

The Advisor



May 2011

ESTATE PLANNER'S TIP

Many married couples automatically elect distributions from qualified retirement plans as a joint and survivor annuity. After all, that's what the tax laws require unless the spouse affirmatively waives the survivorship benefits [Code §401(a)(11)]. And for many couples it seems logical to keep the same income level for the survivor, particularly if one spouse does not have retirement plan benefits of his or her own. But it may not be the most financially beneficial way to receive distributions. One way to assure that the survivor has sufficient income without opting for the lower joint and survivor annuity payouts is through life insurance. Couples should consider the difference between joint versus single-life benefits, the insurability of the spouse with the retirement plan, the ages and health of both spouses, how much insurance would be necessary to "replace" the retirement income at the first spouse's death, and the cost of a life insurance policy in comparison to the additional annual income available from the retirement plan. The surviving spouse may be able to elect an annuity payment option with the life insurance and maintain the same income following the first spouse's death.

HOUSE OUT OF ESTATE, RENT DUE

In April 2000, Sylvia Riese transferred her home to a three-year qualified personal residence trust to benefit her two daughters. She filed a gift tax return reporting the gift. The parties agreed that, at the end of the trust, she would begin paying rent if she chose to remain in the home.

In early 2003, just prior to the trust termination, one of Riese's daughters contacted the drafting attorney about how to establish the fair market rental value. He told her that it could be done by the end of the year and wrote a note to remind himself to check around Thanksgiving that this

had been done. Riese died in October, before any rent had been determined or paid. She had continued living in the home between the trust termination and her death, paying property taxes, insurance and maintenance costs.

When the estate tax return was filed, the value of the home was not included, but the estate did claim a deduction under Code §2053 for a debt of \$46,298 for \$7,500 per month rent between the trust termination and Riese's death. The IRS said the estate should include the \$6,138,000 value of the home, as a transfer with a retained life estate

under Code §2036, and denied the deduction for the rent. The estate argued there was no understanding that Riese would remain in the home without paying rent. The trustees intended to enforce the rent requirement, but were unable to do so due to Riese's untimely death.

The Tax Court agreed with the estate that there was an agreement to pay rent which simply hadn't been determined yet. The IRS has no regulations regarding how and when rent should be paid on the termination of a QPRT, but by the end of the calendar year in which the trust expires was reasonable under the circumstances, the court found. The fact that the parties had an express agreement regarding the payment of rent, the QPRT was established and gift tax paid on the transfer, and the attorney was contacted regarding the amount of rent, led the court to find that Riese was not intending to retain an interest for life without paying rent. The estate correctly excluded the value of the home and was entitled to a deduction for the rent due prior to Riese's death (*Estate of Riese v. IRS*, T.C. Memo. 2011-60).

DEDUCTION ALLOWED FOR AMOUNTS PASSING VIA WILL SETTLEMENT

Antonio Palumbo's earlier wills had named his charitable trust to receive the residue of his estate, but due to a scrivener's error, the will in effect at his death contained no residuary clause. His son

claimed that, as the intestate heir, he was entitled to the residue. The son and the trustee of the trust reached a settlement giving the son \$5.6 million and real property. The trust received \$11.7 million.

The IRS disallowed the charitable deduction claimed by Palumbo's estate, arguing that the amount passing to the trust came from the son, not from the decedent, as required by Reg. §20.2055-1(a). The IRS said that because the trust had no legally enforceable right to the residue under state (Pennsylvania) law, there was no bona fide dispute between the trust and Palumbo's son.

The U.S. District Court (W.D. PA) noted that while the court generally looks only to the "four corners" of a document to ascertain a decedent's intent, it can inquire into the circumstances at the time of the execution of a will if there is an ambiguity. Under Pennsylvania law, a person executing a will is presumed to want to dispose of the entire estate and have no portion pass by intestacy. Therefore, a will should be construed to avoid intestacy, said the court, adding that it is the duty of the court to determine the testator's intent.

All of Palumbo's prior wills provided for the residue to pass to the trust, the drafting attorney admitted to a scrivener's error and the parties entered into arm's-length negotiations. There was no collusion or evidence that Palumbo intended to disinherit the trust, said the court, which granted the trust's motion for summary judgment (*Estate of Palumbo v. U.S.*, 2011-1 USTC ¶60,616).

TRUST AMENDMENTS, TAKEN TOGETHER, EXPRESS TESTATOR'S INTENT

Helen Goza amended her 1991 trust in March 1999, providing for a portion to be set aside for her son for life at her death. The rest was to be held in a perpetual trust for charities. At the son's death, \$5,000 was to pass to a named charity, but the trust made no provision for the distribution of the remaining assets. When the drafting attorney discovered this error, he prepared another amendment, which Goza signed in April 1999. This amendment provided that at the son's death, the balance was to pass to the perpetual trust. In the

PHILANTHROPY PUZZLER

Melvin was charged with and convicted of barratry (fomenting groundless judicial proceedings). He was sentenced to six month's probation and ordered to pay \$50,000 to a victim's relief fund established by the county court system. In reviewing his tax situation for the year, he asked whether he could claim the fine as a charitable contribution deduction on his income taxes. How do you respond?

1991 trust, a portion was to pass to a niece and nephew at the son's death, but they were not named in the 1999 amendments.

Goza died in 2001, followed by her son in 2007. The niece and nephew then sued, claiming the residue should pass to them under intestacy rules. They argued that the April amendment referenced the 1991 trust, not the March 1999 amendment. Since the 1991 trust became a nullity when amended in March, the April amendment's purpose was to "achieve an impossibility, rendering it an invalid contract," they said.

The trial court found that the April 1999 amendment provided for a complete disposition of the trust assets following the son's death. The Court of Appeals of Tennessee agreed with the trial court that to ignore Goza's intent, rather than integrating the April amendment into the March amendment, "would be completely inapposite" to what Goza intended. The appeals court upheld the trial court's declaratory judgment (*Morrow and Wright v. Suntrust Bank*, No. W2010-01547-COA-R3-CV).

ONCE IT'S GIVEN, IT'S GONE

Ray Styles established a donor advised fund with Friends of Fiji (FOF), a public charity at the time of the gift. He claimed an income tax charitable deduction. Following the transfer, FOF failed to fund any of the gifts that Styles recommended.

Styles filed suit, claiming that FOF had breached the donor advised fund agreement and the covenants of good faith and fair dealing by failing to create a specified charitable fund and for failing to maintain its public charity status. The trial court ruled that Styles failed to prove that FOF breached any agreement and that he suffered any damages as a result of any breach. The court did, however, find that FOF had breached the covenant of good faith and fair dealing.

The Supreme Court of Nevada agreed, saying that Styles was not entitled to a return of his donation. In accordance with the donor advised fund agreement, he relinquished any interest in the money when he made an unrestricted gift to

FOF. The court said that while damages may be awarded for a breach of the implied covenant of good faith and fair dealing, Styles suffered no damages because he no longer had any interest or control over the funds and had already claimed a charitable deduction for the gift (*Styles v. Friends of Fiji*, No. 51642).

NO DEDUCTION FOR FUNNY BUSINESS

Roulette Smith claimed an office expense deduction in 2003 for a \$125 donation to a charity dinner event. The invitation from the charity indicated that the fair market value of the dinner was \$125. He also purchased five books at the dinner, for which he claimed a business expense deduction of \$100. Smith said the purchase of the books "acts as a contribution" from his business to the charity.

The Tax Court ruled that Smith's business was not entitled to a charitable deduction because he received goods and services in exchange for and in an amount equal to his payments. The court said a charitable contribution is "a transfer of money or property without adequate consideration" (*Smith v. Comm'r.*, T.C. Summ. Op. 2010-142).

PUZZLER SOLUTION

A contribution to a victim's relief fund operated by the county would generally be considered a gift to the state or a political subdivision for exclusively public purposes and therefore be deductible [Code §170(c)(1)]. However, a gift is generally defined as a voluntary transfer of property by the owner to another without consideration [*Osborne v. Comm'r.*, 57 TC 239] and does not include payments proceeding primarily from a legal duty or moral obligation [*Comm'r v. Duberstein*, 363 U.S. 278]. The lack of donative intent on Melvin's part would disqualify the payment as a charitable contribution.

PART-GIFT/PART-SALE OFFERS BENEFITS FOR BOTH PARTIES

Larry owns five acres of vacant land on the edge of a college campus. The college would like to obtain the property to build new classrooms, but lacks cash to pay the \$900,000 fair market value. Larry is receptive to the idea of making a gift to the school (two of his children are alums), but doesn't feel he can part with the entire \$900,000. He bought the land a number of years ago for \$150,000. College officials encourage Larry to consider a bargain sale.

In a bargain sale, charity agrees to pay an amount less than the fair market value. The donor receives cash and a charitable deduction for the gift portion – the difference between the sale price and the fair market value. But donors also may have to report some capital gain.

Suppose Larry agrees to sell the property for \$500,000. It's clear that his charitable deduction will be \$400,000. But now he must determine his gain on the sale portion of the deal. To do that, he allocates his basis between the gift and sale portions. His basis in the sale portion is:

$$\frac{\$500,000 \text{ (sales price)}}{\$900,000 \text{ (fair market value)}} \times \$150,000 \text{ (basis)}$$

or \$83,333.33. That makes his capital gain \$416,666.67 (\$500,000 - \$83,333.33) [Reg. §1.1011-2(b)]. Assuming Larry pays capital gains tax at a 15% rate, he will owe \$62,500. However, his \$400,000 charitable deduction will save him income tax of \$112,000, assuming a 28% tax

bracket, so he is "ahead" by the \$500,000 cash proceeds and \$49,500 in tax savings.

Charity won't always have the ready cash to buy the asset in a bargain sale, however. In some instances, an installment bargain sale will work to the advantage of one or both parties. For example, the college might not be able to pay Larry \$500,000 all at once, and Larry might not wish to recognize all the income in one year.

Instead, the college agrees to pay Larry the \$500,000 over a 20-year period, with 4% interest. This makes Larry's annual income about \$36,359. He is entitled to a charitable deduction in the year of the sale for the \$400,000 gift portion of the bargain sale, subject to the 30%-of-AGI deduction limits of Code §170(b)(1)(C)(i). Any excess deduction may be carried over for up to five more years [Code §170(b)(1)(B)].

Larry's \$416,666.67 capital gain will be spread over the 20 years of the installment sale. He will recognize \$20,833 each year and pay tax of \$3,125 (15% bracket).

The bargain sale – either an outright sale or in installments – can be advantageous to both the donor and charity and need not be limited to property that charity intends to use.

Note: Bargain sales of property other than marketable securities require qualified appraisals if the gift value exceeds \$5,000.

BALL STATE UNIVERSITY FOUNDATION
P.O. Box 672, Muncie, IN 47308
(765) 285-8312 • (765) 285-7060 FAX
Toll Free (888) 235-0058
www.bsu.edu/bsufoundation

David W. Bahlmann, J.D.
President/CEO

Philip M. Purcell, J.D.
Vice President for Planned Giving
and Endowment Stewardship