First National Bank

Estate Planning Update

Planning Thoughts

March/April 2014

Trusts, estates, and taxes on Net Investment Income

On December 2, 2013, the IRS published Final Regulations on two new taxes created by the Affordable Care Act, the 3.8% tax on net investment income (NII) and the 0.9% additional Medicare tax. These taxes have been in effect since January 1, 2013. The Regs. finalized the Proposed Regs. issued a year earlier, and took into account the many comments received during 2013.

Trustees and executors of estates need to be aware of the tax on NII, because for these entities the threshold for paying the tax is far lower than it is for individuals. The threshold is indexed for inflation. It was $11,950 in 2013 and is $12,150 in 2014. The 3.8% surtax applies to undistributed net investment income in excess of the threshold. Undistributed NII is the trust or estate's NII reduced by any amount of NII distributed to beneficiaries and by any deduction allowed under IRC §642(c) [Reg. 1.1411-3(e)].

Certain state law trusts, such as common trust funds and designated settlement funds, are not subject to the surtax. The Proposed Regs. noted that the surtax would apply to pooled income funds, cemetery perpetual care funds, qualified funeral trusts and Alaska Native settlement trusts. Despite protests from some commentators, the Service did not change its position. However, cemetery trusts and Alaska Native settlement trusts may make an election under IRC §646 to avoid application of the surtax, the IRS noted.

Grantor trusts
A grantor trust is one for which income is taxed not as trust income but as income of the trust owner. The Final Regs. provide that the items of income, deduction or credit that are attributed to the grantor will bring those characteristics with them in calculating the grantor's exposure to the NII tax [Reg. §1.1411-3(b)(1)(v)].

Bankruptcy estates
An individual in bankruptcy may be subject to the 3.8% NII tax. In that case, the bankruptcy estate will have a threshold for the tax of $125,000, the same as for a married person filing a separate tax return [Reg. §1.1411-3(b)(2)(ii)].

This Issue:

First National Bank
2223 Second Avenue
Kearney, NE 68847
810 Allen Drive
Grand Island, NE 68803
800.619.2303
www.firstnationalwealth.com

Charitable trusts

Wholly charitable trusts are exempt from the NII surtax. However, the annuity or unitrust distributions to private beneficiaries may be NII in their hands, so the calculation and reporting of NII remain necessary for CRTs. If there are multiple private beneficiaries, the NII must be apportioned among them.

For purposes of determining the NII surtax, the Proposed Regs. created the term "Accumulated Net Investment Income (ANII)," defined as the sum of all NII received by the trust after December 31, 2012, less the total NII distributed to beneficiaries after that date. The Final Regs. also incorporate the category and class system of IRC §664, in response to comments. A beneficiary who receives a unitrust or annuity trust distribution from a charitable remainder trust will have NII from the distribution equal to the lesser of (a) the beneficiary's share of total distributions for the year; or (b) the beneficiary's same share of the ANII of the trust.

An unresolved issue

Several commentators observed that guidance is needed to determine when an estate or trust materially participates in an activity, so as to avoid the application of the NII surtax. The IRS acknowledged the legitimacy of these concerns in the preamble to the Final Regs., but deferred resolution of the problem until a later date. The question of material participation is currently under study.

Effective dates

Generally, these Regs. apply to tax years beginning after December 31, 2013, and the Proposed Regs. apply to the 2013 tax year.

Cases and Rulings

Reorganization does not void estate tax deferral.

Private Letter Ruling 201403012

At Decedent's death he had a variety of interests in closely held businesses that aggregated more than 50% of his estate. Ac-cordingly, his executor elected to defer federal estate taxes and pay them in installments under IRC §6166.

Now the estate, Decedent's heirs and his business partners want to reorganize. There will be a pro rata distribution of inter-ests in each of the properties to the estate and to the heirs, followed by contributions to separate LLCs. The transaction will not change the relative ownership interests, nor will any cash or property be distributed in connection with the reorganization. Each LLC will continue to be active in the businesses formerly owned by Decedent.

Under these circumstances, the IRS rules in private advice, this change of form will not materially alter the business. Accordingly, there will be no acceleration of the deferred federal estate taxes.

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Extensions granted for portability elections.

Rev. Proc. 2014-18, 2014-7 IRB 513

Spouse 1 died on January 1, 2011, survived by Spouse 2. Spouse 1's estate consisted of $2 million in joint bank accounts with Spouse 2. No estate tax return was required for Spouse 1, and none was filed. That inherently means that Spouse 1's estate did not make a DSUE election (deceased spouse's unused exemption election). Next, Spouse 2 dies on January 14, 2011, with a taxable estate of $8 million. An estate tax return is filed, and taxes are paid on the $3 million in excess of the exclusion from federal estate tax. However, if the DSUE election had been made for Spouse 1, no estate tax would have been due.

Under this Revenue Procedure, Spouse 1's executor has an extension of time to file the DSUE election, which will get Spouse 2's estate a full refund of taxes. The reason for the unusual generosity of the IRS is the Windsor decision in 2013, man-dating that same-sex married couples be eligible for the marital deduction from federal estate taxes. That means that they are eligible for the DSUE election as well, though they couldn't know that in 2011. Although that may motivate the Procedure, the relief is not limited to same-sex married couples. The extension of time is available for decedents who:

- had a surviving spouse;
- died after December 31, 2010, and on or before December 31, 2013;
- had an estate small enough so that no estate tax return was required; and
- did not have an estate tax return filed.

By following the steps in the Revenue Procedure, an executor may make a late DSUE election. To recover estate taxes paid, a claim for credit or refund must be filed by October 14, 2014, even if the DSUE election hasn't been made by then.

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Only one IRA rollover is allowed per year.

Alvan Bobrow et ux. V Comm'r, T.C. Memo 2014-21

Mr. Babrow had a traditional IRA and a rollover

IRA account, and Mrs. Babrow had a traditional IRA of her own. Over a period of six months, they took three distributions, one from each of the three accounts. Mr. Babrow withdrew $65,064 from his traditional IRA on April 14, 2008, and another $65,064 from his rollover IRA on June 6, 2008. On June 10, 2008, $65,064 was returned to the traditional IRA. Mrs. Babrow withdrew $65,064 from her IRA on July 31, 2008. On August 4, within 60 days of the husband's June 6 withdrawal, the $65,064 was redeposited in the rollover IRA. Mrs. Babrow made a partial redeposit of $40,000 to her IRA on September 30. It would appear that they were trying to give themselves one short-term tax-free loan of $65,064, using later distributions to pay off earlier loans. The couple treated all of these transactions as nontaxable rollovers, and they reported no taxable IRA distributions.

Not so, holds the Tax Court. IRC §408(d)(3)(B) allows a taxpayer only one tax-free rollover per year. The couple argued that the limit should apply on an account-by-account basis, but they could cite no authority for the proposition. The Tax Court found that the statutory language is quite clear, one per taxpayer per year, not one per account per year.

What about Mrs. Babrow's IRA? She was entitled to her own rollover, but she failed to complete it in 60 days. One might assume that September 30 is within 60 days of July 31, but, in fact, it is 61 days later, one day too late.

Because the distributions should have been taxable, the couple had a substantial understatement of their tax liability, trigger-ing a 20% tax penalty. The Court held that their failure fully to understand the IRA rules was not reasonable cause for the posi-tion they took, and the penalty was upheld.

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Holding company stock is valued; penalties for understatement are imposed.

Est. of Helen P. Richmond et al. v. Comm'r, T. C. Memo 2014-26

At her death Richmond owned 23.44% of a family-owned personal holding company whose assets were primarily stocks. The net asset value of the holdings was some $52 million. However, her executor, a CPA, reported her interest on the estate tax return at just $3.1 million, based upon capitalizing the dividends paid by the holding company. After an audit the IRS believed that her interest was worth closer to $9.2 million, and it imposed a penalty for substantial understatement. Held, although capi-talization of dividends is a legitimate method for valuing difficult assets, when the net asset value is available, as here, that is the preferred starting point. The Tax Court allowed discounts for built-in capital gain, for lack of control, and for lack of marketability of Richmond's interest, bringing the final value down to $6.5 million.

At trial the estate never defended its $3.1 million reported value, as its expert testified that Richmond's interest was worth $5.0 million. Even if that figure had prevailed, the reported value was less than 65% of the correct value, and the penalty for understatement is warranted.

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Special use value doesn't affect qualification to recover litigation costs.

Estate of Mildred T. Quidley et al. v. Comm'r, No. 7799-10

Mildred Quidley died in 2005. Her estate included agricultural property, so the $2.16 million reported as the gross estate value on Form 706 was reduced to a $1.36 million taxable estate, the result of an election to specially value property under IRC §2032A. IRS audited the estate tax return, assessed additional taxes and penalties. The executor of the estate had to liquidate substantial assets to contest the IRS assessment.

On January 5, 2012, the parties reached a settlement, under which the estate owed no additional estate taxes nor any penal-ties. By that time the total value of the estate's assets had fallen to $567,465, even though it owned the same real property as it did in 2005. The estate filed to recover its litigation costs, and the IRS admits that the estate had prevailed on all substantial issues. However, the Service argued that recovery of litigation costs was barred by the net worth limitation, which for estates is $2 million.

The Tax Court agrees with the IRS. The date for determining the net worth of an estate for purposes of the recovery of litigation costs is the date of decedent's death. Here, the estate admitted, through filing the Form 706, that the estate was larger than $2 million. The language of IRC §2032A expressly limits the application of special valuation rules to Chapter 11, the determination of estate taxes. Accordingly, they cannot apply to Chapter 76, Judicial Proceedings, where the provisions for litigation cost recovery are found.

Washington Talk

The long-awaited discussion draft of a sweeping overhaul of the tax code was release by Representative Dave Camp (R-Mich.), the Chairman of the House Ways and Means Committee, at the end of February. He had earlier stated that there would be no proposed changes for transfer taxes, and there were none. But there were many reforms whose impact would be felt most acutely by high-income taxpayers. Highlights for individual taxpayers included:

• A reduction to two tax brackets, 10% and 25%, plus a 10% surtax for the highest-income taxpayers. In effect, that makes for a 35% tax bracket, but the surtax applies to more than "taxable income," which accounts for the nomenclature. For example, those subject to the surtax will have to include the value of employer-provided health care coverage in their income.

• Personal exemptions would be eliminated, but the standard deduction and child tax credit would be expanded to offset the change.

• The charitable deduction would remain, but only the amount in excess of 2% of adjusted gross income would be deductible.

• The mortgage interest deduction would remain, but the cap on the amount of mortgage indebtedness that creates deductible interest would be reduced over four years to $500,000.

• The alternative minimum tax would be eliminated, which would mean that taxpayers would need to calculate their taxes only once instead of twice, as they do now. However, this welcome change has large revenue consequences.

• New contributions to traditional IRAs would be barred, but the income limits on contributions to Roth IRAs would be eliminated.

• The reduced tax rates for long-term capital gains would be replaced by an exemption of 40% of such gains from taxation.

• The deduction for state and local taxes would be eliminated, because it is an unwarranted subsidy granted to high-tax states by lower-tax states.

• Tax-free municipal bond income would no longer be fully immune from federal taxation. Such income would be subject to the 10% surtax, capping the federal subsidy. Although state and local officials will be understandably upset by this provision, it should be noted that President Obama made a similar recommendation earlier.

Coupled with sweeping changes in business taxation, the proposal would be revenue neutral overall, but it does shift more of the burden to higher-income taxpayers. However, the Joint Committee on Taxation concluded that the proposal would stimulate significant economic growth, which, in turn, would boost revenues by $700 billion over the next ten years.

In February the IRS released two new publications that will be of interest to those charged with settling estates. Publica-tion 559 for Survivors, Executors and Administrators covers the decedent's final income tax return, the fiduciary income tax return of the estate, distributions to beneficiaries, and transfer taxes. Publication 1437 provides procedures for the Form 1041 e-file program for U.S. income tax returns for estates and trusts.

The executors of Michael Jackson's estate reported its taxable value to the IRS at $7.2 million. The IRS reportedly has other ideas. Where the estate reported the value of Jackson's likeness was worth just $2,105, the IRS believes that estate asset alone should be valued at $434.26 million. Similarly, the Service believes that a willing buyer would pay $469 million for Jackson's interest in a trust that owns royalties for some of his songs and those of the Beatles. The estate had assigned no value at all to that interest.

Overall, the IRS alleges that the Jackson estate was worth $1.125 billion, and so it owed $505 million in estate taxes, an additional $197 million in tax penalties, plus interest. If that assessment is sustained, it is hard to see how the estate could raise the cash to pay it.

Estate tax ideas from the last century. President Obama's budget proposal for fiscal 2015 once again calls for a return to the estate tax framework of 2009, with only a $3.5-million estate and gift tax exemption. Implementation would be delayed until 2017 and the next Presidential administration. House Ways and Means Committee Member Jim McDermott (D-Wash.) reached back to the Clinton administration in drafting H.R.4061, the "Sensible Estate Tax Act of 2014." This bill would:

• reduce the federal estate tax exemption to $1 million;

• lift the top estate and gift tax rate back to 55%;

• restore the credit for state death taxes;

• require consistent basis reporting between estates and beneficiaries;

• require a minimum 10-year term for grantor-retained annuity trusts; and

• limit the generation-skipping transfer tax exemption to 90 years.

The legislation has been referred to the Ways and Means Committee.

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Lynne R. Werner
Grand Island

Jodi Rauert
Grand Island

Marisa Sinclair
Kearney

First National Bank

Grand Island • Kearney

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