DALLAS JEWISH COMMUNITY FOUNDATION

The Advisor

September 2011

ESTATE PLANNER'S TIP

Private annuities can be an effective way to pass assets from one generation to another without worrying about the Code §2036 rules on retained life estates. If clients pay attention to valuation and comply with all the formalities, it's possible to remove appreciating assets from a client's estate, report capital gains over a longer period of time and transfer all future appreciation to younger family members free of transfer tax. For example, Mike owns vacant land valued at $250,000 with a basis of $25,000. An outright sale of the land would produce a capital gain of $225,000, on which he would owe tax of $33,750. He could, instead, transfer the land to his son in exchange for an annuity that would pay him a set amount each year for the rest of his life. There will be no gift tax owed on the transfer, provided the actuarial value of the annuity is equal to the value of the property transferred. One way to make sure of this is for the son to pay Mike an annuity amount equal to what would be paid by a commercial carrier. For the remainder of Mike's life expectancy, a portion of each year's annuity payment will be considered a tax-free return of principal. After that, the entire annuity amount is taxable. In the meantime, the son owns the land, with all appreciation inuring to his benefit, and at Mike's death, none of the value is included in his gross estate.

DECEDENT'S "DESIRES" MANDATORY, SAYS IRS

Article III of Howard's will included a heading indicating that it was a "statement of intent" regarding certain closely held investments. The will provided that "it is my desire that such equity interests be retained and that each of them be distributed so that all such equity interests are ultimately owned in equal shares" by Howard's children. In other sections of the will, Howard makes specific bequests to his wife, using language that "I give, devise and bequeath to," "I request, but do not require," and "I further request, but do not require."

The IRS was asked to determine whether the "it is my desire" language was mandatory or precatory. If mandatory, it is a specific bequest to Howard's children. If precatory, the assets will pass as part of the residue of Howard's estate.

Howard had significant debts at his death, and under the state's rules of abatement, if the language constitutes a specific bequest to the children, the amount passing to his wife – and consequently the marital deduction under Code §2056 – will be reduced. If the language is precatory and assets pass under the residuary provision, the

debt obligations will eliminate the residue and the remaining debt will be charged against the specific bequests. The estate's marital deduction would be greater.

The IRS, finding the word "desire" to be mandatory when addressed to an executor, said Article III differed from other sections of the will where Howard gave the executor discretion (e.g., "Executor may" or "Executor shall have absolute discretion"). If he had meant "desires" to be a suggestion, said the IRS, he would have stated so with the same language used in other sections of the will. There is no language within the will indicating that the assets were to be distributed as part of the residue (TAM 201126030).

FORMULA CLAUSE SUPPORTS PUBLIC POLICY

John and Karolyn Hendrix wanted to give shares of closely held stock to their three daughters while also making charitable gifts. They established a donor advised fund at the Greater Houston Community Foundation and, at the recommendation of their advisor, used a formula clause to define the stock transfer in dollar terms, rather than as percentages.

The donors negotiated with the Foundation, which retained its own attorney. The couple gave $100,000 outright to the Foundation and transferred the stock to trusts benefiting their daughters. The Hendrixes, the trustees and the Foundation entered into an agreement under which they irrevocably assigned 287,619.64 shares of the stock to a generation-skipping tax trust and the foundation. The agreement set forth a formula under which a portion of the shares having a fair market value on the date of the gift equal to $10,519,136.12 was assigned to trusts for the daughters, with any remaining portion of the assigned shares passing to the Foundation. The couple claimed a charitable deduction of $100,000 and a total taxable gift of $1,414,581.

While the IRS allowed the $100,000 charitable deduction for the outright gift, it said that the formula clause was invalid because it was not reached in an arm's-length transaction and is contrary to public policy. The IRS also determined the value of the shares to be $48.60, versus the $36.66 value calculated by the donors' appraiser.

The Tax Court agreed with the Hendrixes on the value of the shares and noted that the Foundation had exercised its due diligence regarding the gift, conducted its own appraisal and had a fiduciary duty to ensure that it received the proper number of shares under the formula clause. The court added that formula clauses "do no immediately and severely frustrate any national or State policy." Public policy encourages gifts to charity, added the court, and "formula clauses support that policy" (*Hendrix v. Comm'r*., T.C. Memo. 2011-133).

PHILANTHROPY PUZZLER

Glenn established a testamentary charitable lead annuity trust, to be funded with $2 million. His favorite charity is to receive $60,000 (3%) annually for 25 years, after which trust assets are to be distributed to the grandchildren alive at Glenn's death. Charitable remainder trusts must make minimum payouts of 5% and term-of-years trusts can last no more than 20 years. Will the trust Glenn has established in his estate plan qualify for the estate tax charitable deduction?

DONOR PROPOSES CLASSY GIFT

Bernie is the beneficial owner of both Class A voting and Class B nonvoting shares of stock in a company. He also owns shares outright. While Class A shares are freely transferrable, Class B shares can only be transferred to the corporation, in connection with an acquisition of the company, upon death or with the consent of the company's board of directors.

Bernie and his wife plan to transfer at least 50% of the Class B shares to a charity and to make

additional transfers during their lives. At Bernie's death, he will transfer the Class B shares owned outright to trusts to benefit his children and grandchildren, naming the charity the remainder beneficiary of the trusts.

The goal is for charity to receive a substantial economic benefit from the Class B shares for an extended period of time. The corporation and charity agree that the corporation will pay an annual dividend equal to a specific percentage of the previous year's net income and that the charity will not attempt to compel a sale of the corporation.

Bernie asked the IRS to rule that transfers of the Class B shares to charity will not be split interests under Code §2522 and that the value of the gifts under Code §2512 is equal to the value of the gift tax charitable deduction under Code §2522.

The IRS found that the Class B shares are a separate property interest apart from the other class of stock in the corporation. The shares of one class of stock do not constitute an interest in the shares of any other class of stock. Therefore, said the IRS, for gift tax purposes, the plan will not result in interests in the same property passing for both charitable and noncharitable purposes under Code §2522(c)(2). For gift tax purposes, the value of any property transferred to charity under Code §2512 will be the fair market value of the property for the gift tax charitable deduction (Ltr. Rul. 201129033).

A valuation expert was retained to determine the value of the relative's interest. The executor then asked the court to reform the trust to qualify as a charitable remainder annuity trust under Code §664(d)(1). The court found the distribution language was an ascertainable distribution standard requiring distributions for the relative's health, support and maintenance. The court directed that the residuary assets of the trust be distributed to a charitable remainder annuity trust that would pay 5% annually. Of this, a portion would be paid to the family member and the balance to the foundation. This was conditioned on the IRS's approval of the trust as a qualified charitable remainder annuity trust.

The IRS determined that the method used to value the relative's interest was not reasonable. The valuation expert revised the valuation. At the executor's request, the court amended its original order to provide for a different split of the 5% annuity payout. The IRS found that the charitable remainder interest in the original trust was reformable under Code §2055(e)(3)(C). The interest passing to charity would have qualified for an estate tax charitable deduction but for the requirements of Code §§2055(e)(2) and 664. The IRS also ruled that the reformation resulted in a qualified trust and that Harold's estate was entitled to a charitable deduction under Code §2055(a) (Ltr. Rul. 201125007).

COURT FIX PRESERVES DEDUCTION

The remainder of Harold's trust was to be distributed to his foundation. His estate plan directed the trustee to pay for the health costs of Harold's elderly relative, who was residing in an assisted living facility. Because it was anticipated that expenses for the family member would increase, the trustee was given the authority to invade principal. The trust was not in the form of a sum certain or fixed percentage that would qualify as a charitable remainder annuity or unitrust, so no charitable deduction would be allowed.

PUZZLER SOLUTION

Unlike charitable remainder trusts, charitable lead trusts are not required to make minimum 5% payments to the charitable income beneficiary. Similarly, the 20-year term limit does not apply to lead trusts [Reg. §1.170A-6(c)]. However, an inter vivos reversionary lead trust, intended to generate an income tax deduction for the grantor, may be disqualified if the trust term is so long that the reversionary interest falls below 5%.

CHARITABLE GIFTS THAT GO ON VACATION

Labor Day has traditionally signaled the end of the summer vacation season. For philanthropic clients it may be a time to consider using vacation property to benefit worthwhile organizations – including options that allow the donor to continue using the property.

Undivided interests

A vacation home that is used only part of the year is an excellent candidate for a gift of an undivided interest [Code §170(f)(3)(B)(ii)]. For example, Clark owns a summer home on the lake that he and his family use primarily from April through October. If Clark gives an undivided interest (e.g., one-quarter) in the home to charity, he can claim a current income tax deduction for roughly 25% of the fair market value of the residence [Reg. §1.170A-7(b)(1)(i)]. His family can continue using the home as they always have. When the property is sold – probably at Clark's death – charity will be entitled to 25% of the sale proceeds.

Remainder interest in vacation property

Colleen owns an A-frame mountain lodge in an expensive resort area. She planned to leave the lodge to charity at her death to create a gift in memory of her parents. Her advisor has pointed out that she can make the gift now, qualify for a current income tax deduction and enjoy the lodge during her and her husband's lives [Code §170(f)(3)(B)(i)]. The table below shows sample tax deductions for a gift of a remainder interest in a personal residence or farm for various ages (assuming a $750,000 fair market value, 40-year useful life, $80,000 subject to depreciation and a 3% §7520 rate):

Ages	Deduction
60/60	$327,907
65/65	374,476
70/70	424,597
75/75	476,699
80/80	527,852

Open space easement

A gift of an open space conservation easement in perpetuity entitles the donor to a current income tax deduction plus continued occupancy of the property [Code §170(h)]. For example, Judy has a summer home adjacent to a state park. She grants a conservation easement to the state restricting future development of the parcel. She can continue living in the home or even sell it, subject to the perpetual easement. Her charitable deduction is the difference in the fair market value of the property prior to granting the easement and the value as reduced by the easement [Reg. §1.170A-7(b)(1)(ii)].

Funding a trust

Vacation home owners may reach the point where they no longer use the home or it becomes a financial burden to maintain. If they sell, they face capital gains taxes. Because the vacation home is not a principal residence, owners are not entitled to the $250,000/$500,000 exclusion. Funding a charitable remainder trust with the vacation home may be appealing.

Craig and Louise own a summer place about a two-hour drive from their home. They're retiring to another state soon and will no longer be able to use the property. The home is worth $250,000, with a $50,000 cost basis. If they sold the property, they would lose $30,000 to capital gains taxes.

Instead, Craig and Louise transfer the home to a charitable remainder unitrust that will pay them 5% of the annual value of the trust for their lives following the sale of the home. At their ages (67 and 69), they qualify for a charitable deduction of about $95,400 (assuming quarterly payments and a 3% §7520 rate). They will receive $12,500 in income if the home sells for $250,000, with no loss to capital gains taxes. Income in future years will fluctuate, depending upon the fair market value of the assets in the trust.

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