DALLAS JEWISH COMMUNITY FOUNDATION

The Advisor

November 2007

ESTATE PLANNER'S TIP

Older brides and grooms, particularly those with families from previous marriages, should review their retirement plans after saying "I do." Certain qualified retirement plans are required to be paid as joint and survivor benefits unless the spouse has properly waived the right to receive survivor benefits [Reg. §1.401(a)-(20)]. A waiver of this right prior to marriage (e.g., in a prenuptial agreement) may not be effective, since the parties are not "husband" or "wife" until after the ceremony. Another consideration is the investment mix of the couple's retirement assets. Newlyweds should review their total retirement plan holdings to determine whether they are invested too heavily in equities or bonds, given the ages of the spouses. Portfolio mix is particularly important where one or both participate in 401(k) plans that may have substantial holdings in an employer company's stock. The couple can choose to achieve a more diversified investment mix by balancing one spouse's more aggressive investments against the other's more conservative holdings, or having one spouse concentrate on growth, or growth and income, while the other invests in international and small-cap stocks.

NO INSURING AGAINST THIS LOSS

In 1988, Norman Eckersley signed an employment agreement with Pacific Bank in San Francisco. It contained a provision regarding a $1 million life insurance policy on Eckersley's life. The bank was to pay all the premiums, with the policy to be assigned to and for the benefit of Eckersley's wife Rosemary. The bank, which was the owner and beneficiary of the policy, changed the beneficiary to Rosemary in November 1989.

In December 1996, when Eckersley was no longer affiliated with the bank, he filed suit alleging that the bank had breached the employment agreement by failing to transfer title of the policy to Rosemary. The parties settled the matter, with the bank agreeing to pay the couple, among other amounts, $500,000 calculated to relate to the life insurance policy. The settlement confirmed the bank's full rights to ownership of the policy.

In 1999, the Eckersleys paid their attorney $555,429, approximately one-third of the total settlement. On their income tax return, they filed a Schedule C, Profit or Loss from Business,

reporting income of $634,634, including the $500,000 related to the life insurance policy. They deducted legal expenses of $675,646.

The IRS determined a deficiency, saying the $500,000 was not related to a trade or business, but was instead "other income." The IRS also claimed the bulk of the legal fees were not an ordinary and necessary expense incurred in a trade or business, but were a miscellaneous itemized deduction.

The Eckersleys argued that the $500,000 received for a sale of the life insurance to the bank, less their basis in the policy, was taxable as a capital gain. They claimed that $181,348.33 of the $500,000 was paid for the cash value of the policy, with the balance paid for the policy's other attributes.

The Tax Court agreed with the IRS that the policy was taxable as ordinary income. The Eckersleys had no basis in the policy, which had no particular cash value. The court determined that the $500,000 was received in extinguishment of any right the Eckersleys might have had in the policy, noting that both before and after the settlement, the bank was owner of the policy. The payment received was for the extinguishment of a claim, not a sale or exchange of a capital asset, said the court (*Eckersley v. Comm'r.*, T.C. Memo. 2007-282).

PHILANTHROPY PUZZLER

Chris is a 25% shareholder of an S corporation that made a $10,000 charitable gift in 2007. He is aware that he is entitled to claim his proportionate share of the gift on his personal return, but in compiling his records for a year-end review with his tax advisor, he discovered that he did not have a written acknowledgment from the charity for his share of the gift made by the corporation. Can he claim the deduction?

PUTTING ON A GOOD FACADE – AND VALUING IT

The IRS says that, lacking any "substantial record of market-place sales of comparable easements," the deduction for a contribution of a facade easement is to be determined using a "before-and-after" method. Some taxpayers have been claiming deductions based on a percentage – generally 10% to 20% – of the appraised fair market value of the property prior to the easement grant.

Reg. §1.170A-14(h)(3)(i) provides that the fair market value of a perpetual conservation restriction is the difference between the fair market value of the property before granting the restriction and the fair market value after the grant.

In a Chief Counsel Advice Memorandum, the IRS said that some taxpayers are relying on a Market Segment Specialization Program Guide and Topical Tax Brief that were posted on the IRS website (both have been removed). The briefs suggested a range within which a facade easement might be expected to reduce the value of property. Both made clear, however, that the before-and-after method was the proper way to value a facade easement. In the absence of comparable sales of facade easements, the IRS says that an appraisal that does not use the before-and-after method will not be accepted as proper substantiation under Reg. §1.170a-14(h)(3)(i) [CCA 200738013].

LACK OF INSURANCE CREATES "NON-WEALTH REPLACEMENT UNITRUST"

Attorney Ronald Kooistra referred Florence Smallegan to American Express Financial Advisors for an in-depth estate plan. A key element of the plan was the creation of a charitable remainder unitrust, funded with $900,000 of appreciated stock. Smallegan would be the income beneficiary, with her only child, Kenneth, the trustee. The assets transferred to the unitrust would be replaced in Smallegan's estate with the proceeds of a life insurance

policy funded by income distributions from the unitrust.

Smallegan applied for, but was denied, life insurance coverage. She executed the trust, despite the lack of insurance, based on assurances by American Express representatives that they could find a company willing to issue a policy. After more insurance rejections, Smallegan gave up trying to obtain a policy. When she died nearly four years after executing the trust, Kenneth filed suit to recover the value of the nonexistent insurance proceeds. The trial court, applying the "four corners" rule, granted Kooistra's motion for summary judgment. Kenneth appealed, claiming that ambiguities in the unitrust and legal presumptions based on Kooista's loss of Smallegan's file were evidence of malpractice.

The Michigan Court of Appeals noted that the "four corners" rule precludes the introduction of extrinsic evidence to discern the testator's intent or to undermine a clear and unambiguous testamentary document. The court found that nothing indicated that Smallegan intended anything other than to make a gift to charity through the unitrust. The unitrust was not conditioned upon the issuance of life insurance. Further, noted the court, Kenneth did not argue that the lost will would have provided him with a greater share of his mother's estate. This does not create a presumption that would open the door to parol evidence, said the court.

Smallegan funded the trust despite being rejected for life insurance coverage. In the four years prior to her death she took no action to disavow the trust, rescind it or seek legal recourse herself, the court noted in affirming the trial court (*Smallegan v. Kooistra*, No. 272838, LC No. 04-049107-CZ).

PARTING NOT SUCH SWEET SORROW FOR DONORS

Daisy and Jack created two charitable unitrusts, retaining the income interests for their lives. The couple and the charitable remainderman have agreed to terminate both of the trusts. The charity, as trustee of the trusts, will distribute to Daisy and Jack an amount equal to the actuarial value of the income interests. Charity will receive the balance of the trust assets outright.

The IRS noted that although the transaction takes the form of a distribution of the present values of the unitrust interests to Daisy and Jack, it is in substance a sale of their income interests. The distribution to the couple will be an amount received from the sale or exchange of property [Rev. Rul. 72-243, 1972-1 C.B. 233]. Their adjusted basis in the interest is disregarded under Code §1001(e), noted the IRS. Therefore, the entire distribution received as a result of the early termination will be long-term capital gain.

Daisy and Jack are disqualified persons with respect to the unitrusts. Under Code §4941, any sale or exchange between a disqualified person and a trust is generally self-dealing. However, because the distribution equals the actuarial value of the income interest, the Reg. §53.4947-1(c)(2)(i) exception to the self-dealing rules apply, ruled the IRS (Ltr. Rul. 200727013).

PUZZLER SOLUTION

The corporation is treated as the taxpayer for purposes of Code §170(f)(8) and is required to obtain a contemporaneous written acknowledgment to substantiate the gift before reporting the contribution on its tax return for 2007. The corporation must maintain the acknowledgment in its records. Chris is not required to obtain any additional substantiation to claim his share of the gift [Reg. §1.170A-13(f)(15)]. The same rule applies to contributions by partnerships.

MORE MAY NOT BE MERRIER IN CHARITABLE REMAINDER TRUSTS

Prior to July 29, 1997, donors creating charitable remainder unitrusts had few restrictions on the number of income beneficiaries. The IRS approved a 10% payout unitrust with 37 life-income beneficiaries, ranging in age from one to 93 (Ltr. Rul. 9139006). The ruling did not disclose the size of the trust, but a transfer of $1 million would yield a charitable deduction of only about $180.

Today, however, a trust would not qualify as a charitable remainder unitrust even with the one-year-old as the only income beneficiary and the minimum 5% payout. For all charitable remainder trusts created after July 28, 1997, and for additional contributions to unitrusts created prior to that date, the value of charity's remainder interest must equal at least 10% of the amount transferred [Code §§664(d)(1)(D), 664(d)(2)(D)]. Funding a charitable remainder trust for the lifetimes of younger beneficiaries remains a challenge.

For example, the youngest age for which a 5% charitable remainder unitrust can be created (assuming annual payments and the use of October's §7520 rate of 5.2%) is 25, which yields a deduction of $10,050 on a $100,000 transfer. In the case of a two-life trust, where both beneficiaries are age 37, the remainder would fall just short of satisfying the 10% requirement (deduction of $9,889).

For most charitable remainder trust donors the 10% requirement is not a concern. But it is possible for donors to boost the deduction available for their giving.

Consider a grandfather who plans to transfer $300,000 to establish a 5% charitable remainder unitrust to benefit his three grandchildren, ages 28, 32 and 36. The value of charity's remainder interest would be $18,456 (assuming annual payments and a §7520 rate of 5.2%) and the trust would not be qualified. If the grandfather instead created three trusts, funding each with $100,000, he would have the following deductions:

28-year-old	$11,352
32-year-old	$13,370
36-year-old	$15,741

All three trusts satisfy the 10% test and the total deductions – $40,463 – are more than double what the grandfather could have received with a single trust, even assuming it qualified.

The same is true where the donors are closer in age. In the case of a husband and wife, both age 65, a single 5% unitrust funded with $500,000 would result in a deduction of $172,875 (using annual payments and a §7520 rate of 5.2%). However, two separate unitrusts of $250,000 would produce deductions totaling $230,530. Why the disparity? With a two-life trust, there is a greater likelihood that at least one beneficiary will live beyond the actuarial life expectancy.

There are drawbacks to creating multiple trusts, of course. In the case of the married couple, at the death of the first spouse, payouts from that spouse's unitrust will end; with a two-life trust, the payouts will continue for the life of the survivor. This may be important in the case of spouses, particularly if one is in poor health. It might be less of a factor in the case of the unitrusts for the three grandchildren. Another drawback may be the fees associated with creating and managing the trusts. Small trusts might not be economically feasible, although if the trusts share the same trustee, the funds could be commingled to achieve a better overall return, provided the trustee follows proper accounting for each beneficiary.

Charitable remainder annuity trusts are subject to the same 10% remainder requirement, but are also subject to the 5% probability test [Rev. Rul. 77-374, 1977-2 C.B. 329]. Under the test, if the probability exceeds 5% that a noncharitable beneficiary of the trust will survive to the exhaustion of the trust fund, no deduction is allowed and the trust is not qualified under Code §664 (Ltr. Rul. 9532006).

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