The Advisor

February 2016

ESTATE PLANNER'S TIP

When meeting with clients to prepare 2015 income tax returns, advisors should determine whether gifts, particularly hard-to-value gifts, were made last year. The value of a gift cannot be redetermined at death for estate tax purposes, provided the gift has been adequately disclosed [Code §2504(c)]. Taxpayers need not fear that gifts of hard-to-value property such as real estate or closely held business interests will be revalued upwards many years later, when establishing fair market value may be particularly difficult. This protection applies, however, only where the gifts have been "adequately disclosed." Reg. §301.6501(c)-1(f)(2) provides that the IRS has proper notice of a gift "if it is reported in a manner adequate to apprise the Service of the nature of the gift and the basis for the value reported." Once disclosure has been made, the statute of limitations on an IRS challenge begins to run. Gift tax returns for 2015 are filed at the same time as income tax returns.

NEW LAW MAKES PERMANENT OR EXTENDS SEVERAL POPULAR TAX BREAKS

In addition to making qualified charitable distributions permanent (see back page), the Protecting Americans from Tax Hikes Act of 2015 makes several provisions permanent, while extending the deadline on others. Among the provisions:

Made permanent

■ Residents of states with no state or local income tax can claim state and local general sales tax as an itemized deduction.

■ The American Opportunity Tax Credit of $2,500 for post-secondary education.

■ The $250 above-the-line deduction for school teachers for classroom expenses will be indexed for inflation and expanded to cover professional development expenses.

■ Code §179 expensing for businesses will have a $500,000 limit, with a $2 million overall investment limit before phase-outs begin.

■ The research tax credit for business-related qualified research expenditures.

■ The 100% exclusion from gain for non-corporate taxpayers who hold qualified small business stock for more than five years.

Extended

■ Cancellation of mortgage indebtedness on a short sale of a principal residence will not result in taxable income through 2016, up to $2 million for married couples.

■ The Work Opportunity Credit available for hiring certain long-term unemployed individuals, through 2019.

■ Mortgage insurance premiums will be deductible as qualified residence interest, subject to AGI phaseouts, through 2016.

■ Bonus depreciation will gradually be reduced through 2019.

Additional charitable provisions

■ The incentive for contributions of capital gain real property for conservation purposes has been made permanent. Donors can deduct up to 50%, rather than the usual 30% for gifts of capital gain assets. If the property is agricultural, the deduction limit is 100%, with a 15-year carryover, versus the usual five years.

■ The basis adjustment for S corporation shareholders has been made permanent. A shareholder's basis is reduced by the pro rata share of the adjusted basis – not fair market value – of property contributed by the S corporation.

■ The enhanced deduction for contributions of inventory of "apparently wholesome food" for non-corporate business taxpayers has been made permanent.

PHILANTHROPY PUZZLER

On February 1, Paul and Rita created a charitable remainder trust that is to make a 5% unitrust payout at the end of every quarter. The trust calls for the assets to be valued on the first business day of each year. Since there will not be a valuation date during the first year of the trust, the trustee has asked how much should be paid to Paul and Rita for the three payments due in 2016.

TAX REFUND PART OF GROSS ESTATE

Russell Badgett's estate filed his 2011 income tax return after his death in early 2012. The return showed a refund due of $429,315. The estate asked that $25,000 be applied to Badgett's 2012 estimated tax, with the balance refunded to the estate. When the estate's Form 706 was filed later in 2012, it did not include the refund in the value of the gross estate. The IRS issued a notice of deficiency, saying the income tax refund should have been included in the gross estate.

The estate acknowledged the overpayment, but said there was no property interest until the refund had been declared by the IRS. Under state (Kentucky) law, "a mere expectancy" is not an interest in property.

The Tax Court noted that the IRS has discretion in determining whether overpayments will be refunded to taxpayers or applied to outstanding tax liabilities. But if no offsetting tax liability exists, Code §6402(a) requires the IRS to refund any balance. Because there was no liability or obligation against which to offset the overpayment, the status of Badgett's refund was more than an expectancy. The overpayment "attained the status of independent assets for estate tax purposes," ruled the court (*Estate of Badgett v. Comm'r*., T.C. Memo. 2015-226).

RELIEF AT THE GAS PUMP MEANS LOWER DEDUCTIONS

Taxpayers who use their personal vehicles for business purposes will see a lower optional standard mileage rate for 2016. The IRS announced a 54 cents per mile rate, down 3.5 cents per mile from 2015. The mileage rate for medical and moving purposes also dropped, from 23 cents in 2015 to 19 cents per mile in 2016. The rate for charitable use of a personal vehicle is fixed by statute at 14 cents per mile.

Rather than taking the standard rate, taxpayers can calculate the actual cost of using their vehicle. In addition to the mileage rate, taxpayers are entitled to deductions for the actual cost of parking and tolls when personal vehicles are used for business, medical, moving or charitable use (IR-2015-137).

TRUST'S DEDUCTION NOT LIMITED TO BASIS

The Green Dynasty Trust was established in 1993, allowing the settlors, David and Barbara Green, and the trustee, Mart Green, to distribute amounts from gross income to charity. GDT, a single-member LLC, is wholly owned by the Trust. The Trust was a 99% limited partner in Hob-Lob, which owned and operated many Hobby Lobby stores.

In 2004, GDT contributed several parcels of land held more than one year to various charities. On its Form 1041 for 2004, the Trust initially claimed charitable deductions totaling about $20.5 million. The deduction was increased to more than $29.6 million on an amended return, on which the Trust sought a refund of nearly $3.2 million. The IRS disallowed the refund, saying that the charitable deduction for the real property was limited to basis, not fair market value.

The IRS argued that Code §642(c) limits a trust's deduction to the amount of gross income it contributes to charity and that gross income does not include unrealized appreciation. There was no question that the gifts of real property were made "pursuant to the terms of the governing instrument," said the U.S. District Court (WD OK). The fact that the properties were given in a year subsequent to their purchase does not prevent them from "being considered as charitable donations derived from gross income," the court noted, concurring with the Trust that the IRS was mixing "fiduciary accounting principles with the federal tax concept of gross income."

Congress specifically provided that deductions under Code §642 were "without limitation." The court refused to read into Code §642 the limitations that exist in Code §170 for gifts of appreciated capital gain property (*Green v. U.S.*, 2015-2 USTC ¶50,549).

GIVING IS GOOD FOR BUSINESS

A company advertises its program of making charitable contributions with a portion of the income it receives from the sale of its products. The IRS noted that a taxpayer normally may not deduct voluntary payments made on another's behalf. However, the company's customers do not have a right to a share of the funds in the charitable program. Therefore, the funds are not being donated by the customers.

The company prominently advertises its charitable program "with the reasonable belief" that business will be enhanced and increased. The company has an expectation, said the IRS, that there would be a "commensurate financial return" for its donations. The contributions are therefore deductible as ordinary and necessary business expenses under Code §162(a), not as charitable deductions under Code §170 (CCA 201543013).

Note: Charitable contributions of a company, unlike ordinary and necessary business expenses, are limited to 10% of taxable income, with carryovers.

PUZZLER SOLUTION

In a short taxable year, such as the first year of the unitrust, if no valuation date occurs before the end of the year, the assets are to be valued on the last day of the year [Reg. §1.664-3(a)(1)(v)(a)]. The trustee can make the three payments in 2016 using the value of the assets as determined on the date the trust was funded. Overpayments or underpayments can be corrected at the end of the year when the assets are valued.

ANNUAL WAIT OVER FOR IRA ROLLOVERS

The Protecting Americans from Tax Hikes Act of 2015, signed by President Obama on December 18, 2015, makes permanent the qualified charitable distribution (QCD) for donors ages 70½ and older. Since 2006, Code §408(d)(8) allowed owners of traditional and Roth IRAs to make direct gifts to charity and avoid the income tax that would otherwise be owed on an IRA withdrawal. The IRA charitable rollover had expired and been renewed several times during those years, often at the end of the year, leaving donors little time to plan their IRA gifts.

There are some restrictions to keep in mind when planning with clients for distributions from their IRA:

■ Donors must be age 70½ or older on the date of the gift.

■ No charitable deduction is allowed, but because the donor avoids income tax that would otherwise be due, the effect is similar.

■ The transfer counts toward the account owner's required minimum distribution for the year, so QCD gifts should be planned prior to taking required distributions.

■ Up to $100,000 may be given annually.

■ Transfers must be made directly from the IRA custodian to charity. Donors should not take withdrawals and then contribute the funds to charity.

■ Only funds in traditional and Roth IRAs are eligible. QCDs are not allowed from 401(k)s, 403(b)s or other qualified retirement plans.

■ Transfers must be made to public charities, not to donor advised funds, private foundations or supporting organizations.

■ Funds cannot be transferred to establish charitable remainder trusts or charitable gift annuities. No donor benefits are permitted in return.

Clients too young to make QCDs can name charity to receive all or a portion of an IRA at death, thereby avoiding the tax on income in respect of a decedent [Code §691].

Philanthropic clients who do qualify to make QCDs should be encouraged to make their annual gifts – or major gifts – from their IRAs. Who can benefit?

■ Warren, age 85, is required to take mandatory distributions from his IRA of approximately $10,000 this year, even though he has no need for the funds. He pays tax at a 28% rate, meaning he will keep only $7,200. He makes gifts to charity each year totaling about $7,500, but because he does not itemize on his income tax return, he receives no tax benefit from his generosity. Warren could instead have his IRA custodian transfer the full $10,000 to the charities he supports. Not only does he increase his giving significantly, but he avoids the tax he would otherwise pay on the withdrawal.

■ Maureen, age 82, has several IRAs, including a rollover IRA from her late husband, totaling nearly $1.5 million. As a result, her required minimum distribution for 2016 will be about $93,750. By directing the custodian to transfer $100,000 this year to her favorite charities, Maureen avoids income tax on the distribution and reduces her adjusted gross income, helping her avoid cutbacks on her personal exemption and itemized deductions. Making the full $100,000 distribution over several years will also help reduce the size of her IRAs and minimum distributions in future years.

BALL STATE UNIVERSITY FOUNDATION
P.O. Box 672, Muncie, IN 47308
(765) 285-8312 • (765) 285-7060 FAX
Toll Free (888) 235-0058
www.bsu.edu/bsufoundation

Cherí E. O'Neill
President and CEO

Philip M. Purcell, J.D.
Vice President for Planned Giving and Endowment Stewardship

If you know another professional advisor who would benefit from this publication, please contact The Foundation.