

The Advisor



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ESTATE PLANNER'S TIP

An irrevocable life insurance trust with *Crummey* withdrawal powers can be a tax-wise means of passing substantial assets to family members. Properly structured, there is little or no gift or estate tax to the insured/grantor and no income tax to the eventual trust beneficiaries. But if grandchildren are included in the class of beneficiaries, there may be generation-skipping transfer tax consequences. Generally, an outright gift of cash or property to a grandchild that qualifies for the \$13,000 annual exclusion [Code §2503(b)] is not subject to the GST. However, where the transfer is in trust, the exclusion from GST is available only if, during the skip person's life, none of the corpus or income from the trust can be distributed to or for the benefit of any other individual and if the assets of the trust will be included in the skip person's estate if he or she dies before the trust terminates. Many irrevocable life insurance trusts are structured with multiple beneficiaries. Although the transfers may be gift-tax free, thanks to the annual exclusion, they may be subject to GST. Payment of the tax can be avoided by allocating a portion of the transferor's GST exemption [Code §2631(a)] to the transfers.

DISCLAIMER NOT VALID UNDER OLD LAW

Franklin Tatum Jr., who died in 2003, was the only surviving son of Franklin Tatum Sr., who died in 1987. Under Senior's will, 60% of the residue of the estate passed to Junior. But should Junior predecease him, his descendants were to take per stirpes, according to the will. Junior executed a document in 1987, disclaiming any interest in stock in the estate. The probate court ruled that the disclaimed stock was to pass to Junior's four children, as though he had predeceased Senior.

In 2008, the IRS issued a noticed of deficiency to Junior's estate, saying the estate had failed to pay gift taxes. The IRS claimed that the estate failed to show that the residue of Senior's estate

passed without direction from Junior to someone other than himself when he disclaimed his interest. The U.S. District Court (SD Miss.) noted that the issue was whether Senior intended the direction in his will regarding a beneficiary who predeceased him to allow for a gift over only in the event of a literal death of a beneficiary, or any event that has the legal effect of considering a beneficiary to have predeceased the testator.

The Mississippi Supreme Court had not reviewed the issue when Junior executed the disclaimer in 1987. The court noted that current state law favors the estate's position, but Mississippi did not adopt the Uniform Disclaimer of Property Interest Act until 1994. Since Junior

disclaimed his interest and Senior's will did not provide for an alternative disposition in that circumstance, the disclaimed stock passed intestate to Junior. The disclaimer Junior executed did not disclaim any intestate interest and therefore was not qualified under Code §2518, ruled the court (*Estate of Franklin Tatum Jr. v. U.S.*, 2010-2 USTC ¶60,607).

DEJA VU ALL OVER AGAIN

For the second year in a row, there will be no boost to the Social Security wage base – and no cost-of-living increase to Social Security benefits. Workers and their employers will pay into the Social Security system until wages reach \$106,800. There is no earnings limit on payments to the Medicare portion.

Retirees under age 66 can earn up to \$14,160 in 2011 – the same as in 2010 – without loss of Social Security benefits. Above \$14,160, recipients lose \$1 in benefits for every \$2 of earnings. There is no cutback in Social Security benefits for retirees age 66 or older who continue working.

Because the Consumer Price Index has not risen, both the maximum earnings subject to the Social Security tax and the benefits received by retirees have remained stagnant since a 5.8% cost-of-living adjustment in 2009.

PHILANTHROPY PUZZLER

Helen and Joe contributed their vacation home to their favorite charity early this year. The charity sold the home to an unrelated third party shortly after the gift for \$150,000. The couple plan to claim a charitable deduction on their 2010 tax return for the \$150,000 selling price. A representative from the charity told them they would need a qualified appraisal, completed no later than the due date of their tax return. Helen and Joe have asked if an appraisal is really necessary or whether the sale price establishes fair market value.

NO PENALTIES FOR UNWINDING TRUST THAT NEVER QUALIFIED

Ward and June used appreciated stock to fund a charitable remainder annuity trust that was to pay them a 7% annuity for their joint lives. The state's franchise tax board asked for a computation of the present value of the charitable remainder. The parties then discovered that the remainder interest had a negative value. With the approval of the state's attorney general, the parties propose to rescind the trust, ab initio. The assets will be returned to Ward and June, who will file amended returns for the intervening years.

The IRS noted that no charitable deduction is allowed for the fair market value of a charitable contribution of a remainder interest in property that is less than the donor's entire interest unless it is a charitable remainder annuity trust [Code §664(d)(1)], a charitable remainder unitrust [Code §664(d)(2)] or a pooled income fund [Code §642(c)(5)]. The trust created by Ward and June did not satisfy the requirements of Code §664(d)(1)(D) since it did not have a remainder interest equal to at least 10% of the value of the property placed in trust. Because the trust never met the requirements of Code §170(f)(2), the couple was not entitled to a charitable deduction. The return of the assets will not constitute self dealing under Code §4941, is not a taxable expenditure under Code §4945 and will not subject the trust to a tax on termination of a private foundation under Code §507 (Ltr. Rul. 201040021).

TRUST SUBJECT TO UBIT ON MARGIN STOCK

The U.S. Court of Appeals (Fed. Cir.) affirmed that a tax-exempt trust was subject to the unrelated business income tax on the sale of securities purchased on margin. The Henry E. and Nancy Horton Bartels Trust for the Benefit of Cornell University is a tax-exempt trust. In 1999 and 2000, the trustee used money borrowed from the trust's broker to purchase stock. The trust reported the income from the subsequent sale of the shares as capital gains. After an IRS audit, the trust paid more than \$88,000 in tax for the two years. The Court of Federal Claims agreed with the IRS that the sale of margin-financed securities constituted UBTI and the

trust was not entitled to a refund.

Unrelated business taxable income is generally defined as gross income derived from “any unrelated trade or business” [Code §512(a)(1)]. The trust argued that the UBIT rules do not apply because investing in securities is not a “trade or business” and it is contrary to Congressional intent.

The court said that it doesn’t matter whether the sale of securities purchased on margin falls within the Code §513 definition of an “unrelated trade or business,” since Code §§512(b)(4) and 514 explicitly classify income from debt-financed property as income from an unrelated trade or business.

As to Congressional intent, the court agreed with the trust that the primary objective in adopting UBIT was to eliminate unfair competition by putting the unrelated business activities of exempt organizations on the same basis as nonexempt businesses. However, the court said, the plain language of the statute provides that debt-financed property is gross income derived from an unrelated trade or business (*Bartels Trust for the Benefit of Cornell University v. U.S.*, 2010-2 USTC ¶150,602).

FUTURE USE OF CONTRIBUTIONS NOT RESTRICTED

Loretto High School undertook a capital campaign in 1999, seeking to expand the school campus to accommodate a growing enrollment. By 2007, enrollment was declining and the school faced financial difficulties. The Institute of the Blessed Virgin Mary (IBVM), which operated the school, announced that it would close in early 2009. It entered into a contract to sell the school to a company that operates charter schools. IBVM proposed to use the sale proceeds to repay its loans and set aside funds for retired members of the order.

The Bishop of Sacramento and several individuals who had contributed to the capital campaign sought to halt the sale, arguing that the sales proceeds should be used for the education of high school age women attending Catholic high schools in the Sacramento area. They claimed that any other use of the funds was an improper

diversion of donor restricted contributions. The trial court denied the group’s motion for a preliminary injunction.

Under state law, assets of a religious corporation are impressed with a trust if “the donor expressly imposed a trust, in writing, at the time of the gift or donation.” The Court of Appeals of California said that any language imposing a trust “cannot be ambiguous.” Had the Bishop and the donors intended their gifts to the capital campaign to be restricted beyond the initial application, they could have created a trust for their gift, said the court. IBVM is not guilty of improper diversion, since contributions were used, as represented, for construction at the school (*Anderson v. Loretto High School*, C062514).

IRS OKAY WITH REFORMATION

The IRS ruled that an ab initio judicial reformation of a charitable remainder unitrust would not cause the trust’s disqualification under Code §664 or be self-dealing under Code §4941.

The trust, established with the assistance of an attorney and an accountant, was drafted as a one-life, rather than a two-life unitrust the donors intended. The donors will have to file any necessary income or gift tax return consistent with a two-life trust, added the IRS (Ltr. Rul. 201042012).

PUZZLER SOLUTION

Reg. §1.170A-13(c)(2) requires that donors claiming a charitable deduction for non-cash gifts in excess of \$5,000 must obtain a qualified appraisal, attach the completed appraisal summary to the tax return on which the contribution deduction is first claimed and maintain records of the information. The only exception is for gifts of marketable securities. The failure to obtain the appraisal will cause disallowance of a charitable deduction, even if the deduction claimed accurately reflects the fair market value [*Hewitt v. Comm’r.*, 109 T.C. 12].

YEAR-END CHARITABLE GIFT PLANNING

The end of the year is approaching and with it the last chance for clients to do any 2010 tax planning. This is the time to review tax situations and try to guess what will happen to taxes in 2011.

Should donors try to maximize charitable deductions for 2010? Or would contributions save more taxes in 2011? Income tax rates are scheduled to go up in 2011, following “sunset” of the Bush tax cuts – which would encourage deferring gifts into 2011. But great support exists in Congress to maintain the current, lower tax rates...at least for people in the middle and lower tax brackets.

Unless Congress changes the law, January 1 will usher in cutbacks in certain itemized deductions for high-income individuals (President Obama proposes a \$200,000 threshold for single taxpayers, \$250,000 for joint returns). Under the so-called “Pease” limitation enacted in 2001 (Code §68), up to 80% of affected deductions, including those for charitable contributions, could be lost after 2010.

President Obama has also proposed capping tax savings on certain itemized deductions (including contributions) at 28% for taxpayers in the 36% or 39.6% tax brackets. In effect, if a client had a 2011 charitable deduction of \$1,000, instead of deducting against the full 39.6% rate, he or she would save taxes at only 28¢ on the dollar. Contributions in 2010 are free of any cutbacks, and may have favorable tax results unique to 2010, such as reducing the cost of Roth IRA conversions

Only about 30% of taxpayers itemize, due to the size of the standard deduction (\$11,400 for married couples filing jointly, \$8,400 for heads of households, \$5,700 for single taxpayers and \$5,700 for married persons filing separately). The type of gift clients make can influence the deduction available.

An outright gift by December 31 entitles the donor to a charitable deduction for the full value in 2010. If the gift is cash or publicly traded stock,

there is little problem in determining the exact amount of the deduction. The value to the donor will depend upon the tax bracket. For instance, a \$5,000 cash gift from a donor in the 28% bracket is worth \$1,400 in savings. To a donor in the 33% bracket, that same contribution is worth \$1,650 in taxes saved.

A gift of property may require additional paperwork. For all single-item gifts worth more than \$500, up to \$5,000, Form 8283, Part A, must be completed. This includes a description of the donated property, the donee’s identity, the donor’s cost basis and the fair market value of the property. A qualified appraisal must accompany all contributions of single items worth more than \$5,000 (\$10,000 for closely held stock). No appraisal is needed for gift of publicly traded securities.

There are some other points to remember when planning year-end charitable gifts:

- For most gifts, clients may deduct up to 50% of adjusted gross income. Any excess is carried over for up to five years. The deduct limit is 30%-of-AGI for gifts of long-term capital gain property, also with a five-year carryover.

- Donors must substantiate gifts. They should have a receipt from the donee organization for all gifts of \$250 or more or financial records for smaller gifts for all gifts of \$250 or more or financial records for smaller gifts. [Code §§170(f)(8)(A) and (B)].

- Don’t forget out-of-pocket expenses incurred in work for charity. The value of services can’t be claimed as a deduction, but clients can include the cost of transportation (at 14 cents per mile), parking, tolls and postage.

- Donors who get to the last few days of the year and want to make a contribution can just charge it. Most charitable organizations accept credit card contribution. And even though donors won’t receive or pay the bill until 2011, the gift is deductible in 2010.

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