The Advisor

BALL STATE UNIVERSITY FOUNDATION
Established in 1951

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ESTATE PLANNER'S TIP

After a one-year hiatus to allow qualified retirement accounts to recover from the stock market's steep drop during 2008, required minimum distributions are back. Every year, more people join the ranks of those who must take distributions from IRAs and 401(k) accounts. Distributions must begin no later than April 1 of the year following the year in which account owners turn 70½, with minimum distributions ranging from 3.8168% for those age 70 to 17.5439% for owners age 100. Although many people withdraw funds earlier (generally, penalty-free withdrawals may begin at age 59½), some wait as long as possible, allowing the funds to continue growing tax-deferred. But there are ways an IRA owner can conserve funds past age 70½. In determining the minimum distribution that must be paid in a particular year, all accounts are aggregated and multiplied by the appropriate percentage. For example, a 75-year-old with IRAs totaling $500,000 would have to receive distributions of at least $22,936 (4.5872%). But that amount doesn't have to come out of all accounts proportionally. Instead, the money can be withdrawn from the account or accounts earning the lower rate of return, allowing higher-return accounts to continue earning tax-deferred. The income limit on switching from traditional to Roth IRAs has been eliminated, and income tax can be deferred – one half due in 2011 and one half due in 2012 – for conversions made in 2010. No further required minimum distributions will be owed on amounts converted to a Roth IRA.

GIFT TAX PAID BY DONEES INCLUDED IN DONOR'S ESTATE

At Howard Morgens' death, his wife Anne became the income beneficiary of a residual trust. At her death, trust assets were to pass to the couple's children and grandchildren. A QTIP election was made under Code §2056(b)(7).

In November 2000, Anne's son and grandchildren entered into an agreement under which they would indemnify Anne or her estate for any gift or estate tax due for gifts she made to them from her income interest in the trust. The trust was split into two trusts. In December 2000, Anne transferred her income interest in the first trust to the remainder beneficiaries. The value of her income interest in the trust was nearly $6.4 million. She reported a gift for that year of $4.1 million – the gross amount of the transfer less the gift tax liability of nearly $2.3 million paid by the trustees. In January 2001, she transferred her income interest in the second trust – valued at $28.3 million – in the same manner. The trustees paid gift taxes of nearly $7.7 million.

Following Anne's death in 2002, her executor did not include the gift taxes paid by the trustees on the 2000 and 2001 gifts in her gross estate. The IRS noted that under Code §2035(b), a decedent's gross estate is increased by the amount of any tax paid by the decedent on any gift made during the three years prior to death. The estate claimed that because the trustees were responsible for the taxes, Code §2035(b) does not apply.

The Tax Court noted that Code §2035(b) was added to eliminate the incentive for deathbed gifts. As the deemed donor of the QTIP, the surviving spouse bears the gift tax liability associated with the transfer. The question of "how private parties allocate the burden of the tax is different from the issue of who is liable" for the tax, the court said, adding that it did not believe that allocating the financial burden of the tax to the donees shifted the liability to them. Anne remained liable for the tax, and the gift tax was properly included in her gross estate (*Estate of Morgens v. Comm'r.*, 133 T.C. No. 17).

BENEFICIARY OF PRE-1977 TRUST COULD DISCLAIM AFTER 18TH BIRTHDAY

Becky's great-grandfather created an irrevocable trust prior to 1977, giving the trustee discretion to make distributions. Becky is a contingent remainder beneficiary, entitled to share in the distribution at the termination of the trust. She has previously received discretionary distributions from the trust. Becky recently turned 18, the age of majority in her state, and proposes to disclaim her right to receive a distribution at the trust's termination. She will retain her right to receive discretionary distributions of corpus and income during the trust term.

State law provides that each separate interest in property is subject to disclaimer. Under Reg. §25.2511-1(c), if the interest to be disclaimed was created prior to 1977, the disclaimer must be made within a reasonable time after knowledge of the existence of the transfer creating the interest to be disclaimed. However, the time limit for making a disclaimer does not begin running until the disclaimant has reached the age of majority.

The IRS ruled that Becky's disclaimer will be considered made within a reasonable period. The fact that she received discretionary distributions prior to age 18 is not considered acceptance of the property subject to the disclaimer, added the IRS. Therefore, Becky's disclaimer will not constitute a transfer subject to gift tax (Ltr. Rul. 200953010).

PHILANTHROPY PUZZLER

Under the divorce agreement signed by Sara and Joe, Joe was to pay Sara $24,000 annually for ten years. Rather than write monthly checks to Sara, Joe is considering funding a term-of-years charitable remainder annuity trust that would make monthly payments of $2,000 to her. Joe would get a charitable deduction for the remainder value of the trust, and by funding it with appreciated stock, avoid the capital gains tax. Can Joe do this?

NO INTESTACY FOR RESIDUE EXCESS

Dianne Hill left specific bequests totaling $101,500 to four cousins at her death in 2007. The residue of her estate was divided in shares, with (a) one-fourth, up to $50,000, passing to the Susan G. Komen Foundation, with any excess, up to $100,000 going to the American Cancer Society, (b) one-fourth, not to exceed $100,000, going to the Arthritis Foundation, and any excess added to the share passing to Eastern Kentucky University and (c) one half for an endowed scholarship at Eastern Kentucky University.

The residue of Hill's estate was more than $1,640,000, making the one-quarter for the Komen Foundation and the American Cancer Society worth $410,000. The executors asked the court to determine how the $260,000 in excess of the stated limits in the will should be distributed. Hill's cousins claimed the excess should pass to them under intestacy provisions. The court determined that Hill's will was unambiguous as to her intent to distribute her entire estate and that she intended to distribute any undesignated portion according to the language in the residuary clause. The court ordered the same distribution scheme, with one-fourth of the $260,000 – $65,000 – paid to the Komen Foundation ($50,000) and the American Cancer Society ($15,000), another fourth paid to the Arthritis Foundation and the balance paid to Eastern Kentucky University.

Hill's heirs appealed, arguing that the trial court erred in not finding Hill partially intestate. The Court of Appeals of Kentucky noted that it is presumed a testator executing a will does not intend any portion of the estate to pass by intestacy. This presumption is even stronger when a will contains a residuary clause. Hill's residuary clause operated to save the undesignated portion from intestacy and should not pass to the heirs, who were not named as beneficiaries of the residue. The court upheld the ruling. (*Mackey v. Hinson*, No. 2008-CA-002328-MR).

EARLY DISTRIBUTIONS NOT FATAL TO TRUST

Ben is the surviving income beneficiary of a charitable remainder annuity trust created by his father. The charitable remainderman is in need of funds for its scholarship program. Ben has agreed to a reformation of the trust to permit limited annual distributions of principal to the charity, to be used for scholarship programs. The amount that can be distributed annually will depend on the market value of the trust assets, with no distributions made in the event the value drops below a specified amount.

The IRS noted that the governing instrument of a charitable remainder trust may provide that any amount other than the annuity amount shall be paid, or may be paid in the discretion of the trustee, to a charity. The trust may also provide that a portion of the trust assets may be distributed to charity currently or at the death of one or more income recipients [Reg. §1.664-2(a)(4)].

The IRS ruled that the proposed modification to Ben's trust will not cause it to be disqualified under Code §664 (Ltr. Rul. 200950032).

GRANTOR HAS A RIGHT TO CHANGE HER MIND

Shirley Wild created a revocable trust in 1990, amending the instrument in 1991, 1996, 1997 and 1998. In 2002, she executed a restated revocable trust referencing the original trust and amendments. The restated trust created a charitable remainder trust to benefit College of the Ozarks (CO), naming Cottey College as a contingent remainder beneficiary. Amendments were executed in September and October of 2004, resulting in the creation of two equal charitable remainder annuity trusts for the colleges.

Following Wild's death in 2005, Cottey asked the court to rule that the 2004 amendments were effective and it was entitled to share equally in the residue. CO argued that amendments weren't effective because they made no reference to the restated trust and that Wild lacked testamentary capacity to execute the amendments. The probate court granted Cottey partial summary judgment, finding that the absence of a reference to the restated trust did not negate Wild's intent to ratify and amend prior versions. The court determined that she had the mental capacity to execute the amendments.

The Court of Appeals of Missouri disagreed with CO's argument. In the original trust and throughout all the amendments, Wild specifically reserved the right to revoke, alter or amend the trust. The restated trust had no language revoking the original trust. Instead, the 2004 amendments amended the restated trust and other previous versions of the trust, said the court.

The appeals court said it must affirm the probate court's judgment on Wild's mental capacity "unless it is not supported by substantial evidence." The probate court is free to believe none, part or all of the testimony of witnesses, said the court (*In the Matter of Wild Revocable Trust*, No. SD 29430).

PUZZLER SOLUTION

Joe's alimony payments are a legally enforceable obligation, and the IRS has consistently held that the use of charitable remainder trust payments to satisfy the donor's legal obligations is a violation of the private foundation rules – specifically, the prohibition against self dealing [Reg. §53.4941(d)-2(f)(1)].

GIFTS OF STOCK GOOD FOR BUSINESS TOO

Charitable gifts of stock, particularly highly appreciated shares held more than one year, are especially effective for tax purposes. The donor is entitled to a charitable deduction equal to the fair market value of the stock and avoids capital gains tax.

Gifts of a donor's own stock in a closely held company can be equally attractive, not only for the potential deduction, but because of the flexibility. Here are a few examples of how shareholders in closely held companies can make economical gifts to charity.

Gifts of shares – Randy and Pam were the sole shareholders in a small chain of bookstores. They were long-time supporters of two organizations, but were short on cash for this year's contributions. Their accountant suggested that they consider contributing shares in their company to the charities. They gave each organization 100 shares, worth about $50 per share, of their closely held stock.

For their gifts, Randy and Pam were entitled to a charitable contribution deduction of $10,000, saving them $2,800 in income taxes in their 28% tax bracket. Does this mean that the charities are now owners in the bookstore business? It is unlikely that the charities would wish to be involved in the day-to-day operations of the bookstore or to hold on to the shares. As with most gifts of stock, the colleges would seek to sell the shares, and in the case of closely held stock, the most likely buyer usually is the company itself. The bookstore chain could buy back and retire the shares, leaving Randy and Pam as the sole shareholders.

The IRS has ruled that so long as charity is not *required* to sell the shares back to the company, the transaction will not result in a dividend to Randy and Pam (Rev. Rul. 78-197, 1978-1 C.B. 83).

About-to-be liquidated stock – Glenn is getting ready to "close up shop" at his jewelry store. He owns most of the shares, with the rest held by various family members. If a plan of liquidation is adopted and the assets of the company are distributed in exchange for the shares of stock, the shareholders will have capital gain to the extent the amount received exceeds their basis.

Glenn always makes generous gifts to a local charity. He asks his tax advisor if there is any way to combine the winding down of his business with his charitable gifts. In fact, there is, but it must be done before the plan of liquidation is adopted, or the gain will be attributed to Glenn under an "assignment of income" theory [*Jones v. U.S.*, 76-1 USTC9247 (CA-6, 1976); *Allen v. Comm'r.*, 66 T.C. 340 (1976)].

Glenn gives shares in the company to the charity and receives a charitable deduction for the fair market value. When the plan of liquidation is adopted by the board and approved by the shareholders, the capital gains tax attributable to the redemption of charity's shares is avoided.

Getting an income in return – In addition to outright gifts of closely held stock to charity, it's also possible for the donor to receive an income for life in exchange for the gift.

Ira and Sally, ages 62 and 56, are the sole shareholders in a small commuter airline. They transfer shares worth $300,000 to a 6% charitable remainder unitrust that will pay them for their lives, with the remainder passing to their favorite charity. They are entitled to an income tax deduction of more than $61,200 (assumes §7520 rate of 4%, quarterly payments), saving them income taxes of about $20,200 in their 33% tax bracket. At the death of the survivor, trust assets will pass to two charities they have named.

Gifts of closely held stock, whether outright or in trust, must be accompanied by a qualified appraisal if the value of the deduction claimed exceeds $10,000 [Reg. §1.170A-13(c)(2)(ii)].

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