The Advisor

BALL STATE UNIVERSITY FOUNDATION
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ESTATE PLANNER'S TIP

When unmarried parties hold property in joint tenancy with right of survivorship, the full value is included in the estate of the first joint tenant to die, unless the survivor can show contribution toward the acquisition. Code §2040 presumes that the first to die provided all the funds for the property. Where the estate of the first to die is fully sheltered by the estate tax credit ($5.43 million in 2015), it might be more advantageous to allow the full value to be included in the estate, rather than documenting the survivor's contribution toward the purchase. The survivor will receive a stepped-up basis in the property [Code §1014(a)], which may reduce capital gains taxes when the property is eventually sold.

RELIANCE ON EXPERT MISPLACED

Janice Specht agreed to serve as executor of her cousin's estate, although she was unfamiliar with the duties involved. Specht turned to the attorney who drafted the cousin's will, who estimated the estate would owe approximately $6 million in estate tax. Specht was told the estate would have to sell stock to raise the funds and that the estate tax return was due September 30, 2009.

Despite numerous notices from the probate court about the attorney's failure to meet deadlines, Specht continued to receive assurances from the attorney that the estate had received extensions.

In late 2010, Specht fired the attorney after learning that the stock had never been sold. The estate eventually sold stock worth more than $12 million and filed the return in January 2011. The estate filed a malpractice action against the attorney.

The estate paid penalties and interest of nearly $1.2 million for failure to timely file the estate tax return and pay the tax. The estate argued that its failure to file was due to reasonable cause, not willful neglect, and that the penalty should not apply. The U.S. District Court (S.D. Ohio) agreed with the IRS that failure to file a timely tax return is not excused by reliance on an agent [*U.S. v. Boyle*, 469 U.S. 241 (1985)]. The court found that although Specht "lacked the sophistication to single-handedly complete and file the estate's federal tax return," she was aware of the importance of the estate tax deadline and the need to pay. There was no evidence that Specht was without the ability to control whether the deadline was met, said the court in granting the IRS's motion for summary judgment (*Specht v. U.S.*, 2015-1 USTC ¶60,686).

ESTATE LOSES TWICE

Eileen Belmont's will provided that her brother, David, was to receive $50,000, with the residue of her estate passing to the Columbus Jewish Foundation in Ohio. Belmont's estate included a retirement account, her Ohio residence and a condominium in California. The estate sold the residence in February 2008 for $217,900 and received a distribution from the retirement account of $219,117 after withholding for taxes on the income in respect of a decedent. As of March 31, 2008, the estate had a checking account balance of $285,009.

On its Form 1041, U.S. Income Tax Return for Estates and Trusts for 2008, the estate claimed a charitable contribution deduction of $219,580, based on the residue passing to charity. Nothing had yet been transferred to the Foundation and the funds were not segregated from other amounts in the checking account.

Ancillary probate proceedings were opened in California to administer the condo. David had been living in the unit for about nine months prior to Eileen's death. He suggested swapping his $50,000 bequest with the Foundation for a life tenancy. David was told that the Foundation did not wish to hold the property, so a swap was not possible. It was requested that he vacate the unit by March 21, 2008, in exchange for a "$10,000 stipend" from the foundation. David declined the offer and refused to leave, claiming that he had an oral agreement with Eileen to give him a life estate.

David filed suit, asserting a life tenancy interest on the basis of a resulting trust. The estate countered that David had no ownership interest in the funds Eileen used to purchase the condo or in the condo itself. The probate court's judgment in favor of David was upheld by a California appellate court. The estate incurred expenses in the litigation, leaving it with approximately $185,000 in the checking account.

The IRS disallowed the estate's charitable deduction, saying the $219,580 was not permanently set aside for charity, as required under Code §642(c)(2). An amount is not considered permanently set aside unless the possibility that the amount will not be devoted to charity "is so remote as to be negligible" [Reg. §1.642(c)-2(d)]. The estate argued that the litigation expenses it incurred were not "reasonably foreseeable," but the court agreed with the IRS that David's legal claims were known prior to the filing of the estate's Form 1041. The estate knew it had legal fees in Ohio and California, as well as various fees associated with the condo. While the estate was correct that David's action was not a will contest, his active litigation of his property rights created "a real possibility that the funds set aside for the foundation would be depleted during the pendency of the lawsuit," said the court (*Estate of Belmont v. Comm'r.*, 144 T.C. No. 6).

PHILANTHROPY PUZZLER

Sally and Jack wish to make a gift of a remainder interest in their primary residence to charity. They have had several discussions with the charity concerning the tax benefits and their continuing responsibility for property taxes, insurance and maintenance of the home. Their only concern is that at some point in the future they may have to move from the house to a nursing home. They have asked what will become of the home if that happens.

TAXPAYERS DISCOVER TIMING IS EVERYTHING

A couple made a gift of a facade easement in 2004, claiming a $190,000 charitable deduction. They carried over excess deduction amounts to 2005 and 2006. They eventually acknowledged that the easement had zero value. In addition to denying their deductions, the IRS claimed that the couple made gross valuation misstatements on their returns for the three years, for which they were subject to a penalty.

The IRS agreed they were not liable for the misstatement penalty for 2004 or 2005, because they satisfied the reasonable cause exception [Code §§6664(c)(1) and (2)]. However, under the Pension Protection Act of 2006 (PPA), the reasonable cause exception was eliminated for underpayments attributable to gross overstatements of charitable deduction property. This applied to returns filed after August 17, 2006, including the return the couple filed in 2007 for the 2006 tax year.

The taxpayers argued that the change under the PPA to require that easements include the entire exterior of a building, rather than just a facade [Code §170(h)(4)], applied only to "contributions made after July 25, 2006." The Tax Court agreed, but added that the reasonable cause exception for underpayments attributable to gross valuation overstatements of easement donations was effective for returns "filed after July 25, 2006." Congress clearly intended a distinction between the effective date of the changes under Code §170 and the penalties under Code §6664, the court found (*Reisner and Weintraub v. Comm'r.*, T.C. Memo. 2014-230).

DEDUCTION GETS DISCOUNTED

Scott and Teresita Lain claimed charitable deductions of $8,880 in 2010. Of that amount, $5,730 was by cash or check and $3,150 was for clothing donated to a thrift shop. The only substantiation the couple had was a canceled check for $95 to their church. Scott testified that they also donated $20 in cash to the church each week.

The Lains said that due to a burst water pipe, their tax records had been destroyed. The Tax Court noted that where taxpayers' records are lost or destroyed due to circumstances beyond their control, deductions may be substantiated through reasonable reconstruction, although the taxpayer is still required to substantiate the expenses through "secondary evidence."

The court found Lain's testimony about the destruction of tax records to be credible, adding that it found he had made contributions of $20 per week to their church. On that basis, the court said they were entitled to deduct $1,095 in cash gifts. The court estimated that the couple had given at least $200 in noncash gifts, for a total deduction of $1,295 (*Lain v. Comm'r.*, T.C. Summ. Op. 2015-5).

NO PAYMENTS UNTIL TRUST IS FULLY FUNDED

Cyndi Neal-Lunsford was named the income beneficiary of a $2.4 million testamentary charitable remainder unitrust created by Burnham Neal. The trust provided that "until full funding" of the unitrust, the assets awaiting distribution to the trust would not be taken into consideration in determining the unitrust amount.

Although Neal died on April 12, 2012, the trust was not funded until a single $2.4 million payment was made on December 2, 2013. Lunsford filed suit asking that the trustee be ordered to distribute the unitrust amount for the period between Neal's death and the trust's funding. She argued that, under the Illinois Principal and Income Act, her right to income began at Neal's death.

The circuit court concluded that Lunsford's request was contrary to the plain language of the trust, adding that the Principal and Income Act does not apply if the trust provides a start date. The Appellate Court of Illinois agreed, finding that until "full funding" occurred unitrust amounts were to be paid to Neal's estate (*In re: Estate of Burnham*, 2015 IL App 140293).

PUZZLER SOLUTION

Sally and Jack could lease the home and receive rental income. If they don't need the income, they could make a gift to the charity of their remaining life estate, entitling them to a second charitable deduction. Or they could join with the charitable remainderman and sell the home. The value of their respective interests would depend upon the home's fair market value, Sally's and Jack's current ages and the §7520 rate for the month of the sale. Proceeds would be divided proportionately. Charity may also wish to buy the couple's life interest and then sell the entire parcel.

WHERE TWO (OR MORE) TRUSTS MAY BE BETTER THAN ONE

The value of the remainder interest in charitable remainder trusts must equal at least 10% of the amount transferred [Code §§664(d)(1)(D), 664(d)(2)(D)]. This wasn't always the case. Prior to July 28, 1997, there were few restrictions on the number of income beneficiaries. One IRS letter ruling even approved a charitable remainder unitrust with a 10% payout and 37 life-income beneficiaries, ranging in age from one to 93 (Ltr. Rul. 9139006). Although the ruling did not disclose the size of the trust, a transfer of $1 million would have yielded a charitable deduction of only about $180.

With today's low §7520 rates, funding a charitable remainder trust for younger beneficiaries may be more difficult. For example, the youngest age for which a 5% charitable remainder unitrust can be created (assuming annual payments and the use of a §7520 rate of 2.2%) is 27, which yields a deduction of $10,325. In the case of a two-life trust, where both beneficiaries are age 38, the remainder just barely satisfies the 10% requirement ($10,114).

Low §7520 rates have virtually eliminated the charitable remainder annuity trust as an option for younger donors. Even at the lowest allowable 5% payout rate, a donor under age 71 will not qualify for an annuity trust. For a two-life annuity trust, both beneficiaries would have to be age 73 or older. Although both the one- and two-life annuity trusts generate deductions well in excess of 10% (43.99% and 33.35% respectively), charitable remainder annuity trusts are also subject to a 5% probability test. In Rev. Rul. 77-374, the IRS said that no deduction is allowed if the probability exceeds 5% that a noncharitable beneficiary will survive to the exhaustion of the trust fund.

Consider a grandfather who plans to transfer $300,000 to establish a 5% charitable remainder unitrust to benefit his three grandchildren, ages 28, 32 and 36. The value of charity's remainder interest would be $18,186 (assuming annual payments and a §7520 rate of 2.2%) and the trust would not be qualified. If the grandfather instead created three trusts, funding each with $100,000, he would have the following deductions:

28-year-old.................$10,773

32-year-old.................$12,781

36-year-old.................$15,146

All three trusts satisfy the 10% test and the total deductions – $38,700 – are more than double what the grandfather could have received with a single trust, even assuming it qualified.

The same is true where the donors are closer in age. In the case of a couple, both age 65, a single 5% unitrust funded with $500,000 would result in a deduction of $170,310 (using annual payments and a §7520 rate of 2.2%). However, two separate unitrusts of $250,000 would produce deductions totaling $225,845. Why the disparity? With a two-life trust, there is a greater likelihood that at least one beneficiary will live beyond the actuarial life expectancy.

There are some drawbacks to creating multiple trusts, however. In the case of the married couple, at the death of the first spouse, payments from that spouse's unitrust will end; with a two-life trust, the payments continue for the life of the survivor. That might be of less concern in the case of unitrusts for the three grandchildren. Another drawback may be the fees associated with creating and managing the trusts. Small trusts may not be economically feasible, although if the trusts share the same trustee, the funds could be commingled to achieve a better overall return.

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