

The Advisor



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ESTATE PLANNER'S TIP

Clients still have time to make contributions to IRAs for 2008, but with last year's stock market meltdown, investors may now have an opportunity to get two deductions. With a few exceptions, contributions to IRAs must be in cash. Money must either be withdrawn from another source, or, if stocks are to be used, they must be sold and converted to cash for the contribution. The problem with the latter method is that the investor may have to pay capital gains tax on the sale of the stock. However, if the client sells stock that has declined in value, not only is there a capital loss deduction for 2009 [Code §1211(b)], but also an IRA contribution deduction [Code §219(b)]. Clients can do this for both their 2008 and 2009 contributions. The contribution limit for IRAs is \$5,000, with a \$1,000 catch-up contribution available for those age 50 and older.

GENERATION-SKIPPING TAX AVOIDED THROUGH DISCLAIMERS

Jack and Jill created an irrevocable Crummey trust, naming their four children as the income beneficiaries during the couple's lives. At the survivor's death, after certain specific bequests to the grandchildren, the trust is to be divided into one share for each living child. If a child predeceases Jack and Jill, his or her spouse and/or children would receive that portion. To date, the children have received no distributions of income or principal.

The four children and their spouses propose to execute disclaimers of their entire interests in the trust. Because the disclaimers will not be made within nine months of the date on which the interest was created [Code §2518(b)], they will be non-qualified disclaimers. The

property passing from the children to the grandchildren will be subject to gift tax [Code §2501], with the disclaimants treated as the transferors.

Under Reg. §26.2654-1(a)(2)(i), if there is more than one transferor with respect to a trust, the portions attributable to the different transferors are treated as separate trusts. The disclaimants are not in a generation more than one above the grandchildren, so the grandchildren will not be skip persons. The trust will be subject to generation-skipping transfer tax, but only as to the specific bequests to the grandchildren in the trust. Neither the trust nor any grandchild will be subject to GST tax on any future distributions (Ltr. Rul. 200901013).

COURT CAN'T MANUFACTURE DESIGNATED BENEFICIARIES

On the same day that Hector executed his will and living trust, he completed an account application for an IRA. In naming the primary beneficiary of the IRA, Hector wrote: "as stated in wills." When he died at age 65 he had not reached his required beginning date. His will did not name a beneficiary of his IRA, but did provide for the remainder of his trust assets to pass to eight individuals.

At the request of Hector's executor, a local court ruled that "as stated in wills" is a specification of the trust as the IRA beneficiary and the eight individuals as designated beneficiaries of the IRA. The executor then asked the IRS to rule that because the court had interpreted the eight as beneficiaries, they are entitled to take minimum required distributions from their respective shares of the IRA using their life expectancies [Code §401(a)(9)(B)(iii)].

The IRS noted that a designated beneficiary is an individual who is designated by an affirmative action of the IRA owner. Designated beneficiaries need not be specifically named, so long as they are identifiable. Only individuals may be designated beneficiaries [Reg. §1.401(a)(9)-4].

Hector's beneficiary designation form made no mention of the trust, said the IRS, so therefore the trust cannot be "named as a beneficiary." Hector's estate was the beneficiary. The language "as stated in wills" is "substantively equivalent" to naming the estate, said the IRS. To accept the court order would treat the eight individuals as designated beneficiaries, even though Hector had not named them as such. Therefore, said the IRS, the court order will not be given effect for purposes of Code §401(a)(9) (Ltr. Rul. 200849019).

PHILANTHROPY PUZZLER

Jerome owns timberland that has been in his family for several generations. He wishes to make a gift to his favorite charity of the right to cut the trees, but he wants to retain the underlying land to pass down to his children. He asks whether he can deduct the value of the trees if he makes the gift.

ESTATE SAYS, "WE TOLD YOU SO"

Louise Wilshire included several charitable bequests in her will, directing that they not be charged with the payment of taxes, in order to maximize the deduction. Philip Blomer, the executor, filed the estate's tax return, indicating that an amended return would be necessary at a later time, due to the calculation of the charitable deduction. His note to the IRS included Wilshire's directive regarding the allocation of taxes. Over the next two years, Blomer had several oral and written communications with the IRS regarding the estate tax calculation and a request of a refund of any overpayments.

Several years later, Blomer discovered that taxes had, in fact, been allocated to the charitable bequests. He filed a claim for a refund. Although the IRS said it accepted "the merits and substance of your refund claim," it refunded only \$56,802, while refusing to refund nearly \$430,000 on the grounds that the statute of limitation had expired.

Blomer argued that he had made an informal claim for a refund within the statute of limitations period, adding that while appealing the matter through the courts, the IRS had purged its files of the communications. This created the inference that the file contained evidence of the communications constituting an informal claim, he contended.

The U.S. District Court found that Blomer had made the estate's intentions known from the beginning. A notice informing the IRS of the taxpayer's position, even if it doesn't comply with the formal requirements, will still be treated as a claim where defects and lack of specificity are remedied after the lapse of the statutory period, said the court. The IRS had sufficient information to make a reasonable investigation and evaluation based on the submission of the will and Blomer's communications. The IRS should not benefit from destroying the evidence in its files during the appeal, since the files "likely contained additional documentation supporting the estate's informal claim." Wilshire's will clearly directed that the charitable bequests were not to be charged with the payment of taxes. (*Est. of Wilshire v. U.S.*, 2008-2 USTC ¶60,569).

MERGER OF CHARITIES WON'T AFFECT TRUST BENEFITS

Sisters La Fern Blackman and Ettoile Davis created trusts in the 1960s, to benefit the Edgar County Children's Home. The Home was to receive the income unless it "ceased to exist" or ceased to function in its "present capacity." Other charities were named successor beneficiaries.

In 1980, the Home expanded its mission in order to qualify for residential placement. In 2003, it merged with another charity and the name was changed to Kids Hope United. The century-old facility that had originally housed the orphanage was sold, but Kids Hope continued to serve families in the community.

The bank trustee asked the court to decide whether the Home was still functioning under the terms of the sisters' trusts. The court directed the income be paid to the successor charities, saying the Home had ceased to exist as a result of the merger.

The Appellate Court of Illinois found that under statutory and common law, the merger of two charities does not cause a bequest to either to lapse, absent restrictive conditions in the trust. The court interpreted the language in the trusts to refer to its mission of serving children, which Kids Hope has continued. The court refused to condition the bequests on the maintenance of a particular building, rather than on the mission the building once housed (*Citizens National Bank of Paris v. Kids Hope United, Inc.*, No. 4-08-0162).

COURT DILEMMA: WHO GETS LAPSED BEQUEST?

Frederick and Annabel Zilles funded a trust with their collection of ivory, porcelain lamps and rugs. At the survivor's death, the collection was to be given to a charity, along with 90% of the balance of the trust, to pay for maintenance, storage and display of the works. Shriners Crippled Childrens Hospital and the American Legion were each to receive 5% of the residue of the trust. The trust also contained a "disaster" clause, providing that the trust would pass to couple's heirs in the event all the beneficiaries are deceased.

Sometime prior to Annabel's 2005 death, she sold the entire art collection. The value of the trust at her

death was \$410,000. The trustee asked the court to determine how to distribute the residue of the trust. The American Legion and Shriners Hospital argued that as the remaining residuary beneficiaries, they should receive the entire amount. The heirs claimed that the gift of the collection and 90% of the residue failed and should pass under the disaster clause. The court agreed with the heirs, saying that in the absence of ascertainable beneficiaries, the trust reverts to the successors.

The Court of Appeals of Arizona determined that although the trust language was unambiguous, a latent ambiguity exists because of the absence of the art collection or an express contingent beneficiary. No individuals, only three charitable beneficiaries – the American Legion, Shriners and an unnamed organization – were named to receive the balance. The disaster clause does not apply because both named charities are still in existence. There was no evidence the Zilleses intended to leave the trust to their heirs.

State law provides that if the residue is devised to two or more persons, a share that fails for any reason passes to the other residuary devisees in proportion to their interests. The court ruled that the residuary bequest was a lapsed bequest, not a void bequest, so the two "surviving" beneficiaries are entitled to split the balance of the trust (*In the Matter of the Estate of Zilles*, 1 CA-CV 07-0893).

PUZZLER SOLUTION

In Rev. Rul. 76-331 (1976-2 C.B. 52), the IRS ruled that a gift of land, where the donor retains mineral rights, was not a gift of an undivided portion of the donor's entire interest. Similarly, a gift of the right to cut the timber is a partial interest, for which Jerome would not be entitled to a charitable deduction. He could, instead, use the land to fund a charitable lead trust that would revert to him or pass to his children when the trust ended. Depending upon how the trust was structured, he would be entitled to an income tax or a gift tax charitable deduction. The trustee could cut a sufficient number of trees each year to satisfy charity's payout.

FALLING INTEREST RATES PROMPTS LOWERING OF RECOMMENDED GIFT ANNUITY RATES

In April 2008, when the American Council on Gift Annuities met and lowered recommended gift annuity payout rates, the §7520 rate, used to value split-interest gifts to charity, was 3.4%. Since that time, §7520 rates have dipped to an all-time low of 2% for February 2009. In response, the Council announced in January that, beginning February 1, the recommended rates would be lowered. The new rates are in effect through June 30, 2009.

Charitable remainder trusts are required to provide a minimum 10% remainder to charity when established to qualify [Code §§664(d)(1)(D), (d)(2)(D)]. Although there is no comparable IRS Code section relating to charitable gift annuities, under Code §514(c)(5), an annuity issued by a charity will not be considered “acquisition indebtedness” if “the value of the annuity is less than 90 percent of the value of the property received in the exchange.” The gift annuity will not be disqualified, as a charitable remainder trust would be, but the issuing charity is at risk of having acquisition indebtedness.

The pre-February gift annuity payout rates, when valued using §7520 rates of 2.4% (January rate) or 2% (February rate), might not meet the 90% threshold. For example, a 60-year-old donor was entitled to a 5.5% annuity under the old rates. If the donor arranged a \$10,000 gift annuity, with quarterly payments, the deductions would be:

§7520 Rate	Deduction	Value of Annuity
2.4%	\$1,366.54	\$8,633.46 (86.3%)
2.0	974.72	9,025.28 (90.2%)

Using February’s 2% rate, the annuity would inch above the 90% level. The new recommended rates call for the same donor to receive a payout rate of 5.0%. The new deductions would be:

§7520 Rate	Deduction	Value of Annuity
2.4%	\$2,151.40	\$7,848.60 (78.5%)
2.0	1,795.20	8,204.80 (82.0%)

Using either, the value of the annuity would easily fall below 90% of the \$10,000 transferred.

Code §7520(a) allows the donor to use the rate from the month of the transfer or either of the prior two months, whichever is most favorable, in valuing the charitable deduction. With charitable remainder trusts, the higher the §7520 rate, the higher the deduction. The same is true with charitable gift annuities, but gift annuity donors get an offsetting benefit of higher tax-free income when §7520 rates decline. The chart below shows the difference for the donor above, using the 5% recommended rate:

§7520 Rate	Taxable Portion	Tax-Free Portion
2.4%	\$325.50	\$174.50
2.0	340.50	159.50

Recommended rates for most ages dropped from .4% to .7%, although the top rate, for ages 90 and older, declined a full percentage point, from 10.5% to 9.5%.

Lower rates for immediate payment gift annuities will also be reflected in deferred payment gift annuities. The assumed annual return on gift annuity reserves has been reduced from 5.75% to 5.25%. The chart below shows the effect on the payout rate for the 60-year-old donor above if benefits are deferred:

	If benefits are deferred		
	5 years	10 years	15 years
Pre-February Rates	7.2%	9.7%	13.4%
New Annuity Rates	6.5	8.6	11.7

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