

The Advisor

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ESTATE PLANNER'S TIP

Many divorced clients may be surprised to discover that an ex-spouse is still the beneficiary of a pension plan, and in some cases that fact may not be discovered until after the client's death. Last year, the U.S. Supreme Court ruled that an ex-wife was the beneficiary of a decedent's plan because she was still listed as beneficiary, even though she had waived the designation in the couple's divorce decree [*Kennedy v. Plan Adm. for DuPont Savings and Investment Plan*, 129 S.Ct. 865]. In some states, divorce automatically revokes provisions in a will pertaining to the ex-spouse, unless otherwise provided. But state laws have no bearing on pension distributions. Pensions, IRAs, 401(k)s and other retirement plans generally pass outside probate, directly to the named beneficiary, regardless of directions to the contrary in a will or living trust. An examination of all beneficiary designations should be part of any divorce proceeding or review of a client's estate plan.

GUARDIAN PERMITTED TO EXECUTE PRINCIPAL'S WILL

In 2006, Richard Henry, age 92, was declared a disabled adult due to cognitive decline. JPMorgan Chase Bank was appointed guardian of the estate. The bank sought to recover \$1.3 million it said had been misappropriated by Henry's caretaker, Miroslaw Zawierucha (Mick). The trial court found Henry had lacked capacity to manage his affairs since December 31, 2003, and that the transfers to Mick were presumptively fraudulent since he was in a fiduciary capacity to Henry. While the appeal of the ruling was pending, the bank asked the circuit court for authority to execute a codicil, will and trust on Henry's behalf.

Henry had executed a will in 1999 leaving property to his niece, her children and nieces and nephews of his deceased wife. A large portion of

his \$5 million estate was to pass to five charities, with nothing passing to Mick. A will executed in 2004 left the bulk of the estate to Mick and Henry's nephew-in-law, Peter Wemple, who was named executor under both wills. The bank said the 2004 will was not a valid expression of Henry's wishes due to undue influence. The proposed will would strike the distributive provisions of the 2004 will and substitute the provisions from the 1999 will. The bank would be the executor. The court granted the bank's petition.

On appeal, the bank argued that Mick and Wemple lacked standing because the 2004 will did not confer any protectable interest on them. The two said they were not appealing on behalf of Henry, but on behalf of themselves, since the court's

order to execute a will deprives them of benefits they would have received under the 2004 will.

The Illinois Appellate Court noted that a will has no legal effect until the testator's death, and therefore, any legacy in a will is a future interest. Mick and Wemple have no standing, just as they would have had no standing during Henry's life if he regained his mental faculties and executed a new will overriding their shares in the 2004 will. Instead, said the court, their recourse will be to file a contest to the will and trust under the probate act following Henry's death (*In re Estate of Henry*, Nos. 1-0803398 and 1-08-3479).

HOME BUYERS' CREDIT EXTENDED, EXPANDED

Congress has extended the \$8,000 first-time home buyers' credit through April 30, 2010, and expanded the program to include a "long-time resident" credit of \$6,500. The credits apply to binding contracts signed by April 30, 2010, with closings scheduled no later than June 30, 2010.

A first-time home buyer is one who has not owned a primary residence in the three years prior to the date of purchase. A long-time resident is one who has owned and used the same home as a principal or primary residence for at least five consecutive years of the eight-year period ending on the date of purchase of the new home as a primary residence. Credits may be claimed on either the 2009 or 2010 tax returns.

For homes purchased after November 6, 2009,

PHILANTHROPY PUZZLER

When Victoria, a widow, executed her will several years ago, she left the residue of her estate to her son Albert, a struggling college student. Victoria recently died and Albert, now a millionaire entrepreneur, does not need the inheritance. He would, instead, like to disclaim the bequest and direct that it pass to Victoria's favorite charity. Albert has asked whether Victoria's estate would be entitled to a charitable deduction.

the full credit is available to taxpayers with modified adjusted gross income of \$125,000 for single taxpayers or \$225,000 for joint filers. The credit phases out for those with modified AGI up to \$145,000 or \$245,000 respectively. Several new restrictions have been added to the credit:

- Dependents are not eligible to claim the credit;
- the credit is not available if the purchase price of the home exceeds \$800,000; and
- purchasers must be at least age 18 on the date of purchase.

WHAT WENT UP NOW COMES DOWN

The IRS has announced a new standard rate for business mileage: 50 cents per mile in 2010, a nickel drop from the 2009 rate. Taxpayers using the rate may also claim deductions for parking and tolls for business use of a personal vehicle.

The 2010 standard rate for medical and moving expenses is 16.5 cents per mile, compared with 24 cents in 2009. The rate for charitable use of a personal vehicle – fixed by Code §170(i) – remains at 14 cents per mile (Rev. Proc. 2009-54).

TRUST INVESTMENT RISKY BUT REASONABLE

Mary Campbell transferred appreciated stock valued at \$840,000 to a 10% charitable remainder unitrust in 1996. Her goal was to liquidate the shares with no loss to capital gains tax and reinvest for a steady income stream for Campbell and her husband and then for the couple's three children, before the corpus was distributed to five charities. The trust was expected to last about 50 years.

Shortly after funding the trust, Campbell's income needs increased. The trust, which had been invested for growth and income, was changed to a growth strategy, with equities comprising about 90% of the investment mix. By the end of 1999, the trust value had risen to \$943,000, but by the end of 2002, due to an overall decline in the market, the trust value was only \$356,000. This led to correspondingly lower unitrust payouts.

In 2005, Campbell and her children began arbitration proceedings against the advisor, claiming

that the investment of trust assets was “unsuitable” and contrary to her financial needs and that there was negligent supervision of the account. Campbell did not prevail in arbitration and sought to replace the trustee. Merrill Lynch Trust Company sought an approval of its accounting and a declaratory judgment that its investments were lawful and appropriate.

The Court of Chancery of Delaware found that Campbell lacked an understanding of the risks associated with various investments and did not know how the trust would be managed. The court added that a 10% charitable remainder unitrust with a long expected life might not have been the best investment choice.

In general, a trustee is not liable to a beneficiary for investment strategy where the trustee “acted in reasonable reliance on the terms of the trust.” The trustee has a duty to balance the interests of the various beneficiaries. Preserving the corpus for a 50-year expected term of the trust “presented an onerous challenge,” said the court. The only way to prevent complete depletion of the trust was to invest heavily in equities. The court found that the trustee’s investment decisions were reasonable and not a breach of fiduciary duty or any prudent investor rules (*Merrill Lynch Trust Co. v. Campbell*, C.A. No. 1803-VCN).

Note: This trust predates Code §664(d)(2)(D), which requires that the value of the charitable remainder be at least 10% of the net fair market value of the assets transferred to the trust. The value of the charitable remainder for this trust was only \$6,237, less than .75% of the initial trust value.

AIR RIGHTS MAKE A WRONG FOR DEDUCTION

Maurice Herman owned a building on Fifth Avenue in New York that was located in a registered historic district. The building could not be altered, reconstructed or demolished without prior consent of the city’s landmarks preservation commission.

In 2003, Herman contributed a conservation easement on the building to the National Architectural Trust. Under the covenant, he agreed to restrict the development of 10,000 unspecified

square feet of the 22,000 square feet of unused development rights over the property.

Herman claimed a \$21,850,000 charitable deduction for the easement, based on an appraisal that presumed a hypothetical expansion of the building. The IRS disallowed the deduction. A qualified conservation contribution under Code §170(h)(1)(C) is one that is exclusively for conservation purposes, defined in Code §170(h)(4)(A)(iv) as for the preservation of an historically important land area or certified historic structure. The Tax Court noted that the building was a certified historic structure, but a deduction is not allowed if the contribution accomplishes one of the enumerated conservation purposes but permits destruction of other significant conservation interests.

Herman’s covenant does not preclude the possibility that the building could be altered or even demolished, said the court. It’s possible, the court said, to build up to a full six stories on the front half of the structure, leaving the air rights hidden in the back and useless for preserving the aesthetic value of the building. There are restrictions imposed by federal, state and local law related to the building, but Herman is not entitled to a deduction for these rules that preserve the building (*Herman v. Comm’r.*, T.C. Memo. 2009-205).

PUZZLER SOLUTION

One requirement of a qualified disclaimer [Code §2518] is that the disclaimant not direct where the funds will go. If Albert disclaims, the bequest may end up passing under the state’s intestacy provisions to Victoria’s relatives, but would not pass to charity. Albert could, instead, accept the bequest and make a gift to the charity, for which he would be entitled to an income tax charitable deduction. Victoria’s estate would not receive an estate tax charitable deduction because the bequest was not “transferred by the decedent,” as required under Reg. §20.2055-1(a).

STRATEGIES FOR CHARITABLE DEDUCTION CUTBACKS

President Obama last year proposed restricting tax savings from charitable deductions to a 28% rate, beginning in 2011. A modified proposal was later made in Congress that would limit the benefit of these deductions to 33% or 35% for taxpayers whose income tax brackets would increase to 36% or 39.6% respectively, in 2011.

The President's proposals also would reinstate the Code §68 3% "haircut" on certain itemized deductions (including charitable deductions) for individuals whose adjusted gross incomes exceed a threshold amount. Such taxpayers could lose up to 80% of affected deductions, starting in 2011. The deduction "haircut" is not in effect this year, nor are the proposals to limit tax savings from contributions to certain tax brackets – making 2010 more attractive for charitable giving. Still, many donors are hemmed in by the 50%-of-AGI ceiling on charitable deductions, and about 70% of Americans do not itemize deductions. Here are some gift ideas that can achieve tax savings without the need for charitable deductions, both now and in the future:

Qualified charitable distributions from IRAs

Assuming Congress continues the law enabling IRA owners over age 70½ to make gifts to charity from their accounts, such gifts reduce taxable income to the extent they replace required minimum distributions.

Charitable lead trusts

Betty establishes a \$2 million charitable lead annuity trust that will pay charity \$60,000 a year for 18 years, after which the trust assets will pass to her daughter. Gift taxes are reduced, but there are income tax rewards as well: Charity receives \$60,000 annually, and Betty's investment income is reduced by a like amount during the trust term. It's virtually the same as if she received a \$60,000 income tax charitable deduction for 18 years.

Interest-free loans

Jerome has made so many charitable gifts and has so much in carried-over contribution deductions that he cannot deduct any more contributions for the foreseeable future. However, Temp. Reg. §1.7872-5T permits him to lend up to \$250,000, interest-free and repayable on demand, to charity, without running afoul of imputed interest rules. While the loan is outstanding, Jerome's investment income is reduced because charity is receiving the income the \$250,000 formerly produced in his portfolio, comparable to a deduction. If Jerome provides that the \$250,000 loan be forgiven upon his death, the entire amount escapes federal estate tax, as well.

Capital gains tax avoidance

Terry owns highly appreciated securities that produce no dividends. If he sells and reinvests, he will lose a portion of his investment to capital gains taxes. He can switch to a high-yield investment via a charitable remainder trust, without any loss from capital gains taxes, thereby saving taxes even if a charitable deduction were not available. Estate tax savings will be available at his death.

Tax-free income

Charitable gift annuities provide for a tax-free return of principal when the gift annuity is funded with cash, or a reduction of capital gains tax liability when the gift is funded with appreciated securities. Either way, the donor usually increases his or her income and reduces taxes, even without the benefit of a charitable deduction. A 70-year-old donor with \$100,000 in CDs could transfer the funds, at maturity, for a gift annuity that pays annual income of \$5,700. Of that amount, \$3,950 will be tax-free return of principal for the donor's life expectancy (assuming a 3% §7520 rate and quarterly payments). Donors may elect the §7520 rate that maximizes tax-free payments.

