The Advisor

BALL STATE UNIVERSITY FOUNDATION
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ESTATE PLANNER'S TIP

Clients who make annual exclusion gifts to family members ($14,000 in 2013) should consider giving appreciated stock, rather than cash. Clients in the top 39.6% income tax bracket ($400,000 for single taxpayers, $450,000 for joint filers) will pay a capital gains tax of 20% if they sell the shares, while younger family members may pay only 15% or even avoid capital gains tax entirely (taxpayers in the 15% and 10% tax brackets). There could be capital gains and net investment income tax savings of as much as 23.8% from a gift of appreciated stock to younger family members. Clients who aren't in the 20% capital gains tax bracket may still avoid net investment income tax by transferring shares of appreciated stock. Taxpayers with modified adjusted gross income over $250,000 (joint filers) or $200,000 (single taxpayers) are subject to the 3.8% tax [Code §1411], in addition to a 15% capital gains tax. Because these tax levels are not adjusted for inflation, there could be more clients subject to the 3.8% tax in future years.

GST LOST IN TRANSLATION

Lily, a foreign citizen, resides in the U.S. Bernard, a non-resident, non-citizen, established a trust in his native country naming Lily to receive payments after his sister-in-law's death. The trust was initially funded with a residence located outside the U.S. The home was sold and the trust now consists of foreign currency, held by a foreign trustee. Due to the high costs of trust administration and tax compliance, the trustee would like to terminate the trust and make an outright distribution to Lily.

Lily is more than 37½ years younger than Bernard but not more than 62½ years younger, making her a skip person for generation-skipping transfer tax purposes under Code §§2651(d) and 2613.

A tax is imposed on the transfer of the taxable estate of a non-resident non-citizen on that part of the gross estate that is situated in the U.S. at death [Code §§2101(a), 2103]. Code §2601 imposes a tax on every generation-skipping transfer. Reg. §26.2663-2(b)(1) provides that a transfer by a non-resident, non-citizen is a direct skip only to the extent that the transfer is subject to the federal estate or gift tax under Reg. §26.2652-1(a)(2). The IRS determined that because Bernard's home and the cash sale proceeds were not situated in the U.S., the transfers to the trust were not subject to federal gift tax. The residue of his estate was not subject to the federal estate tax. Therefore, the GST tax does not apply to the distribution to Lily (Ltr. Rul. 201311004).

CHARITIES, INDIVIDUALS SHARE THE PAIN

Warren Fisher's will directed that his estate be divided into two shares. Part A was to be held for his wife if she survived him (which she did not), with assets passing at her death to several named charities. Part B was to be paid at his wife's death to 12 of his 21 nieces and nephews.

At Fisher's death in 2008, the Part A share was $2,455,793. Between the date of death and August 2010, when the trustee was ready to disburse the assets, the stock market declined. The value of the assets had fallen to $2,335,716, leaving insufficient assets to fully fund Part A and no assets to fund Part B.

The bank trustee sought court approval to distribute all remaining assets to the Part A beneficiaries, but the nieces and nephews objected. The court determined that Fisher had not foreseen the possibility that a significant drop in the value of assets would disinherit his nieces and nephews. The court reformed the will under the probable intent doctrine, directing that the remaining assets be divided in the same percentages as Parts A and B would have received if they had been established on the date of death.

One of the charitable beneficiaries of Part A appealed, arguing that there was no ambiguity in the will. The Superior Court of New Jersey upheld the ruling, noting that it was unclear that Fisher would have wanted to follow the literal language of the will if it meant completely disinheriting his nieces and nephews. The fact that Fisher named specific individuals who would receive bequests only if they survived both Fisher and his wife indicated that he sought to benefit those "with whom he had a relationship, rather than an entire class of relatives." Although the overall theme of Fisher's estate plan was to reduce taxes, the court found that he expected both Parts A and B to be funded. Applying the probable intent doctrine allowed both classes of beneficiaries to share in the reduction in value caused by unforeseen market changes, the court concluded (*In re Estate of Fisher*, Docket No. A-1889-11T1).

PHILANTHROPY PUZZLER

Clarence wants to create a charitable remainder trust to benefit his grandchildren for 20 years and then his favorite charity. The grandchildren range in age from four to 18 years. Clarence wants to serve as trustee so he can direct the income. His plan is to provide more help to each grandchild during his or her college years. Clarence's advisor said his plan would have poor tax results. What is the problem?

NO CHARITABLE STATUS FOR PETAL PUSHERS

Zagfly, a California corporation, sought §501(c)(3) charitable status. The company proposed to sell flowers at retail price through its website and allow purchasers to designate a charitable recipient to receive the profits. It hoped to expand its offerings to include travel reservation services.

An organization is not considered charitable if more than "an insubstantial part" of its activities is not in furtherance of its exempt purpose [Reg. §1.501(c)(3)-1(c)(1)]. A charity operating a trade or business may meet the requirements of Code §501(c)(3), but only if the trade or business is in furtherance of the organization's exempt purpose and if the organization is not operated for the primary purpose of carrying on an unrelated trade or business. Code §513(a) defines an unrelated trade or business to include any trade or business that is not substantially related to performing the charitable function.

Zagfly argued that although it will engage in activities that others engage in for "commercial gain," its primary motive is charity. The primary purpose will be to facilitate the donation of its profits to other charities.

The Tax Court determined that Zagfly's primary activity is a commercial venture that amounts to an unrelated trade or business. Selling flowers on the internet "is not substantially related to an exempt purpose" under Code §501(c)(3), the court said (*Zagfly, Inc. v. Comm'r.*, T.C. Memo. 2013-29).

TITHING NOT "NECESSARY" SAYS TAX COURT

George Thompson, who owed nearly $890,000 in taxes and penalties, was attempting to work out an installment payment agreement with the IRS. Thompson indicated that he had monthly income of $27,633 and expenses of $24,416. Among the expenses were $2,342 per month for tithing and church service expenses. The IRS settlement office determined that these were not "necessary expenses" in computing what Thompson could pay to the IRS.

Thompson claimed that the IRS officer abused her discretion in classifying these as "conditional expenses." Necessary expenses are the minimum a taxpayer and family need to live. Conditional expenses are not allowed in partial payment installment agreements, noted the Tax Court.

Thompson argued that classifying the church expenses as conditional violated his rights under the free exercise clause of the First Amendment. He said that his position in the church required tithing, making it a necessary expense. A necessary expense is one that is required for the taxpayer's health and welfare or for the production of income, said the court. Thompson's position in the church does not pay him income, but he claimed that not being able to tithe would "negatively affect his spiritual welfare," therefore making it a necessary expense. His failure to tithe will require him to resign his ministerial positions, he said. The court acknowledged that he would have to resign, but said that it is his church, not the IRS, that will require his resignation. The IRS did not violate Thompson's free exercise rights by classifying the tithing as a conditional expense, ruled the court (*Thompson v. Comm'r.*, 140 T.C. No. 4).

CY PRES FOUND TO BE APPROPRIATE

The Edward John Noble Hospital of Gouverneur, NY, was a residuary income beneficiary of three testamentary trusts. Although the state department of health had ordered the hospital's lab closed, it continued to provide services through affiliates, in the hopes of one day resuming full operations.

Trustee's fees are consuming most or all of the income from the three trusts. The hospital asked the court to apply the cy pres doctrine to allow the trusts to be used as collateral for loans that would allow the hospital to modernize its facilities.

State law requires three conditions be met to apply cy pres, including that the gift or trust be charitable in nature, the donor have demonstrated a general charitable intent and that circumstances have changed making literal compliance "impossible or impracticable." The court found all three testators had general charitable intent to benefit the hospital and the residents of the community. Although the hospital is not claiming that literal application of the trusts' terms is impossible, they are impracticable. The court said there is little doubt, given the devotion to the hospital that the three testators demonstrated, that each would approve the changes proposed to insure that their charitable intentions were met. Using trust corpus as collateral is appropriate and will not divert the trusts to creditors' claims, added the court (*In re Edward John Noble Hospital of Gouverneur*, 2013 NY Slip Op 23016).

PUZZLER SOLUTION

There is nothing to prevent Clarence from implementing his plan, provided he (or his wife) doesn't act as trustee. An independent trustee may be given the power to sprinkle income among the grandchildren [Code §674(c)], but if Clarence retains the power to apportion the income, he will be considered the owner of the trust under the grantor trust rules [Code §§671-678], thereby disqualifying the charitable remainder trust.

BEATING EXEMPTION, DEDUCTION CUTBACKS

Limitations on personal exemptions and itemized deductions have made a return appearance under the Taxpayer Relief Act of 2012. The cutbacks affect single taxpayers with adjusted gross income above $250,000 and married couples with AGI in excess of $300,000. The loss of tax benefits can be especially acute when clients sell highly appreciated real estate or securities, particularly if they are also subject to the 20% capital gains tax rate and/or the 3.8% net investment income tax. For charitably minded clients, there are several tax saving strategies.

Charitable remainder unitrusts

The idea of selling capital gain property through a charitable remainder unitrust has been around for a long time, but now the advantages are even better. Consider an unmarried client with AGI of $200,000 who owns appreciated stock worth $250,000 (basis of $100,000). If the client sells the stock it will trigger capital gains tax of 15%, plus the 3.8% tax on net investment income, and the client will also be subject to the cutbacks in both itemized deductions and personal exemptions. If the client instead transfers the stock to a charitable remainder unitrust, he or she avoids the 18.8% tax when the shares are sold within the trust. In addition, the client's AGI will remain below the $250,000 threshold for the deduction and exemption cutbacks.

Charitable lead trusts

Charitable contribution deductions cannot reduce a donor's adjusted gross income – only *taxable* income. But a non-grantor charitable lead trust can reduce a donor's income taxes, avoid cutbacks and also cut down on gift taxes or estate taxes in passing property to children. The donor can transfer income-producing property to a trust that will pay charity income for five, ten, 20 years or longer, with assets passing to children when the trust ends. During the term of the trust, the donor's adjusted gross income is reduced (the income the property earned is no longer taxable to the donor). The donor benefits charity and, although there is no income tax charitable deduction, the gift creates income tax savings. It also eases the cutback on the itemized deductions and the phaseout of personal exemptions. Gift taxes are reduced in passing property to children.

Qualified charitable distributions from IRAs

Distributions from IRAs are not subject to the 3.8% net investment income tax, but they increase AGI, exposing other investments to tax, and may exacerbate cutbacks in personal exemptions and itemized deductions. Clients age 70½ and older can direct that distributions from IRAs of up to $100,000 be made directly to charity. To the extent that these distributions take the place of required minimum distributions that would otherwise be fully taxable, the donor reduces taxes, even though no charitable deduction is available.

Interest-free loans

Donors may lend up to $250,000 to charity, interest-free, without running afoul of the imputed interest rules [Temp. Reg. §1.7872-5T(9)]. A client who would otherwise lose some itemized deductions and personal exemptions could instead lend funds to a charity that would then invest the money. Although no charitable deduction is allowed, the client reduces taxable interest while the loan is in effect. The reduction in adjusted gross income saves both itemized deductions and personal exemptions.

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