The Advisor

BALL STATE UNIVERSITY
FOUNDATION
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ESTATE PLANNER'S TIP

Many clients owe income tax on up to 50% of their Social Security benefits because their provisional income (adjusted gross income, plus tax-exempt interest and a portion of Social Security benefits) exceeds $32,000 for a joint return or $25,000 for a single taxpayer. Up to 85% of Social Security benefits maybe taxed if provisional income exceeds $44,000 or $34,000. Itemized deductions don't help reduce the tax bite, since these are below-the-line deductions that don't affect AGI. But there may be an opportunity for clients, particularly the many with stocks that have dropped in value, to keep more of their Social Security. Capital losses can offset capital gains and up to $3,000 of other income, thereby reducing the client's AGI. A part of any year-end review of a retired client's tax situation should include a look at the taxation of Social Security benefits and whether realizing capital losses prior to year's end could make a difference. Note: IRA owners over age 70½ might consider satisfying charitable commitments with qualified charitable distributions, which can also reduce AGI to the extent they satisfy required minimum distributions.

ILL-GOTTEN GAINS SUBJECT TO TAX

During 2001, 2002 and 2003, William Wood embezzled funds from his employer, some of which was used to support a grocery business that Wood and his wife owned. Stolen funds were also used to cover the couple's personal expenses and pay credit card bills. They did not report the embezzled funds on their tax returns for those years.

The IRS claimed that the couple owed more than $153,000 in taxes for the three years. Wood argued that because some of the stolen money was used for the grocery business, the funds should be income to the store, not to Wood himself. He also claimed that the money was already included in the store's income and should be considered a contribution to capital of the business.

The Tax Court said how the funds were put to use is immaterial, since Wood had control over the money. The court said Wood confused how the money was used with how it was acquired, adding that using stolen funds as a contribution to capital does not relieve the couple of their responsibility to report the funds as income (*Wood v. Comm'r.*, T.C. Memo. 2011-190).

IRS GIVES EXECUTORS EXTRA TIME

Executors of large 2010 estates have until January 17, 2012 – not November 15, 2011 as originally announced – to file Form 8939 Allocation in Increase in Basis for Property Acquired from a Decedent. The IRS said that no special statement or form is needed to qualify for the later due date. Estates requesting an extension (Form 4768) will have until March 19, 2012 to file and pay any estate tax due. For estates of persons dying after December 16, 2010 and before January 1, 2011, the due date is 15 months after the date of death.

Late payment and negligence penalty relief is available to persons who inherited property from a decedent who died in 2010, then sold the asset in 2010 and improperly reported gain or loss because they did not know whether the estate made the carryover basis election (IR-2011-91).

PHONE CALLS LESS TAXING

The IRS has announced that employer-provided cell phones used primarily for business will not be considered taxable fringe benefits to employees. Under Code §61(a)(1), compensation includes the value of fringe benefits unless the employer is providing property or services for which a deduction would be allowable as an expense under Code §162(a).

PHILANTHROPY PUZZLER

Brian owns 300 acres of timberland that he inherited years ago from his grandfather. He wants to pass the property to his children, but he wants to help his favorite charity by giving the charity the right to cut the timber and keep the income. After researching the issue, charity's representative told Brian that a gift of just the timber would be a partial interest gift and no charitable deduction would be allowed. Brian has asked if there is any way to accomplish his goals of assisting charity and passing the land to his children.

The IRS says that cell phones qualify as working condition fringe benefits that will not cause the value to be included in the employee's income. The value will be treated as a de minimus fringe benefit, defined as any service, the value of which is so small as to make accounting for it unreasonable or administratively impracticable [Code §132(e)] (Notice 2011-72).

PLEDGE STILL DISPUTED 15 YEARS LATER

In 1995, Robert Sessions made an irrevocable pledge of $1.5 million for the construction of a new president's home on the campus of Rush University Medical Center. The following year he confirmed the pledge in writing, noting that his estate plan would provide that any amount not paid as of his death was a debt of his estate. He executed several codicils affirming his intention. Rush built the president's home in 1996 at a cost exceeding $1.5 million.

In 2005, Sessions was diagnosed with cancer. He executed a revocable living trust and a new will, but died a month later, having made no payments toward the pledge. Rush filed a claim against the estate to enforce the pledge. The probate court granted Rush's motion for summary judgement, which the Illinois Appellate Court affirmed. When Rush discovered that Sessions' estate contained less than $100,000, it filed a supplementary claim against the Sessions Family Trust, formed in 1994 and maintained in an offshore account in the Cook Islands, and against the 2005 living trust.

Rush claimed that Sessions transferred assets to the trusts with the intent to "hinder, delay and defraud" Rush's collection attempts, based on Illinois' Uniform Fraudulent Transfer Act (Count I), that the pledge was binding on Sessions' assigns (Count II) and that the transfer to a self-settled trust was per se fraudulent under case law (Count III). The court eventually granted Rush's motions for summary judgment on Counts II and III.

The trusts appealed, arguing that summary judgment on Count III was improper, since the state's fraudulent transfer act supplanted case law regarding self-settled trusts. The trusts said that Rush must plead that Sessions made the transfer with actual intent to hinder, delay or defraud a creditor or without receiving a reasonably equivalent value in exchange for the transfer.

The Appellate Court agreed, saying that normally a statute will not be construed to take away a common law right unless the common law right would "deprive the statute of it efficacy and render its provisions nugatory." The court found that the fraudulent transfer act and the common law "cannot exist in harmony." Because Count III did not allege that Sessions made a transfer with intent to hinder, delay or defraud Rush, the lower court improperly granted summary judgment (*Rush University Medical Center v. Sessions*, 2011 IL App 101136).

COURT FINDS SECOND SPOUSE TOO GREEDY

After Marion Haviland died in 1993, several trusts were created to benefit her husband, James, with the trusts continuing after his death to benefit children, grandchildren and charities.

In 1996, when James was age 85, he met Mary, age 35. He gave her money for expenses, education and to provide a nest egg. He then created a living trust that, at his death, was to give Mary up to $500,000. The balance would pass to his family and charity.

In 1997, James and Mary executed a prenuptial agreement prior to their marriage. James eventually removed the limit on what Mary would receive from the trust and transferred money to the couple's joint checking account. He conveyed real estate to Mary's separate name, cashed in his retirement accounts and made substantial gifts to Mary's children from a previous marriage. He made several changes to his will, resulting in a larger portion of the estate passing to Mary and less to his children and to charities.

Mary asked an attorney to draft a new will in 2006, eliminating bequests to James's children and to the charities. Shortly thereafter, James was diagnosed with symptoms of Alzheimer's.

Following James's death, the family challenged the will. The court determined that the 2006 will was the product of undue influence. The will was set aside and Mary was removed as the executrix. Mary appealed, saying that the issue of undue influence has "no meaningful application between a husband and wife." The trial court had found that Mary served James in a fiduciary capacity, participated in the creation of his 2006 will and received "an unnaturally large share" of the estate in comparison to his earlier estate plans. The court also noted that Mary had depleted his estate by transferring assets to herself and her children.

The Court of Appeals of the State of Washington upheld the lower court, saying that a spouse is not relieved of fiduciary duties when serving as trustee for her husband. The 2006 will that disinherited the children and eliminated the charitable bequests followed a "decade-long campaign of draining" James's estate at a time when his mental and physical abilities were declining. The court said a will is "unnatural" when it is contrary to the intentions the testator would have been expected to make. The elimination of charitable bequests in order to benefit Mary conflicted with James's "reputation for charitable giving," said the court (*In re Estate of Haviland*, No. 64303-7-1).

PUZZLER SOLUTION

Under Code §170(f)(3)(A), no deduction is allowed for a charitable contribution, not in trust, of any interest in property that is less than the donor's entire interest. However, Brian could use the timberland to fund a charitable lead trust that would pay income to his favorite charity for a specified number of years. Each year, the trustee could direct the cutting of trees sufficient to satisfy the lead trust obligation. At the end of the trust term, the land could pass to Brian's children. Although he would not be entitled to an income tax charitable deduction, he would receive a gift tax charitable deduction that would reduce the transfer taxes owed on the transfer of the land to his children. In addition, Brian would not be taxed on the income earned each year on the harvesting of the timber.

NEVER TOO YOUNG FOR PHILANTHROPY

Funds in an IRA generally can't be withdrawn without penalty until age 59½; Social Security usually doesn't begin until age 62; even membership in AARP is limited to those age 50 and older. But there is no minimum age for philanthropy. True, charitable deductions are larger for charitable remainder trusts and other deferred gifts when beneficiaries are older, but there are several situations where charitable gifts in trust can work well for younger individuals.

Retirement planning

Many wage earners in the 33% or 35% tax brackets are frustrated by their inability to shelter as much income in qualified retirement plans as they would like. These clients can defer more income until their retirement years while claiming a partial deduction now, through the use of a net-income with makeup charitable remainder unitrust [Reg. §1.664-2(a)(1)].

A 45-year-old client might fund a 5% net-income with makeup unitrust with $25,000 annually and take charitable deductions ($5,407 in the first year, assuming quarterly payments and a §7520 rate of 2%). The trustee invests primarily in growth stocks or mutual funds that produce little income. Each year that the donor does not receive 5% of the trust's annual fair market value, a deficiency accrues. In 20 years, when the client is ready to retire, the trustee sells the growth stock (with no loss to capital gains tax), invests in high-yield securities and begins making up deficiencies from prior years.

Advantages of a "retirement" unitrust over other retirement plans:

- the unitrust may be established in addition to the donor's IRAs or other qualified plans;
- there is no minimum or maximum contribution;
- deductions increase as the donor gets older;
- there is no penalty if the donor begins receiving income prior to age 59½, and no minimum payment requirements after age 70½;
- the donor may contribute appreciated securities and avoid capital gains tax;
- a generous gift to charity at the donor's death.

The same result is possible through a series of deferred payment charitable gift annuities offered by many charities.

Family support

Many younger clients are providing financial assistance to parents or grandparents. In most cases these funds come from after-tax dollars, so a client in the 35% tax bracket who sends $1,000 a month to a parent has to earn nearly $18,500 to pay the taxes and make the $12,000 gift.

Instead, the client could create a charitable remainder trust that pays the parent the $12,000. The client receives a charitable deduction for the value of the remainder, based on the parent's age and trust payout. The gift to the parent is a present interest that qualifies for the $13,000 annual exclusion. Charity's remainder interest can be used to establish a memorial in the parent's name.

College expenses

Charitable remainder trusts can also assist a child about to enter college. A parent can create a term-of-years charitable remainder trust that pays the child income during college and until the child is established in a career – ten years, for example. A charitable deduction is available, and the trust can be funded with appreciated securities for even greater tax savings.

Capital gains tax relief

Younger clients may consider a charitable remainder unitrust as a way to liquidate appreciated assets within a tax-exempt vehicle. They can retain income for life and, despite the low income tax charitable deduction, benefit from capital gains tax avoidance and eventually estate tax charitable deductions.

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