Wealth Management

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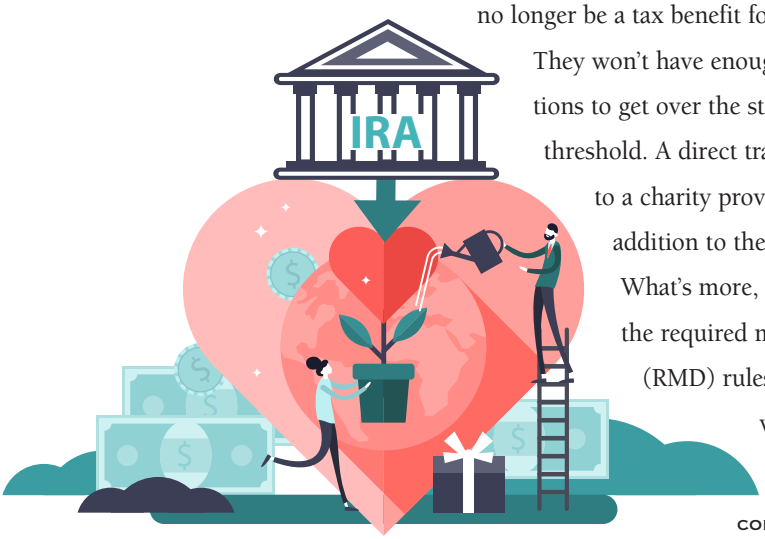
REGISTERED INVESTMENT ADVISOR

Philanthropy and Your IRA

Making a direct transfer from an IRA to a charity, long a valuable planning strategy, has become even more valuable following the enactment of 2017's Tax Cuts and Jobs Act. That's because the higher standard deduction coupled with the $10,000 cap on the deduction for state and local taxes effectively means that for many taxpayers there will no longer be a tax benefit for charitable giving. They won't have enough itemized deductions to get over the standard deduction threshold. A direct transfer from an IRA to a charity provides a tax benefit in addition to the standard deduction. What's more, the transfer satisfies the required minimum distribution (RMD) rules that apply to those who are over age 70½.



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Tax Planning

Notes on an "Ultra-Millionaire Tax"

Senator Elizabeth Warren (D-Mass.) has proposed a dramatic shift of emphasis for the federal government's focus in taxing "the rich." Rather than looking to income, she wants an annual wealth tax, which would apply in addition to any other federal taxes due. A wealth tax is justified, according to Warren, because the share of wealth held by the top 0.1% of Americans zoomed from 7% in the late 1970s to 20% by 2016. "Put another way, the richest 130,000 families in America now hold nearly as much wealth as the bottom 117 million families combined," according to her press release.

The exemption from the wealth tax would be $50 million. At family wealth levels above that cutoff, an annual tax of

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Spotlight on Trust Taxes

Nearly 30 years ago, Joseph Rice created a trust in New York for his three children. A New York trustee was appointed, and the trust was to be governed by New York law. The trustee was given complete discretion over distributions to the trust beneficiaries. At the time that the trust was created, no beneficiary lived in North Carolina. That changed in 1997, when a daughter, Kimberly Rice Kaestner, moved to North Carolina.

Soon after that relocation, the trust was divided into three subtrusts, one for each beneficiary and his or her descendants. The trust originally provided that it would terminate when Kaestner reached age 40, but in accordance with her wishes, the trustee rolled the assets over into a new trust.

North Carolina is one of three states that impose an income tax on the undistributed income of any trust that "is for the benefit of" one of its residents. This tax applies even if no distributions are made to in-state beneficiaries. For tax years 2005 through 2008, the state taxing authorities assessed income taxes of $1.3 million on the trust. During those years neither Kaestner nor her children received any trust distributions, nor did they have the legal right to demand

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Seven requirements

1. Only those over age 70½ are permitted to use this strategy. Watch for this tax trap in the year that a donor reaches the magic age. All IRA distributions made during the year that one turns 70½ count toward the RMD, but only those made after the half birthday may be rolled tax free to a charity.

2. IRAs only. Distributions from 401(k) plans, 403(b) plans, pension plans, or profit sharing plans are not eligible for charitable IRA rollover treatment. For those plans, the donor must first roll the assets into a new IRA.

3. Direct transfers only. The check from the IRA must be made out to the charity. A check made out to the IRA owner that is endorsed over to the charity will not work.

4. Public charities and private operating foundations must be the recipient. Ineligible recipients include private grant-making foundations (non-operating foundations), donor-advised funds, and supporting organizations.

5. The payment would have qualified for a full charitable deduction. In other words, no quid pro quo; the donor must receive nothing in return. The qualified charitable distribution cannot be used to purchase a charitable gift annuity, for example, or even to pay for tickets to a fundraising dinner.

6. Distributions are limited to $100,000 per year and must be otherwise fully taxable. Nondeductible IRA contributions are not taxable when distributed, and thus they are not eligible for treatment as qualified charitable distributions.

7. Documentation required. The charity must supply a contemporaneous written acknowledgement of the gift and certify that the donor did not receive any financial benefit from making the gift.

Failure to meet any requirement results in the entire distribution being taxable to the donor.

Benefits

The biggest winners in using the charitable IRA rollover are those seniors who are using the standard deduction. They would otherwise get no tax benefit from their charitable gifts.

Those who pay more tax as their adjusted gross income rises also are better off with this strategy. This includes people subject to the 3.8% tax on net investment income, those whose income is high enough to cause their Social Security benefits to be taxed, and those who are paying higher Medicare part B premiums because of their high income. Donors who live in states that do not allow a charitable income tax deduction generally will achieve a tax benefit from the direct transfer to charity, as their adjusted gross income for state tax purposes won't be increased. The 60% of AGI limit on the charitable deduction does not apply to the charitable IRA rollover.

Finally, the heirs will be winners as well. They will prefer to receive assets that receive a basis step-up to getting an IRA, which will be fully taxable as ordinary income. ■

2% would apply. A second 3% bracket would kick in at wealth levels above $1 billion (a "billionaire surtax"). The tax presumably would apply each year to unrealized capital gains. It would continue to apply during economic downturns, when family wealth is shrinking. Some 75,000 American households are projected to be snared by the tax, which would raise an estimated $2.75 trillion over ten years.

Any family that wanted to escape this annual tax bite by giving up American citizenship would be subject to a new 40% "exit tax" applied to its entire net worth.

Six American law professors from around the country have weighed in supporting the constitutionality of a wealth tax. The Tax Foundation, on the other hand, has criticized the proposal on administrative and economic grounds. Much family wealth is very difficult to value accurately on an ongoing basis. Interests in privately held businesses, real estate, art collections, and the like are much harder to value than publicly traded securities. Today wealthy individuals face the valuation puzzle only once, for paying death taxes. Having to do so every year would be a substantial burden (but a bonanza for tax lawyers and accountants). Wealth taxes have declined in popularity around the world due to their negative economic impacts—in 1990 12 OECD countries had wealth taxes; today only four do.

Congress is unlikely to act on Warren's proposal, but the idea could play a role in the Democratic Presidential primaries and in the 2020 elections. ■

Social Security 101

Although Social Security benefits aren't likely to make up a sizable part of your retirement income, your planning wouldn't be complete without getting a good grasp on how much you'll be receiving and, if you plan to work part-time after retirement, the impact of your earnings on your benefits.

What is your full retirement age?

For those born in 1954, who are turning 65 in 2019, the full retirement age is 66, so they must wait until next year to begin drawing full benefits. Those born in 1953 reach their full retirement age this year. Two months are added to normal retirement age each year, starting for those born in 1955. Those born in 1960 and later years have a full retirement age of 67.

Receiving benefits early

You can begin receiving Social Security benefits as early as age 62. If you do begin receiving benefits early, they will be reduced permanently, based upon the number of months that you receive checks before you reach full retirement age. For example, if your full retirement age is 66, and you retire at age 62, there is about a 25% reduction in your benefits.

In an actuarial sense, early retirement gives people about the same total Social Security benefits over their lifetimes as retirement at the normal age, but in smaller amounts so as to take into account the longer period during which you will receive them. In a personal sense, it all depends upon how long you live. It will take about 12 years of full benefits to recoup the deferred early benefits, so the breakeven age is about 78.

Starting benefits after normal retirement age

Social Security benefits are increased by a certain percentage if you choose to delay receiving them. These increases will be added in automatically from the time that you reach your full retirement age until you start taking your benefits, or until you reach age 70. The percentage varies depending on your year of birth, but is 8% per year for those born after 1943.

If you decide to delay your retirement, the Social Security Administration strongly urges you to sign up for Medicare at age 65.

Working while collecting benefits

You may continue to work and still receive retirement benefits. Your earnings in or after the month that you reach your full retirement age will not affect your Social Security benefits. However, your benefits will be reduced if your earnings exceed certain limits for the months in the calendar year before you reach normal retirement age.

Note that "earnings" is not the same as "income." It is limited to wages and remuneration received for services. It's a test of whether you are really retired. If you have $100,000 of investment income from dividends and interest ("unearned income"), that will not reduce your Social Security benefit at all.

Taxation of benefits

Under legislation enacted in 1983, the Social Security Trust Funds receive income based on federal income taxation of benefits. The funds receive taxes on up to 50% of benefits from single taxpayers with incomes over $25,000 and from taxpayers filing jointly with incomes over $32,000. "Income" in this context includes tax-exempt municipal bond income, but does not include Roth IRA distributions.

Legislation enacted in 1993 extended taxation of benefits. The legislation increased the limitation on the amount of benefits subject to taxation from 50% to 85% for single taxpayers with incomes over $34,000 and for taxpayers filing jointly with incomes over $44,000. For more information, visit www.ssa.gov. ■

"Retroactive filing"

Jim will be 67 in July, but he has not yet claimed his Social Security benefits. If he starts his benefits then, they will be 8% higher than they would have been at age 66, his full retirement age.

Jim has the option of starting his benefits up to six months earlier, in January of 2019, so-called "retroactive filing." In that case, he would get a lump sum check for the six months during which he did not collect any benefits.

Although some retirees may find this attractive, it is not "free money." It comes with a cost. Jim's benefits will be computed as of the January start date, and some of his credits for delayed retirement will be lost. The reduction is permanent.

Consult with your tax and investment advisors about all your alternatives before making any such important decisions.

distributions.

The trustees paid the tax and sued for a refund, arguing that the nexus between North Carolina and the trust was too tenuous to permit taxation, running afoul of the Due Process clause of the Fourteenth Amendment. The North Carolina Courts agreed, but the state took its case to the U.S. Supreme Court.

The Supremes speak

In a unanimous decision, the Court agreed with the taxpayer and the North Carolina Supreme Court. Justice Sotomayor outlined the two-step process for determining whether a trust has sufficient contact with a state to permit taxation within the parameters of the Due Process clause. There needs to be a definite link, "some minimum connection," between the state and the property it seeks to tax. Second, the income attributed to the State for tax purposes must be rationally related to "values connected with the taxing State."

In this case the trustee resided out of state. The administration of the trust was divided among two states, New York for the trust records and Massachusetts for the custody of the assets. The trustee made no investments in North Carolina during the relevant tax years.

Justice Sotomayor concluded: "When a tax is premised on the instate residence of a beneficiary, the Constitution requires that the resident have some degree of possession, control or enjoyment of the trust property or a right to receive that property before the State can tax the asset." In this case the trust was entirely discretionary, and the beneficiary had no ownership or right to demand the property. In such a circumstance, the demands of the Due Process clause are not satisfied, and state taxation of the trust is not permitted.

The majority decision was premised explicitly upon the narrow facts presented, specifically the fact that the North Carolina resident was a contingent beneficiary. A concurring opinion suggested that the decision should not be read so narrowly.

Effects

Estate planners have been anxiously awaiting the Court's decision in this case, and they will be relieved by the outcome. However, there remains some ambiguity about how much connection there needs to be to permit taxation of undistributed trust income.

Justice Sotomayor noted that a tax based upon the trustee's residence has passed constitutional muster, and the location of trust administration has similarly been held sufficient. The unanswered questions are, what if the beneficiary had the right to demand some or all of the trust income? What if the demand right extended to trust principal? ■

Collectors Corner

***"Cat Fancy"* by Edward Gorey (1925-2000). Cover illustration for *The New Yorker* issue of Dec. 10, 2018. Watercolor, graphite, and ink on paper.** This work is dated 1993 but was not published until 25 years later. Though lacking the overt macabre and surrealistic quality of many Gorey works, the tight cross-hatching and detailed textile patterns of the lavish bedding and the presence of Jack and Onyx, the illustrator's favorite pets, make this a quintessential Gorey artwork. It fetched $16,250 at a Swann's auction.

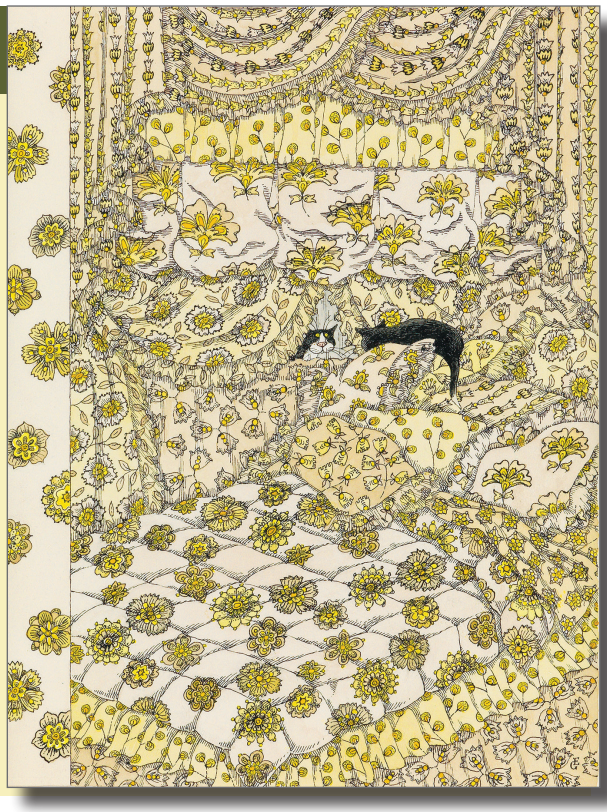

Image courtesy of Swann Galleries