

The Advisor



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ESTATE PLANNER'S TIP

Estate tax planning clearly has added importance for terminally ill clients, but even those whose estates are sheltered from estate tax need to consider income tax planning. For example, capital loss deductions vanish when a taxpayer dies owning assets that have declined in value; the estate or beneficiary takes a basis in the asset at its date-of-death value (Code §1014). A client might consider selling depreciated assets before death to create deductible capital losses. It also may be desirable to accelerate pre-death income if the estate will be in a higher income tax bracket than the client, given the greatly compressed rates in effect for trusts and estates. Income in respect of a decedent (IRD) could be heavily taxed if reported by the estate (Code §691). The client might elect to report accrued interest on savings bonds (Code §454) or receive distributions from an IRA or other retirement plan. Before taking any of these steps, however, it's important to compare tax brackets and deductions available to the client, the estate and the client's beneficiaries and to consider alternatives such as charitable bequests of items of IRD.

TAXPAYER HAS GAIN ON MITIGATION CREDITS

Peter has owned a ranch for five years but has not developed any of the parcel. The land contains a habitat for two federally listed endangered species. Peter has negotiated a mitigation bank agreement with an agency under which he will grant a perpetual conservation easement and will receive mitigation banking credits in exchange.

A mitigation bank is an area containing wetlands, natural habitats or other ecological value that is preserved and set aside to compensate for future conversions of other lands. The transferor may retain the credits and use them to mitigate development activity elsewhere or sell the credits to others who can use them to satisfy compen-

satory mitigation requirements. Peter intends to sell the mitigation credits. He retains the fee interest and limited use of the parcel after granting the conservation easement.

The IRS ruled that conveyance of the perpetual conservation easement on the parcel in exchange for the mitigation credits was a sale or exchange of property under Code §1001 for federal income tax purposes. Under Code §1001(a), the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis. Under Code §1011(c), the entire amount of gain or loss must be recognized (Ltr. Rul. 201222004).

FOUNDATIONS APPROVED, WITH REFINEMENT

When Mary Lotz died in 1958, her two grandchildren began receiving the net income from a trust that held farmland. At the death of the survivor, the property was to be used as a fund for the “erection and maintenance of an old people’s home” in Winterset, Iowa. If such an organization was not established within ten years of the trust’s termination, the funds were to pass to Lotz’s heirs at law.

The surviving grandchild died in 2010. The trustees proposed the creation of a foundation that would allow distributions of net income and principal for one or more charitable purposes. The primary charitable purpose of the foundation would be the erection and maintenance of a home for the aged.

Lotz’s great-grandchildren objected to the proposed foundation, claiming it would not serve the purposes outlined in the will. They suggested that the foundation be revised to reflect all the terms of the trust, or that the assets remain in the trust for ten years to determine the feasibility of accomplishing Lotz’s intent by that time. The probate court found that the trustees were “appropriately attempting” to carry out

Lotz’s testamentary intent. It doesn’t matter, said the court, whether the foundation creates a facility called a “care facility” or a “hospice” or “senior housing.” And it didn’t matter whether the facility housed “two, or twenty, or two hundred residents,” as long as it provides a home, permanent or temporary, for elderly in the area.

The Court of Appeals of Iowa agreed with the probate court, noting that the language used by the trustees follows the language of Lotz’s will. It did, however, find the language allowing distributions for “one or more charitable purposes” to be overly broad and remanded the case with directions to amend the foundation documents to limit the distribution of funds for the charitable purposes described by Lotz (*In re Lotz*, No. 2-182/11-1388).

TAXPAYERS BLAME FAULTY FORM 8283, LOSE DEDUCTION ANYWAY

Joseph and Shirley Mohamed established a charitable remainder unitrust, to which they contributed four parcels of real estate and 40 acres of subdivided land in 2003. The following year, they donated a shopping center to the trust. Joseph was a real estate broker and appraiser. The couple claimed deductions of \$3,858,730 in 2003 and \$488,040 in 2004. Joseph intentionally claimed amounts that were lower than what he thought was justified, because he “didn’t want to risk overvaluing the property.”

Initially, the IRS challenged the value of the couple’s 2003 deduction, on the grounds that Joseph had appraised the properties, rather than hiring an independent appraiser. Later, however, the IRS said that no deductions should be allowed, due to incomplete Forms 8283 for the two years. Joseph obtained an independent appraisal after the audit began, and several of the properties were sold in arm’s-length transactions for amounts equal to or in excess of the values Joseph had claimed. The IRS asked the Tax Court for summary judgment denying the deductions for failing to follow the regulations.

PHILANTHROPY PUZZLER

Kevin has been attending football games at his alma mater since he graduated in 1970. Several years ago, when the school was building a new stadium, he took advantage of the opportunity to make a gift that allowed him to sit in a specially reserved section. His accountant told him that the price of tickets to the individual games wasn’t deductible, but Kevin could deduct 80% of the payment made to the school for the right to purchase seats in the booster section. The school is now planning to make similar arrangements available for seats in the new performing arts center. Kevin occasionally attends performances and has asked if it would be a good idea to pay for the right to preferred seats.

Joseph pointed out that Form 8283 section B, part I indicated that it could be “completed by the taxpayer and/or appraiser.” It also said that if the total art contribution was \$20,000 or more, a signed appraisal must be attached. Because the gift did not involve art, Joseph said he did not think the instructions applied to his gift. He did not sign the appraiser declaration because it stated that “I declare that I am not the donor, the donee, (or) a party to the transaction.” He attached a statement giving the addresses and descriptions of the properties.

The Tax Court noted that the Forms 8283 lacked some information required under Reg. §1.170A-13(c)(4)(ii), including his basis in the parcels, a bargain-sale statement and a qualified appraiser statement. The court added that the lack of an appraisal summary might not have been fatal to the couple’s deduction if they had hired a qualified appraiser, since Reg. §1.170A-13(c)(4)(ii) allows extra time for the taxpayer to provide that to the IRS if requested. However, the untimely independent appraisals were too late to be remedial appraisal summaries, said the court.

The Mohameds argued that the IRS was “arbitrary and capricious” because a taxpayer is allowed to keep some of the deduction if he or she follows the procedures but overvalues the donation, but the entire deduction is disallowed for a taxpayer who accurately values the gift but fails to follow the procedures. The court noted that the rules serve a valuable governmental purpose of preventing tax evasion. The court also said the couple had not substantially complied with the substantiation rules, noting that “a taxpayer can’t substantially comply if he fails to comply with an ‘essential requirement’ of the governing statute.” Although denying the entire deduction to a couple who did not overvalue “and may well have undervalued” their contribution was “harsh,” the court added that it could not allow “a single sympathetic case to undermine” the rules (*Mohamed v. Comm’r.*, T.C. Memo. 2012-152).

VOLUNTEER’S DEDUCTION GETS BURIED

Donald Leak used equipment from his lawn care business to clear several acres of land on which his church planned to build a house of worship. He claimed charitable deductions in 2006, 2007 and 2008 for the amount that he would have billed the church. The IRS disallowed the deductions, saying that deductions are not allowed for services rendered to a charitable organization (*Davis v. U.S.*, 495 U.S. 472 (1990)).

Leak told the Tax Court that he had submitted bills to the church and was given receipts in return indicating that he had made a contribution to the church in the amount of the bills.

The Tax Court ruled that while the out-of-pocket expenses of volunteers are deductible, there must be documentation as to the amount of the expenses incurred. Leak’s receipts from the church lacked information regarding any unreimbursed expenses he incurred in clearing the land (*Leak v. Comm’r.*, T.C. Summ. Op. 2012-39).

Note: The Tax Court has affirmed that volunteers’ out-of-pocket expenses are deductible, provided they are properly substantiated. These can be purchase receipts, which the court termed substitutes for canceled checks, but where the expense is \$250 or more, the donor must also have a contemporaneous written acknowledgment from the charity that the expenses were incurred in performing the volunteer services (*Van Dusen v. Comm’r.*, 136 T.C. 515)

PUZZLER SOLUTION

Code §170(l) permits a charitable deduction of 80% of any amount paid to a college or university that gives the taxpayer the right to purchase tickets – but only for seating at athletic events in an athletic stadium [Code §170(l)(2)(B)]. Kevin could make an outright gift to the school for the building campaign, which would be fully deductible.

PUTTING EMPLOYER STOCK IN CHARITABLE PLANS

As the pace of Baby Boomer retirements increases over the coming years, many will be faced with the question of what to do with shares of employer stock, purchased with the employees' own after-tax contributions in their 401(k) accounts. Special tax advantages are available – as are opportunities to satisfy philanthropic goals.

One of the easiest moves is to simply roll over the account to an IRA. That may not be the most advantageous from a tax standpoint, however. When the client begins taking distributions, whether after age 59½, or after age 70½ when withdrawals are mandatory, the income will be taxed at ordinary income rates. The client can, instead, elect to receive the company stock outright and thereby preserve capital gains treatment for some later date [Code §402(e)(4)(A)]. A drawback, however, is that the client's portfolio may be too heavily weighted with company stock.

What if the client takes a distribution of company stock and simply holds it until death? The stepped-up basis rules apply only to the appreciation from the date of distribution until the date of death. Family members who inherit shares of company stock will be subject to tax on the income in respect of a decedent (IRD) for the difference between the original basis in the stock and the fair market value on the date of distribution.

A charitable remainder trust funded with an outright distribution of employer stock may allow the client to diversify his or her holdings while also achieving charitable goals. The charitable remainder trust permits the donor to retain income for life, similar to an individual retirement account. But unlike an IRA, the income is not necessarily taxed

at ordinary income rates. The donor also is entitled to a charitable deduction based on the fair market value of the shares, not the price paid for them.

Normally, if the shares were sold after an outright distribution, there would be a capital gains tax. Because charitable remainder trusts are tax-exempt, the trustees can sell the company stock and diversify with no loss to capital gains taxes [Code §664(c)]. Income distributions from charitable remainder trusts are taxed under a four-tier system [Code §664(b)], making it possible for a trust to distribute capital gain income – taxed at only 15% through 2012 – rather than the ordinary income paid on distributions from IRAs.

The IRS has ruled that the transfer of shares of company stock to a charitable remainder trust would not cause the donor to recognize ordinary income on the net unrealized appreciation – the excess of the market value of the securities at the time of distribution over the cost or other basis of such securities to the remainder trust (Ltr. Rul. 200335017). The donor qualifies for both income and gift tax charitable deductions.

If it suits the donor's financial planning, a flip unitrust could be used [Reg. §1.664-3(a)(1)(i)(c)]. The trustee would be able to sell the company shares and reinvest for additional growth. The triggering event to change from a net-income to a standard unitrust would be the donor reaching a particular age. If combined with a provision allowing the trustee to allocate post-contribution gains to income rather than principal, the trustee could begin making larger distributions in the years just prior to the triggering event, thereby "repaying" the donor for the income not paid in earlier years.

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