

The Advisor



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ESTATE PLANNER'S TIP

Irrevocable life insurance trusts are often recommended as a way to pass significant wealth to younger family members without gift or estate tax liability. By using *Crummey* provisions in the trust, annual transfers by the insured to pay premiums may qualify for the annual gift tax exclusion (\$14,000 in 2015). In order to support high life insurance premiums, some clients may wish to include grandchildren, as well as children, as eventual beneficiaries of the trust. But adding the grandchildren may create liabilities for generation-skipping transfer taxes (GST). Under Code §2642(c)(2), a nontaxable gift to a trust is excludible for GST purposes only if the beneficiary's interest is vested, meaning that (1) no portion of the corpus or income of the trust may be distributed to any other person during the beneficiary's lifetime, and (2) if the beneficiary dies before the trust terminates, the assets of the trust will be includible in the beneficiary's gross estate. A life insurance trust that gives a grandchild merely a contingent interest, while qualifying for the gift tax annual exclusion (*Estate of Cristofani v. Comm'r.*, 94 T.C. 74), does not qualify for the GST exclusion. The grandparent would have to allocate a portion of his or her lifetime GST exemption (\$5.43 million in 2015) against any future GST liability.

IRS TRIES TO CLARIFY ROLLOVER LIMITS

The Tax Court ruled last year that under Code §408(d)(3)(B), owners of retirement accounts may make only one IRA rollover per 12-month period regardless of the number of accounts the taxpayers maintain (*Bobrow v. Comm'r.*, T.C. Memo. 2014-21). This differed from Proposed Reg. §1.408-4(b)(ii) and IRS Publication 590, both of which provided that the one-year limitation applied on an IRA-by-IRA basis. The IRS stated that, beginning in 2015, it would follow *Bobrow*, revise Publication 590 and withdraw the proposed

regulations (Announcement 2014-15).

The IRS recently issued guidance, indicating that the once-per-year limit will apply by aggregating all of an individual's IRAs starting in 2015. A distribution received and rolled over in 2014 will not preclude a 2015 rollover.

Eligible IRA distributions that are properly rolled over to another IRA within 60 days will continue to be tax-free. However, additional distributions from either traditional or Roth IRAs within one year of the first distribution will not

be tax-free. The one-year limit does not apply to Roth conversions, rollovers between qualified plans and IRAs or trustee-to-trustee transfers. These will be disregarded in determining whether a rollover has been made (IR-2014-107).

NUMBERS LOOKING UP IN 2015

With a few notable exceptions – the annual exclusion, the nanny tax threshold and the IRA contribution limit – most tax numbers have increased for 2015. Here are some of the increases that tax advisors and clients will be working with this year (Rev. Proc. 2014-61):

| | 2014 | 2015 |
|---|-------------|-------------|
| Gift, generation-skipping transfer and estate tax exclusion | \$5,340,000 | \$5,430,000 |
| IRA contribution limit | 5,500 | 5,500 |
| Personal and dependent exemption | 3,950 | 4,000 |
| Standard deduction | | |
| Single | 6,200 | 6,300 |
| Joint | 12,400 | 12,600 |

PHILANTHROPY PUZZLER

Myron owns publicly traded stock that has tripled in value since he bought it several years ago. He would like to sell the shares, but doesn't want to pay capital gains tax. He knows about the advantages of giving appreciated stock to charity (deduction at fair market value plus avoidance of capital gains tax) and has suggested that he give his stock to charity and have the charity sell it back to him at fair market value. He would have a higher basis and could then sell the stock and owe no capital gains tax, he reasons. Will Myron's plan work?

| | 2014 | 2015 |
|---|---------|---------|
| Head of household | \$9,100 | \$9,250 |
| Married filing separately | 6,200 | 6,300 |
| Cutbacks on itemized deductions and personal exemptions begin | | |
| Single | 254,200 | 258,250 |
| Joint | 305,050 | 309,900 |
| Head of household | 279,650 | 284,050 |
| Married filing separately | 152,525 | 154,950 |
| Tax brackets | | |
| 25% bracket starts | | |
| Single | 36,900 | 37,450 |
| Joint | 73,800 | 74,900 |
| Head of household | 49,400 | 50,200 |
| Married filing separately | 36,900 | 37,450 |
| 28% bracket starts | | |
| Single | 89,350 | 90,750 |
| Joint | 148,850 | 151,200 |
| Head of household | 127,550 | 129,600 |
| Married filing separately | 74,425 | 75,600 |
| 33% bracket starts | | |
| Single | 186,350 | 189,300 |
| Joint | 226,850 | 230,450 |
| Head of household | 206,600 | 209,850 |
| Married filing separately | 113,425 | 115,225 |
| 35% bracket starts | | |
| Single, joint, head of household | 405,100 | 411,500 |
| Married filing separately | 202,550 | 205,750 |
| 39.6% bracket starts | | |
| Single | 406,750 | 413,200 |
| Joint | 457,600 | 464,850 |
| Head of household | 432,200 | 439,000 |
| Married filing separately | 228,800 | 232,425 |
| Alternative minimum tax exemptions | | |
| Single, head of household | 52,800 | 53,600 |

| | 2014 | 2015 |
|---|-----------|-----------|
| Joint | \$82,100 | \$83,400 |
| Married filing separately | 41,050 | 41,700 |
| Kiddie tax | 2,000 | 2,100 |
| Nanny tax | 1,900 | 1,900 |
| Annual gift tax exclusion | 14,000 | 14,000 |
| Annual gift tax exclusion for non-citizen spouse | 145,000 | 147,000 |
| Special use valuation for real property devoted to farming or closely held business use | 1,090,000 | 1,100,000 |
| 401(k) contribution limit | 17,500 | 18,000 |
| 401(k) catch-up contribution limit | 5,500 | 6,000 |
| Savings bond interest exclusion phased out | | |
| Single, head of household | 91,000 | 92,200 |
| Joint | 143,950 | 145,750 |

IRS: IRA ESCAPES IRD

The residue of Marshall's estate was to pass to his trust. After the payment of two pecuniary bequests, the balance of the trust's assets were to be distributed to charity. The trust was the beneficiary of Marshall's IRA.

The estate and trust plan to assign and transfer the IRA to charity, as permitted under the trust's terms. Under Code §691(a)(2), if the right to receive an amount is transferred by the estate or a person who received the right by reason of the death, or by bequest, devise or inheritance, the fair market value of the right is to be included in the gross income of the estate or the person receiving the right.

The IRS ruled that the trust retitling the IRA will not constitute a payment or distribution out of the IRA to the estate, trust or charity under Code §408(d) and will be a non-taxable transfer. There

will not be a transfer under Code §691(a)(2), said the IRS. Charity will include the amount of IRD in its gross income, but owe no tax, when the distributions are actually received (Ltr. Rul. 201444024).

FOUNDATION TRIPS ON PAPERWORK

R.S. Ohendalski was the founder and trustee of Grace Foundation, a nonexempt charitable trust that was treated as a private foundation. In 2011, shortly after the IRS informed Ohendalski that Grace had failed to file the required Form 990-PF for 2003, the form was filed showing income of \$883,783, cash contributions of \$890,900 and contributions of \$80,000 to various charities.

Ohendalski questioned whether proper assessment procedures were followed, and stated that the Foundation had a reasonable cause for failing to file on time because it relied on a professional. Ohendalski said the penalty had not been approved by the settlement officer's immediate supervisor, as required by Code §6751(b).

The IRS argued that supervisor approval is not necessary for penalties automatically calculated by electronic means. The Tax Court said Ohendalski's failure to provide evidence that he had relied on the advice of a professional meant that he conceded the IRS's claim that the Foundation failed to file Form 990-PF (*Grace Foundation v. Comm'r.*, T.C. Memo. 2014-229).

PUZZLER SOLUTION

The IRS will look at substance over form. Myron's initial gift of stock will be disregarded – and no charitable deduction will be allowed. He will, however, be allowed a deduction for the amount he pays the charity to repurchase the shares (Rev. Rul. 67-178, 1967-1 C.B. 64). If he instead sold the stock to a third party, he would owe capital gains tax on the difference between his original basis and the selling price. Note: Myron's idea will work if, instead of repurchasing the stock from the charity, he purchases shares on the open market.

CASH OR SECURITIES FOR A GIFT ANNUITY?

A 65-year-old client tells you she wants to contribute \$10,000 for a charitable gift annuity, but asks whether it's better to give cash or contribute \$10,000 in long-term capital gain stock with a \$5,000 basis. What do you recommend, tax-wise?

Gifts annuities provide donors with payouts that are part ordinary income and part tax-free return of principal [Code §72(b)]. But funding an annuity with appreciated securities will result in some capital gain each year during the donor's life expectancy [Reg. §1.1011-2(a)(4)(ii)]. The capital gain erodes the benefits of tax-free return of principal. But the donor will escape some tax on the gift deduction portion of her capital gain and that can be important.

A practical approach is to calculate the donor's effective payout rate (EPR) from her annuity, comparing a cash gift to a stock transfer. The EPR illustrates how much the value of the payout is boosted by virtue of favorable taxation and charitable deduction tax savings. The formula for figuring the EPR from an annuity funded with cash is as follows:

$$\frac{A + B}{1.0 - X} \text{ divided by (Gift - Deduction savings)}$$

where A = the fully taxable portion of the annuity, B = the tax-free portion and X = the donor/annuitant's tax bracket. The deduction savings are the donor's income tax charitable deduction multiplied by her marginal tax bracket. For example, a 65-year-old donor receives an annual payout of 4.7% (\$470) from a \$10,000 annuity. Assuming a 2.2% federal midterm rate, the tax-free portion from a cash gift is \$334 and the taxable portion is \$136. The income tax charitable deduction is \$3,363, which will save \$1,177 in taxes in a 35% tax bracket. If you plug those numbers into the

above equation, the effective payout rate is as follows:

$$\frac{\$136 + \$334}{1.0 - .35} \text{ divided by } (\$10,000 - \$1,177) = \text{EPR}$$

$$\$136 + \$514 \text{ divided by } \$8,823 = \text{EPR}$$

$$\$650 \text{ divided by } \$8,823 = 7.4\% \text{ EPR}$$

The EPR for a gift annuity funded with stock can be calculated as follows:

$$\frac{A + \frac{B}{1.0 - X} + \frac{.85 \times G^*}{1.0 - X}}{\text{divided by (Gift - Tax Deduction Savings - Capital Gains Tax Savings)}}$$

where A = fully taxable portion of the annuity payout
 B = tax free portion of payout
 G = capital gains portion of payout
 X = donor/annuitant's income tax bracket

(* in the 39.6% tax bracket, the capital gains portion is multiplied by .8 because a 20% capital gains tax rate applies).

Here is a comparison of stock versus cash for a \$10,000 gift annuity, donor age 65, 4.7% payout rate and the EPR from each, with varying amounts of gain:

| Tax Bracket | Effective Payout Rates | | | | |
|-------------|------------------------|------------------------------|------------------------------|------------------------------|------------------------------|
| | Cash Gift | \$10,000 Stock \$5,000 basis | \$10,000 Stock \$1,000 basis | \$10,000 Stock \$8,000 basis | \$10,000 Stock \$5,000 basis |
| 28% | 6.6% | 6.2% | 5.9% | 6.5% | 6.5% |
| 33 | 7.1 | 6.7 | 6.3 | 7.0 | 7.0 |
| 35 | 7.4 | 6.9 | 6.6 | 7.2 | 7.2 |
| 39.6 | 7.9 | 7.2 | 6.8 | 7.7 | 7.7 |

The EPR decreases as capital gain increases – the reverse is also true. Modestly appreciated property can produce an EPR only slightly less than a cash gift annuity.

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