THE ESTATE PLANNER

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Estate Planning Red Flag
You haven't properly funded your revocable trust

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Covering your basis

Tax basis planning offers significant benefits

For many people, income tax planning offers far greater tax-saving opportunities than estate tax planning. A record-high gift and estate tax exemption — currently $5.45 million ($10.9 million for married couples) — means that fewer people are subject to those taxes than ever before.

If gift and estate taxes aren't a concern for your family, it pays to focus your planning efforts on income taxes — in particular, basis planning.

Benefits of a "stepped-up" basis

Generally, your basis in an asset is its purchase price, reduced by accumulated depreciation deductions and increased to reflect certain investment costs or capital expenditures. Basis is critical because it's used to calculate the gain or loss when you or a loved one sells an asset.

The manner in which you transfer assets to your children or other beneficiaries has a big impact on basis. If you transfer an asset by gift, the recipient takes a "carryover" basis in the asset — that is, he or she inherits *your* basis. If the asset has appreciated in value, a sale by the recipient could trigger significant capital gains taxes.

On the other hand, if you hold an asset for life and leave it to a beneficiary in your will or revocable trust, the recipient will take a "stepped-up" basis to equal the asset's date-of-death fair market value. That means the recipient can turn around and sell the asset tax-free.

Gifting in action

Given the income tax advantages of holding appreciating assets for life, why would you transfer assets via gift? Historically, gifting was viewed as the preferred strategy because it offered estate tax savings that outweighed the potential income tax costs. Let's look at an example:

In 1991, Jennifer buys $300,000 worth of stock. (For purposes of this example, assume the stock is her only asset.) Two years later, the stock's value has climbed to $500,000 and Jennifer transfers it to an irrevocable trust for the benefit of her

Recent basis rules may affect your estate

Federal legislation enacted in July 2015 added Section 1014(f) to the Internal Revenue Code. The provision requires consistent basis reporting between an estate and beneficiaries who acquire property from the estate.

If an estate is required to file a federal estate tax return, Sec. 1014(f) provides that the basis reported by persons who inherit property from the deceased must not exceed the final value of such property as determined for estate tax purposes. The act also requires executors to furnish basis information to beneficiaries and the IRS.

This means that a beneficiary who sells inherited property may not claim a basis higher than the value reported by the estate — at least not without challenging the estate's valuation in court. Be aware that the new rules don't apply to property whose inclusion in the estate doesn't result in additional estate tax.

daughter, Mollie. At the time, the gift and estate tax exemption was $600,000, so her gift to the trust is tax-free. In 2001, when the stock's value has grown to $1.5 million, Jennifer dies and the trust distributes the stock to Mollie, who immediately sells it. Because Jennifer transferred the stock by gift, Mollie's basis in the stock is its original purchase price of $300,000. As a result of the sale, she recognizes a $1.2 million gain, generating $240,000 in capital gains tax (20% of $1.2 million).

Had Jennifer held onto the stock — either directly or through a revocable trust — and left it to Mollie at death, Mollie would have received a stepped-up basis and avoided the $240,000 capital gains tax. But in 2001, when the exemption was only $675,000, the $1.5 million bequest would have generated $335,250 in estate taxes.

In this scenario, gifting an appreciating asset is the better strategy. But things have changed. If our hypothetical took place today, gift and estate taxes wouldn't come into play, so Jennifer would achieve greater tax savings by holding onto the stock and providing Mollie with a stepped-up basis.

In general, unless your wealth is great enough to trigger estate taxes, your best tax strategy is to transfer appreciated assets at death rather than by gift. Of course, there may be nontax reasons to make gifts during your lifetime, such as helping one of your children pay college tuition or buy a home.

Undoing previous gifts

What if you transferred assets to an irrevocable trust years or decades ago — when the exemption was low — to shield future appreciation from estate taxes? If estate taxes are no longer a concern, there may be a way to help your beneficiaries avoid a big capital gains tax hit.

Depending on the structure and language of the trust, you may be able to exchange low-basis trust assets for high-basis assets of equal value, or to purchase low-basis assets from the trust using cash or a promissory note. This allows you to bring highly appreciated assets back into your estate, where they'll enjoy a stepped-up basis when you die. Keep in mind that, for this strategy to work, the trust must be a "grantor trust." Otherwise, transactions between you and the trust are taxable.

Is your basis covered?

As you develop or review your estate plan, be sure to work with your advisor to determine whether your family would benefit from basis planning. Often, in today's environment, the benefits of income tax strategies may outweigh the benefits of traditional estate tax strategies.

Is a self-directed IRA right for you?

Traditional and Roth IRAs can be powerful estate planning tools. With a "self-directed" IRA, you may be able to amp up the benefits of these tools by enabling them to hold non-traditional investments that offer potentially greater returns. However, self-directed IRAs present pitfalls that can lead to unfavorable tax consequences. Consequently, you need to handle these vehicles with care.

Estate planning benefits

IRAs are designed primarily as retirement-saving tools, but if you don't need the funds for retirement, they can provide a tax-advantaged source of wealth for your family. For example, if you name your spouse as beneficiary, your spouse can roll the funds over into his or her own IRA after you die, enabling the funds to continue growing on a tax-deferred basis (tax-free in the case of a Roth IRA).

A self-directed IRA is simply an IRA that gives you complete control over investment decisions.

If you name a child (or someone other than your spouse) as beneficiary, that person will have to begin taking distributions immediately. But if the funds are held in an "inherited IRA," your beneficiary can stretch the distributions over his or her own life expectancy, maximizing the IRA's tax benefits.

Advantages of self-directed IRAs

A self-directed IRA is simply an IRA that gives you complete control over investment decisions. Traditional IRAs typically offer a selection of stocks, bonds and mutual funds. Self-directed IRAs (available at certain financial institutions) offer greater diversification and potentially higher returns by permitting you to select virtually any type of investment, including real estate, closely held stock, limited liability company and partnership interests, loans, precious metals, and commodities (such as lumber and oil & gas).

A self-directed IRA can be a traditional or Roth IRA, a Simplified Employee Pension (SEP) plan, or a Savings Incentive Match Plan for Employees (SIMPLE). It's also possible to have a self-directed individual 401(k) plan, Health Savings Account or Coverdell Education Savings Account.

Self-directed IRAs offer the same estate planning benefits as traditional IRAs, but they allow you to

transfer virtually any type of asset to your heirs in a tax-advantaged manner. Self-directed Roth IRAs are particularly powerful estate planning tools, because they offer tax-*free* investment growth. In addition, Roth IRAs aren't subject to required minimum distribution (RMD) rules, so you can keep them fully funded beyond age 70½, leaving more for your beneficiaries.

Avoiding the pitfalls

To avoid pitfalls that can lead to unwanted tax consequences, caution is required when using self-directed IRAs. The most dangerous traps are the prohibited transaction rules. These rules are designed to limit dealings between an IRA and "disqualified persons," including account holders, certain members of account holders' families, businesses controlled by account holders or their families, and certain IRA advisors or service providers. Among other things, disqualified persons may not sell property or lend money to the IRA, buy property from the IRA, provide goods or services to the IRA, guarantee a loan to the IRA, pledge IRA assets as security for a loan, receive compensation from the IRA or personally use IRA assets.

The penalty for engaging in a prohibited transaction is severe: The IRA is disqualified and all of its assets are deemed to have been distributed on the first day of the year in which the transaction takes place, subject to income taxes and, potentially, penalties. This makes it virtually impossible to manage a business, real estate or other investments held in a self-directed IRA. So, unless you're prepared to accept a purely passive role with respect to the IRA's assets, this strategy isn't for you.

Proceed with caution

If you're considering a self-directed IRA, be sure to consult your advisor to determine whether this vehicle is right for you. Consider the types of assets in which you'd like to invest and carefully weigh the potential benefits against the risks. ▮

A CLT's effectiveness depends on Sec. 7520 rate

Charitable giving provides many intangible benefits to you and your family. These benefits can be as rewarding as the estate tax savings that may result from your donations. A charitable lead trust (CLT) may help achieve your philanthropic and estate planning goals.

This trust type is most effective in a low-interest-rate environment. And while rates have risen slightly in the past year, they remain low. That said, you'll want to act soon before they rise more significantly.

CLT in action

A CLT provides a regular income stream to one or more charities during the trust term, after which the remaining assets pass to your children or other noncharitable beneficiaries. Essentially, it's the opposite of a charitable remainder trust (CRT), which provides income to your noncharitable beneficiaries during the trust term and leaves the

remainder to one or more charities.

If your beneficiaries are in a position to wait for several years (or even decades) before receiving their inheritance, a CLT may be an attractive planning tool. That's because the charity's upfront interest in the trust dramatically reduces the value of your beneficiaries' interest for gift or estate tax purposes.

CLATs and CLUTs

There are two types of CLTs: 1) a charitable lead annuity trust (CLAT), which makes annual payments to charity equal to a fixed dollar amount or a fixed percentage of the trust assets' initial value, and 2) a charitable lead unitrust (CLUT), which pays out a set percentage of the trust assets' value, recalculated annually. Most people prefer CLATs because they provide a better opportunity to maximize the amount received by noncharitable beneficiaries.

> *If your beneficiaries are in a position to wait for several years (or even decades) before receiving their inheritance, a CLT may be an attractive planning tool.*

Typically, people establish CLATs during their lives (a strategy known as an "inter vivos" CLAT) because it allows them to lock in a favorable interest rate. Another option is a testamentary CLAT, or "T-CLAT," which is established at death by a will or living trust.

T-CLATs offer some important advantages: They allow you to retain control over the assets during your life and, because the assets are transferred at death, their basis is "stepped-up" to the date-of-death value, minimizing or eliminating income taxes in the event they're sold. The main drawback to a T-CLAT is uncertainty about interest rates. If rates are substantially higher when the trust is funded at your death, its ability to reduce estate taxes will be diminished.

Another issue to consider is whether to design a CLAT as a grantor or nongrantor trust. Nongrantor CLATs are more common, primarily because the grantor avoids paying income taxes on the trust's earnings. However, grantor CLATs also have advantages. For example, by paying income taxes, the grantor allows the trust to grow tax-free, enhancing the beneficiaries' remainder interest. Also, the grantor receives a charitable income tax deduction based on the present value of the charitable payment stream (as opposed to a nongrantor CLAT, for which the *trust* deducts amounts paid out to charity).

How interest rates affect CLATs

Here's why CLATs are so effective when interest rates are low: When you fund a CLAT, you make a taxable gift equal to the initial value of the assets you contribute to the trust, less the value of all

charitable interests. A charity's interest is equal to the total payments it will receive over the trust term, discounted to present value using the Section 7520 rate, a conservative interest rate set monthly by the IRS. As of this writing, the monthly Sec. 7520 rate has fluctuated between 1.8% and 2.2%.

If trust assets outperform the applicable Sec. 7520 rate (that is, the rate published in the month the trust is established), the trust will produce wealth transfer benefits. For example, if the applicable Sec. 7520 rate is 2.2% and the trust assets actually grow at a 7% rate, your noncharitable beneficiaries will receive assets well in excess of the taxable gift you report when the trust is established.

Keep an eye on interest rates

If charitable giving is an estate planning goal, discuss with your advisor whether the interest rate environment remains favorable for a CLT. If the Sec. 7520 rate remains low, act quickly to create a CLT that can fulfill your philanthropic and estate planning goals.

ESTATE PLANNING RED FLAG

You haven't properly funded your revocable trust

If your estate plan includes a revocable trust — also known as a "living" trust — it's critical to ensure that the trust is properly funded. Revocable trusts offer significant benefits, including asset management (in the event you become incapacitated) and probate avoidance. But these benefits aren't available if you don't fund the trust.

So, what's involved in funding a trust? It's simply a matter of transferring ownership of assets to the trust or, in some cases, designating the trust as beneficiary. Assets you should transfer include real estate, bank accounts, certificates of deposit, stocks and other investments, partnership and business interests, vehicles, and personal property (such as furniture and collectibles).

Moving an IRA or qualified retirement plan to a revocable trust can trigger unwanted tax consequences. Rather than transfer these assets to the trust, be sure that the trust is properly designed to allow you to designate the trust as beneficiary and enjoy the tax benefits of doing so. For insurance policies and annuities, you can either transfer ownership or change the beneficiary designation. Ask your estate planning advisor which approach is best for you. In some cases, it may be advisable to hold a life insurance policy in an irrevocable life insurance trust to shield the proceeds from estate taxes.

Most people are diligent about funding a trust at the time they sign the trust documents. But trouble can arise when they acquire new assets after the trust is established. Unless you transfer new assets to your trust, or designate the trust as beneficiary, they won't enjoy the trust's benefits.

So to make the most of a revocable trust, be sure that each time you acquire a significant asset you take steps to transfer it to the trust or complete the appropriate beneficiary designation.

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Carlin Comments
Inexperience Does Not Excuse Late Filing of a Tax Return or Payment of Taxes (Part 2)
By Angela G. Carlin

Other than procuring tax releases for each of decedent's (Virginia Escher) 23 separate bank accounts, Plaintiff Janice C. Specht's actions in executing the estate was limited to calling attorney Mary Backsman inquiring about the estate status. When Backsman advised Specht that the former had obtained an extension to file a return and pay the tax, when in fact she had not, Specht did not ask for proof of the extension. This deception by Backsman eventually led to malpractice claims and voluntary relinquishment of her law license. (Backsman was later declared incompetent and put under a full guardianship.)

In addition to the above failures to perform her fiduciary duties, Specht ignored four notices from the probate court as to Backsman's failure to file probate court documents including a first account, and several notices from the Ohio Department of Taxation that the Ohio state estate tax return was not filed nor was the estate tax paid, and that tax adjustments would be made for such failures.

At each occurrence, Specht called or met with Backsman who would assure her that "things were going fine" without any assurances requested by Specht.

In July 2010, Specht received a call from friends of the decedent who had also hired Backsman as attorney for a family member's estate. The friends warned Specht that Backsman was incompetent, and the family was seeking to have the attorney as co-executor of such estate removed. Specht contacted Backsman and accepted the attorney's representation again that the Escher estate was in good order. At this meeting Blackman asked Specht to sign a "blank paper" to allow the sale of UPS stock. Backsman later told Specht that she had initiated such sale to raise funds to pay the estate tax, which statement was false. In October 2010, when Specht called UPS and learned that Backsman had not initiated the stock sale, that the return had not been filed and the taxes were unpaid, Specht fired Backsman, hired an attorney recommended by the decedent's friend to represent Specht as executor of the Escher estate. Within a month of hiring the new attorney, the estate liquidated the UPS stock for a total of $8,251,715. The new attorney filed the federal estate tax return and paid the estate tax liability and interest on January 26, 2011.

ANALYSIS
In its analysis of this case upon appeal, the Sixth Circuit Appellate Court emphasized that "Congress has charged the executor with an unambiguous, precisely defined duty to file the return within nine months…." The appellate court cited its recent unpublished decision in *Vaughn v. United States*, 635 F. App 216 (6th Cir. 2015) where a former Major League baseball player hired a wealth-management firm and tax accountant to prepare and file his returns and make payments, and instead his financial manager embezzled the player's funds, failed to file returns, or pay the taxes due. The court reiterated its interpretation of reasonable cause to mean "something that is beyond the taxpayer's possible control and oversight, not something that occurs under his authorization and control."

CONCLUSION
What does this appellate decision teach a fiduciary and the estate attorney: that the fiduciary has the prime responsibility to ensure that his or her attorney is not committing malpractice in the administration of a decedent's estate, and that neither the good faith of the fiduciary nor reasonable reliance will excuse the nondelegable act of the fiduciary who will be held liable for the late filing of a tax return and the late payment of taxes. Of course, the attorney and the fiduciary are liable to estate beneficiaries for the losses incurred in the unnecessary payment of interest and penalties.

The appellate court noted that the Ohio Department of Taxation fully refunded the Estate's state penalties due to the hardship caused by Backsman's representation. The Estate settled the malpractice action against Backsman in 2012.