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Business & Tax Solutions for the Entrepreneur

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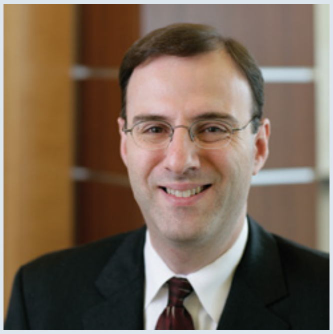

By Jay Benjamin, CPA, JD
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Understanding the Responsibilities and Risks of Serving as a Trustee of a Trust

Being asked to serve as a trustee of a trust may be flattering; however, many factors should be considered in deciding whether to serve as a trustee of a trust. Mistakes can be costly, and trustees can be held liable for breach of fiduciary duty.

The trustee is the legal owner of the trust assets, and the trust beneficiaries are the beneficial owners of the trust assets. The trustee has a fiduciary duty to act solely in the best interests of all beneficiaries (present and future) and in compliance with the terms of the trust document. It is important to read the trust document to see what it says about various issues, including trustee provisions, investments, notices that are required to be sent to beneficiaries and distributions.

Trustee Provisions
Among other issues, trustee provisions discuss who makes decisions if multiple trustees exist. For example, it could be that majority rules or, alternatively, the trustee may be able to act alone. Trustee provisions will also discuss procedures on how a trustee resigns. For example, on resignation, the trustee may need to file timely notices to other trustees and beneficiaries. Further, on resignation, the trustee might want to obtain a release and indemnification from liability from the other trustees, beneficiaries and even the grantor/settlor of the trust (i.e., the person who established the trust).

Investment Provisions
Trustees also need to be aware of investment responsibility. How should trust assets be invested? What limitations on investments, if any, does the trust provide? Is the trustee allowed to own closely held assets? Does the trustee have a duty to diversify? Generally, investments should be diversified, unless the trust specifically allows a concentration of certain assets (e.g., closely held family business interests).

Another point trustees should consider is the potential conflict between current and remainder beneficiaries. That is, current beneficiaries may want investments that generate income, while remainder beneficiaries may want investments that generate growth.

If trust investments go bad, beneficiaries may look to the trustee for liability.

Life Insurance Trusts
Often, trusts are designed to hold life insurance. These trusts typically have no income (and consequently, no tax return filing requirement) during the life of the insured-grantor. However, significant trustee concerns exist. One concern involves responsibility for monitoring the quality of the life insurance policy. The

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See "Serving as a Trustee of a Trust."

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Don't Bet Your Bottom Dollar

On Jan. 29, 2014, proposed regulations under Internal Revenue Code Section 752 were issued by the U.S. Treasury Department and the Internal Revenue Service, which would preclude partners of partnerships (and members of limited liability companies) from utilizing customary guarantees of partnership debt to bolster the tax basis of partnership interests[1]. If finalized in current form, the totality of these proposed changes would have far-reaching effects on the fundamental allocation methodologies for recourse and nonrecourse partnership liabilities. Without proper planning, owners of partnership interests with negative tax basis capital accounts could find themselves having to recognize significant gains due to the proposed changes. All owners of partnership interests should discuss the impact of the proposed regulations with their tax advisors.

Current Law

A partner's allowable losses are limited to the amount of their tax basis[2]. Importantly, §752 enables a partner's tax basis in his partnership interest to be increased by his allocable share of partnership liabilities (or decreased by a net reduction of allocable liabilities). A partner is allocated a partnership recourse liability to the extent they bear the "economic risk of loss" for such liability, as determined under a hypothetical "constructive liquidation" analysis[3]. Partnership nonrecourse liabilities are those for which no partner bears the "economic risk of loss" and are allocated according to a separate three-tier allocation methodology.

Under the hypothetical "constructive liquidation" analysis, it is assumed that the partnership liquidates with all partnership assets (including cash) having no value and all debts coming due. Under the perspective of this worst-case scenario, whether a partner's debt guarantee is top dollar (highest risk) or bottom dollar (lowest risk), identical recourse liability allocation is achieved.

Impact of Proposed Regulations

Authors of the proposed regulations articulated explicit concern that some partners have entered into payment obligations solely to obtain tax benefits, described as being "not commercial." This assertion provides that a partner guarantee will only convey recourse liability allocations if the following six factors are present:

1. The partner or related person must maintain a commercially reasonable net worth throughout the term of the payment obligation or be subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration.

2. The partner or related person is required periodically to provide commercially reasonable documentation regarding the partner's or related person's financial condition.

3. The term of the payment obligation does not end prior to the term of the partnership liability.

4. The payment obligation does not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor.

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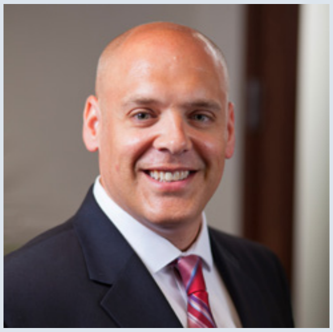
See "Bottom Dollar."*



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Preventing Identity Fraud

In February 2014, the Internal Revenue Service (IRS) ranked identity theft as #1 on its list of "Dirty Dozen" tax scams. From 2008 through May 2012, more than 550,000 taxpayers have been victims of Stolen Identity Refund Fraud (SIRF). The recently concluded tax season was no exception as the IRS saw a significant increase in the number of SIRF cases particularly among healthcare professionals.

SIRF is a type of identity theft that involves a person or organization obtaining an individual's name and social security number, then filing a fraudulent return using the victim's personal information. The hopes of the identity thief are that the IRS accepts the fraudulently filed return and deposits the refund in a bank account that the thief has opened in the taxpayer's name.

The fraud is typically discovered by the victim taxpayer in one of two ways:

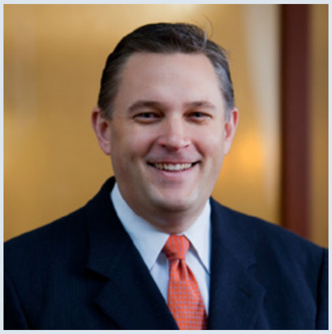
- When the fraudulent return is filed, the IRS identifies income or deduction items that do not match with what the IRS has on record. The IRS then issues a letter to the taxpayer stating that a tax return has been filed in the taxpayer's name and to please contact the IRS as they need additional information, or;
- When the taxpayer attempts to file his tax return and the return is rejected because a return has already been filed with their information.

What should one do if they become a victim of SIRF? Below are initial steps that should be taken, although this is not a comprehensive list:

- Contact the IRS. The IRS will flag the taxpayer's account as an identity theft and stop processing the fraudulently filed tax return. Additionally, an IRS Form 10439, Identity Theft Affidavit, needs to be completed and filed with the tax return.
- Contact the Federal Trade Commission's Identity Theft Clearing House.
- Contact one of the three major credit agencies: Equifax, Experian or TransUnion. Once one has been contacted, they must notify the other two agencies.
- Contact the Social Security Administration.
- Contact a local law enforcement office.

The IRS has more than 3,000 employees working directly on cases regarding identity fraud and has trained another 35,000 to work with taxpayers who have fallen victim to identity fraud. The sheer number of resources that the IRS is allocating shows it is likely impossible to completely eradicate SIRF. While this is the case, here are a few basic tips the IRS offers for protection:

- Do not carry a social security card in a purse or wallet;
- Do not give a social security number to a business just because they ask for it— ask why they need it;
- Do not give personal information over the phone, mail or Internet without having been the one to initiate the contact;
- Secure personal information at home; and
- Check credit reports at least every 12 months. ■



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Cost Reduction Strategies: What About Utilities?

In today's challenging economic times, all businesses and organizations are looking for opportunities to reduce costs. As companies review expenditures, they should not overlook their utilities expense.

There are two ways to reduce the utilities expense: 1) Reduce consumption or 2) reduce rates. Ideally an organization is able to do both, thus helping reduce their expense to the lowest possible amount while still meeting the needs of their business.

To put it simply, rate reduction is reducing the price per unit for electricity, gas or water. The opportunity to reduce the unit price is impacted by utility regulation. Electric and natural gas utilities are regulated by federal, state and local agencies. This regulation impacts free competition as the determinate of prices. In Indiana, only natural gas is deregulated. In the neighboring states of Illinois, Ohio and Michigan, both gas and electricity are deregulated. Deregulation presents a host of opportunities for a company to reduce and avoid costs for utilities. The opportunities for cost reduction in regulated utilities exists, and should not be overlooked, but is limited by free competition.

To reduce costs, companies should consult an advisor who will:

- Determine whether all services are obtained at the lowest possible cost;
- Audit billing for tariff compliance and usage abnormalities;
- Identify all meters and make sure they are functioning and being read properly; and
- Research and analyze alternative rates and tariffs, interpretations and applications.

Reducing consumption is another component to the overall cost reduction strategy on utilities. Almost every business can reduce consumption through a wide variety of initiatives. Many of these initiatives can be achieved at no cost or low cost to the business. Often, simple steps will deliver excellent results—by raising staff awareness and implementing low cost technology with a quick payback.

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See "Utilities."

Serving as a Trustee of a Trust

(Continued from page 2)

trustee will be responsible unless the trust provides otherwise. For instance, if the policy performs poorly and premiums skyrocket or the policy face value decreases dramatically, beneficiaries might sue the trustee for breach of fiduciary duty.

Another concern involves the payment of premiums. Who is responsible for paying the premiums? The grantor? The trustee? What does the trust document say about this? Unless it says otherwise, the trustee is responsible. What if a premium payment is missed and the insured is no longer insurable such that a replacement policy is not possible to obtain? Again, the trustee may be liable.

Withdrawal Notices

Many times, trusts provide that the trustee should send out withdrawal notices (or "Crummey" notices) to beneficiaries. This allows gifts made to the trust to qualify for the $14,000 gift tax annual exclusion for the grantor. Trusts often provide that when the grantor makes a gift to the trust, the trustee is supposed to send out a letter to the beneficiary telling the beneficiary that a gift has been made to the trust and that the beneficiary has a certain amount of time to request withdrawal of the gift amount. However, what if the trustee does not send out the letter? What if the Internal Revenue Service says the gift does not qualify for the annual exclusion? The trustee should understand what the trust provisions say about these notices and the timing of notices, in order to be in compliance with the trust document and to avoid liability.

Dispositive Provisions

What does the trust say about distributions? What are the criteria for distributions? Trusts might require distributions be made at a certain time in a certain amount. Trusts might give trustees discretion on when and how much to distribute. Sometimes trusts provide a standard that trustees must follow. For example, the trust might say that the trustee can make a distribution for the beneficiary's health, education, maintenance or support. What if the trustee makes a distribution to a beneficiary that violates this provision and the beneficiary squanders the money? Ironically, the beneficiary might sue the trustee asserting that the trustee never should have made the distribution. Trustees should consider getting a release and indemnification for distributions made and trustees should be sure to comply with the dispositive provisions of the trust.

Some trusts require "income" to be distributed to a beneficiary each year. How is trust accounting income calculated? Trust "accounting" income is not necessarily trust "taxable" income. Interest (including tax exempt interest), dividends and rents are trust accounting income. Capital gain income is not trust accounting income – it is principal. Corporate/partnership LLC distributions typically are trust accounting income. The K-1 items, however, are not usually regarded as trust accounting income. Trust expenses are generally allocated one-half to income and one-half to principal. Thus, it is important that trustees calculate net trust accounting income correctly where the trust specifically calls for distributions of such income. Otherwise, beneficiaries can be overpaid or underpaid and lawsuits can result.

Tax Returns

If a trust is required to file a tax return, it is the trustee who is responsible. Some trusts are not required to file a tax return (e.g., trusts with no income such as a life insurance trust and trusts that are "grantor" trusts for federal income tax purposes).

Conclusion

It is very important that trustees know what their responsibilities and risks are before agreeing to serve. Trustees should consider numerous factors in order to avoid liability. ■

Bottom Dollar

(Continued from page 3)

5. The partner or related person received arm's length consideration for assuming the payment obligation.

6. In the case of a guarantee or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation, if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

Undermining bottom guarantees (and vertical slice guarantees), the sixth factor's effect is to require exclusive, top-dollar risk if a payment obligation is to be respected.

The proposed regulations also expand the net value requirement under §1.752-2(k) to every partner other than an individual or decedent's estate (currently applicable only to disregarded entities). A partner's obligation in which all six factors are present is allowable only to the extent of the partner's net value, exclusive of any value attributable to the associated partnership. Additional guidance would need to clarify the types of documentation that would sufficiently establish a partner's net value and the frequency at which the second factor must be administered.

Nonrecourse Liabilities

The proposed regulations would additionally provide new rules for allocation of nonrecourse liabilities, the detail of which is outside the scope of this article. In summary, the allowable allocation methods with respect to excess nonrecourse liabilities would be revised to eliminate the "significant item method" and the "alternative method," while instead providing a significant conceptual change with the offering of a new allocation method driven by "liquidation value percentages."

Proposed Applicability for Changes to Recourse Liability Treatment

The proposed regulations call for prospective application and include a seven-year transition period grandfathering the current treatment of recourse liabilities to the extent of a partner's negative capital account, with certain adjustments, on the date the proposed regulations are finalized. During the transition period, partners would have the flexibility to modify existing arrangements or establish new guarantees while still falling under the purview of the grandfathered laws. Importantly, partnership, S-corporation or disregarded entity partners would lose applicability of the transition period if they experience, directly or indirectly, a 50 percent or greater ownership change. ■

[1] REG-119305-11, 79 Fed. Reg. 4826 (1/30/14)
[2] I.R.C. §704(d)
[3] Reg. §1.752-2(b)

Utilities

(Continued from page 5)

To reduce consumption, companies should consult an advisor who will:

- Explore load shifting and peak shaving;
- Evaluate the impact of lighting changes; and
- Implement building automation systems and variable frequency drives.

Reducing the utilities expense requires a comprehensive plan. The professionals at KSM Profit Advisors have the experience and know-how to identify and maximize every opportunity to reduce a company's utilities expense. Developing and implementing a comprehensive plan will help reduce costs and increase profits, all while making the workplace more environmentally conscious. ■

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Congratulations to the following staff members who were recently promoted:
Director — Ben Lyon, Aimee Reavling, Beth Scott

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Congratulations to the following staff members who recently passed all parts of the CPA Exam:
Tad Chew, Ben Crim, Zack McAdams, Allison Stearley, Justin Stephens, Jenna Vaal

For more information about Katz, Sapper & Miller, please visit ksmcpa.com.

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Congratulations to the following staff members who passed an exam:
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