The Advisor

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### ESTATE PLANNER'S TIP

An individual can withdraw IRA savings prior to age 59½ without paying the 10% penalty on early withdrawals if the payments are part of a series of substantially equal periodic payments, made for the life expectancy of the owner [Code §72(t)(2)(A)(iv)]. The payments must continue for at least five years but may cease or be reduced once the owner reaches age 59½ [Code §72(t)(4)]. Because an individual with multiple IRAs is allowed to make the equal withdrawals from one account without tapping into the others (Ltr. Rul. 9243054), a client with one large IRA could fund a new rollover IRA with just the amount needed to provide the desired income each year [see Code §408(d)(3)(D)]. For example, a 55-year-old client has an IRA of $2 million and a life expectancy of 28.6 years (IRS Table V). The client would like to receive $50,000 annually. Using a 2.6% interest rate assumption (August §7520 rate), if the client transfers $890,000 into a rollover IRA, the payments would be $50,177 ($890,000 ÷ 17.7371 annuity factor from IRS Table S). The client does not have to calculate the equal payments on the total $2 million in both accounts. This may be an option for clients with large IRAs who want to work part-time but don't want to reduce their income. Income can be increased in later years by establishing additional rollover IRAs.

### "CINDERELLAS" LEFT WITH TAX FROM STEPMOTHER

When Judith Upchurch died in 2000, her will left her home equally to her three natural-born children (Rodney, Ronald and Robin) and two stepchildren (Bruce and Carl). However, in the months prior to her death, Upchurch had subdivided the parcel and executed quitclaim deeds. Ronald and his wife received a vacant parcel, on which they built a home. Robin received Upchurch's home.

Bruce and Carl filed suit seeking to impose a constructive trust on the parcels or have the quitclaim deeds declared invalid, claiming Judith had been in poor health and Ronald and Robin had violated their fiduciary duty by allowing Judith to sign the deeds. The parties eventually settled, with Bruce and Carl each receiving $53,500. Under the settlement, Bruce and Carl had their attorney file a probate claim against the estate for that amount. The estate issued a check for $107,000 to the attorney, who forwarded $35,667 to each of the brothers ($53,500 less a $17,833 contingency fee).

In 2005, the IRS assessed an estate tax deficiency and interest of more than $54,000. None of the tax liability was recovered from Judith's estate or beneficiaries. In 2007, the IRS sent a notice to the brothers

indicating they were liable up to the $53,500 each received. The two argued that while they were transferees of property of Judith's estate, they were not transferees of property of a decedent under Code §6901(a)(1)(A)(ii). Their stepsiblings, not the estate, were the transferees, they claimed.

The Tax Court said that even if the transfers were from Rodney, Ronald and Robin, they were transfers first from the estate to the three, followed by transfers to Bruce and Carl. The transfers were still burdened with liability for estate tax, said the court. The settlement payments they received were substitutes for the real property devised to them in the will but not available at Judith's death.

Bruce and Carl also argued that, if liable, it should only be to the extent of the $35,667 they actually received. The court said that the two "ultimately controlled the entire litigation process to enforce their rights under the will" and authorized the payments to their attorney. Therefore, the limit of their transferee liability is the full $53,500 (*Upchurch v. Comm'r.*, T.C. Memo. 2010-169).

### TAXPAYERS BURNED DUE TO LACK OF SUBSTANTIATION

When James and Lori Hendrix found it would cost about $10,000 to demolish their existing home in order to build a larger one, they entered into an agreement with the local fire department to use the house for training and then demolish it. The couple obtained an appraisal estimating the fair market value of the property at $520,000.

The couple claimed a charitable deduction on their 2004 income tax return of $287,400. The IRS disallowed the deduction and asked the U.S. District Court (So. Dist. Ohio) for a summary judgment. The IRS said the appraisal obtained by the Hendrixes did not satisfy the requirements of Code §170(f)(11)(A)(l) and the contract with the fire department did not qualify as a contemporaneous acknowledgment under Code §170(f)(8)(A).

The court found that the appraisal did not give the expected date of the contribution, terms of the agreement with the city, the qualification of the appraiser (background, experience, education, professional memberships) or include the required statement that the appraisal was prepared for income tax purposes. Code §170(f)(11)(C) specifically requires the information to be attached to the return. The court said the appraisal provided by the Hendrixes "wholly lacks even a modicum of content in critical areas." Even if the substantial compliance doctrine applied, the couple's effort "has simply fallen short," said the court.

A contemporaneous acknowledgment of a gift must include a description of any property other than cash, indicate whether any goods or services were provided in consideration and a description and good faith estimate of the value of such goods or services [Code §170(f)(8)(A)]. Because none of the documents satisfies this standard, the taxpayers are not entitled to the deduction, ruled the court (*Hendrix v. U.S.*, 2010-2 USTC ¶50,541).

### PHILANTHROPY PUZZLER

Brenda, who inherited a substantial estate from her parents, wants to leave a bequest to charity. However, she is concerned that her family might not approve of her choice of beneficiary. A friend suggested that she specify an amount in her will, but leave the selection of charitable beneficiaries to family members following her death. Brenda's nephew, a law student, questions whether she might lose her estate tax charitable deduction if she does not name the charitable beneficiary. Will Brenda's estate be entitled to a deduction?

### CLASS OF BENEFICIARIES TOO SMALL FOR EXEMPT STATUS

Promoting good health can be a charitable purpose, worthy of tax-exempt status under Code §501(c)(3), but the class of potential beneficiaries must be sufficiently large to benefit the community as a whole. The IRS told William Naylor that his effort to provide his sperm, free of charge, to women seeking to get pregnant by artificial insemination or in-vitro fertilization did not benefit a sufficiently large class.

Naylor and his father founded Free Fertility Foundation to screen for recipients of Naylor's sperm donations. Preference was given to women with "better education," no record of divorce, domestic violence or "difficult fertility histories," from families with a record of contributing to their communities, in "traditional marriages" and under age 37. Of the 819 women who applied in 2004 and 2005, only 24 received sperm from the foundation.

Naylor argued that the potential class of beneficiaries was "all women of child-bearing age." The Tax Court said the actual class was limited to those women interested in having Naylor as the biological father of their children and who survive the "subjective, and possibly arbitrary, selection process" that he controls. The court, which was not convinced that the foundation "promotes health or confers a public benefit," said the organization was not entitled to Code §501(c)(3) status (*Free Fertility Foundation v. Comm'r.*, 135 T.C. No. 2).

### ESTATE RETRIEVES COMMUNITY PROPERTY

In 1978, George Cable transferred community property to a trust that was to pay him 75% of the income for life. If his wife Alice survived him, she was to receive 75% of the income for her life, with the balance reinvested. At Alice's death, the trust was to be liquidated and the trustee was to pay $50,000 to each of George's three grandchildren. The rest was to be divided among three charities. George died in 1987.

Alice left a will at her death in 2006 that passed 20% of the residue of her estate to each of George's three grandchildren and a charity. The balance was to pass to her brother.

In 2007, Robert Cable, one of George's grandchildren, filed a petition for recovery and return of community property. He claimed that the 1978 transfer had been made without valuable consideration or the written consent of Alice, making it ineffective as to her community property interest. He asked the court to order the trustee to transfer Alice's share of the community property to her estate. The charities and the trustee of George's trust claimed (1) that Robert's action was time-barred because he had failed to file a creditor's claim in the probate of George's will, (2) the action was barred by the three-year statute of limitation and (3) Alice had failed to file a claim within a year after George's death. The court found the claims were time-barred.

Robert appealed, saying he made a timely challenge to the nonprobate transfer of community property upon Alice's death. He did not simply challenge the 1978 transfer of community property to the trust, but was contesting the validity of George's provision for the nonprobate transfer of that property at Alice's death.

The Court of Appeals of California noted that the key to determining the timeliness of Robert's action was deciding when the cause of action accrued. Robert claimed the action did not accrue until George's trustee refused to transfer property to Alice's estate, noting that Alice could have consented to the provision in George's trust any time before she died. He could not have brought an action based on a "nonconsensual provision for the nonprobate transfer of the property" prior to her death. The charities argued that Alice was required to assert her claim when George's estate was probated in 1988. However, the court found that the property in question was not in George's estate, since it had been transferred to the trust. The 1978 transfer was effective no later than George's 1987 death, said the court, while the provision for the nonprobate transfer upon Alice's death was effective no earlier than her death. Therefore, the cause of action was not untimely (*Est. of Cable v. Shriners' Hospital for Children*, No. PR160369).

### PUZZLER SOLUTION

The bequest will qualify for an estate tax charitable deduction provided that Brenda's family members have the right only to select the beneficiaries. If family members have the right to veto a bequest to a named beneficiary or to designate the amount of her estate passing to charity, the gift would not be considered to pass from Brenda and no deduction would be allowed [Reg. §20.2055-1(a)].

## GIFT OPPORTUNITIES FOR CLOSELY HELD CORPORATIONS

Owners of closely held corporations have the option of making gifts from their personal assets or having their businesses make the gifts. Gifts from the company can save corporate income taxes and create good will that helps business. An owner can get the best of both worlds by giving charity stock in the company, taking the deduction as an individual and having the corporation "pay" for the gift by redeeming the stock from the charity.

**Corporate gifts**

■ C corporations can claim income tax deductions for up to 10% of taxable income, with a five-year carryover [Code §170(d)(2)(A)]. S corporations are not allowed charitable deductions. Instead, deductions are passed through to the shareholders according to their respective ownership interests [Code §1366(d)(1)].

■ There's no adverse tax result for the business unless the controlling shareholders receive economic benefit from the gift (Ltr. Rul. 8606009).

■ Gift property can include cash, marketable securities, real estate, inventory, "white elephant" property or options to buy stock in the company. Gifts of stock options will be deductible when exercised by the charity or when the option is sold to an unrelated charity (Ltr. Rul. 8826008). The deduction is the difference between the option price and the fair market value of the stock at the time of the exercise.

■ Corporations can be grantors and/or beneficiaries of charitable remainder trusts. For example, a corporation owns undeveloped land worth $250,000 with a $60,000 cost basis. The property could be transferred to a charitable remainder annuity trust paying a 5% annuity for 20 years. The corporation deducts the present value of charity's remainder interest and the trust sells the property, avoids any capital gains tax and reinvests in dividend-paying preferred stock from domestic corporations. The corporation goes from zero income on real estate (actually a negative income when insurance and real estate taxes are considered) to $12,500 a year. The corporation is also entitled to a charitable deduction of about $55,000 (assuming quarterly payments and a §7520 rate of 2.6%).

**Shareholder gifts**

■ A majority shareholder of a closely held corporation typically has a low basis in the shares. Selling the stock will trigger capital gains tax. However, a charitable contribution of the shares does not cause the realization of capital gain and the donor can claim the fair market value of the shares on the date of the gift as a charitable deduction (appraisals are needed for deductions of $10,000 or more). All parties expect that the corporation will redeem the shares and retire the stock. The IRS has ruled that the donor will not be considered to have received a dividend, even though he or she receives a substantial benefit from the corporation, so long as charity is not *required* to turn back the shares of stock to the corporation (Rev. Rul. 78-197, 1978-1 C.B. 83).

■ Instead of an outright gift, donors can transfer stock to a net-income charitable remainder unitrust or a flip unitrust, avoid capital gains tax, deduct the remainder interest in the stock and receive income for life. Self-dealing might seem to be a problem, because the trustee will be "doing business" with the donor's corporation when the stock is redeemed (the donor is a disqualified person). But self-dealing can be avoided if fair market value is paid for the stock and the corporation offers to redeem all other shares at the same price offered to the trustee [Reg. §53.4941(d)-3(d)(1)].

■ Gifts of stock in a person's corporation might be especially attractive prior to a sale or liquidation of a company. Donors can increase deductions and avoid capital gains taxes when they contribute stock to charity.

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