

The Advisor

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ESTATE PLANNER'S TIP

While it may seem counterintuitive, clients between the ages of 59½ and 70½ might consider taking withdrawals from their IRAs and reinvesting the proceeds. Although the distributions will be subject to tax, there is no early withdrawal penalty. Withdrawals will reduce the size of the IRA and amounts that will have to be taken when required minimum distributions begin at age 70½. Use caution to avoid having the distribution push the client into a higher tax bracket. For example, a married couple with taxable income of \$75,000 is in the 25% bracket. They can withdraw up to \$53,500 before they move into the 28% tax bracket. The client can invest the funds (holding out enough to pay taxes) in a brokerage account that will generate capital gains or favorably taxed dividends, rather than ordinary income, in the future. Furthermore, the brokerage account gets a stepped-up basis at death, unlike an IRA which is subject to the tax on income in respect of a decedent [Code §691]. Another option: Convert the funds to a Roth IRA that will continue to grow tax deferred. Qualified distributions from Roth IRAs are tax free and there are no required minimum distributions. Assets in a Roth are not subject to the tax on IRD at the owner's death. Keep in mind, however, that through 2009, taxpayers with adjusted gross income in excess of \$100,000 are not eligible to make a Roth conversion.

ANOTHER YEAR, ANOTHER TAX LAW CHANGE

The Small Business and Work Opportunity Tax Act of 2007 includes a number of provisions aimed at easing the impact on business owners of the higher federal minimum wage being phased in over two years. Among the changes:

Small business expensing – For 2007, businesses formerly could deduct in the current year, rather than through depreciation, up to \$112,000 (as indexed) for qualifying property put into service during the year [Code §179]. The new law increases the amount to \$125,000 for tax years beginning in 2007 through 2010. The increase will also be indexed for inflation.

Under prior law, the expensing limit was to drop to \$25,000 in 2010. The new law also retroactively increases the investment limit from \$450,000 to \$500,000 (indexed annually for inflation).

Married couples in business – If a husband and wife are the only members of an unincorporated business and file a joint tax return, they now can elect not to be treated as a partnership. They would instead report their shares of the income on Schedule C. The change applies only if they both materially participate in the business and allows both to participate in Social Security instead of attributing all the income

to only one of the spouses.

To help offset the cost of the tax relief provisions, the new law includes several revenue raisers, including:

Kiddie tax – The Tax Increase Prevention and Reconciliation Act increased the age limit for the kiddie tax from 14 to 17, retroactive to January 2006. The new law increases the age again, to cover all children under age 19 and students under age 24, effective for tax years beginning after May 25, 2007. For 2007, the tax applies to unearned income over \$1,700. This may complicate the plans of parents who were counting on the capital gains tax rate dropping to zero (beginning next year and continuing through 2010) for taxpayers in the 10% and 15% tax brackets. Stock can be sold free of the kiddie tax through the remainder of 2007 by those age 18 and older, but parents no longer have an incentive to transfer appreciated securities to children, expecting that they can sell, capital gains tax free, from 2008 through 2010 to finance college expenses. The kiddie tax rule does not apply to those age 18 and older if earned income exceeds half the student's support.

Bad checks – Bounce a check to the IRS and the fee increases from \$15 to \$25 for checks of \$1,250 or less (previously \$750 or less). The bad check fee for higher amounts is 2%.

PHILANTHROPY PUZZLER

George owns stock that has increased in value several-fold over the price he paid a number of years ago. He has always wanted to help his favorite charity, but hoped eventually to leave the assets to his children to augment their retirement savings. George read about a charitable lead trust that pays an annuity to charity for several years and then transfers the assets to family members, at reduced transfer tax cost. He has asked whether his stock would be a good asset with which to fund a lead trust.

EXECUTOR CAN'T PICK AND CHOOSE

Elliot Goldman left specific bequests to several charities, to be paid after expenses, costs and other distributions. If funds were insufficient to pay the entire amount, the charitable bequests were to be paid on a pro rata basis. The value of the estate was initially placed at \$2.7 million. Bequests to family members were valued at about \$2 million and debts, funeral and administrative expenses totaled about \$1.5 million, leaving nothing to pay the charitable bequests.

Several years into probate, the estate's real property was reappraised. Thanks to an increase in value, the estate had a balance of \$1.8 million. Jay Goldman, acting as executor of his brother's estate, satisfied all the charitable bequests in full, except for the \$50,000 left to the Jewish Community Foundation of Southern Arizona. The foundation filed suit for an accounting. The probate court, which determined that the bequest to the foundation had not abated, ordered Jay to pay the \$50,000 plus interest.

Jay appealed, claiming that the earlier bequests exhausted the estate's assets, thereby abating the charitable bequests. There was no basis, he said, for claiming an abated bequest is "somehow resurrected because probate assets later appreciate in value." Post-death appreciation should benefit creditors and unabated beneficiaries, he argued.

The Court of Appeals of Arizona agreed with the probate court, saying that a decedent's estate is not fixed at death, but includes property existing throughout the administration of the estate. State law on abatement looks to the value of the estate at the time of distribution, not at the date of death, noted the court. The rule requiring the date-of-distribution values to be used encourages the executor to settle and distribute the estate more expeditiously, said the court. Nothing in Elliot's will suggested that he intended the date of death value to control (*In re Estate of Goldman*, 2 CA-CV 2006-0138).

PAIR "FORGETS" PHILANTHROPIC PROMISES

In early 2001, Albert Stewart had a new will drafted leaving his entire estate – worth more than

\$637,000 – equally to his niece and nephew, Alice and Rudolf Noble. He left nothing to his sons, Charles and Michael. Stewart indicated that he intended his estate to be used for philanthropic purposes and trusted Alice to carry out his wishes.

Stewart died about six weeks after executing the will. Alice and Rudolf immediately paid the estate to themselves, despite a provision requiring that the funds be held in trust for five years to allow time for will contests and to give Alice and Rudolf time to seek advice on carrying out Albert's philanthropic wishes. Alice established a scholarship at an area college, gave \$2,000 to a local school and bought a computer for a young student. She kept the remainder of the funds. Rudolf used the bulk of his share to purchase a home and made no charitable expenditures.

Charles and Michael sued, claiming that the pair received the estate through fraud. The circuit court granted the Nobles a summary judgment, but the Court of Appeals of Kentucky found sufficient evidence for a jury to conclude that the two obtained the bequests by fraudulently misleading Albert to think they would carry out his philanthropic goals when, in fact, they had no intention of doing so. The court said the "relatively insignificant portion" of the estate used for philanthropy and the pair's disregard for the trust provisions in the will reflected an absence of intent to comply with his wishes (*Stewart v. Noble*, No. 2006-CA-000588-MR).

AN OPTION FOR AVOIDING SELF-DEALING

Bill and Mabel created revocable trusts that are to pass a significant portion of their estate to their private foundation at the death of the survivor. The couple have entered into an option agreement with their company that allows the purchase of the company's shares from the revocable trusts or the estate at the survivor's death. The purchase price will be the independent appraised fair market value as determined for estate tax purposes. If the company exercises the option, it may choose to pay by certified check, cash, wire transfer or by an installment note payable in not more than 15 annual installments at a stated interest rate.

Under Code §4941(d)(1), self-dealing includes any sale or exchange between a private foundation and a disqualified person. Because the company is a disqualified person with regard to the foundation, the sale of the shares by the foundation would be a prohibited act of self-dealing, subject to penalties. However, there is an exception [Reg. §53.4941(d)-1(b)(3)] relating to a foundation's interest or expectancy in property held by an estate or revocable trust. A transaction is not considered self dealing if (1) the executor has the power to sell or is required to do so under the terms of an option, (2) the transaction is approved by the probate court, (3) the sale occurs before the estate is terminated for federal income tax purposes, (4) the estate receives an amount equal to or exceeding fair market value and (5) the foundation receives an interest at least as liquid as what it gave up.

The IRS noted that Bill and Mabel's executor will petition the court for approval of the exercise of the option prior to the date when the estate is terminated for tax purposes. Therefore, the exercise of the option and purchase of the shares will not be self-dealing. The IRS added that if the company opts to pay by promissory note, neither the foundation's receipt of the promissory from the estate or trust, nor the retention of the note and receipt of the payments will be self-dealing (*Ltr. Rul. 200722029*).

PUZZLER SOLUTION

If the shares produce sufficient dividends to pay charity's lead interest, there is no drawback to using them to fund the trust. If the trustee is required to sell some shares in order to produce sufficient income, the trust will realize capital gain but should be entitled to an offsetting charitable deduction when it makes a distribution to charity. The IRS has also ruled that if a lead annuity trust distributes stock to charity to satisfy a payment, it realizes capital gain, but will be entitled to a charitable deduction for the distribution (*Rev. Rul. 83-75, 1983-1 C.B. 114*).

IRS ISSUES GUIDANCE ON VALUING RETAINED INTERESTS, PERCENTAGE LIMITATIONS ON CONSERVATION EASEMENTS

The IRS recently issued proposed regulations on the portion of trust property to be included in the gross estate under Code §§2036 and 2039 where the decedent retained the right to an annuity, unitrust or other income for life (REG-119097-05). This pertains not only to charitable remainder unitrusts and annuity trusts, but also to grantor retained annuity trusts (GRATs), grantor retained unitrusts (GRUTs), grantor retained income trusts (GRITs) and qualified personal residence trusts (QPRTs). The IRS noted that the rules also apply to nonqualified charitable remainder trusts.

In Rev. Rul. 76-273 (1976-2 C.B. 268), the IRS ruled that for purposes of Code §2036(a), the portion of the value of the trust corpus includible in the decedent's gross estate is the portion necessary to yield the amount of the annual unitrust payment, at the interest rate in effect at death, in perpetuity. Rev. Rul. 82-105 (1982-1 C.B. 133) provided guidance on the amount included in the estate where the decedent created an inter vivos charitable remainder annuity trust, retaining the right to a fixed annuity for life. The proposed regulations incorporate the rules set forth in these revenue rulings.

Reg. §20.2036-1(c)(2)(i) gives the example of a decedent who transferred \$100,000 to a charitable remainder annuity trust that is to pay \$12,000 annually for the donor's life and then a child's life before distributing the remainder to a charity. At the donor's death, the child is age 40, the value of the trust's assets is \$300,000 and the §7520 rate is 6%. The amount of corpus necessary to yield the annuity payment is the annual annuity

(\$12,000)/§7520 rate (.06), or \$200,000. That amount is included in the donor's gross estate under Code §2036(a)(1). The estate may also deduct the approximately \$30,000 present value of the charity's remainder interest in the annuity trust [Code §2055].

In the case of a unitrust, the amount included in the estate is the amount of corpus necessary to yield the unitrust payments. This is determined by dividing the trust's equivalent income interest rate by the §7520 rate in effect at the decedent's death.

Through 2007, deductions for qualified conservation contributions are subject to a 50%-of-AGI limitation, rather than the usual 30% limit that applies to gifts of capital gain property [Code §170(b)(1)]. This change was included in the Pension Protection Act of 2006. Any excess contributions may be carried over for up to 15 years. Under Code §170(b)(1)(E)(iv), qualified farmers and ranchers may claim deductions of up to 100% of AGI for qualified conservation contributions, provided the property remains available for agriculture or livestock production.

In Notice 2007-50, the IRS answers questions concerning the ordering rules for conservation deductions. For example, if a donor who is not a farmer or rancher has a contribution base of \$100 in 2007 and makes \$60 in cash contributions and also a qualified conservation contribution with a value of \$80, the donor may deduct \$50 of the cash contributions, with a five-year carryover for the extra \$10. None of the conservation easement is deductible, but the entire \$80 is carried over for up to 15 years.

