

The Advisor



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ESTATE PLANNER'S TIP

The IRS recently ruled (PLR 201225004) that trust distributions made under a power of attorney were "pursuant to the governing instrument" and therefore deductible under IRC §642(c)(1). The ruling should serve as a reminder to establish procedures for charitable gift decision-making in the event a client becomes disabled. In general, the attorney-in-fact or standby trustee should have authority to continue a disabled person's historic giving patterns – regular contributions to a house of worship, annual gifts to a school, etc. But clients might be wise to include the power to accelerate bequests in their general durable powers of attorney, or invest trustees of revocable living trusts with the power to prepay testamentary charitable distributions. Such "deathbed" giving arrangements could save considerable taxes on the client's final income tax return. The attorney-in-fact or trustee could also be given the power to establish charitable trusts, gift annuities or other gifts that are outside the client's usual giving patterns.

BENEFICIARY NOT A CREDITOR

Sylvia Bates' first will and trust left \$100,000 to a close friend and the balance to her three grandchildren. The friend, Reggie Lopez, began assisting Bates after she was diagnosed with Alzheimer's disease. He was paid for his services. Bates later executed a second will directing that trust income be divided equally between her incarcerated grandson and Lopez, who had also been named beneficiary of a life insurance policy.

Bates' other two grandchildren sought to invalidate the second will and trust. State (California) law at the time presumed that no instrument shall be valid to make any donative transfers to a care custodian of a dependent adult transferor. The court determined that Lopez was a care custodian, therefore invalidating the second will and

trust. This determination was vacated after the California Supreme Court began a review of whether a bequest to an unlicensed care custodian was presumed invalid. Lopez and the two grandchildren reached a settlement agreement invalidating the second will and trust. In return, Lopez received \$575,000.

On the estate's tax return, a deduction was taken for administration expenses of \$498,113 – the amount by which the settlement with Lopez and the life insurance proceeds exceeded the \$100,000 to which he was entitled under Bates' first will and trust.

The IRS disallowed the deduction. The Tax Court agreed, saying that a claim under Code §2053(a)(3) is deductible only if supported by

adequate consideration and not attributable to the testator's testamentary intent. Lopez had been paid for his services. Therefore, said the court, Lopez's claim represented "a beneficiary's claim to a distributive share rather than a creditor's claim against the estate" (*Estate of Bates v. Comm'r.*, T.C. Memo. 2012-314).

IRS ANNOUNCES

INFLATION-ADJUSTED NUMBERS

A few of the numbers taxpayers will have to work with have been issued for 2013. Others, including income tax rates, estate and gift tax exclusion amounts and any itemized deduction limitations, are expected to be part of a more wide-ranging tax bill (Rev. Proc. 2012-41).

| | 2012 | 2013 |
|---|-------------|-------------|
| Kiddie tax | \$1,900 | \$2,000 |
| Nanny tax | \$1,700 | \$1,700 |
| Annual gift tax exclusion | \$13,000 | \$14,000 |
| Annual gift tax exclusion for non-citizen spouse | \$139,000 | \$143,000 |
| Special use valuation for real property devoted to farming or closely held business use | \$1,040,000 | \$1,070,000 |

| | | |
|---------------------------------------|-----------|-----------|
| 401(k) contribution limit | \$17,000 | \$17,500 |
| 401(k) catch-up contribution limit | \$5,500 | \$5,500 |
| Savings bond interest total phase out | | |
| single taxpayers | \$87,850 | \$89,700 |
| joint taxpayers | \$139,250 | \$142,050 |

IRS PUMPS UP MILEAGE RATE

The standard mileage rate for business use of a vehicle increased by one cent for 2013, from 55.5 cents per mile to 56.5 cents. The rate for medical or moving use also increased by one cent, from 23 cents per mile to 24 cents. The mileage rate for charitable use of a vehicle is set by Code §170(i) at 14 cents per mile. Rather than using the standard rate, taxpayers can calculate the actual cost of using their vehicles (Notice 2012-72).

TRUSTEES FEES NOT ENOUGH TO TERMINATE TRUST

Erma Donelan's trust provided lifetime income to her four sisters-in-law. At the death of the survivor, if trust assets were less than \$500,000, the principal was to be distributed outright to three charities (20%, 20% and 60%). If trust assets were more than \$500,000 the trust was to continue, with trust income paid to the three charities in the same proportions.

In 2005, when the last sister-in-law died, the trust held more than \$500,000. The trust was amended to comply with the private foundation rules. It pays 5% of the trust's assets, with trustee's fees and administrative expenses taken out of the 5% distribution before the balance is paid to the charities.

From 2006 to 2010, the fees and expenses collected by the bank trustee exceeded the shares of the two 20% charities. Although the value of the trust never fell below \$500,000, Church of the Little Flower, one of the 20% beneficiaries, sought to reform the trust, saying that the fees and expenses

PHILANTHROPY PUZZLER

Marty, hoping to save money, decided to draft his own charitable remainder trust, rather than pay an attorney to draw up the document. In the section on trustee's powers, he simply granted all powers allowed by the state in which he lived. One of the powers permitted under state law is the right to use trust assets to pay the funeral expenses of the donor or the donor's surviving spouse. Is Marty's trust headed for trouble?

“substantially frustrated the trust’s purpose.” The trial court granted the charity’s motion for summary judgment on equitable deviation grounds, finding that the fees “interfered with the trust’s charitable purpose.” The court said it was inconceivable that Donelan intended for the trustee to receive more in fees than two of the beneficiaries received in actual income.

The Illinois Appellate Court reversed. Equitable deviation permits a court to modify a trust to address circumstances not anticipated by the settlor or if the deviation will further the purposes of the trust. Donelan’s trust was modified to comply with private foundation rules. The court noted that the private foundation rules cannot be blamed for amounts that the charity complains are too small to justify the trust’s continuation. Trustee fees were “inherent” in the trust that Donelan chose for her charitable gifts. Little Flower does not argue that the fees are unreasonable, said the court, adding that the trust averaged 5.7% growth. The trust is not so inefficient that it interferes with Donelan’s purposes, concluded the court (*Church of the Little Flower v. US Bank*, 2012 IL App (4th) 120266).

TAX COURT TOLD TO TRY AGAIN

In 2003, Huda Scheidelman contributed a facade easement on her Brooklyn row house to the National Architectural Trust. She was also required to contribute cash to the trust, equal to a portion of the value of the easement, to be used to enforce the easement. The easement was appraised at \$115,000, and Scheidelman made a cash gift of \$9,275.

The IRS challenged Scheidelman’s deduction, saying her appraisal was not “qualified” because the appraiser did not state the method of valuation, as required by Reg. §§1.170A-13(c)(2)(J) and (K). The Tax Court agreed, and therefore did not rule on whether the valuation was correct. The IRS also claimed that no deduction was allowed for the cash gift, because Scheidelman had made it for the purpose of “inducing the Trust to accept

her easement so that she could enjoy a tax benefit.”

The U.S. Court of Appeals (2d Cir.) found that, at the time of Scheidelman’s deduction, it was sufficient to submit a summary of the appraisal (Form 8283) with the tax return, but not the appraisal itself. Instructions have since changed, and appraisals now must be submitted with the returns. The court noted that the summary Form 8283 requires no information about how fair market value was determined. The before-and-after approach used by Scheidelman’s appraiser “is an accepted means of valuing conservation easements,” said the court, which found that the appraiser explained at length how he arrived at the number. Scheidelman attached two Form 8283s to her return, which together contained all the information and signatures required by the IRS. The appeals court remanded the case, noting that the Tax Court had not ruled on whether the easement was to be used exclusively for conservation purposes or whether it was preserved in perpetuity. However, as to the cash contribution, the court found that Scheidelman received nothing of value in return for the transfer and was therefore entitled to a deduction (*Scheidelman v. Comm’r.*, 2012-1 USTC ¶50,402).

PUZZLER SOLUTION

A charitable remainder trust is not allowed to make any payments (except to charity) other than the annuity or unitrust amounts [Reg. §§1.664-2(a)(4), 3(a)(4)]. The trustee’s power under state law to pay the funeral expenses of Marty or his wife would disqualify the trust [Rev. Rul. 77-58, 1977-1 C.B. 175]. A trust should specifically provide that the trustee has only those powers conferred by the trust or that the trustee shall have no power under local law that would cause the trust’s disqualification under Code §664.

THE WHATS AND WHEREFORES OF CHARITABLE BEQUESTS

Including a charitable bequest in an estate plan means more than just determining the charity's correct legal name. The size of the bequest, whether it is to be in trust or outright, and the assets to be used are also important considerations.

Outright or in trust?

An outright bequest can be a specific dollar amount, such as "\$50,000 to Old Ivy University." It can also be a specific asset, such as "my baseball card collection," which can be satisfied only by that asset. If the testator disposes of the assets prior to death, the bequest is extinguished.

Outright bequests can be made in the form of a percentage of the net value of the estate (e.g., "10% of my estate"), as the residue of the estate or a portion of the residue (e.g., "one-half the residue of my estate").

Bequests in trust offer flexibility and estate tax savings. An outright bequest to charity produces a larger charitable deduction than a bequest in trust because charity receives the money immediately; there is no wait for intervening income interests. However, some testators need to provide continuing financial support for family members. A split-interest bequest serves both purposes.

Split-interest bequests come in many forms: charitable remainder trusts, QTIP trusts, charitable gift annuities, charitable lead trusts, pooled income funds and remainder interests in homes and farms. Whatever the form of the bequest, it is important that the transfer follow the requirements of Code §2055(e)(2).

Which assets are best?

Certain assets make more sense from a tax standpoint when planning a charitable bequest. Property that would cause problems if given during the donor's life often makes the best bequest.

One example is ordinary income property. The charitable deduction for an inter vivos gift of

ordinary income property, such as a painting in the hands of the artist, is limited to the donor's cost basis [Code §170(e)(1)(A)]. In contrast, a bequest of a painting by the artist produces an estate tax charitable deduction equal to the fair market value of the artwork.

Tangible personal property that will be put to an unrelated use by the donee is also more valuable as a bequest. If given during the donor's life, the income tax charitable deduction is limited to basis (or fair market value if lower) [Reg. §1.170A-4(b)(3)(i)]. As a bequest, the transfer will produce an estate tax deduction equal to fair market value.

Testators may be wise to make charitable bequests of income in respect of a decedent (IRD). IRD is subject to both estate and income tax. A charitable bequest of IRD produces both an estate tax and an income tax charitable deduction [Code §642(c)(1)]. Items of IRD include assets in qualified retirement plans, U.S. savings bonds with untaxed interest, accounts receivable of cash-basis taxpayers, renewal commissions of insurance agents, accrued royalties under a patent license, payments on installment obligations and a deceased partner's distributive share of partnership income.

It has been suggested that a testator could direct that all charitable bequests be made, to the extent possible, from assets constituting IRD. However, in final regulations issued in 2012, the IRS said that provisions in an estate or trust or under local law that contain ordering provisions for payments to charitable beneficiaries will not be given effect for federal tax purposes unless there is an economic effect independent of income tax consequences (T.D. 9582). Testators can avoid this problem by specifically bequeathing IRD assets or naming charity the beneficiary of retirement accounts.

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