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GIFTING FOR EDUCATIONAL AND MEDICAL EXPENSES

by Mary J. Peshel

Recently, a client consulted with me about ways he might assist his daughter to pay the college education expenses of her children, client's grandchildren. We discussed his current estate and concluded that estate tax would likely be due upon the death of the survivor of client and his wife. Thus, gifting could have the added benefit of reducing the taxable estate of client and his wife.

Client raised the possibility of paying the college costs from a generation skipping trust created by his mother. While the terms of the generation skipping trust allow funds to be distributed to his children and used for the benefit of his grandchildren, we determined this was not a tax-wise alternative. The assets of the generation skipping trust are not included in the taxable estate of client or his wife, and such assets will pass to client's children free of estate tax at his death. Therefore, it was best to retain assets in the generation skipping trust during client's lifetime and to find another alternative for paying the grandchildren's college expenses.

We discussed "annual exclusion" gifts, which are generally limited to $14,000 per donee per year. Client and wife can each make tax free gifts of $14,000 to their daughter (total of $28,000) and to her husband (another $28,000), or a total of $56,000 to daughter and her husband each year. Client and his wife can also make gifts totaling $56,000 annually to their married son and his wife. So by making annual gifts to their two children and their spouses, client and his wife can benefit their children and reduce their own estate by (2 x $56,000 or) $112,000 each year.

Annual exclusion gifts can also be made to the grandchildren. For younger donees, gifts can be made to accounts established under the California Uniform Gifts to Minors Act. Assets can be held in such account until the beneficiary reaches the age of 18 or 21 years, as determined by the donor. Such funds are managed by the custodian selected by the donor. Funds can be paid to the minor or used for the minor's benefit.

Another attractive option for paying college/educational expenses is a 529 Plan, though assets of such accounts can be used for college expenses only. An important advantage of a 529 Plan is that the assets contributed, plus the earnings, are free of Federal and California income taxes when used to pay for qualified higher education expenses. Such expenses include tuition, mandatory fees, books, supplies and certain room and board costs.

Generally gifts in excess of $14,000 per person per year are subject to gift tax. However, certain qualified payments for "education expenses" and/or "medical expenses" are excluded from gift tax.

We determined that a good alternative for client would be to use the "education expense" exclusion for his grandchildren's college expenses. He can make gifts of unlimited amounts on behalf of his grandchildren, but the payments must be made directly to the educational institution. Therefore, if a grandchild is attending the University of San Diego, and payments are made directly to the University of San Diego, such gifts are exempt from gift tax, no matter the amount of the gift.

Qualified education expenses include only tuition expenses paid directly to the educational institution. Payments for books, supplies, dormitory room and board fees are not direct tuition costs, thus, they do not qualify for the exclusion.

The education expenses exclusion is available in addition to the annual gift exclusion, so client can pay granddaughter's tuition directly to the school, plus he can make a tax free gift of up to $14,000 to granddaughter each year for her other expenses. The exemption is available whether the student is attending school full time or part time, and the donee of the gift need not be a relative of the donor.

Our discussion about the exclusion for education expenses led to a discussion of medical expenses, which are treated similarly. Client expressed a desire to help his brother with some large medical expenses. Qualified medical expenses must be paid directly to the medical service provider and include expenses incurred for the diagnosis, cure, mitigation, treatment and/or prevention of disease. Also included are expenses primarily for and essential to medical care. Payments for medical insurance can be covered. Alternative treatments such as acupuncture are included, as are some forms of cosmetic surgery, so long as the treatment has some medical function.

If you are considering making gifts for education, medical care or other purposes, keep in mind that many gifting alternatives are available.

APPLICATION OF ONE-PER-YEAR LIMIT ON IRA ROLLOVERS

by Bradford N. Dewan

The formational, operational and administrative aspects of an Individual Retirement Account ("IRA") are found in Section 408 of the Internal Revenue Code of 1986. Under the general rule, any distribution from an IRA to the IRA owner will be subject to income tax in the year received. However, Section 408(d)(3)(A)(i) generally provides that any amount distributed from an IRA will not be included in the gross income of the IRA owner to the extent the amount received is subsequently paid into an IRA for the benefit of that IRA owner no later than 60 days after the distribution was received. Section 408(d)(3)(B) provides that an individual is permitted to make only one rollover described in the preceding sentence in any one-year period.

Currently Proposed Regulations under Section 408[1] and IRS Publication 590, Individual Retirement Arrangements (IRAs), provide that this limitation is applied on an IRA-by-IRA basis. Publication 590 provides the following example:

[1] Prop. Reg. Sec. 1.408-4(b)(4)(ii)

> You have two traditional IRAs, IRA-1 and IRA-2. You make a tax-free rollover of distribution from IRA-1 into a new traditional IRA (IRA-3). You cannot, within 1 year of the distribution from IRA-1, make a tax-free rollover of any distribution from either IRA-1 or IRA-3 into another traditional IRA.
>
> However, the rollover from IRA-1 into IRA-3 does not prevent you from making a tax-free rollover from IRA-2 into any other traditional IRA. This is because you have not, within the last year, rolled over, tax free, any distribution from IRA-2 or made a tax-free rollover into IRA-2.

Thus, under the above scenario (and supposedly IRS guidance), a rollover from one IRA to another would not affect a rollover involving other IRAs of the same individual.

However, a recent Tax Court opinion, *Bobrow v. Comm'r*, T.C. Memo. 2014-21, held that the limitation applies on an aggregate basis. This means that an individual cannot make an IRA-to-IRA rollover if he or she had made such a rollover involving any of the individual's IRAs in the preceding 1-year period.

This Tax Court decision results in the following:

- The IRA owner must include in his or her gross income any previously untaxed amounts distributed from an IRA if that IRA owner had made another IRA-to-IRA rollover in the preceding 12 months; and
- The IRA owner may be subject to the 10% early withdrawal tax on the amount included in gross income.

Additionally, if the IRA owner pays these amounts withdrawn from one IRA into another (or even the same) IRA, they may be:

- Excess contributions; and
- Taxed at 6% per year as long as they remain in the IRA.

Soon after the publication of the *Bobrow* decision, the IRS published Announcement 2014-15 and stated its future intentions:

> The IRS anticipates that it will follow the interpretation of § 408(d)(3)(B) in <u>Bobrow</u> and, accordingly, intends to withdraw the proposed regulation and revise Publication 590 to the extent needed to follow that interpretation. These actions by the IRS will not affect the ability of an IRA owner to transfer funds from one IRA trustee directly to another, because such a transfer is not a rollover and, therefore, is not subject to the one-rollover-per-year limitation of § 408(d)(3)(B). See Rev. Rul. 78-406, 1978-2 C.B. 157.

In the announcement, the IRS noted that it had received several comments about the administrative challenges presented by the *Bobrow* interpretation of Section 408(d)(3)(B). The IRS expressed that it understood that the adoption of the Tax Court's interpretation of the statute will require IRA trustees and custodians to make changes in the processing of IRA rollovers and IRA disclosure documents, and that this will take time to implement. As a result of acknowledging these complications, the IRS stated that it will not apply the *Bobrow* interpretation of Section 408(d)(3)(B) to any rollover that involves an IRA distribution occurring before January 1, 2015. Moreover, despite the ultimate resolution of the *Bobrow* case, the IRS expects to withdraw the current Proposed Regulation and issue a new proposed regulation under Section 408 that will provide that the IRA rollover limitation applies on an aggregate basis. The IRS stressed, however, that the new regulation would in no event be effective before January 1, 2015.

<u>Conclusion</u>: When an IRA owner decides to move IRA funds from one IRA account to another, it is advisable to make a direct trustee-to-trustee transfer as described and authorized in Rev. Rul. 78-406, 1978-2 C.B. 157. IRA owners who have more than one IRA may make multiple direct trustee-to-trustee

transfers from the trustee/custodian of one IRA to the trustee/custodian of another IRA without falling within the one-rollover-per-year limitation. Transferring funds directly between trustees/custodians does not result in a “distribution” within the meaning of Section 408(d)(3)(A), and will not be considered to be “rollover contributions.”

FEDERAL TAX UPDATE

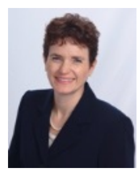
By DeEtte L. Loeffler

Refund Claims: The IRS may soon be keeping over $760 million in unclaimed federal tax refunds from taxpayers who failed to file for 2010. This problem is not a new one. In 2013, the IRS announced it had over $917 million in unclaimed refunds. Taxpayers may file refund claims up to three (3) years after the filing deadline. California residents make up the largest number of these non-filing taxpayers (86,500), followed by Texas (80,600), and New York (54,400). Refund claims must be filed by April 15, 2014 or the funds will be forfeited. Not all taxpayers who file will get a refund - the IRS can hold refunds if taxpayers have not filed 2011 or 2012 tax returns, or may apply the funds to outstanding tax debts owed by the taxpayer.

Proposed Legislation: The 2015 Federal Greenbook was released in February detailing changes to the tax law that the Obama Administration would like to see adopted in 2014. Most of the tax proposals in the Greenbook were also in the 2014 proposal, but a few new proposals were introduced. Adoption of significant changes to taxes affecting estates, trusts and gifts is not expected in 2014 because it is an election year. However, some proposals may still get adopted as members of Congress attempt to position themselves and their parties in the best light possible.

One 2015 proposal would greatly limit the usefulness of "Crummy" powers in trusts for the making of lifetime gifts by severely limiting the number of potential beneficiaries of such trusts and eliminating the use of the annual exemption from gift taxes for gifts make to irrevocable trusts.

Among proposals brought back for reconsideration, the 2015 Greenbook includes a plan to increase the minimum period for a Grantor Retained Annuity Trust (GRAT) from two (2) to ten (10) years, and require consistency for valuations used for gift and income tax purposes. Another proposal would significantly hamper the use of Intentionally Defective Grantor Trusts (IDGTs) for income tax planning by requiring inclusion of these assets in the grantor's estate at death and/or triggering a gift tax on termination of the grantor status. Finally, the President has again proposed reducing the estate and gift tax exemptions to 2009 levels ($3.5 million estate tax exemption; $1 million gift tax exemption).



STATE TAX UPDATE

By DeEtte L. Loeffler

Refund Claims: The State of California is preparing to keep over $107 million in unclaimed income tax refunds for 2009. The Franchise Tax Board estimates that over 979,000 taxpayers failed to file for refunds for 2009. California allows taxpayers to file a late return to claim a refund up to four (4) years after the filing deadline. Refund claims must be submitted no later than April 15, 2014. The FTB can hold refunds if taxpayers have not filed 2010, 2011 or 2012 tax returns, or may apply the funds to outstanding tax debt owed by the taxpayer.

Sales and Use Taxes Increase: While sales and use taxes are going up April 1st for other cities, San Diego will retain its 8.0% tax rate for 2014. Sales taxes generally apply to the sale of merchandise within California. Use taxes apply to merchandise purchased while inside California from a business located outside of California (for example when you make a purchase on the internet or from a catalog). Use taxes also apply when a business owner withdraws merchandise from inventory for personal use, or when a person buys a car, boat, mobile home or other item from someone who is not a licensed seller (i.e. when a person buys a used car directly from the previous owner). California requires residents to self-report and pay use taxes on internet purchases. For a complete listing of tax rates by city, go to the State Board of Equalization website by clicking here.

Fuel Taxes Decrease: The California State Board of Equalization has announced that state fuel taxes will decrease slightly on July 1, 2014. Gasoline taxes are being reduced from $0.395 to $0.36 per gallon. Diesel taxes will increase by one one-hundredth of a cent to $0.11 per gallon, but the Interstate User Diesel Fuel Tax (DI) will decrease from $0.453 per gallon to $0.447 per gallon.

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