DALLAS JEWISH COMMUNITY FOUNDATION

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ESTATE PLANNER'S TIP

Corporations, not just individuals, can establish charitable remainder trusts and receive the trust income, but the trust must last for a term of no more than 20 years [Reg. §§1.664-2(a)(5)(i), 1.664-3(a)(5)(i)]. Are such gifts practical? Consider this scenario: ABC Corporation owns long-term capital gain property (undeveloped land) worth $750,000, with a basis of $150,000. To satisfy charitable commitments, the corporation transfers the property to a charitable remainder annuity trust, retaining a 5% annuity for a term of 20 years. The corporation receives an income tax charitable deduction of $192,094 (assuming annual payments and the use of a 4% §7520 rate), which is deductible up to 10% of its taxable income, with a five-year carryover for any excess deduction. The corporation begins receiving a 5% annuity from the trust – effectively going from zero income to $37,500 a year, with no intervening tax on the appreciation. Charity gets the trust corpus after 20 years, and the corporation receives $750,000 during the trust term and benefits from the charitable deduction and tax avoidance on the $600,000 gain.

IRS GIVES THUMBS DOWN TO AUTOMATIC ANNUITY INCREASES

Two life insurance companies proposed to offer non-qualified single premium immediate annuity contracts. A purchaser could choose a straight life annuity, a life annuity with a guarantee period or a life annuity with various refund features. The annuities can be payable for a single life or joint lives and include both a cash withdrawal feature and an acceleration feature, although neither of these latter two would be available to owners under age 59½.

Owners would receive fixed, level periodic payments from the annuity unless the owner initially elects to have the fixed annuity payments increase annually by a constant percentage for the life of the contract. The increase could be from 1% to 4% and could not change. If this option is elected, the initial payments made will be lower. The insurance companies asked the IRS to rule that payments made under this option would be "substantially equal periodic payments" under Code §72(q)(2)(D).

Generally, distributions from a qualified retirement plan made prior to age 59½ are subject to a 10% penalty [Code §72(q)(1)]. There is an exception, however, if the distributions are part of a series of substantially equal period payments, made at least annually, for the life or life expectancy of the taxpayer, or the joint lives of the taxpayer and a designated beneficiary.

Rev. Rul. 2002-62 (2002-2 C.B. 710) provides for an annual recalculation of the payments by dividing the account balance for the year by the number from the life expectancy table. Payments may increase or decrease based on the account balance and the remaining life expectancy. This differs from the method proposed by the insurance companies, said the IRS, since payments would automatically increase by a fixed percentage over the previous year's payments. Therefore, the distributions would not be determined using the required minimum distribution method or under a cost-of-living adjustment (Ltr. Rul. 201120011).

NO COMPENSATION = NO IRA

Rosemary Niesen claimed a $5,000 deduction for an IRA contribution on the 2007 tax return she filed with her husband. The couple's income for that year included interest, ordinary dividends, taxable refunds, pension, annuity and Social Security payments. They also reported a capital loss and a farming loss. The IRS disallowed the IRA deduction, saying the couple had no compensation.

The Tax Court noted that the IRA deduction is limited to the lesser of the deductible amount or an amount equal to the taxpayer's compensation [Code §§219(b)(1), (5)]. It specifically excludes interest, dividends, pension, annuity and Social Security benefits [Code §219(f)(1)].

The Niesens argued that the IRS had looked at the same issue in 2006 and allowed a deduction, thereby setting a precedent. The court disagreed, saying that each tax year stands alone and the IRS may challenge in one year what was condoned or agreed to in a prior year. The couple reported a net loss from their farming activity, so they had no net earnings from self-employment, no earned income and therefore no compensation, said the court (*Niesen v. Comm'r.*, T.C. Summ. Op. 2011-71)

PHILANTHROPY PUZZLER

Ted met with an attorney about revising his will. He wants to create a testamentary charitable remainder trust to benefit his wife, Georgia, for her life, and then pay income to his two daughters for their lives before the assets pass to his favorite charity. The attorney cautioned Ted that if his children are included in the charitable remainder trust, his estate could not claim a marital deduction for the value of Georgia's interest and, depending upon the ages of the children at Ted's death, the trust might not produce the required minimum 10% remainder. Ted has asked if these are legitimate concerns.

FELINE-FRIENDLY RULING ON VOLUNTEER EXPRESS

Jan Van Dusen claimed a charitable contribution of $12,068 in 2004, the bulk of which was for unreimbursed expenses she incurred in serving as a foster parent for cats. Van Dusen cared for between 70 and 80 cats in her home, in addition to her own seven cats.

Van Dusen was involved with Fix Our Ferals (FOF), a 501(c)(3) organization that trapped, neutered and obtained medical treatment and vaccinations for feral cats and then released them back to the wild. Cats are cared for in foster homes while recovering from neutering and to tame those animals that cannot be returned to the wild. Volunteers, who trap, transport, staff spay/neuter clinics and screen phone calls, are not generally reimbursed for out-of-pocket expenses.

Van Dusen fed, cleaned and looked after the cats. She laundered the bedding and sanitized the floors, household surfaces and cages. Most of the cats roamed free around her house, although the less domesticated cats stayed in a separate room and some lived in cages for taming or due to illness. Van Dusen paid for most of the veterinary expenses. She also purchased large quantities of pet and cleaning supplies, purchased a membership to a club to buy cat food and cleaning supplies at a discount, and incurred higher electricity and gas bills because she laundered so many loads of cat bedding and ran a special ventilation system to ensure fresh air.

Her water bills and garbage bills were also higher due to her work with the cats.

The IRS disallowed Van Dusen's entire deduction for 2004, claiming she was an independent cat rescue worker whose services were unrelated to FOF. Even if she was affiliated with FOF, said the IRS, the organization's mission was "education and sterilization," so fostering cats was not a service to the charity.

The Tax Court found Van Dusen to be a regular volunteer with FOF and said her foster care work was within the organization's mission. The court noted that one type of charitable contribution occurs when a taxpayer incurs unreimbursed expenses when performing services for a charity [Reg. §1.170A-1(g)]. The court determined that one broad category of expenses – veterinary bills, pet supplies, cleaning supplies and utilities – were incidental to her work for FOF. Because Van Dusen did not have separate bills for expenses for her pets and those for the foster cats, she was entitled to deduct only 90% of the veterinary bills, and the cost for pet supplies, paper towels and garbage bags. The court limited her deduction to 50% of the cost of laundry and dish detergent and her utilities, although acknowledging that it was likely the foster cats accounted for a larger share of those expenses. The court added that Van Dusen was entitled to the deduction only to the extent that the expenses were substantiated. For those expenses under $250, the court said that unreimbursed expenses are similar to cash contributions for substantiation purposes [Reg. §1.170A-12(a)]. Her documents are not canceled checks or receipts from the charity, but records of her expenses, which the court called "legitimate substitutes for canceled checks." Therefore, said the court, she had substantially complied with the recordkeeping requirements and was entitled to a deduction, subject to the 90% or 50% limits, for the expenses she incurred.

However, as to expenses in excess of $250, she is required to have a contemporaneous written acknowledgment from FOF [Code §170(f)(8)(A); Reg. §1.170A-13(f)(1)]. The court found several expenses, primarily veterinary bills, that exceeded $250, for which she was not entitled to a deduction, due to the lack of an acknowledgment (*Van Dusen v. Comm'r.*, 136 TC No. 25).

"TRUST ME" NOT GOOD ENOUGH FOR COURT

Aaron Kirman wanted to "get into the right community" that had access to architectural homes, so he said that he donated money to the Architectural Historical Society. The problem? Kirman claimed a charitable deduction of $9,850, but told the Tax Court that he couldn't find the canceled check.

For gifts of $250 or more, an income tax charitable deduction is allowed only if the taxpayer has a contemporaneous written acknowledgment from the donee organization, including the amount of the cash or a description of the property. The acknowledgment must indicate that no goods or services were provided in return for the gift, or include a good faith estimate of the value of any goods or services provided [Code §170(f)(8)(A)].

Kirman urged the court to allow a deduction under the *Cohan* rule [*Cohan v. Comm'r.*, 39 F.2d 540], which permits the court to approximate a deduction that can't be fully substantiated. The court declined to do so, noting that because the contribution claimed is more than $250, it does not qualify as a charitable contribution by statute if there is no written receipt from the donee [*Kirman v. Comm'r.*, T.C. Memo. 2011-128].

PUZZLER SOLUTION

In order to qualify for a marital deduction for a charitable remainder trust, the surviving spouse must be the only noncharitable beneficiary [Code §2056(b)(8)]. In addition, Code §§664(d)(1)(D) and (d)(2)(D) require that a charitable remainder trust provide for at least a 10% remainder interest. Ted could accomplish the same result by establishing a QTIP marital trust [Code §2056(b)(7)] from which Georgia would receive all net income. At her death, trust assets could pass to a charitable remainder trust to benefit his daughters. The QTIP trust will qualify for the marital deduction at Ted's death, and the charitable remainder trust will qualify for a charitable deduction at Georgia's death (Ltr. Rul. 9122029).

LENDING BETTER THAN GIVING? IT CAN BE

A little-known provision in the tax code may be just the answer for clients who are charitably motivated but won't, or can't, irrevocably part with their money. Temp. Reg. §1.7872-5T permits a taxpayer to lend up to $250,000 to any number of charities, interest-free, without running afoul of the imputed interest rules of Code §7872. Four categories of clients might find loans a tax-smart move.

Nonitemizers

In 2007, the most recent year for which figures are available, only about 35% of all taxpayers itemized their deductions. Consider a couple, both over age 65, who give $2,500 annually to their favorite charity but can't claim a charitable deduction because their itemized deductions are less than the $13,900 standard deduction for 2011.

The money to make their annual gift comes from the interest earned on a $250,000 CD (2%), which is subject to income tax. Rather than write a check to the charity, the couple could instead make an interest-free loan of $125,000. There is no charitable deduction because the loan is not a completed gift. However, charity is able to invest the $125,000 and receive the same $2,500 annually that it previously received. The couple is not taxed on the $2,500 income earned, reducing their taxes by $700 (assuming a 28% income tax bracket) – the same tax effect as if they had been able to claim a charitable deduction of $2,500.

Hesitant donors

Many donors hesitate to give because they don't know if they or their families will need the funds in the future. The interest-free demand loan gives these donors the satisfaction of helping charity along with the confidence that they can reclaim the funds in the event of an emergency.

Although there is no income tax deduction for the loan, there will be an estate tax deduction [Code §2055(a)] if the loan is forgiven at the client's death.

Overly generous donors

A donor who makes a cash gift can deduct up to 50% of AGI [Code §170(b)(1)(A)], while gifts of appreciated property can be deducted up to 30% of AGI [Code §170(b)(1)(B)]. Excess deductions may be carried over for up to five years. But some donors may not be able to claim the full deduction, even in the six years allowed.

For example, a 65-year-old donor who transfers appreciated stock worth $500,000 to a 5% charitable remainder unitrust would be entitled to a charitable deduction of $225,285 (assuming quarterly payments and a 3% §7520 rate). But even with annual income of $100,000, the donor would be able to deduct only $180,000 over the six years.

There is little tax incentive for donors already at or near the deduction maximum to make significant additional gifts to charity. The interest-free loan might be an alternative to additional outright gifts – especially those subject to the 30%-of-AGI ceiling.

Taxpayers subject to itemized deduction cutbacks

This is not a concern for donors through 2012, but in 2013, the cutback on itemized deduction for upper-income taxpayers is scheduled to return. The deductions for state and local taxes, mortgage interest, charitable gifts and miscellaneous itemized expenses are reduced by 3% of AGI in excess of certain amounts ($166,800 for married couples in 2009). For example, a couple with AGI of $200,000 would lose nearly $1,000 in itemized deductions using the 2009 threshold ($200,000 – $166,800 = $33,200 x .03 = $996 of cutbacks) up to a maximum of 80% of the deductions.

The vast majority of taxpayers subject to cutbacks have "fixed" expenses, such as mortgage or state and local taxes sufficient to absorb the full brunt of the deduction cutbacks. However, for clients whose charitable deductions would be subject to the 3% cutbacks, the interest-free loan would provide a tax-saving alternative that is not affected by the return of the reductions.

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