The Advisor

BALL STATE UNIVERSITY FOUNDATION
Established in 1951

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ESTATE PLANNER'S TIP

Qualified charitable distributions (QCDs) from IRAs are back, through 2013, as part of the American Taxpayer Relief Act of 2012. Clients age 70½ and older can have IRA custodians make distributions of up to $100,000 directly to charity. QCDs can be used to satisfy the client's required minimum distribution for 2013. No income tax charitable deduction is allowed, but because the QCD is not included in the donor's gross income, taxes will nonetheless be reduced. Donors may not use the QCDs to establish charitable remainder trusts or charitable gift annuities, but the QCD can be used to satisfy existing pledges (Notice 2007-7). Other charitable provisions that were extended under ATRA include the deduction for contributions of real property made for conservation purposes, the enhanced charitable deduction for contributions of food inventory and the favorable basis adjustment to the stock of S corporations making charitable contributions of property. Higher capital gains tax rates (20% versus 15%) for clients with taxable income in excess of $400,000 (single taxpayers) or $450,000 (joint filers) will also make the tax savings from charitable gifts of appreciated property more attractive.

ADULT ADOPTIONS MEANT TO CIRCUMVENT TRUST TERMS

William Hughes married for the first time at age 87, and at age 94, shortly before his death, adopted his wife's three adult daughters. Hughes' family, who had been kept from seeing him, claimed that three family trusts should be administered as though Hughes did not have any children at his death.

The trial court granted summary judgment for Hughes' family, finding that the grantors of the three trusts did not intend for the remainder interests to pass to "non-family members who were adopted long after they became adults and were never raised" by the family. Hughes' wife appealed, saying that under state (Illinois) law, adopted children are presumed to be the descendants of the adoptive parent.

The Appellate Court of Illinois agreed with the trial court, noting that there is a rebuttable presumption that adopted children should be treated as biological children under the terms of the trusts. However, said the court, the record showed that the wife's daughters were adopted for the sole purpose of making them beneficiaries of the trusts. The testators of the three trusts demonstrated their intent that the residue of the trusts was to remain in the family. The intent of the testators would be thwarted if Hughes were allowed to circumvent the trusts by adopting grown women (*Dixon v. Weitekamp-Diller*, 2012 IL App (4th) 120209).

BEQUEST RECIPIENT "UNAMBIGUOUS"

One quarter of the charitable bequest Elaine Hillman made in her trust was to benefit "MIAMI children's hospital foundation, cranial/facial FOUNDATION," to the attention of Dr. Anthony Wolfe. When Hillman died in 2007, both Miami Children's Hospital Foundation and Miami Care Foundation claimed to be the intended beneficiaries.

The trial court determined that Hillman's trust was ambiguous and that her intention had been to give Dr. Wolfe the ability to direct and control the assets of the trust. Dr. Wolfe is, and was at the time Hillman's trust was executed in 2004, the director of Miami Children's Hospital's craniofacial surgical program. He is also head of Miami Care Foundation. The court ruled that the bequest was intended for Miami Care.

The District Court of Appeals of Florida disagreed, finding no ambiguity on the face of Hillman's trust. The court noted that at the time the trust was executed, Miami Care Foundation did not even exist. A court may look beyond the face of a will if there is an ambiguity as to the person to whom it is applicable, said the court, but the general rule is that the misnomer of a legatee will not defeat a bequest where the intended beneficiary can be identified with certainty. Because Hillman's trust unambiguously named Miami Children's Hospital Foundation as beneficiary, the trial court erred in finding Miami Care Foundation to be the beneficiary of Hillman's trust (*Miami Children's Hospital Foundation, Inc. v. Estate of Hillman*, No. 4D11-2153).

PHILANTHROPY PUZZLER

Hiram wants to establish a net-income with make up charitable remainder unitrust that is payable to him for life, then to his son. The trust produces at least a 10% remainder interest for charity. His advisor suggests that he retain the right to revoke his son's survivorship interest in his will. Aside from making the gift incomplete for gift tax purposes, is there any other reason to retain the right to revoke?

PART OF TRUST YIELDS ADDED DEDUCTION

John and Abigail established a charitable remainder unitrust for their joint lives, using community property. They retained the right to change the remainder charities. Following Abigail's death, John proposed to contribute an undivided interest in the unitrust payments to and irrevocably name a specific organization as the beneficiary of a portion of the remainder. The charity's income and remainder interests will merge under state law and a portion of the corpus will be distributed outright to the charity. The balance of the corpus will continue to be held in trust.

In Rev. Rul. 86-60 (1986-1 C.B. 302), the IRS ruled that a gift to charity of an income beneficiary's rights in a charitable remainder annuity trust qualifies for a charitable deduction. John's proposed transfer is analogous and qualifies for a deduction under Code §170. The amount of the deduction is the present value of the right to receive annual payments equal to the percentage payout of the net fair market value of the trust assets. The IRS also ruled that John will be entitled to a gift tax charitable deduction under Code §2522(a) for the fair market value of his gift and that the transfer will not cause the disqualification of the trust under Code §664(d)(2) (Ltr. Rul. 201249002).

DONOR'S HOLDING PERIOD PROVES PROBLEMATIC

In 1996, Joseph Williams agreed with Abbey Art Consultants to buy art at a discount, to be held for more than one year, before the works were donated to charity. Abbey would identify and obtain an appraisal for the art when Williams directed it to be donated.

In December 1997, three pieces were given to Drexel University. The works had an appraised value of $425,625. Abbey sent Williams an invoice for $98,400, to be added to his original $3,600 deposit. Williams claimed a charitable deduction for the appraised value. Williams made a similar gift in 1999 to the art museum at Florida International University, claiming a deduction of $250,525 for artwork for which he paid $57,500 in December 1999. In 2000, he paid Abbey $21,758 for artwork appraised at $98,900 to be given to Drexel University.

The IRS did not challenge the fact that Williams made the payments to Abbey, that Abbey made the gifts on Williams' behalf to the universities or claim that the appraisals were unreasonable. However, the IRS disallowed most of the deductions for 1997, 1999 and 2000 on the grounds that Williams had owned the artwork for less than a year before the date of the gifts. Under Code §170(e), his deduction was therefore limited to his basis, rather than the fair market value.

Williams claimed that the holding period began in December 1996, when he executed the agreement with Abbey. The Tax Court found that although the agreement obligated Abbey to sell the works, it did not obligate Williams to buy them. Therefore, the agreement was an option to purchase the art and Williams' holding period did not begin until he exercised the option and committed himself to pay for the works. In each case, the exercise of the option occurred within less than one year of the contributions. It is not clear, said the court, that Abbey even owned any of the artwork before the appraisal dates. Because Williams owned the art for less than one year, his deduction is limited to basis under Code §170(e)(1) (*Williams v. Comm'r.*, 101 T.C.M. 1408).

A LITTLE SOMETHING EXTRA FOR UNCLE SAM

Taxpayers worried about the national debt can make deductible contributions to the Department of Treasury. Gifts are placed in a special account that may only be used to pay at maturity, or to redeem or buy before maturity, obligations of the government. Treasury is required to dispense account funds only for that purpose.

Under Code §170(c)(1), gifts to the U.S. are considered charitable contributions, provided the gifts are made exclusively for public purposes. A payment to reduce the public debt is exclusively for public purposes, ruled the IRS.

Gifts of cash up to $250 may be substantiated by a bank record or written communication from the donee. For gifts of $250 or more, the donor must obtain a contemporaneous written acknowledgment from the donee, including the amount of the cash or description of the property given, along with a statement that no gifts or services were received in exchange for the transfer, or a good faith estimate of the value of any goods or services received [Code §170(f)(8)]. The Treasury provides a written acknowledgment for contributions made toward reducing the public debt (IT&A-GENIN-148142-11).

PUZZLER SOLUTION

Code §2702 provides that the value of a retained interest in trust, with a transfer of an interest to a family member, is zero unless the retained interest is a qualified interest – defined as the right to receive a fixed amount or a fixed percentage of the fair market value of the property in the trust [Code §§2702(b)(1) and (2)]. Hiram's gift to his son, if complete, would be the full value of the trust income interest – not just the son's right to receive payments after Hiram's death – because of the net-income provision [Code §2702(a)(2)(A)(i)]. Hiram could avoid this result by choosing a fixed percentage charitable remainder unitrust or an annuity trust (although passing the 10% remainder interest threshold is difficult in a low §7520 rate environment) or, as his advisor suggests, simply render the gift incomplete for gift tax purposes by keeping a testamentary right to revoke.

A REMAINDER TRUST WITH NO "WAITING TIME"

Situation:

Wanda and John own a large parcel of undeveloped land that a nearby college would like to acquire for use in its forestry program. The couple has turned down purchase offers in the past because they didn't want to see the trees cut down for a high-density housing development or commercial use – and also because they do not want to pay capital gains tax to the IRS. Their financial situation doesn't permit them to make an outright gift of the property to the college, but they are philanthropically motivated and would consider a charitable remainder trust. But how would a charitable remainder trust benefit the college *now*?

One solution:

Vacant land used to fund a trust must be sold, in order to reinvest the proceeds in income-producing assets. Where a trust is funded with appreciated stock or even a closely held business, there may be income generated prior to a sale and reinvestment. But in most cases, the charitable remainderman is not interested in purchasing the assets used to fund the trust. That doesn't mean the charity cannot buy them from the trustee, however.

The college could purchase the vacant land from the trustee for its current use. If a disqualified person (e.g., Wanda and John's son) bought the property from the trust, it would constitute an act of self-dealing, subject to tax [Reg. §53.4941(d)-2(a)(1)]. But charities are not included in the definition of disqualified persons under Code §4946. The college will have to part with cash in order to make the purchase, but it would have had to make the same cash outlay if it were buying the land outright from the couple. And in the case of the charitable remainder trust, the school knows that at the end of the trust term, it will "get its money back."

Another option:

The college could enter into a bargain sale or an installment bargain sale of the property from Wanda and John. A portion of each annual payment the couple receives would be tax-free return of principal and a portion would be taxed as capital gain. If Wanda and John sell for less than fair market value, they would be entitled to a current income tax charitable deduction for the difference between the sale price and the fair market value.

"Accelerating" benefits:

In most cases, the charitable remainderman is not interested in obtaining the exact asset placed in the trust. However, the charity may have a need for cash prior to the end of the trust term. Is it possible to "accelerate" the remainder by using the expected remainder as collateral for a loan?

The IRS allowed an amendment to a charitable remainder unitrust that gave the trustee the power "to guarantee loans made by third parties to one or more of the remaindermen or to pledge, with the consent of the beneficiaries, assets as collateral to secure such loans (Ltr. Rul. 8807082). The IRS said that the addition of the clause would not cause the trust to have unrelated business taxable income under Code §§511-514 or violate the self-dealing provisions of Code §4941. The IRS also approved a unitrust with similar language that limited the loan to no more than 50% of the trust assets (Ltr. Rul. 8823057). In both cases, all income beneficiaries had to agree to the use of trust assets for loan guarantees.

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