

# The Advisor



January 2014

## ESTATE PLANNER'S TIP

As tax filing season begins, advisors should question clients about 401(k) plans, even if the client's current taxes are not affected. Among issues to discuss: Does the client's employer offer a 401(k) plan, and if so, is there a match? Clients should take advantage of this opportunity to immediately multiply their savings. How much does the client contribute each year? The limit for 2014 is \$17,500, with an additional \$5,500 for those age 50 and older. Is the 401(k) coordinated with the rest of the client's portfolio? The overall investment mix is especially crucial if the client is acquiring shares of the employer's stock within the 401(k). Are there 401(k) accounts from previous employers? If so, the client should consider rolling these over to the current employer's plan (if permitted) or to an IRA. Has the client borrowed from the 401(k)? Some plans allow participants to borrow, but failing to pay back the funds can result in an unpleasant tax surprise. Borrowing also reduces the funds that are growing tax-sheltered for retirement. Has the client reviewed beneficiary designations recently? Because 401(k) plans are subject to federal rules regarding spouse's rights, a client who has married since completing the beneficiary designation may have partly disinherited other family members. And because funds in 401(k) plans are subject to income tax when distributed to beneficiaries, it may make sense to name a charity to receive some or all of the account at death.

## SOCIAL SECURITY, MORE OR LESS

A 1.5% cost-of-living adjustment for Social Security means recipients will see slightly larger checks beginning this year, while those still working may pay in more. The average monthly benefit for all retirees climbs from \$1,275 to \$1,294. The Old-Age, Survivors and Disability Insurance deductions will apply on taxable earnings up to \$117,000, compared to \$113,700 in 2013. The Medicare Hospital Insurance

tax portion applies to all earned income.

Social Security recipients who haven't reached the full retirement age of 66 can earn up to \$15,480 in 2014 before benefits are reduced. In 2013, the maximum was \$15,120. Recipients lose \$1 of benefits for every \$2 of earned income above the limit. Recipients age 66 and older are not subject to earnings limits.

## 2014 INFLATION ADJUSTMENTS RELEASED

The IRS has announced inflation adjustments that will affect taxpayers in 2014. While a few of the numbers remained the same (e.g., annual gift tax exclusion, kiddie tax threshold, IRA and 401(k) contribution limits), most numbers are up slightly (Rev. Proc. 2013-35).

	2013	2014
Gift, generation-skipping transfer and estate tax exclusion	\$5,250,000	\$5,340,000
IRA contribution limits	\$5,500	\$5,500
Personal and dependent exemption	\$3,900	\$3,950
Standard deduction		
Single	\$6,100	\$6,200
Joint	12,200	12,400
Head of household	8,950	9,100
Married filing separately	6,100	6,200
Tax brackets		
25% bracket starts		
Single	\$36,250	\$36,900
Joint	72,500	73,800
Head of household	48,600	49,400
Married filing separately	36,250	36,900
28% bracket starts		
Single	\$87,850	\$89,350
Joint	146,400	148,850
Head of household	125,450	127,550
Married filing separately	73,200	74,425

### PHILANTHROPY PUZZLER

Brenda and John made numerous charitable gifts in 2012 but were unable to claim the entire amount on their 2012 joint return because of the deduction limits of Code §170(b)(1). They divorced in June of 2013 and have asked who gets custody of the charitable deduction carryovers when they file their separate 2013 returns. How do you advise them?

	2013	2014
33% bracket starts		
Single	\$183,250	\$186,350
Joint	223,050	226,850
Head of household	203,150	206,600
Married filing separately	111,525	113,425
35% bracket starts		
Single, Joint,		
Head of household	\$398,350	\$405,100
Married filing separately	199,175	202,550
39.6% bracket starts		
Single	\$400,000	\$406,750
Joint	450,000	457,600
Head of household	425,000	432,200
Married filing separately	225,000	228,800
Kiddie tax	\$2,000	\$2,000
Nanny tax	\$1,800	\$1,900
Annual gift tax exclusion	\$14,000	\$14,000
Annual gift tax exclusion for non-citizen spouse	\$143,000	\$145,000
Special use valuation for real property devoted to farming or closely held business use	\$1,070,000	\$1,090,000
401(k) contribution limit	\$17,500	\$17,500
401(k) catch-up contribution limit	\$5,500	\$5,500
Savings bond interest exclusion total phase out		
Single taxpayers	\$89,700	\$91,000
Joint taxpayers	\$142,050	\$143,950

### FIRST TOO LITTLE, THEN TOO LATE

Kingsley and Anthonia Ofoegbu made gifts to their church of \$17,681 in 2007 and \$19,400 in 2008. When the IRS asked for substantiation for their charitable deductions, the couple produced letters from the church, dated in early 2008 and 2009 respectively. Unfortunately for the Ofoegbus,

neither letter included a statement that no goods or services had been provided in exchange for their contributions. The IRS disallowed the deductions on the grounds that the taxpayers failed to obtain contemporaneous written acknowledgments for the gifts.

The church sent two other letters in October 2011 that included the quid pro quo language, but the IRS responded that neither of these letters was contemporaneous. Under Code §170(f)(8)(C), a letter is contemporaneous if it is received by the earlier of the date the taxpayer files a return or the due date (with extensions) of the return for the year the deduction is claimed.

The Tax Court agreed that the couple was not entitled to deductions because neither the first or second letters from the church satisfied Code §170(f)(8). Therefore, they had not strictly or substantially complied with the substantiation requirements (*Ofoegbu v. Comm'r.*, T.C. Summ. Op. 2013-79).

#### EXECUTOR, NOT DECEDENT, MADE GIFT

In 1993, Helen Trombetta established a qualified personal residence trust (QPRT) that was to last for 15 years and then pass to her children. After a cancer diagnosis in 2006, she reduced the QPRT term, making the month during which she died the last month preceding the termination date. She also amended her will to provide for the funding of a charitable remainder unitrust with the residence trust. The income beneficiary of the unitrust was her estate. Her goal was to have approximately \$250,000 pass to charity at the end of the trust.

Trombetta died in September 2006. Her executor created a 19.9105% charitable remainder unitrust that was to last for five years. When the trust ended in 2011, \$344,000 was distributed to charity. In 2010, Trombetta's estate filed for a refund, claiming a \$250,000 charitable deduction. The IRS disallowed the deduction, saying that the QPRT ended the month before Trombetta's death and she therefore did not possess the right to transfer the property to the unitrust.

Under Reg. §20.2055-1(a), a deduction is allowed

only for transfers made by the decedent during life or by will. Trombetta's QPRT, both before and after the amendment, provided that if she were living at the trust's termination, the property would be distributed equally to her children. If the trust terminated after her death, the trustee was to distribute the property under the terms of her will. The Tax Court held that because the QPRT terminated before her death, amounts passing to the charitable remainder unitrust were at the direction of her executor, not her will. The estate was therefore not entitled to a charitable deduction (*Est. of Trombetta v. Comm'r.*, T.C. Memo. 2013-234).

#### OOPS. IRS OKAYS JUDICIAL FIX

Several months after Joe created a charitable remainder unitrust, but still within the same tax year, he discovered that the trust was to last until the earlier of a fixed period of time or the death of Joe and a second beneficiary. His intent had been for the trust to last for his life.

A court ordered that the trust be reformed, based on a mistake of fact, to comply with Joe's intent – subject to a favorable ruling by the IRS.

Code §1.664-3(a)(4) provides that a charitable remainder unitrust may not be subject to a power to invade, alter, amend or revoke for the beneficial use of a person other than a charity. The IRS ruled that the judicial reformation would not violate Code §664 and does not adversely affect the trust's qualifications under Code §664(d)(2) (Ltr. Rul. 201340012).

#### PUZZLER SOLUTION

They will get "joint custody" of the deduction carryover. Brenda and John will have to recalculate their 2012 income tax to determine what their charitable deduction would have been if they had filed separately. Each is then entitled to a carryover of "an amount which bears the same ratio to such unused excess charitable contribution as such spouse's excess contribution, based on the separate return computation, bears to the total excess contributions of both spouses" [Reg. §1.170A-10(d)(4)].

### BREAKING UP ISN'T HARD TO DO

Charitable remainder trusts must last either for the life of the named income beneficiary(ies) or for a term of not more than 20 years [Code §§664(d)(1)(A), (d)(2)(A)]. But a change in circumstances sometimes prompts beneficiaries to terminate trusts early. For the most part, the IRS has been lenient about such early terminations, whether they involve beneficiaries wanting to contribute their remaining income interests to the charitable remaindermen or those wanting lump-sum payouts, rather than continue periodic payments for life or a term of years.

#### *Additional gifts to charity*

The current climate of low §7520 rates has provided an opportunity for income beneficiaries to give part or all of their income interests to charity and realize deductions that may exceed the amount initially placed in the trust. When valuing charitable remainder interests, donors should select the highest §7520 rate available from the month of the gift or the two previous months to yield the highest deduction. But where the donor is giving up an income interest, the lowest midterm rate will generate the largest charitable deduction. The IRS recently ruled that donors assigning their income interest in a charitable remainder unitrust are entitled to an income tax deduction for the value of the income interest (Ltr. Rul. 201321012).

Consider the example of a donor who transferred \$250,000 to a 6% charitable remainder annuity trust in 2006, using the August §7520 rate of 6.2%. The deduction at the time of the gift, assuming that the donor was age 66 and selected quarterly payments, was \$106,767. If the donor makes a gift of his income interest in January 2014,

electing to value the gift using the December 2013 §7520 rate of 2%, the second deduction is \$157,941. The two deductions total nearly \$265,000 – more than the amount transferred to the trust. In addition, the donor has received income distributions totaling about \$112,500.

The IRS has also ruled that a donor was entitled to an income tax deduction where only a portion of the income interest of a charitable remainder unitrust was given to charity (Ltr. Rul. 9550026). The trust continued paying the same percentage of a smaller corpus, with charity receiving an outright distribution of a portion of the principal.

#### *Agree to split*

The IRS recently issued a ruling involving income beneficiaries who were disappointed with the investment returns of their net-income with makeup charitable remainder unitrust. The IRS approved the dissolution and distribution, but applied an assumed payout that was the lesser of the trust's stated payout percentage or the §7520 rate for the month of termination, to account for the fact that the trust paid the donors the net income (Ltr. Rul. 201325018).

In the case of a trust for the life of the income beneficiary, the IRS has expressed concern that if the income beneficiary is not likely to live to his or her actuarial life expectancy, an early termination might result in "a greater allocation of trust assets to the income beneficiary." Therefore, the IRS generally requires that the beneficiary produce an affidavit from a physician attesting that the beneficiary has no known medical condition likely to result in a shortened life expectancy.

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