The Advisor

BALL STATE UNIVERSITY FOUNDATION
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ESTATE PLANNER'S TIP

Professionals and business owners might benefit from owning the buildings in which their practices or companies are located in their own names, rather than through the business. Personal ownership may protect the building from the creditors of the business and also provide tax and estate planning opportunities. For example, the income received on leasing the building to the company is not subject to employment taxes, and the client can claim depreciation deductions on his or her personal return to offset the rental income. The business can deduct the rental payments. The building can be contributed to a family limited partnership, allowing the client to pass interests to the children at reduced transfer tax costs by taking advantage of various valuation discounts. The client retains control over the building, and if the client sells the business, possibly at retirement, he or she can retain the building and augment retirement income with the rent received from the new owner of the business or other tenants.

NO INTEREST DEDUCTION FOR "CASH-RICH" ESTATE

Henry Stick's estate tax return showed estate tax of slightly more than $1 million following his death in 2004. Among the administrative expenses claimed by the estate was $656,250 of interest paid on a loan from the Stick Foundation. The Henry Stick Trust, residual beneficiary of Stick's estate, had borrowed $1.5 million at 5.25% interest from the Foundation to pay the estate's federal and state estate tax liability.

Stick's estate reported illiquid assets of $1,088,844 and other investments of $1,953,617. The IRS disallowed the interest expense and determined a $371,728 deficiency.

Code §2053(a)(2) allows a deduction for administrative expenses to the extent allowable by the state in which the estate is administered. The IRS said that the estate was not entitled to an interest deduction under Code §2053 because it had sufficient liquid assets to pay the estate tax liability, funeral costs and administrative expenses without borrowing. Stick's estate did not present evidence concerning the amount of its state estate tax liability or a computation of its federal estate tax liability without the interest expense deduction. Lacking such evidence, said the Tax Court, the estate did not demonstrate the necessity of borrowing or that the IRS's determination was in error.

The court found that Stick's estate had sufficient liquid assets to meet its obligations. Without the interest expense, the federal estate tax liability was

$1,367,861 and the state tax was $193,198, for a total tax liability of $1,723,799. Because the estate's liquid assets exceeded that amount by about $230,000, there was no need to borrow and the estate was therefore not entitled to an interest deduction under Code §2053 (*Est. of Stick v. U.S.*, T.C. Memo. 2010-192).

IRS GETS HALF AN ENTIRETIES

Joseph Hersperger acknowledged that he owed the IRS more than $126,000 for his failure to withhold and pay over the taxes withheld from his employees' wages. But Hersperger and his wife objected to the IRS's request that the couple's house be sold to pay the liability. The tax liability would be paid from Hersperger's 50% share of the proceeds. The couple claimed that since the property was held as tenants by the entireties, the wife's interest was actually greater than 50% under the laws of the Commonwealth of Pennsylvania relating to the equitable distribution of marital property in the event of a divorce.

In 2002, the U.S. Supreme Court ruled that a tax lien could attach to a tenant's interest in entireties property [*U.S. v. Craft*, 535 U.S. 274]. The U.S. District Court (W.D. PA) said that there was no basis for preventing the IRS from attaching a lien to the home and applying Hersperger's 50% interest in the sale proceeds to his tax liability. This is true even though his wife may have been awarded a greater than 50% interest in the marital residence as part of an equitable distribution in the event of a future divorce (*U.S. v. Hersperger*, 2010-2 USTC ¶50,615).

PHILANTHROPY PUZZLER

Eugene made a significant cash gift to his favorite charity in 2004. He claimed the maximum charitable deduction that year (50% of adjusted gross income), but was unable to deduct the entire amount due to the deduction limits of Code §170(b)(1)(A). He took charitable deductions for the excess in 2005, 2006 and 2007. In 2008 and 2009, Eugene did not itemize, instead taking the standard deduction. He expects his itemized deductions for 2010 to exceed the standard deduction of $5,700 for single filers this year and has asked if he can use the remaining carryover from his 2004 gift when he files his 2010 return.

BEQUEST VALID WHILE DEBT REMAINS

Willard and Flora Turner made several lifetime contributions to help fund the construction of a health care center at the retirement community where they lived. They also included a bequest in their living trust, leaving 40% of the residue to the health care center replacement fund. If the fund was not in existence at their deaths, the bequest was to pass to other individual beneficiaries.

Construction on the health care center was completed in 2001, paid partially by proceeds from the sale of bonds. Willard died in 1999, but Flora lived in the center from its opening until her death in 2005.

The separate account set up to hold contributions for construction of the center was closed in 2001, although a dedicated account was established within the foundation's general account. The Turners' accountant, who was also the trustee and one of the beneficiaries of their living trust, asked the foundation whether the replacement fund still existed. She was told that the account was still on the ledger to receive donations and deferred gifts from charitable remainder trusts. Not convinced that the replacement fund was active, she asked the court how trust funds were to be distributed.

The trial court found that the Turners' intent had been to contribute to the building of the health care center. Once the building was complete, the purpose of the trust gift was satisfied and the residue of the trust should be distributed to the individual beneficiaries.

The Court of Appeals of California reversed. Contractors had been paid for the work, but paying for construction of the center included paying off the debt incurred to build the facility. The sale of bonds shifted the cost into the future, to be paid out of anticipated donations, bequests and distributions from charitable remainder trusts and charitable gift annuities. It was no less a cost of construction than the payment of other expenses associated with building the center, said the court. To the extent the Turners' gift does not exceed the outstanding debt, the bequest did not lapse and funds are to be paid to the foundation (*Banks v. Pacific Homes Foundation*, E047364).

SCALED-BACK PROGRAM ENTITLED TO BEQUEST

Five charities each received 20% of the residue of Gloria Berry's trust. One share passed to Hearing Dogs for the Deaf, operated by the San Francisco Society for the Prevention of Cruelty to Animals (SPCA), which also received a share of the trust. The trust provided that in the event one of the named organizations was not in existence and had no successor, the share was to be distributed among the remaining charities.

At the time of Berry's death, the SPCA operated a comprehensive hearing dogs program, with a staff that selected, trained and placed dogs. Several months later, the program was scaled back. The SPCA continued to provide support to graduates of its program and provide in-home training to help the dogs retain their skills. Several former employees of the SPCA's program established a new organization – The Hearing Dog Program (HDP) – which offered the comprehensive program previously available from the SPCA.

The trustee of Berry's trust determined that the SPCA was entitled to the 20% share, noting that the program "continues to operate." HDP filed suit, arguing that it should receive the 20% share on the grounds that it was the successor organization to the SPCA program, or under the cy pres doctrine, as the program that most closely resembles Berry's intent.

The probate court ruled that HDP was not the successor and that the cy pres doctrine didn't apply since the SPCA program was still operating. HDP appealed the ruling to the Court of Appeals of California., which found that the plain language of Berry's trust put no minimum standards on the SPCA program. There is nothing in her trust that dealt with the situation where dogs were no longer trained or placed. The cy pres doctrine does not apply, added the court, because the trust already had an alternative disposition in the event one of the named charities no longer existed (*The Hearing Dog Program v. San Francisco Society for the Prevention of Cruelty to Animals*, A126247).

INCORPORATION NOT REQUIRED FOR BEQUEST

The executor of Gwendolyn Wilder's estate asked the probate court how to dispose of her home, which had been left to "the Boston Chapter of Hadassah." The national Hadassah has chapters worldwide, but the Boston chapter is not separately incorporated. The residue of Wilder's estate was left to a cousin.

The executor determined that the Boston chapter was not a legal entity and was therefore unable to take title to the real estate. The probate court judge found that because Wilder's bequest was specific and there was no Boston Chapter of Hadassah, the bequest failed and the home passed under the residuary clause.

The Appeals Court of Massachusetts ruled that the bequest did not fail. The Boston Chapter is an unincorporated association. Under state law, bequests to unincorporated charitable associations are valid and enforceable. "If appointment of a trustee is necessary in order to allow the chapter to take title to the property, the court has authority to appoint an appropriate trustee" (*Pritchard v. Attorney General*, No. 09-P-1221).

PUZZLER SOLUTION

Clients should consider their future tax situation when making gifts involving carryovers. Under Code §170(b)(1)(B), Eugene can claim excess deductions in each of the five years succeeding the year of the gift. But the five-year period does not refer only to years in which the donor itemizes. Excess deductions not claimed within the five years following the gift are lost.

TIMELY YEAR-END REMINDER: SUBSTANTIATE

Close is not good enough when it comes to substantiating charitable gifts. There are several requirements to keep in mind, along with recent cases that underscore the importance of following the rules.

Cash gifts

For gifts under $250, the donor must have a bank record or written communication from the charity with the organization's name, date of gift and amount. Multiple gifts of less than $250 are not aggregated to get above that threshold, but each gift must be properly substantiated.

The Tax Court recently denied a $920 charitable deduction for a donor who said he contributed $20 in cash each week at his church. He provided the court with a computer printout listing the date, amount and recipient of the donations, but did not have a receipt or any documentary evidence of the weekly offerings (*Fessey v. Comm'r.*, T.C. Memo. 2010-191).

The Tax Court also limited a taxpayer's deduction for church offerings to the amount acknowledged by the IRS, noting that the self-prepared "tax receipts" presented by the taxpayer were not signed by anyone purporting to act of behalf of the church. While he may have made deductible charitable gifts, he did not satisfy the burden of proof, said the court (*Saunders v. Comm'r.*, T.C. Summ. Op. 2010-138).

For gifts of $250 or more, the donor must have a written receipt from the charity with the organization's name, date of gift and amount. The acknowledgment must include a statement that no goods or services were received in return for the transfer, or, if the donor received a return benefit, a description of the goods or services, along with a good faith estimate of the value [Code §§170(f)(8)(A) and (B)].

Non-cash gifts

Appraisals are generally required for all non-cash gifts of a single item or a group of similar items in excess of $5,000, with the exception of publicly traded securities or closely held stock up to $10,000. Form 8283 must be completed, at least in part, even if no appraisal is required, for deductions in excess of $500.

Code §170(f)(11)(E) sets forth the requirements for a qualified appraisal. The appraisal must be received by the donor before the due date of the return (including extensions) on which the deduction is claimed. It must be signed and dated and have an effective date no earlier than 60 days prior to the date of the gift.

The U.S. District Court (S.D. Ohio) denied a deduction for a couple who contributed a house that they intended to demolish to a local fire department to burn down. The court agreed with the IRS that the appraiser failed to include her qualifications (background, experience, education, professional memberships) or indicate that the appraisal was done for income tax purposes. The court also found that the agreement between the donors and the fire department did not contain the information needed for a contemporaneous written acknowledgment [Code §170(f)(8)(A)] (*Hendrix v. U.S.*, 2010-2 USTC ¶50,541).

The Tax Court ruled that a couple was not entitled to a charitable deduction for a contribution of a conservation easement because the appraisal was insufficient. It lacked information regarding the date of the contribution, the date of the appraisal or the appraised market value of the easement on the date of the contribution (*Lord v. Comm'r.*, T.C. Memo. 2010-196).

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