The Advisor

BALL STATE UNIVERSITY FOUNDATION
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ESTATE PLANNER'S TIP

Tax planning often takes on added importance for terminally ill clients. Although the vast majority of estates will pass free of estate tax, income tax planning should be considered. For example, capital loss deductions vanish when a taxpayer dies owning assets that have dropped in value; the estate or beneficiary takes a basis in the assets at the date-of-death value (Code §1014). A client might consider selling assets that have declined in value before death to create deductible capital losses. It also may be desirable to accelerate income if the estate will be in a higher income tax bracket than the client, particularly in light of the compressed tax rates in effect for trusts and estates. Income in respect of a decedent (IRD) could be heavily taxed if reported by the estate (Code §691). The client could elect to report accrued interest on U.S. savings bonds (Code §454) or take distributions from an IRA or other retirement plan. Before taking any of these steps, however, it's important to compare tax brackets and deductions available to the client, the estate and the client's beneficiaries and to consider alternatives such as charitable bequests of items of IRD.

GREED LEADS TO REMOVAL

Pete and Tena Steensma, who had no children, wanted to leave the bulk of their estates to various charitable causes. A 1972 will left the entire estate to charity, but in 1990 they executed a new will leaving 5% to their nephew, Dale, who helped farm their land. At Pete's death in 1998, Tena inherited the estate of about $1.6 million and appointed Dale as her attorney-in-fact.

In late 2004, Tena mentioned to several nieces that she had not talked to Dale in a while and wasn't sure she would be able to continue living in the facility to which she had moved. The nieces accompanied her when she met with her investment account representative. She learned there was about $300,000 left from what had been about $1 million a few years earlier. She was also told that the account was to pass to Dale at her death, rather than to her estate. Tena immediately changed the beneficiary to her estate and drafted a new power of attorney.

Tena also realized that her existing will left many bequests to Dale, including one for $500,000, which would have left nothing for charity. Tena had a new will drafted, eliminating all bequests to Dale and removing a provision giving him right of first refusal to purchase her farm. Under the new will, 70% of her estate went to charity and 10% went to each of her three nieces. The attorney and his partner met privately with Tena and also had her meet with her doctor to determine her testamentary capacity. The doctor provided a letter stating that Tena had no impediment that would prevent her from executing her will. In 2007, Tena executed a new will with the same provisions, but added a sentence stating that she was specifically making no provision for Dale because he had been the recipient of a substantial amount of her money over the years. The attorney again met with Tena privately to determine if she was making the changes voluntarily.

After Tena died in 2010, Dale filed suit to set aside the will on the grounds of undue influence by the nieces. The jury found for the nieces. Dale appealed, claiming the trial court erred by admitting certain evidence. The court had allowed the nieces to present the expert testimony of a CPA who testified as to how much charities would have received from each of the wills prior to Pete's death and after. The nieces argued that the testimony showed Tena had executed new wills to provide the majority of her estate to charity. The trial court noted that the accountant was looking strictly at how the estate would be distributed under the four corners of the document. The Court of Appeals of Iowa found no abuse of the lower court's discretion, noting that the expert merely set forth an opinion on the dollar amounts Dale stood to inherit under past wills. He did not express an opinion as to Tena's intent. By Tena's own account in her will, she believed Dale exceeded his authority as her attorney-in-fact and she added the nieces in gratitude for helping her remove him from her plans (*In re Estate of Steensma*, No. 3-1257/13-1003).

PHILANTHROPY PUZZLER

The Good Neighbor Exchange, a small publicly traded company, wants to support a charity selected by its employees by giving the charity an option to purchase shares in the company at a set price for a period of 12 months. The company notified the charity on July 1, 2014, that it had until June 30, 2015, to exercise the option. Will Good Neighbor be entitled to a charitable deduction for its generosity, and if so, in which year?

DEDUCTION NOT LOOKING GOOD

The deduction for a charitable contribution of inventory is generally limited to the donor's basis [Code §170(e)(1)], although an enhanced deduction is available for "qualified contributions" by corporations under Code §170(e)(3). These are contributions used by the charity solely for the care of the ill, needy or infants. The donor is entitled to a deduction equal to basis plus one-half the ordinary income that would be realized on a sale of the donated property, up to twice the basis.

The IRS ruled that a company's charitable donation of wrinkle creams, hair gels, perfumes, hair sprays, texturizers, curling irons, hair dyes, nail polishes and hair restoration treatments was not eligible for the enhanced deduction.

Although the items may be distributed to needy recipients, the products do not satisfy a "necessity of life" such as the need for food, clothing or shelter. Persons who cannot afford to purchase these products may be needy, but the items are considered luxuries, rather than necessities, said the IRS (Ltr. Rul. 201414014).

DONORS' OBJECTION PUT OUT TO PASTURE

The Davis Foundation owned an LLC that operated a working cattle ranch in Wyoming. In 1997, the LLC interests were transferred to the Colorado State University Research Foundation and the University of Wyoming Foundation, to generate scholarships and provide a working laboratory for students on western ranching and resource management. At the same time, a conservation easement was given to The Nature Conservancy.

A memorandum of agreement provided that after 14 years, the ranch and assets of the LLC could be sold, subject to the easement, with the proceeds to be used to fund scholarships. In 2011, the schools decided to sell the ranch, but Davis objected, alleging breach of contract and the covenant of good faith and unjust enrichment. The universities moved to dismiss for lack of standing. They claimed that the ranch had been a gift and that only the attorney general could enforce the terms of a charitable gift. The district court agreed.

Davis appealed, claiming that the agreement had created an implied trust. The Supreme Court of Wyoming found that the intention to hold property in trust must be established by clear and convincing evidence. While the memo of agreement detailed restrictions on the gifts, it did not convert the gift to a trust. As the district court noted, "the granting of the conservation easement accomplished the donors' objectives without establishing a trust." The agreement specifically allowed for the universities to sell the property, subject to the easement. There was no reversionary right within the agreement, the court noted. Therefore, because no trust was established, only the attorney general had standing to enforce the gift, the court ruled (*Davis Foundation v. Colorado State University Research Foundation*, 2014 WY 32).

FORMER EXECUTOR DOESN'T HAVE STANDING

Sonia Sobol executed a living trust and pour-over will that left the bulk of her $22 million estate to a charitable foundation in the name of her late son. The foundation would support medical research and education and the building of a hospital in Israel. Sobol's long-time attorney, Jay Rose, was the successor trustee and had a power of attorney for healthcare decisions.

In August 2012, Sobol amended her trust, removing Rose and naming three successor trustees: a long-time friend and business associate, a friend and colleague of her late son, and Terry Shaylin, an attorney who had assisted Sobol in a matter involving her business. The following month she executed a codicil to her will naming the three as her co-executors, in place of Rose. No other changes were made to the trust or will. Sobol died in December 2012.

Rose challenged the appointment of the three by the probate court, claiming Sobol lacked testamentary capacity to make the changes and that there was undue influence and personal benefit by Shaylin. The probate court agreed with the estate that Rose lacked standing.

The Court of Appeals of California upheld the probate court. Despite testimony from Sobol's doctor, rabbi and several long-time friends regarding Sobol's concerns about Shaylin, the court found that Rose was not an "interested person" under state law. The court rejected the argument that the change of executors would thwart Sobol's wishes. Rose's only legal interest was in receiving fees for services, which is insufficient under state law to make him an interested person. The court found no evidence that the co-executors would contravene Sobol's testamentary intentions. In addition, noted the court, the attorney general has notice of the probate proceedings and "is obligated to protect the interests of charitable trust beneficiaries" (*In re Estate of Sobol*, B250306).

IRS OKAYS TRUST CONSOLIDATION

Two charitable remainder unitrusts shared the same payout rate, income beneficiaries, term and charitable remainder beneficiaries. The trustees hoped to consolidate the trusts in order to save on administrative time and expenses and the filing of duplicate state and federal tax returns.

The IRS ruled that consolidating one trust into the other will terminate the status of one trust but will not cause the remaining trust to fail to qualify as a charitable remainder trust under Code §664 (Ltr. Rul. 201420010).

PUZZLER SOLUTION

The Good Neighbor Exchange will be entitled to a charitable deduction only if the charity exercises the option of purchasing the shares. The company may claim a deduction in the year the option is exercised for the difference between the fair market value and the option price on the day the option is exercised (Rev. Rul. 75-348, 1975-2 C.B. 75).

GET TIMING RIGHT OR PAY THE (TAX) PRICE

A strong selling point for using appreciated assets to make charitable gifts is the ability to avoid capital gains taxes. There are cautions, however, and over the years, donors have learned the hard way that "timing is everything" when planning gifts of appreciated property.

One extreme example involves a couple who transferred their shares in a day care center to a charitable remainder trust and then listed the center for sale with a business broker. The offering included a covenant not to compete with the new buyers. Two years later, buyers began negotiations for the purchase of the day care business but expressed concerns that the non-compete agreement would come from the bank trustee of the unitrust, not from the couple themselves. The couple agreed to personally execute a covenant not to compete. The closing documents allocated a portion of the sale price to the value of the covenant. The full sale price was paid to the trust.

The IRS determined that the couple had income as a result of the bargained-for covenant and were subject to tax on a portion of the sale price. The couple claimed that they had relinquished all ownership of the business to the trust and had received no money for their covenant, which they viewed as merely an accommodation to the buyers.

The Tax Court determined that because the buyers would not have bought the business without the personal assurances from the couple, the covenant cannot be viewed as independent and unrelated to the purchase price. The court determined that the couple assigned the income they earned by agreeing not to compete and was subject to tax on the allocated portion [*Jorgl and Illi v. Comm'r.*, T.C. Memo. 2000-10]. Under the assignment of income doctrine, a taxpayer is not insulated from tax liability merely by assigning the right to receive the income to another [e.g., *Comm'r. v. Sunnen*, 333 U.S. 591(1948)].

A much more common situation is where donors attempt to make a gift when there is a buyer waiting in the wings. For example, a seller who realizes after a sales contract has been signed that significant capital gains taxes will be owed may decide to place the assets in a charitable remainder trust. A donor who plans to put illiquid assets, such as real estate or closely held stock, into a charitable remainder trust may attempt to find a buyer before funding the trust, thereby assuring that the property can be sold and the proceeds reinvested quickly. When all that is left is for charity to step into the shoes of the donor to consummate the sale, the donor generally is unable to avoid recognition of capital gain, even though a charitable deduction may be permitted [*Martin v. Machiz*, 251 F.Supp. 381; *Magnolia Development Corp. v. Comm'r.*, T.C. Memo. 1960-177].

The assignment of income doctrine applies even where the donor is not reserving income for life from the gift, as in a charitable remainder trust. In *Ferguson v. Comm'r.* (108 T.C. 14), the donors made outright gifts of stock subject to a tender offer to their private foundation and church. The court determined that, on the date of the gift, more than 50% of the outstanding shares had been tendered – the functional equivalent of a vote to approve. The donors' interest was converted from an interest in a viable company to a fixed right to receive cash under the terms of the tender offer. The donors were taxed on the capital gain.

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