The Advisor

BALL STATE UNIVERSITY FOUNDATION
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ESTATE PLANNER'S TIP

Married clients can give up to $28,000 in 2014 to as many donees as they wish with no gift tax liability, thanks to gift-splitting [Code §§2503(b), 2513]. But where a second marriage is involved, it may be wise to consider whether gift-splitting is the best route to tax savings. A consent to split gifts is effective for all gifts made during the year [Reg. §25.2513-1(b)(5)], including taxable gifts. By agreeing to split a gift, a spouse may be consenting to apply a portion of his or her unified credit toward gifts to stepchildren (on amounts over $28,000). Remind clients before they sign Form 709-A that using all or a portion of their unified credit for stepchildren may reduce the amount they can shelter on transfers to their own children or grandchildren.

WONDER WHY THEY DIVORCED

Without his knowledge, Andy Roberts' wife made withdrawals totaling about $37,000 from his two IRAs in 2008. Although she forged his signature and deposited the distributions into a joint checking account, Roberts did not have checks to make withdrawals from the account. She used the funds to establish a separate household prior to their divorce.

His wife filed tax returns – hers as married filing separately and his as single taxpayer – without including the IRA distributions. She did not show the returns to Roberts, who thought they had filed as married. The IRS claimed that Roberts, as a participant eligible to receive funds from the IRA, was responsible for the tax on the unreported withdrawals [Code §408(d)(1)].

The Tax Court noted that it had previously rejected the IRS argument that the recipient of an IRA distribution is automatically the taxable distributee [*Bunney v. Comm'r.*, 114 T.C. 259]. Because Roberts' name was forged on the withdrawal requests and the deposited checks, "common sense" says that the distributions are not included in his gross income, said the court. Roberts' wife, not Roberts, received, spent and benefitted from the distributions.

The IRS claimed that under state (Washington) law, Roberts had one year to report that the funds were stolen. Funds recovered from the IRA custodians could have been deposited into the IRAs as a tax-free rollover. Instead, the unauthorized withdrawals were included in the couple's divorce settlement. Nevertheless, said the court, Roberts was not the payee within the meaning of Code §408(d)(1) and therefore did not fail to report income from the IRAs (*Roberts v. Comm'r.*, 141 T.C. 19).

SETTLORS HAVE LOFTY GOALS

Robert Fry and William Smith purchased an antique aircraft, originally built in Venango County, Pennsylvania. They donated it as a constructive trust to the DeBence Museum, with the goal of maintaining the plane in flying condition and keeping it in Venango County. After several years of improper storage, the plane had deteriorated and one of the settlors "kidnapped" it back.

Fry and Smith contacted Golden Age Air Museum, some distance from Venango County, which agreed to restore the plane. EAA, an aircraft enthusiasts' club in Venango County, sought to apply cy pres to become the new trustee of the plane. They said they would display the aircraft, but could not keep it in flying condition. The trial court was faced with choosing whether it was more important to keep the plane in Venango County or keep it airworthy. The court chose to name Golden Age Museum as the successor trustee.

The Superior Court of Pennsylvania agreed. In most cy pres situations, the settlor is deceased and the court is asked to determine intent from trust language and circumstantial evidence. Here, however, one of the settlors repeatedly stated that his desire was to keep the plane flying, noting that simply displaying the plane would make it just "a piece of equipment." That intent superseded the secondary intent of keeping the plane in Venango County, said the court (*Fry v. Oil Region Music Preservation Museum*, No. 1301 WDA 2012).

PHILANTHROPY PUZZLER

Lydia planned to leave stock and other assets worth $7 million to her two nieces – her only living relatives. She would leave the residue of her estate – $2.5 million – to several charities. Lydia's attorney figured the estate tax would be about $664,000 after the charitable deduction. Does it make any difference from a tax standpoint how the estate tax burden is allocated?

TESTATOR HAD TESTAMENTARY CAPACITY, DESPITE "MILD" DEMENTIA

After her husband died, Phyllis Agan established a revocable living trust, naming her siblings and a niece and nephew as beneficiaries. In various amendments between 1996 and 2005, Agan eliminated her brother as a beneficiary and added bequests to local charities. In May 2005, Agan contacted her attorney about additional changes.

In August 2005, Agan asked her longtime friend and neighbor for suggestions for charities. He provided a list, some of which she added to her trust. The neighbor convinced Agan not to exclude her family entirely. In November 2005, Agan signed an amendment that made additional charitable bequests in amounts ranging from $100,000 to $150,000. Her estate at her death in 2008 was valued at more than $8 million.

Agan's sister, niece and nephew filed suit, claiming Agan lacked testamentary capacity and that the 2005 amendment was the result of undue influence. The court found sufficient evidence of "suspicious circumstances" to shift the burden of proof to the charities that the trust amendment was not the product of undue influence. The jury heard from a mental health expert and people who had interacted with Agan on a regular basis in the years prior to her death. The jury found Agan had the testamentary capacity to execute the trust amendment and was not subject to undue influence.

The Supreme Court of Vermont agreed, noting that Agan's longtime attorney had no question about her ability to understand what she was doing. Agan understood the "natural objects of her bounty," was active and interested in the town where she had lived for more than 60 years and made the final decision as to beneficiaries and the amounts they were to receive. The court found no abuse of discretion by the lower court (*Curran v. Bldg. Fund, et al.*, 2013 VT 118).

PARTING MAY BE SWEET SORROW

A donor creates a charitable remainder trust, funding it with appreciated securities that are sold and the proceeds reinvested. The trust pays no capital gains tax on the sale, although the capital gains may be distributed to the beneficiary under the four-tier system [Code. §§664(b)(1) and (2)].

But how much capital gain is realized when the income beneficiary and the charitable remainderman sell their respective interests to a third party, splitting the proceeds according to the actuarial values? According to the Treasury Department, some taxable beneficiaries have taken the position that their basis is the value of the new assets acquired by the charitable remainder trust, rather than the grantor's basis in assets contributed to the trust. The IRS received three comments from a 2009 notice designating this arrangement as a "transaction of interest." The commentators and Treasury agreed that a taxable beneficiary of a charitable remainder trust should not benefit from a basis step-up attributable to gains realized by a tax-exempt trust.

In recently released proposed regulations, a special rule is provided, making the income beneficiary's basis a prorated portion of the charitable remainder trust's adjusted uniform basis reduced by a prorated portion of (1) the amount of undistributed net ordinary income plus (2) the amount of undistributed net capital gain assignable to the interest. For example:

The grantor contributes stock worth $100, basis of $10, to a unitrust. The unitrust sells and uses the $100 sale proceeds to purchase other stock, which is later sold for $110. At a later date, when the value of the trust's assets is $150 and there is no undistributed net ordinary income, the grantor and charity sell their interests to a third party. The grantor receives $100 (66.7%) for the income interest and charity receives $50 (33.3%) for the remainder interest. The grantor's gain on the sale is determined under Code §1001(a). The unitrust's adjusted basis is $110. The grantor's 66.7% actuarial share of the unitrust's basis ($73.37) is reduced by the applying the same factors to the sum of the unitrust's $0 of undistributed net ordinary income and its $100 of undistributed net capital gains. The grantor then subtracts 66.7% of $100, for an adjusted basis of $6.67 ($73.37 - $66.70).

An example is also provided for an annuity trust (NPRM REG-154890-03).

ADDING TEARS TO FOUR TIERS

The four-tier system sounds so easy. Under Reg. §1.664-1(d)(1), annuity or unitrust amounts paid to a beneficiary are characterized as either (1) ordinary income, (2) capital gains, (3) other income or (4) tax-free return of corpus. Within the capital gains tier, there can be net short- or long-term gains, as well as gains taxed at 25% (recapture) or 28% (collectibles).

The latest addition to the four-tier system is the net investment income tax (NII), added as part of the Affordable Care Act. Taxpayers with adjusted gross income over $200,000 (single filers) or $250,000 (joint filers) are subject to an additional 3.8% tax on interest, dividends, capital gains, rents, royalties, nonqualified annuities, income from businesses that are passive activities and income from trading financial instruments or commodities [Code §1411].

(*continued on back page*)

PUZZLER SOLUTION

In most states, if a will is silent on the allocation of estate taxes, the full amount will be paid from the residue, thereby reducing the charitable bequest and deduction (Rev. Rul. 77-202, 1977-2 C.B. 287). If Lydia allocates the tax to the taxable bequests, the nieces will each receive $3,168,000, with charity receiving the full $2.5 million. If the will is silent, the taxes will be paid from the residue, which will then reduce the amount passing to charity, in turn causing the charitable deduction to be reduced, creating a vicious circle.

ADDING TEARS . . . (*continued from page 3*)

Although charitable remainder trusts are exempt from NII, proposed regulations provided that distributions to a beneficiary would consist of NII "separate from and in addition to" the four tiers. However, under the recently released final regulations (TD 9644), NII is to be a subclass in each category of income. Reg. §1.1411-3(d)(2) applies to tax years beginning after December 31, 2012, although returns filed prior to the final regulations and using the proposed regulations do not have to be amended. If a charitable remainder trust has both excluded income (e.g., income received by the trust prior to January 1, 2013) and NII in an income category, these will constitute separate classes of income for purposes of Reg. §1.664-1(d)(1)(i)(b).

The following example is provided in the final regulations:

A charitable remainder annuity trust, established in 2009, provides for a $50,000 annual payment to the beneficiary for 15 years. As of January 1, 2013, the trust had the following items of undistributed income:

Category	Class	Tax Rate	Amount
Ordinary income	Interest	39.6%	$4,000
	Net rental	39.6%	8,000
	Non-qualified dividends	39.6%	2,000
	Qualified dividends	20%	10,000
Capital gain	Short-term	39.6%	$39,000
	Unrecaptured §1250 gain	25%	1,000
	Long-term	20%	560,000
Other income			None
Total undistributed income as of January 1, 2013			$624,000

None of the $624,000 is accumulated NII because none was received after December 31, 2012. It is, therefore, excluded income. During 2013, the annuity trust receives $7,000 of interest, $9,000 of qualified dividends, $4,000 of short-term gain and $11,000 of long-term gain. The $50,000 distribution for 2013 will include the following amounts:

Category	Class	Excluded/NII	Tax Rate	Amount
Ordinary income	Interest	NII	43.4%	$7,000
	Interest	Excluded	39.6%	4,000
	Net rental income	Excluded	39.6%	8,000
	Non-qualified dividend income	Excluded	39.6%	2,000
	Qualified dividend income	NII	23.8%	9,000
	Qualified dividend income	Excluded	20%	10,000
Capital gain	Short term	NII	43.4%	4,000
	Short-term	Excluded	39.6%	6,000
	Un-recaptured §1250 gain	Excluded	25%	None
	Long-term	NII	23.8%	None
	Long-term	Excluded	20%	None

The amount included in the beneficiary's 2013 NII is $20,000, consisting of $7,000 of interest, $9,000 of qualified dividends and $4,000 of short-term capital gain.

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