The Advisor

BALL STATE UNIVERSITY FOUNDATION
Established in 1951

August 2013

ESTATE PLANNER'S TIP

One of the perceived drawbacks to reverse mortgages is the cost associated with arranging the loan. In addition, many older clients may hesitate to "disinherit" their children by loading the home with debt. There is an alternative for some clients and their families, particularly for those who wish to retain the family home. A reverse mortgage between parents and children (or grandchildren) may be more palatable to elderly homeowners – and could be less expensive, too. A child, for example, could lend a specified amount to the parent, taking a security interest in the home as collateral. This may also ease the concerns of parents who wish to avoid having children make outright gifts. The arrangement could also be structured as an installment sale, with the child paying an agreed-upon amount annually. Before entering into any family arrangement, it's important to make sure that the parties understand their rights and obligations. The loan or installment sale should be formalized in writing, should carry a reasonable rate of interest and be properly recorded. This is especially important if the parent may one day need to apply for Medicaid assistance or if the parties anticipate resistance from certain family members who are not involved in the transaction.

RULING ENOUGH TO MAKE TAXPAYER REALLY SICK

William McGraw thought his retirement annuity account was being rolled over, but instead he received a $67,440 check for the gross proceeds of liquidating his annuity. He could have retained the tax-deferred status of the funds by rolling the money over into a new retirement account, but he learned that his wife was pregnant and believed he might need the money to defray pregnancy-related expenses. He deposited the check into a regular savings account.

The IRS determined a deficiency in McGraw's income tax and also imposed a 10% additional tax for an early distribution under Code §72(t). McGraw claimed no medical deductions on his 2009 tax return, but argued that the 10% penalty should not apply because Code §72(t)(2)(B) provides an exception for distributions to cover certain medical expenses.

The Tax Court gave three reasons why the distribution was not eligible for the medical expense exception of Code §72(t)(2)(B). First, McGraw failed to substantiate any medical expenses, beyond his estimate of $5,000 to $6,000. Second, he failed to show that the expenses were unreimbursed. McGraw's wife was covered by medical insurance, but the court said it was impossible to determine the extent to which McGraw had expenses beyond those covered by insurance.

Third, even if McGraw had documented unreimbursed expenses, the amount would not exceed the statutory floor of Code §213, which allows deductions only for expenses exceeding 7.5% of AGI. McGraw's 2009 AGI, which included income and the retirement plan distribution, was $122,000. McGraw failed to show that his expenses were in excess of $9,150 (*McGraw v. Comm'r.*, T.C. Memo. 2013-152).

HER WORD'S NOT GOOD ENOUGH

Pamela Brooks claimed charitable deductions on her 2005 and 2006 returns of $3,500 and $5,200 respectively. The IRS disallowed all but $27 of her 2006 deduction. Brooks claimed that she attended regular church services where she made cash contributions. She also said that she made a $3,000 contribution to a tsunami relief fund through her church in 2006.

For contributions of $250 or more, taxpayers must obtain contemporaneous written acknowledgments from the donees that describe the property or tell the amount of cash given and indicate whether any goods or services were received in return for the transfer, along with a good faith estimate of the value of any goods or services [Code §170(f)(8)(B)].

PHILANTHROPY PUZZLER

Thelma and Tony had discussed leaving their home to charity at their deaths, but are rethinking that idea. Instead, they are considering setting up an inter vivos charitable remainder trust. They told their attorney they wish to fund a trust using their house. They anticipate receiving an income tax charitable deduction, continuing to live in the home and paying rent to the trustee. The trustee, in turn, would make a payout to Thelma and Tony. Their attorney told them to hold off on this plan until such time as they move to an apartment or retirement community. Why?

Brooks provided the court with photocopies of two receipts. The first showed that on September 25, 2006, she received a payment of $15,782 from DaimlerChrysler Corp. The second showed that on September 28, 2006, she made a deposit of $12,782 into her Bank of America account. She testified that the $3,000 difference was used to make the charitable contribution.

The Tax Court said the receipts showed only that Brooks received a payment but did not deposit the entire amount into her account. She failed to provide evidence for her "self-serving testimony," said the court. She also failed to obtain a contemporaneous written acknowledgment of any contributions and was not entitled to a deduction beyond that allowed by the IRS (*Brooks v. Comm'r.*, T.C. Memo. 2013-141).

LETTER LACKING, DEDUCTION DENIED

Ronald and Genine Thompson claimed $12,075 in charitable contributions on their 2009 tax return. The Thompsons provided the Tax Court with two letters from their church, dated in 2012, stating that the church received $5,936 and $6,140 from the Thompsons in 2009. The gifts were made weekly, either by check or cash. The church letter did not include a schedule listing the dates or amounts of the gifts and the couple had no bank records such as canceled checks to substantiate their deduction.

Reg. §1.170A-13(a)(1) provides that no deduction is allowed for contributions in cash or by check unless the donor maintains a record or other written communication showing the donee's name, the date of the gift and the amount contributed. The court found the two letters from the church to be unreliable, noting that the letters were dated more than two years after the Thompsons filed their 2009 return. Further, said the court, the letters did not include any details that would substantiate the claim that the couple made weekly contributions to the church (*Thompson v. Comm'r.*, T.C. Summ. Op. 2013-49).

COURT'S RULING CARVED IN STONE

For more than three decades, efforts to develop the Franklin D. Roosevelt Four Freedoms Park in New York had stalled. In 2010, Reed and Jane Rubin, officers of the Reed Foundation, gave the Park's LLC a $2.5 million grant. In exchange, the LLC contractually agreed to carve text recognizing the Rubins' and the Foundation's contribution. The agreement also provided that the Foundation would be entitled to specific performance in the event of a breach by the LLC.

Shortly before the park's dedication in 2012, the LLC informed the Foundation that due to "aesthetic" considerations, it was refusing to carve the recognition where agreed. Instead, the LLC proposed to place the text at the opposite end of the park with the names of other donors. The Foundation sued, asking for specific performance.

The LLC argued that placing the text where specified was inconsistent with the objectives of the Foundation's own gifts, adding that the court should not rule in favor of "selfish private interest," but rather on the side of the public in "a lasting historical monument."

The Supreme Court of New York directed specific performance. The Appellate Division agreed, saying that "aesthetic considerations extraneous to a contract cannot trump its terms." The LLC's changed aesthetic vision did not render its performance impracticable or impossible. The LLC should have voiced its objections to the location when the agreement was negotiated, not after it had accepted and spent the Foundation's money. The public interest in "enforcing donor recognition agreements" outweighs aesthetic concerns. The court also said that a donor's desire to be recognized as a benefactor "is not a selfish one" (*Reed Foundation, Inc. v. Franklin D. Roosevelt Four Freedoms Park*, LLC, 2013 NY Slip Op. 3191).

CLAT QUALIFIES AFTER FOUNDATION FIX

Warren created a charitable lead annuity trust, naming one of his sons as the sole trustee. A private foundation established by Warren and his wife is the income beneficiary. Warren, his wife, and two of their sons serve on the foundation's board of directors. When the trust terminates, the assets will be distributed in equal shares to trusts established for Warren's three sons.

The foundation's bylaws were amended to provide that Warren could not participate in any matters relating to the receipt, investment, grant or distribution of funds received from the lead trust. Those amounts will be held in a separate account at the foundation.

The IRS ruled that under Reg. §25.2511-2(b), Warren has not retained an interest, reversion or right to alter, amend or revoke the lead trust. He may not serve as a trustee and, although he is a member of the foundation board, he will have no power over the account. Therefore, the transfer to trust is a completed gift for which he will be entitled to a gift tax charitable deduction under Code §2522. If Warren dies prior to the termination of the lead trust, no portion of the trust property will be included in his estate under Code §§2033, 2035, 2036 or 2038, ruled the IRS (Ltr. Rul. 201323007).

PUZZLER SOLUTION

Charitable remainder trusts are subject to private foundation self-dealing rules, which forbid any business dealings between grantors and trustees. Because Thelma and Tony are considered "disqualified persons" in relation to the trust [Code §4946(d)], they are not allowed to rent the home from the trust, even at fair market rental. They could achieve most of their objectives – a current deduction, continued use of the home and a gift to charity at their deaths – through a gift of a remainder interest in the home, not in trust [Code §170(f)(3)(B)(i)].

CHARITABLE IDEAS FOR U.S. SAVINGS BONDS

Births, graduations, weddings and birthdays are traditional occasions to give U.S. savings bonds. Owners of savings bonds are often inclined to put the bonds away for safe keeping, giving little thought to the tax consequences of owning and redeeming them.

Since last year, savings bonds have gone all electronic and are no longer sold at banks. They are available only online at treasurydirect.gov. Purchasers must set up a free account, which allows investments to be tracked without having to worry about lost paper bonds. The Treasury Department reports that billions of dollars in savings bonds have stopped earning interest, but have not been cashed.

Clients may not realize that bonds held at death are subject to both federal estate tax and the income tax on income in respect of a decedent (IRD) under Code §691. There are several ways for philanthropic clients to use savings bonds to benefit charity.

Lifetime gifts

Most bond holders defer income tax on the interest earned by the bonds [Code §454(a)], choosing instead to pay income tax only after the bonds are redeemed. Unlike a gift of stock, donors cannot transfer savings bonds to charity and avoid the income tax on the increase in value. The bonds must first be redeemed by the donor, who will be taxed on accrued interest. Donors receive an offsetting income tax charitable deduction for the value of the charitable gift.

Redemption proceeds can be contributed outright to charity, or the donor can retain income from the gift through a charitable remainder trust, pooled income fund or charitable gift annuity. For example, an individual, age 68 with $24,000 in savings bonds would owe tax on about $12,000. If the donor uses the proceeds to fund a charitable gift annuity, he or she would be entitled to an income tax charitable deduction of about $7,940 (assumes quarterly payments, 1.4% §7520 rate). The donor would receive income of $1,176 annually (4.9%) – more than $900 of which would be tax free.

Gifts at death

The tax results are much better for bonds left to charity at death. Savings bonds, as well as other IRD assets such as retirement plan death benefits, are included in the gross estate. For those estates subject to federal estate tax, an estate tax charitable deduction is available for amounts passing to charity. The income tax liability generally passes to the beneficiary who receives the bonds, but because charities are tax-exempt, the bequest is not diminished by income taxes.

It is important, however, that the bonds (or other IRD assets) be specifically bequeathed to charity – or be included in the residue with the entire residue passing to one or more charities. Note that joint ownership or beneficiary designations on bonds will trump dispositions by will. The IRS has ruled privately that where charity receives a pecuniary bequest that the executor satisfies with bonds, the bonds will be treated as if they were redeemed and the proceeds distributed to charity (Ltr. Rul. 9507008). The estate would owe income tax on the proceeds.

It's also possible for a decedent to use the bonds to fund a testamentary charitable remainder trust or charitable gift annuities to benefit family members. Because a charitable remainder trust is a tax-exempt entity, the tax on IRD is avoided and the income beneficiaries receive payments based on the full value of the bonds (see Ltr. Rul. 9237020, dealing with retirement plan assets). The estate would be entitled to a charitable deduction for the value of charity's remainder interest.

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