

# The Advisor



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## ESTATE PLANNER'S TIP

Clients with disabled family members must consider carefully the best way to leave assets to these special beneficiaries. One goal may be to provide for a disabled child but not jeopardize entitlements under public programs such as Medicaid. In some family situations, parents may be able to transfer assets to other children with assurance that the funds will be used to provide extras for the handicapped sibling. A more formal approach is to establish a special needs trust that gives the trustee discretion to determine when distributions should be made for the benefit of the disabled child. Because the trustee is not required to make distributions of either income or principal, the assets generally are not attributed to the child for purposes of determining eligibility for assistance. State laws typically prevent disabled individuals from establishing discretionary trusts for themselves, so assets should be transferred from a parent or grandparent directly to the trust, not through the child. Another suggestion: Parents should state in the trust instrument that their intent is to supplement any public entitlements – making it clear that the trustee is not to use the assets in a way that would cause the child to lose public entitlements.

## GENEROSITY NOT WITHIN POWER OF ATTORNEY

Willis Barnett executed a document granting his son, Elton, a power of attorney. Between July 31, 2003 and October 13, 2003, Elton executed 17 checks in the amount of \$11,000 each. The checks indicated that they were gifts. Twelve of the checks were cashed after Willis' death on October 13. The IRS added the value of the gifts to the gross estate, noting that the power of attorney did not include the authority to make gifts. Elton acknowledged that there was no authority to make gifts, but said that he was allowed to do so after discussing the matter with Willis, thereby ratifying the gifts.

The U.S. District Court (WD Pa.) noted that under state law, a principal may empower an agent to make gifts, but only by including specific language in the power of attorney. The court added that although there is no question of material fact, and a summary judgment in favor of the IRS was appropriate, it would address the issue of whether the power was modified to allow Elton to execute the checks.

The court found that while earlier case law allowed the principal to modify the agency relationship by acquiescing to new powers, the cases predated the state statutes that required that the

power to make gifts be expressly stated. Courts have since construed the statute narrowly. The court said that because Elton lacked the power to make the gifts, each check failed to constitute a valid gift for estate tax purposes. Having determined that, the court said it was not necessary to address the question of the timing of checks cashed after Willis' death (*Barnett v. U.S.*, 2009-2 USTC ¶60,576).

### IRA OWNER DOESN'T PAY FOR CUSTODIAN'S MISTAKE

Richard began taking substantially equal periodic payments from his IRA in 2003, prior to reaching age 59½ [Code §72(t)(2)(A)(iv)]. The custodian annually withheld and forwarded the appropriate amount for state and federal withholding until 2007, when it failed to make the distribution of state taxes. Richard didn't discover the mistake until he received his Form 1099-R in early 2008. He chose to pay the taxes from other funds, rather than have the payment made from his IRA.

If a series of substantially equal payments is modified, the 10% early withdrawal penalty and interest is due on all payments received [Code §72(t)(4)]. Richard asked the IRS whether the custodian's failure to withhold the amount for state taxes was a modification that triggered the tax,

and whether a make-up payment in 2009 would satisfy the annual payment requirement for 2007.

The IRS noted that other than the proposed make-up payment, Richard will continue using the same method for calculating his annual payments. The failure to distribute the entire amount for 2007 and the subsequent make-up distribution will not be considered a modification, and Richard will not be subject to the 10% additional tax for premature distributions [Code §72(t)(1)] (Ltr. Rul. 200930053).

### GST-EXEMPT REMAINDER TRUST SURVIVES MODIFICATION

Glenn created a trust prior to July 31, 1969 (when charitable remainder trust rules were enacted) that provides an annual annuity to his nieces and nephews, and then to their children, for life. Income from the trust in excess of the annuities is paid in equal shares to six charities and remaining assets will pass to the charities when the trust terminates.

The value of the trust has grown significantly, with the annual payments representing only .1% of the assets. It was determined that less than 4% of the value of the trust was needed to fund the annuities. Based on the ages of the surviving beneficiaries, the trust is expected to last until 2051.

State law permits modification of irrevocable trusts with the consent of all beneficiaries. The parties have agreed to a partial termination, resulting in an outright distribution of funds to the charities. The organizations have purchased commercial annuities, which they will own, to benefit the annuitants. The IRS ruled that because the annuitants have no rights in the commercial annuities, they will not realize immediate capital gain, loss or taxable income.

The partial termination does not alter the interests of the parties or shift income to a member of a lower generation, so the trust continues to be exempt from generation-skipping transfer tax under Code §2601. Because the only modification to the trust is the timing of the receipt of a large portion of the corpus by the charities, the annuitants will not recognize gain or loss under Code §1001(a) (Ltr. Rul. 200922013).

### PHILANTHROPY PUZZLER

Terry is happily married to Jean (his fourth wife) and wants to set up a charitable remainder unitrust for the two of them with his separate property. He expects to die married to Jean, but he is also a realist and asks you privately what tax planning steps should be taken, "just in case" this marriage doesn't last. Terry knows something about taxes and realizes that, in case of divorce, his estate would owe federal estate tax on Jean's survivor income interest (the marital deduction will have been lost).

### CHARITY INELIGIBLE TO RECEIVE ASSETS FROM ESTATE

Lynn Tuvim executed payable on death (POD) designations on CDs, a trust account and U.S. savings bonds held at various banks, naming United Jewish Communities (UJC) as beneficiary. At her death, her sons sued to cancel the contracts, saying that UJC was an ineligible POD beneficiary under state law. UJC asked that a constructive trust be imposed on the grounds of cy pres and unjust enrichment if it was found to be an ineligible beneficiary. The trial court found UJC was a qualified POD beneficiary and ruled alternatively that a constructive trust would be imposed.

The Supreme Court of Georgia reversed, noting that under state law, a POD designee must be a person, defined to expressly exclude any “incorporated enterprise.” UJC is also not a proper POD beneficiary for the savings bonds, said the court. Federal regulations generally limit bond beneficiaries to “individuals.”

The trial court erred in imposing a constructive trust, added the court. Assuming she was attempting to make a charitable bequest to UJC, the manner she chose to make the gift was invalid as a matter of law. That does not permit the trial court to use equitable power to “accomplish through cy pres exactly what could not be accomplished legally,” ruled the court. The court found no unjust enrichment, saying that the financial instruments would become part of her estate. Benefit to the sons would result from the application of intestacy rules, not unjust enrichment (*Tuvim v. United Jewish Communities*, S09A0006).

### DECEDENT’S INTENT DETERMINES ALLOCATION

Robert McDevitt owned and operated a funeral home started by his grandfather in 1880. In addition, he owned stock worth about \$300 million. He was a widower with no living relatives. McDevitt left the funeral home business, worth about \$500,000, and a \$3 million trust, to a long-time employee, with the request that the employee not change the name or sell the business for at least ten years. The balance of the estate was left to various charities within the Catholic Diocese.

McDevitt’s will contained two clauses dealing

with taxes and expenses. The first stated that debts, administrative expenses and taxes were to be paid from the bequest of the funeral home. A later provision required only estate taxes to be paid from the bequest. Debts, attorneys’ fees and administrative expenses are estimated to be more than \$13.8 million, which would completely eliminate the funeral home bequest and require the business to be sold.

The Surrogate’s Court ruled that allocating all expenses to the funeral home bequest would defeat McDevitt’s primary intent – the continuation of the funeral home. The court added that, for conflicting will clauses, the one appearing later is given preference. As a result, only the estate taxes will be paid from the funeral home bequest, with expenses and fees allocated to the residue.

McDevitt’s will also left his home and its contents to the Diocese, with the “expectation” that it could be used rent free by one of four stated officers of organizations within the Diocese. The executors were concerned that this constituted a limitation on the bequest that might preclude the charitable deduction. The court determined that the language was merely precatory, not mandatory, particularly since the will contained no reversionary provision. The bequest was absolute, ruled the court (*In the Matter of the Construction and Reformation of the Last Will and Testament of McDevitt*, 2009 NY Slip Op 51256(U)).

### PUZZLER SOLUTION

Terry should establish a two-life unitrust that pays income first to himself and then to Jean as survivor beneficiary, retaining in the trust instrument the right to revoke Jean’s survivorship interest in his will (see Rev. Rul. 72-395, §7.07). The transfer will be incomplete for gift tax purposes [Reg. §25.2511-2(c)]. If they should divorce, he can change his will to revoke at death. The trust assets will be included in his gross estate but will qualify for the estate tax charitable deduction. If he dies married to Jean, an estate tax marital deduction is available under Code §2056(b)(8).

### GIFT TAX RETURNS NEEDED FOR CHARITABLE GIFTS TOO

■ *Ann places \$100,000 in a trust paying her income for life, with a remainder to her daughter.*

■ *Barbara places \$100,000 in a qualified charitable remainder trust that pays a unitrust amount to her nephew for life and the remainder (valued at \$44,000) to her favorite charity.*

■ *Cynthia gives appreciated securities worth \$100,000 to charity. In the same year, she gives \$50,000 cash to her nephew – a taxable gift.*

Which of these three women must file a gift tax return?

The answer is all three – each for a different reason. Ann’s gift of a remainder interest in trust to her daughter is a gift of a future interest that does not qualify for the annual exclusion [Code §2503(b)]. Barbara’s gift to her nephew, although a present interest, is worth more than the \$13,000 annual gift tax exclusion in effect for 2009. Both women are required to file gift tax returns under Code §6019.

But why does Cynthia need to file a gift tax return for an outright gift to charity? The IRS, in its instructions for Form 709, states that if taxpayers are required to file a return to report noncharitable gifts, then all charitable gifts must be included on the gift tax return, as well.

Cynthia gets two deductions for her one gift to charity. She receives an income tax charitable deduction [Code §170] which she claims as an itemized deduction on Schedule A of her Form 1040. She also gets a 100% gift tax deduction [Code §2522] which she claims on Form 709. The gift tax return must be filed no later than the due date of the income tax return, with extensions.

Aside from the legal requirement to file a gift tax return, there are also practical reasons to do so. Filing Form 709 creates a paper trail. It is important for a taxpayer facing an audit to be able to demonstrate that gifts were made and returns properly filed to account for any gaps in income. The return also may assist the executor of an estate faced with accounting for all of the decedent’s assets.

Filing a gift tax return also starts the clock running on the statute of limitations and limits the time in which the IRS can challenge the value or deductibility of a charitable gift. Otherwise, the donor could be faced with the difficult task of reconstructing the paperwork to document the gift.

Many split-interest charitable gifts require that a gift tax return be filed, if only to declare the value of the noncharitable interest. Unless the value of the noncharitable portion qualifies for either the \$13,000 annual exclusion (\$26,000 if the donor’s spouse consents to gift-splitting) or the unlimited marital deduction, the donor is required to file a return to declare the noncharitable gift. A return must be filed in any case where charity receives a future interest. In certain situations a donor may, in fact, owe a gift tax on a charitable gift. A donor who creates a charitable trust that does not qualify as a unitrust or an annuity trust is not entitled to a gift tax deduction [Code §2522(c)]. A trust that pays all income to the noncharitable beneficiary or a trust that allows the grantor to invade trust principal to pay medical expenses are examples of charitable trusts that do not qualify for the charitable deduction.

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