The Advisor

BALL STATE UNIVERSITY FOUNDATION
Established in 1951

May 2015

ESTATE PLANNER'S TIP

Professional clients might benefit from personally owning the buildings in which their practices or companies are located, rather than in the name of the business. Personal ownership may protect the building from the creditors of the business and also provide tax and estate planning opportunities. For example, the income received from leasing the building to the company is not subject to employment taxes, and the client can claim depreciation deductions on his or her personal return to offset the rental income. The business can deduct the rental payments. The building can be contributed to a family limited partnership, allowing the client to pass interests to children at reduced transfer tax costs by taking advantage of various valuation discounts. The client retains control over the building through the general partnership interest. If the client sells the business, possibly at retirement, he or she can retain the building and augment retirement income with the rent received from the new owner of the business or other tenants.

MOTHER-SON "BONDING" PROVES COSTLY

In 1992, Ruth Lobs used $5,000 from an inheritance she received to purchase U.S. savings bonds for the future benefit of her son, Joseph. The bonds were in Ruth's possession. It was intended that Joseph would receive the proceeds when redeemed.

In 2010, Joseph was in need of funds. Ruth redeemed the bonds and deposited the $12,640 proceeds into her account. She had a cashier's check written to Joseph in the same amount. Ruth did not include the interest from the redemption of the bonds on her tax return.

The IRS determined that Ruth had failed to report $7,640 of interest income from the bond redemption. Ruth argued that the bonds belonged to Joseph, not her, and that the interest was, therefore, not taxable to her.

The Tax Court noted that the registration of U.S. savings bonds is generally conclusive of actual ownership of and interest in the bonds. The interest is fully taxable. The fact that the bonds could have been registered in another name is irrelevant, said the court. Ruth was the registered owner of the bonds and was entitled to receive – and did in fact receive – the proceeds upon their redemption. The check that was written to Joseph with the bond proceeds was a "postredemption gift," according to the court. The check did not indicate any ownership interest by Joseph in the bonds themselves (*Lobs v. Comm'r*., T.C. Summ. Op. 2015-17).

IRS LOOKS BEHIND THE FACADE

Arnold, the managing partner of a partnership, entered into an agreement to assign his membership interest to a charity. The day after the assignment, a corporation with no assets or equity purchased the charity's units in exchange for a promissory note. The corporation was wholly owned by Arnold. Principal on the note was to be paid on or before the expiration of 20 years.

Rev. Rul. 68-174 (1968-1 C.B. 81) provides that a promissory note represents merely a promise to pay at some future date and is not deductible as a contribution under Code §170. Arnold claimed a charitable deduction for the value of the units transferred to the charity.

The IRS noted that within one day of Arnold's assignment, the charity held no rights to the units, just a note. Had Arnold contributed a note directly to the charity, no deduction would be allowed. The substance of the transaction, said the IRS, was that charity received Arnold's promise to make payments through the corporation, in an amount and at the time determined by Arnold for the next 20 years. Recasting the transaction, the IRS said Arnold transferred the units to corporation. Therefore, the corporation is entitled to treat payments under the note as charitable contributions when they are actually made (CCA Memorandum 201507018).

PHILANTHROPY PUZZLER

Brenda, a lawyer, serves on the board of her favorite charity. She has offered to draft wills, codicils and trust documents at no charge, for donors who leave a bequest or arrange a life-income gift for the organization. All she asks in return is that the donor contribute $100 to the charity for the service. Are either Brenda or the donors who take advantage of the offer entitled to a charitable deduction?

NOT WORTH THE PAPER THEY'RE WRITTEN ON

The receipts that Manolito Legaspi was given for his donations of clothing and furniture to a thrift shop did not satisfy the requirements of Code §170(f)(8), said the Tax Court. Legaspi produced photos of the furniture he claimed to have donated, each picture included handwritten notes listing the year the item was purchased, the purchase price and the fair market value, which he listed as one-third of the purchase price. He arrived at these numbers on his own, with no independent appraisal, the court said. Legaspi claimed a charitable deduction of $4,230.

The court noted that for noncash contributions of $500 or less, donors may substantiate their gifts with a receipt from the donee indicating the charity's name and address and a reasonably sufficient description of the property [Reg. §1.170A-13(b)(1)]. For noncash gifts in excess of $500, the taxpayer must also maintain written records of how the item was acquired, the approximate date of acquisition and the cost or adjusted basis.

The receipt that Legaspi received from the charity did not include a detailed description of the gift items and did not indicate that either no goods or services were provided by the charity, or give a good faith estimate of the value of any goods or services provided. Therefore, ruled the court, he was not entitled to any deduction for his noncash charitable gifts (*Legaspi v. Comm'r.*, T.C. Summ. Op. 2015-14).

EASEMENT CAN'T BE SUBJECT TO CHANGE

Balsam Mountain Investments entered into a perpetual conservation easement agreement with the North American Land Trust in 2003. The partnership agreed to restrict development as to a specific 22-acre parcel of land, which was to be used as a natural habitat and open space. The exact boundaries were described in a plat attached to the easement agreement.

One provision in the agreement allowed Balsam to make boundary changes, provided several requirements were met. The total area protected could not be reduced, any additions had to be contiguous with the original area, the Land Trust had to agree to any change and any land substituted could not exceed 5% of the total easement area. No boundary adjustments could be made after five years.

In 2011, after Balsam had dissolved, the IRS disallowed the charitable contribution deduction. The Tax Court agreed, saying the easement was not a qualified real property interest under Code §170(h)(2)(C). A qualified real property interest is one granted in perpetuity, noted the court, adding that the easement agreement cannot permit the donor to change what property is subject to the easement. The easement granted by Balsam was not "an identifiable, specific piece of real property," said the court (*Balsam Mountain Investments, LLC v. Comm'r.*, T.C. Memo. 2015-43).

LAX SUBSTANTIATION TAKES MAJOR BITE OUT OF DEDUCTIONS

On her 2008 income tax return, Adiatu Jalloh claimed deductions for $15,340 in cash gifts and $15,697 in noncash contributions. In 2009, she deducted $6,490 for cash gifts and $3,867 for noncash gifts. The IRS disallowed the cash gifts for both years, but eventually conceded that Jalloh was entitled to deduct $915 and $1,055 for the two years and also $500 for a noncash gift in 2009.

A receipt from one organization to which she made cash gifts reflected multiple contributions, including some in excess of $250. It was undated, failed to state the dates and amounts of the contributions, and therefore was not adequate substantiation under Reg. §1.170A-13(a)(1), said the Tax Court.

Jalloh also attached a Form 8283 to both her 2008 and 2009 returns. She submitted donation receipts from several charities, but the court found each "deficient in one way or another," because they lacked the date of the gifts and/or a description of the property. The court held that Jalloh was not entitled to deductions in excess of those allowed by the IRS (*Jalloh v. Comm'r.*, T.C. Summ. Op. 2015-18).

DONOR LACKS STANDING FOR ALLEGED BREACH

Jacob Frydman was upset that an organization to which he had contributed had named an individual as treasurer that the board "knew, or should have known" was a convicted criminal, and failed to disclose that fact. Frydman filed suit against the organization's officers and directors for gross negligence, fraud, breach of fiduciary duty and loyalty.

The officers moved for a dismissal, arguing that only the state's attorney general can take action against a not-for-profit for a violation of legal obligations. The Supreme Court of the State of New York County agreed, saying that a private individual lacks standing to bring the action against the organization's officers and directors.

The fact that Frydman was a donor does not confer standing, said the court, since he is not seeking to enforce any terms of a donation he made. Instead, noted the court, he was alleging that the officers breached "their general legal obligations." Although the court granted the motion to dismiss, it did not impose sanctions against Frydman, as the defendants requested (*Frydman v. Rosen*, 2015 NY Slip Op. 30171(U)).

PUZZLER SOLUTION

No deduction is allowed for the contribution of services [*Grant v. Comm'r.*, 84 TC No. 32 (1985)], although Brenda would be entitled to a deduction for her out-of-pocket expenses in connection with rendering the services on behalf of charity (e.g., photocopying, mileage at 14 cents per mile). A donor who gives $100 to the organization in exchange for Brenda's free services also is not allowed a deduction because the donor has received an item of value in return. The donor would, however, be entitled to a deduction for the value of charity's irrevocable interest in a qualified trust.

CHARITABLE PLANNING AND §7520 RATES

The §7520 rates, which are used to value split-interest gifts, have not been north of 2.4% since mid-2011, and for 2015 have hovered around 2%. A few split-interest gift techniques thrive in a low interest rate environment. Here are some ideas for gift planning in what might seem to be an adverse climate:

Gifts of income interests in charitable remainder trusts and gift annuities – Your client, age 75, established a 5% charitable remainder annuity trust with $100,000 in July 2007, when the §7520 rate was 6% and the client was age 67. His deduction back then was $52,771. He's received about $40,000 in payments from the trust since 2007, but now feels he doesn't need the trust income any more, and in fact, wants to make another gift to charity. If he assigns his remaining income interest in the annuity trust to charity in May 2015, and selects a 2% §7520 rate to measure the value of his income interest, he can deduct another $48,050. His original and current deductions total about $100,800 – exceeding the amount he originally contributed to the trust. The same strategy works with charitable gift annuities that were arranged when interest rates were high. Many donors find they don't need their annuity payments and decide to tell the charity simply to keep the money.

Trade-offs for charitable gift annuities – Older clients looking for a fixed income component for their investments might find the charitable gift annuity attractive. These same clients may own U.S. savings bonds that have stopped paying interest. The bonds could be cashed, with the proceeds used to fund a gift annuity that provides lifetime income and a charitable deduction that may shelter the interest reported when the bonds are cashed. Lower §7520 rates mean reduced charitable deductions for gift annuities, but donors receive a higher percentage of tax-free income when interest rates are low. For example, if a client age 70 arranges a gift annuity with $10,000 cash, he or she would receive $510 annually under recommended gift annuity rates assuming a 2% §7520 rate. With a 3% §7520 rate – last available in early 2011 – the donor's deduction would be $4,377 and the tax-free portion of the payout would be $353 (assuming quarterly payments). At a 2% §7520 rate, the deduction is only $3,901, but the tax-free portion rises to $384. Some donors may prefer the tax-free income over the larger deduction (nonitemizers, for example).

Charitable lead trusts – With gifts up to $5.43 million sheltered from federal tax in 2015, clients may not need to establish inter vivos charitable lead trusts for the purpose of reducing gift taxes. Reversionary lead trusts may make sense if the goal is to reduce income taxes. Deductions will be relatively high under current low §7520 interest rate assumptions.

A client could fund a lead trust that provides a payout to charity for several years, with assets reverting to the client at the end of the trust. The client can claim an immediate income tax charitable deduction for the present value of charity's income stream [Code §170(f)(2)(B)]. The major drawback to this plan is that the client is taxed on the trust's income under the grantor trust rules (Code §§671-677). One strategy is to fund the trust with tax-free municipal bonds. Another idea is to fund the trust with growth stock that has been held more than one year. The trustee will be required to sell some stock each year to make the payout to charity, but the grantor will be taxed at capital gains rates, which may be only 15%.

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

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