DALLAS JEWISH COMMUNITY FOUNDATION

The Advisor

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ESTATE PLANNER'S TIP

Married couples can give up to $26,000 annually in 2009 and 2010, to as many donees as they wish, with no gift tax liability, thanks to gift-splitting [Code §§2503, 2513]. But where a second marriage is involved, it may be wise to consider whether gift-splitting is the best path to tax savings. A consent to split gifts is effective for *all* gifts made during the year [Reg. §25.2513-1(b)(5)], including taxable gifts. By agreeing to split a gift, a spouse may be consenting to apply a portion of his or her gift tax credit toward gifts to stepchildren (on amounts over $26,000). Remind clients before they sign Form 709-A that using all or a portion of their $1 million exclusion may reduce the amounts they can shelter on transfers to their own children or grandchildren.

HOME BUYERS CAN DEDUCT INTEREST ON $1.1 MILLION

Paul bought a personal residence for $1.5 million, paying $200,000 cash and financing the rest with a loan secured by the residence. The IRS ruled that up to $100,000 of the mortgage loan in excess of $1 million is considered home equity indebtedness, entitling Paul to deduct the interest payments.

Generally, homeowners may deduct interest paid on up to $1 million of acquisition indebtedness, defined as indebtedness that is incurred in acquiring, constructing or substantially improving any qualified residence and is secured by the residence [Code §163(h)(3)(B)]. Interest on up to $100,000 in home equity indebtedness, defined as any indebtedness other than acquisition indebtedness secured by the residence, is also deductible [Code §163(h)(3)(C)].

The IRS determined that the $1 million limit is an element in the definition of acquisition indebtedness, "so that indebtedness that otherwise qualifies as acquisition indebtedness fails to qualify to the extent it exceeds $1 million." The taxpayer may treat the excess as home equity indebtedness, said the IRS, because it by definition does not constitute acquisition indebtedness (Ltr. Rul. 200940030).

RELIGION CLAUSE IN WILL NOT AGAINST PUBLIC POLICY

Max Feinberg, who died in 1986, had executed a will and pour over trust naming his wife, Erla, the life beneficiary. She also had a limited testamentary power of appointment to appoint only in favor of Max's descendants who were not deemed deceased under a beneficiary restriction clause. The trust contained a provision under which any descendant who married outside the Jewish faith or whose non-Jewish spouse did not convert to Judaism within one year of marriage would be deemed deceased.

In 1997, Erla exercised her power of appointment, directing that at her death, her two children and any grandchildren not deemed deceased receive $250,000. The interest of any grandchild deemed deceased was to be paid to the grandchild's parent.

The Supreme Court of Illinois noted that Erla's plan differed from Max's. It designated a fixed sum, rather than the lifetime trust included in Max's plan. The gifts depleted the trust, leaving no assets subject to distribution under Max's original plan. It therefore never became operative, said the court.

At Erla's death in 2003, all five of her grandchildren were married, but only one met the condition and was entitled to receive $250,000. Another grandchild challenged the beneficiary restriction clause. Both the trial court and appellate court agreed that the clause violated public policy and was therefore invalid. The courts found that it "interferes with and limits the right of individuals to marry a person of their own choosing."

The Supreme Court said that it was not necessary to consider Max's original testamentary scheme, since it was altered by Erla's exercise of her power. The grandchildren had no vested interest at Max's death, and would not have had any interest under state intestacy laws. They had "a mere expectancy that failed to materialize for four of them when, at the time of Erla's death, they did not meet the conditions established by Max" (*In re Estate of Feinberg*, Docket No. 106982).

PHILANTHROPY PUZZLER

Janet's mother was cared for by a nurse for many years prior to the mother's recent death. Janet wants to show her appreciation to the nurse by establishing a charitable gift annuity with a portion of the estate that she inherited. The annuity will provide the nurse with payments for life, but Janet is concerned that she could owe gift tax on the present value of the annuity paid to the nurse. Is there a solution for Janet?

THE BIGGER CHECK IS NOT IN THE MAIL

No increase in the Consumer Price Index means no increase in the checks Social Security recipients will see in the mail next year. For 2009, beneficiaries enjoyed a 5.8% cost-of-living adjustment, thanks primarily to higher gasoline prices. That was the largest increase since 1982. Next year marks the first year since COLAs were introduced in 1975 that benefits will not increase.

Also not changing for 2010 is the amount subject to Social Security withholding for workers. The OASDI portion is capped at $106,800, with no limit on Medicare withholding.

Social Security recipients under age 66 will be able to earn $14,160 in 2010 – the same amount as in 2009 – before benefits are reduced by $1 for each $2 earned in excess of the limit.

DEJA VU FOR MOST TAX NUMBERS

Cost of living adjustments for most tax numbers were too low to result in increases for 2010 (Rev. Proc. 2009-50). Among the numbers tax advisers will be working with for next year:

	2009	2010
Personal and dependent exemption	$3,650	$3,650
Standard deduction		
Single	$ 5,700	$ 5,700
Joint	11,400	11,400
Head of household	8,350	8,400
Married filing separately	5,700	5,700

Tax brackets

25% bracket starts		
Single	$33,950	$34,000
Joint	67,900	68,000
Head of household	45,500	45,550
Married filing separately	33,950	34,000
28% bracket starts		
Single	$ 82,250	$ 82,400
Joint	137,050	137,300
Head of household	117, 450	117,650
Married filing separately	68,525	68,650
33% bracket starts		
Single	$171,550	$171,850
Joint	208,850	209,250
Head of household	190,200	190,550
Married filing separately	104,425	104,625
35% bracket starts		
Single, joint, head of household	$372,950	$373,650
Married filing separately	186,475	186,825
Kiddie tax	$1,900	$1,900
Annual gift tax exclusion	$13,000	$13,000
Annual gift tax exclusion for non-citizen spouse	$133,000	$134,000
Special use valuation for real property devoted to farming or closely held business use	$1,000,000	$1,000,000

CHARITY'S SHARE SQUEEZED BY TAXES

William Walrod executed a will and trust in 1992, leaving $16,500 to three charities. In 2006, he created the last of several new trusts, directing that a $3 million lead trust be funded. At his death in 2007, his estate was worth approximately $5 million.

The will directed that taxes were to be paid from the residue "with no right of reimbursement from any recipient of any such property." The trust directed that estate taxes and administrative expenses were to be paid from trust principal before funding any residuary disposition but a second tax provision directed that taxes be paid from the residue with no right of reimbursement.

Estate and gift taxes and penalties totaled about $1.5 million. As a result, little or nothing was left to fund the lead trusts. Taxes were to be paid first from the residue of the probate estate ($125,000), which was insufficient to pay the entire amount. Walrod's son claimed that pre-residuary bequests should be funded first, with taxes paid from the remaining assets. The lead trust was to be funded from whatever is left. The charities argued that taxes should be apportioned, and because charities are exempt from tax, the lead trust should receive the full $3 million. Taxes would be paid from what is left, with anything remaining passing to the family.

The Surrogate's Court said that "no right of reimbursement" has been interpreted to mean "no right of apportionment," so all beneficiaries, including charity, must contribute to the tax. State apportionment laws apply only if contrary directions are not included in the estate documents, noted the court. Both Walrod's will and the trusts direct how taxes are to be paid. Under the trust, taxes and administration expenses are to be paid from trust principal prior to the funding of any residuary dispositions. The court found that Walrod intended to benefit his family first. Interpreting the provisions as suggested by the charities would be contrary to Walrod's wishes. (*In the Matter of the Final Accounting of Walrod*, 2009 NY Slip Op 51974(U)).

PUZZLER SOLUTION

If Janet retains the right to revoke the nurse's annuity interest, the gift will be incomplete and there will be no gift tax due when the gift annuity is established [Reg. §25.2511-2(b)]. Assuming Janet does not exercise the right to revoke, each payment the nurse receives annually will be considered a present interest gift that qualifies for the $13,000 annual exclusion. If Janet outlives the nurse, nothing will be included in her gross estate with respect to the annuity.

CHARITABLE OPPORTUNITIES FOR 2009 AND 2010

There's still time before year's end to take advantage of qualified charitable distributions (QCD) and also to plan ahead for charitable giving next year.

QCDs [Code §408(d)(8)]

Through December 31, owners of IRAs who are age 70½ and older may direct the custodians of the accounts to send payments, up to $100,000, directly to charity. Although no deduction is available, donors – especially those who do not itemize their deductions – still realize tax savings, since they avoid the income tax that would otherwise be due if funds were withdrawn from the IRA and then given to charity.

There are some rules that apply to QCDs:

■ Only funds in traditional and Roth IRAs are eligible. QCDs can't be made from 401(k)s or other qualified retirement plans.

■ Transfers must be made to public charities, not to donor advised funds or supporting organizations.

■ Funds cannot be transferred to establish charitable remainder trusts or charitable gift annuities. No donor benefits are permitted.

Qualified distributions counted toward the account owner's required minimum distributions from 2006 through 2008. Required distributions have been suspended for 2009. Originally, QCDs were only valid in 2006 and 2007. Legislation in late 2008 reinstated the rules retroactively for 2008 and through 2009. Legislation is pending to continue the distributions after 2009, although the measure may not pass prior to year's end.

Should clients make QCD gifts in 2010 if legislation has not passed? Eligible donors who would ordinarily make gifts to charity have nothing to lose by making distributions from IRAs up to the lesser of $100,000 or the amount of their required minimum distributions for 2010. If QCDs are extended, the gifts would qualify. If QCDs are not extended, at worst the donor pays tax on what he or she would have had to withdraw anyway, and would be entitled to a charitable deduction for the gift.

Roth IRA conversions

Starting in 2010, the $100,000 modified adjusted gross income limitation is eliminated on taxpayers who wish to convert traditional IRAs to Roth IRAs. Roth IRAs are popular because:

■ Qualified distributions are tax free, unlike most distributions from regular IRAs, which are taxed at ordinary income tax rates.

■ There are no required minimum distributions after age 70½.

■ Owners still working after age 70½ can continue contributing to their Roths, subject to income limitations.

■ At the owner's death, the Roth is included in the gross estate for estate tax purposes, but is not subject to the tax on income in respect of a decedent [Code §691].

The major drawback is that income taxes are due on the amount converted. A special rule for 2010 conversions allows the tax to be postponed, with half paid in 2011 and half paid in 2012. Clients concerned that income tax rates will be higher in 2011 and 2012 can choose to recognize the income and pay the tax in 2010. The income tax can be offset by boosting deductible charitable gifts next year, including gifts such as charitable remainder trusts and charitable gift annuities that allow donors to retain income for their lifetimes.

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