

The Advisor



December 2016

ESTATE PLANNER'S TIP

Irrevocable life insurance trusts are a tax-efficient way to keep insurance proceeds out of the reach of the federal estate tax. A simpler strategy might be to have the policy owned directly by the beneficiary. For example, a parent might give ownership of a new policy to a son or daughter. A gift of an existing policy would be included in the insured's estate under Code §2035 if death occurs within three years of the transfer. The parent could pay the premiums directly, which is not considered an incident of ownership under Code §2042, or could give the child money with which to pay the premiums. Provided that the premiums – along with other gifts made by the parent – fall within the annual exclusion amount [Code §2503(b)], there would be no gift tax; amounts in excess might be sheltered by the gift tax credit. If the child dies before the insured, the policy is included in the child's gross estate, but the value is only the interpolated terminal reserve plus a portion of the most recent premium (Rev. Rul. 77-181).

AN ELECTION TO DISREGARD

Under Rev. Proc. 2001-38, a QTIP election on a Form 706 estate tax return is generally treated as null and void for estate, gift and GST tax purposes if the election produced adverse tax consequences and no benefit for the taxpayer. For example, if the value of the taxable estate, before the marital deduction, is less than the amount sheltered from tax under Code §2010(c), the QTIP election is unnecessary. The QTIP election causes the property subject to the election to be included in the surviving spouse's gross estate under Code §2044(a), potentially producing adverse tax consequences with no benefit for the taxpayer.

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010

introduced portability, allowing a surviving spouse to claim a deceased spouse's unused applicable exclusion (DSUE) amount. Under Code §2010(c)(5)(A), the election is effective only if made on a timely filed estate tax return.

Rev. Proc. 2001-38 assumes that an executor "would never purposefully elect QTIP treatment for the property if the election was not necessary to reduce the decedent's estate tax liability." However, executors may wish to elect QTIP treatment, even where not necessary. For example, the QTIP election reduces the taxable estate and preserves more of the decedent's credit amount, resulting in more DSUE for the surviving spouse.

The IRS recently issued Rev. Proc. 2016-49, providing procedures under which the IRS will continue to treat the QTIP election as null and void for estates in which the executor “neither made nor was considered to have made the portability election.” If an executor makes a portability election, the QTIP election will not be disregarded.

NO AUTHORITY FOR TRUST'S CHARITABLE GIFTS

Harvey Hubbell, who died in 1957, directed in his will that the residue of his estate be held in trust, with modest sums paid monthly for life to his siblings, nieces and nephews living at his death, and two friends. At the death of the surviving beneficiary, the trust was to terminate unless the trustees decided to continue the trust for up to an additional ten years. Distributions would then be made at the trustees' discretion for uses “exempt from Ohio inheritance and Federal estate taxes and for no other purpose.” Although the will gave the trustees the power to establish a foundation, none was ever created.

Over the years, the trustees made significant contributions to charity, in addition to the annuity payments to the individuals. In 2009, a total of \$1,500 monthly was paid to the two remaining named beneficiaries. The trustees also gave cash and stock to charity, claiming a deduction of \$64,279.

PHILANTHROPY PUZZLER

When Vincent joined the board of directors of Largesse Corp., he learned that one of the perks was the ability to select a charity to receive funds each year from the company's charitable trust, provided he received no benefit in return from the gift and the gift was not made to satisfy an existing gift obligation. He directed the gift to his favorite charity, but has asked if there are any tax consequences to the gift.

The IRS disallowed the deduction, saying that the contributions were not made “pursuant to the terms of the governing instrument” [Code §642(d)(1)]. The trustees argued that Hubbell's will contained a latent ambiguity, since there was “ample evidence” that he intended the use of trust assets for charitable contributions. Income from trust assets far exceeded the amount needed to make annuity payments to the individuals, suggesting that he intended the additional income to be used for charitable purposes.

The Tax Court determined that the will was the governing instrument and that amounts were paid for charitable purposes. However, Code §642(c)(1) also requires that charitable gifts be made “pursuant to” the governing instrument. Hubbell's will made no provision for payments to charity prior to the death of the surviving annuitant. Had he intended to allow gifts to charity while the annuitants lived, he could have done so, said the court, adding that there was no ambiguity that would allow the introduction of extrinsic evidence. The court said it was being asked to “rewrite the will,” not “resolve a latent ambiguity” (*Hubbell Trust v. Comm'r.*, T.C. Summ. Op. 2016-67).

TINY INCREASE FOR SOCIAL SECURITY RECIPIENTS

Social Security recipients will receive a minuscule .3% benefit increase in 2017. Checks for the average retired worker will increase from \$1,355 to \$1,360. The inflation adjustment also means that the wage base will go up next year, from \$118,500 to \$127,200, affecting an estimated 12 million workers. Workers will continue to pay 6.2% up to the higher limit, with employers matching the same amount. The 1.45% rate on the Medicare portion is not subject to the wage base.

Those under the full retirement age of 66 who are currently receiving Social Security checks will be able to earn more before benefits are reduced by \$1 for every \$2 of income above the limit. The earnings limit for 2016 is \$15,720, jumping to \$16,920 in 2017.

EXECUTOR PAYS FOR FIDUCIARY BREACH

The residue of Margaret Billmyer's estate was left to five charities. One of the assets in the estate was a brownstone residence in Brooklyn, NY. In his April 15, 2009, application for letters testamentary, the executor put the approximate value of the brownstone at \$1.5 million.

In January 2011, the executor entered into a contract to sell the unit to an acquaintance for \$670,000. One day before the sale closed, the buyer assigned his rights under the contract to his limited liability corporation. The sale of the property closed on April 12, 2011. Three days later, the LLC sold the property to an unrelated third party for \$1.3 million, pursuant to a contract dated in March 2011.

The residuary charities and the New York attorney general filed objections to the executor's account. The parties moved for summary judgment, alleging breach of fiduciary duty, and seeking a surcharge against the executor. The Surrogate's Court granted the motions and imposed a surcharge of \$630,000, plus 6% interest from the date of the sale to the date of remittance. The executor appealed.

The Supreme Court of the State of New York, Appellate Division, noted that it is not enough to show that the estate did not get the highest price obtainable; the estate must also show that the executor "acted negligently, and with an absence of diligence and prudence." The executor argued that the property required extensive structural and cosmetic repairs and that he had obtained the written consent of the residuary beneficiaries.

The executor did not explain why the property sold three days later for significantly more than the estate received. He did not obtain an appraisal of the property, did not know how the property was marketed, failed to visit the property prior to the sale and relied on a real estate agent who was not familiar with the Brooklyn real estate market. The court said the charities had established that the executor breached his fiduciary duty and acted negligently with respect to the sale. The Surrogate's Court "providently exercised its discretion" in imposing a surcharge and interest, said the court (*In re Billmyer*, 2016 NY Slip Op 5994).

CHARITY GETS INCOME ONLY, NOT CORPUS

At Lillian Loucks' death, her living trust continued making payments for life to two individuals. At the death of the survivor, remaining funds were to be held in a perpetual charitable trust, with income paid to the Otterbein United Methodist Church and a home for the elderly, for the unrestricted use of the organizations.

The trust, which was funded with \$700,000, has been paying income in equal shares to the charities since 1991. In early 2015, the church asked that distributions of principal be allowed, saying that income payments were insufficient to meet its operating costs. Due to the number of indigent people it served, the church said it needed to invade principal to remain "financially viable." The Orphans' Court denied the request.

The Superior Court of Pennsylvania agreed, finding nothing in the trust that would permit distributions of corpus. Trust language clearly stated Loucks' intent that the trust be perpetual, with only income paid to the charities. It's possible, said the court, that Loucks could have anticipated that the charities might need more income than what was generated by the trust, but she did not provide for distributions of corpus. While lauding the church's efforts on behalf of the poor, the court said that "its budgetary affairs is not a factor in interpreting the terms of this trust." Allowing corpus distributions would eventually result in the termination of the church's portion, which is not permitted in the trust language (*In re Loucks*, 2016 PA Super 206).

PUZZLER SOLUTION

Vincent will not be considered to have received any income as a result of the gift to his selected charity. Under Rev. Rul. 79-9, he would recognize income only if he receives property or an economic benefit as a result of the contribution. Largesse's charitable trust, not Vincent, would be entitled to the charitable deduction, although he could receive recognition from the organization for having recommended the gift.

INDIVIDUAL, CORPORATE DONORS NEED TO PLAN NONCASH GIFTS CAREFULLY

Gifts of personal property, whether by an individual or a corporation, require special planning to maximize the donor's charitable deduction. Not only do donors have to be concerned with accurately determining fair market value, they have to consider how the item will be used and special deduction limits that may apply.

Appraisals

Noncash gifts valued at more than \$5,000 generally require an appraisal by a qualified, independent appraiser. Gifts of artwork for which the donor is claiming a deduction of \$20,000 or more must include a photograph to be used by the IRS's Art Advisory Panel. Exceptions to the appraisal requirements include gifts of publicly traded stock (because value normally is easily ascertainable) and gifts of closely held stock worth \$10,000 or less.

The appraisal can be made no more than 60 days prior to the date of the gift and no later than the due date of the return. For example, an appraisal for a gift made on December 1, 2016, may be made anytime from October 2, 2016, to April 17, 2017. The donor is entitled to a miscellaneous itemized deduction for the cost of the appraisal (there is a floor of 2% of AGI that must be satisfied).

Deduction limits

Deduction limits depend upon whether the donor is an individual or a corporation. Generally, an individual may deduct up to 30% of AGI for gifts of appreciated property. A corporation may deduct up to 10% of its taxable income for the year of the gift. Excess deductions may be carried over for up to five years by both individuals and corporations.

Special limits

Deductions may be reduced where assets are not put to a "related use" by the charity. For example, a gift of an antique car to a hospital would generally be considered unrelated to the donee's purposes. The donor must reduce his or her deduction for gifts of unrelated use property by the amount of the long-term capital gain that would have been realized had the gift property been sold at its fair market value [Reg. §1.170A-4(b)(3)(i)]. In other words, the donor generally is limited to deducting his or her basis. Deductions, as reduced, qualify for the 50%-of-AGI ceiling. Donors also must reduce gifts of tangible property by any depreciation deductions previously taken. A bequest of personal property that is unrelated to the charity's exempt purpose is still entitled to an estate tax deduction for the full fair market value.

Cherí E. O'Neill
President and CEO

BALL STATE UNIVERSITY FOUNDATION
2800 W. Bethel Ave., Muncie, IN 47304
(765) 285-8312 • (765) 285-7060 FAX
(888) I-GO-4-BSU
bsu.edu/give

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