DALLAS JEWISH COMMUNITY FOUNDATION

The Advisor

September 2010

ESTATE PLANNER'S TIP

Appraisals may be needed for gift tax purposes, even for gifts that seemingly fall within the $13,000 annual exclusion [Code §2503(b)], if it's possible the IRS may disagree over the gift value. If no return is filed, the three-year statute of limitations does not begin running, giving the IRS unlimited time to readjust the value of the gift [Code §6501(c)(9)]. The gift tax return must include enough specificity to allow the IRS to determine whether the gift is valued correctly. In the case of stock shares, the return must show the number of shares, whether common or preferred, the exact name of the corporation and either the exchange on which listed shares are traded or the location of the principal business office, state of incorporation and date of incorporation for unlisted shares [Reg. §25.6019-4]. It's particularly important that clients obtain qualified appraisals where closely held stock, tangible personal property, partial interests in real estate or other hard-to-value property may be involved, to bolster the client's position in the event the IRS questions the value years later.

NO "CARRY OVER" RESIDENCY IN NEW HOME

David and Christine Gates owned and lived in a small home from 1996 to 1998. They wanted to enlarge and remodel the home, but were told by their architect that due to more stringent building codes, it would be better to build a new one. The couple agreed, demolishing the small home and building a larger one. They never occupied the new home, which was sold in 2000 for $1.1 million.

On their 2000 income tax return, the Gateses did not report any of the $591,406 capital gain from the sale of the home. They later agreed that $91,406 should have been included in income, but argued that the remaining $500,000 was sheltered under Code §121. The IRS said they were not entitled to the exclusion because they never lived in the new home.

Under Code §121(a), a portion of the gain from the sale of property is excluded if the property has been owned and used by the taxpayer as the taxpayer's principal residence for at least two of the five years prior to the sale. The Tax Court noted that the term "property" is not defined. The couple contended that "property" includes not only the dwelling, but also the land on which the dwelling is situated.

The court found the statutory definitions of

property ambiguous, so it turned to the legislative history of Code §121. It determined that "property" and "principal residence" mean a house or other dwelling unit in which the taxpayers actually resided. The court found nothing to indicate that Congress intended Code §121 to exclude gain on the sale of property that does not include a house or other structure used by the taxpayer as a principal residence. The court added that although the couple would have satisfied the requirements of Code §121 if they had sold or exchanged the original house, rather than tearing it down, the legislative history of Code §121 leads to the conclusion that the couple did not sell their principal residence (*Gates v. Comm'r.*, 135 T.C. No. 1).

BENEFICIARIES TOLD TO WAIT THEIR TURN

Miller Cosby's will left his investments to fund a charitable remainder unitrust to pay income for life to four individuals and then split the remainder between the Upper Caroline Volunteer Fire Department and the Ladysmith Volunteer Rescue Squad. Several years of litigation followed Cosby's 2004 death. By 2009, only two of the four income beneficiaries were still living, and the trust was worth between $5 and $6 million.

The income beneficiaries and the Upper Caroline Department asked the court to split the trust into two equal trusts, with one trust for each remainderman. They then proposed to commute the value of the Upper Caroline trust, with the parties receiving outright the actuarial value of their respective interests.

The Ladysmith Squad objected to the move, saying it violated Cosby's intent. The trustees had the power to amend the trust, but only for the purpose of ensuring that it qualified as a charitable remainder trust. The will also contained a spendthrift clause, insulating the interests from the claims of creditors and preventing the beneficiaries from encumbering or controlling their shares. The Ladysmith Squad argued that allowing the division and commutation would violate Cosby's stated intent of placing the assets in trust to be managed for the benefit of certain individuals. The Circuit Court granted the request by the Upper Caroline Department and the income beneficiaries.

The Court of Appeals of Virginia reversed. The court noted that while state law permits a trust to be split and commuted, it may be done only if it does not "materially impair rights of any beneficiary or adversely affect achievement of the purposes of the trust." Cosby's stated intent prevails over the desires of the beneficiaries to have their money currently, said the court. The trust would not fail to qualify as a charitable remainder trust if left as a single trust, and there was no showing that trust assets have been mismanaged, that the trust has become uneconomic or that its objectives are unattainable. Cosby indicated that he wanted the most favorable tax treatment for his estate and to provide a stream of income to named individuals. The beneficiaries' desire to have their money today, rather than waiting, did not further Cosby's purposes, but "completely frustrated them," said the court (*Ladysmith Rescue Squad, Inc. v. Newlin*, Record No. 091388).

PHILANTHROPY PUZZLER

John and Ida wish to help their grandchildren with college expenses while also benefiting their favorite charity. They read a magazine article about charitable remainder trusts and have asked if they could create a trust that would last for the lives of their six grandchildren (ages three to 16). Is their plan feasible?

BREAKING UP PROVES COSTLY TO UNITRUST BENEFICIARY

Alicia and Christopher Lancashire funded a charitable remainder unitrust with shares of closely held stock just prior to the company's sale. Each was entitled to a 4% unitrust payout

for life, with the survivor receiving the full 8%.

During divorce proceedings, Christopher asked the court to determine the value the survivorship benefit, allocate it to Alicia and give him an offsetting payment. Alicia argued that the court had no jurisdiction over the unitrust because it was no longer community property once contributed to the trust.

An accountant put the value of Christopher's survivor benefit at $3,830,427 – half the total of the $7,660,854 value of the entire 8% income stream. Alicia's expert put the value at $3,467,571, but made adjustments for income and estate taxes, leaving a value of around $600,500.

The trial court said the survivor's benefit was community property and found the value to be $3,467,571, with no offset for taxes, saying these were not immediate or specific. The court ordered Alicia to pay Christopher that amount or deduct it from Alicia's share of the proceeds from the sale of their homes.

The Court of Appeals of California noted that where trust settlors are also trust beneficiaries, they retained whatever interest they did not transfer to the trustees. Because the shares of stock were community property, they retained that character in the unitrust. The appeals court also agreed that the value of Christopher's interest in the trust was not to be reduced by taxes, saying that over Alicia's lifetime she may be able to shelter some of the income, tax rates may change or her income may change. The estate tax is not immediate and Alicia could not specify what the tax might be when one of the parties dies (*In re Marriage of Lancashire*, No. B209599).

NO TOE SHOES, NO ENDOWMENT

The Ohio Chamber Ballet ceased operations in 2006 and its articles of incorporation were cancelled by the secretary of state in 2007. Nevertheless, several trustees of the Ballet asked the Court of Common Pleas for a declaratory judgment that the Ballet was entitled to income from two endowed funds administered by the Akron Community Foundation. The trustees asked the court to allow the distribution of funds so debts could be paid. The trial court ruled that the endowment funds were not assets of the Ballet and were to be held by the foundation for use in accordance with the funds' charitable purposes.

The Court of Appeals of Ohio noted that both endowments were conditioned on the Ballet's continued operation in furtherance of its charitable purposes. The trustees argued that the Ballet's continued operation didn't depend on the production of ballet performances. In fact, they said, nothing prevents the Ballet from continuing to operate indefinitely for the sole purpose of collecting endowment income to pay its debts.

The court said paying the debts of a defunct organization is not in furtherance of the Ballet's designated charitable purpose of promoting "ballet, education and culture." The trial court did not err in ruling that the Ballet was not entitled to receive endowment income (*Revis v. Ohio Chamber Ballet*, 2010 Ohio 2201).

PUZZLER SOLUTION

A trust for the joint lives of their grandchildren would not satisfy the requirement that the charitable remainder equal at least 10% of the value of the assets transferred to the trust [Code §§664(d)(1)(D), 664(d)(2)(D)]. However, the couple could create a qualifying trust that lasts for a term of up to 20 years – long enough for all the grandchildren to graduate from college. An independent trustee can be given the power to "sprinkle" the income each year [Code §674(c)], directing it to the grandchild or grandchildren currently attending college. A caution: If John and Ida act as trustees, they will be considered owners of the trust under the grantor trust rules [Code §§671 to 678] and the trust will not qualify as a charitable remainder trust.

FOLLOW-UP GIFTS FROM TRUSTS MAY BE ATTRACTIVE

The bad news: §7520 rates have been steadily dropping this year, meaning charitable deductions for charitable remainder annuity trusts and charitable gift annuities are lower. The good news: There's an opportunity for clients to revisit existing charitable remainder trusts with an eye toward making a second charitable gift of the income interest. Donors who created their trusts several years ago might find their total deductions exceeding their original gifts.

Take the case of Ted, who funded a 6% charitable remainder annuity trust with $100,000 in 2006 when he was age 62. His charitable deduction at the time (assuming quarterly payments and a 6% §7520 rate) was $36,245. For the past four years Ted has received quarterly payouts totaling $6,000 per year.

It's possible for Ted to save taxes by making a gift to the charitable remainderman of his income interest in the annuity trust. Charity's interests would merge under general trust law and the trust would end.

His deduction for the trust income gift would be equal to the present value of his right, at age 66, to continue receiving the $6,000 annuity payment for the rest of his life – $78,897, assuming the use of August's §7520 rate of 2.6%. Overall, Ted receives two charitable deductions totaling $115,142 from his original $100,000 transfer. The deductions are in addition to the $24,000 in income he has received over the past four years.

How is it possible to receive $115,142 in deductions for a transfer of $100,000? When the trust was established in 2006, the charitable deduction for the remainder interest was valued using different mortality tables and a higher §7520 rate. The 6% rate in effect when Ted established the trust gave him a much more generous deduction than he would receive if he were to establish the same trust today. While low §7520 rates reduce the deductions for charitable remainder trust gifts, they increase the deductions for gifts of an income interest in a remainder trust.

How does the IRS feel about Ted getting more in deductions than he transferred to the trust? In a private letter ruling, the IRS approved a gift of the income interest in an existing charitable remainder trust (Ltr. Rul. 8221078) because it constituted the donor's entire interest in the property. It would also be possible for Ted to give charity an undivided fractional interest – 50%, for example – in the trust income, provided the interest lasted for Ted's lifetime [Code §170(f)(3)(B)(ii)].

Favorable deduction benefits are available for gifts of an income interest in both charitable remainder annuity trusts and unitrusts, as well as gifts of a retained life annuity from a charitable gift annuity. The current low §7520 rate makes charitable lead trusts and gifts of remainder interests in homes and farms particularly attractive.

With talk in Congress and the White House of allowing the 2001 and 2003 income tax cuts to expire next year for some taxpayers, a gift of an income interest in an existing trust might be more attractive to philanthropic clients in 2011. They can lower their adjusted gross income, thereby reducing income taxes and any cutbacks in exemptions and deductions that are also scheduled to reappear in 2011.

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