DALLAS JEWISH COMMUNITY FOUNDATION

The Advisor

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ESTATE PLANNER'S TIP

When meeting with clients to prepare 2008 income tax returns, advisors should determine whether gifts, particularly hard-to-value gifts, were made last year. The value of a gift cannot be redetermined at death for estate tax purposes, provided the gift has been adequately disclosed [Code §2504(c)]. Taxpayers need not fear that gifts of hard-to-value property such as real estate or closely held business interests will be revalued upwards many years later, when establishing fair market value may be particularly difficult. This protection applies, however, only where the gifts have been "adequately disclosed." Reg. §301.6501(c)-1(f)(2) provides that the IRS has proper notice of a gift "if it is reported in a manner adequate to apprise the Service of the nature of the gift and the basis for the value reported." Once disclosure is made, the statute of limitations on an IRS challenge begins to run. Gift tax returns for 2008 are filed at the same time as income tax returns.

THE WORST IRA TRANSFER EVER?

Anna and Brad entered into a prenuptial agreement, providing that at Anna's death, her IRA would pass to her estate to fund a QTIP trust for Brad. He would be entitled to the net income, and at his death, the trust would pass to a second trust for the benefit of Anna's four children. If the children were age 21 or older, their shares would be distributed outright.

Some time after the couple married, Anna transferred her IRA to another custodian. She executed a beneficiary designation form listing her four children, but did not designate a contingent beneficiary. Under the terms of the custodian agreement, if the children predeceased Anna, her estate would be the beneficiary.

Within nine months of Anna's death, her children executed written disclaimers of their interests in the IRA. Under state law, the terms of the IRA custodial agreement and Anna's will, the IRA passed to the trust for Brad's benefit. At his death, the trust will terminate and the funds will be distributed to Anna's children, either in trust or outright.

The IRS noted that under state law, a renunciation of the children's interests causes the property to pass as if the children had predeceased Anna. Under Reg. §25.2518-2(e)(3), if a disclaimant also has a right to receive property as an heir at law, residuary beneficiary or by other means and does not effectively disclaim these rights, the disclaimer is not qualified with respect to that portion of the disclaimed property.

Because Anna's children did not disclaim

their interests in the trust to be created from the QTIP trust at Brad's death, they did not disclaim their entire interests in the IRA, ruled the IRS. Therefore, the disclaimers are not qualified under Code §2518. Further, in order for the trust for Brad's benefit to qualify as a QTIP under Code §2056(b)(7), the IRA must have passed from Anna. Instead, the IRS said the children had made a taxable gift to Brad of the fair market value of the IRA. The gift is from the children, not Anna, and the estate therefore is not entitled to a marital deduction (Ltr. Rul. 200846003).

DEBTS TO BE PAID FROM SPOUSE'S RESIDUE, NOT SPECIFIC BEQUESTS

Under Michael Wagner's will, his two daughters by a previous marriage were to receive $50,000 each. He left stock redemption agreement proceeds to a family trust created in the will. His wife, Janet, received the residue. Of the $1.8 million gross estate, $650,514 was joint tenancy property with Janet.

The estate had debts of $240,000. Janet, as executor, sought a declaratory judgment that the state (Iowa) abatement procedures be followed. Doing so would extinguish the specific bequests to the daughters and reduce by $140,000 the redemption agreement assets passing to the family trust. The residue, which was passing to Janet, would not contribute toward the payment.

PHILANTHROPY PUZZLER

Herman bought a new car late in 2008 to replace one that was not big enough to accommodate his growing family. Rather than trade in the old car or try to sell it, Herman decided to contribute the car to a charity and claim an income tax deduction on the return he files this year. He has asked how to determine the value of the vehicle.

The daughters asked the court to follow another section of the state's abatement provisions. The provision Janet sought to have applied was not to be used if the court finds "clear and convincing" evidence that the express or implied purpose of the will would be defeated by doing so. The District Court found that Michael intended to benefit his daughters and ordered that the $240,000 be paid from the residue.

The Iowa Court of Appeals agreed, noting that while preference is given to the spouse in abatement matters, the rule does not apply where the will clearly discloses a contrary intent. Michael executed the will just a few days prior to his death. Under his estate plan, Janet received 95% of the estate, either outright or in a family trust. The daughters received 5%. The court concluded that he had no intention of including bequests that would be a "completely idle act" when transferring his substantial assets. In addition, the court noted, the specific bequests to his daughters came before the residuary bequest to Janet, making clear that he intended Janet to take the residue of the estate "after every other bequest has been satisfied" (*In the Matter of Estate of Wagner*, No. 8-487/07-2033).

REMAINDER INTEREST SURVIVES BENEFICIARY

Rosebud Keys executed her will in 1983, leaving the residue of her estate in trust for the benefit of her niece, Eleanor. The will provided that if trust assets remained at Eleanor's death, the funds were to be split equally among five charities, including the Central Avenue United Methodist Church of Kansas City.

When Eleanor died in 2004, trust assets totaled $774,000. In late 2006, the bank trustee asked the court to approve the distribution of the assets. In 2005, after Eleanor's death but before the bank began the distributions, the church was dissolved with the approval of its members. In accordance with the policies of the United Methodist Church, all assets were distributed to the Conference. The

bank asked the court whether the church's share should be paid to the Conference or be distributed proportionately among the four remaining charities. Only one of the other charities objected to the distribution to the Methodist Church Conference, arguing that since the church was no longer in existence, it was impossible for the bank to make a distribution to it. The District Court agreed.

The Court of Appeals of Kansas noted that initially, the church had a contingent future interest in the trust remainder. Had trust assets been exhausted before Eleanor's death, the trust would have terminated. However, since Eleanor died with a remainder in place, the sole condition precedent in Keys' will had occurred. The court said the will did not make the church's remainder interest contingent even after the termination of the trust, noting that if the bank had filed its petition for distribution while the church was still in existence, there is no question that the church would have been included. The church's remainder interest vested at Eleanor's death, the court found, and nothing in the will suggests that the interests were defeasible after the trust's termination.

Although the Conference is not the church's successor, it is the church's parent, said the court. The rules of the United Methodist Church provide that any devise to a local church that becomes available after the church has been discontinued or abandoned becomes the property of the Conference. This provision was in effect on the date of the will's execution and on the date of Eleanor's death. The Appeals Court ruled the Conference could take the church's remainder interest as part of the assets to which it was entitled (*In Re: The Trust of Keys*, No. 99,142).

SELLING NOT THE SAME AS GIVING FOR RECAPTURE PURPOSES

Code §2032A(a) allows estates to value qualified property – generally real property used for farming or in a trade or business – at its value for that purpose, not at the highest and best use. The rules require that the farming or business use continue in the hands of a qualified heir. If the use is discontinued or the property sold within ten years, Code §2032A(c)(1) provides for a recapture of the estate tax that was avoided at death.

Code §2032A(c)(8), enacted as part of the Taxpayer Relief Act of 1997, provides an exception to the recapture rules where a qualified conservation contribution is made. This is a contribution of a real property interest to a qualified charity exclusively for conservation purposes [Code §170(h)(1)].

Lester, who inherited farmland from his father, has continued to operate the farm. His father's estate elected to value the property valued under Code §2032A. Lester was approached by a land trust seeking to purchase a conservation easement that would restrict the future use of the property to agriculture.

The IRS ruled that while the recapture tax is not imposed for contributions of conservation easements, the legislative history of Code §2032(c)(8) "does not necessarily include sales and exchanges of conservation easements for valuable consideration." The recapture provisions would be triggered if Lester were to sell the easement rather than contribute it, ruled the IRS (Ltr. Rul. 200840018).

PUZZLER SOLUTION

The deduction for a gift of a vehicle is generally limited to the gross proceeds received by charity upon a sale [Code §170(f)(12)(A)(i)]. Herman should receive an acknowledgment from the charity identifying the car and certifying that it was sold in an arm's-length transaction. The substantiation must disclose the gross proceeds of the sale and inform Herman that his deduction is limited to that amount. Different rules apply if the charity uses the vehicle for its exempt purposes. If the charity does not sell the vehicle before Herman is required to file his 2008 return on April 15, he will have to wait to claim the deduction on an amended return.

IRS TARGETS TREATMENT FOLLOWING "SALES" OF REMAINDER TRUSTS

Last January, the IRS issued Rev. Proc. 2008-3, in which it announced that it will no longer rule on transactions in which a charitable remainder trust is terminated early, with the income and remainder beneficiaries receiving the actuarial value of their interests. In several rulings, the IRS has said that under Code §1001(e)(1), the income beneficiary is considered to have a zero basis in the interest, making the entire amount subject to capital gains tax. The question of whether a trust continues to be a qualified charitable remainder trust will be resolved at some point through a revenue ruling, revenue procedure or regulation, the IRS said. This revenue procedure does not affect early terminations in which the income beneficiary contributes his or her interest to the remainder charity.

The IRS recently issued Notice 2008-99, which provides that some early terminations may be "transactions of interest," requiring donors and even charities to report. The IRS stressed that it is not referring to the common situation where a donor funds a charitable remainder trust with appreciated securities which are then sold, tax free, by the trustee.

The transaction that has drawn the IRS's attention involves the sale of the entire charitable remainder trust, after the funding assets have been reinvested, to an unrelated third party for an amount equal to the fair market value of the principal. The trust is then terminated, with the assets distributed to the third-party buyer. Some donors have taken the position that they are not selling a term interest, but rather that the sale is of the entire trust that falls under Code §1001(e)(3). They contend that under Code §1001(a), their basis is neither zero nor a share of the basis in assets originally placed in the trust. They claim, instead, a basis allocation determined by the price paid by the trustee for the new assets in the trust, having sold and reinvested the original trust assets. As a result, the gain on the sale of the appreciated assets is never taxed, even though the donor receives a share of the appreciated fair market value of the assets.

In some variations, said the IRS, donors use a net-income with make up charitable remainder unitrust or a trust that has been in existence for some time; the appreciated assets already may be in trust prior to the beginning of the transaction; the income beneficiary may be someone other than the donor, or the grantor may contribute the appreciated assets to a partnership or other pass-through entity and then contribute the interest in the entity to the trust.

Under the IRS notice, transactions such as these are considered transactions of interest for purposes of Reg. §1.6011-4(b)(6) and Code §§6111 and 6112, effective October 31, 2008. Donors entering into these transactions on or after November 2, 2006, must disclose the transaction. Material advisors who make tax statements on or after November 2, 2006, also have disclosure and list maintenance obligations. A charity is not a participant if it sold or otherwise disposed of its interest in a trust on or before October 31, 2008. However, for interests sold after that date, charity is also a participant, with reporting obligations.

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