

The Advisor



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ESTATE PLANNER'S TIP

Now that an inflation-adjusted \$5 million estate tax exemption (\$5.25 million for 2013) has been made permanent, advisors may want to review credit shelter trust arrangements to make sure clients' children won't reap a windfall at the expense of surviving spouses. For example, a couple with a \$6 million estate might still have formula clauses in their estate plans that call for funding a credit shelter trust with the maximum amount currently sheltered by the estate tax credit. With the increase in the credit, the clause may cause the estate of the first to die to pass too much to the credit shelter trust, leaving too little outright to the surviving spouse, even though the survivor may receive the net income and some principal distributions from the trust. The credit shelter trust may not even be necessary with portability made permanent. A new will or living trust should allow for reduced funding of the credit shelter trust, depending upon the overall size of the estate. Note: Some wills have formula charitable bequest clauses that leave charity the portion of the estate that exceeds the estate tax exemption. High exemptions may eliminate any charitable benefit, which may not be the client's intent.

GST TAX AVOIDED, CHARITABLE DEDUCTION SAVED, THROUGH SETTLEMENT AGREEMENT

Harriet executed a will prior to September 25, 1985, shortly before she was judged incompetent by a court. She never regained competency prior to her death. Her estate was to be distributed to her surviving spouse, children, grandchildren and charity.

Following Harriet's death, the beneficiaries disagreed over how much each was to receive under the terms of the will. The parties, all of whom were represented by separate counsel, reached a settlement in order to avoid the expense, uncertainty and delay of litigation.

The generation-skipping transfer tax does not apply where an individual was under a mental

disability continuously from October 22, 1986 until the date of death, making it impossible to amend an existing document [Reg. §26.2601-1(b)(3)(i)]. Reg. §26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bona fide contest of a trust or will won't cause an exempt trust to be subject to GST tax, provided the settlement is the product of arm's-length negotiations and is within the range of reasonable outcomes. The IRS ruled that the settlement met these criteria and, therefore, the GST tax did not apply.

Harriet's estate was also entitled to a charitable deduction for amounts passing to charity under the settlement, ruled the IRS. In Rev. Rul. 89-31

(1989-1 C.B. 277), the IRS ruled that an estate was entitled to a charitable deduction for a remainder interest in a split interest trust passing directly to charity pursuant to the terms of the settlement of a bona fide will contest (Ltr. Rul. 201316004).

TESTATOR, MALPRACTICE CLAIM EXPIRE TOGETHER

In 1991, Maxine Anton created a revocable trust. At her death, the bulk of the trust's assets were to pass to her niece, Janet Jeanes, with the balance used to fund charitable trusts for Anton's stepson and personal assistant. Anton had an attorney draft the trust, along with a pour-over will. When Anton died in 2003, her gross estate was nearly \$39.5 million, and her estate paid federal and state taxes of more than \$21.8 million.

Jeanes sued the attorney, claiming negligence and breaches of fiduciary duty, contract and trust. Jeanes said that more than \$6 million in taxes could have been avoided if a family limited partnership had been created.

The district court granted summary judgment for the attorney, noting that the tort claims did not survive Anton's death. The Kansas Court of Appeals agreed that the injury resulting from the attorney's alleged malpractice – the estate taxes

imposed against Anton's estate – did not arise until after her death. The cause of action for legal malpractice did not accrue in Anton's lifetime and did not survive her death.

The Supreme Court of Kansas affirmed, noting that a cause of action accrues when the right to maintain legal action arises. Under Kansas law, a cause of action accrues when the plaintiff suffers "substantial injury" – not necessarily when the negligent act occurred that ultimately caused the injury. Jeanes claimed that Anton could have sued for fees and other costs associated with the estate plan during her lifetime, before the estate tax damages actually occurred. The court rejected Jeanes' "damage escalation argument," saying that the excessive taxes became ascertainable only after Anton's death. In general, added the court, a lawsuit that does not accrue during a person's lifetime does not survive the person's death (*Jeanes v. Bank of America*, No. 97,855).

CHARITABLE, YES; DEDUCTIBLE, NO

Mohammed Rehman claimed a charitable deduction of \$5,500 in 2007. He said that the payment was made to a resident of India named Atiqur Rahman. The IRS disallowed the deduction and the Tax Court agreed, noting that Rehman failed to carry his burden of proof under Code §170 to show that he was entitled to the deduction. An individual is not a charitable organization, said the court, adding that nothing in the record indicated that Rahman was authorized to accept contributions on behalf of a charity (*Rehman v. Comm'r.*, T.C. Memo. 2013-71).

ABSENCE OF "MAGIC" WORDS MEANS NO DEDUCTION

In 2000, Jolene Villareale founded NDM Ferret Rescue & Sanctuary, which was granted charitable status. As president, she was responsible for the organization's finances, including paying bills and managing its bank accounts.

PHILANTHROPY PUZZLER

Harold, age 69, wants to establish a charitable remainder unitrust, reserving income for his life and for his sister's life, if she survives him. He plans to fund the trust primarily with appreciated securities and cash, but wonders if it makes sense also to transfer some funds from his IRA to the unitrust. Harold's advisor cautioned that he would have to pay income tax on withdrawals from his IRA contributed to the unitrust. Harold has asked if there is a better plan.

During 2006, Villareale made 44 contributions to the Sanctuary – 27 for less than \$250 (total \$2,393) and 17 for \$250 or more (total \$7,629). The contributions were made electronically or by telephone, transferring funds from her personal account to the Sanctuary’s account.

The IRS does not dispute that Villareale made the gifts to the Sanctuary, but argued that she was not entitled to a deduction for the gifts of \$250 or more, saying they were not substantiated by contemporaneous written acknowledgments. Villareale claimed that her own bank statements and those of the Sanctuary were sufficient to substantiate the gifts.

The Tax Court agreed with the IRS. Code §170(f)(8)(B)(ii) requires that the contemporaneous written acknowledgments state whether the donor received any goods or services in exchange for the contributions. It is immaterial, said the court, that Villareale was on both sides of the transaction. Although she may not have needed an acknowledgment to help determine the deductible amounts of her gifts, the IRS needed the information to determine whether she was entitled to the deduction claimed. The court added that she did not substantially comply with the substantiation requirements, since the specific statement regarding goods and services “is necessary for the allowance of a charitable deduction” (*Villareale v. Comm’r.*, T.C. Memo. 2013-74).

SUBORDINATION TOO LATE TO SAVE DEDUCTION

Walter Minnick owned a 74-acre parcel on which a mortgage was recorded in 2005. In 2006, he granted a conservation easement to the Land Trust of Treasure Valley, prohibiting any building on about 80% of the property. His easement warranted that “there are no outstanding mortgages” on the property. Minnick and his wife claimed a charitable deduction of \$941,000, based on an appraisal.

The IRS initially cited the lack of documentation of the value in challenging the deduction, but dropped that when it discovered that the property was subject to a mortgage. The IRS said Minnick was not entitled to any deduction because, due to the mortgage, the easement was not protected in perpetuity. In 2011, the mortgagee executed an agreement subordinating its mortgage rights to the conservation easement.

Reg. §1.170A-14(g)(2) provides that no deduction is allowed for an interest in property that is subject to a mortgage unless the mortgagee subordinates its rights to those of the charity to enforce the conservation easement. The Tax Court said that the subordination agreement “must be in place at the time that the conservation easement is granted.” Because Minnick did not obtain a subordination agreement until 2011, the lender would have been able to seize the land in the event of a default and would own the property free of the easement, said the court. The value of the conservation easement was not deductible, ruled the court, because the subordination requirement was not met (*Minnick v. Comm’r.*, 104 TCM 755).

PUZZLER SOLUTION

Harold would have to include any distributions from his IRA in his gross income, even if he then transferred the funds to charity or a charitable remainder unitrust. But he could use the IRA to make an additional contribution to the unitrust – at his death – by designating the unitrust as death beneficiary and permitting additional contributions in the trust document. The IRA death benefits would be subject to income tax only as unitrust amounts are paid to his sister. Harold’s estate would be entitled to an estate tax deduction for a portion of the value of the IRA (Ltr. Rul. 9253038).

CHARITABLE DEDUCTION CEILINGS QUIZ

Gift Quiz, Part One:

1. A donor who gives \$100,000 cash to charity is entitled to deduct the gift up to ___% of AGI?

20% 30% 40% 50%

2. A donor who contributes \$100,000 in appreciated, long-term capital gain property to charity is entitled to deduct the gift up to ___% of AGI?

20% 30% 40% 50%

Tax advisors often recommend that philanthropic clients give appreciated long-term capital gain property rather than cash. The donor is generally entitled to a charitable deduction for the full fair market value of the assets and avoids tax on the capital gain, reducing the after-tax cost of the gift.

But there is a price that the donor of appreciated assets pays, in the form of a lower deduction limit. Generally, gifts of cash are deductible up to 50% of the donor's AGI [Code §170(b)(a)(A)]. Gifts of appreciated assets are deductible up to only 30% of AGI [Reg. §1.170A-8(d)(3)]. In both cases, deductions in excess of the limits may be carried over and deducted for up to five years [Code §170(b)(1)(D)(ii)].

Gift Quiz, Part Two:

3. A donor who contributes \$100,000 in appreciated long-term capital gain property to charity and makes an election under Code §170(b)(1)(C)(iii) to reduce the contribution deduction by 100% of the capital gain is entitled to deduct the gift up to ___% of AGI?

20% 30% 40% 50%

The tax law allows donors who would otherwise be subject to the 30% deduction limit to elect to reduce their deductions to basis and qualify for the 50% limit. But when would it be a sound tax move to make the election?

Little Appreciation in the Gift Property

Roger has AGI of \$100,000 and needs the largest deduction possible in 2013. He plans a gift to his favorite charity of stock that he bought several years ago for \$40,000. Today it's worth just \$41,000. Normally he would be able to deduct only \$30,000 in the year of his gift, carrying over the additional \$11,000 to next year.

Instead, he can elect to reduce his gift by the amount that would be considered long-term capital gain if he sold the property. Roger reduces his deduction to \$40,000 in the year of the gift because it falls within the 50%-of-AGI limit. Although he deducts less overall, he receives a larger deduction in 2013.

Too Much Gift, Too Little Deduction

Sally has AGI of \$200,000. She wants to make a major gift in memory of her parents using appreciated stock worth \$2 million. She purchased the stock many years ago for \$500,000.

In the year of the gift, Sally could deduct up to \$60,000, carrying over the remaining \$1,940,000. But even if Sally claimed \$60,000 each year for the next five years, her deductions would total only \$360,000 – far less than the \$2 million she gave.

Instead, Sally could elect to reduce her deduction to her \$500,000 basis. In the year of the gift she can deduct \$100,000. Over the next four years she could deduct the remaining \$400,000. The result: She has increased her total deduction from \$360,000 over six years to \$500,000 over four years.

The election regarding 30% gifts applies to all 30% gifts made during the taxable year, as well as carryovers of 30% gifts – and the election is irrevocable [*Woodbury v. Comm'r.*, 55 TCM 272]. Advisors should forecast a client's AGI for the year of the gift plus five carryover years and calculate total deductions available under both the 30% ceiling and using the special election (50% ceiling).

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