

# The Advisor

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## ESTATE PLANNER'S TIP

Many small businesses experience "off" years, when income is insufficient to continue operating at full capacity. Owners who can afford it sometimes forego receiving salary until the business is back on its financial feet. A drawback to this arrangement, however, is that the company cannot make contributions on the owner's behalf to retirement plans, since contributions are generally based on the owner's compensation. Where possible, the owner should make a loan to the company, which can continue paying his or her current salary during the down cycle. The company is able to deduct the owner's salary plus contributions to the retirement plan and any interest payments made to the owner.

## PENNY FOR THOUGHTS MAY COST MORE

Robert Kahre, who was boycotting the Federal Reserve System, conducted his business with U.S. Treasury gold and silver coins purchased from dealers at fair market value. The coins have a face value far lower than their fair market value. He paid his employees with the coins and reported income from the exchange based on at the face value amount. The IRS charged him with various crimes.

The U.S. District Court (NV) noted that courts have consistently held that when the fair market value of legal tender exceeds its face value, the legal tender is property other than money and the taxpayer must value it at its fair market value. It does not matter that the coins may still be used as legal tender at their face value. In one case, coins that were not currently circulating legal tender were valued at fair market

value [*Cal Fed. Life Ins. Co. v. Comm'r.*, 680 F.2d 85 (9th Cir. 1982)]. Kahre argued that because the gold and silver coins were currently circulating, he could report them at face value.

The court said the two sides differed on the definition of "circulating," adding that the Treasury considers the gold coins not to be circulating. In *Joslin v. U.S.* [666 F.2d 1306 (10th Cir. 1981)], the court found that silver dollars combined the characteristics of cash and property. The fact that a silver dollar is legal tender with a nominal value of one dollar does not mean that income is to be measured by face value rather than fair market value. The court ruled that Kahre had to report gain from the coins using fair market value (*U.S. v. Kahre*, 2007-2 USTC ¶50,548).

### OUT-OF-WEDLOCK NOT ILLEGAL

Vera created an irrevocable trust prior to September 25, 1985, specifically providing that the benefits were to extend to all issue “hereafter born.” After the deaths of both Vera and her husband, the trustee was to create an equal share for each “lawful issue,” per stirpes. The trustee could make discretionary distributions of the net income until 20 years after the death of the survivor of Vera, her husband and their children alive at the creation of the trust. At that time, the trust was to terminate with the principal being distributed to Vera’s “descendants.”

Vera had a great-grandchild who was born out of wedlock and, under state law, would not be considered her “lawful issue” because the child’s parents were not married. The trustee claimed that the use of the term “lawful issue” in portions of the trust, rather than “descendant” or “issue” was a scrivener’s error that could cause inconsistencies in the operation of the trust. The child could be ineligible for certain discretionary distributions, but eligible for a distribution at the termination of the trust.

In an affidavit, Vera indicated that she did not recall discussing with the attorney whether a certain class of beneficiaries would be excluded from income distributions. It was not her intent then or now to exclude any descendant, she said. The trustee proposed to reform the trust, as allowed under state law, to refer to “descendants” or “issue” rather than “lawful issue.”

### PHILANTHROPY PUZZLER

Harold wants to create a charitable remainder trust that will pay him income for life. He’s concerned, however, that he might suffer an untimely death shortly after funding the trust and receive little or no income. He has asked whether payments can be guaranteed to continue for the benefit of someone else, should he meet with disaster.

The IRS acknowledged that the use of conflicting terms could result in inconsistent administration of the trust. Therefore, the proposed reformation will not cause the trust to lose its status as exempt from the generation-skipping transfer tax provisions of Reg. §26.2601-1(b)(1)(i) (Ltr. Rul. 200728033).

### REFUND REQUEST COMES TOO LATE

The Family Leadership Foundation was to receive the balance in Emmett Turner’s deferred compensation plan at his death in 1999 – about \$145,000. The custodian of the account withheld nearly \$40,000 in federal income taxes. Because the foundation was not required to file an income tax return for the year, it did not request an extension or claim a refund of the withheld tax. In November 2003, the foundation filed a return claiming the \$40,000 refund. The IRS denied the refund, noting that the claim had not been made within the statutory period.

The U.S. District Court (AZ) found that it did not have jurisdiction because the claim was filed too late. Taxpayers must file claims for refunds within three years from the time the return was filed or two years from the time the tax was paid, whichever is later [Code §6511]. Although the foundation filed its return and made a claim for a refund on the same day – November 24, 2003 – the claim had to be filed within three years of May 15, 2000, the date the withheld funds were considered paid because no request for an extension had been filed (*Family Leadership Foundation v. U.S.*, 2007-1 USTC ¶150,269).

### TRUST CHANGE GOOD NEWS FOR REMAINDERMAN

When Henry McCance created his charitable remainder unitrust, he intended to include a provision allowing him or his wife to transfer their income interests to The McCance Foundation, the

remainder beneficiary. Their attorney, concerned about the availability of a gift tax deduction, removed the provision and included a spend-thrift provision that prevented any assignment of the couple's interests.

Sometime after the trust was executed, the IRS issued a private letter ruling in favor of the taxpayer in circumstances substantially the same as McCance's. McCance seeks to reform his trust in light of the ruling. The reformation would not restore the acceleration provision, but would allow the couple to make voluntary transfers to the foundation during their lives. In an affidavit, McCance indicated that he always intended to retain this ability and intends to use it to assign his income interest if the trust is reformed.

The Supreme Judicial Court of Massachusetts noted that it has the power to reform trusts to conform to the settlor's intent. Both McCance and his attorney submitted affidavits indicating that he intended to retain the right to make voluntary transfers to the foundation during the couple's lifetimes. The court said that the favorable private letter ruling by the IRS, although nonprecedential, was a change in the law that altered the tax consequences of the trust, so the reformation was allowed (*McCance v. McCance*, SJC-09917).

#### **NOTHING A LITTLE REFORM CAN'T FIX**

Charlie's will left the residue of his estate to a trust that was to pay a monthly annuity amount to Paula for the shorter of five years or her earlier death. Trust assets would then be divided equally among three charities. Because Paula's income interest was less than 5% of the amount transferred to the trust, the trust did not qualify as a charitable remainder annuity trust under Code §664 and the estate wasn't entitled to a charitable deduction under Code §2055.

The trustee proposes to modify the trust to pay a 5% annuity amount annually for five

years or until Paula's earlier death. From the 5%, Paula will receive the smaller amount indicated in Charlie's will, with the balance being paid equally to the three remainder charities. At the trust's termination, the charities will share the remainder.

The IRS ruled that the charitable interest was reformable under Code §2055(e)(3)(C) because the remainder would have qualified for an estate tax deduction but for the requirements of Code §2055(e)(2) that the interest be in the form of a qualified charitable remainder trust. In addition, the payments to Paula were expressed as a dollar amount, as required under Code §2055(e)(3)(C)(ii), so the value of the charitable interest was ascertainable and severable from the noncharitable interest.

The actuarial value of the reformed interest will not exceed 5% of the value of the reformable interest, the interests terminate at the same time, and the reformation is effective as of Charlie's death, noted the IRS, so the estate will be entitled to a charitable deduction for both the remainder interest and the value of the annuity interest paid to the charities (Ltr. Rul. 200726005).

#### **PUZZLER SOLUTION**

One way to guarantee that payments last for a minimum length of time is to use a term-of-years trust, with Harold receiving income for the shorter of his life or up to 20 years. He would name another beneficiary to receive payments for the balance of the 20-year term of the trust if he died early (Rev. Rul. 74-39, 1974-1 C.B. 156). Or he could create a trust that lasts for his life and then pays income to another beneficiary for the shorter of the beneficiary's life or a term of years (up to 20) [Reg. §§1.664-2(a)(5)(i), 1.664-3(a)(5)(i)].

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## IRS TAKES THE LEAD ON SAMPLE TRUST DOCUMENTS

The IRS recently issued its first-ever sample charitable lead annuity trust forms. Rev. Proc. 2007-45 includes samples for an inter vivos nongrantor charitable lead annuity trust for a term of years and an inter vivos grantor charitable lead annuity trust. The nongrantor lead trust has alternative provisions for a trust lasting for the life of an individual, retention of the right to substitute the charitable lead beneficiary, apportionment of the annuity amount in the discretion of the trustee, stating the annuity payment as a specific dollar amount and designation of an alternative charitable beneficiary. The grantor lead trust includes the same alternative provisions, as well as a provision restricting the charitable beneficiary to a public charity.

Rev. Proc. 2007-46 provides sample language for a testamentary charitable lead annuity trust, with alternative provisions for the annuity period to be for the life of an individual, apportionment of the annuity amount in the discretion of the trustee, stating the annuity amount as a specific dollar amount and the designation of an alternative charitable beneficiary. If a charitable lead trust is substantially similar to the sample trusts or properly includes one or more alternative provisions, the value of the charitable lead interest will be deductible for gift and/or estate tax purposes [Code §§2522(c)(2)(B), 2055(e)(2)(B)].

In general, an inter vivos charitable lead trust generates either an income tax charitable deduction (if trust assets revert back to the donor at the end of the trust) or a gift tax charitable deduction (if assets pass to others at the termination). A testamentary charitable lead trust provides an estate tax charitable deduction for the value of the charitable income interest.

The IRS has approved a number of nonreversionary inter vivos charitable lead trusts that pro-

vide the donor with both an income tax deduction as well as a gift tax deduction (e.g., Ltr. Ruls. 9224029, 9642039). These “intentionally defective” grantor lead trusts are generally arranged by giving a “nonadverse” third party the right to substitute property of equal value for any assets in the trust, subject only to the trustee’s right to verify the value of the substituted property. Alternatively, a donor can create an intentionally defective trust by giving a third-party trustee the power to add one or more charities to the class of beneficiaries eligible to receive distributions from the trust property upon termination of the trust (Ltr. Rul. 199936031). The new IRS forms allow for “intentionally defective” arrangements.

An income tax charitable deduction is available for charity’s income interest only if the donor is treated as the owner of the lead trust under the grantor trust rules (Code §§671-677). As noted, that is generally accomplished by having trust assets revert to the donor at the end of the charitable income interest, rather than pass to another beneficiary. However, in the case of intentionally defective lead trusts, the IRS has said that granting the right to substitute property or add new charities would also cause the trust to be a grantor trust, thus generating an income tax deduction.

If the donor dies during the term of the trust, the value of the assets from an intentionally defective lead trust will not be included in the gross estate because the donor has not retained any of the necessary powers: Code §2036 right to designate who shall possess and enjoy the income; Code §2037 reversionary interest; Code §2038 power to amend or revoke any interest; and Code §2041 power of appointment in favor of the donor, the donor’s estate, creditors or creditors of the estate. The donor remains subject to tax on the trust’s income, however.

