able to reach a trust's assets, the trust will be considered a grantor trust for federal taxation purposes).

8- *See*, 26 CFR § 25.2511-2(b) (a gift may be incomplete if the donor reserves any power over its disposition).

9- PLR 200247013.

10- I.R.C. § 677(a) (a grantor will be considered the owner of any portion of a trust if the income can be distributed to the grantor without the approval of an "adverse party").

11- This is assuming that the California tax rate applicable to this transaction is 13.3%.

12- *See, U.S. v. Carlton*, 512 U.S. 26, 33 (1994); *Welch v. Henry*, 305 U.S. 134, 146 (1938).

13- *Calder v. Bull*, 3 U.S. 386, 390-91 (1798).

14- *See, Kentucky Union Co. v. Commonwealth of Kentucky*, 219 U.S. 140, 155 (1911) (Kentucky statute authorizing retroactive tax was not an Ex Post Facto Law because the law did not impose criminal liability upon taxpayers).

15- *Welch*, 305 U.S. at 146.

16- U.S. Const. amend. XIV, § 1.

17- *See, United States v. Hemme*, 476 U.S. 558 (1986); *United States v. Darusmont*, 449 U.S. 292 (1981); *Welch*, 305 U.S. at 134; *United States v. Hudson*, 299 U.S. 498 (1937); *Milliken v. United States*, 283 U.S. 15 (1931); *Cooper v. United States*, 280 U.S. 409 (1930).

18- *Carlton*, 512 U.S. at 30-31.

19- *Id.*

20- *Id.* at 32.

21- *Id.*

22- *Id.*

23- *Id.* at 32-35 (United States Supreme Court determined that the retroactive effective period of fourteen months was "modest" and did not violate Due Process); *Welch*, 305 U.S. at 150-51 (United States Supreme Court found that state tax law enacted in 1935 that was retroactive back to transactions conducted in 1933 did not violate Due Process); *Milliken*, 283 U.S. at 23-24 (United States Supreme Court found that retroactive period of two years did not violate Due Process).

24- *See*, Legislation Proposal C Executive Summary, Taxation of Income from an Incomplete Gift Non-Grantor (ING) Trust, available at https://www.ftb.ca.gov/tax-pros/law/regulatory-activity/lp-c.pdf

Banks Face Growing Regulatory Pressure to Address Risky CRE Portfolios

by
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and Xylex Mangulabnan
S&P Global Market Intelligence

US banks with large commercial real estate loan concentrations must work to proactively mitigate any potential problems or run the risk of regulatory intervention.

As concerns over commercial real estate (CRE) grow and those portfolios face headwinds, regulators have made it clear they are paying extra attention to banks with outsized concentrations and will not shy away from taking action against institutions that present risk. Those actions could include regulatory rating downgrades and increased capital retention requirements, experts told S&P Global Market Intelligence. Banks should take steps now to mitigate risk in order to avoid such actions, they said.

"The fact that [regulators are] calling this out now just heightens the need for banks to really assess how they're mitigating for those risks effectively, and not creating other problems," Peter Dugas, who heads the Center of Regulatory Intelligence at financial consulting firm Capco, said in an interview.

Although CRE loan scrutiny has always been a consistent focus for the agencies, "the pendulum is swinging more towards activism," said Carleton Goss, counsel with law firm Hunton Andrews Kurth. "What you're seeing is regulators saying, 'I'm not going to follow an excessively lengthy and procedural approach when I see a problem. I'm going to use the powers that I have,'" Goss said.

CRE Concentrations

Banks have tightened underwriting standards on CRE loans in recent months as cautious investors looked for weakness in lenders' balance sheets following the recent bank failures.
While some real estate industry borrowers, in property types including industrial and multifamily, remain relatively stable, others have suffered in recent years. In particular, occupancy in office properties has not recovered from the COVID-19 pandemic and the rise of work from home, while labor-related expenses for health care property operators remain high in a tight job market.

In the first quarter, CRE loans made up a median of 23.8% of US banks' total loans. Generally, the nation's largest banks carried lower concentrations than smaller banks.

Among the 20 US banks with the largest CRE loan concentration at March 31, all had assets below $6 billion. First Federal Savings and Loan Association of San Rafael topped the list, with CRE loans making up 98.3% of its total loans, and another seven community banks had more than 90% of their total loans concentrated in CRE, according to an analysis by Market Intelligence.

When narrowing the analysis to banks with more than $10 billion in assets, CRE concentrations for the top 20 banks declined but were still elevated from the industry median. Optum Bank Inc. topped the list with 77.5% of its total loans in CRE. All but one bank on the list had at least half of its total loans concentrated in CRE.

Among the 20 largest US banks, M&T Bank Corp. subsidiary Manufacturers and Traders Trust Co. had the highest CRE loan concentration, with the segment taking up 30.4% of its total loans. Every other bank on the list reported concentrations below 20%.

(continued on p. 30)

US banks with the largest CRE loan concentration, Q1 2023

			Total CRE loans*			
			Proportion of total loans			
Company (top-level ticker)	City, state/territory	Total assets ($B)	(%)	QOQ change (bps)	YOY change (bps)	($B)
First Federal Savings and Loan Association of San Rafael	San Rafael, CA	0.22	98.3	2	-31	0.19
State Bank of Texas	Dallas, TX	2.13	96.5	39	311	1.65
OneUnited Bank	Boston, MA	0.61	96.0	-1	32	0.44
Piermont Bank	New York, NY	0.56	95.1	71	909	0.33
HCN Bank	Riverside, CA	0.94	93.7	-15	-14	0.65
NorthEast Community Bank (NECB)	White Plains, NY	1.48	93.2	-44	197	1.21
Malaga Bank FSB (MLGF)	Palos Verdes Estates, CA	1.50	92.4	30	53	1.19
Eastern International Bank	Los Angeles, CA	0.12	91.6	-8	-21	0.09
Universal Bank	West Covina, CA	0.36	89.9	-363	-310	0.24
United Fidelity Bank FSB (FDLB)	Evansville, IN	5.91	89.5	94	1,084	3.38
City First Bank NA (BYFC)	Washington, DC	1.20	87.4	42	1,324	0.68
Berkshire Bank	New York, NY	0.62	85.0	173	552	0.24
Bank of New England	Salem, NH	1.31	84.7	89	-53	0.96
Albany Bank and Trust Co. NA	Chicago, IL	0.70	84.5	3	216	0.46
Liberty Bank NA	Irvine, CA	0.58	84.0	-220	-680	0.40
River City Bank (RCBC)	Sacramento, CA	4.33	83.4	126	384	2.65
United Texas Bank	Dallas, TX	1.18	83.2	541	1,373	0.49
Genesis Bank	Newport Beach, CA	0.18	81.9	-39	687	0.12
First Federal Savings of Middletown	Middletown, NY	0.17	81.8	1,832	22	0.10
United Pacific Bank	City of Industry, CA	0.15	81.5	257	14	0.09
Industry median			**23.8**	**11**	**36**	

Data compiled June 29, 2023.
CRE = commercial real estate.
Analysis limited to operating US commercial banks, savings banks, and savings and loan associations. Nondepository trusts and companies with foreign banking organization are excluded.
* Regulators define commercial real estate loans as construction and land development loans + multifamily loans + nonowner-occupied nonresidential property loans + commercial real estate loans secured by collateral other than real estate.
Data based on regulatory filings.
Source: S&P Global Market Intelligence.
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Commercial Lending

(continued from p. 29)

Largest CRE loan concentration at US banks with total assets greater than $10B, Q1 2023

Company (top-level ticker)	City, state	Total assets ($B)	Total CRE loans[1]: Proportion of total loans (%)	QOQ change (bps)	YOY change (bps)	($B)
Optum Bank Inc. (UNH)	Draper, UT	16.02	77.5	-339	112	3.30
Dime Community Bank (DCOM)	Bridgehampton, NY	13.83	73.0	-3	-54	7.83
Bank OZK (OZK)	Little Rock, AR	28.97	72.9	-58	-149	16.09
Farmers & Merchants Bank of Long Beach (FMBL)	Long Beach, CA	12.02	71.4	11	394	4.87
EagleBank (EGBN)	Bethesda, MD	11.04	66.5	228	538	5.17
Provident Bank (PFS)	Iselin, NJ	13.77	64.0	-11	167	6.54
Pacific Premier Bank (PPBI)	Irvine, CA	21.36	60.7	70	66	8.64
Lakeland Bank (LBAI)	Newfoundland, NJ	10.84	58.4	37	12	4.64
First Foundation Bank (FFWM)	Irvine, CA	13.59	57.9	13	-109	6.18
Flagstar Bank NA (NYCB)[2]	Hicksville, NY	123.63	57.8	-1,121	-3,285	48.49
Merchants Bank of Indiana (MBIN)	Carmel, IN	13.95	57.4	-159	604	6.57
Independent Bank (IBTX)	McKinney, TX	18.79	56.0	24	213	7.85
Apple Bank for Savings	New York, NY	16.89	55.3	126	117	6.32
Valley National Bank (VLY)[3]	Wayne, NJ	64.31	54.5	73	236	26.55
OceanFirst Bank NA (OCFC)	Toms River, NJ	13.45	53.8	47	245	5.40
Sandy Spring Bank (SASR)	Olney, MD	14.13	53.3	-17	60	6.08
Citizens Business Bank (CVBF)	Ontario, CA	16.27	51.0	140	228	4.56
Axos Bank (AX)	San Diego, CA	18.94	50.4	-92	320	8.08
First Bank (FBNC)[4]	Southern Pines, NC	12.37	50.1	-110	107	3.91
Rockland Trust Co. (INDB)	Rockland, MA	19.45	49.1	-12	-242	6.85
Industry median[5]			**23.8**	**11**	**36**	

Data compiled June 29, 2023.
CRE = commercial real estate.
Analysis limited to operating US commercial banks, savings banks, and savings and loan associations with total assets greater than $10 billion as of March 31, 2023. Nondepository trusts and companies with foreign banking organization are excluded.
[1] Regulators define commercial real estate loans as construction and land development loans + multifamily loans + nonowner-occupied nonresidential property loans + commercial real estate loans secured by collateral other than real estate.
[2] Flagstar Bank NA purchased certain assets and liabilities of Signature Bridge Bank NA on March 19, 2023.
[3] Valley National Bank parent Valley National Bancorp acquired Bank Leumi Le-Israel Corp. on April 1, 2022.
[4] First Bank parent First Bancorp acquired GrandSouth Bancorp on Jan. 1, 2023.
[5] Analysis limited to operating US commercial banks, savings banks, and savings and loan associations. Nondepository trusts and companies with foreign banking organization are excluded.
Data based on regulatory filings.
Source: S&P Global Market Intelligence.

Regulatory Action

Regulators have made it clear in recent months that CRE portfolios are a focus, particularly among banks with large concentrations.

CRE loan concentration at largest US banks, Q1 2023

Company (top-level ticker)	Total assets ($B)	Total CRE loans[1]: Proportion of total loans (%)	QOQ change (bps)	YOY change (bps)	($B)
JPMorgan Chase Bank NA (JPM)[2]	3,267.96	11.8	15	-24	134.59
Bank of America NA (BAC)	2,518.29	7.3	26	36	75.78
Citibank NA (C)	1,721.55	6.4	63	57	40.08
Wells Fargo Bank NA (WFC)	1,687.51	15.6	1	15	141.86
U.S. Bank NA (USB)	590.46	13.6	6	9	45.80
Truist Bank (TFC)	564.84	13.5	-1	-92	44.53
PNC Bank NA (PNC)	556.31	15.5	-12	-43	50.77
Goldman Sachs Bank USA (GS)	490.80	9.4	73	-318	15.15
Capital One NA (COF)[3]	469.43	16.1	28	-951	49.70
TD Bank NA (TD)[4]	401.24	13.7	-17	-88	23.45
Charles Schwab Bank SSB (SCHW)	347.39	6.4	-4	-68	2.57
Bank of New York Mellon (BK)	341.46	19.0	155	198	5.62
State Street Bank and Trust Co. (STT)	287.07	8.5	-73	124	2.90
BMO Harris Bank NA (BMO)[5]	265.45	15.5	27	205	24.51
Citizens Bank NA (CFG)[6]	221.96	19.3	17	764	30.25
First-Citizens Bank & Trust Co. Inc. (FCNC.A)[7]	214.60	13.2	-823	-826	18.21
Fifth Third Bank NA (FITB)	207.59	9.8	8	-20	12.09
Morgan Stanley Bank NA (MS)	205.85	13.1	-65	-266	10.18
Manufacturers and Traders Trust Co. (MTB)[8]	202.36	30.4	-19	-332	40.47
Morgan Stanley Private Bank NA (MS)	195.67	5.4	19	54	6.98
Industry median		**23.8**	**11**	**36**	

Data compiled June 29, 2023.
CRE = commercial real estate.
Analysis limited to operating US commercial banks, savings banks, and savings and loan associations. Nondepository trusts and companies with foreign banking organization are excluded.
[1] Regulators define commercial real estate loans as construction and land development loans + multifamily loans + nonowner-occupied nonresidential property loans + commercial real estate loans secured by collateral other than real estate.
[2] JPMorgan Chase Bank NA assumed substantially all of the deposits and purchased essentially all of the assets of First Republic Bank on May 1, 2023.
[3] Capital One Bank (USA) NA merged with and into Capital One NA, with the latter as the surviving entity on Oct. 1, 2022.
[4] Toronto-Dominion Bank and First Horizon Corp. terminated their merger agreement on May 4, 2023.
[5] BMO Harris Bank NA acquired Bank of the West on Feb. 1, 2023.
[6] Citizens Bank NA parent Citizens Financial Group Inc. acquired Investors Bancorp Inc. on April 6, 2022.
[7] First-Citizens Bank & Trust Co. Inc. acquired certain assets and liabilities of Silicon Valley Bridge Bank NA on March 26, 2023.
[8] M&T Bank Corp. acquired People's United Financial Inc. on April 1, 2022.
Tickers based on top-level entities' home country stock exchanges.
Data based on regulatory filings.
Source: S&P Global Market Intelligence.

"We have a long-standing expectation, this is interagency, that CRE-concentrated banks should look at their own performance in a downturn. And so we're scrutinizing that very vigorously," Todd Vermilyea, senior associate director of the Fed Board of Governors Division of Banking Supervision and Regulation, said June 16.

Martin Gruenberg, chairman of the Federal Deposit Insurance Corp., said at the release of the FDIC's most recent Quarterly Banking Profile that CRE would be a significant focus for his agency, calling it "a matter of ongoing attention in our supervision work."

Speaking at S&P Global Market Intelligence's Community Bankers Conference in May, an FDIC examiner cautioned that the agency will take a hard look at internal risk assessments, reserves and capital positions for banks with high CRE concentrations.

However, the intensity of regulators' scrutiny depends on a number of factors.

For example, states that encourage flexible return-to-work policies or have a lot of technology and other companies that make it easier for employees to work from home pose more risk, Capco's Dugas said.

"When it comes to CRE, it's really going to be a regional issue," Dugas said. "When you look at banks that are operating in states like Florida and Texas and some areas within the South ... they're in much better shape than states like California or New York or Illinois."

Moreover, office is seen as a higher risk than other property types.
"Not all commercial real estate is the same. A high-rise office building in a big city is different than an owner-occupied mom-and-pop business on Main Street," said James Stevens, co-leader of the financial services industry group at Troutman Pepper.

Wherever supervisors see "very significant risk concentrations that aren't being handled properly," they will take swift action, according to Goss of Hunton Andrews Kurth. Such consequences include ratings downgrades and supervisory agreements, he said. They could also require banks to raise additional capital, Goss said.

To prepare for the enhanced scrutiny, banks should work now to proactively address any risk before it is identified by regulators, bank advisers said.

Financial institutions should be asking themselves, "'Do I have concentrations of any of these [risky] kinds of properties, or any risks geographically by asset class? Is there anything at my bank that could be an issue, and if there is, what should I be doing to mitigate that?'" said Matthew Bisanz, partner with

Mayer Brown's financial services regulatory and enforcement practice.

Banks can mitigate risk with interest rate hedges or by slowing their lending, Bisanz said. Those are actions "that a banking regulator might press a bank to do based on a concern that exposure to a portion of the CRE market is too large," Bisanz said.

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Employees Want Financial Planning Support

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"Professional retirement planning assistance has become a key focus for employees in terms of benefits considerations."

Financial stressors including stubbornly high inflation and historic levels of credit card debt continue to impact workers across a wide range of income brackets. Twenty-eight percent of full-time employees often or always run out of money between paychecks, as do 15% of those who earn $100,000 or more per year. And among workers who carry balances on their credit cards, 44% say they struggle to make their monthly minimum payments on time.

A survey of 3,638 full-time U.S. employees found that 44% of financially stressed workers admit their struggles have been a distraction while at work, and 36% are actively looking to change jobs (versus 18% of their non-stressed counterparts). Moreover, nearly three in four employees say they would like assistance with their personal finances. Fortunately, stigma over financial difficulties appears to be somewhat less of an obstacle for receiving help — with only one-third expressing embarrassment about asking for the advice they need, down from 42% in 2019.

Professional retirement planning assistance has become a key focus for employees in terms of benefits considerations. More than half of workers identify it as a high priority, marking a 5% increase from the previous year, and one-fourth rank it as the No. 1 benefit they sought from their employee, according to Morgan Stanley's State of the Workplace III: Financial Benefits Study. The research also revealed that 92% of employees consider help with retirement planning a priority in their job selection. Nonetheless, one out of every four human resource (HR) leaders surveyed report their company is reducing employee financial benefits to cut costs. This even though 97% of the same HR professionals say they believe their companies need to do an even better job providing resources to maximize financial benefits.

As financial pressures continue to significantly impact work and personal life for many Americans well into 2023, employers who offer professional financial planning assistance may gain an advantage in the competitive labor market and reap the rewards of a healthier, more productive, happier workforce. By providing personalized financial benefits and resources that address workers' unique needs, organizations can create a culture of financial stability and empowerment that help foster a mutually beneficial relationship where employees feel supported.

A Crisis of Confidence

Employers can deploy a number of strategies with the assistance of their employee benefits and retirement plan advisor to help customize the right approach for their plan participants to restore confidence and reduce stress. Some examples:

Financial Wellness Assessment. Provide a comprehensive financial wellness assessment to uncover and address the specific needs of your participants to create a custom financial literacy and planning program.

Support Financial Literacy. Offer seminars, webinars and educational content on retirement planning, emergency savings, long-term care, budgeting, or other subject matter per the results of your wellness initiative.

Plan Design Changes. Increase employer match and add Auto Enrollment and Escalation. Consider increasing your match or and adding auto features to incentivize employees to contribute more to their retirement plan. There are many other plan design strategies to consider.

Encourage Catch-Up Contributions. Older workers may feel more anxiety about a looming, underfunded retirement. Remind and encourage employees over age 50 to take advantage of the IRS catch-up contribution provision, allowing them to save more as they approach retirement.

Offer One-on-One Financial Consultations. Encourage participants to meet one-on-one with a financial advisor who can offer personalized advice and guidance based on their specific circumstances. Your retirement plan advisor should offer these services as part of their overall support model.

Provide Holistic Support. A well thought out holistic approach to financial wellbeing reduces stress. If employees experience financial stress, it may be affecting their mental and physical health. Provide a one stop consolidated approach to your benefits program that will educate employees about assistance and support available to them, whether through an EAP, wellness programs or their employer-sponsored benefits

Financial Health — and Hope

Given the many monetary stressors facing workers today, organizations need to help workers achieve greater financial health and equip them with tools to bolster confidence that they can achieve a secure financial future. With the right approach, employers can instill hope that no matter where employees are on their financial wellness journey, support is available to help them improve their chance for a secure retirement.

This article is not intended to be exhaustive. The summarized information comes directly from our Retirement Times Newsletter – August Addition through our RPAG partnership. Please contact us for survey sources. If you would like to be added to our email list, get more information, or schedule a financial planning session, please contact our WBG Team.

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Converting a 529 Plan to a Roth IRA

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"Congress has now provided taxpayers with another alternative with the passing of SECURE Act 2.0 in hopes this would encourage more taxpayers to take advantage of 529 Plans."

529 Plan participants have recently received an increase in benefits from both Federal and Delaware tax legislative updates.

Contributions to 529 Plan qualified tuition programs are not tax deductible for Federal income tax purposes. The true benefit of 529 Plans is that the earnings can grow tax-free as long as the distributions are used for qualified educational expenses. Therefore, it is more advantageous to fund a 529 Plan sooner rather than later to take advantage of the tax-free compounding interest. However, if the funds are used for anything other than qualified educational purposes, then the earnings portion of the nonqualified distributions would be subject to income tax and a 10% penalty.

The biggest risk when contributing to a 529 Plan in the early stages is the possibility of overfunding the plan. What if the beneficiary receives a scholarship? What if the beneficiary decides not to go to college? It's impossible to predict the future and know exactly how much money the beneficiary will need. Until recently, the only options for an overfunded 529 Plan were to pay the income taxes and 10% penalty or to transfer the 529 Plan to another beneficiary who could use the funds for qualified educational expenses.

Congress has now provided taxpayers with another alternative with the passing of SECURE Act 2.0 in hopes this would encourage more taxpayers to take advantage of 529 Plans. For distributions after December 31, 2023, taxpayers can roll up to $35,000 of 529 Plan funds to a Roth IRA tax-free. While this is a great opportunity, taxpayers will want to be aware of the fine print. Congress had to put some additional guard rails on this new benefit to prevent taxpayers from using it as a loophole to contribute additional dollars to a Roth IRA over the annual limitation.

Some of these restrictions include:

1. The rollover must be done in a direct trustee-to-trustee transfer.
2. The 529 Plan fund must have been maintained for the same designated beneficiary for at least a 15-year period prior to the date of the distribution.
3. The amount rolled over tax-free cannot exceed the aggregate amount of contributions and earnings attributed to the contributions before the five year period ending on the date of the distribution.
4. The annual limit for tax-free rollovers from a 529 Plan to a Roth IRA is equal to the Roth contribution limit under Code Sec. 408A(c)(2) which is currently $6,500. If the designated beneficiary makes contributions to any other Roth individual retirement plans for the designated beneficiary's benefit, then that contribution amount reduces the annual limitation for a tax-free rollover from a 529 Plan to a Roth IRA.

Based on the above limitations, a 529 Plan with a hypothetical remaining balance of $35,000 would take at a minimum 6 years to completely convert to a Roth IRA assuming that the designated beneficiary was not making any other contributions to individual Roth retirement accounts during those years.

The limitations sound relatively low but nevertheless, never doubt the power of compounding interest. If taxpayers roll over $35,000 into a Roth while they are 18 to 24 years of age, the account could grow to over half a million dollars by the time the beneficiary reaches retirement, assuming the account can earn an annual rate of return of 7%.

It is important to note that state governments are also recognizing the importance of planning ahead for educational costs. Delaware legislators passed House Bill 145 in June 2022 which allows Delaware residents to deduct up to $1,000 of contributions ($2,000 on a joint tax return) to a Delaware-sponsored qualified tuition program. However, an individual's federal adjusted gross income cannot exceed $100,000 ($200,000 for joint returns) and the funds cannot be used for tuition in connection with the enrollment or attendance at an elementary or secondary public, private or religious school. Many of the surrounding local states including PA, NJ, and MD offer even more generous deduction thresholds for contributions to their respective state's 529 Plan programs.

Education costs are one of the largest expenditures a family may incur over their lifetime. Taxpayers should try to use every tool that government provides to help deal with it.

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*Not Pictured:
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