

June 2014

ESTATE PLANNER'S TIP

Owners of traditional IRAs may convert the accounts to Roth IRAs, but any amount converted is included in the owner's gross income in the year of the switch. A conversion may be especially attractive to an owner who has already reached the required beginning age of 70½. Roth IRAs do not require annual distributions [Code §408A(c)(5)], so no additional distributions are required following conversion. However, what happens if the value of the investments in the Roth drops between the date of the conversion and the end of the year? The client pays tax on amounts "lost." To avoid this, a recharacterization may be done until the due date of the tax return (with extensions). A better option when initially making a conversion from a traditional IRA to a Roth is to establish several Roth IRAs, each with separate assets. At year's end, the client can determine whether any of the Roth IRAs have dropped in value and simply recharacterize those. The Roth IRAs that have grown in value can be left, with the client paying tax only on the value of the assets at the time of conversion.

HAZARDS OF FILL-IN-THE-BLANK WILLS

Ann Aldrich executed a legal form, bequeathing her house and contents, IRA, life insurance, vehicle and all her accounts at a specific bank to her sister. If the sister predeceased her, the assets were to pass to her brother, James Aldrich. Ann's sister did die before her, leaving Ann cash worth about \$122,000. Ann placed the funds in a separate account. At her death, about \$87,000 remained.

Two nieces claimed that they were entitled to a portion of the account, arguing that, because the will did not contain a residuary clause, the funds passed via intestacy. James argued that "the most

reasonable and appropriate construction of the will" was that Ann intended that assets passing from her sister should go to him. He added that he was the only named beneficiary at Ann's death, that Florida law provides that a will shall be construed to pass all property the testator owns at death, including after-acquired assets, and that there is a legal presumption against partial intestacy. The trial court granted summary judgment in favor of James.

The Court of Appeals remanded the case, directing summary judgment for the nieces. The court said that Ann devised her property with

“painstaking specificity,” but expressed no intent as to the inherited property. A handwritten note that purported to be a codicil left “all my worldly possessions” to James, but because it was not witnessed properly, was not enforceable.

The Supreme Court of Florida noted that under state statutes, a will is construed to pass all property owned at death, including property acquired after the will’s execution. However, Ann did not express any intent as to the after-acquired property. Her will did not explicitly state that the identified beneficiaries were to receive all property owned at her death. She had two years following her sister’s death in which to decide how the property would be distributed, but did not express her intent, the court noted. She could have added the inherited funds to the account that was named in her will, but chose instead to open a new account. This would seem, said the court, that she intended that property to be separate from the money already mentioned in her will. The court refused to make inferences beyond the four corners of the will, saying to do so would require the court to rewrite the will (*Aldrich v. Basile*, No. SC11-2147).

THREE-PLUS DECADES LATER NOT “TOO LATE”

Jerome established a trust prior to 1977, giving the trustees discretion to make distributions to his children or grandchildren. Jerome had three children and eight grandchildren, all of whom

are still living. Twenty years after the death of all descendants living when the trust was executed, it is to terminate. The remaining principal and undistributed income is to be distributed to the descendants of Jerome who have no living ancestor who is a descendant of Jerome, per stirpes.

Lindsey, the 17-year-old granddaughter of one of Jerome’s children, is entitled to receive a share of trust distributions and could potentially receive a share when the trust terminates. The age of majority in her state is 18. Lindsey plans to disclaim any interest in the trust, executing a written disclaimer within nine months of reaching age 18. She has asked the IRS to rule that the disclaimer will not constitute a transfer subject to gift tax.

Under state law, anyone receiving a gift may disclaim any or all of the transfer, in which case the interest will pass as though the disclaimant had died prior to the transfer. Under Code §25.2511-1(c), in the case of a transfer in trust, the transfer occurs, in general, when the trust is created, rather than when the interest vests in the disclaimant. Any disclaimer must occur within a “reasonable time” after knowledge of the existence of the interest. However, the time limitation for making a disclaimer does not begin running until the disclaimant has reached the age of majority [*Jewett v. Comm’r.*, 455 U.S. 305]. Therefore, ruled the IRS, Lindsey will not be subject to gift tax as a result of the disclaimer (Ltr. Rul. 201407009).

FAILURE TO FUND TRUSTS PROVES COSTLY

Elwood Olsen survived his wife and was supposed to create two marital trusts and a separate family trust from the assets in her living trust. After Olsen’s death in 2008, his family discovered that the trusts had never been funded. The value of his wife’s trust had grown to nearly \$2.7 million by the end of 2000.

In 2002, Olsen made a charitable contribution of nearly \$250,000 to a college from funds in the trust. In 2004, he made an additional gift of more than \$831,000. He claimed deductions for both

PHILANTHROPY PUZZLER

Geraldine wants to establish a scholarship at her alma mater, with preference to be given to students from the county in which she lives. She has several nieces and nephews who live in the county and who are interested in attending the college in the near future. Geraldine has asked whether her deduction is in jeopardy because her relatives might qualify. Any problems?

gifts. In 2007, Olsen amended his own living trust to eliminate the charitable provisions, saying he had “taken care” of the bequests to the college through lifetime gifts.

The executor of Olsen’s estate did not include any portion of the value of his wife’s estate in his gross estate. The IRS claimed that the value of Olsen’s gross estate should include the \$1.07 million value of the marital trusts in Olsen’s wife’s estate at her death. The IRS said that Olsen had a qualifying income interest for life in the trusts. The estate argued that the marital trusts should not be considered to have held any assets of Olsen’s wife’s trust as of his death. The charitable contributions should be considered to have come from the marital trusts, the estate contended. These withdrawals for charitable gifts depleted the marital trusts, leaving the balance of the wife’s trust to fund the family trust.

The Tax Court agreed with the IRS that withdrawals for charitable gifts came from the family trust, since the wife’s trust gave Olsen the power to appoint principal from the family trust to charities. The withdrawals Olsen made in order to make charitable gifts were consistent with the powers given to him under the family trust, noted the court. Olsen’s estate was therefore required to include the value of his wife’s estate in his gross estate (*Est. of Olsen v. Comm’r.*, T.C. Memo. 2014-58).

STATE LAW THWARTS EASEMENT DEDUCTION

Members of the Wachter family – through a partnership and an LLC – entered into several bargain sales of conservation easements to the American Foundation for Wildlife (AFW). Using before and after appraisals, the entities determined the contributions for 2004, 2005 and 2006 to be \$170,000, \$171,150 and \$144,500 respectively.

A portion of the funds used to buy the easements came from the U.S. Department of Agriculture, through the Natural Resources Conservation Service (NRCS). If certain criteria

were met, NRCS would reimburse AFW for up to 50% of the easement purchase price. Landowners could donate up to 25% of the appraised fair market value of the easement, which would be considered as part of AFW’s contribution to the purchase price. The easements were required to be in perpetuity “or a minimum of thirty years where State law prohibits a permanent easement.”

The IRS disallowed the deductions, saying that North Dakota law restricts easements to 99 years, thereby preventing the conservation easements from being in perpetuity. The Tax Court found that because easements are limited to 99 years, they are not qualified real property interests under Code §170(h)(2) nor exclusively for conservation purposes under Code §170(h)(5). The court rejected the family’s argument that the limitation was a remote future event that made the remainder “essentially valueless.” The court said the event was not remote, since it was not only possible but “inevitable” that AFW would be divested of its interests by operation of law.

The court granted summary judgment for the IRS as to the conservation easements, but said that the family’s cash contributions would be deductible if it could be shown by contemporaneous written acknowledgment that they made the gifts (*Wachter v. Comm’r.*, 142 T.C. No. 7).

PUZZLER SOLUTION

Geraldine’s charitable deduction is safe, provided the school has full control over the funds and discretion over the use (Rev. Rul. 62-113, 1962-2 C.B. 10). Because the nieces and nephews are members of a larger class of potential scholarship recipients, there is no guarantee that any would receive assistance. Even if one does, however, Geraldine’s deduction is not at risk (Ltr. Rul. 9338014).

NUMBERS TELL THE GIFT ANNUITY STORY

The American Council on Gift Annuities recently released the results of its survey of member charities, showing that the average age of gift annuitants has dropped to its lowest level in nearly 20 years. Previously, the average age had been climbing slowly, from 77 years in 1994 and 1999, to 78 years in 2004 and 79 years in 2009. According to the 2013 survey, the average age dropped to 75.

At the same time that the average age of annuitants has dropped, the percentage of the initial contribution remaining for charities at the end of the annuity has declined. In 1999, the amount remaining for charity – the residuum – was 98%. In the most recent survey, that figure had declined to 64%. Charitable gift annuity recommended rates are designed to produce a residuum of 50%.

Women continue to make up the bulk of gift annuity donors. Of the 5,752 annuitants represented by respondents to the survey, 57% were female. At the same time, both deferred gift annuities and flexible deferred gift annuities increased in popularity. A deferred gift annuity is one in which payments begin one year or more after the date of the gift. In a flexible deferred gift annuity, the donor does not have to designate a precise date when payments will begin. Instead, a range is provided, allowing the donor to begin payments earlier – at a lower annuity rate – or later – with higher payments. The charitable deduction, which is determined at the time the annuity is arranged, is the same, regardless of when payments begin.

The vast majority of charities issuing gift annuities – 63.8% – found there was no difference in

annual giving by donors who arranged gift annuities. Only 5.59% reported a decrease in annual gifts by gift annuity donors. The same is true with bequests through estates of gift annuitants. The survey found that 54% of gift annuitants were likely to include a gift to charity in their estate plans. Another 45% found gift annuities were likely to have no effect on a donor's likelihood of making estate gifts, while only 1% said gift annuity donors were likely to remove a charitable gift from an estate plan.

Responding charities reported more than \$3.15 billion in total gift annuity assets. The vast majority of gift annuities were funded with either cash or stocks and bonds. Of the responding charities, 62% said their minimum required to fund a gift annuity is between \$10,000 to \$24,000. Nine percent require \$25,000 or more. The minimum age for an immediate payment gift annuitant is 60 at 29% of the charities, and 65 for 30% of the charities, although for deferred gift annuities, 32% of organizations accept gifts beginning at age 50 and 36% issue gift annuities starting at age 55.

The responding charities reported nearly 95,000 charitable gift annuity contracts in force during 2013, with 13% of the organizations reporting ten or fewer gift annuities and one charity reporting 9,385 contracts. While 70% of the charities reported having \$1 million or more in gift annuity assets under management, one organization had \$98 million. The average of all charities was \$7,771,428.

BALL STATE UNIVERSITY FOUNDATION

Cherí E. O'Neill
President and CEO

P.O. Box 672, Muncie, IN 47308
(765) 285-8312 • (765) 285-7060 FAX
Toll Free (888) 235-0058
www.bsu.edu/bsufoundation

Philip M. Purcell, J.D.
Vice President for Planned Giving
and Endowment Stewardship