

# *The* Advisor

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April 2011

## ESTATE PLANNER'S TIP

The IRS says estates of decedents who died in 2010 will have 90 days following the final release of Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent, in which to file. Executors wishing to be subject to the estate tax rules in effect for 2010 will need to file the form, which asks for the name and taxpayer identification number of estate recipients. The estate will also need to identify property in the estate, the adjusted basis at death, fair market value at death and the basis increase allocated to the property. Under the Economic Growth and Tax Relief Reconciliation Act, the estate tax was eliminated for 2010, but replaced by a modified carryover basis [Code §1022]. The estate can allocate up to \$1.3 million for a stepped up basis, along with another \$3 million for surviving spouses. Estates below \$5 million will want to use the default position offered in the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 to apply the rules for 2011, with a full step up in basis for all assets. Beneficiaries of large estates who receive assets with a carryover basis might use them to satisfy charitable commitments. An heir could use highly appreciated assets to fund a charitable remainder trust, for example, and receive payments for life from the full value, with no loss to capital gains tax. The trust will also generate an income tax charitable deduction, and a portion of the annual payments may be taxed at lower capital gains rates. Heirs can avoid capital gains tax entirely by using the appreciated assets to make outright charitable gifts. They will be entitled to income tax charitable deductions for the full fair market value of the property.

## PARTS NOT LESS THAN THE WHOLE

Axel Adler transferred an undivided 20% interest in an 1,100-acre parcel to each of his five children in 1965. He continued living on the property under a life estate that was reserved in the deed. He paid all expenses, did not pay rent to the children and did not seek the children's permission to alter the property. At his death in 2004, the value of the land was \$6,390,000.

Adler's estate acknowledged that the value of the property was includible in his estate under Code §2036(a) because he retained a life estate. However, the executor claimed that the value was not the fair market value of the fee simple interest, but was instead the aggregate value of the fractional interests, which should be determined separately applying minority-interest and marketability discounts.

The Tax Court noted that the purpose of Code §2036 is to include the value in the gross estate where a decedent transfers property during life and the transfer is essentially testamentary in nature. Where a person holds a fractional interest at death, it is appropriate to apply discounts, said the court. But if the split occurs at death, the property is valued as a whole, with no discount for split ownership. By retaining a life estate, “it was as if Adler had retained the entire interest in the land during his life and transferred the property to his children at death,” said the court. Therefore, the estate was not entitled to apply any discounts (*Estate of Adler v. Comm’r.*, T.C. Memo. 2011-28).

#### **TAX REFUND NOT AVAILABLE FOR BANKRUPTCY ESTATE**

Helen and Otto elected to receive a tax refund of \$1,200 and apply the remaining \$800 overpayment as a prepayment of the following year’s taxes. After the deadline for filing their return had passed, the couple filed for Chapter 7 bankruptcy.

The bankruptcy trustee requested that the IRS turn over the \$800, as property of the bankruptcy estate. Under Chapter 7 rules, if a debtor had the right to claim a tax refund, the right becomes the property of the estate.

#### **PHILANTHROPY PUZZLER**

Marco, the sole shareholder of an S corporation, attended a presentation on charitable remainder trusts. He has long wanted to make a significant gift to his favorite charity, but his company shares represent the bulk of his assets. Marco asked his advisor about using some of his S shares to fund a charitable remainder trust, but was told that placing any S corporation shares in a charitable remainder trust would cause the company to lose its S status and convert to a C corporation. Marco has asked if there is any other option.

In a Chief Counsel Advice memorandum, however, the IRS said that the \$800 was not subject to the turnover request. When an election is made under Code §6402(b) to apply a refund to future tax liability, “no claim for refund of such overpayment shall be allowed for the taxable year in which the overpayment arises.” The credit election is irrevocable and binding on both the taxpayer and the IRS.

A central precept of bankruptcy law is that the trustee succeeds only to the title and right in the property that the debtor had at the time the bankruptcy petition was filed, said the IRS. Because Helen and Otto had no right to claim a refund, no right to claim the refund passed to the bankruptcy estate (Ltr. Rul. 201103020).

#### **PRIVATE BENEFIT = DONOR DISTRESS**

In 1998, Setty Viralam transferred \$262,433 in appreciated stock to a foundation run by xélan, a 501(c)(3) organization designed to help doctors with financial planning. His contributions were held in a donor advised fund.

The foundation offered account holders a student loan program. This was especially attractive to Viralam, who had three children and expected to pay \$40,000 annually for each child for eight years of college and graduate school. He understood his children could benefit from the loan program. After making the stock transfers, he received a letter from the foundation indicating that no goods or services were received in return.

At Viralam’s request, the foundation made distributions to various charities between 1999 and 2003, in amounts ranging from \$500 to \$5,000. In 2001, the foundation distributed \$17,247 to the University of Pennsylvania as part of the foundation’s student loan program. This was to cover tuition and room and board for Viralam’s oldest son. The son signed loan documents indicating that he would provide 2,000 hours of charitable work each year or repay the loan, with interest, beginning five years after graduation. Over the next several years, distributions to the son totaled \$70,299.

In 2003, the IRS issued a notice of deficiency, disallowing the deduction claimed for the contribution to the foundation. Several days before receiving the IRS letter, Viralam repaid the full \$70,299.

The Tax Court agreed with the IRS that Viralam was not entitled to a charitable deduction, saying he had not relinquished dominion and control over the property. Viralam established the account knowing that he would use the student loan program for his children. Distributions for his son's college expenses dwarfed the distributions for other purposes, said the court, adding that the distributions for student loans to his son "would have continued to constitute the predominant use of the assets" but for the attention paid by the IRS.

The court also determined that the foundation's acknowledgment letter was deficient, since it did not indicate the value of any goods or services provided. Reg. §1.170A-13(f)(6) provides that an organization is treated as providing goods and services if the taxpayer *expects* to receive goods or services in another year. The evidence showed that Viralam anticipated that the foundation would extend the student loan to his children at the time he transferred the stock.

The court ruled that Viralam was not entitled to the charitable deduction, was subject to capital gains tax on the sale of the stock contributed to the foundation and was liable for an accuracy-related penalty under Code §6662 (*Viralam v. Comm'r.*, 136 TC. No. 8).

#### **LACK OF APPRAISAL DOOMS DEDUCTION**

In 2006, Maria Towell contributed a timeshare to a charity and claimed a deduction of \$12,900. She had purchased the interest in 2001 for \$12,396. The IRS disallowed the deduction on the grounds that Towell did not have the required appraisal.

Code §170(f)(11)(C) requires donors to attach Form 8283, including a qualified appraisal summary to their returns when claiming deductions for noncash gifts (other than marketable securities) of more than \$5,000. The appraisal must be made no

earlier than 60 days prior to the date of the gift and no later than the due date of the return (plus extensions) on which the deduction is claimed. Because Towell failed to obtain an appraisal, the Tax Court denied her deduction (*Towell v. Comm'r.*, T.C. Summ. Op. 2010-141).

#### **GIFT AVOIDS TAX LIEN**

After the IRS levies a tax assessment, a lien applies to all of a taxpayer's property [Code §6322]. A constructive trust arises where the taxpayer disposes of property while the lien is in place. But what if the taxpayer gives money to charity prior to the tax assessment?

In a Chief Council Advice memorandum, the IRS determined that a lien does not attach to gift property prior to the date when the lien arose. Therefore, the IRS may not make a levy on the gift funds. Once the funds were donated, they were no longer the taxpayer's property, but instead became the charity's property.

A constructive trust may arise if a party receives funds either through actual or constructive fraud or questionable means, noted the IRS (CCA 2010112216310259).

#### **PUZZLER SOLUTION**

The advisor is correct that Marco's company would lose its S election if any shares were contributed to a charitable remainder trust [Rev. Rul. 92-48, 1992-1 C.B. 301]. However, the S corporation itself may be the donor and income beneficiary of a charitable remainder trust (Ltr. Rul. 9340043). Code §664(d) requires that income be payable to one or more "persons," defined under Code §7701(a)(1) to include a corporation. The trust must be a term-of-years trust (no more than 20 years) [Reg. §§1.664-2(a)(5), 1.664-3(a)(5)]. The charitable deduction passes through to Marco, to be deducted on his personal income tax return [Code §1366(a)(1)(A)].

## DON'T LET DEDUCTIONS GO TO WASTE

Charitable remainder trusts are popular with many older donors because they allow current gifts without a loss of income. One drawback to a remainder trust though – whether an annuity trust that pays a fixed amount for the donor’s life or a unitrust that pays a percentage of the annual value of the trust assets – is that the percentage amount chosen when the trust is created cannot be increased if more income is needed at a later date.

One way to overcome this problem is to select a unitrust with a high payout level when the trust is created. However, as the payout rate increases, the charitable deduction allowed for the gift of the remainder interest drops. That may not be a negative, provided the deduction does not drop below the required 10% minimum [Code §§664(d)(1)(D), (d)(2)(D)]. A lower deduction might not make any difference at all if the donor would be unable to use the entire deduction at a lower rate.

Consider Ralph, age 65, who has adjusted gross income of \$50,000. He owns a parcel of vacant land worth \$850,000 that currently earns no income. He purchased the land for \$100,000. If he needed money in the future, he could sell the property, but would pay capital gains tax of up to 15%, leaving him with only \$737,500 to reinvest.

Ralph could fund a charitable remainder unitrust with the property, let the trustee sell the land and avoid the capital gains tax. If he chose the minimum 5% payout, Ralph’s income from the land the first year would jump from zero to \$42,500. His income in later years would remain a constant 5% of the changing value of the trust assets. Ralph’s charitable deduction would be \$382,985 (assuming quarterly payments and the use of a 3% §7520 rate).

In the year he creates the trust, Ralph could deduct up to 30% of AGI [Reg. §1.170A-8(d)(3)], with carryover for up to five years for any excess [Code §170(b)(1)(B)]. His AGI would be \$92,500 with the addition of the \$42,500 in trust income, making his allowable deduction \$27,750. Assuming Ralph’s AGI remains at \$92,500 for the

next five years, he will be able to deduct a total over the six years of only \$166,500. He will “lose” nearly \$216,500 of his deduction.

There is another possibility that will enable Ralph to satisfy his philanthropic goals, increase his income and take full advantage of his allowable deduction. By electing a higher payout from a net-income unitrust, he can arrive at a deduction equal to the maximum allowable deduction. Here are the deductions at various payout levels:

Payout rate	Deduction
6%	\$332,648
7	290,666
8	255,544
9	225,990
10	201,059
11	179,860
12	161,781

By selecting a payout rate of 12%, Ralph would reduce his deduction to an amount that could be fully deducted over six years. This doesn’t mean that Ralph will receive a 12% payout each year from his unitrust. Rather, he will receive the lesser of net income or 12% [Reg. §1.664-3(a)(1)(i)(b)]. In all likelihood, Ralph will receive less than the 12% amount, depending upon the trustee’s investment strategy. If he receives more than a 5% payout in the first six years of the trust, he will increase his AGI and be entitled to use his carryover deductions faster.

The real benefit to Ralph with this arrangement is that he is not locked into a 5% payout in the event the trust earns more. He gives up a portion of his deduction, but since he couldn’t take full advantage of the carryover anyway, it is not really a loss. And he is able to boost his income over what he would have if he sold the property and reinvested the after-tax proceeds. Disadvantages? If the trustee earns less than 5%, Ralph’s payments may drop below what he had anticipated.

