Gift Planning Now

A Newsletter for Berkeley's Donor Advisors

Fall 2012

Never Too Young for Philanthropy

Funds in an IRA generally can't be withdrawn without penalty until age 59 1/2; Social Security usually doesn't begin until age 62; even membership in AARP is limited to those age 50 and older. But there is no minimum age for philanthropy. True, charitable deductions are larger for charitable remainder trusts and other deferred gifts when beneficiaries are older, but there are several situations where charitable gifts in trust can work well for younger individuals.

Retirement planning

Many wage earners in the 33% or 35% federal tax brackets are frustrated by their inability to shelter as much income in qualified retirement plans as they would like. These individuals can defer more income until their retirement years while claiming a partial deduction now, through the use of a net-income with makeup charitable remainder unitrust [Reg. §1.664-2(a)(1)].

A 45-year-old donor might fund a 5% net-income with makeup unitrust with $25,000 annually and take charitable deductions ($5,371 in the first year, assuming quarterly payments and a §7520 rate of 1.2%). The trustee invests primarily in an equity oriented portfolio that produces little income. Each year that the donor does not receive 5% of the trust's annual fair market value, a deficiency accrues. In 20 years, when the donor is ready to retire, the trustee sells some of the equity holdings (with no loss to capital gains tax), invests in high-yield securities, and begins making up deficiencies from prior years.

Advantages of a "retirement" unitrust over other retirement plans:

- the unitrust may be established in addition to the donor's IRAs or other qualified plans;
- there is no minimum or maximum contribution;

(continued on page 2)

Bears Bring Home 17 Medals from London – 11 Gold

All told, the Bears earned 17 medals, matching their record haul from the 2008 Summer Olympics in Beijing. Eleven of the medals were gold, one silver, and five bronze. If UC Berkeley were its own country, it would be sixth in the world for the number of gold medals it earned, tying with France and Germany. Over the last three Olympiads, UC Berkeley athletes have won a total of 50 medals, with 16 in 2004 and 17 in both 2008 and 2012. In history, the Bears now have 99 gold medals and 178 overall. Although a majority of the London medalists are alumni, four are current students —swimmers Rachel Bootsma and Caitlin Leverenz, rower Kara Kohler, and water polo's Aleksa Saponjic.

Never Too Young . . . *(continued from page 1)*

- deductions increase as the donor gets older;
- there is no penalty if the donor begins receiving income prior to age 59 1/2, and no minimum payment requirements after age 70 1/2;
- the donor may contribute appreciated securities and avoid capital gains tax;

Tax Planning Pointer

Corporations, not just individuals, can establish charitable remainder trusts and receive the trust income, so long as the trust lasts for a term of no more than 20 years [Reg. §§1.664-2(a)(5)(i), 1.664-3(a)(5)(i)]. Are such gifts practical? Consider this scenario: ABC Corporation owns long-term capital gain property (undeveloped land) worth $750,000, with a basis of $150,000. To satisfy charitable commitments, the corporation transfers the property to a charitable remainder annuity trust, retaining a 5% annuity for a term of 20 years. The trust immediately sells the land for its fair market value and no tax on the appreciation is due at the time of the sale. The corporation receives an income tax charitable deduction of $86,726 (assuming annual payments and the use of a 1.2% §7520 rate), which is deductible up to 10% of its taxable income, with a five-year carryover for any excess deduction. The corporation begins receiving a 5% annuity from the trust – going from zero income to $37,500 a year. Charity gets the trust corpus after 20 years, and the corporation receives $750,000 during the trust term.

Family support

Many younger individuals are providing financial assistance to parents or grandparents. In most cases these funds come from after-tax dollars, so a client in the 35% tax bracket who sends $1,000 a month to a parent has to earn nearly $18,500 to pay the taxes and make the $12,000 gift.

Instead, the donor could create a charitable remainder trust that pays the parent the $12,000. The donor receives a charitable deduction for the value of the remainder, based on the parent's age and trust payout. The gift to the parent is a present interest that qualifies for the $13,000 annual exclusion.

College expenses

Charitable remainder trusts can also assist a child about to enter college. A parent can create a term-of-years charitable remainder trust that pays the child income during college and until the child is established in a career – ten years, for example. A charitable deduction is available, and the trust can be funded with appreciated securities for even greater tax savings.

Prime Time for Charitable Lead Trusts

Circumstances are more favorable now than ever for creating charitable lead trusts. Current low interest rates combined with historically high lifetime gift and estate tax exemptions provide the perfect environment for using lead trusts to transfer wealth to descendants while also accomplishing philanthropic goals. The §7520 rate used to calculate charitable deductions for split-interest gifts including charitable lead trusts sank to an all-time low of 1% in August and September. Lower §7520 rates mean higher deductions for charitable lead trusts. In addition, the all-time high gift tax lifetime exemption of $5.12 million (which may expire at the end of 2012) provides a particularly good opportunity to create a charitable lead trust now to transfer wealth at little or no out-of-pocket transfer tax cost.

Consider a father with substantial assets including a $10 million portfolio of securities that he plans to eventually leave to his children. His tax advisor has recommended that he fund a charitable lead trust prior to year's end that will allow him to make significant charitable gifts while also taking advantage of the $5.12 million gift tax lifetime exemption. The advisor shows him the tax and financial advantages of acting now, using a charitable lead trust paying charity $500,000 annually (5%) for ten years (assuming quarterly payments to charity and the use of a 1% §7520 rate): gift tax charitable deduction, $4,753,172; taxable transfer to family, $5,246,828.

The advisor explains that the combination of the gift-tax charitable deduction and the $5.12 million gift tax exemption would minimize any transfer taxes almost to zero. He could "zero out" transfer taxes by extending the trust to 11 years, which boosts the charitable deduction to

$5,202,980. By making the gift now, rather than leaving the assets to the children at his death, the father removes all future growth in the portfolio from his gross estate, saving estate taxes. In addition, assuming the portfolio earns a 6% return, he reduces his current income by $600,000 annually, saving income taxes. And, finally, over the term of the lead trust, his favorite charities will receive $5 million to support important programs. When the trust ends in ten years, the assets pass to the children free of further gift tax, no matter how much the securities have appreciated.

Lesson Learned the Hard Way

Joseph and Shirley Mohamed claimed a charitable deduction in 2003 for the value of several parcels of real property contributed to their charitable remainder unitrust. Although they included a Form 8283 with their return, they did not hire an independent appraiser. Instead, Joseph, a real estate broker and certified appraiser, determined the value of the property and purposely deducted a lower value to avoid the risk of an overvaluation. They made an additional donation of land to the trust in 2004.

The IRS initially challenged the valuation of the properties, but later asserted that the couple was not entitled to any deduction whatsoever because they failed to substantiate the gifts as required under Reg. §1.170A-13.

The Tax Court agreed with the IRS, noting that the couple's Form 8283 lacked certain required information and that Joseph was not a qualified appraiser for these gifts. An appraisal obtained after the IRS audit began was deemed not timely. The court acknowledged that the taxpayers' deductions actually understated the value of the gifts.

The Mohameds called the IRS's actions "arbitrary and capricious," noting that taxpayers who follow the procedures but overvalue their gifts are entitled to keep some of the deductions, while the deduction is disallowed entirely for a taxpayer who accurately values the gift but fails to follow the procedures.

The court said that the verification rules serve a valuable governmental purpose of preventing tax evasion, adding that a qualified appraisal is an "essential requirement" for a deduction. The court admitted the result was "harsh," but concluded that it could not allow "a single sympathetic case" to undermine the substantiation rules. *Mohamed v. Commissioner, T.C. Memo. 2012-152.*

Did You Know...

- Berkeley is welcoming roughly 3,000 new graduate students this year including 80 National Science Foundation Graduate Research Fellows, 16 Fulbright Scholars, and 22 former Peace Corps volunteers.

- Berkeley's graduate admissions are very competitive with only 14% of applicants receiving offers, down from 17.9% in 2007. For doctoral applicants, the admissions rate is 11.1%.

- Because Berkeley graduate students report being admitted to an average of three schools, the expected yield on our offers of admission should be 33%. In 2012, our yield was 52% – more than half of admitted applicants chose Berkeley over other offers.

- Where are our graduate students from? 33% are from California, 39% are from other U.S. states, and 28% are international.

Stairstep Lead Trust Payments Allowed

The trustees of a testamentary ten-year charitable lead annuity trust asked the IRS whether the formula contained in the trust could be construed to permit payments that increased each year. The trustees indicated that it would be difficult to make the payments over the trust term using a straight-line annuity. Instead, they proposed to make each year's payment 120% of the prior year's payment. The charitable income beneficiary would receive more under the variable ascending annuity method than it would as a straight annuity.

The IRS ruled that the trust constituted a guaranteed lead annuity trust interest under Code §2055(e)(2) for which the testator's estate was entitled to a charitable deduction. The formula contained in the trust, which was designed to zero out the noncharitable remainder interest, contained an ambiguity, the IRS found. The variable ascending annuity payments approved by the probate court resolved the ambiguity and will be treated as the settlement of a bona fide will contest. The trust will not violate any of the private foundation rules under Code §§4941 - 4945. **Letter Ruling 201216045.**

Substantiation Missing "Magic Words"

David and Veronda Durden claimed charitable contributions of $25,171 in 2007, most of which consisted of checks written to their church in amounts exceeding $250. In response to an IRS notice of deficiency, the couple produced their canceled checks and a letter from the church, dated January 10, 2008, acknowledging the contributions during 2007. The IRS did not accept the letter, noting that it lacked the statement regarding whether any goods or services were received in return for the payments [Code §170(f)(8)(B)].

The Durdens obtained another letter from the church with the required statement, dated June 21, 2009. The IRS rejected this letter, saying it was not contemporaneous. Under Code §170(f)(8)(C) and Reg. §1.170A-13(f)(3), a written acknowledgment is contemporaneous if it is obtained by the taxpayer before the earlier of the date the tax return is filed for the year of the gift or the due date, including extensions, for filing the original return.

The Durdens argued that while they did not strictly comply with the statute, they had substantially complied, since the first letter was sufficient to enable a determination of the contribution amounts because their gifts were made in cash, not in property that had to be valued. The Tax Court disagreed, saying that substantial compliance was not sufficient when the express terms of the statute require the statement regarding goods and services. It's impossible to tell, said the court, whether the couple's payments were for meals or other goods or services provided by the church. The Durdens claimed that the lack of a statement was sufficient to indicate that no goods or services were provided, but the court said that the statutes require an affirmative statement to that effect (*Durden v. Comm'r.*, T.C. Memo. 2012-140).

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