

The Advisor



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ESTATE PLANNER'S TIP

Irrevocable life insurance trusts can hold insurance proceeds out of the reach of the federal estate tax, but in many cases, it may be simpler to have the policy owned directly by the beneficiary. For example, a parent might give ownership of a new policy to a reliable son or daughter. (A gift of an existing policy would be included in the insured's estate under Code §2035 if the transfer occurs within three years of death.) The parent could pay the premiums directly – not considered an incident of ownership under Code §2042 – or give the child money with which to pay the premiums. Provided the premiums, along with other gifts made by the parent, fall within the annual exclusion amount [Code §2503(b)], there would be no gift tax. If the child dies before the insured, the policy is included in the child's gross estate, but the value is only the interpolated terminal reserve plus a portion of the most recent premium covering the period after the child's death (Rev. Rul. 77-181). Disadvantage? Impatient and unreliable offspring may raid the policy before the insured dies, frustrating the estate owner's intentions.

NO DEDUCTION FOR TAXES NOT PAID

On the advice of his attorney, Sheldon Sommers transferred several works of art from his collection to an LLC to take advantage of valuation discounts before giving ownership interests to his three nieces. He made a gift of some LLC shares in late 2001 and the rest in early 2002, taking advantage of the gift tax annual exclusion from the two years.

After an appraisal, it was determined that gift tax would not be completely avoided. The nieces

agreed to pay any gift tax resulting from the transfers in 2002.

Sommers died later in 2002, reporting a taxable estate of \$507. The IRS determined the taxable estate to be just over \$1 million, which included the value of the gift tax due for 2002 [Code §2035(b)]. The marital deduction was also reduced by the estate tax liability that would be paid from marital assets. The nieces eventually paid the gift tax liability.

Sommers' estate argued that a deduction should be allowed for gift taxes paid, despite the fact that these were paid by the nieces, because Sommers was obligated to pay the tax [Code §2502(d)]. The Tax Court noted that the estate would have had a right of reimbursement from the nieces if he had paid the gift tax. The reimbursement would have had to be taken into account in determining Sommers' taxable estate, so no deduction was allowed (*Estate of Sommers v. Comm'r.*, 149 T.C. No. 8).

DEDUCTION GETS SHOT DOWN

Paul Gardner, a big-game hunter, was downsizing his collection of animal specimens. In 2006, he contributed 177 items, including skins, skulls, horns, tails and hooves to the Dallas Ecological Foundation (DEF). He obtained an appraisal listing all the items as being of "excellent" quality and valued at \$1,425,900. The appraiser used the replacement cost method, which included out-of-pocket expenses for travel, permit and trophy fees, shipping and taxidermy. The IRS determined the value to be \$163,045, using the comparable sales method.

The Tax Court said that if the specimens given to DEF were "collectibles," the replacement cost was the appropriate valuation method. However,

if the items were "commodities," the market price was the correct method. To be considered a collectible, a buyer would want to know who shot the animal, where it was shot and previous owners. Because the items given to DEF were either in storage, sold or given away, the court determined that they were commodities.

Although Gardner argued that there was no market for such items, making the comparable sales method inappropriate, the IRS's expert found 504 sales of comparable items on traditional and internet auction sites. The court found that the existing market for taxidermied products has "vastly expanded" with the internet trade (*Gardner v. Comm'r.*, T.C. Memo. 2017-165).

Note: In a footnote to *Gardner*, the court said there were likely to be fewer such disputes in the future, following passage of the Pension Protection Act of 2006. Congress added Code §§170(e)(1)(B) and (f)(15), limiting the deduction for charitable gifts of "prepared, stuffed or mounted" animal specimens to the lower of fair market value or the cost of "preparing, stuffing or mounting." The cost for travel and transportation are no longer deductible.

NO DEDUCTION FOR INCOMPLETE GIFT

Grou Development LLC (Grou) purchased the St. George Theatre in 2001 for \$700,000. When plans to demolish the dilapidated building were met with community resistance, Grou sought to donate the structure to a nonprofit. A newly formed organization, Richmond Dance Ensemble, was interested in acquiring the building, but because it hadn't yet been granted charitable status, Grou instead contributed the building to WEMGO Charitable Trust, with the stipulation that the Trust was prohibited from selling the building for five years, except to Richmond Dance. Grou received \$470,000 for the transfer in 2004.

Just prior to the transfer, the building was appraised at \$5 million. George Fakiris, manag-

PHILANTHROPY PUZZLER

Brian's mother died, naming Brian as the beneficiary of her living trust. While having his mother's estate tax return prepared, Brian discovered that it would be subject to estate tax. He thought that a charitable deduction might reduce his mother's estate to a level that was sheltered by the estate tax credit. He has asked if he could disclaim part of his interest and instead have the funds pass to his favorite charity, thereby generating a deduction.

ing partner of Grou, reported a \$3 million non-cash charitable deduction on his 2004 personal return for his 60% interest in Grou. Part of the deduction was carried over to later tax years. The IRS issued a deficiency for years 2006 through 2008, saying Grou's transfer of the St. George Theatre to WEMGO was not a completed gift because Grou "retained dominion and control" over the building following the transfer. The sales contract allowed Grou to take back the theater and transfer it to Richmond Dance after the purported transfer, said the IRS. The Tax Court agreed, noting that in the five-year period following the sale, WEMGO was prohibited from selling the building and Grou retained the right to transfer the theater to Richmond Dance once it received its tax-exempt status from the IRS. Grou's rights under the contract rendered the gift "conditional," and because the possibility that the condition would be satisfied was not so remote as to be negligible, no gift was made within the meaning of Code §170(a)(1), the court held (*Fakiris v. Comm'r.*, T.C. Memo. 2017-126).

EASEMENT DEED SERVES AS ACKNOWLEDGMENT

In 2005, 310 Retail, LLC executed a preservation deed of easement for the facade of a landmark building. The deed did not specifically say that no goods or services were provided by the donee, the Landmarks Preservation Council of Illinois (LPCI), although it did say that the document "reflects the entire agreement" of the parties. The LLC claimed a charitable deduction of \$26.7 million, based on an appraisal.

In 2009, the IRS indicated that it intended to disallow the deduction. That same year, the LPCI sent a letter to the LLC stating that no goods or services had been provided in consideration of the gift. The IRS disallowed the gift in 2014, saying the LLC failed to satisfy the contemporaneous written acknowledgment requirement of Code §170(f)(8)(A). An acknowledgment is contemporaneous only if provided on or before the earlier

of the date on which the taxpayer files a return for the taxable year in which the contribution was made or the due date (with extensions) for filing the return [Code §§170(f)(8)(C)(i), (ii)].

The LLC argued that the deed of easement constituted a contemporaneous written acknowledgment. The Tax Court noted that acknowledgments need not take any particular form, but must include an affirmative indication that the donee has provided no goods or services. The court had previously said that a deed of easement might qualify, if properly executed and contemporaneous [*Simmons v. Comm'r.*, T.C. Memo. 2009-208, *aff'd.*, 646 F.3d 6 (D.C. Cir. 2011)]. The deed of easement between the LLC and LPCI was properly executed and recorded, thus constituting a contemporaneous acknowledgment, said the court. The fact that it was the "entire agreement" between the parties was not affected by the boilerplate language indicating that the LLC received \$1 and other "good and valuable consideration." Such language has no legal effect for purposes of Code §170(f)(8), said the court (*310 Retail, LLC v. Comm'r.*, T.C. Memo. 2017-164).

PUZZLER SOLUTION

Under Code §2518(a), if a qualified disclaimer is executed, the bequest will pass as though the beneficiary had predeceased the testator. However, one of the requirements for a qualified disclaimer is that the interest must pass without any direction by the disclaiming person. The interest will pass either through provisions in the estate plan or by intestacy. If Brian's mother had included a provision in her trust naming charity as a contingent beneficiary, a qualified disclaimer would mean that assets would pass without any direction on Brian's part and the estate would be entitled to a charitable deduction.

GIVE NOW OR LATER?

Estate planners often suggest that clients transfer certain assets to family members at death, rather than during lifetime. For example, a bequest of appreciated stock receives a stepped-up basis at the owner's death, unlike an inter vivos transfer, for which there is a carryover basis. Certain assets given to charity also carry different tax benefits, depending upon when they are transferred.

Appreciated securities or real estate

A gift to charity during the donor's lifetime generates an income tax charitable deduction equal to the fair market value, provided the assets have been held long-term (more than one year). If the donor plans to keep the assets until death, assets such as stock, mutual fund shares or real property are generally better to leave to family members, who will receive the stepped-up basis. These assets can be sold with no loss to capital gains tax. If capital gain property is short-term (one year or less), the income tax charitable deduction for a gift is limited to the donor's basis. The estate tax deduction for a bequest of short-term capital gain property is the full fair market value – the same value assigned to the asset for estate tax purposes. If the estate is not likely to be subject to estate tax, a lifetime gift to charity will generate an income tax deduction that can reduce taxes.

Life insurance

Life insurance proceeds generally pass to family members free of income tax, although the full value is included in the estate for estate tax purposes. A life insurance policy can be given to charity during the insured's life, but the income tax deduction will depend upon whether the policy is paid up. In general, the deduction allowed for a policy with additional premiums due is the less of the interpolated terminal reserve or the premiums paid [Reg. §25.2512-6(a)]. If the donor gives a paid-up policy, the value equals the single premium the insurance

company would charge for a comparable contract issued at the insured's current age [Reg. §25.2512-6]. In either case, the donor may not deduct more than the total amount of premiums paid. If charity is named the death beneficiary of a policy, with the donor retaining ownership, the full value is included in the gross estate, with a corresponding charitable deduction.

Personal property

A lifetime gift to charity of artwork, antiques, collectibles or other items of tangible personal property may result in a reduced income tax charitable deduction for the donor. If the property is considered unrelated to charity's exempt purpose, the deduction is limited to the donor's basis [Code §170(e)]. Assets that can be put to a related use (e.g., artwork to an art museum) and have been held long-term entitle the donor to a deduction equal to fair market value. There is no related use rule for estate tax purposes, so the estate is entitled to a deduction for fair market value.

Retirement accounts

A donor who wishes to use funds in a qualified retirement plan to make a charitable gift must first pay income tax on the amount withdrawn. (There is an exception for qualified charitable distributions from IRAs by donors age 70½ or older. Tax-free gifts – up to \$100,000 annually – must come directly from the IRA custodian.) At death, retirement accounts are taxable for estate tax purposes and are also considered income in respect of a decedent (IRD) [Code §691]. Family members who receive these assets could pay income tax at rates as high as 39.6% and may also owe state tax. Retirement accounts left to charity, however, generate an estate tax deduction and also avoid the income tax, making them an ideal asset to leave to charity. Certain other assets in an estate – annuities, U.S. savings bonds, accounts receivable and others – are also IRD, making them attractive options for satisfying charitable goals.

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