The Advisor

BALL STATE UNIVERSITY FOUNDATION
Established in 1951

June 2010

ESTATE PLANNER'S TIP

Clients who take advantage of the $13,000 gift tax annual exclusion [Code §2503(b)] to make tax-free gifts to children or grandchildren may want to encourage the use of some of the funds to establish IRAs. Consider a grandfather who makes annual gifts of $13,000 to each of this three teenage grandchildren, all of whom have part-time and summer employment. If $5,000 went into a grandchild's IRA every year for five years – starting when the grandchild was age 16 – the balance in the account would grow to $27,352.50 (assuming 3% interest) by the end of the fifth year. By the time the grandchild is ready to retire at age 67, the account will have grown to more than $111,800, even if no further contributions are made. But if the grandchild continues making $5,000 contributions annually until retirement, the account will grow to more than $627,000. If the grandchild is eligible to make contributions to a Roth IRA, qualified distributions will be tax free. A note of caution: The grandchild must have at least $5,000 of earned income in any year in which a $5,000 contribution is made (Code §408).

FULL MORTGAGE PAYMENT QUALIFIES AS ALIMONY

When Ernesto and Norma Contreras divorced, the decree provided that Norma was to receive the couple's house and Ernesto was to pay the first mortgage on the residence, along with real estate taxes and insurance on the property. This was designated as spousal maintenance and was to continue until Ernesto is eligible to retire, at which time Norma will receive her share of his retirement funds.

In 2005, Ernesto executed a quitclaim deed transferring his interest in the home to Norma. In 2006, he made mortgage payments of $5,746, which he claimed on his income tax return as an alimony deduction. The IRS argued that because Ernesto was still contractually liable on the mortgage note, he received a benefit each time a mortgage payment was made and was therefore entitled to deduct only one-half the amount paid.

The Tax Court found that even though Ernesto might have been jointly liable for the mortgage, he did not have any financial interest in the house during the 2006 tax year. Because the payments meet the definition of alimony under Code §71(b)(1), he is allowed an equivalent alimony deduction under Code §215, ruled the court (*Contreras v. Comm'r.*, T.C. Summ. Op. 2010-35).

BEQUESTS TRIP OVER DECIMAL POINTS

William and Marian Dudley created a living trust in 2000, along with a discretionary trust to benefit one of Dudley's sisters. The couple's living trust directed that at the death of the survivor, the discretionary trust was to receive .142857% of the remaining trust assets. Another sister was to receive the same amount outright. Three charities were each to receive .0035714%. The balance of the trust assets was to be divided equally among 23 named individuals.

When Marian died in 2007, the trust value was $941,903. The trustee asked the court how distributions should be made. Using the percentages in the trust, the discretionary trust and the other sister's outright portions would be $1,345.57. Each charity would take $33.64, while the 23 named individuals would each receive nearly $41,000. The parties claimed that the drafting attorney made a mathematical error by first stating the amounts in numerals and then adding a percentage sign, which had the effect of moving the decimal point over two places. Although the attorney was serving overseas in the military, her records were still available.

The probate court heard testimony from an attorney who consulted with Marian after William's death. He testified that he pointed out the small amounts to Marian, but said she wanted the trust left as written. The court ruled that, based on the attorney's testimony, there was no reason to deviate from the percentages listed in the trust.

The Court of Appeals of Michigan said that the probate court "apparently found that the trust document contained a latent ambiguity because it resorted to extrinsic evidence" from the attorney. The evidence showed that the Dudleys created a "separate, rather complex discretionary trust" for William's sister. The appeals court added that this expense would make little sense if they intended to fund it with such a nominal amount. The probate court erred in relying on the testimony of the attorney who consulted with Marian following William's death and not the drafting attorney, who could have provided information about the couple's intent at the time the trust was drafted. The matter was remanded to the probate court to ascertain the intent when the trust was funded (*In re Dudley*, No. 287918).

PHILANTHROPY PUZZLER

Jake received a sizeable bequest from his brother who died earlier this year. Because he has a significant estate of his own, he doesn't need the additional funds. Jake has thought about disclaiming the bequest and having it pass, instead, to his favorite charity, hoping to entitle the brother's estate to an estate tax charitable deduction. Jake has asked if this technique will work.

INDIRECT GIFTS TO FOREIGN CHURCHES NOT DEDUCTIBLE

In 2006, a naturalized U.S. citizen made four wire transfers totaling $25,050 to a relative in her native country, which the relative gave to local Catholic churches. The donor, who was raised a devout Catholic, witnessed a massacre as a young child before her family fled to the U.S. During a trip back to her homeland, the donor was detained and interrogated by the local police, who told her they had been monitoring her activities and were aware of her family's support for the former government. The donor felt she had to disguise her contributions to support the rebuilding of Catholic churches.

The donor and her husband claimed charitable contributions in 2006 for the wire transfers and for a $1,025 airline ticket to travel home and provide services for the local Catholic churches. The IRS disallowed the deductions.

The donor argued that the ultimate beneficiary of the wire transfers was the Roman Catholic Church, a qualified donee under Code §170(c)(2). Because the Catholic Church is a universal organization, churches in her native country are qualified donees, she argued.

The Tax Court disagreed, noting that the wire transfers were not made to or for the use of an organization created or organized in the U.S. The transfers were made to a relative who then contributed them for the benefit of foreign churches. The transfers therefore were not deductible. The court added that the transfers also were not "for the use of" a qualified organization, since that requires that the charitable beneficiary have a legal right to constrain the trustee to comply with the terms of a trust or other similar legal arrangement.

The court also disallowed the deduction for airfare, saying that unreimbursed expenses are deductible only when made incident to the rendering of services to an organization that is a qualified recipient of charitable contributions. There was no showing that the churches in the donor's native country were qualified under Code §170(c)(2) (*Anonymous v. Comm'r.*, T.C. Memo. 2010-87).

CLOSE ISN'T GOOD ENOUGH FOR DEDUCTION

In both 2001 and 2002, Newton and Vonise Friedman claimed charitable contributions of $217,500 for donations of diagnostic and laboratory equipment. They attached three Forms 8283 to their 2001 return, with appraisals from two appraisers and a receipt from the organization for some of the equipment. With their 2002 return, they provided Forms 8283 for items appraised by three appraisers, along with a receipt covering some of the equipment. In 2004 and 2006, after the returns were examined by the IRS, a separate appraisal report was prepared. The IRS disallowed all the deductions.

Reg. §1.170A-13(c)(3)(ii) requires that a qualified appraisal include a description of the property in sufficient detail for a person who is not generally familiar with the type of property to determine that the property appraised is the property that was contributed, a description of the physical condition, the valuation method used to determine fair market value and the donor's cost basis. Appraisals must be done no earlier than 60 days prior to the date of the gift and no later than the due date of the return, with extensions [Reg. §1.170A-13(c)(3)(i)(A)].

The Tax Court said that the Forms 8283 did not include appraisal reports or receipts for all the items. While acknowledging that they had not strictly complied with Reg. §1.170A-13, the Friedmans claimed they were entitled to the deductions because they had substantially complied with the requirements. The court noted that the couple had not obtained a qualified appraisal, and failed to provide an adequate description of the condition of the donated items and the cost basis and did not indicate what valuation method was used. The couple said that the 2004 and 2006 appraisals could supplement the Forms 8283. The court rejected that argument, noting the appraisal was done years after the gift and that the taxpayers cannot rely on the late appraisals to "cure the absence of the required information in a timely fashion."

Further, the court added, the Friedmans failed to show they obtained adequate written acknowledgment of their gifts, as required by Code §170(f)(8). Although the donee organization signed the Forms 8283 and sent receipts, these did not contain a statement that no goods or services were provided in exchange. The court disagreed with the donors' argument that such a statement was required only where the donee actually furnishes goods or services to the donor. Because the donors failed to strictly or substantially comply with the substantiation requirements, the court disallowed the deductions (*Friedman v. Comm'r.*, T.C. Memo 2010-45).

PUZZLER SOLUTION

Under Code §2518, the person disclaiming cannot direct where the bequest will pass. If his brother's will does not specify alternative beneficiaries, in the event of a disclaimer or Jake's prior death, the disclaimed bequest would become part of the residue or pass under state intestacy rules. Absent such disclaimer language naming a charitable beneficiary, the brother's estate would not be entitled to a charitable deduction because the bequest would not be considered to have been "transferred by the decedent" [Reg. §20.2055-1(a)]. Jake could accept the bequest and make an outright gift to charity, for which he would be entitled to an income tax deduction.

COMBINING MARITAL, CHARITABLE DEDUCTIONS FOR ESTATE TAX SAVINGS

Congress has provided two unlimited federal estate tax deductions: the marital deduction (Code §2056) and the charitable deduction (Code §2055). A client who leaves a surviving spouse doesn't really need a charitable deduction to completely avoid estate taxes (after taxes are reinstated in 2011). But for philanthropic clients, it's possible to create split-interest bequests that will benefit the surviving spouse for life, with the property then passing to charity. The combination of the marital and charitable deductions allows unlimited property to pass free of estate tax at both deaths.

There are several ways to arrange a spouse/charity split-interest bequest that will qualify for both deductions. The first is the QTIP (qualified terminable interest property) charitable remainder trust, provided for in Code §2056(b)(8), that pays either a qualifying unitrust or annuity amount (Code §664) for life to the surviving spouse, with the remainder passing to charity. There can be no other noncharitable beneficiaries (children, for example) in this trust.

A second type of split-interest bequest is a "regular" QTIP trust giving the surviving spouse all income for life and naming charity as the remainderman [Code §2056(b)(7)]. The estate of the first spouse to die avoids tax thanks to the marital deduction; the estate of the surviving spouse avoids tax thanks to the charitable deduction.

Another option is a QTIP trust that, at the surviving spouse's death, passes to a charitable remainder trust paying income to the children for life, then to charity (Ltr. Rul. 9122029). The charitable deduction at the death of the surviving spouse is equal to the value of charity's remainder interest in the charitable remainder trust.

One concern in establishing a testamentary charitable remainder trust for a surviving spouse is the possibility that the donor spouse may die in 2010, while the federal estate tax is repealed. Testamentary unitrusts or annuity trusts must qualify for an estate tax charitable deduction; if not, they will be disqualified as charitable remainder trusts [Reg. §1.664-1(a)(1)(iii)(a)]. As a technical matter, no testamentary charitable remainder trust can qualify while the federal estate tax is suspended, which may seem academic from a transfer tax standpoint.

The importance of having a qualified testamentary charitable remainder trust is (1) that the trust will be tax exempt for income tax purposes and (2) that the surviving spouse will be taxed under the four-tier system, which may be more favorable from a tax standpoint. The donor spouse ordinarily might want to fund the trust with items of income in respect of a decedent, such as U.S. savings bonds or IRA distributions, which can be liquidated without tax in a qualified charitable remainder trust. Or the donor spouse may wish to avoid the 2010 "modified carryover basis" rules by leaving assets with tens of millions of dollars in appreciation to a unitrust or annuity trust for the surviving spouse. In either case, loss of tax-exempt status for the trust could be costly.

Solution? One commentator suggests funding a lifetime unitrust in 2010 with a few thousand dollars. The unitrust would have a "flip" provision and would make payments initially to the donor spouse, with the surviving spouse as successor beneficiary. The trust would qualify for the Code §170 income tax charitable deduction and would thus be a qualified charitable remainder trust, even if the donor spouse dies while the estate tax is repealed. The donor spouse could bequeath appreciated assets or IRD to the inter vivos unitrust as additional contributions. The trust could be drafted to "flip" to a standard payment unitrust upon the death of the donor spouse (a permitted "trigger event").

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