Adding Charity to the Marital Deduction

Combining the marital deduction [Internal Revenue Code §2056] and the charitable deduction [Code §2055] makes it possible to avoid all estate taxes at the death of the first spouse, and to reduce estate taxes at the death of the surviving spouse. Often a couple’s goal is to assure the survivor a comfortable lifestyle while anticipating ways to minimize estate taxes at the second death. Several options can accomplish both these goals while providing significant support for favorite charities.

Qualified terminable interest property (QTIP) trust

A QTIP trust [Code §2056(b)(7)] is often used by spouses with children from previous marriages, but it can also be used to pass assets to charity after the death of the surviving spouse. The surviving spouse receives all income from the trust, paid at least annually. The trust also can permit principal distributions to the survivor. The entire value of the trust qualifies for the marital deduction in the estate of the first spouse to die. At the survivor’s death, the value is included in his or her gross estate. However, if a charity is named to receive some or all of the remaining assets at the death of the survivor, the value passing to charity qualifies for the charitable deduction.

Testamentary charitable remainder trust

Normally, a testamentary charitable remainder trust would not qualify for the estate tax marital deduction since the surviving spouse is not entitled to all income for life, but rather just an annuity or unitrust percentage. Code §2056(b)(8) provides for a hybrid trust that does qualify for the marital deduction and also the charitable deduction. No QTIP election is required. The surviving spouse must be the only non-charitable beneficiary [Code §2056(b)(8)(A)].

Update on Tax Law Changes

As this issue of Gift Planning Now goes to press, the fiscal cliff negotiations are still underway. Hopefully by the time you are reading this issue, new tax law will in fact have been enacted and we are not still in limbo. For the latest updates to the estate, gift, and income tax provisions, please visit our website at planyourlegacy.berkeley.edu.
Adding Charity . . . (continued from page 1)

QTIP trust followed by testamentary charitable remainder trust

People who want to provide for their spouse and their children while still minimizing taxes in the surviving spouse’s estate can use a QTIP trust for the spouse, followed by a testamentary charitable remainder trust. The IRS has ruled favorably where a standard QTIP trust was to distribute assets to a charitable remainder trust, benefitting the decedent’s children, at the death of the surviving spouse (Ltr. Rul. 9122029). At the death of the first spouse, the value of the trust qualified for the marital deduction. At the death of the survivor, the value of the remainder interest would qualify for the charitable deduction.

Life estate in a home or farm

A bequest of a home or farm to charity, with a life estate reserved for the surviving spouse, can qualify for both a marital deduction and a charitable deduction. The surviving spouse must have the right not only to occupy the property, but also to rent the home or farm and receive the income for life [Reg. §20.2056(b)-7(h)].

One bequest, two deductions

If retaining income for the surviving spouse is not an issue, it is possible to increase the tax savings available from a charitable bequest at the first spouse’s death, assuming the surviving spouse will support the same charitable goals. Rather than make a charitable bequest ($100,000, for example) at the first death, the entire amount can be left to the surviving spouse, completely sheltered by the marital deduction. The survivor can then make a $100,000 outright gift in memory of the deceased spouse and qualify for an income tax charitable deduction. If the survivor is in the 33% income tax bracket, this amounts to a tax savings of $33,000.

Putting Employer Stock in Charitable Trust

As the pace of Baby Boomer retirements increases over the coming years, some Boomers may be faced with the question of what to do with shares of employer stock purchased with their own after-tax contributions in their 401(k) accounts. Special tax advantages are available – as are opportunities to satisfy philanthropic goals.

One of the easiest moves is to simply roll over the 401(k) account to an IRA. That may not be the most advantageous from a tax standpoint, however. When the client begins taking distributions, whether after age 59½, or after age 70½ when withdrawals are mandatory, distributions from the IRA will be taxed at ordinary income tax rates. The client can, instead, elect to receive the company stock outright and thereby preserve capital gains treatment for some later date [Code §402(e)(4)(A)]. A drawback, however, is that the client’s portfolio may be too heavily weighted with company stock.

A charitable remainder trust funded with an outright distribution of employer stock may allow the client to diversify his or her holdings while also achieving charitable goals. The charitable remainder trust provides the donor with income distributions for life, however, unlike IRA distributions the income is not necessarily taxed exclusively at ordinary income tax rates. The donor also is entitled

Tax Planning Pointer

One way for grandparents to help their grandchildren with college expenses while also assisting charity is through a term-of-years charitable remainder trust with sprinkle powers. The trustee can be given the power to pay income in varying amounts to different beneficiaries within the stated class, according to their changing needs [Code §674(c)]. An independent trustee is required, however, to avoid the grantor trust rules and disqualification of the charitable remainder trust (Code §§671-678).
Haas Professor to Help Advise U.S. Department of Treasury

Haas School of Business Professor Nancy Wallace has been selected to serve on a new advisory committee charged with advising the U.S. Department of Treasury on improving the quality of financial data and improving analysis of risks to the financial system. Wallace is among 30 professionals in economics, finance, financial services, data management, risk management and information technology who were chosen to serve on the Financial Research Advisory Committee of the Office of Financial Research. The committee, which also includes two Nobel laureates, held its inaugural meeting on Dec. 5 in Washington, D.C.

Earmarking Gift for Specific Individual Not a Charitable Gift

Explicitly extending the decision in Rev Rul 1962-113 to the scholarship context, the IRS has stated that making a gift to a church's college scholarship fund can be a tax-deductible gift, but not if the donor specifies that the funds be disbursed to a specific individual. In response to an inquiry from a Congressman, the IRS said that earmarking the gift for a designated individual – in this case the daughter of the church's minister – makes the gift a contribution to the designated recipient, not the charity. A charitable deduction is allowed only if the church has full control of the funds and discretion over the use. (CONEX-147960-11)
Beneficiary Appoints, Trust Deducts

Alan, the income beneficiary of an irrevocable trust, has a lifetime limited power of appointment allowing him to direct the trustee to distribute all or any portion of the income or principal to any charitable organizations. He plans to exercise this power by having the trustee distribute some or all of the trust’s income to charity.

Code §642(c)(1) provides an unlimited deduction in computing taxable income for the year for any amount of gross income distributed to charity pursuant to the terms of the governing instrument. This deduction is in lieu of a charitable deduction under Code §170(a).

The IRS ruled that a distribution to charity made from gross income under Alan’s limited power of appointment will be made “pursuant to the terms of the governing instrument” and thus will qualify for the charitable deduction. (Letter Ruling 201225004)

Comment: On a related note, durable general powers of attorney should include the ability to accelerate charitable bequests into lifetime gifts. Any “deathbed” gifts could save taxes on the client’s final income tax return. Providing the power to establish charitable trusts should also be considered.

Pledge Enforceable Against Trust

In 1995, Robert Sessions made an irrevocable $1.5 million pledge to Rush University Medical Center for the construction of a home for the university president. He reaffirmed the pledge in 1996, indicating that any outstanding amounts would be binding on his estate.

Sessions had made no payments on the pledge when he was diagnosed in 2005 with late-stage lung cancer. He blamed Rush for failing to diagnose the disease earlier. He executed a new will, making no provision for paying the pledge. Rush, which had built the house relying on Sessions’ pledge, sued his estate, but found that it contained less than $100,000.

Rush then filed suit against the trustees of a family trust that Sessions had established in 1994. Sessions or his estate. Rush argued that a spendthrift provision in a trust created by the settlor for his own benefit is void as to existing or future creditors.

The trustees argued, and the appellate court agreed, that the spendthrift clause shielded the family trust assets from Rush’s suit to enforce the irrevocable pledge. The Supreme Court of Illinois reversed, finding that the Fraudulent Transfer Act (relied on by the trustees) and the common law regarding self-settled trusts (relied on by Rush) “operate in different spheres” and are supplementary, not contradictory. The common law looks at interests retained by the settlor, not simply the fraudulent transfer of assets, said the court, adding that the Fraudulent Transfer Act did not “displace or abrogate the common law trust rule with respect to self-settled trusts.” (Rush University Medical Center v. Sessions, 2012 IL 112906)