The Advisor

BALL STATE UNIVERSITY FOUNDATION
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ESTATE PLANNER'S TIP

Some clients begin taking reduced Social Security benefits at age 62, optimistically believing they have enough resources to carry them through the next 30 years or more. A few find, several years later, that they need to return to work. Are they stuck with the reduced Social Security benefits for the rest of their lives? There may be an option. Social Security recipients are allowed to rescind their decision to take benefits by filing Form 521 and repaying all benefits received to date. There is no interest charged and they may even be able to get a refund on income taxes paid on the benefits (see IRS Publication 915). The clients can return to the workforce and add to their Social Security earnings for eventual retirement at age 70. Their benefits are boosted by an 8% annual bonus for every year benefits are delayed past full retirement age. Or, if they're already past full retirement age, they can immediately reapply for Social Security benefits and receive checks that they would have been entitled to at that age. Will this work for everyone? Clearly, the clients would need to have funds available to repay what they had received since first applying. Health concerns are also an issue, since it may take several years of larger checks to recoup their repayment.

LIMITATIONS KEEP RUNNING FOR UNREPORTED GIFTS

Michael made taxable gifts in six separate years, for which no gift tax returns were filed. He made another gift in a seventh year, for which a Form 709 was filed, but it lacked a description of the property transferred and the method used to determine valuation. The IRS was asked if the period of limitations on assessing gift tax remains open for any of the gifts.

Generally, the IRS has only three years after a return is filed to assess gift taxes [Code §6501(a)], although an exception applies if the gift was not adequately disclosed when it was required to be reported [Code §6501(c)(9)]. If a Form 709 has not been filed, the collection of the appropriate tax may begin at any time [Reg. §301.6501(c)-1(f)(1)]. Similarly, where a return is filed but the gift is not adequately reported in a manner adequate to apprise the IRS of the nature of the gift and the basis for the value, the period of limitations remains open [Reg. §301.6501(c)-1(f)(2)].

The IRS determined that Michael's failure to file returns for the gifts in years one through six meant the period of limitations had not expired. As to gifts in the seventh year, for which Michael did file a Form 709, the lack of adequate descriptions meant that the assessment period also had not expired (Field Attorney Advice 20172801F).

REFORMATION FIXES SCRIVENER'S ERROR

Elizabeth executed a trust, on the advice of her financial planner and attorney, that would hold life insurance on her life but not be included in her estate at death. She would report gifts made to the trust during her lifetime to pay annual premiums and allocate a portion of her generation-skipping transfer tax exemption amount to each transfer. At her death, the trust would be divided into shares for each child.

For several years, Elizabeth made gifts to the trust, filed Forms 709 and allocated her GST exemption. She discovered, however, that due to a scrivener's error, the trust assets might be included in her gross estate. Elizabeth petitioned the state court to retroactively reform the trust to conform with her intent. The IRS was asked to rule that, as a result of the reformation, the gifts Elizabeth had made are completed for gift tax purposes and that trust assets will not be included in her gross estate.

PHILANTHROPY PUZZLER

In her will, Betty left the residue of her estate to a trust to benefit various charities in perpetuity. She gave the trustee the right to distribute up to one-quarter of the corpus to her brother during his life, if he survived her. Betty's brother was alive at her death, but was financially secure, so no distributions from corpus were ever made to him. How large is the charitable deduction to which Betty's estate is entitled?

The IRS noted that under state law, a scrivener's error that could defeat the grantor's intention may be corrected in equity by reformation. The reformation does not change the trust, but rather makes a change to correctly express the original intent. It was clear, the IRS found, that Elizabeth intended that trust property would not be included in her gross estate. The filing of the Forms 709 and the allocation of a portion of her GST exemption were steps in her intended plan. Therefore, ruled the IRS, her transfers to the trust are completed gifts and she did not retain any powers or interests that would cause the trust to be included in her gross estate under Code §§2035, 2036 or 2038. She also has no incidents of ownership in the life insurance for purposes of Code §2042 (Ltr. Rul. 201723002).

PAYING BACK TAXES NO EXCUSE

David and Barbara Pritchard, both under age 59½, withdrew more than $69,000 from an IRA in 2008, using $6,800 to pay an outstanding state income tax liability and $9,800 for an IRS tax liability for 2004. They reported the distribution on their 2008 income tax return and showed the 10% additional tax of $6,900 [Code §72(t)(1)], but they did not pay the additional tax.

The couple asked to have the additional tax removed, arguing reasonable cause, because the funds were used to pay back taxes. They claimed there was an equitable argument to "expand" the exceptions listed in Code §72(t)(2).

The IRS said it was bound by the exceptions enumerated in Code §72(t)(2), noting the couple's distribution did not fall within any of these. The IRS declined to abate the 10% additional tax on the basis of reasonable cause (*Pritchard v. Comm'r.*, T.C. Memo. 2017-136).

PHILANTHROPY WAS SPECIFIC, NOT GENERAL

The residue of Margaret Gurney's revocable living trust was to pass to three named charities at her death in 2015. St. Mary's Roman Catholic School, which was to receive 20%, closed in 2011.

The trustee sought permission from the Surrogate's Court to distribute the school's share to the other two residuary charities.

St. Mary's Roman Catholic Church of New York and the Roman Catholic Diocese of Albany, NY, argued that the cy pres doctrine applied and that the school's share should be distributed to the parish's faith formation ministry and a diocesan scholarship fund. The court declined to apply the cy pres doctrine, directing that the school's share pass to the two remaining charities.

The Appellate Division of the Supreme Court of New York noted that cy pres is appropriate only where the document demonstrates a general charitable intent, "rather than merely to give to a particular object or institution." All three charities named in Gurney's trust were located in her adopted hometown, suggesting that she intended to limit her giving to organizations in that area. In addition, the trustee testified that although Gurney was a regular churchgoer, she was primarily interested in supporting the school where she had volunteered. The court determined that the refusal to apply the cy pres doctrine was correct (*In re Gurney*, 2017 NY Slip Op. 05902).

Note: Cy pres, meaning "as near as possible," is designed to prevent the failure of bequests to charity where the charity has ceased to exist or because the specified charitable purpose is impossible or impractical to carry out.

THOSE WERE SOME EXPENSIVE USED CLOTHES

Mark and Rose Ohde made dozens of trips to Goodwill Industries in 2011, where they contributed clothes, furniture and books. In total, the couple claimed to have given more than 20,000 separate items and took a charitable deduction of $145,250. The IRS disallowed all but $250.

For each donation, the Ohdes obtained a one-page printed receipt indicating that no goods or services were provided in return for the contributions. The receipts did not, however, describe any of the items, tell how many items in any category were donated or indicate the condition of the items. Before the Tax Court, the couple produced a self-generated spreadsheet of the items given, with a total value for each trip to Goodwill, ranging from $830 to $14,999. The court noted that between 2007 and 2010, the couple claimed deductions for noncash gifts totaling more than $292,000, and for 2012 and 2013, their deductions were nearly $105,000.

The court found that although the Goodwill receipts included a statement that no goods or services were provided to the donors, there was no description of the number, type or condition of individual items, as required under Code §170(f)(8)(B). For contributions in excess of $500, all "similar items of property" must be aggregated. The court estimated that more than 99% of the contributions fell within this range, yet the donors failed to maintain reliable written records of the approximate date and manner that the property was acquired, a detailed description, the cost or other basis, the fair market value on the date of the gift and the method of determining value [Code §170(f)(11)(B)].

For items in excess of $5,000, a qualified appraisal is also required [Reg. §1.170A-13(c)(2)]. The court noted that the couple obtained no appraisal of any kind, "much less a qualified appraisal." The court agreed with the IRS that the donors were entitled to deduct only $250 (*Ohde v. Comm'r.*, T.C. Memo. 2017-137).

PUZZLER SOLUTION

Because 25% of Betty's bequest to charity is subject to diversion for noncharitable purposes, her estate is entitled to a deduction only to the extent that the property is exempt from the exercise of the power, or 75% [Reg. §20.2055-2(b)(1)]. This is true regardless of whether or not the trustee exercises the power in favor of Betty's brother.

WHEN MORE MEANS MORE

The interest rates on CDs have been inching up, albeit slowly. So too have the §7520 rates that are used to value split-interest gifts to charity (charitable remainder trusts, charitable lead trusts, charitable gift annuities and remainder interests in homes and farms). The average rate for 2016 was 1.8%; for 2017, the average rate through August is 2.4%. What difference do increasing interest rates mean to donors? For most, it means larger charitable deductions – and it may mean that charitable remainder annuity trusts will be an option for more donors.

Donors can use the §7520 rate from the month of the transfer or the rate from either of the two prior months in valuing their split-interest gifts. Using the highest rate generates the largest deduction for remainder trusts and charitable gift annuities. Lower rates favor charitable lead trusts and gifts of remainder interests in homes and farms. A donor who uses the §7520 rate from a month other than the month of the gift must make an election under §7520(a) and inform the IRS of the month and rate chosen to value the gift [Reg. §1.7520-2(b)].

How much of a difference do the higher rates make? Compare the results between the 1.4% rate in August 2016 and the 2.4% rate for August 2017. Consider a donor, age 71, who funds a 5% charitable remainder annuity trust with $100,000 (assuming quarterly payments). Using the 1.4% rate, the donor's deduction would be $39,720, but the trust would not satisfy the 5% probability test (Rev. Rul. 77-374), which denies a deduction where the probability that the beneficiary will survive to the exhaustion of the trust exceeds 5%. The IRS has ruled that a trust for which a deduction is not available due to the 5% probability test was not a qualified charitable remainder trust (Ltr. Rul. 9532006). At the §7520 rate of 2.4%, the trust satisfies the 5% probability test and generates a charitable deduction of $44,412.

At lower §7520 rates, younger donors and couples are generally precluded from funding charitable remainder annuity trusts. Assuming the lowest permissible payout rate of 5% and the use of the 1.4% §7520 rate, a single donor would have to be at least age 75 to fund a qualifying trust. With two beneficiaries, the minimum ages would be 77 years. Charitable remainder annuity trust donors can choose to include contingency language that will bypass the 5% probability test by causing the trust to terminate early in the event a transfer would cause trust corpus to fall below 10% of the value of the initial trust corpus [Rev. Proc. 2016-42].

The 5% probability test does not apply to charitable remainder unitrusts, permitting donors to fund the gifts at younger ages, although both the unitrust and the annuity trust must generate at least a 10% charitable remainder interest [Code §§664(d)(1)(D), (d)(2)(D)]. Unitrusts are less affected by interest rate changes. Substituting a unitrust for the annuity trust in the first example, the deduction at a 1.4% §7520 rate is $53,725; at the August 2017 rate of 2.4%, the deduction increases slightly to $53,911.

A donor who funds a charitable gift annuity will find a larger charitable deduction, but less tax-free income, thanks to the higher §7520 rates. Consider a donor, age 70, who contributes $20,000 cash in exchange for a gift annuity with quarterly payments. The recommended annuity payout rate is 5.1%. At the §7520 rate of 1.4%, the donor has a deduction of $7,164 and of the $1,020 received annually, $807 is tax-free for the donor's life expectancy. Using the §7520 rate of 2.4%, the deduction jumps to $8,198, but the tax-free portion of the annuity drops to $743.

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