First National
Wealth Management

# Estate Planning Update

## Planning Thoughts

January/February 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:**

*Planning Thoughts* .............1

*Cases and Rulings* ...............2

*Washington Talk* ..................4

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**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

### U.S. Supreme Court will rule on status of inherited IRAs in bankruptcy.

***Clark v. Rameker, U.S. No. 13-299, cert. granted 11/26/2013***

Heidi Clark inherited a $300,000 IRA from her mother. Shortly afterward she and her husband declared bankruptcy. The bankruptcy judge held that, in contrast to an IRA or 401(k) account to which an individual has contributed, an inherited IRA does not constitute "retirement assets." Accordingly, the inherited IRA could be reached by Clark's creditors. The District Court disagreed, following the precedent of *Matter of Chilton*, CA-5 2012 USTC ¶50,275. There the Fifth Circuit Court of Appeals held that retirement funds do not change character as retirement assets simply because they are inherited rather than created by the owner's contributions.

The Seventh Circuit Court of Appeals reversed the District Court in *Clark*, rejecting the Fifth Circuit's reasoning and restoring the judgment of the bankruptcy judge. The Court held that an inherited IRA is very different from a normal IRA—no new contributions may be made, and the balance may not be rolled over or merged with any other account. What's more, the assets in the inherited IRA are not to be held until retirement, but must begin to be distributed to the heir immediately, perhaps in as short a period as five years. As such, these accounts should not be considered "retirement assets" for bankruptcy purposes.

The decision split the Circuits, and in November the U.S. Supreme Court agreed to hear the case, perhaps to heal the rift.

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### Extensions for making carryover basis elections permitted, denied.

***Private Letter Ruling 201342006***
***Private Letter Ruling 201343001***

When the federal estate tax was restored retroactively in 2010, executors were given the option of choosing to avoid the tax by accepting carryover basis instead. The election is made on Form 8939. Perhaps because of the novelty of the situation, and because it took the Service many months to draft the Form, the IRS set the due date at November 15, 2011. That date was moved farther, to January 17, 2012 [*Notice 2011-76*, 2011-40 IRB 479], regardless of the date of decedent's death.

Even so, that wasn't enough time for some executors, and so the Service has received many requests for additional extensions of time to make the carryover basis election. In the first-cited Ruling above, no specific hardships were behind the extension request. The executor had retained a tax professional for advice on making the election and allocating the decedent's basis, and the professional needed more time. The IRS agreed to an additional 120 days.

The second Ruling included a problematic fact. Son and Daughter were the executors of Mother's estate. During her life Mother had given each of them substantial taxable gifts, and she had filed gift tax returns. Although the children obviously knew of the gifts, the Ruling is silent on whether they were aware of the gift tax returns.

The children retained a law firm to prepare the estate

tax return for Mother's estate, but they neglected to tell the firm about the taxable gifts. Without the gifts, Mother's estate came to less than $5 million, so no estate tax would be due. Accordingly, the firm advised the children to file the Form 706, in order to obtain a basis step-up for their inherited assets, rather than the Form 8939.

The IRS audited the estate tax return, and it challenged the line indicating lifetime taxable gifts of $0, which the children had signed under penalty of perjury. At that point, the children realized that they would be much better off filing the Form 8939, and they asked for an extension to do so. Too late, said the IRS, denying the request. They cannot be said to have relied on the advice of a professional when they themselves did not make the professional aware of all the relevant facts.

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**An IRS attempt to offset a refund with recalculations from a prior taxable year is rebuffed.**

***Anne Batchelor-Robjohns et al. v. U.S., No. 1:12-cv-20038***

George Batchelor sold his aviation company in 1999 in a complex installment sale transaction. He received some payments and reported them as taxable capital gains in 1999 and 2000. George died in 2002, so his estate had to defend his income tax returns. In 2003 the IRS challenged the 1999 tax return. Ultimately, that decision went in the estate's favor. In 2005 the Service audited the return for tax year 2000. After examining over 1,000 pages of documentation, the IRS concluded that George had underreported his capital gain that year by $5.8 million.

The estate pointed out that the apparent discrepancy actually was taxable interest on the transaction, that it had been reported properly on Schedule B, and that tax had been paid. The IRS rejected this explanation. The estate paid the assessed tax and filed for a refund in District Court. Now the IRS concedes that it was mistaken about the year 2000 tax return, but it still wants to deny the refund. The Service has determined that a portion of the capital gain reported in 1999 should have been taxed as interest instead. The refund must, in the IRS' view, be reduced by the amount of additional taxes due for 1999.

No good, the Court holds. The 1999 tax year can't be reopened now, under the doctrine of *res judicata*. Furthermore, the doctrine of equitable recoupment does not apply in this situation.

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**IRS asks the public for comments on the marital deduction for noncitizen spouses.**

***T.D. 8612, 79 F.R. 206-207***

The IRS seeks public comment on the Final Regulations concerning Qualified Domestic Trusts, which enable the marital deduction for transfers to noncitizen spouses. The regulations provide guidance to individuals or fiduciaries: (1) For making a qualified domestic trust election on the estate tax return of a decedent whose surviving spouse is not a United States citizen in order that the estate may obtain the marital deduction; and (2) for filing the annual returns that such an election may require. Could compliance be streamlined? Comments are due by March 3, 2014.

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**Happy tax consequences when a family trust is divided into successor trusts.**

***Private Letter Ruling 2013 49002***

Father created an irrevocable trust for Son and Son's heirs before 1985. No additions have been made to that trust since, so it is fully exempt from the generation-skipping transfer tax. Son has three children, two of whom have minor children of their own. There is some disagreement in the family as to how best to manage the trust assets—passive versus active investment management, use of alternative investments, asset allocation issues. To resolve the conflict, the family proposes to divide the trust into separate trusts, each being free to pursue its own investment philosophy. The dispositive provisions of all three trusts will remain substantially the same. The private advice from the IRS on the plan is excellent news.

1. The proposed modifications will not cost the trust its GSTT-exempt status.
2. The transaction will not create a transfer that is subject to federal gift tax.
3. The modifications will not constitute a transfer that might trigger estate inclusion for any beneficiary.
4. The three successor trusts will be treated as separate trusts for federal income tax purposes.
5. The division of the trust into three equal trusts will not require recognition of gain or loss.
6. Basis of the trust assets will be the same after the division as before.

Thus, family harmony should be restored—unless,

perhaps, one trust dramatically outperforms the others.

## Washington Talk

**The IRS gets a new commissioner.** John Koskinen, who supervised Freddie Mac following the 2008 financial crisis, has been approved by the Senate as the new IRS Commissioner. The post had been vacant for more than a year, since Douglas Shulman resigned in November 2012. Acting Commissioners Steven Miller and then Daniel Werfel guided the agency in the interim.

The new Commissioner has many tough challenges ahead. First up is recovering from the impact of the 16-day government "shutdown" in October, which affected preparation for the tax-filing season. At Koskinen's confirmation hearing, it was clear that many Senators remain concerned about getting the full story on how the IRS targeted certain exempt organizations for extra scrutiny based upon their names.

Koskinen brings decades of experience at restructuring large organizations to these tasks. He'll be working with a budget that is about $1 billion less than the IRS had to work with in 2010, as well as about 8,000 fewer full-time equivalent employees.

**The Obama administration's 2014 budget proposal** calls for a restoration of the 2009 federal transfer tax regime, which would reduce the federal estate and gift tax exemption to $3.5 million and increase the tax rate to 45%. (It's 40% this year.) However, the implementation of the new rule would be delayed until 2018, halfway into the term of the next President. The exemption is $5.34 million this year; inflation adjustments could bring it to $6.0 million by 2017, making the transition even more jarring.

The budget also calls for coordinating the income and transfer tax rules for grantor trusts and for clarifying the generation-skipping transfer tax treatment of "Health and Education Trusts." Practitioners have argued that distributions from such trusts for medical and education expenses qualify as an exclusion from the gift tax. The proposal would clarify that the exclusion is only permitted for direct payments by a donor, not payments from a trust.

The President also has renewed his call for a limit on qualified plan accruals. The new limit would not replace existing contribution limits, but would supplement them. The limit is geared to the amount needed to fund a maximum joint-and-survivor annuity at age 62, which Treasury calculates to be about $3.4 million. Once the accrual limit is reached, no additional plan contributions would be permitted. However, existing 401(k) and IRA balances could grow beyond the limit.

**House Ways and Means Committee Chairman Dave Camp** (R-Mich.) has been stumping all year for comprehensive tax reform. However, in a November 20 meeting with reporters, Camp stated that such reform is not likely to include estate or gift tax changes. He believes that ATRA 2012 has settled the transfer tax issues appropriately for the near future.

On the other hand, there is a constituency for full repeal of the federal estate tax. H.R. 2429 would do just that, and it has 170 cosponsors. There could be an attempt to amend any tax reform legislation to include additional transfer tax relief.

**A new director of the Tax Exempt and Government Entities Division** has been named, to replace Lois Lerner. Lerner resigned after refusing to testify before Congress about her division's targeting of public advocacy groups with "Tea Party" in their name or other indicators of conservatism, and subjecting them to inappropriate additional questioning. Congressional investigators have yet to get to the bottom of this story.

The new director is Tamera Ripperda, who most recently worked in the IRS' Large Business and International Division. She joined the IRS in 1988 as a revenue agent and has worked in several compliance divisions since then.

**The tax code does more than just raise revenue** for the federal government, it also shapes the economy and encourages taxpayer choices through its myriad deductions and exemptions. Most people agree that the tax code also should promote economic growth, but there are wide differences over the exact relationship between any particular tax rule and performance of the economy. It's hard to run an experiment to test alternative visions of taxpayer response to a particular rule.

In a paper published by the Tax Foundation, William McBride has identified "Twelve Steps Toward a Simpler, Pro-growth Tax Code." He explains in more detail the effects of:

- cutting the corporate tax rate;
- improving capital allowances;
- moving to a territorial tax system;
- reducing shareholder taxes;
- lowering taxes on pass-through business forms;
- eliminating estate taxes;
- eliminating the alternative minimum tax;
- scrapping the personal exemption phaseout and the Pease limitation;

- dropping the "Obamacare" taxes;
- eliminating corporate welfare in the tax code;
- ending refundable tax credits; and
- maintaining or improving provisions that protect savings and investment.

Unfortunately, no matter how much economic sense any of these suggestions make, they can be characterized by opponents as "tax cuts for the rich." Accordingly, they are likely to gain little traction in Washington, D.C., these days.

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