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NEWSLETTER

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INTRODUCTION

Merry Christmas and a Happy New Year!

Thanks to you, 2005 has been a year of growth for my firm. We have enjoyed being your attorneys and look forward to continuing to serve you in 2006.

We will be growing even more on January first! Watch our website in January for the details about the most recent attorney to join my firm. She is a woman I have known for many years. She is a great attorney, wonderful mother and will be an excellent addition to our team.

I have included in this month's newsletter three memos, some information on end-of-the year tax tips to help you prepare for your CPA and a some IRS news. Enjoy!

The memos are on subjects that have come up over the last few months that may have an interest for you or, as they are on tax matters, help you get to sleep this Holiday Season. The memos that include cases are only a brief summary. If you would like to reach any of these cases in the entirety, please let us know and we can send you a copy of the entire case.

Sincerely

Peter L. Klenk, Esq.

IRS ALERT

November 30, 2005- The Internal Revenue Service issued a consumer alert about an Internet scam in which consumers receive an e-mail informing them of a tax refund. The e-mail, which claims to be from the IRS, directs the consumer to a link that requests personal information, such as Social Security number and credit card information.

This scheme is an attempt to trick the e-mail recipients into disclosing their personal and financial data. The practice is called “phishing” for information.

The information fraudulently obtained is then used to steal the taxpayer’s identity and financial assets. Generally, identity thieves use someone’s personal data to steal his or her financial accounts, run up charges on the victim’s existing credit cards, apply for new loans, credit cards, services or benefits in the victim’s name and even file fraudulent tax returns.

The bogus e-mail, which claims to come from "tax-refunds@irs.gov" tells the recipient that he or she is eligible to receive a tax refund for a given amount. It then says that, to access a form for the tax refund, the recipient must use a link contained in the e-mail. The link then asks for the personal and financial information.

The IRS does not ask for personal identifying or financial information via unsolicited e-mail. Additionally, taxpayers do not have to complete a special form to obtain a refund.

If you receive an unsolicited e-mail purporting to be from the IRS, take the following steps:

- Do not open any attachments to the e-mail, in case they contain malicious code that will infect your computer.
- Contact the IRS at 1-800-829-1040 to determine whether the IRS is trying to contact you about a tax refund.

The IRS has seen numerous attempts over the years to defraud the public and the federal government through a variety of schemes, including abusive tax avoidance transactions, identity theft, and claims for slavery reparations, frivolous arguments and more. More information on these schemes may be found on the criminal enforcement page at www.irs.gov.

IRS UPDATES

- Beginning with 2005 returns due in 2006, individuals will be able to use a single IRS form (Form 4868) to get an automatic six-month extension of time to file. This will replace the existing two-step process under which an automatic

extension was only allowed for four months, generally until Aug. 15. If more time was needed, a taxpayer had to explain why, using a second extension request form (Form 2688). About 6% of individual taxpayers request the initial four-month extension, and about a third of those go on to request a second extension, usually for two months until October 15. Form 2688 will be eliminated.

Extension procedures will also be streamlined for business taxpayers, thus eliminating three existing forms. Under existing procedures, only corporations can request an automatic six-month tax-filing extension. The new regulations will also make this option available to most non-corporate business taxpayers, including partnerships and trusts.

Accordingly, starting Jan. 1, all eligible business taxpayers will use Form 7004 to request an automatic six-month extension of time to file. In the past, eligible non-corporate business taxpayers had to request an initial three-month extension and, if more time was needed, then request another three months.

- Personal exemptions and standard deductions will rise, tax brackets will widen and individuals will be able to make larger tax-free gifts in 2006, thanks to inflation adjustments announced today by the Internal Revenue Service.

By law, a variety of tax provisions must be revised each year to keep pace with inflation. As a result, more than three dozen tax benefits, affecting virtually every taxpayer, are being modified for 2006. Key changes affecting 2006 returns, filed by most taxpayers in early 2007, include the following:

1. The value of each personal and dependency exemption, available to most taxpayers, will be \$3,300, up \$100 from 2005.
 2. The new standard deduction will be \$10,300 for married couples filing a joint return, \$5,150 for singles and \$7,550 for heads of household. Nearly two out of three taxpayers take the standard deduction, rather than itemizing deductions, such as mortgage interest, charitable contributions and state and local taxes.
 3. Tax-bracket thresholds will increase for each filing status. For a married couple filing a joint return, for example, the taxable-income threshold separating the 15% bracket from the 25% bracket will be \$61,300, up from \$59,400 in 2005.
- The annual gift tax exemption will be \$12,000, up from \$11,000 in 2005. Revenue Procedure 2005-70, containing a complete rundown of inflation adjustments, is posted on the IRS Web site and will appear in Internal Revenue Bulletin 2005-47, dated Nov. 21, 2005.

You can access the Internal Revenue's website at www.irs.gov.

HURRICANE KATRINA AND ITS TAX IMPLICATIONS

In the wake of Hurricane Katrina, the Internal Revenue Service is offering taxpayers incentives to make contributions to the relief efforts. If you want to ensure that you are making a contribution to a legitimate organization, you can visit the Internal Revenue Service's website at www.irs.gov. For more detailed information, please contact your CPA or tax advisor. Here are examples of the some of the incentives offered:

FORMING FOUNDATIONS

- Form 1023 applications to form private foundations are being processed quickly.

CHARITABLE CONTRIBUTIONS FROM IRA'S

- An individual may take make a withdrawal from a qualified retirement plan to make a charitable contribution toward the Hurricane Katrina Relief Effort. An individual is now allowed to make a contribution up to the amount by which the taxpayer's contribution base exceeds the deduction for other charitable contributions.

LOSSES AND CASUALTY FROM KATRINA

- The Internal Revenue Service today is advising taxpayers who suffered casualty or theft losses as a result of Hurricane Katrina about a recent change to the tax law. A new provision lifts certain loss limitations for Hurricane Katrina victims. Ordinarily, to figure a deduction for a personal casualty or theft loss, you must reduce the loss by \$100 and also reduce the total of your casualty and theft losses by 10 percent of your adjusted gross income. Only the excess over these \$100 and 10 percent limits is deductible. The new law removes these limits for Hurricane Katrina losses, so that the entire amount is deductible. To qualify, a loss must be attributable to Hurricane Katrina and it must have occurred after August 24, 2005, in the Presidentially-declared disaster area. The \$100 and 10-percent limits still apply to losses that were not caused by Hurricane Katrina. Like all casualty and theft losses, Hurricane Katrina losses must be claimed as an itemized deduction. If you take the standard deduction you cannot claim them. You cannot claim a deduction for any part of a loss for which you receive or expect to receive insurance or other reimbursement. Casualty and theft losses are generally deductible only in the year the casualty occurred or the theft was discovered. However, because a Hurricane Katrina loss is a disaster loss, you have the option to deduct it on your tax return for the previous year, 2004. The \$100 and 10-percent limits will not apply to that loss in redetermining your 2004 tax. If you have already filed your 2004 return, the loss may be claimed by filing an amended return, Form 1040X, for 2004. Claiming the loss on an original or amended return for 2004 will provide you an earlier refund, but waiting to claim the loss on this year's return could result in a greater tax saving, depending on your tax situation for 2005. If you wish to claim the loss for 2004, you generally have until the due date for filing your 2005 return to do so. You determine your loss for personal use property by first figuring the decrease in its fair market value as a result of the

casualty or theft. To do this, you must determine the fair market value of your property both immediately before and immediately after the casualty or theft (counting the value of stolen property as zero). An appraisal is the best way to make this determination, but under certain conditions you can use the cost of cleaning up and repairing the property as a measure of the decrease in value. Compare the decrease in fair market value with your adjusted basis in the property. The adjusted basis is typically the cost of the property and any improvements. From the smaller of these two amounts, subtract any insurance or other reimbursement you receive or expect to receive. Generally, you figure your loss separately for each item, but treat real estate used for personal purposes, such as your home, as one item (including the land, buildings, trees and other improvements). Taxpayers filing or amending their 2004 tax return and whose only casualty or theft losses to personal use property claimed on that return were caused by Hurricane Katrina should write in red ink "Hurricane Katrina" at the top of Form 1040X. They must also attach the 2004 Form 4684, writing "Hurricane Katrina" on the dotted line next to line 11 and entering "0" on lines 11 and 17. Taxpayers filing or amending their 2004 tax return and who also have casualty or theft losses to personal use property not related to Hurricane Katrina should disregard the caution directing taxpayers to use only one Form 4684, located above line 13, and complete lines 13 through 18 for two Forms 4684. The Form 1040X and the first Form 4684 should be prepared as explained above for Hurricane Katrina losses only. The second Form 4684 should be prepared in the normal manner for all gains and non-Hurricane Katrina losses. If both Forms 4684 have a loss on line 18, they should carry the combined losses from that line to Schedule A (Form 1040), line 19. If there is a gain on line 15 of the second Form 4684, disregard the instruction to enter it on Schedule D, and instead enter on Schedule A (Form 1040), line 19, the excess of the loss from the first Form 4684 over the gain on line 15 of the second Form 4684.

END OF THE YEAR TAX TIPS

- Take a look at your health care plan for reimbursement and dependent care accounts.
- Check contributions to retirement plans. If you haven't made the maximum contribution, consider doing so now.
- Many taxpayers don't realize that they can deduct mileage for such charitable activities as delivering meals to seniors. Money spent on meals associated with charitable volunteer work may be deductible, but check with your tax advisor first. Little things like this underscore the need to keep accurate records.
- If exercising a stock option will push you into a higher tax bracket, consider deferring it for a year--especially if you'll have fewer options or lower compensation in the future. This can be tricky, so check with your tax adviser.
- If you are a settlor of an irrevocable trust (complex) that allow for discretionary distributions, you may want to pass out the income to a beneficiary in a lower tax bracket (Remember, trusts pay tax at the highest tax rates).
- If you want to make use of the \$11,000 gift tax exclusion or if you are married, \$22,000, you have until 12/31/2005 to make gifts.
- If you want to make contributions to charity, you have until the end of the year to do so.

If you have any tax questions, we recommend that you contact your tax advisor.

HILL VS. THE INTERNAL REVENUE SERVICE

T.C. MEMO 2004-156

Many people have misconceptions about the purpose of a trust. The Hill vs. the Internal Revenue Service (IRS) case provides an excellent example of why it is important to seek professional legal advice before opening a trust account.

STATEMENT OF FACTS

Mr. Hill worked as a real estate broker for over 20 years. In 1995, he attended seminars promoting the use of trusts to shelter his liability for Federal income taxes. Shortly after attending these seminars, Mr. Hill formed the Re-Cap Trust and transferred most if not all of his personal assets to the account. It is important to note that neither he nor his wife sought professional help concerning the tax implications.

In 2000, Mr. Hill filed a 1999 Form 1041, US Income Tax Return for Estates and Trusts, reporting income in the amount \$332,520 and total deductions of \$320,818. With the exception of interest income totaling \$435.00, all of his income was derived from real estate commissions. The deduction claimed on the 1041 included Mr. Hill's personal expenses. He also included his living expenses. His 1041 showed his tax liability to be \$255. Mr. Hill claimed a deduction for gifts and donations totaling \$21,439.00. There was no proof to substantiate these gifts.

Mr. Hill and his wife also filed a joint tax return reporting total income of \$19,365.00. Mr. Hill claimed that this income was attributable from Re-Cap Trust.

ANALYSIS

Under Section 170 (f) (8) (A) of the Internal Revenue Code (IRC), the Court found that Mr. Hill could not deduct any charitable contribution of \$250 or more because he did not have the requisite written acknowledgment for the amount he claimed. Under that section, the taxpayer must produce a written acknowledgment from the organization that received the contribution. The written acknowledgment should include the dollar amount, a description of the property and good faith estimates of any goods or services provided.

In addition, under section 6662 (a) and (b), the Court agreed with the IRS that Mr. Hill should be assessed an Accuracy-related penalty. Negligence includes any failure to make a reasonable attempt to comply with the provisions of the tax law, exercise ordinary and reasonable care in tax return preparation, or keep adequate books and records. The regulations also provide that negligence is strongly indicated when a taxpayer fails to report income shown on an information return, fails to make a reasonable inquiry into the correctness of a deduction, credit, or exclusion on a tax return that seems "too good to be true," or when the returns of partners or S corporation shareholders are clearly inconsistent with the tax returns of their respective entities.

CONCLUSION

The court found Re-Cap Trust was not a valid trust for Federal income tax purposes. Mr. Hill was assessed a tax liability of \$130,260.00 and an accuracy-related penalty of \$26,052.00.

This case is a prime example of what happens when one doesn't consult trust and tax professionals. The client needs the assistance of trust professionals who has a vast knowledge of trust and its tax implications. This is why if you are interested in setting up a trust, you should contact Peter L. Klenk and Associates and you should always consult your CPA when there is an income tax issue arises that is beyond your expertise level. We offer our experience in estate, trust and probate matters.

**UNITED STATES TAX COURT
T. C. MEMO 2004-271
ROARK VS THE INTERNAL REVENUE SERVICE**

Here at Peter L. Klenk and Associates, we constantly stressed the importance of seeking competent legal and tax advice. Estate and Tax Planning strategies must be executed in a way to provide our customers with the best results. When new estate-planning vehicles are made available to our clients, careful research and prudence are both needed. T.C. Memo 2004-271 is an example of what happens when one doesn't understand all of the tax consequences of an estate-planning tool. This case was filed on November 29, 2004.

FACTS

Petitioner, David Roark prides himself on his philanthropy. He is a very successful business owner and felt the need to give back to the very community that supported his efforts. He and his wife tithed regularly to their church and local religious charities. His favorite charity is the North Chattanooga Camp of the Gideons.

For years the Roarks relied on American Express Financial Services for financial advice. Robert Pippinger served as their financial advisor. He knew of their interest in charitable giving and also the Roarks' net worth.

NCF, a section 501 (c) (3) charitable organization, receives money from its own investments and from donations. One of the ways it receives donations is through "donor-advised" accounts. These accounts are also known as "individual foundations". Donors to these foundations contribute money or other property to a special individual account and they can direct NCF to contribute up to 75% of the principal and interest from that account to other charities of their own choosing. The remaining 25% of each account goes to the charitable programs at NCF, which focus on Christian humanitarian and missionary work. NCF also received donations through **charitable split-dollar insurance plans**.

A **charitable split-dollar insurance agreement** involves an individual transferring funds to pay premiums on a cash value life insurance policy that benefits both the charity and the taxpayer's family. In 1997, Mr. Pippinger became aware of **charitable split-dollar life insurance plans**. In fact, he spent his own funds to learn about these plans. Mr. Pippinger thought that this vehicle would be an excellent estate-planning tool for the Roarks. Mr. Pippinger reasoned that because proceeds from a life insurance contract that are paid by reason of the insured's death are excluded from income, section 101 (a) (1), sharing the cost of the premiums with a charity in a way that created current tax deductions an attractive option.

The Roarks immediately opened a donor-advised account with NCF. The account was called the David C. Roark Foundation. His charity of choice was the North Chattanooga Camp of the Gideons. The Roarks then created the Roark\ Irrevocable Life Insurance Trust on April 16, 1998. The policy was purchased through IDS Life, a subsidiary of American Express. The policy had a value of 2.2 million dollars. Mr. Roark was both grantor and beneficiary. His wife was named the trust's beneficiary if she survived her husband; the remainder beneficiaries were their children. Mrs. Roark also served as trustee.

The Plan Agreement called for the Roarks to donate large sums of money to the Roark Foundation and the NCF would pay the insurance premiums. The total sum was \$220,996. NCF also charged a \$2,000 administrative fee. After each payment, NCF would send a letter to the Roarks with the following language:

“I further acknowledge that, New Life Corporation of America (NCF’s legal name) is a charitable organization with the meaning of Section [170(c)] of the Internal Revenue Code, and is listed as such in the current revision of IRS Publication 78. In accordance with IRS regulations, no goods or services have been provided in connection with this gift.”

Everything went well until February 1999. Split-dollar agreements became so widespread that Congress stepped in. NCF acted fast; the possibility of Congress passing any bills and making them retroactive caused them to stop making payments on split-dollar agreements. Letters were sent out to those customers affected. Mr. Roark opted not to terminate his policy. He started paying the insurance premium.

In 1998, The Roarks contributed a total of \$220,966 to charity. Due to rules that set an annual ceiling on charitable contributions deductions, section 170 (d) (1), the Roarks deducted only \$166,031 in 1998 and carried over the remainder to 1999. The IRS sent a notice of deficiency disallowing the \$180,000 they gave to NCF for 1998 and 1999. The IRS later reduced the disallowance to \$160,000.

ANALYSIS

The Tax Court cited two previous cases that were similar to the Roark case. Addis v. Commissioner, 118 T.C. Memo 528 (2002) and the Weiner v. Commissioner, T.C. Memo 2002-153.* The Court ruled that deductions in these arrangements—known as split dollar life insurance agreements “foundered” on section 170 (f) (8). This section requires substantiation of a charitable contribution with a written statement by the charity. This statement must state whether the donor received any consideration, in whole or in part. In both of these cases, the Court found that the letters were invalid because the charities were paying their life insurance premiums.

Interesting enough Mr. Roark tried to distinguish his case from Addis’ by stating that Addis admitted that she expected the charity in her case to pay the premiums. Mr. Roark asserted that he had no idea what was going on with NCF because all of the

information went to his financial adviser. The Court, in turn, argued that the idea came from his financial advisor, not his charitable advisor. The Court also argued that he was very involved with American Express, i.e., IDS Life, a subsidiary of American Express and Robert Pippinger, his senior financial advisor at American Express. Mr. Roark had to know what the plan entailed. He was a very “sophisticated” businessman.

CONCLUSION

When recommending an estate-planning tool to customers, one must make sure that they understand all of the legal and tax consequences it entails. Robert Pippinger, as the Court noted, was a financial advisor, not a **charitable** advisor. He clearly tried to provide a viable estate-planning option but he apparently didn’t have a clear understanding of the tax consequences. We have to be very careful when giving advice to our clients, particularly when a specialty area is involved. At Peter L. Klenk and Associates, our practice is solely estate, trust and probate. Our entire staff have specialized training in all aspects of estate and tax planning.

***Both the Addis and Weiner cases were recently affirmed on appeal: Addis, 374 F.3d 881 (9th Cir. 2004) and Weiner, 102 Fed. Appx. 631 (9th Cir. 2004) The Internal Revenue Service issued an alert regarding charitable split-dollar insurance plans (IRS-Notice 99-36).**