Legal Matters®

Estate Planning
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New problem for some executors and heirs

Executors who have to file a federal estate tax return, and some heirs who receive assets from an estate that is subject to the federal estate tax, may be facing a significant new problem as a result of rules just issued by the IRS.

The problem only affects larger estates – generally those where the deceased person's assets, large lifetime gifts, and life insurance proceeds total more than $5.45 million. But for those estates, it's a serious issue.

The problem stems from a law passed by Congress last year. The law says that an executor who files an estate tax return must now also fill out a form – called Form 8971 – identifying all heirs to the IRS as well as the value of the assets to be distributed to them. Each heir must also be given a related form (called Schedule A) identifying the assets they will receive and their value.

If the estate is subject to the federal estate tax, then the heirs *must* use the value of the assets as stated on Form 8971 as their capital gains tax basis if they eventually sell them. There's a 20% penalty for claiming a different value.

(The idea was to prevent a perceived tax abuse where an executor claims a low value to save on estate taxes, and an heir later claims a higher value for the same asset to save on capital gains taxes.)

The IRS has just released proposed regulations explaining how all this will work in practice. And while the IRS's proposed rules clarify some things, they also highlight some serious issues.

For instance, Form 8971 must be filed fairly quickly after the deceased person's death, and an executor might not yet know exactly which estate assets will be given to which heirs, or which assets will be sold to fund a particular bequest. If that happens, then the executor must send the heirs a Schedule A that includes the value of *all* assets that could even conceivably be used or sold to fund their bequest.

So imagine that an estate is worth $7 million, and a distant relative or friend is going to receive an inheritance equal to 1% of the estate. That beneficiary might have to be given highly detailed and personal information about the entirety of the deceased person's financial affairs – something the deceased person almost certainly never expected to happen.

What's more, a relative or friend might look at the lengthy list of assets

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Charitable donations from your IRA could save taxes

Congress has revived a law that lets you make charitable donations directly from your IRA, which might provide you with some significant tax advantages.

The "IRA charitable rollover" was discontinued at the end of 2014. But Congress has now resurrected it, made it permanent, and also made it retroactive to the beginning of 2015.

Donating from an IRA is definitely to your advantage if you otherwise wouldn't be eligible for a charitable deduction

If you're over the age of 70½, you're required to take minimum distributions each year from your IRA, and you have to pay income tax on those distributions. But the "charitable rollover" law lets you transfer assets from your IRA to a charity, and whatever amount you transfer reduces the amount you're required to withdraw. So if you're required to withdraw $20,000 in 2016, but you instead donate $20,000 to charity, you don't have to withdraw any funds for yourself, and you don't have to pay any income tax.

You won't get a charitable deduction for the amount you donate in this way. However, donating directly from an IRA may be better than taking a distribution and then making a donation, because it results in a lower adjusted gross income – which can help you avoid taxes on Social Security benefits, reduce your Medicare premiums, limit the 3.8% surtax on investment income, and qualify for other deductions and credits.

In addition, donating from an IRA is definitely to your advantage if you otherwise wouldn't be eligible for a charitable deduction, either because you don't itemize your deductions or because you're subject to the charitable deduction "phase-out" for higher-income taxpayers.

To qualify, you must contact the plan custodian and have the custodian transfer the assets directly to the charity. If the custodian sends you the funds and then you give them to the charity, you'll have to pay income tax on the distribution.

You can donate up to $100,000 to charity each year from an IRA. A married couple can donate up to $100,000 each, as long as each spouse contributes from his or her separate account.

You can't contribute to a private foundation or a donor-advised fund, however. And the tax break applies only to IRAs, not to 401(k)s, 403(b)s, Keoughs, profit-sharing plans, Simple IRAs, SEPPs, etc.

While the tax break theoretically applies to Roth IRAs, there's much less of an advantage because Roth IRAs aren't subject to the minimum distribution rules.

Financial advisors have more responsibility to clients

Stockbrokers, financial planners and insurance agents who provide advice regarding IRAs and other retirement accounts will have new responsibilities toward clients, and the way they bill their clients may change, under new rules announced by the U.S. Labor Department.

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Under the rules, advisors must now act in their clients' best interests when they make recommendations. In the past, many advisors merely had to make recommendations that were "suitable" for a client, even if what they recommended wasn't the best possible option.

In addition, advisors must now disclose if they have a conflict of interest (for instance, if the advisor is being paid by a third party to recommend a particular investment), and must adopt procedures to limit such conflicts.

Advisors who receive commissions must have a signed contract regarding them, and all commissions must be reasonable, under the new rules.

The Labor Department estimates that the changes will save investors some $4 billion a year, because they will get better advice and buy fewer inappropriate high-commission products.

As a result of the new rules, it's expected that many advisors will stop charging commissions altogether, and instead will manage money in return for a flat annual fee or a percentage of the amount invested.

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New problem will affect some executors and heirs

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and assume that he or she is going to get a lot more than the actual bequest. This could leave an executor with a number of very angry and frustrated beneficiaries.

The Schedule A form itself doesn't help much. Here's what it tells the heirs: "You have received this schedule to inform you of the value of property you received from the estate of the decedent named above." A beneficiary could read this and easily assume that he or she is receiving *all* the property listed.

Nor does Schedule A clearly explain (in language a non-expert could understand) the fact that heirs face a big penalty if they sell an asset and claim a different basis.

For this reason, many executors are going to have to go to some lengths to tell beneficiaries what they need to know and keep them from getting false hopes.

Another big problem is that, under the IRS's proposed rules, if an heir later transfers an inherited asset to a family member (or even just a portion of an asset), the *heir* must then file a second Form 8971, and must send a Schedule A to the family member. Many heirs will be totally unaware of this requirement, and as a result many family members might have no clue what the required basis is and end up inadvertently owing a 20% tax penalty.

Here are some other important points in the IRS's proposed rules:

- Oddly, an executor who files an estate tax return has to file a Form 8971 even if no estate tax is owed, and therefore the heirs aren't legally required to use the value on the form as their basis. (This could happen, for instance, if there's a large marital or charitable deduction.)

- However, if an executor is filing a return solely to claim "portability" of the estate tax exemption (so a surviving spouse can later use his or her own exemption *plus* the spouse's exemption), a Form 8971 doesn't have to be filed.

- An executor who files a Form 8971 doesn't have to declare cash, assets in certain retirement accounts, or items of tangible personal property worth less than $3,000.

- If additional assets are discovered after an estate tax return is filed, their capital gains tax basis will be zero unless the estate files a supplemental return.

- If no estate tax return is filed, but one should have been filed, then *all* estate property will have a zero basis until a return is filed.

You should note that the IRS has only issued *proposed* regulations. Taxpayers can comment before they become final, and the IRS might tweak them later. But for now, though, we should assume the IRS means what it says.

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'Spendthrift trust' is divided in beneficiary's divorce

Even though a wealthy family put assets in a trust for their children in order to protect them from creditors, a child's interest in the trust could be divided in a divorce, says the Massachusetts Appeals Court.

While this result is unusual, it goes to show that even a solid spendthrift trust might not be perfect if a creditor – in this case, a spouse – is sympathetic enough.

Curt Pfannenstiehl was a beneficiary of a family trust worth some $25 million. He and his wife Diane had a son with dyslexia and ADD and a daughter with Down syndrome.

Curt worked for his family's business and earned $170,000 a year for a job that usually pays about $50,000. Diane had been an Army Reserve officer, but Curt's family pressured her to give up her job shortly before she completed the 20 years of service that would have earned her a military pension. Diane became the primary homemaker and took care of the children, whose needs were very demanding. About half the family's income came from trust distributions.

The distributions were controlled by Curt's brother and a lawyer for the family business. Once a divorce was filed, the trustees immediately stopped all distributions to Curt (but not to the other family members), and the family took what a judge called a very tough, "scorched earth" approach to fighting Diane financially in court. This was true even though Diane would have custody of the couple's daughter and a very limited ability to earn a living due to the daughter's special needs.

The Appeals Court (in a 3-2 vote) sympathized with Diane and said she should be entitled to a portion of the value of Curt's interest in the trust.

Again, this is an unusual result. Spendthrift trusts usually work well. But the case goes to show that even a good spendthrift trust might not be bulletproof in all cases, especially if the result could be perceived as unfair.

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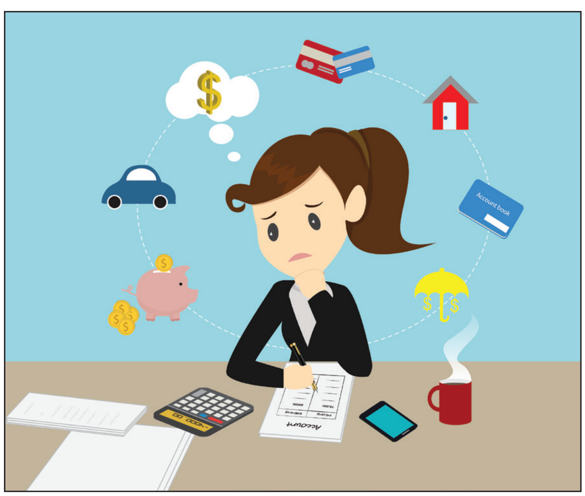
The advantages of making a list of assets and debts



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Have you ever considered writing down a list of all your assets (with account numbers, passwords, and so on), as well as debts and recurring payments?

Making such a list and putting it in a secure place can be a godsend if something ever happens to you and you become incapacitated, because your family will have a much easier time looking after your affairs.

In a recent article in the *Wall Street Journal,* a middle-class couple described the extraordinary difficulties they faced when the wife's parents developed medical problems and could no longer handle their own finances. The couple had no idea what assets the parents owned, what insurance they had, where to find records, what bills needed to be paid, and so on. Handling the parents' affairs became a nearly full-time investigative job.

As a result of the experience, the couple resolved to maintain such a list for their own children.

The problem has only gotten worse in recent years, because of the proliferation of electronic reporting. In the past, bills and account statements would arrive regularly by mail, but now, many people access everything online. As a result, a family might never have the comfort of knowing they've located all of a person's assets.

If you make such a list, a good plan is to update it at least once a year, maybe when you do your taxes. The list has other advantages – for instance, you can always go to one spot if you forget an account number or a password. Also, reviewing and updating the list regularly can help you see what changes or improvements might be needed in your own estate planning.