The Advisor

BALL STATE UNIVERSITY FOUNDATION
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ESTATE PLANNER'S TIP

Making tax-free gifts to family members each year can help clients reduce future estate taxes [Code §2503(b)]. It can also encourage younger family members to begin a savings and investment program. Grandparents, for example, could offer to "match" the contributions that grandchildren make to an IRA. Individuals with earned income are eligible to contribute up to $5,500 in 2014 [Code §408]. If the grandchild does not need the deduction available for funding a traditional IRA, the Roth IRA might be an attractive option. All qualified withdrawals in the future are tax free. How much can a grandchild save? If $5,500 is contributed annually for five years, starting at age 16, when the grandchild reaches the full retirement age of 67, the account will be worth more than $617,000 (assuming 6% return, compounded monthly), even if no further contributions are made. If the grandchild continues putting $5,500 annually into an IRA until full retirement age, the fund will grow to more than $1.9 million.

COURT ALLOWS ONLY ONE TAX-FREE BITE OF APPLE

Alvan Bobrow took two distributions totaling $65,064 from one of his two IRAs on April 14, 2008. On June 6, 2008, shortly before the 60-day period for reinvesting the distribution into an IRA had expired [Code §408(d)(3)(A)], Bobrow took a distribution in the same amount from the second IRA. He repaid the funds back to the first IRA with funds from a personal account on June 10, 2008. On July 31, 2008, Bobrow's wife, Elisa, requested a distribution in the same amount from her IRA. On August 4, 2008, the couple transferred $65,064 from their joint account to Bobrow's second IRA. On September 30, 2008, Elisa transferred $40,000 from the couple's joint account to her IRA.

The IRS claimed that the Bobrows were not entitled to exclude the distribution from their gross income because Code §408(d)(3)(B) permits only one tax-free rollover during a one-year period beginning on the date of the withdrawal from an IRA. The Bobrows argued that the rules apply to each IRA separately, not in the aggregate.

The Tax Court said that the plain language of Code §408(d)(3)(B) limits the frequency to once per one-year, regardless of the number of IRAs the taxpayer maintains. When Bobrow withdrew the funds on June 6, the tax treatment of the April 14 withdrawal was unresolved because he had not yet repaid the funds, the court said. By recontributing the funds on June 10, he had satisfied all the requirements for a nontaxable rollover contribution. Therefore, the April 14 distribution was not includible in gross income. Bobrow had already received a nontaxable distribution and was not eligible for similar treatment for the June 6 distribution.

Elisa's entire $65,064 distribution was also included in gross income because she did not redeposit the full amount within the 60-day period, the court said. The couple claimed that they had directed the full amount to be repaid from their personal account, but the court said they failed to show that they requested full repayment. In addition to the income tax, Elisa was subject to a 10% early distribution tax under Code §72(t)(1) (*Bobrow v. Comm'r.*, T.C. Memo. 2014-21).

Note: Proposed Reg. §1.408-4(b)(ii) and IRS Publication 590, Individual Retirement Arrangements, both provided that the one-year limitation applied on an IRA-by-IRA basis. In Announcement 2014-15, the IRS has said that it intends to follow the ruling in *Bobrow* and will be withdrawing the proposed regulations and revising Publication 590. The IRS added this will not affect trustee-to-trustee transfers from one IRA to another, since they are not subject to the one-rollover-per-year limitation.

PHILANTHROPY PUZZLER

Helen has $500,000 in highly appreciated stock that she wants to use to fund a charitable remainder trust. She would like to reduce her taxable income and wonders if the trustee can sell the stock and invest in municipal bonds that would provide her with tax-free income. Is there any problem with Helen's plan?

LACK OF POWER MEANS NO SELF-DEALING

Larry, who established a private foundation, is currently the owner of all membership units in an LLC. The LLC's only asset is a note from Larry's daughter, making income paid on the note the LLC's only income. The LLC does not engage in the operation of any business.

At Larry's death, a non-voting interest in the LLC will pass to the foundation. The foundation asked the IRS to rule on whether the foundation's retention of the non-voting units will constitute an act of self-dealing under Reg. §53.4941(d)-1(b)(5)-(b)(6).

The IRS noted that both the LLC and Larry's daughter are disqualified persons relative to the foundation [Reg. §4946(a)(1)]. However, the arrangement is neither a loan nor an extension of credit. The foundation will acquire its units by gift rather than through a self-dealing transaction. The foundation will not have control over the LLC, due to the lack of voting power. Therefore, ruled the IRS, the retention of the non-voting interest and the receipt of passive income from the LLC will not constitute self-dealing (Ltr. Rul. 201407021).

TRUST ALLOWED A LITTLE EXTRA TIME

A noncharitable trust may make a gift to charity of any amount of gross income and, under Code §642(c)(1), take an unlimited deduction in computing taxable income, provided that the gift is made pursuant to the governing instrument. The deduction is in lieu of a charitable deduction under Code §170(a). Trusts may also make gifts after the close of the taxable year and elect to treat the contribution as made during the year.

A trust made a gift in one year, intending to elect to treat it as paid in the prior year, but the trustee failed to make the election. The IRS was asked to grant an extension of time to make the election. Reg. §301.9100-1(c) allows the IRS to grant a reasonable extension of time to make regulatory elections. There must be a showing of good faith on the taxpayer's part and that granting the relief will not prejudice the interests of the government.

Under Reg. §1.642-1(c)-1(b)(2), the election to treat a charitable gift as made in the prior year must be made no later than the time, including extensions, for filing the income tax return for the prior year. The IRS ruled that the trust had met the requirements of Reg. §301.9100-1 and that the trustee would have 120 days to file the election (Ltr. Rul. 201343002).

COURT LEFT TO UNSCRAMBLE AFTER EMBEZZLEMENT

The residue of Beverly Hersh's estate – estimated at between \$12.5 million and \$15.8 million – passed to a trust. The trust was to pay 20% to Hadassah, with the remaining 80% divided into two trusts. Of the 80% remaining, 30% was allocated to a charitable trust and 50% went to the Hersh Needy Benefits Foundation. The attorney appointed as executor and trustee made some charitable distributions, but embezzled large sums from the trusts. He agreed to pay restitution of \$2.29 million – the amount it would have received – to Hadassah. The organization has collected only \$1.36 million.

New trustees were appointed by the probate court and the parties proposed an arrangement under which Hadassah would receive its 20% distribution. In addition, Hadassah was named a qualifying charity eligible for distributions from the Hersh charitable trust. Hadassah was to receive distributions "equal to, when combined with the sums received under [the restitution order], a total sum of, at least, 30%" of the amount to be distributed. The agreement was signed on October 1, 2012, and filed with the court.

On October 18, the parties sought to amend the agreement, providing that the 30% received by Hadassah was in addition to any restitution received. The court denied the motion, saying Hadassah would "receive a windfall." In January 2013, Hadassah filed a motion to vacate the October 1 agreement and asked the court to accept the October 18 proposal. The court declined and Hadassah appealed.

The Ohio Court of Appeals found that Hadassah had not alleged any fraud. The best the charity could do, said the court, was argue that "its attorney neglected to read closely the relevant paragraph prior to signing the document." The court said that language in the October 1 agreement gives the trustee significant discretion, providing that Hadassah is to receive "at least" 30%. The court added that it was not convinced that the October 1 order "failed to reflect the parties' agreement." The court found no error in denying the motion to vacate the order (*In re Estate of Hersh*, 2014 Ohio 612).

PUZZLER SOLUTION

Under the four-tier system [Reg. §1.664-1(d)(1)], trust payouts are allocated in the following order: ordinary income, capital gain, "other" income (tax-exempt) and return of corpus. Because the trust would have capital gains on the sale of the stock, Helen's payout would not consist of tax-free income until all undistributed capital gain had been passed through, even if the trustee invests in municipal bonds. Tax-free income is possible immediately if the donor contributes cash or municipal bonds and the trustee invests in municipal bonds, subject to fiduciary laws. There can be no express or implied obligation for the trustee to invest in municipal bonds (Rev. Rul. 60-370, 1960-2 C.B. 203), and prudent investment rules must be considered.

IT'S A WHOLE NEW (MONETARY) WORLD OUT THERE

Most donors and their advisors are familiar with the usual assets given to charity – cash, shares of stock and mutual funds – and possibly less common gift assets such as real estate interests, life insurance policies and intellectual property. But there's a new type of asset – one that's been around only a few years – that could open up new giving opportunities: virtual currencies, such as Bitcoin.

Virtual currency does not have the backing of and is not controlled by any country or central bank. It is, instead, a digital representation of money. Virtual currency can be bought, sold, traded and used for purchases. It can also be converted to real currency.

The IRS recently issued guidance (Notice 2014-21) on the tax consequences of using, receiving and investing in virtual currency. While the IRS did not address the issue of using virtual currency for charitable gifts, the treatment of the currency as a capital asset would seem to make it an option for clients who have virtual currency that has appreciated in value, since "general tax principles applicable to property transactions apply to transactions using virtual currency."

A taxpayer who receives virtual currency as payment for goods or services must include the fair market value in computing gross income. The fair market value of virtual currency is the value measured in U.S. dollars on the date the currency is received. This value also serves to establish the basis in the recipient's hands. If every use of virtual currency, no matter how small, results in capital gains or losses, users may experience tax-reporting nightmares.

The IRS said that, for tax purposes, if a virtual currency is listed on an exchange and the exchange rate is established by market supply and demand, the fair market value of the virtual currency is determined by converting the virtual currency into U.S. dollars (or another real currency that can be in turn converted to U.S. dollars) at the exchange rate.

Each time virtual currency is used, a gain or loss can occur. If the currency is considered a capital asset, the transaction will result in a capital gain or loss. If the virtual currency is considered inventory, ordinary gain or loss will occur. The IRS also said that virtual currency received by an independent contractor for personal services can constitute self-employment income, subject to the self-employment tax. Virtual currency paid by an employer constitutes wages and is subject to withholding taxes.

The use of virtual currency valued at $600 or more to a non-exempt recipient to make payments in the course of a trade or business (rent, salaries, wages, premiums, annuities and compensation) is subject to information reporting rules.

Because the IRS is treating virtual currency as a capital asset for most taxpayers, it could become a new asset to consider in making charitable gifts. Clients should keep in mind, however, that if they contribute virtual currency that does not have a readily ascertainable fair market value, such as on a recognized exchange, IRS appraisal requirements would likely apply for transfers in excess of $5,000 [Code §170(f)(11)(C)]. Some charities also may be hesitant, due to valuation uncertainties, to establish charitable gift annuities or serve as trustee of charitable remainder trusts funded with virtual currency.

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