

# Advisor Update

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A professional advisor resource courtesy of Advocate Charitable Foundation

## ■ Latest Rulings From the Courts and the IRS

### *Donor Mistakenly Transfers Personal Funds to Charitable Remainder Unitrust for Three Years — And Gets Them Back! Private Letter Ruling 200601003*

In this surprising ruling, the IRS allowed a taxpayer to reclaim property accidentally transferred to her charitable remainder unitrust three years earlier. The trustee of the CRUT was also the taxpayer's personal financial advisor. When the taxpayer became dissatisfied with the performance of a particular investment product, she requested that the financial advisor liquidate her position and deposit the funds in her personal account. The financial advisor prepared the redemption notice, but the notice stated that the funds would be deposited in the account for the CRUT. The taxpayer did not catch the error and executed the notice. The funds were deposited in the account for the CRUT. The taxpayer did not take a charitable deduction because she believed that the funds were transferred to her personal account. The error went undiscovered for three years, during which time the assets were included on the CRUT's tax return and were used to calculate the annual unitrust distribution to the donor and her spouse. After the discovery, the donor successfully obtained a court order directing the return of the funds, reduced by the augmented distribution amounts received as a result of the CRUT's overvaluation and increased by the interest generated by the funds. The IRS held the property would be treated as if it had never been a part of the CRUT for tax purposes, and the court-ordered relief would not constitute an act of self-dealing or payment to a disqualified person, so long as there was an appropriate accounting for the misplaced funds through date of return and tax returns for the CRUT and the donor were amended to reflect the reallocated figures for all years.

### *IRS Refuses to Grant Foundation Five-Year Extension to Dispose of Excess Business Holdings, Private Letter Ruling 200552018*

Private foundations, as well as some charitable lead trusts, charitable remainder trusts and pooled income funds, are subject to the excess business holdings rule which imposes limits on business holdings unrelated to the charitable entity's tax-exempt purpose. (Generally the limit is a 20 percent voting interest in a business, aggregating the voting stock of disqualified persons, or a 35 percent voting interest, depending on the facts.) When the excess business holdings result from a gift or bequest, the Tax Code allows the entity up to five years to reduce holdings to permitted levels. If more time is needed, the Service can extend the period for five years if the entity has made a diligent effort to reduce the holdings; the sale has not been possible because of the size, complexity, or diversity of the holdings; and the extension request includes a reasonable plan to reduce holdings over the extension period. In these facts, a private foundation with excess business holdings waited until the expiration of the initial five-year period to seek an extension. While negotiating for an extension, the foundation received an offer to purchase the stock but turned it down, holding out for a higher price. In denying the extension request the IRS noted the foundation had not taken advantage of the sale opportunity and did not submit a plan for disposal. The foundation was given several months after the ruling date to bring the holdings into compliance.

### *Private School Tuition is Simply Not Deductible Even if a Percentage of the Education is Religious Instruction, Michael Sklar et. ux. v. Commissioner; 125 T.C. No 14, No. 395-01 (Dec. 21, 2005)*

In this long-running case stemming from a 1994 audit of the taxpayers' income tax return, the petitioners claimed a charitable deduction for 55 percent of the tuition paid to the private Jewish Orthodox day schools their children attended. The claim was predicated on two points: first, religious education is an intangible religious benefit that is deductible and exempt from substantiation under the Tax Code; second, the 1993 IRS settlement with the Church of Scientology allowed its members to deduct contributions for religious training and other practices, and this privilege should apply to all religions. The Tax Court denied the claim because the taxpayers' children received an education in exchange for the payments made and the payments made were not motivated by a charitable intent. The court also held that the settlement with the Church of Scientology would not be extended in this situation because the schools were not operated exclusively for religious purposes. The Court noted that the 1993 substantiation rules were not designed to change permissible deductions, but rather to address substantiation requirements. The taxpayers avoided an accuracy-related penalty since they had amended their 1991 and 1992 returns to claim the tuition deduction (receiving refunds), and had successfully claimed the tuition deduction on their 1993 return.

### **Advisors: Coming soon**

Look for a copy of *Healing Gifts*, the magazine of Advocate Charitable Foundation, in your mailbox soon. This free quarterly publication offers stories of how real people are affected by philanthropic gifts to Advocate Health Care. As you work with your clients, feel free to share these stories with them. To request additional copies or to register a client for a free subscription with no obligation, call 847.384.3400.

***The Rules are Important — IRS Denies Petition for Reformation Filed Three Months After Statutory Deadline, Private Letter Ruling 200548019***

A series of errors resulted in a denial of an estate's request for an extension of time to begin judicial proceedings to reform a testamentary charitable remainder trust. In these facts, the estate assets included a trust requiring reformation to qualify as a charitable remainder trust. The attorney hired to file the estate tax return failed to initiate judicial reform proceedings and filed the estate's Form 706 two and half months after its due date without requesting an extension. The first attorney was fired and a second retained. The new attorney initiated judicial reformation proceedings three months after the statutory deadline. (Generally, estate judicial reformation proceedings must be initiated no later than 90 days after the due date — including extensions — for the estate's tax return.) In a final error, the new attorney petitioned the IRS under a section providing relief for regulatory elections rather than for statutory elections. The IRS denied the request.

■ **Items of Interest to Planners**

***IRS Publishes 2006 Inflation Adjusted Figures for Taxes, Giving Limits, Mileage and Pooled Income Fund Assumed Rate, Rev. Proc. 2005-70, 2005-47 IRB 1 (inflation adjustments); Rev. Proc. 2005-78, 2005-51 IRB (mileage); Rev. Rul. 2006-4, 2006-2 IRB 1(new pooled income fund rate).***

The IRS has published the 2006 inflation-adjusted exclusions and exemptions for gifts and estate transfers, and posted the miscellaneous deduction limits applicable to individual taxpayers. Selected figures of interest to planners are set out below.

**Individual Income Tax**

"Kiddie tax" threshold (for children under age 14) before income is taxed at parent's rate	\$1,700
Standard deduction, married individual filing jointly/surviving spouse	\$10,300
Standard deduction, head of household	\$7,550
Standard deduction, unmarried individual (not surviving spouse or head of household)	\$5,150
Standard deduction, married individual filing separate return	\$5,150
Personal exemption	\$3,300
Gross income threshold for phase out of itemized deductions	\$150,500

**Gift, Estate and Generation Skipping Exclusion Amounts and Rates**

Annual exclusion for gifts under IRC § 2503	\$12,000
Annual non-domestic spouse gift limit	\$120,000
Lifetime gift tax exclusion amount	\$1,000,000
Estate generation-skipping exclusion amount	\$2,000,000
Estate tax exclusion amount	\$2,000,000
Highest tax rate for gifts, estates and generation skipping	46%

**Miscellaneous Charitable Rules**

Deemed rate of return for pooled income funds less than three years old	3.8%
Insubstantial benefit limits	\$8.60, \$43, \$86
Mileage rate for charitable work deduction (Hurricane Katrina, 32¢)	14¢

***American College of Trust and Estate Council Letter to IRS Commissioner Contains Excellent Analysis of Impact of New Charitable Remainder Trust Spousal Waiver Requirement, www.pgdc.com, News Stories (Jan. 9, 2006).***

Revenue Procedure 2005-24, effective March 30, 2005, was issued to ensure charitable remainder trust assets were used exclusively for charitable purposes. It requires that on creation of a charitable remainder trust, the donor's spouse execute an irrevocable, written waiver giving up the right to elect against the trust assets. Judith W. McCue, President of McDermot Will & Emery, LLP, submitted the comments of The American College of Trust and Estate Council which recommend Tax Code changes that achieve those goals in a more practical and effective manner. The letter is provided in full on the Planned Giving Design Center website (<http://www.pgdc.com/usa/item/?itemID=319768>) and contains an excellent analysis of potential problems and obligations for donors, trustees and charities.

The Disposition of Remains Act became effective January 1, 2006. 755 ILCS 65 (2006). The Act permits a person to designate an agent for disposition of remains. It also sets forth who makes decisions when no written designation has been made and who is liable for the reasonable cost of the disposition.

## ■ Legislative Developments

### *Charitable Reform Still Difficult to Predict; Tax Relief Act of 2005 (S. 2020) Latest Proposal in Congress*

2005 was a year in which Congress considered many issues affecting charitable planning. These included charitable incentives for donors, nonprofit regulatory reforms and the permanent elimination of the estate tax. Adding to options offered in legislation discussed in prior issues, the Senate on Nov. 18 passed the Tax Relief Act of 2005 containing a wide range of charitable giving incentives and nonprofit reforms. Although too numerous to detail, highlights include: the IRA charitable rollover; a non-itemizer's deduction with a \$210 floor (\$420 for joint return) with no cap (itemizers would be subject to the same \$210 floor); expanded conservation easement gift limits (raising adjusted gross income limits and extending the carry forward period); and deductions for artistic gifts contributed by the artist (limited to the artist's artistic adjusted gross income with no carry forward). Nonprofit reforms include: penalties on charities that participate in tax shelter transactions; excise taxes on certain life insurance transactions; increased excise taxes on private foundation prohibited transaction activities; distribution requirements for donor-advised funds; and substantial changes for supporting organization operation.

While it is difficult to predict what 2006 will bring, it is likely the House will first address budget reconciliation (which may contain one or more of the charitable revenue items) and will wait until later in the year (or perhaps 2007) to take on a substantial charitable agenda.

## ■ Charitable Planning in Practice

### *Planning Options for Charitable Remainder Trusts When Circumstances Change: Exit Strategies and Change in Form*

#### **Why Does Your Client Need an Exit Strategy?**

Charitable remainder trusts are irrevocable, yet a lot can happen in a lifetime. Donors may have a change in financial circumstances, personal circumstances (such as death, divorce or remarriage), investment challenges or charitable remainder needs. Are there options for donors who change their minds after a charitable remainder trust is established? Exit strategies exist, although results vary depending upon the nature of the intended change, state law and the degree to which the drafter anticipated and provided for the actions in the document. If you read the private letter rulings (PLRs) on this topic, you will find the IRS has approved a variety of strategies. The most commonly requested strategies — and supporting PLRs — are summarized below. Although PLRs are not law, they do provide insights into the position that the IRS may take upon certain set of facts.

#### **Commonly Approved Strategies**

1. A partial termination of the charitable remainder trust with gift of the unitrust/annuity interest to the charity. See PLRs 9550026, 200310024.
2. A total early termination of the trust. See PLRs 200543061, 200548023, 200441024, 200124010, and 200208039.
3. A sale of the income interest at its present value to the charitable remainderman. See PLR 200552015.
4. A division of the trust into two trusts because of divorce. See PLRs 200502037, 200539008, 200340022, 200333013, 200221042.
5. A division of the trust into multiple trusts for non-divorce purposes. See PLR 200524013.
6. A division of the trust into multiple trusts to facilitate an acceleration/termination of one trust to the charity. See PLRs 200525008, 200140027.
7. A sale of unitrust/annuity beneficiary's interest to the charitable remainder beneficiary to generate cash (no gift). See PLRs 200552015, 200127023.
8. An exchange of unitrust/annuity income interest for charitable gift annuity. See PLR 200152018.

#### **Charitable mid-term federal rates**

The charitable mid-term federal rates under IRC § 7520 for gifts made in February 2006 are set out below. These rates are used to determine the present value of an annuity, an interest for a life or term of years or a remainder or reversionary interest. Call any member of the Gift Planning team if you need assistance with your calculations.

<b>February 2006</b>	<b>5.2%</b>
<b>January 2006</b>	<b>5.4%</b>
<b>December 2005</b>	<b>5.4%</b>

#### **The Checklist**

Once you determine your client's goals, use this checklist to select the best approach.

- Check the trust document for authority or language that might enable or prohibit the transaction. (Consider drafting for these possibilities in future documents.)

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## Charitable giving in practice *Continued from page 3*

- Check state law. Some state laws allow early termination of a trust when all parties agree. Some require a trust division before making a partial assignment of income. Make sure what you propose to do is permissible.
- For terminations involving a gift to charity, make sure the transaction is structured to allow the donor both an income and gift tax deduction. The donor should also be aware of the income tax consequences. (The released income interest is considered a capital asset with zero basis.)
- On termination, ensure the released, severed or sold interest is calculated using the IRS methodology and current discount rates. It is important to document that no known factors exist to shorten the income beneficiary's normal life expectancy.
- When a single trust is divided into multiple trusts, the allocation of assets and accumulated income should be made on pro rata fashion between the trusts.
- Court action, notice to the state's Attorney General and/or other notices may be required under state law, depending upon the action taken.
- Concerns about self-dealing, disqualification of the charitable remainder trust or imposition of a termination tax may require a private letter.

### Contact information

For assistance in structuring gifts to Advocate Health Care hospitals, sites and programs, contact the Office of Gift Planning at Advocate Charitable Foundation.

Elizabeth B. Roghair, CPA  
Vice President of Gift Planning and  
Senior Philanthropic Advisor  
847.384.3435


Marilyn B. Schaffer, CAP<sup>TM</sup>  
Director of Gift Planning  
847.384.3424

Don Gottesman, JD, LLM  
Manager of Gift Planning  
847.384.3418

Also, visit our Web site at  
[www.advocatehealth.planyourgift.org/](http://www.advocatehealth.planyourgift.org/)

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 Advocate Charitable Foundation  
Office of Planned Giving  
205 West Touhy Avenue, Suite 225  
Park Ridge, Illinois 60068-4201  
847.384.3428  
[www.advocatehealth.org/foundation](http://www.advocatehealth.org/foundation)