

The Advisor

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ESTATE PLANNER'S TIP

There may be an opportunity for clients to postpone distributions from qualified retirement plans where spouses die "out of order." Consider a husband, age 72, with a wife, age 65, who predeceases him, leaving a retirement account naming her husband as the death beneficiary. Although he has the option to roll her account over to his own IRA, he has already reached the age when mandatory distributions are required. A better alternative might be for the husband to instead leave the account in the wife's name and delay the start of required distributions until the date on which the wife would have had to begin withdrawals, had she lived [Code §401(a)(9)(B)(iv)(I)], particularly if he does not need the added income on top of his own mandatory distributions. If he does need additional funds, he may take withdrawals, just as his wife could have, but the ability to "park" the funds in the account for several more years permits tax-deferred growth that may eventually benefit family members.

IRS CAN PURSUE LIEN AGAINST ESTATE

The IRS had a lien on property, due to a tax assessment. The taxpayer had filed several bankruptcies, but the IRS did not pursue its claim to secured status in the most recent bankruptcy proceeding. At the taxpayer's death, the IRS sought to enforce its claim against his stock portfolio. The executrix argued that the IRS should be estopped from asserting its lien because it abandoned the claim during the taxpayer's final bankruptcy.

The U.S. District Court (S.D. Texas) noted that an IRS lien continues in force until the assessment

is paid. While it may be adjusted for certain categories of third parties, such as bona fide purchasers for value, a decedent's estate and executrix are not protected parties. The court rejected the executrix's argument that the IRS abandoned its claim. Under Code §6321, a lien attaches to all property and rights to property. The court said that the IRS has one set of rights in a taxpayer's bankruptcy and additional rights in probate proceedings, so the IRS is not estopped from asserting its lien (*Spillar v. Comm'r.*, 2011-1 USTC ¶150,321).

TAX ON IRD AVOIDED IN TRANSFER

George, who is disabled and receiving public benefits, was a designated beneficiary of his father's IRA. He transferred his IRA share to a newly established IRA that is to benefit a special needs trust. George is the only beneficiary of the trust during his life. The trustee can apply as much of the income as determined for George's use, and can invade principal, unless doing so would jeopardize government benefits to which George is entitled. At his death, any principal and undistributed income of the trust will be used to reimburse the state for George's assistance. If anything is left, it will be distributed to George's heirs.

Under Code §691(a)(2), if the right to receive income in respect of a decedent under Code §691(a)(1) is transferred, the amount is to be included in gross income. A "transfer" includes a sale, exchange or other disposition. Rev. Rul. 85-13 (1985-1 C.B. 184) provides that if a grantor is treated as the owner of a trust, the transfer is not a sale for income tax purposes. George will be treated as the owner of the special needs trust under Code §§671 and 677(a), said the IRS. Therefore, the transfer of George's share of the IRA to the trust is not a sale or disposition for income tax purposes or a transfer under Code §691(a)(2) (Ltr. Rul. 201116005).

PHILANTHROPY PUZZLER

Natalie gave 1,000 shares of closely held stock to her favorite charity. Although not publicly traded, there were frequent sales of the shares by other owners. One sale about two weeks prior to Natalie's gift was for \$15 per share. Several other trades were made shortly after Natalie's gift, at a price of \$15.50 per share. Natalie's advisor asked whether an appraisal had been done for the shares. Natalie asked if an appraisal is really necessary.

TRUSTEE RESPONSIBLE FOR INVESTMENT FAILURE

The Los Angeles County Museum of Art was the remainder beneficiary of a charitable remainder annuity trust. Following the death of the income beneficiary, Susan Cole, trust assets were to be used to purchase Japanese and Chinese art for the museum's collection. The initial fair market value of the trust in 1984 was \$1.3 million.

In 2001, Michael Schiff became the successor trustee. At the museum's request, he prepared annual valuations. The first letter showed a value of \$932,953. The present value of the museum's interest was approximately \$25,000, based on Cole's 26-year life expectancy. In 2002, Schiff's letter showed an investment in FMI LLC, indicating that the investment was to pay 12.54% annually in quarterly payments for at least 28 quarters, after which the \$650,000 investment would be returned. The 2003 letter was the same as the 2002 letter.

In 2004, Schiff reported that it had been necessary to renegotiate the FMI investment by taking an assignment of a promissory note from DollarWorks to FMI, secured by 157,500 shares of DollarWorks. Schiff said that due to a shortfall in the interest being paid, it was necessary to use principal to make Cole's payments.

In 2006, Cole renounced her interest in the trust, assigning her interest to the museum. In 2007, the museum requested a formal accounting and claimed that Schiff had breached his fiduciary duty by failing to invest and manage as a prudent investor. Schiff's accounting showed a total distribution of \$738,000, including the \$650,000 promissory note. The museum received total payments on the note of \$39,000.

The trial court found Schiff had breached his duty and ordered him to pay damages of \$532,701. He appealed, saying the museum's action had been outside the statute of limitations, since they had known of the FMI investment since 2002. The court found nothing in Schiff's letters to the museum

in the 2002 and 2003 letters that would put it on notice of the investment problems. The Court of Appeals of California agreed, saying neither earlier letter would have raised a duty to inquire, since both letters indicated that quarterly interest payments were being made on time and the funds were secured (*Museum Associates v. Schiff*, B219729).

ANNUITY TRUSTS NOT TO BE BURDENED WITH TAX

Shirley Gene Wild executed several estate planning documents on the same day. Her living trust provided that at her death, the trustee is to distribute the residue equally to two charitable remainder annuity trusts to benefit two colleges. Her brother is the life income beneficiary of both. Her brother, as trustee, had the discretion to pay estate taxes from the residue before funding the remainder trusts.

Wild also established an irrevocable insurance trust, with the stated goal of not burdening any gift, devise or bequest with death taxes. The trustee of the insurance trust was to “distribute, outright and free of trust” to each beneficiary “an amount equal to such death taxes” for which such person is determined liable under state law. Funds remaining in the insurance trust were to benefit her brother for life and then be distributed to descendants of a named individual. The descendants claimed that only they were entitled to distributions from the insurance trust. The trial court agreed.

The Missouri Court of Appeals agreed with the estate and the charitable remaindermen that it was Wild’s intent that those receiving gifts under the living trust not be burdened by death taxes. Providing for her brother during his life was Wild’s major objective, noted the court. Any interpretation of the estate planning documents that would place the death tax burden on her brother by reducing the funding of the charitable remainder trusts would frustrate that goal. If the trustee pays the tax out of the residue, the burden

of the tax is to be lessened by a gift from the insurance trust, the court found (*In the Matter of Gene Wild Insurance Trust v. Wild*, No. SD30449, No. SD30457, No. SD30459).

COURT ALLOWS CHARITABLE GIVING TO CONTINUE

How generous is too generous? A couple in the midst of a divorce prepared budgets of what each expected in the way of post-dissolution expenses. The wife, who was to receive permanent spousal maintenance from the husband, included \$100 per month for charitable contributions. The husband challenged the amount, claiming that during the couple’s period of separation, the wife did not make contributions at that level.

The Court of Appeals of Minnesota agreed with the district court, which approved the expense. The lower court found that during the marriage, the parties regularly contributed to their church and, where possible, donated 10% of their income. The \$100 expense was only about 2% of the wife’s monthly income. The court said that the relevant standard of living is not what the wife spent during the separation, but the standard of living established during the marriage (*In re the Marriage of: Iskierka*, A09-2350).

PUZZLER SOLUTION

Under Reg. §1.170A-13(c)(2)(ii), if Natalie claims a charitable deduction in excess of \$10,000 for nonpublicly traded stock, a qualified appraisal must be obtained. Even where shares are traded frequently and the deduction claimed by the donor represents the fair market value of the stock, the lack of a qualified appraisal will cause the deduction to be disallowed [*Hewitt v. Comm’r.*, 98-2 USTC ¶150,880].

CHARITABLE DEDUCTION ISN'T EVERYTHING

Charitable remainder trusts are attractive options for clients who want to make significant gifts to charity while retaining income for themselves or family members. Charitable remainder trusts also offer income tax and estate tax charitable deductions, avoidance of immediate capital gains taxes when the trust is funded with appreciated assets, professional investment and management and possible tax-free payments.

Charitable remainder trusts can make sense even when charitable deductions are minimal. For example, a farmer funded a charitable remainder unitrust with cattle, crops and farm machinery (Ltr. Rul. 9413020). In anticipation of retirement, the farmer proposed to create a net-income charitable remainder unitrust with make-up provisions, meaning the trustee would pay the lesser of the unitrust percentage or the trust's net income, with payment deficiencies made up in future years when income exceeded the unitrust amount [Reg. §.1.664-3(a)(1)(i)(b)].

The cattle and crops were ordinary income property in the farmer's hands. Code §170(e)(1)(A) requires that a donor who contributes ordinary income property reduce the income tax charitable deduction by 100% of the amount that would be ordinary income on its sale. The farmer had deducted the full cost of raising the cattle and crops, leaving him with zero basis.

However, by funding the unitrust with these assets, the farmer was able to avoid the ordinary income he would have recognized had he sold the cattle and crops outright. And, according to the IRS ruling, he avoided the self-employment tax that he would have paid on the income he received. Although his charitable deduction was minimal, he benefitted by having the sale occur within a tax-exempt trust.

Note: A charitable remainder trust cannot qualify if it does not produce a charitable

deduction – however small. So cash or other assets should be included when funding a trust like the one described.

Tangible personal property

Clients who wish to fund lifetime charitable remainder trusts with tangible personal property encounter two hurdles. Their deductions are postponed until the interests of the donor and family members (spouse, siblings, ancestors or lineal descendants) have expired [Code §170(a)(3)]. Furthermore, if the trust property is put to an "unrelated use," (a use not related to the charity's exempt purposes) the donor's deduction is calculated on the property's basis [Code §170(e)(1)(B)(i)].

But the lack of an income tax charitable deduction may not bother a client. A donor who funded a charitable remainder annuity trust with a violin was told that a deduction was available "only when all intervening interests in, and rights to the actual possession or enjoyment of, the (tangible personal) property have expired" (Ltr. Rul. 9452026). Although the donor, as income beneficiary, could not claim the deduction so long as the trust held the violin, the IRS ruled that a charitable deduction would be allowed when the trustee sold the instrument. At that point the donor would no longer have an intervening interest in the item of property but would instead hold an income interest in the sale proceeds of the violin. The charitable deduction was reduced under the related use rules. Where a gift is in trust, any use is considered unrelated if it would be an unrelated use by the charitable remainderman. A sale of the violin by a remainderman would be an unrelated use. A donor might nevertheless choose to use tangible personal property to save on capital gains taxes, since the income paid to the beneficiary, contrary to the deduction, is calculated on fair market value.

