

# The Advisor



June 2015

## ESTATE PLANNER'S TIP

While it may seem counterintuitive, clients between the ages of 59½ and 70½ might consider taking withdrawals from their IRAs and reinvesting the proceeds. Although the distributions will be subject to tax, there is no early withdrawal penalty. Withdrawals will reduce the size of the IRA and amounts that will have to be taken when required minimum distributions begin after age 70½. Use caution to avoid having the distribution push the client into a higher tax bracket. For example, a married couple with taxable income of \$75,000 is in the 25% bracket. They can withdraw up to \$76,200 before they move into the 28% tax bracket. The client can invest the funds (holding out enough to pay taxes) in a brokerage account that will generate capital gains or favorably taxed dividends, rather than ordinary income, in the future. Furthermore, the brokerage account gets a stepped-up basis at death, unlike an IRA which is subject to the tax on income in respect of a decedent [Code §691]. Another option: Convert the funds to a Roth IRA that will continue to grow tax deferred. Qualified distributions from Roth IRAs are tax free and there are no required minimum distributions. Assets in a Roth are not subject to the tax on IRD at the owner's death.

## WITHDRAWAL RIGHTS NOT ILLUSORY

Israel and Erna Mikel established an irrevocable inter vivos trust to which they transferred property worth \$3,262,000. The trust, which had 60 family beneficiaries, gave each beneficiary the right to withdraw up to the amount of the annual exclusion in the year the trust was funded and in any year in which additional property was added. The trustees also had absolute authority to make discretionary distributions for the health, education, maintenance or support of any beneficiary. The trustees' actions were "final and conclusive." The trust provided that if a dispute arose, it was to be submitted first to a three-

person panel of the Orthodox Jewish faith (a *beth din*). Beneficiaries also had the right to appeal disputes to a state court. The Mikel trust contained an in terrorem provision intended to discourage beneficiaries from challenging the discretionary acts of the trustees.

In 2011, after being contacted by the IRS, Israel and Erna filed separate Forms 709, each reporting a value of \$1,631,000 and claiming annual exclusions of \$720,000 (\$12,000 annual exclusions for 60 beneficiaries). The IRS said the transfers were not present interests that qualified for the annual

exclusion [Code §2503(b)]. The IRS claimed the withdrawal rights were not legally enforceable since, if the *beth din* upheld the trustees' refusal to honor a withdrawal demand, a beneficiary would be reluctant to take the matter to a state court due to the in terrorem clause. The withdrawal rights were "illusory," said the IRS.

The Tax Court disagreed, saying that the in terrorem clause pertained only to discretionary distributions by the trustees. The beneficiaries had a present interest in property because the clause would not deter beneficiaries from pursuing judicial relief if the trustees refused a withdrawal request (*Mikel v. Comm'r.*, T.C. Memo. 2015-64).

### "HONORABLE" ACT STILL RESULTS IN TAX

George Morris' son, Elroy, was the sole beneficiary of his IRA. Following George's death in 2011, Elroy submitted a death claim to the IRA custodian and received a gross distribution of \$95,484. No income tax was withheld. Elroy, acting on what he thought his father would want, issued checks totaling \$37,000 to two of his siblings.

A paralegal in the law firm handling George's estate told Elroy that there would be no tax due on

the IRA distribution. The Tax Court said that the paralegal "evidently" meant that there was no federal estate tax or state inheritance tax. Elroy, who understood the paralegal to mean that there would be no tax of any kind, did not report the distribution on his 2011 income tax return, although he received a Form 1099-R from the IRA custodian. The IRS issued a notice of deficiency. Elroy claimed that he should not be held solely responsible for the tax.

Under Code §408(d)(1), any amount paid or distributed out of an IRA is to be included in gross income by the payee or distributee. Elroy argued that it would be "inequitable" to hold him solely liable for the tax when he voluntarily shared the proceeds with his siblings, from whom he was unlikely to recover anything.

The court said that Elroy "acted honorably" in following what he thought were his father's wishes, but it had no bearing on whether the IRA distribution was included in his gross income (*Morris v. Comm'r.*, T.C. Memo. 2015-82).

### HSA DEDUCTION LIMITS CHANGING – IN 2016

There are still six months to go in 2015, but the IRS has issued the inflation adjustments for health saving accounts for calendar year 2016. The annual limit on deductions for taxpayers with self-only coverage under a high deductible plan is \$3,350. For family coverage, the deduction limit is \$6,750. A "high deductible health plan" is one with an annual deductible of not less than \$1,300 for single coverage or \$2,600 for family coverage [Code §§223(c)(2)(A) and (B)]. Out-of-pocket expenses cannot exceed \$6,550 or \$13,100 respectively (Rev. Proc. 2015-30).

### SUBSTANTIATION: A RECURRING THEME

The IRS and Tax Court seem to be working overtime on cases involving substantiation of charitable gifts.

### PHILANTHROPY PUZZLER

Maureen owns stock that has increased in value several-fold over the price she paid a number of years ago. She has always wanted to help her favorite charity, but hoped eventually to leave the assets to her children to augment their retirement savings. Maureen read about a charitable lead trust that pays an annuity to charity for several years and then distributes the assets to family members at a reduced gift tax cost. She has asked whether her stock would be a good asset with which to fund a lead trust.

*Kunkel v. Commissioner*, T.C. Memo. 2015-71

A couple claimed a charitable deduction of \$42,455 on their 2011 return. Of that, \$37,315 was for noncash gifts, which the IRS disallowed. The taxpayers contended that they donated items to their church's annual flea market and to three thrift stores. They said they gave clothing worth nearly \$21,000, furniture valued at \$2,680, household items worth \$350 and \$250 worth of toys. They had no documentary evidence and did not remember which items were given to which charities.

The couple said that because they deposited many of the items in the after-hours bins, they received no receipts, but added they were careful to ensure that the items in each batch were worth less than \$250, so they would not need receipts. For some items, which were picked up at their home while they were gone, they had doorknob hangers that the organizations had left. These were not dated and did not list or describe the property contributed.

The couple testified that, when it was time to prepare their 2011 tax return, they assigned estimated values to the master list of items they had contributed. The Tax Court said it found no credibility to the testimony, noting that it would have been difficult for the taxpayers to ensure that no single contribution was more than \$250 if they didn't value the items until they were preparing their tax return. In addition, noted the court, it would mean that they would have made 97 separate donations in order to reach \$24,200 in batches of less than \$250. The court called that "implausible." For contributions of more than \$500, the taxpayers failed to present evidence that the items were "in good used condition or better" and they lacked a qualified appraisal [Code §170(f)(16)(C)]. The court conceded that the couple donated "some property" to charities in 2011, but said it was unable to allow a deduction for noncash gifts due to the lack of substantiation.

*Howe v. Commissioner*, T.C. Summ. Op. 2015-26

The IRS allowed Roberta Howe a deduction of only \$2,500 in 2010 and \$1,000 in 2011 for noncash contributions. Howe donated furniture, clothes and household appliances that she had inherited. Although she had receipts from the charities, they lacked information on the type of property donated, a signature of anyone acting on behalf of the charity or a statement that no goods or services were provided in exchange for the donation.

Howe had prepared a list of items, using donation valuation guides from Goodwill and the Salvation Army, choosing to assign the maximum recommended value to each item. She also admitted to modifying the receipts just prior to trial by adding estimated fair market values and more detailed descriptions of the property. The Tax Court said it would not rely on the modified receipts, adding that they are not contemporaneous written acknowledgments.

The court said Howe failed to satisfy the substantiation requirements and was not entitled to deductions in excess of amounts already allowed by the IRS.

#### PUZZLER SOLUTION

If the shares produce sufficient dividends to pay charity's lead interest, there is no drawback to using them to fund the trust. If the trustee is required to sell some shares in order to produce sufficient income, the trust will realize capital gain but should be entitled to an offsetting charitable deduction when it makes a distribution to charity. (Unlike a charitable remainder trust, a charitable lead trust is not tax-exempt.) The IRS has also ruled that if a lead annuity trust distributes stock to charity to satisfy a payment, it realizes capital gain, but will be entitled to a charitable deduction for the distribution (Rev. Rul. 83-75, 1983 C.B. 114).

### ANNUITY NOW, PROPERTY LATER

An elderly client wishes to benefit a favorite charity but is house-poor. “Isn’t there some way,” the client asks, “to get income from my home, live there for the rest of my life and have the home pass to charity at my death?” There are stumbling blocks to nearly every gift technique that can detour a donor’s quest to “have it all.” A donor can:

- Give charity a home or farm while retaining a life interest in the residence – but there is no income unless the donor moves out and rents the property.

- Transfer the home to a charitable remainder trust, retaining an income interest for life – but there’s a popular saying among charitable planners that “donors can’t live in their remainder trusts.” The donor would have to vacate the home. The trustee could then sell the property and reinvest the proceeds to satisfy the annual trust payments. The donor can’t even rent the home from the trust at fair rental value due to self-dealing prohibitions [Code §4941].

There is one way, however, for a donor to continue occupying the home, receive payments for life and make a gift to charity, although it’s not for every donor or every charity. The technique is a gift of a remainder interest in a home or farm in exchange for a charitable gift annuity (Ltr. Rul. 8305075) – sometimes referred to as a charitable reverse mortgage. The donor would be entitled to payments based not on the fair market value of the property, but on the actuarial value of the remainder interest.

Consider Harriet, age 78, with a home worth \$800,000. The charitable deduction for a gift of a remainder interest in the home would be \$536,406, assuming the house was currently worth \$650,000 and would be depreciated down to \$20,000 by the end of its 35-year useful life, the

land was worth \$150,000 and using a §7520 rate of 2%. (In the current low §7520 rate climate, the charitable deduction for this type of gift is more attractive.) But because Harriet will be using the remainder interest to fund a charitable gift annuity, the \$536,406 is not the deduction, but the amount transferred. Assuming quarterly annuity payments, her charitable deduction would be \$251,320, which she may use in the year of the transfer and carry over excess deductions for up to five succeeding years. More important for Harriet, however, is that she receives \$34,330 annually for her life, continues to live in her home and has the satisfaction of knowing that charity will benefit at her death.

The downside to the gift is that charities may be hesitant or unable to accept such an arrangement. Many charities accept only cash or marketable securities in exchange for immediate payment charitable gift annuities. A few will accept real estate, but generally only for deferred payment gift annuities, giving them time to sell the home before their obligation to make annuity payments begins. State gift annuity rules may also be an issue.

The obvious drawback to this gift technique, from charity’s standpoint, is that the organization must have pockets sufficiently deep to fund the gift annuity for the donor’s life before the charity will receive the property. That may be part of the price charity is willing to pay if the real estate is a parcel the charity wants (e.g., next to a college campus or hospital). The charity may also be able to negotiate a lower annuity rate or discount the value of the property. This is clearly a gift technique that is not for every donor – or every charity – but may be a solution for philanthropic clients who aren’t ready to leave the nest.

**Cherí E. O’Neill**  
President and CEO

**BALL STATE UNIVERSITY FOUNDATION**  
P.O. Box 672, Muncie, IN 47308  
(765) 285-8312 • (765) 285-7060 FAX  
Toll Free (888) 235-0058  
[www.bsu.edu/bsufoundation](http://www.bsu.edu/bsufoundation)

**Philip M. Purcell, J.D.**  
Vice President for Planned Giving  
and Endowment Stewardship