THE SALVATION ARMY

Charitable Intent

PLANNING NEWS AND IDEAS FOR THE PROFESSIONAL ADVISER

Annuity Trusts Get a Helping Hand

Charitable remainder annuity trusts have nearly gone extinct in recent years as a result of low §7520 rates. Annuity trusts are subject to the same 10% remainder requirement as charitable remainder unitrusts [Code §664(d)(1)(D)], but also must satisfy a 5% probability test [Rev. Ruls. 70-452 and 77-374]. No deduction is allowed for a charitable remainder annuity trust if the probability exceeds 5% that a noncharitable beneficiary of the trust will survive to the exhaustion of the trust fund. An annuity trust for which a deduction is not allowed is not a qualified charitable remainder trust [Letter Ruling 9532006].

Satisfying the 5% probability test is generally not an issue when the trust provides for the minimum 5% payout and the §7520 rate is 5% or more. However, interest rates last touched 5% in December 2007, and are currently in the 1.6% range (October 2016). A donor age 73 could not establish a one-life annuity trust, assuming the minimum 5% payout, quarterly payments and the use of a 1.6% §7520 rate, due to the 5% probability test, although the charitable deduction of nearly 46% would easily pass the 10% remainder requirement. With a two-life trust, both beneficiaries would have to be at least age 76 to qualify.

The IRS recently issued Rev. Proc. 2016-42, offering a way to avoid the 5% probability test. Inter vivos and testamentary trusts created on or after August 8 will not be subject to the 5% test if they include contingency language provided in the revenue procedure. The provision calls for the early termination of the annuity trust and an outright distribution of the trust's assets to the charitable remainderman prior to the date on which an annuity payment would result in the value of the trust corpus falling below 10% of the value of the initial trust corpus. However, because the value of the trust corpus is determined using a specified discount factor, the amount left in trust in the event of a termination might actually be significantly more than 10% of the initial value of the trust. For example, the IRS's own example in the revenue procedure has a $1 million annuity trust terminating just prior to the payment at the end of the 18th year, when the value of the corpus is $210,000, although 10% of the initial value of the trust would be only $100,000.

Charitable remainder annuity trusts also have been easier to administer than charitable remainder unitrusts. While an annuity trust income beneficiary receives a fixed amount each year, unitrust beneficiaries are entitled to a percentage of the fluctuating value of the trust, requiring the assets to be valued annually. Trustees of annuity trusts that include contingency language will now be required to determine the value of the trust assets on the day prior to the day of a payout, although it's possible to determine, at the time the annuity trust is created, what the threshold amount is for every future year.

Adding the contingency language might enable younger donors to establish charitable remainder annuity trusts, despite the slight risk that the trust will have to end early. It's likely that trustees will be able to generate investment returns higher than the presumed interest rate of the §7520 rates and the corpus will remain high enough not to result in a termination prior to the income beneficiary's death.

Investment Restrictions Removed

In 2007, Rockefeller University received the remainder of a testamentary trust created in James Martin's 1962 will. The principal was to be held in perpetual trust, with the income used for research into arteriosclerosis. Martin's will prohibits Rockefeller from selling the stock of 17 named companies and restricts investments in companies engaged in certain activities. The stock of one company had lost more than half its value between 2007 and 2015, and several of the companies had ceased to exist as independent entities.

The securities were generating considerably less than the University's endowment, reducing the amount available to fund the research Martin wanted. Rockefeller asked that the court apply the doctrine of deviation, which permits a trustee to deviate from restrictions in order to further the purposes of the trust.

The Supreme Court of the State of New York found the doctrine of deviation to be warranted, noting that economic circumstances have changed since the time the investment restrictions were imposed. Lifting the restrictions gives Rockefeller greater investment discretion than Martin originally granted, said the court, adding that diversification of investments is favored. ***In re Rockefeller University*, 2016 NY Slip Op 31556 (U)**

ATTORNEY OWED DUTY TO CHARITABLE BENEFICIARY

Alice Dumville consulted attorney James Thorsen to draft her will. Her intent was to leave all her property to her mother, if alive at her death, but if her mother predeceased her, her property was to pass to the Richmond Society for the Prevention of Cruelty to Animals (RSPCA). Dumville's mother predeceased her, so Thorsen, co-executor of the estate, notified RSPCA that it was the sole beneficiary.

The title insurance company informed Thorsen that the will left only the tangible estate to the RSCPA, but not the real property. Thorsen sought to correct the "scrivener's error," but the Circuit Court found the language unambiguous and declined to amend the will. The RSPCA received assets worth $72,000, while more than $600,000 passed by intestacy to two relatives. The RSPCA sued Thorsen for breach of contract-professional negligence, as a third-party beneficiary of the contract between Thorsen and Dumville. The Circuit Court admitted Thorsen's testimony from the earlier proceeding to correct the will and found for the RSPCA. Thorsen was ordered to pay more than $600,000 in damages.

The Supreme Court of Appeals of Virginia agreed that the RSPCA had the authority under common law to proceed as a third-party beneficiary of an oral contract. When Thorsen agreed to draft Dumville's will, the RSPCA became the intended beneficary of her will and of her contract of employment with Thorsen. Although the RSPCA was a contingent beneficiary, it was still a clearly intended beneficiary, said the court. Thorsen also argued that the statute of limitations on any breach began running when the legal services were completed in 2003. The court disagreed, saying the statute cannot begin running as to testamentary beneficiaries until after the death of the testator. Because Dumville could alter her will prior to death, the RSPCA had a bare expectancy and could not bring suit against Thorsen until after Dumville's death. ***Thorsen v. Richmond Society for the Prevention of Cruelty to Animals,*** **Record No. 150528**

COPY OF WILL SATISFIES COURT

When the Superior Court of Pennsylvania ruled that two witnesses were needed to admit to probate a copy of a will where the original was lost, it urged the Supreme Court to clarify the law (*In re Wilner*, 2014 PA Super. 94). Dana Wilner, who left the bulk of her estate to charity, was blind and had physical limitations that would have prevented her from destroying her will with the intent to revoke it, her attorney and caregiver claimed. However, because state law requires two witnesses to testify as to the contents of a will in order to admit a conformed copy to probate, the Superior Court reluctantly held that the estate passed by intestacy to two relatives, one of whom had access to Wilner's will.

The Supreme Court of Pennsylvania did review the case and determined that it is unlikely, in general, that anyone other than the testator and drafting attorney know the contents of a will. Subscribing witnesses need not read the will, just confirm the validity of the signature. Adhering to the two-witness rule would mean that, without two witnesses familiar with a will's contents, "the testator's wishes would be defeated." The court held that if the contents of a lost will can be proven in some lawful manner by clear and convincing evidence – such as by a conformed copy or photocopy – two witnesses are not required to be familiar with the will's contents, just its execution. The matter was remanded, reinstating the Orphan's Court decision to admit the conformed copy to probate. ***In Re: Estate of Wilner*****, J-18-2016 No. 136 MAP 2014**

HARVESTING TAX SAVINGS THROUGH CROP GIFTS

Charities in farming and ranching communities are sometimes the recipients of in-kind gifts of crops or farm animals. The tax treatment of these gifts will differ, depending upon how they are structured and the assets involved. For example, a farmer could contribute harvested crops; a negotiable warehouse receipt for crops that have been harvested and stored in an elevator or warehouse; the rights to growing crops or the land on which crops are growing. Special rules govern gifts of timber and timberland. Crops, farm animals and machinery can be used to fund charitable remainder trusts. In many cases, there is no charitable deduction available for these gifts because the assets would produce ordinary income, not capital gains. However, a gift of the assets may provide the donor with income for life without being taxed when the farm products are sold. The Salvation Army's Office of Planned Giving can answer questions about structuring clients' gifts from farms or ranches.