DALLAS JEWISH COMMUNITY FOUNDATION

The Advisor

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ESTATE PLANNER'S TIP

An individual can withdraw IRA savings prior to age 59½ without paying the 10% penalty on early withdrawals if the payments are part of a series of substantially equal periodic payments, made for the life or life expectancy of the owner (or joint life expectancies of the owner and designated beneficiary) [Code §72(t)(2)(A)(iv)]. The payments must continue for at least five years but may cease or be reduced once the owner reaches age 59½ [Code §72(t)(4)]. Because an individual with multiple IRAs is allowed to make the periodic equal withdrawals from one account without tapping into the others (Ltr. Rul. 9243054), a client with a large IRA could fund a new rollover IRA with just the amount needed to provide the desired income each year. For example, a 55-year-old client has an IRA of $4 million and a life expectancy of 28.6 years (IRS Table V). The client would like to receive $50,000 annually. Using a 5.8% interest rate assumption (March federal midterm rate), if the client transfers $650,000 into a rollover IRA, the annual payments would be $53,795 ($650,000 ÷ 12.0830 annuity factor from IRS Table S). The client does not have to calculate the equal withdrawals on the total $4 million in both accounts. This may be an option for clients with large IRAs who want to work part-time but don't want to reduce their income. Income can be increased in later years by establishing additional rollover IRAs.

TAX DUE ON MISAPPROPRIATED FUNDS

Wendell Hester was the trustee and income beneficiary of a testamentary trust created by his wife. In breach of his fiduciary duty, he transferred the trust's assets to his own trust and then began day trading, resulting in net losses of more than $2 million. He used the funds until it was impossible to determine what belonged to Hester and what belonged to the remainder beneficiaries.

Following Hester's death in 1998, his estate paid more than $2.5 million in tax on the value of his trust. The estate later sought a refund, claiming that the gross estate should not have included the misappropriated funds or, alternatively, that there should be a deduction under Code §2053(a)(3) for a claim against the estate or under Code §2053(a)(4) for indebtedness.

The U.S. District Court (W. Dist. VA) agreed with the IRS that Hester exercised dominion and control over the assets as though they were his own. The gross estate includes all property in which the decedent has an "interest" at death [Code §2031(a)]. He controlled the funds and did not reimburse them prior to his death, so they were properly included in his gross estate, said the court.

The court also found that no beneficiaries had made a claim against Hester's estate, nor did the estate ever anticipate a claim to be made, adding

that the state's two-year statute of limitations for breaches of fiduciary duty had elapsed (*Hester v. U.S.*, 2007-1 USTC ¶60,537).

TAX DEFERRED ON ESOP TO QRP TO GRAT

Alex and several other shareholders participated in the establishment of an employee stock ownership plan (ESOP). He elected to defer recognition of capital gain on the sale of his shares of the company's stock to the ESOP by purchasing qualified replacement property (QRP) under Code §1042(c)(4). Alex now intends to transfer the QRP to a grantor retained annuity trust (GRAT) that will give him the power, solely in a nonfiduciary capacity and without the approval of any person in a fiduciary capacity, to reacquire the trust principal by substituting other property of equivalent value.

Under Code §1042(e)(1), deferred gain on the sale of shares to an ESOP is recognized when the taxpayer disposes of the QRP. However, under Rev. Rul. 85-13 (1985-1 C.B. 184), a grantor is treated as the owner of a trust's assets if the grantor is the owner of any portion of the entire trust. Therefore, ruled the IRS, if Alex is the owner of the QRP held in the GRAT, the transfer of the QRP will not be a disposition under Code §1042(e).

Similarly, it will not be a disposition if he exercises his power to substitute property or if he receives QRP as a periodic annuity payment from the GRAT. If Alex dies during the term of the GRAT, a final payment of QRP made to his estate or trust will not result in recapture of gain because, under Code §1042(e)(3)(B), the recapture rules do not apply to transfers occurring by reason of the death of the person making the QRP election (Ltr. Rul. 200709012).

PHILANTHROPY PUZZLER

Shirley and George want to make a gift of a remainder interest in their home to charity. They have had several discussions with the charity concerning the tax benefits and their continuing responsibility for property taxes, insurance and maintenance of the home. Their only concern is that at some point in the future they may have to move from the house to a nursing home. They have asked what will become of the home if that happens.

WHAT'S IN A NAME? MAYBE A BEQUEST

Frederick Scale devised 10% of the residue of his estate to "The Audubon Society of New York State." Both the Audubon Society of New York State, Inc. (a state organization) and the National Audubon Society, Inc. (d/b/a Audubon New York) claimed to be the intended beneficiary. The Surrogate's Court determined there was a latent ambiguity and allowed extrinsic evidence. The attorney who drafted the will indicated that although Scale said he intended to benefit the state organization, he actually intended the national organization to receive the bequest. The state society appealed the Surrogate Court's finding, claiming the will was unambiguous on its face and that extrinsic evidence should not have been admitted.

The Appellate Division of the Supreme Court of New York (3rd Dept.) noted that extrinsic evidence is admissible only if an examination of the names and general character and purposes of the charities, as declared by their by-laws, reveals an ambiguity. The court said that Scale's failure to include the "Inc." in naming the beneficiary did not render the will ambiguous (*In the Matter of Scale*, 2007 NY Slip Op 01660).

HIGH FASHION, LOW DEDUCTION

Christiana Stamoulis estimates that she spent nearly $63,000 on clothing and shoes in 2002. She claims to routinely purchase designer items, wear them once or twice, and then donate them to a thrift store. She claimed a charitable contribution that year of $55,764 although her gross income was less than $115,000.

The IRS disallowed her deduction, although it later conceded that she was entitled to a deduction of $4,652. Stamoulis acknowledged that her

deduction should be reduced by $6,629.

Stamoulis gave most of the clothes to the Housing Works Thrift Shops and Used Book Café. The organization provides donors with a donation inventory list form, but does not verify the accuracy of the information. The Tax Court noted that donors are required to list the approximate date and method of acquisition for donated items, along with the cost basis for deductions in excess of $500 [Reg. §§1.170A-13(b)(3)(i)(A) and (B)]. The court found that while her inventory form was fairly descriptive, the valuation method was faulty. The court ultimately allowed a deduction of $8,949 for the noncash gifts, along with the $1,053 allowed by the IRS for cash gifts (*Stamoulis v. Comm'r*., T.C. Summary Opinion 2007-38).

Note: Under the Pension Protection Act of 2006, a deduction is allowed for contributions of clothing only if the item is in good used condition or better [Code §170(f)(16)(A)]. Form 8283 is required for a gift of a single clothing or household item in excess of $500.

MOM ALWAYS LIKED HIM BEST

Lucile Young created a testamentary trust, naming Kathy McCoy as trustee and giving her discretion over distributions. The trust was for the benefit of Young's son, Steven, who was serving a life sentence in prison for attempting to murder Young's other son, Richard. McCoy could distribute as much income and principal as deemed necessary for Steven's health, support, maintenance and education, taking into consideration all other sources available. At Steven's death, trust assets are to pass to the Christian Science Foundation of Boston. The trust indicated that the primary purpose was to care for Steven, with charity's interest as secondary. Richard, who suffered injuries in the murder attempt, obtained a judgment against Steven for $1,275,000.

Shortly after Lucile's death, Richard filed a petition to enforce his judgment from the trust assets. McCoy indicated that she made no payments to Steven because his needs of support and health were being taken care of by the state while in prison. The church, as remainder beneficiary, also objected to the petition. The Superior Court of Los Angeles denied Richard's petition, noting that it had no authority to compel the distribution.

Richard appealed, arguing that once a restitution judgment exists, the court can order the trustee to distribute funds from the trust. The California Court of Appeals noted that state law permits a court to order a trustee to satisfy all or part of the restitution judgment out of future payments that the trustee, pursuant to discretion, determines to make for the beneficiary. In a trust where the beneficiary can compel the trustee to make payments, the court can order the trustee to satisfy the restitution from the payments as they become due or payable.

When and if McCoy makes payments, the court has the power to ensure that Steven receives nothing until the restitution is fully paid, but it has no power to invade trust assets (*Young v. McCoy*, B189885).

Note: The trust created by Lucile is not a qualified charitable remainder trust because it does not provide for a unitrust or annuity trust distribution to Steven. It would, therefore, not generate an estate tax deduction unless reformed.

PUZZLER SOLUTION

Shirley and George could lease the home and receive rental income for their lives. If they don't need the income, they could make a gift to the charity of their remaining life estate, entitling them to a second charitable deduction. Or they could join with the charity to sell the home. The value of their respective interests would depend upon the home's fair market value, their ages at the time and the midterm rate for the month of the sale. Proceeds would be divided proportionately. Charity may also wish to buy the couple's life interest and then sell the entire parcel.

PLANNING IDEAS FOR CHARITABLE BEQUESTS

Clients who wish to include charity in their estate plans may be unaware of the many options for creating testamentary gifts – and reducing the amount of the estate that will be subject to estate taxes.

Outright bequests

■ A specific bequest of a stated sum of money or a particular asset ensures that the charity will receive that amount or item of property before other general bequests are satisfied. A client concerned that the estate may not be as large as anticipated and that the charitable bequest could deplete assets needed by family members can specify that the charitable bequest is dependent upon the estate being a particular size.

■ A percentage bequest of a portion of the estate or residue allows the bequest to fluctuate with the value of the estate. However, if taxes are paid from the residue, charity's share – and the estate's charitable deduction – could be reduced. Instead, the estate plan can allocate taxes to those bequests that generate tax.

Split-interest bequests

Many testators hesitate to include charitable bequests, feeling that they must leave everything to family members. It's possible to satisfy both family and philanthropic goals through split-interest gifts.

■ *Charitable remainder trusts* – Clients can create testamentary trusts that pay income to family members for life or a term of up to 20 years and then distribute the remaining assets to charity.

■ *Charitable lead trusts* – A lead unitrust that pays income to charity for a number of years and then distributes the assets to grandchildren can leverage the $2 million sheltered from the generation-skipping transfer tax [Code §2631(a)]. A lead annuity trust is generally employed to reduce estate tax where GST tax is not an issue.

■ *Gift annuities* – If the charity offers gift annuities, the bequest can provide income for life to a family beneficiary and eventual benefits for the charity.

■ *Remainder interests* – The client can bequeath a home or farm to charity while reserving a life estate for a spouse or other family member.

Types of assets

Charitable gifts of appreciated assets are recommended for lifetime giving because the donor receives a charitable deduction for the fair market value and avoids capital gains tax that would be due if the property were sold. At death, however, appreciated property generally receives a stepped-up basis to its date of death value, meaning family members will pay no capital gains tax if the asset is sold immediately. Other assets may be more tax-wise for charitable bequests:

■ *Income in respect of a decedent (IRD)* – IRD assets, such as U.S. savings bonds, IRA balances and deferred compensation, are subject to both income tax and estate tax (Code §691). IRD property passing to charity avoids the income tax and entitles the estate to a charitable deduction. But the estate plan must designate the IRD property specifically for charity; the tax advantages are not available if the executor merely satisfies a pecuniary bequest with IRD assets [Reg. §1.691(a)-4(a); TAM 200644020].

■ *Unrelated tangible personal property* – A donor who makes a lifetime gift of personal property that is unrelated to the charity's exempt purpose may deduct only his or her basis [Reg. §1.170A-4(b)(3)(i)]. But a bequest of the same property entitles the estate to an estate tax deduction for fair market value.

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