

The Advisor



September 2013

ESTATE PLANNER'S TIP

No one can predict the future. That's why it's important that estate plans anticipate that named beneficiaries may become disabled and need Social Security disability benefits. A bequest may jeopardize those benefits if left to an individual who, due to accident or a disability that manifests itself at a later age, is receiving government benefits. One option is to include a provision in the estate planning documents that permits the executor or trustee to establish a special needs trust for any beneficiary who, at the time of the testator's death, qualifies as "disabled" under Social Security definitions. Another provision that should be included in estate plans is a contingent charitable bequest, naming a charity or allowing the executor to name a charity, to receive funds in the event a named beneficiary has predeceased the testator.

DIVIDENDS A REDUCTION OF PREMIUMS, NOT AN INCIDENT OF OWNERSHIP

Under their property settlement, Henry was obligated to maintain an insurance policy on his life for Lillian's benefit. He was to pay all premiums, but could not borrow against or pledge the policy. Dividends belonged to Henry. At his death, his executor included the policy proceeds in his gross estate.

Insurance policies on the life of a decedent are included in the gross estate under Code §2042(2) if the decedent possessed any incidents of ownership at death. The right to change the beneficiary, surrender, assign or cancel the policy, to

pledge the policy for a loan or to obtain a loan from the insurer against the surrender value are incidents of ownership [Reg. §20.2042-1(c)(2)]. In *Estate of Bowers* (23 T.C. 911), the Tax Court ruled that the right to dividends which may be applied against the current premium is merely a reduction in the amount of premiums paid, not a right to the income of the policy. Although the dividends "belonged" to Henry, the IRS said it was not an incident of ownership that would cause the proceeds to be included in his gross estate (Ltr. Rul. 201328030).

PAYMENT NEITHER ALIMONY NOR DEDUCTIBLE

John Nye was obligated to pay his former wife Alice permanent alimony of \$3,600 per month until either one of them died or she remarried. In 2006, Alice asked the court to increase the monthly amount. The parties reached an agreement under which John would pay Alice a lump sum of \$350,000 and would have no further alimony obligations.

In January 2008, John made the \$350,000 payment, which he claimed as alimony on his income tax return. The IRS disallowed the bulk of the payment, saying it did not fall within the definition of alimony under Code §71(b).

The Tax Court agreed with the IRS, noting that under Code §71(b)(1)(D), a payment is not considered alimony if the obligation to pay extends beyond the death of either party. Although the mediation agreement was silent as to whether John's obligation to pay Alice would have terminated if she had died prior to the effective date of the agreement, under state (Florida) contract law, the rights and obligations under a contract generally survive a party's death and become binding

on and enforceable by the personal representative of the estate. Therefore, the payment did not constitute alimony, the court ruled (*Nye v. Comm'r.*, T.C. Memo. 2013-166).

CHARITABLE DEDUCTION WITHERS ON THE VINE

In 2005, Michael Mountanos conveyed a conservation easement over an 882-acre parcel of undeveloped land to the Golden State Land Conservancy. The property was largely surrounded by federal land. Mountanos had an easement over neighboring property for accessing the ranch and a limited access easement for single-family use from the U.S. Bureau of Land Management. The land was under a contract with the county that limited the use and development according to the California Land Conservation Act of 1965. A spring crossed the property, but Mountanos did not have the necessary permit to divert water for private use.

Mountanos claimed a charitable deduction of nearly \$4.7 million, part of which was carried over to later years. He relied on three appraisals, all of which determined that the highest and best use of the land included a vineyard over a portion of the property. Two of the appraisals also said the property could have been subdivided for residential use. The IRS did not challenge the easement as a "qualified conservation contribution" under Code §170(f)(3)(B)(iii), but said the value was overstated.

The Tax Court found several impediments to the use of the property as a vineyard, including the lack of required access, water supply, lack of demand for property suitable for vineyard use and economic feasibility. The court said Mountanos failed to show that vineyard use was "reasonably probable" in the near future so as to be affected by the easement. Roadblocks also prohibited residential development of the property. In addition to issues of access, the contract with the county prohibited subdivision of the land, with minor exceptions. The court said Mountanos failed to show that the easement

PHILANTHROPY PUZZLER

Anthony made a substantial cash gift to charity in 2007. He was unable to deduct the entire amount in the year of the gift because of the deduction limitations of Code §170(b)(1)(A), but he knew that he could carry over the excess. In tax years 2008 through 2010, Anthony claimed carryover deductions, but in 2011 and 2012 he did not itemize, taking the standard deductions instead. This year he expects his itemized deductions to exceed the \$6,100 standard deduction amount for single filers. He plans to use the remaining carryover from his 2007 gift when he files his 2013 income tax return. Can he do that?

diminished the ranch's fair market value. Therefore, he was not entitled to the carryover charitable deduction (*Mountanos v. Comm'r.*, T.C. Memo. 2013-138).

SETTLEMENT NOT SELF-DEALING

Larry and his two children owned interests in a limited partnership. They entered into an agreement giving the children the right to purchase Larry's partnership interests at a price determined by independent appraisal at his death, subject to an increase or decrease equal to the final determination of value for federal estate tax purposes.

In the will admitted for probate, Larry left his general partnership interests outright to a private foundation. The executors of Larry's estate were also the co-trustees of the foundation. The will directed the executors to offer the option for the children to purchase the limited partnership interests at the value determined for federal estate tax purposes. The residue of Larry's estate was to pass to the foundation.

The children, the executors and the trustees filed various claims, resulting in protracted litigation and arbitration. Eventually, the parties arrive at a settlement agreement. The children will purchase all of the interests at a price set forth in the agreement and will pay an amount to settle claims alleging that they took excess distributions from the partnership. The probate court approved the settlement. The parties asked the IRS to rule that performance of the settlement agreement would not constitute acts of direct or indirect self-dealing under Code §4941.

Code §4941(a) imposes excise taxes on direct and indirect acts of self-dealing between a disqualified person and a private foundation. The IRS noted that the foundation had an expectancy under the terms of Larry's will. The foundation's ultimate expectancy "depended on final resolution of the litigation and arbitration proceedings." Although the foundation could have awaited the end of the proceedings, it could have taken many more years and cost a considerable amount in

legal fees, the IRS said. All the parties were represented by legal counsel and the resulting agreement was the product of arm's-length negotiations. Therefore, ruled the IRS, the transaction will not give rise to self-dealing and no tax under Code §4941 will be due (Ltr. Rul. 201321027).

IS IT WORTH ANYTHING?

A company owned property located within a national park. It donated the land and mineral rights to the U.S. Park Service, for which it claimed a charitable deduction, based on two appraisals. Mining in the park had been phased out under federal law.

The IRS said that the land is to be valued at its highest and best use, even if that use is prohibited on the date of the gift. That value would be discounted by a reasonable estimate of the cost of removing the restrictions and the time needed to remove the restrictions. The likelihood of removing the legal restrictions on mining must also be determined, said the IRS. If it is determined that the property only has value as a mine and that due to mining restrictions in place the property is worthless, it must be considered whether the property became worthless at some prior time when mining ceased (Ltr. Rul. 201319010).

PUZZLER SOLUTION

Anthony is out of luck with respect to his remaining deductions. Code §170(b)(1)(B) permits cash gifts in excess of 50% of AGI to be deducted in each of the five succeeding tax years. The five-year period does not refer only to years in which the donor itemizes deductions. Excess deductions not claimed within the five tax years following the gift are lost. Clients should consider their likely tax situation when making gifts that will involve carryovers.

CHARITABLE BEQUESTS NEED CAREFUL PLANNING

Some clients who hesitate to part with assets during their lifetimes are more than happy to remember charities in their estate plans. For many smaller charities, realized bequests represent a significant portion of their charitable gifts. Careful planning can enable charitable bequests to save both estate taxes and income taxes.

Property passing to charity from a decedent generally qualifies for the estate tax charitable deduction. The transfer must be to an organization described in Code §2055(a) and the property must (1) be included in the decedent's gross estate, and (2) be considered "transferred by the decedent." Charitable bequests are 100% deductible; there are no deduction ceilings as with the income tax charitable deduction. The bequest should be contingent upon the organization being a qualified charity at the decedent's death and should name an alternative charity (or permit the executor or trustee to name an alternative charity) in the event the named organization is no longer qualified.

It's important to carefully plan bequests, even if estate taxes are not an issue (estates under \$5.25 million in 2013). What assets should be considered in planning a charitable bequest?

Income in respect of a decedent

Items of income earned by a decedent before death but paid to the estate after death are considered income in respect of a decedent (IRD). If left to other beneficiaries, the IRD assets are subject to both income tax and possibly estate tax. However, charities usually don't pay income tax and therefore keep every dollar of bequests of IRD assets. In addition, a bequest of IRD qualifies the estate for a charitable deduction. IRD assets include:

- interest on U.S. savings bonds

- IRAs, 401(k)s and other qualified retirement plans
- accounts receivable of a cash-basis individual
- renewal commissions of insurance agents
- deferred compensation, last salary check, bonuses and distributions from employee benefit plans
- accrued royalties under a patent license
- a deceased partner's distributive share of partnership income to the date of death
- payments on installment obligations.

The will, trust or beneficiary designation should specifically bequeath the IRD assets to charity to avoid income tax to the estate.

Ordinary income property

The income tax charitable deduction for a gift of ordinary income property to charity is generally the donor's basis [Code §170(e)(1)(A)]. For example, the deduction for a gift of artwork by the artist who created it would be the artist's basis, rather than fair market value. No such reduction applies in the estate tax charitable deduction. The artwork is included in the artist's estate at its fair market value, which is also the value for estate tax charitable deduction purposes.

Tangible personal property

If an individual makes a lifetime gift to charity of tangible personal property (e.g., a painting, boat or a coin collection), and the charity puts the gift to a use that is unrelated to its exempt purposes or sells the property, the donor's deduction is reduced by 100% of any long-term capital gain present in the property [Reg. §1.170A-4(b)(3)(i)]. No estate tax reduction occurs, however, with bequests of tangible personal property.

David W. Bahlmann, J.D.
President/CEO

BALL STATE UNIVERSITY FOUNDATION
P.O. Box 672, Muncie, IN 47308
(765) 285-8312 • (765) 285-7060 FAX
Toll Free (888) 235-0058
www.bsu.edu/bsufoundation

Philip M. Purcell, J.D.
Vice President for Planned Giving
and Endowment Stewardship