FINANCIAL STRATEGIES
For estate planning and planned giving.
- Legislation
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UNIVERSITY OF ROCHESTER

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DEDUCTION FOR TUITION PAYMENTS NETS PRISON SENTENCE FOR TAXPAYER

The IRS has sent a strong signal that it is serious about pursuing activities it considers to be tax evasion with the recent disposition of a California case. The United States Attorney's Office for the Northern District of California has announced sentencing for a taxpayer who admitted in a plea agreement to deducting payments as charitable contributions that ultimately were used to pay the private school tuition of his children.

In 1995, Tim Mosley created an account at the National Heritage Foundation (NHF) that was designated as the "Tim and Carol Mosley Family Foundation." He sent payments to NHF in 1995 through 1999 earmarked for the Mosley Family Foundation and indicated to his tax return preparer that the payments were charitable contributions.

Mr. Mosley directed NHF to make distributions to San Domenico Convent from the Mosley Family Foundation account. Mr. Mosley admitted that the funds sent to San Domenico Convent were not used as charitable contributions but were used to pay tuition for his children at the San Domenico Primary School.

Accordingly, Mr. Mosley pleaded guilty and admitted to filing personal income-tax returns for the years 1995 through 1999, knowing them to be false with the intent to evade the payment of income tax that he owed. U.S. District Court Judge Martin J. Jenkins sentenced Mr. Mosley to five months in prison followed by five months of home detention and two years supervised release.

Taxpayers continue to be quite creative in devising "charitable" strategies that provide inappropriate personal benefits. Some donors may be motivated by the desire to get the best "deal" possible while others may simply be naive about what is appropriate. And, in some cases, donors may be knowingly pursuing an improper course of action.

In any event, such cases underscore the importance of sound advice from competent professionals. Skilled advisors often can steer clients away from paths fraught with problems and help them find appropriate avenues to achieve their personal and charitable goals.

POWER TO CHANGE CHARITABLE BENEFICIARY CAUSES LEAD TRUST TO BE INCLUDIBLE IN ESTATE

The IRS has determined that a proposed plan to create a charitable lead trust (CLT) under which the donor can change the charitable income beneficiaries would cause the trust to be includible in the donor's estate (PLR 200328030).

The taxpayer wanted to establish a charitable lead unitrust (CLUT) that would pay 5% of its annual value to a foundation for 20 years. Upon the termination of the CLUT, the trustee would distribute the remaining trust assets, if any, to a "distribution trust" and the assets would be distributed for the benefit of the donor's family members in accordance with the terms of that trust.

One of the primary objectives of a taxpayer in creating this kind of charitable lead trust generally is to reduce or even eliminate transfer-tax costs on assets that ultimately pass to non-charitable beneficiaries. This is possible because the present value of the charitable income interest in the CLT typically qualifies for the gift-tax (or estate-tax, if testamentary) charitable deduction. The portion of a lead trust that is subject to transfer tax is determined by subtracting the value of the charitable interest from the total amount transferred to the trust with only the balance –if any–treated as a taxable transfer to the noncharitable beneficiaries.

Generally, the proposed trust contains terms typically found in CLTs, with the exception of the trust's Article XI. That article provided that the charities designated in Article II as income beneficiaries may be amended or revoked by a specific written instrument delivered by the settlor to the trustee, adding or substituting other charities and/or changing the shares of any one or more charities. In all other regards, the trust may not be altered, amended, or revoked by anyone, except that the trustee may pursue amendments for the sole purpose of ensuring that the trust continues to be a qualified charitable lead trust.

According to Reg. §25.2511-2(b), a gift is complete and subject to the gift tax when the donor has so parted with dominion and control over the property transferred as to leave the donor no power to change its disposition, whether for the donor's own benefit or for the benefit of another. Reg. §25.2511-2(c) provides that a gift is incomplete to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves.

In this case, the IRS ruled that the gift was incomplete under Reg. §25.2511-2(c) and that the donor was therefore not entitled to a gift-tax charitable deduction. In addition, the ruling pointed out, IRC §2036(a) requires that the value of all property be included in a decedent's gross estate to the extent the decedent has retained the right to designate the person or persons who shall possess or enjoy the property or the income therefrom. Because the settlor retained the power to change the charitable beneficiaries, the IRS concluded that the trust would be includible in the settlor's gross estate.

According to the ruling, the trust did not contain any provisions or powers that would cause the settlor to be treated as the owner of any portion of the trust under IRC §673, 674, 676, or 677. However, it did indicate that it was possible that the donor might exercise administrative control for the benefit of the settlor that would cause the settlor to be treated as the owner under IRC §675. That, however, is a question of fact that could not be determined prospectively but which would need to be determined upon review of the trust's future income-tax returns. The trust would be entitled to income-tax deductions, though, under IRC §642(c)(1) for amounts of gross income–but not principal–paid to charitable beneficiaries each year.

Contrast the situation in this ruling with a charitable remainder trust in which the settlor retains the right to change the charitable beneficiaries. The retention of such a power does not present the significant obstacle the retention of such a power poses with a lead trust.

Retaining the power to change the charitable remainder beneficiary still causes the gift to be incomplete for gift-tax purposes. With a CRT, however, the income-tax consequences typically are primary rather than the gift-tax consequences as in the case of lead trust. The retention of the power to change the remainderman does not negatively impact the income-tax deduction in the case of a CRT.

Even though in the case of an *inter vivos* CRT the gift of the remainder is incomplete for gift-tax purposes, that does not present a practical problem. When the trust terminates, the entire remainder value passes to charity and thus is deductible at that point.

As a matter of public policy, there would not seem to be compelling reasons to deny a gift-tax deduction when a settlor retains the right to change the charitable beneficiary, either in a lead trust or a CRT. As long as the charitable interest is irrevocable, which it must be for either kind of trust to otherwise pass muster, the power merely to change the identity of the charitable beneficiary will not give the settlor the ability to alter the value of the respective charitable and non-charitable interests. It also does not seem to give a donor any ability to manipulate such a power to his or her benefit.

IRS RULES AMERICAN DEPOSITORY SHARES ARE "QUALIFIED APPRECIATED STOCK"

Funding a gift to a private foundation can present a challenge in that non-cash gifts are generally only deductible to the extent of the lesser of the donor's basis or the donated asset's fair-market value (IRC §170[e][1][B][ii]). However, IRC §170(e)(1)(B)(ii) does not apply to contributions of *qualified appreciated stock*, which may be deducted at full fair-market value (IRC §170[e][5][A]).

This, of course, begs the question, What constitutes qualified appreciated stock? That question became the pivotal issue in recent private letter rulings issued to multiple taxpayers seeking guidance on gifts of American Depository Shares (ADSs) (PLR 200322005, 200322006, 200322007, 200322008, 200322009, 200322010, 200322011, and 200322018).

An ADS is issued by a U.S. depository bank and represents an interest in the underlying ordinary shares of a non-U.S. company. An ADS is evidenced by an American Depository Receipt (ADR), which is a negotiable receipt issued in certified form representing an ADS. The holder is entitled to demand delivery of the underlying shares of the non-U.S. company.

The facts of this ruling involve a general partnership that owned common shares of a company that merged with two other companies to form a new non-U.S. entity. Pursuant to the merger, the partnership received American Depository Shares in the new entity.

The sole partners of the general partnership are the taxpayers seeking these rulings and trustees of trusts for the benefit of such taxpayers. The partnership proposes to distribute a portion of the ADSs to the trustees who, in turn, will distribute them to the taxpayers. Upon receipt of the ADSs, the taxpayers will contribute the ADSs to one or more private foundations or to charitable remainder unitrusts (CRUTs) of which private foundations may be the remainder beneficiary.

All of the CRUTs will be for the benefit of the taxpayers, the taxpayers and family members, or family members of the taxpayers. It is anticipated that the basis in each ADS to be contributed by the taxpayers will be less than its fair-market value on the date of contribution.

IRC §170(e)(5)(B) defines *qualified appreciated stock*, except as provided in IRC §170(e)(5)(C), to mean any stock of a corporation (i) for which (as of the date of the contribution) market quotations are readily available on an established securities market, and (ii) which is capital-gain property (as defined in IRC §170[b][1][C][iv] –essentially property the sale of which will result in the realization of long-term capital gain).

Under IRC §170(e)(5)(C), securities will not be deemed "qualified appreciated stock" to the extent the amount contributed exceeds 10% (in value) of all outstanding stock of the corporation. For purposes of this section, an individual is treated as making all contributions made by any member of his family, as defined in IRC §267(c)(4).

In analyzing these facts, the IRS determined that the ADSs proposed to be contributed were traded on the New York Stock Exchange and, therefore, market quotations were readily available. It further concluded that the ADSs are stock for purposes of IRC §170(e)(5) since each ADS is evidenced by an ADR and the holder of the ADR is entitled to demand delivery of the underlying shares. The ruling further noted that the IRS has interpreted ADRs to be treated as shares of stock for various tax purposes, such as the foreign tax credit.

The taxpayers represented that they had taken steps to ensure that the donee charities will be able to sell the contributed ADSs in compliance with Rule 145 of the General Rules and Regulations under the Securities Act of 1933, as amended. The total number of shares donated will be substantially less than 1% of the total number of outstanding shares of the new corporation. The taxpayers also represent that the contributions will be made only at such times when, to the best of their knowledge, there will not be any proposed recapitalization, tender or exchange offer, stock repurchase program, or similar plan that would have the effect of substantially reducing the number of outstanding shares of the corporation within the three-month period following the contributions.

Accordingly, the IRS concluded that the shares will be capital-gain property within the meaning of IRC §170(b)(1)(C)(iv) and will meet the requirements of IRC §170(e)(5)(B)(ii).

BRIEFLY…

Final regulations resolve conflict with tax court holdings on deductibility of annuity or unitrust interests. A conflict has existed between case law and the Regulations for many years since the Tax Court granted an estate a charitable deduction for the present value of a unitrust interest payable to charity, even though it was preceded in point of time by a noncharitable interest that was in the form of a guaranteed unitrust interest (*Estate of Boeshore v. Commissioner*, 78 T.C. 523 [1982]). The court noted that its ruling was contrary to Reg. §20.2055-2(e)(2)(vi)(e), but determined there was no policy reason why the regulation should be enforced. The final regulations remove this requirement that a deductible annuity or unitrust interest payable to a charity cannot be preceded in time by a noncharitable interest in the form of a guaranteed annuity or unitrust interest in the same property.

IRS issues new and updated sample CRAT documents. The IRS has issued eight new and/or updated sample charitable remainder annuity trust documents for donors to use to be sure they meet the requirements of IRC §664 and Reg. §1.664-2 (Rev. Proc. 2003-53 through Rev. Proc. 2003-60).

Specifically, the new forms address four situations:

- A CRAT for one measuring life
- A CRAT for a term of years
- A CRAT for consecutive interests for two measuring lives
- A CRAT for concurrent and consecutive interests

There is a sample *inter vivos* form and a sample testamentary form for each of these four situations.

The IRS had long been promising new and updated forms to supplement the original forms issued in 1989 and 1990. The term-of-years samples provide guidance on situations not addressed by the original forms, while the others update the original samples.

IRS seeks comments on charitable lead trust forms. The IRS has announced its intention to bring a similar level of security to the drafting of charitable lead trusts that it has brought to the drafting of charitable remainder trusts by issuing sample forms that “reflect the statutory and regulatory provisions applicable to charitable lead trusts” (Notice 2003-39).

To that end, the IRS sought comments on “the type of format to be used, the substantive provisions to be included, and the various types of charitable lead trusts for which samples would be most helpful” through October 1 of this year. The Service gave no timetable on when sample forms would be available.

***Financial Strategies** is intended for a select group of attorneys, accountants, trust officers, insurance advisors, investment counselors, and financial planners. It is designed to keep philanthropic planners up-to-date on developments in estate planning as they relate to testamentary and lifetime plans of support of qualified charities.*

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