

The Advisor

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ESTATE PLANNER'S TIP

Part of any year-end tax review should include a check to determine whether clients' withholding and estimated tax payments are sufficient. Up to 85% of Social Security benefits are subject to income tax if provisional income (adjusted gross income, tax-exempt income and a portion of Social Security benefits) exceeds \$34,000 for single taxpayers or \$44,000 for married couples [Code §86]. Clients who continue working while also drawing Social Security benefits may find they have underwithheld their income tax liability. One way to avoid a penalty is to have additional amounts withheld from paychecks in the final months of the year. Unlike estimated payments, which must be made by specific dates [Code §6654(c)(1)], taxes withheld from wages are considered to be paid ratably over the year [Code §6654(g)(1)]. Another option – for efficient clients – is to file the 2008 income tax return and pay any taxes due by January 31, 2009 [Code §6654(h)].

MARITAL DEDUCTION ALLOWED DESPITE MATH ERROR

A QTIP election, once made, is irrevocable [Code §2056(b)(7)(B)(v)], but the IRS did allow the executor of an estate to correct a mathematical error that caused the estate to underpay estate tax. Herb's will provided that the residue of his estate was to be placed in trust, with all income to be paid to his wife. At her death, the property was to be divided equally between Herb's son and daughter. The will granted the executor the power to make a QTIP election.

The executor and lawyer intended that the election be made in the amount necessary to reduce the estate tax to zero. On the estate tax return, the lawyer mistakenly employed the credit shelter

amount from the year the return was filed, not the lower exemption amount from the year of Herb's death. The error, which was not noticed until the executor received a notice from the IRS, resulted in the estate underpaying tax.

The estate then filed a supplemental Form 706 using the correct exemption amount and reporting a tax liability of zero. The IRS noted that the executor and lawyer intended to make the QTIP election in the amount necessary to result in zero tax. The marital deduction is allowable under Code §2056(b)(7), ruled the IRS, using the correct applicable credit shelter amount (Ltr. Rul. 200832011).

IRS LEADS THE WAY WITH SAMPLE DOCUMENTS

The recent release by the IRS of sample documents for charitable lead unitrusts completes the forms for split-interest trusts (Rev. Procs. 2008-45, 2008-46). The sample documents released:

■ A term-of-years testamentary charitable lead unitrust, with alternate provisions for (1) a trust for the life of an individual, (2) apportionment of the unitrust amount in the discretion of the trustee and (3) designation of an alternate charitable beneficiary in the trust instrument.

■ An inter vivos nongrantor charitable lead unitrust for a term of years, with alternate provisions for (1) a trust for the life of an individual, (2) retention of the right to substitute the charitable lead beneficiary, (3) apportionment of the unitrust amount in the discretion of the trustee and (4) designation of an alternate charitable beneficiary in the trust instrument.

■ An inter vivos grantor charitable lead trust for a term of years, with alternate provisions for (1) a trust for the life of an individual, (2) retention of the right to substitute the charitable lead beneficiary, (3) apportionment of the unitrust amount in the discretion of the trustee and (4) designation of an alternate charitable beneficiary in the trust instrument.

WHY DRAFTING DOCUMENTS IS NOT A DO-IT-YOURSELF PROJECT

Larry, with assistance from family members and a representative from charity, created a

PHILANTHROPY PUZZLER

Pete's corporation reports income on a calendar year accrual method. He would like the company to make a substantial charitable contribution for 2008, but because the company's business cycle is generally best in the first quarter of the year, he'd like to wait until then to make the gift. The company's CFO told him that the corporation's board could authorize the gift this year and claim a deduction for 2008, then wait until as late as March 15, 2009, to actually pay. Pete wants to know if the CFO's advice is on target.

charitable remainder unitrust. He intended that the trust last until the later of (i) the death of the survivor of Larry and his wife or (ii) the earlier of 20 years after a specified date or the death of his last surviving child. Instead, the trust provided that the unitrust amount would cease upon the death of the survivor of Larry and his wife.

Several months after the trust was signed, but before the end of the tax year, the mistake was discovered. The trustee asked the court to reform the trust ab initio. The court found that the trust failed to accurately reflect Larry's intent and reformed it, subject to a favorable ruling from the IRS. No tax returns have been filed with respect to the trust, and no payments have been made that are inconsistent with the proposed changes.

Although Reg. §1.664-3(a)(4) provides that a charitable remainder trust may not be subject to a power to invade, alter, amend or revoke for the beneficial use of any person other than charity, the IRS determined that the judicial reformation ab initio did not violate Code §664 or adversely affect the trust's qualification as a charitable remainder unitrust (Ltr. Rul. 200831002).

INCOME, GIFT AND ESTATE TAX DEDUCTIONS FOR GIFT FROM "OLD" TRUST

Martha and George created an irrevocable trust prior to passage of the Tax Reform Act of 1969. They reserved all income for their joint lives. At the death of the survivor, the remaining assets were to pass to the charities designated by the couple.

The couple made additional contributions to the trust, both before and after July 31, 1969. They amended the trust, providing that all property transferred prior to July 31, 1969, would continue to be held under the provisions of the trust. All property transferred after July 31, 1969, was to be held in a second trust that was reformed into a charitable remainder unitrust [Code §664(d)(2)].

George died several years ago, leaving Martha as the sole income beneficiary. She now proposes to transfer her income interest in the pre-July 31, 1969 trust to the charitable remainder beneficiaries. Under state law, the trust would terminate

and assets would be distributed to the charities.

Code §2522(c)(2) provides that no gift tax charitable deduction is allowed where an interest in the same property is transferred for an individual and charity. There is an exception for a transfer of an undivided portion of the donor's entire interest. Because Martha's only interest in the trust was an income interest, she is transferring everything she owns and will be entitled to a charitable deduction under Code §2522, ruled the IRS.

The value of the retained income interest in the trust would be included in Martha's gross estate, under Code §2036. If she dies within three years of transferring the interest to charity, the value will be brought back into her gross estate under Code §2035. However, her estate would then be entitled to a corresponding estate tax charitable deduction under Code §2055.

The IRS determined that Martha would also be entitled to an income tax charitable deduction, under Code §170(a) (Ltr. Rul. 200834013).

COURT SHOWS NO LENIENCY ON SUBSTANTIATION

Daniel and Ruth Gomez contributed \$6,885 to their church and affiliated auxiliaries in 2005. Although both the IRS and Tax Court acknowledge the gifts were made, the couple's charitable deductions were nevertheless disallowed because they lacked proper substantiation.

The donors wrote 20 separate checks to the church, which requires members to tithe, totaling \$6,548.27. The checks had entries on the memo line indicating they were for tithes, the men's auxiliary or the women's auxiliary.

Code §170(f)(d)(A) requires that contributions of \$250 or more be substantiated with contemporaneous written acknowledgment. The acknowledgment must be obtained by the taxpayer on or before the earlier of the date on which the taxpayer files a return for the taxable year in which the contribution is made or the due date (with extensions) for filing the return [Code §170(f)(8)(C)].

The church did provide a letter, dated January 22, 2008, stating that the couple tithed in the amount of \$6,552 in 2005. However, noted the court, the letter was not contemporaneous and

did not meet the substantiation requirements, which require charity to include a good faith estimate of the value of any goods or services received in consideration [Code §170(f)(8)(B)]. While the court found the canceled checks and letter "reliable," it said "they do not meet the substantiation requirements" (*Gomez v. Comm'r.*, T.C. Summ. Op. 2008-93).

DONOR DIDN'T SUBSTANTIATE ANONYMOUS GIFTS

Paul and Anita Tucker had 40 canceled checks for gifts made to their church in 2002. The total: \$6,410. The couple claimed total charitable gifts of \$19,979. The IRS disallowed all but \$2,196 for failure to properly substantiate the gifts.

Tucker claimed that his religious principles required him to make anonymous cash donations to the church. The Tax Court said it appreciated his religious beliefs and practices, but deductions, whether in cash or otherwise, must be substantiated with either a canceled check, a receipt from the donee organization showing the name of the charity, date of the gift and the amount, or some other reliable written records with the charity's name, date of the gift and amount [Reg. §1.170A-13(a)(1)].

Although Tucker maintained a log, the court said it was not persuasive and did not satisfy the substantiation requirements. Tucker's charitable deduction was limited to the amount shown in the canceled checks (*Tucker v. Comm'r.*, T.C. Summ. Op. 2008-78).

PUZZLER SOLUTION

The CFO is correct that accrual method corporations can deduct charitable gifts in one year, even though charities are not paid until the next year [Code §170(a)(2)]. Furthermore, Pete's company need not claim a 2008 charitable deduction for the entire amount contributed early next year. Under Rev. Rul. 57-228 (1957-1 C.B. 506), the company can choose to take only a portion of the total deduction in 2008, claiming the rest in 2009.

PROPOSED REGULATIONS CLARIFY SUBSTANTIATION CHANGES

Proposed regulations have been released to reflect changes to gift substantiation rules contained in the American Jobs Creation Act of 2004 and the Pension Protection Act of 2006 (NPRM REG-140029-07).

Cash, check or monetary gifts

Code 170(f)(17) provides that no deduction is allowed for a contribution of cash, check or other monetary gift unless the donor maintains a bank record or other written communication from the donee. A de minimis exception was not adopted in the proposed regulations, although there is an exception for the unreimbursed expenses of less than \$250 incurred in rendering services to a charity. Taxpayers who incur out-of-pocket expenses for charitable services should maintain records, however. If the donor's bank statement does not include the name of the donee, a monthly bank statement and a photocopy or image obtained from the bank of the front of the check, indicating the donee's name, is sufficient.

Noncash contributions

Donors who make noncash contributions of less than \$250 must obtain a receipt from the donee or keep reliable records. For noncash gifts of \$250 or more, but not more than \$500, the donor is required to obtain a contemporaneous written acknowledgment [Reg. §1.170A-13(f)]. For gifts valued over \$500 but not more than \$5,000, the donor must have a contemporaneous written acknowledgment and file Section A of Form 8283 along with the return. For deductions of \$5,000 or more, the donor must also obtain a qualified appraisal and complete either Section A or B of Form 8283. A copy of the qualified appraisal must be attached to the tax return if the donor is claiming a contribution of more than \$500,000.

There is an exception to the substantiation rules if the donor can show that the failure to meet

requirements is due to "reasonable cause and not to willful neglect" [Code §170(f)(11)(A)(ii)(II)]. To do so, the donor must submit a detailed explanation of why the failure to comply was due to reasonable cause and not to willful neglect and must have a contemporaneous written acknowledgment and a qualified appraisal, if applicable. The IRS has indicated that the "reasonable cause" exception will be strictly enforced.

Timing of appraisal

Current regulations call for an appraisal to be made no earlier than 60 days prior to the date of the gift. Under the proposed regulations, the "valuation effective date," the date to which the value opinion applies, generally must be the date of the contribution. Where the appraisal is made before the date of the gift, the valuation effective date must be no earlier than 60 days prior to the date of the gift and no later than the date of the contribution. The date the appraiser signs the report may be no later than the due date of the return (including extensions). If the deduction is claimed for the first time on an amended return, the appraisal report date must be no later than the date the amended return is filed.

Used clothing and household items

No deduction is allowed unless the items are "in good used condition or better," although this rule does not apply to a contribution of a single item of clothing or household item for which a donor claims a deduction of more than \$500, provided the donor also submits a qualified appraisal with the return. A donor claiming a deduction of less than \$250 must obtain a receipt from the charity or maintain reliable written records of the gift, including a description of the condition of the items. The donor must have a contemporaneous written acknowledgment from charity for deductions of \$250 or more [Reg. §1.170A-16(a)].

