

The Advisor



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ESTATE PLANNER'S TIP

Income taxes may soon be on the minds of many clients, but they should also be aware of the need to file a gift tax return by April 15 for taxable gifts made in 2010. It's important that a discussion of gifts be included as part of the income tax return preparation process, particularly in light of the statute of limitation on gift valuation. The IRS is not permitted to revalue a gift in determining adjusted taxable gifts for estate tax purposes if the statute of limitations has expired [Code §2001(f)]. Gift valuation can't be challenged after a "final determination" of value has been made. A determination is final where (1) the value is shown on a return and is not contested by the IRS before the statute of limitations (generally three years) expires, (2) the value is determined by the IRS and not challenged by the taxpayer or (3) the value is determined by a court or pursuant to a settlement agreement between the taxpayer and IRS [Code §2001(f)(2)]. Even clients who believe their gifts fall within the \$13,000 annual exclusion may wish to file a gift tax return, if the asset is hard-to-value, in order to trigger the statute of limitation period.

MARITAL DEDUCTION SURVIVES DISPUTE

Earl and Margaret entered into a marital agreement prior to their wedding. Sometime after they were wed, Earl amended a revocable trust that he created prior to marrying Margaret. When Earl died, Margaret and Natalie, Earl's daughter from a previous marriage, discovered conflicting provisions between the trust and the marital agreement.

The trust provided for certain outright distributions to Margaret and the creation of a QTIP trust for her benefit, with the balance of the assets passing to Natalie. The trust also provided that certain real property was to pass to the QTIP, while the marital agreement called for Margaret to receive the real property outright. The trust

gave Margaret greater financial benefits than provided for in the marital agreement. Natalie was originally the beneficiary of Earl's IRA, but the account was transferred to another bank and no new beneficiary designation was made. Under the bank agreement, the IRA passes to the owner's surviving spouse.

Attorneys for Margaret and Natalie drafted a settlement agreement under which Margaret received Earl's IRA and certain property, including the real property, free of trust. Natalie received the remaining assets, also free of trust. Estate taxes are charged against Natalie's share. The executor of Earl's estate made an election to qualify the value of assets passing to Margaret for

the marital deduction (Code §2056). The court approved the settlement agreement, subject to the IRS ruling favorably on the availability of the marital deduction.

Reg. §20.2056(c)-2(d)(2) provides that property assigned to a surviving spouse as the result of a controversy over the decedent's will is considered to have passed from the decedent if pursuant to a "bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate." The IRS noted that Margaret and Natalie had legally enforceable rights and were both represented by attorneys. The settlement agreement was the product of arm's-length negotiations and the allocation "is within a range of reasonable settlements." Therefore, ruled the IRS, property passing to Margaret under the settlement qualifies for the marital deduction (Ltr. Rul. 201046004).

INTEREST ON \$1.1 MILLION DEDUCTIBLE

Harvey bought a \$1.5 million home in 2009. He paid \$300,000 and financed the balance by borrowing \$1.2 million secured through a loan on the property. He asked the IRS whether he could deduct interest on \$1.1 million of indebtedness.

Qualified residence interest is not considered personal interest [Code §163(h)(2)(D)] and is

deductible. Under Code §163(h)(3)(B)(ii), interest on acquisition indebtedness (incurred in acquiring, constructing or substantially improving a qualified residence) of up to \$1 million is deductible. Under Code §163(h)(3)(C)(i), interest on home equity indebtedness up to \$100,000 is also deductible.

The IRS ruled that Harvey could deduct interest on up to \$1.1 million of indebtedness, treating some as acquisition indebtedness and some as a home equity loan. Interest on the remaining \$100,000 is considered nondeductible personal under Code §163(h) (Rev. Rul. 2010-25).

2011 TAX NUMBERS - INSTALLMENT 1

The IRS has issued a partial list of tax numbers, adjusted for inflation, for 2011 (Rev. Proc. 2010-40). Cost of living adjustments for some items were too low to result in increases. Tax brackets and some changes are awaiting Congressional action.

	2010	2011
Kiddie tax	\$1,900	\$1,900
Nanny tax	\$1,700	\$1,700
Annual gift tax exclusion	\$13,000	\$13,000
Annual gift tax exclusion for non-citizen spouse	\$134,000	\$136,000
Special use valuation for real property devoted to farming or closely held business use	\$1,000,000	\$1,020,000
401(k) contribution limit	\$16,500	\$16,500
401(k) catch-up contribution limit	\$5,500	\$5,500
Savings bond interest total phase out		
single taxpayers	\$85,100	\$86,100
joint taxpayers	\$135,100	\$136,650

PHILANTHROPY PUZZLER

Maureen's will left \$3 million to fund a charitable lead annuity trust. The trust is to distribute the \$120,000 annual payout (4% of the \$3 million placed in the trust) among several named charities. The trust will continue for 30 years, after which time the assets will be distributed to Maureen's grandchildren. Maureen's executor has asked whether the trust is valid since it doesn't meet the 5% minimum payout requirement and maximum 20-year term that applies to charitable *remainder* trusts.

DEDUCTION JUST A PILE OF ASHES

Theodore Rolfs and Julia Gallagher owned a three-acre lake front lot in Wisconsin. They obtained prices for demolishing the nearly century-old home on the property in order to build a new home. When the couple learned it would cost between \$10,000 and \$15,000 to demolish the home and remove the debris, they instead entered into discussions with the local fire department. The parties eventually agreed that the home, but not the lot, would be transferred – a constructive severance under state law – to the fire department. Under the conditions of the conveyance, the home could be used only for fire and police training and the demolition would have to take place within a short time of the transfer.

The couple claimed a charitable deduction of \$76,000, based on an appraisal of the home. The IRS disallowed the deduction, relying on appraisers who valued the home as if it were to be moved from the lot. The appraisers determined that due to the obstacles to moving the house and the cost of land in the immediate area, the home had little or no value.

The IRS said that in view of the negligible value of the home and the quid pro quo received by the couple – demolition of the home – they were not entitled to a charitable deduction. The value of the home did not exceed the value of what they received, the IRS argued. In the alternative, the IRS said that no deduction was allowed because the transfer was a gift of a partial interest [Code §170(f)(3)(A)]. The couple countered that the “incidental benefit” received in return did not outweigh the value of what they gave.

The Tax Court said the couple saved at least \$10,000 on demolition and found the conditions placed on the transfer of the home made it “virtually worthless.” The court added that the couple expected a substantial benefit in exchange for their gift of the house. Because the value of what they gave did not exceed the value of the quid pro quo, they were not entitled to a charitable deduction, concluded the court (*Rolfs and Gallagher v. Comm’r.*, 135 T.C. No. 24).

PAY UP, COURT TELLS DONOR

The Paul and Irene Bogoni Foundation asked the court to rule that a pledge made to St. Bonaventure University to build a library was subject to conditions and restrictions that were not in the written agreement. The court granted the University’s motion for summary judgment, saying that parol evidence may not be used to supply conditions to a contract. The Foundation was also denied its request for an accounting, with the court noting that the pledged gift did not create a fiduciary relationship between the parties giving rise to such a right.

The Supreme Court of the State of New York agreed, adding that the University was entitled to summary judgment on its counterclaim for \$900,000 in outstanding pledge amounts. The pledge was made in an “unambiguous gift commitment agreement” upon which the University relied in securing additional pledges and undertaking the construction project, noted the court. Under state law, “charitable pledges are enforceable because they constitute an offer of a unilateral contract that – when accepted by the charity by incurring liability in reliance thereon – becomes a binding obligation” (*The Bogoni Foundation v. St. Bonaventure University*, 2010 NY Slip Op 08801).

PUZZLER SOLUTION

Unlike charitable remainder trusts, charitable *lead* trusts are not required to pay a 5% minimum to the charitable income beneficiaries. Likewise, the 20-year maximum length for a term-of-years remainder trust does not apply to lead trusts, so neither of these factors will cause Maureen’s trust to be disqualified [Reg. §1.170A-6(c)]. However, in the case of an inter vivos reversionary lead trust designed to generate an income tax deduction for the grantor, the deduction might fail if the trust term is so long that the reversionary interest falls below 5%.

THE LOWDOWN ON §7520 RATES

The December 2010 §7520 rate of 1.8% was the lowest since floating midterm rates were introduced to value split-interest gifts in March 1989. (As of press time, the rate for January 2011 had not been released by the IRS.) The record-low rates create a number of problems and opportunities:

■ Even using the lowest payout rate allowed – 5% [Code §664(d)(1)(A)] – a one-life charitable remainder annuity trust could not be established for a beneficiary under age 73, assuming quarterly payments and the use of the 1.8% §7520 rate, under the IRS 5% probability test [Rev. Rul. 77-374]. For a two-life annuity trust, the beneficiaries would have to be at least 75 each.

■ For a one-life 5% charitable remainder unitrust, the beneficiary could be as young as 27 and still meet the required 10% minimum charitable remainder value [Code §§664(d)(1)(D), (d)(2)(D)]. For a two-life trust, the beneficiaries would both need to be at least 39 years old.

■ Using the 1.8% §7520 rate, the annuitant of a one-life charitable gift annuity would have to be at least 60 years old before the value of charity's interest would exceed 10% [Code §514(c)(5)], assuming quarterly payments and the use of suggested gift annuity rates of the American Council on Gift Annuities. For a two-life gift annuity, both annuitants would need to be at least age 67 to generate a 10% charitable deduction.

■ Under Code §7520(a), donors can elect to use either the rate for the month of the transfer or either of the two prior months, whichever is most favorable. The donor must inform the IRS when filing a tax return if the rate for a prior month is being used. If §7520 rates head back up, it's possible that donors will never need to use the December rate. However, if rates continue to drop, donors will have to use extra caution in

determining whether split-interest gifts are qualified.

■ Clients whose estate plans include testamentary charitable remainder trusts should revisit those documents in light of the low §7520 rates. If there is a possibility that the trusts might not qualify, contingency language can be added to reform the trusts to provide for lower payout rates, if possible. Clients could also choose to make direct distributions to charity and family members as an alternative if the trusts would not qualify, or could opt for term-of-years trusts (lasting not more than 20 years).

■ The low rates greatly benefit donors funding charitable lead annuity trusts and making gifts of homes or farms with retained life interests. It's possible to "zero out" the transfer taxes with a charitable lead trust at a much lower payout rate (unlike remainder trusts, charitable lead trusts do not have a minimum payout) or with a shorter term.

■ Clients with existing charitable remainder trusts might consider terminating the trusts early and allowing charity to receive the remainder now. The combination of the charitable deduction when the trust was created and the second deduction when the trust is terminated could exceed the amount originally contributed to the trust. For example, Joe, age 75, used \$100,000 to fund a 5% charitable remainder annuity trust in August 2006. His deduction, at age 70, assuming quarterly payments and the use of a 6.2% §7520 rate, was \$57,131. If he now makes a gift of his income interest in the trust to the remainder charity, he will be entitled to a second deduction of \$48,722, using the 1.8% §7520 rate. Joe receives deductions totaling nearly \$109,000. In addition, he has received annuity payments of \$5,000 annually since the trust was funded.

BALL STATE UNIVERSITY FOUNDATION

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