

The Advisor



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ESTATE PLANNER'S TIP

Clients who remarry or create charitable bequests need to take a fresh look at estate tax apportionment provisions. This is particularly true where the estate has large assets, such as retirement accounts, that pass to a nonspouse outside probate. The estate tax attributable to the inclusion of an IRA or 401(k) account in the estate may affect beneficiaries who don't receive the accounts. Clients may prefer that estate taxes be borne by beneficiaries in proportion to their shares of the entire estate or that taxes be paid out of a particular share. Most assets passing at death to spouses and charity will qualify for the marital and charitable deductions [Code §§2056 and 2055]. But if estate taxes are payable out of assets designated to a spouse or charity, the deductions will be reduced by the amount of the taxes owed, necessitating an interrelated computation that is costly to the estate, the spouse or charity [Code §2056(b)(4)(A); *Mosher v. U.S.*, U.S.D.C. (Conn.), 1975].

AGE ISN'T JUST A STATE OF MIND

Gail Watson retired from her job in December 2006, when she was age 53. In 2008, when she was age 55, she received distributions totaling \$30,006 from her employer's qualified retirement account. She reported the distributions and paid the tax on her 2008 income tax return, but did not pay the 10% additional tax.

Under Code §72(t)(1), a tax penalty of 10% is due on early distributions from qualified retirement plans. This tax does not apply to distributions made after the taxpayer reaches age 59½ or "to an employee after separation from service after attainment of age 55" [Code §72(t)(2)(A)(v)].

Watson argued that she qualified for the exception because she was age 55 when she received the distributions, even though she was age 53 when she retired. The Tax Court agreed with the IRS that the exception did not apply to Watson since she had not attained age 55 when she retired. The court noted that the legislative history of Code §72(t)(2)(A)(v) provides that the exception applies "only if the participant has attained age 55 on or before separation from service." The exception under Code §72(t)(2)(A)(i) also didn't apply since Watson had not reached age 59½ (*Watson v. Comm'r.*, T.C. Summ. Op. 2011-113).

UPS AND DOWNS OF SOCIAL SECURITY

Social Security recipients will be receiving more money in 2012, thanks to a 3.6% cost-of-living adjustment. This is the first boost in payments since 2009, when the increase was 5.8%. The maximum Social Security benefit for workers retiring at full retirement age is \$2,513 per month, compared with \$2,366 in 2011, although the average monthly benefit for all workers is \$1,229, an increase of \$43.

The COLA means that workers will continue paying into the system until earnings reach \$110,100, an increase over this year's limit of \$106,800. Social Security recipients under age 66 who continue working will lose \$1 of benefits for every \$2 of earned income over \$14,640 in 2012. In 2011, the earnings limit is \$14,160.

MOTHER DOESN'T ALWAYS KNOW BEST

Kimberly was age 13 when her father died, naming her the sole beneficiary of his qualified retirement plan. She was eligible for a trustee-to-trustee transfer into an IRA in her own name [Code §402(c)(11)].

Kimberly's mother, acting as guardian, instead filed the paperwork to have a lump-sum distribution made of the entire account balance. She also filed a tax return on Kimberly's behalf, reporting the distribution and paying the tax.

The probate court appointed a conservator for Kimberly, who brought suit to contest the lump-sum distribution. The conservator asked the IRS to rule on whether a trustee-to-trustee transfer could be made with the reimbursed funds.

The IRS said that but for the misuse of the funds by her mother, Kimberly could have received a tax free transfer of the account balance. She is eligible to make the transfer with the court-ordered reimbursement and the refund of federal and state taxes following the filing of an amended return. It will be treated as an inherited IRA under Code §408(d)(3)(C), said the IRS (Ltr. Rul. 201139011).

COMPANY MADE THE GIFT, MISSED THE DEDUCTION

A food manufacturer that contributed products to food banks and similar organizations took an enhanced charitable deduction under Code §170(e)(3)(A). In general, a gift of inventory is deductible only up to the donor's basis in the property [Reg. §1.170A-1(c)(1)]. But a deduction of up to two times the donor's basis may be available for gifts to be used solely for the care of the ill, needy or infants.

The IRS ruled that the food manufacturer was not entitled to the deduction claimed, saying that it did not properly value the gift property. The donor must document the price the taxpayer would have received if the contributed property had been sold in the usual market. However, the donor did not take into account reductions for vendor allowances. In addition, the products were all within 110 days of their "best by" date. The manufacturer generally does not sell products within that time frame.

While the IRS did not dispute that the food manufacturer made a "qualified contribution" for which it received no money or other property, and that it had proper substantiation from the donee organizations, the company did not attach the required Form 8283 to its return. The company did not meet the burden of establishing the fair market value of the food products, but even if it had, said the IRS, the failure to attach Form

PHILANTHROPY PUZZLER

Clarence wishes to create a charitable remainder trust that will pay income to him for life and then continue paying for the life of his sister before distributing the remainder to his favorite charity. In reviewing the proposed trust drafted by his attorney, Clarence was concerned about a provision making his sister's interest contingent upon her payment of any federal or state death taxes owed by the trustee. He wanted to avoid burdening his sister with this obligation and asked why the trust couldn't simply pay any taxes instead. Is that possible?

8283 precluded the company from claiming the deduction (Field Attorney Advice 20113801F).

PAPERWORK SNAFU PROMPTS SUIT

Luther Dietrich's mother was the original "payable on death" beneficiary of his bank accounts at Fifth Third Bank. The bank's computer system showed a change was made in 2005, naming Watch Tower Bible and Tract Society as POD beneficiary.

Following Dietrich's death, the bank notified Watch Tower that it was a beneficiary, but placed a hold on the accounts since the estate was claiming the funds were assets of the estate. The estate filed a concealment action against the bank.

The probate court directed the bank to release the nearly \$100,000 in the accounts to the estate, saying that no written contract or agreement between Dietrich and the bank entitled Watch Tower to the funds. Under bank policy, Dietrich had to fill out a written beneficiary form and new signature card to supersede the prior POD designation. Although the bank representative handling Dietrich's accounts was aware of the requirement, she could not locate the necessary paperwork when he sought to make the change.

In 2008, Watch Tower filed suit against the bank, alleging negligence, breach of contract, conversion and tortious interference with an expectancy. The trial court granted summary judgment in favor of the bank, which argued that Watch Tower was precluded from suing under the doctrine of collateral estoppel. The bank had said Watch Tower's claims should have been raised in the probate court.

The Court of Appeals of Ohio reversed and remanded the matter, finding that Water Tower's cause of action arose only after the probate court judgment, because that was when the charity learned that the bank had acted negligently. The court noted that Watch Tower was not claiming that it was the proper POD beneficiary, but rather that the intended bequest from Dietrich "was not consummated due to the bank's negligence." There are questions of material fact whether the bank acted negligently in failing to secure the paperwork need-

ed for a proper POD designation, ruled the court (*Fifth Third Bank v. Watch Tower Bible & Tract Society of Pennsylvania*, 2011 Ohio 5180).

EXECUTOR TAKES UNAUTHORIZED LIBERTIES

Edgar Hollis's will left his home to the City of Newnan, GA, to establish a museum, along with funds to establish an endowment. If the bequest was declined, the executor was required to offer the home and cash to the Newnan-Coweta Historical Society or a "comparable charitable entity."

After the city declined the bequest, the executor, Mayo Royal, deposited \$1.5 million from the estate into the account of a local foundation which he deemed to be a comparable charitable entity.

The trial court found that Royal had breached his fiduciary duty by distributing estate funds without regard to the terms of the will. In granting summary judgment, the court said the will required Royal to first offer the bequest to the city, then to the historical society. A "comparable charitable entity" was to receive the bequest only if the historical society had ceased to exist and had no successor. Although Hollis gave Royal discretion in other matters in the will, he did not use similar language regarding the bequest of his home. The Supreme Court of Georgia agreed, noting that Royal had acted in bad faith and caused unnecessary fees and expenses (*Royal v. Blackwell*, S11A0009).

PUZZLER SOLUTION

A trust will not qualify as a charitable remainder trust if any amount other than the annuity or unitrust amount may be paid by the trust to or for the use of any person other than a charity [Reg. §§1.664-2(a)(4), 1.664-3(a)(4)]. Two-life charitable remainder trusts must include a clause guaranteeing that the trust will not be invaded to pay estate or death taxes [Rev. Rul. 82-128, 1982-2 C.B. 71]. Making his sister's interest contingent on the payment of taxes will satisfy the requirement.

TAX ADVANTAGES OF OWNING PROPERTY WITH CHARITY

Many advisors and their clients are familiar with the tax benefits of charitable remainder trusts: avoidance of immediate capital gains tax, current charitable deduction, potential for increased spendable income. But some donors aren't ready to part with the property that would be used to fund the trust, and self-dealing rules prohibit a donor – a disqualified person under Code §507(d)(2) – from using or even renting the property in the trust. But there are other options that allow donors to own property “jointly” with charity – and reap tax savings as a result.

Remainder interest in a residence or farm

A farm couple wishes eventually to leave their land to a charity. They can accelerate their gift – and their charitable deduction – by deeding the property to charity and reserving a life estate [Code §170(f)(3)(B)(i)].

The donors are free to continue farming the land or they can receive the rental income from the property during their lifetimes. They receive an income tax charitable deduction at the time of the gift, based on the current value of the land, their ages and the useful life of depreciable structures. Remainder interest gifts are also an option for owners of vacation homes.

Undivided interests

Reg. §1.170A-5(a)(4) disallows deductions where a donor contributes an item of personal property (e.g., a painting) to charity and retains an interest in the property during life. But a donor instead can give charity an undivided interest in the property that entitles charity to use of the property for a certain portion of the year.

No deduction is allowed for a gift of an undivided interest in tangible personal property unless all interest in the property is held immediately before the gift by the donor or the donor and charity. If the donor later makes an additional gift of an undivided interest in the same

asset, the deduction is limited to the lesser of the fair market value of the property at the time of the initial fractional interest gift or the fair market value at the time of the additional gift [Code §170(o)(2)]. The donor must contribute the remaining portion of the tangible personal property within ten years of the initial fractional gift or the date of death, whichever is sooner. Failure to do so results in a recapture of the amount of the deduction plus a 10% addition to tax. Charity must have substantial physical possession of the property and use of it for a related use during a portion of the ten-year period [Code §170(o)(3)].

A donor may also contribute an undivided interest in real property – a vacation home, for example. The owner may give charity an undivided interest and take an immediate charitable deduction for the value of charity's interest. An undivided portion is defined as a fraction or percentage of each and every substantial interest or right owned by the donor in such property [Reg. §1.170A-7(b)(1)(i)]. The donor's basis is allocated between the contributed and retained portions. When the property is eventually sold, whether during the donor's lifetime or at death, charity is entitled to a portion of the sale proceeds.

Conservation easement

A perpetual easement granted to charity for conservation purposes also allows the donor to continue to use – or even sell – the property, subject to the restrictions of the easement [Code §170(h)(4)]. “Conservation purposes” includes the preservation of the land areas for public outdoor recreation; education or scenic enjoyment; preservation of historically important land areas or structures; protection of natural environmental systems; or the preservation of open space. The deduction for a gift of a conservation easement is equal to the difference between the value of the property prior to the easement and the diminished value with the easement.

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