The Advisor

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ESTATE PLANNER'S TIP

The transfer of wealth from the World War II generation to their baby boomer children is well underway, and in the coming years the wealth will pass hands again as the boomers die. It's a good idea for 40- and 50-something year old clients to consider how any anticipated bequests from parents (or grandparents) will affect their own estate planning. Clients should plan not only for the estates they expect to accumulate on their own, but also for distributions from parents' estates. Multi-generational estate tax planning may be desirable, necessitating changes to the estate plans of the parents. Among the options available: have grandparents leave assets to grandchildren rather than children, keeping in mind the generation-skipping transfer tax and taking advantage of the $5.49 million exemption; incorporate disclaimer language in the estate plans of the older generation to direct assets to other family members or charity if the children do not need the bequest; or the use of trusts that provide the clients with income but won't cause the assets to be included in their gross estates.

IRS'S DISCLOSURE DAMAGES LIMITED

The IRS was examining the return filed by a married couple for 2007. The examination report, containing the taxpayers' names, Social Security numbers and detailed financial information, was inadvertently sent to another individual. When the couple learned of the disclosure from the attorney for the person who received their information, they sought damages from the IRS for wrongful disclosure.

Code §7431(c) provides that damages for disclosure are equal to the greater of $1,000 for each act or the sum of the actual damages sustained by the taxpayers, plus punitive damages for willful disclosure. While the couple admitted they suffered no actual damages, they argued that the statutory damages should be calculated by treating each piece of return information disclosed as a separate act of disclosure.

The U.S. District Court (ED NY) determined that "each act" referred to the mailing of the examination report and awarded each spouse $1,000 in statutory damages. Because there was no showing

that the disclosure was willful or the result of gross negligence, the court declined to award punitive damages (*Minda and Frost v. U.S.*, 2015-2 USTC ¶50,523).

TRUST AVOIDS PRIVATE FOUNDATION RULES

Charles established a charitable remainder unitrust, retaining income for his life. At his death, payments are to continue for the *longer* of Sally's life or a period of 20 years. The remainder is to pass to a charity. Charles has never claimed a charitable deduction for the value of the remainder interest.

Under Code §4947, a trust that is not exempt from taxation under Code §501(a) but has an interest devoted to charity is subject to the same requirements and restrictions as private foundations. The purpose is to prevent trusts from being used to avoid the rules applicable to private foundations. A trust is presumed to have amounts in trust for which a deduction was allowed if a deduction would have been allowable under Code §§170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2) or 2522.

The IRS determined that Charles' trust was not exempt from tax, although part of the unexpired interest is devoted to charity. Because no deduction has ever been taken, the trust is not subject to Code §4947(a)(2), even though a deduction was allowable. Charles will have to show, through the life of the trust, that no deduction has ever been taken. Without this proof, said the IRS, Reg. §53.4947-1(a) will cause Code §4947(a)(2) to be applied (Ltr. Ruls. 201713002, 201713003).

Note: Reg. §§1.664-2(a)(5)(i) and 1.664-3(a)(5)(i) provide that a qualified charitable remainder trust cannot last beyond the lives of one or more named beneficiaries and a term greater than 20 years. A trust can provide for income to be paid for life to a named beneficiary with payments continuing to another individual for the *shorter* of life or a term not to exceed 20 years. This differs from the trust term in the letter rulings above.

PHILANTHROPY PUZZLER

Marsha's family didn't have the money to send her to college when she was younger. She wants to help others who would like to obtain a college degree but lack the funds, so she consulted a college in her area about establishing a scholarship fund. Marsha has numerous grandnieces and grandnephews living in the area who could use the scholarships. She asked the college whether they could be given preference for the funds.

HEIRS MORE THAN A CENTURY LATE FOR REVERSION

Stephen and Amanda Stone conveyed a block of property to the city of Fayetteville, Arkansas, in 1906. The property was to revert to the Stones or their heirs if the city failed to build a hospital on the site within four years or if at any time failed to use the spot for a hospital purpose. In 1909, the deed was amended, adding a condition that if the hospital's location changed, the proceeds of the property would constitute a charitable trust for the maintenance of the hospital at a new location.

A hospital was opened in 1912. From 1906 to 1978, the city owned and held legal title to the hospital property. The property was conveyed to the hospital in 1978, but in 1991 was deeded back to the city by the board operating the hospital. In 2010, the city and the medical center entered into a land swap to ease traffic in the area. In 2014, Washington Regional Medical Center sought to quiet title in the property, saying that it had been in continuous and exclusive possession and use of the property since 2013.

Heirs of the Stones sought to have ownership revert to them, saying the city had failed to operate the hospital pursuant to the terms of the charitable trust. The circuit court denied their motion, instead granting a motion for summary judgment in favor of the medical center and the city. The court said the 1906 and 1909 deeds were clear and unambiguous and that the medical center had satisfied the elements of a quiet title action. The court of appeals affirmed.

The Supreme Court of Arkansas agreed, noting that under the 1906 deed, the land would revert to the Stones or their heirs if the city failed to establish and put into operation a hospital or if the hospital became abandoned or ceased to be used for a hospital purpose. Prior to the 1909 deed, the Stones possessed a reversionary interest that could be released, said the court. The reversionary interest was released, the court found, in the 1909 deed, which created a charitable trust to hold the funds in the event the location changed. The 1909 deed "effectively released and terminated any reversionary interest," said the court (*Stone v. Washington Regional Medical Center*, 2017 Ark. 90).

LEAD TRUST SALVAGED THROUGH MODIFICATION

George's living trust provided that at his death, two trusts – a marital election trust and a non-exempt marital trust – were to be established, both of which were to pay income for life to his wife, Lillian. At Lillian's death, all remaining principal was to pass to a residuary trust, which would be split equally between a charitable lead unitrust and a trust for the benefit of the couple's three children. The lead trust is to pay an amount annually to charity for 25 years that will zero out the GST tax when the lead trust distributes to the grandchildren.

The attorney of George's estate failed to divide the marital trust into two trusts, instead treating the residuary of George's gross estate as net assets passing to Lillian. The intended reverse QTIP election was never made. The error was not discovered until Lillian's death.

The trustees sought a court order to resolve ambiguities regarding funding of the lead trust. The changes were contingent on a favorable ruling from the IRS. The IRS granted an extension of time to sever the marital trust into two trusts and to make a reverse QTIP election. To qualify for a charitable deduction, the amount passing to charity must be ascertainable and determinable as of the date of death [Reg. §20.2055-2(a)]. The amendments proposed will further George's intent to maximize the GST exemption amount when determining the lead trust percentage. The IRS found that the charitable interest would qualify as a lead trust. The beneficiaries will have the same interests after the proposed modification that they had prior to the changes. Therefore, ruled the IRS, the change will not constitute a taxable disposition of trust assets and the beneficiaries will not realize gain under Code §1001 (Ltr. Rul. 201704005).

PUZZLER SOLUTION

In general, a gift to an individual does not qualify as a charitable contribution. However, contributions to establish a scholarship fund may be deductible if the class of potential recipients is not limited to members of the donor's family, although the class may include family members [*Est. of Robinson v. Comm'r*., 1 T.C. 19; Ltr. Rul. 9338014]. The scholarship restrictions cannot be so narrowly drawn as to limit the scholarship to a private class (TAM 9631004).

SHIFTING THE FOCUS FROM ESTATE TAX TO INCOME TAX DEDUCTIONS

With estates up to $5.49 million sheltered from estate taxes in 2017, fewer clients may be in the estate tax danger zone. Reducing income tax and capital gains tax may be a more important focus for many taxpayers than minimizing estate taxes. Here are some options for philanthropically inclined clients to accelerate bequests and reduce income taxes while assisting worthwhile organizations:

Charitable remainder trusts

With charitable remainder trusts – whether annuity trusts or unitrusts – clients can generate an income tax charitable deduction for the value of the remainder interest. If the trust is funded with long-term appreciated property such as securities or real estate, the deduction is based on the fair market value of the assets. The trustee can sell the assets with no loss to capital gains tax. The donor can deduct up to 30% of adjusted gross income (AGI) for the year of the gift, with a five-year carryover for excess deductions [Code §170(b)(1)(B)]. If the trust is funded with cash, the deduction is up to 50% of AGI. A couple, ages 68 and 65, who establish a 5% charitable remainder unitrust with assets valued at $250,000, would be entitled to an income tax deduction of $89,570 (assuming quarterly payments and the use of a 2.6% §7520 rate).

Note: Testamentary charitable remainder trusts can minimize income taxes if they are funded with U.S. savings bonds, retirement accounts or other items of income in respect of a decedent (IRD). State estate or inheritance taxes also may be available in some jurisdictions.

Retained life estate in a home or farm

Donors are allowed an income tax deduction for a charitable contribution, not in trust, of an irrevocable remainder interest in a personal residence or farm [Code §170(f)(3)(B)(i)]. A personal residence includes any property used by the donor as a personal residence, even though it is not the donor's principal residence. This can include a vacation home, condominium or co-op [Reg. §1.170A-7(b)(3)]. A farm is any land used for the production of crops, fruits or other agricultural products or for the sustenance of livestock [Reg. §1.170A-(b)(4)].

The amount of the charitable deduction depends primarily upon the value of the home or farm and the age or ages of the retained life owners. For example, a couple, both age 60, who contribute a remainder interest in farmland worth $500,000, would be entitled to an income tax charitable deduction of about $267,230 (assuming the use of a 2.4% §7520 rate). *Note:* In calculating the charitable deduction, it's best to use the lowest §7520 rate from the month of the gift or either of the two prior months.

Undivided interest

An undivided interest is an exception to the partial interest rule that precludes a charitable deduction where the donor is contributing less than his or her entire interest [Code §§170(f)(3)(A), (f)(3)(B)(ii)]. The undivided interest is defined as a fraction or percentage of each and every substantial interest or right owned by the donor, extending over the entire term of the donor's interest [Reg. §1.170A-7(b)(1)(i)]. A donor could, for example, give charity a 25% undivided interest in a vacation home, entitling the charity to use the home for three months each year or to receive one-quarter of the proceeds on a sale. The charitable deduction would be equal to approximately 25% of the home's fair market value, although there could be discounts for lack of marketability.

BALL STATE UNIVERSITY FOUNDATION
2800 W. Bethel Ave., Muncie, IN 47304
(765) 285-8312 • (765) 285-7060 FAX
bsu.edu/give

Cherí E. O'Neill
President and CEO

D. Mark Helmus
Senior Vice President
for Development

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