DALLAS JEWISH COMMUNITY FOUNDATION

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ESTATE PLANNER'S TIP

The recent drop in the stock market is a signal for clients to review estate plans. What changes should they be looking for? Consider bequests of stock. A specific bequest may no longer be as valuable as originally planned. Residuary beneficiaries may also be "squeezed" out of their appropriate shares of the estate, particularly if there are numerous specific bequests. Because specific bequests must be satisfied first, there could be little left to be divided among family members who are the usual residuary beneficiaries. One solution is to bequeath percentage shares of the estate, so that all beneficiaries share in the fortunes – or misfortunes – that befall the estate. Another possibility is to anticipate potential reductions in value and provide for lower specific bequests in the event the total estate falls below a certain value.

TRUST'S INVESTMENT ADVICE SUBJECT TO 2% FLOOR

Michael Knight, trustee of the William Rudkin Testamentary Trust, sought advice in 2000 on investing the trust's $2.9 million in assets. The trust deducted the entire $22,241 paid to the advisor that year. The IRS said the fees were subject to the 2% floor on miscellaneous itemized deductions [Code §67(a)] and disallowed a portion. The Tax Court and the U.S. Court of Appeals (2nd Cir.) agreed with the IRS.

The U.S. Supreme Court agreed to hear the case to resolve a conflict between the circuits. While affirming the Second Circuit's holding, the Supreme Court differed in its reasoning.

Under Code §67(e), the 2% floor is applicable to both individuals and estates and trusts. An exception, however, allows taxpayers to fully deduct expenses "which would not have been incurred if the property were not held" in the trust or estate [Code §67(e)(1)]. Knight had argued that because he was held to the prudent investor standard under state (Connecticut) law, he was required to obtain investment advice, making the fees unique and therefore fully deductible. The Second Circuit held that because investment advisory fees were "costs of a type that could be incurred if the property were held individually rather than in trust," they were subject to the floor.

Two conditions must be met for the Code §67(e) exception to the floor: The relevant cost must be "paid or incurred in connection with the administration of the . . . trust" and must be one "which would not have been incurred if the property were not held in such trust." Chief Justice Roberts, writing the opinion, said the question is

not, as asked by the Second Circuit, whether the cost could have been incurred by an individual. Instead, said the Supreme Court, the question is whether a particular cost "would not have been incurred if the property were not held in such trust." Using a test adopted by the Fourth and Federal Circuits, an expense would only escape the 2% floor if it was one not "commonly" or "customarily" incurred by individuals.

The Supreme Court said it was not uncommon or unusual for individuals to hire investment advisers. It is possible, said the court, that a trust might have unusual investment objectives in balancing the interests of various parties. In that case, a comparison with an individual investor would be improper and the "incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2% floor" (*Knight v. Comm'r*., 2008-1 USTC ¶50,132).

REPRIEVE FROM AMT

An 11th hour move by Congress will keep an estimated 25 million taxpayers out of the alternative minimum tax for 2007. The Tax Increase Prevention Act of 2007, passed on December 19, increases the AMT exemption amounts for 2007 only.

The exemptions for 2007 are:

Single taxpayers and heads of households – $44,350

Married filing jointly – $66,250

Married filing separately – $33,125

The exemptions were to have dropped to $33,750, $45,000 and $22,500 respectively. The 2007 exemptions are an increase over 2006.

PHILANTHROPY PUZZLER

George's attorney helped him establish a revocable living trust to hold his major assets. Whenever he acquires additional investments, the title is in the name of the trustee of his trust. He wishes to create a charitable remainder trust that will pay income to him for life, but he wants the remainder trust to pay the income to his living trust, not to him personally. He has asked if there is any problem with this arrangement.

YEAR-END PRESENTS FROM CONGRESS

In addition to the Tax Increase Prevention Act of 2007, Congress also passed the Mortgage Forgiveness Debt Relief Act of 2007. Among the provisions:

- Beginning in 2008, widows and widowers will have two years after the date of a spouse's death to take advantage of the $500,000 capital gains tax exclusion for the sale of a jointly owned principal residence. Previously, a surviving spouse could take the $500,000 exclusion – rather than the $250,000 exclusion available to single taxpayers – only in a year in which he or she could file a joint income tax return. The surviving spouse continues to get a step up in basis for the deceased spouse's share.
- Homeowners whose lenders forgive all or a portion of the indebtedness on a mortgage debt following foreclosure will not incur taxable income for the forgiveness of indebtedness. The relief applies to discharges of up to $2 million, secured by a principal residence, and is effective for 2007, 2008 and 2009.
- The itemized deduction for premiums on qualified mortgage insurance is extended through 2010, for contracts entered into after 2006.

VOID TRUST NEVER OWNED LAND

Hartford Bealer, a Florida resident, owned a 277-acre riverfront farm in West Virginia that he wished to preserve for family members. His son-in-law, Jay Parker, a tax attorney, assured Bealer that he could place the farm in a charitable foundation and would not have to meet the annual distribution rules. Bealer's Florida attorneys informed him that he would have to distribute 5% of the value of the foundation's assets each year, which would require that he sell a part of

the farm each year. Bealer nevertheless allowed Parker to create the foundation, naming himself and Parker as co-trustees.

Bealer later learned that Parker was incorrect regarding distributions, but his attempts to contact him were unsuccessful. Concerned that Parker would sell the farm, Bealer deeded the property back to himself. He left the farm in his will to a granddaughter who expressed interest in preserving it.

At Bealer's death, his daughter, Nancy Parker, sued the estate, claiming that the farm was still part of the foundation and that her father did not have the legal right to deed it back to himself. The circuit court agreed, granting summary judgment.

The Supreme Court of Appeals of West Virginia looked to Florida law, which provides that a trust is void if procured by fraud, duress, mistake or undue influence. The estate argued that Bealer made a mistake in creating the foundation because he relied on bad advice concerning the 5% distribution requirement. Bealer did not claim a charitable deduction for the transfer of the farm into the foundation and paid all taxes and upkeep from personal funds, not from the foundation.

The court found that Bealer's intent was to preserve the farm and that the advice he received was wrong. Had he understood that Parker's advice was incorrect, he would have found another way to preserve the property. There was no effective foundation, said the court, because a fundamental mistake in creating it made it void ab initio under Florida law. The farm remains part of his estate, ruled the court (*Parker v. Estate of Bealer*, No. 3339).

SECOND DEDUCTIONS WHEN TRUSTS END

Leroy created two charitable remainder unitrusts, funding each with stock. He named himself as the income beneficiary and his wife, Jane, as successor beneficiary, retaining the right to revoke her interest at his death. Leroy and Jane, as trustees, have the right to select the remainder beneficiaries.

The couple now wishes to name a charitable beneficiary and assign their respective interests in the trusts to the remainderman. Under state law, the interests will merge and charity will be entitled to an outright distribution of the assets. To accomplish this, they will have to take several steps:

- The trusts will have to be amended to provide that the beneficiaries have the authority to assign their respective interests to charity;
- Leroy will release his power to revoke Jane's successor interest in the trusts;
- Leroy will release his testamentary power to designate the charitable remainderman;
- the couple will designate a charity as the remainderman of the trusts;
- Leroy and Jane will release their authority to designate a charitable remainderman; and
- they will assign their respective unitrust interests to the remainder beneficiary.

The IRS noted that Leroy did not originally transfer assets into the trusts to avoid the partial interest rules. The modifications proposed will not cause the trusts to lose their status under Code §664(d)(2). Leroy and Jane will be entitled to an income tax charitable deduction under Code §170(c) and a gift tax charitable deduction under Code §2522(a) in the year they assign their interests for the present value of the unitrust interests (Ltr. Rul. 200802024).

PUZZLER SOLUTION

Charitable remainder trusts must pay income to a "person," which may include a trust [Code §7701(a)(1)]. However, where the remainder trust pays income to a beneficiary that is not an individual, the trust must be a term-of-years trust [Reg. §§1.664-2(a)(5), 1.664-3(a)(5)]. The IRS has allowed a remainder trust to pay income for the life of an individual to another trust, but only where the income beneficiary is incompetent (Rev. Rul. 76-270, 1976-2 C.B. 194) or "financially disabled," as defined in Code §6511(h)(2)(A) (Rev. Rul. 2002-20). Note: A 1992 private letter ruling permitted a unitrust payable for the grantor's lifetime to be paid to a "blind trust" while he held political office (Ltr. Rul. 9202033). At the termination of the blind trust, all its assets were to return to the grantor or his estate.

TECHNICAL CORRECTIONS ACT AFFECTS CONTRIBUTIONS

On December 29, 2007, President Bush signed into law the Tax Technical Corrections Act of 2007 (HR 4839), which included important changes to charitable giving laws enacted in 2006 and earlier years.

Partial interests in art. The Act eliminated a gift and estate tax trap created by the Pension Protection Act of 2006. Under PPA 2006, if a donor contributes a fractional interest in a painting (20%, for example), the donor's income tax deduction will be roughly 20% of the painting's fair market value. However, if the donor contributes an additional 20% several years later, the new deduction must be based on the painting's value on the date of the original contribution – even where the artwork has gone up in value. The same valuation rule was applied unthinkingly to the gift tax charitable deduction, which created the possibility that art donors would have taxable gifts when they made repeat contributions of fractional interests. For example, if a donor gave a museum a 10% interest in a $1 million painting, his income tax and gift tax charitable deductions would both be about $100,000. Suppose that five years later he gives another 10%, when the painting is worth $2 million. The museum will have received an additional $200,000 in value, but the donor's income tax and gift tax deductions will be only $100,000. For income tax deduction purposes, the result is merely disappointing, but for gift tax purposes the donor will have made a $100,000 taxable gift to charity (less the annual exclusion amount) that would require expending part of his gift tax credit or even paying some gift tax. At death, when any remaining portion of the painting passed to the museum, the estate tax charitable deduction would be limited in a similar manner, creating a potential estate tax liability. The Corrections Act amended Code §§2055 and 2522(e) to restore full gift tax and estate tax deductions for any amount passing to charity from subsequent partial interest gifts or bequests.

Related use rules on gifts of tangible personal property. The Act amended Code §170(e)(7)(D)(i) to provide that donors can deduct fair market value for gifts of tangible personal property only where an officer of the donee charity certifies, upon disposition of the property, that the use of the property by the charity was not only related to its tax-exempt purposes, but was also "substantial."

Gifts of appreciated property by S corporations. The Act amended Code §1336(d)(4) to provide that, for S corporation gifts of appreciated assets made prior to 2008, shareholders' deductions are not limited to the prorated cost basis they have in their shares; instead, they can deduct a prorated share of the value of the contributed asset, so long as the cost basis of their stock exceeds the cost basis of the contributed property. Shareholders must reduce the basis in their stock by a prorated portion of the basis in the contributed property.

Qualified charitable distributions from IRAs. The Act amended Code §408(d) to provide that, where the IRA donor owned multiple accounts, charitable gift amounts would be considered to have been distributed from all of the accounts.

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