

The Advisor



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ESTATE PLANNER'S TIP

The IRS will be holding hearings soon on proposed regulations [NPRM REG 163113-02] that could significantly alter the landscape for transfers between family members of interests in family businesses. The rules would eliminate discounts for gift, estate and generation-skipping transfer tax purposes of interests in family controlled entities such as corporations, partnerships and LLCs. For example, a 5% interest that might currently be eligible for discounts for minority control or lack of marketability could instead be valued at 5% of the full value of the entity. There is considerable opposition to the proposed rules, which would not be final until after the hearings. Clients may want to consider accelerating gifts that might be subject to the new rules under Code §2704, keeping in mind that gifts could still be included in the donor's gross estate if death occurs within three years. Simply executing a partnership, shareholder or LLC operating agreement prior to the effective date of any change may not be enough to preserve the discounts.

ESTATE ALLOWED THEFT LOSS DEDUCTION FOR PONZI SCHEME

James Heller, who died in January 2008, owned a 99% interest in James Heller Family (JHF), LLC, valued at \$16,560,990. The only asset of JHF was an account with Bernard Madoff Investment Securities. During 2008, \$11,385,000 was withdrawn from the Madoff account and distributed to the estate to pay taxes and administrative expenses.

As a result of Bernard Madoff's arrest on charges of securities fraud in December 2008, the estate's interest in JHF became worthless. When Heller's estate filed Form 706 in April 2009, it reported a \$26 million gross estate and claimed a theft loss deduction of \$5,175,990, the difference between the value of the estate's interest in JHF reported on the estate tax return and the estate's share of the amounts withdrawn from the JHF Madoff account [Code

§2054]. The IRS disallowed the deduction, saying the estate did not incur a theft loss during its settlement.

The Tax Court noted that a loss refers to "a reduction of the value of property held by an estate," adding that JHF lost its sole asset as a result of the Madoff Ponzi scheme, but the estate, during its settlement, incurred a loss because the value of its interest in JHF declined to zero. The IRS claimed that JHF, not the estate, incurred the loss. The court found the connection between the theft and the value of the estate's JHF interest "direct and indisputable." The worthlessness of the JHF interest "arose from the theft," and the estate is therefore entitled to the theft loss deduction (*Estate of Heller v. Comm'r.*, 147 T.C. No. 11).

TRUST RETAINS GST-EXEMPT STATUS

Deborah created an irrevocable trust prior to September 25, 1985, for the benefit of her great-grandchildren. Each descendant's share was to be held in a separate trust from which the trustee could make payments of net income and principal. Beginning at age 25, the great-grandchildren could request distributions of up to 50% of the value of the trusts. Each trust was to terminate when the beneficiary reached age 35, with various provisions for a power of appointment in the event the great-grandchild died prior to age 35.

Judy, one of the great-grandchildren, was born with cognitive and physical disabilities, making her incapable of executing a power of appointment. The trustees proposed to modify the trust terms to make it terminate on Judy's death, not when she reached age 35.

State law permits a court to modify a trust to further the purposes of the trust if necessary because of circumstances not anticipated by the settlor. The court approved the proposed changes, contingent on the IRS ruling that the trust would remain exempt from the generation-skipping transfer tax. The IRS noted that Judy does not have the capacity to execute her powers of appointment. The trust will continue for Judy's life, even after age 35, and upon termina-

tion the entire value will be included in her gross estate (Ltr. Rul. 201633022).

BANKRUPTCY IS NO EXCUSE

Rosella Hill was more than \$8,400 behind in mortgage payments while under Chapter 11 bankruptcy. When the judge ordered that she make the payments as a condition to keeping an automatic stay in effect, Hill's attorney indicated that she would take a distribution from her IRA.

Hill withdrew \$39,650 from her IRA in 2012, using \$10,000 to pay her mortgage. She did not include the amount on her income tax return, arguing that she should not be taxed on the distribution because the bankruptcy judge ordered the withdrawal in order to pay her mortgage.

The Tax Court noted that while Code §408(d) provides several exceptions to the requirement that IRA withdrawals be included in gross income, there is no exception for distributions used to pay ordinary living expenses or for the conditional payment of debt in a bankruptcy case (*Hill v. Comm'r.*, T.C. Summ. Op. 2016-64).

TIMES CHANGE, SO SHOULD INVESTMENTS

In 2007, Rockefeller University received funds from a trust created by James Martin in 1962, following the death of the last income beneficiary. Martin's will provided that the principal was to be held by Rockefeller in perpetual trust for the purpose of combating arteriosclerosis. The University has allocated income to research into arteriosclerosis since 2007.

Martin's will restricted Rockefeller from selling the stock from 17 named corporations and prohibited the University from purchasing mortgages, corporate bonds, preferred stock or government bonds while the value of the U.S. dollar remains unindexed to the price of gold. The University is also prohibited from purchasing stock in companies engaged in steel, copper and railroad equipment production.

As of December 31, 2015, the value of Martin's

PHILANTHROPY PUZZLER

Peter has \$150,000 in publicly traded stock saved outside his retirement accounts. He would like to lock in his gains, but he doesn't want to pay the capital gains tax. He read something about a flip charitable remainder unitrust that would initially pay him the lesser of the income earned or the payout percentage, then later switch to a standard unitrust. He has asked if he could fund a flip unitrust, have the trustee sell the stock and reinvest the proceeds and then have the trust switch in ten or 12 years when he tells the trustees he's ready to retire. Will this plan work?

bequest was more than \$12.9 million. However, six of the 17 named corporations subject to the sale restriction had ceased to exist as independent entities and shares in one corporation – Eastman Kodak – lost more than half its value since the 2007 distribution. The restricted securities are generating a 2.2% annualized return, far underperforming the return on the University’s endowment.

Rockefeller asked that the investment restrictions be lifted, saying they have become “impracticable, wasteful and an impediment” to the prudent investment of the bequest. The New York attorney general agreed, saying that lifting the restrictions would increase the amount of income available for the purpose Martin specified in his will.

The Supreme Court of the State of New York noted that under the equitable doctrine of deviation, a court can modify or permit a trustee to deviate from will or trust provisions if, because of circumstances not anticipated by the donor, the deviation furthers the purposes of the trust. The court found that allowing the University greater investment discretion was appropriate because economic circumstances had changed since the restrictions were imposed (*In re Rockefeller University*, 2016 NY Slip Op. 31556(U)).

TRADING VACATION FOR STORM RELIEF VICTIMS NOT INCOME

Many employers have or are considering adopting leave-based donation programs that allow employees to forgo vacation, sick or personal leave in exchange for cash payments that the employer makes to charities for the relief of victims of the storms in Louisiana.

The IRS announced that it will not assert that cash payments an employer makes constitute gross income or wages of the employees, provided the payments are made to Code §170(c) organizations for the relief of storm victims in Louisiana and are made before January 1, 2018. Employees are not entitled to claim charitable deductions with respect to the value of forgone leave. The IRS also said it would not assert that

the employer is permitted to deduct the cash payments exclusively under Code §170, rather than the rules of Code §162 (Notice 2016-55).

TAX COURT: WE DON’T BELIEVE YOU

Betty Spencer included four Forms 8283 with her 2010 income tax return, each of which was only partially completed. She claimed a total of \$57,000 in gifts of clothing, furniture and small appliances in “excellent” condition to various charities. The IRS disallowed the deductions.

The Tax Court noted that Spencer’s only receipts substantiating the contributions were ones she completed. The court also found her testimony “uncorroborated and self-serving” pointing out that while the Forms 8283 indicated that she purchased the gift items, she acknowledged that she inherited some of the property. And while the court was satisfied that the invoices showed Spencer had purchased furniture, there is nothing to show that those pieces were the ones donated to charity. Because she failed to establish that she made the noncash gifts claimed, she is not entitled to a deduction (*Spencer v. Comm’r.*, T.C. Summ. Op. 2016-62).

PUZZLER SOLUTION

The triggering event for a flip from a net-income to a standard charitable remainder unitrust can be a specific date or an event that is outside the control of the donor or trustee (e.g., the sale of unmarketable assets, marriage, divorce, death) [Reg. §1.664-3(d)]. The sale of marketable securities or a request by a beneficiary to convert to a fixed percentage payout are not valid triggering events. If Peter can’t determine in advance the exact date he wants the trust to flip, he could instead include some unmarketable assets – closely held stock, vacant real estate – when funding the trust. The trustee could sell those assets and cause the trust to flip when Peter retires.

PLAN NOW TO REDUCE PREMIUMS LATER

Beginning in 2018, premiums for Medicare Parts B and D will be increasing for certain high-income beneficiaries. The price rise was included in the Medicare Access and CHIP Reauthorization Act of 2015. Although the premium increases are more than a year away, a Medicare beneficiary's 2016 modified adjusted gross income (MAGI) is used to determine the brackets for 2018. MAGI is adjusted gross income plus tax-exempt interest.

Currently, single beneficiaries with MAGI between \$133,501 and \$160,000, and couples with MAGI between \$267,001 and \$320,000 pay monthly premiums based on 50% of the Parts B and D costs. That is set to increase to 65% for 2018. These income thresholds are not indexed for inflation.

There are planning options for clients during the remainder of 2016 and future years that may shelter them from the Medicare surcharges, including some that involve gifts to charity. Because the key number is adjusted gross income, simply boosting itemized deductions will not make a difference in MAGI. What steps should clients consider?

Convert to a Roth IRA – Because income tax must be paid on a Roth conversion, clients may want to consider this step prior to reaching the age for Medicare. With a Roth, all qualified distributions are tax free, reducing adjusted gross income. There are no required minimum distributions after age 70½ with a Roth.

Contribute the maximum to IRAs and 401(k)s – Clients who are still working may be able to contribute up to \$5,500 to IRAs in 2016, plus a \$1,000 catch-up contribution for those ages 50 or older. The 2016 limit for 401(k) contributions is \$18,000, plus a \$6,000 catch-up contribution.

Pay attention to capital gains and losses – While capital gains will add to a client's AGI, losses can offset gains plus up to \$3,000 of other income each year. Year-end tax reviews should include a look at how capital gains will affect AGI, with an eye toward realizing capital losses. A client planning to sell a capital asset can also consider spreading the sale over two or more years.

Give appreciated assets to charity – Rather than sell appreciated stock or other property, clients can use the assets to make their charitable gifts. The charitable deduction for a gift of appreciated securities held more than one year is the fair market value of the stock, although the deduction has no effect on AGI. For purposes of the Medicare surcharge, however, by using the appreciated property to make charitable gifts, clients can avoid the capital gains that would be realized if the assets were sold, thereby reducing AGI.

Make qualified charitable distributions from IRAs – Clients ages 70½ or older can make gifts to charity – up to \$100,000 annually – from their traditional or Roth IRAs. Because QCD gifts can take the place of required minimum distributions from IRAs, clients can reduce their AGI. Gifts in excess of the required minimum distribution will reduce the value of the IRA and, therefore, the amount that must be withdrawn in subsequent years. QCD gifts can be made to public charities only, not to donor advised funds, private foundations or to fund charitable remainder trusts or charitable gift annuities. The gifts must come directly from the IRA custodian.

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