Tax Service Update

AUGUST 2010

COURT REJECTS WILL REFORMATION ATTEMPT

Testator's intent, ten-year delay major stumbling blocks.

William Bruinsma was a frugal man who was "extremely private" about the value of his estate. He declined to discuss his assets when he met with an attorney to draft a will. Bruinsma explained that he wanted to keep legal costs to a minimum. Based on this information, and the fact that Bruinsma lived in subsidized senior housing, the attorney assumed his estate would not be subject to tax. He drafted a simple two page will that provided for one-half the income from his securities and bank accounts to pass to Bruinsma's sister and the other half to a friend, for their lives. The assets were then to pass in equal shares to the American Cancer Society and the American Heart Association.

At his death in 1998, Bruinsma left an estate of $1.7 million. In 2008, the executor of Bruinsma's estate asked the court to reform the will to create a charitable remainder annuity trust. The attorney indicated that if he had been aware of the size of the estate, he would have drafted a will that would have qualified as a remainder trust. If the will is not reformed, the executor noted that the estate will owe state and federal estate taxes of nearly $467,000, meaning less for the charitable beneficiaries. Bruinsma's friends said that he would not have wanted his life's savings to be used for taxes.

The Supreme Judicial Court of Massachusetts took the case on direct appellate review. Under state law, the court may reform a trust where, due to a mistake, it fails to conform to the testator's intent. The court said that it had previously reformed a charitable remainder trust to comply with IRS requirements for charitable remainder unitrusts and had permitted the reformation of a trust that would qualify as a charitable remainder annuity trust. However, this matter involved a will, not a trust. A will can be reformed to clarify an ambiguity, but the court found none, adding that there was no indication of a mistake on the part of the drafting attorney. Nowhere in the will is it mentioned that Bruinsma was concerned about the possible tax consequences of his bequests. It is possible, said the court, that Bruinsma did not want to disclose the value of his assets because it could jeopardize his subsidized housing. Further, added the court, while the charitable remaindermen would benefit by a reformation, so too would the income beneficiaries. The court estimated that the income distributions received by the beneficiaries thus far were far less than what they would have received under the minimum 5% annuity trust payout. There is nothing to sug-

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gest that Bruinsma intended them to receive that much, or that he would have wanted them to receive an annuity trust interest, rather than a unitrust interest.

Finally, the court noted that even if a retroactive reformation were allowed, it's questionable whether the IRS would recognize it for estate tax purposes, coming a decade after Bruinsma's death (*Pellegrini v. Breitenbach*, SJC-10458).

ATTEMPT TO DIVIDE AND CONQUER REJECTED

Splitting trust and communting half contrary to purpose of settlor's trust.

Miller Cosby's will directed that all stocks, bonds and other securities be used to fund a charitable remainder unitrust, naming four individuals to receive the 6% income payments. At the death of the survivor, trust assets were to pass in equal shares to the Upper Caroline Volunteer Fire Department and the Ladysmith Volunteer Rescue Squad for their general purposes. The will included a spendthrift clause to protect the income interests from the claims of creditors and prevent the beneficiaries from encumbering or controlling their shares.

After Cosby died in 2004, his estate was embroiled in lengthy litigation regarding the payment of taxes and abatement of bequests. By April 2009, only two of the four income beneficiaries were still alive and the value of the trust corpus was between $5 and $6 million. The surviving income beneficiaries and the Upper Caroline Fire Department asked the court to direct that the trust be split into two equal trusts for the two charities. The parties also asked the court to allow the trustees to commute and terminate the Upper Caroline trust, paying the actuarial value of the interests outright to the parties. The Ladysmith trust would continue as provided under the terms of Cosby's will.

The Upper Caroline Department and income beneficiaries pointed to state law giving the court the power to combine two or more trusts into a single trust or divide a trust if the result does not materially impair the right of any beneficiary or adversely affect the achievement of the purposes of the trust. State law also allows the termination of a trust if, because of circumstances not anticipated by the settlor, the termination will further the purposes of the trust. The Upper Caroline Department and income beneficiaries indicated that the "unanticipated circumstance" was that the beneficiaries wanted to eliminate risk and handle their own funds. The Ladysmith Squad appealed the circuit court's order, arguing that division and commutation of the trust violated Cosby's explicitly stated intent.

The Court of Appeals of Virginia noted that Cosby's will gave the trustees the authority to amend the will "for the sole purpose of ensuring that this trust qualifies and continues to qualify as a charitable remainder unitrust." The court found no showing that the trust would have failed to qualify if it were not split into two trusts. The income beneficiaries and Upper Caroline Department claimed that the Ladysmith Squad had no pecuniary interest in the trust and therefore lacked standing to object to the commutation. The court said the lack of standing was premised solely on the validity of the circuit court's order to divide the trust. The division "was merely a device" to achieve the commutation of a portion of the trust, since the Ladysmith Squad's approval would no longer be required, said the court. The Ladysmith Squad

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was “the only party expressing a desire to defend the settlor’s intent.”

The court noted that although state law permits a court to divide and commute trusts, the “express terms of the trust prevail” over the state law provisions. The settlor’s intent prevails over the desires of the beneficiaries. That intent is to be ascertained by the language used by the testator, said the court, adding that state law does not allow the court to defeat the terms of a will that postpones the interests of the beneficiaries simply because they “would rather have their money today than wait.” The income beneficiaries and the Upper Caroline Department have not shown that trust assets have been mismanaged, that the trust is no longer economical or that its objectives have become unattainable. The circuit court had authority to modify or terminate the trust only upon a showing that circumstances not anticipated by Cosby existed and only where such modification or termination will further the purposes of the trust. The income beneficiaries and Upper Caroline Department argued that Cosby could not have foreseen that the beneficiaries would “rather have their money today” and would resort to expensive litigation.

The appeals court said the circuit court’s ruling would not further the purposes of Cosby’s trust, noting that Cosby wanted the most favorable treatment for estate tax purposes and to provide a stream of income to named individuals in a manner that shielded the beneficiaries from creditors. Because the circuit court erred in dividing the trust, the Ladysmith Squad has standing to object to the division. The matter was remanded with orders to deny the motions to divide the trust and commute the Upper Caroline Department’s portion of the trust (*Ladysmith Rescue Squad, Inc. v. Newlin*, Record No. 091388).

INCOME BENEFICIARIES BECOME OUTRIGHT RECIPIENTS AFTER 99 YEARS

Court applies cy pres doctrine where trust lacks remainder language.

Joseph Cannon’s will left the residue of his estate to his wife and three children. His wife’s share was to be paid to her immediately, but the children were to receive their shares as each turned age 28. He also directed that 300 shares of stock be held in trust, with the income paid to his longtime secretary, Clara Gillon, for life. At her death, the 300 shares were to revert to the heirs of Cannon’s estate. Another provision directed that Cannon’s shares of bank stock be held in trust for 99 years. Income from the shares was to be paid annually to 10 charities, with instructions that the funds be used to provide “happiness and cheer at Christmas Time” to those served by the organizations.

Cannon died in 1939. Although the Christmas trust will not terminate until 2038, the trustee filed a motion in 2008 to ascertain remainder beneficiaries. The trustee asked the court to declare that the same charities receiving income will be entitled to the remainder. The trial court found that under state (North Carolina) law, the court could apply the cy pres doctrine to modify the trust in a manner consistent with

Cannon's charitable purposes. The lack of specific instructions regarding the remainder does not cause the trust to fail and the assets of the Christmas trust to revert to Cannon's residuary beneficiaries, said the court. A nephew by marriage of Cannon's daughter objected to the ruling, claiming that the remainder should pass to the residuary beneficiaries of Cannon's estate.

The Court of Appeals of North Carolina agreed with the trial court, noting that Cannon clearly expected his children to outlive his secretary, Clara Gillon, and provided for that trust to revert to his residuary beneficiaries. However, he did not expect any family members to be alive at the end of the 99-year term of the Christmas trust to derive any benefit from the remaining corpus. He could have, but did not choose to, use the same reversionary language in the Christmas trust that was used in the Gillon trust, indicating that he did not intend for the corpus to pass to the residuary beneficiaries. He must have intended for the charities to receive guaranteed income for 99 years, with any remaining corpus to be distributed to the same organizations that were receiving income, ruled the court (*First Charter Bank v. American Children's Home*, No. COA09-1232).

WHEN THE DANCING STOPPED, SO DID THE MONEY

Endowment funds not available to pay bills of defunct organization.

Thomas Revis and several other trustees of the Ohio Chamber Ballet (OCB) filed suit seeking the release of endowment funds to pay OCB's bills. The organization had ceased operations sometime prior to the suit. The Akron Community Foundation, the John S. and John L. Knight Foundation and GAR Foundation moved to intervene, saying that OCB's assets consisted of restricted endowment funds that Knight and GAR had contributed and the Community Foundation administered. The Court of Common Pleas ruled that the endowment funds were not assets of OCB and ordered that the funds remain with the Community Foundation for use in accordance with the foundations' charitable purposes.

Revis appealed, claiming the court erred in its interpretation of the endowment agreements. He argued that OCB should be able to use endowment income to pay debts, since the agreements are unambiguous and do not restrict OCB from using the income from the funds to pay bills, debts or obligations. Revis agreed that the endowment funds would revert to Akron Community Foundation if OCB stopped operating and became a defunct organization, but said OCB's continued operation "does not depend upon its production of ballet performances." Nothing in the endowment agreements prevents OCB from continuing to operate indefinitely, "for the sole purpose of collecting endowment income distributions" and applying them to paying debts, Revis claimed. He acknowledged that both the Knight and GAR gifts are contingent on OCB continuing to operate "in furtherance of its charitable purposes."

The Court of Appeals of Ohio noted that OCB ceased operations in the summer of 2006 and its articles of incorporation were cancelled by the Secretary of State in February 2007. Paying the debts of a defunct organization does not mean that it is carrying out its once stated charitable purpose, said the court. Because both the

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Knight and GAR gifts depended on OCB's continued operation in furtherance of it charitable purposes, the trial court did not err in ruling that it should not be able to use endowment income to pay debts (*Revis v. Ohio Chamber Ballet*, 2010 Ohio 2201).

TRUSTS FUNDS REMAIN COMMUNITY PROPERTY

Court had jurisdiction to value survivorship interest in charitable remainder trust.

Alicia and Christopher Lancashire funded a charitable remainder unitrust in 1997, using 240,000 shares of a company the two had founded. The trust was created just prior to a sale of the company. The shares represented community property under California law. The trust calls for each spouse to receive a 4% unitrust amount for life, with the survivor receiving the deceased spouse's 4% share for life.

Alicia filed for divorce in 2006. Christopher asked that the survivorship benefit be evaluated and allocated to Alicia, with an offsetting payment to him. Alternatively, he asked that the unitrust be divided into two separate trusts, but withdrew this option when the court sustained Alicia's objection to the expert's testimony. Alicia argued that community property transferred into an irrevocable trust is no longer community property and the trial court therefore had no jurisdiction over the unitrust.

Christopher's expert testified that the value of the survivor benefit was $3,830,427 – one half the total $7,660,854 value of the entire 8% income stream. Alicia's expert said the gross value of the 4% survivor's benefit was $3,467,571, but after adjustments for income and estate taxes, the adjusted value of the survivor's benefit was $600,464. The trial court found the survivor's benefit to be community property and placed the value at $3,467,571. The court did not adjust the value for taxes or the possibility that Alicia might predecease Christopher, saying the taxes were neither immediate nor specific. The court ordered Alicia to pay Christopher $3,467,571 for the buy-out of his interest or ruled that the amount, with interest, could be deducted from Alicia's share of the sale of the family residences.

The Court of Appeals of California rejected Alicia's argument that the trial court had no jurisdiction over the trust assets because they were not community property. Where the trust settlors are also the beneficiaries, "the most reasonable conclusion is that they simply retained whatever interest they did not transfer to the trustee," said the court. The beneficial interests they transferred to the trust continued to be community property. Although some settlors of irrevocable trusts retain no ownership interest, that is not the case here, noted the court.

The court also refused to offset Alicia's survivorship benefit to account for income taxes, saying that over her lifetime she might be able to shelter some of her income, the tax rates may change or her income may change. The same was true with estate taxes, since both parties are still living and no one knows what the estate tax will be – or even if there will be an estate tax – when one of the spouses dies. The trial court did not err in refusing to reduce the value of Alicia's interest by an amount that takes into account the possibility that she might predecease Christopher. It was reasonable to conclude, said the court, that Alicia will outlive Christopher, who is 17 years her senior (*In re Marriage of Lancashire*, No. B209599).

NEWSPAPER GETS ACCESS TO RECORDS, BUT WITHOUT DONOR NAMES

Foundation's activities on behalf of state university subject to state's open records rules.

The Pocono Record newspaper made a request under Pennsylvania's Right-to-Know Law for a list of donors to East Stroudsburg University's Science and Technology Center, including the amounts of their pledges, payments and outstanding balance. The paper also sought to inspect donor files and asked for copies of the minutes of the Foundation's board of directors meetings from 2005 through 2007. The request noted that while the records were held by the Foundation, "they reflected decisions and actions authorized and carried out by employees of the University who were public employees."

The Foundation denied the request, saying it had an independent contractor relationship with the University and was not performing essential government functions under state law. *The Record* appealed, arguing that the management and distribution of scholarships to University students, along with the University's mission to provide an education at the lowest possible cost, made the records public under state law. The state's Office of Open Records (OOR) held that the Foundation's board meetings were not public meeting and the minutes were, therefore, not public records. However, the Foundation was required to provide the amounts of pledges, payments and the dates made and outstanding balances, although information related to specific donors was exempt if disclosure would reveal their identity. Both the Foundation and *The Record* appealed.

The Commonwealth Court of Pennsylvania found that the Foundation, under a memorandum of understanding with the University, carries out fundraising on behalf of the school. Raising and disbursing funds is a governmental function that the Foundation is performing on behalf of the University, said the court. Therefore, any portion of meeting minutes related to the management of funds constitute a public record to which *The Record* is entitled access. The court said the OOR properly ruled that *The Record* could review and copy the Foundation's list of donors, although names and financial information could be redacted (*East Stroudsburg University Foundation v. Office of Open Records*, No. 886 C.D. 2009).

OUTRIGHT DISTRIBUTION, TRUST, RESOLVE AMBIGUITY

As reformed, charity's interest will qualify for estate tax deduction, IRS rules.

Charlie directed that a portion of his estate be "set apart," to pay a specified monthly amount to Angela and Ben. The trustee was to use the residue of the estate to construct several buildings for the town that Charlie lived in, with the balance of the funds to be used for upkeep and maintenance of the buildings. If the town declined the gift, several other charities were to receive the funds.

The executor of Charlie's estate asked the court to resolve an ambiguity about how to set apart a portion of Charlie's estate to make the payments to Angela and Ben

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while also establishing the trust in a timely manner with the residue of the estate. The court determined that Charlie intended to establish a charitable trust from the residuary estate and that there was an ambiguity regarding the trust and the legacies to Angela and Ben. The court also found that Charlie wanted the trust to qualify for the estate tax charitable deduction.

The court ordered that Angela and Ben be paid amounts outright in full satisfaction of the bequests in Charlie's estate. They would receive the actuarial value of their interests, using the §7520 rate from the date of Charlie's death. The balance of the estate would be used to fund the trust. The IRS ruled that the court's order would satisfy the requirements of Code §2055 and that the value of the trust would qualify for the estate tax charitable deduction (Ltr. Rul. 201022001).

SPREADING SEEDS NOT CHARITABLE

Class of potential beneficiaries not sufficiently large to benefit the community.

William Naylor and his father are the board members and officers of Free Fertility Foundation. The younger Naylor entered into a contract with a sperm bank in 2001 to store and distribute his sperm to recipients of his choice. Naylor pays an annual storage fee and has the right to select recipients. He established the foundation in 2003 to provide sperm free of charge to women seeking to become pregnant through artificial insemination or in vitro fertilization.

The foundation says that it is operated exclusively for the charitable purpose of promoting health. On the foundation's web site, Naylor says that being a sperm donor is a way to help a few people who otherwise could not have children. Women seeking to receive sperm must complete an application created by the Naylors, with preference given to women with "better education," no divorce, domestic violence or "difficult fertility histories," who are from families with "a track record of contributing to their communities," in "traditional marriage situation," under age 37, "ethnic minorities" and from areas where the foundation has not previously accepted recipients.

The IRS denied the foundation's request for exempt status, saying the organization was not operated exclusively for exempt purposes and its operations did not promote health or serve a charitable purpose. Naylor turned to the Tax Court for a declaratory judgment that the foundation meets the requirements of Code §501(c)(3).

The court agreed with the IRS, noting that in 2004 and 2005, the foundation received 819 inquiries and supplied sperm to only 24 women. While the promotion of health for the benefit of the community is a charitable purpose, the class of beneficiaries must be sufficiently large to benefit the community as a whole [*Sound Health Association v. Comm'r*., 71 T.C. 158]. Providing sperm for free may, "under appropriate circumstances" be charitable, said the court, but the class of beneficiaries is not sufficiently large to benefit the community as a whole. Naylor argued that the potential class of beneficiaries includes all women of child-bearing age, but the court noted that the class is limited to only those women who are interested in having Naylor be the biological father of their children and "who survive the very subjective,

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and possibly arbitrary, selection process controlled by the Naylors." The court added that while the foundation's activities may "promote the propagation of Naylor's seed and population growth," they do not promote health for the community's benefit (*Free Fertility Foundation v. Comm'r*., 135 T.C. No. 2).

REBATE ACKNOWLEDGMENT FOUND DEFICIENT

Election to have funds go to charity is a contribution, but letter lacks date of transfers.

Nick and Nora are applying for a credit card that offers a rebate based on the value of purchases made. They will have the option to receive the cash back, or to have the amount paid to a charity they choose from a list of participating organizations. The option to have the rebates paid to charity is made at the time they open the credit card account, but can be changed at any time by notifying the company.

The couple will receive a written acknowledgment in the form of a letter with the charity's name, address and date of the letter, stating:

Dear Contributor:

*This letter is to acknowledge your contribution made to the ****, an organization described in section 501(c)(3) of the Internal Revenue Code and qualified to receive contributions deductible for federal income tax purposes, provided the contribution is made exclusively for charitable purposes.*

*We appreciate your contribution of $***** made in calendar year ***** and wish to confirm for you that no goods or services were provided to you in consideration, in whole or in part, for your contribution.*

The IRS ruled that Nick and Nora will not have to include the amount of the rebate in their gross income, since it constitutes an adjustment to the purchase price (Rev. Rul. 76-96, 1976-1 C.B. 23, as modified by Rev. Rul. 2005-28, 2005-1 C.B. 997). They will also be considered to have made a charitable contribution on the date the company remits the rebate payment to the charity.

However, the sample acknowledgment does not meet the recordkeeping requirements of Code §170(f)(17), which requires the date of the contribution, not merely the calendar year of the gift. The IRS ruled that the sample acknowledgment will not satisfy the requirement if it does not include the date the company remits the payments to the charity (Ltr. Rul. 201027015).

DONOR "GUESSES" $29,000, COURT SAYS ZERO

No substantiation for cash or noncash gifts.

Edmund Roberts claimed a charitable deduction of nearly $29,000 on his 2005 income tax return, which was filed more than 13 months late. The claimed contributions included $200 for cash given to panhandlers and The Salvation Army, and $28,655 in noncash gifts, primarily consisting of used clothes, towels, bed sheets, books, costume jewelry, children's toys and glass lamps. Roberts provided copies

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of five receipts from Goodwill Industries, only one of which bore a signature indicating the items received were clothing. The IRS disallowed the deduction, saying Roberts had failed to substantiate the items claimed as charitable contributions.

The Tax Court noted that for cash gifts of less than $250 made prior to August 18, 2006, the donor could substantiate the gifts with a canceled check, receipt or other reliable evidence showing the name of the donee, date of the gift and amount of the contribution [Reg. §1.170A-13(a)(1)]. Roberts offered only "self-serving testimony" of his gifts, said the court, which agreed with the IRS's denial of a deduction.

For noncash gifts, the taxpayer must have a receipt from the donee showing the organization's name, date and location of the gift and a description of the property in reasonable detail [Reg. §1.170A-13(b)(1)]. Where the value of the deduction exceeds $5,000, the taxpayer must obtain a qualified appraisal, attach a fully completed appraisal summary to the tax return and maintain records with the name and address of the organization, date and location of the contribution, description of the property and the fair market value at the time the gift is made, including the method used to determine fair market value [Reg. §1.170A-13(c)(2)]. Roberts indicated that the determination of fair market value was "an estimate." The court said that Roberts was not entitled to a deduction because he failed to properly substantiate the gifts (*Roberts v. Comm'r.*, T.C. Summ. Op. 2010-76).

ESTATE ESCAPES TAX ON IRAs

Trustee had power to allocate estate assets to Foundation.

Marilyn was the death beneficiary of an IRA owned by Harold. At his death, she converted it to an inherited IRA, but did not designate a beneficiary. She also had an IRA of her own with no named beneficiary. Marilyn's will directed that residuary probate assets should be added to a trust. Geraldine was to receive a specified amount from the trust, with the balance to be distributed to a foundation. The trustee has the authority to distribute income and principal in cash or in kind and to allocate or distribute different assets or disproportionate assets.

Marilyn's estate was the default beneficiary of her IRA. The trustee and estate propose to fund the residuary bequest by assigning Harold's and Marilyn's IRA in satisfaction of the foundation's share. The trust has sufficient assets to satisfy Geraldine's specific bequest without using funds in the IRAs.

Under Code §691(a)(2), if a right to receive an amount is transferred by the estate of the decedent, the gross income of the estate includes the amount by which any consideration for the transfer exceeds the fair market value. The term "transfer" includes a sale, exchange or other disposition, but does not include a transfer at death pursuant to the right of the beneficiary to receive the amount by reason of the decedent's death. Under Rev. Rul. 92-47, 1992-1 C.B. 198, a distribution to the beneficiary of an IRA is income in respect of a decedent [Code §691(a)(1)], includible in the gross income of the beneficiary. The IRS ruled that the assignment of the IRAs to the foundation in satisfaction of its share of the residue of the estate and trust will not be an assignment within the meaning of Code §691(a)(2), and only

the foundation will include the IRD in gross income when the distribution is received by the foundation (Ltr. Rul. 201027031).

Editor's Note:

After December 2010, the *Charitable Giving Tax Service* will no longer be published and sent to you every two months. Subscriptions can be converted to R&R Newkirk's online service at no additional charge. However, for those who prefer to maintain their four-volume service, we will be offering PDFs of the replacement pages every few weeks. The pages will be replaced as new developments occur, not just once every two months. For those who wish to receive the pages in PDF format, which can be printed and inserted into the binders, please provide us with your name and the e-mail address to which you want the pages sent. You can still access the electronic version.

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