FINANCIAL STRATEGIES
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UNIVERSITY of ROCHESTER

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Painful Lessons: Details Matter

Details, details. They can be so troubling—but when it comes to claiming huge tax deductions, they are almost always crucial. In this issue of our newsletter we take a look at some recent developments in which this reality came home to roost in dramatic fashion.

Too Much of a Good Thing Dooms Deduction

Such was the lesson learned by a limited liability company that saw a claimed deduction of approximately $33 million disappear pursuant to a recent decision of the U.S. Tax Court. **RERI** *Holdings I, LLC et al. v. Commissioner*, 149 T.C. No. 1 (July 3, 2017). The facts of **RERI** are rather complex, involving multiple entities holding multiple interests in the subject real estate. However, the gift in question was essentially a remainder interest—identified in the decision as a successor member interest (**SMI**)—in commercial real estate donated to the University of Michigan by **RERI**.

RERI had acquired the interest for approximately $3 million in 2002 and made the donation in 2003. This gave rise to the necessity of determining the value of the contribution, which was not only critical but also complicated given the nature of the **SMI**.

The value, if any, of the **SMI** depended in large part on whether or not the initial tenant of the subject property, AT&T, chose to exercise multiple options to continue leasing the building—the second exercise of which coincided with the vesting of the **SMI** approximately 20 years in the future. Other contingencies could have affected the value of the **SMI** as well. **RERI** arrived at the $33 million value relying on Internal Revenue Code Section 7520 and the regulations thereunder, applying assumed growth of rental value and assumed discount rates.

The **IRS** took exception to that calculation and employed its own experts, who came up with vastly different conclusions. The University of Michigan had, in fact, sold the interest for slightly less than $2 million. The Tax Court agreed with the **IRS**, saying that under the circumstances different methods needed to be utilized to determine the actual fair-market value of the **SMI** interest on the date of contribution:

> Held, further, because of the limitation on remedies available to the holder of the remainder interest for breaches of protective covenants, the agreement that created that interest did not provide adequate protection to its holder, for purposes of sec. 1.7520-3(b)(2)(iii), Income Tax Regs.; the standard actuarial factors provided under I.R.C. sec. 7520 thus do not apply in valuing the remainder interest; instead, the value of that interest is its "actual fair market value," determined without regard to I.R.C. sec. 7520, on the basis of all of the facts and circumstances. Sec. 1.7520-3(b)(1)(iii), Income Tax Regs.
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> Held, further, on the basis of all of the facts and circumstances, the remainder interest that PS [partnership **RERI**] assigned to U [University of Michigan] on Aug. 27, 2003, had a fair market value on that date of $3,462,886.

But the bad news did not end there for **RERI**. As with virtually all gifts for which a deduction of more than $5,000 is claimed, **RERI** was required to file an **IRS** Form 8283 in substantiation of the amount of the deduction.

RERI did file the 8283, including date of acquisition, but failed to fill in the box which asked the donor's cost or other basis in the donated property. The Tax Court opinion landed squarely on that as dispositive of the matter, refusing to view the information provided on the 8282 as "substantial compliance" given the great discrepancy of the claimed deduction and the value determined by the court:

> Held: PS' omission from its Form 8283 of its cost or other adjusted basis in the contributed remainder interest violated the substantiation requirement of sec. 1.170A-13(c)(4)(ii)(E), Income Tax Regs.
>
> Held, further, because PS' disclosure of its cost or other basis in the contributed property would have alerted R to a potential overvaluation of that property, omission of that information prevented the Form 8283 from achieving its intended purpose; the omission thus cannot be excused on the grounds of substantial compliance.
>
> Held, further, PS' failure to comply, either strictly or substantially, with the requirements of sec. 1.170A-13(c)(2), Income Tax Regs., requires denial in full of its claimed charitable contribution deduction.

Not only did the Court uphold denial of the deduction, but it also upheld enforcement of a 40% accuracy-related penalty because the $33,019,000 value **RERI** assigned to the remainder interest is more than 400% of that interest's actual fair-market value. PS' claimed charitable contribution deduction resulted in a gross valuation misstatement under I.R.C. §6662(e)(1)(A), (h)(2).

Extreme Goodwill Doesn't Pay Off for Taxpayers

On their 2011 federal income-tax return, a couple claimed deductions of $145,250 for the donation of more than 20,000 items to Goodwill. The sheer volume of items they claimed to have contributed was impressive: 1,040 items of boys' clothing, 811 items of girls' clothing, 658 items of men's clothing, and 945 items of women's clothing. In addition, they purportedly gave Goodwill 115 chairs, 36 lamps, 22 bookshelves, 20 desks, 20 chests of drawers, 16 bedframes, and 14 filing cabinets.

They made multiple trips from their home in West Virginia to the Goodwill facility in Frederick, Maryland, to make these gifts. They produced dozens of one page receipts from Goodwill acknowledging that they had received no goods or services in exchange for their donations.

However, the receipts merely indicated a category of the type of property donated but did not indicate the number of such items, nor did it describe the items or their condition. The taxpayers produced their own listings specifying the number of items and indicating its condition—in each case describing the condition as "fine."

The U.S. Tax Court did not find their evidence and their testimony credible, disallowed all of the claimed deductions except for $250, and upheld accuracy-related penalties. *Ohde v. Commissioner*, T.C. Memo. 2017-137, (July 10, 2017).

The evidence showed that the taxpayers claimed to have made many trips to deliver donations. Their lists of items donated, created after the fact, did show types and numbers of items listed but only contained a total value for all the property donated on each trip not the individual value of specific items.

The Tax Court noted multiple flaws with the information they presented. First, the court determined they did not meet their obligation of maintaining sufficient records to substantiate their contributions and the value thereof:

> Petitioners did not maintain contemporaneous records establishing any of these facts. We did not find their subsequently generated TurboTax spreadsheet credible. In any event, that spreadsheet did not show an individual value for any of the items, only an aggregate figure for the thousands of items allegedly delivered to Goodwill on a particular trip. Many of those aggregate dollar figures are suspect on their face.

They also did not acquire adequate contemporaneous written acknowledgment of their contributions nor did they secure or provide necessary substantiation of the value of the claimed donations. The Court noted that they failed to meet these obligations on multiple tiers.

The records they produced showing the aggregate value of each separate donation ranged from $830 to $14,999. Each of these would have required an appropriate contemporary written acknowledgment. To the extent that the cumulative value of any particular type of item exceeded $500 they would have also needed to have records detailing these contributions, the fair-market value of each, and an explanation of how that was determined. The court pointed out that this would have applied to more than 99% of the alleged contributions.

When the aggregate value of similar types of property exceeds $5,000, a taxpayer must also obtain a qualified appraisal in addition to other record-keeping requirements. The Court pointed out that while the taxpayers did attach multiple Forms 8283 to their return, those forms were not executed by a qualified appraiser or the donee charity. Based on the evidence presented, the court estimated that this would apply to more than 88% of the claimed deductions. All of this caused the court to determine that "petitioners have not satisfied any of the substantiation requirements that apply to their alleged charitable gifts. We thus sustain the **IRS**' determination that $145,000 of their claimed $145,250 deduction must be disallowed."

The court also held that imposition of 20% accuracy-related penalties in the amount of $6,593 under IRC §6662(a) were appropriate in addition to a deficiency finding of $32,964.

Last Minute Maneuvers Prove Too Little Too Late

A son's last minute efforts to shelter his dying mother's sizable estate from federal estate tax were deemed insufficient by the IRS. *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (May 18, 2017).

In a whirlwind of activity, Mrs. Powell's son transferred approximately $10 million to a limited partnership with the mother retaining a 99% limited partner interest and the son holding a 1% general partner interest. That same day, acting pursuant to a power of attorney, the son transferred Mrs. Powell's limited partnership interest to a charitable lead annuity trust (CLAT) that would pay a specified annual distribution to the Nancy H. Powell Foundation, a Delaware nonprofit corporation, for the remainder of Mrs. Powell's life.

After her death, the remaining CLAT assets were to be divided between two trusts for the benefit of the son and his brother. Mrs. Powell died seven days later.

The IRS contested these transactions and advanced multiple theories for collection of deficiencies of approximately $5.9 million in gift tax and $2.9 million in federal estate tax. It took particular exception to the treatment of the contribution to the CLAT.

Using a nongrantor charitable lead trust can be a very effective way to reduce or even completely eliminate gift or estate tax on the value of assets used to fund the trust that will ultimately be distributed to noncharitable beneficiaries. The charitable lead interest can be for a specified period of years or for the life of certain persons. The amount that is subject to transfer tax is determined by subtracting the value of the charitable lead interest from the total amount transferred to the trust.

If the trust is for the life of a named person, this is typically calculated pursuant to a formula based on the life expectancy of a person the age of the designated life. In this case, the son calculated the value of the taxable remainder interest in this manner—and also applied a 25% discount to the value of the limited partnership interest contributed to the CLAT due to the fact that it was less than 100% of the interests in the limited partnership and limited marketability.

The IRS contended that it was inappropriate to calculate the portion of the transfer to the trust that would be taxable based simply on the life expectancy of a person of Mrs. Powell's age because she was terminally ill. It also argued that the discount for the value of the partnership interest was excessive, and the court agreed on both counts.

What the IRS was arguing in practical terms was, in effect, that instead of waiting an extended period of time that would be expected until their noncharitable interests vested based on the life expectancy of a typical person the age of Mrs. Powell, it was reasonable to assume they would only wait a short time because of the nature of her health. Indeed, in this case it was only one week.

In addition, the IRS argued that transfer to the CLAT was improper in any event in that it exceeded the limits of the son's authority under the power of attorney, rendering the transfer void or revocable and bringing the entire amount back into Mrs. Powell's estate for tax purposes. Again, the court agreed.

The court determined, based largely on the fact the transfers took place less than three years before her death, essentially which of the underlying assets should be included in the decedent's estate.

Note: The facts in this case as well as ***RERI*** and *Ohde* may call to mind a few old sayings, such as, "Nothing ventured, nothing gained," or perhaps, "You can't blame a person for trying." One more, though, also seems appropriate: "Pigs get fat, hogs get butchered."

Potential Bequest Will Be "Unusual Grant"

Concerned that its status as a public charity could be in jeopardy, an organization that was anticipating a very large bequest from a donor recently sought a private letter ruling on the impact of such a gift on its public charity status. PLR201729025. The charity had been informed that it would get a substantial bequest at the death of a donor who had provided only a small amount of support in the past.

In order to maintain its status as a pubic charity, as opposed to a private foundation, an organization must be able to demonstrate that at least one-third of its annual support comes from the general public or from government grants. Typically, a gift that comprises more than 2% of an organization's support is considered to be given by a "substantial contributor" deemed to be a "disqualified person." Gifts from such donors are disregarded in calculating the percentage of public support.

The IRS determined that the conditions and circumstances justified a finding that, under Treasury Regulations Sec. 1.170A-9(f)(6)(ii), the proposed gift should be classified as an unusual grant that would not affect its public charity status. It concluded that the gift was attracted by the publicly supported nature of the organization, that it was unexpected and unusual in its size, and that, absent a finding that it was an unusual grant, it would adversely affect the status of the organization as a public charity.

It also found that the proposed transaction met the requirements of Regs. Sec. 1.509(a)-3(c)(4) in several regards, stating:

a) The grant was not made by a person who created you or who previously contributed a substantial amount of your support. The grantor also does not stand in a position of authority with respect to you and does not exercise control over you.

b) The grant is a bequest and is in the form of cash or investments.

c) You have carried on an actual program of public solicitation, have exempt activities, and have attracted a significant amount of public support over the years.

d) You have met the public support test in past years.

e) Because you have relied on public support in the past, it can be assumed that you will be able to maintain that level of support in the future.

f) You have a large representative governing body.

The ruling further found that the gift proposed no material restrictions or conditions on the recipient donee organization.

BRIEFLY…

Acquiring Shares of Endowment Okay. The IRS has released a number of private letter rulings recently reaffirming the position it has taken before that it is okay for the trustee of a charitable remainder trust to invest the trust assets in units of a charity's endowment fund. PLR 2017290143, PLR 201729014, PLR 201730019, PLR 201730022

Background: In recent years several charities that serve as trustees of charitable remainder trusts have sought private letter rulings on the legal implications of the trustee investing trust assets in shares or units of a charity's endowment. Typically, the charity has an endowment that has produced good investment returns and, as the trustee, believes it can achieve better results and more diversification of assets by investing in units of its own endowment instead of investing the trust assets separately.

The trustees typically represent that they will charge a fee for investment services, although they do reserve the right to charge third party fees and expenses to the trust. These rulings addressed to the charity as trustee affirms that the charity will not realize any unrelated business taxable income under these circumstances.

In regard to the implications for the trust, the contracts with the endowment entitle the holder of the units to periodic distributions approved by the endowment. As such, the trust will not be deemed to receive any unrelated business taxable income, regardless of the underlying investments of the endowment.

Estate Tax Portability Election Extended. The IRS has extended the time for making a "portability" election by surviving spouses for any unused portion of the estate-tax equivalent exemption. Rev. Proc.2017-34.

Every individual can make a specified amount of transfers during life or at death free of net transfer tax due to an exemption that offsets the tax on that amount. For 2017 that amount is $5,490,000.

If a first spouse to die does not utilize all of his or her equivalent exemption, the surviving spouse can utilize any remaining portion.

In order to do that, though, the executor of the decedent spouse must make a timely election to do so. Rev. Proc. 2017-34 extends the time for making the election to the later of January 2, 2018, or the second anniversary of the decedent's death.

__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 these planners up to date on developments in estate planning as they relate to testamentary and lifetime plans in support of qualified charities.

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