

# The Advisor



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## ESTATE PLANNER'S TIP

Irrevocable life insurance trusts can hold insurance proceeds out of the reach of the federal estate tax, but in many cases, it may be simpler to have the policy owned directly by the beneficiary. For example, a parent might give ownership of a new policy to a "reliable" son or daughter. (A gift of an existing policy would be included in the insured's estate under Code §2035 if the transfer occurs within three years of death.) The parent could pay the premiums directly – not considered an incident of ownership under Code §2042 – or give the child money with which to pay the premiums. Provided the premiums, along with other gifts made by the parent, fall within the annual exclusion amount [Code §2503(b)], there would be no gift tax. If the child dies before the insured, the policy is included in the child's gross estate, but the value is only the interpolated terminal reserve plus a portion of the most recent premium covering the period after the child's death (Rev. Rul. 77-181, 1977-1 C.B. 272). Disadvantage? Impatient and unreliable offspring may raid the policy before the insured dies, frustrating the estate owner's intentions.

## COURT ALLOWS TWO BITES FROM APPLE

After leaving her employer prior to age 59½, Kim Benz elected to begin taking substantially equal withdrawals, based on her life expectancy, from her IRA. The annual distributions were not subject to the 10% early withdrawal penalty because they fell within the exception under Code §72(t)(2)(A)(iv). Two years later, in addition to a \$102,311.50 payment from the IRA, Benz took two distributions totaling \$22,500 to pay the higher education expenses of her son. Benz and her husband reported and paid income tax on the \$124,811.50 distributions. The IRS determined a tax deficiency, saying that \$89,590 was subject to

the 10% tax on early withdrawals. The couple argued that the higher education expenses fell within the Code §72(t)(2)(E) exception.

The Tax Court noted that Congress had found it "appropriate and important" to allow early distributions from IRAs for higher education expenses without the 10% penalty. The issue, said the court, was whether the distribution for education expenses was a modification of the substantially equal periodic payments the taxpayer had begun. Benz argued that a distribution used for a purpose qualifying for a statutory exception is not a modification. The court agreed,

noting that Code §72(t)(2)(E) recognized that a taxpayer may qualify for more than one statutory exception to the additional tax. Further, the legislative history provides that the 10% tax will be imposed if a change to the distribution method is made “to a method which does not qualify for the exception.” The court said it found no Congressional intent to disallow all additional distributions within the first five years of the election to receive periodic payments, adding that the legislative purpose is not frustrated where a taxpayer receives distributions for more than one of the purposes that Congress has recognized as deserving special treatment (*Benz v. Comm’r.*, 132 TC No. 15).

### QTIP ELECTION RULED “NOT NECESSARY”

Paul’s will provided that the residue of his estate was to pass to a QTIP trust, with a separate credit shelter trust to be funded with “the largest amount that can pass free of federal estate tax.” The executor made a QTIP election under Code §2056(b)(7) on the Form 706. After closing the estate, it was discovered that Paul’s estate was less than the credit-sheltered amount. Because no tax was due, the QTIP election was not necessary. The IRS was asked to rule that the marital

deduction election was null and void.

Under Code §2056(b)(7)(B)(v), the QTIP election, once made, is irrevocable. However, in Rev. Proc. 2001-38, the IRS said that a QTIP election will be treated as null and void where the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes. Rev. Proc. 2001-38 gives the example of an estate where a credit shelter trust is to be funded with an amount equal to the exclusion amount, with the balance of the estate passing to a marital trust. The estate makes a QTIP election with respect to both trusts, but the election for the credit shelter trust was not necessary because no estate tax would have been imposed, even without the election.

Similarly, Paul’s estate tax liability would have been zero because the estate was below the exclusion amount. Therefore, the QTIP election is null and void. The property in the trust will not be included in his wife’s gross estate under Code §2044 and she will not be treated as making a gift under Code §2519 if she disposes of the income interest with respect to that trust, said the IRS (Ltr. Rul. 200918014).

### NO GETTING AROUND THE TAX

George created a charitable lead annuity trust, funding it with a partial interest in a family owned limited liability company. The trust is to make payments to a private foundation for 20 years. The trustee wants to distribute appreciated securities directly to the foundation, rather than making the annuity payment from income, and has asked the IRS to rule that neither George nor the trust will recognize a gain on the transaction.

In *Kenan v. Comm’r.* [114 F.2d 217 (2d Cir. 1940)], The court held that because the beneficiary had a claim against the trust for an ascertainable value, the transfer of securities to pay the beneficiary resulted in a taxable exchange. The court added that there should not be different tax consequences just because the trustee exercised its power to make a transfer from corpus instead of selling the stock and realizing a gain first. The IRS confirmed this result in Rev. Proc. 2007-45

### PHILANTHROPY PUZZLER

Thomas, age 60, wished to fund a charitable remainder annuity trust that would pay him 8% annually. After running the computation, the planned giving officer at his favorite charity informed him that the trust would not pass the 5% probability test, so the trust would not qualify. She suggested that Thomas either reduce the payout percentage or consider funding a charitable remainder unitrust, which does not have to meet the test. Thomas has asked whether he can fund the annuity trust anyway, even if there is no deduction, in order to enjoy the larger payout.

(2007-2 C.B. 89), where it ruled that if a trustee distributes appreciated property in satisfaction of the required payment of a grantor charitable lead trust, the donor will realize capital gain on the assets distributed to satisfy part or all of the payment.

The IRS determined that if the trustee used appreciated assets to make the annuity payment to the foundation, George would recognize any gain (Ltr. Rul. 200920031).

### DIFFERENT COURTS, SAME RESULTS

#### *Jones v. Comm'r.*, 2009-1 USTC ¶50,316

Leslie Jones was an attorney for Timothy McVeigh, convicted in the 1995 bombing of the federal building in Oklahoma City. Jones was given photocopied documents, photographs and computer disks from the FBI related to the case. In 1997, Jones contributed the material to the Center for American History at the University of Texas at Austin. He claimed a charitable deduction of nearly \$295,000, based on an appraisal of the documents.

The Tax Court agreed with the IRS that Jones was not entitled to the deduction, saying none of the material was his work product, but merely documents provided to him by the FBI. Because he did not “own” the material, he could not make a valid gift of it. The court said that even if Jones did “own” the documents and could ethically donate them under Oklahoma’s rules of professional conduct, his deduction would be limited to his basis. Since he did not show that his basis was greater than zero, he was not entitled to a deduction [*Jones v. Comm'r.*, 129 T.C. 146].

The U.S. Court of Appeals (10th Cir.) upheld the Tax Court’s ruling that the discovery material donated by Jones “falls within the plain language of Code §1221(a)(3)(B),” limiting his deduction to basis.

#### *Sklar v. Comm'r.*, 2009-1 USTC ¶50,106

The Tax Court denied a charitable deduction for a portion of the tuition parents paid to send their children to a religious school. The parents argued that because the school allocated its teaching time between religious and secular edu-

cation, they should be entitled to deduct the portion allocable to the religious teaching [*Sklar v. Comm'r.*, 125 TC No. 14].

The U.S. Court of Appeals (9th Cir.) affirmed the ruling, saying that to allow the deduction would be “tantamount to rewriting the Tax Code” and “disregarding Supreme Court precedent.”

### BENEFICIARY GIVES, TRUST GETS DEDUCTION

Jean is the beneficiary of an irrevocable trust that gives her a lifetime limited power of appointment to distribute all or any portion of the trust to any charitable organizations. She intends to exercise the power to direct the trustees to distribute all or part of the income to charity.

An unlimited charitable deduction is allowed under Code §642(c)(1) for any amount of gross income paid for charitable purposes pursuant to the governing instrument. The IRS ruled that Jean’s exercise of her power of appointment to have the charitable distributions made would be considered “pursuant to the terms of the governing instrument” and would qualify for the charitable deduction (Ltr. Rul. 200906008).

### PUZZLER SOLUTION

Under the 5% probability test (Rev. Rul. 77-374, 1977-2 C.B. 329), no deduction is allowed for a charitable remainder annuity trust if the probability exceeds 5% that the noncharitable beneficiary will survive to the exhaustion of the trust fund. A charitable remainder trust is one for which a deduction is allowable under Code §§170, 2106 or 2522 [Reg. §1.664-1(a)(1)]. An annuity trust that does not satisfy the 5% probability test does not qualify as a charitable remainder trust (Ltr. Rul. 9532006). Thomas’ trust thus would not be tax-exempt, and he could also be liable for gift tax on the value of charity’s remainder interest. Alternative? A term-of-years annuity trust is not subject to the 5% probability test.

## PASSPORT TO FOREIGN GIFT DEDUCTIONS

Foreign travel and internet connections have increased the number of charitable contributions by American taxpayers to support charities in foreign countries. Whether cross-border generosity yields a charitable deduction depends upon a number of factors, however.

### *Inter vivos gifts to foreign charities*

Generally, a gift from a U.S. citizen to a foreign charity does not qualify for an income tax charitable deduction. Gift tax charitable deductions are permitted, however [Reg. §25.2522(a)-1]. Code §170(c)(2) defines a charitable contribution as a gift made to or for the benefit of an organization “created or organized in the United States.” There are exceptions, created by tax treaties, such as the Convention Between the U.S. and Canada with Respect to Taxes on Income and on Capital. The treaty provides that a gift by a U.S. citizen or resident to an organization that is resident in Canada and is generally exempt from Canadian tax and which could qualify in the U.S. to receive deductible contributions if it were located in the U.S. is treated as a charitable contribution that is deductible against Canadian source income. Gifts to Canadian colleges are deductible against U.S. income if donors or family members have attended the schools (Pub. 597).

### *Bequests to foreign charities*

Unlike the income tax code, the estate tax laws permit a deduction for bequests to foreign charities, provided that the funds are restricted to exclusively religious, charitable, scientific, literary or educational purposes [Code §2055(a)(2)]. For example, a bequest to an orphanage located in a foreign country qualified for a charitable deduction (Ltr. Rul. 9853037), as did a bequest to

rebuild a mosque in a foreign country (Ltr. Rul. 200024016). A bequest to a city in a foreign country “to be used for charitable purposes” also qualified (Ltr. Rul. 200905015). But a bequest left outright to a foreign country did not qualify for a charitable deduction because the use of the funds was not restricted to charitable purposes (Ltr. Rul. 8748001), even though the foreign country intended to so use the funds.

### *Gifts to U.S. charities operating in foreign countries*

Many charities organized in the U.S. have foreign affiliates or perform charitable work in foreign countries. Gifts to such charities for use outside the U.S. may qualify for an income tax charitable deduction, provided the American charity is not merely a conduit for funneling contributions to the foreign country. If the U.S. charity reviews and approves the use of the funds as being in furtherance of its own exempt purposes and if it retains control and discretion over the use of the funds, an income tax charitable deduction is allowed [Rev. Rul. 66-79, 1966-1 C.B. 48].

### *Charitable remainders following qualified domestic trusts*

The unlimited estate tax marital deduction is not available where the surviving spouse is a noncitizen [Code 2056(d)]. Any estate tax that might be owed can be postponed by the use of a qualified domestic trust [Code §2056A]. If, at the death of the surviving spouse, the assets of the qualified domestic trust pass to charity, an estate tax charitable deduction will be allowed, similar to the treatment of a charitable bequest following a QTIP trust, including transfers to foreign charities [Code §2056(b)(8)].

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