

# The Advisor



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## ESTATE PLANNER'S TIP

Older brides and grooms, particularly those with families from previous marriages, should review their retirement plans after saying "I do." Certain qualified retirement plans are required to be paid as joint and survivor benefits unless the spouse has properly waived the right to receive survivor benefits [Reg. §1.401(a)-(20)]. A waiver of this right prior to marriage (e.g., in a prenuptial agreement) may not be effective, since the parties are not "husband" or "wife" until after the ceremony. The investment mix of a couple's retirement assets may also be a concern. Newlyweds should review their total retirement plan holdings to determine whether they are invested too heavily in equities or bonds, given the ages of the spouses. Portfolio mix is particularly important where one or both participate in 401(k) plans that may have substantial holdings in the employer company's stock. The couple can choose to achieve a more diversified investment mix by balancing one spouse's more aggressive investments against the other's more conservative holdings, or having one spouse concentrate on growth, or growth and income, while the other invests in international and small-cap stocks.

## DOCTOR GETS A LESSON IN TAXES

Middle Tennessee Medical Center (MTMC) entered into an agreement with Tripp Dargie to pay his medical school tuition if he agreed to work as a doctor in a medically underserved area for four years after completing his residency. If he chose to work elsewhere, he would have to repay twice the amount of all payments, with interest. When Dargie graduated, he decided to work elsewhere, and in 2002 repaid \$121,440.

On an amended tax return, Dargie claimed an ordinary and necessary business expense for the full amount of the repayment. The IRS disallowed the deduction and a U.S. Magistrate Judge

granted summary judgment to the IRS, finding that the repayment was a personal expense [Code §265(a)(1)] and the repaid amount was allocable to tax-free income that Dargie had received.

Dargie appealed, arguing that the payment was "damages" for breaching the agreement with MTMC. Therefore, he claimed, it was an ordinary and necessary business expense because it allowed him to pursue his medical practice in a different area. The IRS said the repayment represented expenses that allowed him to meet the minimum requirements for practicing a profession and were therefore personal.

The U.S. Court of Appeals (6th Cir.) noted that under Code §162(a), five elements must be met to qualify as an ordinary and necessary business expense. One of these is that the expense must arise in connection with or proximately result from a trade or business. The issue, said the court, was the circumstances under which Dargie *received* the money, not the circumstances under which he repaid it. MTMC paid for his education, which is specifically categorized as non-deductible [Reg. §1.162-5(b)(2)], so he is not entitled to the deduction, the court ruled (*Dargie v. U.S.*, 2014-1 USTC ¶50,168).

### STILL TIME TO TAKE ADVANTAGE

Portability, which allows a surviving spouse to claim the deceased spousal unused exclusion (DSUE) [Code §2010(c)(5)(A)], is a relatively new addition to the estate planning arsenal. Some surviving spouses who might have benefitted from making an election missed the deadline. In a new revenue procedure, the IRS has set out a simplified procedure for requesting an extension of time to file (Rev. Proc. 2014-18).

A portability election must be made on a

### PHILANTHROPY PUZZLER

Martha's will provided for the creation of a charitable remainder trust, to be funded with her valuable salt-and-pepper shaker collection. Martha's grandson is the income beneficiary. Karen, Martha's daughter, had hoped to inherit the collection and was disappointed to hear that the shakers were passing to the trust. She asked the trustee if he would sell the shakers to her, but the trustee was concerned that the sale of trust assets to Karen, a disqualified person, would be an act of self-dealing [Reg. §53.4941(d)-2(a)(1)]. Is there another way for Karen to acquire the collection?

timely filed Form 706 – generally nine months after the date of death. The return must show a computation of the DSUE amount. Some surviving spouses failed to make the election because the deceased spouse's estate was below the amount sheltered from estate tax and the survivor was unaware that a return would need to be filed, even if no tax was due.

The simplified procedure for an extension to make the election is available for surviving spouses of U.S. citizens or residents who died after December 31, 2010, and before December 31, 2013. The deceased spouse's estate must not have been required to file an estate tax return under Code §6018(a), and a return was not filed within the time prescribed by Temporary Reg. 20.2010-2T(a)(1). Eligible surviving spouses must file a properly prepared Form 706 by December 31, 2014 and write across the top "Filed pursuant to Rev. Proc. 2014-18 to elect portability under §2010(c)(5)(A)."

### TAXPAYER LOSES INTEREST

Boyd Black owned a whole life insurance policy that allowed him to borrow up to the cash value. The policy provided that it would terminate if the debt were to equal or exceed the cash value.

In 2009, the policy was terminated. At the time, the combined loan principal and interest was \$196,230 and Black's investment in the contract was \$86,663. The insurance company sent him a Form 1099-R reflecting these amounts. Black included only \$16,885 on his return – the difference between his investment in the contract and his loans of \$103,548. He did not include the interest amounts.

The Tax Court said that interest on the loans was properly treated as part of the principal of the indebtedness, and is includible in determining gross income when a policy is terminated. Black argued that the termination of the policy was a discharge of indebtedness, but the court

found that the loans were not discharged, but rather extinguished when the insurance company applied the cash value of the insurance policy toward the debt owed. The policy was the sole collateral from which the insurance company could seek repayment. Black was liable for the added tax and an accuracy-related penalty [Code §§6662(a) and (d)] (*Black v. Comm'r.*, T.C. Memo. 2014-27).

#### “TRUST US” ISN’T ENOUGH FOR TAX COURT

William and Jana Cor claimed a charitable deduction of \$14,657 on their 2010 income tax return, all of which was disallowed by the IRS. The couple produced written acknowledgments from charity for gifts totaling \$2,937, which the IRS then allowed. They offered an unsigned document to substantiate a gift of \$6,830, but the letter did not include the Cors’ name, the address or tax identification number of the charity and did not include the mandatory language indicating whether the donee provided any goods or services in return for the donation, as required under Code §170(f)(8)(A). The Tax Court ruled that because the couple did not satisfy the substantiation requirements, they are not entitled to any deduction beyond what the IRS conceded (*Cor v. Comm'r.*, T.C. Memo. 2013-240).

#### A LITTLE IS JUST NOT ENOUGH

Ben Alli contributed a 34-unit apartment building to charity in 2008, claiming a \$499,000 charitable deduction. At the time of the gift, only six units were occupied, with the remainder in need of substantial repair work. The donee organization, which had secured a buyer prior to accepting the building, received only \$60,000 for the property. The IRS disallowed Alli’s deduction, in part due to the lack of a qualified appraisal.

Reg. §1.170A-13(c)(2) requires that a donor claiming a deduction for a noncash gift in excess of \$5,000 obtain a qualified appraisal. The appraisal must be made no earlier than 60 days prior to the date of the gift and no later than the due date of the

return. It must also contain specific information, including a description of the property, the physical condition of tangible property, the date of the gift, the credentials and tax identification number of the appraiser, a statement that the appraisal was done for income tax purposes and the method of valuing the property. If more than one appraisal is used, each must comply with the requirements.

Alli produced two appraisals. One, prepared in 1999, said the building has gross rental potential of about \$390,000. The second, prepared approximately five months before the date of the gift and intended to be an update of the earlier appraisal, concluded that with extensive renovations, the property would have a value of about \$530,000.

The Tax Court noted that neither appraisal was performed within two months prior to the gift and both suffered from “a number of material deficiencies.” The donor argued that he had substantially complied with the appraisal requirements, but the court found “entire categories of information” missing. The court denied the deduction, noting that strict compliance cannot be excused where a substantive requirement of the appraisal requirements is not satisfied (*Alli v. Comm'r.*, T.C. Memo. 2014-15).

#### PUZZLER SOLUTION

Rather than buy the collection from the trustee, Karen should purchase the shakers from the executor of her mother’s estate prior to funding the trust. Under Reg. §53.4941(d)-1(b)(3), Karen’s purchase would not be self-dealing, provided (1) the executor has the power to sell estate assets, (2) the probate court approves the transaction, (3) the sale occurs before the estate is terminated for income tax purposes, (4) the estate receives at least a fair market price for the shakers and (5) the trust receives assets at least as liquid as those that it sells.

### FAMILY VALUES AND CHARITY

The family limited partnership has become a popular tool in the estate planning arsenal because of its many advantages:

- The availability of significant valuation discounts for lack of marketability, lack of control and minority interests on partnership units mean reduced transfer costs.

- The older family generation can maintain control of partnership assets by retaining the general partnership interest, giving the children and grandchildren only limited partnership units. Units can be transferred over a number of years, allowing younger family members time to mature.

- Additional limited partnership interests may be given annually, sheltered fully or partially by the \$14,000 gift tax annual exclusion.

- Real property can be converted to personal property, thereby avoiding ancillary probate at death.

- The partnership form provides protection from creditors of younger family members.

General partners also may be interested in options available for using limited partnership interests in planning charitable gifts. For example, an outright gift of a partnership interest to charity creates a "Catch-22" situation for the IRS. The donor may be willing to settle for a lower charitable deduction, based on the valuation discounts. In exchange, the donor knows that if the IRS argues that the value of charity's interest is lower, the same lower value applies to the interests given to family members.

Another option, combining the valuation discounts of the family limited partnership, the time value of money and the current low §7520 climate, is the use of partnership units to fund a charitable lead trust. Consider the following scenario:

Father and mother own assets worth \$50 million. They wish to create a charitable lead trust to benefit their favorite charities, but want the assets eventually to pass to their children. They use \$25 million of the assets to establish a charitable lead annuity trust that will pay charity \$1 million (4%) annually for 15 years. The value of their gift of a remainder interest to their children will be about \$12,150,700 (assuming a 2% §7520 rate).

Instead, they could transfer the assets to a family limited partnership, creating 100 limited partnership units and using 50 units to fund the trust. Applying a 50% valuation discount, each limited partnership unit would be worth \$250,000 ( $\$50 \text{ million} \div 100 = \$500,000 \times .5$ ). The value of the remainder interest to the children drops by 50% to \$6,075,350. If they wish, they can adjust the term of the trust or the income payout to charity to arrive at a satisfactory remainder value.

It's also possible to use family limited partnership units in conjunction with a charitable remainder trust. For example, a father and mother (ages 65 and 67) create 100 partnership units using \$5 million in assets. Applying a 50% valuation discount, each partnership unit is worth \$25,000. They transfer 20 units (value \$500,000) to a charitable remainder unitrust that will pay them 5% annually for their joint lifetimes. Their income tax charitable deduction (assuming a 2% §7520 rate and quarterly payments) would be \$175,290.

The parents may wish to "replace" the value of the partnership interests transferred to the trust and eventually going to charity by creating an irrevocable life insurance trust, naming their children as beneficiaries. The parents should name an independent trustee, particularly since annual valuations are needed for the unitrust.

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