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THE SALVATION ARMY

Charitable Intent

DOING THE MOST GOOD℠

PLANNING NEWS AND IDEAS FOR THE PROFESSIONAL ADVISER

COURT: SETTLEMENT AT ARM'S-LENGTH AND DEDUCTIBLE

Antonio Palumbo had executed several wills and codicils prior to the 1999 will that was in effect at his death in 2002. All these wills provided that the residue of his estate was to pass to a charitable trust that he had created in 1974. After Palumbo's death, it was discovered that the 1999 will contained no residuary clause, due, the drafting attorney admitted, to a scrivener's error. Palumbo's son claimed the residue as intestate heir.

The estate and Palumbo's son entered into negotiations that resulted in $11.7 million passing to the trust and the son receiving $5.6 million and real estate. The estate claimed a charitable deduction for the distribution to the trust. The IRS disallowed the deduction, saying that it had come from Palumbo's son via a settlement agreement and not from the estate. According to the IRS, the trust had no legally enforceable right to any portion of the residue. Therefore, the agreement was not made to settle a bona fide dispute between the parties.

The U.S. District Court (W.D. PA) disagreed, noting that the 1999 will, unlike all prior wills and codicils, did not contain a residuary clause. There was unrefuted evidence that Palumbo intended, in the 1999 will, to continue providing for the trust. There was also a legal malpractice lawsuit brought against the drafting attorney, who admitted the lack of a residuary clause was the result of a scrivener's error.

In general, if the court feels it can ascertain a testator's intent from the will, it will not examine other evidence. However, under state law, if a person executes a will, it is presumed that he or she intended to dispose of the entire estate and not have any portion pass by intestacy. Where there is an ambiguity, the court can consider extrinsic evidence to discern the testator's intent. The court found the negotiations between the estate and Palumbo's son to have been at arm's-length, with no evidence of collusion. There was also no evidence that Palumbo intended to disinherit the trust. The court ruled that the estate was entitled to the charitable deduction.

***Estate of Palumbo v. U.S.*, 2011-1 USTC ¶60,616**

DONOR RETAINED CONTROL, LOSES DEDUCTION

Setty Viralam had three children, all of whom were expected to need $40,000 annually for eight years for college and graduate school. Viralam transferred $262,433 in appreciated securities to a donor advised fund and claimed a charitable deduction in 1998. The fund had a student loan program under which foundation account funds could be loaned to cover college and graduate school expenses. The fund was operated by a financial planning company's charitable foundation.

From 1999 to 2003, Viralam directed several charitable distributions totaling $15,500. In 2001, he requested $17,247 be paid to the University of Pennsylvania as a loan to his son. The son agreed to perform 2,000 hours of charitable work annually for the foundation in return for the loan. If he did not perform the charity work, the loan would have to be repaid, with interest.

In 2001, the IRS began examining Viralam's 1998 return. Viralam directed additional loans to his son, eventually totaling $70,299. Just prior to the IRS's written disallowance of the 1998 charitable deduction, Viralam repaid all the loans. The IRS argued that Viralam was not entitled to the charitable deduction because he had not relinquished dominion and control of the contributed funds and because the acknowledgment by the foundation did not comply with the requirements of Code §170(f)(8).

The Tax Court agreed with the IRS, noting that the foundation's program was designed to allow Viralam to retrieve his contributions in the future. Because he retained control over the transferred property, he was not entitled to a deduction. The court also noted that the acknowledgment received from the foundation indicated that Viralam received no goods or services in exchange for the transfer. However, Reg. §1.170A-13(f)(6) provides that a donee organization is treated as providing goods or services if the taxpayer *expects* to receive goods or services when the transfer is made, even if these are to be provided in a year other than the year of the

transfer. The court ruled that the student loan program fell within the definition of "goods or services" under Reg. §1.170A-13(f)(5). Viralam's charitable deduction was disallowed and he was subject to capital gains tax on the sale of the appreciated securities transferred to the foundation.

***Viralam v. Comm'r.,* 136 T.C. No. 8**

DONOR ADVISED FUND NEED NOT LISTEN TO DONOR, COURT SAYS

Friends of Fiji (FOF), a donor advised fund, refused to make any of the charitable distributions requested by donor Ray Styles. He filed suit, claiming breach of the fund agreement and of the covenant of good faith and fair dealing. Although the district court determined that FOF had breached the implied covenants of good faith and fair dealing, it said that Styles failed to prove damages.

Styles had claimed a charitable deduction for his unrestricted gift, noted the court, adding that he therefore gave up any interest in the funds. He had no right to control the funds or require FOF to use them in the manner he recommended.

Styles appealed, arguing that he was entitled to a return of his donation. The Supreme Court of Nevada agreed with the district court, saying that his intent to give up control of the funds was shown by the income tax deduction claimed for the amount of the transfer. Although damages may be awarded for a breach of the implied covenant of good faith and fair dealing, the Supreme Court agreed with the lower court that Styles suffered no damages.

***Styles v. Friends of Fiji,* No. 51642**

SMOKE AND FIRE, BUT NO DEDUCTION

Theodore Rolfs and Julia Gallagher owned a three-acre lakefront parcel with a nearly century-old house. They obtained estimates of $10,000 to $15,000 to demolish the home in order to build a new house. Instead, the couple donated the house to the fire department to be used for firefighter training. They claimed a charitable contribution deduction of $76,000, based on an appraisal.

The IRS disallowed the deduction. Two IRS appraisers determined that the home had little or no value, saying that the home could be used only if it were moved from the site, which would have involved logistical issues outweighing the value of the structure. The IRS also claimed that the donors received a quid pro quo benefit from their transfer: the demolition of the house on the site where they planned to build a new home.

The Tax Court agreed, finding that the couple anticipated the benefit when transferring the home to be used for firefighter training. The question, said the court, was whether the value of the home exceeded the value of the demolition services the donors received. The court found that the couple put restrictions on the transfer of the home (that the training exercise had to be undertaken soon after the conveyance and that the home could not be used for any other purpose) that had to be taken into consideration in determining the value of the donated property. The court found that the value of the home, as encumbered, was de minimis, and because the value of the home did not exceed the value of the benefit the couple received, they were not entitled to a charitable deduction.

***Rolfs and Gallagher v. Comm'r.,* 135 T.C. No. 24**

THE TIME IS RIGHT

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, passed in mid-December last year, restored qualified charitable distributions from IRAs for 2010 and 2011. Unfortunately, many eligible clients had already taken required minimum distributions for 2010 and were unable to direct those dollars directly to charity without recognizing the income. It's still early enough in 2011 to allow those over age 70½ to take advantage of the opportunity to make charitable distributions of up to $100,000 to favorite organizations. Although no charitable deduction is allowed, donors can save taxes anyway by directing transfers to charity of amounts that would otherwise have to be withdrawn and included in gross income. Only transfers from IRAs – not 401(k) plans or other retirement savings – are eligible. The distributions must be made by the IRA custodian directly to a public charity, not to the account owner. Transfers must be outright and cannot be used to fund charitable remainder trusts or charitable gift annuities. If you have any questions about the advantages of qualified charitable distributions in your clients' planning, please feel free to contact our office.