

# *The* Advisor

June 2007

## ESTATE PLANNER'S TIP

When unmarried parties hold property in joint tenancy with right of survivorship, the full value is included in the estate of the first joint tenant to die, unless the survivor can show contribution toward the acquisition. Code §2040 presumes that the first to die provided all the funds for the property. Where the estate of the first to die is fully sheltered by the estate tax credit (\$2 million through 2008, \$3.5 million in 2009), it might be more advantageous to allow the full value to be included in the estate, rather than documenting the survivor's contribution toward the purchase. The survivor will receive a stepped-up basis in the property [Code §1014(a)], which may reduce capital gains taxes when the property is eventually sold.

## COURT'S RULING NOT WARM AND FUZZY FOR ESTATE

Muppets creator Jim Henson entered into a separation agreement with his wife in 1987. At the time, Jim owned 55 of the 90 shares outstanding of Henson Associates, with Jane owning the balance. Jane transferred her shares to Jim in exchange for his promise that if, during her lifetime, he received "value" in connection with a merger or sale, he would pay her a portion of the proceeds. Jane was entitled to 35/90 of the value received on a sale or merger. "Value" was defined as a receipt by Jim or his estate, but did not include any amounts received by the couple's children.

Jim died in May 1990, leaving all the shares to his children. There were 25.5 shares held in escrow to protect Jane from a default on Jim's obligations to her. The estate eventually paid estate taxes of nearly \$21 million.

In 2000, the children sought to sell the company but believed they did not have unencumbered title

to the shares. The children, the estate and Jane entered into a settlement agreement. Jane received \$10 million in exchange for terminating the escrow agreement and releasing the shares. After paying Jane, the estate filed a refund claim seeking \$4,156,696 plus interest, which the IRS disallowed.

The estate argued that it was entitled to a deduction under Code §2053 because the payment was in satisfaction of Jane's valid and enforceable claim against the estate. The estate also claimed that the payment to Jane qualified for the marital deduction under Code §2056(a) because the funds passed to Jim's surviving spouse.

The U.S. District Court (So. Dist. NY) noted that a deduction would be available under Code §2053(a)(3) if Jane had an enforceable claim against the estate under the separation agreement. However, that agreement expressly excluded

amounts received by the children. Had the estate sold the shares, she would have been entitled to a portion, but the agreement did not give her a right to a subsequent sale by the children.

The marital deduction [Code §2056(a)] applies to transfers passing from the decedent to a surviving spouse. The court said that because Jim bequeathed his shares to the children and the children made the payment to Jane, the estate was not entitled to a marital deduction (*Gottesman v. U.S.*, 2007-1 USTC ¶60,536).

### NEW RULES FOR CLAIMS AGAINST ESTATES

Deductions for claims against an estate under Code §2053(a) frequently result in disputes with the IRS. Proposed regulations now address the issue. The proposed regulations provide that an estate may deduct under Code §2053(a)(3) only amounts actually paid in settlement of claims against the estate. If a resolution of a contested claim cannot be reached before the expiration of the limitation period for claims for a refund, an estate may file a protective claim for refund to preserve its right to claim a deduction.

The regulations also provide that:

■ Final court decisions as to the amount and enforceability of the claim or expenses are accepted if the court passes upon the facts upon which deductibility depends.

■ Settlements are accepted if reached in bona fide negotiations between adverse parties with valid claims recognized under applicable law.

### PHILANTHROPY PUZZLER

Harold, who serves on the board of a charity, is a lawyer. He has offered to draft wills, codicils and trust documents, at no charge, for donors willing to leave a bequest or arrange a life-income gift for the organization. All he asks in return is that the donor contribute \$100 to the charity for the service. Are either Harold or the donors who take advantage of the offer entitled to charitable deductions?

■ A deduction is not allowed to the extent the expense or claim is compensated for by insurance or is otherwise reimbursed.

■ No deduction may be taken for a claim that is potential, unmatured or contested at the time the return is filed, although a protective claim for a refund may be filed.

■ If the decedent is one of multiple defendants, the estate may deduct only the decedent's portion of the liability.

■ Claims by family members or beneficiaries of the estate will be strictly scrutinized to ensure they are legitimate claims.

■ A claim that is unenforceable after the decedent's death may not be taken.

■ If a claim represents an obligation to make recurring payments likely to continue beyond the final determination of the estate tax liability, a deduction is allowed only as each payment is made, provided the period of limitations for claims for refunds has not expired or the estate has properly preserved the claim for refund. In the alternative, a deduction is allowed for the cost of a commercial annuity purchased by the estate from an unrelated dealer in satisfaction of the obligation (NPRM REG-143316-03).

### RECOMMENDED GIFT ANNUITY RATES UNCHANGED

The board of the American Council on Gift Annuities voted to maintain recommended rates for both immediate and deferred gift annuities at current levels through July 1, 2008. Rates for one-life immediate gift annuities range from 3.7% to 11.3% (age 90 and older).

### DECEDENT'S WILL LEAVES THEM GUESSING

Alice Armstrong died leaving three nieces and a nephew and an estate valued at \$669,000. Her will directed the payment of debts and expenses, then set forth 16 paragraphs with separate dispositions in varying amounts to her relatives and other individuals. She also left bequests for a church, an ambulance squad, a fire department and a local animal society. The last paragraph of her will

directed that 25% of her estate “is to be set up for a Nursing Scholarship thru Moriah Central School and the recipient is to be determined by my Executor.” The will contained no residuary clause.

The executor asked the Surrogate’s Court whether the portion for the scholarship was to be calculated before or after the preceding monetary dispositions (totaling \$88,500) and how the balance of the estate was to be distributed with no residuary clause.

The school district argued that the scholarship should be calculated prior to all other cash dispositions and that the funds should be held by the district. The court said it found “no support at all” in the will for the school district’s position. The will is unambiguous that the scholarship is to be funded with 25% of the net estate, said the court, adding that the sequence in which dispositions are set out in a will is evidence of the testator’s intent that the bequests be funded in that order. The provision for the scholarship appears after 16 monetary dispositions.

Although the court noted that a will interpretation resulting in intestacy is to be avoided, if possible, in this case “the only possible construction” is intestacy for the residue. (*In the Matter of Armstrong*, 2007 NY Slip Op 50577).

#### LANGUAGE REFERS TO FEDERAL, NOT STATE, EXEMPTION

Tillie Zahrobsky added a codicil to her will in 2000, providing that if her estate exceeded the “applicable exemption amount available for the year of my death,” the excess was to pass to a scholarship fund with the Edgar High School District Foundation. At the time, Wisconsin had no estate tax and the federal exemption was \$675,000.

At Zahrobsky’s death, the federal exemption was \$1.5 million and the state had enacted an estate tax, which had a \$675,000 exemption. Zahrobsky’s estate was just over \$1 million, meaning that the school district would receive nothing if the will referred to the federal exemption.

The court ruled that the codicil was ambiguous

and allowed extrinsic evidence. Zahrobsky’s personal representative, who had drafted the codicil, claimed that she wanted to keep the family name in the area and also to avoid taxes. While there was no state estate tax at the time, he testified that he knew the state could impose one in the future. An attorney testifying for family members stated that Zahrobsky could not have intended to avoid the state estate tax because at the time the codicil was drafted, even the idea of the state tax “wouldn’t have been in anybody’s vocabulary.” A nephew testified that Zahrobsky was not particularly philanthropic and he agreed with her caretaker that Zahrobsky never expressed a desire to have her name live on. The court determined that Zahrobsky’s motivation was to avoid taxes, not give to charity, and that the idea of a state tax would have been outside even a professional’s contemplation at the time. The school district appealed.

The Wisconsin Court of Appeals (Dist. III) said the matter boiled down to a conflict over whether Zahrobsky could have anticipated a state estate tax. The lower court did not err in finding that the term “applicable estate exemption” referred to the federal, not the state, estate tax exemption (*In re Estate of Zahrobsky*, NO. 2006AP2527-FT).

#### PUZZLER SOLUTION

No deduction is allowed for the contribution of services [*Grant v. Comm’r.*, 84 TC No. 32], although Harold would be entitled to a deduction for his out-of-pocket expenses in connection with rendering the services on behalf of charity (e.g., photocopying, mileage at 14 cents per mile). A donor who gives \$100 to the organization in exchange for Harold’s free services also is not allowed a deduction because the donor has received an item of value in return. Note: Aside from the tax issues involved, Harold’s offer raises serious ethical concerns – most importantly, conflict of interest.

## FAMILY OBLIGATIONS AND CHARITABLE GIVING

Just when clients in their 50s and 60s have finished with college tuition payments, married off their children and paid off home mortgages, there may be new financial concerns: providing support for aging parents. A review of a parent's asset and investments may help uncover hidden sources of income, such as a life insurance policy that can be cashed in, or low-yield savings accounts that can be invested for higher income. The parent's house also may provide extra cash through a reverse mortgage or rental income. A child who provides the bulk of the parent's support may be able to claim the parent as a dependent.

Clients also can couple support for charity with financial assistance for parents. Take the case of Jean, age 55, who sends her 77-year-old widowed mother \$500 per month. Jean has to earn \$8,955 from investments to pay the income tax and have \$6,000 left over to give to her mother (33% income tax bracket) each year. Jean also supports a number of charities.

Instead of writing a check to her mother each month, Jean could transfer investment assets to a charitable remainder trust that would "replace" the income – and give her a charitable deduction, in addition. For example, she could fund a charitable remainder unitrust with \$100,000, directing that her mother receive a 6% unitrust amount, paid monthly (\$6,000 the first year). Payments would continue for Jean's life upon the death of her mother. Jean would be entitled to a charitable deduction of \$25,584 (assuming monthly payments and a 5.8% §7520 rate), saving her \$8,443 in income taxes. She arguably owes no gift tax on the transfer if she keeps the right to revoke her

mother's interest by will; trust payments would be sheltered by the annual exclusion [Code §2503(b)].

Jean could add to the unitrust in future years, boosting the income paid to her mother and herself and the eventual benefit for charity. The chart below shows Jean's charitable deductions and tax savings from future transfers to the unitrust.

Year	Transfer	Charitable Deduction	Tax Savings
2007	\$100,000	\$25,584	\$8,955
2008	25,000	6,693	2,209
2009	25,000	6,998	2,309
	\$150,000	\$39,275	\$13,473

In addition to the tax savings from the charitable deductions, Jean would shift the income earned on the investments from her 33% tax bracket to a tax-exempt trust. If the value of the trust grows, so will the trust income. Jean also has the satisfaction of knowing that the charities that she has named eventually will benefit. Jean saves more if she funds the trust with appreciated securities, bypassing the capital gains tax that she would have paid if she had sold the stock.

What if Jean can't afford to part permanently with the assets to fund the trust? She can continue paying her mother \$500 per month and change her will to create a testamentary charitable remainder trust that would pay income to the mother for life, if she outlives Jean, and then distribute the assets to charity. Her estate would be entitled to a charitable deduction.

