

The Advisor



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ESTATE PLANNER'S TIP

A revocable living trust is a well-known method of avoiding probate, at least for assets transferred to the trust. There are other options, however, that may be equally effective. Payable-on-death and transfer-on-death designations are permitted on bank accounts, securities and even real property (in some states). The owner retains all rights to the property and the right to revoke the transfer designations until death. Joint ownership of assets, in which the surviving joint owner becomes the sole owner at the first death, also avoids probate. However, a joint owner has lifetime ownership interests that may not be desired or practical. Assets with death beneficiary designations also generally bypass probate. These can include life insurance and retirement plans, although if no death beneficiary is named, the assets could be included in the probate estate. Clients seeking to avoid the cost and time associated with probate should explore other options as part of their overall estate planning.

BENEFICIARY RECEIVES, IRS TAKES

The estate tax due on Joseph Mangiardi's 2000 estate was nearly \$2.5 million. His estate requested and was granted six extensions of time to pay the tax, on the grounds that the majority of the estate's assets were marketable securities in an inter vivos trust that were undervalued due to the depressed market. The executor said the estate intended to hold the securities until the value increased, at which time the shares would be liquidated and the proceeds used to pay the estate tax. Instead, the co-trustees actively traded the securities and paid themselves hundreds of thousands of dollars in fees.

In 2006, the IRS levied against the estate, which had paid only \$250,000. Because the estate was insolvent by that time, the IRS brought suit against

Mangiardi's daughter, Maureen, one of the trustees. She argued that Code §6901 provides the exclusive procedure to assess liability against a transferee and must be done within four years of the filing of the estate tax return.

The U.S. District Court (S.D. Florida) agreed that the IRS could pursue transferee liability under Code §6324(a)(2), which provides that a lien, lasting for ten years from death, is automatically created on a decedent's gross estate. If estate assets are transferred, the lien remains with the transferred property and the transferee takes the assets subject to the lien. In addition, noted the court, the running of the ten years is suspended for any extensions of time for payment [Code §6503(d)] (*U.S. v. Mangiardi*, 2013-2 USTC ¶60,669).

COURT FINDS PROCRASTINATION, NOT FRAUD

Jose Marbaix's holographic will, executed in 2006, was admitted to probate on October 14, 2011. It left a large part of her estate to ten named charities. Vincent Bagby, who was not named in the will, filed an objection to the will on July 19, 2012, claiming a 2009 will revoked the 2006 document. Bagby was the primary beneficiary of the 2009 will.

Under California law, Bagby had until February 11, 2012 – 120 days after the 2006 will was admitted to probate – to file a petition to revoke the will. He argued that he was unable to challenge the will prior to July 2012 because he did not learn of Marbaix's death until he returned from a tour of duty in Iraq. The trial court ruled Bagby's claim was time-barred.

There is an exception to the 120-day limit for contesting the admission of a will if there is evidence of extrinsic fraud. The essence of extrinsic fraud is "one party's preventing the other from having his day in court," noted the California Court of Appeals. On the other hand, where a party had an opportunity to present his case but "unreasonably neglected to do so," the fraud is intrinsic and is not a valid ground for extending the limitation.

The court found that Bagby returned from Iraq in November 2011, within the 120-day period. He had more than two months to learn of Marbaix's death and challenge the 2006 will. The estate administrator followed proper notice procedures

PHILANTHROPY PUZZLER

Helen, who always tries to be scrupulously fair to her two daughters, plans to create a testamentary charitable remainder annuity trust that will pay out 6% of the initial trust value – 3% to each daughter. To avoid the possibility of one daughter receiving more than the other just by living longer, Helen wants to provide that the payments are to be reduced to just 3% at the death of the first daughter. Any problem with this arrangement?

and no one prevented Bagby from participating in the probate proceedings, so there was no showing of extrinsic fraud, ruled the court (*In re Estate of Marbaix*, B244137).

OUT-OF COUNTRY EXPERIENCE NOT DEDUCTIBLE

The IRS disallowed Pauline Golit's charitable deduction for a \$10,000 gift to a church in Nigeria. Under Code §170(a)(1), a charitable deduction is defined as a gift "to or for the use of" an organization "created or organized in the United States or in any possession thereof or under the law of the United States, any State, the District of Columbia, or any possession of the United States."

The Tax Court ruled that Golit failed to show that the church is a qualified organization and she was therefore not entitled to a charitable deduction (*Golit v. Comm'r.*, T.C. Memo. 2013-191).

Note: Although income tax charitable deductions are not allowed for *gifts* to foreign charities, *estate* tax deductions are available for bequests to foreign organizations [Reg. §20.2055-1(a)(4)].

THE INCREDIBLE SHRINKING INCOME INTEREST

Hector and Betty created a net-income with make up charitable remainder unitrust sometime prior to 2008. They have become disappointed with the returns and would like, with the agreement of the charitable remainderman, to terminate the trust. Hector and Betty would receive the actuarial value of their income interest and charity will receive the balance.

The IRS was asked to rule on the consequences of the trust's termination. Both Hector and Betty have been examined by their doctors, who submitted statements that the couple have no medical conditions that are likely to result in a shorter life expectancy than expected for persons of their ages.

Hector and Betty are disqualified persons in relation to the trust [Code §4946(a)(1)(A)], but amounts payable under the terms of the trust are not self-dealing [Code §4947(a)(2)(A)]. Payments received on the termination of the trust would not be con-

sidered self-dealing, provided the allocation method is reasonable and does not result in a greater allocation of trust assets to the couple than appropriate, said the IRS.

Net-income with make up unitrusts do not necessarily pay a stated percentage of the trust value each year, the IRS noted. It's possible, therefore, that the income beneficiaries could receive an amount in excess of the rates specified in Code §7520. Therefore, the allocation must be adjusted to reflect amounts that "reasonably may be paid to the beneficiaries." The IRS set forth what it called a "reasonable method" to prevent a greater allocation of assets to Hector and Betty than is appropriate, involving the use of a special §7520 factor.

The IRS assumed that the termination would occur in March or April 2013, when the §7520 rate was 1.4%. Hector and Betty were ages 72 and 70. Therefore, the unadjusted payout rate of 1.4% and annual payments made at the beginning of each year yield a remainder interest of .77971. The present value of the income interest is \$1 minus \$.77971, or \$.22029 for each dollar of trust value. The amount received by Hector and Betty will be treated as an amount realized from the sale or exchange of a capital asset under Code §1222, taxed as long-term capital gain (Ltr. Rul. 201325018).

Note: The calculation proposed by the IRS results in the income beneficiaries potentially receiving significantly less than they might otherwise be entitled to if the actuarial interests were valued using the stated payout percentage (minimum 5%).

OH, WHAT A TANGLED WEB

When the IRS questioned the charitable deductions claimed by Margaret Payne – \$12,025 in 2008 and \$25,140 in 2009 – she produced letters from the Living Stone Baptist Church, signed by the pastor. IRS agents questioned the pastor, who said that Payne was not a member of the church. He said the letters, on church letterhead, were a "cut and paste job."

Juanita Stevenson, Payne's friend and co-worker, was a member of the church and initially told the pastor that Payne went by another name. The Tax Court determined that the pastor met Payne

for the first time after the IRS examination began. The pastor wrote to the IRS recanting his original statement. He said Stevenson later told him she was actually Margaret Payne. The pastor provided two additional letters stating that Payne had, in fact, given to the church in the amounts disallowed by the IRS, and that he may have confused her with Stevenson and suggesting that Payne had promised to make a contribution at some later point in return for the letters.

The Tax Court, which found the series of events "full of inconsistencies, contradicting testimony, fabricated documents and simple untruths," found it "probable" that Payne and Stevenson created the substantiation letters, and found the testimony of Payne, Stevenson and the pastor contradictory. Even after being confronted with the false documents, Payne continued to pursue documents to support the deductions. The court said the only matter that was certain was that Payne had not presented any "credible evidence" that she made the contributions (*Payne v. Comm'r.*, T.C. Summ. Op. 2013-64).

Note: At the time of the trial, Payne had been an IRS revenue agent for more than 20 years and was, therefore, presumably aware of the substantiation requirements of Reg. §1.170A-13(a)(1). The court imposed an accuracy-related penalty under Code §6662(a).

PUZZLER SOLUTION

If the total payout of the trust is simply cut in half – to 3% – it will not meet the requirement that the payout be at least 5% of the initial value of the assets placed in trust [Code §664(d)(1)(A)]. However, Reg. §1.664-2(a)(2)(ii) allows the trust to distribute a portion of the corpus to charity at the death of a beneficiary, while keeping the payout at the same rate. Helen could provide that half the corpus pass to charity at the death of the first daughter, with the survivor then receiving 6% of the reduced value – the same dollar amount as before her sister's death.

GIFTS OF SECURITIES: A REVIEW OF THE RULES

Year's end is a time when many clients choose to make charitable gifts, in order to qualify for a deduction on the current year's tax return. Many financial advisors recommend that donors make their charitable gifts with long-term capital gain property, rather than cash. That advice could be especially true this year, as many clients could be subject to the higher 20% capital gains tax rate and the 3.8% net investment income tax on the sale of securities. Not only is the donor entitled to a charitable deduction for the full fair market value of the donated shares held more than one year, but the capital gains tax that would be owed if the shares were sold is avoided, as well.

A review of rules governing gifts of securities may be in order for donors:

■ Clients should not contribute depreciated stock. The charitable deduction is limited to the fair market value. Instead, donors should sell the shares, thereby securing a capital loss deduction, and contribute the proceeds to charity, entitling them to a second tax deduction for the cash gift to charity.

■ The deduction for a gift of stock held one year or less is the lesser of the donor's basis or the fair market value [Code §170(e)(1)].

■ The value of a gift of publicly traded stock is the mean (average) between the high and low selling price on the date of the gift [Reg. §25.2512(a)]. If there are no trades on the date of the gift, the regulations provide for a weighted average to be used [Reg. §25.2512-2(b)(1)]. The average is weighted inversely by the respective number of trading days between the last sale occurring before the gift, the date of the gift, and the date of the first recorded sale date after the gift. Because Saturdays and Sundays are not

trading days, gifts made on a weekend are averaged between the mean sale prices on Monday and Friday.

■ The value of mutual fund shares is the net asset value in effect at the time of the gift [Reg. §25.2512-6(b)]. The gift is considered complete when the shares are received in the charitable donee's fund account. Check with the charity's representative regarding transfer instructions.

■ A donor who claims an income tax charitable deduction for a non-cash gift of \$5,000 or more must obtain a qualified appraisal and file Form 8283. This requirement does not apply to gifts of publicly traded securities. If the gift involves closely held stock, an appraisal is required if the deduction is \$10,000 or more.

■ A gift of appreciated securities to a public charity is deductible up to 30% of the donor's adjusted gross income [Code §170(b)(1)(B)]. Excess deductions may be carried over for up to five additional years. The donor may make an election under Code §170(b)(1)(C)(iii) to deduct only up to the stock's basis and be eligible for a 50%-of-AGI limitation.

■ Most clients who own shares will have the stock in a brokerage account. Gifts can be made by a direct transfer and will be complete when the shares arrive in the charity's account. Clients should notify charity's representative when a gift is being made, both to get transfer instructions and to assure that proper substantiation is given.

Because the transfer process can be subject to delays, clients should allow ample time for the gifts to be completed before year's end, especially for transfers of mutual fund shares, which can take longer than transfers of stock from a brokerage account.

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