

# The Advisor



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## ESTATE PLANNER'S TIP

An irrevocable life insurance trust with Crummey withdrawal powers can be a tax-wise means of passing substantial assets to family members. Properly structured, there would be little or no gift or estate tax to the insured/grantor and no income tax to the eventual trust beneficiaries. But if grandchildren are included in the class of beneficiaries, there may be generation-skipping transfer tax (GST) consequences. Generally, an outright gift of cash or property to a grandchild that qualifies for the \$14,000 annual exclusion [Code §2503(b)] is not subject to the GST. However, where the transfer is in trust, the exclusion from GST is available only if, during the skip person's life, none of the corpus or income from the trust can be distributed to or for the benefit of any other individual and if the assets of the trust will be included in the skip person's estate if he or she dies before the trust terminates. Many irrevocable life insurance trusts are structured with multiple beneficiaries. Although the transfers may be gift-tax free, thanks to the annual exclusion, they may be subject to GST. Payment of the tax can be avoided by allocating a portion of the transferor's GST exemption [Code §2631(a)] to the transfer.

## DINNER, BUSINESS DON'T MIX

Dreck Wilson, who owned a landscape design business, claimed a \$4,150 deduction on his 2011 income tax return for legal and professional services. He reasoned that because he incurred the expenses to resolve litigation regarding ownership and possession of his home, and because he used the dining room of the home as his office, the legal costs were ordinary and necessary business expenses [Reg. §1.162-1]. The IRS disallowed the deduction.

The Tax Court agreed with the IRS that Wilson failed to satisfy the home office expense deduction [Code §280A(c)(1)(A)] because he did not show that the portion of the dwelling was "exclusively used on a regular basis" as his principal place of business. While he may have used the dining room for business purposes for some portion of time, it was insufficient for the allowance of a deduction, said the court (*Wilson v. Comm'r.*, T.C. Summ. Op. 2017-25).

### GIFT, ESTATE, GST CREDITS CAN BE RECALCULATED

Prior to the U.S. Supreme Court's ruling in *U.S. v. Windsor*, transfers between same-sex spouses were subject to gift, estate and generation-skipping transfer taxes. Under the Defense of Marriage Act, the term "marriage" applied only to persons of the opposite sex. As a result, the marital deduction was not available and the applicable exclusion amount was automatically applied to reduce the amount of gift or estate tax due on transfers between same-sex spouses. The IRS has now issued procedures for recovering the exclusion amount previously applied, even if the limitations period has expired. For the GST tax, same-sex spouses will no longer be assigned generations based on their ages (Notice 2017-15).

#### PHILANTHROPY PUZZLER

Betsy has been collecting coins since her retirement 13 years ago, estimating the value at more than \$8,000. As she prepares to move into a retirement home, she has been giving serious thought to disposing of the collection. She found a college that expressed an interest in the collection and agreed to display the coins in its library. Betsy's advisor explained that if the college puts the coins to a related use by displaying them, Betsy would be entitled to a deduction equal to fair market value, rather than just her basis. The advisor also mentioned that Betsy would need an appraisal because the deduction claimed is over \$5,000. Betsy has asked if she could avoid the appraisal requirement by giving half the collection to the college and the other half to a nearby museum which would also display the coins.

### THE UNITRUST THAT NEVER WAS

Clarence established what was intended to be a charitable remainder unitrust, funding it with low-basis, non-dividend paying stock, at the suggestion of a financial planner. The planner and the drafting attorney assured Clarence that capital gains would be avoided on the sale of assets in the trust and that there would be no gift tax because the trust would give Clarence the right to revoke a successor beneficiary's interest. The trust was to pay Clarence for the shorter of his life or 20 years. If he died within 20 years, unitrust payments were to continue for the balance of that period to Barbara.

The drafting attorney failed to include language in the trust retaining the right to revoke Barbara's interest, making it vested and subject to gift tax. Clarence's accountant, relying on the attorney's assurance, reported that no gift tax was due at the trust's creation.

The financial planner assured Clarence that if trust assets were invested as recommended, including in annuities and insurance products that the planner was licensed to sell, the trust would generate a guaranteed annual return sufficient to make the unitrust payments. The investments actually made it difficult for the trust to generate the promised return, and the unitrust amount could not be achieved without including capital gains. Under state law, capital gains were allocable to principal, not income. Payments were made to Clarence annually by including capital gains, although the attorney had used net-income with make up language. Clarence made additional contributions to the unitrust over the years, based on the erroneous advice from the planner and attorney that the value of the trust would not be included in his gross estate.

Barbara, who became the income beneficiary at Clarence's death, sought to reform the trust when

she learned of the problems. The remainderman and the state's attorney general objected. Barbara eventually filed another petition to either reform or terminate the trust. The court determined that the trust was void ab initio, contingent on an IRS ruling that no additional federal income taxes would result. If the IRS did not rule favorably, the court said the trust would be terminated after the payment of all taxes due, with trust assets distributed to Barbara.

To be a charitable remainder trust, a trust must meet the definition of and function exclusively as a charitable remainder trust from its creation [Reg. §1.664-1(a)(4)]. The IRS said it was unable to rule that a declaration that the trust was void ab initio would have no tax consequences. Despite the fact that the trust was not qualified, it was nevertheless subject to the split-interest trust rules of Code §4947(a)(2). Distribution of trust assets to Barbara prior to termination of the trust's private foundation status would result in an excise tax. The trust would also be required to file income tax returns and pay any income, interest and penalties, the IRS determined (Ltr. Ruls. 201714002, 201714003).

#### NEW WIFE NOT SUBSTITUTED

Albert Aaron lived with Myrna Kaplan for at least ten years, although still married to Eileen Aaron. His living trust, which referred to Eileen as his wife, directed that if Eileen survived him, his property was to be distributed to her. If she predeceased him, a residuary trust was to be established for the benefit of Kaplan, another individual and Aaron's descendants. At the death of Kaplan and the other individual, 25% of the property was to pass to a private foundation, with the balance passing to the family share.

Eileen died on November 1, 2012; Aaron died January 26, 2013. In the interim, Aaron married

Kaplan and amended his trust. At the request of the trustees, a circuit court determined that references to "my wife" in Aaron's trust did not automatically transfer from Eileen to Kaplan. The family appealed, arguing that "my wife" referred to Kaplan and that as a result, the charitable trust should not come into being. Instead, the family claimed, Aaron's intent had been to assure his descendants were financially secure.

The Court of Special Appeals of Maryland found that at no time did Aaron alter the trust's definition of "my wife." One amendment Aaron did make following Eileen's death was to change the composition of the foundation's advisory committee, indicating that he intended the foundation to be established after the deaths of Kaplan and the other individual. It was reasonable to infer, said the court, that Aaron would have provided that the foundation was not to be established if that was his intent. A second spouse does not necessarily take under a testamentary document unless the context clearly shows that to be the settlor's intent, the court added (*In re Aaron Living Trust*, No. 253 (Md. Ct. Spec. App. Apr. 14, 2017)).

#### PUZZLER SOLUTION

Code §170(f)(11)(C) requires qualified appraisals where the deduction claimed for a noncash gift exceeds \$5,000. Under Code §170(f)(11)(F), in determining the \$5,000 threshold, all similar items of property donated to one or more donees shall be treated as one property. Betsy could not avoid the appraisal requirement by splitting the gift between two charities, but could avoid it by contributing the entire collection to the college over two years.

### KEEPING THE RIGHT TO TAKE AWAY

Charitable remainder trusts and charitable gift annuities can be used to provide payments to more than just the donor. When payments are made to the donor or to the donor and spouse, there is no gift tax concern, but where a parent, child, sibling or other person is also receiving a portion of the payment, gift tax issues may arise. Although lifetime gifts up to \$5.49 million are sheltered from tax, clients may wish to avoid the necessity of filing gift tax returns for these gifts. One way to bypass the gift tax issue is to retain the right to revoke the beneficiary's interest, making the gift incomplete [Reg. §25.2511-2(c)].

#### *Charitable remainder trusts*

A charitable remainder trust may not be subject to a power to invade, alter, amend or revoke for the beneficial use of a person other than a charity. However, the grantor may retain the power, exercisable only by will, to revoke the interest of any beneficiary of the annuity or unitrust amount [Reg. §§1.664-2(a)(4), 1.664-3(a)(4)].

By retaining such a power, the grantor may avoid any gift tax liability for the value of the rights in the trust that are transferred to another. Any payments actually received from the trust during the grantor's lifetime generally will be treated as completed gifts to the extent they exceed the annual exclusion. Retaining the right to revoke has no effect on the charitable deduction.

For example, Harold transfers \$100,000 to a charitable remainder annuity trust paying \$5,000 annually – \$2,500 to Harold and \$2,500 to his sister Maryann for their joint lives. The \$5,000 payment is to continue for the survivor's life. Harold retains the power to revoke Maryann's interest by will. He is viewed as having made two separate revocable transfers: (1) a transfer of the right to receive a \$2,500 payment each year while both are alive; and (2) a transfer of the right to receive a

\$5,000 payment each year if Maryann survives him. Since each transfer is revocable, Harold is not deemed to have made a gift to Maryann upon creation of the trust. Each \$2,500 payment received by Maryann during Harold's life is a completed transfer but is excluded from the computation of Harold's taxable gifts by virtue of the annual exclusion.

A grantor may also want to retain the right to revoke a successor beneficiary's interest, particularly since it is a future interest that does not qualify for the annual exclusion when the trust is created. A donor concerned about whether he or she will still be married at death may want to retain the right to revoke the spouse's survivor interest in the event the couple divorces, particularly since the estate tax marital deduction would not be available.

Although the charitable remainder may not be revoked, the donor may reserve the power to substitute another charity [Rev. Rul. 76-7].

#### *Charitable gift annuities*

An individual who arranges a gift annuity for another can avoid making a taxable gift by retaining the power to revoke the interest of the annuitant, making the gift incomplete. Completed gifts occur only when payments are actually received by the annuitant during the donor's life. Unlike charitable remainder trusts, the right to revoke an annuitant's interest may be made during life or at death.

For example, Jerry arranges an immediate payment joint and survivor gift annuity for himself and his sister. Annual payments of \$1,000 are split equally between the two. If Jerry retains the power to revoke his sister's interest either during life or by will, he is not deemed to have made a gift to her when the annuity is created. Each \$500 payment she receives during Jerry's life will be considered a completed gift.

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