DALLAS JEWISH COMMUNITY FOUNDATION

The Advisor

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ESTATE PLANNER'S TIP

Making gift-tax-free gifts to family members each year can help clients reduce future estate taxes [Code §2503(c)]. It can also encourage younger family members to begin a saving and investment program. Grandparents, for example, could offer to "match" the contributions that grandchildren make to an IRA. Those with earned income are eligible to contribute up to $5,000 to an IRA each year [Code §408]. If the grandchild does not need the deduction available for funding a traditional IRA, the Roth IRA might be an attractive option. All qualified withdrawals in the future are tax free. How much can a grandchild save? If $5,000 is contributed annually for five years, starting at age 16, the account will be about $471,250 (assuming 6% interest, compounded monthly) when the grandchild reaches the full retirement age of 67, even if no further contributions are made. If the grandchild continues putting $5,000 annually into an IRA, the fund will grow to more than $2.1 million.

PROPOSED REG LIMITS ALTERNATE VALUATION

Code §2032 permits executors to value an estate six months after death, rather than the date of death, if the value is lower. The IRS notes that the predecessor to Code §2032 – §302(j), added as part of the Revenue Act of 1935 – was in response to "the hardships which were experienced after 1929 when market values decreased very materially between the period from the date of death and the date of distribution to the beneficiaries." The IRS takes the position that the decrease in value must be due to market conditions, not to changes due to a mere lapse of time.

In *Flanders v. U.S.*, 347 F.Supp. 95 (N.D. Cal. 1972), a trustee entered into a land conservation agreement under the California Land Conservation Act of 1965 to restrict the use of the trust's property to agricultural uses for ten years, thereby reducing the assessed value of the land. The district court ruled that the decrease in value was due to a voluntary act by the trustee, not market conditions, and denied the use of the alternate valuation date. However, the Tax Court in *Kohler v. Commissioner* [T.C. Memo. 2006-152], allowed an estate to use the alternate valuation date where the estate elected to receive new shares of restricted stock under a reorganization that took place two months after the decedent's death. The IRS nonacquiesced to *Kohler*.

To resolve this split between the courts and to clarify that the alternate valuation date is available only for changes due to market conditions, the IRS has issued proposed regulations. Reg. §20.2032-1(f) defines market conditions as "events outside the control of the decedent (or the decedent's executor or trustee) or other person whose property is being valued that affect the fair market value." Examples are given of events that are caused by the mere lapse of time. When

adopted as final regulations, the rules will apply to estates of decedents dying on or after April 25, 2008 (NPRM REG-112196-07).

GST EXEMPTION NOT LOST BECAUSE OF TRUSTEE'S MISTAKE

Valerie is the beneficiary of a trust created by her grandfather, who died prior to September 25, 1985. The trust's assets include mineral interests. Under state statute, if the principal of a trust consists of a right to receive an interest in minerals, 27.5% of the proceeds are allocated to principal and the balance to income.

For several years, the trustee reported all mineral receipts as income on the K-1 provided to Valerie. As a result, she included all of the mineral revenue in calculating her personal income tax.

When the errors were discovered, the trust filed amended Forms 1041 for the years. Valerie exercised her rights under state law to seek reimbursement for the excess federal income tax paid. The reimbursement, plus interest, will come from trust principal.

The generation-skipping transfer tax does not apply to amounts received from trusts that were irrevocable on September 25, 1985 [Reg. §26.2601-1(b)(1)(i)]. However, the tax does apply to a pro rata portion if actual or constructive additions are made to the trust after that date. The IRS ruled that no addition to the trust was made as a result of Valerie's erroneous payment of income tax, adding that she did not make a gift to the trust in paying the tax and has enforced her right to reimbursement (Ltr. Rul. 200816008).

PHILANTHROPY PUZZLER

On July 1, Fred and Ethel created a charitable remainder trust that is to make a 5% unitrust payout at the end of every quarter. The trust calls for the assets to be valued on the first business day of each year. Since there will not be a valuation date during the first year of the trust, the trustee has asked how much should be paid to Fred and Ethel for the two payments due in 2008.

RETAINED CONTINGENT INTEREST VOIDS DISCLAIMER

Christine Hamilton was the sole heir of her mother's estate. The mother's will provided that if Christine disclaimed any portion of the estate, 75% was to pass to a charitable lead trust and 25% was to pass to the family's private foundation. Following her mother's death, Hamilton disclaimed all but $6,350,000 of the estate.

The estate filed a tax return showing a gross estate of just over $6.5 million, meaning that about $40,500 would pass to the foundation and $121,600 to the lead trust. A charitable deduction was claimed for those amounts. The IRS, which determined a higher value for the gross estate, eventually came to an agreement with Hamilton, putting the total value of the estate at $9.6 million. The estate argued the increased value merely boosted the estate's charitable deduction, with about $2.4 million passing to the lead trust and $807,000 to the foundation.

The Tax Court noted that Hamilton's disclaimer was a partial disclaimer. Although allowed under Code §2518(c)(1), it must meet four requirements. Hamilton's disclaimer was in writing, received by the estate within nine months and she had not accepted any of the disclaimed property. However, Code §2518(b)(4) requires that the disclaimed interest pass "without any direction on the part of the person making the disclaimer and * * * to a person other than the person making the disclaimer." Reg. §2518-2(e)(3) provides that in the case of disclaimed property passing to a trust in which the disclaimant has a remainder interest, the disclaimer won't be qualified unless the remainder interest is also disclaimed. Because Hamilton had a contingent remainder interest in the lead trust that she did not disclaim, the disclaimer was not qualified, said the court. Worse for the estate was that it was not entitled to a charitable deduction for any of the property passing to the trust. The estate was entitled only to the deduction for the increased amount passing to the foundation as a result of Hamilton's disclaimer (*Estate of Christiansen v. Comm'r*., 130 T.C. No. 1).

1954 TRUST TOO OLD TO REFORM AS CRT

Jack established an inter vivos trust in 1954, directing it to pay a specific monthly amount to his wife for life. After her death, a specified amount was to be paid monthly to Jack's two children for their lifetimes, with income distributed per stirpes at the children's deaths. Following the deaths of Jack's wife, children and grandchildren, the trustee is to select a beneficiary for the trust assets, which are to be used for assisting "crippled or underprivileged children."

Jack's wife and children have died, leaving three grandchildren as beneficiaries. The trustee petitioned the court to reform the trust to pay the grandchildren a 5% unitrust amount in equal shares during their joint lives. The trustee asked the IRS to rule that the trust, as reformed, qualifies as a charitable remainder unitrust under Code §664(d)(2).

The IRS noted that prior to the Tax Reform Act of 1969, there were no substantial restrictions on estate or gift tax charitable deductions for income and remainder interests passing to charity. The Act applies to decedents who die after 1969 or to gifts made after July 31, 1969. Code §2055(e)(3) was added in 1974 to permit posthumous reformations of trusts in order to qualify for the estate tax charitable deduction [Code §2055(a)] – but only for estates of decedents dying after 1969. The Tax Reform Act of 1984 added Code §2522(c)(4), allowing inter vivos split interest trusts to be reformed to qualify for a gift tax charitable deduction. However, in order to qualify as a charitable remainder trust, a trust must meet the definition of and function exclusively as a charitable remainder trust from its creation. Jack's trust has not functioned exclusively as a charitable remainder trust, the IRS pointed out. The reformation provision allowing a remainder interest in a split interest trust to qualify for the gift tax charitable deduction applies only to transfers made after 1969, said the IRS. Because Jack's trust was created in 1954, it cannot be reformed to qualify for income, gift or estate tax charitable deductions (Ltr. Rul. 200818003).

WHERE THERE'S A CHOICE, THERE'S A DEDUCTION

A for-profit cooperative offers patronage dividends, based on a percentage of purchases, and rebates for the use of its credit card. Coop members may choose to receive the dividends and rebates in cash or for merchandise. A third option is planned that would allow members to direct the coop to transfer some or all of the dividends or rebates to charity. The coop will notify the charity of the donor's name and address, along with the amount and date of the contribution, so proper acknowledgment can be made.

In *U.S. v. American Bar Endowment* [477 U.S. 105 (1986)], the court ruled that insurance program members who were required to refund their premiums to the membership organization were not entitled to charitable deductions. The contributions were not voluntary or made with donative intent, said the court.

Coop members, who have the option to receive the dividends and rebates themselves or transfer them to charity, will be making voluntary contributions, said the IRS. Donors will have to comply with the substantiation rules under Code §§170(f)(8) and 170(f)(17). The transfers will be considered complete for deduction purposes when the coop transfers the payments to charity, not when the member directs the transfers be made (Ltr. Rul. 200817018).

PUZZLER SOLUTION

In any short taxable year, such as the first year of the unitrust, if no valuation date occurs before the end of the year, the assets are to be valued on the last day of the year [Reg. §1.664-3(a)(1)(v)(a)]. The trustee can make the two payments in 2008 using the value of the assets as determined on the date the trust was funded. Overpayments or underpayments can be corrected at the end of the year when the assets are valued.

APPRAISALS – A VITAL PART OF SUBSTANTIATING NON-CASH GIFTS

Obtaining an appraisal for a gift to charity might seem like a nuisance, but clients who fail to follow the requirements could find their deductions denied or severely reduced. In general, an independent appraisal is needed for any non-cash gift in excess of $5,000 ($10,000 in the case of closely held stock) [Code §170(f)(11)(C)]. No appraisal is needed for gifts of publicly traded securities, defined as securities for which market quotations are readily available on an established securities market [Code §6050L(a)(2)(B)], or for most vehicle donations, which are subject to separate rules [Code §170(f)(12)(A)(i)].

In *Bond v. Comm'r*. [100 TC No. 4], donors of a blimp provided all the information necessary for the IRS to determine the validity of their contribution. However, instead of attaching it to their Form 8283 [Reg. §1.170A-13(c)(2)(i)(A)], they included it on the form. The court allowed the deduction, finding they had substantially complied. The key for the court was whether the information supplied by the donors was adequate to determine whether or not a gift had been made. For gifts after June 3, 2004, the complete appraisal must be attached to a donor's return for non-cash gifts valued at more than $500,000 [Code §170(f)(11)].

Courts have refused to find substantial compliance, as in *Bond*, where donors did not obtain an appraisal for closely held stock [*Hewitt v. Comm'r*., 98-2 USTC ¶50,880] or obtained an appraisal several years after the gift [*Jorgenson v. Comm'r*., TC Memo. 2000-38].

What is required for a qualified appraisal? In general, the appraisal must be made no earlier than 60 days prior to the date of the gift and no later than the due date of the return (including extensions) on which the charitable deduction is claimed [Reg. §1.170A-13(c)(3). The appraisal must give a description of the property, the date or expected date of the contribution, the donor's name and address, the method used to determine the value (e.g., market-data, replacement-cost-less-depreciation, income approach) and the qualifications of the appraiser.

Donors may obtain more than one appraisal, but the appraiser cannot be the donor, a party to the transaction, the charity or anyone related to or employed by the donor or charity [Reg. §1.170A-(13)(c)(5)(iv)]. The appraiser's fee cannot be based on a percentage of the appraised value [Reg. §1.170A-13(c)(6)].

For appraisals related to returns filed after August 17, 2006, more stringent rules apply to the professional qualifications of appraisers. Code §170(f)(11)(E)(ii) defines a qualified appraiser as one who (1) has earned an appraisal designation from a recognized professional appraiser organization or has met minimum education and experience requirements, (2) regularly performs appraisals for which the individual receives compensation and (3) meets other requirements prescribed by the IRS. A civil penalty can apply to appraisers who know or should have known that the appraisal would be used in connection with a tax return or refund claim and the claimed value of the appraised property results in a substantial valuation misstatement under Code §6662(e) or a gross valuation misstatement under Code §6662(h).

For returns filed after February 16, 2007, the appraiser must have (a) successfully completed college or professional-level coursework relevant to the property being valued, (b) have at least two years of experience in the trade or business of buying, selling or valuing the type of property being valued and (c) fully describe in the appraisal the education and experience that qualify him or her to value the type of property [Reg. §1.170A-13(C)(5)].

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