

The Advisor

February 2009

ESTATE PLANNER'S TIP

The ink was barely dry on the Emergency Economic Stabilization Act of 2008, which retroactively reinstated tax-free qualified charitable distributions (QCD) from IRAs, when Congress passed the Worker, Retiree and Employer Recovery Act of 2008. The WRER suspends, for 2009 only, the requirement that minimum distributions be taken from qualified plans and IRAs. Although no charitable deduction is allowed for QCDs, available only to taxpayers age 70½ and older, transfers to charity in 2006 to 2008 counted towards the donor's required minimum distribution. Does a charitable gift from an IRA still make sense in 2009 if the IRA owner is not required to take a minimum distribution? A QCD enables donors who do not itemize to access IRAs for charitable giving without increasing their taxes. For these donors, their charitable gifts can be made with funds that otherwise would be taxed at ordinary income tax rates – without the need for an offsetting charitable deduction. For IRA owners who still have substantial accounts, even after the market's dramatic 2008 decline, making a QCD of up to \$100,000 will also reduce required minimum distributions in future years and the income tax that will eventually be due on funds remaining in the accounts at death.

PREMATURE DISTRIBUTION IN WRONG YEAR

Bernard and Deborah Evers borrowed \$15,000 from a credit union in 2003 to pay expenses related to infertility treatments. In 2004, the couple withdrew \$16,250 from a qualified plan and used \$13,000 to repay part of the loan. They included the distribution in income on their 2004 tax return, but did not include the additional 10% tax due on withdrawals from qualified plans made before age 59½ [Code §72(t)].

The taxpayers claimed that they qualified for an exception to the 10% additional tax on premature distributions because they used the funds to repay the loan undertaken to pay medical

expenses [Code §72(t)(2)(B)]. That exception provides that the additional tax does not apply to distributions "to the extent such distributions do not exceed the amount allowable as a deduction under section 213 to the employee for amounts paid during the taxable year for medical care."

Under Code §213, an income tax deduction is allowed for unreimbursed expenses paid during the year for medical care, to the extent the expenses exceed 7.5% of the taxpayer's adjusted gross income. The Tax Court noted, however, that the deduction is allowed only for expenses actually paid during the year, regard-

less of when the expenses were incurred. The IRS argued that the medical expenses were actually paid in 2003 using borrowed funds. The court agreed, finding the couple was not eligible for the exception under Code §72(t)(2)(B) (*Evers v. Comm'r.*, T.C. Summ. Op. 2008-140).

REIMBURSEMENT RATES DROP WITH GAS PRICES

In mid-2008, the IRS raised the standard business mileage rate from 50.5 cents per mile to 58.5 cents per mile, recognizing the steep increase in gasoline prices. For 2009, the rate has fallen to 55 cents per mile, reflecting the decline in fuel prices. The rates for medical and moving use of a vehicle are 24 cents per mile for 2009. This compares with 19 cents per mile at the beginning of 2008 and 27 cents for the second half of the year. The rate for charitable use of a personal vehicle is set by Code §170(i) at 14 cents per mile and is not adjusted annually (Rev. Proc. 2008-72).

THE WRONG WAY TO REFORM A REMAINDER TRUST

The Virginia Biggs Charitable Remainder Trust was to pay Biggs's daughter, Gina, all the net income for her life. The trustee was to select the charities to receive the remainder at Gina's death. A \$328,316 charitable deduction was claimed for the remainder value of the trust on the estate tax return, filed in April 2003. Shortly

PHILANTHROPY PUZZLER

Bruce owns a car dealership that also leases cars. He gave his favorite charity free use of a lease car last year. Charity used the car for its charitable purposes and has sent Bruce a letter thanking him for his generosity. Bruce has asked whether he is entitled to a charitable deduction for the lease value of the car.

thereafter, the IRS informed the executor that the deduction was being examined.

In April 2004, the trustee sought and was granted a judicial modification of the trust to conform with the requirements of Code §2055, "effective immediately." The IRS denied the deduction in July 2004, saying that the trust did not satisfy the requirements of Code §2055 and was not reformed within the 90-day time limit of Code §2055(e)(3)(C)(iii). The estate argued that the deduction should have been allowed because the trust was modified retroactively under state (Kansas) law.

The IRS noted that a reformable interest is one in which all payments to individuals are expressed in "specified dollar amounts or a fixed percentage of the fair market value of the property." If, as in the Biggs trust, the income beneficiary is entitled to all net income, the only way to reform the trust is to initiate a judicial reform procedure no later than 90 days after the due date of the estate tax return [Code §2055(e)(3)(C)(iii)].

The U.S. District Court found that the reformation action was not initiated within the 90-day period. Congress provided relief for erroneous split-interest trusts, noted the court, but one of the safeguards included in the code was the narrow time limit for reformations, intended to prevent reformation attempts that were only initiated after the IRS discovered defects on audit. The court added that the estate's failure to obtain a retroactive reformation of the trust was an independent reason to disallow the deduction (*ESB Financial v. U.S.*, 2008-2 USTC ¶60,567).

COURT FINDS DOCUMENTATION BELIEVABLE

Donald and Penny Nicholas reported charitable gifts in 2005 of \$43,637 – nearly half the couple's adjusted gross income of \$89,092. The total deduction included a \$6,012 carryover from the previous year when they exceeded the 50%-of-AGI limit. Most of the gifts were in cash, but the couple also made periodic gifts of books, CDs and furniture valued at about \$4,900.

Their tax preparer mistakenly listed all the gifts as cash on their income tax return. When the IRS began examining their taxes, Penny realized the error and they filed a timely amended return with a Form 8283 for the noncash gifts. The couple had substantiation for all the cash gifts, but the IRS disallowed the deduction for the noncash gifts.

Most of the noncash gifts were less than \$500. The charities provided the couple with receipts and letters, but left it to the donors to fill in the items and values. The Tax Court noted that although the couple did not have receipts to substantiate the original cost of most items, Penny had maintained notes and other documents recording the types of assets, names of the charities, costs and estimated values. As a frequent shopper at garage sales and flea markets, the court found that she had a “keen sense of the value of her contributed items.”

The court ruled that the assets were contributed and the values placed on the gifts were “appropriately derived.” The court added that while the IRS accepted the receipts for the cash gifts, which comprised nearly 90% of their deduction, it did not accept the receipts for the noncash gifts. The income deficiency attributable to the disallowance was only \$712, but the couple chose to fight “as a matter of principle,” noted the court, which was persuaded by Penny’s testimony and the documents the couple provided (*Nicholas v. Comm’r.*, T.C. Summ. Op. 2008-155).

NO WILL CONTEST, NO DEDUCTION

Harold’s will established a testamentary trust, which was the designated beneficiary of his IRA. The trustee was to pay a specified percentage of the trust property annually divided among his six children and four charities. The trust did not have a termination date or direct what was to happen to a child’s portion at death.

The parties obtained a judicial reformation in order for the trust to qualify as a designated beneficiary of the IRA under Code §401(a)(9).

As reformed, the trustee paid a percentage outright to the charities equal to their interests under the terms of Harold’s trust. The children’s interests were reformed to create six separate shares, with income paid from the shares until each child reached a specified age, when an outright distribution would be made.

Reg. §1.642(c)-1(a)(1) permits an unlimited deduction for any part of the gross income of a trust which, pursuant to the terms of the governing instrument, is paid during the taxable year for charitable purposes. In Rev. Rul. 59-15 (1959-1 C.B. 164), the IRS held that a settlement agreement arising from a will contest qualifies as a governing instrument.

There was no contest with respect to Harold’s trust, said the IRS, which noted that charities received the same percentage under both the original and modified trust. The purpose of the reformation was not to resolve a conflict but to obtain the tax benefits available if the trust were the designated beneficiary of Harold’s IRA. Where a modification is not pursuant to a will contest, the resulting document will not be considered the governing instrument, ruled the IRS. Therefore, the accelerated payments to the charities are not pursuant to the governing instrument and the trust is not entitled to a deduction under Code §642(c) (Ltr. Rul. 200848020).

PUZZLER SOLUTION

Although Bruce has provided a valuable benefit for charity, he is not entitled to an income tax deduction. He has given less than his entire interest in the car, making it a partial interest gift [Code §170(f)(3)(A)]. Rent free use of a vehicle is similar to the example provided in Reg. §1.170A-7(d), where a building owner gives rent-free use of one floor of the building to charity. The regulations provide that the interest is a partial interest for which the donor is not entitled to a charitable deduction.

CHARITABLE REMAINDER ANNUITY TRUSTS – YOUNGSTERS NEED NOT APPLY

Age may have its privileges, but don't even try to establish a 5% charitable remainder annuity trust (the lowest payout rate possible) unless you're at least age 70 if you're using the January 2009 §7520 rate of 2.4% with annual payments. And if it's a two-life trust, at least one of the income beneficiaries must be age 72, while the other can be a youthful age 71.

Granted, a donor establishing a charitable remainder trust can use the §7520 rate from the month of the gift or either of the two prior months, whichever is more favorable [Code §7520(a)]. However, even using the November 2008 rate of 3.6% only reduces the eligible ages to 60 for a one-life and 63 for two lives. And who knows whether rates in the coming months will drop even further?

The impact of the historically low §7520 rates are not as severe on charitable remainder unitrusts. For example, a 25-year-old could establish a 5% unitrust (annual payments) that would satisfy the minimum 10% remainder requirement [Code §664(d)(2)(D)]. For a two-life unitrust, the income beneficiaries would have to be at least age 37 using the 2.4% §7520 rate.

There are alternatives for charitable giving in a low-interest rate environment:

- Rather than a charitable remainder annuity trust for the life or lives of the income beneficiaries, donors could use a term-of-years trust of up to 20 years. Even using the 2.4% §7520 rate, a 5% annuity trust with quarterly payments satisfies the 10% remainder requirement. In fact, the payout can be as high as 5.6% before charity's remainder drops below 10%. For donors in their 60s, a 20-year trust may be an attractive option. And if the beneficiaries both die within the 20-year trust term, payments can continue to other family members.

- Use a charitable gift annuity instead of a charitable remainder annuity trust. The recommended payout rate for a 65-year-old annuitant is 5.7%. For two 65-year-olds, the rate is 5.4%.

- With low §7520 rates, the charitable deduction for a charitable remainder unitrust is actually higher than with the annuity trust. For example, assuming annual payments, a \$100,000 gift, a 5% payout rate and the §7520 rate of 2.4%, a 70-year-old donor would be entitled to a charitable deduction of \$43,870.50 for a charitable remainder annuity trust. The deduction for a unitrust would be \$53,569. For a donor who is not concerned with having a fixed income, the unitrust may be an attractive alternative.

The low §7520 rates aren't all bad news for donors. Some gift vehicles are more attractive when rates drop. A gift of a remainder interest in a home or farm [Code §170(f)(3)(B)(i)] is more valuable when interest rates are down. For example, the deduction for a \$100,000 parcel of vacant farmland is \$67,881 for a donor age 65 using the §7520 rate of 2.4%. At a §7520 rate of 4%, the deduction would be \$53,958. Donors who previously established charitable remainder trusts may wish to make additional gifts to charity by assigning their income interests to the remainderman. This generates an additional charitable deduction, which is calculated using the current rate. The combination of the deduction when the trust was established and the deduction for the gift of the income interest may actually exceed the amount transferred to trust.

The real star in a low-interest rate environment, however, is the charitable lead trust. Parents hoping to transfer wealth to the next generation can reduce or even eliminate transfer taxes by establishing a nonreversionary charitable lead trust. Low interest rates enable the trust to "zero out" gift taxes and last for a shorter period and/or use a smaller payout.

