A PLANNED GIVING PRIMER

Lawrence P. Katzenstein
Thompson Coburn LLP
One US Bank Plaza
St. Louis, Missouri 63101
(314) 552–6187
lkatzenstein@thompsoncoburn.com

© 2023 Lawrence P. Katzenstein

TABLE OF CONTENTS

FORGET THE DEFERRED GIFT – DO IT NOW 2
BASIC RULES 2
DONATIONS OF PARTIAL INTERESTS 3
RECAPTURE ON DISPOSITION OF TANGIBLE PERSONAL PROPERTY? 5
WHEN ARE OUTRIGHT CHARITABLE GIFTS EFFECTIVE? 5
PERCENTAGE LIMITATIONS FOR CHARITABLE CONTRIBUTIONS OF CASH 6
PERCENTAGE LIMITATIONS AND OTHER SPECIAL RULES FOR GIFTS OF PROPERTY 6
APPRECIATED PROPERTY 6
GIFTS OF PROPERTY SUBJECT TO POSSIBLE SALE 7
MARITAL PLANNING 8
APPRAISAL AND VALUATION ISSUES 8
RECORD KEEPING AND SUBSTANTIATION REQUIREMENTS TIGHTENED 9
CRACKDOWN ON APPRAISAL ABUSE 9
CHARITABLE REMAINDER TRUSTS AND POOLED INCOME FUNDS 10
TAX EFFECTS 11
COMMON ELEMENTS OF UNITRUSTS AND ANNUITY TRUSTS 11
PERIOD OF PAYMENT 12
PAYMENT AMOUNT 13
CALENDAR YEAR REQUIREMENT 13
GOVERNING INSTRUMENT REQUIREMENTS 13
TAXPAYER RELIEF ACT OF 1997 13
WHY USE CHARITABLE REMAINDER TRUSTS? 14
DIFFERENCES BETWEEN ANNUITY TRUSTS AND UNITRUSTS 14
VARIATIONS ON THE UNITRUST THEME 14
WHY USE AN INCOME–ONLY UNITRUST? 14
FLIP UNITRUSTS 15
OTHER REGULATORY CHANGES 15
ANNUITY TRUST VERSUS UNITRUST 16
ANNUITY TRUST FIVE PERCENT PROBABILITY TEST 16
THE "ALLOWED" VS. "ALLOWABLE" DISTINCTION 17
COMPUTING THE CHARITABLE DEDUCTION 18
INTEREST ASSUMPTIONS 18
MORTALITY ASSUMPTIONS 18
CHARITABLE REMAINDER UNITRUST COMPUTATIONS 19
GIFT AND ESTATE TAX RULES ONE LIFE INTERVIVOS CHARITABLE REMAINDER TRUSTS 19
TESTAMENTARY CHARITABLE REMAINDER TRUST FOR TESTATOR’S SPOUSE 20
CHARITABLE REMAINDERMAN 21
MISCELLANEOUS ITEMS 21
QUALIFIED REFORMATIONS 22
POOLED INCOME FUNDS 22
SPECIFIC REQUIREMENTS 23
TAXATION OF BENEFICIARIES 23
CHARITABLE CONTRIBUTION 23
TRANSFER TAX RULES 23
INTRODUCTION TO OTHER SPLIT INTEREST GIFTS 24
CHARITABLE GIFT ANNUITIES 24
DIFFERENCES BETWEEN CHARITABLE REMAINDER ANNUITY TRUSTS AND CHARITABLE GIFT ANNUITIES 24
GIFT OF A REMAINDER INTEREST IN A PERSONAL RESIDENCE OR A FARM 25

A PLANNED GIVING PRIMER

FORGET THE DEFERRED GIFT – DO IT NOW

Gifts of cash or property to charitable organizations, with certain limitations, are deductible for federal income, estate and gift tax purposes, although not necessarily to the same extent. IRC §§170, 2055 and 2522. Charitable contributions made during lifetime are generally preferable to charitable gifts made by will. A charitable bequest is deductible for federal estate tax purposes, but is not deductible for income tax purposes. A gift made during lifetime is out of the donor's estate for estate tax purposes, but also provides the donor with a deduction for income tax purposes. Thus for donors in a 40% combined federal-state bracket, a charitable gift during lifetime is 40% cheaper than a similar gift by will. The beauty of split interest gifts is that they accelerate a charitable deduction into lifetime, but allow the donor to use the property during lifetime.

BASIC RULES

Before reviewing the split interest rules in detail, let us first review the basic rules governing the charitable deduction.

Deductibility assumes there is no quid pro quo for the gift, such as tuition reduction, or other special privileges granted to the donor. Deductions may also be disallowed where the gift is earmarked for the use of a particular individual.

A gift of services to a charitable organization is not deductible. Actual out–of–pocket expenses rendered in connection with the performance of services for a charity are deductible. This includes a mileage deduction for automobile expense. Similarly, the gift of use of property––for example, rent–free use of a building—is not deductible, on the theory that to allow a deduction would produce a double deduction, since the donor has not been required to include the foregone rent in income. Regulation §1.170A–7(a)(1).

Only gifts to certain organizations are deductible. For income tax purposes, contributions are deductible only if made to organizations which:

1. Are created or organized in or under the laws of the United States, a state or the District of Columbia, or certain possessions. Note: for estate tax purposes, the organizations need not be located in the United States.

2. The organization must be organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, or for prevention to cruelty to children or animals.

3. No part of the net earnings of the organization can inure to the benefit of any private shareholder or individual.

4. The organization may not be disqualified for tax exemption under §501(c)(3) by reason of attempting to influence legislation, and cannot participate in or intervene in (including publishing or distributing of statements) any political campaign on behalf of or in opposition to any candidate for a public office. IRC §170(c)

In addition to the charitable organizations described above, contributions to governments and governmental subdivisions, certain war veterans organizations, cemetery companies and other special–case organizations may qualify for deductible contributions. But be careful! The rules are often different for income, gift and estate tax purposes. For example, a lifetime gift to a cemetery company owned and operated for the benefit of its members is deductible for income tax purposes, but not estate tax purposes. A gift to a post or organization of war veterans is deductible for income tax purposes, but only bequests to veterans organizations incorporated by an act of Congress are deductible for estate tax purposes. For most donors, deductibility because of the organization's activities is rarely an issue. The Internal Revenue Service publishes on its web site a complete listing of organizations, contributions to which are deductible. If you are not certain whether the charity qualifies, ask the charity for a copy of its exemption letter.

DONATIONS OF PARTIAL INTERESTS

Non–trust gifts of partial interests are for the most part not deductible. For example, if I own an art work and also the copyright in the art work and contribute one but not the other I have made a non-deductible split interest gift. Or if I contribute land but retain the mineral rights, I get no deduction. As another example, non–trust gifts of remainder interests in real estate are not deductible (except for gifts of remainder interests in personal residences or farms) and gifts of remainder interests in personal property are not deductible.

> Example: An art collector's inter vivos, irrevocable, binding gift of a painting to a museum, effective on the donor's death, is not deductible for income tax purposes. IRC §170(a)(3), 170 (f)(3). A contribution of an undivided portion of the taxpayer's entire interest in property is deductible, although subject to special rules that apply to fractional interest gifts in tangible personal property. IRC §170(f)(3)(B)(ii).

What many donors of art would really like to do is keep a life estate and donate a remainder interest to charity, as donors are permitted to do with a personal residence. Since 1969, of course, this cannot be done because the split interest is not in the form of an annuity trust or unitrust. One way in which this rather simple case has sometimes been handled is with gifts of fractional interests in art. This is ideal for the donor who spends a portion of the year at another residence.

> Example: Donor spends four months each year at a Florida residence and resides for the remainder of the year in a cold northern city. Donor can give to Museum a one-third undivided interest in the painting and retain an undivided two-thirds interest. Museum will have the right to possess the painting for one-third of the year and the donor will have the right to possess the painting two-thirds of the year.

Note that in Winokur, 90 T.C. 733 (1988), Acq. 1989-1 C.B.1, the United States Tax Court

ruled that the deduction would be permitted even if the museum did not in fact exercise its right so long as it had the legal right to do so. Any donor relying on the Winokur case would run the risk, however, that if the museum did not exercise its right, the Service would argue that there was an understanding that the museum would not exercise its right during donor's lifetime.

A deduction has always been permitted for an undivided interest in tangible personal property despite the prohibition of Code section 170(f)(3), which denies a deduction in the case of a contribution not in trust of an interest in property which consists of less than the taxpayer's entire interest in the property. The deduction is permitted by Code section 170(f)(3)(B)(ii) because the taxpayer is contributing an undivided interest in all of the taxpayer's interest. In other words, a vertical division (such as a one-third fractional interest) is permitted but a horizontal division is not.

Since the Pension Protection Act of 2006, gifts of a fractional interest in tangible personal property are still deductible at fair market value if the property will be used by the charity in a way that is related to its exempt purpose. However, unlike prior law, if a donor makes an initial fractional contribution and then fails to contribute all of the donor’s remaining interest to the same donee before the earlier of ten years from the initial fractional contribution or the donor’s death, then the donee’s income tax and gift tax deductions for all previous contributions of interest in the item are recaptured with interest. (A special rule applies if the donee of the initial contribution is no longer in existence.) Furthermore, the 2006 law overruled the Winokur decision noted above by providing that if the donee of a fractional interest in tangible personal property fails to take “substantial physical possession” of the property during this period or fails to use the property for an exempt use, then the income and gift tax deductions for all previous contributions of interest in the item are recaptured plus interest. The Joint Committee report notes that inclusion of a painting in an art exhibit sponsored by the donee museum would generally be considered as satisfying the related use requirement. Adding further teeth to this provision is an additional tax equal to ten percent of the amount recaptured if there is a recapture of the deduction as above described. The Joint Committee report notes that the Secretary is authorized to provide regulatory guidance where more than one individual owns undivided interests in tangible personal property.

A contribution which occurred before the effective date of enactment is not treated as an initial fractional contribution for purposes of this provision. However, the first fractional contribution by the taxpayer after the date of enactment is considered the initial fractional contribution even if there has been a prior fractional interest contribution. This provision will have an impact on donors who have made an initial fractional contribution and intend to make continuing fractional contributions with the final contribution occurring, perhaps, not until death. Unless all further contributions of fractional interests are completed within a ten year period the recapture provisions will apply.

The estate and gift tax trap in the original act was fixed by a technical corrections bill. Under the Pension Protection Act as originally passed, in determining the deductible amount of an additional contribution of a fractional interest, the fair market value of the item for income, gift and estate tax purposes was the lesser of (1) the value used for purposes of determining the charitable contribution of the initial fractional contribution; or (2) the fair market value of the item at the time of the subsequent contribution. That meant that if the property appreciated after the first fractional gift, the donor would have had to pay gift or estate tax on the appreciation. That

problem has been fixed. The donor's income tax deduction will still be based on original values, but at least the generous donor won't get socked with estate or gift tax on a subsequent gift.

If this hadn't been fixed, it would have meant the end of fractional gifts of interests in art which would have been very detrimental to museums. A visit to any major museum, particularly museums of modern art, will show gifts of fractional interests on the donor recognition plaques.

RECAPTURE ON DISPOSITION OF TANGIBLE PERSONAL PROPERTY?

A related provision of the Pension Protection Act also dealt with gifts of tangible personal property. The tax law has for many years provided that contributions of appreciated tangible personal property to charity are deductible only to the extent of cost basis unless the property will be used in connection with the donee charity's exempt purpose. The classic example is the gift of a painting to a museum. But what happens if after the gift the museum in fact sells the painting or ceases to use it for an exempt use? Under prior law, this was dealt with only by random audit. A charity selling donated property within three years after the date of the gift must report the sale on a form 8282, but the form 8282 was mostly designed to substantiate values rather than to deal with charitable uses of tangible personal property. Under the 2006 provision, if the charity disposes of the tangible personal property within three years of the contribution, the donor will be subject to a reduced contribution deduction. If the disposition occurs in the tax year of the donor in which the contribution is made, the deduction will generally be basis rather than fair market value. If the disposition occurs in a later year, the donor must include as ordinary income for the taxable year in which the disposition occurs the excess deduction claimed over the donor's basis. The adjustment can be avoided if the charitable donee certifies under penalties of perjury to the IRS that the use of the property was related to the purpose or function constituting the basis for the donee's exemption and describing the use and how the use furthered the purpose, or must state that the intended use became impossible or infeasible to implement. The reporting requirements have been modified so that any disposition within three years after receipt (rather than two years) must be reported on a form 8282. In addition, the donee must provide a description of the donee's use of the property, a statement of whether the property's use was related to the purpose or function constituting the basis for the donee's exemption and in some cases a certification of the use as noted above. This provision was effective for contributions made and returns filed after September 1, 2006 for contributions for which more than a $5000 charitable deduction is claimed.

WHEN ARE OUTRIGHT CHARITABLE GIFTS EFFECTIVE?

Charitable pledges are enforceable in many states, but neither a pledge nor a gift of the donor's promissory note is deductible for income tax purposes until satisfied. Gifts of cash are effective when the gift is beyond the control of the donor. For example, if donor's agent is used to deliver a cash gift to a charity, the gift is complete only when charity takes possession. If the charity's agent receives the cash from the donor, the gift is complete when the charity's agent receives the cash.

Checks represent a special case. Although a donor can stop payment on a check, the rule for charitable deduction purposes is that the charitable gift is complete upon delivery or mailing of the check, even though payment can be stopped, if the check clears in the ordinary course of business. Therefore, checks dated December 31 and mailed to the charity before midnight are

considered complete for income tax deduction purposes if the checks clear in the ordinary course of business. Charitable gifts made by credit card are deductible in the year in which the charge is made to the donor's account even if the monthly statement is not paid until the following year.

As with gifts of cash, gifts of tangible personal property are effective upon delivery to the charity or charity's agent. With respect to gifts of securities, the question of timing turns on whether the securities are delivered to the donor's broker or the charity's broker. If the securities are delivered to the donor's broker with instructions to transfer securities to charity, the gift is effective only when the securities are transferred on the books of the company, because donor until that time could revoke the gift through his agent. If, on the other hand, the securities are delivered to the charity's broker, the gift is effective upon delivery since donor theoretically is unable to revoke the gift after that point.

Gifts of real property are effective upon delivery of the deed to the charity, unless recording is required to perfect title, in which case the transfer is effective upon recording.

PERCENTAGE LIMITATIONS FOR CHARITABLE CONTRIBUTIONS OF CASH

A donor who contributes cash to public charities may deduct up to 60% of his "contribution base"—basically adjusted gross income computed without regard to net operating loss carrybacks. Note, however, that because of a drafting error, if the donor makes any non-cash gifts in the same year, the 60% enhanced cash contribution deduction is not available. This will almost certainly be fixed in technical corrections. Any part of the gift not deductible because of the contribution percentage limitation can be carried over and deducted in the five following taxable years until exhausted. The carryovers are themselves subject to the 60% limitation in each of the carryover years, which gifts made in that year taken into account first, before application of any carryovers. If the donor dies, the carryover is lost—it does not become available to his estate or beneficiaries. Gifts made to private non–operating foundations or for the use of an organization rather than "to" the organization have a 30% contribution limitation with the same five year carryover. Note that a charitable lead trust is considered a transfer "for the use of" charity and is thus subject to the 30% limitation. The 30% and 60% limitations are not separate limits, but have a complicated interrelationship.

PERCENTAGE LIMITATIONS AND OTHER SPECIAL RULES FOR GIFTS OF PROPERTY

Where property has depreciated in value, only the fair market value is deductible, and a donor is not entitled to a loss on his income tax return. Therefore, a donor who desires to contribute property which has gone down in value should sell the property first, thus realizing the loss for tax purposes, and contribute the proceeds.

APPRECIATED PROPERTY

Gifts to public charities of appreciated property which has been held for the long term capital gain holding period (currently one year) are fully deductible at fair market value on date of gift. The donor is not taxed on the appreciation as he would be if he sold the appreciated property and gave the proceeds to charity. The contribution limitation for gifts of appreciated property to a public charity is 30% of the donor's contribution base. However, a special election permits the

donor to deduct up to 50% of his contribution base if he forgoes the deduction for the appreciation and deducts only his cost basis in the property. 170(f)(3)(B)(iii). When should the election be made? The deduction will obviously be desirable where the appreciation is small. For example, if the donor makes a charitable gift of securities worth $50,000 which he purchased for $49,900, the election should be made if it will increase the amount currently deductible. If the donor is unlikely to survive the carryover period, the election may be desirable, since the carryover dies with the donor. So the election should be considered where the donor is very elderly or in poor health, and therefore unlikely to survive the carryover period.

If a donor holds both appreciated securities he wishes to retain and cash, the donor should consider a gift of the securities followed by a purchase on the open market of shares with his cash. This achieves a "free" step–up in basis for the shares held by the donor.

Gifts of securities which have not been held for the long term capital gain holding period are deductible only to the extent of donor's basis. The same rule applies to assets which are not capital gain property at all, but would produce ordinary income if sold. These include most inventory as well as property created by the donor. Another example would be a farmer's crops.

> Example: The painter contributes a painting worth $500,000, painted by himself, to charity. The donor's deduction is limited to the cost of the canvas and paint. The theory is that the donor has not had to include the value of the sale proceeds in income. Similarly, an author cannot contribute his manuscripts to charity and deduct an amount in excess of the cost of the paper. However, a person inheriting the property from the creditor will be able to do so, since he has a new cost basis equal to date of death value.

Gifts of appreciated capital gain property to private foundations are generally allowable only to the extent of basis.

Special rules apply to contributions of appreciated tangible personal property. A donor is limited to his basis in tangible personal property if the gift is to a charity whose use of the property is unrelated to the charity's exempt purpose.

> Example: A gift of a painting to a museum is deductible at fair market value, but a gift of a painting to a medical research institution would probably not be. Similarly, if a painting is given to a museum which intends to sell it rather than display it, the gift is unrelated to the charity's exempt purpose, and no deduction for the appreciation will be allowed. Section 170(e)(1)(B)(i).

For estate tax purposes, there is no percentage limitation for gifts to charity. Estates of any size can be left to charity without any imposition of transfer tax.

GIFTS OF PROPERTY SUBJECT TO POSSIBLE SALE

A donor often considers a gift of appreciated property to charity in anticipation of the sale of the property. This is particularly true with gifts to charitable remainder trusts, where the donor expects a return from the entire proceeds of the sale rather than the proceeds reduced by income

taxes. So long as on the date of gift there is no "meeting of the minds" between the buyer and the seller, the gift to the charity should result in the charity being taxed on the gain rather than the donor. This will not work where a sale contract has been signed without substantial contingencies to closing and the charity's only required activity is to carry out the terms of the previously negotiated sale.

One way to remove cash from a donor's closely held corporation for charitable gifts is a gift of closely held corporation for charitable gifts is a gift of closely held shares by the donor to charity, followed by redemption of the stock by the charity. See Palmer, 62 T.C. 684 (1974). The Internal Revenue Service acquiesced in Palmer in Rev. Rul. 78–197, 1978–1 C.B. 83, ruling that the Service would treat proceeds of a redemption as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption.

MARITAL PLANNING

A frequent technique since the unlimited marital deduction is a bequest of a certain amount to a spouse, with a request that the spouse make the charitable contribution, so as to obtain the income tax deduction. Where the donor's will creates a trust, the will can provide that to the extent the spouse has not made the gift, the trust would make the distribution to charity at the spouse's death. Section 2056(b)(8) provides that the surviving spouse's interest in a charitable remainder trust qualifies for the marital deduction if the spouse is the only non–charitable beneficiary. A qualified terminable interest property trust can sometimes achieve the same result with more flexibility. The property is deductible in the estate of the first spouse under the marital deduction provisions, is includable in the second spouse's estate but qualifies in the second spouse's estate for a charitable contribution deduction, thus resulting in no tax. The advantage of using the QTIP is that it is more flexible—the principal can be invaded if the surviving spouse requires it, for example. The advantage of the charitable remainder trust is that capital gains in the trust will not be taxable, whereas in the QTIP the capital gains will be subject to tax.

APPRAISAL AND VALUATION ISSUES

One of the most litigated issues in the area of charitable contributions is the problem of valuation. Because of substantial, widespread abuse, many charitable gifts of property other than marketable securities must have formal appraisals. Failure to attach the appraisal to the return could result in loss of the charitable deduction. What property is subject to the appraisal rules? Any gift in excess of $5,000, other than cash or marketable securities, is subject to the appraisal requirements. If a group of items of similar kinds of property is contributed, if the group itself is worth more than $5,000, the appraisal rules apply even though the gifts of property are made to different charities, no one of which receives more than $5,000.

For gifts of stock which is not publicly traded, if the value deducted is between $5,000 and $10,000, a formal appraisal is not required, but a partially completed Form 8283 should be attached. See instructions to Form 8283. Even gifts of publicly traded stock in excess of $5,000 must be reported on a partially completed Form 8283, though no appraisal is required.

The appraisal requirements apply even though the gift is soon thereafter sold. For example: suppose donor is negotiating a sale of the stock to a buyer, and the sale is consummated shortly

after the gift. Even though the best evidence of the value of the stock is the amount a willing buyer and a willing seller were able to negotiate, there is no exception in the appraisal rules for such later developments. For art work contributed to charity, the donor must attach a copy of the appraisal itself, and either an 8 x 10 color photograph or a 4 x 5 color slide of the property. With respect to the appraisals, note that the appraisal is not required merely because the property contributed is worth more than $5,000. The appraisal is required only if a deduction of more than $5,000 is claimed. For example: if a donor contributes art to a charity with a value of $6,000, the donor can avoid the appraisal requirements by deducting only $5,000 on his return. Appraisals for claimed deductions of over $500,000 must actually be attached to the return and the returns for any carryover years for the donation.

A qualified appraisal must be prepared by an appraiser who holds himself out to the public as an appraiser and the appraisal must include detailed information regarding the appraiser, including information regarding his background, educational experience and qualifications. The appraisal can be prepared no earlier than 60 days before the contribution, and the appraiser's fee cannot be based on a percentage of the appraised price, since this obviously would inflate the appraisal. See Regulation §1.170A–13(c)(i) which includes the appraisal requirements in detail. Most appraisers do not know how to be a charitable qualified appraisal—they are not like other appraisals. For example, they must include a statement that the appraiser acknowledges that the appraisal will be used for tax purposes and that there are penalties for overvaluation.

Note that for tangible personal property gifts of more than $500 but less than $5,000, the appraisal rules do not apply, but a partially completed Form 8283 must still be attached to the return.

Since the best evidence of fair market value is the price a willing buyer and willing seller are able to negotiate, if a charity sells contributed property within three years after the gift, it must report the sale price to the Internal Revenue Service on a Form 8282. A copy of the form must be supplied to the donor. Receipts are required for all charitable gifts in excess of $250 and further require substantiation with regard to quid pro quo gifts.

RECORD KEEPING AND SUBSTANTIATION REQUIREMENTS TIGHTENED

The substantiation rules provide that no charitable deduction is allowed for contributions of $250 or more unless the taxpayer has in his or her possession a contemporaneous written acknowledgment from the charitable recipient. Even donors claiming a deduction for amounts less than that must have reliable written records proof of the contribution, either a bank record or written acknowledgment from the donee showing the name of the donee or organization, the date of contribution and amount of the contribution. So, unlike the old days, no deduction for cash left in the church collection plate Sunday mornings and the recordkeeping requirements cannot be satisfied by written records such as a contemporaneous log or journal maintained by the taxpayer. Many charities deal with this by acknowledging all gifts with a written acknowledgment, regardless of amount.

CRACKDOWN ON APPRAISAL ABUSE

Under the 2006 law changes, substantial valuation understatements of charitable gifts are

more likely to trigger penalties. Under the 2006 changes, a substantial valuation misstatement is deemed to exist if the appraised/claimed value of the property in question is 150% or more of the finally determined value rather than 200%. A gross valuation misstatement penalty is triggered at a 200% overstatement rather than 400%. The reasonable cause exception for underpayments was eliminated. Note that for income tax purposes the reasonable cause exception may apply in some cases if the taxpayer bases the value on a qualified appraisal, makes a good faith investigation and meets other requirements. Penalties may also apply to the appraiser – a civil penalty for some valuation misstatements.

CHARITABLE REMAINDER TRUSTS AND POOLED INCOME FUNDS

Charitable remainder trusts take advantage of the fact that lifetime gifts to charity are almost always superior from a tax standpoint to testamentary charitable transfers. A bequest by Will is deductible for estate tax charitable deduction purposes. A lifetime gift has the same estate tax effect as a bequest because at the donor's death the property has been removed from the donor's estate, but in addition a portion of the lifetime gift is recaptured through the charitable income tax deduction.

> Example: A testator in a 45% estate tax bracket who bequeaths $100,000 to charity recovers 45% of it through the estate tax deduction. If the property had been given to charity during lifetime, not only would the estate tax have been saved (because the property would not have been in the donor's estate at the date of death) but a portion of the gift would have been recovered through the income tax deduction.

Charitable remainder trust basic concept: Donor transfers property to trust retaining an income interest for life or lives, with remainder passing to charity at the last beneficiary's death. Donor receives an immediate income tax deduction for the actuarial value of the remainder. The life beneficiaries may (but are not required to) include the donor.

In the good old days (i.e., before the Tax Reform Act of 1969) donors simply established trusts providing for payment of all of the income to the donor or other life beneficiary, prohibiting invasion of corpus, and providing for the remainder to pass at termination of the life interest to the charitable remainderman. The donor received an income tax deduction based on the actuarial value of the remainder following an income interest for a life or lives. Why did Congress change the rules? Congress was primarily concerned that assets would be invested to produce a high rate of return with little consideration for the protection of corpus for the benefit of the remainderman. The solution was a form of trust which would pay amounts to the income beneficiaries which were not dependent upon investment return.

The two types of remainder trusts permitted by Section 664 are charitable remainder annuity trusts, which provide for payment of a fixed amount at least annually, and charitable remainder unitrusts, which require payment of a fixed percentage of the trust, revalued annually. The Code now provides that no charitable deduction is permitted for a charitable remainder in a split interest trust (other than a pooled income fund) unless the life or term interest is a fixed annuity or unitrust amount. This is true for income tax deduction purposes (section 170(f)(2)(A)),

federal estate tax charitable deduction purposes (section 2055(e)(2)) and gift tax charitable deduction purposes (section 2522(c)(2)).

TAX EFFECTS

The charitable remainder trust is exempt from tax pursuant to Section 664(c) unless it has unrelated business income. The unrelated business income problem can be a real trap. See, for example, the Leila G. Newhall decision, 105 F.3rd 482 (9th Cir., 1997) affg. 104 T.C. 236 (1995) where a unitrust was disqualified because of UBTI. The trust was funded with publicly traded stock. On liquidation of the corporation, the trust received interests in publicly traded partnerships holding various mineral and other rights. The Tax Court held that the business interests and operations of the partnerships would be attributed to the unitrust, and the decision was affirmed by the Ninth Circuit. Under a changes in the law which became effective January 1, 2007 UBTI is subject to a 100% excise tax but will not disqualify the trust.

Unlike the usual trust rules, which provide for pro rata inclusion in the beneficiary's income of various classes of income, charitable remainder trust beneficiaries are taxed on a tier system providing for least desirable types of income to be exhausted first in accordance with the tier system.

Ordinary income, either from current year earnings or prior year accumulations, is deemed to be distributed first, followed by capital gains, followed by tax–exempt income, followed by return of corpus. Within each tier the same ordering rules apply, so that in the ordinary income tier, interest which taxed at a higher rate than qualified dividends is deemed distributed first. Net investment income ("NII") accumulated prior to January 1, 2013 is grandfathered from the new net investment income tax. NII earned on or after that date can be held in a sub-tier with the usual tier system or calculated separate from and in addition to the usual four tiers.

Income in the trust in excess of the current year distributions is not taxed to the trust but is accumulated by class of income for purposes of determining taxability of beneficiaries in future years.

What this means is that highly appreciated assets paying little income can be sold by the trust and reinvested without capital gains cost either to the beneficiary or to the trust. But if the proceeds are invested in assets producing tax–exempt income, the amounts distributed either from current year earnings or prior–year accumulations are deemed to be taxable capital gains until they are entirely exhausted.

COMMON ELEMENTS OF UNITRUSTS AND ANNUITY TRUSTS

Unitrusts and annuity trusts have many common elements, and the two types of payouts may not be combined. For unitrusts for a life or lives, section 664 requires that payment be made to one or more persons, at least one of whom is not an organization described in Section 170(c) and, in the case of individuals, only to an individual who is living at the time of creation of the trust. It is apparent from reading Section 664 that a person does not have to be a natural person, but may be a corporation, partnership or other entity. See Section 7701 for the statutory definition of person. Charitable remainder trusts for persons who are not individuals are rare. Obviously, in

the case of payments to a person who is not a natural person, the payment can only be for a term of years, and may not be for the lifetime of the "person". Payment may be made to multiple beneficiaries, either jointly or concurrently. Additional life beneficiaries will, of course, lower the charitable deduction.

PERIOD OF PAYMENT

Both charitable remainder annuity trusts and charitable remainder unitrusts must be payable for the life or lives of one or more individuals living at the time of the creation of the trust or for a term of years, not in excess of twenty years. (Charitable lead annuity trusts and charitable lead unitrusts need not be limited to a 20–year term.) The longer the term, the less will be the tax deduction. Some combinations of life or lives plus term of years will qualify, so long as the term of the trust cannot exceed lives in being at the creation of the trust.

> Example: To A for life and then to B for the shorter of B's life or a term of years not to exceed twenty years. So long as both A and B are living at the creation of the trust, the trust qualifies.

The key here is that the trust cannot last longer than the lives of the beneficiaries. Therefore, payment to A for life and then to B or B's estate for term of years does not qualify. The trust could last longer than the lives of the beneficiaries living at the creation of the trust or term not to exceed twenty years.

> Example: Payment to A for twenty years, provided that if A dies before the expiration of term, payment will be made to B and if B dies before the expiration of the term, then payment to C. The term cannot exceed twenty years and therefore qualifies.

The payment period can terminate earlier than it would otherwise terminate, dependent upon any contingency. Earlier rulings had held that trusts did not qualify where the unitrust or annuity payment would end upon a contingency, resulting in earlier payment to the charity. A typical such contingency is remarriage. There is no policy reason to disqualify the trust in the event of early termination since the only effect is that the charity receives the remainder earlier than it would otherwise. A 1984 amendment to Section 664 provided that any "qualified" contingency the effect of which is to accelerate the charitable remainder is permitted. A qualified contingency is defined in Section 664(f)(3) as any provision of a trust which provides that upon the happening of a contingency the unitrust or annuity trust payments will terminate not later than the payments would otherwise have terminated. Thus, a trust providing for payment of a unitrust amount to X for life or until X's remarriage will qualify, even if the value of the contingency is unascertainable. The qualified contingency will not increase the value of the remainder for charitable deduction purposes. This is true even where the contingency is capable of valuation, as is, for example, the possibility of remarriage. But this means the contingency can be far–fetched without disqualifying the trust.

Use of the qualified contingency makes possible a number of planning ideas. In terrorem provisions, for example, are now permitted. In private letter rulings before 1984, the Service ruled that an in terrorem provision disqualified a charitable remainder trust, because the term of the trust

would no longer be measured by the lifetime of the beneficiary, but by the lifetime of the beneficiary or, if shorter, the beneficiary's filing of a will contest. Trusts which end on remarriage are also now permitted. Note that the marital deduction will be available for such trusts, as Section 2056(b)(8) provides that the terminable interest rule does not apply to charitable remainder trusts.

> Example: A unitrust providing for payment of a unitrust amount to A for life or, if earlier, the date on which the St. Louis Cardinals next win the World Series, qualifies.

PAYMENT AMOUNT

The payment amount from both unitrusts and annuity trusts must be at least 5%. (Note that there is no minimum payment for lead unitrusts or lead annuity trusts, PLR 9415009 to the contrary notwithstanding. That ruling is wrong.) In the case of a charitable remainder unitrust, the payment must be at least 5% of the trust revalued annually. In the case of a charitable remainder annuity trust, the payments must be at least 5% of the initial fair market value of the trust assets. The Taxpayer Relief Act of 1997 added two additional requirements. First, the payment may not exceed 50% of the fair market value of the assets revalued annually in the case of a unitrust, or 50% of the initial fair market value of the assets in the case of an annuity trust.

CALENDAR YEAR REQUIREMENT

Code section 644 (former section 645) requires all trusts except wholly–charitable trusts to use a calendar year for tax reporting purposes. Split–interest trusts are not wholly charitable and are therefore required to be on a calendar year.

GOVERNING INSTRUMENT REQUIREMENTS

The Service in many rulings has issued governing instrument requirements for charitable remainder trusts. Without going into details of drafting, suffice it to say that the requirements are technical and often nitpicking. In Rev. Procs. 89–20, 89–21, 90–30, 90–31, 90–32 and 90–33 the Service issued sample charitable remainder unitrusts and annuity trusts which include much simpler language than some of the earlier Internal Revenue Service announcements. This is particularly true with regard to proration of partial year payments and similar technical provisions. If the language of the Rev. Procs. is used and if the Rev. Proc. is referred to in the trust instrument, the Service will recognize the trust as satisfying all the requirements and will no longer normally issue rulings as to qualification. The Rev. Procs include sample suggested language for two–life trusts and for various variations such as income–only unitrusts.

TAXPAYER RELIEF ACT OF 1997

The Taxpayer Relief Act of 1997 added two additional requirements for charitable remainder trusts. First, the payout from the charitable remainder trust (whether a unitrust or an annuity trust) may not exceed 50%. In addition, the actuarial value of the remainder interest (determined under Section 7520) must be at least 10% of the initial fair market value of the property placed in the trust. The 1997 act included liberal reformation provisions so that defective trusts which flunk the test can be reformed so as to qualify.

WHY USE CHARITABLE REMAINDER TRUSTS?

As noted above, the contribution to the trust generates an immediate income tax deduction even though the donor is able to keep a life income interest. The charitable remainder trust can often enable a donor to diversify his or her assets, increasing the donor's income without incurring capital gains cost. For example, a donor may have highly appreciated securities paying a 4% dividend. In order to diversify or increase his income, the donor could sell the securities and reinvest the proceeds in higher yielding assets, but the amount reinvested would be reduced by capital gains taxes incurred. The charitable remainder trust makes it possible to achieve diversification without capital gains cost. Stock can be contributed to a charitable remainder trust, sold without capital gains cost and the proceeds reinvested in higher yielding assets. The effect of all of this is to greatly reduce the cost of charitable giving for charitably–inclined donors.

If cash is contributed, the cash can be invested in tax–exempt securities, yielding tax–exempt income to the donor, provided that there is no express or implied understanding that the trustee will so invest and so long as the agreement does not prohibit the trustee from investing so as to achieve a reasonable return. (And if there is no non–exempt accumulated income from prior years.) See Rev. Rul. 60–370, 1960–2 C.B. 203, in which the Service ruled that where the trustee is under an expressed or implied obligation to sell or exchange the property contributed for tax exempt securities, the donor will be deemed to have sold the property and to have realized the gain himself. Unlike a pooled income fund, the CRAT or CRUT investments can be separately managed and tailored to a particular donor's needs, or can be invested with endowment funds.

DIFFERENCES BETWEEN ANNUITY TRUSTS AND UNITRUSTS

As noted above, the charitable remainder unitrust must provide for payment of a fixed percentage (at least 5%) of the trust revalued annually. The unitrust must explicitly either permit future contributions or must prohibit them. If future contributions are permitted by testamentary addition, the instrument should contain language providing for interest on delayed distributions from the estate at 10% interest or at such other interest rate as may then be required by federal regulation. See Regulation Section 1.664–1(a)(5), T.D. 7955. Generic language incorporating whatever federal rate is then in effect should be included. Annuity trusts must prohibit future contributions.

VARIATIONS ON THE UNITRUST THEME

The charitable remainder unitrust, which calls for payment of a percentage of the trust revalued annually, may also provide that if the income of the trust is less than the unitrust amount, only the income need be paid. The valuation of the charitable remainder is not affected. The trust may, but is not required to, provide that if income is less than the unitrust amount in any year, deficiencies can be made up in future years in which income exceeds the unitrust amount. The calculation of the remainder (and therefore the charitable deduction) is made without taking into account the income–only feature.

WHY USE AN INCOME–ONLY UNITRUST?

Income only unitrusts are appropriate where a donor contributes appreciated property paying less than the unitrust amount, with the expectation that the property will be sold and reinvested in higher yielding assets, but it may take some time to make the sale. For example, a donor may contribute unproductive real estate which will be sold by the trust. Until the property is sold, the trust may have little or no income, making it impossible to pay the unitrust amount and at least theoretically requiring a distribution of a portion of the asset in order to make each unitrust payment. The annuity trust may not have an income–only exception. The annuity amount must be paid whether or not the asset produces income. For this reason, annuity trusts are not appropriate where unproductive property may be held by the trust before sale.

FLIP UNITRUSTS

Some commentators, most notably the late David Donaldson, had suggested use of a so–called "flip" unitrust—an income only unitrust which becomes a straight unitrust upon sale of the unproductive property. This would allow a trustee to invest for total return rather than having to strain to achieve income equal to the unitrust payout percentage. There is no policy reason a flip trust should not be permitted, since the charitable deduction for a unitrust is the same whether or not the income–only feature is included. But for many years there was no authority for such a provision. In fact, in PLR 9506015, the Service ruled that judicial reformation of an income only unitrust to add a flip provision would be a disqualifying self–dealing transaction. An alternative which some advisors considered was a provision allocating capital gains to income. If permitted under state law (and state law usually permits this if the instrument so provides) when the property is sold there would then be sufficient income (since capital gains are defined as including income) to meet the unitrust payout percent. The Service in fact approved use of the capital gains allocation to income type provisions in unitrusts (see PLRs 9511029, 9511007 and 9609009) but later made the technique of little practical use by ruling that only post–contribution gain could be so allocated.

In 1998, the Internal Revenue Service issued final regulations permitting flip unitrusts. Unlike the provisions of the proposed regulations, these regulations do not require that any fixed percent of the trust consist of unmarketable assets. No person, including the trustee, can have discretion as to when the flip would occur, so the flip can be triggered by a date certain, an event such as a death or marriage, the sale of an unmarketable asset or a group of unmarketable assets or any other event which is not a merely discretionary trigger. The flip is effective on the first day of the first year following the date on which the trigger occurs. If the trust includes a makeup provision, any makeup provided for is foregone. A makeup provision is allowed during the rest of the year in which the sale occurs, but on the first day of the following year, the trust becomes a regular unitrust in all respects.

OTHER REGULATORY CHANGES

Time for Paying the CRT Amount. In order to deal with the accelerated payout charitable remainder trust (such as the two–year, 80% payout unitrust) the proposed regulations had provided that regular unitrusts as well as annuity trusts would have to make unitrust or annuity payments to the beneficiaries by the close of the taxable year in which the payments were due. Income–only unitrusts were exempted because their fiduciary accounting income cannot usually be determined by December 31. Although recognizing that recent legislative changes (the 50% maximum payout and 10% minimum remainder value rules) had reduced the potential for abuse, the Service felt that

there was still an abuse potential which needed to be dealt with. In a compromise, the final regulations provided that payments from charitable remainder trusts other than income–only unitrusts may be made within a reasonable time after the close of the year for which the payments are due if the character of the amounts in the recipient's hands is income under the charitable remainder trust tier system or the trust distributes property owned as the close of the taxable year to pay the unitrust or annuity trust amount and the trustee elects on form 5227 to treat any income generated by the distribution as occurring on the last day of the taxable year for which the amount is due. In the case of trusts created before December 10, 1998 the annuity or unitrust amount may be paid within a reasonable time after the close of the taxable year for which it is due without regard to the 1998 rules if the percentage used to calculate the annuity or unitrust amount is 15% or less. This provision creates considerable administrative difficulties in some very non–abusive situations. Take for example the simple case of a trust funded on December 28 with cash. Because there is no property to distribute in kind and there is probably no income in any of tiers for the few days in which the trust was in existence in the year of the gift, distribution of a small prorated payment must be made by the end of the year. As a practical matter, this will often be impossible. A donor may deliver a signed trust with a check (or stock power) to the charity on the last day of the year. The check will likely not even be deposited until January 2, at the earliest. What is the consequence of failure to make the prorated payment by the end of the year? This problem needs to be dealt with. One solution is to use a flip unitrust.

The final regulations made several other changes of less importance. Capital gains allocated to income could not include capital gains resulting from pre-contribution gain. Finally, the regulations provide that if a donor is serving as trustee, unmarketable assets do not have to be valued by an independent trustee, but can be valued instead by a qualified appraiser as defined in section 1.170(A–13)(c)(3).

ANNUITY TRUST VERSUS UNITRUST

Which one should the donor use? Where productive property will be contributed, the choice between the annuity trust and the unitrust depends on several factors. Some donors like the idea of a fixed income amount which will never vary, regardless of investment performance. For these donors, the annuity trust may be attractive. Such donors should also consider charitable gift annuities if the charitable institution is an appropriate issuer. The fixed amount may be unattractive to younger donors because of inflation over many years.

The unitrust, on the other hand, provides a hedge against inflation. As the assets increase in value, the unitrust amount will increase. It can also, however, work the other way if the assets decrease in value. Generally, the annuity trust will produce a higher charitable deduction. (See discussion below on computation on deduction.)

ANNUITY TRUST FIVE PERCENT PROBABILITY TEST

Amazingly enough, even though you can compute a charitable factor for the charitable remainder annuity trust, it may still fail to qualify if there is a more than a 5% probability, actuarially determined, that the trust assets will be exhausted before the remainder vests. See Revenue Ruling 77–374, 1977–2 C.B. 329. 10% interest assumptions made it much less likely than the old 6% assumptions that the test would not be met. With the floating interest rates, the

probability of exhaustion test must again be considered. When interest rates are low, it is much easier to flunk the test. For example, with a 7520 rate of 6.0% (the actual interest rate has been as low as 1.0%) the youngest permitted age for an 7% quarterly annuity is 66. Many practitioners were shocked to learn that an 7% annuity payable quarterly to a 65 year old donor flunked the test. You need to worry about the probability of exhaustion test even if the payout rate of the annuity does not exceed the 7520 rate if the payments are made other than annually. For example, a 10% annuity payable quarterly to a donor age 60 may flunk the test even in a month when the rate is also 10%. The reason is the effective payout is actually more than 10% because the payments are made more frequently than annually. Is the ruling correct? It has not yet been litigated. Possible solution: use a charitable gift annuity.

Why use a charitable annuity trust at all? The deduction for a charitable gift annuity is identical to the deduction for a gift to a charitable remainder annuity trust, and avoids many of the problems of the annuity trust. Whenever a charitable remainder annuity trust is being contemplated, a gift annuity should be considered as well. Not only does the 5% probability of exhaustion test not apply, but both the governing instrument requirements and administration are markedly simpler with the gift annuity. A charitable remainder annuity trust may be preferable if there are concerns about the charity's ability to make the annuity payments. A gift annuity must be for one or two lives—term of years gift annuities and gift annuities for more than two lives are not permitted, and in these cases, too, an annuity trust must be used.

THE "ALLOWED" VS. "ALLOWABLE" DISTINCTION

Private letter rulings 201713002 and 201713003 are fascinating. Do I have a qualifying charitable remainder trust if no deduction was allowed? Consistent with Regulation section 1.664-1(a)(2)(iii)(a), the IRS ruled yes. That section provides that a charitable remainder trust means a trust with respect to which a deduction is allowable under section 170, 2055, 2106 or 2522 and which meets the specific requirements for a charitable remainder annuity trust or a charitable remainder unitrust. Why does the regulation use the word "allowable" rather than "allowed"? Undoubtedly because otherwise certain perfectly valid charitable remainder trusts would not qualify at all. An income tax charitable deduction may be allowable but not allowed because of percentage limitations or because the taxpayer chose not to itemize deductions, and no gift tax charitable deduction may have been taken because the donor's retained the right to change the charitable remainder beneficiary prevented a completed gift for gift tax purposes. So in order not to disqualify otherwise valid charitable remainder trusts simply because no deduction was available or needed, the regulations use the word "allowable" rather than "allowed."

What were the donors trying to accomplish with this trust which qualified as a charitable remainder trust, but for which they did not take a charitable deduction? (Possibly no gift tax deduction was allowed because of the retained right to change the charitable remainder beneficiary as noted above.) Perhaps what they were trying to accomplish was to avoid gain on sale of a highly appreciated asset in a transaction that would have otherwise violated the self-dealing rules—a sale by the trust to a family member or other disqualified person. Code section 4941(d)(1) defines self-dealing as including any sale or exchange of property between the private foundation (in this case, the charitable remainder trust) and a disqualified person such as a family member. Or perhaps the plan was to have the stock redeemed by a corporation in a transaction which would have otherwise been a self-dealing transaction because the corporation was a disqualified person as defined in

Code section 4946 and a redemption offer to all shareholders was either undesirable or not practical for other reasons. A redemption offer to all shareholders can be an exception to the self-dealing rules per Code section 4941(d)(2)(F) and Reg. section 53.4941(d)-3(d)(1). So, threading the needle, the Service ruled that although the trust was exempt from tax as a qualifying charitable remainder trust, the private foundation prohibitions would not be applied by section 4947(a)(2) because no income, gift or estate tax deduction had ever been claimed. Avoidance of gain here may have been more important than a tax deduction.

COMPUTING THE CHARITABLE DEDUCTION

Remainder factors for charitable remainder annuity trusts are computed on an actuarial basis. The average practitioner never needs to know the actuarial formulas, as the Service publishes tables to compute many of the factors, both term of years factors and factors dependent upon a life estate. Computer programs (including the author's) are available to calculate the factors. The actuarial computation of the remainder factor of an annuity trust depends on two components, an interest assumption and mortality table assumptions.

INTEREST ASSUMPTIONS

The regulations under Section 664 have required the use of varying rates of interest, steadily rising since the 1970's. In the early 1970's the tables were revised to assume a return of 6% and in 1983 the tables were further revised to assume an interest rate of 10%. Section 7520, passed as part of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) requires use of interest assumptions of 120% (adjusted to the nearest two–tenths of 1%) of federal midterm rates, assuming annual compounding. This interest rate is published monthly and is available in an e-mail directly from the IRS and in many places online. In the case of charitable gifts, such as computations for a charitable remainder trust, donors may use either the federal interest rate for the month of the gift or may elect the federal interest rate for either of the two months prior to the month of the gifts. Because the annuity is a fixed amount, a higher interest assumption means that the amount going to charity will presumably be greater. Therefore, a higher interest rate produces a larger deduction. Because the interest rate for the following month is announced on approximately the 20th of each month, donors really have a four month period to choose from: the month of the gift, either of the two months preceding the gift, or the following month if donor can wait until the following month to make the gift.

MORTALITY ASSUMPTIONS

TAMRA also required the use of updated mortality assumptions for gifts made after April 30, 1989, based on the 1980 census. Data from the 1990 census was incorporated into new tables which became effective on May 1, 1999 and the tables were again updated effective May 1, 2009. The tables were supposed to have been revised again in 2019, but because the mortality information was not yet available from the Centers for Disease Control, the Internal Revenue Service was quite late in issuing new Tables. Final regulations under section 7520 with updated tables were issued on June 1, 2023, but with the option to elect either set of mortality assumptions 2019 for certain transactions done before final regulations became effective on June 2, 2023.

The IRS publishes factors for a remainder interest after one or two lives via its web site. (Search for IRS publication 1457.) To determine the charitable deduction in an annuity trust, subtract the published remainder factor from one to determine the income factor. The income factor divided by the interest rate gives an annuity factor. Multiply the annuity factor times the amount of the annual annuity to determine the amount of the annuity and subtract that from the amount transferred to determine the amount of the charitable contribution.

> Example: Donor age 75 creates a charitable remainder annuity trust paying an annual annuity of $7000 to himself for life and then to his wife, age 70, for her life. The 7520 federal interest rate for the month of the gift is 5.6%. The published remainder factor for these ages at 5.6% is .39540. That factor subtracted from one equals .60460. That factor divided by 5.6% gives an annuity factor of 10.7965. The annuity factor of 10.7965 when multiplied times the $7000 annual annuity produces a value for annuity of $75,575. That figure subtracted from the $100,000 gift produces a value for the charitable remainder of $24,425.
>
> Note: If the payment is due more frequently than annually, or at the beginning of each payment period, the annuity factor must be multiplied by a frequency of payment adjustment (also published in volume Aleph) which is itself interest–sensitive. The author's Tiger Tables Actuarial Software will also calculate all of these factors. Information is available at www.tigertables.com.

CHARITABLE REMAINDER UNITRUST COMPUTATIONS

Because the unitrust payment is a percentage of the entire trust revalued annually, the relative size of the remainder and life estate "pots" stays the same and, therefore, no interest assumption is relevant in determining the deduction. The only relevant information is the unitrust payout of the trust and the mortality assumptions. Again, published tables show the remainder factors in a charitable remainder unitrust. If the payment is for any payout frequency other than annually with the first payment due at the time of the gift, the annual payout must be multiplied by an adjustment factor to determine an adjusted payout rate and from that rate, the actual charitable factor is determined. This adjustment factor is interest–dependent, but interest rates will make relatively little difference in the deduction because only the adjustment factor is interest–sensitive. A higher interest rate will produce a lower adjusted payout rate and, therefore, a slightly higher charitable deduction. Unitrust factors are published by the IRS via its web site in IRS publication 1758.

GIFT AND ESTATE TAX RULES
ONE LIFE INTERVIVOS CHARITABLE REMAINDER TRUSTS

Gift Tax. The donor is making an immediate gift of a future interest to charity, which qualifies for the federal gift tax charitable deduction.

Estate Tax. On the donor's death, because the donor retained an interest in the trust which did not in fact end before his death, all or a portio of the trust will be includable in his estate under Section 2036, but the estate receives a full dollar for dollar offsetting charitable estate tax deduction under Section 2055, resulting in no tax effect from the inclusion. The exact amount of CRATs

and CRUTs includible in the gross estate can be calculated with formulas described in Revenue Rulings 76-273 and 82-105.

Testamentary charitable remainder trust. The estate of the donor receives an immediate federal estate tax charitable deduction for the value of the charitable remainder based on the beneficiary's age at the death of the testator.

Two life intervivos charitable remainder trust for donor for life and a successor life beneficiary. Donor is making a charitable gift of a remainder interest after two lives. The donor is also making a present gift to the successor life beneficiary which as a future interest doesn't qualify for the $10,000 gift tax annual exclusion. A present gift can be avoided, however, if the donor is the first beneficiary, by providing that the donor retains the testamentary power to revoke the successor beneficiary's interest. The mere presence of the power prevents the establishment of the trust from constituting a present gift. On the death of the donor, the trust will be included in the donor's estate. If the successor beneficiary survives, the estate has a charitable estate tax deduction for the remainder based on the then–age of the successor beneficiary. The life interest of the successor beneficiary may generate estate tax. If the successor beneficiary predeceased the donor, the remainder is fully deductible for estate tax purposes. Note, however, that if the successor beneficiary is the donor's spouse, the donor's spouse's interest qualifies for the marital deduction despite the fact that it would generally be a terminable interest. Section 2056(b)(8) provides a special marital deduction for the surviving spouse of the decedent where the surviving spouse is the only non–charitable beneficiary of a qualified charitable remainder trust. A similar provision in Section 2523(g) provides a marital deduction for gift tax purposes. This special marital deduction provision does not, at least literally, apply if there is another non–charitable beneficiary after the spouse's interest, as the spouse is not then the only non–charitable beneficiary. There is no policy reason for this restriction. In such cases, a QTIP followed by a charitable remainder trust on the surviving spouse's death should be considered.

Should the power to revoke the successor beneficiary's interest be included where the successor beneficiary is the donor's spouse? Although no longer necessary to prevent a gift for gift tax purposes (because of the special marital deduction provision noted above) the power may be useful in the event of divorce and it adds additional flexibility.

Special caution on tax allocation. Because the Service was concerned that two–life charitable remainder trusts for persons other than the donor's spouse could generate an estate tax payable from the charitable remainder trust, therefore reducing the amount ultimately passing to charity, the Service ruled in Revenue Ruling 82–128, 1982–2 C.B. 71 that two–life remainder trusts must include language providing that no federal estate or other death taxes can be payable from the unitrust or annuity trust and that if any taxes become so payable the successor beneficiary must provide for payment of the taxes from another source or the beneficiary's interest will not commence. The pro forma trusts issued by the Service include appropriate language.

TESTAMENTARY CHARITABLE REMAINDER TRUST FOR TESTATOR'S SPOUSE

A testator can create a charitable remainder trust for the benefit of his or her spouse, as noted above. The surviving spouse's interest will qualify under the marital deduction provisions and the remainder will qualify for the estate tax charitable deduction, thus resulting in no tax at all

on the donor's death. Donor could, alternatively, use a qualified terminable interest property trust (QTIP) for the surviving spouse. The entire trust would be deductible as a marital deduction, would be includable in the surviving spouse's estate and would qualify in her estate for complete charitable deduction, resulting, again, in no tax.

Which is preferable, a testamentary charitable remainder trust or a qualified terminable interest property trust with remainder to charity? The QTIP has the advantage of flexibility. The testator can permit invasion of principal and give the spouse special powers of appointment to take care of unanticipated changes of circumstance. The big advantage of the charitable remainder trust is that income in excess of the unitrust or annuity payment amount is not subject to tax, and capital gains incurred in the trust will not be subject to tax. In rare cases the inclusion of the property in the surviving spouse's estate may affect the size of her estate for tax purposes and, therefore, for 6166 or 2032A purposes. A charitable remainder trust can terminate on remarriage, as noted above. A QTIP must last for the spouse's lifetime.

CHARITABLE REMAINDERMAN

The charitable remainderman must be an exempt organization. If the charity named is a public charity, the gift will be deductible with a 60% percentage limitation rather than subject to the private foundation cut down rules. The donor or the beneficiaries can retain the power to substitute one charity for another charity or to add charities so long as all are qualified charities. This provision should be limited to public charities, unless the donor specifically wants the right to name private foundations. The effect of being able to name private foundations will be to reduce the percentage limitation for long term capital gain property to 20% of adjusted gross income or 30% for cash gifts.

The provision for changing charitable remaindermen is very useful in adding flexibility to the charitable remainder trust and has no adverse tax consequences for the donor, since the trust will be in the donor's estate anyway (and qualify for a complete charitable estate tax deduction if he is the only beneficiary).

MISCELLANEOUS ITEMS

Section 170(a)(3) had often been interpreted as providing that no future interest in tangible personal property qualifies for a charitable deduction and, therefore, tangible personal property may not be contributed to a charitable remainder trust. Actually, however, Section 170(a)(3) provides that a contribution of a future interest in tangible personal property shall be treated as made only when all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired or are held by persons other than the taxpayer or there standing in a relationship to the taxpayer described in Section 267(b) or 707(b). That Section should therefore may mean that no deduction is permitted the donor until the trust sells the property. Finally, the Internal Revenue Service has acknowledged that this interpretation of this statute is correct. In PLR 9452026, the taxpayer proposed funding a charitable remainder unitrust with tangible personal property—in this case a violin. There were no other strings attached (if you will forgive the pun). The Service ruled that the deduction would be allowable at the time the property is sold and that the trust qualifies as a charitable remainder trust. What is not answered is whether the donor's deduction will be limited to basis because of the related use requirements of section

170(e)(1)(b)(i). Can a technical argument be made that since the deduction is not deemed to have occurred until the property is no longer owned by the trust, and since at that point the trust holds cash, that the gift is considered one of cash rather than tangible personal property and therefore the cut down to basis is not required? It is interesting to note that the Service ruled favorably despite the fact that no deduction was permitted at the time the trust was funded. This seems to fly in the face of PLR 9501004. In this ruling, the Service held that a contribution of a deep–in–the–money option to a unitrust disqualified the charitable remainder unitrust because no income or gift tax deduction was allowable at the time the property was contributed to the trust. (Use of an option would be handy in order to keep the trust out of the line of ownership of possibly tainted real estate, or to enable donors to contribute S corporation stock.) If residential property is contributed to a unitrust, the donor should not reside in the property after the date of gift because he will be deemed to have retained an interest other than a unitrust interest. Have the donor move out before the gift.

QUALIFIED REFORMATIONS

Because the Service interpreted all of the rules in such a nitpicking way, disqualifying many trusts, Congress in 1984 provided generous relief by means of special fix up provisions. If the trust attempted to comply with the 1969 rules, the statute provides an essentially unlimited opportunity to reform the trust. If the trust does not specify payments to noncharitable beneficiaries in terms of either dollar amounts or fixed percentages, the reformation must be commenced within ninety (90) days after filing the estate tax return or, in the case of a trust for which no estate tax return will be filed, within ninety (90) days after the due date for the first trust income tax return. Many trusts include language permitting the trustee to amend the trust to comply with Section 664. In cases where language is not included and there is no state law power to amend, the reformation proceeding can be commenced in the state courts. The actuarial value of the reformed interest cannot differ more than 5% from the actuarial value of the unreformed interest. The fix–up statute even permits reformation of some trusts which did not attempt to meet the 1969 requirements.

POOLED INCOME FUNDS

A pooled income fund is a pool of donated funds, somewhat like a mutual fund. Each donor receives the income from his or her share of the fund and at the death of the beneficiary or beneficiaries, that portion of the fund is severed and distributed to the charity. The donor receives an immediate income tax deduction at the time property is contributed to the fund. Unlike a charitable remainder trust beneficiary, the pooled income fund beneficiary actually retains the income from his or her share of the fund rather than a unitrust or annuity trust interest. Because the charity must control the pooled fund directly or indirectly, Congress was not concerned that the funds would be invested without regard to the interest of the remainderman. The charity must maintain control of the fund, but this does not mean that the charity must be the trustee. As long as the charity has the right to remove the trustee and name a new trustee, it will be deemed to have complied with the pooled income fund rules.

The pooled income fund is not an exempt trust as such. All of the income is deductible under the regular distribution deduction rules, and long term (as defined) capital gains are

deductible as charitable set asides under Section 642(c)(3). Gains from the sale of assets held one year or less are subject to tax.

SPECIFIC REQUIREMENTS

Obviously, in order to constitute a pool, there must be more than one donor to the fund. The trust must prohibit the donor or any beneficiary from serving as a trustee of the pooled income fund. The trust must prohibit investment in tax exempt securities. There are a number of other more technical drafting requirements. In Rev. Proc. 88–53, 1982 C.B. 712 the Service issued a sample declaration of trust and announced that it will no longer be necessary for a taxpayer to request a ruling as to qualification of a substantially similar trust and the Service normally will not issue such a ruling.

TAXATION OF BENEFICIARIES

Each beneficiary is taxed on his or her pro rata share of the income. There must be at least four valuation dates per year, and the value on the valuation dates determines the value of the fund for allocation of contributed interests. Where contributions are made between valuation dates, many drafters provide for averaging the values on the dates before and after each valuation. This avoids having to revalue the fund each time there is a contribution. It may also be unfair, however, where there has been great appreciation or depreciation in the fund. An alternative would be to prorate any changes between valuation dates on a daily basis.

CHARITABLE CONTRIBUTION

The donor receives a charitable contribution based on the value of the remainder interest. As with charitable remainder gifts, the older donor receives a greater deduction. Instead of an interest assumption, the fund's highest return in the three previous years is substituted. For funds in existence less than three years, the Service has announced that average interest rates for the three years preceding establishment of the fund, less 1%, should be used.

TRANSFER TAX RULES

The transfer tax rules parallel those for charitable remainder trusts discussed above. However, where a donor creates an interest for donor and then donor's spouse, there is no comparable provision to 2056(b)(8) which automatically qualifies the spouse's interest for the estate tax marital deduction. The interest in a pooled fund does, however, almost by accident qualify as qualified terminable interest property. Therefore, in the typical case where a donor contributes property to a pooled fund for the donor's life and then for the donor's spouse for life, the donor should retain a power to revoke the successor interest to prevent a present gift at the time the pooled fund gift is made. Upon the death of the donor, the donor's executor (if the donor's spouse survives) should make a QTIP election for the spouse's interest in the pooled income fund. This has been acknowledged in the final marital deduction regulations.

Why use a pooled income fund rather than a charitable remainder trust? A main reason, from the charity's standpoint, is simplicity of administration. No separate trust vehicle is required and much smaller contributions can be economically accepted. For example, many charities have

a $50,000 minimum for charitable remainder trusts, but have a limit as low as $5,000.00 for pooled fund gifts and even smaller amounts for subsequent gifts. The pooled fund offers the same advantage of being able to accept appreciated property and sell it without incurring capital gains tax. Many pooled funds achieve 8% or 9% investment returns so the donor can often substantially increase his income. The pooled fund is also a very handy vehicle for the planned giving officer who, on the afternoon of December 31st, finds a donor who wishes to make a last minute gift.

INTRODUCTION TO OTHER SPLIT INTEREST GIFTS

Two other kinds of split interest gifts are worthy of brief description.

CHARITABLE GIFT ANNUITIES

Charitable gift annuities are similar to charitable remainder annuity trusts in that the donor retains an annuity interest. However, the gift is not funded—there is no trust. The donor contributes cash or securities to the charity in exchange for the charity's unfunded promise to pay an annuity to the donor for the donor's lifetime. Most charities follow recommended rates issued by the Council on Gift Annuities. The rates are designed so that approximately half of the gift will be remaining for the charity at the donor's death. The result is a charitable income tax deduction of about 50% of the value of the contributed property on establishment of the annuity. The charitable deduction is exactly what the deduction would be in a charitable remainder annuity trust—the actuarial value of the annuity is subtracted from the value of the property contributed and the difference is the charitable deduction. However, the annuity payments are taxed not under the tier rules which apply to charitable remainder trusts, but under the section 72 annuity rules. Under these rules, each payment is deemed to consist in part of a return of the donor's investment, so that if cash is contributed, a portion of each payment will consist of tax–free return of principal. This generally results in better treatment for income tax purposes than the annuity trust. If appreciated capital gain property is contributed, the purchase is treated as a bargain sale, and basis and gain in the property are allocated pro rata between the gifted portion and the sold portion. The capital gain is likewise allocated over the lifetime of the annuity. Gift annuities should not be used unless the donor is confident that the charitable organization has the financial ability to pay the annuity and is likely to be around. Gift annuities issued by Harvard University are probably safe. Gift annuities issued by a new church with 20 members are probably not.

DIFFERENCES BETWEEN CHARITABLE REMAINDER ANNUITY TRUSTS AND CHARITABLE GIFT ANNUITIES

Both charitable remainder annuity trusts and charitable gift annuities pay a fixed dollar annuity to one or more beneficiaries. The income tax deduction is the same whether the donor creates a charitable gift annuity or a charitable remainder annuity trust. There are, however, several major differences:

1. The donor to a charitable remainder annuity trust is relying on the trust's assets to pay the annuity. If the trust's investments do not perform well, the trust could run out of money, in which case the annuity payments would end. The charitable gift annuity is not funded through a trust. Instead, the charitable gift annuity is an unfunded, unsecured promise by the charity to pay

an annuity from its general assets. The gift annuitant is therefore a creditor of the charity and is relying on the charity's contractual promise to pay the annuity.

2. The payments received from a gift annuity are taxed very differently from the payments received from a charitable remainder annuity trust. Distributions from a charitable remainder annuity trust are taxed under a tier system so that the mostly highly taxed forms of income earned by the trust, whether earned in the current year or earned but undistributed from a prior year, are considered distributed first. Therefore, any ordinary income earned currently or undistributed from a prior year is considered distributed first, then capital gain income, followed by tax exempt income from municipal bonds and finally non-taxable return of basis. Gift annuities, on the other hand, are taxed in the same way commercial annuities are taxed. If a gift annuity is purchased with cash, part of each annuity payment received will be tax free for the donor's life expectancy. If the gift annuity is purchased with appreciated securities, then part of the payments will be taxed as capital gain, part will be taxed as ordinary income and some portion may be tax free. From an income tax standpoint, therefore, a gift annuity will generally be better for the donor than a charitable remainder annuity trust.

There are a number of other technical differences between charitable remainder annuity trusts and charitable gift annuities. Charitable gift annuities can only be one or two lives, whereas charitable remainder annuity trusts can in some cases be set up for more than two lives or for a term of years.

GIFT OF A REMAINDER INTEREST IN A PERSONAL RESIDENCE OR A FARM

A final useful split interest gift is the gift of a remainder interest in a personal residence or farm. The donor deeds property to the charity and retains use of the property during the donor's lifetime. An immediate deduction is allowed for income tax purposes based on the actuarial value of the remainder interest. The regulations under section 170 require that depreciation be taken into account for the depreciable portion of the property, which reduces the charitable deduction somewhat. The depreciation adjustment factor can be computed for one life with IRS commutation tables published by the IRS via its web site in Publication 1459. This is often an attractive gift for donors who plan to leave their estates to charity at death, because it generates an immediate income tax deduction without in any way affecting the donor's liquid assets. If the property should be subsequently sold, the charity and the donor can agree to split the proceeds on the basis of the then actuarial value. This is a particularly attractive gift when interest rates are low—a much higher deduction is available

1600403

31254823