# The Advisor

BALL STATE UNIVERSITY FOUNDATION
*Established in 1951*

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### ESTATE PLANNER'S TIP

Clients who take advantage of the gift tax annual exclusion ($14,000 for 2014) [Code §2503(b)] to make gifts to children or grandchildren may want to encourage the use of some of the funds to establish IRAs. Consider a grandfather who plans to make annual gifts of $14,000 to each of his three teenage grandchildren, all of whom have part-time and summer employment. If $5,500 goes into an IRA every year for five years – starting when the grandchild is age 16 – the balance would grow to nearly $32,000 (assuming a 5% return) by the end of the fifth year. By the time the grandchild is ready to retire at age 67, the account will have grown to more than $300,000, even if no further contributions are made. To make the IRA contribution, the grandchild must have at least $5,500 of earned income for the year [Code §408].

### GOOD INTENTIONS, POOR EXECUTION

Gust and Frances Kalapodis used the $75,000 in life insurance they received at the death of their son to establish a memorial scholarship in his name. The fund, which was structured as an irrevocable trust, provided that income was to be used exclusively for educational purposes. The fund never applied for or received tax-exempt status.

In 2008, $2,000 payments were made directly from the fund to three high school students. The money came from the trust's investment income.

The couple claimed a $6,000 charitable deduction on their 2008 personal income tax return, which the IRS disallowed. The Tax Court found three reasons to deny the deduction. First, the trust, not the Kalapodises, made the scholarship payments. They would only be entitled to claim the payments as a charitable deduction if they were treated as owners of the trust under Code §671. The court said it found no trust provision that would allow them to report the trust's tax attributes on their personal return, adding that just as they did not have to report the trust's income on their return, they are not entitled to deductions for charitable gifts the trust made.

Second, said the court, payments made directly to the students do not qualify as charitable gifts. The students receiving the funds do not fall into any of the recipient categories listed under Code §170(c). Finally, the couple lacked contemporaneous written acknowledgment of their contributions. Gifts of $250 or more are required to be substantiated with an acknowledgment from the donee that includes a description of the cash or property contributed and a statement indicating that no goods or services were provided in return for the transfer or a good-faith estimate of the value of any goods or services. The only documentation provided by the Kalapodises lacked the dates of the gifts and other information required to be included, said the court (*Kalapodis v. Comm'r*., T.C. Memo. 2014-205).

### ESTATE RECEIVES COSTLY LESSON

Verne's living trust, which was the designated beneficiary of his IRA, included pecuniary bequests to two charities. At his death, the value of the charitable bequests exceeded the trust's non-IRA assets.

A state court ordered the trust to be reformed to provide that the trust's distribution of IRA assets to charity would be treated as direct bequests, rather than as income in respect of a decedent under Code §691. In the alternative, the reformation was designed to qualify for a charitable deduction under Code §642(c).

In general, if a trust or estate satisfies a pecuniary legacy with property, the payment is treated as a sale or exchange of the property [*Kenan v. Comm'r*., 114 F.2d 217 (2d Cir. 1940)]. Because the trustee will use IRA assets to satisfy Verne's pecuniary legacies, the IRS ruled that the trust must treat the payments as sales or exchanges and include the IRA in the trust's gross income to the extent the IRA was used for the charitable bequests. No charitable deduction is allowed under Code §642(c), despite the reformation, because the court order was designed to obtain tax benefits, not resolve a bona fide will contest. Therefore, the IRS said it is not required to respect the reformation (Ltr. Rul. 201438014).

### IT'S ALL BUSINESS

A limited liability company that was required, as a condition for operating in the state, to make payments to charity, conveyed a portion of its annual gross income from three facilities that it ran. In 2010, 2011 and 2012, there were deficiencies between the required percentage and the LLC's actual services. For those three years, the LLC made cash contributions to charity to address the shortfall.

Under Rev. Rul. 72-314 (1972-1 C.B. 44), whether payments to a charity are deductible under Code §170 as a charitable deduction or under Code §162 as a business expense depends upon whether the payments are completely gratuitous or whether they bear a direct relationship to the taxpayer's business and are made with a reasonable expectation of a financial return commensurate with the amount of the payment.

The IRS found that because the payments satisfy a condition of its certificate to operate in the state, they are not deductible as charitable gifts. Failure to make the payments could jeopardize the LLC's continued operation in the state, the IRS said. Therefore, the payments bear a direct relationship to the business and are deductible as ordinary and necessary business expenses under Code §162(a) (Ltr. Rul. 201437004).

### PHILANTHROPY PUZZLER

Nelson is reviewing his estate plan following the recent death of his wife. The couple's only child, Leon, is mentally incompetent. Nelson would like to include a bequest to charity, but wants to make sure Leon is properly cared for. He has considered a charitable remainder trust that would pay income for life to Leon, but is concerned that the payout would have to be made directly to Leon, even though he is incapable of handling his financial affairs. Nelson has asked whether there is any other way to structure the trust payout.

### POOR RECORD-KEEPING REDUCES DEDUCTION

Jeffrey and Ulondra McCarty claimed a charitable deduction of $17,113 on their 2007 tax return. This total consisted of cash donations, gifts of property and mileage. The IRS disallowed the deduction in its entirety, although it eventually conceded that the couple was entitled to a deduction of $9,820.

The McCartys introduced a summary schedule showing $15,630 in charitable gifts, but provided no explanation for the difference between that and the amount they originally deducted. They did not maintain a mileage log for the charitable miles driven and had no substantiation for the property donations. Most of their gifts were to their church, the schools their children attended or to Goodwill.

The Tax Court noted that any gift of $250 or more must satisfy the substantiation requirements of Reg. §1.170A-13(f)(1). The taxpayer is required to obtain a contemporaneous written acknowledgment from the charity. For a gift of property in excess of $500, the taxpayer must also maintain written records showing the manner of acquisition and the approximate date of the acquisition.

After reviewing the couple's summary schedule, the court found that they were entitled to a deduction of $120 more than the amount allowed by the IRS (*McCarty v. Comm'r.*, T.C. Summ. Op. 2014-81).

### STORAGE OF DISQUALIFIED PERSON'S ARTWORK NOT SELF-DEALING

Gerald, an avid art collector, established both a foundation and a museum, with the goal of making many of the works in his collection available to the public. He is a disqualified person with respect to the foundation and museum, both of which are considered private foundations. Gerald plans to loan pieces from his collection to the foundation and museum, free of charge. He will pay for insurance, maintenance costs, packing and moving for the art while on loan. At any one time, a significant portion of the collection will be on loan or on view at the museum.

The museum will also be storing some of the artwork owned by Gerald or the foundation. This arrangement is designed to reduce the need for shipping and make more of the works available to the public or for study by scholars and professionals. There will be no additional cost to the museum to store these items, since the museum was designed to accommodate the foundation's works and items on loan.

An excise tax is imposed on acts of self-dealing, which includes a transfer to, or use by or for the benefit of, a disqualified person, of the income or assets of a private foundation [Code §4941(d)(1)(E)]. However, the IRS found no self-dealing in the museum's storage of Gerald's collection, saying that it furthers the museum's and foundation's charitable and educational purposes. Any benefit to Gerald is merely incidental. Any reasonable expenditures made by the museum in storing the artwork will not change the character of the loans, which will be considered to be "furnished without charge" under Reg. §53.4941-2(d)(3) (Ltr. Rul. 201423032).

### PUZZLER SOLUTION

Normally, a charitable remainder trust must be payable to or for the use of one or more named "persons." Code §7701(a)(1) defines "person" to include a trust, although if a noncharitable trust is the beneficiary, the charitable remainder trust must be for a term of not more than 20 years. However, where the life income beneficiary is an incompetent and the only function of the noncharitable trust is to receive and administer payments from the charitable remainder trust, the IRS has held that the payments would be deemed as received directly by the incompetent beneficiary [Rev. Rul. 76-270, 1976-2 C.B. 194].

## CHARITABLE OPPORTUNITIES FOR SPOUSES OF NONCITIZENS

Since 1988, the gift and estate tax marital deductions have been severely curtailed for U.S. citizens married to noncitizen spouses. The gift tax annual exclusion [Code §2503(b)], which currently shelters gifts up to $14,000, is increased to $145,000 in 2014 for gifts to noncitizen spouses.

U.S. citizens do not have an unlimited estate tax marital deduction for property passing outright to noncitizen spouses, although transfers can be sheltered up to the $5.34 million applicable exclusion amount (2014 amount). Estate tax can be postponed if property is placed in a qualified domestic trust (QDT) [Code §2056(d)(2)(B)].

A QDT requires at least one trustee to be a U.S. citizen or domestic corporation. The surviving spouse must be entitled to all the income from the trust, paid at least annually. Income distributions and distributions in the event of hardship are not subject to estate tax, but the tax is imposed on inter vivos distributions of corpus and on the value of trust assets remaining at the surviving spouse's death. Estate tax can also be avoided if the surviving noncitizen spouse becomes a U.S. citizen [Code §2056A(b)(12)].

A QDT cannot be a qualified charitable remainder trust, because of the requirement that all trust income be payable to the spouse [see Reg. §§1.664(d)(1)(A), 1.664(d)(2)(A)]. A QDT might seem to qualify for marital and charitable deductions if structured as a charitable QTIP under Code §2056(b)(8) – all income to the spouse, all the remainder to charity. However, Code §2056(b)(1)(B), which imposes an estate tax on the value of property in the QDT at the death of the surviving spouse, does not provide for an estate tax charitable deduction. Therefore, estate tax would be owed, even if the remainder passes to charity.

There are ways a citizen can benefit a noncitizen spouse and take advantage of gift tax, estate tax and income tax charitable deductions.

For example, Susan, a U.S. citizen, is married to Hans, a noncitizen. She could create a lifetime charitable remainder unitrust with Hans as the income beneficiary. Assuming Hans is age 55 and the §7520 rate is 2.2%, Susan could fund a $200,000 unitrust paying 5% in quarterly payments. Her income tax charitable deduction would be $63,786 for charity's remainder interest. Hans's income interest would be $136,214 and would qualify for the annual exclusion. Each year Susan could make additional contributions to the unitrust to take advantage of the increasingly larger exclusion. The exact amount of Susan's gift that will be sheltered would vary with Hans's age and the §7520 rate used.

Although a QDT with a remainder passing to charity does not qualify for an estate tax charitable deduction, other estate planning options are available that allow Susan to benefit charity while passing her estate to Hans.

She could, for example, create two testamentary trusts. The first would qualify as a QDT, leaving the bulk of her estate directly to Hans. The second trust would be a charitable remainder trust with Hans as the income beneficiary. The charitable trust would be funded to provide an income interest to Hans of $5.34 million. The value of Hans's interest would be subject to estate tax, but would be sheltered by the credit under Code §2010, so that no tax would be due.

A charitable remainder annuity trust could be funded with $10 million, to pay Hans an annual income of $600,000 in quarterly payments. Assuming Hans is 79 years old and a §7520 rate of 2.2% is used, Susan's estate would get a charitable deduction of $5,321,125. Hans's interest, valued at nearly $4.8 million, will be totally covered by the applicable credit amount.

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

**Cherí E. O'Neill**
**President and CEO**

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