

# *The* Advisor

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## ESTATE PLANNER'S TIP

Code §135 allows parents to finance college expenses through the purchase of U.S. savings bonds. Proceeds from the redemption of bonds are excluded from tax if used for the qualified higher education expenses of the taxpayer, spouse or children. But the exclusion is phased out, starting when modified adjusted gross income hits \$70,100 for single taxpayers and \$105,100 for married couples. The exclusion is completely eliminated at \$85,100 (singles) or \$135,100 (married couples) [Code §135(b)]. If the exclusion phase-out is a problem, another way to use bonds for college is to buy them in the name of the child and have the child elect to report the income as earned each year. Any tax generally will be at the child's lower rate. When the child is ready for college and the bonds are cashed in, there will be little or no interest income to report. But keep in mind the "kid-die tax," which starts at \$1,900 in 2010 and may cause the child's unearned income to be taxed at the parents' higher tax rate.

## SURVIVING SPOUSE PROTECTION DOESN'T APPLY TO IRAs

Wayne Wilson participated in his employer's 401(k) plan until 1994, when he rolled it over to an IRA. In 2000, Wilson married Katherine Chandler. He transferred approximately half the account to a new IRA in 2002, naming his four adult children from a previous marriage as primary beneficiaries.

Following Wilson's death in 2005, Charles Schwab & Co. filed an interpleader action seeking to determine how funds in the account should be distributed. Chandler argued that under either ERISA rules or the Internal Revenue Code, she was entitled to the funds as the surviving spouse.

The district court ruled in favor of Wilson's children, noting that he and Chandler were not married until several years after he had ended his participation in the 401(k) plan. Chandler

appealed, arguing that the surviving spouse protections afforded under ERISA continued to apply even after the funds were rolled over into an independently managed IRA.

The U.S. Court of Appeals (9th Cir.) said that ERISA's surviving spouse provisions "may apply only when an ERISA-qualified plan is implicated." The employer's plan was ERISA-qualified, the court noted, but the protections ended when Wilson ceased participating in the plan and transferred the proceeds to an independent IRA. The surviving spouse protection applies only to an "employee benefit plan" that is "established or maintained" by an employer, said the court. The IRA was established and maintained by Wilson. The court added that IRAs are specifically excluded

from ERISA's coverage [29 C.F.R. §2510.3-2(d)(1)]. The fact that contributions to the plan made in the past by a former employer were transferred to the IRA does not mean that the employer "maintained" the rollover IRA, ruled the court, which found no grounds to extend surviving spouse coverage to IRAs (*Charles Schwab & Co., Inc., v. Chandler*, No. 07-15261 D.C. No. CV-06-00119-FJM).

#### **SOURCE OF FUNDS MADE EXPENSIVE DIFFERENCE**

Due to a poor credit rating, John Armbrust was unable to finance the home he wanted to purchase. Instead, his father closed on the home in 2006, getting a mortgage and recording the deed in his own name. John Armbrust made all mortgage payments and in 2008, the father executed a quitclaim deed transferring the home to Armbrust and his wife.

Shortly after the closing, Armbrust requested a \$50,000 lump-sum distribution from his employer's retirement plan, which was in the process of converting from a pension plan to a 401(k) plan. He used \$21,700 to reimburse his father for the down payment and had \$10,000 withheld for federal taxes.

The IRS claimed that Armbrust owed \$5,000 – 10% of the lump sum distribution – in additional income tax in 2006 for the premature distribution [Code §72(t)]. Armbrust acknowledged that the distribution was made prior to age 59½, but argued that it met the exception under Code §72(t)(2)(F) for distributions of up to \$10,000 for first-time home buyers.

#### **PHILANTHROPY PUZZLER**

Jeff consulted his attorney about establishing a charitable lead trust to benefit his favorite charity. He would like the trust to last for ten years, with the assets then coming back to him. The attorney explained that although Jeff would be entitled to an income tax charitable deduction, he will be subject to tax on the trust's income each year because he will be considered the owner of the trust. Jeff has asked what happens if he dies before the end of the trust term.

The Tax Court agreed with the IRS that the exception did not apply because Armbrust withdrew the funds from an employer-sponsored plan, not an IRA. Code §72(t)(2)(F) provides that distributions "from an individual retirement plan" that are qualified first-time home buyer distributions are not subject to the 10% penalty. Even if the distribution had come from a 401(k) rather than a pension plan, the court added, the outcome would be the same (*Armbrust v. Comm'r.*, T.C. Summ. Op. 2010-5).

#### **"EXCESS TO CHARITY" FORMULA FRUSTRATES IRS**

Anne Petter inherited shares of UPS stock from her uncle in 1982. The value in 1998 was about \$12 million, which prompted her to consult an estate planner. Her goals were to provide a comfortable life for her two children and give to charity. She knew her children would need help investing and managing the money.

Petter created a life insurance trust for her children and grandchildren and a 5% charitable remainder unitrust, which would provide funds to cover her day-to-day expenses for life.

She also created a family LLC and trusts. Prior to funding the trust, UPS announced it was going public, preventing Petter from funding the trust immediately. When the public offering was completed, Petter's stock had risen in value to \$22.6 million. She transferred the shares to the LLC and established intentionally defective trusts for her children. She gave LLC units to the trusts and sold other units in return for interest-bearing promissory notes. She also gave units to the Seattle Foundation and the Kitsap Community Foundation. Petter had nearly \$908,000 in unused applicable gift tax exclusion. Her plan used a formula to make gifts of LLC units to the trusts. Each trust was to receive an amount equal to half the unused exclusion, with any amount above that passing to the two foundations.

The IRS claimed the value of the LLC units was higher than originally determined, with the parties eventually agreeing on a value of \$744.74 per unit. Petter's plan called for any revaluation to trigger a reallocation of shares from the trusts to the charities, resulting in a greater charitable deduction but

no additional gift tax. The IRS claimed that the formula clause used in the plan was void, as contrary to public policy. Allowing such a reallocation reduces the incentive for the IRS to audit returns, since any additional value passes to charity, while not resulting in additional taxes.

The Tax Court found that the plain language of the documents showed Petter was giving gifts of an ascertainable dollar value of stock, not a specific number of shares or a specific percentage interest. The court also noted that both foundations retained their own counsel, won changes to the documents to protect their interests and at all times conducted arm's-length negotiations with Petter. The court said it was "confident that this gift was made in good faith and in keeping with Congress's overall policy of encouraging gifts to charities." This was not, as the IRS had argued, a gift that was susceptible to abuse, or a reason to find the transfers void on public policy grounds (*Est. of Petter v. Comm'r.*, T.C. Memo. 2009-280).

#### CITY CAN'T LEASE DONATED PARK LAND

Fox Chase Cancer Center approached the City of Philadelphia about a long-term lease of park property adjacent to the Center's campus. The plan was to build as many as 18 buildings on the land, in order to expand its facilities. Much of the land was originally bequeathed to the city by Robert Ryerss in 1889, to be used as a public park "for the use and enjoyment of the people forever." The city council approved the lease terms, noting that it was no longer practicable or possible to continue using the land as public park. The city found that failure to negotiate the lease would cause Fox Chase to relocate, causing the loss of thousands of jobs and harming the city's tax base.

Several taxpayers challenged the lease. The orphans' court denied the city's petition, based primarily on common law public trust doctrine. The city claimed that under the state's Donated or Dedicated Property Act (DDPA), the city is entitled to sell the property if the "original trust purpose is no longer practicable or possible or in the public interest." The court, however, noted that the DDPA applies only where there has been no formal record of acceptance of donated land.

The City of Philadelphia had enacted an ordinance in 1905 officially accepting the devise and incorporating language from Ryerss' will regarding the purposes of the bequest.

The Commonwealth Court of Pennsylvania found that the DDPA was applicable to the petition, but looked to whether the continued use as a park was no longer practicable or possible. While the decision of a political subdivision is given "considerable deference," the court found the city did not show the use was no longer practicable or possible or that the property had ceased to serve the public interest. In addition to the bequest of the land, Ryerss also created an endowment to maintain the park. That fund had over \$1 million as of August 2008, so the city could not claim that the park created a financial hardship.

The city argued that the use as parkland was not the most beneficial use of the property, but the court found that the park is popular and actively used. Allowing municipalities to balance the benefits of varying uses would "likely discourage individuals from donating their property to be used for public purposes in the future," said the court. While acknowledging that Fox Chase makes an important contribution to the city and expressing the hope that the Center does not leave the city, the court ruled that the city was not entitled to proceed with the lease of the land (*In re Est. of Ryerss*, No. 2446 C.D. 2008).

#### PUZZLER SOLUTION

Under the recapture rule, a portion of the income tax charitable deduction will be added to Jeff's final income tax return [Reg. §1.170A-6(c)(4)]. The amount paid to charity each year will be discounted, using IRS actuarial tables. The total of the discounted values of all payments made between the date the trust was created and the date of Jeff's death would be subtracted from the charitable deduction originally claimed. Any excess would be added to gross income for the year of his death.

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## FINDING A PLACE FOR CHARITY IN LIVING TRUSTS

Living trusts have a number of estate planning advantages, enabling clients to:

- cut estate administration expenses by reducing the size of the probate estate;
- provide for quicker distribution of estate assets to beneficiaries;
- maintain confidentiality;
- provide for management of assets in the event of disability;
- consolidate distribution of retirement benefits, life insurance proceeds and assets passing under a will;
- avoid ancillary probate action for decedents with assets in more than one state;
- shift investment and management obligations;
- provide for continued operation and smooth transition of a closely held business at death; and
- avoid many formalities of drafting a will.

Revocable living trusts also offers a variety of ways to make gifts to charity.

*Lifetime gifts* – The grantor can name charity an income beneficiary of a living trust. For example, Duane provides in his trust that the trustee will pay 5% of the income to his church. If trust income is \$20,000, the trustee will pay \$1,000 to the church. Duane will be entitled to an income tax deduction in that amount.

*Distributions at death* – The grantor can direct that at his or her death, the trustee will distribute certain assets or a percentage of the trust corpus to charity. The estate is entitled to a charitable deduction for the value of charity's interest.

Why would someone prefer to leave assets to charity through a trust rather than by will? First, it may be easier and less expensive to make later adjustments in charity's interest through a trust than to have a new will or codicil drafted. Assets will pass to charity faster through a trust than a will. Privacy may be a consideration

and the gift may be harder to contest.

*Revocable charitable remainder trust* – Clients can create revocable inter vivos trusts that provide them income for life with remainder to a charity. The donor obtains no particular income tax benefits from the trust, but he or she is able to exercise unlimited control over the trust, which is not possible with a qualified charitable remainder trust. Upon the donor's death, if the trust has not been revoked, the trust assets will be included in the donor's gross estate but will wash out as an estate tax charitable deduction [Code §2055].

*Conversion into qualified charitable remainder trust* – Clients can provide that their revocable living trusts be transformed at death into qualified charitable remainder trusts that will provide lifetime income to a family member plus a substantial estate tax charitable deduction for the value of charity's remainder interest.

*Conversion into irrevocable, nonqualified charitable remainder trust* – Clients may wish to have their revocable trusts become irrevocable at death, paying income to a private beneficiary, with remainder to charity. Such a trust makes sense where the client is willing to sacrifice the estate tax charitable deduction in order to have more flexibility for family beneficiaries (permitting invasion of trust principal, for example). Where the estate is too small to pay federal estate tax, the loss of the charitable deduction will be academic.

*Conversion into QTIP trust, remainder to charity* – A client's revocable living trust can become an irrevocable QTIP trust at death, securing the unlimited estate tax marital deduction [Code §2056(b)(8)] and a subsequent, unlimited estate tax charitable deduction upon the death of the surviving spouse – with charity as remainderman. As noted above, a qualified charitable remainder trust is unnecessary where estate taxes are not a problem at the death of the client [Code §§2044(c), 2055].

