

The Advisor



June 2009

ESTATE PLANNER'S TIP

A durable power of attorney can be drafted to cover a broad range of financial decisions. One instrument granted the attorney-in-fact "full power and authority to do everything necessary in exercising any of the powers herein granted as fully as I might or could do if personally present." But even that language might not be broad enough to accomplish desired estate planning goals. The IRS and a number of courts have ruled that the holder of a power of attorney does not have the authority to make gifts of property where the authority is not expressly conferred in the instrument [*Estate of Casey v. Comm'r.*, 948 F.2d 895]. It may be desirable for the attorney-in-fact to make annual exclusion gifts to family members [Code §2503(b)] or even lifetime taxable gifts, but without express gift-empowering language in the document, transfers made within three years of death may be brought back into the decedent's gross estate under Code §2038. Clients should weigh the practicality and desirability of having others make gifts on their behalf – and counsel should draft specific language, if needed.

MAKING PAYING A LITTLE LESS PAINFUL

Taxpayers who owe tax when filing their income tax returns can simply say, "charge it." And while the cardholders may earn cash back or airline miles, the drawback has been that they also have to pay a service fee to the credit card company that averages approximately 2.5%. Federal law restricts the IRS from paying any fees.

The IRS recently announced that certain taxpayers may deduct the service fees as miscellaneous itemized deductions. The taxpayer must file Form 1040, Schedule A and have enough itemized expenses (e.g., job search expenses, tax preparation fees, safe deposit box rental, unreimbursed employee expenses)

to exceed 2% of adjusted gross income. The fee is deductible in the year it is paid (IR-2009-37).

MORE CANDLES ON THE CAKE

Americans are living longer, according to the IRS, which recently released a new mortality table. Table 2000CM, replacing Table 90CM, reflects figures gathered from the 2000 census. The mortality table, which is to be used to value transfers made after April 30, 2009, will result in slightly lower charitable deductions for charitable remainder trusts and charitable gift annuities. The IRS also updated Publications 1457, 1458 and 1459, with examples for computations using the new factors.

ESTATE TAX COMPUTATION RULES PROPOSED

Proposed regulations have been issued to determine the amount to be included in the gross estate of the grantor of a grantor retained trust or charitable remainder trust. Under Prop. Reg. §20.2036-1, the amount includible is the sum of (1) the amount of corpus required to generate sufficient income to pay, without reducing or invading principal, the annual amount payable to the decedent at death and (2) for each succeeding year of the trust, the amount of corpus required to generate sufficient income to pay, without reducing or invading principal, the increase (if any) in the annuity, unitrust or other payment for that year, deferred until the beginning date of the increase (NPRM REG-119532-08).

FIVE YEARS MEANS FIVE CONSECUTIVE YEARS

The IRS audited the 2002 income tax return of Gregory and Terri Maddux, finding that their charitable contributions of more than \$122,000 were properly substantiated. The IRS said they would have to carry over \$61,150 to later years. The couple claimed amounts on their 2004 and 2005 returns, but did not amend their 2003 return, which had already been filed. When the

PHILANTHROPY PUZZLER

Paul and Daphne own a beach home in Mexico that they use several months each year, renting it out for income the remainder of the year. They are generous supporters of several charities and have no children to whom they wish to leave the home at their deaths. They attended a seminar where they learned how they could receive an income tax deduction today, when their income is high, and continue to use the home for the rest of their lives by giving charity a remainder interest. They have asked whether this gift technique applies to foreign real estate.

IRS disallowed the bulk of their 2005 carryover, the Madduxes sued.

Code §170(d)(1)(A) provides that cash contributions exceeding 50% of the donor's adjusted gross income (contribution base), are treated as charitable contributions paid in each of the five succeeding taxable years in order of time. The limitations apply even if a taxpayer uses the standard deduction in a particular year

The Tax Court rejected the couple's argument that because the rules regarding carryovers were "confusing," they should be given additional time to file an amended return for 2003. The Madduxes also said that they should have been told when the 2002 return was audited that they needed to amend their 2003 return to claim a portion of the carryover. The court said that while the rules may be "intricate," deductions are allowed as a matter of legislative grace and only as provided by statute (*Maddux v. Comm'r.*, T.C. Summ. Op. 2009-30).

BEQUESTS AND DEDUCTIONS CROSS THE BORDER

Miriam's will left a bequest in trust to a city in a foreign country, "to be used for charitable purposes." She also left paintings to a museum in the city. The museum is a public entity owned by the foreign city, and therefore tax exempt. Its collections are held for the exclusive benefit of the public and exempt from transfer tax. Miriam's executor asked the IRS whether her estate is entitled to a charitable deduction for the value of the foreign bequests.

Code §2055(a) provides a charitable deduction for bequests "to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary or educational purposes." Reg. §20.2055-1(a)(4) notes that the charitable deduction is not limited to transfers within the U.S.

In Rev. Rul. 74-523 (1974-2 C.B. 304), the IRS said that a gift to a foreign government that is to be used exclusively for charitable purposes

qualifies for an estate tax charitable deduction under Code §2055. Charitable deductions are not allowed for bequests to foreign governments or political subdivisions if the use of the property is not limited to charitable purposes.

The IRS said that Miriam's estate would be entitled to charitable deductions under Code §2055(a)(3) for the value of the bequest to the city and under Code §§2055(a)(2) and (3) for the value of the paintings (Ltr. Rul. 200905015).

CHARITIES "SHARE" IN PAYMENT OF STATE TAXES

Carrie Menchhofer moved from California to Iowa after her husband's death in 2001. The couple had executed a trust, to be administered under California laws, directing the trustee to pay from income or principal, "any federal estate tax and state death tax." The trust divided the amount sheltered by the estate tax credit (\$1.5 million in 2005) equally among 20 individuals, with the residue passing to three charities.

An Iowa District Court, applying California law, found that "death taxes" in the trust was defined broadly enough to include Iowa inheritance taxes. The charities argued that Iowa apportionment rules, which require taxes to be paid by the beneficiaries whose interests generated the tax, should apply. The Court of Appeals of Iowa noted that the apportionment rules do not apply if the testator directs otherwise by "clear and express words or necessary implication." The appeals court affirmed that the testators wanted the tax to be paid from trust income or principal, even if this meant that charities would receive less.

The Court of Appeals also approved the expenditure of up to \$4,000 by the trustee to determine whether Menchhofer had been subject to undue influence prior to her death when she made gifts and forgave loans totaling more than \$541,000 to three of the 20 individual beneficiaries. These gifts were not in keeping with the provisions of the trust, which called for the individuals to receive equal shares. The court

noted that the charities might benefit if money is returned to the trust (*In the Matter of Menchhofer Family Trust*, No. 8-464/07-1702).

GIFTS TO CHARITY NICE, BUT NOT "NECESSARY"

Gerry Freeman objected to a \$10,522.35 tax lien filed by the IRS. Freeman, who made an offer in compromise, said the IRS improperly rejected his argument that the tax liabilities should be offset by charitable donations of \$471.75 per month. The U.S. Court of Appeals (9th Cir.) noted that while Freeman considers the expenditures "essential to his health and welfare," the Tax Court did not err by determining that the contributions did not meet the "necessary expense" test used in evaluating offers in compromise under the Internal Revenue Manual (*Freeman v. Comm'r.*, 2009-1 USTC ¶50,320).

STRATEGIES FOR CHARITABLE BEQUESTS

Planning charitable bequests involves more than just determining a charity's correct legal name and its status as a qualified organization. The testator must consider whether the bequest should be outright or in the form of a testamentary trust and which assets would best be given to charity. (*Continued on back page*)

PUZZLER SOLUTION

The qualification of the charity, not the location of the real estate, determines whether Paul's and Daphne's gift of a remainder interest in their home will entitle them to an income tax charitable deduction. Provided the organization is a qualified U.S. charity, they will be permitted a deduction for the value of charity's remainder interest (Ltr. Rul. 8411059). The transfer of a remainder interest to charity must also pass muster under the laws of the foreign jurisdiction.

STRATEGIES . . . (Continued from page 3)

Outright or in trust?

An outright bequest can be a specific dollar amount, such as "\$10,000 to XYZ Charity." It can also be a specific asset, such as "my stamp collection," which can be satisfied only by that assets. If the testator disposes of the assets prior to death, the bequest is extinguished. A bequest also may be for a particular type of property, for example, "1,000 shares of X stock."

Outright bequests can be made in the form of a percentage of the net value of the estate (e.g., "ten percent of my estate"), as the residue of the estate or a portion of the residue (e.g., "one-half the residue of my estate").

Bequests in trust, also known as deferred bequests or split-interest bequests, offer flexibility and possible estate tax savings. An outright bequests to charity produces a larger charitable deduction than a bequest in trust because charity receives the money immediately. However, some testators may need to provide continuing financial support for dependents. A split-interest bequest serves both purposes.

Split-interest bequests come in many forms: charitable remainder annuity trusts, charitable remainder unitrusts, QTIP trusts, charitable gift annuities, charitable lead unitrusts, charitable lead annuity trusts and remainder interests in farms or personal residences. Whatever the form of the bequest, it is important that the transfer follow the requirements set out in Code §2055(e)(2)

Which assets are best?

Certain assets make more sense from a tax standpoint. Property that would cause problems if given during the donor's life often makes the best bequest. One example is ordinary income

property. The charitable deduction for an inter vivos gift of ordinary income property, such as a painting in the hands of the artist, is limited to the donor's cost basis under Code §170(e)(1)(A). In contrast, a bequest of a painting by the artist produces an estate tax charitable deduction equal to the fair market value of the artwork.

Tangible personal property at risk of being put to an unrelated use by the donee is also more valuable as a bequest. Consider for example the contribution of an antique car to a college. If given during the donor's life, the income tax charitable deduction likely would be reduced by 100% of any long-term capital gain [Reg. §1.170A-4(b)(3)(i)]. The same car bequeathed to the college will produce an estate tax charitable deduction equal to the fair market value.

Testators may be wise to make charitable contributions of income in respect of a decedent (IRD). This is income that the decedent earned prior to death that is paid to the estate after death. IRD is taxed twice – in the decedent's gross estate and in the estate's income. A bequest to charity of items of IRD can create both estate tax and income tax charitable deductions [Code §642(c)(1)], and because charities usually pay no income taxes, the bequest will not be reduced. Items of IRD include interest on U.S. savings bonds, accounts receivable of a cash-basis individual, renewal commissions of insurance agents, deferred compensation, last salary check, bonuses and distributions from employee benefit plans, accrued royalties under a patent license, a deceased partner's distributive share of partnership income up to the date of death and payments on installment obligations.

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