

The Advisor



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ESTATE PLANNER'S TIP

Because stepchildren generally do not inherit under state intestacy laws, parents in blended families need wills and/or living trusts if they wish to include a spouse's children in their estate plans. If a child is legally adopted, he or she is entitled to inherit through intestacy, but in many cases – where the child is an adult or the birth parent is still alive, for example – adoption may be impossible or impractical. As an alternative, stepchildren can be named beneficiaries of life insurance, retirement accounts or as payable-on-death beneficiaries of financial accounts. Clients wishing to omit stepchildren should specifically name them and indicate the children are not being provided for, to avoid a will challenge by children arguing that the omission was an oversight. For clients in states with inheritance taxes, the amount left to stepchildren may be taxed at a higher rate, which should be considered when making the bequests.

NO CONSTRUCTIVE RECEIPT, SO NO TAX

Raymond McGaugh directed the custodian of his self-directed IRA to wire \$50,000 from his account to purchase shares of First Personal Financial Corp. (FPFC). The brokerage made the transfer on October 7, 2011. On November 28, FPFC issued the stock certificate in the name of McGaugh's IRA. Although FPFC claims it mailed the certificate the same day, the custodian said it was not received until early in 2012. Because this was outside the 60-day window for qualified rollover transactions [Code §408(d)(3)], the brokerage said it mailed the certificate to McGaugh and reported the \$50,000 as a taxable distribution. McGaugh denies having possession of the certificate. The IRS said McGaugh owed tax on the amount, plus a 10% early distribution penalty [Code §72(t)] because he was under age 59½.

The Tax Court determined that no cash, check or wire transfer ever passed through McGaugh's hands, so he was not a "payee or distributee" of any amount. An IRA owner is allowed to direct the investment of the account "without forfeiting the tax benefits," the court said. Even if McGaugh had physical possession of the stock certificate, he was not in constructive receipt of it because it was issued in the name of his IRA, not to him personally.

The court issued summary judgment in McGaugh's favor, saying that at most he acted as a conduit for the IRA custodian. The 60-day rollover limitation was not an issue, added the court, since there was no distribution to him (*McGaugh v. Comm'r.*, T.C. Memo. 2016-28).

SUBSTANTIATION RULES FOIL COUPLE'S DEDUCTIONS

Juan and Caridad Garcia claimed charitable deductions totaling \$13,279 in 2010, including cash contributions, clothing donations and charity-related travel expenses. The IRS disallowed all but \$2,415 in cash gifts for which they had substantiation [Reg. §1.170A-13(a)(1)]. The couple produced a receipt from their church, dated in 2010, that the Tax Court found to qualify as a contemporaneous written acknowledgment [Code §170(f)(8)(A)].

The court denied a \$390 deduction for travel expenses, noting they had no contemporaneous records of the travel, how it was computed or the services performed. The couple's deduction of \$3,560 for donated clothing was similarly denied. The Garcias compiled a log of donated items during the IRS examination and obtained a receipt dated in 2014. Further, said the court, they would not have satisfied the additional substantiation requirements for noncash gifts in excess of \$500 [Code §§170(f)(11)(B), (F)].

Finally, ruled the court, their \$5,350 deduction was disallowed for cash and property gifts to the Knights of Columbus chapter. While the chapter was a Code §501(c) entity, it was not on the IRS master list of Code §501(c)(3) organizations to which gifts are deductible and the couple did not establish that their gifts were used exclusively for any exempt purpose, the court said (*Garcia v. Comm'r.*, T.C. Memo. 2016-21).

PHILANTHROPY PUZZLER

Bruno owns three dogs that have been his faithful companions for several years. He wants to provide for the dogs' care after his death, but also wants whatever funds remain at the death of the last dog to pass to his favorite charity. Bruno read that charitable remainder trusts provide income for life for the beneficiaries and asked whether he can establish a testamentary charitable remainder trust to pay for the care of his dogs, with the remainder then passing to charity.

LATE ACKNOWLEDGMENT, MISSING LANGUAGE DOOM DEDUCTION CARRYOVER

Bayne French, his sister and parents formed trusts that acquired parcels of land in Montana. In 2005, the parties granted a conservation easement on the property to the Montana Land Reliance (MLR). The deed indicated that the easement was intended to preserve open space for wildlife habitat, recreation, forest management and agricultural purposes.

The deed did not indicate the parties' respective ownership interests, did not state whether any goods or services were provided in return for the easement or indicate whether the deed constituted the entire agreement between the trusts and MLR. An appraisal put the value of the easement at \$1.1 million. The parties valued French's proportional share at \$350,971.

French filed a timely 2005 return, without claiming a charitable deduction. Prior to April 15, 2006, he filed an amended return, including Form 8283, on which he claimed a charitable deduction of \$56,796. He received a letter from MLR dated June 6, 2006, stating that no goods or services were provided in exchange for the easement donation.

In 2006, 2007 and 2008, French claimed carryover charitable deductions of \$44,687, \$57,154 and \$31,572. The IRS disallowed the carryover, saying that French failed to prove he had an ownership interest in the property, failed to obtain a contemporaneous written acknowledgment that complied with the requirements of Code §170(f)(8) and failed to prove the value of the easement.

The Tax Court found that French had two written acknowledgments that might satisfy the substantiation requirements: the deed recorded in December 2005 and the letter from MLR dated June 2006. Under Code §170(f)(8)(C), an acknowledgment is contemporaneous if it is received by the taxpayer on or before the earlier of the date the return was filed or the due date, with extensions, for filing the return for the year. Because the letter was not received before April 15, 2006, it did not satisfy the substantiation requirements, said the court.

The court has previously held that a conservation easement deed may satisfy the substantiation requirements if it includes the quid pro quo language or indicates that the deed constitutes the entire agreement between the parties. This information allows the IRS to conclude that the taxpayer correctly reported the gift and received no other consideration, said the court. Because the conservation deed contained neither of those provisions, the IRS could not have determined that the donors received nothing in return. Therefore, concluded the court, French was not entitled to any carryover deductions (*French v. Comm'r.*, T.C. Memo. 2016-53).

TRUST'S DEDUCTION ELIMINATES TAX ON IRD

Ken owned multiple IRAs, each of which named a trust as the sole designated beneficiary. The trust provided that at Ken's death, his IRAs were to be distributed to a foundation. The trust expects to receive lump sum distributions of cash from each of the IRAs, which it will then pay in cash to the foundation in the same tax year.

The IRAs represent income in respect of a decedent in Ken's estate [Code §691(c)(1)]. The value of the IRAs will constitute IRD to the trust. Code §642(c)(1) allows a deduction in computing taxable income for any amount, without limitation, which, pursuant to the terms of the trust, is paid for a charitable purpose. Provided the trust pays the entire lump sum distributions to the foundation in the year received, it is entitled to a deduction equal to the amount of IRD included in gross income as a result of the distributions from the IRAs, the IRS ruled (Ltr. Rul. 201611002).

NO APPRAISAL PASS ON COIN COLLECTION

Charitable gifts of \$5,000 or more generally require a qualified appraisal [Code §170(f)(11)(C)]. There is an exception, however, for gifts of readily valued property, such as cash and publicly traded securities [Code §170(f)(11)(A)(ii)]. But what about a gift of a coin collection?

The IRS said that the readily valued property exception does not apply to the coins unless the

value claimed by the donor does not exceed the face amount and the coins are acceptable as legal tender. If the deduction exceeds the face amount of the coins, the IRS ruled that an appraisal is required because "there is a potential valuation issue" (Ltr. Rul. 201608012).

"TAKE OUR WORD"

NOT GOOD ENOUGH FOR TAX COURT

The IRS disallowed all but \$4,227 of the more than \$19,000 in charitable deductions claimed by Charles and Connie Brown, citing a lack of substantiation. They had no receipts for the gifts, which were purportedly made in cash. Their only records before the Tax Court were self-generated charts. These did not relate to any bank records and, the court noted, did not equal the amount claimed on their return.

Although neither taxpayer testified about their gifts, a niece acknowledged the cash contribution, but the only receipts were not contemporaneous records. The court concluded that the amounts of cash gifts claimed to have been made during certain short periods were "improbable," adding that there was no independent verification of the receipts or the reliability of what the documents attempted to show. The court denied any deductions in excess of those already allowed by the IRS (*Brown v. Comm'r.*, T.C. Memo. 2016-39).

PUZZLER SOLUTION

A pet is not a permissible income beneficiary of a charitable remainder trust, because Reg. §§1.664-2(a)(3) and 1.664-3(a)(3) require that the income be payable to or for the use of a named person or persons (Rev. Rul. 78-105). Animals do not fall within the definition of a person under Code §7701(a)(1). Bruno could create a term-of-years charitable remainder trust, naming a trusted individual to receive the payments and presumably use the income to care for the pets. His estate would be entitled to a charitable deduction for the remainder interest.

ADD DAFS TO SOURCES OF POTENTIAL CHARITABLE GIFTS

Donor advised funds (DAF) in the U.S. hold more than \$70 billion in assets, representing a huge potential source of funding for donors' favored charities. DAFs are often funded by donors who wish to generate large deductions in one year, while postponing the decision on which charities to benefit until a later year. For example, a taxpayer who has high income in one year, possibly from converting a traditional IRA to a Roth IRA or from receiving a bonus, may want a charitable deduction to offset the income tax. Funding a DAF allows the donor to claim the deduction in the year of the gift and then advise gifts to charitable organizations in future years. DAFs also allow contributions to be made anonymously to charities.

Once an irrevocable contribution is made to a DAF, the assets become the property of the sponsoring organization, which must maintain the right to accept or reject a recommendation [Reg. §1.507-2(a)(8)(iv)(A)]. The sponsor cannot be subject to any restrictions that would limit the DAF's charitable purpose or use or control of the funds [Reg. §1.170A-9(e)(11)]. The sponsoring organization maintains a separate account for each DAF and may allow the donor to designate a charity to receive any remaining funds at the donor's death or to appoint a successor advisor to continue making recommendations.

In most cases, DAFs comply with the donors' request regarding distributions, but it is not required. The Nevada Supreme Court found that although a DAF breached a covenant of good faith and fair dealing by refusing to make requested distributions, the donor had given up any right to control the distributions or require them to be used

in the manner recommended. The donor had already claimed a charitable deduction for the contribution and failed to show any damages, the court held [*Styles v. Friends of Fiji*, No. 51642].

Because contributions to a DAF are considered the property of the sponsoring organization, donors may not receive any benefit from recommended distributions. For example, a DAF donor may not use the distribution to pay for tickets to a golf outing or dinner. The same is true if the donor recommends a distribution that is to satisfy an outstanding pledge to the named charity, since the DAF distribution would be fulfilling a legal obligation of the donor.

A tax is imposed if the person advising on a distribution receives, directly or indirectly, "a more than incidental benefit" as a result of the distribution. The tax equals 125% of the benefit, to be paid by the person who advises or the person receiving the benefit [Code §4967(a)(1)]. There is also a 10% tax on the fund manager who knowingly makes such a distribution that results in a benefit [Code §4967(a)(2)].

In addition to DAFs sponsored by firms such as Fidelity, Vanguard and Schwab, many community foundations sponsor DAFs. While individual charities can and do sponsor DAFs, Code §4966(d)(2)(B) expressly provides that the term "donor advised fund" does not include any fund that "makes distributions only to a single identified organization." To be considered a DAF, the sponsoring organization would have to allow donors to recommend distributions to charities other than the sponsoring organization.

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