DALLAS JEWISH COMMUNITY FOUNDATION

# The Advisor

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## ESTATE PLANNER'S TIP

Although the exact figures keep climbing, tens of trillions of dollars are expected ultimately to pass from the World War II generation to their Baby Boomer children. It's a good idea for 40- and 50-something clients to consider how any anticipated bequests from parents (or grandparents) will affect their own estate planning. Clients should plan not only for the estates they expect to accumulate on their own, but also for distributions from parents' estates. Multi-generational estate tax planning may be desirable, necessitating changes to the estate plans of the parents. Among the options available: have grandparents leave assets to grandchildren rather than children, keeping in mind the generation-skipping transfer tax and taking advantage of the $2 million exemption ($3.5 million in 2009); incorporate disclaimer language in the estate plans of the older generation to direct assets to other family members or charity if the children do not need the bequest; or the use of trusts that provide the clients with income but won't cause the assets to be included in their gross estates.

## EXCHANGE OF A PART FOR A WHOLE GENERATES NO TAX

Charles owned three parcels of real property at his death that had been held for income and investment purposes. He left Parcel 1 to his wife; Parcels 2 and 3 were placed in trust for the benefit of his wife for her life, with the remainder to his four children. Shortly after his death, his wife transferred Parcel 1 to the children as tenants-in-common.

The trustees and three of the children decided to sell their holdings in all three parcels. One of the children, Jane, did not want to sell, so the parties agreed that Jane would exchange her undivided 25% interest in Parcel 1 for a 100% unencumbered fee simple interest in Parcel 3. The parties agreed that the fair market value of the undivided interest and the fee simple interest were equal. Following the exchange, the trust and Jane's siblings sold Parcels 1 and 2 to an unrelated third party.

Code §1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind to be held for business use or investment. In Rev. Rul. 73-476 (1973-2 C.B. 300), the IRS ruled that an exchange of an undivided interest in multiple parcels of real estate for 100% ownership of one or more parcels of the same real estate qualifies as a like-kind exchange. In the case of exchanges between related parties, Code §1031(f)(1) provides that the nonrecognition does not apply if there is a disposition of the property within two years.

The IRS determined that the exchange of Jane's undivided interest for a fee simple interest was a like-kind exchange. Further, neither the exchange nor the subsequent disposition of Parcel 1 caused recognition of gain. Because of the step-up in basis that occurred when Jane's father died owning the parcels, the avoidance of income tax was not one of the principal purposes of the exchange between the related parties (Ltr. Rul. 200706001).

### TUITION AT SPECIAL SCHOOL IS MEDICAL EXPENSE

Joyce has been diagnosed with several developmental disorders, requiring that she receive special education assistance at the local public school. After a series of tests, a neuronpsychologist determined that Joyce needed different schooling that was more therapeutic and specialized in dealing with her conditions.

Her parents enrolled Joyce at a school established to help students overcome her specific conditions. The school accepts only students with these documented conditions. The school has special education teachers, mental health specialists, a speech pathologist and an occupational therapist. The school's curriculum focuses on basic skills, plus emphasis on social and life skill development targeting emotional regulation, conflict resolution, communication and independent living.

#### PHILANTHROPY PUZZLER

Bernie was planning to create a charitable remainder trust but didn't want his favorite charity to have to wait until his death before receiving any benefits. His lawyer suggested that he could include the charity as an income beneficiary, as well as remainder beneficiary, of the trust. In reviewing the computation of his charitable deduction with Bernie, the lawyer explained that he could deduct the value of charity's remainder interest but could deduct nothing as to charity's share of the income interest. Bernie has asked why.

Reg. §1.213-1(e)(1)(v)(a) provides that the cost of ordinary education is not medical care. However, the cost of attending a special school for a mental or physical handicap may be a medical expense if the student's condition is such that the resources of the school for alleviating the handicap are the principal reason for the child to attend the school. The deduction includes the cost of attending the school, meals and lodging, plus the cost of ordinary education furnished at the school if incidental to the special services furnished by the school

The IRS determined that the school Joyce attends uses special teaching techniques to assist its students to overcome Joyce's condition. It is a "special school" within the meaning of Reg. §1.213-1(e)(1)(v)(a), making the cost deductible as a medical expense under Code §213 (Ltr. Rul. 200704001).

### EXECUTOR'S OVERREACHING HAND GETS SLAPPED

E. Tefft Barker had been Dorothy Witherill's attorney for many years prior to her death in 1998. After his retirement in 1984, he continued to act as her financial advisor at a fee of $17,000 per month. Barker and his former legal secretary, Dorothy Ritchie, were named Witherill's coexecutors, although Ritchie's role was primarily to carry out Barker's decisions.

The final accounting for Witherill's estate was filed in 2003, at which time the sole residuary beneficiary, Central New York Community Foundation, filed objections. The Surrogate's Court imposed surcharges on the coexecutors, denied Barker's commissions and revoked his appointment as executor, citing misconduct in the handling of Witherill's estate. Barker appealed the ruling.

The Appellate Division of the Supreme Court of New York (3rd Dept.) found the Surrogate's Court had applied the correct standards in assessing Barker's performance, adding that the record showed self-dealing, misfeasance and gross negligence. The court noted that Barker was paid handsomely for his financial services, obligating him to exercise diligence in investing and managing the assets.

The Surrogate's Court had assessed an $85,000 surcharge for an advanced payment he directed Ritchie to make to him for his services to Witherill when he discovered her death was imminent, noting that he should have returned the unearned funds to the estate. There was an additional $92,000 surcharge for falsely claiming a reimbursement owed to him from Witherill.

The court also determined that nearly three years after all the estate's debts and administrative expenses had been paid, Barker took at least half the assets from New York to Florida without consulting the Foundation or Ritchie or seeking court approval. He invested the funds in a junk bond mutual fund that he failed to monitor for nearly 17 months, resulting in losses to the estate. Barker then had the estate pay $10,000 in legal fees to determine whether to sue the broker for the loss. The court found the fees to be an attempt to "rectify his own persistent neglect."

The court also found that Barker had "intentionally and unreasonably delayed making distributions of estate assets" to the Foundation, noting that he had acted in bad faith, motivated out of spite due to the Foundation's separate litigation against him challenging a charitable remainder unitrust that he had set up for Witherill, naming himself and his wife as income beneficiaries. The appeals court said his pattern of misconduct warranted the denial of commissions and revocation of letters of administration (*In the Matter of Witherill*, 2007 NY Slip Op 00704).

### CHARITY HASN'T USED WHAT IT RECEIVED, DOESN'T GET MORE

Anna Martin left a 65-acre parcel of land to the Lorain YWCA at her death in 1964, with directions that it be used only for the benefit of the members and that the grounds should be kept "in a beautiful and attractive condition." For years the YWCA made no use of the property, finally petitioning the probate court in 1994 to allow a sale to a church that was better suited to fulfill Martin's charitable intent. The proceeds of the sale – $317,500 – were to be placed in a trust by the YWCA, but the church was required to permit the YWCA to use any facilities that might be developed on the land.

In 2004, the church conveyed the property to a trust, which sought probate court approval to sell the land to a developer without deed restrictions. The trustees claimed that the cost of maintaining the property was prohibitive and that sale proceeds would be set aside for a charitable purpose. The probate court approved the sale, directing that the $1.2 million sale price pass to the Community Foundation of Greater Lorain County. The Foundation was to establish two $150,000 endowed funds for the Lorain and Elyria YWCAs and use the balance to support organizations providing services for local women and girls.

The Lorain YWCA appealed, objecting not to the sale of the land, but to how the proceeds were to be distributed. The YWCA claimed that it had a separate interest in the property based on the 1994 deed restrictions and was entitled to $450,000 of the proceeds because Martin had intended the organization to receive the sole benefit of her bequest.

The Court of Appeals of Ohio noted that Martin's charitable bequest had already been modified in 1994 when the YWCA requested the right to sell the land. The YWCA received more than $300,000 at that time. Further, said the court, in the 30 years from Martin's death until the sale to the church, the YWCA never used the

**PUZZLER SOLUTION**

In order to deduct the value of charity's income interest in a trust, the grantor must be considered the owner of the trust [Code §170(f)(2)(B)], as in a reversionary charitable lead trust. But for charitable remainder trust purposes, a qualified trust is not created until neither the grantor nor any other person is considered the owner under the grantor trust rules (Code §§671-677). Bernie receives no additional deduction for charity's income interest. A different rule applies to testamentary trusts, where the estate can be entitled to a deduction for the value of charity's income and remainder trust interests [*Estate of Boeshore v. Comm'r.*, 78 T.C. No. 34].

property for the benefit of its members or for any other purpose. The YWCA also never used its rights in the property between 1994 and 2004. Nor has the YWCA made use of the 1994 sale proceeds that were placed in trust. For more than 40 years, the YWCA had failed to fulfill Martin's charitable intentions, said the court. The probate court was correct in declining to allocate more to the YWCA that might sit unused and benefit no one. The community foundation, on the other hand, was in the business of putting charitable dollars to use in the $3.5 million that it distributed each year (*Kayatin v. Petro*, 2007 Ohio 334).

## SWEET DREAMS WITH ESOP FABLE

"If you can't avoid capital gains tax entirely, at least postpone it as long as possible." That's the advice given by many financial and tax advisors to their clients when the discussion turns to ways of selling a closely held C corporation. There is a technique, however, that allows capital gains tax to be postponed – and when coupled with charitable gifts, possibly avoided entirely.

A business owner can create an employee stock ownership plan (ESOP), sell shares of the company stock held at least three years to the ESOP and defer the capital gain by reinvesting the proceeds in shares of stock of domestic corporations within 12 months. The basis in the qualified replacement property (QRP) is the same as the basis in the shares sold to the ESOP. Gain normally is recognized when the QRP is sold [Code §1042(e)(1)]. The ESOP, a defined contribution plan qualifying under Code §401(a), must own at least 30% of the company's outstanding shares.

In addition to deferring the capital gain until the QRP shares are sold, the ESOP allows a business owner to diversify holdings that might otherwise be too heavily invested in a single company.

But it's possible for a client to defer the capital gain even further – or avoid it entirely – with gifts of QRP to charity. Under Code §1042(e)(3), the capital gain recapture rules do not apply to transfers of the QRP by gift, including gifts to charity. The IRS has ruled that an outright gift of QRP to charity does not cause a recapture of capital gain because the donor does not receive money or other property as a result of the transfer (Ltr. Rul. 9533038).

What about a transfer to a charitable remainder trust where the donor reserves an income interest in the gift property? The IRS has ruled that a transfer of QRP to a charitable remainder trust is a gift that does not trigger the capital gain (e.g., Ltr. Ruls. 9438012, 9438021). When the QRP is sold by the trustee of the charitable remainder trust, the gain is sheltered within the tax-exempt trust. The donor/beneficiary will be taxed on the capital gain under the four-tier system of Reg. §1.664-1(d)(1), meaning a portion of the payout will be taxed at favorable capital gains tax rates (15% maximum).

It's also possible for the business owner to fund the charitable remainder trust with company shares and allow the trustee to sell the shares to the ESOP, provided there is no requirement that the trustee sell the shares to the ESOP. This bypasses the Code §1042 requirements entirely.

If the donor has family members who would otherwise receive the QRP, the plan can incorporate an irrevocable life insurance trust with *Crummey* powers. The life insurance trust allows the donor to replace the QRP with the proceeds of the insurance while avoiding or minimizing gift and estate taxes on the transfer.

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