The Advisor

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ESTATE PLANNER'S TIP

Starting in 2010, all IRA owners, not just those with modified adjusted gross income below $100,000, will be able to convert traditional IRAs to Roth IRAs. Roth IRAs are attractive because all qualified distributions are tax-free and there are no minimum distributions required beginning at age 70½. Taxpayers with earned income may continue contributing to Roth IRAs after age 70½ (subject to income limitations), unlike contributions to traditional IRAs which must cease at age 70½. At death, the balance in both traditional and Roth IRAs is subject to estate tax, but unlike a traditional IRA, the balance in a Roth IRA is not subject to the tax on income in respect of a decedent [Code §691]. Some clients may be interested in conversions early next year, while IRA values are still depressed over earlier levels, thereby reducing the amount subject to tax. For conversions made in 2010 only, owners have the option to postpone the income tax, paying half in 2011 and half in 2012. However, taxpayers concerned about potential income tax rate increases may choose to include the income and pay the tax on their 2010 returns. For these clients, gifts to charity could create deductions to help offset the "conversion tax." Bunching several years' charitable gifts into 2010 would magnify deductions, as would establishing charitable remainder trusts, charitable gift annuities and grantor charitable lead annuity trusts.

COURT RETURNS GIFT ANNUITY FUNDS TO ESTATE

Henry Wurster, acting as conservator and guardian for his mother, Josephine Roosen, used her $300,000 commercial annuity to arrange a charitable gift annuity with Alabama Sports Hall of Fame. Roosen was the first annuitant, with payments to continue to Wurster after her death.

Roosen died in 2002, but the probate court was not timely notified of her death. In 2005, the court appointed a special fiduciary who sought to have Wurster removed as conservator of the estate. The special fiduciary petitioned for a freeze on the funds remaining from the gift annuity and an eventual return of the balance to the estate, for distribution under the state's intestacy rules. Wurster objected, arguing that he had acted properly as conservator when arranging the gift annuity. The probate court ordered the return of the gift annuity funds.

The Court of Appeals of Michigan noted that a conservator has the power to make gifts to charity under state law, but only if the estate is more than sufficient to provide for the individual and only in amounts that generally do not exceed 20%

of the estate's annual income. Wurster made a $300,000 transfer from an estate valued at a total of $440,543. The court found that the charitable gift was impermissible and ruled that the probate court did not err by ordering a return of the remaining principal from the gift annuity to the estate, calling funds a proper asset of Roosen's estate (*In re Estate of Roosen*, No. 282979).

IRS FINDS NO SELF-DEALING, JUST SCRIVENER'S ERROR

Joseph created a net-income with make up charitable remainder unitrust, retaining income for his life and then his wife's life before assets passed to charity. Because the trust was to be funded with illiquid assets that would not generate the income needed to pay the unitrust amount, Joseph agreed to the net-income with make up provision. He requested, however, that the net-income with make up provisions only be effective so long as the trust held the contributed property [Reg. §1.664-3(a)(1)(i)(c)(2)]. Due to miscommunication between Joseph and his advisors, a revised trust agreement that did not contain flip language was executed. The trustee discovered that the trust did not comply with Joseph's intent and sought a judicial reformation.

The IRS ruled that a modification or reformation of a charitable remainder trust does not violate Code §664 if necessary to conform the trust to the grantor's intent. An examination of the evidence presented showed Joseph's trust was contrary to his stated intent. The judicial reformation was consistent with state law and does not adversely affect the trust's qualification, said the IRS.

The IRS also noted that the reformation may have the effect of increasing the annual amount paid to Joseph. Any such increase could be considered a transfer to or for the benefit of a disqualified person – an act of self-dealing under Code §4941. However, the rules of Code §4941 do not apply to amounts payable under the terms of a split-interest trust to income beneficiaries, so long as no deduction was allowed under Code §§170(f)(2)(B), 2055(e)(2)(B) or 2522(e)(2)(B) with respect to the income interest [Code §4947(a)(2)]. The IRS said the self-dealing rules will not apply to Joseph, since he took no such deduction (Ltr. Rul. 200932003).

PHILANTHROPY PUZZLER

George plans to fund a charitable remainder trust that will pay him income for life and then benefit his favorite charity. The trust is to be funded with an office building and the underlying real estate. George is a do-it-yourselfer who has always done the landscaping maintenance on the property and plans to continue doing so once the real estate is in the trust. He would like to be reimbursed for his expenses (gasoline, fertilizer, equipment maintenance) and paid a modest compensation for his time. He has asked whether the payment by the trust would present a self-dealing problem, under applicable private foundation rules.

REFORMATION APPROVED, BUT DEDUCTION MIGHT CHANGE

Dick and Jane established a private foundation, qualified under Code §509(a). They later funded a charitable remainder unitrust, to which each contributed shares of stock. Their son Roger was the trustee and income beneficiary of the trust, with assets to pass at Roger's death to the foundation.

Following Dick's death, Roger discovered that the trust requires the charitable remainderman to be an organization described in Code §§170(b)(1)(A), 170(c), 2055(a) and 2522(a). The couple's private foundation is not an organization described in Code §170(b)(1)(A), making it ineligible to be the remainderman.

Roger asked the court to approve a modification, citing a scrivener's error. State law permits amendments where necessary to comply with the original intentions of the grantors. Jane submitted an affidavit indicating that it was her intention to make the foundation the remainderman. The drafting attorney also said that it was the couple's clear intention to make the foundation the remainderman, noting that he failed to modify the standard unitrust form to delete the reference to Code §170(b)(1)(A).

The IRS ruled that the reformation would not violate any provisions of Code §664, due to the scrivener's error. As amended, the trust's qualifications as a charitable remainder trust were not adversely affected. The IRS added, however, that the percentage limitations under Code §170(b)(1)(B) applicable to gifts to private foundations might limit the charitable deduction available to Dick and Jane (Ltr. Rul. 200932020).

CRT FOUR-TIER RULING DEFERRED

Sydell Miller owned 3 million shares of Bristol-Myers Squibb stock, either directly or through her wholly owned S corporation, Nevadamax, Inc. She transferred the stock in 1999 to a partnership in exchange for a 99% limited partnership interest and a .6% general partnership interest. Nevadamax transferred its shares to the partnership for a .4 limited partnership interest. Several days later, Miller contributed the 99% limited partnership interest to a term charitable remainder annuity trust that was to pay her the annuity amount and terminate in 2001.

The day after transferring her interest into the annuity trust, Miller caused the partnership and Bear Stearns International, to enter into a variable forward purchase contract for the Bristol-Myers stock, with a 2001 purchase date. Bear Stearns paid the partnership $198 million in 1999, under the agreement.

The partnership made cash distributions to the annuity trust in 1999, 2000 and 2001, calculated to meet the trust's monthly obligation to Miller. The primary source of the funds for the distributions was the $198 million paid from Bear Stearns. Miller received more than $204 million from the annuity trust from July 1999 to June 2001. She reported this income as nontaxable return of corpus [Code §664(b)] on her returns for those years.

The IRS argued that the partnership made a completed sale when it executed the forward contract and therefore had approximately $214 million in capital gain income for 1999. The partnership-level case was pending before the Tax Court. The IRS also said that the annuity trust is treated as having sold a pro rata portion of the Bear Stearns stock each year, making the distribution to Miller capital gains rather than return of corpus under the anti-abuse regulations [Reg. §1.643(a)-8].

The Tax Court noted that distributions from the annuity trust are taxed under the four-tier system [Code §664(b)]. Anti-abuse regulations issued in 2001 were designed to prevent "inappropriate manipulation" of the four-tier system. The court stated that the regulations apply only to the extent that the remainder trust distributions would be characterized as distributions of corpus. Therefore, said the court, the anti-abuse rules would not apply if the partnership gain issue is upheld in the partnership-level proceedings. Distributions would be characterized as gain under Code §664(b)(2), rather than return of corpus under Code §664(b)(4).

Recharacterization of the annuity trust distributions, whether as capital gain or under the anti-abuse regulations, depends upon a final determination of the partnership gain issue, said the court, adding that the IRS had improperly issued the deficiency notice to Miller before the court had ruled in the partnership proceeding. Because the notice is invalid, the court lacks jurisdiction (*Miller v. Comm'r.*, T.C. Memo. 2009-182).

PUZZLER SOLUTION

The payment of compensation or reimbursement of expenses by a private foundation to a disqualified person is generally an act of self-dealing [Code §4941(d)(1)(D)]. There is an exception, however, where the disqualified person is receiving compensation or reimbursement for personal services that are reasonable and necessary to carry out the exempt purposes of the private foundation and where the compensation or reimbursement is not excessive [Code §4941(d)(2)(E)]. Provided payments to George are comparable to those charged by outside vendors, the payments will not constitute self-dealing (Ltr. Rul. 9626007).

SUBSTANTIATION MANDATORY, NOT JUST A SUGGESTION

As year-end planning season approaches, many clients may be considering last-minute charitable gifts. Several recent cases underscore the need for donors to be aware of and follow the rules regarding gift substantiation.

Guerrero v. Comm'r., T.C. Memo. 2009-164

The taxpayers claimed a charitable deduction of $26,000 on their 2004 return. The donors said the gifts were made in cash, anonymously, to their church, and they therefore had no contemporaneous written acknowledgment. When asked by the court if he had documentation for the gifts, the donor said he was unaware that he needed to substantiate them, adding that, in regard to instructions on the tax return relating to charitable contributions, "I don't have to follow [them]."

The court ruled that despite the donors' denial of any duty to substantiate the gifts, "it is clear taxpayers must provide records supporting their claimed deductions." Because the donors did not meet the substantiation requirements, the court determined that they were not entitled to the deductions.

Foriest v. Comm'r., T.C. Summ. Op. 2009-110

The donors claimed charitable deductions of $1,200 and $6,896 respectively in 2003 and 2004. They claimed to have made the gifts to their church by check, but presented neither canceled checks nor other substantiating documentation. The court ruled that they were not entitled to the charitable deductions.

Bruns v. Comm'r., T.C. Memo. 2009-168

The IRS disallowed $945 of the charitable deduction claimed on the couple's 2003 income tax return. That amount included a new baking rack that the donors purchased for $423.98 and had delivered directly to their church, and various cash gifts. The taxpayers had the invoice from the purchase of the baking rack, indicating that it was to be delivered to the church, along with a letter from the church stating that the rack had been a gift. The Tax Court said that the invoice established the fair market value of the rack. That, along with the letter from the church met the statutory requirement of a contemporaneous written acknowledgment.

The cash gifts, however, were made in $20 or $30 increments at miscellaneous events that occurred during the year. The donors did not have any substantiation for the additional $470 in cash gifts. Because they provided no documentation for these gifts and did not even identify the recipients, the court ruled that they were not entitled to the deductions.

In general, gifts must be substantiated by a (1) canceled check, (2) receipt from the donee organization showing the name of the charity, the date of the contribution and the amount of the gift or (3) other reliable written records showing the name of the charity, date and amount of the contribution [Code §170; Reg. §1.170A-13(a)(1)]. For gifts under $250, if the donor's bank statement does not include the donee's name, a monthly bank statement or photocopy from the bank showing the front of the check and indicating the donee's name will suffice (NPRM REG-140029-07). For gifts of $250 or more, the taxpayer must have a written receipt from the charity with a statement indicating that no goods or services were received in return for the transfer, or, if the donor received a return benefit, the statement must describe the goods or services, along with a good faith estimate of the value [Code §§170(f)(8)(A) and (B)].

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