

The Advisor

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ESTATE PLANNER'S TIP

Professional clients might benefit from personally owning the buildings in which their practices or companies are located, rather than in the name of the business. Personal ownership may protect the building from the creditors of the business and also provide tax and estate planning opportunities. For example, the income received from leasing the building to the company is not subject to employment taxes, and the client can claim depreciation deductions on his or her personal return to offset the rental income. The business can deduct the rental payments. The building can be contributed to a family limited partnership, allowing the client to pass interests to the children at reduced transfer tax costs by taking advantage of various valuation discounts. The client retains control over the building through the general partnership interest. If the client sells the business, possibly at retirement, he or she can retain the building and augment retirement income with the rent received from the new owner of the business or other tenants.

ENDORSEMENT NOT TAX-FREE EXCHANGE

Sally owned a non-qualified annuity contract with RigidCo Insurance Company. She asked that RigidCo issue a check to FlexCo Insurance Company, which was to use the funds as consideration for a new annuity contract. Sally intended that the transaction be treated as a tax-free exchange under Code §1035. RigidCo refused, instead issuing a check directly to Sally. She did not deposit the check, but instead endorsed it to FlexCo for the new annuity contract.

Under Code §72, amounts received under an annuity contract are included in gross income. This includes amounts received on the complete surrender, redemption or maturity of an annuity contract [Code §72(e)(5)(E)]. There is an exception under Code §1035(a)(3) where an annuity contract is exchanged for another annuity contract.

In Rev. Rul. 72-358 (1972-2 C.B. 473), the IRS ruled that where the taxpayer assigned a life insurance contract, prior to its maturity, to a second insurance company in exchange for a variable annuity, the transaction fell within Code §1035. Similarly, in the assignment of an annuity issued by one insurance company to a second insurance company, with the cash surrender value added to the taxpayer's existing annuity contract, the tax-free treatment applied (Rev. Rul. 2002-75, 2002-2 C.B. 812).

The IRS determined that Sally's endorsement of the check did not qualify as a tax-free exchange under Code §1035(a)(3). There was no actual exchange of annuity contracts, Sally did not assign the RigidCo contract to FlexCo and there was no direct transfer from one insurance

company to the other. Code §1035 does not make any special provision for the purchase of an annuity contract with amounts distributed to the policyholder under another contract (Rev. Rul. 2007-24).

COURT REJECTS LAST-MINUTE PARTNERSHIP

In 2001, Hilda Erickson and her two daughters formed a family limited partnership. At the time, Mrs. Erickson was 87 and suffered from Alzheimer's disease. Her daughter Karen, who had a power of attorney, contributed securities and an investment condominium worth approximately \$2.1 million on Mrs. Erickson's behalf in exchange for an 86.25% partnership interest. The daughters and their husbands contributed assets in exchange for general and limited partnership interests.

Although the partnership agreement was signed in May, transfers of the assets to the partnership did not take place until two days before Mrs. Erickson died at the end of September. Concurrent with the transfers, Karen reduced Mrs. Erickson's interest significantly (from 86.25% to 24.18%) by making gifts of partnership interests to the grandchildren.

When the estate was unable to pay the estate and gift taxes, Karen, as the personal representative, sold Mrs. Erickson's home to the partnership.

The partnership also made a disbursement to the estate, characterized as a redemption of some of Mrs. Erickson's partnership interests. The IRS claimed that the assets transferred to the partnership shortly before death were included in her estate under Code §2036. The estate argued that Mrs. Erickson retained no rights to the assets once transferred and, alternatively, that the assets were transferred in a bona fide sale for adequate and full consideration.

The Tax Court determined that Mrs. Erickson retained the right to enjoy the assets transferred to the partnership, pursuant to an implied understanding or agreement among the parties. The fact that the assets were not transferred until just prior to her death indicates that the parties "were in no hurry to alter their relationship to the assets," said the court.

The value of assets are not included in the estate if the decedent received full and adequate consideration under a bona fide sale [Code §2036(a)]. The estate argued that the partnership was formed to centralize management of the family's assets. However, the court found no non-tax purpose, noting that Karen already had significant control over management and the assets were not actually transferred until just prior to death. The court found that "the transfers were made to avoid estate tax" (*Estate of Erickson*, T.C. Memo. 2007-107).

PHILANTHROPY PUZZLER

Ted, an inhabitant of a northern state, is planning to give a used boat worth \$18,000 to charity in December. He paid \$25,000 for the boat a few years ago. The charity intends to sell the boat, but as a practical matter it may not find a buyer until after next year's boating season begins – which could be beyond the due date for Ted's income tax return. Ted wants to know how he should go about substantiating his charitable deduction, and whether he needs to get a qualified appraisal.

INCOME DISTRIBUTIONS WON'T CAUSE TRANSFORMATION

The IRS had previously ruled that an ordinary complex trust that allowed income to be paid to charities would be entitled to deductions under Code §642(c). Trust language provided that part or all of the trust's income could be paid to charities selected by the trustee. Income was not to be set aside permanently for charity, and any distributions would be free of trust.

The IRS was subsequently asked to rule on whether the distributions to charity would cause the trust to be characterized as a split-interest trust. The trust is not exempt from tax under

Code §501(a) and does not hold amounts devoted to charitable purposes for which a deduction was allowed. Therefore, ruled the IRS, distributions of income made pursuant to the trustee's exercise of discretion under the terms of the trust will not cause the trust to come within the split-interest trust rules of Code §4947(a)(2) (Ltr. Rul. 200714025).

KNOW WHERE TO LOOK

Donors, their advisors and IRA custodians have raised questions concerning the eligibility of certain organizations to receive qualified charitable distributions pursuant to the Pension Protection Act of 2006. To provide help, the IRS has said that until further guidance is available, a donor, acting in good faith, can rely on information contained in the IRS Business Master File (BMF) or the organization's current IRS letter granting exemption and indicating whether the charity is a public charity under Code §§509(a)(1), (a)(2) or (a)(3).

The BMF can be downloaded from the IRS website (go to charitable statistics at www.irs.gov, and click on Exempt Organization IRS Master File Data). The BMF is updated monthly. Donors may also use a third party to obtain the BMF information, provided the third party report includes (a) the organization's name, employer identification number and public charity classification under Code §§509(a)(1), (a)(2) or (a)(3); (b) a statement that the information is from the most currently available IRS monthly BMF update, along with the IRS BMF revision date; and (c) the date and time of the grantor's search. The report must be in a form that can be stored as a hard copy or electronically (Notice 2006-109).

TRY A LITTLE TENDER OFFER

The Largesse Company has only one class of stock, owned 5% by Helen, 62% by a charitable remainder unitrust created by Helen, and 33% by an employee stock ownership plan. Largesse plans to offer to redeem for cash a specified num-

ber of the common shares held by its shareholders. The redemption price will be the fair market value of the shares as determined by an independent appraiser. Helen does not intend to tender her shares, but the unitrust is expected to tender as many of its shares as possible. It isn't known whether the ESOP will tender any shares.

Largesse is a disqualified person with respect to the unitrust. In general, a transaction between the company and the unitrust would be an act of self-dealing [Code §4941(d)(1)(A)]. There is an exception, however, for a transaction pursuant to a liquidation, merger, redemption, recapitalization or other corporation adjustment, provided all the securities of the same class are subject to the same terms and the unitrust receives no less than fair market value [Reg. §53.4941(d)-3(d)(1)].

The IRS determined that because the redemption of the stock is subject to the same terms for all shareholders and the unitrust will receive fair market value, the redemption will not be an act of self-dealing (Ltr. Rul. 200720021).

PUZZLER SOLUTION

Based on the facts, Ted's deduction will be limited to the gross proceeds from the charity's sale of his boat, a "qualified vehicle" under Code §170(f)(12)(A)(i). Therefore he does not need a qualified appraisal, according to instructions on Form 8283. On the other hand, for Ted to claim a charitable deduction in excess of \$500, he must obtain a "contemporaneous written acknowledgment" from the donee charity stating, among other things, the gross proceeds charity received from selling the boat (see Form 1098-C). If the charity can't sell the boat before Ted files his taxes, he will need to wait for the sale to occur, obtain charity's acknowledgment, and then file an amended return to claim the deduction, according to the IRS staff person who drafted Form 1098-C.

If a donor owns 100 shares of stock, worth \$100 each, and wants to make a gift to charity of \$5,000, it's simple to give just half the shares. But what happens when the asset the donor has to give is not as easily divisible as shares of stock – real estate, for example? There are times when clients want to make gifts but would like “change” back from their generosity.

A bargain sale is one technique that allows the donor to part with only a portion of the value of the gift property. Bargain sales work especially well when the property is something the charity wishes to acquire – a parcel of real estate next to a college campus, for example. In a bargain sale, charity purchases the property for less than fair market value. The donor receives cash and an income tax charitable deduction for the difference between the sale price and the fair market value. However, the donor recognizes capital gains on the sale portion of the property.

How is the capital gain computed? Take the example of Harry, who owns vacant real estate next to a college for which he originally paid \$50,000. The college has wanted to acquire the land for use in an expansion program but can't afford to pay the fair market value of \$250,000. If Harry sells the land to the school for \$150,000, he is entitled to a \$100,000 income tax charitable deduction. His basis is allocated between the sale and the gift portions [Reg. §1.1011-2(b)]:

<u>\$150,000 (sale price)</u>	x \$50,000 (basis)
\$250,000 (fair market value)	

\$30,000 of his basis is allocated to the sale portion, making his capital gain \$120,000 (\$150,000 - \$30,000). The tax on his capital gain would be \$18,000, which is more than eliminated by the tax savings from his \$100,000 charitable deduction (\$33,000, assuming a 33% tax rate).

If the asset is not one that the charity wishes to acquire, the donor could instead make a gift of an undivided interest [Code §170(f)(3)(B)(ii)]. Harry could give charity a 40% undivided interest in the land, entitling him to an income tax charitable deduction of roughly \$100,000 (a minority discount may apply). The donor and the charity could then find a buyer for the land and divide the proceeds based on their proportional interests. Harry would recognize 60% of the capital gain on the sale (\$120,000). In this situation, however, charity will likely be “stuck” with part of the property unless and until the donor is ready to sell.

With both a bargain sale and a gift of an undivided interest followed by a sale to a third party, the donor receives the cash and recognizes the capital gain the same year. The bargain sale of real estate also can be structured to spread out both the payments and the capital gain, through an installment bargain sale. Harry could agree to sell the land to the college for \$150,000 to be paid over a number of years, at a stated rate of interest. He is entitled to the charitable deduction in the year of the bargain sale, but his capital gain is spread out over the term of the note.

