

The Advisor



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ESTATE PLANNER'S TIP

Nearly everyone who owns a home has homeowner's insurance. In fact, if the property is mortgaged, the lender will insist on protection and may require that the insurance premium be paid through an escrow added to the monthly payment. But lenders aren't always concerned about *how much* insurance is being carried on the home. The homeowner should be. Coverage should equal at least 80% of the replacement cost of the home. Any less than 80% and the homeowner could be penalized on a claim. Consider the owner of a home valued at \$300,000 who carries only \$200,000 of coverage (83% of the required 80% coverage). If damage to the home totals \$50,000, the insurance company may pay only \$41,500 (83%), rather than the full amount it would pay if the home had been insured up to the 80% level (\$240,000). An insurance evaluation, including homeowner's insurance, should be a standard part of any periodic financial planning review, particularly with home prices down in many regions of the country. Homeowners may actually be insuring their homes for more than the current market value and could benefit financially by reducing coverage limits.

STUDENT GETS A COSTLY LESSON IN ANNUITY RULES

In 1988, after the death of his father, Michael Lieber's mother used some of the proceeds of a life insurance policy to purchase an annuity to pay for Michael's future college expenses. The single premium, nonqualified deferred annuity permitted partial withdrawals before the maturity date in 2056.

In 2005, Michael's mother received a distribution of \$40,310.80, which was used for his college expenses. The IRS determined that the 10% penalty for premature distributions applied [Code §72(q)(1)]. Michael claimed that the distribution should fall within the Code §72(t)(2)(E) exception for higher education expenses. The title of Code §72 is "Annuities; Certain Proceeds of

Endowment and Life Insurance Contracts." Therefore, Michael argued, the exception for his expenses should apply to annuities.

The Tax Court said that the heading of a section does not limit the meaning of the text, noting that the exception for higher education expenses applies only to distributions from qualified retirement plans [Code §72(t)(2)(E)]. The court also rejected Michael's equity argument that the annuity was purchased to provide funds for his college education, his mother was told there would be "no repercussions" for an early withdrawal used for college expenses and the accountant who prepared the return knew the annuity had been purchased

to cover education expenses. The court said this argument was “not relevant,” adding that it can’t create exceptions to reach “what someone believes is an equitable outcome.”

The court also noted that while the exceptions to the 10% penalty under Code §72(q)(2) include distributions made on or after the death of the holder, this annuity was funded with insurance proceeds and distributions were not made on or after the death of the holder (*Lieber v. Comm’r.*, T.C. Summ. Op. 2009-34).

TRUST AMBIGUITY WORKS IN ESTATE FAVOR

In 1999, John McCoy amended a trust that was originally created in 1994. His will, also created in 1994, was not updated to reflect that he had gotten divorced and remarried. The will directed that the residue of the probate estate would pass to the trust at his death. The original trust provided that if he was survived by his wife, estate taxes and expenses were to be charged to the nonmarital share of the trust. Under the restated trust, however, the tax apportionment provision was not as clear. The IRS determined a tax deficiency of more than \$412,000, contending that taxes were to be paid from the residue of the trust, prior to any distribution to his wife, thereby reducing the marital deduction.

The Tax Court noted that the parties disagreed whether the “residue of the trust estate” mentioned in the restated trust referred to the will or the residue of the trust referenced in the trust agreement.

State (Utah) law governs how estate taxes are apportioned. In general, unless otherwise directed in the will or trust, the estate taxes are to be apportioned in the proportion that the value of the interest of each person bears to the total value of the interests. Under this equitable apportionment formula, estate taxes are charged only to the property generating or creating the tax liability. The court found that it was not clear whether McCoy intended the provisions to govern the allocation of the taxes or merely intended the residue to be the source of the estate tax payment.

The court noted that the Utah Supreme Court had found a “strong policy in favor of the equitable allocation of the tax burden,” adding that any direction to the contrary “must be expressed in terms that are specific, clear, and not susceptible of reasonable contrary interpretation” [*In re Estate of Huffaker*, 641 P.2d 120 (Utah 1982)]. Although McCoy specified the residue was to be the source of the estate taxes, he failed to specify how they were to be apportioned among the beneficiaries. Because of this ambiguity, the equitable apportionment rule should apply, ruled the court (*McCoy v. Comm’r.*, T.C. Memo. 2009-61).

PHILANTHROPY PUZZLER

Fred, a long-time animal lover, owns three dogs that have been his faithful companions for several years. He wants to provide for their care (or the care of any other pets he may own) after his death. He also wants whatever funds remain at the death of the last animal to pass to his favorite charity. He has read that charitable remainder trusts provide income for life for the beneficiaries and has asked whether he can establish a testamentary charitable remainder trust to pay for the care of his dogs, with the remainder then passing to charity.

COURT CAN’T REFORM DEED CONTINGENCY

For more than 70 years, the Boy Scouts of America used the land deeded to them in 1934 by William and Augusta Kilworth as a camp. When the Boy Scouts wanted to sell the land to fund improvements to other camps, they sought court approval to have reversionary language removed from the deed. The donors had expressly conditioned their gift on the property never being conveyed. Under the reversionary clause, if the property is sold, the land would pass to the donors’ heirs.

In 2006, the Boy Scouts asked the court to use its equitable powers to remove the clause, noting the urbanization of the area surrounding the camp and the deterioration of the land due to erosion. The Scouts claimed that the deed constituted a trust that could be reformed under the equitable deviation

doctrine, where, due to circumstances unanticipated by the settlors, modification would advance the trust's purpose. The trial court agreed, over the objections of the heirs, who claimed the court had no power to reform the deed.

The Court of Appeals of Washington noted that a trust is a fiduciary relationship arising "as a result of a manifestation of an intention to create it." Granting a gift does not establish a trust if there was no intention to do so, said the court. The deed granted by the Kilworths "clearly and unambiguously granted the property to the Boy Scouts, provided it followed certain conditions." The donors expressed no intent that a trust be created, said the court, ruling that the deed should not have been reformed (*In the Matter of 1934 Deed to Camp Kilworth*, No. 37015-8-II).

IRS DENIED ACCESS TO DOCUMENTS

When Alan and Wendy Pesky contributed a conservation easement in 2002, their attorney anticipated that litigation would ensue with the IRS over the value. The law firm hired Mark Richey, an appraiser, to determine the diminution in value of the property – and therefore the amount of the charitable deduction – as a result of the gift. Richey found that the value had declined by 29%. The Peskys claimed this amount on their 2002 return, with carryovers to 2003 and 2004.

The donors attached Richey's 49-page final report to their return. The report indicated that other than what was attached to the appraisal, "all of the documentation is contained within my files." The IRS denied the conservation easement deduction and issued a summons for Richey's workfile, which had been turned over to the lawyer. The taxpayers argued that the workfile was subject to attorney-client privilege and the work product doctrine. The Peskys had paid the tax assessment and penalties in full, which they said made the summons moot.

The U.S. District Court (Idaho) disagreed with the IRS, which said the matter was not moot, despite the payment, because the time period for filing a claim for a refund had not passed. The court said it was "not a given" that the taxpayers would file for a refund.

Even assuming the summons was not moot, said the court, the papers do not have to be turned over to the IRS. The appraisal was prepared at the law firm's direction to aid the attorney in providing legal advice to the couple. The appraisal actually had a dual purpose, noted the court, since it was also used to substantiate the charitable deduction. The final report attached to the couple's return was not protected, but the workfile is covered by attorney-client privilege or work product doctrine, said the court, which added that it's difficult to know what additional information the IRS was seeking since the final appraisal report is "a fairly complete document." Any IRS attempts at further discovery at this stage "is no longer in good faith," said the court (*U.S. v. Richey*, 2009-1 USTC ¶50,274).

IRS STATISTICS OF INCOME LAYS BARE CRTs AND CLTs

The Winter 2009 Statistics of Income Bulletin issued by the IRS includes data on charitable remainder trusts and charitable lead trusts, drawn from trust tax returns filed in 2007 for the tax year 2006. The following is a compilation of facts and trends gleaned from "Split-Interest Trusts, Filing Year 2007."

What's hot and what's not. The year 2006 was a good one for the stock market, with the Dow Jones Industrial average rising from 10,718 in

PUZZLER SOLUTION

A pet is not a permissible income beneficiary of a charitable remainder trust, because Reg. §§1.664-2(a)(3) and 1.664-3(a)(3) require that the income be payable to or for the use of a named person or persons (Rev. Rul. 78-105, 1978-1 C.B. 295). Animals do not fall within the definition of a person under Code §7701(a)(1). Fred could create a term-of-years charitable remainder trust (up to 20 years), naming a trusted individual to receive the payments and presumably use the income to care for the pets. Fred's estate would be entitled to a charitable deduction for the remainder interest.

January to 12,463 by the end of December. Highly appreciated stocks are attractive for funding tax-exempt CRTs, but the bull market apparently did not spur creation of many trusts in 2006. Net assets of CRTs increased by 7.9% and CLTs by 13.2%. Further detail:

For Filing Year 2007, a total of 123,659 Forms 5227 were filed, a slight dip from the 124,036 total in 2006. Charitable remainder trusts declined overall from 116,062 to 115,754 (.3%), but unitrust returns actually increased in number by 800 (from 94,767 to 95,567). Annuity trust tax returns fell more than 5%, from 21,296 to 20,187. Charitable lead trust returns increased from 6,298 to 6,377 (+1.3%).

Net income of CRTs was up 22.1% over returns filed for 2005, reflecting strength in the 2006 stock market. Net ordinary income represented 27.6% of all CRT income, net capital gains 71.3%. Nontaxable income was only 1.1%.

CRT income and taxation of beneficiaries. Capital gains (71.3%) predominated, a situation less likely to occur in the current environment. "Nontaxable income" was virtually nonexistent (1.1%) for CRTs in 2006. On average, unitrust beneficiaries in 2006 received payments that were favorably taxed under the four-tier system of CRT trust taxation. Ordinary income distributions (Tier 1) accounted for 37% of all unitrust distributions (no breakdown for qualified dividends). Short-term gains, also taxed at ordinary rates, amounted to another 6%, and Tier 2 long-term gains provided 51% of all CRUT payments, generally taxed at 15%. Tiers 3 and 4 – tax-free "other" income and return of corpus – generated just 6% of payouts to unitrust beneficiaries. In terms of payout percentages, 19% of unitrust beneficiaries received between 5% and 6%; 19.3% were paid at least 6% but less than 7%; 20.3% of CRUTs paid at least 7% but less than 8%; 20% paid 8% up to 9% and 5.3% paid at least 9% but

less than 10%. A total of 13.3% of unitrusts paid at least 10% but less than 20%, and .7% paid out more than 20%.

How large are these trusts? Unitrusts accounted for 95,567 of the CRT returns filed in 2007, of which 65,371 (two-thirds) contained less than \$500,000. Assets of \$500,000 to \$3 million were listed on 26,437 returns (27%) and only 3,758 unitrusts showed total assets of more than \$3 million. The IRS showed unitrust investments as being comprised of 51.4% corporate stock, 30.7% "other" (including partnerships, annuities and bonds issued by foreign governments), 9.9% corporate bonds, 7.1% state and federal obligations, and 1% land, buildings and equipment. Annuity trusts (20,187 returns) tended to be smaller: 16,156 (80%) were under \$500,000, with 3,604 (18%) between \$500,000 and \$3 million and only 427 over \$3 million. A surprising percentage of the 6,377 charitable lead trusts – 42% – reported assets of less than \$500,000. Another 44% held assets totaling \$500,000 to \$3 million, and the remaining 14% reported assets in excess of \$3 million. On the other hand, CLTs over \$3 million accounted for 78.9% of total CLT asset values.

Conclusions? Conditions obviously have changed dramatically since 2006, and trust tax returns filed for 2008 may show more capital losses than gains. Average asset values for all split-interest trusts will have declined, along with payouts from CRUTs. The only bright spot may be that tax-free distributions of corpus to CRT beneficiaries probably increased in 2008 (with the exception of net income unitrusts). Low \$7520 rates in 2008 likely discouraged funding of charitable remainder annuity trusts while stimulating formation of charitable lead annuity trusts. Payout rates for new CRTs probably were in the 5% to 6% range, in contrast to the high-payout arrangements reported for tax year 2006.

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