

A Potpourri of Charitable Planning Tricks and Traps

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Table of Contents

| | | |
|---|---|----|
| ➤ | MAKE CHARITABLE GIFTS DURING LIFETIME, NOT AT DEATH | 1 |
| ➤ | DON'T WASTE THE CHARITABLE DEDUCTION ON GIFTS AT THE FIRST DEATH | 2 |
| ➤ | USE CHARITABLE LEAD TRUSTS TO AVOID PERCENTAGE LIMITATION RULES | 3 |
| ➤ | SOME OBSERVATIONS ON PLANNING CHARITABLE GIFTS OF TANGIBLE PERSONAL PROPERTY | 4 |
| ➤ | USE OF QUALIFIED CONTINGENCIES IN CHARITABLE REMAINDER TRUSTS | 11 |
| ➤ | THE REVERSE MORTGAGE ANNUITY | 14 |
| ➤ | DONOR-RETAINED RIGHTS TO REARRANGE NON-CHARITABLE BENEFICIARIES' INTERESTS..... | 17 |
| ➤ | MARITAL DEDUCTION ISSUES IN SPLIT INTEREST GIFTS..... | 18 |
| ➤ | HOW TO LOCK IN VALUE NOW BUT DELAY THE GIFT TO A FUTURE TAXABLE YEAR | 26 |
| ➤ | A SIMPLE CHARITABLE PLANNING TECHNIQUE FOR WEALTHY FAMILIES | 27 |
| ➤ | INTERACTION OF NEW STATE LAW RULES ON DEFINITION OF INCOME WITH SECTION 643(B) REGULATIONS AND SPLIT INTEREST CHARITABLE TRUSTS | 28 |
| ➤ | SELECTED POST MORTEM FIDUCIARY INCOME TAX ISSUES INVOLVING CHARITABLE DISTRIBUTIONS..... | 30 |
| | 1. Publication 904 | 36 |
| | 2. Interrelated Calculations by Spreadsheet..... | 36 |
| | D. Writing a Computer Program..... | 37 |
| ➤ | MEMO TO CHARITABLE CLIENTS RE LOW INTEREST RATES | 51 |
| ➤ | DRAFTING ISSUE FOR YEAR-END CHARITABLE REMAINDER UNITRUSTS SOLVED BY THE FLIP UNITRUST | 55 |

| | | |
|---|--|----|
| ➤ | INTERNAL REVENUE SERVICE ISSUES SAMPLE CHARITABLE REMAINDER UNITRUST FORMS | 56 |
| ➤ | INTERNAL REVENUE SERVICE REVOKES 2005 PRIVATE LETTER RULING ON EARLY TERMINATION OF CHARITABLE REMAINDER TRUST | 60 |
| ➤ | INCLUSION OF PRIVATE FOUNDATION IN GROSS ESTATE..... | 62 |
| ➤ | IRS ISSUES LEAD TRUST FORMS | 63 |
| ➤ | SERVICE ISSUES CONTROVERSIAL CHARITABLE LEAD TRUST RULING | 66 |

MAKE CHARITABLE GIFTS DURING LIFETIME, NOT AT DEATH

Charitable gifts made during lifetime do double duty. A gift to charity at death by bequest is deductible for federal estate tax purposes, but there is no income tax or other benefit. The same gift made the day before death is removed from the estate for estate tax purposes (the gift tax charitable deduction, like the estate tax charitable deduction, is unlimited) but in addition the gift made the day before death to charity generates an income tax charitable deduction – two for the price of one.

Several techniques can be useful in accelerating charitable gifts into lifetime:

- A. A client with charitable bequests in his or her will should consider making the gift during lifetime.
- B. Alternatively, a person with charitable bequests in his or her will might consider signing a durable power of attorney giving the attorney-in-fact the right to prepay charitable bequests during lifetime.
- C. If the primary dispositive document is a revocable trust, the revocable trust can provide authority to the trustee to prepay charitable distributions which would otherwise be made at death.
- D. Finally, charitable remainder trusts and charitable gift annuities serve many valuable functions, but one of them is to accelerate into lifetime a charitable deduction for gifts of property or cash which will not pass to the charity until death. With a charitable remainder unitrust or annuity trust, or with a charitable gift annuity, the donor may keep an income stream and provide for the remainder to pass to charity at death, but receive an income tax deduction during lifetime.

DON'T WASTE THE CHARITABLE DEDUCTION ON GIFTS AT THE FIRST DEATH

Suppose that your client wishes to leave her entire estate to her husband, but also wants to make a \$10,000 bequest to her alma mater. Many practitioners would simply draft a document saying, in effect, "I leave \$10,000 to X charity and the residue of my estate to my husband." The problem is that this charitable bequest generates no tax benefit. There is no estate tax benefit because the marital deduction has eliminated the estate tax, and the bequest generates no income tax deduction either. A better way to handle this might be the following: "I bequeath \$10,000 to my husband, and request, without intending to legally obligate him, that he make a gift of this bequest to X charity. I give and bequeath the rest and remainder of my estate to my husband."

This way the surviving spouse will receive the income tax deduction. If a marital trust or credit shelter trust is created, the will could provide that if the bequest has not been made by the surviving spouse by the time of his death, the bequest comes out of the marital trust so as to generate an estate tax deduction at that point, or if there is no marital trust the bequest could come out of the credit shelter trust.

USE CHARITABLE LEAD TRUSTS TO AVOID PERCENTAGE LIMITATION RULES

Section 170 of the Internal Revenue Code imposes income tax percentage limitations on charitable gifts. For gifts by individuals, the percentage limitations are essentially as follows:

- 50% of adjusted gross income for gifts of cash to a public charity;
- 30% of adjusted gross income for gifts of appreciated capital gain property to a public charity;
- 30% of adjusted gross income for gifts of cash to a private foundation; and
- 20% of adjusted gross income for gifts of appreciated capital gain property to a private foundation.

(In the case of gifts of appreciated property to a private foundation, only marketable securities qualify for a fair market value deduction in excess of basis.) With all of these percentage limitations, section 170 provides for a five-year carryover if the gift exceeds the amount deductible after imposition of the percentage limitations.

The charitable lead trust is a valuable estate planning device but it also can be used to avoid percentage limitation problems. A charitable lead trust pays a fixed annuity or unitrust interest to a charity for a period of years, with the remainder passing to non-charitable beneficiaries, typically children. The lead annuity trust works mathematically very much like a grantor retained annuity trust – if the trust assets produce a total return in excess of the section 7520 rate which was in effect when the trust was created, the gift to remainder beneficiaries will be undervalued for gift tax purposes.

But the charitable lead trust can also be a very useful device for avoiding percentage limitations. Charitable lead trusts come in two flavors: the grantor lead trust and the non-grantor lead trust. If the trust is not a grantor trust and the income is therefore not taxed to the grantor, no income tax deduction is allowed for creation of the trust. This makes sense because with the non-grantor trust, the grantor will not be taxed on the trust income—it would be anomalous to allow a deduction for income which has never been included in the taxpayer's tax base in the first place. (The main exception to this rule is 170(e)'s allowance of a deduction for the fair market value of capital gain property without inclusion of the gain in income.) If the trust is a non-grantor trust, no income tax deduction is allowable, but the income will not be included in the taxpayer's income either. This is economically equivalent to receiving all the income and then being able to deduct all of it without reference to percentage limitations. So the non-grantor lead trust, besides its estate planning advantages, is a very useful way for the very philanthropic donor to shift taxable income to a charitable beneficiary without percentage limitation issues.

SOME OBSERVATIONS ON PLANNING CHARITABLE GIFTS OF TANGIBLE PERSONAL PROPERTY

Planning charitable gifts of tangible personal property presents difficult and unique problems. Not only is tangible personal property often difficult to value, but collectibles are not income producing, which makes their use in split interest gifts problematical.

The rules on income tax deductions for tangible personal property are themselves complex.

- A. Code section 170(e) limits the deduction for tangible personal property gifts to basis unless the use by the donee is related to the charity's exempt purpose. Art to the museum is the usual example (assuming the art is of museum quality and the museum does not intend simply to sell it). The Service has interpreted this provision liberally, allowing a deduction, for example, for a gift of art to a nursing home for use in public areas (PLR 8247062). Obviously if the donor's basis is high (because, for example, of a new basis at death) limitation to basis may not matter. If basis is low, a bequest to the surviving spouse who can then make the gift may be the solution in some cases.
- B. Code section 170(e) also reduces the charitable contribution deduction by the amount of gain which, if the property were sold, would not be long-term capital gain. Section 1221 excludes from the definition of capital asset a copyright, literary, musical or artistic composition created by the taxpayer or held by a taxpayer whose basis derives from the creator of the property. So a painter may not deduct the fair market value of a painting given to charity even if the use is related. The same rule would apply to a gift by a donee of the creator.
- C. Remember that all of these special rules--related use and limitation to basis for non-capital assets--apply for income tax purposes only. There are no such limitations in section 2055 for estate tax purposes.

Watch this trap in gifts of copyrighted property, especially works of art. Most art work created in the last 70 years is protected by copyright. If the donor owns both the art work and the copyright and conveys the painting to charity without also conveying the copyright, the gift is a split-interest gift and no deduction is allowable. The following points should be considered:

- A. If the owner of the art work owns only the art work and does not own the copyright, he may safely contribute the property to charity because the donor will have given all of his interest in the property, just as a person owning only a life estate or remainder may contribute the entire interest without violating the split interest rules.
- B. The reason it is so easy to fall into this trap is that under the 1977 Copyright Act, a conveyance of an art work does not carry with it the copyright unless it is specifically conveyed. For works created before the 1977 copyright revision, the

presumption was just the opposite. A purchase of the art work automatically carried with it the copyright unless it was specifically reserved.

- C. In cases where the donor owns the copyright--either because it was a pre-1977 work and the conveyance was silent as to copyright or because the donor specifically purchased the copyright with the art work--a lifetime gift of the art work by itself without the copyright will be a split-interest gift and will not qualify for an income tax deduction.
 - D. Note that for estate tax purposes, the rule is different. Section 2055(e)(4) provides that works of art and their copyrights are treated as separate properties for estate tax purposes.
 - E. Query as to the effect on the valuation of art work given to charity without the copyright where, for example, the artist has retained copyrights.
- I. Fractional interest gifts of art.

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.

- A. Until enactment of the Pension Protection Act of 2006, this rather simple case could sometimes be handled in part by gifts of undivided interests in art. This was ideal for the donor who spent 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 could 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.

- B. 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. The risk the donor ran, however, if the museum did not exercise its right is that the Service would argue that there was an understanding that the museum would not exercise its right during donor's lifetime.
- C. A deduction was permitted for an undivided interest despite the prohibition of 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 was permitted because the taxpayer was

contributing an undivided interest in all of the taxpayer's interest. In other words, a vertical division was permitted but a horizontal division was not.

- D. In PLR 200202032 the Service ruled that artworks bequeathed subject to restrictions on display would be fully deductible for estate tax purposes. The will did not prohibit sale, but if it had, it could very well be includable in the gross estate at a higher value than the allowed charitable deduction. See *Ahmanson Foundation*, 674 F.2d 761 (CA-9, 1981). The ruling is interesting in part because the Service was willing to rule on what is essentially a valuation question.
- E. A deduction has always been permitted—and is still permitted under the new law—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 is permitted but a horizontal division is not.
- F. Under the 2006 law, 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.
- G. What does that mean in the case of gift tax to recapture the deduction? If the statute has run on the gift year, does that mean that in the recapture year I am deemed to have made a taxable gift?

H. A contribution which occurred before the effective date of enactment is not treated as an initial fractional contribution for purposes of this new 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.

I. The estate and gift tax trap in the original act has been fixed by the technical corrections signed by President Bush in January, 2008. 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.

A related provision also deals 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 two 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 new 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 is effective for contributions made and returns filed after September 1, 2006 for contributions for which more than a \$5000 charitable deduction is claimed.

II. Use of tangible personal property in charitable remainder trusts.

- A. The statement is often made that tangible personal property cannot be used to fund a unitrust as no charitable deduction will be allowed. Is that statement really correct?
- B. There are two possible problems with using tangible personal property to fund charitable remainder trusts, section 170(a)(3) and section 170(e).
- C. Section 170(a)(3) provides that payment of a charitable contribution which consists of a future interest in tangible personal property shall be treated as made only when all intervening interests in, and rights to actual possession or enjoyment of, the property have expired or are held by persons other than the taxpayer or a related party.
- D. Note that this section was added to the Code in 1964, and therefore preceded the present split interest trust rules by five years. (There is some speculation that failure to repeal it in 1969 was inadvertent.) But Section 170(a)(3) is a timing provision. It does not say that no contribution is permitted for a gift of a future interest in tangible personal property. It says that no contribution deduction is permitted until the intervening interests have expired or are held by persons other than the taxpayer or a related person. It would appear, therefore, that if tangible personal property is contributed to a charitable remainder trust, the deduction will be permitted at such time as the property is sold by the trust. 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 musical instrument. 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 clear is whether the donor's deduction will be limited to basis because of the related use requirements of section 170(e)(1)(b)(i). Section 170(e) reduces the deduction for gifts of personal property to basis unless the use of the property by the donee is related to the donee's exempt charitable purpose. What does this mean in the context of a charitable remainder trust funded with personal property? If a charity

sells donated property, the property will normally be considered to have an unrelated use. But can a technical argument be made that since in the charitable remainder trust context the contribution is not deemed to be made 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 cutdown to basis is not required?

- E. Even if only basis can be deducted, that may still in many cases be substantial. Given percentage limitations, a deduction for basis may be sufficient for some donors. And for some generous donors with percentage limitation issues, sheltering the capital gain may be more significant than the deduction. If the deduction is important, why not mix and match: give an undivided interest outright to the museum (deductible at full fair market value with no capital gains realization) and use the rest to fund a charitable remainder trust (deduction limited to basis but no capital gain on sale). The charity can buy the undivided interest from the trust. (After all, it will get the remainder back some day.) If the trust is an annuity trust, the charity can buy the art work for a note calling for payments of interest only in an amount sufficient to cover the annuity obligation. The note would call for a balloon balance due after the donor's life expectancy.
- F. Other solutions are fun to think about but cutting edge: using a partnership or corporation to hold art in order to avoid the tangible personal property characterization is one idea. Is this a sham? It may depend on whether the entity has other activities. Another untried method would be contribution to the trust of a deep in the money option to buy the painting, which the charitable remainder trust would sell to the museum remainderman. Has the donor given an option or tangible personal property? This seems to fly in the face of PLR 9501004.

III. An oft-overlooked solution.

- A. In analyzing gifts of personal property to charitable remainder trusts, donors and their advisors often overlook another alternative which has none of the disadvantages of the charitable remainder trust: A contribution of tangible personal property to a charity in exchange for a charitable gift annuity.
- B. Section 170(a)(3) would not apply because the charity does not have a future interest but a present interest in the property.
- C. The unrelated use rule will not apply if the charity's exempt purpose is related to the gift.

Example: Suppose that the Museum wishes to acquire a painting from Donor. Donor has some charitable interest but also wants to have some income from the gift. Donor can contribute the property to Museum in exchange for a charitable gift annuity. The American Council on Gift Annuities sets annuity rates so that approximately one-half of the

contribution supports the annuity and the other half qualifies as a charitable contribution. If there is substantial appreciation in the painting, the capital gain will be spread over the donor's life expectancy (if the donor is an annuitant) although in no event will it exceed the amount which would have otherwise been excluded from income under the Section 72 annuity exclusion ratio rules.

- D. This may be a better result than could be obtained with the charitable remainder trust, where all of the income would be taxed under the tier system at ordinary income rates, assuming there is sufficient income to cover the payments.
- E. The charity, it is true, will have to dip into current revenues to pay the annuity. But museums have acquisition budgets and purchasing art work with a gift annuity is much cheaper than paying full fair market value.

USE OF QUALIFIED CONTINGENCIES IN CHARITABLE REMAINDER TRUSTS

- I. Code Section 664(f) provides that a trust which otherwise qualifies as a charitable remainder trust may include any qualified contingency. A qualified contingency is defined as any provision of the trust which provides that upon the happening of the contingency the unitrust or annuity trust payments will terminate no later than such payments would otherwise terminate under the trust. In English, this means that a charitable remainder trust can provide for early termination and acceleration of the remainder upon the happening of any event specified in the instrument.
 - A. Section 664(f)(2) provides that for purposes of determining the amount of any charitable contribution (or the actuarial value of any interest) a qualified contingency shall not be taken into account.
 - B. Section 664(f) was added to the code in 1984 retroactive to transfers made after December 31, 1978. What planning opportunities does the qualified contingency exception present?
 - C. In terrorem clauses. An in terrorem clause provides that if a beneficiary contests a will or trust, the beneficiary will be treated as if he or she predeceased the testator.
 1. Prior to 1984, the Internal Revenue Service ruled in a number of private letter rulings that the presence of an in terrorem provision in a charitable remainder trust disqualified the trust because the term of the trust was not measured solely by a term of years or the life or lives of one or more beneficiaries as required by Section 664. See Private Letter Rulings 7732011, 7942073 and 8321028.
 2. The presence of Section 664(f) makes these rulings obsolete. A qualifying contingency can be anything at all, no matter how remote or impossible to value, so long as the only effect of the contingency is to accelerate the charitable remainder. An in terrorem provision seems to be exactly the kind of qualified contingency Section 664(f) was designed to permit. So the in terrorem provision can now be included in charitable remainder trusts without fear of disqualifying the trust under Section 664.
 3. Note that with all such qualified contingencies, including in terrorem provisions, the contingency is not taken into account for any actuarial valuation purposes even if the contingency can, in fact, be valued.
 - D. What else can be done with qualified contingencies? Qualified contingencies may make possible creative payment sequences which were not permissible before Section 664(f) was added to the code.

Example: Suppose that A creates a charitable remainder trust solely for the benefit of child B. As B will inherit the bulk of A's estate, B would like to terminate the charitable remainder trust on A's death if it should occur prior to the death of B.

1. This would not have been permitted prior to Section 664(f) because the measuring life would have been a life other than the life of the beneficiary.
 2. Section 664(f) permits this payment sequence. Since the only effect of A's death will be to terminate the trust early, the use of the qualified contingency exception makes permissible a payment sequence which was not permissible before Section 664(f). A payment sequence which on its face is not permissible can be sometimes be tailored to meet the qualified contingency exception.
- E. The remarriage charitable remainder trust. Suppose that donor wishes to create a testamentary charitable remainder trust for his or her spouse, which will provide that the unitrust or annuity trust payments to the spouse will cease on the spouse's remarriage. Such a provision may also be desired in a charitable remainder trust established as part of a divorce. What is the effect of the remarriage penalty?
1. It is clear that the remarriage provision is a qualified contingency under Section 664(f).
 2. What about the marital deduction? The remarriage penalty makes the spouse's interest a terminable interest, but does it qualify for the marital deduction anyway?
 3. Section 2056(b)(8) establishes a special rule granting an automatic marital deduction to the spouse's interest in a charitable remainder trust. If the surviving spouse of the decedent is the only non-charitable beneficiary, the terminable interest rule does not apply.
 4. Does the remarriage penalty make the spouse's interest, however, unascertainable and therefore not deductible? The answer should be no. Section 664(b) provides that for "purposes of determining the amount of any charitable contribution (or the actuarial value of any interest), a qualified contingency shall not be taken into account." (underlining added). The real question is: does the underlined parenthetical language apply for chapter 11 and chapter 12 purposes as well as for income tax purposes? Since for income tax purposes the actuarial value of any interest other than the charitable remainder is irrelevant, it appears that the Section 664(b) language does apply for estate tax valuation purposes as well, particularly since section 2055(e)(2) specifically references Section 664(b).

5. Note that no marital deduction will be permitted if another beneficiary follows the spouse's interest. (See last section of this outline for a more detailed discussion of this issue.) Where a remarriage provision will be included, and the donor wishes to include a secondary beneficiary, the obvious alternative of the QTIP followed by a charitable remainder trust will not work either because the spouse's interest in the QTIP will not qualify for the marital deduction with the remarriage penalty.
- F. Are there other qualified contingency planning opportunities?
- G. Obviously, qualified contingencies are not permitted in charitable lead trusts, since the purpose would be to accelerate the non-charitable remainder. There is no policy objection to accelerating the charitable interest in the charitable remainder trust but plenty of policy objections to accelerating the non-charitable interests in a lead trust!

THE REVERSE MORTGAGE ANNUITY

- I. How can a donor convert a gift of a remainder in a personal residence to present income?
- A. Donors often contribute a remainder interest in a personal residence to charity. Section 170(f)(3)(B) makes such gifts an exception to the usual restrictions on split interest gifts. This can produce a substantial tax deduction for the donor but it does not produce income. Is there anything else that can be done for the donor who wants income but does not have assets he can use to fund a life income gift?
- B. Why can't the actuarial value of the remainder in the residence be used to purchase a charitable gift annuity, either present or deferred?
- C. Here is how the idea would work: Donor (let's call him Benny Factor) owns a house worth \$500,000, of which \$300,000 is the value of the house and \$200,000 is the value of the land. Code section 170(f)(4) requires that depreciation be taken into account for the house. Although we are not claiming a deduction for the remainder in the residence (because we are buying a gift annuity with it) we will for illustration purposes compute the value of the remainder as required under section 170(f)(4). Further assume that our donor is 70 years old and that the section 7520 applicable federal rate for the month of the gift is 7.0%. The actuarial value of the remainder (which will be the purchase price of the gift annuity) is determined as follows:

| | |
|-------------------------------------|--------------------|
| Factor for depreciable portion: | .34420 |
| Factor for non-depreciable portion: | .44456 |
| .34420 x \$300,000 | = \$103,260 |
| .44456 x \$200,000 | = <u>\$ 88,912</u> |
| Actuarial value of remainder | = \$192,172 |

Assume that at the time of the gift, the American Council on Gift Annuities recommended annuity rate for a donor age 70 is 7.5%. \$192,172 x 7.5% produces an annual annuity of \$14,413 per year. The income tax treatment of this gift annuity is as follows:

ONE-LIFE CHARITABLE GIFT ANNUITY FACTORS

| | |
|-------------|--------------|
| Donor: | BENNY FACTOR |
| Annuitant: | BENNY FACTOR |
| CMFR Rate: | 7.0% |
| Issue Date: | 09/01/2000 |

| | |
|---------------------------|--------------|
| Date of First Payment: | 12/31/2000 |
| Annuitant Birthdate: | 09/01/1930 |
| Nearest Age of Annuitant: | 70 |
| Amount Transferred: | \$192,172.00 |
| Annuity Percent: | 7.50% |
| Payment Frequency: | Quarterly |
| Annual Annuity: | \$14,413 |
| Each Payment: | \$ 3,603.25 |
| Annuity Factor: | 7.9348 |
| Adjustment: | 1.0259 |
| Adjusted Factor: | 8.1403 |
| Value of Annuity: | \$117,326.14 |
| Charitable Gift: | \$74,845.86 |
| Return Multiple: | 16.0 |
| Adjustment: | -0.1 |
| Adjusted Multiple: | 15.9 |
| Expected Return: | \$229,166.70 |
| Exclusion Ratio: | 51.2% |

ANALYSIS OF ANNUAL ANNUITY PAYMENTS

| | |
|-----------------|--------------|
| Non-Taxable | \$ 7,379.46 |
| Ordinary Income | \$ 7,033.54 |
| TOTAL | \$ 14,413.00 |

A portion of payments received will be non-taxable until complete recovery of basis, which will occur in 15.9 years, after which 100% of payments will be taxable. (Some of the nontaxable portion may be taxed as capital gain, depending on the availability of the section 121 exclusion.)

- D. The charity's treasurer may balk at this gift as it means using current funds to acquire a future gift, but if the real estate is attractive enough and likely to appreciate enough, or if the donor is likely to be influenced to make further gifts, the trade-off may be worthwhile. And in a case such as this, the charity may offer an annuity lower than the American Council on Gift Annuities recommended rate.

DONOR-RETAINED RIGHTS TO REARRANGE NON-CHARITABLE BENEFICIARIES' INTERESTS

- I. A donor may not retain the right to rearrange the interests of successor non-charitable beneficiaries in a charitable remainder trust, although an independent trustee may have the power. Any solutions?
- A. Actual example: Donor wished to establish a charitable remainder trust for his life and thereafter for one or more of three beneficiaries. To increase the charitable deduction, the trust will end 15 years after the donor's death.
 - B. Donor cannot retain the right to change the amount going to the three individuals. The reason is that Code Section 674 provides that the grantor of a trust is treated as the owner of the trust for income tax purposes where he retains the power to control the beneficial enjoyment of either the corpus or the income therefrom. A right to allocate income or corpus among a class of beneficiaries would be such a right. A grantor trust cannot qualify as a charitable remainder trust. An independent trustee could hold the power, but this may not satisfy the grantor.
 - C. The regulations under Section 664 provide that a donor may retain the right solely by will to revoke the interest of any income beneficiary. It is clear, therefore, that the donor could retain the right to revoke the first beneficiary's interest as well as the interest of any other beneficiary.
 - D. There should also be no policy objection to permitting the donor to retain the right to revoke the interest of any beneficiary in whole or in part.
 - E. Thus if the donor could revoke, for example, the right of beneficiary A to receive one-half of his or her payments with the rest falling down to beneficiary B, whose interest is revoked in part so that it falls down to beneficiary C. So using rights to revoke may enable the donor to accomplish indirectly what he cannot accomplish directly.
 - F. If a term of years trust is not attractive to the donor, adding the additional beneficiaries will cut down the deduction. Each additional beneficiary will further limit the amount of the charitable deduction.

MARITAL DEDUCTION ISSUES IN SPLIT INTEREST GIFTS

Planners for charitably inclined married couples often focus so intently on the charitable deduction aspects of a proposed gift that they lose sight of an equally important issue, namely the marital deduction. Charitable planning for married couples is fraught with marital deduction issues and traps.

I. Simple cases not involving split interest gifts.

- A. The simplest case is the married couple with no non-charitable interests which desires that the entire estate pass to charity on the second death. In such cases, the first spouse can simply leave the entire estate outright to the surviving spouse, and the surviving spouse can leave the entire estate on the second death to the charity. The marital deduction is assured in such cases on the first death as is the charitable deduction on the second death.
- B. Where one spouse wants some portion of his or her estate to pass to charity immediately on the first death, a charitable bequest by the first spouse to die is simple and straightforward. It also, however, produces no tax advantage if the entire residue of the estate will qualify for the marital deduction and there will therefore be no estate tax.
 - 1. A better strategy is a bequest of a specific dollar amount to the surviving spouse with a non-binding request that the surviving spouse use the bequest to make a charitable gift. In this manner, the surviving spouse will receive an income tax deduction, and the cost of the gift will be reduced by approximately one-third.
 - 2. Where the first spouse to die creates a credit shelter trust or marital trust for the surviving spouse, the will can also provide that if the survivor spouse has not made the gift by the time of the survivor spouse's death, the bequest will come out of the trust.
- C. QTIP for surviving spouse with remainder to charity. The first spouse to die may, however, be unwilling to leave the entire estate to the surviving spouse because of uncertainty that the surviving spouse will honor the first spouse's desires. An obvious solution here is the QTIP for surviving spouse with remainder to charity. The trust will qualify for the marital deduction in the first spouse's estate, be includable in the second spouse's estate under Section 2044 and qualify in the surviving spouse's estate for an offsetting charitable estate tax deduction. Section 2044(c) provides that for all purposes of Chapters 11 and 12, the QTIP property will be treated as passing from the decedent. The final regulations make this clear, not that there was ever any doubt as to this one: For purposes of section 1014 and chapters 11 and 13 of subtitle B of the Internal Revenue Code, property included in a decedent's gross estate under section 2044 is considered to have

been acquired from or to have passed from the decedent to the person receiving the property upon the decedent's death. Thus, for example, the property is treated as passing from the decedent for purposes of determining the availability of the charitable deduction under section 2055 and the marital deduction under section 2056.

- D. An aside on the question of QTIP versus charitable remainder trust. Instead of using a QTIP, the first spouse to die might instead have left the entire estate in a charitable remainder unitrust or annuity trust for the surviving spouse with the remainder on the surviving spouse's death passing to charity. What are the advantages and disadvantages of using a CRAT or CRUT instead of a QTIP?
1. The estate tax result will still be no tax, at either death. The actuarial value of the charitable remainder qualifies for an estate tax deduction under Section 2055. The actuarial value of the spouse's interest qualifies for a marital deduction under code Section 2056(b)(8), even though the interest is not an income interest for life meeting QTIP requirements. Section 2044 will not operate to put the trust in the surviving spouse's estate, so no charitable deduction is necessary there.
 2. The major advantage of the QTIP is that the principal can be invaded for the surviving spouse's benefit.
 3. The big disadvantage of the QTIP is that capital gains in the trust will be subject to tax whereas capital gains and accumulated income in a charitable remainder trust in excess of the payout are not subject to tax.
 4. Inclusion of the QTIP of the surviving spouse's estate may have other implications as well which should be considered in special cases. Inclusion will increase the size of the surviving spouse's estate, which could be detrimental for Section 303, 2032A and 6166 purposes. This could be significant in cases where less than the entire estate is passing to charity (and there will be a tax) on the second death.
 5. There may be other things that can be done with a CRAT or CRUT that cannot be done with a QTIP. Example: Moneyed spouse wants to provide for the surviving spouse and wants the assets remaining at the second death to pass to charity. However, moneyed spouse also wants to terminate the surviving spouse's interest on remarriage or some other event. The trust cannot be a QTIP unless the surviving spouse has a qualifying income interest for life. Section 2056(b)(8), on the other hand, which allows a marital deduction for a spouse's interest in a CRAT or a CRUT, provides that paragraph (1) of section 2056 shall not apply to any interest in a qualified section 664 trust which passes or has passed from the decedent to the surviving spouse. Paragraph (1) is the terminable interest rule. In addition, Section 664(f) provides that a trust will be a

qualified charitable remainder trust even if the trust may terminate on the happening of a contingency or event which has the effect of accelerating the charitable remainder. Read together, these provisions mean that the charitably inclined testator can establish a qualified charitable remainder trust for his or her surviving spouse which will terminate on the surviving spouse's remarriage or death and still get a marital deduction and a charitable deduction. The final regulations confirm this conclusion. Although it is clear that a remarriage provision (or any other contingency terminating a spousal trust before the spouse's death) is fatal for 2056(7) purposes, final regulation section 20.2056(b)-8(a)(1) provides explicitly that "if an interest in property qualifies for a marital deduction under section 2056(b)(8), no election may be made with respect to the property under section 2056(b)(7)." The additional requirements of a QTIP, such as the terminable interest rule, cannot therefore apply.

6. The qualified contingency can be anything, no matter how unlikely or remote--the remarriage of the surviving spouse, the Cardinals winning the World Series, etc.
7. Note that for purposes of valuing the charitable contribution or the actuarial value of any interest, the qualified contingency is not taken into account.
8. Finally, income in respect of a decedent can be paid to a CRAT or CRUT and the income will be free of tax. That would not be true of course with the QTIP.

II. Treatment of Specific split interest arrangements in the final regulations.

- A. Charitable remainder unitrust and annuity trust. As we have seen, Section 2056(b)(8) provides a marital deduction for the donee spouse's interest in a qualified charitable remainder trust. The parallel gift tax section, section 2523(g), provides a marital deduction for gift tax purposes as well.
- B. Watch this trap! Perhaps because of oversight, both of those sections provide a marital deduction only if after the transfer "the donee spouse is the only non-charitable beneficiary other than the donor". So, read literally, those sections would deny a marital deduction to the donor to a charitable remainder trust for the joint lifetime of the donor and the donor's spouse, followed by the donor's child. An income tax charitable deduction will be available for the remainder, but no gift or estate tax marital deduction, even though the actuarial value of all of the interests can be easily determined. This makes no sense and the statute should be amended to provide a marital deduction for the actuarial value of the spouse's interest. In private letters rulings 8742001 and 8730004 the Service ruled that no marital deduction is available in precisely this situation.

1. The final regulations confirm this conclusion. Regulation section 20.2056(b)-8 provides as follows:

“In the case of a charitable remainder trust where the decedent’s spouse is not the only non-charitable interest beneficiary (for example, where the non-charitable interest is payable to the decedent’s spouse for life and then to another individual for life), the qualification of the interest as qualified terminable interest property is determined solely under section 2056(b)(7) and not under section 2056(b)(8). Accordingly, if the decedent died on or before October 24, 1992, or the trust otherwise comes within the purview of the transitional rules contained in §20.2056(b)-7(e)(5), the spousal annuity or unitrust interest may qualify under §20.2056(B)-(7)(E) as a qualifying income interest for life.”

There is no policy reason to deny a marital deduction in that situation for the portion of the trust passing to the surviving spouse. The drafting solution for now is a QTIP for the surviving spouse followed by a CRAT or CRUT for the second beneficiary.

2. The Energy Policy Act of 1992 added Code section 2056(b)(7)(10) which provides that although section 2056(b)(7)(B)(iv) provides that a specific portion of property shall be treated as separate property, the portion must be treated on a fractional or percentage basis. The final regulations provide that although section 2056(b)(8) appears to preclude a marital deduction under that section in cases where the spouse is not the only non-charitable beneficiary, the marital deduction may be available for trusts created before the effective date of the Energy Policy Act of 1992 (generally October 24, 1992), not under 2056(b)(8) but under the QTIP provisions. The Service has asked for comments as to whether a unitrust or annuity interest for spouse followed by another non-charitable beneficiary may qualify under the QTIP provisions in view of the 1992 amendments. (An election would still be necessary.) This avenue seems more likely for annuity trusts than unitrusts: the last sentence of 2056(b)(7)(B)(ii) provides that to the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property regardless of whether the property from which the annuity is payable can be separately identified. A legislative fix may to be the only possible fix for unitrusts.

- C. Retention of Right to Revoke Surviving Spouse’s Interest in a Qualified Charitable Remainder Trust. Before the enactment of the special gift and estate tax marital deduction provisions for charitable remainder trusts, a common technique in order to prevent a present gift in the case of two-life spousal inter vivos charitable remainder trusts was to include a provision permitting the donor to revoke the surviving spouse’s survivorship interest by will. This prevented the initial transfer from being a completed gift to the spouse for gift tax purposes.

Many practitioners have deleted that provision as unnecessary. But is it? There are no apparent disadvantages to retention of the power, and if the spouses are ever divorced, the donor spouse may be unhappy if he or she does not have the right to revoke the successor spouse's interest. So there may be good non-tax reasons to keep these provisions.

- D. Note that the Service's pro forma CRATs and CRUTs do not include a power of revocation. Note also that with spousal trusts, Revenue Ruling 82-128, 1982-2 C.B.71, requiring language in two life instruments to avoid the possibility of estate tax being charged to the trust, cannot be ignored on the theory that there will be no estate tax. There could be state inheritance taxes and the spouses could be divorced before the first death.
- E. Where jointly-held property is contributed to the trust, the power of revocation should only apply to the donor spouse's interest in the joint property, not the entire property.

III. Gifts of Remainders in a Personal Residence.

- A. What are the marital deduction implications of gifts of a remainder in a personal residence? Where the donor contributes his or her residence to charity reserving a life estate for the donor and the donor's spouse, is a marital deduction available? Note that there is no automatic marital deduction under 2056(b)(8) for split interest gifts other than charitable remainder trusts.

- B.
 - 1. Because the surviving spouse's interest terminates at death, and property passes to a third party, the interest of the surviving spouse is a terminable interest. Does it, however, qualify for QTIP treatment if a QTIP election is made?
 - 2. The spouse will not receive income from the property. However, the final regulations under section 2056(b)(7) confirm that a marital deduction is available for the surviving spouse's right to occupy a personal residence. See regulation section 20.2056(b)-6(g)—Example:

(1):

“Life estate in residence. D owned a personal residence valued at \$250,000 for estate tax purposes. Under D's will, the exclusive and unrestricted right to use the residence (including the right to continue to occupy the property as a personal residence or to rent the property and receive the income) passes to S for life. At S's death, the property passes to D's children. Under applicable local law, S must consent to any sale of the property. If the executor elects to treat all of the personal residence as qualified terminable

interest property, the deductible interest is \$250,000, the value of the residence for estate tax purposes.”

Note that in this Example (1) the interest was not an interest in trust, but merely a legal life estate. The implications for marital deduction purposes seem to be as follows:

- a. Where the donor spouse owns the entire residence, the deed should permit the donor spouse to revoke the successor beneficiary spouse’s interest by will in order to prevent a gift for gift tax purposes. No gift tax marital deduction is available for the spouse’s interest because of the intervening interest of the Donor spouse.
- b. Where the property is held jointly, the deed should provide that each spouse reserves the right by will to revoke the surviving spouse’s survivorship interest in the first spouses’ contribution.
- c. When the first spouse dies, his or her interest will be includable in his or her estate and a QTIP election should be made on the estate tax return to qualify the survivor spouse’s interest.
- d. Even this may not be enough. To qualify as a QTIP, the surviving spouse must have what under state law is equivalent to a legal life estate. A right to occupy the residence is not enough: In the regulation quoted above, the spouse also had the right to rent the property. The extent of rights in a legal life estate is a question of state law. In Private Letter Ruling 9033004, the Service noted that use must include both the right to occupy the property as a personal residence and the right to convey the life estate to others. The deed should make clear that what is being retained is a full legal life estate, including the right to occupy the property, lease the property and convey the life interest. Merely reserving the right to use and occupy the property may be insufficient in many states to obtain a marital deduction.
- e. This is another trap. How many donors’ executors actually make a QTIP election for gifts of a remainder interest in their personal residence to charity? Is there any reason the marital deduction shouldn’t be automatic in this case as it is with the charitable remainder trust? Should an election out be permitted?

III. Pooled Income Fund.

- A. Section 2056(b)(8) and section 2523(g) do not provide automatic marital deductions for a gift to a pooled income fund. However, the spouse’s interest

qualifies as a QTIP and, again, the QTIP election must actually be made to secure the marital deduction. See final regulation section 20.2056(b)-6(g)--Example (13):

“Pooled Income fund. D’s will provides for a bequest of \$200,000 to a pooled income fund described in section 642(c)(5), designating S as the income beneficiary for life. If D’s executor elects to treat the entire \$200,000 as qualified terminable interest property, the deductible interest is \$200,000.”

This is another unnecessary trap and a legislative fix to make the marital deduction automatic would be advisable. Should an election out be permitted?

1. As with the charitable remainder trust, there are excellent non-tax reasons for retaining the right to revoke the surviving spouse’s interest in the pooled income fund gift. The donor’s interest will be includable in his estate under section 2036 and will qualify for a marital deduction if an election is made on a federal estate tax return.
2. The Joint Committee report on section 2056(b)(7) noted that for QTIP qualification purposes, the stub period income from the last payment to the date of the spouse’s death need not actually be paid in the case of a pooled income fund gift. Cf. Howard Estate, Cf. Howard Estate, 910 F.2d 633 (9th Cir. 1990) revg. 91 T.C. 329 (1988).
3. Effect on basis. If a QTIP election is made, the surviving spouse’s interest in the QTIP/pooled fund will be includable in the surviving spouse’s estate, receive a stepped up basis, and be deductible as a charitable deduction. The result is a wash for estate tax purposes. But the step-up in basis for the assets in the pooled income fund may be relevant where there are short-term capital gains, since short-term loans are taxable to a pooled income fund. How many pooled fund trustees adjust basis on the surviving spouse’s death? Will they even know whether a QTIP election was made?
4. In the two-life situation, the successor spouse’s interest does not qualify for a gift tax marital deduction because it has not yet vested in the surviving spouse. (See regulation section 25.2523(F)-(1)(c)(2) on the question of an intervening interest between the donor and the spouse.) This may be another reason to retain the right to revoke the surviving spouse’s interest by will.
5. Unlike the charitable remainder trust situation, there is no problem with pooled income gifts for the donor and the donor’s spouse, followed by third beneficiary. In the charitable remainder trust situation we saw that section 2056(b)(8) denies a marital deduction in that situation. There is of

course no such issue with the QTIP/pooled income fund gift. The entire fund will be includable in the surviving spouse's estate under section 2044, and the surviving spouse's estate would receive a charitable deduction based on the then actuarially-determined value of the remainder interest taking into account the age at that time of the third beneficiary.

IV. Charitable Gift Annuities. Here the story is somewhat different. Section 2056(b)(7) and Section 2523(f) provide for a marital deduction in the case of a joint and survivor annuity where only the donor spouse and the donee spouse have the right to receive payments until the death of the last spouse to die. In such case, the donee spouse's interest is treated as a qualifying interest for life and the donor spouse is treated as having made an election with respect to the annuity unless the donor spouse elects out. Note that the statutory language includes the same requirement as 2056(b)(8) that no marital deduction is permitted if there is a non-charitable interest following the spouses' interest. This is of little significance with gift annuities since sections 501(m) and 514(c)(5) already require that gift annuities be for not more than two lives.

- A. As with charitable remainder trusts, the donor may retain the right to revoke the successor spouse's interest.
- B. Are there any cases where the executor might want to elect out of marital deduction treatment?
- C. The amendments permitting the marital deduction were passed in 1988, retroactive to 1981. The Service has issued regulations outlining the procedure for refunds of gift or estate tax paid. The final regulations reserved judgment on joint and survivor annuities, and those regulations will be issued later.

Testamentary gift annuities for a spouse. One of the main questions here is how to set the amount of the annuity, since no charitable or marital deduction will be permitted if the amount of the annuity is unascertainable. Perhaps incorporating the then current American Council on Gift Annuities recommended rates would be one technique.

HOW TO LOCK IN VALUE NOW BUT DELAY THE GIFT TO A FUTURE TAXABLE YEAR

Actual Situation:

Client was heavily concentrated in one highly appreciated security. The client had decided to make an outright gift to a charity and planned to use the appreciated security for the gift. The client would like to make the gift as soon as possible because she fears the stock will decline in value. On the other hand, if the gift is made now charitable contribution carryovers from a prior year will expire this year unused. (Current year contributions count against percentage limitations before carryover years.) Therefore, the accountant would prefer that the gift be made next year.

Solution:

The client will create a 49% payout charitable remainder unitrust calling for annual payments beginning one year from the date of the trust. The actuarial value of the remainder in this trust is a little over 10%. The stock will be contributed now and sold by the unitrust, thus locking in the gain. In January of next year, before any payment from the trust has been received, the client will contribute to the charity her remaining life income interest. This should add up to almost a 100% deduction, except for the fact that she will be one (1) year older at the time of the gift of the life estate. On the other hand, if the trust assets increase between now and next January, the total deduction may be more than the present value of the shares.

A SIMPLE CHARITABLE PLANNING TECHNIQUE FOR WEALTHY FAMILIES

Suppose that a wealthy family is philanthropic not only at the generation of the parents, but also the generation of the children. Without planning, what would typically happen would be that the children would make charitable gifts, the parents would make charitable gifts, and the parents would try to devise other ways to transfer property to children to reduce estate tax. Here is a simple technique which can work efficiently in these multi-generational philanthropic families: the parents can ask the children how much the children wish to give to charity that year and the parents can make the gifts in the children's names directly rather than having the children make the gifts. This then results in the same tax effect as if the children had made the gifts and the parents had made gifts to children to replace those gifts, except that if structured so that the parents make all of the gifts there is no gift tax on the transfer to children. For "crediting" purposes, the parents can ask that the gifts made in the children's names be shown as gifts by the children for crediting purposes.

INTERACTION OF NEW STATE LAW RULES ON DEFINITION OF INCOME WITH SECTION 643(b) REGULATIONS AND SPLIT INTEREST CHARITABLE TRUSTS

In December, the Internal Revenue Service issued new regulations under section 643(b) to bring those regulations into accord with new state law definitions of income. The new state laws, enacted in more and more states, allow income to be defined as a unitrust amount and give the trustee authority to make equitable adjustments between income and principal. These state law developments are in part the result of historically low interest rates and dividend yields, exacerbating the tension between income beneficiaries and remainder beneficiaries.

Attention needs to be given, in some cases quickly, to the complex interaction between these new rules, the 643(b) regulations and split interest charitable trusts which incorporate income as a measure of payout, specifically pooled income funds and income only unitrusts.

Pooled Income Funds. Internal Revenue Code section 642(c)(3) provides that a pooled income fund is one which distributes its "income" as that word is defined for state income and principal fiduciary accounting purposes. A pooled income fund deducts income paid to pool participants, deducts long-term capital gains permanently set aside for charity and is taxed on short-term capital gains. The concern of the IRS is that if these new state laws permit capital gains to be invaded pursuant to a state law permitting allocation of principal to income as an equitable adjustment, the deduction for long term capital gains permanently set aside for charity should not be available since it is not certain the charity will, in fact, receive the capital gains. The new regulations require amendment of a pooled income fund governing instrument before October 2, 2004 (or, if later, nine months after the effective date of a state statute authorizing a unitrust conversion or equitable adjustment power) to avoid loss of the set aside deduction unless state law includes a savings provision prohibiting a trustee from making the allocation and that deadline is rapidly approaching. Review of governing law and possible amendment is necessary now. The same issue exists for pre-Tax Reform Act of 1969 charitable trusts paying ordinary income to a beneficiary for life with remainder to charity.

Income-only Unitrusts. Here the situation is a little different. Many states now authorize election of a unitrust definition of income unless the trust specifically prohibits such an election. Unlike pooled income funds and pre-Tax Reform Act of 1969 charitable trusts, there is no charitable set aside issue for income-only unitrusts. Their income is instead taxed when distributed pursuant to a tier system. The Internal Revenue Service regulations specifically prohibit an income only unitrust from adopting a unitrust definition of income pursuant to the new state laws. But because there is no set aside deduction to be jeopardized, the mere existence of a power to adopt a unitrust definition of income under state law should not require any remedial action.

The other statute which could apply to net income only unitrusts is a state law power to make adjustments between income and principal on an equitable basis. This section could potentially apply to an income-only unitrust, subject to the limitations in the final IRS regulations that proceeds from the sale or exchange of assets contributed to an income only unitrust be allocated to principal and not to income at least to the extent of the fair market value

of the assets on the date of contribution, and that proceeds from the sale or exchange of assets purchased by the trust be allocated to income and not to principal at least to the extent of the trust purchase price of those assets.

Many income-only unitrusts were converted to regular unitrusts a few years ago during the IRS window but many of the ones left probably have relatively high payouts, since elimination of the income only feature would have required paying out an unrealistically high unitrust amount in those cases. With respect to these trusts, trustees may want to consider in individual cases increasing the income stream as is now permitted by many states by allocating a portion of capital gains to income within the limitations permitted by the regulations.

Several cautions are in order. First, care should be taken to treat beneficiaries similarly situated in the same way so that one donor doesn't learn from another donor that favorable treatment was given to some beneficiaries but not others. It will also be important to do any allocation consistently rather than making ad hoc decisions from year to year. The regulations speak unfavorably of powers to allocate capital gains to income in some years and not others in a trustee's sole discretion. Finally, note that in many states, the statutes permitting these equitable adjustments provide that where the trustee is a beneficiary, the equitable adjustment can be made only by a cotrustee who is not a beneficiary of the trust.

**SELECTED POST MORTEM FIDUCIARY INCOME TAX ISSUES INVOLVING
CHARITABLE DISTRIBUTIONS
CHARITIES AS BENEFICIARIES OF ESTATES:
HOW SHOULD THEY PROTECT THEIR INTERESTS?**

Estates with charitable beneficiaries pose unique problems. Not only are the qualification rules for post-mortem income tax charitable deductions different from the qualification rules for an estate tax deduction, but the income tax rules for deductibility of income paid to charity during administration are different from the rules for deductibility of distributions to non-charitable beneficiaries. Every attorney representing a charitable beneficiary which will receive charitable bequests (particularly bequests of residue) should advise the charity to request copies of any federal estate tax return filed for the estate, as well as accountings, income tax returns and, of course, the will or trust giving rise to the bequest. Only in this way will charities be able to assure themselves that the charity has received everything to which it is entitled. This outline will highlight the kinds of questions charitable beneficiaries of estates should be asking—or which we should be asking for them.

I.

ARE INCOME TAXES BEING PAID UNNECESSARILY?

The section 642(c) deduction, which permits estates and (for current distributions) trusts to deduct from income amounts distributed to charity, is often poorly understood or ignored by practitioners and is even less likely to be understood by our charitable clients. But the issues posed by section 642(c) arise surprisingly frequently. Take, for example, this very typical situation: Residuary estate is left to charity. Income is accumulated during administration years 1 and 2 and is distributed with the residue of the estate in year 3. Is the income generated in years 1 and 2 taxable? In which years? Does the distribution to charity in year 3 carry out income to the charity? From which years?

A. Section 642(c) provides for deductions from gross income in two specific cases: Cases where income is actually distributed (section 170(c)(1)) and cases where the income is set aside for future distribution to charity (section 170(c)(2)).

B. The general rule set forth in section 642(c)(1) is that estates and complex trusts are permitted a deduction in computing taxable income (in lieu of the deduction allowed under 170(a)) for any amounts of gross income, without limitation, which pursuant to the terms of the governing instrument are during the taxable year paid for a purpose specified in section 170(c) determined without regard to section 170(c)(2)(A).

C. Several things are notable about the general rule.

1. First, note that amounts are deductible without limitation. Although trusts and estates generally compute their income in the same manner as individuals, section 642(c) overrides section 170, with its percentage limitations. If all income is distributed to charity during the taxable year, all is deductible without regard to percentage limitations.

2. Note also that income is deductible if paid for a purpose specified in section 170(c) determined without regard to section 170(c)(2)(A). Section 170(c)(2)(a) references organizations created in the United States. Therefore, distributions to foreign charities are deductible for income tax purposes under section 642(c) even though such gifts would not be deductible for income tax purposes by individuals under section 170.

3. Finally, note that section 642(c)(1) includes an election to treat distributions to charity made in one year as if they were made in a prior year. This is similar to the 65 day rule applicable to complex trusts, except it is a 365 day rule in the case of charitable distributions.

D. Gross Income Requirement. One of trickiest issues in connection with distributions to charity is the requirement that a distribution be from the estate or trust's gross income.

1. This is inconsistent with the general philosophy of subchapter J, which does not require tracing of sources of income in most cases. A distribution, whether in cash or in kind, to an individual will carry out income to the extent of DNI without regard to whether the amounts being distributed are income or principal for fiduciary accounting purposes. This no-tracing rule greatly simplifies taxation of trusts and estates.

2. Section 642(c), on the other hand, requires that the amounts distributed, to be deductible, must be from gross income, which for this purpose means fiduciary accounting income. This rule can serve to deny deduction in some cases. For example, where property is sold in order to raise money to pay a charitable bequest, a distribution of the cash realized on the sale will not be deductible because the distribution was not required to be paid out of the sale proceeds.

3. What about the case where a substantial partial distribution is made to a charity? Does the distribution carry out income? If the distribution is one of corpus under state law the deduction will not be permitted under section 642(c) because the distribution is not from income as determined by state law.

a. Is it in that case deductible as a distribution deduction under section 661? Section 663(a)(2) provides that there shall not be included as amounts falling within section 661(a) any amount paid or permanently set aside or otherwise qualifying for the deduction under section 642(c). It would appear that the purpose of this provision is to deny a double

deduction: the section denies a distribution deduction if the charitable deduction is also available: I can't deduct the same distribution under both sections. But the cases of Mott¹ and O'Connor² upheld the Service's position that distributions to charity are deductible only under section 642(c) and that if they do not qualify under that section, the distributions are not deductible at all. The distributions in those cases were distribution of corpus not income and so did not qualify under 642(c). Ferguson, Freeland and Ascher in their invaluable treatise Federal Income Taxation of Estates, Trusts, and Beneficiaries note that the Mott case perhaps reached this result because the effect would have been shifting almost all of the DNI to the charity so that the other beneficiaries would have paid very little tax. But the authors feel these cases are wrongly decided.

b. Now that the separate share rule applies to estates, the abuse the courts worried about in Mott and O'Connor is not possible. Is the time ripe for the courts to reconsider those cases?

E. What should the executor do in these cases? First, it is essential that for fiduciary accounting purposes, distributions to charity be made from income and denominated as such. It may be good practice to make two distributions with two checks, one an income distribution from fiduciary accounting income denominated as such, and the other a corpus distribution. If the administration is no more than two years, it may be that a 642(c) election can be made to treat the distribution as made in the prior year, but the distribution must still be from gross income.

F. If trust residue is distributable to charity, must the charitable deduction be reduced by income taxes payable out of the residue? In other words, should the income tax deduction be figured on a "straight" basis or an interrelated basis requiring an algebraic solution? Under some sets of facts, this question can determine whether there is a full deduction or no deduction at all. In *Hartwick College vs. United States*³ it was held that the deduction would be figured on a "straight" deduction basis.

1. How did the court reach this result? 2055(c) provides that no estate tax charitable deduction is allowed for any portion of a charitable bequest which is used for payment of estate taxes. Since section 642(c) does not include similar disallowance language, the court ruled that in fact that entire amount would be deductible. The court noted Mr. Justice Holmes's remark in *Edwards v. Slocum* that "algebraic formulae are not lightly to be imputed to legislators."

¹ Mott v. United States, 462 F.2d 512 (Ct. Cl. 1972), cert. denied 409 U.S. 1108 (1973)

² Estate of O'Connor v. Commissioner, 69 T.C. 165 (1977)

³ 801 F.2d 608 (2d Cir. 1986)

G. The Charitable Set Aside Deduction. Section 642(c)(2) provides a special deduction for amounts not currently distributed, but set aside for future distribution to charity. It applies to estates, but does not apply to trusts except for grandfathered trusts created on or before October 9, 1969. The set aside deduction is very useful in the case of a probate estate which cannot distribute income currently. This will, of course, often be the case because of uncertainty as to estate tax liability, will contests or other fiduciary concerns which warrant holding the estate intact during an administration period.

1. Because the set aside deduction applies only to certain Pre-Tax Reform Act of 1969 trusts, revocable trusts may not avail themselves of the set aside deduction.

2. Until the recent addition of section 645 to the Code, this posed a significant hardship on revocable trusts which could not make current distributions of income.

3. Section 645 permits a trustee of a revocable trust and the executor (if any) of an estate to treat both entities for income tax purposes as part of the estate. This means that for the first time income set aside in a revocable trust for eventual distribution to charity will qualify for the set aside deduction. Since a revocable trust will now qualify for the set aside deduction, one wonders why section 642(c) should not simply be amended to provide that a revocable trust after death will be permitted a set aside deduction in the same manner as a probate estate.

4. The 645 election is effective for 2 years after the decedent's death in cases where no estate tax return is required to be filed, and until 6 months after the date of final determination of liability of estate tax in cases where a return is required to be filed.

5. Even probate estates can fall into a set aside trap. In Berger⁴, the Tax Court disallowed a set aside deduction to an estate where the estate administration was unduly prolonged. The court treated the estate as having terminated and taxed it instead as a trust, which was not allowed a charitable set aside deduction.

II.

DELAYED FUNDING OF CHARITABLE REMAINDER TRUSTS

A number of issues can arise in connection with delayed funding of charitable remainder trusts.

A. A first issue which can arise is the question of whether the private foundation rules apply to an estate during the period of trust administration and before the trust is funded. Regulation section 52.4947-1(c)(6)(i) provides that a testamentary charitable

⁴ Estate of Berger v. Commissioner, 60 T.C.M. 1079 (1990)

remainder trust will be treated as a split interest trust from the time of the testator's death. This contradicts the provision in the regulations to the effect that a charitable remainder is not deemed created until it is first funded. See Regulation section 1.664-(a)(4). Note that the regulations provide differently for revocable trusts which continue for a period of administration before the charitable remainder trust is funded. In this case the regulations provide, in section 53.4947-1(c)(6)(iii) that only after a reasonable period of settlement as defined in the regulations will the split interest trust be deemed created.

B. Even a probate estate can be subject to the private foundation rules (particularly the self-dealing rules) if there is any delay from the time the estate is considered terminated under the section 641 regs. until funding of the charitable remainder trust.

C. For all of these reasons, care should be taken even during administration and before funding with regard to self-dealing transactions with the entity which will eventually fund the charitable remainder trust.

D. Another issue which is the source of considerable confusion is the question of deferred payments from testamentary unitrusts. The Internal Revenue Service requires that where a charitable remainder trust is established at death, payments to the beneficiary can be delayed for a reasonable period of administration but they must bear interest at a statutory rate. See Rev. Rul. 82-165, 1982-2 C.B. 117. In Rev. Rul. 88-81, 1988-2 C.B. 127, the Service provided language for computation of the retroactive amount. The subsequent IRS pro forma trusts have better, more understandable language. See, for example, the language in Rev. Proc. 2005-52. What is less clear is whether the distribution to the trust must itself bear interest. The answer to this should be no, but some careful drafters include language doing that. State law may very well require interest in these cases.

E. Finally, note that despite the commentaries of some authors to the contrary, income accumulated by an estate during administration for eventual distribution to a charitable remainder trust does not qualify for the set aside deduction under section 642(c) because the distribution will not be made for exclusively charitable purposes.

III.

ARE ESTATE TAXES BEING ALLOCATED PROPERLY?

A. Unfortunately, we find that many lawyers in drafting wills or trusts where a portion of the residuary estate will pass to charity use a standard pay from residue tax clause. This can be a recipe for disaster, except in those cases where it is clearly intended that that be the case. The application of estate tax to the charitable residuary share will result in a reduction of the charitable deduction and therefore an increase in the tax and therefore a further decrease in the charitable deduction. This is because Internal Revenue Code section 2055(c) provides as follows:

(c) **Death taxes payable out of bequests.** If the tax imposed by section 2001, or any estate, succession, legacy, or inheritance taxes, are, either by the terms of the will, by the law of the jurisdiction under which the estate is administered, or by the law of the jurisdiction imposing the particular tax, payable in whole or in part out of the bequests, legacies, or devises otherwise deductible under this section, then the amount deductible under this section shall be the amount of such bequests, legacies, or devises reduced by the amount of such taxes.

B. An interrelated computation will be necessary any time an otherwise deductible⁵ bequest bears the estate tax burden of a taxable bequest.

EXAMPLE: Assume a \$6,000,000 taxable estate. Further assume a will which leaves a specific bequest of \$3,000,000 to children and the residue to charity. Also assume the will directs that estate taxes be borne by the residue. The result would be the same if \$3,000,000 passed to charity under a will directing payment of estate tax from the residue⁶ and a \$3,000,000 life insurance policy owned by and on the life of the decedent were payable to a niece.⁷

C. How is the estate tax calculated in such a case? The calculation is circular, because the tax borne by the charitable interest reduces the charitable deduction, which in turn increases the estate tax, which further reduces the charitable deduction.

⁵ I.e., a charitable or marital bequest.

⁶ So as to override Code section 2206.

⁷ Although it may seem obvious to us that an estate tax charitable deduction should be allowed only for the net amount passing to charity after tax, the Supreme Court ruled otherwise in *Edwards v. Slocum*, 264 U.S. 61 (1924). Code section 2055(c) was enacted to overrule the Court's decision and limits the deduction to the amount passing to charity after death taxes. Code section 2056(b)(4) similarly limits the marital deduction to the net value passing to the surviving spouse.

1. *Publication 904.* In now out-of-print Publication 904 (*Interrelated Computations for Estate and Gift Taxes*) the Internal Revenue Service made a valiant attempt to demonstrate various methods of computing the tax in interrelated situations. The first method was called the “Trial and Substitution Method” which, as the name implies, required multiple recalculation trials of tax. The alternate so-called “Algebraic Method” was not much simpler, and includes such instructions as “Divide both sides of the equation by the decimal coefficient”, “Transpose to simplify the equation” and “Consolidate the F terms.”

2. *Interrelated Calculations by Spreadsheet.* But in fact, interrelated computations have been made relatively simple by software packages⁸ and by the availability of spreadsheets. How would one solve this problem on a spreadsheet? Let’s start with a simple case involving a flat 45% tax. We will assume a \$100,000,000 estate with a \$30,000,000 taxable specific bequest, a bequest of the residue to charity and a tax clause requiring payment of tax from the residue of the estate. A spreadsheet could be set up as follows:

| | A | B |
|---|-------------|---------------|
| 1 | Estate | \$100,000,000 |
| 2 | To charity | \$70,000,000 |
| 3 | Net taxable | \$30,000,000 |
| 4 | Tax | \$13,500,000 |

Cell B4 is the estate of \$100,000,000 less the charitable deduction times 45%. The \$70,000,000 charitable deduction must now be reduced by the \$13,500,000 of tax so that the next iteration would be as follows:

| | A | B |
|---|-------------|---------------|
| 1 | Estate | \$100,000,000 |
| 2 | To charity | \$56,500,000 |
| 3 | Net taxable | \$43,500,000 |
| 4 | Tax | \$19,575,000 |

And so forth. Fortunately, spreadsheets have built into them a reiteration function, so that in a flash, the computer will run through as many loops as the user sets.⁹ The final charitable deduction will be reached after about 30 iterations although only six or seven are necessary to come within a few hundred dollars of the exact answer. (I use an Excel spreadsheet default of 100 iterations.)

Now that all estates are taxed at a flat 45% rate, the spreadsheet no longer needs to have the tax rates built in. This will be necessary for years prior to the flat rate

⁸ The BNA Estate Tax Planner makes these calculations simple.

⁹ The formula will generate a circular reference error message which can be overridden.

and spreadsheet lookup tables make this easy. A lookup table for calculating estate tax can be as simple as this:

| Taxable Gift or Estate | | Tentative Tax | |
|------------------------|-----------|---------------|------|
| Col. 1 From | To | Tax on Col. 1 | Rate |
| 0 | 10,000 | 0 | 18% |
| 10,000 | 20,000 | 1,800 | 20% |
| 20,000 | 40,000 | 3,800 | 22% |
| 40,000 | 60,000 | 8,200 | 24% |
| 60,000 | 80,000 | 13,000 | 26% |
| 80,000 | 100,000 | 18,200 | 28% |
| 100,000 | 150,000 | 23,800 | 30% |
| 150,000 | 250,000 | 38,800 | 32% |
| 250,000 | 500,000 | 70,800 | 34% |
| 500,000 | 750,000 | 155,800 | 37% |
| 750,000 | 1,000,000 | 248,300 | 39% |
| 1,000,000 | 1,250,000 | 345,800 | 41% |
| 1,250,000 | 1,500,000 | 448,300 | 43% |
| 1,500,000 | Infinity | 555,800 | 45% |

A unified credit lookup table might look like this:

| Year of Death | Unified Credit | Exclusion Equivalent |
|---------------|----------------|----------------------|
| 2000 | 220,550 | 675,000 |
| 2001 | 220,550 | 675,000 |
| 2002 | 345,800 | 1,000,000 |
| 2003 | 345,800 | 1,000,000 |
| 2004 | 555,800 | 1,500,000 |
| 2005 | 555,800 | 1,500,000 |
| 2006 | 780,000 | 2,000,000 |
| 2007 | 780,000 | 2,000,000 |
| 2008 | 780,000 | 2,000,000 |
| 2009 | 1,455,800 | 3,500,000 |

Writing a lookup function to calculate the tax to use in each iteration is quite simple. Mastery of spreadsheets for this kind of calculation is essential for the 21st century estate planner.

D. Writing a Computer Program. Finally, the true techie may wish to write a simple software loop to calculate interrelated taxes. The code in Appendix A (written by

the author in Borland Pascal) calculates the tax and does 100 iterations in a repeat loop.¹⁰ This takes a fraction of a second in a compiled program. For this illustration, the lines of code to take into account generation-skipping tax paid from the deductible bequest have been omitted. Non-functional comments on specific sections of Code are both bracketed and highlighted like **{this}**.

E. A critical point to remember is that even if the will or trust seems to allocate estate tax to the charitable residue, it may be possible to escape that result. This may be true because of contribution provisions of the Internal Revenue Code which may apply to some includible interests, or because state equitable apportionment law may require more definite intent to allocate tax to deductible bequests than simply a broad “pay from residue” tax clause.

1. **Cases where a federal statute applies.** Several Internal Revenue Code provisions provide that property passing outside an estate may be required to pay its own share of tax unless the will provides to the contrary, and a number of cases have held that providing to the contrary requires an expression of definite intent rather than a mere statement that taxes are to be paid from residue. For example, Code section 2206 provides that if the gross estate includes policies of insurance on the life of the decedent receivable by a beneficiary other than the executor, the executor is entitled to recover from the beneficiary the tax attributable to inclusion of the insurance unless the decedent directs otherwise in his will. A broad statement of “pay tax from residue” may not be sufficient to override the Code section.

*Estate of Elmer Cohen v. Crown*¹¹ is a good example. The facts were simple: decedent’s will left the entire estate to charity. The will included the following tax clause:

“I direct my Personal Representatives to pay, without reimbursement or contribution, all estate, inheritance taxes and succession duties assessed by reason of my death by the United States or any State thereof.”

Undoubtedly, the attorney included the provision because it was part of his standard document, despite the fact that obviously with the entire residuary estate left to charity there would be no estate tax due. Unfortunately, decedent also owned a life insurance policy payable to his niece. Payment of the estate tax generated by the life insurance out of the residue would have exhausted the residue almost entirely. The question, therefore, is whether the decedent had directed otherwise in his will. The court held that despite what would seem to be clear language in the document, the insurance would bear the tax burden. The

¹⁰ Rates shown in the code are pre-2001 tax law changes.

¹¹ 954 S.W.2d 409 (Mo. App. 1997)

court noted that the courts in Missouri were “very cautious in shifting the ultimate tax burden of the portion of the tax attributable to the non-testamentary insurance gift to recipients who take under the will. It has required the evidence be clear that the testator not just intended this, but actually directed such action, and has implied the insurance proceeds should be specifically mentioned as passing free of estate taxes if this is in fact the testator’s direction.”

This result seems correct and most likely would have been the testator’s intent. That seems especially true here because the will provided that had decedent’s spouse survived him, the entire residue went to the spouse, and allocation of estate tax to the marital share would have essentially wiped out the spouse’s inheritance. It is hard to believe that would have been his intent. But if that had not been the case and this had arisen in another state, a state court may very well have applied the tax clause literally and come to a different result.

The case illustrates the important point that charities need to review these tax clauses – many charities at first glance would simply concede that taxes must be paid from the residue and unless they review the estate tax return and accountings they will never know, in fact, how the estate tax has been paid. Other Code sections similarly create rights of reimbursements in some cases although not, unfortunately, in the case of joint property. See, for example, sections 2207, 2207A, and 2207B.

2. **Cases where there is no federal contribution statute.** What about cases where there is no federal override statute applies and the tax clause merely says pay out of residue in a situation where the residue passes partly to charity and partly to taxable beneficiaries? Here again, charities should not just assume that all taxes will be borne equally by charitable and non-charitable beneficiaries. This is not the place for a detailed treatise on equitable apportionment, but several points are worth making.

a. First, see whether the state in question has a state estate tax apportionment act. Five states¹² have passed a version of the Uniform Estate Tax Apportionment Act. That act provides for many situations not clearly covered by the documents, including apportionment where a portion of the estate does not generate estate tax. The prefatory note to the 2003 revision of the Act notes that “Under the statutory scheme, marital and charitable beneficiaries generally are insulated from bearing any of the estate tax, and a decedent’s direction that estate tax be paid from a gift to be shared by a spouse or charity with another is construed to locate the tax burden only on the taxable portion of the gift.” Section 3(b)(2) of the UETA provides that unless the decedent

¹² Alabama, Arkansas, Idaho, New Mexico and Washington

expressly and unambiguously directs to the contrary, “If an apportionment provision directs that an estate tax is to be apportioned to an interest in property a portion of which qualifies for a marital or charitable deduction, the estate tax must first be apportioned ratably among the holders of the portion that does not qualify for a marital or charitable deduction and then apportioned ratably among the holders of the deductible portion to the extent that the value of the non-deductible portion is sufficient.”

The National Conference of Commissioners on Uniform State Laws comment on this section notes:

A decedent’s direction will not control the apportionment of taxes unless it explicitly refers to the payment of an estate tax and is specific and unambiguous as to the direction it makes for that payment. For example, a testamentary direction that “all debts and expenses and claims against me or my estate are to be paid out of the residue of my estate” is not an express direction for the payment of estate taxes and will not control apportionment.

Some states have apportionment statutes of their own which may or may not follow the similar language of the Uniform Act. A typical case construing a state statute is *Estate of McKinney*¹³, a decision of the Surrogate’s Court of New York for Westchester County. Among the issues involved in that case was allocation of death taxes to residue, a portion of which passed to charity and a portion of which passed to an individual. Relying in part on a New York statutory apportionment provision that exempted from tax charitable bequests unless the will provided otherwise, the Court held that because the gift to charity did not contribute to the tax burden, it was not equitable to charge it with tax. Again, a broad “pay from residue” type tax clause was not construed literally to apply in the absence of more explicit indication that this was the actual intent of the testator.

b. For estates in which there is no law on this subject by statute, case law must be looked to and here cases will very much depend on the exact language used. Again, it is not the purpose of this outline to review the entire equitable apportionment law, but to serve as a reminder that to protect our charitable clients’ interests, we should review tax clauses and estate tax returns to see if taxes have been apportioned correctly. An executor applying a pay from residue clause without considering whether equitable apportionment applies may considerably reduce the charity’s eventual inheritance. This may be an area where enlisting the assignment of the state attorney general can be helpful. But unless

¹³ 117 Misc. 2d 173; 458 N.Y.S.2d 144 (1982)

charities review tax clauses and tax returns—and we review them for them—the charities will never know if they have received what they have received what they are entitled to.

IV.

Non-Qualifying Transfers

Charities (or their lawyers) also need to review charitable bequests to make certain that technical issues will not prevent the bequest from qualifying for an estate tax deduction. These may be curable either by disclaimer or, in the case of defective split interest trusts, by qualified reformation.

Curing Defects with Disclaimers

A. Although, again, this is not the place for a detailed disquisition on the law of disclaimers, we simply note that the careful review of dispositive provisions may disclose defects in an otherwise qualifying charitable bequest which can be cured by a timely disclaimer. There are many private letter rulings dealing with disclaimers used to save or increase a charitable deduction. For example, in PLR 200127007, the Service ruled that a disclaimer of the section 2207A right of recovery which had the effect of increasing the property passing to charity would be a qualified disclaimer and that the disclaimed right of recovery would increase the charitable deduction. PLR 9017026 came to the same conclusion in connection with the disclaimer of a survivorship interest in joint property. In other cases, disclaimers can convert what would otherwise be an unreformable interest under section 2055(e) to a reformable interest. For example, a will may create a trust providing for payment of income (rather than a unitrust or annuity interest) to an individual with remainder to charity and may also provide for broad discretion over invasion of principal. The provision allowing invasion of principal will, of course, disqualify the otherwise reformable interest, but a disclaimer of a right to principal encroachments will make the interest reformable.¹⁴

B. Disclaimers may also serve to increase the charitable deduction. Suppose, for example, that a charitable remainder trust is created for two beneficiaries, a 50 year old and an 85 year old. Because it is unlikely the 85 year old successor beneficiary will ever receive anything because of the requirement of surviving the younger beneficiary, a disclaimer by the older beneficiary will (slightly) increase the charitable deduction without, in all likelihood, costing the disclaiming beneficiary a nickel.

C. A disclaimer may also serve to save the special marital deduction of section 2056(b)(8) which applies to bequests to a spouse in a charitable

¹⁴ See, for example, PLR 8550018, PLR9004011, PLR 9347013, PLR 9532026 and PLR 200010019

remainder trust. One of the peculiarities of that section is that the marital deduction is not available if there is another non-charitable beneficiary other than the spouse. TAM8730004 involved a charitable remainder trust providing an interest for a 59 year old spouse and, following her death, an 83 year old brother. As in the above example, it was unlikely the brother would ever receive anything, and his disclaimer would make the marital deduction available to the spouse's interest in the charitable remainder trust. In that particular TAM, the disclaimer was too late, unfortunately, but had it been timely it would have saved the marital deduction as well as increased the charitable deduction.

Curing Defects with Section 2055(e) Reformations

Split interest transfers should be reviewed especially closely to make certain they qualify, because many defective transfers can be cured by qualified reformation.

A. It is worth noting at the outset that an obscure and often forgotten provision may apply in rare cases so that a qualified reformation will not even be necessary. Section 2055(e)(3)(F) provides that if because of the death of an individual (or by termination of the trust in accordance with its terms) by the due date for filing the estate tax return the reformable interest passes to charity, the deduction is allowed without reformation.

B. In a more typical case, defects may be curable by reformation. Not only should provisions be reviewed for technical compliance, but in addition the provisions should be reviewed to make certain that unitrusts meet the 10% actuarial remainder test of section 664 and that charitable remainder annuity trusts meet both the 10% remainder test of section 664 and the 5% exhaustion test of Rev. Rul. 77-374, 1977-2 C.B. 329.

C. The reformation provisions of section 2055(e) are surprisingly liberal and have enabled many estate planning lawyers to sleep better at night. If the trust permits it, or if state law allows it, the trust may even be reformable without court authority. Technical errors have been reformable since 1984. When the 10% minimum remainder requirement was added in 1997, the reformation rules were also amended to permit reformation of a trust which does not meet those new requirements. The committee report indicates that in the latter case, the normal rule requiring that the reformed and reformable interest not differ by more than 5% would not apply.

D. To be reformable, a trust must have met the requirements for pre-Tax Reform Act of 1969 trusts. That meant essentially that the interest must be ascertainable. As noted above, partial disclaimers may remove broad invasion provisions and turn what would otherwise be an unreformable into a reformable interest.

E. If the trust provides for an annuity or unitrust interest, the statute provides that the interest can be reformed without court order and there is no time limit to undertake the reformation.

F. If the trust was drafted by someone who never heard of the 1969 Tax Reform Act – i.e., a trust providing for payment of income rather than a unitrust or annuity trust interest – the trust is still reformable, but the reformation must commence on or before the 90th day following the due date of the estate tax return (including extensions) or if no estate tax return is required, the due date, including extensions, of the fiduciary income tax return for the first taxable year for which the trust must file a return. Among the many defects which have been cured are reformations to increase the minimum payout to 5%.¹⁵ A myriad of technical defects have been reformed by 2055(e) but unless the trust is reviewed defects can't be found in the first place.

G. One of the harder to requirements to meet may be the requirement that the reformed and unreformed interests may not differ by more than 5%. But even this requirement can sometimes be met with a little ingenuity. PLR 200306008 involved a charitable remainder trust funded with \$100,000 and calling for a \$3000 annual annuity with remainder to charity. Reforming the trust to increase the annuity to \$5000 is easy enough, but the actuarial value of the reformed and unreformed interests would differ by more than 5%. Solution: reform the trust to pay a 2% annuity to charity. Other trust may be reformed by converting a life estate to a term of years – by tinkering with the term length it may be possible to meet the 5% test.

H. Sometime it may take several of these tricks to get the job done. For example, suppose a trust provides for income to X, remainder to charity, and also provides for broad invasion of principal. To fix this trust would require both disclaimer of the invasion right and reformation of the resulting income only trust.¹⁶ Or a non-qualifying charitable remainder trust for a spouse may generate better tax results by a spousal election against the will: the spouse's interest will qualify for the marital deduction and the charitable remainder will pass directly to charity and qualify for the charitable deduction.

¹⁵ See PLR200306008

¹⁶ See PLR 200302029

Appendix A

Example Of Code To Calculate Interrelated Estate Tax

```
procedure calculate_interrelated_tax;
```

```
begin
```

```
  if year_of_death < 1998 then  
    exemption_equivalent := 600000;  
  if year_of_death = 1998 then  
    exemption_equivalent := 625000;  
  if year_of_death = 1999 then  
    exemption_equivalent := 650000;  
  if year_of_death = 2000 then  
    exemption_equivalent := 675000;  
  if year_of_death = 2001 then  
    exemption_equivalent := 675000;  
  if year_of_death = 2002 then  
    exemption_equivalent := 1000000;  
  if year_of_death = 2003 then  
    exemption_equivalent := 1000000;  
  if year_of_death = 2004 then  
    exemption_equivalent := 1500000;  
  if year_of_death = 2005 then  
    exemption_equivalent := 1500000;  
  if year_of_death = 2006 then  
    exemption_equivalent := 2000000;  
  if year_of_death = 2007 then  
    exemption_equivalent := 2000000;  
  if year_of_death = 2008 then  
    exemption_equivalent := 2000000;  
  if year_of_death = 2009 then  
    exemption_equivalent := 3500000;
```

```
{set default values}
```

```
counter := 1;  
tentative_estate_tax := 0;  
gsttax := 0;
```

```
{define taxable estate}
```

```
taxable_estate := gross_estate + adjusted_taxable_gifts  
- preresiduary_charitable_bequests - debts;
```

```

if pct_to_charity >0 then charitable_deduction :=
((gross_estate - debts -
preresiduary_charitable_bequests-preresiduary_taxable_bequests) * pct_to_charity)
-gsttax
else charitable_deduction := 0;

if gross_estate -(((gross_estate {+ adjusted_taxable_gifts}- debts -
preresiduary_charitable_bequests-preresiduary_taxable_bequests) * pct_to_charity)
+preresiduary_charitable_bequests) + adjusted_taxable_gifts-debts >= exemption_equivalent
then begin;

repeat

{begin 100 iterations}

if charitable_deduction >= gross_estate-debts then taxable_estate
:= 0 else
taxable_estate := gross_estate -preresiduary_charitable_bequests
+ adjusted_taxable_gifts- debts - charitable_deduction;
tentative_estate_tax := 0;

{calculate estate tax}

if taxable_estate < 10001 then tentative_estate_tax := (taxable_estate * 0.18);

if taxable_estate > 10000 then if taxable_estate < 20001 then
tentative_estate_tax := 1800 + ((taxable_estate-10000)) * 0.20;

if taxable_estate > 20000 then if taxable_estate < 40001 then
tentative_estate_tax := 3800 + ((taxable_estate-20000)) * 0.22;

if taxable_estate > 40000 then if taxable_estate < 60001 then
tentative_estate_tax := 8200 + ((taxable_estate-40000)) * 0.24;

if taxable_estate > 60000 then if taxable_estate < 80001 then
tentative_estate_tax := 13000 + ((taxable_estate-60000)) * 0.26;

if taxable_estate > 80000 then if taxable_estate < 100001 then
tentative_estate_tax := 18200 + ((taxable_estate-80000)) * 0.28;

if taxable_estate > 100000 then if taxable_estate < 150001 then
tentative_estate_tax := 23800 + ((taxable_estate-100000)) * 0.30;

if taxable_estate > 150000 then if taxable_estate < 250001 then
tentative_estate_tax := 38800 + ((taxable_estate-150000)) * 0.32;

```

if taxable_estate > 250000 then if taxable_estate < 500001 then
 tentative_estate_tax := 70800 + ((taxable_estate-250000)) * 0.34;

if taxable_estate > 500000 then if taxable_estate < 750001 then
 tentative_estate_tax := 155800 + ((taxable_estate-500000)) * 0.37;

if taxable_estate > 750000 then if taxable_estate < 1000001 then
 tentative_estate_tax := 248300 + ((taxable_estate-750000)) * 0.39;

if taxable_estate > 1000000 then if taxable_estate < 1250001 then
 tentative_estate_tax := 345800 + ((taxable_estate-1000000)) * 0.41;

if taxable_estate > 1250000 then if taxable_estate < 1500001 then
 tentative_estate_tax := 448300 + ((taxable_estate-1250000)) * 0.43;

if taxable_estate > 1500000 then if taxable_estate < 2000001 then
 tentative_estate_tax := 555800 + ((taxable_estate-1500000)) * 0.45;

if taxable_estate > 2000000 then if taxable_estate < 2500001 then
 tentative_estate_tax := 780800 + ((taxable_estate-2000000)) * 0.49;

if taxable_estate > 2500000 then if taxable_estate < 3000001 then
 tentative_estate_tax := 1025800 + ((taxable_estate-2500000)) * 0.53;

if taxable_estate > 3000000 then tentative_estate_tax := 1290800 +
 ((taxable_estate-3000000) * 0.55);

if year_of_death = 2002 then

if taxable_estate > 2500000 then
 tentative_estate_tax := 1025800 + ((taxable_estate-2500000)) * 0.50;

if year_of_death = 2003 then
 if taxable_estate > 2000000 then
 tentative_estate_tax := 780800 + ((taxable_estate-2000000)) * 0.49;

if year_of_death = 2004 then
 if taxable_estate > 2000000 then
 tentative_estate_tax := 780800 + ((taxable_estate-2000000)) * 0.48;

if year_of_death = 2005 then
 if taxable_estate > 2000000 then
 tentative_estate_tax := 780800 + ((taxable_estate-2000000)) * 0.47;

if year_of_death = 2006 then

```
if taxable_estate > 2000000 then
tentative_estate_tax := 780800 + ((taxable_estate-2000000)) * 0.46;
if year_of_death > 2006 then
if taxable_estate > 1500000 then
tentative_estate_tax := 555800 + ((taxable_estate-1500000)) * 0.45;
```

{Adjust tax for bubble glitch}

```
if taxable_estate > 10000000 then if year_of_death > 1997 then
if year_of_death < 2002
then if taxable_estate < 17184001
then tentative_estate_tax :=
tentative_estate_tax + (0.05 * (taxable_estate - 10000000));
```

```
if taxable_estate > 17184000 then if year_of_death > 1997 then
if year_of_death < 2002
then tentative_estate_tax :=
tentative_estate_tax + (0.05 * (17184000-10000000));
```

```
if taxable_estate > 10000000 then if year_of_death < 1998 then
if taxable_estate < 21040000 then tentative_estate_tax :=
tentative_estate_tax + (0.05 * (taxable_estate-10000000));
```

```
if year_of_death < 1998 then if taxable_estate > 21040000 then
tentative_estate_tax := tentative_estate_tax + (0.05 *
(21040000-10000000));
```

recalculate_gift_tax; **{this separate procedure not shown}**

apply_unified_credit; **{this separate procedure not shown}**

```
charitable_deduction := ((gross_estate-debts-
preresiduary_charitable_bequests-preresiduary_taxable_bequests-
(tentative_estate_tax-
gift_tax_paid)+unified_credit) * pct_to_charity)-(gsttax*(1-
skip_tax_on_skippees));
```

```
if charitable_deduction < 1 then charitable_deduction := 0;
if tentative_estate_tax - unified_credit -gift_tax_paid <= 0
then charitable_deduction :=
((gross_estate - debts -preresiduary_taxable_bequests)
* pct_to_charity)-gsttax;
counter := counter +1;
direct_skip_amt := (gross_estate - debts -
```

```

preresiduary_taxable_bequests-
preresiduary_charitable_bequests)* (direct_skip_pct);
direct_skip_amt := direct_skip_amt-
((tentative_estate_tax-unified_credit-gift_tax_paid)*direct_skip_pct);
if year_of_death < 2002 then
  gsttax := (direct_skip_amt-gst_exemption-(gsttax*skip_tax_on_skippees))*0.55;
if year_of_death = 2002 then
  gsttax := (direct_skip_amt-gst_exemption-(gsttax*skip_tax_on_skippees))*0.50;
if year_of_death = 2003 then
  gsttax := (direct_skip_amt-gst_exemption-(gsttax*skip_tax_on_skippees))*0.49;
if year_of_death = 2004 then
  gsttax := (direct_skip_amt-gst_exemption-(gsttax*skip_tax_on_skippees))*0.48;
if year_of_death = 2005 then
  gsttax := (direct_skip_amt-gst_exemption-(gsttax*skip_tax_on_skippees))*0.47;
if year_of_death = 2006 then
  gsttax := (direct_skip_amt-gst_exemption-(gsttax*skip_tax_on_skippees))*0.46;
if year_of_death > 2006 then
  gsttax := (direct_skip_amt-gst_exemption-(gsttax*skip_tax_on_skippees))*0.45;

if gsttax < 0 then gsttax := 0;

until counter = 100;
end;

```

{end 100 iterations}

```

if tentative_estate_tax - unified_credit - gift_tax_paid > 0 then
estate_tax := tentative_estate_tax - unified_credit - gift_tax_paid else
estate_tax := 0;
  if tentative_estate_tax - unified_credit -gift_tax_paid <= 0
  then charitable_deduction :=
  ((gross_estate - debts -preresiduary_taxable_bequests)
  * pct_to_charity) else
charitable_deduction := charitable_deduction + preresiduary_charitable_bequests;
if gross_estate -(((gross_estate {+ adjusted_taxable_gifts}- debts -
preresiduary_charitable_bequests-preresiduary_taxable_bequests) * pct_to_charity)
+preresiduary_charitable_bequests) + adjusted_taxable_gifts-debts < exemption_equivalent
then begin
charitable_deduction := (((gross_estate - debts -
preresiduary_charitable_bequests-preresiduary_taxable_bequests) * pct_to_charity)
+preresiduary_charitable_bequests);
taxable_estate := gross_estate+adjusted_taxable_gifts -debts -
charitable_deduction;
if taxable_estate < 10001 then tentative_estate_tax := (taxable_estate * 0.18);

if taxable_estate > 10000 then if taxable_estate < 20001 then

```

$tentative_estate_tax := 1800 + ((taxable_estate - 10000)) * 0.20;$
 if taxable_estate > 20000 then if taxable_estate < 40001 then
 $tentative_estate_tax := 3800 + ((taxable_estate - 20000)) * 0.22;$
 if taxable_estate > 40000 then if taxable_estate < 60001 then
 $tentative_estate_tax := 8200 + ((taxable_estate - 40000)) * 0.24;$
 if taxable_estate > 60000 then if taxable_estate < 80001 then
 $tentative_estate_tax := 13000 + ((taxable_estate - 60000)) * 0.26;$
 if taxable_estate > 80000 then if taxable_estate < 100001 then
 $tentative_estate_tax := 18200 + ((taxable_estate - 80000)) * 0.28;$
 if taxable_estate > 100000 then if taxable_estate < 150001 then
 $tentative_estate_tax := 23800 + ((taxable_estate - 100000)) * 0.30;$
 if taxable_estate > 150000 then if taxable_estate < 250001 then
 $tentative_estate_tax := 38800 + ((taxable_estate - 150000)) * 0.32;$
 if taxable_estate > 250000 then if taxable_estate < 500001 then
 $tentative_estate_tax := 70800 + ((taxable_estate - 250000)) * 0.34;$
 if taxable_estate > 500000 then if taxable_estate < 750001 then
 $tentative_estate_tax := 155800 + ((taxable_estate - 500000)) * 0.37;$
 if taxable_estate > 750000 then if taxable_estate < 1000001 then
 $tentative_estate_tax := 248300 + ((taxable_estate - 750000)) * 0.39;$
 if taxable_estate > 1000000 then if taxable_estate < 1250001 then
 $tentative_estate_tax := 345800 + ((taxable_estate - 1000000)) * 0.41;$
 if taxable_estate > 1250000 then if taxable_estate < 1500001 then
 $tentative_estate_tax := 448300 + ((taxable_estate - 1250000)) * 0.43;$
 if taxable_estate > 1500000 then if taxable_estate < 2000001 then
 $tentative_estate_tax := 555800 + ((taxable_estate - 1500000)) * 0.45;$
 if taxable_estate > 2000000 then if taxable_estate < 2500001 then
 $tentative_estate_tax := 780800 + ((taxable_estate - 2000000)) * 0.49;$
 if taxable_estate > 2500000 then if taxable_estate < 3000001 then
 $tentative_estate_tax := 1025800 + ((taxable_estate - 2500000)) * 0.53;$
 if taxable_estate > 3000000 then tentative_estate_tax := 1290800 +
 $((taxable_estate - 3000000)) * 0.55);$

```
if year_of_death = 2002 then

if taxable_estate > 2500000 then
tentative_estate_tax := 1025800 + ((taxable_estate-2500000)) * 0.50;

if year_of_death = 2003 then
if taxable_estate > 2000000 then
tentative_estate_tax := 780800 + ((taxable_estate-2000000)) * 0.49;

if year_of_death = 2004 then
if taxable_estate > 2000000 then
tentative_estate_tax := 780800 + ((taxable_estate-2000000)) * 0.48;

if year_of_death = 2005 then
if taxable_estate > 2000000 then
tentative_estate_tax := 780800 + ((taxable_estate-2000000)) * 0.47;

if year_of_death = 2006 then
if taxable_estate > 2000000 then
tentative_estate_tax := 780800 + ((taxable_estate-2000000)) * 0.46;

if year_of_death > 2007 then
if taxable_estate > 1500000 then
tentative_estate_tax := 555800 + ((taxable_estate-1500000)) * 0.45;

if tentative_estate_tax < 0 then tentative_estate_tax := 0;
end;
end;
```

**MEMO TO CHARITABLE CLIENTS RE
LOW INTEREST RATES**

To: Our Charitable Clients

From: Lawrence P. Katzenstein

Date: April 24, 2008

Re: May 7520 Rate

As you may be aware, the section 7520 rate used to value split interest charitable gifts (sometimes called the Charitable Monthly Federal Rate or CMFR) has dropped to an extraordinarily low May rate of 3.2%. Since Congress enacted section 7520 in 1989, the rate has only been lower in one month, back in 2003. (As recently as last summer, the interest rate was 6.2%.) This unusually low interest rate creates special opportunities for individuals with philanthropic interests and gives charities some marketing opportunities. Charitable lead trusts and gifts of a remainder in a personal residence to charity are particularly attractive now because of the low interest rate. Note that for all of these charitable planning vehicles, the 3.2% May rate can be used for gifts made in May, June or July.

CHARITABLE LEAD ANNUITY TRUSTS

A charitable lead annuity trust ("CLAT") is in many ways the opposite of a charitable remainder annuity trust: the trust provides for payment of an annuity interest to charity, typically for a term of years, with the remainder payable to other family members. It is both an estate planning device and a charitable giving vehicle. If a CLAT is established during life, the donor is making a taxable gift of the remainder. The lower the interest rate, the less the gift for gift tax purposes. If over the term of the trust the investment performance exceeds the section 7520 rate in effect when the trust is created, the value of the gift for gift tax purposes will be less than the value of the assets actually passing to family members, and the excess will be a free transfer to family members for transfer tax purposes. At the May 7520 rate, the investment performance must exceed only a 3.2% rate of return to result in a gift and estate tax free transfer to family members. That is why this low interest rate makes CLATs so attractive now. You might want to make selected wealthy donors aware of the current attractiveness of charitable lead annuity trusts.

As CLATs are typically structured, the donor does not receive an income tax deduction when creating the trust. But since the donor is not taxed on the trust income, the economic result is the same as if the income were received by the donor and then fully deductible. (An income tax deduction is available for the actuarial value of the charitable lead annuity interest only if the trust is structured so that the donor is taxed on the income of the trust during the trust term even though the donor will not receive the income. This can be useful as a way of accelerating a

charitable deduction into a high income year, such as the year in which the donor sells a business or has unusually high income for some other reason).

Charitable lead annuity trusts are a very technical subject and I can provide you with a more detailed outline and technical discussion if you wish.

GIFTS OF A REMAINDER IN A PERSONAL RESIDENCE

The other gift which is particularly attractive given current low interest rates is a gift of a remainder in a personal residence or farm with retained life estate. With this gift, the donor deeds his or her personal residence to charity, reserving the right to live in the house for the remainder of the donor's lifetime. An income tax deduction is available for the actuarial value of the remainder. The lower the section 7520 rate at the time of the gift, the greater the income tax deduction. To illustrate how dramatically interest rates affect this kind of gift, let us assume a donor 70 years old who reserves a life estate in a residence deeded to charity. Assume further that the residence is worth \$1 million, \$200,000 of which represents the value of the land and \$800,000 of which represents the value of the residence. If the gift had been made in May, 2007 when the section 7520 rate was 5.6% the income tax deduction would have been \$412,068. If the gift is valued using the May, 2008 3.2% interest rate, the income tax deduction increases from \$412,068 to \$521,198. If two individuals age 70 made the gift (for example, a married couple with the house in joint name), the deduction increases from \$280,718 to \$399,372. You may want to make appropriate donors are aware of this opportunity.

THE BAD NEWS FOR CRATs AND CGAs

The bad news about the unusually low section 7520 rate is that certain gifts will now be less desirable than they were before. The income tax deduction for charitable gift annuity donors as well as donors to charitable remainder annuity trusts will be dramatically reduced. (Charitable remainder unitrusts are essentially unaffected by interest rate swings.) In addition, the unusually low interest rate creates certain traps for both charitable remainder annuity trusts and charitable gift annuities

A. Charitable Remainder Annuity Trusts. Since annuities are worth more when interest rates are low, the deduction for a donor's contribution to a charitable remainder annuity trust will be less when interest rates are low. The effect of low interest rates is dramatic. Suppose, for example, that in May, 2007 a 70-year old donor contributed \$100,000 to a charitable remainder annuity trust and elected to use the more favorable March Section 7520 rate of 5.8%. A \$100,000 trust paying out a \$6,000 annual annuity in quarterly payments generated a charitable deduction of \$47,169. The actuarial value of a charitable remainder in a CRAT created in May, 2008 (and electing to use the higher March rate of 3.6%), is \$38,153 — but the income tax deduction will be zero because at a 3.6% 7520 rate the trust flunks the 5% probability of exhaustion test of Revenue Ruling 77-374.

Charitable remainder annuity trusts, in fact, have to pass *two* tests, both of which become more difficult to pass when interest rates are low. The first is the probability of exhaustion test noted above. If the annuity payout rate is higher than the applicable Section 7520 rate, there is

some chance the trust will theoretically run out of money before the donor dies, and if that probability exceeds 5%, the trust flunks.

Here is a shocker: at the applicable section 7520 for May, 2008 of 3.2% a 64 year old donor who wants quarterly payments can't create a CRAT at all, because even with the minimum 5% payout, the trust flunks the 5% test!

Charitable remainder annuity trusts (as well as charitable remainder unitrusts) also have to pass the test in Internal Revenue Code Section 664 that the actuarial value of the *remainder* (the interest passing to charity) must be at least 10%. CRATS are more likely to fail this test when interest rates are low because the low interest rate reduces the charitable deduction.

The two tests — the exhaustion test and the 10% remainder test — look at two very different things. The exhaustion test looks at whether the trust is likely to run out of money and may become a problem when the payout rate is higher than the 7520 rate. But the 10% test can be flunked even if the payout rate is less than the Section 7520 rate if, for example, the beneficiary is fairly young or there are multiple annuity beneficiaries. The lower the interest rate, the older the beneficiary may have to be to pass the 10% test.

B. Charitable Gift Annuities. Charitable gift annuities do *not* have to pass a 5% exhaustion test and from the donor's standpoint, they do not have to pass a 10% test. But the charity issuing the annuity will have taxable unrelated debt-financed income unless the actuarial value of the remainder is at least 10%, pursuant to Code Section 514(c)(5). Charitable gift annuities issued at American Council on Gift Annuities recommended maximum annuity rates will normally pass the 10% test. But at the current low interest rates, even annuities issued at recommended ACGA rates may fail the test, *so the 10% test should be checked carefully*. In fact the ACGA current rate schedule notes that if the 7520 rate is less than 4.0%, the deduction will be less than 10% when annuitants are below certain ages. For the new suggested rates which will become effective on July 1, the deduction will be less than 10% below certain ages when the 7520 rate is less than 3.4%. The Council warns therefore that “to avoid adverse tax consequences, the charity should reduce the gift annuity rate to whatever level is necessary to generate a charitable deduction in excess of 10%.”

THE GOOD NEWS FOR CRATs AND CGAs

Not all the low rate news is bad for CRATS and CGAs. Although the deduction on purchase of a charitable gift annuity is lower when interest rates are low, the amount of each payment *excluded* from income under section 72 will be *higher*. So a non-itemizer who cares more about how much income is taxable than about the charitable deduction will find the charitable gift annuity especially attractive now. Also, the low interest rate creates an opportunity for beneficiaries of existing charitable remainder annuity trusts. The fact that the present value of the charitable remainder is now unusually low also means of course that the value of the annuity itself is quite high. There may be donors who would be willing to donate all or a portion of their remaining annuity interests to the charitable remainder beneficiary. They will be entitled in that event to a charitable deduction for the actuarial value of the annuity released, and that deduction is much enhanced because of the current low interest rate. Example: Assume a 70-year old donor agrees to give her \$6,000 lifetime annuity in a CRAT to the charitable remainder beneficiary. At a 5.8% interest rate, she would have gotten an income

tax deduction of \$52,831. The same annuity interest given to charity in May, 2008 will generate an income tax deduction of \$63,775.

What if the holder of a charitable gift annuity wants to give the remaining life annuity interest to charity? Unfortunately, although the actuarial value of the annuity is the same as the value of the retained annuity in a CRAT, the deduction for the gift of an annuitant's charitable gift annuity interest is limited to the donor's unrecovered basis in the contract.

A NOTE ABOUT UNITRUSTS

We have not discussed unitrusts in this memorandum because interests in unitrusts are essentially unaffected by interest rates. In fact, if a unitrust makes payments annually rather than more frequently and the valuation date is the same as the payment date, interest rates have no effect whatsoever.

This makes sense on a moment's reflection, because if I own a fixed percentage of the fair market value of the assets as revalued annually, relative to each other the values of the unitrust interest and the remainder interest will always be the same.

However, if payments are made more frequently than annually, or if there is any gap between valuation date and payment date, a Table F adjustment must be made to the payout rate. But the effect of interest rates is minimal and for planning purposes can essentially be ignored.

CONCLUSION

The May section 7520 rate of 3.2% creates some real marketing opportunities to selected donors as well as challenges for certain kinds of gifts. The rate can be used for gifts made in May, June or July of this year. And don't forget that because the ACGA's recommended maximum annuity rates for charitable gift annuities decline for annuities issued after June 30, donors considering charitable gift annuities can be encouraged to act now.

DRAFTING ISSUE FOR YEAR-END CHARITABLE REMAINDER UNITRUSTS SOLVED BY THE FLIP UNITRUST

The final charitable remainder unitrust regulations issued in 2001 create administrative problems for charitable remainder unitrusts which may be alleviated by using a flip unitrust. In order to counter the abuses of the accelerated unitrust, the regulations provide that normally payments from charitable remainder trusts other than income-only unitrusts must be made within the unitrust's taxable year. However, the regulations provide a rather complicated alternative: payments 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.¹ The final regulations made some minor changes in the proposed regulations in response to comments received and in order to make it less likely that a non-abusive trust would violate the payment rule. Specifically, two exceptions were added to §§1.664-2(a)(1)(a) and 1.664-3(a)(1)(g). These exceptions provide that a distribution of cash made within a reasonable period of time after the close of the year may be characterized as corpus under section 664(b)(4) to the extent it was attributable to (i) a contribution of cash to the trust with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522, or (ii) a return of basis in any asset contributed to the trust with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522, and sold by the trust during the year for which the annuity or unitrust amount was due.

These requirements provision can still create considerable administrative difficulties in some very non-abusive situations. Take for example the simple case of a trust funded on December 28 with marketable securities. Either distribution of a small pro rated payment must be made by the end of the year, which will often be impractical or the trustee must make a complex election which is deemed to generate gain. One way to deal with the practical problem is to draft these as flip unitrusts with the triggering event being December 31 of the first year of the trust. A donor may deliver a signed trust with a check (or stock and a 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 pro rated payment by the end of the year? No one knows. The flip unitrust comes to the rescue by eliminating the need for the partial payment or election.

¹ 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 these rules if the percentage used to calculate the annuity or unitrust amount is 15% or less.

INTERNAL REVENUE SERVICE ISSUES SAMPLE CHARITABLE REMAINDER UNITRUST FORMS

In Revenue Procedures 2005-52 through 2005-59, the Internal Revenue Service has issued sample charitable remainder unitrust forms replacing the sample forms issued in 1990. As with the annuity trust forms issued in 2003, the new forms are a significant improvement over the prior forms and the explanatory material and annotations provided by the Internal Revenue Service are very useful. The specific forms issued are as follows:

1. Inter vivos charitable remainder unitrust (CRUT) for one measuring life – Rev. Proc. 2005-52.
2. Inter vivos CRUT for a term of years – Rev. Proc. 2005-53.
3. Inter vivos CRUT with consecutive interests for two measuring lives – Rev. Proc. 2005-54.
4. Inter vivos CRUT for concurrent and consecutive interests for two measuring lives – Rev. Proc. 2005-55.
5. Testamentary CRUT for one measuring life – Rev. Proc. 2005-56.
6. Testamentary CRUT for a term of years – Rev. proc. 2005-57.
7. Testamentary CRUT with consecutive interests for two measuring lives – Rev. Proc. 2005-58.
8. Testamentary CRUT with concurrent and consecutive interests for two measuring lives – Rev. Proc. 2005-59.

The forms are more complicated than the annuity trust forms, of course, because there are more flavors of unitrusts: regular unitrusts, income-only with makeup, income-only without makeup, and flip unitrusts (referred to by the Service as “combination of methods unitrusts”).

The forms track closely the annuity trust forms issued in 2003 and many of the comments one could make about the forms were also true of the annuity trust forms. But a number of the items are specific to unitrusts. For example, the annotations note that if an additional contribution is made to an existing charitable remainder unitrust and the contribution does not satisfy the 10% test of section 664(d)(2)(D) the contribution is treated as a transfer to a separate trust under section 664(d)(4). The annotations also include information and language regarding unitrusts with more than one valuation date. It will be rare when more than one valuation date will be desirable, because of the considerable complexities such a provision entails.

The annotations also include alternate language for testamentary additions to unitrusts and alternate methods of computing the deferred payments.

The annotations to the income-only variants take into account changes in state law definitions of income and provide that proceeds of sales of assets may be allocated to income under the terms of the governing instrument if not prohibited by applicable local law. Further, a discretionary power to make the allocation may be granted to the trustee to the extent that the applicable estate statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially. One assumes that prior IRS pronouncements prohibiting allocation of pre-gift gain to income still govern.

The annotations to the flip unitrust—which can make a one time change from an income only (with or without makeup) to a regular unitrust—note that the change may not be discretionary with or in the control of the trustees or any other persons. However, the usual trigger will be the sale of unproductive property which is, of course, within the control of the trustees. I suppose what the Service is really saying is that only events of dependent significance count. There is something new in the flip unitrust forms: separate and detailed language regarding proration of the unitrust amount in years both before and after the effective date of the triggering event.

Interestingly, and perhaps even bizarrely, the two life trusts, which will almost always be for husband and wife, say nothing about the waiver requirements of Revenue Procedure 2005-24. The forms include no sample waiver language for a spousal interest and the annotations do not even mention the existence of the necessity imposed by Revenue Procedure 2005-24. Has the Service had a change of heart, or are they merely punting on the exact requirements? Or maybe spousal waivers is some else's department.

The trust language itself is straightforward and to the point, and each form includes alternate provisions. As with the prior forms, the new forms must be used with care, although the thorough annotations provided by the Service will prevent many more inadvertent errors than the previous versions.

Examples of the kinds of alternatives provided by the Service, as well as explanatory cautions in the explanatory material, are the following:

1. The annotations point out that if the trust is funded with unmarketable assets, the annual or more frequent fair market value determination must be made by an independent trustee or must be determined by a qualified appraisal from a qualified appraiser as defined in the regulations.

2. The old IRS unitrust forms included language to the effect that the charitable remainder beneficiary must be an organization described in Code section 170(c). This was a trap for many, because section 170(c) includes private foundations, which have lower income tax percentage limitations. In addition, the deduction for gifts of appreciated property other than marketable securities is limited to basis if the charity is a private foundation. The explanatory annotations include a warning and alternative language for the case (which is the usual one) where the donor wishes the charitable beneficiary to be a public charity.

3. The annotations point out that the unitrust amount may be payable to members of a named class in a term of years trust even if the members of the class are not living or ascertainable at the creation of the trust. The annotations also point out that sprinkling powers cannot be held by certain persons without causing the trust to be treated as a grantor trust for income tax purposes.

4. The forms point out that the unitrust amount may be paid in equal or unequal installments throughout the year. Unequal installments create complexities of valuation, and most practitioners will want to avoid unequal payments.

5. The annotations point out that generally the unitrust amount must be paid before the close of the taxable year in which it is due, and refer the reader to the regulations under section 664 which were adopted to prevent abuses related to the 2-year, high pay out charitable remainder trust.

6. The annotations point out that the trust may provide for an amount other than the unitrust amount to be paid in the discretion of the trustee to a charitable organization, and further point out that if distribution is made in kind, the adjusted basis of distributed property must be fairly representative of adjusted basis of property in the trust.

7. The annotations point out that the charitable remainder beneficiary may be selected by the trustee or some other person, or that the power to name the charitable beneficiary may be retained by the donor. In that case the gift will be incomplete for gift tax purposes, but the charitable income tax deduction will still be available. The forms also include alternate provisions in which the donor retains the right to substitute the charitable remainderman.

8. Another interesting provision referred to in the annotation is the qualified contingency provision of section 664(f) which permits a trust to end early upon the happening of any contingency, whether or not the actuarial value of the contingency can be determined. The qualified contingency is ignored for valuation purposes, but it will not disqualify the trust.

There are several changes most practitioners will want to make in the forms.

1. First, the forms provide as the default that the final payment will be prorated. In many cases this necessitates a payment of the stub period payment to the beneficiary's estate for the period after the last payment and until the beneficiary's death. Most practitioners will want to provide that the final payment will be the regular payment preceding the beneficiary's death.

2. As noted above, most practitioners will want to limit the charitable remainder beneficiary to public charities described in section 170(b)(1)(A), as provided in the alternative language.

3. Most practitioners will want to include a spendthrift provision, at least where the beneficiary is not the donor. The advisability and effect of a spendthrift provision will depend on state law.

4. In the two-life trusts, the forms have much simpler language regarding payment of taxes on the first death than were used in some of the prior IRS pronouncements. The two-life trust form does not include as a default provision a retained testamentary power to revoke the interest of the successor beneficiary so as to prevent a gift for gift tax purposes. Most practitioners will want to include that provision, even in the case of trusts for spouses. Where the donor has retained the right to change the charitable remainder beneficiary, including a power to revoke the survivorship interest of the spouse will avoid the necessity for filing a gift tax return. Note that this power must be testamentary rather than a lifetime power to avoid grantor trust treatment. (By contrast, the power to designate a different charitable remainder beneficiary may be an inter vivos or a testamentary power.)

In one respect, the generally useful forms are unnecessarily nitpicking. The explanatory material accompanying the term of years trust states that the term of a term of years trust must not exceed 20 years, and then includes the following sentence: “Thus, for example, the unitrust period of a CRAT for a term of 20 years will end on the date preceding the 20th anniversary of the date the trust was created.” But surely a trust ending on the 20th anniversary date of the trust should qualify. Requiring that the term end one day before the 20th anniversary seems unnecessarily nitpicking and undoubtedly many trusts have been written calling for the trust to terminate on the 20th anniversary date. Do all of these fail to qualify? Actually, now that we have a required 10% minimum actuarial value for both CRATs and CRUTs, the term limitation is really unnecessary, but it will be up to Congress to change that.

Internal Revenue Service Revokes 2005 Private Letter Ruling On Early Termination Of Charitable Remainder Trust

In private letter ruling 200525014, the Internal Revenue Service found no self dealing or other problems with the early termination of a charitable remainder unitrust and division of trust assets between the charity and the income beneficiary on an actuarial basis. In PLR 200614032 the Service has now revoked its earlier ruling. The latest PLR provided that the letter did not constitute an adverse letter ruling with respect to these issues, but the revocation certainly indicates the Service's second thoughts and it is interesting to speculate on what might be behind the revocation.

Background

As everyone who has not been asleep since 1969 is aware, trusts providing for payment of income to one or more individuals with remainder to charity must, to be tax-qualified, pay either a fixed annuity or a unitrust percentage of fair market value to the non-charitable beneficiary for a life or lives or for a term of not more than 20 years. But what if the charity and the income beneficiary want to terminate the trust early and simply split up the trust in accordance with their present actuarial interests? The Service in a number of prior private letter rulings – PLR 200314021 and PLR 200127023, for example – has approved just that. (The Service has consistently applied a different rule to charitable lead trusts, which must prohibit commutation whether they are lead unitrusts or lead annuity trusts. See Revenue Ruling 88-27, 1988-1 C.B. 331 and PLR 9734057.)

In the earlier private letter rulings, the Service permitted commutation and division of charitable remainder unitrusts holding, in addition, that the income beneficiary would be treated as having sold his or her remaining life interest to the charity in exchange for the commuted value of the income interest, and that section 1001(e) of the Code would deny any basis to the income interest.

So why in the latest private letter ruling has the Service had second thoughts? One's first speculation might be that what bothered the Service was the fact that although the trust provided for the payment of lesser of income or a 15 percent unitrust amount, division on an actuarial basis would result in putting far more back in the grantor's hands than the grantor would have received from just the income payments, because section 664 provides that for actuarial calculation purposes the income-only feature in a NIM-CRUT is ignored.

But word from lawyers who have been involved with similar ruling requests report what's really going on here. In the middle of 2004 the IRS Exempt Organizations group put a hold on all early CRT early termination rulings so that the issue could be examined more fully. What apparently prompted the review was a flood of CRT termination ruling requests which apparently caused the Service to wonder if something was up.

The legal issue which caused the revocation of PLR 200525014 arose only because the charitable remainder beneficiary was a private foundation. But I now know the legal issue which

caused revocation of the 2005 private letter ruling. As noted above, the Service takes the view that the early termination of a CRT is in effect a sale by the income beneficiary of his interest in the trust to the charitable remainder beneficiary. If this recharacterization of the transaction as a “sale” is correct, the sale to a private foundation would be a prohibited self-dealing transaction—this is what caused the Service to revoke the private letter ruling. That this is really what was going on became clear with the release of PLR 200616035, superseding PLR 200614032. and all becomes clear. In the latest PLR, the Service issued a favorable ruling because, pursuant to powers in the instrument, the grantor substituted public charities for private foundations as charitable remainder beneficiaries.

Two comments:

1. This problem only arises because of the Service’s odd view that what is involved is a sale, rather than merely a division between the parties of their respective interests, with each simply taking what is already his. It is only this legal fiction of a sale that creates the problem in the first place.

2. Although the 2005 private letter ruling involved a private foundation, the Service had put a hold on all early termination rulings, including those involving public charities. I am told by one of the attorneys involved in a similar ruling request that the Service will apparently start ruling favorably again on terminations where the remainder beneficiary is a public charity, but will not rule favorably where the remainder beneficiary is a private foundation.

Inclusion of Private Foundation in Gross Estate

Suppose I create a private foundation and name myself trustee. Is the foundation included in my gross estate under Code section 2036? The answer is clearly yes. In 1972 the Internal Revenue Service issued Revenue Ruling 72-552, 1972-2 C.B. 525 which held that the foundation would be included in the donor's estate because the decedent had the power to direct disposition of funds for charitable purposes. There is no exception in the gross estate inclusion rules for charitable transfers as there is in the grantor trust rules in Code section 674(b)(4). Having concluded that a private foundation is includable in the estate under these circumstances, do we care? The answer may be surprising: usually we will want the foundation to be includable in the gross estate. Although the foundation will be includable in the estate, it will be completely offset by the charitable estate tax deduction. Why do I then usually desire includability? The reason is that assets held by the foundation will receive a new basis. Again, why should I care since the foundation is tax exempt? The reason is that the private foundation excise tax imposed by section 4940 on investment income of private foundations includes capital gains. See Code section 4940(c)(4). If the assets in the foundation get stepped up on death, the excise tax could be reduced substantially. For this reason, it may be desirable in many cases to make certain that the donor is a trustee or officer of the foundation.

In two cases, however, it may be inadvisable for a foundation to be includable. The first case is, obviously, the situation in which assets have declined in value. Then, a step down in basis would increase the excise tax. The second situation is one in which it is important to qualify for section 303 or section 6166. Swelling of the gross estate by the foundation assets may in some cases make an otherwise eligible estate ineligible.

IRS Issues Lead Trust Forms

In June, 2007, the Internal Revenue Service issued sample charitable lead annuity trusts. (Sample lead unitrusts followed in Rev. Procs. 2008-45 and 2008-46.) The forms provided in Rev. Procs. 2007-45 and 46 are, respectively, inter vivos charitable lead annuity trusts (both grantor and non-grantor type) and a testamentary charitable lead annuity trust.

- A. Inter Vivos Lead Annuity Trust Form. The inter vivos form includes options both for a non-grantor CLAT and a grantor CLAT and the introductory material notes that the income tax consequences are different for each as more fully discussed in the above outline. As with the charitable remainder unitrust and annuity trust forms, the Service noted that generally the service will not issue a letter ruling on whether a charitable lead annuity trust qualifies for income, estate and/or gift tax charitable deductions, but will generally issue rulings related to the tax consequences of inclusion in a CLAT of a substantive trust provision different from those set forth in the revenue procedure. A form not following the IRS form does not necessarily fail to qualify, but will not be eligible for the safe harbor.
- B. Sample Inter Vivos Non-Grantor Charitable Lead Annuity Trust. The sample inter vivos non-grantor charitable lead annuity trust is straightforward and does not have the interesting grantor trust issues of the grantor lead trust. The default provision states the annuity in terms of a percentage of the initial fair market value, which provides protection against faulty evaluations if what is contributed to the trust is not marketable securities or cash.

Note several things about the form. The form provides specifically that no person can hold any power that would cause the donor to be treated as owner of any portion of the trust for income tax purposes. Retention of the power to designate charities would not be a faulty power for income tax purposes because of section 674(b)(4), although such a power would cause estate tax inclusion under section 2036.

The annotations note that the trust is a complex trust under subchapter J of the Code. And note specifically that income paid to charity is deductible under section 642(c)(1). Annotations further note that the income will be deductible even if paid to a foreign charity.

The annotations remind us that an annuity expressed as the right to receive an annual payment equal to the lesser of a sum certain or a fixed percentage of the trust assets (determined annually) is not a guaranteed annuity interest. Since that sounds more like a unitrust than an annuity trust payment, this comment is puzzling.

The annotations note that a trust will not be qualified if the trustee has the discretion to “commute and prepay” the charitable interest prior to termination of

the annuity. As noted above, prepayment without discount should be permitted and the Service has previously so ruled by private letter ruling.

The annotations note that CLATs are not subject to minimum or maximum payout requirements – unlike charitable remainder trusts. The payout can be less than five percent or more than fifty percent. In connection with the payout, the annotations note that as per Rev. Rul. 83-75, 1983-1 C.B. 114, gain realized on satisfaction of the annuity with appreciated property will be deductible under section 642(c)(1).

Where a measuring life is used rather than a term of years, the annotations note that only the donor, the donor's spouse or an individual who is a lineal ancestor or spouse of a lineal ancestor of the beneficiary may be used as a descendant of the remainder beneficiary who is ineligible as a measuring life.

The annotations note that if the donor is serving as trustee and retains the power to select the charitable beneficiaries, the gift will be incomplete for gift tax purposes. This is clearly correct. However, the comment goes on to note that such a power may cause some or all of the trust property to be included in the donor's gross estate. This is odd – I would have thought there is no question that such a power will cause estate tax inclusion as per the Revson case discussed above. In fact, the annotation discusses the very situation involved in Revson and notes that if the donor-trustee is an officer or director of the private foundation and possesses authority to make charitable distribution, some or all of the trust property may (rather than will) be included in the donor's gross estate.

The annotations note that although the sample trust provides for retention of excess income by the trust (where it will be taxable) the governing instrument may instead provide that the excess income may be distributed to the charitable beneficiary. No additional estate or gift tax deduction will be allowed, but the income will at least not be subject to tax.

- C. Sample Inter Vivos Grantor Charitable Lead Annuity Trust. Many of the provisions are, of course, the same as in the non-grantor form. But the most interesting aspect of the grantor trust form is the selection of the particular grantor trust power used to trigger grantor trust treatment. This is not an easy choice because many of the powers which we normally use to invoke grantor trust treatment would be self-dealing transactions if used in a charitable lead trust – such as the donor's right to borrow from the trust or to substitute assets. The IRS form triggers grantor trust treatment by using a section 675(4) substitution power held by a person other than the donor, the trustee, or a disqualified person as defined in section 4949(a)(1) which is exercisable only in a non-fiduciary capacity. This answers the question many of us have worried about for a long time – whether the use of the word “reacquire” in section 675(4) means that only the grantor can trigger grantor trust treatment with a substitution power. The

annotation seems to put that issue to rest and is good authority for using this power in other contexts.

Sample Testamentary Charitable Lead Annuity Trusts

The testamentary form is much simpler since we don't have to worry either about gift tax or grantor trust issues and the comments regarding the non-grantor inter vivos trust above will be generally relevant to the testamentary form.

Service Issues Controversial Charitable Lead Trust Ruling

Litigators like to say that you should never ask a question of a witness if you don't know what the answer will be. Maybe the same should be true of private letter rulings. In Private Letter Ruling 200920031, the taxpayer requested a ruling that the annual payment of an annuity by a grantor-type charitable lead annuity trust would not trigger gain to the grantor or the trust. The Service ruled that it would trigger gain.

We have all known since elementary school that satisfaction of a pecuniary obligation with appreciated property generates gain. This makes perfect sense in the trust context from an economic standpoint because the benefit of the gain will pass to the remainder beneficiaries.

In the case of a non-grantor type charitable lead trust, Rev. Rul. 83-75, 1983-1 C.B. 114 ruled that satisfaction of the obligation to pay the fixed annuity would result in taxable gain, and the IRS comments to its lead trust pro formas Rev. Proc. 2007-45, 2007-2 C.B. 89 make the same observation. However, in the case of the non-grantor type lead trust, which is taxed as a complex trust, the gain realized on payment of the lead annuity will be deductible under section 642(c) so no actual tax is paid.

The question posed in the PLR is whether gain would be realized in the grantor lead trust situation. The taxpayer attempted to apply the reasoning of Rev. Rul. 55-410, 1955-1 C.B. 297 which held, perhaps somewhat anomalously, that an individual's satisfaction of a legally binding charitable pledge with appreciated property is not a realization event. The Service reached this conclusion on the theory that it would be inconsistent to treat the payment as a contribution and at the same time as a satisfaction of a debt. Remember – no deduction is available for a mere promise to make a charitable gift even though binding. Only when the pledge is fulfilled does it become deductible.

There is a superficial appeal to this argument. If an individual makes a promise to make payments to a charity, satisfaction of the obligation with appreciated property is not a realization event as we just noted. If a non-grantor type charitable lead trust satisfies the annuity obligation with appreciated property, although there is gain, there is no tax because of the deductibility of the gain under section 642(c).

The argument in favor of no tax liability can best be stated as follows: if we treat the grantor-type lead trust as a trust which is simply ignored for all tax purposes, the lead annuity trust can be analogized to a charitable pledge. If the trust is ignored, in effect the grantor has made a legally-binding promise to make payments to the charity. The problem with this analysis is that the grantor also gotten an income tax deduction at the time the trust was created for the discounted value of the stream of annuity payments. Remember that part of the theory of Rev. Rul. 55-410 was that since no deduction was available when the pledge was made, no realization should occur when the gift is paid with appreciated property later. That reasoning is undermined where a deduction was in fact available. But in my opinion, this is a fairly close question and I could imagine the Service having come out on the other side of this issue.