

The Advisor

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ESTATE PLANNER'S TIP

An irrevocable life insurance trust with *Crummey* withdrawal powers can be a tax-wise means of passing substantial assets to family members. Properly structured, there would be little or no gift or estate tax to the insured/grantor and no income tax to the eventual trust beneficiaries. But if grandchildren are included in the class of beneficiaries, there may be generation-skipping transfer tax (GST) consequences. Generally, an outright gift of cash or property to a grandchild that qualifies for the \$12,000 annual exclusion [Code §2503(b)] is not subject to the GST. However, where the transfer is in trust, the exclusion from GST is available only if, during the skip person's life, none of the corpus or income from the trust can be distributed to or for the benefit of any other individual and if the assets of the trust will be included in the skip person's estate if he or she dies before the trust terminates. Many irrevocable life insurance trusts are structured with multiple beneficiaries. Although the transfers may be gift-tax free, thanks to the annual exclusion, they may be subject to GST. Payment of the tax can be avoided by allocating a portion of the transferor's GST exemption [Code §2631(a)] to the transfer.

TWO WILLS, LOTS OF LEGAL EXPENSES

Ruth Hawkins executed a will in 1994 naming her cousin, Robert Ross, as executor and one-third beneficiary. In 2000, she executed a second will naming her step-daughter, Margaret Dieffenbach, as executor. After Hawkins' death, Margaret petitioned to probate the 2000 will. Robert challenged, seeking to probate the earlier will.

The court determined that Ruth had lacked testamentary capacity since 1999, making the second will invalid. Before the court determined whether to admit the 1994 will, the parties reached a settlement, which was approved by the court. The court's order noted that the administration of the estate had been complex, resulting

in substantial legal expenses. Litigation expenses and attorney fees totaling \$903,000 were properly payable by the estate, according to the court.

An amended estate tax return was filed claiming a refund of nearly \$530,000. The IRS disallowed almost \$400,000, saying that the fees were not reasonable, not allowable by state law and not necessarily incurred for the benefit of the administration of the estate, as required by Code §2053.

The IRS pointed out that state (California) law does not allow attorney fees in these circumstances to be charged to the estate, notwithstanding the order entered by the probate court. The estate responded that a state court decision sanctioning a

charge against an estate will “ordinarily be accepted as establishing the validity and amount of the claim” [Reg. §20.2053-1(b)(2)]. However, the U.S. District Court (No. Dist. CA) said that such a decree is not accepted if it is at variance with state law. The IRS noted that state law expressly provides only for payment by the estate of attorney fees incurred by a personal representative, not beneficiaries. The court found that payment of Robert’s attorney’s fees were proper, and that Margaret, as executor of the 2000 will, had a duty to offer it for probate unless she knew it to be invalid. The court therefore denied the IRS’s motion for summary judgment (*Kessler v. U.S.*, 2007-2 USTC ¶60,544).

TRUST LOSES ON LOSSES

A residuary trust was created pursuant to Susan’s will. Among the assets that were to pass to the trust were S corporation shares that she had owned individually. During the administration of Susan’s estate, the S corporation incurred losses that the estate did not have sufficient income to offset, giving rise to a net operating loss under Code §172.

The NOL remained unused at the termination of the estate, the same day the trust was funded, and the trust succeeded to the carryover [Code §642(h)(1)]. The trust qualified as a permissible S corporation shareholder under Code §1361(c)(2)(A)(iii) during the two-year period beginning on the date it was funded. However, in order to remain an eligible trust following that two-year period, the trustee had to make an election for the trust to be an electing small business trust (ESBT) [Code §1361(c)(3)].

PHILANTHROPY PUZZLER

After he was named executor of his uncle’s estate, John discovered that the charitable remainder trust created in the will was defective. The trust was to pay a 5% annuity amount to John for life, with the remainder divided between charity (75%) and John’s children (25%). John has asked if anything can be done to salvage the charitable deduction.

Code §641(c)(2)(C) provides a list of the items of income, loss, deduction or credit that the S portion of an ESBT may take into account. No deduction or credit is allowed for any amount not listed [Code §642(c)(2)(C)]. The IRS ruled that the NOLs that the trust succeeded to are not among the amounts described in Code §641(c)(2)(C), and the S portion of the trust is precluded from taking those deductions. The trust could, however, claim the NOL deduction as to the non-S portion of the trust (Ltr. Rul. 200734019).

THIS “GIFT” DOESN’T PASS THE IRS SNIFF TEST

The IRS and the Treasury Department have put advisors, taxpayers and charities on notice that, while there’s not sufficient evidence to determine whether a particular gift is a “tax avoidance transaction,” it has the potential for “tax avoidance or evasion.”

The typical transaction, according to the IRS, involves an advisor who owns all the membership interests in a limited liability company that directly or indirectly owns real property that may be subject to a long-term lease. The taxpayer purchases a successor member interest in the LLC, entitling the taxpayer to own all the membership interests upon the expiration of a term of years.

After holding the successor interest for more than one year, it is transferred to a charity. The taxpayer then claims the value of the interest to be significantly higher than the purchase price, based on an appraisal of the fee interest of the underlying real property. In addition to the overstatement of value, the IRS said it is also concerned with any agreement by charity not to transfer the interest for a period of time and any sale by charity to a party selected by or related to either the advisor or taxpayer.

Transactions that are the same or similar to these, entered into on or after November 2, 2006, are considered “transactions of interest” under Reg. §1.6011-4(b)(6) and Code §§6111 and 6112, effective August 14, 2007. The transactions must be disclosed by the advisors and taxpayers. In addition, charities receiving such interests after August 14, 2007 must report the receipt of the successor member interest in the year received (Notice 2007-72).

A NEW MEANING TO “GARDEN WALK”

Henry and Martha Kolb deeded farmland to their sons as trustees for the “use and benefit of the City of Storm Lake.” The couple had earlier signed an agreement with the city for the establishment of a flower garden in memory of their grandson at a specific location within a city park.

In 2003, the city began an economic revitalization project that required the relocation of the memorial garden within the park. Initially, Norman Kolb worked with the city toward this goal, but in 2005 he filed suit seeking an injunction or a declaratory judgment that the original trust had failed. The city claimed that the cy pres doctrine applied to continue the trust. The court refused to issue an injunction, after which the city removed the garden. The court ruled that the cy pres doctrine did not apply since it was possible for the garden to exist, except for the city’s voluntary destruction. As a result, the trust’s purpose had been destroyed and the resulting trust would benefit the Kolbs’ successors. The city appealed.

The Supreme Court of Iowa noted that state law presumes that cy pres should apply if the trust does not state “to the contrary.” The Kolbs did not anticipate the failure of the trust or provide for an alternative plan. Although the city, by destroying the garden, caused the impossibility of maintaining the garden at its original location, the actions were the result of “natural and unavoidable” changes, said the court, noting that cities have the responsibility to make improvements. While the Kolbs would be disappointed about the relocation, “they would have been even more disappointed in the complete failure of the trust.” The court ruled the cy pres doctrine should apply (*Kolb v. City of Storm Lake*, No. 63/06-0067).

SECOND CHANCE FOR NON-EXISTENT FOUNDATION

Margaret Scarbrough left the bulk of her estate to a private foundation that she had planned to establish during her lifetime. At her death, however, the foundation had not been created. Merrill Lynch, the successor trustee, asked the court to rule whether the cy pres doctrine could be applied to direct the funds to a foundation that had been

established after her death, or to a community foundation. Margaret’s heirs claimed that the property should revert to them by operation of law.

The trial court ruled for the heirs, saying Scarbrough’s trust did not reveal a charitable intent. Because the language of the trust was clear and unambiguous, the court said that the testimony of the attorney who drafted the will was inadmissible.

The Court of Appeals of Georgia acknowledged that the trust could not be effectuated in the precise manner set forth in Scarbrough’s trust. Cy pres is generally applied only where there is an otherwise valid charitable trust or grant, where the settlor’s specific intentions cannot be legally or practicably carried out and where the settlor has exhibited a general charitable intent.

The appeals court found that it was not clear from the trust language whether Scarbrough had a general charitable intent. Her trust referred to a foundation that was not described. The trial court therefore erred in determining that there was no ambiguity, said the appeals court. State law allows the introduction of parol evidence regarding the execution of the trust to explain both patent and latent ambiguities. The appeals court remanded the matter for consideration of parol evidence (*Baker v. Merrill Lynch Trust Co.*, FSB, A07A0404).

PUZZLER SOLUTION

The uncle’s trust would have qualified for an estate tax charitable deduction but for the requirements of Code §2055(e)(2) that it be a qualified annuity trust or unitrust. Therefore, it is reformable under Code §2055(e)(3). The interests of the parties will be identical if two trusts are created – one funded with 75% of the assets and the other with 25% and with John the income beneficiary of both. At his death, the remainder of the larger trust will pass to charity. The uncle’s estate will be entitled to a deduction for charity’s remainder interest in that trust (Ltr. Rul. 9529042).

FROM LIKE-KIND EXCHANGE TO UNITRUST

Many real estate investors are familiar with the like-kind exchange provisions of Code §1031. These rules allow taxpayers to postpone capital gains tax on the disposition of a piece of income-producing or investment real estate by “trading” or exchanging for another parcel of similar use.

Take the example of Warren, who owns a small apartment building near his home in Minnesota. He originally paid \$650,000 for the property many years ago, but has since depreciated it down to \$150,000. He estimates that it is now worth \$900,000. Warren recently retired and will be moving to Florida within the next few months. Because he will no longer be able to keep an eye on the apartment, he would like to sell it. If he does, however, he’ll be hit with a substantial capital gains tax.

One option for Warren is to defer the recognition of capital gain by means of a like-kind exchange. How would it work? Warren could identify rental real estate that he wishes to acquire in Florida. Because it’s unlikely the owner of the Florida property would want to exchange it for Minnesota real estate, Warren would have to persuade the potential buyer of his Minnesota property instead to purchase the Florida real estate he wants to acquire. The two could then “trade” parcels. Warren would keep the same basis in his new property that he had in the Minnesota building, with adjustments for other property, such as cash, that changed hands.

An even easier method for Warren to postpone the capital gains tax is through a Starker-delayed exchange [Code §1031(a)(3)]. He could sell his

Minnesota property and arrange to have the proceeds held by an intermediary (e.g., trust department of a bank). He would have 45 days to designate the replacement property in Florida and 180 days to close on the property.

But what happens to Warren and the thousands of other real estate investors when they finally decide to get out of the real estate business? Several like-kind or Starker exchanges may have taken place over the years, leaving the taxpayer with a low basis in property with an appreciated fair market value.

Philanthropic clients faced with this dilemma could find that a charitable remainder unitrust is the solution to several problems. First, there is no capital gains tax when the real estate is placed in the trust or sold by the trustee. Second, there is a charitable deduction based on the fair market value of the property, not the much lower adjusted basis. Third, the client receives the payments over his or her life, so the cash flow can mimic the rental income the donor previously received. Fourth, rather than receiving rent, which is ordinary income, a portion of each year’s trust payout may consist of capital gain income, taxed at only 15% or 25%. And finally, the client is able to satisfy charitable goals. It may make sense to arrange a “flip” unitrust [Reg. §1.664-3(a)(1)(i)(c)]. The trust would begin as a net-income or net-income with make up unitrust and then convert to a standard unitrust in the year after the sale of the real estate, entitling the donor to a fixed percentage of the trust’s annual value.

