

February 2017

### ESTATE PLANNER'S TIP

Terminally ill individuals may want to take advantage of tax reduction strategies. Deathbed gifts qualifying for the annual exclusion can reduce the gross estate by up to \$14,000 per donee (\$28,000 per donee for married donors) [Code §2513(a)]. Cash may be a better gift asset than appreciated property when it comes to deathbed gifts, particularly because beneficiaries receive a stepped-up basis in assets that pass at death [Code §1014]. But what about depreciated assets? The recipient's basis will be the lesser of the donor's basis or the fair market value if the asset is given during life [Code §1015(a)]; the lower date-of-death value will be the beneficiary's basis if transferred at death [Code §1014(a)(1)]. The opportunity for a capital loss deduction vanishes when the item is transferred. Code §1041(b) provides an exception to these general rules, however, for lifetime transfers between spouses. The donee-spouse takes the donor-spouse's basis, even where it exceeds fair market value. By making a deathbed gift of depreciated property to a spouse, the capital loss deduction that would otherwise expire with the client is preserved.

### NO EXTENDED LIMITATION FOR REPORTED GIFT

A donor filed a gift tax return, reporting a gift made in the prior year. However, the return did not report gifts made in prior years, causing the tax on the reported gift to be incorrectly calculated at a lower rate. The gifts made in prior years had been reported on tax returns.

Under Code §6501(a), tax must be assessed within three years of when a return is filed, although there is an exception for unreported gifts. An extended limitation period applies if a gift is not reported on a gift tax return. If the gift

was reported, the special limitation period does not apply and the analysis is concluded, the IRS determined. If the gift was not reported, the IRS must decide if the gift was adequately disclosed. If so, the special limitation period does not apply. The clear language of Code §6501(c)(9) precludes the IRS from applying the special limitation period to a gift reported on a gift tax return, "even if prior years' gifts were omitted," the IRS ruled (CCA 201643020).

### STANDARD MILEAGE RATE DROPS

Drivers have been enjoying generally lower gas prices, reflected in the drop in the optional standard mileage rate for business use of a personal vehicle in 2017. The new rate is 53.5 cents per mile, compared with 54 cents in 2016. The rate for medical and moving uses dropped from 19 cents per mile in 2016 to 17 cents in 2017. The rate for charitable use of a personal vehicle is fixed by statute at 14 cents per mile (Notice 2016-79).

### TRUST SURVIVES DIVORCE

David established a charitable remainder unitrust, naming himself and his wife, Carol, as income beneficiaries. The couple is divorcing and, pursuant to their settlement agreement, propose to split the unitrust into two trusts. David and Carol would each be the sole income beneficiary of their own trust and would retain the right to name the charitable remainder beneficiary. At each spouse's death, his or her trust would terminate and distribute assets to charity.

The IRS ruled that because the two resulting trusts each meet the requirements of Code §664(d)(2), the division of the original trust will not cause either resulting trust to fail to qualify. The IRS also ruled that:

### PHILANTHROPY PUZZLER

Glen established a charitable remainder trust to benefit his daughter. Under trust laws in effect in Glen's state of domicile, the trustees of any trust created in the state have all the powers, duties and responsibilities conferred by the trust laws of the state. One of the powers is the right to invade trust assets to pay funeral expenses of the donor or surviving spouse. Glen's trust is silent as to the trustee's power under local law. Is the lack of restricting language a problem?

■ The division of the trust is not a sale or exchange resulting in the realization of gain or loss under Code §§61 or 1001. Each trust's holding period will be the same as that of the original trust.

■ Because the trust split is incident to a divorce, there is no gain or loss on the transfer of property from David to Carol [Code §1041(a)]. The basis in Carol's trust will be a pro rata portion of David's basis in the original trust.

■ The pro rata distribution of trust assets to the two new trusts will be treated as a transfer for full and adequate consideration and therefore will not be subject to gift tax under Code §2501.

■ Because David and Carol will each retain the right to change the charitable beneficiary, the value of the assets of their respective trusts will be included in their gross estates [Code §2036]. They will each be entitled to an estate tax charitable deduction [Code §2055] for the value of charity's remainder interest (Ltr. Rul. 201648007).

### ONE LOSES, ONE WINS

Brian Holman left an estate of about \$18 million at his death in 2013. His will left bequests of \$1 million each to several charities, including Cabrini Medical Center and St. Rose's Free Home, directing that if any organization shall not be in existence, unless it has merged with another charity, the bequest shall lapse and be added to the residue. The residue of Holman's estate was to pass to charities selected by his executor.

Cabrini Medical Center had ceased functioning as a hospital in 2008, and was in the final stages of bankruptcy. The bankruptcy court's final decree came about a month after Holman's death. The executor asked the court to declare the bequest as lapsed, due to the cessation of Cabrini's charitable function. The hospital argued it was still entitled to the distribution because its charitable status had not been revoked. The Surrogate's Court of New York County agreed with the executor, pointing to earlier cases holding that donors "do

not intend their gifts to be received” by entities that have ceased to function as charities. Cabrini’s bequest will pass as part of the residue, the court ruled.

St. Rose’s Free Home was one of two facilities operated by the Servants of Relief for Incurable Cancer. Although St. Rose’s closed in 2009, the Servants of Relief continues to carry out the functions of St. Rose’s at its remaining facility, Rosary Hill Home. In essence, the court found, St. Rose’s “merged into” Rosary Hill Home. The court agreed with the executor that the bequest should pass to Rosary Hill Home (*In re Duckworth*, 2016 NY Slip Op. 32278(U)).

### IRS TAKING A CLOSER LOOK

Imagine purchasing an interest in a pass-through entity that owns real estate and then taking an income tax charitable deduction for an amount greater than the purchase price when the pass-through entity makes a conservation easement gift to a charity. Sounds too good to be true? The IRS thinks so and has labeled the scheme as a “listed transaction” under Reg. §1.6011-4(b)(2).

The IRS said that promotional material suggests investors may be entitled to deductions equaling or exceeding the amount invested. Required appraisals often greatly inflate the value of the conservation easements, based on “unreasonable conclusions” regarding the real estate’s development potential. In addition, investors who have held their interests one year or less can treat the easement gift as long-term capital gain property, relying on the entity’s holding period [Code §170(e)(1)].

The listed transaction designation means that taxpayers who have participated in these investments on or after January 1, 2010, must disclose the transactions in each taxable year (Notice 2017-10).

### NO TRUST, SO NO STANDING

Avis Chase’s will provided for annuities for several named individuals. At the death of the

last annuitant, certain real property was to pass “absolutely and in fee simple” to the Young Women’s Christian Association of Philadelphia, in trust. If the YWCA of Philadelphia “will not or for any reason cannot accept this gift,” it was to pass to the YWCA of Boston.

In 1994, at the death of the surviving annuitant, the Orphan’s Court of Philadelphia approved the transfer. In 1999, the Probate and Family Court ruled that the distribution of cottages to the YWCA of Philadelphia was not held in a formal trust, but that the deed contained restrictions on the uses and purposes contained in Chase’s will.

In 2012, the YWCA of Boston filed suit, claiming the YWCA of Philadelphia failed to satisfy the conditions and asserting that ownership of the cottages should be transferred to the YWCA of Boston because the YWCA of Philadelphia “could not, or did not” accept the gift.

The Commonwealth of Massachusetts Appeals Court said the YWCA of Boston had no standing, since there is no formal trust. Because the property passed in fee simple, there is no estate in probate over which the court can exercise jurisdiction (*Young Women’s Christian Association of Boston v. Young Women’s Christian Association of Philadelphia*, 15-P-1594).

### PUZZLER SOLUTION

A trust does 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), -3(a)(4)]. Glen’s trust, therefore, would not qualify, even if the trustee did not, in fact, invade trust corpus to pay his funeral expenses [Rev. Rul. 77-58]. A simple way to avoid this result is to include language precluding the trustee from having any power under state law that would prevent the trust from qualifying as a charitable remainder trust.

### USING CONTINGENCIES IN CHARITABLE REMAINDER TRUSTS

Grantors of charitable remainder trusts – especially testamentary trusts – may want to control the actions of income beneficiaries through the use of contingencies that cause the trust to end early upon the happening of a specified occurrence. Under Code §664(f)(1), added as part of the Tax Reform Act of 1984, a charitable remainder trust will not be disqualified because of the inclusion of a “qualified contingency.” Instead, the trust merely terminates, with the remainder interest to charity accelerated. The charitable deduction is not affected by the presence of a contingency.

The IRS has ruled privately on several uses of qualified contingencies:

■ A unitrust would pay income to A for life, or could end sooner upon the earlier death of B (Ltr. Rul. 9322031).

■ A testamentary charitable remainder trust could pay income for life, unless the couple divorced or separated prior to the daughter’s death (Ltr. Rul. 9252017).

■ A 20-year annuity trust could make payments to the donor, or if he died within 20 years, payments could continue to an educational trust that would pay college expenses for 15 students. The trust would end on completion of the 20-year term or the date on which all students had completed their educations, whichever happened sooner (Ltr. Rul. 8749052).

■ A testamentary annuity trust could last for the shorter of five years or the death of the income beneficiary (Ltr. Rul. 200726005).

What practical uses does the qualified contingency offer?

*Remarriage of a surviving spouse* – Prior to the addition of Code §664(f)(1), a charitable remainder trust that provided for payments to terminate on the remarriage of a surviving spouse would have disqualified the trust.

*Discouraging will or trust challenges* – The IRS had ruled privately in several instances that the presence of an in terrorem clause in a charitable remainder trust caused the trust’s disqualification because the trust was not a term of years or measured by the life of a beneficiary (e.g., 7732011, 7942073, 8321028). With the addition of Code §664(f)(1), it is now possible to accelerate the charitable interest if the trust beneficiary contests the trust provisions.

*Avoiding the 5% probability test for annuity trusts* – Rev. Ruls. 70-452 and 77-374 imposed a 5% probability test on charitable remainder annuity trusts. An annuity trust is disqualified and no charitable deduction is allowed if the actuarial probability exceeds 5% that a noncharitable beneficiary of the trust will survive to the exhaustion of the trust assets. Although the rule still applies, under Rev. Proc. 2016-42, an annuity trust created on or after August 8, 2016, that includes contingency language is not subject to the 5% probability test. Rev. Proc. 2016-42 calls for the early termination of the annuity trust and an outright distribution of trust assets to the charitable remainderman prior to the date on which an annuity payment would be made, if that payment would result in the value of the trust corpus falling below 10% of the value of the initial trust corpus.

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