

The Advisor



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ESTATE PLANNER'S TIP

Clients for whom a revocable living trust is appropriate may find that having the trust drafted is the easy part. Far too often, grantors neglect to transfer ownership of assets to the trust or later acquire new assets in their own names rather than in the name of the trust. Periodic estate plan updates should include a review of the ownership of various assets. For example, if real estate is held in trust, insurance on the home – homeowner's insurance, title insurance and umbrella policies – should also be held in the trustee's name. Life insurance available from an employer should be made payable to the trust, and any personal policies the client owns should be transferred to the trustee. Successor trustees can then borrow against any cash value in the event of the grantor's disability. Ownership of business interests (partnerships, S corporations, closely held companies) should be transferred to the trustee, provided such a change will not trigger buy-sell agreements. One asset that may not be suitable for transfer to a living trust: retirement plan benefits. Special payout rules apply to benefits payable to trusts, and tax-deferral opportunities may be lost.

CRIME REALLY DOESN'T PAY FOR BENEFICIARY

Mike was the sole designated beneficiary on two IRAs owned by Karen. Sandra is Karen's stepdaughter and a beneficiary of her estate. Mike was charged in Karen's 1998 murder. Under state law, a person who feloniously and intentionally kills a decedent is deemed to have predeceased the murder victim and is not entitled to benefit under an IRA.

During the ten years that it took for Mike to be convicted of Karen's murder and exhaust his appeals, no distributions were made from the IRAs. Sandra's petition to determine her interest in the IRAs was put on hold by the court, and the

IRA custodian was ordered not to make any distributions. In 2008, the court finally ordered the executor to distribute the IRAs to Sandra.

The IRS ruled that although Mike is not entitled to receive any interest in the IRAs, as of September 30 of the year following Karen's death, he had not predeceased Karen, had not disclaimed his interest in the IRAs and had not been found guilty of murder. He was, therefore, the designated beneficiary [Reg. §1.201(a)(9)-4], and minimum distributions would be determined using his life expectancy.

Funds in the IRAs should have been distributed

to Sandra. Generally, a 50% penalty applies if less than the required minimum distribution is made [Code §4974(a)]. The IRS ruled that the failure to receive the distributions was due to circumstances beyond Sandra's control and the 50% tax should be waived (Ltr. Rul. 201008049).

DOMESTIC PARTNERS SHARE INCOME TOO

Joel and Aaron registered as domestic partners in California under the state's Domestic Partner Rights and Responsibilities Act. Since 2007, the state treats the earned income of registered domestic partners as community property for both property law and state income tax purposes. The state also gives domestic partners the right to enter into agreements, identical to premarital agreements between prospective spouses, to modify or avoid the application of the community property laws. Joel and Aaron have not entered into such an agreement.

The IRS was asked whether the two must each report one-half the combined earned income and one-half the income from community property assets on their separate income tax returns. The IRS noted that federal tax law generally looks to state property laws to determine how ownership is characterized. The U.S. Supreme Court has held that a husband and wife must each report one-half the community income on his or her separate return, regardless of which spouse earned

the income [*Poe v. Seaborn*, 282 U.S. 101 (1930)]. Because California has extended full community property treatment to registered domestic partners, Joel and Aaron must each report one-half the income on their federal income tax returns. Each will also be entitled to half of the credits for income tax withholding.

The IRS added that although half of each partner's earnings vest in the other under state law, it does not result in a transfer of property from one to the other for federal gift tax purposes (Ltr. Rul. 201021048).

INCOME BENEFICIARIES ENTITLED TO CORPUS WHEN TRUSTS ENDS

The Joseph F. Cannon Christmas Trust isn't scheduled to terminate until 2038, but the bank trustee asked the court to determine who is to receive trust assets at that time. The trust was created at Cannon's death in 1939, with directions to pay the income to ten charities to be used to provide "happiness and cheer at Christmas Time" for those served by the charities. The residue of Cannon's estate passed to his wife and three children, as each reached age 28. Cannon's will was silent as to how assets in the Christmas Trust were to be distributed at the trust's termination.

A relative of one of Cannon's children appealed the trial court's ruling that Cannon did not retain a reversionary interest in the trust and that state (North Carolina) cy pres doctrine permits the trust to be modified "consistent with the settlor's charitable purpose."

The Court of Appeals of North Carolina agreed, saying that language in the will indicates Cannon's intent was that the remaining assets not revert back to the residuary beneficiaries. Cannon knew that his wife and children would not be alive to benefit from the trust assets at the termination. Instead, said the court, he must have intended that, after the ten charities enjoyed guaranteed income for 99 years, any remaining corpus would be distributed to the same organizations (*First Charter Bank v. American Children's Home*, No. COA09-1232).

PHILANTHROPY PUZZLER

Lyle expects to have exceptionally high income for the next three years, prior to when he retires. He attended a seminar where charitable lead trusts were discussed. He is interested in a trust that would generate a current charitable deduction (and possibly carryovers) but then return the assets to him several years later, when his income drops (a grantor trust). He has asked about the tax consequences if he dies during the term of the trust.

REQUEST FOR REFORMATION COMES TOO LATE

William Bruinsma consulted an attorney in 1993 to have a will drafted. He refused to share information with the attorney about the size of his estate, but based on the fact that Bruinsma lived in subsidized senior housing and said he wished to keep legal costs as low as possible, the attorney assumed that the estate was not large enough to be subject to estate tax.

The two-page will Bruinsma executed left half the income from bank accounts to his sister and half to a friend for their lives. After their deaths, the residue of the estate was to be shared equally by the American Cancer Society and the American Heart Association. When Bruinsma died in 1998, he left an estate of \$1.7 million.

In 2008, the executrix of Bruinsma's estate asked the court to reform the will to create a charitable remainder annuity trust. If the will is not reformed, the estate will owe state and federal estate taxes of approximately \$466,733, meaning less remaining for the charitable beneficiaries, argued the estate.

The Supreme Judicial Court of Massachusetts, taking the case on direct appellate review, declined to reform the will. Under state law, a trust may be reformed where it fails to conform to the settlor's intent, due to a mistake. The court noted that it had permitted a charitable remainder unitrust to be reformed and a trust to be reformed to qualify as a charitable remainder annuity trust. However, in this situation, the court is asked to reform a will to create a trust.

While a will may be reformed in cases where an ambiguity exists, there is no indication here of a mistake on the part of the drafting attorney. Nor does the will indicate that Bruinsma was concerned about possible tax consequences in connection with his bequests. The court also noted the timing of the estate's request, saying that the IRS might not give effect to the reformation of a will under Code §2055(e)(3)(C)(iii), coming ten years after the settlor's death (*Pellegrini v. Breitenbach*, SJC-10458).

IRS ENDORSES COURT-ORDERED TRUST

Barry's will directed that a portion of his estate was to be set aside to make monthly payments to Ted and George for life. The residue of his estate is to be transferred to a trust. The trustees are directed to construct several buildings for the town, with the balance of the trust funds to be used for upkeep of the buildings and to benefit several listed charities. If the town declines the gift of the buildings, the trust is to benefit the listed charities and other charities selected by the trustees. Two of the listed charities are §501(c)(3) organizations and another is a political subdivision of the state.

The executor asked the court to resolve an ambiguity over how to set aside part of Barry's estate for the lifetime payments to Ted and George while also establishing, in a timely manner, a trust with the residue of the estate. The court concluded that Barry intended to create a charitable trust from the residue that would qualify for the estate tax charitable deduction under Code §2055. He also intended to provide that an amount equal to the actuarial value of the monthly payments for Ted and George be set aside. The court ordered that a specified amount be paid to Ted and George in full satisfaction of the legacies and that the charitable trust be funded with the remainder of the estate.

The executor claimed a charitable deduction for the amount transferred to the trust. The IRS ruled that the estate was entitled to a charitable deduction for the amount passing to the trust under the court's order (Ltr. Rul. 201022001).

PUZZLER SOLUTION

If Lyle dies prior to the end of the trust term, the lead trust ceases to be a grantor trust. On Lyle's final income tax return, he would recognize recapture income equal to the difference between his original deduction and the discounted value of all amounts that were required to be, and actually were, paid to charity before the grantor trust status ended [Reg. §1.170A-6(c)(4)]. The trust will be allowed deductions for amounts paid to charity between the date of Lyle's death and the termination of the trust.

“DEFERRED GIFT”: IMMEDIATE DEDUCTION FOR FUTURE BENEFIT

There are several ways to make lifetime gifts to charity, enjoy immediate income tax charitable deductions and have the satisfaction of current recognition for gifts – all without visibly parting with any assets. These are sometimes referred to as “deferred” gifts, meaning charity’s benefit is postponed.

Undivided interests in property – Frank owns a summer home that he and his family use about six months of the year. He made a gift of a one-quarter undivided interest in the home to his college and was entitled to an income tax charitable deduction [Code §170(f)(3)(B)(ii)] for about 25% of the home’s \$250,000 value. The gift saved Frank about \$17,500 in income taxes in his 28% tax bracket.

Frank and his family can continue using the home, just as they always have. The college is entitled to use the property three months a year, but the real benefit will occur when the home is sold and the college receives one-quarter of the proceeds. If he leaves the remaining portion of the home to the college at his death, his estate will be entitled to a further charitable deduction.

Gifts for conservation, open space – The owner of property with significant historical or ecological features may make a gift to charity of an irrevocable easement in perpetuity and receive an income tax deduction while continuing to use the property for specified purposes [Code §§170(f), 170(h)]. If sold, the property will be subject to the conditions of the easement, which may restrict the uses to which the land may be put or the alteration of structures on the property. The

deduction is equal to the difference between the value of the property without the easement and the reduced value with the easement.

Remainder interest in home or farm – A donor who places a home or farm land into a charitable remainder trust is prohibited by the self-dealing rules [Code §4941(d)] from continuing to use the property, even if fair market rent is paid. But the donor can have the property eventually pass to charity, receive an immediate income tax charitable deduction and continue to use the property by deeding a home or farm to charity and retaining a life estate – a gift of a remainder interest, not in trust [Code §2055(e)(2)].

Take the case of Tom and Vicki, who own a home worth \$250,000 that they wish to leave to their favorite charity. They deeded the home to the charity, retaining a life estate for their joint lives. They are entitled to a charitable deduction for the value of the remainder interest in the home. Assuming they are both age 68 and the land on which the home sits is worth \$75,000, their deduction would be nearly \$102,500 – even though nothing will pass to the charity until after they die. (Deduction assumes the use of July’s 2.8% §7520 rate, a useful life of 40 years and a salvage value of \$20,000.)

During their lifetimes, Tom and Vicki can continue living in the home or rent it out and receive income. If the home is sold prior to their deaths, the proceeds will be divided, with the parties receiving the actuarial value of their respective interests.

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