DALLAS JEWISH COMMUNITY FOUNDATION

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ESTATE PLANNER'S TIP

Most parents have an idea of which person they would like to see raise their minor children should the children become orphaned. In the absence of an expressed direction in a will, a court will make the decision based on the best interests of the children. The court's decision may not always be what the parents would have wanted. Therefore, parents should state their preference for a person or persons to have custody of the children. There may be two guardians. The guardian of the person is responsible for making decisions for the minor children on matters of schooling, medical care and discipline. Although the court still must approve the placement, the parents' wishes are generally followed. But in addition to a guardian of the person, there may be a guardian of the children's estate. The guardian of the estate is responsible for making investment decisions and accounting for the funds. Some jurisdictions require a bond or insurance for this person, unless waived in the will. In many cases, the two roles can be filled by the same person or persons. Sometimes, however, the parents might feel the two jobs should go to different people. Whatever the parents' desires, spelling out their objectives in as much detail as possible will help assure the parents that, as nearly as possible, their wishes for the children will be carried out.

"MY ESTATE" MEANS JUST PROBATE ESTATE

Arshad Malik's will directed that "all taxes shall be paid by my estate." Malik's fiancee was the sole beneficiary of his will, although several other beneficiaries received nonprobate assets. The executor sought to apportion federal and state taxes between the estate and recipients of nonprobate assets. The trial court rejected that move, saying that taxes were to be paid under the "burden of the residue" rule.

The value of the probate estate was $185,000, with taxes and administrative expenses totaling $112,845. The executor sought reimbursement for taxes under the principle of equitable apportionment, where the burden of certain expenses is distributed among the beneficiaries proportionate to the expenses incurred by their bequests. State (Illinois) law does not provide for equitable apportionment, although the supreme court has allowed apportionment where the decedent died intestate or did not provide direction for the payment of taxes in the will.

A testator's intent must be drawn from the language of the will, said the Illinois Appellate Court, adding that surrounding circumstances

are not to be considered unless language in the will is ambiguous or uncertain. Where the language is clear and unmistakable on its face, it will be taken as an expression of the testator's intent. The question, said the court, was whether "my estate" used in Malik's will included the recipients of nonprobate assets in determining liability for taxes. The court ruled that without a modifier, the word "estate" should not be broadened to include assets passing outside the will (*Estate of Malik v. Jafar Lashkariya*, No. 95 P 4347).

TIMING OF DEATH SIDESTEPS IRD

Sam's revocable living trust had negotiated for the sale of real property, expecting to close on a specified date. Prior to that day, the parties discovered a gas pipeline located underneath the land. The closing was delayed to resolve issues relating to restitution and easements. Sam died before the matters were resolved.

In Rev. Rul. 78-32 (1978-1 C.B. 198), an individual who had entered into a binding sale contract had completed all of the prerequisites for consummating the sale and was unconditionally entitled to the sale proceeds at the time of death. The gain realized when the sale was completed by the executor was held to be income in respect of a decedent under Code §691(a).

In Sam's case, however, various issues needed to be addressed before the sale could be completed. The discovery of the pipeline created contingencies that might have disrupted the sale prior to Sam's death, said the IRS. Therefore, the gain realized from the sale after Sam's death is not income in respect of a decedent, ruled the IRS. The trust's basis in the property before the sale is determined under Code §1014(a) (Ltr. Rul. 200744001).

PHILANTHROPY PUZZLER

Harold and his wife, Carole, are in the process of a divorce. As part of the settlement agreement, Harold has agreed to pay Carole $5,000 per year for ten years. He wishes to satisfy this obligation by contributing appreciated stock to a term-of-years charitable remainder annuity trust that would pay Carole $5,000 annually, then transfer the assets to his favorite charity. What are the tax consequences of the proposed arrangement?

SUBSTANTIAL, NOT STRICT, COMPLIANCE SUFFICIENT FOR IRS

A grandmother made gifts to qualified tuition programs for each of her eight grandchildren. She filed Form 709 on which she reported the gifts, attaching a sheet indicating that she intended to prorate each contribution over a five-year period. She did not check the box to make an election under Code §529(c)(2)(B) to treat each gift as ratably made over five years. The gifts were not in excess of five times the annual gift tax exclusion under Code §2503(b).

Code §529(c)(2)(A) provides that contributions to 529 plans are treated as completed gifts of present interests, provided the donor does not exceed the gift tax limitation. The election to treat the gift as ratably made is to be noted on the Form 709 for the year of the contribution.

Although the donor failed to check the appropriate box on her Form 709, literal compliance with procedural instructions is not always necessary, said the IRS. An election that does not strictly comply will be valid if information on the return is sufficient to indicate the intent to make the election. Because the grandmother stated on the attachment that each gift was to be prorated over five years, the IRS said that it substantially complied with the requirements and the donor was deemed to have made a valid and timely election (Ltr. Rul. 200743001).

ATTORNEY DOESN'T "OWN" DEFENSE DOCUMENTS

Leslie Stephen Jones contributed 171 boxes of photocopied documents to the University of Texas at Austin in 1997. These were items he had received from the FBI in connection with his

defense of Timothy McVeigh for the bombing of the federal building in Oklahoma City in 1995. Jones claimed a charitable deduction of nearly $295,000, based on an appraisal which discounted the materials by 50% because none of the documents was original. Jones did not personally prepare any of the material.

The IRS disallowed the deduction, saying that Jones did not own the items that were provided to him for the purpose of preparing McVeigh's defense. The Tax Court noted that state (Oklahoma) law does not address the issue of ownership of client files. In general, possession of personal property is evidence of ownership, but because of the fiduciary relationship between attorneys and clients, the court said it was not persuaded that items in a lawyer's possession were owned by the lawyer.

The majority of jurisdictions have held that clients are the legal owners of their case files, reasoning that they purchased the material when paying the attorney's fees. Other jurisdictions have held that an attorney's work product remains the attorney's property, although clients have a superior right in the end product. Oklahoma's Rules of Professional Conduct provide that clients have ownership rights in their case files. Jones argued that McVeigh waived attorney-client privilege, but the court said that Jones is nevertheless bound by ethical considerations to refrain from disclosing or capitalizing on information relating to his representation. Although McVeigh cannot seek, and his successors likely would not seek, to enforce the rules of professional conduct, the court said that Jones was not entitled to capitalize on the material for his personal gain. The court said it was not required to address the ownership issue, since the documents were not Jones' work product, or the valuation issue, since Jones was not legally entitled to donate the material. The court added, however, that even if the documents were work product, the deduction would be limited to basis under Code §170(e)(1)(A). There was no evidence that the basis was greater than zero, noted the court (*Jones v. Comm'r.*, 129 T.C. No. 16).

COURT DETERMINES OWNERSHIP OF UNCASHED CHECK

Dona Mae Franklin bequeathed her home and all "corporeal movable contents" to Robert Davis, with the residue of her estate passing to two charities. One of the assets found in the home was an uncashed check for $33,801.72 from the redemption of a CD. Franklin's executor asked the court to determine ownership of the check.

Davis claimed that the check was equivalent to cash, making it a corporeal movable. The parties agreed that if cash had been found in the home, Davis would have been entitled to it under the terms of the will. The charities contended that the check was an incorporeal movable, or simply an instrument representing the bank's obligation to pay. The district court granted the charities' motion for a summary judgment, which Davis appealed.

The Court of Appeals of Louisiana noted that state law defines incorporeals as things that have no body but are comprehended by the understanding, such as right of inheritance, obligations and right of intellectual property. A check that has not been cashed prior to death is still an incorporeal moveable, representing the bank's obligation to pay funds. The bank had no obligation to pay the funds to Davis, ruled the court, which affirmed the district court's holding (*Succession of Dona Mae Franklin*, No. 42,496-CA).

PUZZLER SOLUTION

Harold will be entitled to an income tax charitable deduction for the value of charity's remainder interest. Normally, Harold would be considered the owner of the trust and taxed on its income if it is used to satisfy his legal obligations [Reg. §1.677(b)-1(d)]. However, Carole will be taxed on trust income under an exception in Code §682(a). If the transfer of appreciated assets takes place within one year of the divorce and is related to the end of the marriage, it will be considered "incident to the divorce" and Harold will not owe tax on the capital gain [Code §1041(c)].

ALLOWING CHILDREN TO "BUY" THEIR INHERITANCE

Larry is like many parents who have "accelerated" bequests to their children with substantial lifetime gifts and trusts. He doesn't feel the need to leave significant assets to the children at death, choosing instead to make charitable bequests to favorite organizations. He is concerned, however, about expensive items of personal property that the children may want from his estate. If he gives these items to his children now, or leaves them at death, there may be a transfer tax cost. He's not interested in selling the items to the children because it seems callous and would result in a capital gains tax. He has asked his financial advisor how to satisfy his philanthropic goals, allow the children to receive particular items they wish to own and achieve tax savings.

The first step is to determine exactly how much it would cost in additional estate tax for Larry to leave specific items of personal property to his children rather than to charity. Assuming the estate is subject to tax at 45% and he shifted an asset worth $500,000 from charity to a child, the cost to charity would be not only the value of the asset but also $225,000 in estate taxes that otherwise would have passed to charity. The added tax in turn reduces the charitable deduction available to the estate, resulting in additional estate tax. If Larry is willing to have his estate and charity absorb this cost, charity could be named a contingent beneficiary of certain assets, allowing the children to disclaim any items they do not want [Code §2518(a)]. The value of any disclaimed assets will pass to charity and qualify for the estate tax charitable deduction.

An alternative that is available in situations where the children have sufficient wealth of their own is to allow them to buy assets from the estate. Language can be included in a will or living trust that gives the children the first option to purchase certain items of personal property at the fair market value, as determined for estate tax purposes, within a specified period after the decedent's death. The cash proceeds from the sale would be added to the residuary estate passing to charity, leaving both charity and the estate in the same position as if the decedent had left the property to charity. The option also should provide that if the IRS determines the fair market value to be greater than the amount paid, the child will make up the difference, with interest from the date of death, to avoid any estate tax liability. If the decedent wishes to leave particular assets to a charity (e.g., a rare book collection to a museum), the will can designate the items of personal property that may be purchased.

It may seem that the children are at a disadvantage under this arrangement. However, the decision to purchase a particular item of personal property is voluntary on their part. A child can choose to buy – or not to buy – an asset, based on the fair market value. The child will have a basis in the asset equal to the purchase price (date of death fair market value), just as if the asset had been left outright and received a stepped-up basis.

This technique can be used in conjunction with an irrevocable life insurance trust in which the proceeds of a policy pass free of income and estate tax. The estate would be entitled to a deduction for the full value of the residue passing to charity, even though certain items had been replaced with cash, and the children would have the flexibility of keeping the insurance proceeds or using the funds to acquire estate assets.

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