

The Advisor



January 2016

ESTATE PLANNER'S TIP

There's only a short time left for using the file-and-suspend strategy to maximize Social Security benefits for married couples. The Bipartisan Budget Act of 2015 put an end to the technique for most Americans, although there is a grace period until the end of April. A spouse who reaches the full retirement age of 66 can file for and immediately suspend his or her benefits. This action allows the second spouse to file a restricted application for benefits equal to one-half the first spouse's benefits at age 66. In the meantime, both spouses can continue working and accruing delayed retirement benefits of up to 8% annually – 32% maximum – between the ages of 66 and 70. After April, a worker who files and suspends benefits also postpones the benefits based on his or her work record for a spouse and/or dependents. Planning strategies to maximize Social Security benefits after April will depend much more on the health of the spouses, the ages and their earnings history. In some cases, the higher-earning spouse may opt to begin benefits prior to receiving the maximum at age 70, just to enable the lower-earning spouse to claim spousal benefits.

DEDUCTIONS GO UP IN SMOKE

Martin Olive opened the Vapor Room Herbal Center, a medical marijuana dispensary, in 2004. On business income tax returns for 2004 and 2005, he reported net income of \$64,670 and \$33,778 respectively. He reported business expenses of \$236,502 and \$417,569 for the two years.

The IRS disallowed the deductions on the grounds that Code §280E prohibits deductions for the purpose of "carrying on any trade or business . . . consist[ing] of trafficking in controlled substances." Although medical marijuana is legal in California, the use and sale of marijuana is prohibited under federal law. The Tax Court agreed with the IRS.

The U.S. Court of Appeals (9th Cir.) upheld the Tax Court, noting that the Vapor Room sold the marijuana, but all its other amenities – games, books and art supplies in its facility, yoga, movies, massage therapy, tea, water and snacks and the use of vaporizers – were complimentary. Therefore, said the court, the only income-generating activity was the sale of marijuana.

Olive argued that medical marijuana dispensaries did not even exist when Code §280E was enacted, so Congress could not have intended them to fall within the list of nondeductible items. The court disagreed, saying that it is "common for statutes to apply to new situations" (*Olive v. Comm'r.*, 2015-2 USTC ¶150,377).

COURT REJECTS D-I-Y DOCUMENTS

Donald Wesley served as pastor of Disciples Empowered by Christ Ministries, a community outreach program. Wesley and his wife filed a 2011 tax return on which they claimed a charitable deduction of \$28,697. After the IRS issued a notice of deficiency regarding unreported income of more than \$50,000, the couple filed an amended return on which they claimed additional charitable deductions of nearly \$4,000 for gifts to or for the use of the ministry.

The Tax Court found the couple's testimony "uncorroborated and self-serving," noting that Wesley admitted that he "manufactured" documents in 2014, dating them 2011. One of the documents shows a gift made to the ministry which Wesley acknowledged was purportedly given to United Way. Another document shows a gift made by credit card in the ministry's name, not in the couple's names.

The court said the Wesleys failed to carry their burden under Reg. §1.170A-13(a)-(c) of showing they were entitled to the additional deductions (*Wesley v. Comm'r.*, T.C. Memo. 2015-200).

IRS GIVES ITSELF EXTRA TIME

The IRS generally has three years after the filing of a gift tax return to assess any additional tax [Code §6501(a)], assuming the gift has been adequately reported on Form 709. If a gift is required to be "shown" but is not, there is no statute of limitations [Code §6501(c)(9)].

PHILANTHROPY PUZZLER

Eva created a charitable lead trust that will pay charity a 6% annuity for 10 years before distributing assets to her three nieces. She asked if it was possible, in any years where trust income exceeded 6%, for the trustee to pay the excess to her nieces, reasoning that they will eventually be entitled to the assets anyway.

Harold made two gifts to his daughter of interests in family limited partnerships of which he was the general partner. The Form 709 clearly identified his daughter's name, address and relationship to Harold, as well as the percentage of the interests transferred, but the description of the transferred property was incomplete. A digit was omitted from the EIN for one of the partnerships; the "LP" and "LLP" designations were left off the descriptions, implying that both were traditional partnerships; the return used incorrect, abbreviated names for the partnerships; and the nature of the interests transferred – general, limited or limited liability – was missing.

The Form 709 also failed to adequately describe the method used to value the partnership interests. The partnerships primarily held farm land. Although the land was appraised, no appraisal was done for the partnership or the donated partnership interests. The description of the land did not identify restrictions that might have affected fair market value.

Harold's estate claimed that it had adequately disclosed the gifts and therefore refused to extend the assessment period beyond the three years following the filing of Form 709. A notice after that period would require the IRS to show that the exception to the three-year period applies. The IRS determined that Harold failed to adequately disclose the transfers and that the gift tax can be assessed at any time (Field Attorney Advice 20152201F).

LITTLE OR NO CHANGE IN 2016 NUMBERS

Cost-of-living adjustments were modest or non-existent for tax numbers in 2016. While the amount sheltered from gift, estate and generation-skipping tax rose slightly, the annual exclusion stayed at \$14,000, where it has been since 2013. Following are some of the numbers advisors and taxpayers will be using in the coming year (Rev. Proc. 2015-53):

	2015	2016		2015	2016
Gift, generation-skipping transfer and estate tax exclusion	\$5,430,000	\$5,450,000	39.6% bracket starts		
IRA contribution limit	5,500	5,500	Single	\$ 413,200	\$415,050
Personal and dependent exemption	4,000	4,050	Joint	464,850	466,950
Standard deduction			Head of household	439,000	441,000
Single	6,300	6,300	Married filing separately	232,425	233,475
Joint	12,600	12,600	Alternative minimum tax exemptions		
Head of household	9,250	9,300	Single, head of household	53,600	53,900
Married filing separately	6,300	6,300	Joint	83,400	83,800
Cutbacks on itemized deductions and personal exemptions begin			Married filing separately	41,700	41,900
Single	258,250	259,400	Kiddie tax	2,100	2,100
Joint	309,900	311,300	Nanny tax	1,900	2,000
Head of household	284,050	285,350	Annual gift tax exclusion	14,000	14,000
Married filing separately	154,950	155,650	Annual gift tax exclusion for non-citizen spouse	147,000	148,000
Tax brackets			Special use valuation for real property devoted to farming or closely held business use	1,100,000	1,110,000
25% bracket starts			401(k) contribution limit	18,000	18,000
Single	37,450	37,650	401(k) catch-up contribution limit	6,000	6,000
Joint	74,900	75,300	Savings bond interest exclusion phased out		
Head of household	50,200	50,400	Single, head of household	92,200	92,550
Married filing separately	37,450	37,650	Joint	145,750	146,300
28% bracket starts					
Single	90,750	91,150			
Joint	151,200	151,900			
Head of household	129,600	130,150			
Married filing separately	75,600	75,950			
33% bracket starts					
Single	189,300	190,150			
Joint	230,450	231,450			
Head of household	209,850	210,800			
Married filing separately	115,225	115,725			
35% bracket starts					
Single, joint, head of household	411,500	413,350			
Married filing separately	205,750	206,675			

PUZZLER SOLUTION

The value of charity's interest in a charitable lead trust is nondeductible if any amount such as excess income may be paid for private purposes before the expiration of charity's annuity interest [Reg. §25.2522(c)-3(c)(2)(vi)(f)]. Charity's interest will qualify and Eva will be entitled to a gift tax charitable deduction if income in excess of the annuity amount is added to corpus, but not if it's paid to her nieces (Rev. Rul. 88-82).

CHARITABLE REMAINDER ANNUITY TRUSTS: YOUNGER DONORS NEED NOT APPLY

Philanthropy has no age limit, but clients thinking of funding a charitable remainder annuity trust may need to look for other options if they are under age 72 (one-life trust) or age 74 (two-life trust). Low §7520 rates have put charitable remainder annuity trusts off limits to a large segment of the philanthropic population. For example, a couple, both age 73, could not establish a charitable remainder annuity trust – even at the minimum 5% payout – assuming quarterly payments and the use of December 2015's 2% §7520 rate.

Under low §7520 rates, annuity trusts run the risk of failing the 10% remainder requirement [Code §664(d)(1)(D)] or the 5% probability test (Rev. Rul. 77-374), which disqualifies an annuity trust if the probability exceeds 5% that the noncharitable income beneficiary will survive to the exhaustion of the trust fund. There are other options, however, that may help clients achieve their philanthropic goals.

Term-of-years annuity trust – The 5% probability test applies only to trusts for the lifetime of the beneficiaries – not to term-of-years trusts. The trust must still generate a 10% remainder, however. Assuming the maximum 20-year term, an annuity trust with a payout of up to 5.4% will qualify (2% §7520 rate). Payouts could go higher if a shorter term is used. Some donors may feel that a 20-year term will provide them the fixed income they want for all or most of the rest of their lives. And if the donor should die before the 20-year term is up, payouts could continue to family members.

Two is better than one – Rather than establishing one charitable remainder annuity trust, a couple could create two one-life annuity trusts. The deduction for a one-life annuity trust, assuming quarterly payments and a §7520 rate of 2%, is

nearly 45% for a 72-year-old, and the trust satisfies the 5% probability test. The downside, however, is that payments from one trust will cease at the death of the first spouse.

Use a charitable remainder unitrust – Although the charitable remainder unitrust is also subject to the 10% remainder requirement [Code §664(d)(2)(D)], the 5% probability test does not apply. In addition, the drop in the §7520 rate has less impact on the unitrust, since the trust tends to be “self correcting.” The beneficiary's payout amount will drop in conjunction with the decline in the value of the trust's assets, unlike an annuity trust, which pays a constant amount regardless of market performance. A couple, both as young as age 39, could establish a charitable remainder unitrust that satisfies the 10% remainder test using the §7520 rate of 2% and quarterly payments. One downside may be the unitrust's fluctuating payouts.

Use a charitable gift annuity – The client could achieve fixed payments without using a trust by funding a charitable gift annuity. The recommended payout rate for a couple, both age 65, is 4.2%. Gift annuities are not subject to the 5% probability test and recommended rates are designed to achieve the required 10% residuum for charity.

For octogenarians – the ones most likely to be seeking the security of fixed payouts – the drop in §7520 rates is not an impediment to creating an annuity trust, although deductions will not be as robust. For example, a couple, both age 82, could fund a 6.4% charitable remainder annuity trust that meets both the 10% remainder and 5% probability test, although their deduction is only about 41.5% of their gift.

Cherí E. O'Neill
President and CEO

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

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