

The Advisor



May 2010

ESTATE PLANNER'S TIP

As of late March, the IRS reported that the average income tax refund was \$3,036, a \$266 increase over the 2008 tax year. As nice as it is to receive a large income tax refund after filing a return, it's not a financially smart thing to do. Taxpayers who look forward to a big check are actually making a loan to the government – and an interest-free loan at that. Taxpayers are required to pay in at least 90% of the taxes due or 100% of their prior year's tax in order to avoid an underwithholding penalty [Code §6654(d)]. The safe-harbor payment for those with adjusted gross income in excess of \$150,000 for the prior year is 110% of the prior year's tax liability. Payments can be made either through employer withholding, timely filed estimated payments or both. Now may be the time to review a client's tax situation to make sure that enough, but not too much, is being forwarded to the IRS. If you find that income this year is down over last year and that estimated payments and withholding are too high, take steps to reduce them. If taxes will be more this year, make sure your clients have paid in at least enough to meet the safe-harbor amount. But remember, estimated payments are supposed to reflect taxes owed on income for that quarterly period, so making a larger payment in one quarter will not offset a deficiency in another period. Withholding, on the other hand, is considered paid evenly throughout the year, so if it gets close to the end of the year and it appears a client may have underwithheld, increase the withholding. Make sure the client understands that it's actually better financially to owe the IRS a little on April 15 than to receive a whopping refund check several weeks later.

TRANSFERS OF LLC SHARES ARE FUTURE INTERESTS

In 2000, 2001 and 2002, John and Janice Fisher transferred 4.762% interests in their LLC to each of their seven children. The LLC's primary asset was a parcel of undeveloped land in Michigan bordering Lake Michigan. The couple said that the transfers were gifts of present interests, qualifying for the annual exclusion under Code §2503. The IRS assessed a gift tax deficiency of nearly

\$626,000, saying that the transfers were future interests that did not qualify.

The children's interests were defined as a share of the profits and losses and the right to receive distributions. The U.S. District Court (S.D. IN) reviewed the LLC's operating agreement, which provided that the children could transfer their interests only if certain conditions were met. One

of the conditions was a right of first refusal by the LLC for the purchase of any interest. The LLC had 30 days to exercise its right, up to 90 days to close on any purchase and could pay with a non-negotiable promissory note payable over a period of up to 15 years.

The court noted that the annual gift tax exclusion applies only to present interest gifts, defined as “an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property” [Reg. §25.2503-3(b)].

The Fishers claimed that upon the transfer, the children had the unrestricted right to receive distributions, but the court found that any potential distributions were subject to a number of contingencies, all within the control of the general manager. Therefore, said the court, they did not have a right to a “substantial present economic benefit.” The Fishers also said the children had the unrestricted right to possess, use and enjoy the beach property, although the court found nothing in the operating agreement that the right was transferred to the children when they became members. Even so, said the court, without more it was not a present benefit. The court also found that the children had no unilateral right to transfer their right to receive distributions, since it was subject to certain conditions. The LLC’s right of first refusal effectively prevented the children from transferring their interests in exchange for immediate value, said the court, which granted the IRS’s motion for partial summary judgment (*Fisher v. U.S.*, 2010-1 USTC ¶60,588).

PHILANTHROPY PUZZLER

Several years ago Betsy and Sam deeded ownership of their vacation home to their favorite charity, retaining a life estate. They use the home frequently in the summer, but rarely use it in the winter. They think they would use the home more if they added a garage, and have asked the tax consequences of making this improvement to the property.

WHAT’S IN A NAME? MAYBE TAXES?

Oscar Goldberg owned an 11.66% interest and a 12.5% interest in two New York properties that he had received from his mother. In 1997, Goldberg executed deeds transferring the entire interests to “Oscar Goldberg and Judith Goldberg, as wife.” After Judith’s death in 2001, Goldberg, as executor, executed a deed conveying all of his wife’s interests in the properties to her testamentary trust.

Following Goldberg’s death in 2004, his estate reported a 5.83% and 6.25% interest in the properties. The IRS increased Goldberg’s interest to the full amount. Under state law, a disposition of real property to a husband and wife creates a tenancy by the entirety, unless expressly declared to be a joint tenancy or a tenancy in common. If a tenancy by the entirety existed, Judith’s interest was not divisible, and at her death, Goldberg became owner of the entire interest.

The estate argued that the couple owned the interests as tenants in common, because that is how they intended to hold the properties. In the alternative, the estate claimed that the couple converted the ownership to tenants in common at some point prior to Judith’s death.

The Tax Court found that the 1977 deeds clearly created a tenancy by the entirety. Although the estate suggested the deeds were ambiguous because they did not specify how the property was to be held, the court found that state law precluded any ambiguity. When a deed is clear and unambiguous, parol evidence of the parties’ intent is not admissible. Lacking any evidence that the parties converted the interests to a tenancy in common, the court said the entire value was included in Goldberg’s estate (*Est. of Goldberg v. Comm’r.*, T.C. Memo. 2010-26).

NO DEDUCTION FOR PORTION PASSING TO CHARITY UNDER WILL SETTLEMENT

Archie’s will and codicils created trusts for the benefit of his son, Larry, and several other beneficiaries. When the trusts ended, the remainders were to pass to a charitable trust that Archie had previously established. An in terrorem clause also

provided that the share of the estate passing to anyone who contested or elected against the will would be distributed to the charitable trust. Neither the original will nor any of the codicils addressed the residuary estate.

Following Archie's death, Larry claimed that the omission of the residuary clause was a scrivener's error and that as sole heir, he was entitled to the residue under state intestacy laws. The drafting attorney filed an affidavit indicating that Archie told him that he intended for the residue to pass to the charitable trust. The trustee pointed to the fact that previous wills executed by Archie left the residue to charity and pointed to his history of making large lifetime charitable gifts.

Larry and the trustee eventually settled the dispute, with a portion of the residue passing to Larry outright and the balance to the trust. The probate court approved the agreement.

Under Reg. §20.2056(c)-2(d)(2), the amount passing to a surviving spouse as the result of a settlement of a bona fide challenge is considered to have passed from the decedent to the surviving spouse and will qualify for the marital deduction. The same rule applies to a deduction under Code §2055 for amounts passing to charity pursuant to a settlement agreement. Archie's estate argued that the portion of the residue passing to the charitable trust was deductible.

The IRS, however, said that the parties to a settlement are entitled to deductions only to the extent they have enforceable rights under state law. The IRS found no enforceable right for the charitable trust, noting that although state law does not favor intestacy where there is a will, the presumption that the testator intended to dispose of his entire estate is "met by an equally potent presumption that an heir is not to be disinherited except by plain words or necessary implication." It was an error for the court to consider extrinsic evidence to show the testator's intent independent of the words used in the will. Although the residuary clause may have been erroneously omitted, that does not create an ambiguity that allows for the introduction of collateral evidence, said the IRS, which denied the estate's charitable deduction (TAM 201004022).

IRS WINTER 2010 STATISTICS OF INCOME DISSECTS CRTs, CLTs AND PIFs

Thumbing through the IRS quarterly Statistics of Income may seem like a sure cure for insomnia, but the government's numbers can offer insight into a variety of tax and financial activities, including charitable gift planning. The just-released Winter 2010 edition includes data on charitable remainder trusts, charitable lead trusts and pooled income funds, drawn from trust tax returns filed in 2008 for the tax year 2007. The following is a compilation of facts and trends gleaned from "Changing Times: An Analysis of the 2007 Revision of the Split-Interest Trust Information Return" – certain to enliven any social gathering.

What's hot and what's not. 2007 was the last golden year for the stock market before the 2008 meltdown. Highly appreciated stocks are advantageous for funding tax-exempt CRTs, but the bull market apparently did not spur creation of many trusts in 2007. Further detail:

- For Filing Year 2008, a total of 123,498 Forms 5227 were filed, a slight dip from the 123,659 total filed in 2007.
- Charitable remainder trusts declined overall from 115,754 returns to 115,489, but unitrust returns actually increased in number (from 95,567 to 96,248). Annuity trust tax returns declined by nearly 5%, from 20,187 in 2007 to 19,241.
- Charitable lead trust returns increased from 6,377 to 6,521.

PUZZLER SOLUTION

Betsy and Sam will be entitled to another income tax charitable deduction. Their deduction is not the full cost of the garage, but rather the remainder value. This is calculated using their current ages, the cost of construction and straight-line depreciation of the structure (Ltr. Rul. 8529014).

- Pooled income fund returns dropped from 1,528 to 1,488, reflecting a trend by charities to close down their PIFs.
- Most unitrusts (77.7%) provided a “standard” fixed percentage payout, while 17.5% were net-income with make-up trusts (“NIMCRUTs”) and 4.8% net-income trusts (NICRUTs). No listing was provided for “combination of methods” unitrusts (FlipCRUTs).
- On average, unitrust beneficiaries in 2007 received payments that were favorably taxed under the four-tier system of CRT trust taxation. Ordinary income distributions (Tier 1) accounted for 40% of all unitrust distributions (no breakdown for qualified dividends). Short-term gains, also taxed at ordinary rates, amounted to another 5.8%. But Tier 2 long-term gains provided 49.5% of all CRUT payments, generally taxed at 15%. Tiers 3 and 4 – tax-free “other” income and return of corpus – generated just 4.7% of payouts to unitrust beneficiaries.
- New contributions to unitrusts were listed as 8.5% cash, 69% marketable securities (virtually all in stocks), 8.5% real estate, and 14% “other assets” (such as retirement assets, annuities, partnerships, insurance assets, and art).

How large are these trusts? Interesting, too, were the end-of-year book values of CRTs and CLTs. About two-thirds (67.6%) of all charitable remainder unitrusts contained less than \$500,000. Assets of \$500,000 to \$3 million were listed on 28.3% of returns and only 4,055 unitrusts (4.1%) showed total assets of more than \$3 million. Annuity trusts (19,241 returns) tended to be smaller. A surprising percentage of charitable lead trusts – 63.5% – reported assets of less than \$1 million. Another 32.2% held assets totaling \$1 million to \$10 million, and the remaining 4.3% reported assets in excess of \$10 million.

Conclusions? Market conditions obviously changed dramatically in 2008 and early 2009, and trust tax returns filed for 2008 could show more capital losses than gains. Average asset values for all split-interest trusts will have declined, as well. The only bright spot may be that tax-free distributions of corpus to CRT beneficiaries probably increased in 2008 (with the exception of the beneficiaries of net income unitrusts). Low §7520 rates in 2008 would have discouraged funding of charitable remainder annuity trusts while stimulating establishment of charitable lead annuity trusts. The trend of charities to close down pooled income funds undoubtedly has continued.

For the full IRS report, go to <http://www.irs.gov/pub/irs-soi/10winbulchangingtimes.pdf>.

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