# THE ESTATE PLANNER

May/June 2016

## CHARITABLE IRA ROLLOVER OFFERS SIGNIFICANT BENEFITS

## Postmortem planning

Add decanting provisions to a trust to increase trustee flexibility

## Don't overlook tax apportionment when planning your estate

Estate Planning Red Flag

## You're setting up trusts in your home state

Weston Hurd LLP
Attorneys at Law

Cleveland ▪ Columbus ▪ Beachwood


The Tower At Erieview
1301 East 9th Street, Suite 1900
Cleveland, Ohio 44114-1862
tel 216.241.6602 • fax 216.621.8369

10 West Broad Street, Suite 2400
Columbus, Ohio 43215-3469
tel 614.280.0200 • fax 614.280.0204

24100 Chagrin Boulevard
Beachwood, Ohio 44122-5535
tel 216.241.6602 • fax 216.621.8369

www.westonhurd.com

# Charitable IRA rollover offers significant benefits

At the end of last year, Congress reinstated — and made permanent — qualified charitable distributions (QCDs) from IRAs, also known as charitable IRA rollovers. If you're age 70½ or older and plan to make charitable donations this year, a charitable rollover can provide significant tax benefits. It allows you to transfer up to $100,000 per year directly from your IRA to a qualified charity without including that amount in your adjusted gross income (AGI).

## Rollover benefits

Before Congress authorized QCDs, people who wanted to use their IRAs to fund charitable donations typically would take a taxable distribution, write a check to their favorite charity and deduct the donation on their tax returns.

The problem with this approach is that the charitable income tax deduction may not fully offset the tax on the distribution. For one thing, the deduction isn't available at all if you don't itemize, and some states don't allow charitable deductions for state income tax purposes. Even if you itemize, charitable deductions are limited to 50% of your AGI for the year (or less, depending on the type of donation). Unused deductions may be carried over for up to five years and used to offset income in those years (subject to the same limits).

Another potential disadvantage is that taxable IRA distributions increase your AGI, which can:

- Increase taxes on your Social Security benefits,
- Trigger the 3.8% Medicare tax on net investment income, which kicks in after your modified AGI hits $200,000 ($250,000 for joint filers),
- Decrease your itemized deductions, which begin to phase out after your AGI reaches $259,400 ($311,300 for joint filers), and
- Raise your Medicare premiums.

Because it bypasses AGI, a QCD avoids all of these limitations. Plus, it applies toward your required minimum distributions (RMDs) for the year — a big advantage if you don't need IRA funds for living expenses. (See "Rollover satisfies RMD requirements" on page 3.)

## Read the fine print

QCDs offer valuable benefits, but it's important to understand their requirements to avoid costly tax mistakes. In addition to minimum age and maximum contribution limits, the requirements include:

**Traditional or Roth IRAs only.** QCDs aren't available for inherited IRAs, IRAs that are part of a Simplified Employee Pension (SEP) plan or a Savings Incentive Match Plan for Employees (SIMPLE), or other employer-provided retirement accounts. It may be

## Rollover satisfies RMD requirements

A benefit of charitable IRA rollovers is that they apply toward your required minimum distributions (RMDs) for the year. To ensure that retirement funds don't escape taxation, federal law generally requires you to begin taking RMDs when you reach age 70½, with the first RMD due by April 1 of the following year. Subsequent distributions are due by the end of each calendar year.

If you don't need your IRA funds for living expenses, this requirement results in unnecessary income taxes. Fortunately, if you're otherwise charitably inclined, a qualified charitable distribution is automatically applied toward your RMDs for the year. Keep in mind that, if your RMD is greater than the amount you roll over to charity, you'll need to withdraw the excess by the end of the year.

possible, however, to move funds from an employer plan into an IRA (through a tax-free rollover) and then use the IRA to make a QCD.

**Eligible charities only.** The donation must be received by a public charity, a private operating foundation or a "conduit" private foundation. Donations to private nonoperating foundations, supporting organizations and donor advised funds aren't eligible.

*QCDs offer valuable benefits, but it's important to understand their requirements to avoid costly tax mistakes.*

**Direct transfers only.** The IRA must distribute the funds directly to the charity. If it makes the check out to you, it's not a QCD, even if you endorse it over to the charity.

**Deferred taxable income only.** A QCD must consist of deferred taxable income — that is, funds that otherwise would be taxable if distributed to you. It doesn't include distributions that are attributable to nondeductible contributions to a traditional IRA or to otherwise tax-free distributions from a Roth IRA. For this reason, Roth IRAs generally aren't good candidates for QCDs, unless distributions would otherwise be taxable (for example, because the account is less than five years old).

**Fully deductible gifts only.** To be a QCD, a donation must be "otherwise deductible." In other words, the gift would be fully deductible (without regard to AGI limits) had you made it with non-IRA assets. If you receive something of value from the charity in exchange for your gift, it's not a QCD.

**Acknowledgment required.** The charity that receives the distribution must provide you with the same type of written acknowledgment required to substantiate other types of charitable donations. Failure to obtain the acknowledgment will invalidate a QCD.

### Weigh your options

If you're charitably inclined and have a significant amount of deferred taxable income in an IRA, a charitable rollover is worth a look. This technique can be particularly valuable if you don't itemize deductions or if your AGI is high enough to reduce the value of charitable deductions.

Before making a QCD, compare its benefits to those of other charitable giving strategies. For example, if you own highly appreciated securities, donating them to charity may produce greater tax savings than a QCD.

# Postmortem planning

*Add decanting provisions to a trust to increase trustee flexibility*

An estate plan shouldn't be a static document — meaning you should continue to revise and update it as needed in light of major life changes or estate tax law changes up until your death. Postmortem, your trustee can have similar power to adapt a trust to changing circumstances.

The technique is known as decanting a trust, and it's permitted in many states. This strategy allows a trustee to use his or her distribution powers to "pour" funds from one trust into another trust with different terms.

## Creating flexibility

Depending on the language of the trust and applicable state law, decanting may enable the trustee to correct errors, take advantage of new tax laws, eliminate or add a beneficiary, extend the trust term, modify the trust's distribution standard, and add spendthrift language to protect the trust assets from creditors' claims.

If you're in the process of planning your estate, consider including trust provisions that specifically authorize your trustee to decant the trust. Even for an existing irrevocable trust, however, your trustee may be able to take advantage of decanting laws to change its terms.

## Factoring in state laws

Differences in state law complicate the decanting process. In some states, decanting is authorized by common law. But in recent years, more than a dozen states have enacted decanting statutes. Several other states are considering similar laws. A detailed

discussion of the various decanting laws is beyond the scope of this article, but here are several issues that you and your advisor should consider:

**If your trust is in a state without a decanting law, can you take advantage of another state's law?** Generally, the answer is "yes," but to avoid any potential complaints by beneficiaries it's a good idea to move the trust to a state whose law specifically addresses this issue. In some cases, it's simply a matter of transferring the existing trust's governing jurisdiction to the new state or arranging for it to be administered in that state.

**Will the trustee need court approval?** Most states' laws permit decanting without court approval. If the trustee anticipates beneficiary objections, however, he or she may want to seek court approval voluntarily.

**Will the trustee need to notify beneficiaries or obtain their consent?** Decanting laws generally don't require beneficiaries to consent to a trust decanting and several don't even require that beneficiaries be notified. Where notice is required, the specific requirements are all over the map: Some laws require notice to current beneficiaries while others also include contingent or remainder beneficiaries. Even if notice isn't required, notifying beneficiaries may help stave off potential disputes down the road.

**What is the trustee's authority?** When exploring decanting options, trustees should consider which states offer them the greatest flexibility to achieve their goals. Generally, decanting authority is derived from a trustee's power to make discretionary distributions. In other words, if the trustee is empowered to distribute the trust's funds among the beneficiaries, he or she should also have the power to distribute them to another trust. But state decanting laws may restrict this power.

Some decanting laws, for example, require the trustee to act in the best interests of certain beneficiaries or heirs or to meet certain standards of care. Also, while decanting laws generally allow decanting when the trustee has complete discretion over distributions of principal and income, their rules differ for trustees whose powers are restricted.

*If you're in the process of planning your estate, consider including trust provisions that specifically authorize your trustee to decant the trust.*

Some state laws prohibit decanting if distributions are limited by an "ascertainable standard" — such as a beneficiary's health, education, maintenance and support — but others don't. Laws in several states permit a trustee with ascertainable standard authority to decant a trust even if there's no current need for a distribution. Decanting laws in other states generally don't address this issue.

## Add proper provisions to the trust document

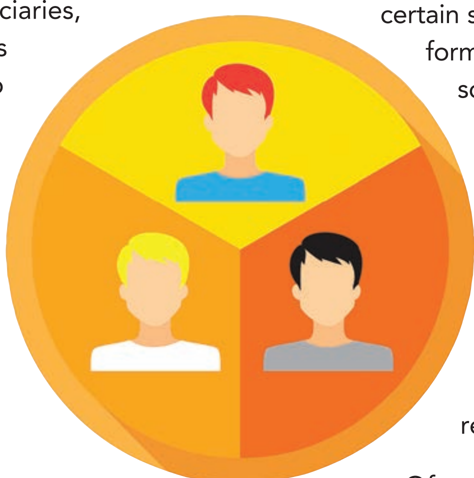
Decanting a trust is a viable option for your trustee after you're gone. However, because of the complexities involved and varying state laws, work with your estate planning advisor today to add the proper provisions to the trust's terms. Doing so will make it easier for your trustee to decant the trust in the future if he or she sees fit.

# Don't overlook tax apportionment when planning your estate

If you expect your estate to have a significant estate tax liability at your death, pay attention to the tax apportionment clause in your will or revocable trust. An apportionment clause specifies how the estate tax burden will be allocated among your beneficiaries. Omission of this clause, or failure to word it carefully, may result in unintended consequences.

## Apportionment options

There are many ways to apportion estate taxes. One option is to have all of the taxes paid out of assets passing through your will. Beneficiaries receiving assets outside your will — such as IRAs, retirement plans or life insurance proceeds — won't bear any of the tax burden. Another option is to allocate taxes among all beneficiaries, including those who receive assets outside your will. Yet another is to provide for the tax to be paid from your residuary estate — that is, the portion of your estate that remains after all specific gifts or requests have been made and all expenses and liabilities have been paid.



There's no one right way to apportion estate taxes. But it's important to understand how an apportionment clause operates to ensure that your wealth is distributed in the manner you intend. Suppose, for example, that your will leaves real estate valued at $5 million to your son, with your residuary estate — consisting of $5 million in stock and other liquid assets — passing to your daughter. Your intent is to treat your children equally, but your will's apportionment clause provides for estate taxes to be paid out of the residuary estate. Thus, the entire estate tax burden — including taxes attributable to the real estate — will be borne by your daughter.

One way to avoid this result is to apportion the taxes to both your son and your daughter. But that approach could cause problems for your son, who may lack the funds to pay the tax without selling the property. To avoid this situation while treating your children equally, you might apportion the taxes to your residuary estate but provide life insurance to cover your daughter's tax liability.

## Omission of apportionment clause

What if your will doesn't have an apportionment clause? In that case, apportionment will be governed by applicable state law (although federal law covers certain situations). Most states have some form of an "equitable apportionment" scheme. Essentially, this approach requires each beneficiary to pay the estate tax generated by the assets he or she receives. Some states provide for equitable apportionment among all beneficiaries while others limit apportionment to assets that pass through the will or to the residuary estate.

Often, state apportionment laws produce satisfactory results, but in some cases they may be inconsistent with your wishes. Consider this example:

Laura's will provides for her $5 million residuary estate, which is subject to estate tax, to be divided equally between her daughter, Sara, and a charity. It doesn't contain an apportionment clause. Laura's estate takes a charitable deduction for the half that goes to charity, so the estate tax liability is 40% of $2.5 million, or $1 million. Under the state's equitable apportionment statute, the entire amount is allocated to Sara, whose inheritance generated the tax liability. If Laura wants Sara to share the benefit of the charitable deduction, she should include an apportionment clause in her will that allocates a portion of the tax liability to the charity.

## Avoid surprises

If you ignore tax apportionment when planning your estate, your wealth may not be distributed in the manner you intend. To avoid unpleasant surprises for your beneficiaries, be sure to include an apportionment clause that clearly spells out who will bear the burden of estate taxes.

ESTATE PLANNING RED FLAG

## You're setting up trusts in your home state

While it's natural to set up trusts in the state where you live and where your estate planning advisor practices, you may be losing out on significant benefits available in more "trust-friendly" states. For example, some states:

- Don't tax trust income,
- Authorize domestic asset protection trusts, which provide added protection against creditors' claims,
- Permit silent trusts, under which beneficiaries need not be notified of their interests,
- Allow perpetual trusts, enabling grantors to establish "dynasty" trusts that benefit many generations to come,
- Have directed trust statutes, which make it possible to appoint an advisor or committee to direct the trustee with regard to certain matters, or
- Offer greater flexibility to draft trust provisions that delineate the trustee's powers and duties.

To take advantage of these and other benefits, review your state's trust laws and trust-related tax laws and consider whether another state's laws would be more favorable.

It's also important to review both states' rules for determining a trust's "residence" for tax and other purposes. Typically, states make this determination based on factors such as the grantor's home state, the location of the trust's assets, the state where the trust is administered (that is, where the trustees reside or the trust's records are kept), or the states where the trust's beneficiaries reside. Keep in mind that some states tax income derived from in-state sources even if earned by an out-of-state trust.

To enjoy the advantages of a trust-friendly state, establish the trust in that state and take steps to ensure that your choice of residence is respected (such as naming a trustee in the state and keeping the trust's assets and records there). It may also be possible to move an existing trust from one state to another.

Weston Hurd LLP
Attorneys at Law

**Angela G. Carlin** is the Co-Chair of Weston Hurd's Estate, Trust and Probate Practice Group. She focuses her practice on estate, trust and probate administration and litigation, and tax matters. Angela is the author of the Merrick-Rippner Probate Law publication which is the recognized authority in Ohio on probate law. She received the Nettie Cronise Lutes Award from the Ohio State Bar Association in 1996 as the Outstanding Woman Lawyer and for many years, she has been named as an *Ohio Super Lawyer* by Thomson Reuters and a *Leading Lawyer* by Inside Business Magazine.

**Karen A. Davey** focuses her practice on estates, trust and probate administration. She also handles litigation in probate related matters, such as will contests, trust contests, and power-of-attorney disputes.

**Jerrold L. Goldstein** focuses his practice on estate planning, probate and corporate law. Jerry is also Co-Chair of Weston Hurd's Estate, Trust and Probate Practice Group. He represents clients in a wide variety of matters involving probate administration, probate litigation, estate and income tax compliance, wills and trusts, business formation, contract negotiations, and commercial real estate.

**Gary W. Johnson** advises clients on matters involving commercial litigation, business entities creation and maintenance, land use, construction law, zoning, estate planning and probate. Gary has been recognized as an *Ohio Super Lawyer* in the area of Business Litigation by Thomson Reuters.

**Eugene (Gene) A. Kratus** advises individuals in the areas of tax, business and estate planning and counsels privately-owned businesses and their owners on corporate, tax, mergers, acquisitions and business succession issues. His estate planning practice includes implementing various estate planning techniques, ranging from modest By-Pass Trusts to the implementation of sophisticated planning with family limited partnerships, family limited liability companies, charitable trusts and private foundations.

**Samuel J. Lauricia III** focuses his practice on tax planning, at both the Federal and state level, involving corporate, partnership, individual and gift tax issues, succession planning and general corporate transactions, contracts, mergers and acquisitions. Sam has been recognized as an *Ohio Rising Star* in the area of Taxation by Thomson Reuters.

**Shawn W. Maestle** is the Chair of Weston Hurd's Appellate section and a member of the firm's Litigation section. He focuses his practice in the areas of appellate, estate planning and probate litigation.

# Carlin Comments

## Inexperience Does Not Excuse Late Filing of a Tax Return or Payment of Taxes (Part 1)

By Angela G. Carlin

The U.S. Court of Appeals for the Sixth Circuit on September 22, 2016, in *Janice C. Specht and Jon Hoffheimer as Co-Fiduciaries of the Estate of Virginia L. Escher v. United States of America* No. 15-3095, CA-6, 2016 – USTC §60,695, upheld the decision of the U.S. District Court for the Southern District of Ohio, Western Division, Case No. 1:13-CV-705, in granting the motion for summary judgment in favor of the Internal Revenue Service by affirming that an estate fiduciary was liable for late filing and late payment of an estate tax return when the fiduciary unreasonably relied upon her attorney who committed malpractice in representing the estate.

Although in many instances the reliance of a fiduciary upon the estate attorney's professional advice may excuse the late filing of an estate tax return and late payment of estate tax, in this case the appellate court stated that the fiduciary's lack of experience or sophistication did not render her incapable of performing her fiduciary duties, when she was aware of the filing deadline and the late payment of tax penalties. The fiduciary's total reliance upon her unreliable attorney was the cause of the late filing, and not any circumstance beyond the fiduciary's control. The appellate court agreed with the district court that delegating a task by a fiduciary to the estate attorney does not constitute ordinary care and prudence, and although there was inadequate legal counsel and no evidence of purposeful delay, the duty to file the tax return and pay the tax is nondelegable. Further although the fiduciary's reliance may have been in good faith, good faith did not amount to reasonable cause to excuse the late filing of the return or the late payment of the estate tax after all of the notices and warnings received by the fiduciary such as in the instant case.

Plaintiffs Janice C. Specht ("Specht") and Jon Hoffheimer ("Hoffheimer") filed an action in U.S. District Court, Southern District of Ohio, Western Division, as co-fiduciaries of the Estate of Virginia Escher ("Decedent") to recover $1,198,261.38 in penalties and interest, which the Internal Revenue Service ("Defendant", "IRS") imposed on the estate for failure to timely file its estate tax return and to timely pay the estate tax due. The legal question was simple: whether such Plaintiffs' failures were due to reasonable cause and not willful neglect. The district court commented that the facts were both "complex and sad." The estate paid the penalties and interest under protest and sued the IRS to recover the monies paid. Finding that the estate showed neither reasonable cause nor absence of willful neglect to excuse late filing and late payment, the district court granted the IRS's motion for summary judgment, and later upon appeal by the co-fiduciaries, the U.S. Court of Appeals for the Sixth Circuit affirmed such district court decision.

Decedent died on December 30, 2008, 92 years of age, leaving an estate of $12,506,462, the bulk of which was in United Parcel Service ("UPS") stock. The Federal Estate Tax return was due September 30, 2009, but which return was filed on January 26, 2011. At filing the estate paid $3,909,951 in tax plus $210,601.74 in interest. The estate later paid an additional $1,189,261.38 in penalties for failure to file such return and pay estate taxes due until over 15 months after the deadline. Eight months before her death, decedent, accompanied by her cousin, co-plaintiff-appellant Specht, met attorney Mary Backsman ("Backsman") to execute decedent's Will. Backsman had over 50 years of experience in estate planning. During the meeting, Specht agreed to be the executor of decedent's estate and witnessed her cousin's Will. Specht was 73 years old at that time, had no formal education after high school graduation, had never served as an executor, and had never been in any attorney's office prior to serving as a witness on decedent's Will.

After decedent's death, Specht retained Backsman to represent the estate. Unbeknownst to Specht, Backsman suffered from brain cancer, and her competency was deteriorating. In January 2009, Backsman informed Specht that the estate tax was approximately $6,000,000, that the estate needed to sell UPS stock to pay the tax, which tax return and tax had to be filed and paid on September 30, 2009, and also suggested that her law firm pay the tax liability on the estate's behalf and seek reimbursement later. On February 9, 2009, Specht signed two probate court forms: The Application of Authority to Administer Estate (as executor) and the Fiduciary's Acceptance, delineating her duties as executor including filing all tax documents as required by law. Specht later testified that she did not understand the "fiduciary acceptance" form, did not know the meaning of "fiduciary," and never asked Backsman to explain the meaning thereof. However, based on her experience in filing her own income taxes, Specht was aware that there might be a consequence if the estate taxes were paid late.