

The Advisor



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ESTATE PLANNER'S TIP

Many retirees are taxed on a portion of their Social Security benefits because their provisional adjusted gross income is over certain limits. Up to 50% of benefits are subject to tax when income exceeds \$25,000 for single taxpayers or \$32,000 for joint filers. And once income reaches \$34,000 for singles or \$44,000 for married couples, up to 85% of Social Security benefits are taxed. There are ways for clients who are close to the limits to reduce income to avoid the extra tax. Two options are to postpone the sale of appreciated property or offset gains with capital losses. Clients may also want to switch from investments that generate current income (e.g., short-term CDs, money market funds) to U.S. savings bonds that allow income to be deferred to a later time. Converting from a traditional IRA (which requires minimum distributions after age 70½) to a Roth IRA (which has no mandatory withdrawals) is another possibility, although the full amount will be subject to tax in the year of the conversion. The switch to a Roth could be made in a year when the client is already subject to tax on Social Security benefits, with the goal of saving taxes in future years.

BOTH PARTIES WIN . . . AND LOSE

When Dennis Enomoto's mother died in 2013, she left outright bequests to his two siblings, but left Enomoto's share in trust. A federal tax lien had been levied against Enomoto for the years 2007 through 2011. In 2014, a levy was served on the executor of the estate asking that Enomoto's share of the estate be turned over to the IRS. The U.S. District Court (AZ) ordered the executor to transfer the funds to the trustee before it would consider the parties' motions for summary judgment.

The legal issue, said the court, was whether the federal tax lien on Enomoto's "property" or

"property rights" attached to the trust funds. While state law determines what rights a taxpayer has in property the IRS seeks to reach, federal law determines whether the state-delineated rights qualify as property or rights to property.

The trust's terms gave the trustee sole discretion to pay Enomoto "so much or all of the net income and principal of the trust as . . . required for support in Enomoto's accustomed manner of living." The court determined the trust was a hybrid trust, with the trustee determining how much in payments is required, reviewable only for abuse of discretion.

The court said that if the IRS were only seeking a judgment that the tax lien attaches to the right to trust funds, “no further discussion would be necessary.” However, the motion seeking to transfer the trust funds was “a step too far.” While Enomoto’s right to compel payments subject to an ascertainable standard “affords him enough control over the trust funds to trigger federal tax lien attachment,” it does not allow the IRS to demand any specific amount. The court granted the IRS’s motion for a judgment that the federal tax lien attaches to the right to trust funds, but denied the motion as to any transfer of funds, saying more evidence would be needed to allow the IRS to reach the funds (*Duckett v. Enomoto*, 2016-1 USTC ¶150,262).

ATTORNEY TOLD TO TURN OVER PAPERS

Walter Westendorf created a living trust in 1997, directing that the remainder be paid to three local charities. He amended the trust twice in 2004, again in 2006 and annually from 2009 to 2012, prior to his death in 2013. Starting in 2006, Unity Christian School was added as a charitable beneficiary. With each subsequent amendment, the school’s share was increased, until the school was named the sole residuary beneficiary in the 2012 amendment.

PHILANTHROPY PUZZLER

April, May and June are equal partners in a business venture. The partnership owns vacant land that it no longer needs. April has suggested that the partnership use the property to fund a charitable remainder trust, naming the partners’ alma maters as remainder beneficiaries. The trio has asked whether a partnership may be the grantor and income beneficiary of a charitable remainder trust and, if so, what charitable deduction is available.

Following Westendorf’s death, the trustee filed an interpleader action, saying he did not believe Westendorf had any connection to Unity and that the attorney, who was also the lawyer for the school, had exerted undue influence over Westendorf. The attorney refused to produce certain documents, claiming they were protected by the attorney-client privilege or the work product doctrine. The trial court denied the motion to quash the subpoena, saying attorney-client privilege did not survive Westendorf’s death.

The attorney appealed a contempt finding, saying the exception to the attorney-client privilege survives only in a will contest, not in the case of a trust. The Appellate Court of Illinois disagreed, saying the case presents “no material difference” between a will contest for purposes of the exception. The work product doctrine also doesn’t apply, the court held, because none of the documents were created “in preparation for any impending or pending litigation” (*Eizenga v. Unity Christian School*, 2016 IL App (3d) 150519).

CHURCH HAD VESTED INTEREST

Net rent from a farm was to be divided annually between four relatives named in Stanley Carpenter’s will. As each died, his or her portion was to be shared equally by the First Presbyterian Church and the First Baptist Church. At the death of the last relative, the two churches were to split the remainder. Carpenter died in 1967.

Following First Presbyterian’s dissolution in 2004, its assets were transferred to Covenant Presbytery. The bank trustee made payments to Covenant until 2011, when First Baptist questioned Covenant’s right to receive the income. The trustee asked the court to determine the rights of the parties. The court applied the cy pres doctrine to reform the trust, directing that all future payments should go to First Baptist.

Covenant appealed, claiming that the vested interest created at Carpenter’s death was freely

assignable. The Supreme Court of Arkansas agreed, finding that the will did not create a charitable trust and that, therefore, the *cy pres* doctrine was inapplicable. The only purpose of the testamentary trust created in Carpenter's will was to administer the life estates and distribute the proceeds to the churches. The trustee was not required to ensure that the property passing to the churches be used for any particular charitable purpose. As First Presbyterian's successor in interest, Covenant was entitled to the payments, the court held (*Covenant Presbytery v. First Baptist Church*, No. CV-15-391).

REMOTE POSSIBILITY DOOMS EASEMENT DEDUCTION

A couple deeded a conservation easement over a 25-acre parcel to the Maryland Environmental Trust (MET) and the Land Preservation Trust (LPT). The goal was to restrict, in perpetuity, building on the property, in order to maintain significant scenic, cultural, rural, agricultural, woodland and wetland characteristics of the land.

The deed provided that, in the event of unexpected changes that made it impossible or impractical to continue the conservation purposes, the easement could be terminated in a judicial proceeding. In the event of a sale, the proceeds would be divided in accordance with the respective percentage interests in the fair market value of the property on the date of the grant. The value "shall be the deduction for federal income tax purposes allowable," under the deed.

The value of the easement was appraised at \$1.2 million, deducted on the donors' 2005 return and carried over to the 2006, 2007 and 2008 tax years. The IRS disallowed the carryover deductions, saying that the conservation easement was not protected in perpetuity, as required under Code §170(h)(5)(A). Under Reg. §1.170A-14(g)(6), a conservation purpose can be treated as protected in perpetuity if the restrictions are extinguished by judicial proceedings and the

charity's proceeds from a subsequent sale are used in a manner consistent with the intent of the original contribution. This applies if, at the time of the gift, the donor agrees that charity's interest is immediately vested, with a fair market value that is at least equal to the proportionate value that the restriction at the time of the gift bears to the value of the property as a whole at the time of the gift. The proportionate value of the organization's property rights must remain constant.

The Tax Court noted that, in the event of an extinguishment, the value of MET's and LPT's interests is determined with respect to the deduction allowed for income tax purposes. The court agreed with the IRS that the requirements of Reg. §1.170A-14(g)(6) were not met. "Deductions for conservation easements can be denied for many reasons unrelated to valuation," said the court. In the event of extinguishment, if the charitable deduction had been disallowed, the donors or their heirs could argue that MET and LPT were not entitled to any portion of the proceeds because no deduction had been received. Because of this possibility, the court found that the conservation easement was not protected in perpetuity and the donors were not entitled to the carryover deductions (*Carroll and Smith v. Comm'r.*, 146 TC No. 13).

PUZZLER SOLUTION

A charitable remainder trust must pay an annuity or unitrust to one or more "persons" [Code §664(d)]. Person is defined in Code §7701(a)(1) to include an individual, trust, estate, partnership, association, company or corporation. If the income beneficiary is not an individual, the trust must be for a term of years (not to exceed 20) [Reg. §1.664-2(a)(5), 3(a)(5)]. The partnership is not allowed a charitable deduction [Code §703(a)(2)(C)]. Instead, the deduction flows through to the partners and is deducted on their personal returns [Reg. §1.170A-1(h)(7)].

KEEP CAPITAL GAINS AT BAY BY COMBINING CHARITABLE GIFTS, ESOPS

The next best thing to avoiding capital gains taxes entirely is postponing the tax for as long as possible. Congress has even provided help achieving this goal for C corporation shareholders who want to sell their companies.

A business owner can create an employee stock ownership plan (ESOP), sell shares of the company stock held at least three years to the ESOP, and defer the capital gain by reinvesting the proceeds in shares of domestic corporations within 12 months. The basis in the qualified replacement property (QRP) is the same as the basis in the shares sold to the ESOP. Gain normally is recognized when the QRP is sold [Code §1042(e)(1)]. The ESOP, a defined contribution plan qualifying under Code §401(a), must own at least 30% of the company's outstanding shares.

In addition to deferring the capital gain until the QRP shares are sold, the ESOP allows a business owner to diversify holdings that might otherwise be heavily invested in a single company.

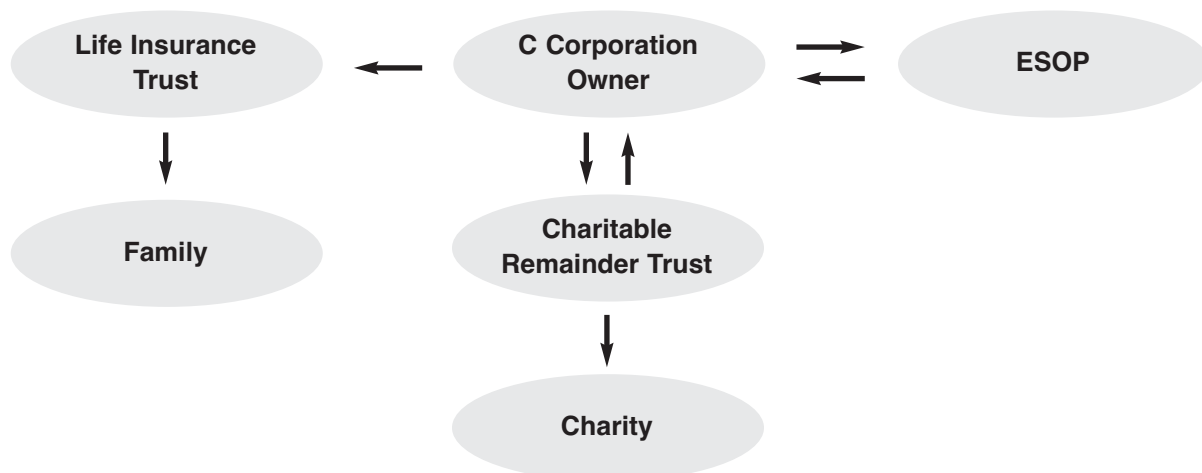
But it's possible for a client to defer the capital gain even further – or avoid it entirely – with gifts of QRP to charity. Under Code §1042(e)(3), the capital gain recapture rules do not apply to transfers of the QRP by gift, including gifts to charity. The IRS ruled that an outright gift of QRP

to charity does not cause a recapture of capital gain because the donor does not receive money or other property as a result of the transfer (Ltr. Rul. 9533038).

What about a transfer to a charitable remainder trust where the donor reserves an income interest in the gift property? The IRS ruled that a transfer of QRP to a charitable remainder trust is a gift that does not trigger the capital gain (Ltr. Ruls. 9438012, 9438021). When the QRP is sold by the trustee, the gain is sheltered under the provisions of the tax-exempt trust. The donor/beneficiary will be taxed on the capital gain under the four-tier system of Reg. §1.664-1(d)(1).

It's also possible for the business owner to fund the charitable remainder trust with company shares and allow the trustee to sell the shares to the ESOP, provided there is no requirement that the shares be sold to the ESOP. This bypasses the Code §1042 requirements entirely.

If the donor has family members who would otherwise receive the QRP, the plan can incorporate an irrevocable life insurance trust with Crummey powers. The life insurance trust allows the donor to replace the QRP with the proceeds of the insurance while avoiding or minimizing gift and estate taxes on the transfers.



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