The Advisor

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ESTATE PLANNER'S TIP

Mutual funds returns have started looking more attractive, but clients should be aware that a sharp increase in the long-term performance of a particular mutual fund may not necessarily be due solely to the fund's activity during the recent bull market. Instead, the boost may be due, at least in part, to the fact that the results of the 2008 market drop will no longer be included in the evaluation. Erasing the losses will have the effect of dramatically boosting the average five-year return over the next few months.

REFORMATION FIXES TRUST'S DEFICIENCIES

Jerome died testate in 2010, leaving the residue of his estate to a trust that was to be divided into two trusts. One of these – a charitable trust – was to be funded with an amount equal to the unified credit exclusion at the time of Jerome's death. The trustees of the charitable trust were to pay a percentage of the trust corpus annually to Jerome's two children. Trust assets were to be invested in an attempt to generate the specified income payments, with payments of principal prohibited. At the death of the surviving child, assets are to be distributed outright to charity.

Because Jerome died in 2010 while the estate tax was temporarily repealed, a question arose as to funding the charitable trust. In addition, the trustee had the discretion to pay the funeral expenses and expenses of last illnesses for the income beneficiaries, which would disqualify the trust as a charitable remainder trust under Code §664. The trust's direction regarding investments raised concerns about the trustee's ability to invest assets impartially.

The children and three charities entered into an agreement under which the trust would be funded with a stated amount and divided into two trusts. One of these was intended to be reformed as a charitable remainder unitrust. The reformed charitable trust will pay a percentage amount to the two children. At the death of the first child, that child's share will be paid to the three charities, with the balance passing at the surviving child's death.

The judicial reformation of the trust was commenced before the 90th day after the last date for filing Jerome's estate tax return. The IRS ruled that the charitable interest in the trust was a reformable interest because the amount was presently ascertainable and severable from the noncharitable interest. The remainder interest passing to the

three charities would have qualified for an estate tax deduction under Code §2055(a), but for the requirements of Code §§664 and 2055(e)(2). The actuarial value of the reformed charitable interest does not differ by more than 5% from the value under the original trust and the interests of Jerome's children will terminate at the same time as they would have under the original trust. The reformation is effective as of the date of Jerome's death.

The IRS said that the agreement constitutes a qualified reformation under Code §2055(e)(3) and that an estate tax charitable deduction is allowable for the present value of the charitable remainder (Ltr. Rul. 201333006).

Note: The estate tax was reinstated retroactively on December 17, 2010, under the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010. Estates of decedents who died in 2010 were allowed to elect to have the estate tax not apply and to have the carryover basis rules of Code §1022 apply to property transferred from the decedent. Jerome's personal representative did not elect to have the carryover basis apply, choosing instead to be subject to the estate tax.

"OVERFUNDED" TRUST CAN'T BE DIVERTED

Mary Latimer left $5,000 in trust at her death to be used for the perpetual care of two specific cemetery lots in the Wilmington and Brandywine Cemetery. Income could be accumulated and used to relocate the deceased, if necessary.

PHILANTHROPY PUZZLER

In her will, Jane left the residue of her estate to a trust to benefit charity in perpetuity. She gave the trustee the right to distribute up to one-quarter of the corpus to her father during his life if he survived her. Jane's father was alive at her death, but was financially secure, so no distributions from corpus were ever made to him. How large is the deduction to which Jane's estate is entitled?

The cemetery, which foresees financial problems in the future, asked the court to modify Latimer's trust to allow 3% of the net assets to be distributed annually for the cemetery's general maintenance. The trust, which contains approximately $500,000, is far in excess of what's needed to maintain the two lots, the cemetery claimed.

The Court of Chancery of Deleware said that the move would mean that a trust funded to maintain two burial lots would instead subsidize a cemetery with 22,000 interments. The court noted that state law views burial trusts as noncharitable and specifically excludes them from the rule against perpetuities. Therefore, the charitable doctrine of cy pres does not apply to permit a diversion of trust assets.

State law does permit statutory cy pres for noncharitable trusts, but only upon a showing that the purposes of the trust have become unlawful or the trust would otherwise no longer serve any purpose. The cemetery has failed to show that either condition exists. The cemetery's "real beef" is that the trust does not serve the purpose they prefer, said the court. The fact that the trust is "amply funded" is not grounds for a modification. Even if the cemetery falls into disrepair due to its financial situation, the trust specifically provides for relocation of the deceased. Compliance with the terms of the trust is not impossible or illegal, noted the court, so there are no grounds to apply the doctrine of deviation (*In re Latimer Trust*, C.M. No. 17254-N-VCL).

GIFTS BY AGENT REIMBURSED, DEDUCTIBLE

Larry Zavadil sold his shares in American Solutions for Business (ASB) to an employee stock ownership plan in 2000, but remained as an unpaid member of the company's board and its CEO. The company maintained a ledger account for Zavadil for non-ASB expenditures, from which he made numerous charitable gifts. Zavadil reimbursed ASB by the end of each month.

Zavadil claimed charitable deductions of $576,827 and $535,731 respectively in 2004 and 2005. The IRS disallowed a significant portion of each year's deductions. Zavadil initially conced-

ed he was not entitled to some of the disallowed deductions, but before the Tax Court, he said that the IRS would not be prejudiced if the court disregarded the concessions because the dispute centered on whether the deductions were Zavadil's or properly belonged to ASB. The court agreed.

Before the court, Zavadil conceded that he was not entitled to certain deductions because he lacked the proper substantiation under Code §170(f)(8). The IRS noted additional disputed deductions that lacked substantiation. However, the court found that these gifts were below the $250 threshold that required a contemporaneous written acknowledgment and therefore were deductible.

The IRS claimed that ASB, not Zavadil, "bore the economic burden" of the charitable contributions that were charged to his ledger account. In the alternative, the IRS said that if ASB did not bear the burden, a separate entity, Zavadil Sales, bore the burden.

The court said the IRS's argument failed to recognize that during the years Zavadil repaid the ledger balances with his own funds. Because the balances were paid off by the end of 2004 and June 2005, Zavadil, not ASB, bore the economic burden of the gifts and was entitled to the deductions. The court found ASB was acting as Zavadil's agent in making the gifts. However, Zavadil was unable to show which, if any, of the gifts made after June 2005 were paid with his own funds. Therefore, he was not entitled to the deductions, the court ruled. The IRS noted that Zavadil Sales was an unincorporated entity, so Zavadil continued to bear the burden of the gifts (*Zavadil v. Comm'r.*, T.C. Memo. 2013-222).

ACCELERATING REMAINDER YIELDS ADDED DEDUCTION

Jack and Jill created two charitable remainder unitrusts several years apart. In both trusts, the couple retained the right to change the remainder beneficiary in their wills or other writings [Reg. §§1.664-2(a)(4), 1.664-3(a)(4)]. Jack, as trustee, has the power to make distributions of trust assets to charities.

The couple entered into an agreement with an organization to irrevocably relinquish their rights to change the remainder beneficiary. They plan to name the charity as the sole remainder beneficiary and to then assign all trust assets to the organization. They also have agreed to make an additional outright gift to reach a specified amount.

The IRS ruled that the couple would be entitled to a gift tax charitable deduction under Code §2522 for relinquishing their right to change the remainder beneficiary. They are also entitled to a gift tax deduction and an income tax charitable deduction under Code §170 for assigning their unitrust income interest to the charity. The IRS found that Jack and Jill did not create the unitrusts to avoid the partial interest rules of Code §170(f)(2)(A) and Reg. §1.170A-6(b)(1)(iii). Therefore, ruled the IRS, their income tax charitable deduction will not be disallowed (Ltr. Rul. 201321012).

Note: Although the §7520 rate, used to value split-interest charitable gifts, has inched up over the past few months, making a gift to charity of all or part of an existing charitable reminder trust may still be attractive to philanthropic clients. The deduction allowed for gifts of income interests are generally higher when §7520 rates are depressed.

PUZZLER SOLUTION

Because 25% of Jane's bequest to charity is subject to diversion for noncharitable purposes, her estate is entitled to an estate tax deduction only to the extent the property is exempt from the exercise of the power, or 75% [Reg. §20.2055-2(b)(1)]. This is true regardless of whether or not the trustee exercises the power in favor of Jane's father.

NO ESTATE TAX DEDUCTION? NOT A PROBLEM

Most life-income and split-interest gifts come with strict criteria that must be met to qualify for a charitable deduction. But with the increased estate tax exemption ($5.25 million for 2013) making fewer estates subject to tax, new avenues may be open to non-qualified testamentary charitable gifts. For example:

■ A testator wants to establish a trust that will pay all the income to a child before assets are distributed to charity at the child's death. With a qualified charitable remainder trust, only a specific annuity or unitrust percentage may be payable to the child, subject also to the 10% remainder requirement of Code §664(d)(2)(D) and the 5% probability test for annuity trusts (Rev. Rul. 77-374). With a nonqualified trust, a testator can direct that all the income be paid or even provide for payments to be skipped in certain years. Because the remainder value of the trust is not an issue for estate tax purposes, it's also possible to have the trust continue for the lives of multiple beneficiaries, which might not be possible with qualified charitable remainder trusts that have to be valued using the §7520 rates.

■ Reg. §1.664-3(a)(1)(i)(c)(2) allows charitable remainder unitrusts to "flip" from a net-income to a standard unitrust on a specific date or upon the happening of a triggering event whose occurrence is outside the control of the trustees or any other persons. That would preclude a qualified trust where the income beneficiary is able to direct the flip to occur at his or her discretion. However, with a nonqualified trust, the trustee could pay the lesser of a specified percentage or the trust's net income annually until the beneficiary selects a date for the flip to occur. In addition, any make-up from previous years when the full percentage payment is not made would not have to be lost, as it is with a qualified flip trust. Note: The trust would be taxable on undistributed income.

■ It might be possible to fund a nonqualified charitable remainder trust with mortgaged property or jointly owned property, actions that would jeopardize a qualified trust.

■ Under the partial interest rule [Code §170(f)(3)(A)], no charitable deduction is allowed for a transfer, not made in trust, of any interest in property that is less than the donor's entire interest. If the charitable deduction is not needed, a decedent could bequeath real property to charity while leaving mineral rights to a family member, with the mineral interests passing to the charity at the individual's death.

■ One exception to the partial interest rule is for remainder interests in personal residences and farms [Code §170(f)(3)(B)(i)]. Generally this involves a donor transferring an interest in a home or farm while retaining the right to live in, rent or farm the property for life. These split-interest gifts can also be arranged for survivors through an estate plan. Where the testator is not concerned about the charitable deduction, it would be possible to arrange a similar split-interest gift where commercial property (e.g., office or apartment building) was involved. Charity could own the property outright at the death of the individual or after a period of years.

■ No deduction is allowed for a future interest in tangible personal property (e.g., artwork, antiques, collections) until all intervening noncharitable interests have ended. Without the need for an estate tax charitable deduction, a testator could leave personal property to family members, with the items passing to charity at the death of the survivors or after a period of years.

The larger estate tax exemption may allow more flexibility for clients wishing to split the benefits of their bequests between charity and family members. However, it's important to involve charity in the planning, to determine whether the organization wants to be a party to some of these arrangements.

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