First National Bank

Estate Planning Update

Planning Thoughts

March/April 2014

When estate planning becomes basis planning

Old conventional wisdom: Minimize estate and/or inheritance taxes by making lifetime transfers and taking appropriate steps to reduce the taxable value of transfers. New conventional wisdom for many "smaller" estates: Avoid lifetime transfers, especially of appreciated assets, and maximize asset values at death.

Under the old tax regime, with a 40% federal estate tax and a 15% maximum capital gains tax for heirs, the tax-wise choice was pretty easy. Give assets away during life, even though the donor's tax basis carries forward to the donee, because 15% of the taxable gain is going to be a much smaller tax bite than 40% of the gross value. Now, however, that calculus goes the other way. With a federal estate tax exemption of $5.34 million this year ($10.68 million for married couples), 99.8% of estates will no longer need to worry about paying any estate tax at all. For these estates, the tax benefit to zero in on is the step-up in basis at death. Basis step-up is even more valuable now that the top tax rate on long-term capital gains is 20%, plus an additional 3.8% net investment income tax from the Affordable Care Act.

Example. Grandfather's investment portfolio is worth $4 million, with a tax basis of $1 million. He plans to divide the portfolio among four grandchildren. If he makes a lifetime gift of the securities, and assuming that the basis is divided equally, each grandchild will have to plan for taxes on $750,000 worth of gains. If Grandfather holds the assets until his death, the tax on the $3 million capital gain is forgiven under IRC §1014(a), at zero estate tax cost.

Exceptions

Not all assets received from a decedent get a basis step-up. Most importantly, income in respect of a decedent does not change basis [IRC §1014(c) and §691]. For example, retirement plan assets and traditional IRAs may be income in respect of a decedent. Accordingly, it may prove beneficial for an IRA to be converted to a Roth IRA before death. Similarly, the net unrealized appreciation (NUA) in employer stock distributed from a qualified retirement plan does not get a basis step-up at the death of the participant [Rev. Rul. 75-125].

If the alternate valuation date is elected under IRC §2032, the basis

This Issue:

Planning Thoughts 1

Cases and Rulings 2

Washington Talk 4

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will be fair market value at the earlier of the date of distribution or the alternate valuation date [IRC §1014(a)(2)]. If special use valuation is elected, then the special use value becomes the basis [IRC §1014(a)(3)]. If a conservation easement election has been made, there is no basis step-up [IRC §1014(a)(4)].

Spousal transfers

IRC §1014(e) was added to the tax code with the Economic Recovery Tax Act of 1981. That was the legislation that removed the percentage and dollar limits on the marital deduction. Apparently, Congress was worried about the possibility of transfers to dying spouses so as to obtain a basis step-up without having to pay an estate tax. Although the law is 33 years old, there have been no Regulations, Revenue Rulings or Revenue Procedures explaining its application.

If an appreciated asset is given to a spouse, the spouse dies within a year, and the asset is reacquired by a surviving spouse, there is no basis step-up under this provision. The rarity of this sequence of events may account for the lack of IRS guidance. However, the provision also applies to indirect reacquisitions. If the deceased spouse's estate or a trust sells the asset, and the donor spouse is entitled to the sales proceeds or a portion of the proceeds, to that extent there is no basis step-up [IRC §1014(e)(2)(B)].

Recordkeeping

In order to secure the income tax benefits of basis step-ups, executors or personal representatives of estates will need to doc-ument very clearly the value of all assets at the date of the decedent's death. Appraisals will be needed for nonmarketable assets. This should be done as soon as possible, rather than waiting until a later sale.

Note also that there is no statute of limitations for tax basis, so basis records must be kept indefinitely. If an inherited asset is sold 20 years after it is received, the donee will need to refer to those decades-old records to determine gain or loss.

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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