The Advisor

April 2012

ESTATE PLANNER'S TIP

The IRS has announced an extension of time for electing portability of a deceased spouse's unused exclusion amount. Notice 2012-21 recognizes that the executors of estates of decedents who died in early 2011 might have been unaware of the need to file Form 706 to make the portability election where an estate tax return might not otherwise have been required. Qualifying estates are those where the decedent is survived by a spouse, the decedent died after December 31, 2010 and before July 1, 2011, and the market value of the gross estate does not exceed $5 million. In Notice 2011-82, the IRS provided that the estate of a decedent who is survived by a spouse will be deemed to elect portability by the timely filing of a complete and properly prepared Form 706. Notice 2012-21 provides that the Form 706 for qualifying estates will be due 15 months after the decedent's date of death.

BAD TIMING COSTLY TO ESTATE

Robert Wooler's estate tax return was due January 25, 2004. His executor, Thomas Freeman, retained an attorney to handle the administration of Wooler's estate and prepare the tax return. Although Freeman initially met with the attorney regularly, their contacts became more infrequent.

In 2007, Freeman learned from the IRS that the return had not been filed and the estate owed interest and penalties. The attorney had been suffering from various physical and mental ailments, causing him to neglect his duties to the estate. An estate tax return was filed, along with payment in the amount shown as due on the return. Over the next few years, the IRS tapped the estate's income tax returns for the penalties and interest.

Freeman sought a refund, saying the attorney's illness was "reasonable cause" for the late filing under Code §6651(a)(1). The IRS said that, under *U.S. v. Boyle* (469 U.S. 241), the late filing was inexcusable because the estate had a nondelegable duty to file the return. In *Boyle*, the Supreme Court held that a taxpayer's duty to file a timely return is nondelegable and the reliance on an agent does not excuse an untimely filing.

The U.S. District Court (E.D. Pa) said that an executor's reliance on an attorney is understandable, but that the estate does not have a reasonable cause for a late filing where the attorney misses the deadline. A taxpayer does not have to be a tax expert to know that returns have fixed filing deadlines, noted the court, adding that the attorney's disability is immaterial. Freeman would have to show that he, not the attorney to whom the job was delegated, had reasonable cause to miss the deadline, the court said (*Estate of Wooler v. U.S.*, 2012-1 USTC ¶60,636).

STATE MAY TELL IF TAXPAYERS DON'T

The IRS estimated that between 60% and 90% of taxpayers who transferred real property to family members for little or no consideration failed to file gift tax returns. To help identify these individuals, the IRS asked the U.S. District Court (E.D. Ca) to allow the issuance of a summons on California's Board of Equalization (BOE).

The court noted that a summons may be issued even when the identity of the taxpayer is unknown, if there is an ascertainable class of persons, a reasonable basis exists to believe the unknown taxpayers failed to comply with federal tax laws, and the information sought cannot be obtained from another readily available source [Code §7609(f)].

The court found there was an ascertainable class of persons who had failed to file Form 709 between 2005 and 2010. Although the IRS could have sought the property transfer information from each of California's 58 counties, the BOE is the only agency that was guaranteed to have all property transactions for the period sought in a format needed to ensure accuracy. The court approved the issuance of a John Doe summons to allow the IRS to obtain the information from the state (*In the Matter of the Tax Liabilities of Does*, No. 2:10-mc-00130-MCE-EFB).

COURT DOUSES CHARITABLE DEDUCTION

Theodore Rolfs planned to build a new home on a three-acre lakefront parcel he had purchased, but first needed to remove the existing home. The estimate for demolition was about $10,000. Instead, he deeded the home to the local fire department to use for training purposes, on the condition the house be destroyed and that no one live in it.

Rolfs claimed a charitable deduction of $76,000 for the value of the home. The Tax Court agreed with the IRS that Rolfs was not entitled to the deduction (*Rolfs v. Comm'r.*, 135 TC 471). The IRS's appraiser determined that the home should be valued as if it were to be sold and moved to a different location. Due to the age and size of the home, the difficulty of moving it and the preference for larger homes in the area, the appraiser said the home had little or no value.

The U.S. Court of Appeals (7th Cir.) has affirmed the Tax Court, noting that while taxpayers are entitled to a deduction where the value of what is given exceeds the benefit received, there was negligible value in this donation. The market value of donated property must take into account any conditions on the gift. The court acknowledged that $76,000 of home value was lost in the fire, but found little of that value was transferred to the fire department. It was the taxpayer, not the fire department, who was responsible for the decrease in value, said the court, adding that none of the value of the house, as a house, was actually given away. The value of what Rolfs received – removal of the home – exceeded the value of the gift transferred to the fire department (*Rolfs v. Comm'r.*, 2012-1 ¶USTC ¶50,186).

PHILANTHROPY PUZZLER

Mike's will left a number of sizable charitable bequests, with the balance of his estate passing to his wife, Rosemary. Realizing that it might be several years before the estate was settled, he gave his executor the discretion to pay the net income from his entire estate to Rosemary during the administration of the estate. The executor has asked whether Mike's estate is entitled to a charitable deduction for the value of the charitable bequests.

CHAIN OF TITLE ENDS IN CHARITY'S FAVOR

Ben Meador left his wife Martha a life estate in real property at his death in 1962. At her death, the land was to pass to Father Flanagan's Boys' Home, on the condition that the property never be sold. Martha never probated Meador's will. Just prior to her death in 1973, she transferred the property to her brother, retaining a life estate.

In 1978, the Boys' Home offered Meador's will for probate and sold the land. The chancery court determined that Meador's intent was to give his wife a life estate and have the property then pass

to the Boys' Home, but that the no-sale condition violated Mississippi's mortmain statute, which required any charity inheriting land to divest itself of the land within ten years. The court said the will was valid, but struck the no-sale condition.

In 1983, Nolan Clark was given a mineral interest on the property by his father, who had received it from Martha. At Clark's death in 1996, the interest was left to Hemeter Properties. The chancery court eventually resolved the ownership dispute in 2010, ruling that although the no-sale condition was illegal, removal of the condition restored the legality of Meador's will. The conveyance to Clark was void, said the chancellors.

Hemeter Properties appealed, arguing that even if the land legally passed to the Boys' Home, it should have been divested within ten years of Meador's death. The Mississippi Court of Appeals disagreed, saying that the Boys' Home was required to – and did – divest itself of the land within ten years of Martha's death. Until her death, the Boys' Home had no valid interest in the property and therefore could not have sold it. The sale in 1978 was within ten years of her 1973 death (*Hemeter Properties v. Clark*, No. 2010-CA-02000-COA).

DEDUCTIONS LOST BECAUSE DONORS "KNEW"

Several family members conveyed ecologically sensitive land on Martha's Vineyard to members of the Wallace family in 1969. Under the agreement, the sellers retained rights of first refusal if the property was offered for sale prior to 2010. In 1996, the sellers formed Herring Creek Acquisition Co. (HCAC) and assigned their rights of first refusal.

In 2001, the Nature Conservancy, which had expressed an interest in acquiring the land and restoring it to its natural state, purchased the property from the Wallace family. It had also been negotiating with HCAC over the rights of first refusal. The parties finally agreed that HCAC would receive several parcels of land, leases on two properties, an option on another parcel, relocated right-of-way, beach rights and tax indemnification for taxes resulting from the arrangement.

The transfer was structured as a bargain sale, with tax savings from any charitable deduction offsetting the tax indemnification obligations. The Nature Conservancy sent HCAC a letter calculating the difference between the fair market value of the rights of first refusal and the value of the consideration received at $2,068,245, which HCAC claimed as a charitable deduction. The letter also indicated that no other goods or services had been provided to HCAC. The IRS challenged the deduction.

The Tax Court noted that taxpayers generally may rely on a contemporaneous written acknowledgment for the fair market value of goods or services provided by a charitable organization [Reg. §1.170A-1(h)(4)(i)]. This does not apply, however, where the taxpayer "knows, or has reason to know, that the estimate is unreasonable" [Reg. §1.170A-1(h)(4)(ii)].

The court determined that HCAC could not rely on the acknowledgment from the Nature Conservancy, because several items of consideration were not included in the calculation. The Nature Conservancy had an incentive to exclude part of the consideration, said the court, because that would lessen the amount the organization would have to pay in tax indemnification. The court added that the parties appeared to have "made a conscious decision to exclude items of consideration" and "play audit lottery" in the hopes of minimizing the reimbursement. HCAC could not reasonably rely on the gift letter in calculating the charitable deduction, ruled the court (*Cohan, et al. v. Comm'r.*, T.C. Memo. 2012-8).

PUZZLER SOLUTION

Rosemary essentially has an income interest in property that is designated for charity, based on the potential that the executor can give her all the income for an extended period of time. Because this "split-interest" is not in the form of a charitable remainder trust or pooled income fund, Mike's estate is not entitled to a charitable deduction under Code §2055 [Rev. Rul. 83-45, 1983-1 C.B. 233; TAM 9347002]. Instead, Mike's will should have provided that income would be paid to charity and Rosemary in proportion to their respective interests in the entire estate during the period of administration.

IT'S A BIG JOB, BUT SOMEBODY HAS TO DO IT

Every trust, including charitable remainder trusts, requires a trustee. Generally, there are three choices: a corporate trustee such as a bank or trust company, the charity or an individual, including the donor, or a professional. Which is best? That depends upon the powers contained in the trust, the donor's level of sophistication, the types of assets used to fund the trust and the size of the trust. Here are a few considerations:

Corporate trustee

A corporate trustee may be the best option where neither the grantor nor charity is willing or able to serve. All trustees are subject to fiduciary obligations requiring them to act impartially, balancing the interests of the income beneficiary and the remainder beneficiary. This may be easier for a corporate trustee than either the grantor or the charity.

A corporate trustee also may be necessary where the trust allows sprinkling of income among various members of a class (e.g., children or grandchildren). If the grantor holds the power to determine income distributions, the trust will be considered a grantor trust and will be disqualified under Code §664 (Rev. Rul. 77-285, 1977-2 C.B. 213).

A major consideration in using a corporate trustee is the fee structure. Small trusts, in particular, may be below the corporate trustee's threshold.

Charity

Some charities will serve as trustees of charitable remainder trusts. Charities may impose restrictions as to the ages of the income beneficiaries, the size of the trust or the portion passing to the charity at the end of the income interest. In addition, most charities won't serve as trustee where the donor retains the right to change the charitable beneficiary.

Charities may provide trustee services at low or no cost. This may be especially important to donor/income beneficiaries of charitable remainder unitrusts, where the annual payout is directly affected by the value of the trust assets, as determined annually. It's important to consult state law before naming a charity to serve as trustee to determine if there are any restrictions or special requirements.

Donor or other individual

There is no prohibition against the donor acting as trustee of a charitable remainder trust. But there should be serious consideration given to the donor's financial acumen and level of knowledge of fiduciary responsibilities. In addition to the caution regarding sprinkling powers, there are other considerations before naming the donor as trustee.

Donors often elect to serve as trustee where they want to avoid the expenses of a corporate trustee and don't qualify under the restrictions imposed by charity. Advisors should be certain that clients are familiar with the various rules governing fiduciary responsibility and the annual filing requirements. The donor/trustee is not required to personally fill out the required tax forms, but is required to make sure that they are completed and filed on time. If a donor serves as trustee of a unitrust that owns hard-to-value assets, an independent appraisal consistent with Reg. §1.170A-13(c) must be obtained annually to avoid the need for a separate trustee for valuation.

One of the hardest concepts for donor/trustees may be the duty of impartiality. In the case of a charitable remainder unitrust, where the beneficiary's income is determined by the annual value of trust assets, there may be a particular temptation to invest for income, figuring that charity will be satisfied with whatever it receives. In addition, because the nature of the beneficiary's income is determined under the four-tier system [Reg. §1.664-1(d)(1), there may be a temptation for the donor/trustee to invest in municipal bonds, at the expense of growth in the trust for the charitable remainderman. The donor/trustee should also be aware of private foundation rules regarding investments.

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