CHARITABLE GIVING TAX TECHNIQUES

. . . Avoiding Bad Heir Days and Near-Death Tax Experiences

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WARNING: MAY CAUSE DROWSINESS

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Conrad Teitell's Credentials

PRACTICING LAWYER AND PROFESSOR OF LAW

Conrad Teitell is a principal in the Connecticut and Florida law firm of Cummings & Lockwood, based in the firm's Stamford office. He is an adjunct professor (Masters Graduate Program in Estate Planning) at the University of Miami School of Law. He holds an LL.B. from Columbia University Law School and an LL.M. from New York University Law School.

LECTURER

He has lectured nationally on taxes and estate planning for thousands of hours at programs sponsored by bar associations, estate planning councils, colleges, universities, law schools, community foundations, hospitals, museums, religious, health, social welfare and other organizations.

AUTHOR

His publications on taxes, wills and estate planning have been read by millions—lay people and professional tax advisers. His many articles include columns in *Trusts & Estates* magazine and the *New York Law Journal*. He is the editor and publisher of *Taxwise Giving*, a monthly newsletter and is the author of the five-volume treatise, *Philanthropy and Taxation*. His column, *Speaking and Writing*, has appeared in the American Bar Association's *Journal* and in *TRIAL*, the magazine of The American Association for Justice.

A SPEAKER'S SPEAKER

Conrad Teitell founded and teaches the American Bar Association's (ALI/ABA's) public speaking course. He also teaches public speaking to other professional advisers and laypeople. He teaches public speaking in a six-part PBS television series.

TELEVISION AND RADIO

Teitell was the on-air tax adviser for the PBS series ON THE MONEY produced by WGBH/Boston. He has done six PBS television specials on taxes and estate planning— two produced by WGBH/Boston, two produced by KVIE/Sacramento, one produced by WMHT/Schenectady and one produced by KCTS/Seattle. He is a commentator on National Public Radio's *Marketplace.*

LEGISLATIVE ACTIVITIES

Conrad Teitell has testified at hearings held by the Treasury, the Internal Revenue Service, the Senate Finance Committee, the House Ways and Means Committee and the House Judiciary Committee. Most recently, he was one of four invited witnesses to testify at the Senate Finance Committee on estate tax revision. The other invited witnesses were a businessman from Iowa, a rancher from South Dakota and an investor from Nebraska—Warren Buffett.

OTHER STUFF

Conrad Teitell, the subject of three lengthy interviews in *U.S. News & World Report*, is regularly quoted in such publications as *The New York Times, The Wall Street Journal, The Los Angeles Times, Newsweek, Money Magazine*, *Barron's* and *Forbes Magazine*. Profiled in *Bloomberg Personal Finance* as one of the nation's lawyers who has reshaped estate planning by helping clients protect wealth, avoid taxes and benefit charities, he is listed in *The Best Lawyers in America, Who's Who in the World, Who's Who in America* and *Who's Who in American Law*. He has been awarded the designation "Distinguished Estate Planner" by the National Association of Estate Planners and Councils. He is a fellow of the American College of Trust and Estate Counsel and the recipient of the *American Law Institute/American Bar Association's* Harrison Tweed Award for Special Merit in Continuing Legal Education.

AT PLAY

Runner, sailor, aviator.

Charitable Giving Tax Techniques

. . . Avoiding Bad Heir Days and Near-Death Tax Experiences

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I. IN THE VERY BEGINNING

A. Donative intent. Read no further if you believe that a donor will create a charitable remainder trust solely because of the tax and financial benefits. But if the prospect (client) believes in the charity's cause, then a charitable remainder trust might be the appropriate way to make a gift. If the donor doesn't need income for him- or herself and doesn't wish to provide income for another individual, an outright gift is generally the most appropriate.

B. Advantages of charitable remainder trusts. An inter vivos (lifetime) charitable remainder trust (instead of an outright bequest by will) can:

(1) generate an income tax charitable deduction and provide the same estate tax benefits as a bequest;
(2) increase a donor's income;
(3) provide favorable taxation of life-income payments;
(4) reduce or eliminate capital gain taxation on changing investments; and
(5) **enable a donor to have the joy of giving (not possible with a bequest).**

C. Information needed to decide whether a charitable remainder trust is appropriate and if so, the type of charitable remainder trust to use:

(1) donor's wishes
(2) needs and health of beneficiaries
(3) marital status and citizenship of spouses
(4) type of property — securities, real estate, tangible personal property, marketability, Sub-S stock
(5) how property owned — separate, joint, tenants by the entirety, tenants in common, community property
(6) cost-basis and holding period of property
(7) fair market value of property
(8) any mortgages?
(9) any prior negotiations or contracts for sale, options?
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(11) remainder charity — public charity, private foundation?
(12) for sizable gift, information about donor's (and spouse's) overall estate and financial plan

II. CHARITABLE REMAINDER UNITRUSTS AND ANNUITY TRUSTS HIGH-SPEED OVERVIEW:

STAN-CRUT—Standard ("Fixed Percentage") Charitable Remainder Unitrust. Pays the income beneficiary ("recipient") an amount determined by multiplying a fixed percentage of the net fair market value (FMV) of the trust assets, revalued each year. On death of beneficiary or survivor beneficiary (or at end of trust term if trust measured by term of years—not to exceed 20 years) charity gets the remainder. The fixed percentage can't be less than 5% nor more than 50% and the remainder interest must be at least 10% of the initial net fair market value of all property placed in the trust. These percentage requirements also apply to the following types of charitable remainder trusts.

NIM-CRUT—Net Income With Makeup Charitable Remainder Unitrust. Pays only the trust's income if the actual income is less than the stated percentage multiplied by the trust's FMV. Deficiencies in distributions (*i.e.,* where the unitrust income is less than the stated percentage) are made up in later years if the trust income exceeds the stated percentage.

NI-CRUT—Net Income Charitable Remainder Unitrust. Pays the fixed percentage multiplied by the trust's FMV or the actual income, whichever is lower. Deficiencies are not made up.

FLIP-CRUT. A trust set up as a NIM-CRUT or NI-CRUT. On a qualifying triggering event specified in the trust instrument (*e.g.,* the sale of the unmarketable asset used to fund the trust) it switches (flips) to a STAN-CRUT. The regulations sometimes refer to this trust as a "combination of methods unitrust."

FLEX-CRUT. That's my name for a FLIP-CRUT drafted so as to give flexibility in determining when—if ever—a NIM-CRUT or NI-CRUT will flip to a STAN-CRUT. If you want a NIM-CRUT or NI-CRUT to flip on the sale of a parcel of real estate or on a specified date or event say so in the CRT. **BUT** if you want maximum flexibility, specify that the trust is to flip on the sale of an unimportant unmarketable asset that is one of the assets used to fund the trust. That way you have flexibility in determining when—if ever—a NIM-CRUT or NI-CRUT will flip to a STAN-CRUT.

CAPITAL GAIN NIM-CRUT. Post-transfer-to-the-trust capital gains (governing state law permitting) can be treated as income for purposes of paying income to the income beneficiary. This provides another way of making up NIM-CRUT deficits in payments from earlier years.

FULL-MONTY CRUT. That's my coinage for a FLIP-CRUT that goes all the way—has FLEX-CRUT and CAPITAL GAIN CRUT provisions.

ACCELERATED (CHUTZPAH) CHARITABLE REMAINDER UNITRUST. A STAN-

CRUT for a very short term of years (*e.g.,* two years) with a sky-high percentage payout (*e.g.*, 80%). The aim was to transform highly appreciated assets into cash returned to the donor while avoiding almost all capital gains tax. IRS announced in 1994 that it would challenge those trusts. The 10% minimum remainder interest and 50% maximum unitrust amount requirements of the 1997 law killed those trusts. And the regulations' grace period rules for making payments after year-end added the final nail to the coffin.

CHARITABLE REMAINDER ANNUITY TRUST (CRAT). Pays the income beneficiary ("recipient") a fixed dollar amount (at least annually) specified in the trust instrument. On the death of the beneficiary or survivor beneficiary (or at end of trust term if trust measured by a term of years—not to exceed 20 years) charity gets the remainder. The fixed dollar amount must be at least 5% but not more than 50% of the initial net fair market value of the transferred assets and the remainder interest must be at least 10% of the initial net fair market value of all property placed in the trust. Additional contributions after the initial contribution may not be made to a CRAT. *Caveat.* CRAT must meet "5% probability test" of Rev. Rul. 77-374, 1977-2 CB 329. But see *Moor*, 43 TCM 1530 (1982).

III. INCOME TAX RULES

A. Contribution deduction. Allowed for value of remainder interest—computed using Treasury tables. Be mindful of various percentage-of-adjusted-gross-income ceilings for the income tax charitable deduction and the 5-year carryover rules. **Unitrusts—**IRC §170(f)(2); Reg. §§1.664-3(c) and 1.664-4; IRS Pub. 1458. **Annuity trusts—**IRC §170(f)(2); Reg. §§1.664-2(c) and 20.2031-7, IRS Pub. 1457.

B. Taxation of payments. Unitrust and annuity trust payments are taxable under the four-tier provisions of IRC §664(b) and Reg. §1.664-1(d)(1). And the income paid to the income beneficiary retains the character it had in the trust. Each payment is treated as follows:

First, as ordinary income to the extent of the trust's ordinary income for the year (and any undistributed ordinary income from prior years);

Second, as capital gains for the year (and any undistributed capital gains from prior years);

Third, as tax-exempt income to the extent of the trust's exempt income for the year (and any undistributed exempt income from prior years); and

Fourth, as a tax-free return of principal.

Note: In tiers *First* and *Second*, the income and gains that are taxable at the highest rates are deemed distributed first.

C. **Capital gains.** No capital gain incurred on transfer of appreciated assets to trust. *Rev. Rul. 55-275,* 1955-1 CB 295; *Rev. Rul. 60-370,* 1960-2 CB 203. Nor is there gain to donor on a sale by trust (except as taxable under four-tier system, above). *Exception:* Gain taxable to donor if trust assets sold and proceeds invested in tax-exempt securities pursuant to express or implied agreement between donor and trustee. *Rev. Rul. 60-370,* 1960-2 CB 203. See below.

Nor is there capital gain to the trust. Avoidance of gain on sale by trust enables a donor to avoid tax on changing from one investment to another.

D. **Unrelated business taxable income.** Charitable remainder trusts with UBTI in taxable years beginning after December 31, 2006 remain exempt from federal income tax, but are subject to a 100-percent excise tax on the trust's UBTI.

Background. CRTs were exempt from income tax for a tax year unless the trust had *any* unrelated business taxable income for the year. UBTI includes certain debt-financed income.

Before 2007 a CRT that lost its income tax exemption for a tax year was taxed as a regular complex trust. As such, the trust was allowed a deduction in computing taxable income for amounts required to be distributed in that year (not to exceed the trust's distributable net income for the year).

One taxpayer did battle with IRS on the UBTI issue maintaining that only the unrelated business income was taxable—not all the trust's income. But the Tax Court in *Leila G. Newhall Unitrust,* 104 TC 236 (1995) ruled that a unitrust receiving *any* UBTI is taxable on *all* its income for the year—not just the unrelated income. And a circuit appeals court affirmed the Tax Court. *Leila G. Newhall Unitrust*, 105 F.3d 482 (CA-9) 1997. Wealthy taxpayers in Leila's shoes were no doubt the force behind the new law. What ever Leila wants, Leila gets?

Starting with the 2007 tax year (all CRTs are on a calendar tax year), a 100% excise tax is imposed on the UBTI of a charitable remainder trust. This replaces the rule that took away the CRT's income tax exemption for any year in which it had *any* unrelated business taxable income. UBTI is considered income of the trust for purposes of determining the character of the distribution made to the beneficiary under the four tiers. And, consistent with earlier law, the tax is treated as paid from corpus. A Treasury regulation, TD 9403, 73 Fed. Reg. 35583 (June 24, 2008) gives examples under the new law.

Observation. A 100% tax on unrelated business income will *generally* be better than paying regular taxes on all of a CRT's income—unrelated business income *plus* income from dividends, interest and royalties, for example. **But watch your step.** UBTI includes certain debt-financed income. So if the acquisition indebtedness rules apply on the sale of a highly appreciated asset, a huge capital gain—based on a percentage of the property mortgaged—would be taxable at 100%.

Foregone conclusion. It is better, of course, for a CRT to pay no tax at all. To do that, avoid unrelated business taxable income. Easier said than done for CRTs that invest in LLPs, LLCs, for example. LLPs and LLCs are passthrough entities and often have income from an active trade or business and from debt-financed property. That income flows through the LLP and the LLC as UBTI to a CRT. (Don't you just love all this jargon.)

IV. GIFT TAX RULES—INCLUDING MARITAL DEDUCTION RULES

One-life unitrust or annuity trust for donor's life. Value of charitable remainder interest in qualified trust is not subject to gift tax. Donor must report remainder gift (regardless of size because it is a future interest) on federal gift tax return. IRC §6019. Donor takes offsetting gift tax charitable deduction.

One-life unitrust or annuity trust for beneficiary other than donor. Donor who creates a charitable remainder trust calling for payments to another for life, with the principal to be delivered to charity on life beneficiary's death, makes two gifts: one to beneficiary (value of life interest) and one to charity (value of remainder interest).

The charitable remainder interest. Charitable remainder interest is reportable (regardless of size because it is a future interest) on federal gift tax return. Then deductible as a charitable contribution—resulting in a wash. IRC §2522 (c)(2)(A); Reg. §§25.2522(c)-3(c)(2)(iv) and 1.664-4.

Life beneficiary's interest when beneficiary is not donor's spouse. Donor makes gift to life beneficiary of value of life interest. If the life interest is a present interest it will qualify for annual exclusion. If the value of the interest exceeds the annual gift tax exclusion and "tentative" tax on gift is not offset by unified transfer tax credit, gift tax will be due. IRC §2503(a); Reg. §25.2503-3(b).

Life beneficiary's interest when beneficiary is donor's spouse. Rules are the same as above with this positive exception: As long as the trust doesn't have any non-spouse beneficiaries, U.S. citizen spouse's life interest qualifies for automatic unlimited gift tax marital deduction (no election need be made). IRC §2523(g). See below for alien spouse rules.

Two-life unitrust or annuity trust funded with donor's separate property and donor is first beneficiary. Donor who uses his or her own separate property to create a charitable remainder trust—that pays income to donor for life and then to survivor beneficiary for life—makes two gifts: one to charity (remainder interest) and one to survivor beneficiary (right to receive unitrust or annuity trust payments if he or she survives the donor).

The charitable remainder interest. Charitable remainder interest is reportable (regardless of size because it is a future interest) on gift tax return, then deductible as charitable contribution—resulting in a wash.

Second life beneficiary's interest when beneficiary is not donor's spouse.

Donor makes gift to beneficiary of value of survivorship life interest. Gift is of a future interest—it does not qualify for the annual gift tax exclusion. If "tentative" tax on gift isn't offset by unified transfer tax credit, gift tax will be due. IRC §2503(a); Reg. §25.2503-3(a).

Pointer. Donor can avoid making gift to survivor by providing in inter vivos trust instrument the right (exercisable only by will) to revoke survivor's life interest. Should donor exercise that right, trust terminates on donor's death. Trust principal then delivered to charity. Donor need not actually exercise right in will; merely retaining the right avoids donor's making completed gift to survivor beneficiary. *Rev. Rul. 79-243,* 1979-2 CB 343; Reg. §§1.664-3(a)(4) and 25.2511-2(c).

Second life beneficiary's interest when beneficiary is donor's spouse. As long as the trust doesn't have any non-spouse beneficiaries, a U.S. citizen spouse's future interest in a charitable remainder unitrust or annuity trust qualifies for automatic unlimited gift tax marital deduction (no election need be made). IRC §2523(g). Alternatively, gift tax concerns can be avoided as discussed above by having donor reserve right in the inter vivos trust instrument to revoke surviving spouse's life interest by will. See below for alien spouse rules and estate tax concerns if American spouses divorce.

Two-life unitrust or annuity trust funded with joint property, tenancy in common property or community property and donors are spouses. Trust should provide payments to donors jointly for life and then to survivor for life.

The charitable remainder interest. Charitable remainder interest is reportable (regardless of size because it is a future interest) on federal gift tax return, then deductible as charitable contribution, resulting in a wash.

The interests of the life beneficiaries. Actuarially older spouse makes gift to actuarially younger spouse of difference in value of their survivorship interests. However, as long the trust doesn't have any non-spouse beneficiaries, gift qualifies for automatic unlimited gift tax marital deduction (no election need be made) for U.S. citizens. IRC §2523(g). Unnecessary for gift tax purposes (although can't hurt) for spouses to reserve the right to revoke, outlined above. But may want to retain right to revoke and actually revoke it if there is a divorce. Won’t qualify for estate tax marital deduction if spouses are divorced. A divorce settlement agreement should deal with this issue. See below for alien spouse rules.

Cautions regarding right to revoke a beneficiary's interest.

Although retained in inter vivos instrument creating charitable remainder trust, right to revoke should be exercisable only by will. If right is exercisable during donor's lifetime, trust will be disqualified.

Right to revoke should not be retained unless the donor is herself a trust beneficiary. For example, in a trust providing payments to donor's son for life, with remainder to charity, donor's retaining right to revoke son's interest could disqualify trust because it would be potentially measured by donor's life instead of the son's life. Reg. §§1.664-2(a)(5), -3(a)(5). Absent retained right, son's interest would not be includable in donor's gross estate.

But apparently a non-beneficiary donor can keep a testamentary right to revoke a beneficiary's interest in a term-of-years trust. IRS approved one such trust in *Letter Ruling 8949061*.

Gifts to alien spouse. An unlimited gift tax marital deduction is not allowed. But gifts to a noncitizen spouse qualify for an annual exclusion of $128,000 in 2008, assuming the usual annual gift tax exclusion requirements are met. The annual exclusion is indexed for inflation.

To qualify for the noncitizen spouse $128,000 in 2008 annual gift-tax-exclusion (or the usual annual gift tax exclusion), a gift must be a present interest. So a survivorship income interest in a trust, for example, doesn't qualify.

If the gift is a charitable remainder gift with the noncitizen spouse succeeding to the interest of the donor citizen spouse, gift tax concerns are avoided by the donor-spouse’s retaining the right by will to revoke the noncitizen spouse's survivorship interest. If the citizen-spouse does not exercise this right of revocation, the surviving noncitizen-spouse will receive his or her survivorship interest. The citizen-spouse's estate would be able to claim an estate tax marital deduction for the surviving noncitizen spouse's life interest if the Qualified Domestic Trust (QDOT) rules are met.

V. ESTATE TAX RULES—INCLUDING MARITAL DEDUCTION RULES

Donor is the sole beneficiary ("recipient") of an inter vivos unitrust or annuity trust. Value of trust assets at donor's death (or at the alternate valuation date) is includable in the gross estate when donor retains life interest in the trust. Estate deducts value of trust assets as charitable contribution, resulting in a wash. IRC §§2036 and 2055(e)(1)(B); Reg. §1.664-4.

Inter vivos unitrust or annuity trust for beneficiary or beneficiaries other than donor. Value of trust assets not included in donor's gross estate. IRC §2035(d).

Two-life inter vivos unitrust or annuity trust funded with donor's separate property with payments to donor for life, then to non-spouse second beneficiary ("recipient") for life.

> Include value of trust assets at donor's death (or alternate valuation date) in the gross estate whether or not second beneficiary survives donor. IRC §2036.
>
> If second beneficiary does not survive donor, deduct as a charitable contribution the amount that was included in the gross estate—resulting in a wash. IRC §2055(e)(1)(B); Reg. §20.2031-7.
>
> If second beneficiary does survive donor, deduct value of charitable remainder as charitable contribution [applicable factor for survivor's age (at nearest birthday) at donor's death and stated percentage x value of trust assets at death (or alternate valuation date)]. In effect, only value of survivor beneficiary's life interest is subject to tax. If alternate valuation date is elected, in computing value of charitable remainder, use value of assets at alternate valuation date, but use age of the survivor beneficiary (at the nearest birthday) at the date of donor's death. IRC §2032(b)(2).

Two-life inter vivos unitrust or annuity trust funded with donor's separate property with payments to donor for life, then to U.S. citizen spouse as second beneficiary for life. Rules are same as discussed above, except that an estate tax marital deduction is allowed for value of surviving spouse's life interest. Trust assets are completely immune from estate tax because charity's remainder interest qualifies for estate tax charitable deduction and surviving spouse's life interest automatically qualifies (no election need be made) for estate tax marital deduction, as long as the trust doesn't have any non-spouse beneficiaries. IRC §2056(b)(8). See above for alien spouse rules.

Two-life inter vivos unitrust or annuity trust funded with jointly owned property when donors who are beneficiaries are spouses. Only half of jointly held property owned by spouses is includable in estate of first spouse to die, regardless of who furnished consideration. IRC §2040(b). Estate of first-to-die receives an estate tax charitable deduction for remainder interest in half of property includable in the gross estate and automatically receives (no election need be made) marital deduction for value of surviving U.S. citizen spouse's life interest in half of joint property includable in the gross estate, as long as the trust doesn't have any non-spouse beneficiaries. IRC §§2055(e)(2)(A) and 2056(b)(8). See below for alien spouse rules. **Attention step-up-in-basis aficionados.** Although not relevant here, IRS has acquiesced in *Hahn*, 110 TC 140 (1998) holding that for a joint interest of spouses created before 1977, 100% of the property's FMV is includable in the gross estate of the first spouse to die except to the extent that the surviving spouse contributed to the asset's purchase price.

Two-life inter vivos unitrust or annuity trust funded by spouses with community property or tenancy in common property and donors are beneficiaries. Include value of half trust assets in the gross estate of first spouse to die. Estate of first-to-die is entitled to charitable deduction for value of charitable remainder interest and marital deduction (automatic) for U.S. citizen spouse's life interest in that half, as long as the trust doesn't have any non-spouse beneficiaries.

Unitrust or annuity trust created by donor's will for benefit of U.S. citizen spouse.

Estate receives estate tax marital deduction (no election need be made) for value of surviving spouse's life interest and estate tax charitable deduction for value of charity's remainder interest. Thus, entire value of trust assets is not subject to tax. IRC §§2055(e)(2)(A) and 2056(b)(8).

Estate tax marital deduction for spouse's life interest is allowable only if spouse is sole beneficiary. See *Letter Ruling 8730004*. For example, remainder trust created by donor's will providing payments to spouse for life, and then to son for life, would not qualify for estate tax marital deduction. Charitable remainder interest would still qualify for estate tax charitable deduction. In *Letter Ruling 200204022* a disclaimer saved the marital deduction, but at a price. The non-spouse beneficiaries had to give up income.

VI. Q-TIP/CRUT COMBO

There is no estate tax marital deduction for a CRUT (or CRAT) created by Husband that pays Wife for life, then Son and then remainder to Charity. Instead, Husband's will creates a Q-TIP marital deduction trust for Wife to be followed by a CRUT for Son, with remainder to Charity. Under the Q-TIP rules, Husband's estate gets a 100% marital deduction. (There's no charitable deduction, but, hey, a 100% marital deduction avoids the estate tax). And the marital deduction is available even though the Q-TIP trust benefits other individuals after the surviving spouse's death.

But wait a minute. The fair market value of the Q-TIP trust will be includable in the surviving Wife's gross estate. **Yes, but.** The surviving Wife's estate will get an estate tax charitable deduction for the value of the charitable remainder interest based on Son's age at her death, the unitrust (or annuity trust) payout, and the applicable federal rate for the month of Wife's death, or either of the two prior months (at the estate's election).

Yet another reason to create a testamentary Q-TIP/CRUT COMBO. With a Q-TIP trust for the surviving spouse, the trustee can make payments to her (or him) out of principal for health, maintenance, support or for other reasons. Authorizing those payments from charitable remainder unitrusts (and annuity trusts) would disqualify those trusts. And even if there is to be no income beneficiary other than the surviving spouse (and thus no marital deduction concerns), a Q-TIP for the surviving spouse's life, with remainder to charity makes sense if principal may be needed by the surviving spouse.

VII. SPLIT-INTEREST CHARITABLE GIFTS AND THE CMFR . . . the good and the bad (sometimes really ugly)

Background. The valuation of charitable remainders (for unitrusts, annuity trusts, personal residences and farms), of charitable lead annuity trusts and lead unitrusts, and the gift portion of charitable annuities is determined by using the charitable mid-term federal rate (CMFR) for the month of the gift—or either of the two prior months at the donor's election.

The CMFR is also used for determining the 10%-minimum-remainder interest (MRI) requirement for CRUTs and CRATs; also for determining whether the gift portion of a gift annuity is more than 10%.

Another also: For determining compliance with the 5% probability test (Rev. Rul. 77-374) for charitable remainder annuity trusts, the CMFR is also used.

Alert. If you plow through this stuff, you will see why I believe it could be dangerous to use the two-month lookback for determining whether the 10% MRI requirement is met.

Observation. Aren't all these rules and the jargon beautiful to behold? And this is just the tip of the IRSberg.

Warning. This isn't light reading. But if you want to know the ins and outs of valuing charitable split-interests and meeting the various requirements, read on.

Charitable Mid-Term Federal Rate—more background. Donors who create split-interest charitable gifts are allowed charitable tax deductions (income, gift and estate) for the value of the charity's interest computed using Treasury tables. The tables' interest assumption is pegged to the federal mid-term interest rate, based on the average market yield of U.S. obligations. Each month, Treasury announces an Applicable Federal Rate (AFR). The interest rate for computing charitable gifts—a figure we call the Charitable Mid-Term Federal Rate (CMFR)—is 120% of the annually compounded AFR for mid-term obligations, rounded off to the nearest 0.2%.

Two-month lookback—more rules. For gifts that have no charitable component—e.g., giving a child a remainder interest in a house—the donor uses the applicable rate for the month of the transfer. However, donors whose gifts are partially charitable (e.g., a charitable remainder unitrust) can use the CMFR for the month of the gift or can elect to use the CMFR from either of the two previous months. The two-month "lookback" can actually give a donor four months to choose from, because IRS publishes the CMFR ahead of time—generally about the 21st day of the previous month.

Example. Melvin plans to create a charitable remainder annuity trust in July. He can wait until toward the end of July to see what August's CMFR will be; if it would yield a higher deduction, he can wait until August before funding the trust. Or, if he funds it in July, he can use the July rate or elect to use the CMFR for June or May.

WHY YOU SHOULD WATCH THE CMFR LIKE A HAWK—BRIEFLY STATED. The CMFR—like most things financial—goes up and down. In February 2011, the CMFR was on the low end—2.8% (lowest ever December 2010—1.8%).

First the ugly. With a low CMFR, the 10%-minimum-remainder-interest requirement—especially for charitable remainder annuity trusts—is easily flunked. Ditto for the 5% probability test governing charitable remainder annuity trusts. For charitable gift annuities, the requirement that the gift portion be more than 10% is also easily flunked.

Although charitable remainder unitrusts are affected by swings in the CMFR, for reasons known to the actuaries the effect is much less significant.

Consequences. Flunking the 10% MRI requirement for charitable remainder unitrusts and charitable remainder annuity trusts and the 5% probability test for charitable remainder annuity trusts means loss of income, gift and estate tax charitable deductions—*and* the trusts aren't qualified. Furthermore, if a spouse is involved, the marital deduction will also be lost. And for charitable gift annuities (including deferred payment and flexible starting date gift annuities), if the gift portion doesn't exceed 10%, the *charities* will be taxed under IRC §514(c)(5) and 501(m). Not a good thing.

Can the 10% MRI requirement be met by using the CMFR for either of the two months preceding the month a CRAT or CRUT is created, or must the valuation be made using the CMFR for the month the trust is created? IRC

§7520 says you can use either of the two preceding months for computing any income, estate or gift tax charitable deduction. It doesn't say you can use either of those two months for determining whether the 10% MRI requirement is met. Yet IRC §664(d)(1)(D) and IRC §664(d)(2)(D) say the values for meeting the 10% MRI requirement shall be "determined under section 7520," and those Code sections don't carve out the "either-of-the-two-preceding months" election. **Another yet.** IRC §664(d)(2)(D) provides: "with respect to each contribution of property to the trust, the value (determined under section 7520) of such remainder interest in such property is at least 10% of the net fair market value of such property ***as of the date such property is contributed to the trust."*** [emphasis added.]

A splendid argument can be made that for purposes of meeting the 10% MRI requirement, the remainder can be valued using the CMFR for either of the two preceding months or the month of the transfer. *But do you want to have to make that argument to the IRS, or to a court?* The words of Justice Oliver Wendell Holmes, Jr., in *U.S. v. Wurzbach,* 280 U.S. 396, 399 (1930) are instructive: "Whenever the law draws a line there will be cases very near each other on opposite sides. The precise course of the line may be uncertain, but no one can come near it without knowing that he does so, if he thinks." So unless clarification comes from the IRS, cautious individuals will make sure the 10% MRI requirement is met for the month of the transfer.

Fine hairs: For CRUTs and CRATs, the remainder interest (gift portion) must be *at least* 10%. But for gift annuities, the gift portion must be *more than* 10%. Oh, what fun.

Note: The 10%-minimum-remainder-interest rule doesn't apply to pooled income funds.

Now for the beautiful. Charitable lead annuity trusts are treated most favorably when the CMFR is low. The value of the charity's lead interest under a low CMFR is much greater than under a high CMFR. That makes the value of the remainder interest in the lead trust— that typically goes to family members—much smaller. *Result:* A charitable lead annuity trust can pass assets on to family members down the line at greatly reduced or no gift or estate tax. You'll want to take the generation-skipping tax considerations into account. A low CMFR is also beneficial for remainders in personal residences and farms. The lower the rate, the larger is the charitable deduction for the remainder interest.

Is a charitable lead annuity trust when the CMFR is low an abusive arrangement? The topic came up at the April 3, 2008 U.S. Senate Finance Committee estate tax hearing. In a statement that I prepared for the American Council on Gift Annuities and the National Committee on Planned Giving for the record of the hearing, ACGA and NCPG pointed out that the CMFR is a two-edged sword. Although it can now be highly advantageous to create charitable lead annuity trusts, the charitable deduction is especially low for charitable remainder annuity trusts. And there are many, many more charitable remainder annuity trusts than charitable lead annuity trusts.

Silver lining for gift annuities. With a low CMFR, the charitable deduction is now smaller than it had been. So what's so good about that? For donors who create charitable gift annuities and take the standard deduction, the size of the charitable gift portion is irrelevant. However, a low CMFR means that the part of each payment excluded from income by the annuitant (under IRC §72) will be larger. Depending upon the circumstances, it may be preferable to choose (under the month of the gift and two-month lookback rule), the CMFR that has the lowest valuation of the charitable gift. On the other hand, if appreciated assets are used to fund the gift annuity, the capital gain—computed under the bargain sale rules—will be larger if the value of the charitable gift is smaller. Thus weigh the charitable deduction (whether it can be used or not), the exclusion ratio and the capital gains implications. Piece of cake!

How and when to make the lookback election. You make the election by: (1) stating to do so on the return for the year of the transfer; and (2) identifying the elected month. The election is generally made on a timely filed return, but it may be made or revoked on an amended return that's filed within 24 months after the later of: (1) the date the original return was filed; or (2) the due date for filing the return. Reg. §1.7520-2(b)(1) through (3).

Information required with the tax return whether or not the lookback election is made. To claim a charitable deduction for a split-interest gift, the tax return must contain: (1) a description of the interest that is transferred, including a copy of the instrument of transfer; (2) the valuation date of the transfer; (3) the names and identification numbers of the beneficiaries of the transferred interest; (4) the names and birthdates of any measuring lives; and (5) a computation of the deduction showing the interest rate used to value the transferred interest. Also, if a measuring life is of a person who is terminally ill, that should be stated and explained. For a definition of terminally ill, see Reg. §1.7520-2(a)(4).

Valuation date. If you elect the two-month lookback, the month you look back to is the valuation date for purposes of determining the interest rate. Reg. §1.7520-2(a)(2). Donors who transfer more than one interest in the same property at the same time must use the same interest rate for each interest in the property transferred. Donors who transfer more than one interest in the same property in two or more transfers at different times value each interest by using the interest rate in effect during the month of the transfer, or either of the two months preceding the month of the transfer. Reg. §1.7520-2(a)(3). What is IRS driving at? I think the following example illustrates what the IRS has in mind:

Example. A donor funds her charitable remainder unitrust with securities. The trust pays income to her son for life with the remainder to charity. The donor must use the same month's rate to value both the son's and the charity's interests. If the donor uses an undivided half-interest in real estate to fund the just-described trust (and assuming the IRS doesn't believe that doing so would violate the self-dealing rules), she must still use the same month's rate to value the son's and the charity's interests. But, if six weeks later, she transfers the other half interest to create another unitrust, that transfer has nothing to do with the first transfer. So the second trust's interests are valued in the month of that transfer—or either of the two preceding months at the donor's election. In short, the donor doesn't use the month's rate selected for the first trust to value the interests in the second trust.

Charitable remainder trust payout dates. If the governing instrument of a charitable remainder trust doesn't specify when the distributions are to be made during the period, they're presumed to be payable on the first day of the specified period. Reg. §1.664-4(a)(3).

VIII. TAX-EXEMPT UNITRUSTS AND ANNUITY TRUSTS

Trust funded with tax-free bonds. The investment or reinvestment in tax-free bonds won't disqualify the trust as a charitable remainder trust and will not "affect the trust's exemption from income taxation under section 664(c) of the Code as long as there is no express or implied agreement that the trustee must invest or reinvest in such bonds." *Letter Ruling 7803041.* **Caveat.** Be mindful of diversification issues under state prudent investor laws.

What about a trust funded with appreciated property that is to be sold and the proceeds invested in tax-exempts?

Background. Rev. Rul. 60-370, 1960-2 CB 203 says that, if the trustee is under an express or implied obligation to sell or exchange the transferred property and purchase tax-exempt securities, the donor is deemed to have sold the property himself and given the trustee the proceeds. The gain from the sale is imputed to the donor and includable in his gross income.

Heads IRS wins, tails you lose. If donor loses the *Rev. Rul. 60-370* argument, he has to pay capital gain tax out of his own pocket (not out of proceeds of the trust's sale). If donor wins the *Rev. Rul. 60-370* argument, he doesn't have tax-exempt income until entire gain is deemed distributed to him under the four-tier provision in satisfaction of his annual payments.

IX. CRTS—DIVIDING AND SOMETIMES REUNITING

Setting the stage. A recent "published" revenue ruling (on which all can rely and are bound by) tells the tax consequences of a not uncommon situation in which two beneficiaries—typically divorcing spouses—of a CRUT or CRAT split their trust down the middle and then each goes his and her own (perhaps merry) way. The ruling starts out, however, with a not common situation in which a trust with two or more beneficiaries split the original trust into separate trusts for each beneficiary.

But in that case, a trust that is split asunder is later reunited. The assets of a beneficiary's separate trust on his or her death are added to the separate trust or trusts of the surviving beneficiaries. Private letter rulings have favorably dealt with the situation of divorcing spouses.* But reunification after the original split is something new.

Alert to worry warts.** The published ruling follows the private letter rulings, but adds a potentially troublesome rub. And I have a few concerns about stuff not addressed in the ruling. But first the facts, then the ruling, and finally the concerns and the rub.

The plot—Situation 1. Two or more individuals (recipients) of a qualified charitable remainder annuity trust or a qualified charitable remainder unitrust (Original Trust) are each entitled to an equal share of the annuity or unitrust amount, payable annually, during the recipient's lifetime. On the death of one recipient, each surviving recipient becomes entitled for life to an equal share of the deceased recipient's annuity or unitrust amount. Thus the last surviving recipient wins the tontine*** and becomes entitled to the entire annuity or unitrust amount for his or her life. On the death of the last surviving recipient, the trust assets are to be distributed to one or more qualified charities (charitable remainder organizations).

The state court having jurisdiction over Original Trust has approved **a pro rata division** (the rub, as you shall see) of the trust into as many separate and equal trusts as are necessary to provide one separate trust for each recipient living at the time of the division, with each separate trust being intended to qualify as the same type of CRT (e.g., CRAT, STAN-CRUT) as Original Trust. Either a court order or Original Trust agreement incorporates the provisions described in these facts that will govern the separate trusts.

Situation 1—more facts. The separate trusts may have different trustees. To carry out the division of Original Trust into separate trusts, each asset of that trust is divided equally among and transferred to the separate trusts. For purposes of determining the character of distributions to the recipient of each separate trust, each separate trust upon the division of Original Trust is deemed to have an equal share of that trust's income in each tier described in IRC §664(b). Similarly, on each subsequent consolidation of separate trusts by reason of the death of a recipient, the income in each tier of the consolidated trust is the sum of the income in that tier formerly attributed to the trusts being combined.

Same after as before—except. Each of the separate trusts has the same governing provisions as Original Trust, except that: immediately after the division of Original Trust, each separate trust has only one recipient, and each recipient is the annuity or unitrust recipient of only one of the separate trusts (that recipient's separate trust). And each separate trust is administered and invested independently by its trustee(s).

NOW FOR SOMETHING NEW—CONSOLIDATION AFTER THE SPLIT. Upon the death of a separate trust's recipient, each asset of that recipient's separate trust is to be **divided pro rata** (the rub, as you shall see) and transferred to the separate trusts of the surviving recipients. The annuity amount payable to the recipient of each separate CRAT is thereby increased by an equal share of the deceased recipient's annuity amount. The unitrust amount of each separate CRUT is similarly increased as a result of the augmentation of the CRUT's corpus, and each separate CRUT incorporates the requirements of Reg. §1.664-3(b) with respect to the subsequent computation of the unitrust amount from that trust. Upon the death of the last surviving recipient, that recipient's separate trust (being the only separate trust remaining) terminates, and the assets are distributed to the charitable remainder organizations.

The remainder organizations of Original Trust are the remainder organizations of each of the separate trusts and are entitled to the same (total) remainder interest after the division of Original Trust as before. In addition, each recipient is entitled to receive from his or her separate trust the same annuity or unitrust amount as the recipient was entitled to receive under the terms of Original Trust.

Additional facts about unitrusts. Because the annual net fair market value of the assets in each of the separate trusts may vary from one another due to differing investment strategies of the separate trusts, in situations where Original Trust is a CRUT, the amount of the unitrust payments from each separate CRUT may vary over time, both from year to year and among the separate CRUTs. Nevertheless, the unitrust percentage of each separate CRUT remains the same as each recipient's share of the unitrust percentage under the terms of Original Trust. And the recipients and the charitable remainder organizations are entitled to the same benefits after the division of Original Trust as before.

> *Example.* Under the terms of Original Trust (a CRUT), Xenophon, Yenta, and Zhlub are entitled to share equally the annual payments of a 15% unitrust amount (unless all three recipients are actuarially close to death's door, the trust will fail the 10% minimum remainder interest requirement. But, hey, this is the IRS's example. Only the names have been changed by me to protect the innocent) amount (5% each) while all three are living, and upon the death of one recipient, the surviving recipients are entitled to the deceased recipient's share. Thus, if Xenophon dies first, the surviving recipients (Yenta and Zhlub) are entitled to share equally in the annual payments of the 15% unitrust amount (7.5% each) while both are living. Thereafter, if Yenta predeceases Zhlub, then upon the death of Yenta, Zhlub is entitled to receive annual payments of the entire 15% unitrust amount for life.
>
> **The three recipients and a horse, who is their lawyer, go into a bar and divide Original Trust into three separate trusts (one for each of Xenophon, Yenta, and Zhlub).** Each of the separate trusts holds one-third of the assets of Original Trust. Xenophon, Yenta, and Zhlub are each entitled to annual payments of a 15% unitrust amount from his or her separate trust (15% of one-third of the assets is equivalent to 5% of all the assets of Original Trust). After the division of Original Trust and upon the death of Xenophon, each asset of Xenophon's separate trust is divided pro rata and transferred to Yenta and Zhlub's separate trusts. Yenta and Zhlub each remain entitled to annual payments of a 15% unitrust amount from his or her separate trust, each of which is now funded with the equivalent of one-half the assets of Original Trust (15% of one-half of the assets is equivalent to 7.5% of all the assets

> of Original Trust). On Yenta's death, the assets of her separate trust are transferred to Zhlub's separate trust, and Zhlub remains entitled to annual payments of a 15% unitrust amount from his separate trust.
>
> These are the same interests to which Xenophan, Yenta, and Zhlub would have been entitled under the terms of Original Trust if that trust had not been divided into separate trusts. (*Note that Xenophon, Yenta and Zhlub have died in alphabetical order.* This is realistic. If you read the obituary pages, you'll see that day after day people die in alphabetical order.)

The plot gets thinner—Situation 2. The facts are the same as in *Situation 1* except that Original Trust has only two recipients, husband and wife, who are U.S. citizens. They are in the process of getting divorced. Instead of the provision described in *Situation 1*, each separate trust in *Situation 2* provides that upon the death of the recipient, that recipient's separate trust terminates and the assets of that separate trust are then distributed to the charitable remainder organizations. Because the charitable remainder organizations of Original Trust (and thus of each separate trust) receive a distribution of one-half of the assets of that trust upon the death of the first spouse to die and the remaining half of the assets upon the death of the surviving spouse (rather than a distribution of all the assets of Original Trust upon the later death of the surviving recipient), the value of the remainder payable to the charitable organizations as a result of the division of Original Trust into separate trusts may be larger than the present value of that interest as computed at the creation of Original Trust. However, no additional *income* tax charitable deduction is permitted. **Why not?** Actuaries should be able to value the larger charitable remainder. On another point, see my comment on page 5 for a possible concern about qualification for the *gift* tax charitable deduction. Oh, by the way, you should take a peek at IRC §1041— Transfers of Property between Spouses or Incident to Divorce.

Each recipient (spouse) is entitled to receive from his or her separate trust the same share of the annuity or unitrust amount as the recipient was entitled to receive under the terms of Original Trust. However, each spouse relinquishes all interests in Original Trust to which he or she would have been entitled by reason of having survived the other.

Pro rata division—the rub as you shall see. To carry out the division of Original Trust in *Situation 1* and *Situation 2*, each asset of Original Trust is divided on a pro rata basis among and distributed to the separate trusts. And on a consolidation (*Situation 1*) upon the death of a separate trust's recipient, each asset of that recipient's separate trust is to be divided pro rata and transferred to the separate trusts of the surviving recipients.

Who foots the bill? The recipients pay all the costs associated with the division of Original Trust into separate trusts, including legal fees of any court proceeding, and the administrative costs of the creation and funding of the separate trusts. (See my comment on the payment of the legal fees on page 6.)

The IRS rules—drum roll:

1. In *Situation 1* and *Situation 2*, the pro rata division of Original Trust (a qualified CRT) into two or more separate trusts doesn't cause Original Trust or any of the separate trusts to fail to qualify as a CRT under IRC §664(d).

2. In *Situation 1* and *Situation 2*, where a trust that qualifies as a CRT under IRC §664(d) is divided pro rata into two or more separate trusts: the division is not a sale, exchange, or other disposition producing gain or loss; the basis under IRC §1015 of each separate trust's share of each asset is the same share of the basis of that asset in the hands of the trust immediately before the division of the trust; and, under IRC §1223, each separate trust's holding period for an asset transferred to it by Original Trust includes the holding period of the asset as held by Original Trust immediately before the division.

3. In *Situation 1* and *Situation 2*, the pro rata division of Original Trust into two or more separate trusts does not terminate under IRC §507(a)(1) Original Trust's status as a trust described in, and subject to, the private foundation provisions of IRC §4947(a)(2), and doesn't result in the imposition of an excise tax under IRC §507(c).

4. In *Situation 1* and *Situation 2*, where Original Trust is divided pro rata into two or more separate trusts, the division doesn't constitute an act of self-dealing under IRC §4941.

5. In *Situation 1* and *Situation 2,* where Original Trust is divided pro rata into two or more separate trusts, the division doesn't constitute a taxable expenditure under IRC §4945.

Rev. Rul. 2008-41

Drafting Information. The principal authors of this revenue ruling are Megan A. Stoner of the Office of Associate Chief Counsel (Passthroughs & Special Industries) and Ward L. Thomas of the Office of the Commissioner (Tax Exempt & Government Entities) Exempt Organizations Ruling Division. For further information regarding this revenue ruling, contact Ms. Stoner regarding issues 1 and 2 at (202) 622-3070 and contact Mr. Thomas regarding issues 3-5 at (202) 283-8913.

Worry warts this is what you may have been waiting for. The major concern (the rub) deals with an issue that you'll find within the four corners of Rev. Rul. 2008-41 itself—the pro rata division of Original Trust. But before getting to that, here are some concerns on stuff not dealt with in the ruling—so that you won't be caught off guard.

• Gift to other recipient—concern. In *Situation 2*, the two recipients are divorcing spouses and unlike *Situation 1* after Original Trust is split there is no consolidation of their separate trusts on the death of the first spouse to die. Although not dealt with in the ruling, there could be gift tax implications between the recipients if the younger recipient spouse is not a U.S. citizen or if the two recipients aren't spouses. By surrendering the right to receive the entire annuity amount or unitrust amount on the death of the first spouse to die, doesn't the younger recipient make a gift to the older recipient equal to the difference in value of their survivorship rights? The facts say that the spouses are U.S. citizens so the gift tax marital deduction comes to the rescue. But for alien spouses there isn't a gift tax marital deduction and the gift wouldn't qualify for the $128,000 gift tax annual exclusion for alien spouses. And if the two recipients in *Situation 2* aren't spouses, the gift wouldn't qualify for the $12,000 annual-per-donee exclusion. Why? Those exclusions are for present interests only.

• Gift tax charitable deduction—concern. In *Situation 2*, after the separation of Original Trust the charitable remainder organizations get part of the remainder interest on the death of the first of the spouses to die—rather than waiting to get their remainder interest in Original Trust at the death of the survivor of the spouses. So the charities are, in effect, getting an additional gift by getting part of the remainder earlier. The ruling states that there is no *income* tax charitable deduction for this earlier gift of the remainder. But what about a *gift* tax charitable deduction?

Possible gift tax trap—caution. In Letter Ruling 9550026, a NIM-CRUT was funded with community property and both spouses (donors) were to receive life income. Each disclaimed the right to receive income from the other's share of the community property used to fund the trust. Suppose the husband had funded the trust with his own separate property—providing unitrust payments for himself for life with payments to his wife if she survived him. Would the IRS maintain that no *gift* tax charitable deduction is allowable if the donor were to give away his remaining NIM-CRUT life interest and his wife were to give away her survivorship interest? Would IRS maintain that the husband-donor had already transferred an interest in the trust to a noncharity beneficiary, thus disqualifying him for the *gift* tax charitable deduction? Would it make any difference if his wife were to first disclaim her survivorship interest. IRS has allowed a gift tax charitable deduction when one spouse renounced her survivorship interest before the other in Letter Ruling 9529039. IRS stressed that one party was acting before the other. *Reminder:* Letter rulings aren't precedents.

• Spendthrift trusts—something else to think about. Some trusts are spendthrift trusts. Simply put, they make it impossible for a beneficiary to sell or give away his or her interest in the trust. So a determination must be made whether a survivor beneficiary has the right to disclaim or relinquish his or her interest. That's determined by state law, the governing instrument, or both.

• If the trust in *Situation 1* is a CRAT—comment. Every schoolchild knows that you can't make additional contributions to a charitable remainder annuity trust. Under the section of Rev. Rul. 2008-41 titled "Law and Analysis," the IRS states: "Section 1.664-2(b) provides that a trust is not a CRAT unless its governing instrument provides that no additional contributions may be made to the CRAT after the initial contribution."

Yet, after Original Trust (that can be a CRAT) is divided, the IRS has, in effect, ruled that when the separate trusts are consolidated on the death of a separate trust's recipient, it's ok to add that trust's assets to the other separate trusts. Apparently, the IRS doesn't deem that this is adding to a CRAT. The separate trusts have the same DNA (not to be confused with DNI) as Original Trust.

• Payment of legal fees—comment. Rev. Rul. 2008-41 states that the recipients pay all the costs associated with the division of Original Trust into separate trusts including legal fees of any court proceeding and the administrative costs of the creation and funding of the separate trusts. No mention is made whether the recipients of the separate trusts (or the estate of a deceased recipient) will pay legal and administrative costs on a subsequent consolidation of separate trusts on the death of a recipient. Letter Ruling 200616008 held that the CRT itself could pay reasonable legal fees and other expenses for dividing the trust. See also Letter ruling 200301020. Although Rev. Rul. 2008-41's statement of facts recites that the payment of legal and administration costs will be by the recipients, that fact is not recited in any of the ruling's five "holdings."

NOW FINALLY HERE'S THE RUB in Rev. Rul. 2008-41—comments by Lawrence Katzenstein, nationally recognized lawyer (based in St. Louis):

Leave it to the Service to confuse us. Nothing surprising in Rev. Rul. 2008-41 except the statement in the facts that "…each asset of Trust is divided equally among and transferred to the separate trusts." Well—that's a nuisance. Is the Service implying that a non pro rata division is not OK, or that we have capital gain on such a division?

The history is confusing. In PLR 200525008, the Service OK'd a similar division, but there the assets would be divided so that each trust would be funded with assets fairly representative of the aggregate adjusted bases of trust assets and "the division of the assets between Trust A and Trust B must be on a pro rata basis with respect to each major class of investments held at the date of the division, and within each class, must be fairly representative of overall appreciation or depreciation of the assets therein." Similar language is also in PLR 200808018. Neither of these rulings discusses the capital gain implications of these non pro rata distributions.

In non-charitable areas (such as division of trusts for GST purposes), the rulings require only that the assets fairly reflect net appreciation and depreciation…no class of investments language and no discussion of the capital gain issue. See Reg. §26.2654-1(b)(1)(ii): the severance of a trust that is included in the transferor's gross estate (or created under the transferor's will) into two or more trusts is recognized for purposes of chapter 13 if the governing instrument does not require or otherwise direct severance but the trust is severed pursuant to discretionary authority granted either under the governing instrument or under local law; and (among other things) "If severed on a fractional basis, the separate trusts need not be funded with a pro rata portion of each asset held by the undivided trust. The trusts may be funded on a non pro rata basis provided funding is based on either the fair market value of the assets on the date of funding or in a manner that fairly reflects the net appreciation or depreciation in the value of the assets measured from the valuation date to the date of funding."

So if we now divide a CRT post Rev. Rul. 2008-41, do we need to:

1. Divide each asset?
2. Divide so that assets allocated are fairly representative of the aggregate adjusted bases of the trust assets, on a pro rata basis with respect to each major class of investments held at the date of the division, and within each class, so that assets are fairly representative of overall appreciation or depreciation?
3. Merely divide so that the assets in each new trust fairly reflect net appreciation and depreciation?

If we do 2 or 3, do we have gain?

P.S.—Immer schlimmer (from bad to worse). In addition to the "pro rata" division concerns raised by Larry Katzenstein regarding ruling 2: Rulings 1, 3, 4 and 5 also state that Original Trust is divided pro rata. So, if the division isn't on a pro rata basis:

• Will Original Trust and the separate trusts fail to qualify as CRTs under IRC §507(c)?

• Will excise taxes be imposed under IRC §507(c)?

• Will there be self-dealing under IRC §4941?

• Will there be taxable expenditure under IRC §4945?

Iam satis—enough already.

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*It is said that half the marriages in the United States end in divorce. The other half, as it turns out, end in death. So I ask you, which is worse?

**Worry Wart was a character in the comic strip, "Out Our Way." He caused others to worry. But since his first appearance in 1956, the term has evolved to mean an individual who worries on his or her own. So in the classic sense, I am the worry wart—the one who causes you to worry. Sorry.

***A tontine is an investment (and a lottery) in which each participant pays into a common fund. The funds are invested and each participant receives dividends. When an investor dies, his or her share is divided among the other participants. The last surviving participant then gets the whole kit and caboodle, the whole ball of wax, the whole nine yards, the whole shebang—in short, everything.

The tontine is named after Lorenzo de Tonti who invented the scheme in France in 1653. Tontines have been banned in the United States and Britain because of the potential incentive of participants to murder other participants to increase their shares.

X. GIFT OF REMAINING LIFE INTEREST AFTER GIFT OF REMAINDER INTEREST, THEREBY ACCELERATING CHARITABLE REMAINDER

A donor who has created a charitable remainder unitrust—reserving life income for herself with remainder to charity—gets an income tax charitable deduction if she later contributes her remaining life interest to the charitable remainder organization, thereby accelerating the charitable remainder. The interest transferred can't be less than the donor's entire interest in the contributed property. The amount of the deduction is the then value of the remaining life interest. Reg. §1.170A-6(c)(3)(ii).

Letter ruling on this point. A 9% NIM-CRUT—funded with community property—pays the spouses jointly and then all to the survivor. On the survivor's death, the trust terminates with the remaining assets going to University. The husband has the power—by will—to revoke his wife's interest in the trust as to his community property interest in the trust. The wife has the same right as to her community property interest.

Donors want to now give a 20% undivided interest in their unitrust payments to University to fund the construction of a building. Each donor will disclaim the right to receive the other's unitrust interest and will irrevocably assign the interest to University.

University's income and remainder interests will merge so it will then have a 20% undivided interest in the entire trust and an 80% undivided interest in the trust remainder. The parties will agree to terminate 20% of the trust and the trustee will then distribute 20% of the trust assets to University. The adjusted bases of the distributed assets will be fairly representative of all the property available. The trustee will continue to hold the balance of the trust assets.

IRS reviewed an earlier published ruling. In *Rev. Rul. 86-60,* 1986-1 CB 302, Alice was the sole beneficiary of a charitable remainder annuity trust that she created in 1980. Her interest wasn't created to avoid the rules prohibiting deductions for "partial interests." In 1984 Alice transferred her remaining retained income interest to the charitable remainder organization. IRS ruled that the gift of her income interest qualified for an income tax charitable deduction because she gave her entire interest in the property. Her gift also qualified for a gift tax charitable deduction because she hadn't made a prior transfer from the trust for private purposes. Thus, the income interest didn't have to be an annuity interest (or other qualified interest) described in IRC §2522 (although it was).

IRS rules—income tax deduction. Donors' situation is analogous to the facts in *Rev. Rul. 86-60*—except that they propose to contribute only 20% of their life interest. Donors claim that they didn't create the trust to avoid the partial interest rule. IRS agrees partly because of the six-year period between the trust's creation and the proposed gift. An income tax charitable deduction is allowable for the value of the undivided interest in the unitrust payments transferred to University, rules IRS.

IRS rules—value of income tax charitable deduction. It's the present value of the spouses' relinquished right to receive annually 9% of the net fair market value of 20% of the trust assets, rules IRS. The spouses' relinquished right is valued using their ages (to their nearest birthdays) at the time of the gift of 20% of their remaining life interest, based on the interest tables in effect for that month or in either of the two prior months—at the spouses' election—and 20% of the then value of the trust assets, rules IRS. *Letter Ruling 9550026.*

Background—gift tax implications for transfer to other income beneficiary. When donors who are spouses fund a two-life unitrust with joint or community property, the actuarially older spouse makes a gift to the actuarially younger spouse of the difference in value of their survivorship interests. However, the gift qualifies for the gift tax marital deduction—if the actuarially younger spouse is a U.S. citizen. Alternatively, the spouses can reserve the right—exercisable only by will—to revoke the other spouse's survivorship interest in one half of the life income gift. That's what the donors in this letter ruling did.

More background—gift tax implications for gift to charity. There's no gift tax deduction for a charitable gift of less than the donor's entire interest in property if the donor has already transferred an interest in that property to a noncharity beneficiary, but a gift tax deduction is allowed for transfers of a donor's undivided portion—a fraction or percentage—of his or her entire interest. IRC §2522(c)(2); Reg. §25.2522(c)-3(c)(2)(i).

IRS rules—gift tax deduction. Since the donors will each disclaim their right to receive the other's unitrust interest, neither is deemed to have made a noncharitable transfer when they created the trust. Their transfer of a 20% undivided interest in their unitrust interests will consist of a fraction or percentage of their entire interest. A gift tax charitable deduction is allowable for the value of the undivided interest in the unitrust payment transferred to University, rules IRS.

IRS rules—value of gift tax charitable deduction. It's the present value of the spouses' right to receive 9% of the net fair market value of 20% of the trust assets—as valued each year. The calculation is based on the spouses' ages (to their nearest birthdays) at the time of the transfer of 20% of their interest using the interest tables in effect for that month or in either of the two prior months—at the spouses' election—and 20% of the then value of the trust assets. The income-only limitation (a "net income with no makeup" unitrust) is disregarded for purposes of valuing the spouses' gifts of a 20% undivided portion of their unitrust interest because the transfer of the undivided portion of the spouses' unitrust interests results in a merger with a 20% undivided portion of University's remainder interest in the trust. But see the recent IRS position (below) on valuing a NIM-CRUT when it is collapsed and the proceeds are divided between the income beneficiary and the charity.

Gift tax trap—caution. Here the trust was funded with community property and both spouses (donors) were to receive life income. Each disclaimed the right to receive income from the other's share of the community property used to fund the trust. Suppose the husband funded the trust with his own separate property providing unitrust payments for himself for life with payments to his wife if she survived him. Would IRS maintain that no gift tax charitable deduction is allowable if the donor were to give away his remaining life interest and his wife were to give away her survivorship interest? Would IRS maintain that the husband-donor had already transferred an interest in the trust to a noncharity beneficiary, thus disqualifying him for the gift tax charitable deduction? Would it make any difference if his wife were to first disclaim her survivorship interest? **Comment:** IRS allowed a gift tax charitable deduction when one spouse renounced her survivorship interest before the other in *Letter Ruling 9529039.* IRS stressed that one party was acting before the other. *Reminder:* Letter rulings are not precedent. If in doubt, get your own ruling.

Income tax charitable deduction—what kind of gift is it? When a non-grantor beneficiary (someone else created the trust for his or her benefit) contributes his or her life interest, IRS treats it as a capital asset, deductible at full fair market value. *Rev. Rul. 72-243*, 1972-1 CB 233. Several letter rulings suggest that when a donor gives away his or her own retained life interest, the interest is a capital asset. *Letter Rulings 8052092* and *8311063*. In *Letter Ruling 8613046*, IRS said that the life interest of a charitable remainder trust's sole beneficiary was a capital asset, entitling her to a deduction for the full fair market value on the date of the contribution.

Spendthrift trusts—something else to think about. Some trusts are spendthrift trusts. Simply put, they make it impossible for a beneficiary to sell or give away his or her interest in the trust. So a determination must be made whether a survivor beneficiary has the right to disclaim or relinquish his or her interest. That's determined by state law, the governing instrument, or both.

IRS rules—capital gains avoidance. Any capital gain that the donors' unitrust had in prior years (before the gift of the 20% interest) that wasn't realized by the donors won't be included in their income solely because of the transfer of 20% of their interest in the unitrust— rules IRS.

XI. TERMINATING A CRUT AND DIVIDING ASSETS BETWEEN BENEFICIARY AND CHARITABLE REMAINDER ORGANIZATION

A donor wanted to terminate his unitrust without giving the charity his income interest. Instead, the donor, the trustee and the charity agreed to terminate the trust, with the donor getting assets equal to the then value of his interest, and the charity getting assets equal to the then value of its remainder interest.

Arnold was the donor (a/k/a the settlor, grantor or trustor) and income beneficiary of a unitrust that was to make unitrust payments to him for 20 years with remainder to charity. If he dies during the 20-year period, the payments are to be made for the balance of the term, as he appoints by his will or in default thereof, to his estate.

IRS rules. Arnold (IRS calls him “A”) has capital gain equal to the value of his remaining term-of-years interest. Here’s how it reached that conclusion:

> A is selling A’s interest in Trust to the [charitable remainder-organization]. Provided that the property received by A is distributed to A in accordance with A’s interest in Trust, the amount that A will realize from the sale of A’s interest in Trust is the fair market value of the property received by A.

IRS then reviewed how unitrust amounts distributed to a unitrust beneficiary are taxed under IRC §664(b). But after that recital, IRS said that money or property received by Arnold on the trust’s termination doesn’t represent a distribution of an annual unitrust amount. Thus the four tiers are inapplicable. Rather, Arnold is disposing of his interest in the trust in exchange for money and property, and his transaction is governed by IRC §1001.

IRS goes into more detail. *Rev. Rul. 72-243*, 1972-1 CB 233 provides that a sale of an income interest in a trust is a sale of a capital asset within the meaning of IRC §§1221 and 1222. The holding period for determining whether gain or loss from the disposition of an income interest is long term or short term commences on the date the taxpayer first held the interest. Apparently, the unitrust was created over a year before the unitrust was terminated because IRS ruled that Arnold will have long term capital gain.

Poor Arnold. IRS said he had no basis in his interest in the trust—it is zero, zip, nada: “Pursuant to section 1001(e)(1), the portion of the adjusted uniform basis assigned to A’s interest in Trust is disregarded. The exception contained in section 1001(e)(3) is not applicable, because the entire interest in Trust’s assets is not being sold, or otherwise disposed of, to a *third party.*” [Emphasis supplied.]

Comment. IRS concluded that Arnold “is *selling* his interest in Trust to the [charitable remainder-organization].” Apparently, Arnold is the first party. Is the charity the second party? Apparently, IRS doesn’t consider it to be a third party. Had Arnold sold his remaining term-of-years interest and the charity sold its remainder interest to Arnold’s neighbor (instead of Arnold and the charity whacking up the assets), would Arnold then have sold to a third party and then had a basis greater than zero for determining capital gain?

IRS also rules—no self-dealing. Arnold, as the trust’s grantor, is a disqualified person. But Reg. §53.4947-1(c)(2)(i) exempts him from self-dealing. The actuarial amount paid to him representing his term-of-years interest in the trust is derived solely from his right to annual unitrust payments. Just as the unitrust amounts paid over time are excluded from self-dealing, so too is the payment of Arnold’s term-of-years interest in the trust. **Reason:** That payment is derived from Arnold's legal right to the unitrust amounts under the trust agreement. So there's no self-dealing when terminating the trust and distributing the assets to Arnold and the charitable remainder-organization.

Caution. If the remainder is to go to a private foundation (rather than a public charity) there would be a prohibited act of self dealing. *Letter Ruling 200525014* revoked by *Letter Ruling 200614032*; *Letter Ruling 200616035*.

IRS places conditions on its favorable ruling. The trust's termination must not be prohibited by state law and must be made under a court order resulting from a proceeding to which the state attorney general is a party. And the amounts distributed to Arnold must be determined under IRC §7520's valuation rules. Any distribution of assets in kind must be made pro rata. *Letter Ruling 200127023*.

Comment on IRC §7520 valuation: For determining income, gift and estate tax charitable deductions for split-interest trusts, a donor may use the IRC §7520 rate for the month of the transfer, or for either of the two proceeding months. However, a charitable deduction isn't available in Arnold's case. So the IRC §7520 rate to use (although IRS didn't discuss this) is the rate for the month the trust is terminated.

XII. TERMINATED NI-CRUT—OK IF INCOME BENEFICIARY HEALTHY

Adult child is the sole income beneficiary of a "net income with no makeup" charitable remainder unitrust (NI-CRUT) that pays her 8% of the assets' net fair market value or actual trust income, whichever is lower. Parent (now deceased) created the NI-CRUT so Child is a disqualified person. Church is the charitable remainder organization and Trustee is a Church affiliate.

For several years, the NI-CRUT's payments have been less than 3% of the assets' net fair market value because Trustee has been investing for total return rather than to maximize the annual distributable income. As a result, the NI-CRUT payments have been relatively low and Child has been dissatisfied.

Trustee says it is faced with the uncomfortable situation of balancing its fiduciary obligations to the income and remainder beneficiaries in a marketplace that favors capital appreciation over the production of distributable income. To resolve the situation, the parties want to terminate the NI-CRUT with Child and Church to receive lump-sum payments equal to the present values of their respective interests.

The termination will comply with state law that permits early termination with the consent of all the parties provided that all income and remainder interests are vested, and no individual has retained the right to change the remainder beneficiaries. Child, Church, Trustee, and the state attorney general will all consent to the termination.

Child's good health key to favorable ruling. Child's long-time physician has examined her and signed an affidavit that she has no medical condition that would shorten her life expectancy. Child has also signed an affidavit that she is in good physical health. Stay tuned for why this is important, but you may already have figured it out.

IRS rules. Early termination of the NI-CRUT won't constitute self-dealing under IRC §4941(d). Although the NI-CRUT is silent on early termination, state law allows its early termination and so that's an implied trust provision. The termination payment to Child is derived from her legal right to the unitrust amounts under the trust agreement. So there's no self-dealing when terminating the NI-CRUT and distributing its assets to her and Church. *Note.* If the charity is a private foundation and not a public charity, IRS takes the position that the termination would be a prohibited act of self-dealing. *Letter Ruling 200525014* revoked by *Letter Ruling 200614032*; *Letter Ruling 200616035*.

Back to child's health. IRS was particularly concerned that an early termination might result in a greater allocation of the trust assets to the Child (income beneficiary) to the detriment of the Church (remainder organization), given that Child was a disqualified person with respect to the NI-CRUT. That would be the case if she knew that her life expectancy was shorter than that assumed in the actuarial tables used to value the life and remainder interests.

IRS also noted that all the parties consented to the termination (including the state attorney general), and that the present values of the income and remainder interests would be determined according to the Code and regulations. *Letter Ruling 200208039.*

XIII. NIM-CRUT TERMINATED—VALUING THE INTERESTS

Donor created a 10% net-income-with-makeup charitable remainder unitrust (NIM-CRUT). He is the income recipient and publicly supported charities are the remainder organizations. Donor is also a trustee along with an independent special trustee.

Donor wishes to terminate the NIM-CRUT and have the trust assets distributed to him and the charities according to their respective interests. The IRS deems the termination to be a constructive sale of the income recipient's interest and he has a zero basis. If the trust was created more than a year before the CRT's termination, Donor's constructive sale is treated as a sale of a long-term capital asset (taxable at a maximum 15% rate). The gain is the difference between the value of the income recipient's interest and zero. Naturally, an income recipient wants the highest-possible valuation of his interest because he gets more assets—and keeps 85% after paying a 15% tax.

The law in Donor's state permits early termination of the trust provided all the parties *agree (income recipients, trustees and charitable remainder organizations).* The state's attorney general and a court needn't be involved as long as all the parties consent. In addition, the Restatement of the Law of Trusts 3d (2001) provides at section 651(1) that ". . . if all of the beneficiaries of an irrevocable trust consent, they can compel the termination or modification of the trust."

As is commonplace in CRT terminations, when a CRUT or CRAT is measured by an individual's life (as opposed to a term of years) Donor represented to the IRS that he was aware of no physical condition that would decrease his normal life expectancy. He also submitted a statement from his physician confirming that he had examined Donor, and that there was no indication that his life expectancy was less than would otherwise be expected for a man his age. Naturally, if someone is at death's door—or closer to the door than normal—his life interest's value is diminished.

The plot thickens. In Donor's initial ruling request, he stated that the actuarial values of the respective interests (his and the charitable remainder organizations) should be calculated using the discount rate in effect under IRC §7520 on the date of the constructive sale, and the method of valuing a charitable remainder in Reg. §1.664-4.

After discussions with the IRS, Donor, as the income recipient, agreed to a different method of calculating the respective interests in the trust. Specifically, the letter ruling stated:

> The Taxpayer understands and agrees that, contrary to the formula assumed in his earlier letter ruling request, the payout rate to be used in calculating the respective interests will be the lesser of the Code Section 7520 rate in effect at the time of termination of the trust and the stated interest rate [unitrust amount] of 10% contained in the trust agreement.

IRS rules. The appropriate calculation of the actuarial value of the income recipient's interest must take into account the net-income provisions of the trust. That requires the use of a reasonable method for the calculation which doesn't inappropriately inflate the income recipient's interest to the detriment of the charitable remainder organizations. One reasonable method to calculate the actuarial value of the income and remainder interests, rules the IRS:

> The computation of the remainder interest is found using a special factor as indicated in section 1.7520-3(b)(1)(ii) of the regulations. The special remainder factor is found by using the methodology stated in section 1.664-4 for computing the factor for a remainder interest in a unitrust, with the following modification: where section 1.664-4(a)(3) of the regulations provides an assumption that the trust's stated payout percentage is to be paid out each year, instead the assumed payout shall be that of a fixed percentage which is equal to the lesser of the trust's stated payout

> percentage or the section 7520 rate for the month of termination. The special factor for the non-charitable payout interest is 1 minus the special remainder factor.

Based on this methodology, here's how to calculate Donor's income interest:

> The section 7520 rate for May 2006 is 5.8 percent. Assuming the termination occurred in May 2006, the lesser of this rate and the trust's stated payout percentage is 5.8 percent. The assumed taxpayer's age as of the nearest birthday is 75. Based on Table 90CM, interest at 5.8 percent, an unadjusted payout rate of 5.8 percent, and quarterly payments made at the end of each quarter, the present value of the remainder interest in a unitrust which falls in at the death of a person aged 75 is $0.56904 for each $1.00 of the trust estate. The present value of the payout interest in the same unitrust until such death is $1.00 minus $0.56904, or $0.43096 for each $1.00 of the trust estate.
>
> The income recipient is not expected to receive more than he would during the full term of the trust under the above-described methodology for valuing his interest in a charitable remainder trust with a net income make-up feature.
>
> *Letter Ruling 200725044*

Comment. One tax Einstein opines that arguably IRS's method of valuing the NIM-CRUT's income interest is solely to determine whether the self-dealing excise tax applies—and the methodology doesn't necessarily apply to determining the share of the assets to be received by the income recipient.

Another tax genius says that the best way—for all purposes—to determine the value of a NIM-CRUT's income interest is to have a qualified appraisal on what in the real world a reasonable buyer would pay a reasonable seller both having knowledge of relevant facts and neither being under compulsion to buy or sell.

For those not relishing a battle with the IRS, here's a suggested plan for favorably valuing a life interest on a gift or constructive sale (the assets are divided between the income recipient and the charitable remainder organization). This plan should result in the NIM-CRUT's life interest being valued using the same method as is used for the charitable deduction for the remainder interest when the trust is initially funded.

Don't draft a plain old NIM-CRUT. Instead, draft the NIM-CRUT with a *flexible* FLIP-CRUT provision. Then if the income recipient wants to contribute his remaining life interest or receive his share of the trust, he pulls the trigger—and voila we're dealing with a STAN-CRUT. Hey, no problem in getting a more favorable valuation without doing battle with the IRS.

What is a flexible FLIP-CRUT (a FLEX-FLIP-CRUT)? A typical FLIP-CRUT provides that a NIM-CRUT shall flip and become a STAN-CRUT on January 1 of the year following the sale of Greenacre (a nonmarketable asset). And that's often an appropriate time to flip a NIM-CRUT. But instead of doing it that way, fund the trust with Greenacre *and* a few shares of nonmarketable securities (e.g., cookthebooks.com). Make the sale of cookthebooks.com the flipping event. Then if you wish to flip the trust earlier than Greenacre's sale, on its sale, or later than its sale, you can flip at will—by selling the shares in cookthebooks.com.

Think of the issues at the outset when drafting the NIM-CRUT. This plan won't help the hapless donor in this letter ruling.

Drafting pointer. IRS takes the position that you can't divide the assets between an income beneficiary and a private foundation remainder organization—that would be self-dealing. So keep the right in the trust instrument to substitute a public charity for the private foundation. Then make the substitution before terminating the trust.

Parthian shot. This letter ruling deals with a net-income-with-makeup unitrust. IRS would likely apply the same computation method to a net-income-with-no-makeup unitrust (NI-CRUT). As a practical matter, the life interest for that trust would be worth even less because deficiencies can never be made up.

XIV. CRT CAPITAL GAIN AVOIDANCE PLAN ON IRS RADAR—NOTICE 2008-99

- **Participants must notify IRS**
- **Costly penalties for notification failure**
- **Avoidance or evasion?**

The meek shall inherit the earth and with a stepped-up basis. So for appreciated assets inherited at death, an heir gets a basis equal to the then fair market value (rather than taking over the decedent's lower basis). But a decedent has to give his life to achieve this.

Can the donor (or other beneficiary) of a charitable remainder unitrust or annuity trust during his lifetime step up the basis of appreciated assets used to fund the CRT and then on an early termination of the trust get back proceeds equal to his interest in the trust free of capital gains tax? That's what concerns the IRS in Notice 2008-99, the subject of this article.

Three scenarios follow. Scenario 3 troubles the IRS. Scenarios 1 and 2 are for background.

Scenario 1 — no problem. Every schoolchild knows that a donor can transfer appreciated assets to a charitable remainder unitrust or annuity trust and avoid capital gain on the trust's funding, and not be taxed on the capital gain on a subsequent sale by the trust. The capital gain is, however, taxable to the donor or other beneficiary (recipient) but only to the extent that the gain is deemed distributed to the recipient under the four-tier taxation regime in satisfaction of the annual unitrust or annuity trust amount.

Scenario 2 — no problem. Some recipients terminate their CRTs before the end of the specified term and the trust assets are divided between the recipient and the charitable remainder beneficiary according to their respective interests at the CRT's termination. A number of letter rulings have sanctioned this. The termination is treated as a sale of the recipient's term interest (generally measured by his life but sometimes a term-of-years interest). The recipient is deemed to have a zero basis and has long-term capital gain if the trust was created more than one year before its termination.

A harbinger of Scenario 3. In January 2008, to the annual list of areas under study in which rulings will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations or otherwise, IRS added:

> •*IRC §664. — Charitable Remainder Trusts.* Whether the termination of a charitable remainder trust before the end of the trust term as defined in the trust's governing instrument, in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets, causes the trust to have ceased to qualify as a charitable remainder trust within the meaning of §664.

Something to think (and worry?) about. What bad consequences can befall the donor and a CRT that terminates early and has ceased to qualify as a charitable remainder trust within the meaning of §664*?*

Note. The IRS's work plan (to-do list) for the period of July 1, 2007 to June 30, 2008 stated that a revenue ruling on the termination of charitable remainder trusts under IRC §664 and the division of the assets between the life beneficiary and the charitable remainder organization will be issued. Could Notice 2008-99 be the forerunner to a revenue ruling or other binding authority?

Scenario 3 — a big problem. The IRS and the Treasury announce in Notice 2008-99 that they are aware of a transaction (described soon) in which a sale or other disposition of all interests in a charitable remainder trust (subsequent to the contribution of appreciated assets to the trust and their sale and reinvestment by the trust) results in the donor or other noncharitable recipient getting the value of that person's trust interest and claiming to recognize little or no taxable gain. "The IRS and Treasury Department believe this transaction has the potential for tax avoidance or evasion*, but lack enough information to determine whether the transaction should be identified specifically as a tax avoidance transaction." The IRS identifies this transaction and substantially similar transactions as transactions of interest for purposes of Reg. §1.6011-4(b)(6) and IRC §§6111 and 6112. IRS also alerts persons involved in these transactions to certain responsibilities that may arise from their involvement. More about transactions of interest, listed transactions and reportable transactions later. To keep this article from becoming a book, I won't explain all the Code and regulation sections cited in Notice 2008-99 regarding required notifications to the IRS. Suffice it to say if you're involved in this type of transaction, you'll want to study them.

Here's the transaction of interest to the IRS and the Treasury. *Step 1.* Donor creates a CRT and contributes Appreciated Assets to Trust. Donor retains an annuity or unitrust interest (Term Interest) and designates Charity as the remainder beneficiary. Charity may, but need not, be controlled by Donor; he may, but need not, reserve the right to change the Charity designated as the remainder beneficiary.

Step 2. Trust sells or liquidates the Appreciated Assets and reinvests the net proceeds in other assets (New Assets) such as money market funds and marketable securities often to acquire a diversified portfolio. Because a charitable remainder trust generally is tax-exempt under IRC §664, Trust's sale of the Appreciated Assets is exempt from income tax, and Trust's basis in the New Assets is the price Trust pays for those New Assets. Some portion of Trust's ordinary income and capital gains may become taxable to Donor as the periodic annuity or unitrust payments are made by Trust (under the rules of IRC §664 and its regulations).

Step 3. Donor and Charity, in a transaction they claim is described in IRC §1001(e)(3), sell or otherwise dispose of their respective interests in Trust to Xenocrates, an unrelated third party, for approximately the fair market value of the Trust's assets including the New Assets.

Step 4. Trust then terminates, and Trust's assets, including the New Assets, are distributed to Xenocrates.

Donor takes these positions regarding the tax consequences of this transaction:

- Donor claims an income tax charitable deduction for the portion of the fair market value of the Appreciated Assets attributable to the remainder interest as of the date of their contribution to Trust.

- Donor claims to recognize no gain from the Trust's sale or liquidation of the Appreciated Assets. When Donor and Charity sell their respective interests in Trust to Xenocrates, Donor and Charity take the position that they have sold the <u>entire</u> interest in Trust within the meaning of IRC §1001(e)(3). Because the <u>entire</u> interest in Trust is sold, Donor claims that IRC §1001(e)(1), which disregards basis in the case of a sale of just the <u>term</u> interest, doesn't apply. Donor also takes the position that, under IRC §1001(a) and related provisions, the gain on the sale of Donor's term interest is computed by taking into account the portion of uniform basis allocable to Donor's term interest under Reg. §§1.1014-5 and 1.1015-1(b), and that this uniform basis is derived from the basis of the New Assets rather than the basis of the Appreciated Assets. (If this works, Donor has achieved Tax Nirvana — a stepped-up basis without giving his life.)

Variations on a scheme:

- A net-income-with-make-up charitable remainder unitrust (NIM-CRUT) is used.
- Trust may have been in existence for some time prior to the sale of Trust interests.
- The Appreciated Assets may already be in Trust before the commencement of the transaction.
- The recipient and seller of the term interest may be the Donor and/or another person.
- Donor may contribute the Appreciated Assets to a partnership or other passthrough entity and then contribute the interest in the entity to Trust.

Claimed tax treatment of the transaction. The gain on the sale of the Appreciated Assets is never taxed, even though the Donor receives his share of the appreciated fair market value of those assets.

Ordinary folks needn't worry. The IRS and the Treasury aren't concerned about the mere creation and funding of a charitable remainder trust with Appreciated Assets and/or the trust's reinvestment of the contributed Appreciated Assets. Those events alone don't constitute the transaction subject to Notice 2008-99.

Who should be concerned? The IRS and the Treasury "are concerned about the manipulation of the uniform basis rules to avoid tax on gain from the sale or other disposition of appreciated assets. Accordingly, the type of transaction described in this notice includes a coordinated sale or other coordinated disposition of the respective interests of the [Donor] or other noncharitable recipient and the Charity in a charitable remainder trust in a transaction claimed to be described in §1001(e)(3), subsequent to the contribution of appreciated assets and the trust's reinvestment of those assets. In particular, the IRS and Treasury Department are concerned about [Donor's] claim to an increased basis in the term interest coupled with the termination of the Trust in a single coordinated transaction under §1001(e) to avoid tax on gain from the sale or other disposition of the Appreciated Assets."

Now for Notice 2008-99's teeth — transactions of interest. Transactions that are the same as, or substantially similar to, those described in Notice 2008-99 "are identified as transactions of interest for purposes of §1.6011-4(b)(6) and §§6111 and 6112 effective October 31, 2008, the date this notice was released to the public. Persons entering into these transactions on or after November 2, 2006, must disclose the transaction as described in §1.6011-4. Material advisors who make a tax statement on or after November 2, 2006, with respect to transactions entered into on or after November 2, 2006, have disclosure and list maintenance obligations under §§6111 and 6112. See §1.6011-4(h) and §§301.6111-3(i) and 301.6112-1(g) of the Procedure and Administration Regulations."

The IRS's and the Treasury's warning. Participants who entered into these transactions at any time may already be in hot water. "Independent of their classification as transactions of interest, transactions that are the same as, or substantially similar to, the transaction described in this notice already may be subject to the requirements of §§6011, 6111, or 6112, or the regulations thereunder. When the IRS and Treasury Department have gathered enough information to make an informed decision as to whether this transaction is a tax avoidance type of transaction, the IRS and Treasury Department may take one or more actions, including removing the transaction from the transactions of interest category in published guidance, designating the transaction as a listed transaction, or providing a new category of reportable transaction."

Who are participants? "Under §1.6011-4(c)(3)(i)(E), each recipient of the term interest and Trust are participants in this transaction for each year in which their respective tax returns reflect tax con-sequences or a tax strategy described in this notice. Charity is not a participant if it sold or otherwise disposed of its interest in Trust on or prior to October 31, 2008. For interests sold or otherwise disposed of after October 31, 2008, under §1.6011-4(c)(3)(i)(E), Charity is a participant for the first year for which Charity's tax return reflects or is required to reflect the sale or other disposition of Charity's interest in Trust. In general, Charity is required to report the sale or other dis-position of its interest in Trust on its return for the year of the sale or other disposition. See §6033 and §1.6033-2(a)(ii). Therefore, in general, Charity will be a participant for the year in which charity sells or otherwise disposes of its interest in Trust."

Time for Disclosure. See Reg. §§1.6011-4(e) and 301.6111-3(e).

Material Advisor Threshold Amount. The threshold amounts in Reg. §301.6111-3(b)(3)(i)(B) are reduced to $5,000.

Penalties — the book will be thrown at those who are required to disclose but don't. "Persons required to disclose these transactions under §1.6011-4 who fail to do so may be subject to the penalty under §6707A. Persons required to disclose these transactions under §6111 who fail to do so may be subject to the penalty under §6707(a). Persons required to maintain lists of advisees under §6112 who fail to do so (or who fail to provide such lists when requested by the IRS) may be subject to the penalty under §6708(a). In addition, the IRS may impose other penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under §6662 or §6662A."

Treasury and the IRS invited public comments. They said that the government is aware of concerns expressed by commentators on this transaction of interest and requested written comments on how the transaction might be addressed in published guidance. One approach might involve issuing regulations under the authority of IRC §643(a)(7) to address the uniform basis rules under IRC §§1014 and 1015 and the regulations thereunder.

The deadline for comments was January 31, 2009.

My opinion. Clearly, Congress didn't intend to allow the capital gains tax avoidance plan described in Notice 2008-99. And that avoidance should be curbed. Any corrective legislation or regulation should, however, also deal fairly with transactions that aren't designed to slide between any loopholes.

Example. Five years ago, a donor transferred securities valued at $1 million to fund a charitable remainder unitrust. The securities were not appreciated and had a $1 million basis (and the CRT took over the donor's basis). The donor and the charity now terminate the CRT by selling their respective interests to a third party for $1 million (the current fair market value).

The donor's life interest is now valued at 60% and the charity's remainder interest is now valued at 40% of the trust's assets. So the donor receives $600,000 and the charity receives $400,000. It would be unfair for the donor's basis to be deemed to be zero. In this case, he hasn't through the CRT stepped up the basis of the assets used to fund the trust. Thus the basis of his share of the trust assets sold to the third party should be $600,000. The same rule should apply if the CRT sold the assets originally used to fund the trust and purchased other assets and at the time the trust is terminated those assets are also worth $1 million (with the donor's then interest being valued at $600,000).

What should the rule be in the following situation? Donor funds his charitable remainder unitrust with appreciated assets that have a basis of $800,000 and a $1 million fair market value. The funding assets are sold by the trust and the proceeds reinvested in new assets having a $1 million fair market value. Five years after the CRT is created, the donor and the charity sell their respective interests to a third party. At that time, the donor's life interest is worth 60% of the value of the trust assets and he receives $600,000. It would be unfair (not intended by Congress) for him to have no capital gain — nor would it be fair for him to have a zero basis and a $600,000 capital gain. To thicken the plot, suppose the donor as the trust recipient was taxed on some or all of the capital gain when it was deemed distributed to him under tier two of the four-tier rule for taxation of the unitrust amount to the recipient. This should be taken into account in determining the donor's basis on the termination of the CRT.

Suggested solution — fair to the IRS, the Treasury and the recipient (person receiving the value of the term interest) on a sale by the recipient and the charity of the trust assets to a third party. The recipient's basis is his pro rata share of the CRT's basis reduced by his pro rata share of any undistributed amounts then in tier two (capital gain) of the four-tier provision for taxation of unitrust (and annuity) amounts to the trust recipient.

*Evasion is more serious than avoidance. Avoidance can be achieved by taking advantage of tax-saving methods specified in the Code. Sometimes it is achieved by a loophole (something that Congress didn't think of — but kosher until the loophole is closed by legislation, regulation, revenue ruling, etc.). Tax evasion, on the other hand, can end you up in a federal gated community.

XV. NOTICE 2008-99—AMERICAN COUNCIL ON GIFT ANNUITIES COMMENTS TO THE TREASURY AND THE INTERNAL REVENUE SERVICE

Comments submitted by the American Council on Gift Annuities (ACGA) (formerly the Committee on Gift Annuities). ACGA, formed in 1927, is an IRC §501(c)(3) organization described in IRC §170(b)(1) (A)(vi). ACGA's board of directors and its legal counsel are all unpaid volunteers. **ACGA is sponsored by over 1200 social welfare charities, health organizations, environmental organizations, colleges, universities, religious organizations and other charities.** The Mission of ACGA is to "actively promote responsible philanthropy through actuarially sound charitable gift annuity rate recommendations, quality training opportunities and the advocacy of appropriate consumer protection." American Council on Gift Annuities, 233 McCrea Street, Suite 400, Indianapolis, IN 46225. Phone: (317) 269-6271; Fax: (317) 269-6276; E-mail: acga@acga-web.org.

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We support the Treasury's and the Internal Revenue Service's efforts to curb any abuses involving the tax treatment of charitable contributions. In fact, the charities initially alerted the Internal Revenue Service about the abusive so-called accelerated charitable remainder trust.

Clearly, Congress didn't intend to allow the capital gains avoidance described in Notice 2008-99. And that avoidance should be curbed. Any corrective regulation or legislation should, however, also deal fairly with and not thwart proper transactions.

In these difficult economic times, some life-income recipients of charitable remainder trusts and the charitable remainder organizations wish to terminate those trusts early — the charities need funds now (instead of in the future when the trust term ends) and the life-income recipients need immediate funds (instead of piecemeal over the balance of the trust term). Improper capital gain avoidance is not on their radar.

The abuse under the facts detailed in Notice 2008-99 should be curbed by at a minimum reducing the life-income recipient's basis in his interest to zero. However, the following two examples show how it would be unfair and not in furtherance of good tax policy to reduce in all cases the basis in the life-income recipient's interest to zero on a sale to a third party of the respective interests of the life-income recipient and the charitable remainder organization.

The examples are followed by a suggested solution to the abuse outlined in Notice 2008-99. It is fair to the Treasury, the IRS, the life-income recipient, and the charitable remainder organization.

Example 1. Five years ago, a donor transferred securities valued at $1 million to fund a charitable remainder unitrust. The securities were not appreciated and had a $1 million basis and the CRUT took over the donor's basis. The CRUT retained the assets used to fund the trust. The donor, who is the life-income recipient, and the charitable remainder organization now terminate the CRUT by selling their respective interests to a third party for $1 million, the current fair market value.

The life-income recipient's interest is now valued at 60% of the fair market value of the CRUT's assets and the charity's remainder interest is now valued at 40% of the CRUT's assets. So the life-income recipient receives $600,000 and the charity receives $400,000. It would be unfair for the life-income recipient's basis to be deemed to be zero. In this case, he hasn't through the CRUT stepped up the basis of the assets used to fund the trust. Thus the basis of his share of the trust assets sold to the third party should be $600,000. The same rule should apply if the CRUT sold the assets originally used to fund the trust and purchased other assets and at the time the trust is terminated those new assets are also valued at $1 million (with the life-income recipient's then interest being valued at $600,000).

Example 2. Donor funded his charitable remainder unitrust with appreciated assets that had a basis of $800,000 and a $1 million fair market value and the trust took over the donor's basis. The funding assets were sold by the CRUT and the proceeds reinvested in new assets having a $1 million fair market value. Five years after the CRUT was created, the life-income recipient and the charitable remainder organization sell their respective interests to a third party for $1 million. At that time, the life-income recipient's interest is worth 60% of the value of the CRUT's assets and he receives $600,000. It would be unfair (not intended by Congress) for him to have no capital gain — nor would it be fair for him to have a zero basis and a $600,000 capital gain. To thicken the plot, suppose the donor as the CRUT life-income recipient was taxed on some or all of the capital gain when it was deemed distributed to him and taxable under the capital gains category of Reg. Sec. 1.664-1. This should be taken into account in determining the life-income recipient's basis on the termination of the CRUT.

Suggested solution — fair to the Treasury, the IRS, the life-income recipient and the charitable remainder organization on a sale by the life-income recipient and the charity of the trust assets to a third party. The life-income recipient's basis is his pro rata share of the charitable remainder unitrust's or annuity trust's basis reduced by his pro rata share of any undistributed amounts then in the capital gains category of Reg. Sec. 1.664-1. **Hereinafter, this suggested solution is called the**

"adjusted uniform basis rule."

ACGA requests that when the situation described in Notice 2008-99 is addressed, that you also issue guidance on the following related situations involving early termination of charitable remainder unitrusts and annuity trusts so that donors, charities and their advisers can plan without having to seek costly private letter rulings. This would also reduce the workload of the Service's overburdened staff. (The safe-harbor charitable remainder and charitable lead unitrust and annuity trust specimen agreements that have been issued by the Service are examples of how published guidance has benefitted donors, charities, their advisers and the Service.)

• **The adjusted uniform basis rule should apply not only when a charitable remainder trust is terminated by the parties' sale of their respective interests to a third party, but also to a termination of the trust with the assets being divided pro rata between the life-income recipient and the charitable remainder organization.** It is not wise public policy to require the life-income recipient and the charitable remainder organization to go through the exercise and expense of finding and then selling the trust assets to a third party. If the adjusted uniform basis rule is adopted for a termination by a sale to a third party, it should also apply to a pro rata distribution of the assets between the parties. Since capital gain won't be improperly avoided under the adjusted uniform basis rule, that rule should also be made applicable in the latter situation by guidance in the form of a revenue ruling, revenue procedure, regulations or otherwise.

• **Apart from the capital gain treatment on the early termination of a charitable remainder trust is the issue of the valuation of the life-income recipient's interest on the termination of a net-income-with-makeup charitable remainder trust (NIM-CRUT).** In Letter Rulings 200725044 and 200833014 the Service ruled that on early termination of a NIMCRUT, "one" reasonable method of calculating the actuarial value of the income interest upon early termination is to use the lower of the stated percentage distribution rate of the NIMCRUT or the section 7520 rate in effect for the month of termination. This special rule has never been applied, it should be noted, in computing the charitable deduction on the creation of a NIMCRUT.

We believe it is important that the computation of the value of the life-income recipient's and the charitable remainder organization's interests on both the creation and early termination of a NIMCRUT accurately reflect the respective values of those interests. The cited letter rulings specify "one" method of calculating the value of the NIMCRUT's income interest on early termination. Another way to determine the value of a NIMCRUT's life-income recipient's interest on early termination would be to have a qualified appraisal on what a reasonable buyer would pay a reasonable seller both having knowledge of relevant facts and neither being under compulsion to buy or sell. If this additional approach were to be adopted, guidance should be given on the qualification of the appraiser and other appraisal requirements.

● **The IRS has suspended issuing letter rulings on the early termination of charitable remainder unitrusts and annuity trusts.** Most recently in Rev. Proc. 2009-3 under Section 5. Areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through the publication of a revenue ruling, revenue procedure, regulations or otherwise, it is stated:

> .09 Section 664. — Charitable Remainder Trusts. — Whether the termination of a charitable remainder trust before the end of the trust term as defined in the trust's governing instrument, in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets, causes the trust to have ceased to qualify as a charitable remainder trust within the meaning of §664.

This pronouncement can have a deep-freeze effect on the non-abusive early termination of charitable remainder trusts. And the ability to do so, as stated earlier, is important to charitable remainder organizations and life-income recipients in these troubled economic times.

We ask that the issues in Notice 2008-99 and those that we have raised in this letter be resolved promptly and that published guidance be issued — thus making letter rulings necessary only in unusual cases. We ask that the published guidance cover these points:

● The adjusted uniform basis rule be allowed for sales of the respective interests to a third party and also be allowed for a pro rata distribution of the assets between the life-income recipient and the charitable remainder organization.

● An early termination of a charitable remainder unitrust or annuity trust by either a sale to a third party or a pro rata distribution of the assets between the life-income recipient and the charitable remainder organization must be authorized under the law of the state governing the trust. If state law requirements have been met, a letter ruling is not required if the life-income recipient furnishes an affidavit that he is unaware of any medical condition that would shorten life expectancy and also furnishes an affidavit from his physician that he has examined the life-income recipient and he has a normal life expectancy.

● Specify the approved (but not exclusive) methods of valuing the life interest and the remainder interest on the termination of a net-income-with-make-up and a net-income-with-no-make-up charitable remainder unitrust.

● If a charitable remainder unitrust or annuity trust is terminated following the Treasury's and the IRS's guidance, none of the self-dealing rules will apply to any of the parties to the trust and its trustees and the charitable remainder trust will not be subject to termination tax.

● Appropriate forms for reporting the details of an early termination should be issued so that the Service has notice.

Conclusion. The American Council on Gift Annuities appreciates this opportunity to express our views on Notice 2008-99. Please let us know if you wish additional information or amplification. We ask that any guidance issued by the Treasury and the IRS not be final, but in proposed form so that the American Council on Gift Annuities and other interested parties may make their views known. Thank you.

XVI. FIVE PROBLEM AREAS—WATCH YOUR STEP

Multiple grantor CRTS. IRS privately ruled that a CRUT with more than one donor is not a qualified trust. *Letter Ruling 9547004.* Responding to requests that the ruling be withdrawn and that IRS affirmatively announce that multiple grantor CRTs are OK, the author of that ruling said IRS holds to its position—except the letter ruling wouldn't apply when spouses are the grantors. See also *Letter Ruling 200203034.* Also, the IRS in its safe-harbor charitable remainder unitrust and annuity trust revenue procedures state that it is OK to have multiple grantors if they are spouses. See Rev. Proc. 2003-53 through Rev. Proc. 2003-60 and Rev. Proc. 2005-52 through Rev. Proc. 2005-59.

Funding CRTS with undivided property interests. Spouses wanted to fund CRUTs with an undivided interest in a shopping center, keeping an undivided interest for themselves in *Letter Ruling 9114025.* But IRS—I understand—warned the spouses that common ownership of the center with the trusts would be deemed self-dealing. So the couple transferred their interests to a limited partnership and funded the CRUTs with part of the partnership interest. The partnership arrangement apparently "cleansed" the relationship to IRS's satisfaction and IRS ruled that the CRUTs qualified.

Funding CRTS with mortgaged property. IRS disqualified a CRUT because it was funded with mortgaged property and the donor remained personally liable on the mortgage. IRS reasoned that a CRT must function exclusively as one from its creation. But a trust isn't deemed "created," said IRS, as long as the donor is treated as an owner of the trust under the grantor trust rules. *Letter Ruling 9015049*. Another donor funded a CRUT with mortgaged property but wasn't personally liable on the mortgage. IRS ignored the issue of whether the nonrecourse mortgaged property disqualified the trust and didn't rule whether the trust qualified. Before 1990 many donors funded CRTs with mortgaged property without a peep from the IRS.

Funding CRTS with tangible personal property. IRS privately ruled that no *income* tax charitable deduction was allowable when a CRT was funded with a violin—tangible personal property—because the donor retained an income interest in the property. But when the trust sells the asset, a deduction would be available—although limited to the remainder value element of the basis because of the "unrelated" use wrinkle. *Letter Ruling 9452026.* Will there be a *gift* tax charitable deduction for the value of the charitable remainder when the property is transferred to the trust? Donor didn't ask, so IRS didn't rule.

CRAT "5% probability test." A CRAT doesn't qualify for a charitable deduction (and by implication isn't a qualified trust) unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If there's more than a 5% probability that the noncharitable income beneficiary will survive the exhaustion of the trust assets, that probability isn't negligible. *Rev. Rul. 77-374,* 1977-2 CB 329. The Tax Court upheld the "5% probability test" in *Moor,* 43 TCM 1530 (1982). However, the court also held that the test is satisfied as long as the trust's annual earnings can be reasonably anticipated to exceed the required annual payout to the beneficiary. Suppose a donor creates an inter vivos two-life CRAT that pays the donor for life, then his sister for life and it passes the 5% probability test. So the donor is entitled to an income tax charitable deduction. But because of a new interest assumption every month for computing the value of the charitable deduction, it's not certain that the trust will pass the 5% probability test on the donor's death. That puts a shadow over the estate tax charitable deduction. **Caution.** It's possible to pass the 10% minimum remainder interest requirement (below) by a mile, but nevertheless flunk the 5% probability test.

XVII. REMINDER—CRUTS AND CRATS MUST MEET 10% MINIMUM REMAINDER INTEREST (10% MRI) AND 50% MAXIMUM ANNUAL PAYOUT (50% MAP) REQUIREMENTS

Consequences of noncompliance. Failure to meet either of the requirements means loss of otherwise allowable income, gift and estate tax charitable deductions. Also, the trusts won't be CRATs or CRUTs. Thus sales of appreciated property by those trusts will be taxable to the donors or the trusts. Sales of appreciated property by qualified CRATs and CRUTs are generally not taxed to the trusts and are taxed to the beneficiaries only to the extent deemed distributed under tier two of the four-tier taxation rules. Correcting a mucked-up trust won't always be possible, and some questions remain unanswered. Marital deductions are also lost.

Valuing CRAT and CRUT remainder interests. The value is to be "determined under section 7520." That section provides for valuing both charitable and noncharitable split-interest trusts and other arrangements. Those interests are determined under tables prescribed by the Treasury using an interest rate (rounded to the nearest 2/10ths of one percent) equal to 120% of the Federal midterm rate in effect under IRC §1274(d)(1) for the month in which the valuation date falls. The rate so determined is the applicable Federal rate (AFR). IRC §7520 goes on to provide that if an income, estate or gift tax charitable contribution [deduction], is allowed for any part of the property, the taxpayer—instead of valuing the interest for the month of the creation of the interest—may elect to use the AFR for either of the two preceding months.

Can the 10% MRI requirement be met by using the AFR for either of the two months preceding the month the CRAT or CRUT is created? Or must the valuation be made using the AFR for the month the trust is created? IRC §7520 says you can use either of the two preceding months for computing any income, estate or gift tax charitable deduction. It doesn't say you can use either of those two months for determining whether the 10% MRI requirement is met. Yet IRC §664(d)(1)(D) and IRC §664(d)(2)(D) say the values for meeting the 10% MRI requirement shall be "determined under section 7520" and those Code sections don't carve out the "either-of-the-two-preceding months" election. *Another yet:* IRC §664(d)(2)(D) provides: "with respect to each contribution of property to the trust, the value (determined under section 7520) of such remainder interest in such property is at least 10% of the net fair market value of such property as <u>of the date such property is contributed to the trust.</u>" [emphasis supplied]

A splendid argument can be made that for purposes of meeting the 10% MRI requirement, the remainder can be valued using the AFR for either of the two preceding months or the month of the transfer. But do you want to have to make that argument to the IRS—or to a court?

Short deadline for reforming or amending to satisfy the 10% MRI requirement. A "proceeding" must be commenced within the period required in IRC §2055(e)(3)(C)(iii). That section provides that a proceeding must begin within 90 days after the filing date (including extensions) of the estate tax return. IRC §2055(e)(3)(C)(iii)(I). If no estate tax return is required (the estate isn't large enough to require the filing of a return, or the trust is created during the donor's lifetime), reformation must begin within 90 days after the due date (including extensions) for the trust's first income tax return. IRC §2055 (e)(3)(C)(iii)(II). Does a "proceeding" mean a court reformation exclusively or can the trustee correct by "amendment or otherwise" without going to court? The statute isn't clear.

Consequence of declaring a trust void *ab initio*. No deduction will be allowed for any transfer to the trust and any transactions entered into by the trust before being declared void will be treated as entered into by the donor. IRC §2055(e)(3)(J).

XVIII. REFORMING DEFECTIVE SPLIT-INTEREST GIFTS

A. Many faulty split-interest charitable gifts can be reformed to obtain tax benefits. But for some faulty governing instruments, a judicial reformation proceeding must be begun by a close deadline (and for some, the deadline may already have passed). If an arrangement is tax-defective, determine which deadline for reformation applies. Even if the deadline for reformation is not close, reform the trust as soon as possible to keep potential interest costs down.

B. **Charitable remainder trust: intention-to-comply rule.** The trust smells like a unitrust or annuity trust (it pays a fixed percentage of fair market value or pays specified dollar amounts), but is defective because it has incorrect or missing governing instrument provisions. This trust can be reformed to obtain tax benefits.

No deadline is imposed for reforming these trusts, but do so as soon as possible in case IRS maintains that the trust does not pay specified dollar amounts or a fixed percentage of fair market value. In that case, you must meet the 90-day rule (see below).

Caution. The Committee reports state that a trust does **not** evidence an attempt to comply with TRA '69 "if governing instrument provides for powers of invasion for a noncharitable beneficiary of any sort."

C. **Charitable remainder trust: no-intention-to-comply rule.** The draftsperson never heard of TRA '69 (trust does not pay beneficiary a fixed percentage of fair market value or specified dollar amounts), but the trust does meet the pre-TRA '69 requirements. The trust pays income to the beneficiary, with remainder to charity. This would have been a qualified trust had TRA '69 not been enacted; it can be reformed to qualify for tax benefits, but there is a deadline. Reformation must begin within 90 days after the filing date (including extensions) of the estate tax return. If no estate tax return is required (estate is not large enough to require filing of return, or the trust is created during the donor's lifetime), reformation must begin within 90 days after the due date (with extensions) for the trust's first income tax return. Under a special rule, a trust meeting the requirements of pre-TRA '69 law is exempt from the 90-day rule if the trust is in a will executed before January 1, 1979, or is in an inter vivos trust created before that date.

D. **A scrivener's error.**

When all else fails, a scrivener's (drafter's) error—if IRS and a state court are convinced that the lawyer is the culprit—may be a way to save an otherwise non-reformable charitable remainder trust. See *Letter Rulings 200002029, 199923013, 9833008, 9833010*, and *9804036.*

XIX. CHARITABLE REMAINDER TRUST—DRAFTING CHECKLIST

1. Understand the meaning of every provision.

2. Spousal right of election: IRS has withdrawn Rev. Proc. 2005-24. It provided that unless its requirements were met, inter vivos charitable remainder unitrusts and annuity trusts will be disqualified—retroactively to the date of creation—if a spousal right of election now exists under state law, exists in the future, exists if the grantor (donor) of a CRUT or CRAT moves, marries or remarries. IRS may issue a new revenue procedure on this topic. So keep an eye out for it.

3. Double check that the trust contains all the required governing instrument provisions.

4. A specimen—no matter how good—is lousy if it doesn't cover or isn't amended to cover the client's situation.

5. Yesterday's form—no matter how good—is terrible if it doesn't take today's changes in the law into account.

6. Charitable remainder trusts must, of course, comply with the federal tax laws. But state laws must also be taken into account.

7. The trust should reflect how the funding assets are owned—separate property, joint property, tenancy by the entirety, tenancy in common, community property.

8. Has the trust been drawn to avoid gift taxes (when possible) on an income beneficiary's life interest?

9. Confirm that the spouses are American citizens. If they aren't, take the special rules that apply to alien spouses into account. (There's a difference between an alien spouse and an alienated spouse. The latter may well be a U.S. citizen.)

10. IRS in 2003 issued specimen charitable remainder annuity trusts that are excellent. See Rev. Proc. 2003-53 through Rev. Proc. 2003-60 and in 2005 issued excellent specimen charitable remainder unitrusts. See Rev. Proc. 2005-52 through Rev. Proc. 2005-59. Of course, one size doesn't fit all. IRS recognized that with ample annotations to many of the provisions and furnished alternate provisions. So use the IRS specimens as your guide. But make sure to read the annotations and in many cases you'll want to mix and match and make your own modifications.

11. No matter how skillfully the trust is drawn, make sure that CRUTs and CRATs pass the 5% minimum payout requirement, the maximum 50% payout requirement, the 10% minimum remainder interest requirement and for CRATs, the 5% probability test of Rev. Rul. 77-374.

12. Make sure the trust has an appropriate trustee—e.g., an independent trustee for hard-to-value assets in a unitrust (or provide for a qualified appraiser) and for a sprinkling trust.

13. Make sure the payments are made and are timely lest you run afoul of the rule that requires that a CRT not only meet the Code's requirements, but also be administered according to its terms. In *Atkinson,* 309 F.3d 1290 (CA-11, 2002) the U.S. Court of Appeals for the Eleventh Circuit held that an inter vivos charitable remainder annuity trust's failure may result in complete loss of the estate tax charitable deduction (there were four survivor beneficiaries). And that's so even though substantial sums would go to charity. The loss of the charitable deduction cost the estate $2,654,976. U.S. Supreme Court denied cert., 540 U.S. 946 (2003).

14. The trust should meet state law investment requirements—e.g., prudent investor rules. See: *Americans for the Arts, The Poetry Foundation, and Lilly Endowment, Inc. v. Ruth Lilly Charitable Remainder Annuity Trust #1 National City Bank of Indiana, Trustee, and Ruth Lilly Charitable Remainder Annuity Trust #2, National City Bank of Indiana, Trustee,* 855 N.E. 2d 592 (Ct. App. Ind. 2006). See also: *Fifth Third Bank and Elizabeth Gamble Reagan v. Firstar Bank, N.A. Ohio App.1 Dist., 2006.* See also: *Estate of Rowe*, N.Y. App. Div. (3rd Dept), 712 NYS2d 662 involving a charitable lead trust.

15. Check whether there is a patent or patent application on a tax strategy plan involving the contemplated CRT.

16. Don't fund the trust with Sub S Corp stock. Doing so will kill the S election.

17. Check if there are any SEC restrictions on transferring securities.

18. If life-insurance-wealth-replacement is part of the plan, make sure that the insurance is obtained before signing and funding the charitable remainder trust.

19. Is a right retained to substitute public charities for named private foundation remainder organizations? That can avoid self-dealing concerns on terminating a CRT and dividing the assets between the income beneficiary and the charitable remainder organization. Also can enable client to get a larger charitable deduction on the contribution of the existing life interest to the charitable remainder organization.

20. Finally, trust no one. If your mother tells you she loves you—check it out.

XX. CHARITABLE GIFT ANNUITIES — IN THE VERY BEGINNING

A. Donative intent. Read no further if you believe that a donor will create a gift annuity solely because of the tax and financial benefits. But if the donor believes in the charity's cause, then a gift annuity might be the appropriate way to make a gift. If the donor does not need income for himself or herself and does not wish to provide income for another individual, an outright gift is generally the most appropriate.

B. What is a gift annuity? Very generally, a gift annuity is a contract whereby a donor irrevocably transfers money or property to a qualified organization in return for its promise to pay the donor, another individual or both, fixed and guaranteed payments for life. The value of the consideration paid by the donor to the charity exceeds the actuarial value of the payments made by the charity to the annuitant. Payments may begin immediately under an immediate charitable gift annuity ("CGA") or may be deferred until a future time – more than one (1) year from the gift ("deferred payment gift annuity" or "DPGA") or at such time as chosen by the annuitant ("flexible deferred payment gift annuity" or "Flex-DPGA"). In essence, the transfer is part charitable gift and part purchase of an annuity.

The transferred assets become a part of the charity's general assets and the annuity payments are backed by all of the charity's assets – not just the transferred property. This is an important distinction between gift annuities and other planned giving methods such as charitable remainder trusts ("CRT"s) or pooled income funds where the obligation to make payments is limited to the assets in a particular trust or segregated fund.

C. Why a gift annuity? – A donor's perspective. Of all planned giving arrangements, gift annuities are probably the simplest and most commonly used. A typical gift annuity agreement is fairly short and easy to understand, making even novice donors comfortable with the arrangement. Under a gift annuity agreement, the donor or other annuitant receives a guaranteed income stream for life. Upon the death of the annuitant, any remaining property (the "residuum") is applied by the charity for the charity's general use unless a specific purpose is called for in the agreement.

The donor, as an itemizer, is entitled to a current income tax charitable deduction and, in cases involving gifts of appreciated property, reduced capital gains taxation. Unlike other types of planned gifts, gift annuities can be funded with difficult assets and are not subject to the private foundation self-dealing rules or penalties for unrelated business taxable income ("UBTI"). Furthermore, an inter vivos gift annuity can provide favorable taxation of life-income payments, reduce capital gains taxation on changing investments and in most cases, the capital gain can be reported ratably over the life expectancy period, and enable a donor to have the joy of giving (not possible with a bequest).

D. **Why a gift annuity? – A charity's-eye view.** From the charity's perspective, gift annuities are attractive because, unlike with other planned gifts, such as charitable remainder trusts, or bequests, the charity often gets immediate use of the gifted assets.

The charity may spend a portion of the gifted assets, so long as it meets all reserve requirements imposed by the state(s) in which the charity may be registered, or may hold the gifted assets in reserve until the death of the annuitant or, in the case of gift annuities for the benefit of more than one annuitant, the death of the surviving annuitant. Furthermore, gift annuities are also a relatively low-cost gift plan, thereby permitting the charity to market these gifts to a wide pool of potential donors.

E. **Considerations.** In determining whether a gift annuity is appropriate, consider: 1. the donor's wishes, 2. the needs and health of beneficiaries, 3. the marital status and citizenship of spouses, 4. the type of property to be contributed — securities, real estate, tangible personal property, marketability, Subchapter S stock, 5. how the property is owned — separate, joint, tenants by the entirety, tenants in common, community property, 6. the cost-basis and holding period of property, 7. the fair market value of property, 8. whether the property is subject to any mortgages, 9. any prior negotiations or contracts for sale, options,10.in the cases of stock, whether corporation is about to liquidate, merge, or make an initial public offering, 11. whether the sponsoring charity is a public charity or a private foundation, 12. for sizable gift, information about donor's (and spouse's) overall estate and financial plan, and 13. state law requirements of both the charity's state and the state in which the donor is domiciled.

XXI. MECHANICS: Creation, state regulation, taxation of payments.

A. **Creation.** Gift annuities are creatures of contract and are governed by a written agreement between the donor and the issuing charity. These agreements are typically fairly short and easy to understand.

1. **Requirements.** The agreement itself should contain several basic provisions: the identity, age and date of birth of the donor(s) and the issuing charity, the identity of the annuitant(s) and the type and fair market value of the transferred property. The agreement should specify the amount of the annual annuity payment and the timing/manner in which such payment will be made (whether annually, semi-annually, quarterly or monthly at either the beginning or end of the period). Other important provisions include a statement as to

whether the property remaining upon the termination of the annuity (the "residuum") should be used for a specific purpose or the charity's general purposes, a payment correction provision and a governing law clause. Many states also require specific disclosure statements and other provisions, so it is *crucial* to check state law before executing a gift annuity agreement. Of course, the agreement should be signed by both the donor and the charity, although some states do accept agreements without the donor's signature, provided that the donor has signed an application form. **Note:** The annuity may need to meet the requirements not only in the charity's state but also the law of the state of the donor's domicile. Some states also require that the law of the donor's state be the governing law in the agreement.

2. **Annuitant(s).** The individual(s) to whom payments are to be made is (are) referred to as the "annuitant(s)". A gift annuity agreement may be for the life of a single annuitant (a "single life gift annuity"), for the life of one annuitant followed by a successor annuitant ("two lives in succession gift annuity") or for the benefit of two annuitants during both of their lifetimes, with payments to the survivor after the death of one of the annuitants (a "joint and survivor gift annuity"). An annuity may not be for a term of years. Code §§ 501(m) and 514(c)(5).

3. **Forms of agreement.** As noted above, the gift annuity agreement may specify that annuity payments are to begin immediately with a CGA or are to be deferred until a later date with a DPGA. DPGAs may either specify a commencement date which must be more than one (1) year after the date of the gift or, with a Flex-DPGA, permit the annuitant to choose the date on which annuity payments will begin. Whatever the type, a gift annuity agreement may be for the life of a single annuitant (a "single life gift annuity"), for the life of one annuitant followed by a successor annuitant ("two lives in succession gift annuity") or for the benefit of two annuitants during both of their lifetimes, with payments to the survivor after the death of one of the annuitants (a "joint and survivor gift annuity"). These various types of agreements are discussed in more detail below.

B. **State regulation.** A number of states regulate charitable gift annuities by requiring charities issuing gift annuities to be licensed and/or to file annual reports. In addition, some states specify minimum reserves and allowable investments. Furthermore, as noted above, certain states also require specific disclosure language in gift annuity agreement. The American Council on Gift Annuities ("ACGA") provides detailed, state-by-state information regarding the applicability of licensing, reporting and disclosure requirements. This information can be accessed at www.acga-web.org.

Note: The Philanthropy Protection Act of 1995 (P.L. 104-62) exempts collective investment funds that are maintained by charities and contain assets of irrevocable charitable remainder unitrusts, charitable remainder annuity trusts, charitable lead trusts and charitable gift annuities from registration with the Securities and Exchange Commission. It does, however, require certain disclosures to donors that may be useful in determining whether to make a gift. And the Act doesn't provide complete exemptions for charities maintaining collective funds that include the assets of revocable charitable remainder trusts.

C. Federal Appeals Court in egregious case holds that gift annuities are securities

- Philanthropy Protection Act inapplicable
- Marketing of legitimate gift annuities now under microscope
- Obvious lesson — don't pay commissions
- Other lessons — crucial to emphasize the charitable gift, avoid terms such as yields and returns; don't compare with stocks, bonds and CDs

"Not only did Robert Dillie promise his investors 'a gift for your lifetime and beyond,' he pledged 'preservation of the American way of life,' 'preservation of your assets,' and 'preservation of the American family.' Unless Dillie meant to refer to the way of life perfected by the Boston swindler Charles Ponzi and his family, we can safely say that Dillie's claims were a bit overstated." So begins U.S. Circuit Court of Appeals Judge Sidney R. Thomas's opinion affirming the district court's holding that the Dillie-controlled Mid-America Foundation's gift annuity contracts were investment contracts under federal securities law.

The facts. Mid-America Foundation from 1996 until 2001 sold charitable gift annuities through financial planners, insurance agents, and others. They all received commissions.

The Foundation's marketing literature assured investors that they would receive a lifetime stream of income, with the money remaining at their death directed to a charity designated by the investor. The promotion was initially an enormous success for Dillie; the return for the investors was not. The Foundation raised $55 million from the sale of more than 400 charitable gift annuities. The business model was simply a Ponzi scheme in which, rather than investing the investors' funds, the Foundation used their funds to make annuity payments to earlier annuitants, commission payments to facilitators, and payments to Dillie and others for personal expenses (including Dillie's gambling expenses). Although it collected millions in investments, the Foundation quickly became insolvent. With a few minor exceptions, no charitable contributions were ever made, and the scheme collapsed in 2001.

Shortly after the collapse, the Securities and Exchange Commission filed a civil complaint against Dillie. He was subsequently indicted, ultimately pled guilty to wire fraud and money laundering, and was sentenced to 121 months in prison.

Observation. Madoff got 150 years for his $55 billion swindle; Dillie got 121 months for his $55 million scheme. You do the arithmetic.

The narrow effect of the circuit court's decision. The sales people are required to return their commissions to the receiver who was appointed to recover any remaining funds to make some payments to the defrauded and hapless donors.

The broad effect of the court's decision is that all annuity programs are now under the microscope. The circuit court didn't base its decision on the Philanthropy Protection Act's prohibition of paying commissions, but took pains to show that the annuities were promoted as investments.

Charitable organizations and their advisers should review gift annuity marketing materials in light of this case. Here's how the court described some of the Foundation's marketing materials:

> Our review of the record in this case demonstrates that the Foundation marketed its gift annuities as investments, and not merely as vehicles for philanthropy. One promotional brochure entitled "Maximizer Gift Annuity: A Gift that Offers Lifetime Income . . . and Beyond" states, under the heading "Attractive Returns," that "[y]our annuity payment is determined by your age and the amount you deposit. The older you are, the more you'll receive." The brochure goes on to list the "current average net-yield" rates. Elsewhere, under a heading titled "A Gift that Gives to the Donors," the brochure states:
>
>> To get this same return through the stock market, [the hypothetical investor] would have had to find investments that pay dividends of 19.3%! (Even the most profitable companies rarely pay dividends of more than 5%.) The rate of return on a Mid-America Foundation "Gift Annuity" is hard to beat!
>
> The brochure also includes a chart comparing the benefits of a $200,000 commercial annuity with a $200,000 charitable gift annuity, indicating the superiority of the charitable gift annuity in such categories as annuity rate, annual income, income tax savings, federal estate tax savings, and "partial bypass capital gains." Although the brochure also notes that the investor will "make a difference" through the purchase of the gift annuity, the brochure as a whole

emphasizes the income generation and tax savings aspect of the charitable gift annuity. Indeed, a bullet point summary of the advantages of the Foundation's charitable gift annuities states: "High Rates; Tax Free Income; Capital Gains Tax Savings; Current Tax Savings; Estate Tax Free; Safe; Secure; Simple; Flexible; PAYS YOU NOW!!! HELPS YOU MAKE A DIFFERENCE LATER."

Another brochure entitled "The Charitable Gift Annuity: Preserving Your Family Legacy . . . Now and For Generations to Come" places emphasis on the opportunity for the investor to designate family members as secondary annuitants under the scheme, noting that "[y]ou can easily include your spouse, children, or grandchildren to receive these lifetime benefits." This brochure also emphasizes the stability and security of charitable gift annuities, noting that "[a] gift annuity is one of the OLDEST and SAFEST financial instruments available." On the whole, this brochure pitches charitable gift annuities to an investor whose main concern is to provide a steady stream of income to dependents after he or she is gone. The brochure's emphasis is on the long-term income production potential of the charitable gift annuity. The fact that some purchasers may have been attracted to the gift annuities in part by the Foundation's promise to donate funds remaining after the annuitants' life to a designated charity does not alter the outcome. See Forman, 421 U.S. at 853 n.17 (suggesting that existence of collateral non-investment motive does not shield transaction from securities laws). In sum, when the promotional materials are examined, the investment component of the annuity is evident.

The court of appeals holds. ". . . [W]e affirm the judgment of the district court. The charitable gift annuities sold by Defendants on behalf of the Foundation were investment contracts, and hence securities for purposes of federal and state securities laws. Defendants were not exempt from registration as securities brokers under the terms of the Philanthropy Act. Because the charitable gift annuities were securities, the district court had personal jurisdiction over the non-resident Defendants."

Warfield v. Alaniz, 569 F.3d 1015 (9th Cir. 2009)

Guidance from the American Council on Gift Annuities: "Two important points may be derived by charities and gift planners from this case. First, in case there was still any doubt in anyone's mind, charities should not offer or pay commissions to anyone (employees or independent third parties like financial planners) for solicitation of gift annuities. Second, CGA marketing materials should emphasize the philanthropic, rather than the investment, objectives of this gift vehicle. Of course, it's OK to talk about payments to the annuitant, and to express those payments as a percentage of the amount transferred to the charity. But we should avoid referring to those percentages as 'yields' or 'returns', or comparing CGAs to investments like stocks, bonds and certificates of deposit."

ACGA Online, 9/3/09

D. Annuity payments.

1. **Payments measured by one life.** Annuity payments under a gift annuity agreement must be measured by the lifetime of one or more individuals. See Code §501(m)(5) which defines the term "charitable gift annuity" as an annuity "if (A) a portion of the amount paid in connection with the issuance of the annuity is allowable as a deduction under section 170 or 2055, and (B) the annuity is described in section 514(c)(5)(determined as if any amount paid in cash in connection with such issuance were property). Code §514(c)(5)(B) specifically requires that the annuity be payable over the life of one individual or the lives of two individuals in being at the time the annuity was issued. Gift annuities may not be created for a term of years.

2. **Payment amount.** The amount of the annual payment—which can also be paid in monthly, quarterly or semi-annual installments—is fixed at the outset and never varies. As with a commercial annuity: (1) the older the annuitant at the annuity starting date, the larger the annual payments; (2) when there are two annuitants, the annual payments are smaller than if there is one annuitant; and (3) a portion of each annuity payment is excludable from gross income for the period of the annuitant's life expectancy. The excludable (tax-free) amount is established at the annuity starting date.

3. **The annuity payout rates.** Annuity payment rates are decided by the charity. Most charities calculate the annuity payments based on the recommended rates published by the ACGA. For the rates currently recommended by ACGA for both immediate and deferred payment gift annuities, go to its website: www.acga-web.org. Any state law requirements must be met. The rates, whether determined independently by the charity, or by following the ACGA's published rates, are the same for males and females and are based on the following factors: a) number and age of the annuitant(s); b) expenses; c) estimated annual return; and d) assumed residuum (the amount remaining for the charity after the death of all of the annuitants). The ACGA's recommended rates are based upon an assumed residuum of 50% of the property initially transferred.

   Note: A 1995 lawsuit charged that charities issuing gift annuities were conspiring to fix rates in violation of federal antitrust and securities law. **The Charitable Gift Annuity Antitrust Relief Act of 1995 (P.L. 104-63)** was enacted so as to specifically permit two or more charities to use or agree to use the same annuity rate for the purpose of issuing charitable gift annuities (subject to each state's right to enact statutes electing not to have their antitrust laws preempted by the Act). **The Philanthropy Protection Act of 1995 (P.L. 104-62)** and **The Charitable Donation Antitrust Immunity Act of 1997 (P.L. 105-26)** were also enacted in the wake of the lawsuit.

E. **Comparison with annuity trusts. Gift annuities differ from charitable remainder annuity trusts in several respects.** An annuity trust's payments are made only as long as the trust has sufficient assets while payments under a gift annuity agreement are backed by all of the charity's assets. Further, the capital gain implications, the way rates are set, and the taxation of the annual payments also differ. Among other differences, the self-dealing and jeopardy investment prohibitions don't apply to CGA's mortgaged property and S corp stock can be used to fund a CGA–but even though allowed it may not be wise. **Note:** If a donor contributes assets to charity in return for annual income based on the earnings on the donated assets, the arrangement is treated as a trust—not an annuity—and donor will be fully taxed on the trust's income. *Letter Ruling 8223014.*

XXII. INCOME TAX RULES

A. **Income tax considerations for the donor.** A donor considering a gift annuity, whether an immediate CGA, a DPGA or a Flex-DPGA, should be advised of the following income tax considerations:

1. **Income tax charitable deduction.** The donor is entitled to an immediate income, gift and/or estate tax charitable deduction for the charitable contribution, calculated as the difference between the amount money (or the fair market value of long-term securities or real estate transferred) and the present value of the annuity. Reg. §1.170A-1(d), 20.2055-2(f) and 25.2522(c)-3(d).The present value of the annuity is based upon the life expectancy(ies) of the annuitant(s), the frequency of payments and timing of payments and the 7520 rate in effect at the time the gift annuity is entered into. The tables used to value the income interest in a charitable remainder annuity trust are also used to calculate the actuarial value of charitable gift annuities (investment in the contract); the tables are in IRS Publication 1457. The income tax charitable deduction is subject to the usual limitations on deductibility of charitable gifts.

2. **Caveat:** If there is a requirement that charity reinsure its obligation to pay the annuity, the deduction will be based on the difference

between the amount transferred and the (current) cost of commercial annuity policy. Arguably, the favorable "ratably" rule (discussed below) won't apply even if the donor is a beneficiary. *Letter Ruling 8322068.*

B. Capital gains tax implications.

1. **Bargain sale.** The transfer of appreciated property in exchange for a gift annuity is deemed to be a bargain sale under Reg. §1.1011-2(a)(4). As a result, the donor may recognize capital gain upon entering into a gift annuity agreement. Generally speaking, any gain recognized on the transfer is taxable to the donor at the time of transfer either as long-term or short-term capital gain (depending on the kind of property transferred and the donor's holding period). However, in certain situations, the capital gain may be reported ratably over the lifetime of the annuitant(s). In computing the amount of the gain, the cost basis of the transferred property must be allocated between the gift portion and the actuarial value of the gift annuity. The amount of gain is the difference between the value of the CGA and the cost basis allocated to the value of the gift annuity. Reg. §1.1011-2(a)(4), -2 (c) Example 8.

2. **The "ratably" rule.** The gain determined under the bargain sale rules is reportable by the donor-annuitant ratably over her life expectancy if: (1) the annuity is nonassignable; and (2) the donor is the sole annuitant or is one of the annuitants in a two-life annuity. Reg. §1.1011-2(a)(4). If the donor-annuitant dies before all of the gain has been reported, the remaining gain is buried with her—and is not reportable. When the donor is the first annuitant in a two-life annuity funded with her separate property, the gain is reported ratably over her life expectancy and not the joint life expectancy of the two annuitants. For annuities funded with joint or community property, the capital gain is reported ratably over the joint life expectancy of the two annuitants.

   Pointer: For annuities for spouses, convert separate property to joint property <u>before</u> funding. That should not be subject to the gift tax because of the unlimited gift tax marital deduction for gifts to U.S. citizen spouses. For non-U.S. citizen spouses, the annual gift tax exclusion of $133,000 (in 2009) could offset the gift. And the gain will then be reportable ratably over two lives (instead of one life).

   Note: The instructions to Form 1099-R tell charities to report taxable and nontaxable amounts—*as well as any capital gain.* The instructions say: "If cash or capital gain property is donated in exchange for a CGA, report distributions from the annuity on Form 1099-R." "Report in box 3 any amount taxable as capital gain. Report in box 1 the total amount distributed during the year. Report in box 2a the taxable amount. Advise the annuity recipient of any amount subject to the 28% rate gain for collectibles and any unrecaptured section 1250 gain. Report in box 5 any nontaxable amount. Enter F in box 7 the Code F. See Regulations §1.1011-2(c), Example 8."

C. **Income taxation of annuity payments to the annuitant.** Since the value of the consideration paid by the donor exceeds the present value of the annuity payments under the agreement, a portion of each annuity payment is treated as a return of principal and is excludable (tax-free) for the period of the annuitant's life expectancy under Code §72. The percentage (called the "exclusion ratio") is determined when the annuity is created and remains constant. Reg. §1.72-4 *et seq*.

1. **Computation of the exclusion ratio.** The exclusion ratio is computed by dividing the investment in the contract (the actuarial value of the gift annuity – i.e., non-charitable portion of the amount transferred to the charity) by the "expected return" (annual annuity multiplied by the annuitant's life expectancy). Reg. §§1.72-4 and 1.72-5(a). The actuarial value of the annuity and the expected return are computed using the Treasury tables under Reg. §1.72-9. The exclusion ratio multiplied by the annual payment gives the amount excludable. The difference between the payment and the excludable amount is taxable.

2. **"Exclusion ratio" wrinkle—the way it was.** Under prior law, the ratio was based on the annuitant's life expectancy. The annuitant continued to exclude a portion of each payment even if he or she outlived the life expectancy, thus recovering more than all the "investment in the contract." If the annuitant died before his or her life expectancy expired, no deduction or exclusion was allowed for the unrecovered investment in the contract.

3. **Effective for annuities with "starting dates" after 1986,** an annuitant who outlives his or her life expectancy may not exclude a portion of each payment. Code §72(b)(3). But the hapless annuitant who predeceases his or her life expectancy gets a deduction for the unrecovered investment on his or her last income tax return. This deduction is not subject to the 2% miscellaneous itemized deduction rule. Code §72(b)(3).

   Alert: Often overlooked, Code §72(b)(3)(C) states that for purposes of Code §172 (dealing with net operating loss deductions), a deduction allowed under §72(b)(3) will be deemed attributable to a trade or business of the taxpayer. Thus, it appears that any part of the unrecovered investment in the contract not deductible on the final income tax return should qualify to be carried back to the 2 years preceding the year of the loss. Code §172(b)(1)(A).

Note: Unless the agreement provides for payments to be made at the beginning of the (annual, semi-annual, quarterly, monthly) period, the "starting date" is generally the date that the agreement is signed and money or assets are transferred to the charity. Code §72(c)(4). So annuities purchased in 1986 might not be subject to the changed rule even though they made first payments in 1987. Admittedly, this will be rare but it is good to know about because rare cases could come up and you could be a hero.

XXIII. GIFT TAX ISSUES

A. **Overview.** The creation of a gift annuity involves one or more gifts: first, the gift to the charity and second, in the case of an annuity created for another individual, a taxable gift to that annuitant. If the donor is the only annuitant, there are no gift tax consequences apart from the charitable gift.

B. **Gift to charity eligible for the gift tax charitable deduction.** The gift to the charity first qualifies for the gift tax annual exclusion ($13,000 in 2011). The balance of the gift to charity qualifies for the unlimited gift tax charitable deduction.

Note: The provision exempting charitable gifts from reporting requirements does not apply to gift annuities or other split-interest gifts, so be *certain* to file a gift tax return if the charitable gift exceeds the applicable annual exclusion amount. Code §6019(a)(3).

C. **Taxable gift to annuitant.** If the donor creates a gift annuity for the benefit of another individual, he or she will have made a taxable gift to the annuitant. With a CGA (requiring immediate payments), the gift to the annuitant constitutes a present interest and will qualify for the gift tax annual exclusion. Code §2503(c), *Letter Rulings 8721023* and *8637084*. Depending upon the relationship of the annuitant to the donor, one or more options may be available to mitigate any tax due on the gift.

1. **Right of revocation.** In a one-life gift annuity providing for an annuity to another, some commentators advocate retaining a right to revoke the non-donor annuitant's interest so as to avoid making completed gift. While this sounds simple enough, there are a few issues to consider:

a) **Gift tax issues.** The retention of the right to revoke the annuitant's annuity interest, exercisable by the donor either during the donor's lifetime or at death, will cause the gift of the annuity interest to be an *incomplete* gift for gift tax purposes. Reg § 25.2511-2(c). Accordingly, the donor will not be required to report the value of the annuitant's annuity interest as a taxable gift at the time the charitable gift annuity is created. Rather, the donor will be deemed to have made a taxable gift to the annuitant in each year that the donor does not exercise his right of revocation. The receipt of the annuity payment by the annuitant will operate to "free" the property from the exercise of the donor's reserved power and will constitute a gift of the payment during the calendar year. Reg. §25.2511-2(f). Accordingly, the receipt of the annuity payment by the annuitant in each year will be deemed a present interest gift and will qualify for the gift tax annual exclusion. The donor must, however, report the value of the annuity interest to the extent that it exceeds the annual exclusion amount. No gift tax will be payable if the gift is offset by the donor's $5 million unified gift and estate tax exemption.

If the donor's right of revocation is only a testamentary right, it is arguable that the donor may have made a completed gift at the outset to the annuitant of the right to receive annuity payments measured by the donor's lifetime. While there is no authority on this point, watch your step.

b) **Estate tax issues.** The retention of the right to revoke the annuitant's annuity interest may cause a portion of the amount transferred for the charitable gift annuity to be included in the donor's gross estate. The determination of the estate tax implications of the reserved right of revocation depends upon the order of death and whether the donor exercised or did not exercise the right of revocation.

If the donor predeceases the annuitant and *does not* exercise the right of revocation, the present value of the annuitant's future annuity payments (calculated from the donor's date of death through the annuitant's assumed life expectancy) will be includable in the donor's gross estate. Code §2038. If the donor predeceases the annuitant and *does* exercise the right of revocation, nothing would be includable in the donor's gross estate. If the annuitant predeceases the donor, no portion of the gift annuity would be includable in either the donor's or the annuitant's gross estate.

c) **Income tax issues.** Ordinarily, the annuitant must include the value of the annuity payments received in his or her gross income and the donor will not be subject to tax on the annuity payments. Code §72(a). However, it appears that where the donor retains the right to revoke the annuitant's interest, there is the possibility that the annuity payments *would* be taxable to the donor. The concern is that the Service might apply the grantor trust rules, specifically Code §674, to charitable gift annuities. Under Code §674, a grantor will be taxable on income earned by a trust over which the grantor has retained the right to control the beneficial enjoyment of the trust. A power to terminate a beneficiary's interest is a power that causes the grantor of a trust to be treated as the "owner" of the trust for income tax purposes.

d) **Issue for the charity.** If you are representing the charity, be aware that, particularly in the case of a one-life gift annuity for the benefit of another individual, the donor's retention of a right of revocation might cause the gift annuity to run afoul of Code §§ 514(c)(5)(b)(requiring that the annuity be payable over the lifetime of one or more individuals) and 501(m). The IRS has not ruled on this issue but watch your step.

2. **Gift tax marital deduction.** Gift annuities for the benefit of a U.S. citizen spouse automatically qualify for the unlimited gift tax marital deduction. Gift annuities for the benefit of a non-U.S. citizen spouse may qualify for the $136,000 annual exclusion for gifts to non-U.S. citizen spouses or the $13,000 gift tax annual exclusion (for gifts made in 2011).

3. **Gift tax annual exclusion.** To the extent that a donor of an immediate CGA makes a taxable gift, the annuitant's interest will qualify for the gift tax annual exclusion.

D. Specific examples of gift tax implications of gift annuities.

1. **One-life annuity for donor.** The value of the charitable gift element of a gift annuity is deemed a present interest. However, the donor must report the gift on a federal gift tax return if it exceeds the annual gift tax exclusion. The donor then takes an offsetting gift tax charitable deduction. Code §2522(a).

2. **One-life gift annuity for annuitant other than donor.** A donor who creates a CGA calling for payments to another (*e.g.,* a spouse or sibling) makes two gifts: one to the annuitant (the actuarial value of

the annuity) and one to the charity (the gift element). The charity's gift is a present interest gift and is reportable if it exceeds the annual gift tax exclusion. The balance is then deductible as a charitable gift—resulting in a wash.

a) **Annuitant's interest when annuitant is not the donor's spouse**. The gift to the annuitant qualifies for the annual gift tax exclusion. If it exceeds the amount of the exclusion and the "tentative" tax on the gift is not offset by the $5,000,000 unified gift and estate gift tax exemption (as of January 1, 2011), gift tax will be due.

b) **Annuitant's interest when annuitant is the donor's U.S. citizen spouse.** One-life gift annuities when a U.S. citizen spouse is the annuitant automatically qualify for the unlimited gift tax QTIP marital deduction. You have to "elect out" if you don't want it. The election not to take the marital deduction is made by attaching a statement to the return for the first taxable year for which the election is to be effective. The statement must: (1) contain the name, address and TIN of the electing taxpayer; (2) identify the election; (3) indicate the section of the Internal Revenue Code under which the election is made; (4) specify the period for which the election is being made and the items to which it applies; and (5) provide any information requested in applicable forms and instructions.

If donor's spouse is a non-U.S. citizen, the gift can qualify for the $136,000 (in 2011) per-year gift tax exclusion. But it would have to meet the "present interest" requirement of the annual gift tax exclusion.

3. **Two-life gift annuity funded with donor's separate property when donor is first annuitant.** A donor who uses her own separate property to create a CGA that pays an annuity to her for life and then to a survivor annuitant makes two gifts: one to the charity (which is reportable if it exceeds the annual exclusion, and then deductible—resulting in a wash), and one to the survivor annuitant (right to receive annuity payments if she survives the donor). No annual gift tax exclusion for the gift to the survivor beneficiary because the gift is a future interest. Code §2503(b). For the same reason, there's no gift tax marital deduction. Code §2523(b); Reg. §25.2523(b)-1(c). A non-U.S. citizen spouse's future interest in a CGA does not qualify for $136,000 (in 2011) annual gift tax marital exclusion because it's a future interest. It would be preferable to create separate annuity for non-U.S. citizen spouse.

Pointer: The donor can avoid making a gift to the survivor annuitant by providing in the CGA agreement that the donor retains the right to revoke the survivor's life interest. Should the donor exercise that right, the payments won't terminate on the death of the survivor of the donor and the second beneficiary, but on the donor's death. The donor need not actually exercise the right; merely retaining the right avoids the donor's making a completed taxable gift to the survivor annuitant. Unlike charitable remainder trusts, a gift annuity donor can revoke during life, by will or both. Reg. §25.2511-2(c).

4. **Two-life gift annuity funded with joint property or tenancy in common property when donors are annuitants but not spouses.** The actuarially older annuitant makes a gift to the actuarially younger annuitant of the difference in their survivorship interests. To avoid adverse gift tax implications, each annuitant should reserve the right to revoke the other annuitant's interest. If that right were exercised, the charity would only have to pay half of the payments to the survivor annuitant for his or her life. The gift to the charity—the gift element—is a present interest gift and is reportable if it exceeds the annual gift tax exclusion. The balance is then deductible as a charitable gift—again, resulting in a wash.

5. **Two-life gift annuity funded with joint property, tenancy in common property or community property when donors are spouses and the annuitants and payments are made to them jointly and then to the survivor.** U.S. citizen-spouses' interests qualify for QTIP marital deductions. Alternatively, each spouse can—in the gift annuity agreement—reserve the power to revoke the survivor's interest in the payments from his or her half share of the joint or community property. Joint and survivor annuities automatically qualify for the unlimited gift tax QTIP marital deduction. You have to "elect out" if you don't want it. The election not to take the marital deduction is made by attaching a statement to the return for the first taxable year for which the election is to be effective. The statement must: (1) contain the name, address and TIN of the electing taxpayer; (2) identify the election; (3) indicate the section of the Internal Revenue Code under which the election is made; (4) specify the period for which the election is being made and the items to which it applies; and (5) provide any information requested in applicable forms and instructions.

Caution. It's not clear that the automatic QTIP marital deduction applies to gift annuities that make *consecutive* payments—first to one spouse and then to the survivor for life—as opposed to paying the spouses *jointly* for life and then to the survivor for life. Presumably a timely QTIP election could be made. But to be safe, the donors should reserve the right to terminate the surviving spouse's annuity. Unlike charitable remainder unitrusts, annuity trusts and pooled income fund gifts where the right to revoke can only be by will, the gift annuity donor can keep the right to revoke during life, by will, or both. It is also unclear whether joint and survivor gift annuity can qualify for the $136,000 (in 2011) per-year gift tax exclusion for non-U.S. citizen spouses (discussed above).

XXIV. ESTATE TAX CONSIDERATIONS

A. **Overview.** The donor of either an inter vivos gift annuity or a testamentary gift annuity should also consider potential estate tax inclusion issues. Whether an inter vivos gift annuity is includable in a donor's gross estate depends upon the number of annuitants, the relationship of the annuitants to the donor and whether the donor, at the time of his or her death, retained the right to revoke any annuitant's interest to receive payments.

B. **Specific examples of estate tax treatment of gift annuities.**

1. **Donor is the sole annuitant of an inter vivos CGA.** For a single life annuity making payments to a donor-annuitant, no amount is included in his or her gross estate.

2. **CGA for annuitant(s) other than donor.** For an annuity providing payments to an annuitant or annuitants other than the donor, no amount is included in the donor's gross estate.

3. **Two-life inter vivos CGA funded with donor's separate property with payments to donor for life and then to a survivor annuitant for life.**

a) If the survivor annuitant does not survive the donor, no amount is includable in the donor's gross estate.

b) If the survivor annuitant does survive the donor, includable in the donor's gross estate is the value of an annuity paying the same amount to the survivor annuitant (at the survivor's age at the donor's death) as the donor received during his life: i.e., what it would cost to purchase a comparable annuity from a commercial insurance company. Code §2039(b).

c) **Survivor annuitant is donor's U.S. citizen spouse.** The gift to the survivor qualifies for the estate tax marital deduction for a U.S. citizen spouse to the extent it is includable in the donor's gross estate. Reg. §20.2056(b)-1(g), Example 3.

d) **Survivor annuitant is donor's non-U.S. citizen spouse.** Property bequeathed in a garden-variety qualified terminable interest property (QTIP) or general power of appointment trust to a noncitizen surviving spouse isn't eligible for the estate tax marital deduction. To get the deduction the property must pass through a qualified domestic trust (QDOT). Code §2056(b).

Any estate tax attributable to the survivor's annuity is allowed as an income tax deduction to the survivor annuitant—if the survivor itemizes deductions on her income tax return—and is claimed over the survivor's life expectancy. Code §691(c).

C. Tax issues associated with testamentary CGAs.

1. **Capital gains tax issues.** No gain should be incurred by an estate on the difference between the donor's cost basis in appreciated property used to obtain the annuity and the property's fair market value. *Reason:* the property is no longer appreciated; the estate has a stepped-up basis. However, if the estate funds the annuity with property that has appreciated after the estate tax valuation date, gain (computed under the bargain sales rules) will be incurred. In that case, the "ratably" rule wouldn't apply. IRS hasn't ruled on any of this. But be warned.

2. **Estate tax issues.** An estate tax charitable deduction is allowable for the difference between the amount transferred to the charity and the actuarial value of the CGA (computed the same way as an inter vivos CGA).

   a) For transfers to a U.S. citizen spouses, see above.

   b) For transfers to non-U.S. citizen spouses, see above.

   Caution. An estate tax charitable deduction for a CGA will not be allowed, however, if a will does not properly define the amount of the annuity to be paid. IRS will disallow a deduction if the annuity is unascertainable. See *Letter Ruling 8045010*.

XXV. THE DEFERRED PAYMENT GIFT ANNUITY

A. Brief description. In a DPGA transaction, a donor transfers money or property to a charitable organization in exchange for its promise to pay an annuity to the donor, another or both, to begin more than one year from the date of the transfer. The donor is able to make a gift now and get an income tax charitable deduction when he or she is in a high tax bracket, deferring payment until those years when the donor may need the income more (*e.g.*, after retirement) and may be in a lower income tax bracket.

B. **Charitable contribution.** The charitable contribution is the amount of money, or fair market value of long-term securities or long-term real estate transferred, minus the actuarial value of the deferred annuity.

C. **Setting the payments.** The payments under a DPGA agreement are determined by taking the amount transferred to the charity and compounding annually at the interest rate, determined by an actuary, for the period until the annuity begins. That figure is then multiplied by the rate of return currently offered to donors who are now the age the donor will be at the "starting anniversary" date—the anniversary of the date of purchase (gift) that coincides with (or next precedes, if none coincides with) the due date of the first annuity payment. The ACGA recommends interest rates and provides procedures for determining the payments under a DPGA. This information can be found at www.acga-web.org.

D. **Taxation of annual payments.** The amount of each payment that will be excludable, or tax-free, will depend on the rules in effect when the payments start. A reasonable rule would be that the "expected return" (which is needed to compute the exclusion ratio and hence the excludable amount) is to be computed at the time payments begin, using the life expectancy tables then in effect.

E. **Capital gains tax implications.** Treasury regulations and *Rev. Rul. 72-438,* 1972-2 CB 38, are silent on the gain implications of deferred payment gift annuities funded with appreciated property. An unpublished private letter ruling holds that the rules applicable to immediate CGAs apply to DPGAs. Thus, the gain will be determined under the bargain sale rules and will be reportable ratably over the annuitant's life expectancy if: (1) the annuity is nonassignable; and (2) the donor is the sole annuitant in a one-life annuity or is one of the annuitants in a two-life annuity. The private letter ruling holds that the gain will not be reportable until payments begin, and then will be reported ratably over the life expectancy (determined as of the "starting anniversary" date). This is logical because in no event can the capital gain be greater than the return on the contract for the year.

F. **Other tax rules—the estate tax marital deduction.** The deduction should be allowed for joint and survivor and two-life consecutive gift annuities where the spouse(s) kept the right to revoke and the deferral period extends beyond the death of the first spouse. The deduction should also be allowed for testamentary one-life CGAs. Those deductions appear to be allowable even though the payments for the surviving spouse don't begin at death (but at some future date) because there is no requirement in Code §2056 or the regulations that payments to a surviving spouse begin immediately upon the death of the first spouse. There should be no question, however, that an estate tax marital deduction is allowed for DPGAs which are already paying income at the death of the first spouse because the payments to the surviving spouse are immediate. The marital deduction is not allowed if the executor, under a power, directs the creation of the annuity rather than the decedent's doing so. Reg. §20.2056(b)-1(f).

G. **Tax implications in surviving spouse's estate.** As with "immediate" payment charitable gift annuities, there's no tax to the surviving spouse's estate. The value of a "survivor annuity" for which a marital deduction was previously allowed is includable in the surviving spouse's gross estate. Reg. §20.2044-1(a). The amount included in the surviving spouse's gross estate is "the value of the entire interest in which the decedent had a qualifying income interest for life, determined at the decedent's date of death. . . ." Reg. §20.2044-1(b). The value of a survivorship annuity at the date of the surviving annuitant's death is zero. Thus, nothing is included in his or her estate.

H. **Specific example of gift tax issues.**

1. **One-life DPGA for donor.** The value of the charitable gift element of a DPGA is deemed a present interest. However, the donor must report the gift on a federal gift tax return if it exceeds the annual gift tax exclusion. The donor then takes an offsetting gift tax charitable deduction.

2. **One-life DPGA for annuitant other than donor.** A donor who creates a DPGA with payments to another (*e.g.*, a spouse or sibling) makes two gifts: one to the annuitant (the actuarial value of the annuity) and one to the charity (the gift element). The charity's gift is a present interest gift and is reportable if it exceeds the annual gift tax exclusion. It is then deductible—resulting in a wash.

   a) **Annuitant's interest when annuitant is not the spouse.** It is not clear whether the gift to the annuitant qualifies for the annual gift tax exclusion. If the tax on the gift is not offset by $5,000,000 unified gift and estate tax exemption (as of January 1, 2011), tax will be due.

   b) **Annuitant's interest when annuitant is the spouse.** The gift tax marital deduction is not available for one-life DPGAs created for a spouse because the spouse has no immediate right to income. If a donor during his or her life wishes to provide a one-life DPGA for the donor's spouse, he or she should consider making an outright gift to the spouse. That qualifies for the unlimited gift tax marital deduction. The spouse may then use the gift to establish a one-life DPGA for himself or herself. The income tax charitable deduction is then taken by the spouses on their joint income tax return. This end run gives them income tax benefits and wipes out gift tax concerns.

3. **Two-life DPGA funded with donor's separate property when the donor is the first annuitant.** A donor who uses his or her own property to create a DPGA that pays an annuity to the donor for life and then to a survivor annuitant makes two gifts: one to the charity (which is reportable if it exceeds the annual gift tax exclusion, and then deductible—resulting in a wash), and one to the survivor annuitant (the right to receive annuity payments if he or she survives the donor). The gift to the survivor annuitant is a future interest, and thus doesn't qualify for the annual gift tax exclusion. For the same reason, it doesn't qualify for a gift tax marital deduction.

   Pointer: The donor can avoid making a gift to the survivor annuitant by retaining the right to revoke the survivor's life interest. Should the donor exercise that right, the payments won't terminate on the death of the survivor of the donor and the second beneficiary, but on the donor's death. The donor need not actually exercise the right; merely retaining the right avoids making a completed taxable gift to the survivor annuitant. Unlike charitable remainder trusts, a DPGA donor can retain the right to revoke during life, by will, or both.

4. **Two-life DPGA funded with joint property when donors are annuitants but not spouses.** The actuarially older annuitant makes a gift to the actuarially younger annuitant of the difference in their survivorship interests. To avoid adverse gift tax implications, each annuitant should reserve the right to revoke the other annuitant's interest. If that right were exercised, the charity would only have to pay half of the payments to the survivor annuitant for his or her life. The gift to the charity—the gift element—is a present interest gift and is reportable if it exceeds the annual gift tax exclusion. It is then deductible—resulting in a wash.

5. **Two-life DPGA funded with joint or community property when donors are spouses and the annuitants and payments are made to them jointly and then to the survivor.** The gift tax marital deduction is not available for joint and survivor DPGAs created for a spouse because the spouse has no immediate right to income. To

avoid adverse gift tax implications, each annuitant should reserve the right to revoke the other annuitant's interest. If that right were exercised, the charity would only have to pay half of the payments to the survivor annuitant for his or her life. The gift to the charity—the gift element—is a present interest gift and is reportable if it exceeds the annual gift tax exclusion. It is then deductible—resulting in a wash.

6. **A Hybrid deferred annuity.** Harold plans to get a deferred CGA for himself and his wife, Enid. Payments will go to them jointly, then to the survivor for life. *The twist:* If either spouse dies before the starting date, the survivor can start receiving reduced annuity payments sooner.

IRS rules. . . Harold will be entitled to an income tax charitable deduction. In *Rev. Rul. 73-1*, 1973-1 CB 117, IRS disallowed the charitable deduction where a donor had the option to revoke the annuity and get all his money back at any time before the starting date. But the proposed arrangement in this instance doesn't make the charitable gift revocable; it simply gives the annuitants a different payment option. *Letter Ruling 9017071.*

. . . and doesn't rule. IRS wouldn't rule on the value of the annuity or the amount of the charitable deduction. Nor would it rule on how the acceleration provision might affect the annuity's value or the potential debt-financed income (Code §514(c)(5)) consequences to the issuing organization. *Note:* Code §501(m) could also be a concern.

Comment. This arrangement would be an excellent alternative for donors who want to make a charitable gift that provides retirement income, but fear being locked into an ironclad payment schedule. Now that computer software for calculating deductions is widely available, it should be possible to design a time acceleration/rate reduction schedule that results in equal actuarial values in each instance. That would help nail down the amount of the charitable deduction, the gift tax marital deduction and compliance with Code §514 (c)(5)(A)—which, among other things requires that the gift portion be at least 10% of the amount transferred for an annuity.

How about the other requirements of Code §§514(c)(5) and 501(m)?

Under Code § 514(c)(5), the term "acquisition indebtedness" does not include an obligation to pay an annuity which:

(A) Is the sole consideration (other than certain mortgages to which Code §514(c)(2)(B) applies) issued in exchange for property if, at the time of the exchange, the value of the annuity is less than 90% of the value of the property received in the exchange (the gift is more than 10%). **Caution:** low charitable mid-term federal rates for split interest gifts (7520 rates) may result in failing the "more-than-10%-gift portion" test for CGAs.

(B) Is payable over the life of one individual in being at the time the annuity was issued, or over the lives of two individuals in being at such time, and

(C) Is payable under a contract which –

(i) does not guarantee a minimum amount of payments or specify a maximum amount of payments, and

(ii) does not provide for any adjustment of the amount of the annuity payments by reference to the income received from the transferred property or any other property.

(They're also important because charities can be taxed as insurance companies (or lose their exemptions) unless their annuities comply. Code §501(m)(3)(E) and 501(m)(5).) Harold and Enid's annuity is payable over the lives of individuals, and the agreement doesn't guarantee a minimum or maximum amount of payments. Even though the amount received might vary, it won't depend on the income earned by the property they've transferred—or on any other property.

Comment: Only a brave and daring soul would do this without a letter ruling.

XXVI. PLANNING CONSIDERATIONS

A. **Testamentary gift annuity funded with an IRA.** Until fairly recently, it was uncertain whether an IRA could be used to fund a CGA. Conservative scholars and estate planning practitioners, such as Christopher Hoyt of the University of Missouri (Kansas City) School of Law, discouraged making a bequest from an IRA to acquire a CGA because there was absolutely no legal precedent about the tax consequences. In *Letter Ruling 200230018*, the IRS ruled favorably on funding a CGA at death with an IRA, but left some issues open.

1. **Situation.** Abel will enter into a gift annuity agreement with Charity under which he agrees to make a testamentary gift of his IRA to

Charity, and Charity agrees to pay Barbara (Abel's sister) an annuity on Abel's death. To facilitate the transfer, Abel will complete a beneficiary designation form that will provide that upon his death, the entire assets of his IRA will be transferred to Charity. The annuity, to be paid quarterly, will be based on the amount transferred to Charity, the percentage rate then recommended by the American Council on Gift Annuities (ACGA isn't identified in the letter ruling), and Barbara's age at Abel's death. The annuity will be irrevocable and nonassignable (except to Charity for no consideration), and can't be commuted. Further, the annuity is to be paid from Charity's "general fund." (More about the "general fund" point later.)

2. **IRS rules—issue #1.** Charity's tax-exempt status won't be adversely affected by receiving Abel's IRA in exchange for Barbara's annuity, nor will Charity recognize taxable income on receiving the IRA.

IRS's rationale. Code §501(m)(1) provides that a charity is exempt from tax only if no substantial part of its activities consist of providing commercial-type insurance. Code §501(m)(3)(E) provides that "commercial-type insurance" doesn't include a "CGA." Code §501(m)(5) provides that "to be a CGA, a portion of the amount paid in connection with the issuance of the annuity must be allowable as a deduction under Code §170 or §2055, and the annuity must be described in Code §514(c)(5)." Moving right along to Code §514(c)(5), an "acquisition indebtedness" doesn't include an obligation to pay an annuity which: (1) is the sole consideration issued in exchange for property if, at the time of the exchange, the value of the annuity is less than 90% of the value of the property received in the exchange (the gift is more than 10%); (2) is payable over the life of one individual, or over the lives of two individuals; (3) is payable under a contract that doesn't guarantee a minimum amount of payments, or specify a maximum amount of payments; and (4) doesn't provide for any adjustment of the amount of the annuity payments by reference to the income received from the transferred property or any other property. In this case, IRS rules that the annuity to be issued by Charity will meet the foregoing requirements.

Comment. The ACGA has been around since 1927 and all hope it will live forever. This is a testamentary arrangement, however, so a cautious draftsperson should provide for an alternative disposition if there are no rates recommended by the ACGA at the IRA owner's death. Also, it may be possible that the "90% test" is met now, but won't be met at death because the applicable mid-term federal rate for computing the gift portion of the annuity changes every month. Also, a future Congress may change the 90% requirement. So, back to our cautious drafter: he or she should provide for those contingencies.

3. **IRS doesn't rule—issue #2.** IRS was asked to rule that, for purposes of determining the character of the annuity payments received by Barbara (the taxable and non-taxable portions), the "investment in the contract" would be equal to the IRA proceeds transferred to the Charity for the annuity less the estate tax charitable contribution deduction.

   IRS declined to rule, stating that in order to rule on that issue, it would have to assume that Barbara will survive Abel. That assumption would involve a hypothetical situation because both Barbara and Abel are living. Accordingly, pursuant to section 8.02 of Rev. Proc. 2001-4, 2001-1 IRB. 121, IRS declined to rule.

   Comment. Presumably, the investment in the contract will be zero, unless the IRA was partially funded with after-tax dollars. Thus the IRA payments received by Barbara will be taxable as ordinary income. (That would also be the case if she were to receive payments directly from the IRA with no intervening CGA.)

4. **IRS rules—issue #3.** The IRA's value at Abel's death will be included in his gross estate. *Reason:* He has the right to designate the IRA beneficiaries and receive payments during his lifetime. Also, the IRA is funded with his contributions.

5. **IRS rules—issue #4.** Abel's estate may claim an estate tax charitable deduction for the IRA's value (the amount includable in his gross estate) less the value of the annuity to be paid to Barbara.

   IRS's rationale. *Rev. Rul. 80-281*, 1980-2 CB 282, dealt with a donor who purchased an annuity that was payable from a charity's general funds for the donor's lifetime. The ruling concluded that because the annuity was payable out of the charity's general funds, rather than the transferred funds, the donor hadn't retained any interest in the transferred funds. Accordingly, the provisions of Code §2522(c) (providing gift tax rules similar to the estate tax rules of Code §2055(e)(2)) are inapplicable (those are the charitable remainder unitrust, annuity trust and pooled income fund requirements). IRS thus ruled that a gift tax charitable deduction was allowable for the amount by which the value of the property transferred by the donor exceeded the present value of the annuity.

   In the present letter ruling, IRS noted that the annuity will be payable from the Charity's general funds. Thus Abel's estate will be entitled to an estate tax charitable deduction for the value of the IRA at his death, less the present value (determined as of his date of death) of the annuity payable to Barbara. The present value of the annuity will be determined under Code §7520 and Reg. §20.2031-7.

Caution. In this letter ruling and in *Rev. Rul. 80-281*, IRS makes the point that a charitable deduction won't be allowed if the annuity is payable out of the assets transferred to the charity rather than out of its general funds. In a state such as New York, gift annuities aren't payable out of a charity's general funds. The charity must maintain a special reserve fund for gift annuities. Apparently, IRS means that the charity shouldn't be obligated to make the payments out of a donor's gift or reinvestments of the gift. If that were the case, to get income, gift and estate tax charitable deductions, the arrangement would have to be a charitable remainder unitrust, annuity trust, or pooled income fund trust.

6. **IRS rules—issue #5.** On Abel's death, the IRA proceeds won't be included in his estate's gross income.

   IRS rationale. Based on the information submitted and the representations made, if Charity is named as the designated beneficiary of Abel's IRA, the proceeds distributed to Charity from his IRA will be items of "income in respect of a decedent" to Charity under Code §691(a)(1)(B) when distributed to it. The character of the IRD in the hands of the Charity will be considered to have the character that it would have had in Abel's hands if he had lived and received those amounts. *Note.* Because Charity is tax-exempt and the Code §501(m) and §514 requirements are met (see ruling issue #1, above), Charity won't be taxable on the IRD.

   The usual IRS warning. This ruling is directed only to the taxpayer requesting it. Code §6110(k)(3) provides that it may not be used or cited as precedent.

   But here's another IRS warning. "The rulings are based on information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination." *Letter Ruling 200230018*.

7. **Unanswered questions.** Hopefully the next ruling will address these issues:

a) **No taxable income to beneficiary when IRA is distributed to charity or when annuity is issued?** The ruling held that the estate has no taxable income when the IRA is transferred to the charity to acquire an annuity. We all would feel better if there were also a statement that the beneficiary of the annuity did not have any income either at the time of the distribution or at the time the annuity contract became a fixed right.

b) **How much taxable income to annuitant with each payment?** The IRS did not present a formula to us determine how much of each payment that the annuitant will receive is taxable or tax-free. Assume all of it would be taxable because the IRA has a tax basis of zero dollars (unless the IRA held non-deductible contributions).

c) **What rules apply to pass-through income tax deductions to annuitant?** By way of background, if an estate is subject to estate tax, the recipient of inherited IRA distributions is entitled to claim an income tax deduction with each distribution for the attributable estate tax. Sec. 691(c). The IRS did not explain how that deduction would flow through (if at all) when an IRA is used to purchase a CGA.

Many of us will be hesitant to recommend using IRAs for charitable gift annuities until these and other questions are answered. Still, this ruling is encouraging because it tells us some of the tax consequences.

B. **Gift annuity funded with remainder interest in personal residence.** A donor can combine two deferred charitable gifts in one transaction: (1) a remainder interest in his or her personal residence (donor retains a life estate); and (2) a lifetime annuity payable to the donor from the charity's general assets. To the extent the value of the remainder interest exceeds the value of the lifetime annuity on the date of transfer, the donor has made a charitable gift. Income and gift tax charitable deductions are allowable, but donor recognizes gain on the transaction, determined under Code §1011(b) and Reg. §1.1011-2. *Letter Rulings 8120089, 8305075* and *8806042*. Check state law on whether charity can issue gift annuity in exchange for real property. Also, charity must decide whether it wants to start paying annuity now though it won't receive property until later.

C. **Gift annuity funded with mortgaged property.**

1. **Overview:** Gift annuities, unlike charitable remainder trusts, may be funded with mortgaged or other debt-encumbered property but there can be tax concerns.

2. **Debt-financed income.** If a charity accepts mortgaged property for a gift annuity, it will have taxable debt-financed income unless the mortgage was placed on the property more than five years before the inter vivos transfer for the annuity, and the donor owned the property more than five years before the transfer. In that case, the mortgage is not considered an acquisition indebtedness during the ten years following the transfer. If the property is transferred by a donor's will, the "five-year before the transfer" requirement does not apply. Code §514(c)(2).

3. **Exception.** Even if the charity receives unmortgaged property for a gift annuity, it will be deemed to have received debt-financed income—and/or may find itself being taxed as an insurance company under Code §501(m)—unless these tests are met:

   a) The value of the annuity is less than 90% of the value of the property received (the gift part is more than 10%);

   b) The annuity is payable over the life of one or two individuals living when the annuity is created;

   c) The annuity does not guarantee a minimum or maximum amount of total payments; and

   d) The annuity does not provide for adjustment of payments by reference to the income received from the transferred or other property. Code §514(c)(5).

4. **Gain implications when annuity funded with mortgaged property.** Add the amount of the mortgage to the actuarial value of the annuity in determining the gain implications. The gain attributable to the indebtedness cannot be reported ratably over the donor-annuitant's life expectancy.

5. **Gift annuities may be a problem solver for gifts of mortgaged property and tangible personal property.** Under current IRS interpretations, unitrusts, annuity trusts and pooled funds can't be created with mortgaged property. But CGAs can be funded with mortgaged property (keep the bargain sale rule and consequences to the charity in mind). No income tax charitable deduction is allowable for transfers of tangible personal property to unitrusts, annuity trusts

and pooled income funds (a limited deduction, however, may be allowable when the trust disposes of the tangible personal property). But that property can produce an income tax charitable deduction when transferred for a gift annuity. Keep in mind: (1) the related/unrelated issue for valuing the charitable contribution; (2) Is this a good deal for the charity? If it keeps the property, it will have to pay the annuity from other funds; if the charity sells the property, the proceeds may be less than the valuation placed on the property for determining the annuity payments; make sure state law permits issuance of an annuity for tangible personal property.

D. **Gift annuity funded with S corporation stock.** CGAs, unlike CRTs, may be funded with S corp stock because charities are eligible S corporation shareholders. However, Code §170(e)(1) requires that the charitable income tax deduction be reduced to reflect assets such as unrealized receivables, appreciated inventory and depreciation recapture, which would produce ordinary income upon sale. As to the charity, Code §512(e)(1) treats all income attributable to the S corp as UBTI and gain on the sale of the stock is also treated as UBTI.

E. **Self-dealing and excess business holdings issues.** Gift annuities may also be a problem solver if you run into self-dealing and excess business holding problems for charitable remainder unitrusts and annuity trusts.

F. **Reinsurance of gift annuities.** In Letter Ruling 200847014, the IRS ruled that a donor was entitled to income and gift tax charitable deductions even though the charity had the right to but was not required to reinsure his gift annuity with a commercial insurance company. The insurance company – not the charity – paid commissions to the brokers. The rulings were contingent on the charity receiving favorable rulings from the Exempt Organizations Division on other issues (which it did, as you will see in Letter Ruling 200852037 (below). The annuity purchased by the charity had an option – for an additional premium – to have part of the premium paid by the charity returned to it if the annuitant dies before the payout equals the premium paid by the charity.

The IRS ruled that the donor is entitled to an income tax charitable deduction for his payment to the charity minus the present value of the gift annuity determined under Reg. §1.170A-1(d). Note that the tests of Code §§ 501(m) and 514(c)(5) were met and thus the charity's gift annuity program did not constitute commercial-type insurance and income from the program was not unrelated business taxable income.

Note: In Letter Ruling 8322068 (dealing with an escalating annuity amount), the charity was <u>required</u> to reinsure the annuity. The IRS ruled that the charitable contribution was the difference between the amount transferred to the charity and the premiums paid by the charity to the insurance company.

Query: How will the contribution deduction be determined today if a charity is required to reinsure an annuity? If it is not required to reinsure but always does so? Suppose the IRS interprets a reinsurance program to mean that charity is deemed to not "regularly issue" gift annuities? If the non-assignability and other tests are met will the donor nevertheless be precluded from spreading the gain ratably over his or her life expectancy?

XXVII. CHARITABLE GIFT ANNUITY DRAFTING CHECKLIST

A. Understand the meaning of every provision in the annuity agreement.

B. A specimen—no matter how good—is lousy if it doesn't cover or isn't amended to cover the client's situation.

C. Yesterday's form—no matter how good—is terrible if it doesn't take today's changes in the law into account.

D. Double check that the gift annuity agreement contains all the provisions required by state law. The ACGA website has excellent state-specific resources (www.acga-web.org).

E. If the annuity is for the donor's life alone or if it is a two-life annuity and the donor is one of the annuitants, the capital gain when funded with appreciated property can be spread over the donor's life expectancy if the annuity is non-assignable. Make sure the annuity agreement states: This is non-assignable. Or, the agreement can state that the annuity is non-assignable except that is may be assigned to the charity that issues the annuity.

F. A non-assignable two-life annuity funded with a donor's separate property providing payments first to the donor and then to a survivor results in the capital gain being spread ratably over the donor's life expectancy whereas a two-life one-annuity funded with joint, tenancy in common or community property has the capital gain spread ratably over the two-life expectancy. Consider changing ownership of the property to co-ownership before funding the annuity and the fund with the co-owned property. That way the gain will be reportable ratably over the two-life expectancy. Be mindful of the gift-tax implications—generally not a concern if the conversion to co-ownership involves spouses who are citizens.

G. Make sure that the gift annuity agreement reflects how the property is owned. Otherwise, bad gift tax things can happen to good people.

H. Has the annuity agreement been drawn to avoid gift taxes (when possible) on the survivor annuitant's interest?

I. Confirm that both spouses are U.S. citizens. If they aren't, take the special rules that apply to transfers to non-U.S. citizen spouses into account. (There's a difference between a non-U.S. citizen spouse and an alienated spouse. The latter may well be a U.S. citizen.)

J. No matter how skillfully the annuity agreement is drawn, make sure that the gift portion is more than 10% and that the three other requirements of Code §514(c)(5) and 501(m) are met. If not, the charity will be taxed on debt-financed income, as an insurance company and in extreme cases can lose its tax exemption. Not a good thing.

K. Make sure the payments are made and are timely. A rule governing charitable remainder trusts requires that a CRT not only meet the Code's requirements, but also be administered according to its terms. In *Atkinson*, 309 F.3d 1290 (CA-11, 2002) the U.S. Court of Appeals for the Eleventh Circuit held that an inter vivos charitable remainder annuity trust's failure resulted in complete loss of the estate tax charitable deduction (there were four survivor beneficiaries). And that's so even though substantial sums would go to charity. The loss o f the charitable deduction cost the estate $2,654,976. U.S. Supreme Court denied cert., 540 U.S. 946 (2003).

L. Unlike CRTs, gift annuities can be funded with S corp stock without losing the S election. BUT, there can be adverse tax implications for the charity. If you are representing the charity, consider these issues carefully.

M. Check if there are any SEC restrictions on transferring securities.

N. If life-insurance-wealth-replacement is part of the plan, make sure that the insurance is obtained before signing and funding the gift annuity agreement. In *Smallegan v. Kooistra*, the decedent signed and funded her CRUT before obtaining a life-insurance-wealth-replacement policy that was to be part of her estate plan. The decedent was subsequently denied insurance and died without the anticipated insurance in place. The son sued the attorney who drafted the CRUT to recover the value of the insurance he should have received as his inheritance. It is surprising that the decedent's attorney had the decedent sign and fund her CRUT before the insurance was nailed down. The Michigan Court denied the son's claims, but the laws of other states may have resulted in a different outcome. So be sure to have the insurance in place before signing and funding a gift annuity agreement or any other planned gift if wealth-replacement insurance is part of the estate plan. *Smallegan v. Kooistra,* 2007 WL 840123 (Mich. App. 2007).

O. One of the elements taken into account in determining the amount deemed contributed for the income tax deduction is the section 7520 rate for the month of the gift or either of the two prior months at the donor's election. The higher the section 7520 rate, the greater is the contribution deduction. But the excludable amount of each payment is greater with the lowest section 7520 rate. Another but: the capital gain is smallest with the highest section 7520 rate. So weigh all of this in determining which section 7520 rate to select. Many gift annuity donors take the standard deductions so the size of the deduction should not be a factor. Or an itemizer may have hit the deductibility ceiling and is making full use of the carryover.

P. Finally, trust no one. This checklist can't possibly cover everything, so if your mother tells you she loves you—check it out.

XXVIII. GIFT OF REMAINDERS IN PERSONAL RESIDENCES AND FARMS

Alert. Gifts of remainders in personal residences and farms are especially attractive now because of the extremely low section 7520 rates. The donor receives an income tax deduction for the actuarial value of the remainder interest passing to the charity. The section 7520 rate at the time of the gift is used to calculate the value of the reminder interest. The lower the section 7520 rate, the greater is the value of the remainder interest and the greater is the donor's income tax charitable deduction.

A. **Basics — brief description.** Donor can obtain income and estate tax benefits by making a charitable gift of a personal residence (need not be a principal residence) or farm even though he or she retains the right to life enjoyment. A life estate may be retained for one or more lives. Or an estate may be retained for a term of years.

Remainder interest must be in a personal residence or farm. Does not include furnishings or other tangible personal property. However, property that qualifies as a fixture under local law can be included in value. See *Letter Ruling 8529014* (heating and air conditioning system). **Gift can't be in trust.** *Estate of Cassidy,* 49 TCM 580 (1985); *Rev. Rul. 76-357,* 1976-2 CB 285.

Charitable deduction. For the income tax charitable deduction, depreciation (computed on the straight-line method) and depletion must be taken into account to determine the value of the remainder interest. Those values are discounted at an interest rate that depends on the federal rate (IRC §7520) in effect in the month of the transfer or either of the two prior months. For gift and estate tax purposes, depreciation (or depletion) need not be taken into account in valuing the remainder.

Capital gain. Capital gain is generally not taxable on a transfer of appreciated property to charity. Gain is, however, taxable to a donor who donates property subject to an indebtedness, whether or not charity assumes the debt. IRC §1011(b); Reg. §1.1011-2(a)(3). See also *Guest,* 77 TC 9 (1981). If a donor bargain-sells a remainder interest in an appreciated personal residence or farm to charity, donor will have gain determined under IRC §1011(b) and Reg. §1.1011-2.

B. GIFT TAX RULES

The charitable remainder qualifies for the unlimited charitable deduction. **Caution.** If a life estate is retained for an individual other than the donor, there can be gift tax implications. Those implications are beyond the scope of this outline. To highlight some (but not all issues) a QTIP marital deduction is available for an American spouse. For an alien spouse, there is the $136,000 gift tax annual exclusion and for non spouses, the $13,000 annual exclusion for present interests in 2011 (indexed annually for inflation). If an individual has a survivorship interest, generally gift tax concerns can be avoided on the donors retaining the right to revoke the survivor's interest.

C. ESTATE TAX RULES—INCLUDING MARITAL DEDUCTION RULES

Gift of remainder interest with life estate reserved for donor's life. The fair market value of the personal residence or farm at the donor's death (or the alternate valuation date) is includable in his or her gross estate when donor retains a life estate in the property. IRC §2036. The estate then deducts as a charitable contribution the amount included in the gross estate—resulting in a wash. IRC §2055(e)(2); Reg. §20.2055-2(e)(2)(ii), (iii).

The estate tax implication for survivorship interests are beyond the scope of this outline. Suffice it to say that the charity's remainder interest isn't subject to the estate tax. And the survivor's interest for a citizen spouse can qualify for the QTIP marital deduction.

D. PLANNING CONSIDERATIONS

Charitable gift of proceeds from sale of farm or residence.

IRS's position.

No deduction is allowed for a gift of a remainder interest in a residence or farm when donor's will directs that the property be sold and all or part of the sales proceeds be distributed to charity. *Rev. Rul. 76-543,* 1976-2 CB 287; *Rev. Rul. 76-544*, 1976-2 CB 288.

IRS allows a deduction, however, if the second beneficiary's interest terminates (he or she dies) before the due date of donor's estate tax return, so that the remainder interest passes directly to charity and is deductible under a special exception in IRC §2055(e)(3). *Letter Ruling 7812005.*

IRS will also allow a deduction if state law permits the charitable remainder organization to take the farm or residence itself, despite the terms of donor's will. *Letter Ruling 8141037.*

IRS has allowed a deduction on these facts: Donor gave his personal residence to charity, retaining a life estate, and directed that on his death the charity sell the residence and add its proceeds to a trust Donor had previously established for charity's benefit. Here, said IRS, the charity's remainder interest is in the residence itself, not just the proceeds of a future sale. *Letter Ruling 7835010.*

Previously, no deduction where remainder interest (or proceeds therefrom) in a personal residence is split between charity and noncharity. *Letter Ruling 8341009.* But see 4., below.

U.S. Tax Court allowed deduction even though the interest received by charity was not a remainder interest in a personal residence, but rather a remainder interest in the proceeds from the sale of the residence. *Blackford,* 77 TC 1246 (1981). IRS acquiesces in the result of *Blackford,* but disagrees with the Tax Court's reasoning. IRB 1983-42, 5. IRS intends to continue challenging *Blackford*-type bequests when local law doesn't allow for equitable conversion of remainder interests. *Rev. Rul. 83-158*, 1983-2 CB 159.

Gift of remainder interest coupled with gift of undivided interest in property. Donor can give a charity a remainder interest and an undivided interest in the same property. For example, donor can deed his personal residence or farm to charity, reserving the right for life to use the property during the summer months as a vacation home. Donor will be entitled to a charitable deduction for: the remainder interest; and the undivided portion of his life interest in the property. *Rev. Rul. 76-473,* 1976-2 CB 306.

Gift of remainder interest split between charity and individual. Reversing its prior position, IRS now allows a charitable deduction when a home remainder is split between a charity and an individual.

Background. IRS had denied an estate tax deduction where a remainder in a personal residence passed to a charity and an individual as equal tenants in common at the donor's death. Although the law and regulations were silent on the point, IRS said that the entire remainder must pass to charity in order to qualify. *Rev. Rul. 76-544,* 1976-2 CB 288.

Another donor willed his sister a life estate in his personal residence. On her death, the remainder interest would pass under his will's residuary clause, which devised 90% of the residue to charity and 10% to individuals. In *Letter Ruling 8341009,* IRS denied an estate tax charitable deduction, citing *Rev. Rul. 76-544.*

Presumably here is IRS's current position. Alphonse conveyed the remainder in his home to a charity and Sarah as tenants in common. Sarah has a 90% interest; the remaining 10% goes to the charity. Alphonse filed a gift tax return, but subtracted the charity's undivided 10% interest from the value of his gift to Sarah.

IRS rules. Alphonse may deduct the charity's 10% interest as a charitable contribution. *Rev. Rul. 87-37*, 1987-1 CB 295.

A house divided is greater than the sum of its parts. The amount of the charitable deduction must be reduced, said IRS, *"to reflect appropriate valuation discount for the cotenancy arrangement. See Estate of Fawcett, 64 T.C. 889, 900 (1975), acq., 1978-2 CB 2."*

Comment. This ruling deals only with the *gift tax* charitable deduction. The reasoning should apply for income tax purposes, but what's deductible for estate and gift tax purposes isn't always deductible for income tax purposes.

IRS's copious citations to IRC §170 in this ruling don't assure parity for income tax deductions—the gift tax statute itself is cross-referenced to §170. Note that if an income tax charitable deduction is allowable, the amount must be discounted twice: once for cotenancy and once for depreciation on the structures. For gift tax purposes, though, depreciation is not taken into account.

How much discount for cotenancy? The *Fawcett* case cited by IRS doesn't offer much guidance beyond telling why a discount may be appropriate. Under the facts of that case, a decedent's executor sought a 25% discount on the estate tax value of his half interest in a ranch. The court said:

"Although we believe that such a factor should be considered to reflect the possible legal and other problems that would arise when such an interest is sold, we believe in this instance its importance is

overstated.

"The subject ranch was owned by a family unit, not total strangers; consequently, we believe that neither the likelihood nor the magnitude of such problems would be great."

Unfortunately, the court didn't say how much of a discount would be applied under the facts at hand; it simply arrived at a valuation "after a careful review of the entire record." Still, it indicated the two factors to be considered in determining the amount of a discount: the likelihood and the magnitude of "problems" resulting from the cotenancy.

A more recent case shed more light on the subject of cotenancy discounts (while not involving a charitable gift). An estate wanted a discount for federal estate tax valuation purposes where the decedent held a half-interest in a farm (the other half-interest was divided among eight heirs of the decedent's sister). The estate's expert testified that local appraisers often discount fractional interests in real property by 20%—25%. Citing the difficulty of finding an arm's-length buyer for a fractional interest in property—and the considerable expense that might be encountered in any attempt to partition the land under local (Illinois) law—the Tax Court found a 12.5% discount appropriate. *Estate of Youle,* 56 TCM 1594 (1989).

Charitable gift of life interest after gift of remainder interest.

A donor who has given a remainder interest in his residence or farm to charity, reserving a life estate for himself, should be entitled to an income tax charitable deduction if he later contributes his remaining life interest to the charitable remainder organization, thereby accelerating the charitable remainder. The amount deduction should be for the then value of the remaining life interest.

Caution. If the property in which the partial interest exists was divided to create an interest that would avoid the "less than the entire interest" rule, no deduction is allowable. It is a fact question whether a donor created a partial interest for reasons other than avoidance of IRC §170(f)(3)(A). If a donor, for example, can show that she retained a life interest to provide for her security and that her security is now otherwise assured (or she is no longer concerned about it), she should be entitled to a charitable deduction of the current value of her remaining life interest. See, *e.g.*, *Rev. Rul. 76-523*, 1976-2 CB 54.

Reforming defective remainder interest in personal residence of farm.

TRA '84 instructed Treasury to issue regulations. However, Treasury has closed its regulation project. IR 86-167.

***Letter Ruling 9329017*—some interesting points.** A donor who contributes a remainder interest in a mortgaged farm (or personal residence) makes a gift to the extent of the remainder interest in the *equity* in the property. Donor is deemed to make a gift to the extent of the remainder interest in principal payments on the mortgage and to the extent of the remainder interest in any improvement that constitutes real property under applicable local law. Finally, a donor who gives a remainder interest in a mortgaged farm (or personal residence) is deemed to have sold a portion of the property to the charitable remainder organization and must take the full value of the mortgage into account as an amount realized in determining gain or loss (not loss for a personal residence) under Regs. §§1.170A-4(c)(2)(ii) and 1.1011-2. See the formula in Reg. §1.1011-2.

Property improvements by life tenant and foundation—not self-dealing. Husband (now deceased) contributed his house to Private Foundation, retaining a life interest for himself and Wife. Wife, as the life tenant, has continuously used the property as her principal residence for many years. Wife, who is over 90 years old, is a disqualified person under IRC §4946.

Wife and Private Foundation want to make much-needed improvements—replacement of the driveway, central air conditioning, and water heater—each paying a proportional share of the costs.

IRS rules. Wife's and Private Foundation's payments of a proportional share of the costs of the improvements (equal to the present value of each party's interest in the improvements at the time of the payments) won't be an act of self-dealing under IRC §4941. If Private Foundation were to pay the entire cost of the improvements, IRS noted, it could be argued that the value of the life tenant's property interest would be increased and that Private Foundation would be making a prohibited direct or indirect transfer to the life tenant. On the other hand, if Wife, as the life tenant, were to pay the total costs, the payment would constitute a gift to Private Foundation equal to Private Foundation's remainder interest in the improvements.

IRS emphasizes that the proposed improvements are necessary to maintain the property's condition (a valuable Foundation asset) and that the life tenant is over 90 years old; thus, any benefits that Wife (a disqualified person) receives would be incidental. *Rev. Rul. 73-407*, 1973-2 CB 383; Reg. §53.4941(d)-2(f)(4), Ex. 1 and 4. *Letter Ruling 200149040.*

XXIX. CHARITABLE REMAINDER GIFTS

A. SPOUSAL RIGHT OF ELECTION

In Rev. Proc. 2005-24, 2005-1 CB 909, the IRS ruled that *inter vivos* charitable remainder unitrusts and annuity trusts were disqualified if a spousal right of election existed under state law. The IRS provided safe harbor procedures for avoiding disqualification by obtaining a waiver of the right of election. For trusts created before June 28, 2005, the Service ruled it would disregard the right of election, even without a waiver, but only if the spouse did not exercise the right of election. However, Rev. Proc. 2005-24 created many practical problems for donors, trustees, advisers and charities. In IRS Notice 2006-15, 2006-8 IRB 501, the Service stated that, until further notice, a spousal waiver of a right of election is no longer needed for charitable remainder unitrust and annuity trust qualification. The Service extended the June 28, 2005 grandfather date indefinitely. Therefore, a spouse's right of election, even without a waiver, will be disregarded, but only if the surviving spouse doesn't exercise that right. Rev. Proc. 2005-24 was withdrawn as a result of letters—pointing out the problems—by The American Council on Gift Annuities, the ABA, ACTEC, AICPA, and bar groups.

B. GIFT OF DONOR'S REMAINING LIFE INCOME INTEREST, ACCELERATING CHARITABLE REMAINDER

Overview. A donor who has created a charitable remainder unitrust or annuity trust gets an income tax charitable deduction if she later contributes her remaining life interest to the charitable remainder organization, thereby accelerating the charitable remainder. The interest transferred can't be less than the donor's entire interest in the contributed property. The amount of the deduction is the then value of the remaining life interest. Reg. §1.170A-6(c)(3)(ii).

Proceed with caution. Giving up all or part of an income interest and benefitting the charity sooner rather than later is great. And tax advantages often abound. But sometimes there are pitfalls. Reg. §1.170A-7(a)(2)(i) says:

If, however, the property in which such partial interest exists was divided in order to create such interest and thus avoid section 170(f)(3)(A), the deduction will not be allowed. Thus, for example, assume that a taxpayer desires to contribute to a charitable organization an income interest in property held by him . . . If the taxpayer transfers the remainder interest in such property to his son and immediately thereafter contributes the income interest to a charitable organization, no deduction shall be allowed under section 170 for the contribution of the taxpayer's entire interest consisting of *the retained income interest. In further illustration, assume that a taxpayer desires to contribute to a charitable organization the reversionary interest in certain stocks and bonds held by him . . . If the taxpayer grants a life estate in such property to his son and immediately thereafter contributes the reversionary interest to a charitable organization, no deduction will be allowed under section 170 for the contribution of the taxpayer's entire interest consisting of the reversionary interest.*

Letter Ruling 9550026. Facts. A 9% NIM-CRUT funded with community property pays spouses jointly and then all to the survivor. On the survivor's death, the trust terminates with the remaining assets going to University. Husband and wife each have the power—by will—to revoke their spouse's community property interest in the trust. Donors propose to now give a 20% undivided interest in their unitrust payments to University. Each donor will disclaim his or her right to receive the other's unitrust interest and will irrevocably assign the interest to University.

University's income and remainder interests will merge so it will then have a 20% undivided interest in the entire trust and an 80% undivided interest in the trust remainder. The parties will agree to terminate 20% of the trust and the trustee will then distribute 20% of the trust assets to University. The adjusted bases of the distributed assets will be fairly representative of all the property available. The trustee will continue to hold the balance of the trust assets.

IRS reviewed an earlier published ruling. In *Rev. Rul. 86-60,* 1986-1 CB 302, Alice was the sole beneficiary of a charitable remainder annuity trust that she created in 1980. Her interest wasn't created to avoid the rules prohibiting deductions for "partial interests." In 1984 Alice transferred her remaining retained income interest to the charitable remainder organization. IRS ruled that the gift of her income interest qualified for an income tax charitable deduction because she gave her entire interest in the property. Her gift also qualified for a gift tax charitable deduction because she hadn't made a prior transfer from the trust for private purposes. Thus, the income interest didn't have to be an annuity interest (or other qualified interest) described in IRC §2522 (although it was).

IRS rules—income tax deduction. Donors' situation is analogous to the facts in *Rev. Rul. 86-60*—except that they propose to contribute only 20% of their life interest. Donors claim that they didn't create the trust to avoid the partial interest rule. IRS agrees partly because of the six-year period between the trust's creation and the proposed gift. An income tax charitable deduction is allowable for the value of the undivided interest in the unitrust payments transferred to University.

IRS rules—value of income tax charitable deduction. It's the present value of the spouses' relinquished right to receive annually 9% of the net fair market value of 20% of the trust assets. The spouses' relinquished right is valued using their ages (to their nearest birthdays) at the time of the gift of 20% of their remaining life interest, based on the interest tables in effect for that month or in either of the two prior months and 20% of the then value of the trust assets.

IRS rules—gift tax deduction. Since the donors will each disclaim their right to receive the other's unitrust interest, neither is deemed to have made a noncharitable transfer when they created the trust. Their transfer of a 20% undivided interest in their unitrust interests will consist of a fraction or percentage of their entire interest. A gift tax charitable deduction is allowable for the value of the undivided interest in the unitrust payment transferred to University.

IRS rules—value of gift tax charitable deduction. It's the present value of the spouses' right to receive 9% of the net fair market value of 20% of the trust assets—as valued each year. The calculation is based on the spouses' ages at the time of the transfer of 20% of their interest using the interest tables in effect for that month or in either of the two prior months, and 20% of the then value of the trust assets. The income-only limitation (a "net income with no makeup" unitrust) is disregarded for purposes of valuing the spouses' gifts of a 20% undivided portion of their unitrust interest because the transfer of the undivided portion of the spouses' unitrust interests results in a merger with a 20% undivided portion of University's remainder interest in the trust.

Gift tax trap—caution. Here the trust was funded with community property and both spouses (donors) were to receive life income. Each disclaimed the right to receive income from the other's share of the community property used to fund the trust. Suppose the husband funded the trust with his own separate property providing unitrust payments for himself for life with payments to his wife if she survived him. Would IRS maintain that no gift tax charitable deduction is allowable if the donor were to give away his remaining life interest and his wife were to give away her survivorship interest? Would IRS maintain that the husband-donor had already transferred an interest in the trust to a noncharity beneficiary, thus disqualifying him for the gift tax charitable deduction? Would it make any difference if his wife were to first disclaim her survivorship interest? *Comment:* IRS allowed a gift tax charitable deduction when one spouse renounced her survivorship interest before the other in *Letter Ruling 9529039.* IRS stressed that one party was acting before the other.

Income tax charitable deduction—what kind of gift is it? When a non-grantor beneficiary contributes his or her life interest, IRS treats it as a capital asset, deductible at full fair market value. *Rev. Rul. 72-243*, 1972-1 CB 233. Several letter rulings suggest that when a donor gives away his or her own retained life interest, the interest is a capital asset. *Letter Rulings 8052092* and *8311063*. In *Letter Ruling 8613046*, IRS said that the life interest of a charitable remainder trust's sole beneficiary was a capital asset, entitling her to a deduction for the full fair market value on the date of the contribution.

Spendthrift trusts—something else to think about. Some trusts are spendthrift trusts, which make it impossible for a beneficiary to sell or give away his or her interest in the trust. So a determination must be made whether a survivor beneficiary has the right to disclaim or relinquish his or her interest. That's determined by state law, the governing instrument, or both.

IRS rules—capital gains avoidance. Any capital gain that the donors' unitrust had in years prior to the gift of the 20% interest that wasn't realized by the donors won't be included in their income solely because of the proposed transfer of 20% of their interest in the unitrust.

The trust still qualifies. University's 20% income interest will merge with its remainder interest. The unitrust will partially terminate after the proposed transfer, but it will continue to qualify as a CRUT.

Letter Ruling 200010035. Facts. In 1994, Donors created a charitable remainder annuity trust naming themselves co-trustees. They now wish to give part of the trust principal to charity (and some income along the way). But their annual payments won't be reduced. Donors funded their CRAT with $1 million dollars (the figures are mine for ease of understanding) and provided for an annual payment (annuity amount) of $70,000 for their joint lives and then to the survivor for life. The remainder is payable to their private foundation (created in 1988). The CRAT assets have doubled in value and are now worth $2 million dollars. The cost of the foundation's charitable activities has increased and it no longer has enough revenue from investments and donations to conduct its activities.

Solution. To enable the foundation to conduct its charitable activities, Donors will petition a state court to reform their CRAT to:

Authorize the trustees (Donors), in their discretion, to distribute trust principal to the foundation to "improve its financial situation" provided the aggregate fair market value of the CRAT assets remaining after the distribution will not be less than $1 million (the value of the trust when Donors initially funded it).

Provide that any trust income not needed to pay the annuity amount to the Donors be paid to the foundation.

The CRAT will continue to pay Donors a $70,000 annuity amount for their joint lives and then for the life of the survivor.

The reformed trust will provide that for any distributions in kind, the adjusted basis of the property distributed will be fairly representative of the adjusted basis of the property available for payment on the date of payment.

No income tax charitable deduction—IRS rules. To the extent that Donors are consenting to an acceleration to the foundation of a portion of the trust remainder. They will not be allowed an income tax charitable deduction under IRC §170. Donors received an income tax charitable deduction for the value of the remainder interest when they created and funded the CRAT. Donors won't have reduced annual payments, so they are not making an additional charitable gift to charity.

In *Rev. Rul. 86-60*, 2986-1 C.B. 302, the beneficiaries transferred their *entire* retained annuity interest to the charitable remainder organization. They thus qualified for an income tax charitable deduction (for the then value of the life interest).

Note. An income tax charitable deduction would be available for a *unitrust* donor who gives part of the trust assets to the remainder charity now. That's because her annual payments will be smaller. The amount by which the fixed percentage is multiplied will be smaller.

C. SWAP OF CRUT LIFE INTEREST FOR GIFT ANNUITY

Donor's 5% standard charitable remainder unitrust—created several years ago—pays him for life, with remainder to Academy. The school needs funds for a new building. (This fact—which should have no bearing on the ruling request—was presumably pointed out to IRS to show that no hanky-panky is involved.)

Donor wants to transfer his remaining STAN-CRUT life-income interest to Academy in exchange for a gift annuity. The annuity payments will be made from Academy's general funds and not from any CRUT assets so Donor won't retain any interest in the CRUT. Also, Donor will be the sole annuitant, the annuity will either be nonassignable or assignable only to Academy, and any commutation, prepayment, or refund is prohibited.

IRS rules—income tax charitable deduction. Donor will be entitled to an income tax deduction for the difference between the value of his current life interest in the unitrust and the annuity's value (the "investment in the contract") on the transfer date. (IRS believed that Donor didn't divide his interest in the CRUT to avoid the partial-interest rule under IRC §170(f)(3)(A).

This issue is always raised when a donor gives away his or her remaining interest in a CRT.)

IRS rules—gift tax charitable deduction. Donor is entitled to that deduction for the gift element of the gift annuity because he didn't make any prior transfers from the CRUT for private purposes.

IRS rules on capital gains on collapsing CRUT. Any unrecognized capital gains (*i.e.*, capital gain income not previously included in Donor's unitrust payments under the four tiers) won't be included in his income when he transfers his remaining life interest in the unitrust for a gift annuity.

IRS rules on capital gains on transfer for annuity. It's a bargain sale when appreciated property is transferred for a gift annuity. In computing the gain, the transferred property's cost basis must be allocated between the "gift" portion and the "sale" portion (the annuity's actuarial value). Reg. §1.1011-2(a)(4), -2(c), Ex. 8. First, IRS tells how to determine Donor's basis. But then it rules that his basis is disregarded, giving him a zero basis.

IRS's reasoning: Donor's basis is determined under IRC §1015 because his property interest was in a trust. Under that section, the portion of the adjusted basis allocable to Donor's unitrust interest will be disregarded as required by IRC §1001(e)(1) because Academy won't be receiving the entire interest in the CRUT in a single transaction. Because Donor's unitrust interest is a capital asset, he will have long-term capital gain (the CRUT was created more than one year earlier) equal to the annuity's value. *Letter Ruling 200152018.*

Feel little pain over the capital gain. Donor's annuity is non-assignable and he is the annuitant. Thus the donor-annuitant may report the gain—determined under the bargain sale rules—ratably over his life expectancy. *Note.* The gain reportable each year can't be greater than the portion of the annual payment that constitutes a return of the investment in the contract for the year. If death gets to the donor-annuitant before he's done paying IRS, any remaining gain gets buried with him and, thus, isn't reportable.

D. CRUT—EARLY TERMINATION APPROVED AND THEN IRS CHANGED ITS MIND

Bob and Carol created a net-income-with-no-makeup charitable remainder unitrust (NI-CRUT) paying income to them jointly, then to the survivor with remainder to their private foundation. The NI-CRUT provides that they are to receive the lesser of the trust income for each taxable year or 15% of the net fair market value of the trust assets valued on the first day of each taxable year. The primary asset used by Bob and Carol to fund their trust was closely held stock. The stock was recently sold to a third party leaving cash as the trust's primary asset. Bob, Carol and the trustees of the private foundation remainder organization determined that the purposes of the trust to provide management over trust assets no longer existed and that the charitable intent could be better served by early termination and distribution of the remainder interest directly to the private foundation and the life interest to Bob and Carol.

All the interested parties agree to termination and the distribution to the income beneficiaries and the remainder beneficiary—the private foundation. Bob and Carol plan to treat the proceeds they receive as an amount received from the sale of a term interest in property, subject to limitations of IRC §1001(e)(1)—that is the gain equals the entire amount realized, with no offsetting basis in their interest. The actuarial value determining how much shall be distributed to the life beneficiaries and the remainder organization will be determined by using the effective IRC §7520 discount rate on the date of termination (using the method under Reg. §1.664-4 for valuing interests in charitable remainder trusts).

The trust has received an opinion from its legal counsel that early termination is permissible if the beneficiaries agree and none of the beneficiaries interests are contingent. Bob and Carol, who had in the trust instrument retained the right to change the charitable remainder organizations, plan to release that power.

Termination will be accomplished with court proceedings and the consent of the state attorney general will be obtained prior to termination.

Bob and Carol have confirmed that neither of them has a medical condition that would result in a shorter than average longevity for persons of their ages. A physician has examined both of them and provided confirmation of their assertion. Also Bob and Carol have signed affidavits that they know of no health condition that would reduce their normal life expectancy.

IRS rules: 1. Early termination and division of the trust won't constitute self-dealing under IRC §4941(a)(1) by the trustee or by either donor with respect to the trust, or by either donor with respect to the private foundation remainder organization; 2. Consent to the early termination by the private foundation won't constitute participation in a self-dealing under IRC §4941(a)(2) by any foundation manager, and 3. The proposed termination will not constitute a termination of foundation status under IRC §507(a).*Letter Ruling 200525014.*

Comment. Presumably Bob and Carol are husband and wife, but the ruling doesn't so specify. The IRS has earlier ruled in Letter Ruling 9547004 that a multiple grantor unitrust isn't qualified. IRS resisted many requests that the ruling be withdrawn, but did say that the ruling wouldn't apply when the grantors are spouses. Here IRS wasn't asked to rule on the CRUT's qualification, but just on the consequences of its termination.

Interesting development: After Letter Ruling 200525014 (above) was issued, I learned that the IRS has refused to issue a favorable ruling in a similar case on the ground that the early termination would be a prohibited act of self dealing (a sale) because the remainder organization is a private foundation. The IRS has indicated that it would rule favorably if the remainder organization is changed to a public charity (the donor could do so under the terms of his trust) prior to the trust's termination.

Later development. IRS in April, 2006 Letter Ruling 200614032 revoked, without explanation, Letter Ruling 200525014 (above) "which addressed whether your early termination constituted an act of self-dealing under section 4941 of the Internal Revenue Code and whether such action constituted a termination of private foundation status under 507(a) of the Code."

"This action is consistent with section 13.04 of Rev. Proc. 2006-4, 2006-1 I.R.B. 132, 159.

"Therefore, you may not rely on this letter ruling. However, section 13.05 of Rev. Proc. 2006-4 provides that under certain circumstances, the retroactive effect of the revocation of this letter ruling may be limited. Please follow the procedures described in section 13.09 to request such retroactive relief under section 7805(b) of the Code.

"This letter does not constitute an adverse letter ruling with respect to the above issues. You may request a conference to discuss this matter further."

Rev. Proc. 2006-4, Section 13.04: Unless it was part of a closing agreement as described in section 3.03 of this revenue procedure, a letter ruling found to be in error or not in accord with the current views of the Service may be revoked or modified. If a letter ruling is revoked or modified, the revocation or modification applies to all years open under the statute of limitations unless the Service uses its discretionary authority under §7805(b) to limit the retroactive effect of the revocation or modification.

A letter ruling may be revoked or modified due to—

(1) a notice to the taxpayer to whom the letter ruling was issued;

(2) the enactment of legislation or ratification of a tax treaty;

(3) a decision of the United States Supreme court;

(4) the issuance of temporary or final regulations; or

(5) the issuance of a revenue ruling, revenue procedure, notice, or other statement published in the Internal Revenue Bulletin

Consistent with these provisions, if a letter ruling relates to a continuing action or a series of actions, it ordinarily will be applied until any one of the events described above occurs or until it is specifically withdrawn.

Publication of a notice of proposed rulemaking will not affect the application of any letter ruling issued under this revenue procedure.

Rev. Proc. 2006-4, Section 13.05: Except in rare or unusual circumstances, the revocation or modification of a letter ruling will not be applied retroactively to the taxpayer for whom the letter ruling was issued or to a taxpayer whose tax liability was directly involved in the letter ruling provided that—

(1) there has been no misstatement or omission of material facts;

(2) the facts at the time of the transaction are not materially different from the facts on which the letter ruling was based;

(3) there has been no change in the applicable law;

(4) the letter ruling was originally issued for a proposed transaction; and

(5) the taxpayer directly involved in the letter ruling acted in good faith in relying on the letter ruling, and revoking or modifying the letter ruling retroactively would be to the taxpayer's detriment. For example, the tax liability of each employee covered by a ruling relating to a qualified plan of an employer is directly involved in such ruling. However, the tax liability of a member of an industry is not directly involved in a letter ruling issued to another member and, therefore, the holding in a revocation or modification of a letter ruling to one member of an industry may be retroactively applied to other members of the industry. By the same reasoning, a tax practitioner may not extend to one client the non-retroactive application of a revocation or modification of a letter ruling previously issued to another client. If a letter ruling is revoked or modified by letter with retroactive effect, the letter will, except in fraud cases, state the grounds on which the letter ruling is being revoked or modified and explain the reasons why it is being revoked or modified retroactively.

Rev. Proc. 2006-4, Section 13.09: Under §7805(b), the Service may prescribe any extent to which a revocation or modification of a letter ruling or determination letter will be applied without retroactive effect.

A taxpayer to whom a letter ruling or determination letter has been issued may request that the Commissioner, Tax Exempt and Government Entities Division, limit the retroactive effect of any revocation or modification of the letter ruling or determination letter.

(1) Request for relief under §7805(b) must be made in required format.

A request to limit the retroactive effect of the revocation or modification of a letter ruling must be in the general form of, and meet the general requirements for, a letter ruling request. These requirements are given in section 9 of this revenue procedure. Specifically, the request must also—

(a) state that it is being made under §7805(b);

(b) state the relief sought;

(c) explain the reasons and arguments in support of the relief requested (including a discussion of the five items listed in section 13.05 of this revenue procedure and any other factors as they relate to the taxpayer's particular situation); and

(d) include any documents bearing on the request. A request that the Service limit the retroactive effect of a revocation or modification of a letter ruling may be made in the form of a separate request for a letter ruling when, for example, a revenue ruling has the effect of revoking or modifying a letter ruling previously issued to the taxpayer, or when the Service notifies the taxpayer of a change in position that will have the effect of revoking or modifying the letter ruling. However, when notice is given by the Director, EP or EO Examinations during an examination of the taxpayer's return or by the Appeals Area Director, Area 4, or the Appeals Area Director, LMSB, during consideration of the taxpayer's return before an appeals office, a request to limit retroactive effect must be made in the form of a request for technical advice as explained in section 19 of Rev. Proc. 2006-5.

When germane to a pending letter ruling request, a request to limit the retroactive effect of a revocation or modification of a letter ruling may be made as part of the request for the letter ruling, either initially or at any time before the letter ruling is issued. When a letter ruling that concerns a continuing transaction is revoked or modified by, for example, a subsequent revenue ruling, a request to limit retroactive effect must be made before the examination of the return that contains the transaction that is the subject of the letter ruling request.

Consideration of relief under §7805(b) will be included as one of the taxpayer's steps in exhausting administrative remedies only if the taxpayer has requested such relief in the manner described in this revenue procedure. If the taxpayer does not complete the applicable steps, the taxpayer will not have exhausted the taxpayer's administrative remedies as required by §7428(b)(2) and §7476(b)(3) and will, thus, be precluded from seeking a declaratory judgment under §7428 or §7476. Where the taxpayer has requested §7805(b) relief, the taxpayer's administrative remedies will not be considered exhausted until the Service has had a reasonable time to act upon the request.

(2) Taxpayer may request a conference on application of §7805(b).

A taxpayer who requests the application of §7805(b) in a separate letter ruling request has the right to a conference in EP or EO Technical as explained in sections 12.01, 12.02, 12.03, 12.04 and 12.05 of this revenue procedure. If the request is made initially as part of a pending letter ruling request or is made before the conference of right is held on the substantive issues, the §7805(b) issue will be discussed at the taxpayer's one conference of right as explained in section 12.02 of this revenue procedure. If the request for the application of §7805(b) relief is made as part of a pending letter ruling request after a conference has been held on the substantive issue and the Service determines that there is justification for having delayed the request, the taxpayer is entitled to one conference of right concerning the application of §7805(b), with the conference limited to discussion of this issue only.

Latest development—an IRS switcheroo. IRS, based on additional information from a taxpayer, approved the termination of a CRUT having a private foundation as the remainder organization, but it imposed a condition.

Here's the story. Donor was the sole beneficiary and the trustee of his unitrust. A private foundation was named as the remainder organization. Another party served as the independent special trustee. The ruling doesn't tell us why the trust had that trustee. Presumably, the CRUT had—or might have—non-marketable assets and an independent trustee is needed to make the annual determination of the trust's fair market value. If a donor is the trustee of a CRUT with non-marketable assets, the trust to be qualified must have an independent trustee for determining the annual valuation. Alternatively, the trust can provide that the annual valuation is to be made by a qualified independent appraiser having the same qualifications needed to substantiate—for the income tax charitable deduction—gifts of real estate and tangible personal property valued at over $5,000 and closely held stock valued at over $10,000.

Donor informed IRS that he—under the powers held by him in the trust—had substituted five publicly supported organizations as the remainder organizations for the one private foundation originally named.

Donor told IRS that he wished to terminate the trust by selling his income interest to the five public charitable remainder organizations for an amount equal to the present value of his life income interest. The actuarial value of that interest would be calculated using the effective discount rate under IRC §7520, and the method for valuing interests in charitable remainder trusts contained in Reg. §1.664-4.

Donor represented that he was unaware of a physical condition that would decrease his normal life expectancy. He submitted a statement from his physician confirming that he had examined Donor and that there was no indication that his life expectancy was less than would otherwise be expected for a man of his age.

State law governing the trust permits early termination, provided there is agreement among the trustees and beneficiaries (life tenant and remainder organizations). There is no requirement that the state Attorney General or any court be involved in a trust termination in which all beneficiaries consent.

IRS rules in Letter Ruling 200616035. Now that the charities are publicly supported: **(1)** early termination of the trust won't be self-dealing under IRC §4941(a)(1) by the donor as trustee or as the donor with respect to the trust; **(2)** early termination of the trust won't be self-dealing under IRC §4941(a)(1) by the independent trustee with respect to the trust; and **(3)** the proposed termination of the trust won't be subject to termination tax under IRC §507.

Lesson to be learned. Most CRTs are created with no intention of collapsing them down the road, with the assets being divided between the life tenant and the charitable remainder organization (based on the value of their respective interests)—or a sale by the life beneficiary of his interest to the charitable remainder organization. If the originally named remainder organization is a private foundation, keeping the right to substitute public charities gives flexibility—the ability to collapse the trust and divide the assets according to the respective interests of the donor and the charity.

But don't be hoist by your own petard in other situations. For example, if a donor initially names one or more *public charities* as the remainder organization(s) and retains the right to substitute other charities, the trust instrument should require that any substitute charity be a *public charity.* If the donor has the right to substitute a *private foundation*—even though he never exercises that right—his income tax charitable deduction will be computed just as if he had named a private foundation at the outset. That would result in a lower adjusted-gross-income ceiling on deductibility. Further, the deduction for long-term appreciated property would be based on the remainder interest in the cost basis rather than the remainder interest in the fair market value.

Exception time. If the trust is funded with long-term "qualified appreciated stock" (listed or over-the-counter), the deduction for the remainder interest for a private foundation remainder organization would be based on the fair market value. But the AGI deductibility ceiling would be 20%, not the 30% of AGI as is the rule for CRTs for public charity remainder-organizations.

Exception to the exception. Gifts of stock subject to SEC Rule 144 restrictions, including volume and resale limitations, may not qualify as qualified appreciated stock. *Letter Ruling 9746050.*

Ready for another exception? A gift of stock in any one corporation won't be of qualified appreciated stock if the cumulative amount of that stock contributed by a donor to all private foundations exceeds 10% of the value of all that corporation's outstanding stock. *Caution.* Under attribution rules, charitable gifts by a spouse, siblings, ancestors and lineal descendants are deemed made by the donor.

Iam satis—enough already.

E. NIM-CRUT TERMINATED—VALUING THE INTERESTS

Watch Out for the MacGuffin. MacGuffin. The word was coined by Alfred Hitchcock to describe a technique he used in his mystery films. It is a plot element that throws the viewer off—sort of a red herring.

Recent letter ruling on a NIM-CRUT has an unintentional MacGuffin. The trust will be terminated before the life beneficiary's death with the assets being divided between the income beneficiary and the charitable remainder organizations. The primary thrust and emphasis of the ruling is that the termination won't involve a prohibited act of self dealing by anybody in sight. But the real significance is how IRS rules on the valuation of the income and remainder interests—not favorable to the donor/income beneficiary.

An aside, but not a MacGuffin. Valuation of a life recipient's interest is important not only for a CRT that is terminated with the assets divided between the income recipient and the charity, but also when a life income recipient contributes his remaining life interest to the charity (thus terminating the trust). He has to value that interest when he claims his charitable deduction.

Here's the letter ruling's plot. Donor created a 10% net-income-with-makeup charitable remainder unitrust (NIM-CRUT). He is the income recipient and publicly supported charities are the remainder organizations. Donor is also a trustee along with an independent special trustee.

Donor wishes to terminate the NIM-CRUT and have the trust assets distributed to him and the charities according to their respective interests. The IRS deems the termination to be a constructive sale of the income recipient's interest and he has a zero basis. If the trust was created more than a year before the CRT's termination, Donor's constructive sale is treated as a sale of a long-term capital asset (taxable at a maximum 15% rate). The gain is the difference between the value of the income recipient's interest and zero. Naturally, an income recipient wants the highest-possible valuation of his interest because he gets more assets—and keeps 85% after paying a 15% tax.

The law in Donor's state permits early termination of the trust provided all the parties agree (income recipients, trustees and charitable remainder organizations). The state's attorney general and a court needn't be involved as long as all the parties consent. In addition, the Restatement of the Law of Trusts 3d (2001) provides at section 651(1) that ". . . if all of the beneficiaries of an irrevocable trust consent, they can compel the termination or modification of the trust."

As is commonplace in CRT terminations, when a CRUT or CRAT is measured by an individual's life (as opposed to a term of years) Donor represented to the IRS that he was aware of no physical condition that would decrease his normal life expectancy. He also submitted a statement from his physician confirming that he had examined Donor, and that there was no indication that his life expectancy was less than would otherwise be expected for a man his age. Naturally, if someone is at death's door—or closer to the door than normal—his life interest's value is diminished.

The plot thickens. In Donor's initial ruling request, he stated that the actuarial values of the respective interests (his and the charitable remainder organizations) should be calculated using the discount rate in effect under IRC §7520 on the date of the constructive sale, and the method of valuing a charitable remainder in Reg. §1.664-4.

After discussions with the IRS, Donor, as the income recipient, agreed to a different method of calculating the respective interests in the trust. Specifically, the letter ruling stated:

> The Taxpayer understands and agrees that, contrary to the formula assumed in his earlier letter ruling request, the payout rate to be used in calculating the respective interests will be

the lesser of the Code Section 7520 rate in effect at the time of termination of the trust and the stated interest rate [unitrust amount] of 10% contained in the trust agreement.

Flashback—
The IRS's rulings on the self-dealing issues:

• The charitable remainder organizations are public charities. (Donor substituted them for previously named private foundation under a power he retained in the trust.) Thus for purposes of IRC §§4941 and 4946, the income beneficiary is not a disqualified person with respect to the charitable remainder beneficiaries.

• IRC §4941 applies to certain transactions between private foundations and disqualified persons. By early termination, the trust will distribute lump sums to the income recipient and the charitable remainder organizations equal to the actuarial value of their interests —taking into account the net-income provisions of the trust (discussed soon). The distributions are treated as a constructive sale between Donor, income recipient, and the charitable remainder organizations. See Rev. Rul. 69-486.

• Generally, payments to the income recipient from the trust would constitute self-dealing. However, because the distribution to him equals the actuarial value of the income interest—taking into account the net-income provisions of the trust—the exception to self-dealing provided by Reg. §53.4947-1(c)(2)(i) applies and the distribution will not be an act of self-dealing. Further, because the charitable remainder organizations are public charities, IRC §4941 doesn't apply to the transaction between Donor and the charitable remainder organization.

The denouement. The appropriate calculation of the actuarial value of the income recipient's interest must take into account the net-income provisions of the trust. That requires the use of a reasonable method for the calculation which doesn't inappropriately inflate the income recipient's interest to the detriment of the charitable remainder organizations. One reasonable method to calculate the actuarial value of the income and remainder interests, rules the IRS:

The computation of the remainder interest is found using a special factor as indicated in section 1.7520-3(b)(1)(ii) of the regulations. The special remainder factor is found by using the methodology stated in section 1.664-4 for computing the factor for a remainder interest in a unitrust, with the following modification: where section 1.664-4(a)(3) of the regulations provides an assumption that the trust's stated payout percentage is to be paid out each year, instead the assumed payout shall be that of a fixed percentage which is equal to the lesser of the trust's stated payout percentage or the section 7520 rate for the month of termination. The special factor for the non-charitable payout interest is 1 minus the special remainder factor.

Based on this methodology, here's how to calculate Donor's income interest:

The section 7520 rate for May 2006 is 5.8 percent. Assuming the termination occurred in May 2006, the lesser of this rate and the trust's stated payout percentage is 5.8 percent. The assumed taxpayer's age as of the nearest birthday is 75. Based on Table 90CM, interest at 5.8 percent, an unadjusted payout rate of 5.8 percent, and quarterly payments made at the end of each quarter, the present value of the remainder interest in a unitrust which falls in at the death of a person aged 75 is $0.56904 for each $1.00 of the trust estate. The present value of the payout interest in the same unitrust until such death is $1.00 minus $0.56904, or $0.43096 for each $1.00 of the trust estate.

The income recipient is not expected to receive more than he would during the full term of the trust under the above-described methodology for valuing his interest in a charitable remainder trust with a net income make-up feature.

Additional rulings on self-dealing:

•Because the effect of the transaction is to vest the income interest and remainder interest in the remainder organization, the trust no longer will be a split-interest trust and section 4947(a)(2) will no longer apply and section 507 will not apply.

• Early termination of the trust will not constitute an act of self-dealing under IRC §4941(a)(1) by Donor individually and as trustee with respect to the NIM-CRUT using the methodology described above.

• Early termination of the trust will not constitute an act of self-dealing under IRC §4941(a)(1) by the NIM-CRUT's independent trustee with respect to the trust using the methodology described above.

• The termination of the NIM-CRUT will not be subject to a termination tax under IRC §507.

Letter Ruling 200725044

Comment. One tax Einstein opines that arguably IRS's method of valuing the NIM-CRUT's income interest is solely to determine whether the self-dealing excise tax applies—and the methodology doesn't necessarily apply to determining the share of the assets to be received by the income recipient.

Another tax genius says that the best way—for all purposes—to determine the value of a NIM-CRUT's income interest is to have a qualified appraisal on what in the real world a reasonable buyer would pay a reasonable seller both having knowledge of relevant facts and neither being under compulsion to buy or sell.

For those not relishing a battle with the IRS, here's a suggested plan for favorably valuing a life interest on a gift or constructive sale (the assets are divided between the income recipient and the charitable remainder organization). This plan should result in the NIM-CRUT's life interest being valued using the same method as is used for the charitable deduction for the remainder interest when the trust is initially funded.

Don't draft a plain old NIM-CRUT. Instead, draft the NIM-CRUT with a *flexible* FLIP-CRUT provision. Then if the income recipient wants to contribute his remaining life interest or receive his share of the trust, he pulls (squeezes according to my old drill instructor) the trigger —and voila we're dealing with a STAN-CRUT. Hey, no problem in getting a more favorable valuation without doing battle with the IRS.

What is a flexible FLIP-CRUT (a FLEX-FLIP-CRUT)? A typical FLIP-CRUT provides that a NIM-CRUT shall flip and become a STAN-CRUT on January 1 of the year following the sale of Greenacre (a nonmarketable asset). And that's often an appropriate time to flip a NIM-CRUT. But instead of doing it that way, fund the trust with Greenacre *and* a few shares of nonmarketable securities (e.g., cookthebooks.com). Make the sale of cookthebooks.com the flipping event. Then if you wish to flip the trust earlier than Greenacre's sale, on its sale, or later than its sale, you can flip at will—by selling the shares in cookthebooks.com.

Think of the issues at the outset when drafting the NIM-CRUT. This plan won't help the hapless donor in this letter ruling.

As the school master in *The History Boys* might say: "Foresight and flexibility lads, those are the lessons that I want you to learn."

Parthian shot. This letter ruling deals with a net-income-with-makeup unitrust. IRS would likely apply the same computation method to a net-income-with-no-makeup unitrust (NI-CRUT). As a practical matter, the life interest for that trust would be worth even less because deficiencies can never be made up.

F. CRT CAPITAL GAIN AVOIDANCE PLAN ON IRS RADAR

- **Participants must notify IRS**
- **Costly penalties for notification failure**
- **Avoidance or evasion?**

The meek shall inherit the earth and with a stepped-up basis. So for appreciated assets inherited at death, an heir gets a basis equal to the then fair market value (rather than taking over the decedent's lower basis). But a decedent has to give his life to achieve this.

Can the donor (or other beneficiary) of a charitable remainder unitrust or annuity trust during his lifetime step up the basis of appreciated assets used to fund the CRT and then on an early termination of the trust get back proceeds equal to his interest in the trust free of capital gains tax? That's what concerns the IRS in Notice 2008-99, the subject of this article.

Three scenarios follow. Scenario 3 troubles the IRS. Scenarios 1 and 2 are for background.

Scenario 1 — no problem. Every schoolchild knows that a donor can transfer appreciated assets to a charitable remainder unitrust or annuity trust and avoid capital gain on the trust's funding, and not be taxed on the capital gain on a subsequent sale by the trust. The capital gain is, however, taxable to the donor or other beneficiary (recipient) but only to the extent that the gain is deemed distributed to the recipient under the four-tier taxation regime in satisfaction of the annual unitrust or annuity trust amount.

Scenario 2 — no problem. Some recipients terminate their CRTs before the end of the specified term and the trust assets are divided between the recipient and the charitable remainder beneficiary according to their respective interests at the CRT's termination. A number of letter rulings have sanctioned this. The termination is treated as a sale of the recipient's term interest (generally measured by his life but sometimes a term-of-years interest). The recipient is deemed to have a zero basis and has long-term capital gain if the trust was created more than one year before its termination.

A harbinger of Scenario 3. In January 2008, to the annual list of areas under study in which rulings will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations or otherwise, IRS added:

•*IRC §664. — Charitable Remainder Trusts.* Whether the termination of a charitable remainder trust before the end of the trust term as defined in the trust's governing instrument, in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets, causes the trust to have ceased to qualify as a charitable remainder trust within the meaning of §664.

Something to think (and worry?) about. What bad consequences can befall the donor and a CRT that terminates early and has ceased to qualify as a charitable remainder trust within the meaning of §664*?*

Note. The IRS's work plan (to-do list) for the period of July 1, 2007 to June 30, 2008 stated that a revenue ruling on the termination of charitable remainder trusts under IRC §664 and the division of the assets between the life beneficiary and the charitable remainder organization will be issued. Could Notice 2008-99 be the forerunner to a revenue ruling or other binding authority?

Scenario 3 — a big problem. The IRS and the Treasury announce in Notice 2008-99 that they are aware of a transaction (described soon) in which a sale or other disposition of <u>all</u> interests in a charitable remainder trust (subsequent to the contribution of appreciated assets to the trust and their sale and reinvestment by the trust) results in the donor or other noncharitable recipient getting the value of that person's trust interest and claiming to recognize little or no taxable gain. "The IRS and Treasury Department believe this transaction has the potential for tax avoidance or evasion*, but lack enough information to determine whether the transaction should be identified specifically as a tax avoidance transaction." The IRS identifies this transaction and substantially similar transactions as transactions of interest for purposes of Reg. §1.6011-4(b)(6) and IRC §§6111 and 6112. IRS also alerts persons involved in these transactions to certain responsibilities that may arise from their involvement. More about transactions of interest, listed transactions and reportable transactions later. To keep this article from becoming a book, I won't explain all the Code and regulation sections cited in Notice 2008-99 regarding required notifications to the IRS. Suffice it to say if you're involved in this type of transaction, you'll want to study them.

Here's the transaction of interest to the IRS and the Treasury. *Step 1.* Donor creates a CRT and contributes Appreciated Assets to Trust. Donor retains an annuity or unitrust interest (Term Interest) and designates Charity as the remainder beneficiary. Charity may, but need not, be controlled by Donor; he may, but need not, reserve the right to change the Charity designated as the remainder beneficiary.

Step 2. Trust sells or liquidates the Appreciated Assets and reinvests the net proceeds in other assets (New Assets) such as money market funds and marketable securities often to acquire a diversified portfolio. Because a charitable remainder trust generally is tax-exempt under IRC §664, Trust's sale of the Appreciated Assets is exempt from income tax, and Trust's basis in the New Assets is the price Trust pays for those New Assets. Some portion of Trust's ordinary income and capital gains may become taxable to Donor as the periodic annuity or unitrust payments are made by Trust (under the rules of IRC §664 and its regulations).

Step 3. Donor and Charity, in a transaction they claim is described in IRC §1001(e)(3), sell or otherwise dispose of their respective interests in Trust to Xenocrates, an unrelated third party, for approximately the fair market value of the Trust's assets including the New Assets.

Step 4. Trust then terminates, and Trust's assets, including the New Assets, are distributed to Xenocrates.

Donor takes these positions regarding the tax consequences of this transaction:

- Donor claims an income tax charitable deduction for the portion of the fair market value of the Appreciated Assets attributable to the remainder interest as of the date of their contribution to Trust.

- Donor claims to recognize no gain from the Trust's sale or liquidation of the Appreciated Assets. When Donor and Charity sell their respective interests in Trust to Xenocrates, Donor and Charity take the position that they have sold the entire interest in Trust within the meaning of IRC §1001(e)(3). Because the entire interest in Trust is sold, Donor claims that IRC §1001(e)(1), which disregards basis in the case of a sale of just the term interest, doesn't apply. Donor also takes the position that, under IRC §1001(a) and related provisions, the gain on the sale of Donor's term interest is computed by taking into account the portion of uniform basis allocable to Donor's term interest under Reg. §§1.1014-5 and 1.1015-1(b), and that this uniform basis is derived from the basis of the New Assets rather than the basis of the Appreciated Assets. (If this works, Donor has achieved Tax Nirvana — a stepped-up basis without giving his life.)

Variations on a scheme:

- A net-income-with-make-up charitable remainder unitrust (NIM-CRUT) is used.

- Trust may have been in existence for some time prior to the sale of Trust interests.

- The Appreciated Assets may already be in Trust before the commencement of the transaction.

- The recipient and seller of the term interest may be the Donor and/or another person.

- Donor may contribute the Appreciated Assets to a partnership or other passthrough entity and then contribute the interest in the entity to Trust.

Claimed tax treatment of the transaction. The gain on the sale of the Appreciated Assets is never taxed, even though the Donor receives his share of the appreciated fair market value of those assets.

Ordinary folks needn't worry. The IRS and the Treasury aren't concerned about the mere creation and funding of a charitable remainder trust with Appreciated Assets and/or the trust's reinvestment of the contributed Appreciated Assets. Those events alone don't constitute the transaction subject to Notice 2008-99.

Who should be concerned? The IRS and the Treasury "are concerned about the manipulation of the uniform basis rules to avoid tax on gain from the sale or other disposition of appreciated assets. Accordingly, the type of transaction described in this notice includes a coordinated sale or other coordinated disposition of the respective interests of the [Donor] or other noncharitable recipient and the Charity in a charitable remainder trust in a transaction claimed to be described in §1001(e)(3), subsequent to the contribution of appreciated assets and the trust's reinvestment of those assets. In particular, the IRS and Treasury Department are concerned about [Donor's] claim to an increased basis in the term interest coupled with the termination of the Trust in a single coordinated transaction under §1001(e) to avoid tax on gain from the sale or other disposition of the Appreciated Assets."

Now for Notice 2008-99's teeth — transactions of interest. Transactions that are the same as, or substantially similar to, those described in Notice 2008-99 "are identified as transactions of interest for purposes of §1.6011-4(b)(6) and §§6111 and 6112 effective October 31, 2008, the date this notice was released to the public. Persons entering into these transactions on or after November 2, 2006, must disclose the transaction as described in §1.6011-4. Material advisors who make a tax statement on or after November 2, 2006, with respect to transactions entered into on or after November 2, 2006, have disclosure and list maintenance obligations under §§6111 and 6112. See §1.6011-4(h) and §§301.6111-3(i) and 301.6112-1(g) of the Procedure and Administration Regulations."

The IRS's and the Treasury's warning. Participants who entered into these transactions at any time may already be in hot water. "Independent of their classification as transactions of interest, transactions that are the same as, or substantially similar to, the transaction described in this notice already may be subject to the requirements of §§6011, 6111, or 6112, or the regulations thereunder. When the IRS and Treasury Department have gathered enough information to make an informed decision as to whether this transaction is a tax avoidance type of transaction, the IRS and Treasury Department may take one or more actions, including removing the transaction from the transactions of interest category in published guidance, designating the transaction as a listed transaction, or providing a new category of reportable transaction."

Who are participants? "Under §1.6011-4(c)(3)(i)(E), each recipient of the term interest and Trust are participants in this transaction for each year in which their respective tax returns reflect tax consequences or a tax strategy described in this notice. Charity is not a participant if it sold or otherwise disposed of its interest in Trust on or prior to October 31, 2008. For interests sold or otherwise disposed of after October 31, 2008, under §1.6011-4(c)(3)(i)(E), Charity is a participant for the first year for which Charity's tax return reflects or is required to reflect the sale or other disposition of Charity's interest in Trust. In general, Charity is required to report the sale or other disposition of its interest in Trust on its return for the year of the sale or other disposition. See §6033 and §1.6033-2(a)(ii). Therefore, in general, Charity will be a participant for the year in which charity sells or otherwise disposes of its interest in Trust."

Time for Disclosure. See Reg. §§1.6011-4(e) and 301.6111-3(e).

Material Advisor Threshold Amount. The threshold amounts in Reg. §301.6111-3(b)(3)(i)(B) are reduced to $5,000.

Penalties — the book will be thrown at those who are required to disclose but don't. "Persons required to disclose these transactions under §1.6011-4 who fail to do so may be subject to the penalty under §6707A. Persons required to disclose these transactions under §6111 who fail to do so may be subject to the penalty under §6707(a). Persons required to maintain lists of advisees under §6112 who fail to do so (or who fail to provide such lists when requested by the IRS) may be subject to the penalty under §6708(a). In addition, the IRS may impose other penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under §6662 or §6662A."

Treasury and the IRS invited public comments. They said that the government is aware of concerns expressed by commentators on this transaction of interest and requested written comments on how the transaction might be addressed in published guidance. One approach might involve issuing regulations under the authority of IRC §643(a)(7) to address the uniform basis rules under IRC §§1014 and 1015 and the regulations thereunder.

The deadline for comments was January 31, 2009.

My opinion. Clearly, Congress didn't intend to allow the capital gains tax avoidance plan described in Notice 2008-99. And that avoidance should be curbed. Any corrective legislation or regulation should, however, also deal fairly with transactions that aren't designed to slide between any loopholes.

Example. Five years ago, a donor transferred securities valued at $1 million to fund a charitable remainder unitrust. The securities were not appreciated and had a $1 million basis (and the CRT took over the donor's basis). The donor and the charity now terminate the CRT by selling their respective interests to a third party for $1 million (the current fair market value).

The donor's life interest is now valued at 60% and the charity's remainder interest is now valued at 40% of the trust's assets. So the donor receives

$600,000 and the charity receives $400,000. It would be unfair for the donor's basis to be deemed to be zero. In this case, he hasn't through the CRT stepped up the basis of the assets used to fund the trust. Thus the basis of his share of the trust assets sold to the third party should be $600,000. The same rule should apply if the CRT sold the assets originally used to fund the trust and purchased other assets and at the time the trust is terminated those assets are also worth $1 million (with the donor's then interest being valued at $600,000).

What should the rule be in the following situation? Donor funds his charitable remainder unitrust with appreciated assets that have a basis of $800,000 and a $1 million fair market value. The funding assets are sold by the trust and the proceeds reinvested in new assets having a $1 million fair market value. Five years after the CRT is created, the donor and the charity sell their respective interests to a third party. At that time, the donor's life interest is worth 60% of the value of the trust assets and he receives $600,000. It would be unfair (not intended by Congress) for him to have no capital gain — nor would it be fair for him to have a zero basis and a $600,000 capital gain. To thicken the plot, suppose the donor as the trust recipient was taxed on some or all of the capital gain when it was deemed distributed to him under tier two of the four-tier rule for taxation of the unitrust amount to the recipient. This should be taken into account in determining the donor's basis on the termination of the CRT.

Suggested solution — fair to the IRS, the Treasury and the recipient (person receiving the value of the term interest) on a sale by the recipient and the charity of the trust assets to a third party. The recipient's basis is his pro rata share of the CRT's basis reduced by his pro rata share of any undistributed amounts then in tier two (capital gain) of the four-tier provision for taxation of unitrust (and annuity) amounts to the trust recipient.

*Evasion is more serious than avoidance. Avoidance can be achieved by taking advantage of tax-saving methods specified in the Code. Sometimes it is achieved by a loophole (something that Congress didn't think of — but kosher until the loophole is closed by legislation, regulation, revenue ruling, etc.). Tax evasion, on the other hand, can end you up in a federal gated community.

G. COMMENTS BY ACGA TO THE IRS AND THE TREASURY ON EARLY TERMINATION OF CHARITABLE REMAINDER TRUSTS

In these difficult economic times, some life-income recipients of charitable remainder trusts and the charitable remainder organizations wish to terminate those trusts early — the charities need funds now (instead of in the future when the trust term ends) and the life-income recipients need immediate funds (instead of piecemeal over the balance of the trust term).

Notice 2008-99 (explained above) tells about the IRS's concerns about early terminations of charitable remainder trusts by some donors who attempt to get back most of the assets of their charitable remainder trusts *and* avoid capital gains taxes by using the CRT to step-up the basis of the returned assets. The Treasury and the IRS requested public comments. The American Council on Gift Annuities strongly stated that the transactions described in Notice 2008-99 should be curbed, but suggested a way to protect the fisc without adversely affecting non-abusive CRT terminations. ACGA also asked the Treasury and the IRS to authorize an additional way to value a life interest on the termination of a net-income-with-make-up charitable remainder trust (NIM-CRUT). The IRS has suspended issuing letter rulings on the consequences of early CRT terminations — and this has a deep-freeze effect on early terminations. ACGA asked for prompt guidance by the IRS.

ACGA's comments follow:

January 12, 2009

People of the Treasury and the Internal Revenue Service:

Comments submitted by the American Council on Gift Annuities (ACGA) (formerly the Committee on Gift Annuities). ACGA, formed in 1927, is an IRC §501(c)(3) organization described in IRC §170(b)(1) (A)(vi). ACGA's board of directors and its legal counsel are all unpaid volunteers. **ACGA is sponsored by over 1200 social welfare charities, health organizations, environmental organizations, colleges, universities, religious organizations and other charities.** The Mission of ACGA is to "actively promote responsible philanthropy through actuarially sound charitable gift annuity rate recommendations, quality training opportunities and the advocacy of appropriate consumer protection." American Council on Gift Annuities, 233 McCrea Street, Suite 400, Indianapolis, IN 46225. Phone: (317) 269-6271; Fax: (317) 269-6276; E-mail: acga@acga-web.org.

Prepared by: ACGA's pro bono legal counsel, Conrad Teitell, Cummings & Lockwood, Six Landmark Square, Stamford, CT 06901. Phone: (203) 351-4164; Fax: (203) 708-3840; E-mail: cteitell@cl-law.com.

We support the Treasury's and the Internal Revenue Service's efforts to curb any abuses involving the tax treatment of charitable contributions. In fact, the charities initially alerted the Internal Revenue Service about the abusive so-called accelerated charitable remainder trust.

Clearly, Congress didn't intend to allow the capital gains avoidance described in Notice 2008-99. And that avoidance should be curbed. Any corrective regulation or legislation should, however, also deal fairly with and not thwart proper transactions.

In these difficult economic times, some life-income recipients of charitable remainder trusts and the charitable remainder organizations wish to terminate those trusts early — the charities need funds now (instead of in the future when the trust term ends) and the life-income recipients need immediate funds (instead of piecemeal over the balance of the trust term). Improper capital gain avoidance is not on their radar.

The abuse under the facts detailed in Notice 2008-99 should be curbed by at a minimum reducing the life-income recipient's basis in his interest to zero. However, the following two examples show how it would be unfair and not in furtherance of good tax policy to reduce in all cases the basis in the life-income recipient's interest to zero on a sale to a third party of the respective interests of the life-income recipient and the charitable remainder organization.

The examples are followed by a suggested solution to the abuse outlined in Notice 2008-99. It is fair to the Treasury, the IRS, the life-income recipient, and the charitable remainder organization.

Example 1. Five years ago, a donor transferred securities valued at $1 million to fund a charitable remainder unitrust. The securities were not appreciated and had a $1 million basis and the CRUT took over the donor's basis. The CRUT retained the assets used to fund the trust. The donor, who is the life-income recipient, and the charitable remainder organization now terminate the CRUT by selling their respective interests to a third party for $1 million, the current fair market value.

The life-income recipient's interest is now valued at 60% of the fair market value of the CRUT's assets and the charity's remainder interest is now valued at 40% of the CRUT's assets. So the life-income recipient receives $600,000 and the charity receives $400,000. It would be unfair for the life-income recipient's basis to be deemed to be zero. In this case, he hasn't through the CRUT stepped up the basis of the assets used to fund the trust. Thus the basis of his share of the trust assets sold to the third party should be $600,000. The same rule should apply if the CRUT sold the assets originally used to fund the trust and purchased other assets and at the time the trust is terminated those new assets are also valued at $1 million (with the life-income recipient's then interest being valued at $600,000).

Example 2. Donor funded his charitable remainder unitrust with appreciated assets that had a basis of $800,000 and a $1 million fair market value and the trust took over the donor's basis. The funding assets were sold by the

CRUT and the proceeds reinvested in new assets having a $1 million fair market value. Five years after the CRUT was created, the life-income recipient and the charitable remainder organization sell their respective interests to a third party for $1 million. At that time, the life-income recipient's interest is worth 60% of the value of the CRUT's assets and he receives $600,000. It would be unfair (not intended by Congress) for him to have no capital gain — nor would it be fair for him to have a zero basis and a $600,000 capital gain. To thicken the plot, suppose the donor as the CRUT life-income recipient was taxed on some or all of the capital gain when it was deemed distributed to him and taxable under the capital gains category of Reg. Sec. 1.664-1. This should be taken into account in determining the life-income recipient's basis on the termination of the CRUT.

Suggested solution — fair to the Treasury, the IRS, the life-income recipient and the charitable remainder organization on a sale by the life-income recipient and the charity of the trust assets to a third party. The life-income recipient's basis is his pro rata share of the charitable remainder unitrust's or annuity trust's basis reduced by his pro rata share of any undistributed amounts then in the capital gains category of Reg. Sec. 1.664-1. **Hereinafter, this suggested solution is called the "adjusted uniform basis rule."**

ACGA requests that when the situation described in Notice 2008-99 is addressed, that you also issue guidance on the following related situations involving early termination of charitable remainder unitrusts and annuity trusts so that donors, charities and their advisers can plan without having to seek costly private letter rulings. This would also reduce the workload of the Service's overburdened staff. (The safe-harbor charitable remainder and charitable lead unitrust and annuity trust specimen agreements that have been issued by the Service are examples of how published guidance has benefitted donors, charities, their advisers and the Service.)

H. GIFT ANNUITY FUNDED WITH REMAINDER INTEREST IN PERSONAL RESIDENCE

A donor can combine two deferred charitable gifts in one transaction: (1) a remainder interest in his or her personal residence (donor retains a life estate); and (2) a lifetime annuity payable to the donor from the charity's general assets. To the extent the value of the remainder interest exceeds the value of the lifetime annuity on the date of transfer, the donor has made a charitable gift. Income and gift tax charitable deductions are allowable, but donor recognizes gain on the transaction, determined under IRC §1011(b) and Reg. §1.1011-2. *Letter Rulings 8120089, 8305075* and *8806042*. Check state law on whether charity can issue gift annuity in exchange for real property. Also, charity must decide whether it wants to start paying annuity now though it won't receive property until later.

The debt-financed income rules. If a charity accepts mortgaged property for a gift annuity, it will have taxable debt-financed income unless the mortgage was placed on the property more than five years before the inter vivos transfer for the annuity, and the donor owned the property more than five years before the transfer. In that case, the mortgage is not considered an acquisition indebtedness during the ten years following the transfer. If the property is transferred by a donor's will, the "five-year before the transfer" requirement does not apply. IRC §514(c)(2).

Even if the charity receives unmortgaged property for a gift annuity, it will be deemed to have received debt-financed income—and/or may find itself being taxed as an insurance company under IRC §501(m)—unless these tests are met:

The value of the annuity is less than 90% of the value of the property received (the gift part is more than 10%);

The annuity is payable over the life of one or two individuals living when the annuity is created;

The annuity does not guarantee a minimum or maximum amount of total payments; and

The annuity does not provide for adjustment of payments by reference to the income received from the transferred or other property. IRC §514(c)(5).

Gain implications when annuity funded with mortgaged property. Add the amount of the mortgage to the actuarial value of the annuity in determining the gain implications. Gain attributable to the indebtedness cannot be reported ratably over the donor-annuitant's life expectancy.

Gift annuities may be the problem solver for gifts of mortgaged property and tangible personal property. Under current IRS interpretations, unitrusts, annuity trusts and pooled funds can't be created with mortgaged property. But gift annuities can (keep the bargain sale rules in mind). No income tax charitable deduction is allowable for transfers of tangible personal property to unitrusts, annuity trusts and pooled income funds. But that property can produce an income tax charitable deduction when transferred for a gift annuity. Keep in mind: (1) the related/unrelated issue for valuing the charitable contribution; (2) Is this a good deal for the charity? If it keeps the property, it will have to pay the annuity from other funds; if the charity sells the property, the proceeds may be less than the valuation placed on the property for determining the annuity payments; make sure state law permits issuance of an annuity for tangible personal property.

I. SPLIT INTEREST GIFTS FOR EMPLOYEES

Some corporations use unitrusts, annuity trusts or pooled fund gifts to compensate employees, thus making charitable gifts in the process. IRS specifically approved this technique for pooled funds in *Rev. Rul. 85-69.*

Consequences for the corporation. A corporation that provides a life income gift for an employee will be treated—for tax purposes—just as if it gave the employee a cash bonus equal to the value of the employee's life income interest. The corporation gets an income tax business expense deduction for the value of the employee's life interest and a charitable deduction for the value of the charitable institution's remainder interest. That's good. But if the life income beneficiary is a stockholder, the value of the stockholder's income interest will be treated as a dividend—and won't qualify for an income tax business expense deduction. The corporation will, however, be entitled to an income tax charitable deduction for the value of the charity's remainder interest.

Consequences for the income beneficiary. The life income beneficiary—whether an employee or stockholder—would have income in the year of the transfer equal to the value of her entire life income interest. The beneficiary would also have to report her *payment for the year* as income. Thus she'd have to report much more income on the tax return than she'd receive that year.

J. TAX-EXEMPT UNITRUSTS AND ANNUITY TRUSTS

Trust funded with tax-free securities. The investment or reinvestment in tax-free bonds won't disqualify the trust as a charitable remainder trust and will not "affect the trust's exemption from income taxation under section 664(c) of the Code as long as there is no express or implied agreement that the trustee must invest or reinvest in such bonds." *Letter Ruling 7803041.*

Trust funded with appreciated property to be sold and proceeds invested in tax-exempts.

Background. Rev. Rul. 60-370, 1960-2 CB 203 says that, if the trustee is under an express or implied obligation to sell or exchange the transferred property and purchase tax-exempt securities, the donor is deemed to have sold the property himself and given the trustee the proceeds. The gain from the sale is imputed to the donor and includable in his gross income. Donor asked IRS to rule that gain from the sale of trust assets would not be gross income to him. The trust was funded with appreciated securities, but donor, as trustee, expected to reinvest in tax-exempt bonds.

IRS rules. Citing *Rev. Rul. 60-370*, IRS said it may be necessary to go beyond the trust instrument to determine whether the trustee has an obligation to sell the property and invest the proceeds in tax-exempts. We will not rule, said IRS, whether there is such an obligation; nor will we rule that gain from the sale of the initial trust property after the trust is executed and funded will not be includable in your gross income. *Letter Ruling 7815017.*

Heads IRS wins, tails you lose. If donor loses the *Rev. Rul. 60-370* argument, he has to pay capital gain tax out of his own pocket (not out of proceeds of the trust's sale). If donor wins the *Rev. Rul. 60-370* argument, he doesn't have tax-exempt income until entire gain is deemed distributed to him under the four-tier provision in satisfaction of his annual payments. Argument can be made, however, that four-tier provision does not apply to a "net income" unitrust (a literal reading of the Code). But Treasury, reading its own regulations, maintains that it does. *Letter Rulings 7905024* and *7904028*. And in Reg. §1.664-4(d)(1)(iii) (December 10, 1998) IRS said again that the four-tier provision covers NIM-CRUTs and NI-CRUTs.

K. MULTIPLE DONOR CRUT NOT QUALIFIED

A harsh 1995 IRS letter ruling puts a shadow over countless charitable remainder trusts. IRS says that for income tax purposes the attempted unitrust is an association and not a trust.

Situation. The donors, a husband and wife and their six grandchildren, propose to form a $2 million net income with makeup unitrust (NIM-CRUT). The grandchildren together will contribute about $940,000 and the balance will be from the husband and wife. The trust will pay the unitrust amount to the husband and wife for their lives and then to the survivor of them, then to the grandchildren as a class for their lives. On the death of the last grandchild to die, the trust property goes to charity. The unitrust amount is the lesser of trust income or 11% of the trust assets valued at the beginning of each year. In any year when the trust income exceeds the stated percentage, the excess will make up any prior years' shortfall. *IRS rules.* The attempted unitrust isn't qualified because the arrangement isn't a trust. *Letter Ruling 9547004*.

L. FUNDING CRTS WITH MORTGAGED PROPERTY

IRS disqualified a CRUT because it was funded with mortgaged property and the donor remained personally liable on the mortgage. A CRT must function exclusively as one from its creation. But a trust isn't deemed “created,” said

IRS, as long as the donor is treated as an owner of the trust under the grantor trust rules discussed in *Letter Ruling 9015049.* From 1970 until 1990, many donors funded charitable remainder trusts with mortgaged property without a peep from IRS.

M. TANGIBLE PERSONAL PROPERTY TO FUND CRT

Musical instrument. An appreciated musical instrument (tangible personal property) can be used to fund a charitable remainder trust, according to *Letter Ruling 9452026*. But is there an income tax charitable deduction?

The musical instrument—future interest in tangible personal property rule. A gift of a future interest in tangible personal property is deemed made only when all intervening interests in the property have expired or are held by people other than the donor or close family members (described in IRC §267(b) and 707(b)). IRC §170(a)(3). Because a musical instrument is tangible personal property, the deduction for the remainder interest is not allowable so long as the donor retains an income interest in the musical instrument. However, an income tax deduction would be allowed under IRC §170(a)(3), when the trustee sells the musical instrument. At that time the donor would no longer retain an intervening interest in the tangible personal property. He would then be holding only an income interest in the instrument's sale proceeds. Thus the taxpayer's intervening interest in the instrument would terminate on its sale.

The musical instrument is an "unrelated" use gift because the instrument will be sold. So even if the charitable remainder organization must be a public charity, the Donor's deduction in the year of the sale would be for the remainder element of the donor's basis (rather than the remainder element of the fair market value). IRC §170(e)(1)(B)(i). Capital gains implications: Any gain on the sale of the musical instrument or the stock would not be attributable to the donor. In addition, the annuity payments received by the donor will be taxable under the four-tier provision of IRC §664(b).

N. THE "5% PROBABILITY" TEST FOR CRATS

IRS has ruled that a charitable remainder annuity trust must meet two tests: *Test 1—Actuarial Value Test.* There must be a charitable remainder computed using the tables prescribed for split-interest charitable gifts; and Test 2—5% Probability Test. Even if there's an actuarially determined value for the remainder interest satisfying Test 1, charitable deductions (income, gift and estate) are not allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If there's more than a 5% probability that the noncharitable income beneficiary (or beneficiaries) will survive the exhaustion of the trust assets, that probability is not so remote as to be negligible. *Rev. Rul. 77-374,* 1977-2 CB 329.

The Tax Court upheld the “5% probability test" in *Moor*, 43 TCM 1530 (1982). However, the court also held that the test is satisfied as long as the trust’s annual earnings can be reasonably anticipated to exceed the required annual payout to the beneficiary. The court also suggested—and might be construed as holding—that in any event, the 5% figure used by IRS was too low. The Tax Court said that Treasury tables may be disregarded if application of those tables is shown to be unreasonable or inappropriate. However, "the determination of whether the chance that the charity will not take is remote is to be made *at the date of death*" (emphasis added). Apparently, if the 5% test is failed, the trust isn’t a CRAT for any purpose. *Letter Ruling 9532006.*

Caution—unitrusts. A 1978 General Counsel's Memorandum (*GCM 37770*) proposed a ruling to IRS (but not issued by IRS) that would in limited circumstances—depending on the facts of each case—apply *Rev. Rul. 77-374* to charitable remainder unitrusts. The proposed revenue ruling would have held that the conclusions of *Rev. Rul. 77-374*, which involved a charitable remainder annuity trust, may be applicable to charitable remainder unitrusts in cases involving a relatively high adjusted payout rate, combined with a small initial asset value, a relatively young life beneficiary or high administrative costs.

O. CRT’S CAPITAL GAINS GENERALLY NOT TAXABLE TO DONORS—BUT WATCH OUT FOR EXCEPTIONS

Some exceptions. Donors will be socked with capital gain when the charitable transfer is made too late—a corporate liquidation, merger or IPO has already marched beyond the point of no return. And bad tax things happen to good donors who contribute appreciated property subject to a sales contract. That’s also the case when the charity or trust is obligated to sell to a potential buyer with whom the donor had negotiated. *Worst of all worlds.* Not only is the capital gain taxable, but it’s taxable to the donor and paid out of his or her pocket (not out of the profit).

Donor’s covenant not to complete—add that to the list of unintended tax consequences. Donors who contributed a business to a charitable remainder unitrust were taxed when the trust later sold the business because the donors, as well as the trust, gave the buyer a covenant not to complete. *Jorgl,* T.C. Memo 2000-10.

P. SPRINKLING CRUTS AND CRATS

CRT puzzler. Donald, who is to be the trustee, plans to fund a CRUT with closely held stock. The beneficiaries are to be his nephews, Louie, Dewey and Hughie. The trustee is to sprinkle the unitrust amount among them as their needs require (authorized by Reg. §1.664-3(a)(3)(i), (ii)). The trust provides for the annual valuation to be made by a qualified appraiser. The trust meets the unitrust requirements of the Code, the regulations and everything else in sight. Why is this trust nevertheless a bum unitrust? *Answer.* The trustee of a sprinkling charitable remainder unitrust (annuity trust, too) must be independent. If the donor is the trustee, he or she will be an "owner" and the trust will be disqualified. *Rev. Rul. 77-73*, 1977-1 CB 175. The donor-as-trustee- of-a-sprinkling-trust rules will do you in no matter what the trust assets—marketable or unmarketable.

Q. SPLIT-INTEREST CHARITABLE GIFTS AND THE CMFR . . . the good and the bad (sometimes really ugly)

Background. The valuation of charitable remainders (for unitrusts, annuity trusts, personal residences and farms), of charitable lead annuity trusts and lead unitrusts, and the gift portion of charitable annuities is determined by using the charitable mid-term federal rate (CMFR) for the month of the gift—or either of the two prior months at the donor's election.

The CMFR is also used for determining the 10%-minimum-remainder interest (MRI) requirement for CRUTs and CRATs; also for determining whether the gift portion of a gift annuity is more than 10%.

Another also: For determining compliance with the 5% probability test (Rev. Rul. 77-374) for charitable remainder annuity trusts, the CMFR is also used.

Alert. If you plow through this stuff, you will see why I believe it could be dangerous to use the two-month lookback for determining whether the 10% MRI requirement is met.

Observation. Aren't all these rules and the jargon beautiful to behold? And this is just the tip of the IRSberg.

Warning. This isn't light reading. But if you want to know the ins and outs of valuing charitable split-interests and meeting the various requirements, read on.

Charitable Mid-Term Federal Rate—more background. Donors who create split-interest charitable gifts are allowed charitable tax deductions (income, gift and estate) for the value of the charity's interest computed using Treasury tables. The tables' interest assumption is pegged to the federal mid-term interest rate, based on the average market yield of U.S. obligations. Each month, Treasury announces an Applicable Federal Rate (AFR). The interest rate for computing charitable gifts—a figure we call the Charitable Mid-Term Federal Rate (CMFR)—is 120% of the annually compounded AFR for mid-term obligations, rounded off to the nearest 0.2%.

Two-month lookback—more rules. For gifts that have no charitable component—e.g., giving a child a remainder interest in a house—the donor uses the applicable rate for the month of the transfer. However, donors whose gifts are partially charitable (e.g., a charitable remainder unitrust) can use the CMFR for the month of the gift or can elect to use the CMFR from either of the two previous months. The two-month "lookback" can actually give a donor four months to choose from, because IRS publishes the CMFR ahead of time—generally about the 21st day of the previous month.

Example. Melvin plans to create a charitable remainder annuity trust in July. He can wait until toward the end of July to see what August's CMFR will be; if it would yield a higher deduction, he can wait until August before funding the trust. Or, if he funds it in July, he can use the July rate or elect to use the CMFR for June or May.

WHY YOU SHOULD WATCH THE CMFR LIKE A HAWK—BRIEFLY STATED. The CMFR—like most things financial—goes up and down. In February 2011, the CMFR was on the low end— (lowest ever December 2010—1.8%).

First the ugly. With a low CMFR, the 10%-minimum-remainder-interest requirement—especially for charitable remainder annuity trusts—is easily flunked. Ditto for the 5% probability test governing charitable remainder annuity trusts. For charitable gift annuities, the requirement that the gift portion be more than 10% is also easily flunked.

Although charitable remainder unitrusts are affected by swings in the CMFR, for reasons known to the actuaries the effect is much less significant.

Consequences. Flunking the 10% MRI requirement for charitable remainder unitrusts and charitable remainder annuity trusts and the 5% probability test for charitable remainder annuity trusts means loss of income, gift and estate tax charitable deductions—*and* the trusts aren't qualified. Furthermore, if a spouse is involved, the marital deduction will also be lost. And for charitable gift annuities (including deferred payment and flexible starting date gift annuities), if the gift portion doesn't exceed 10%, the *charities* will be taxed under IRC §514(c)(5) and 501(m). Not a good thing.

Can the 10% MRI requirement be met by using the CMFR for either of the two months preceding the month a CRAT or CRUT is created, or must the valuation be made using the CMFR for the month the trust is created? IRC §7520 says you can use either of the two preceding months for computing any income, estate or gift tax charitable deduction. It doesn't say you can use either of those two months for determining whether the 10%

MRI requirement is met. Yet IRC §664(d)(1)(D) and IRC §664(d)(2)(D) say the values for meeting the 10% MRI requirement shall be "determined under section 7520," and those Code sections don't carve out the "either-of-the-two-preceding months" election. **Another yet.** IRC §664(d)(2)(D) provides: "with respect to each contribution of property to the trust, the value (determined under section 7520) of such remainder interest in such property is at least 10% of the net fair market value of such property ***as of the date such property is contributed to the trust."*** [emphasis added.]

A splendid argument can be made that for purposes of meeting the 10% MRI requirement, the remainder can be valued using the CMFR for either of the two preceding months or the month of the transfer. *But do you want to have to make that argument to the IRS, or to a court?* The words of Justice Oliver Wendell Holmes, Jr., in *U.S. v. Wurzbach,* 280 U.S. 396, 399 (1930) are instructive: "Whenever the law draws a line there will be cases very near each other on opposite sides. The precise course of the line may be uncertain, but no one can come near it without knowing that he does so, if he thinks." So unless clarification comes from the IRS, cautious individuals will make sure the 10% MRI requirement is met for the month of the transfer.

Fine hairs: For CRUTs and CRATs, the remainder interest (gift portion) must be *at least* 10%. But for gift annuities, the gift portion must be *more than* 10%. Oh, what fun.

Note: The 10%-minimum-remainder-interest rule doesn't apply to pooled income funds.

Now for the beautiful. Charitable lead annuity trusts are treated most favorably when the CMFR is low. The value of the charity's lead interest under a low CMFR is much greater than under a high CMFR. That makes the value of the remainder interest in the lead trust— that typically goes to family members—much smaller. *Result:* A charitable lead annuity trust can pass assets on to family members down the line at greatly reduced or no gift or estate tax. You'll want to take the generation-skipping tax considerations into account. A low CMFR is also beneficial for remainders in personal residences and farms. The lower the rate, the larger is the charitable deduction for the remainder interest.

Is a charitable lead annuity trust when the CMFR is low an abusive arrangement? The topic came up at the April 3, 2008 U.S. Senate Finance Committee estate tax hearing. In a statement that I prepared for the American Council on Gift Annuities and the National Committee on Planned Giving for the record of the hearing, ACGA and NCPG pointed out that the CMFR is a two-edged sword. Although it can now be highly advantageous to create charitable <u>lead</u> annuity trusts, the charitable deduction is especially low for charitable remainder annuity trusts. And there are many, many more charitable remainder annuity trusts than charitable lead annuity trusts.

Silver lining for gift annuities. With a low CMFR, the charitable deduction is now smaller than it had been. So what's so good about that? For donors who create charitable gift annuities and take the standard deduction, the size of the charitable gift portion is irrelevant. However, a low CMFR means that the part of each payment excluded from income by the annuitant (under IRC §72) will be larger. Depending upon the circumstances, it may be preferable to choose (under the month of the gift and two-month lookback rule), the CMFR that has the lowest valuation of the charitable gift. On the other hand, if appreciated assets are used to fund the gift annuity, the capital gain—computed under the bargain sale rules—will be larger if the value of the charitable gift is smaller. Thus weigh the charitable deduction (whether it can be used or not), the exclusion ratio and the capital gains implications. Piece of cake!

How and when to make the lookback election. You make the election by: (1) stating to do so on the return for the year of the transfer; and (2) identifying the elected month. The election is generally made on a timely filed return, but it may be made or revoked on an amended return that's filed within 24 months after the later of: (1) the date the original return was filed; or (2) the due date for filing the return. Reg. §1.7520-2(b)(1) through (3).

Information required with the tax return whether or not the lookback election is made. To claim a charitable deduction for a split-interest gift, the tax return must contain: (1) a description of the interest that is transferred, including a copy of the instrument of transfer; (2) the valuation date of the transfer; (3) the names and identification numbers of the beneficiaries of the transferred interest; (4) the names and birthdates of any measuring lives; and (5) a computation of the deduction showing the interest rate used to value the transferred interest. Also, if a measuring life is of a person who is terminally ill, that should be stated and explained. For a definition of terminally ill, see Reg. §1.7520-2(a)(4).

Valuation date. If you elect the two-month lookback, the month you look back to is the valuation date for purposes of determining the interest rate. Reg. §1.7520-2(a)(2). Donors who transfer more than one interest in the same property at the same time must use the same interest rate for each interest in the property transferred. Donors who transfer more than one interest in the same property in two or more transfers at different times value each interest by using the interest rate in effect during the month of the transfer, or either of the two months preceding the month of the transfer. Reg. §1.7520-2(a)(3). What is IRS driving at? I think the following example illustrates what the IRS has in mind:

Example. A donor funds her charitable remainder unitrust with securities. The trust pays income to her son for life with the remainder to charity. The donor must use the same month's rate to value both the son's and the charity's interests. If the donor uses an undivided half-interest in real estate to fund the just-described trust (and assuming the IRS doesn't believe that doing so would violate the self-dealing rules), she must still use the same month's rate to value the son's and the charity's interests. But, if six weeks later, she transfers the other half interest to create another unitrust, that transfer has nothing to do with the first transfer. So the second trust's interests are valued in the month of that transfer—or either of the two preceding months at the donor's election. In short, the donor doesn't use the month's rate selected for the first trust to value the interests in the second trust.

Charitable remainder trust payout dates. If the governing instrument of a charitable remainder trust doesn't specify when the distributions are to be made during the period, they're presumed to be payable on the first day of the specified period. Reg. §1.664-4(a)(3).

R. MARITAL DEDUCTION RULES—CRUTS AND CRATS

Spouse as beneficiary. A donor who creates a unitrust [annuity trust] calling for payments to another (*e.g.,* a spouse or child) for life, with the principal to be delivered to the charitable remainder organization on the life beneficiary's death makes two gifts: one to the beneficiary (the value of his or her life interest) and one to the charity (the value of its remainder interest).

The charitable remainder interest. The charitable remainder interest is reportable (regardless of size because it is a future interest) on a federal gift tax return. It is then deductible as a charitable contribution—resulting in a wash. IRC §2522(c)(2)(A); Reg. §§25.2522(c)-3(c)(2)(iv) and 1.664-4.

Nonspouse beneficiary's interest. The donor makes a gift to the life beneficiary of the value of the beneficiary's life interest. If the life interest is a present interest, it will qualify for the annual gift tax exclusion. But if the value of the interest exceeds the annual exclusion and the "tentative" tax on the gift isn't offset by unified transfer tax credit, gift tax will be due. IRC §2503(a); Reg. §25.2503-3(b).

Query. Is the beneficiary's life interest really a present interest? In *Letter Ruling 8637084* IRS ruled that term-of-years interests in a unitrust were present interests that qualified for the annual exclusion. And, IRS ruled in *Letter Ruling 8932018* that a life interest in a unitrust was a present interest that qualified for the annual gift tax exclusion.

U.S.-citizen spouse beneficiary. The rules are the same, with this positive exception: the spouse's life interest qualifies for an unlimited gift tax marital deduction. IRC §2523(g).

Keeping the right to revoke a unitrust by will—where a spouse is the sole survivor beneficiary after the donor—is a holdover from the past, before there were special unlimited gift and estate tax marital deductions for charitable remainder unitrusts and annuity trusts. But the right to revoke may still have some uses in spousal charitable remainder trusts:

It's a hedge in case of divorce (although IRC §664(f)—which allows unitrust payments to end upon the occurrence of a "qualified contingency," like divorce or remarriage—serves the same purpose).

It provides some insurance in case the trust is disqualified—which would also foul up the IRC §2523(g) gift tax marital deduction.

Alien spouse beneficiary. There is no gift tax marital deduction for lifetime gifts to noncitizen spouses. IRC §2523(g). However, the first $128,000 (in 2008) of gifts per year to a noncitizen spouse are tax-free, under rules similar to those for IRC §2503(b)'s annual $12,000-per-donee gift tax exemption. IRC §2523(i)(2).

The $128,000 (in 2008) exemption is available only for present interests—not future interests (See Reg. §25.2503-3(a))—but as discussed above, IRS has ruled that a unitrust interest (and presumably an annuity trust interest) can be a present interest. Thus, a unitrust created for an alien spouse will qualify for that annual exclusion, assuming that the present actuarial value of the spouse's life interest is $128,000 (in 2008) or less. (The exclusion for present interest gifts to a non-citizen spouse is indexed annually for inflation.)

S. Q-TIP/CRUT COMBO

We know that there's no estate tax marital deduction for a CRUT (or CRAT) created by Husband that pays Wife for life, then Son and Daughter and then remainder to Charity. Instead, Husband's will creates a Q-TIP marital deduction trust for Wife to be followed by a CRUT for Son and Daughter, with remainder to Charity. Under the Q-TIP rules, Husband's estate gets a 100% marital deduction. (There's no charitable deduction, but, hey, a 100% marital deduction avoids the estate tax). And the marital deduction is available even though the Q-TIP trust benefits other individuals after the surviving spouse's death.

But wait a minute. The fair market value of the Q-TIP trust will be includable in the surviving Wife's gross estate. *Yes, but.* The surviving Wife's estate will get an estate tax charitable deduction for the value of the charitable remainder interest based on Son's and Daughter's ages at her death, the unitrust payout, and the applicable federal rate for the month of Wife's death, or either of the two prior months (at the estate's election).

Yet another reason to create a testamentary Q-TIP/CRUT COMBO. With a Q-TIP trust for the surviving spouse, the trustee can make payments to her (or him) out of principal for health, maintenance, support or for other reasons. Authorizing those payments from charitable remainder unitrusts (and annuity trusts) would disqualify those trusts. And even if there is to be no income beneficiary other than the surviving spouse (and thus no marital deduction concerns), a Q-TIP for the surviving spouse's life, with remainder to charity makes sense if principal may be needed by the surviving spouse.

Caution—non-citizen spouses. The above assumes that the spouse who is to receive trust income is a U.S. citizen. If he or she is an "alien" spouse (not to be confused with an "alienated" spouse who may be an American), other rules apply. For a testamentary CRUT or CRAT, it may be possible to get the marital deduction by qualifying the CRUT or CRAT as a Q-DOT (Qualified Domestic Trust).

T. CRAT—5%-MINIMUM-PAYOUT REQUIREMENT

The problem. The minimum annual payout for a charitable remainder annuity trust is 5%. A CRAT flunked the 5% minimum-payout requirement and had to jump over this hurdle so that it could be reformed: The difference between the actuarial value of the qualified annuity interest (the interest after reformation) determined as of the date of the trust's creation and the actuarial value of the reformable interest (the interest prior to reformation) can't exceed 5% of the actuarial value of the reformable interest. Let's call this the "5%-difference-in-values requirement."

The amount payable to the CRAT beneficiary, in a recent letter ruling, couldn't be increased to a minimum 5% annual payout without flunking the 5%-difference-in-values requirement. But it was a piece of cake for a smart lawyer to patch things up.

What happened. The letter ruling tells about a trust funded with $A, with Son to receive $B, with the trust being reformed to pay $C (an amount equal to 5% of the initial fair market value of the assets of the trust), and of that amount, $B being paid to Son for life and the remaining $D paid annually to University (the remainder organization) for the period of the son's life. Got it? Let's translate this into English by using Arabic numerals and an example.

Donor's will created a $100,000 annuity trust for Son paying him $3,000 a year. The trust flunks the 5%-minimum-payout requirement.

Increasing the annual payment to $5,000 by a reformation would satisfy the 5%-minimum-payout requirement, but would flunk the 5%-difference-in-values requirement.

Here comes the magic. The trust is reformed to pay $5,000 a year; Son's payments continue at $3,000 a year, but now University (the remainder organization) in addition to its eventual remainder interest is to receive $2,000 a year for the period of Son's life. Since Son's payment remains the same, IRS found that the actuarial value of his annuity interest (determined as of the date the trust was created) and the actuarial value of the reformable interest were identical. Thus the 5%-difference-in-values requirement was met. And the 5%-minimum-payout requirement was met by making the additional $2,000 annual payment to University (and not to Son). *Letter Ruling 200306008*.

Arcane point department. Reg. §1.664-2(a)(2)(iii) provides that if the grantor of an inter-vivos CRAT underestimates in good faith the initial net fair market value of the property placed in the trust as finally determined for federal tax purposes and specifies a fixed dollar amount for the annuity that is less than 5% of the initial net fair market value, the CRAT will be deemed to have met the 5%-minimum-payout requirement if the grantor or his representative consents, by appropriate agreement with the IRS District Director, to accept an amount equal to 20 times the annuity as the fair market value of the property placed in trust for purposes of determining the appropriate charitable deduction.

How to set the annuity amount when it is difficult to know the value of the assets being used to fund the CRAT (hard-to-value assets or a residuary estate or part of the residuary): As we have seen, specifying a fixed-dollar amount (pay $3,000 annually) can create a problem. If it turns out that the property used to fund the trust is greater in value than initially thought, the 5%-minimum-payout requirement may be flunked. So instead of stating a fixed-dollar amount, provide that the annuity payment shall be a "percentage (at least 5%) of the initial net fair market value of the assets as finally determined for federal tax purposes."

Keep in mind, of course, that a charitable remainder annuity trust must also pass the 10%-minimum-remainder-interest (MRI) requirement and not flunk the 5%-probability test of Rev. Rul. 77-374. That last test can be flunked even though there is a substantial remainder interest under Treasury's own tables and the 10%-MRI requirement is passed by a mile. And keep the 50%-maximum payout requirement in mind.

U. CRT 10%-MINIMUM-REMAINDER-INTEREST REQUIREMENT—TICKING TAX BOMB

The IRS looked to the past in determining whether an inter vivos charitable remainder unitrust qualified for the *estate* tax charitable deduction for the value of the remainder interest. The Service held that the 10%-minimum-remainder-interest (10%-MRI) requirement had to have been satisfied when the inter vivos trust was created—years earlier during the donor's lifetime. And, sad to say, the short period for reforming the trust to qualify had expired. *Letter Ruling 200414011.*

V. LEONA HELMSLEY'S CHARITABLE BEQUESTS AND CRUTS

The evil that men (women too) do lives after them,
The good is oft interred with their bones

Shakespeare: Julius Caesar III, ii

That's the case on the death of the so-called Queen of Mean. Most radio, television and print coverage dwelled on the provisions of her will that disinherited two of her four grandchildren "for reasons which are known to them," the ostensible $12 million trust fund exclusively for her pooch, Trouble, and her direction that the family mausoleum be acid washed or steam cleaned at least once a year.

Buried in the media coverage—or not mentioned at all. Ms. Helmsley's estate, estimated to be $5 billion, all goes to charity (except for about $35 million to family members). The charity is the Leona M. And Harry B. Helmsley Charitable Trust.

According to the *Chronicle of Philanthropy,* Ms. Helmsley during her lifetime gave $70 million to the New York Presbyterian Hospital and $5 million to the American Red Cross to help Hurricane Katrina victims.

In addition to Ms. Helmsley's outright charitable bequests, her will created three 5% charitable remainder unitrusts—a $5 million CRUT for each of two grandchildren and a $10 million CRUT for her brother. The charitable remainder organization of each trust is the Leona M. and Harry B. Helmsley Charitable Trust.

The will goes to the usual great lengths to assure the estate tax charitable deduction for the CRUTs, with one important exception.

> I intend that [each trust] shall qualify as a charitable remainder unitrust within the meaning of Section 6 of Rev. Proc. 90-30 and Section 664(d)(2) of the Code. Accordingly, the provisions of the trust . . . shall be construed and . . . shall be administered solely in accordance with said intention and in a manner consistent with Section 664(d)(2) of the Code and the regulations thereunder and with any successor section or regulations and any revenue rulings, revenue procedures, notices or other administrative pronouncements that may be issued thereunder by the Internal Revenue Service. Should the provisions of the trust . . . be inconsistent or in conflict with any such section, regulation, or administrative pronouncement, as issued from time to time, then such section, regulation or administrative

pronouncement shall be deemed to override and supersede the provisions which are set forth herein. If any such section, regulation or administrative pronouncement at any time requires a charitable remainder unitrust to contain provisions that are not expressly set forth herein, such provisions shall be incorporated into this Will by reference and shall be deemed to be a part of this Will to the same extent as through they had been expressly set forth herein. **However, anything to the contrary notwithstanding, I direct that even if the value of the charitable remainder interest is less than the minimum amount which is required for a trust to qualify as a charitable remainder trust (such minimum is currently ten percent), I nevertheless direct that the unitrust amount of five percent not be changed, even if it means the trust would therefore not qualify as a charitable remainder trust.** [Emphasis supplied]

. . .

The operation of the trust shall be governed by the laws of the State in which this Will is first admitted to probate. The trustees, however, are prohibited from exercising any power of discretion granted under said laws that would be inconsistent with the qualification of the Trust under section 664(d)(2) of the Code and the corresponding regulations.

I intend to create charitable remainder trusts as described in section 664(d)(2) of the Internal Revenue Code, and this Will shall be interpreted in accordance with this intent. **My trustees may, by an instrument filed in the court in which this Will is probated, amend the trust for the sole purpose of effecting this intent, except that the five percent annual payments many not be changed.** [Emphasis supplied]

Comment. Ms. Helmsley's intent was that the CRUT beneficiaries receive a 5% payout. She made it abundantly clear that the trust payout should not be changed even if that resulted in the CRUTs being disqualified. As it turns out, the trusts will pass the 10% minimum remainder interest requirement with flying colors.

Here's something to talk about while at the estate planning giving water cooler.

Notwithstanding any provision of this Will to the contrary, my grandchildren DAVID PANZIRER and WALTER PANZIRER shall not be entitled to any distributions from any trust established for such beneficiary's benefit under this Will unless such beneficiary visits the grave of my late son, JAY PANZIRER, at least once each calendar year, preferably on the anniversary of my said son's death (March 31, 1982) (except that this provision shall not apply during any period that the beneficiary is unable to comply therewith by reason of physical or mental disability as determined by my Trustees in their sole and absolute discretion). If DAVID or WALTER fails to visit the grave during any calendar year, . . . his interest in the separate trust established for ... his benefit shall be terminated at the end of such calendar year and the principal of such trust, together will all accrued and undistributed net income, shall be disposed of as if such beneficiary had then died.

Does the foregoing provision disqualify the CRUT? No, it is a qualified contingency—authorized by IRC §664(f). Simply put, a qualified contingency is a CRUT or CRAT provision that provides that upon the happening of the contingency the payments to the beneficiary will terminate not later than the payments would otherwise terminate.

Comment. Before 1979, such a contingency would have disqualified CRUTs and CRATs. Note that a contingency that meets the requirements of IRC §664(f) doesn't apply to pooled income funds.

Qualified contingency planning pointer. For CRATs and CRUTs "[I]f an individual receives an amount for life, it must be solely for his life." See Reg. §§1.664-2(a)(5) and 1.664-3(a)(5). Suppose a son wants to create a CRAT or CRUT to pay the CRAT or CRUT amount to his mother for the period of the son's life. The regulations clearly disqualify such a trust.

Here's the end run to accomplish the son's objective. "Pay the CRAT (or CRUT) amount to my mother for her life; however this trust shall terminate upon my death if I predecease her." That momma, is a qualified contingency.

Advice to Trouble—the pooch with the $12 million trust to be funded by Ms. Helmsley's will. Take the trust and run. Don't contest the will and spend the rest of your life in the doghouse. Why? Her will provides:

If any beneficiary under this Will shall, directly or indirectly, file or cause to be filed objections to this Will, or shall in any other manner contest this Will, in part or in whole, or attempt to prevent the probate thereof, or shall, directly or indirectly, institute or prosecute any action or proceeding to invalidate or set aside this Will or any of its provisions, or shall assert any claim against me or my estate, then any bequest under this Will to or for the benefit of such beneficiary (whether outright or in trust) and his or her issue shall not be paid to them or for their benefit and such beneficiary and his or her issue shall be deemed to have predeceased me for all purposes of this Will. The determination of my Executors concerning the application of this Article shall be conclusive on all interested parties.

W. DIVORCE AMERICAN STYLE

Alimony CRTs. An individual who wishes to make a charitable gift *and* who has an obligation to provide alimony for a divorced spouse might consider a charitable remainder trust with the obligation to make payments ending on the remarriage of the former spouse—with an acceleration of the charity's remainder interest.

Qualified contingency. A special rule allows the payments to a beneficiary to stop upon the happening of a qualified contingency, such as a beneficiary's remarriage. IRS §664(f). A contingency is qualified as long as it doesn't extend the otherwise allowable trust term. Thus “pay my ex-husband for life, but if he remarries, the trust terminates and the remainder goes to charity” is a qualified contingency. The actuarial value of the charitable remainder—for computing the charitable deduction—is nevertheless calculated without taking the contingency into account.

In terrorem provisions. A will sometimes provides that if an individual contests the will, he or she will be disinherited. Cutting off a disgruntled heir’s unitrust or annuity trust payments shouldn’t disqualify the trust because that’s a qualified contingency.

Caveat for pooled income funds. The IRC §664(f) qualified contingency rule applies to charitable remainder unitrusts and annuity trusts—not to pooled income funds. IRS's position is likely to be that a beneficiary's interest in a pooled income fund won't qualify if it: (1) isn't measured by his or her life; (2) will end on remarriage; (3) ends if the beneficiary contests the donor's will; or (4) ends on any other contingency.

X. H AND W SEVER THE KNOT—AND THEIR CRUT

Husband and wife had created a 10% net-income-with-makeup charitable remainder unitrust with “various property” including shares of Glutton Industries (not its real name). Their trust called for payments to husband and wife jointly and then to the survivor for life, with remainder to named charities (and any additional or replacement charities). Although they shared so much—even unitrust amounts—they landed in divorce court where the judge ordered them to petition another court to divide their NIM-CRUT into two separate trusts with husband as sole trustee of the separate trust for his benefit and wife as sole trustee of the separate trust for her benefit. The court then ordered this division of the CRUT’s assets between the two new separate trusts: Glutton Industries stock was divided equally between the two new trusts; the remaining assets were divided unequally (the ruling is silent on the percentages) and added to the two new trusts. Husband and wife were named successor beneficiaries and successor trustees in each other’s separate trust. Husband and wife represented to IRS that the initial trust—as modified by the court—met all the requirements of IRC §664 and that all the provisions of the two new separate trusts are identical to those of the initial trust (as modified by the court order).

IRS rules. Division of the initial trust into two separate trusts won’t cause the initial trust or the two new trusts to fail to qualify as charitable remainder trusts under IRC §664. *Letter Ruling 200045038.*

Caveat. The income tax consequences as well as who gets the dog must be considered. IRS hints at that by expressing no opinion about the tax consequences under IRC §§61, 170, 1001 and 1041. And there can be other implications. As observed by Mickey Rooney: “A lot of people have asked how short I am. Since my last divorce, I think I’m about $100,000 short.”

Y. PROHIBITED CONTRIBUTION RETURNED— CRUT SAVED

Background. Every schoolchild knows that you can’t make additional contributions to a charitable remainder annuity trust. You can, however, make additional contributions to a charitable remainder unitrust if the governing instrument permits and gives a formula for determining the payments in any year an additional contribution is made.

Facts in letter ruling. Donor (H & W) funded their charitable remainder unitrust with securities. They are the trustees and income beneficiaries. Later they made an additional stock contribution to the trust and the stock was sold.

Just one problem. The unitrusts’s governing instrument prohibited additional contributions. Soon after the second contribution, Donors realized their mistake. The trust’s custodians, at Donors direction, identified and maintained records of the proceeds of the second contribution. H and W didn’t take a charitable deduction for the second contribution, and it wasn’t used to calculate their unitrust payments.

Let’s patch this up. Donors, as trustees, propose to return the proceeds of the second contribution to themselves as donors. They will amend their individual tax returns to report any capital gains and dividend income generated by the second contribution while it was in the unitrust.

IRS rules. The second contribution of stock will be ignored for federal tax purposes and won’t disqualify the trust as a charitable remainder unitrust, provided that Donors amend their tax returns to report any capital gains and dividend income generated by the second contribution of stock while it was in the trust's account. *Letter Ruling 200052026*.

Z. CRUT—ERRONEOUS TRANSFER PATCHED UP

What happened. Donor created a CRUT with payments for herself and her husband for life and remainder to charity. Zack was the CRUT’s trustee and also Donor’s personal financial adviser (PFA).

PFA suggested that Donor make a personal investment in Warrants and so invested some of Donor’s personal funds. Donor became dissatisfied with the performance of Warrants. She signed a redemption notice prepared by Zack directing that her Warrants’ investment be liquidated with the proceeds to be wired to her personal money market account pending further decisions on investments. When reading the description of the account in the redemption notice, Donor believed that the account described was her personal money market account. But the account described in the redemption notice was the CRUT's and the liquidated amount of Donor's personal investment in Warrants was wired to the CRUT's account. Upon the transfer, the funds were placed in a separate fund in the CRUT's account. At all times since then, the transferred funds were invested solely in short-term interest bearing instruments.

Oops. Two years after creating the CRUT, Donor contacted her lawyer (Hawkeye) asking him to review Zack's administration of the CRUT. Hawkeye told the donor that the proceeds from the sale of the Warrants were transferred into the CRUT's account. Donor told Hawkeye that she had never intended to donate the proceeds from the Warrants' sale to the CRUT and asked for his advice on retrieving the mistakenly transferred funds. Donor didn't claim a charitable deduction for the transferred funds (as an additional transfer to the CRUT). However, the value of the mistakenly transferred funds was used when calculating the Unitrust distributions to Donor and her husband for three years.

A trip to a state court to patch things up. The court directed that Zack—who was the CRUT trustee and Donor's PFA—restore to Donor from the principal of the CRUT funds equal to the mistakenly transferred funds on the ground that a valid donation was not made of the transferred funds by Donor to the CRUT. *But first an adjustment:* the returned amount of the mistaken transfer was to be reduced by the amount of unitrust distributions received by Donor and her husband that were attributable to the transferred funds and increased by the earnings attributable to those funds.

The bottom line. It's just as if the proceeds from the Warrants' sale had never been added to the CRUT. The state court conditioned its judgment on Donor's receiving a favorable private letter ruling from IRS that the principal distribution to Donor ordered by the court wouldn't adversely affect the CRUT's status under IRC §664(d)(2).

Donor asked IRS for a letter ruling blessing the court's judgment. Donor represented to IRS that upon receipt of the ruling, she, her husband and the CRUT will amend their tax returns for the three years that the CRUT had the unintended funds. Donor, her husband and CRUT will amend their tax returns as if Donor had always held the transferred funds in her own personal money market account. She will be treated as having made the same investments as the CRUT. The amended returns will be adjusted to take into account the income that Donor and her husband had already reported due to the unitrust distributions they received that were attributable to the mistakenly transferred funds. They will report the interest generated by those funds resulting in the transferred funds being invested in short-term interest bearing instruments.

IRS rules. The restoration to Donor of the mistakenly transferred funds will result in Donor's being deemed to have never added those funds to the CRUT. In addition, a return of those funds to Donor—reduced by the amount of unitrust distributions received by Donor and her husband that were attributable to the transferred funds and increased by earnings attributable to the transferred funds—won't adversely affect the CRUT's qualification under IRC §664(d)(2) and won't constitute self-dealing by Donor under IRC §4941(d)(1)(E) or a payment to a disqualified person under IRC §4946. *Letter Ruling 200601003.*

AA. CHARITABLE REMAINDER TRUST: SCRIVENER'S ERROR—A CAUTIONARY TALE

The tale. This is a letter ruling about a donor, the donor's lawyer and the charity's estate planning director. The plot centers on a mucked-up charitable remainder trust.

Donor created and funded a trust intending that it qualify as a charitable remainder unitrust (CRUT) under IRC §664(d)(2). He established the trust with the assistance of his lawyer and ABC Charity's Estate Planning Director.

Estate Planning Director (who educates and informs potential donors about gift opportunities to ABC Charity) informed Donor that he could create a CRUT and name ABC Charity and also other charities as beneficiaries. Donor told Estate Planning Director that he also wished to retain the power to change the charitable beneficiaries and the percentages that each would receive.

Estate Planning Director provided a specimen trust to Donor's lawyer to assist him in drafting the CRUT. Through an error and oversight in Estate Planning Director's office, the specimen given to Donor's lawyer didn't include the provisions desired by Donor that would permit him to change the charitable beneficiaries and their respective percentage interests.

The plot thickens. Donor's lawyer used the specimen trust provided by Estate Planning Director's office to create the CRUT and it was executed by Donor. The Schedule of Charitable Distribution in the trust agreement specifically named ABC Charity, DEF Charity, and GHI Charity as charitable beneficiaries. Because Donor's lawyer used the specimen provided by Estate Planning Director's office, the CRUT didn't include the provisions permitting Donor to change the charitable beneficiaries and their respective percentages.

The error wasn't discovered until many years later when Donor informed ABC Charity that he wanted to change the charitable beneficiaries and their percentage interests. The trustee sought an order from State Court to correct the trust's governing document. State law permits reformation of trusts, upon the approval of the court, to correct mistakes to accord with the trust creator's intent.

State Court (based on the scrivener's error) reformed the trust ab initio to provide that Donor retains the right by written instrument to add qualified charities and remove charities from the Schedule of Charitable Distribution and to change the percentage allocation to all charities provided that ABC Charity remain a 50% beneficiary.

IRS rules. Based solely on the representations submitted, IRS concluded that the trust's judicial reformation doesn't violate IRC §664. Furthermore, assuming that the terms of the reformed trust are otherwise valid under IRC §664, the reformed trust will be treated as a valid CRUT under IRC §664(d)(1), ab initio.

IRS also ruled. "Specifically, no opinion is expressed concerning whether Trust is or was a charitable remainder **annuity** trust within the meaning of section 664(d)(1)." (emphasis supplied) *Letter Ruling 200447033.*

Even Homer sometimes nods. This ruling deals with a charitable remainder **unitrust**. So even IRS can make a scrivener's error.

Comment. Generally, IRS won't rule that a trust is qualified based on a correction of a scrivener's error unless a state court first finds that there was indeed such an error and reforms the trust to correct the error.

IRS in all its scrivener's error rulings has been liberal in ruling that the correction of the error results in the charitable remainder trusts' qualification. But letter ruling requests come to IRS after the errors have been corrected based on state court decrees. In the letter rulings, the state courts have appeared to be liberal in allowing reformation based on those errors.

"But is that really so, Watson? If state courts have refused reformation based on scriveners' errors, the trusts don't make it to IRS for approving letter rulings."

"That's an amazing deduction, Holmes."

"Eleemosynary, my dear Watson."

True story. In the early 1980s, a director of planned giving—who attended my planned-giving course in San Francisco—was asked by a donor's lawyer for a specimen charitable remainder unitrust and a specimen charitable remainder annuity trust. His client wanted to fund each trust with $1 million. That was a lot of money back then. The planned giving director gave him specimens from my course manual. (As an aside, the donor's lawyer was a member of a firm that listed all its partners, associates, counsels, and of counsels, and addresses of the firm's many offices on its letterhead. A cover letter from the firm began two pages later). The lawyer used the specimens—the only changes made were to substitute the names of the donor, the charity, and the trustee for the fictitious names in the specimens.

So faithful to the specimens was he, that he even included (in the trusts to be signed by his client) the five footnotes to each specimen telling when to substitute other provisions. The oversight was caught by the charity's lawyer—and corrected—before the trusts were presented to the donor by his lawyer for signature.

BB. DEFECTIVE CRT—SUBSTANTIAL COMPLIANCE DOCTRINE INAPPLICABLE

The bottom line up top. The Seventh Circuit Appeals Court upholds the Tax Court and rules that a defective charitable remainder unitrust couldn't qualify based on the substantial compliance doctrine (discussed soon). The defective CRUT could have been patched up by a judicial proceeding that had been timely begun—not later than 90 days after the estate tax return's due date (plus extensions).

Observation. The Tax Court's opinion is an excellent primer on the rules for reforming defective charitable remainder unitrusts and annuity trusts.

What happened. Father Tamulis, a Catholic priest, died in 2000, leaving a $3.4 million estate. His will left the bulk of his estate to his living trust—the trust to continue for the longer of 10 years or the joint lives of his brother and sister-in-law. During that period, they would have a life estate in a house owned by the trust with the trust to pay the real estate taxes. The trust's net income "determined in accordance with normal accounting principles," would go to two of the couple's grandchildren (the priest's grandnieces), except $10,000 a year would go to their third grandchild until she graduated from medical school. On the trust's termination, the assets are to go to a Catholic diocese.

The estate took a $1.5 million charitable deduction on its 2001 estate tax return claiming that to be the present value of the charitable remainder—described on the return as the "residue following 10 year term certain charitable remainder unitrust at 5% quarterly payments to two grandnieces."

In each of the years 2001 through 2004, the trust distributed no more than 5% of the fair market value of the trust's assets, as valued at the beginning of each year, to the grandnieces and for the payment of the real estate taxes on the house.

The IRS denied the charitable deduction. The charitable remainder, as defined in the trust, was not in a qualified charitable remainder trust because the trust didn’t specify either a fixed dollar amount or a percentage of the trust's fair market value. Instead, income would go to the grandnieces and they didn’t receive an annuity amount or a unitrust amount. Plus their parents had a life estate in the house and the real estate taxes were to be paid out of the trust's income.

The trust was clearly and fundamentally defective—it didn’t even come close.

Missed deadline. This defective trust missed the reformation deadline. It could have been corrected by a judicial proceeding to reform the trust, filed within 90 days (plus extensions) after the estate tax return was due (CRTs that are close to perfect—but have minor defects can be amended or reformed without meeting the 90-day deadline).

The trustee awakened—sort of. The trustee (who was also the executor of Father Tamulis's will) and the diocese eventually realized that there was a problem. But more than eight months elapsed before the executor prepared a complaint to reform the trust to be filed in an Illinois court (the trust was governed by Illinois law). And for unexplained reasons, the compliant was never filed.

Instead, in 2003 the executor circulated to the income beneficiaries a proposed trust reformation to bring the trust into compliance with the Code. But one of the beneficiaries didn’t sign it—so the trust was never reformed, with or without a judicial proceeding.

Actions don’t speak louder than actions and words. The trustee continued to administer the trust by following the Code’s CRUT requirements, as did her predecessor (the original trustee, who had died) and so said on the estate tax return. Her argument, rejected by the Tax Court and renewed before the appellate court, was that the statement on the return, coupled with the trustee's continued administration of the trust as if it were a qualified unitrust, should be deemed substantial compliance with the Code (although she conceded that it wasn’t literal compliance).

The appellate court had often criticized that doctrine’s use in many cases, saying that the "doctrine of substantial compliance should not be allowed to spread beyond cases in which the taxpayer had a good excuse (though not a legal justification) for failing to comply with either an unimportant requirement or one unclearly or confusingly stated in the regulations or the statute." [citing cases]

The court noted that the executor-trustee, represented by counsel, was well aware that a significant tax deduction was at stake, and had no excuse for failing to bring the required judicial proceeding to reform the trust.

The court continued:

The requirement is not unimportant; it protects against efforts to bend trust law to get a tax benefit. Nor is the requirement stated unclearly or confusingly in the Code or in any regulation—it is perfectly clear. Until the trust was reformed, compliance with the spirit of the Code's provisions dealing with charitable remainder trusts had depended largely on the good faith of the trustee; had Congress thought this enough it would not have amended the Code as it did in 1969.

Nor can the trustee get mileage from the fact that the deduction for a charitable remainder unitrust is made to depend on the taxpayer's being able to obtain a remedy from a state court (in this case, an Illinois state court). It is true that in all likelihood she could not have not obtained the remedy from a federal court. The "probate exception" to federal jurisdiction, on which see, e.g., *Marshall v. Marshall*, 547 U.S. 293, 126 S. Ct. 1735, 164 L. Ed. 2d 480 (2006); *Struck v. Cook County Public Guardian*, No. 07-2420, 2007 WL 4145845 (7th Cir. Nov. 26, 2007); *Jones v. Brennan*, 465 F.3d 304 (7th Cir. 2006), would doubtless bar the way; perhaps Article III of the Constitution, as well. For under Illinois law the reformation of a trust to take advantage of the charitable remainder deduction requires unanimous consent of the beneficiaries [citations omitted] and the trustee who seeks reformation in a judicial proceeding is thus not suing anyone. So there would be no case or controversy within the meaning of Article III unless the Internal Revenue Service intervened to oppose the reformation in order to thwart the charitable deduction and by doing so converted the proceeding to an adversary one and thus a case or controversy. (The Tax Court is not an Article III court, but it has not been authorized to reform wills or trusts.)

Even if, no federal forum being available, the state whose law governed the trust did not authorize a proceeding to convert a charitable remainder trust to a charitable remainder unitrust, that omission–though closing the only path to qualifying for the deduction–would deprive the state's residents of the federal tax benefit. Congress has made the benefit dependent on state law, and there is no doubt of its power to do so. Nothing is more common than for tax benefits to depend on state law; a state that does not permit 14-year-olds to marry deprives them of access to the benefits of filing a joint return. But Illinois law *does* authorize a judicial proceeding to reform a will, e.g., *Bangert v. Northern Trust Co*., 362 Ill. App. 3d 402, 298 Ill. Dec 317, 839 N.E.2d 640, 646-47 (Ill. App. 2005); *In re Estate of Bishop*, *supra*, 82 Ill. Dec. 244, 468 N.E.2d at 506, as indeed, as far as we know, every other state does. See *Restatement (Second) of Trusts* § 259 and comment a (1959). So there was nothing to prevent the trustee from bringing the trust into compliance with the requirements of the Internal Revenue Code for obtaining the charitable remainder deduction—except that, as we mentioned, Illinois does not allow a trust to be reformed for purposes of qualifying for the deduction unless all the beneficiaries of the trust consent. This is a significant protection for trust beneficiaries (though it could give rise to high transaction costs, given the power of holdouts in any situation in which unanimity is required for action, not to mention complications introduced when beneficiaries are minors or unborn), especially in this case, where no judicial proceeding to reform the trust was instituted. Neither the (federal) requirement of filing a state judicial proceeding if the state permits, nor the (state) requirement of unanimous consent of beneficiaries, can be deemed unimportant or unclear, and therefore the doctrine of substantial compliance cannot be used to excuse a failure to comply with them.

When the conditions for applying the doctrine [of substantial compliance], are not satisfied, it makes compellingly good sense to hold a taxpayer to the requirements of the tax code, as the courts have held in cases comparable to this one [citations omitted], although they do not involve charitable remainder trusts. The doctrine of substantial compliance "seek[s] to preserve the need to comply strictly with regulatory requirements that are important to the tax collection scheme and to forgive noncompliance for either unimportant and tangential requirements or requirements that are so confusingly written that a good faith effort at compliance should be accepted." [citations omitted]

Appellate Court holds. The substantial compliance doctrine is inapplicable in this case, affirming the Tax Court.

Estate of Tamulis, US Court of Appeals,
7^{th} Circuit No. 06-4141 (11/29/07)

The substantial compliance argument in charitable contribution cases has worked sometimes but the taxpayers had to go to court. And that is to be avoided; so comply at the outset. But it's good to know when it has worked—just in case.

Background. To substantiate contributions of tangible personal property and real estate for the income tax charitable deduction, a donor must have a qualified appraisal when the claimed charitable deduction exceeds $5,000. And for closely held stock, a qualified appraisal is required when the claimed income tax charitable deduction exceeds $10,000. When an appraisal is required, Form 8283 must be annexed to the donor's return (with a No. 27 Swingline staple). The $250-and-over-substantiation-receipt rules also apply.

Substantial Compliance with the Appraisal Requirements:

In *Bond*, 100 TC 32 (1993), Donor contributed two thermal airships to charity. The appraiser, Cutter, personally inspected the airships, computed the value of their component parts, and concluded that the aggregate fair market value of the parts was $60,000—the amount the donor claimed as a charitable deduction. On Form 8283, Cutter described the donated property, stated the appraised fair market value as $60,000, and summarized their overall physical condition. He also certified that he was not the donor, the donee, or a party to the transaction in which the donor acquired the property. In addition, he attested that he held himself out to the public as an appraiser, that he was qualified to make appraisals of the type of property being valued, and that the appraisal fee was not based upon a percentage of the appraised property value. In short, Cutter you did a heck of a job completing Form 8283, but you didn't give the donor an underlying appraisal—just the Form 8283, which the donor attached to his timely filed tax return.

IRS audited donor's tax return. Shortly before the audit, Cutter gave IRS a letter describing his qualifications, and estimating the airships' resale value at $150,000, and the replacement value at approximately $500,000. (On Form 8283, he had valued the airships at $60,000.)

IRS disallowed the deduction. "It has not been established that the thermal airships had a fair market value" or "that all the items supposedly donated were in fact donated." But at trial, IRS merely asserted that the deduction wasn't allowable because the donor didn't *obtain* and *attach* a qualified appraisal to his return. Thus the donor had failed to satisfy the requirements under Reg. §1.170A-(13)(c)(2)(i)(A) and (3). The donor countered that he had *substantially* complied with the requirements and, thus, qualified for a charitable deduction under the "doctrine of substantial compliance." See *Taylor*, 67 TC 1071 (1977).

The issue. The critical question was whether the substantiation requirements related "to the substance or essence of the statute." *Sperapani*, 42 TC 308 (1964). If so, strict adherence to all statutory and regulatory requirements is a precondition to an effective election. *Dunavant*, 63 TC 316 (1974). By contrast, if the requirements are procedural, they may be fulfilled by substantial, rather than strict, compliance.

Tax Court holds. The donor's charitable deduction is allowed. The reporting requirements are directory and not mandatory.

At the onset, it is apparent that the essence of section 170 is to allow certain taxpayers a charitable deduction for contributions made to certain organizations. It is equally apparent that the reporting requirements of section 1.170A-13, Income Tax Regs., are helpful to [IRS] in the processing and auditing of returns on which charitable deductions are claimed. However, the reporting requirements do not relate to the substance or essence of whether or not a charitable contribution was actually made.

Comment. It all worked out for the donor even though the court and the parties were a bit confused about the law. Notwithstanding this favorable decision, donors should comply with the IRS's requirements to the letter. The donor won, but had to go to court.

In *Fair*, TCM 1993-377, the donors sold their boat to charity in a bargain sale. In claiming their deduction, the donors attached to their income tax return: (1) appraisals of the boat from two qualified appraisers; (2) a copy of the bargain sale agreement; (3) a statement that the charity was an exempt organization qualified to receive the contribution; (4) a deed of gift to the charity; and (5) a copy of an acknowledgment letter from the charity. But they failed to supply information on the boat's cost basis, as required by Reg. §1.170A-13(b)(3)(i)(B). IRS disallowed the deduction because the donors failed to supply that information, even though it was available to them when they made the donation. The donors appealed, claiming that they had *substantially* complied with the regulations' requirements and, thus, qualified for a charitable deduction under the doctrine of substantial compliance. See *Taylor*, 67 TC 1071 (1977).

Tax Court holds. The donors' charitable deduction is allowed. The cost-basis information didn't have to be included on the donors' return, and is irrelevant to the calculation of the amount of the charitable contribution deduction. When an IRS form, or its instructions, requires cost-basis information, failure to keep the relevant records doesn't bar a charitable deduction if the donor's failure is reasonable. Reg. §1.170A-13(b)(3)(ii). Thus, a donor's reasonable failure to submit that information shouldn't prevent him or her from taking the deduction when the form, or its instructions, *don't* require it. See *Bond*, 100 TC 32 (1993).

In *D'Arcangelo*, TCM 1994-572, a CPA claimed a charitable deduction for art supplies donated to a high school. He submitted a Form 8283 along with a letter of appraisal prepared by the school principal, but IRS said that he failed to obtain a qualified appraisal. The CPA argued that Form 8283 and the principal's appraisal letter attached to his tax return constituted a "qualified appraisal," even though it didn't meet the regulations' requirements.

Tax Court holds. Distinguishing this case from *Bond*, the Tax Court disallowed the charitable deduction, noting that the CPA didn't merely fail to attach evidence of the qualified appraisal to his return, but failed to obtain a qualified appraisal.

The record does not establish that [high school principal] holds himself out as an appraiser or performs appraisals on a regular basis. Consequently, we hold that he is not a qualified appraiser. Moreover, [Reg. §]1.170A-13(c)(5)(iv)(D) . . . expressly prohibits an employee of the donee from making the appraisal. . . . Finally, [CPA] did not submit a fully completed appraisal summary."

In *Hewitt*, 109 TC 258 (1997), *aff'd*, 166 F.3d 332 (4th Cir. 1998), the Tax Court held that the taxpayers' charitable deductions for non-publicly traded stock gifts were limited to the stock's $6,500 basis, rather than its $121,000 fair market value, due to their failure to substantiate the

gifts with a qualified appraisal.

The Hewitts based their deductions on the average per-share price of the stock traded in arm's-length contemporaneous transactions, but they didn't have the stock appraised. IRS agreed with the Hewitts' valuations but only allowed them to deduct their cost basis, because they didn't comply with the appraisal requirements under Reg. §1.170A-13(c).The Tax Court sustained IRS's determination, and the Hewitts appealed.

The Fourth Circuit affirmed the Tax Court, holding that:

*The legislative history [of the qualified appraisal requirement] indicates that Congress intended the . . . requirement to be mandatory. The Conference Report for the Tax Reform Act of 1984 states that 'pursuant to present law (sec. 170(a)(1)), which expressly allows a charitable deduction only if the contribution is verified in the manner specified by Treasury regulations, **no deduction is allowed** for a contribution of property for which an appraisal is required under the conference agreement **unless the appraisal requirements are satisfied.**' H.R. Conf. Rep. 98-861 at 995 (1984).* [emphasis added.]

Rejecting the Hewitts' reliance on *Bond*, the appeals court pointed out that:

[I]n Bond, the taxpayers made a good faith effort to comply with the appraisal requirement. In [this case], the Hewitts utterly ignored the appraisal requirement. Furthermore, unlike the taxpayers in Bond, the Hewitts failed to supply all the information required by the regulations. Their returns lacked, among other items, any indication of the number of shares donated, and failed to provide the 'method of valuation used to determined the fair market value.' . . . In sum, the Hewitts failed to substantially comply with the regulations.

CC. STATUTE OF LIMITATIONS BARS REFUND FOR TAXES MISTAKENLY PAID BY CRT

Change your tune if you think that all opinions in tax cases are — b-o-r-i-n-g.

Federal circuit court Judge Carnes begins his opinion in a case involving a claim for an IRS refund of taxes mistakenly paid by a charitable remainder trust:

The Beatles' taxman told us what we'd see:
"There's one for you, nineteen for me."
But if we really want some funds to free,
how soon does asking have to be?

The issue. "Doggerel aside," Judge Carnes continues, "the issue presented in this case is whether the statute of limitations period set forth in 26 U.S.C. §6511(a) applies to claims for refunds made by those who have mistakenly filed a return and paid tax when they were not actually required to file a tax return. And as the Beatles probably would have guessed, the lamentable answer is yes."

Alert. See the end of this article for troublesome issues that go way beyond the CRT's failure to recover mistakenly paid taxes.

What happened. Wachovia Bank is the trustee of a charitable remainder trust created in 1984. Since 1991, when it was reformed to meet the requirements of IRC §664(c), the trust has qualified as a CRT that is exempt from federal income tax. As a qualified CRT, the trust wasn't obligated since 1991 to file fiduciary income tax returns or to pay income taxes, but only to file information returns. Unfortunately, the trustee failed to recognize the trust's tax exempt status after its reformation, and filed income tax returns for and continued to pay taxes out of the trust for the years 1991 through 2001.

Oops. Belatedly realizing its mistake, the trustee in 2003 filed amended Forms 1041 requesting a $111,823 refund of the taxes inadvertently paid for 1997 and 1998. (Apparently, refund claims weren't filed for 1991 through 1996 because those claims were barred by *all* statutes of limitations. Read on for a discussion of the statutes at play in this case.)

The IRS denied the refund claims for 1997 and 1998 on the ground that those claims were barred by IRC §6511(a)'s three-year statute of limitations.

The federal district court, after a he said, she said discussion, decides for the trustee. IRS contended that the trustee's suit was time-barred because it hadn't filed a refund within IRC §6511(a)'s three-year time limit. The trustee didn't dispute that it had filed its refund claims after the three-year period had expired. Instead, it contended that IRC §6511 didn't apply because the CRT wasn't required to file a tax return for the trust to begin with. The trustee maintained that only the general six-year statute of limitations outside the Internal Revenue Code—the one set forth in 28 U.S.C. §2401(a)—applied to its refund claim. Agreeing with the trustee, the court ordered IRS to refund $111,823. IRS appealed.

The scene changes—the 11th Circuit Court of Appeals. The court at great length discusses the three- and six-year statutes of limitations. If IRS's reading of IRC §6511(a) is correct, then the trustee loses. Reason: The three-year statute of limitations in IRC §6511(a) applies to its effort to get an income tax refund, and the trustee waited more than three years.

IRS argued. The trustee's interpretation of IRC §6511(a) would undermine one of the principal policies and benefits of a statute of limitations—to foreclose litigation on the merits of late-filed claims. The trustee's interpretation would require that the merits be decided because only then would it be known if the claimant was a taxpayer required to file a return and therefore was one to whom the three-year statute applied.

"As far as tax cases go, this is an interesting issue," Judge Carnes commented. (Meaning no disrespect your honor, I find *all* tax issues fascinating.)

Although it is one of first impression with us, the First Circuit has decided it in *Little People's School, Inc. v. United States*, 842 F.2d 570, 571 (1st Cir. 1988). That case involved a school which, as a non-profit corporation, was exempt from federal income and unemployment taxes, but mistakenly filed returns paying them for tax years 1978-81. *Id*. at 571. Its refund claims were filed in 1985. After the IRS concluded that the claims were time-barred by [IRC] §6511(a), the school filed a lawsuit. *Id.* That case turned on the same language from §6511(a) that this one does—the language describing refunds of taxes "in respect of which tax the taxpayer is required to file a return."

The First Circuit rejected the school's contention that the quoted language from [IRC] §6511(a) covered only those taxpayers who were actually required to file a return for the tax that they had overpaid. *Id.* at 573. The court acknowledged that "[d]oubtless, the most 'natural' meaning of the first sentence of section 6511(a), read in isolation, is the one urged upon us by the Little People's School," but explained that "the provision can also be read as the government urges, and that reading is far more plausible in light of the rest of the Tax Code." *Id.*

* * *

The First Circuit also adopted the government's policy argument, as the following passage from its opinion shows:

It would indeed be a perverse statute of limitations that would operate in accordance with the school's favored interpretation of section 6511(a), that is, by requiring the decisionmaker (either a district court or the IRS) to determine whether a taxpayer was required to file a return in order to determine whether the taxpayer was covered by section 6511(a)'s limitations period. The government aptly points out that such an inquiry often implicates the claim's merits.

* * *

This is not the first time that we have heeded the instruction that context is king. In one decision, we put it this way:

As a reviewing court, we should not restrict ourselves to examining a particular statutory provision in isolation when determining whether Congress has specifically addressed the question at issue. The meaning, or lack thereof, of certain words or phrases may only come to light when placed in the appropriate context. It is a fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme.

* * *

The Supreme Court in *Dalm* also recognized the primary purpose behind IRC §6511(a)'s three-year limitations period, one which strongly supports the applicability of IRC §6511(a) in the present case. The Court explained that "[t]he very purpose of statutes of limitations in the tax context is to bar the assertion of a refund claim after a certain period of time has passed, without regard to whether the claim would otherwise be meritorious." *Id.* at 610 n.7, 110 S. Ct. at 1369 n.7. We do not "lift the statutory bar" simply because a taxpayer learns too late that her taxes were "paid in error" or that "she has a ground upon which to claim a refund." *Id.*

Determining whether a particular taxpayer is required to file a return often involves an inquiry into the merits of a refund claim. If we adopted Wachovia's [the trustee's] position, no one could know whether the §6511(a) statute of limitations provision applied to a claim until the merits of the claim were decided. First would come the decision on the merits, then would come the decision on whether a decision on the merits was barred. To switch the order of decision around like that would make as little sense as having the issue of whether a runner is disqualified from competing in a race depending on whether he wins it.

11th Circuit Court of Appeals holds for IRS. Because the trustee failed to file its claims for a refund for the 1997 and 1998 tax years within the three-year limitations period in IRC §6511(a), the district court was barred by IRC §7422(a) from exercising any jurisdiction over those claims. For that reason, the district court's decision for the trustee is reversed and the refund claim is dismissed. *Wachovia Bank, N.A.* (as trustee of the George C. Nunamann Trust), 11th Circuit Court of Appeals (No. 05-12814), July 13, 2006

Additional Issues that Come to Mind

Can the trustee sleep nights? Do the CRT's income beneficiary and the charitable remainder organization—on behalf of the CRT—have an action against the trustee to reimburse the CRT for the mistakenly paid taxes (plus interest)? And if so, what is the statute of limitations on that claim under the law of the state governing the CRT? When does the statute start to run? From the dates that taxes were mistakenly paid (for the years 1991 through 1996 in addition to 1997 and 1998)? From the date of the circuit court's decision? From the date that the income beneficiary and charity learned about the trustee's costly mistakes?

Can the charitable remainder organization close its eyes? If so, might not the state attorney general step in and enforce the charity's rights?

Should the CPAs and the lawyers check their malpractice policies? Did they have a role in this costly mistake?

Oh yes—income and gift tax issues. Do the mistaken payments disqualify the trust from being a valid charitable remainder trust from the date of its 1991 reformation to meet IRC §664's requirements? The opinion doesn't specify whether the reformed trust was a unitrust or an annuity trust.

Suppose it was a unitrust and additional contributions were made after the reformation (additional contributions can't be made to an annuity trust)? Would IRS run into statute of limitations issues if it now seeks to deny the income and gift tax charitable deductions for the value of the remainder interest based on an additional contribution? Suppose a gift tax return hadn't been filed (the statute wouldn't have started to run)?

And another thing—what about the CRT's qualification? Income and gift tax charitable deduction issues aside, did the CRT continue to function as a qualified CRT after making the mistaken payments? If the answer is no, does the trust lose its tax exemption?

Estate tax issue too? I've assumed the trust is an inter vivos and not a testamentary trust (the opinion doesn't tell us). If so, will the trust on the donor's death qualify for the estate tax charitable deduction? In *Atkinson,* 309 F.3d 1290 (CA-11, 2002), *cert. denied,* 540 U.S. 946 (2003), the estate tax charitable deduction was denied (at a $2,654,976 estate tax cost) because the trustee of an inter vivos charitable remainder trust had failed to make seven quarterly payments before the donor's death.

Taking a leaf from the judge's song book, here are my concluding words:

How many issues must a man run down
Before you call him a man?
The answer, my friend, is blowin' in the wind,
The answer is blowin' in the wind.

How many issues must a man look up
Before he sues to the sky?
The answer, my friend, is blowin' in the wind.
The answer is blowin' in the wind.

How many years can a CRT exist
Before it goes to a 501(c)(3)?
The answer, my friend, is blowin' in the wind,
The answer is blowin' in the wind.

DD. SPOUSAL RIGHT OF ELECTION, DISCLAIMER, REFORMATION —CHARITABLE GIFTS

Tale of an after-the-testator's death three step that benefitted her surviving husband and charities—and saved estate taxes. The testator (Tessie) was survived by her husband and two children. Her will gave her tangible personal property (including a painting) primarily to her children and Museum, with the remaining tangible personal property going in equal shares to her husband and children to be divided among them as they may agree—or if they don't agree as Tessie's executors determine in their absolute discretion. She also devised real property to Conservancy (a qualified charity). She gave her residuary estate equally to 14 other qualified charities.

Step one—election against the will. Within six months after probate, Tessie's husband elected against her will under state law. That law provides that a surviving spouse, within six months after a will's probate, may waive any provisions that may have been made for him or her, and if the deceased left issue, the surviving spouse shall take one-third of the personal and real property. However, if the surviving spouse would take real and personal property exceeding $25,000 in value, the surviving spouse shall receive, in addition to that amount, only the income—during the surviving spouse's life—of the excess of his or her share of the estate above $25,000. The personal property is to be held in a Statutory Trust (provided by state law) and the real property vested in the surviving spouse for life.

Step two—disclaimer. After exercising the right of election—and within nine months after Tessie's death, her husband disclaimed his interest in partnership interests and in some of the tangible personal property that would pass to him because he exercised his right of election. As a result of the husband's election against Tessie's will coupled with the disclaimer, he is entitled to receive: $X outright (letter rulings don't give the actual figures); plus income for life from the excess of one-third of Tessie's real and personal property over $X. Further, under state law the personal property is to be held in trust and the real property will be vested in the husband for life.

Museum and the husband agreed to share possession of the painting on a one-third, two-third basis rather than convert it to an income-producing asset. The Statutory Trust doesn't include the real property bequeathed to Conservancy; the husband and Conservancy sold the real property. The Statutory Trust provides income to the husband for life with the remainder passing to the 14 charities specified in Tessie's will.

Step three—reformation. A state court was asked to reform the Statutory Trust to provide an annual 5% unitrust payment for the period of the husband's life, with the remainder to the charities. (The reformed trust would be a qualified CRUT.)

The annual unitrust would be payable A% to the husband and B% in equal shares to the 14 charities. The trustees may in their sole discretion adjust the allocation of the unitrust percentage between the husband and the charities for purposes of qualifying the trust under IRC §2055(e). On the husband's death, the remainder is to be paid to the 14 charities.

A state probate court reformed the Statutory Trust to a CRUT (as outlined above) on the condition that a favorable letter ruling is obtained.

IRS rules: (1) The Statutory Trust is eligible for reformation under IRC §2055(e)(3); (2) the proposed reformation will be a qualified reformation within the meaning of IRC §2055(e)(3); (3) the value of the charities' unitrust interest and remainder interest in the reformed trust will be deductible under IRC §2055; (IRS could be mistaken in allowing a charitable deduction for the unitrust interest) and (4) the value of the husband's unitrust interest will be deductible under IRC §2056(b)(8) as a Q-TIP trust. *Letter Ruling 200541038.*

EE. DISCLAIMERS—A WISE ESTATE PLANNING TOOL

How disclaimers work. As the disclaimant, you can't just name the recipient of property you wish to disclaim. Generally, the person who named you as the beneficiary must have specified who gets the bequest if you disclaim. Sometimes state law plays a role. Here are some typical cases:

●The will or other instrument names an alternative beneficiary. ("If X disclaims my stamp collection, it goes to Y instead.")

●The property goes to the alternative beneficiary under a residuary clause of a will. ("If any beneficiary disclaims his or her bequest, the disclaimed property shall pass under my residuary estate.")

●The property goes to the desired recipient under state intestacy law (e.g., a man disclaims and his issue receive the bequest).

Internal Revenue Code requirements for a valid disclaimer. A written refusal must be received by the decedent's representative (e.g., executor) within nine months of the transfer or bequest (generally the date of death). The disclaimant can't accept any benefits from the property—e.g., income. (But that's okay when a spouse disclaims and gets the property in a different way—under another provision of the will or through intestacy law.)

Example of d*isclaimer in favor of charity.* Paul's will gives the bulk of his estate to his wife and children, making a few small charitable bequests. He'd like more to go to charity, but only if the family is "comfortable about it." So his will provides that any part of a bequest disclaimed by a family member shall go to named charities.

If Paul's estate is not subject to estate tax (because of the marital deduction and the estate tax exemption), the family can accept the bequests. Then, on their own, they can contribute to charity— claiming deductions on their income tax returns. But if Paul's estate is subject to estate tax in the 45%

estate tax bracket, for example, and family members are in the 35% (or lower) income tax bracket, the family as a whole can achieve greater tax savings by disclaiming bequests in favor of charity. They may, of course, decide not to disclaim, keep the property and not make charitable gifts.

Most donors who want to assure their charitable bequests name the charities in their wills. A backup disclaimer gift is appropriate for those individuals who want the charitable bequests to be a family decision.

Disclaimer to make charitable gift—facts in a letter ruling. Elizabeth's will gave her jewelry, automobiles, artworks and other tangible personal property to her husband. If he didn't survive her, those items were to go to her surviving children. Any lapsed legacies were to go to Private Foundation. The husband didn't survive her, so the tangible personal property was to go to her sons, Albert and Barton.

The sons told IRS that they planned to disclaim 13 paintings that would thus go to Private Foundation. They represented to IRS that the paintings had not been distributed by the estate and that they had not accepted the paintings or any benefit from them. At first the paintings remained in Elizabeth's apartment. Then they were put in storage. At their mother's death, the two sons and a daughter-in-law were members, directors and then officers of Private Foundation.

The sons represented to IRS that they took a number of steps to insure that neither of them as members, directors or officers of Private Foundation will have any power to dispose of the paintings received by Private Foundation as a result of the disclaimers or the proceeds of any sale. The existing directors have appointed four additional members. Albert and Barton have irrevocably waived and renounced the right while Private Foundation holds the paintings to: (1) participate in the election and/or removal of members and directors of Private Foundation; (2) participate in the appointment of directors to any committee formed to administer and dispose of the paintings (or the proceeds from their sale); and (3) participate in the exercise of any control, as a member, director or officer, in the administration or disposition of, the paintings (or the proceeds from their sale).

The sons also represented to IRS that the estate contained sufficient assets to fund any pre-residuary bequest so that the disclaimed paintings will pass to Private Foundation.

IRS ruled. If the disclaimers are received by the decedent's legal representative (or the holder of legal title to the property) not later than nine months after Elizabeth's death, the disclaimers will be qualified under IRC §2518. And Elizabeth's estate will be entitled to an estate tax charitable deduction for the disclaimed paintings received by Private Foundation. *Letter Ruling 199929027.*

Summing up. Disclaimers can provide a second look at an estate plan after all the evidence is in. Sometimes they can save taxes. And property can be redirected with no gift tax to the disclaimant. In a pinch, disclaimers may provide a way to alter a defective plan or correct drafting errors. As always, both state law and federal tax laws must be taken into account.

FF. CHARITABLE BEQUESTS: DISCLAIMERS, PUBLIC POLICY, MORE—SEMINAL TAX COURT CASE

Homage to tax cases. For me, a tax law junkie, almost all tax cases are interesting—and each in its own way. Some have fascinating facts. Some have colorful language. Some have interesting issues. Some have holdings and reasoning that can determine issues that have greater significance than those before the court. Some show a lawyer's ingenuity. Some cite other interesting cases. Some deal with public policy. The Tax Court case, *Estate of Helen Christiansen* has it all.

The players. Helen Christiansen, a lifelong South Dakotan was one of the state's first women lawyers. She practiced law until the late 1950s, when she married and with her husband farmed full time. Their only child, Christine, graduated from Smith College and earned an MBA from the University of Arizona. Christine married a South Dakota State University professor, and helped her mother run the family farm.

Mother and daughter were deeply involved in their community, and Christine to this day serves on many charities' boards.

Helen's financial and estate plan. Helen and her late husband's farming and ranching businesses—which for decades had been run as sole proprietorships—were reorganized as two limited partnerships—MHC Land and Cattle, Ltd. (MHC), and Christiansen Investments, Ltd. (Christiansen). Helen kept a 99 percent interest in each limited-partnership, with the rest going to Hamilton Investments, L.L.C (Hamilton). Hamilton also became the general partner of both MHC and Christiansen. Helen's daughter and her professor son-in-law became its members. Family limited partnerships are, the court noted, fairly common. But they are often challenged estate-planning devices and not new to the Tax Court. See *Estate of Strangi*, 115 T.C. 478, 484 (2000), revd. on other grounds 293 F.3d 279 (5th Cir. 2002).

The objects of Helen's bounty. She wanted her estate to benefit Christine, a Private Foundation and a Lead Trust that would benefit the Foundation for 20 years, with remainder to Christine if she survived the 20-year term.

The disclaimer provision in Helen's will is key to all that follows. Instead of simply dividing her estate among Christine, the Foundation and the Lead Trust, Helen's will gave everything (after payment of debts and funeral expenses) to Christine. **But** her will went on to direct that if Christine disclaimed any part of the estate, 75 percent of the disclaimed portion would go to the Lead Trust and 25 percent to the Foundation.

The disclaimer. Helen died April 17, 2001. As planned by mother and daughter, Christine executed a partial disclaimer—central to this case:

A. *Partial Disclaimer of the Gift*: Intending to disclaim a fractional portion of the Gift, Christine Christiansen Hamilton hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, less Six Million Three Hundred Fifty Thousand and No/100 Dollars ($*6,350,000.00*) and the denominator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001 ("the Disclaimed Portion"). For purposes of this paragraph, the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, shall be the price at which the Gift (before payment of debts, expenses and taxes) would have changed hands on April 17, 2001, between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts for purposes of Chapter 11 of the Code, **as such value is finally determined for federal estate tax purposes.** [Emphasis supplied]

Why Christine retained $6,350,000. That was an amount she and her advisers determined would allow the family business to continue, and to provide for her and her family's future.

Effect of Christine's disclaimer. The disclaimed amount goes to the Private Foundation and the Lead Trust. **She did not, however, disclaim her remainder interest in the Lead Trust.**

Enter the IRS. In brief, the disclaimer is invalid, the assets are undervalued and the IRS can't be whipsawed. Details soon.

The court puts the disclaimer under its judicial magnifying glass. Note especially, said the court, the final phrase: "as such value is finally determined for federal estate tax purposes." And, continued the court, add to it another shield strapped to the disclaimer—a "savings clause." That clause provided that to the extent that the disclaimer is not effective to make it a qualified disclaimer, Christine takes such actions to the extent necessary to make it a qualified disclaimer under IRC §2518.

How do these insertions of uncertainty as to the amount actually being disclaimed come into play should the estate assign an unusually low value to the property being disclaimed? In that case, noted the Tax Court, Christine would take (and the estate tax would be paid on) her $6.35 million.

The residue would be divided between the Foundation and the Lead Trust. Should it turn out that the estate's value was underreported (the IRS prevails in setting a higher value), Christine's failure to disclaim her remainder interest in the Lead Trust (the principal after the 20-year term) would mean that she would capture much of the value of that underreporting as she herself approached retirement age in 20 years. Remember, Christine didn't disclaim her remainder interest in the Lead Trust.

A cynic's-eye view. "And if one took an especially skeptical view of the situation," the court continued, "the final quoted phrase in the disclaimer and the savings clause meant that the Commissioner would face an interesting choice if he thought the estate was lowballing its own value—any success in increasing the value of the estate might only increase the charitable deduction that the estate would claim. Which would presumably reduce the incentive of the Commissioner to challenge the value that the estate claimed for itself." And that, said the court, is the Commissioner's view of what was going on here.

Valuation claimed by Helen's estate. Helen owned 99 percent limited-partnership interests in both MHC and Christiansen when she died. She also owned $219,000 of real property, and over $700,000 in cash and other assets. The estate obtained appraisals of the limited-partnership interests, including a 35 percent discount for being a "minority interest," and reported on its estate-tax return that the 99 percent limited-partnership interest in MHC had a fair market value of $4,182,750, and that the 99 percent limited-partnership interest in Christiansen had a fair market value of $1,330,700.

The estate's tax return used those values to report a total gross estate value of slightly more than $6.5 million. When read in conjunction with the disclaimer's reservation to Christine of $6.35 million worth of property, this meant that only $40,555.80 would pass to the Foundation and $121,667.20 to the Lead Trust.

The estate tax return. The estate deducted as a charitable contribution the entire amount passing to the Foundation, and the part passing to the Lead Trust that was equal to the present value of 7 percent of $121,667.20 annually for 20 years. The total came to about $140,000. The estate didn't deduct the value of Christine's contingent-remainder interest in the Lead Trust.

The IRS puts the kibosh on Helen's plan. The fair market values of Helen's 99 percent limited partnership interests should be increased and Christine's disclaimer doesn't qualify (more about this later). Thus the estate's assets passing to the Lead Trust and the Foundation don't qualify for a charitable deduction.

The estate appealed to the Tax Court. The valuation question was settled before the trial—the fair market value of Helen's interest in Christiansen was valued at $1,828,718.10, an increase of more than 35 percent over its reported value; also Helen's interest in MHC was worth $6,751,404.63, an increase of more than 60 percent over its reported value. Thus the total value of the gross estate was $9,578,895 instead of $6,512,223.

The estate maintained. The disclaimers were valid. So increased amounts passed to the Foundation and the Lead Trust based on the increased stipulated value of the estate. Thus an increased charitable deduction should be allowed for the entire amount going to the Foundation and the value of the Foundation's 20-year interest in the Lead Trust.

Let's do the numbers. According to the estate, property with a fair market value of $2,421,671 would pass to the Lead Trust and property with a fair market value of $807,223 would pass to the Foundation. Thus the estate maintained that the increase in value entitled it to an increased charitable deduction—both for the entire part passing to the Foundation and also the increased value of the Lead Trust's annuity interest.

The IRS position in the Tax Court. No charitable deduction at all should be allowed for the property passing to the Lead Trust; and the deduction for the property passing to the Foundation shouldn't be increased.

The IRS attacks the Lead Trust disclaimer. Christine didn't disclaim her contingent remainder in the Lead Trust, so her disclaimer was a partial disclaimer and failed to qualify under the partial disclaimer rules.

Background on disclaimers. IRC §2518 governs transfers by disclaimer. If a disclaimer meets that section's test, a bequest to a disclaimant is treated as if it had never been made. Without that provision, said the court, the government might serve itself a second helping of tax by treating the disclaimed property as if it went from the estate to the disclaimant followed by a transfer from the disclaimant to another recipient; thus potentially piling gift tax onto estate tax.

Christine's disclaimer is further complicated because it is a "partial disclaimer." The Code recognizes and allows partial disclaimers. IRC §2518(c)(1); Reg. §25.2518-3(a). But, whether partial or full, a disclaimer is qualified—meaning that it will be treated as if the disclaimed property had never gone to the disclaimant—only if it meets IRC §2518(b)'s four requirements: (1) It must be in writing; (2) It must (with some exceptions not relevant here) be received by the personal representative of the estate no later than nine months after the date of the transfer creating the disclaimant's interest; (3) It must not allow the disclaimant to accept the disclaimed property or any of its benefits; and (4). The disclaimed interest must pass "without any direction on the part of the person making the disclaimer and *** to a person other than the person making the disclaimer."

Did the disclaimer fail because it didn't meet the fourth requirement? The IRS maintained that Christine's retention of the contingent-remainder interest in the Lead Trust meant that the property being disclaimed was not going "to a person other than the person making the disclaimer"?

A disclaimer is valid if an undivided portion of a bequest is disclaimed. Did Christine disclaim an undivided portion of her bequest which if other tests were met would be qualified? An undivided portion of the property is an undivided portion of a disclaimant's separate interest in property. It must consist of a fraction or percentage of each and every substantial interest or right owned by the disclaimant in the property and must extend over the entire term of the disclaimant's interest in the property. A disclaimer of some specific rights while retaining other rights isn't a qualified disclaimer of an undivided portion of the disclaimant's interest. IRC §2518(c); Reg. §25.2518-3(a), (b). Thus, for example, a disclaimer made by the devisee of a fee simple interest in Blackacre isn't a qualified disclaimer if the disclaimant disclaims a remainder interest but retains a life estate.

Severable property issue. A block of stock can be disclaimed share by share, but not by a severance of the right to receive dividends from the right to vote the shares. Thus Christine could have disclaimed a particular number of partnership units. For the Lead Trust, she disclaimed the present enjoyment (20 years of payments to the Foundation) but kept a remainder interest in all of them.

The Lead Trust disclaimer didn't make the cut. But for Christine's retaining a remainder interest (after the 20-year term) and giving up present enjoyment (the 20-year lead interest), noted the court, instead of the reverse, an example in *Walshire*, 288 F.3d at 347 describes this case. The Eighth Circuit Court of Appeals explained the distinction by comparing it to horizontal and vertical slices. Disclaiming a vertical slice—from meringue to crust—qualifies; disclaiming a horizontal slice—taking all the meringue, but leaving the crust—does not. The only difference that the Tax Court saw between *Walshire* and this case is that Walshire disclaimed a remainder interest and kept the income, while Christine tried to do the reverse. No matter how you slice it, the cases are indistinguishable, said the court. So Christine's Lead Trust disclaimer is not a qualified disclaimer with respect to any portion of the property. Reg. §25.2518-2(e)(3).

After a detailed discussion of the partial disclaimer regulations, the Tax Court found that Christine's disclaimer was not qualified. It didn't meet either the "severable property requirement" or the "undivided portion of the property requirement."

The estate goes down swinging with an additional argument. Christine's disclaimer stated that she "hereby takes such actions to the extent necessary to make the disclaimer set forth above a qualified disclaimer." The estate argued that Christine intended to do whatever it took to qualify the transfer to the Lead Trust for the charitable deduction—and if that means she has to disclaim her contingent-remainder interest, then that clause suffices to disclaim it.

Tax Court disallows charitable deduction for Lead Trust. As we have seen, the partial disclaimer didn't qualify and the whatever-it-took language didn't resurrect the charitable deduction. Allowing Christine to now disclaim her remainder interest in the Lead Trust would, said the court, be a paradox. It was this same partial disclaimer excluding the contingent remainder from its scope that would, on her reading of the savings clause, end up including it after all.

Property passing to the Foundation. The IRS challenged the increased charitable deduction that the estate sought (the IRS and the estate had agreed on a much higher value of the gross estate) for the transfer of property to the Foundation directly. Christine kept no interest at all in that property.

Estate wins on the increased charitable deduction for disclaimed property passing to the Foundation. After a long discussion of the disclaimer rules, conditions subsequent, contingencies and other fine points, the court allowed an increased charitable deduction equal to the agreed upon (by the IRS and the estate) increased fair market value of the assets going to the Foundation.

The IRS's last stand—public policy. The disclaimer's adjustment clause is void on public policy grounds. It would, said the IRS, discourage it from examining estate tax returns because any deficiency in estate tax would just end up being offset by an equivalent additional charitable deduction.

Tax Court discusses the public policy issue:

It is true that public policy considerations sometimes inform the construction of tax law as they do other areas of law. For example, section 178 of the Restatement (Second) of Contracts (1981) has a multifactor test for when a promise or a contractual term is unenforceable because of public policy considerations, and lists numerous illustrations in the comments... But *Commissioner v. Tellier*, 383 U.S. 687, 694 (1966), warns us of the narrowness of this aid in statutory construction—the public policy being frustrated must be shown by a governmental declaration, and the frustration that would be caused by allowing the contested deduction must be severe and immediate. Our caution has deep roots: "Public policy is a very unruly horse, and when once you get astride it you never know where it will carry you. It may lead you from the sound law. It is never argued at all, but when other points fail." E. Allan Farnsworth, Contracts, 326 (3d ed. 1999), citing Burrough, J., in *Richardson v. Mellish*, 130 Eng. Rep. 294, 303 (Ex. 1824).

Tax Court turns public policy argument around; that policy favors charitable gifts. The disclaimer in this case involves a fractional formula that increases the amount donated to charity should the value of the estate be increased. The court said that it was hard pressed to find any fundamental public policy against making gifts to charity—if anything the opposite is true. Public policy encourages gifts to charity, and Congress allows charitable deductions to encourage charitable giving. *United States v. Benedict*, 338 U.S. 692, 696-97 (1950).

The IRS compared the contested adjustment clause to the one in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). The Fourth Circuit was faced with a trust specifying that a gift would be deemed to revert to the donor if it were held subject to gift tax. The court voided the clause as contrary to public policy because it would: (1) discourage collection of tax; (2) render the court's own decision moot by undoing the gift being analyzed, and (3) upset a final judgment.

This case is not *Procter* said the Tax Court. The contested phrase would not undo a transfer, but only reallocate the value of the property transferred among Christine, the Lead Trust, and the Foundation. If the fair market value of the estate assets is increased for tax purposes, then property must actually be reallocated among the three beneficiaries. That would not, said the court, make it opine on a moot issue, and wouldn't in any way upset the finality of its decision in this case.

The Tax Court recognized that the incentive to the IRS to audit returns affected by such disclaimer language will marginally decrease if it allowed the increased deduction for property passing to the Foundation. Lurking behind the IRS's argument is the intimation, said the court, that this will increase the probability that people in Christine's situation will lowball the value of an estate to cheat charities. There's no doubt that this is possible, however:

. . . IRS estate-tax audits are far from the only policing mechanism in place. Executors and administrators of estates are fiduciaries, and owe a duty to settle and distribute an estate according to the terms of the will or law of intestacy. See, e.g., S.D. Codified Laws sec. 29A-3-703(a) (2004). Directors of foundations—remember that [Christine] is one of the directors of the Foundation that her mother created—are also fiduciaries. See S.D. Codified Laws sec. 55-9-8 (2004). In South Dakota, as in most states, the state attorney general has authority to enforce these fiduciary duties using the common law doctrine of *parens patriae*. Her fellow directors or beneficiaries of the Foundation or Trust can presumably enforce their observance through tort law as well. And even the Commissioner himself has the power to go after fiduciaries who misappropriate charitable assets. The IRS, as the agency charged with ruling on requests for charitable exemptions, can discipline abuse by threatening to rescind an exemption. The famed case of Hawaii's Bishop Estate shows how effectively the IRS can use the threat of the loss of exempt status to curb breaches of fiduciary duty. See Brody, "A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?", 21 U. Haw. L. Rev. 537 (1999). The IRS also has the power to impose intermediate sanctions for breach of fiduciary duty or self-dealing. See sec. 4958.

Bottom line—increased charitable deduction for property passing to the Foundation. The Tax Court holds that allowing an increase in the charitable deduction to reflect the increase in the value of the estate's property going to the Foundation violates no public policy and should be allowed.

Estate of Helen Christiansen, 586 F.3d 1061 (CA-8, 2009)

Almost all the Tax Court judges got into the act. Judge Holmes's opinion was reviewed by the entire Tax Court (except for Judge Halpern). Concurring judges were: Colvin, Cohen, Wells, Foley, Vasquez, Thornton, Marvel, Haines, and Goeke. Judges Haines and Goeke joined the majority opinion but wrote separately to elaborate on why Christine's remainder interest in the Lead Trust and the Foundation's 20-year annuity are not severable property for purposes of qualifying the disclaimer for the portion of the disclaimed property that will pass to the Lead Trust. Judges Cohen, Foley, Thornton, Marvel, Wherry, and Holmes, agreed with the concurring opinion. A few judges concurred in part and dissented in part.

Lessons to be learned:

•Disclaimers provide flexibility in estate planning—giving a second look close to the time the property is to be distributed (instead of casting the plan in concrete at the time the document is drawn). Personal circumstances and laws change—so disclaimers are included in many plans—especially now with the changing estate tax exemption, estate tax interruptus in 2010 and its resurrection in 2011 with a $1 million exemption (unless Congress acts before then, which it will—but who knows when).

•The disclaimer rules can be complicated—so if a disclaimer is in the plan, know the ins and outs.

•The overarching significance of this case is that a unanimous Tax Court upheld an adjustment clause. In this case, it validated a formula that passed additional property to charity that reflected an increase in the federal estate tax valuation. And that didn't violate public policy. Defined value and formula clauses are not uncommon in sophisticated estate plans. The IRS has frowned on them when assets are shifted or value is adjusted to reduce taxes. Will IRS take this case lying down or will it appeal? Stay tuned.

•As always, be mindful of issues not before the court. A disclaimant's participation in selecting a private foundation's grant recipients (of the funds received as a result of the disclaimer) can disqualify a disclaimer. A disclaimer's qualification can be saved if the private foundation's governing document prohibits disclaimants and their spouses from participating in the selection of grantees for the disclaimed property.

A U.S. Appeals Court affirmed the Tax Court decision that approved a "charitable-lid" plan. The testator was enabled, in effect, to freeze the value of her estate's assets through the use of disclaimers that directed assets over a set dollar amount to charity. Her sole-beneficiary daughter timely disclaimed assets above the set dollar amount and those assets went outright to a private foundation and to a lead trust for the foundation for 20 years with remainder to the daughter. An estate tax charitable deduction was allowed by the Tax Court for the disclaimed assets that went outright to the private foundation, but not for the assets that would fund the charitable lead trust.

On appeal, the IRS presented two arguments. First, it said that because the overall value of the estate was not finally determined at the time of the decedent's death, but only after the IRS partially successful challenge, the transfer to the foundation was, ultimately, "dependent upon the performance of some act or the happening of a precedent event" in violation of Treasury Regulation § 20.2055-2(b)(1). The IRS identifies as the purported "precedent event" or contingency the challenge mounted against the estate's initial return and the ultimate process of settling the estate's value.

As a second argument, the IRS asserted policy concerns related to the incentives and disincentives that exist regarding the decision to conduct audits in any given case. In particular, the IRS argued that the court should disallow fractional disclaimers that have a practical effect of disclaiming all amounts above a fixed-dollar amount.

According to the IRS, those disclaimers fail to preserve a financial incentive for the IRS to audit an estate's return. With such a disclaimer, any post-challenge adjustment to the value of an estate could consist entirely of an increased charitable donation. Because this scenario would provide no possibility of enhanced tax receipts as an incentive for the IRS to audit the return and ensure accurate valuation of the estate, the IRS argued that those disclaimers should be categorically disqualified as against public policy.

The court shot down the IRS's interpretation of Treasury Regulation §20.2055-2(b)(1).

> The regulation is clear and unambiguous and it does not speak in terms of the existence or finality of an accounting valuation at the

date of death or disclaimer. Rather, it speaks in terms of the existence of *a transfer* at the date of death. See Treas. Reg. § 20.2055-2(b)(1) ("If, as of the date of a decedent's death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible.") * * *

That the estate and the IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent in the sense of dependent for its existence on a future event. Resolution of a dispute about the fair market value of assets on the date Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future.

In fact, in a different subsection of the regulation, the agency itself recognizes that references to values "as finally determined for Federal estate tax purposes" are sufficiently certain to be considered "determinable" for purposes of qualifying as a guaranteed annuity interest. Treas. Reg. § 20.2055-2(e)(2)(vi)(a). In doing so, the agency expressly uses the above-quoted language to distinguish fixed determinable amounts from fluctuating formulas that depend upon future conditions for their determination. * * *

Regarding the second argument, we agree with the Commissioner that the Tax Court's ruling in this case may marginally detract from the incentive to audit estate returns. It is possible that in some hypothetical case involving a fixed-dollar-amount partial disclaimer, a post-challenge correction to an estate's value could result in a charitable deduction equal to the increase in the estate, resulting in no increased estate tax. The Commissioner argues that a policy supporting audits as a means to enforce accurate reporting requirements mandates that we disallow fixed-dollar-amount partial disclaimers because of the potential moral hazard or untoward incentive they create for executors and administrators to under-value estate.

For several reasons, we disagree with the Commissioner's argument that we must interpret the statute and regulations in an effort to maximize the incentive to audit. First, we note that the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws. See 26 U.S.C. § 7801 (a)(1) ("[T]he administration and enforcement of [the Tax Code] shall be performed by or under the supervision of the Secretary of the Treasury.") * * *

Second, we find no evidence of a clear Congressional intent suggesting a policy to maximize incentives for the Commissioner to challenge or audit returns. The relevant policy in the present context is clear, and it is a policy more general in nature than that articulated by the Commissioner: Congress sought to encourage charitable donations by allowing deductions for such donations. See 25 U.S.C. §2055(a)(2); Sternberger's Estate, 348 U.S. at 190 n.3 ("The purpose of the deduction is to encourage gifts to the named uses."). Allowing fixed-dollar-amount partial disclaimers supports this broad policy.

Third, and importantly, even if we were to find a general congressional intent regarding a need to maximize the incentive-to-audit, no corresponding rule of construction would be necessary in the present context to promote accurate reporting of estate values. The Commissioner premises his policy argument on the assumption that executors and administrators will purposefully undervalue assets in order to take advantage of his marginally decreased incentive to audit. In the present context, however, there are countless other mechanisms in place to ensure that fiduciaries such as executors and administrators accurately report estate values. State laws impose personal liability on fiduciaries, and state and federal laws impose financial liability or, in some circum-stances criminal sanctions, upon false statements, fraud, and knowing misrepresentations. See, e.g., S.D. Codified Laws § 29A-3-703(a) ("A personal representative is a fiduciary . . . ."); id. § 55-9-5 (providing that the attorney general is the representative of beneficiaries of charitable foundations and has a duty to enforce their rights in court actions); 18 U.S.C. 1001 et seq. (criminalizing various acts of fraud and knowing misrepresentations); Ward v. Lange, 553 N.W.2d 246, 250 (S.D. 1996) ("[T]he fiduciary has a 'duty to act primarily for the benefit' of the other.") (quoting High Plains Genetics Research, Inc. v. J K Mill-Iron Ranch, 535 N.W.2d 839, 842 (S.D. 1995)).

In addition, with a fixed-dollar-amount partial disclaimer, the contingent beneficiaries taking the disclaimed property have an interest in ensuring that the executor or administrator does not under-report the estate's value. Such beneficiaries, therefore, have an interest in serving a watchdog function. Further, in this case Hamilton was not only the primary beneficiary who made the contested partial disclaimer, she was the executor of the estate and a board member for the foundation. Because she owed a fiduciary obligation to both the estate and the foundation, any self-dealing in this instance would be a clear violation of her general state-law fiduciary obligation to put the interests of the foundation above her own interests and possibly a violation of state and federal statutory prohibitions on certain forms of self dealing.

Christiansen CA-8, No. 08-3844 (11/13/09)

So what's ahead? Under similar facts, the IRS must follow this case in the Eighth Circuit (Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota). If the IRS disallows deductions for other taxpayers in similar cases, the taxpayers will most likely appeal to the Tax Court. And assuming the IRS loses in the Tax Court (seems likely), the IRS could appeal to a circuit court of appeals. Perhaps the IRS at the outset won't take on donors who are domiciled in an Eighth Circuit state. The Eighth Circuit is not likely to overturn its own opinion in a recent case.

The Tax Court decision was strongly in favor of the taxpayer and was an en banc decision (the entire court). Suppose other appeals courts differ from the Eighth Circuit? A split in the circuits is reason for Supreme Court review — but we're talking about eons folks. Of course, Congress could settle the matter by changing the law. And there's no predicting what those people will or will not do.

GG. FORMULA CHARITABLE REALLOCATION CLAUSE — AVOIDS TAX ON CHILDREN'S GIFT

In a peanut shell. A defined-value clause that limited gift tax exposure for gifts to children by allocating to charity any increase in value of the gifted property was upheld by the Tax Court.

Now the full story. Anne Petter inherited UPS stock in 1982 and formed a company to hold it. She divided ownership of the company among herself, trusts for her children's benefit, and charities. This division allocated a fixed number of units in the company to herself, a fixed dollar amount to the trusts, and the rest to the charities.

The estate and the IRS agreed that the value of the company was higher than Anne first reported. That triggered the obligation to reallocate more shares in the company to the charities.

Issue. How to measure the size of the gift on which gift tax is owed? The answer: multiply the new value of the shares by the number of shares going to the charities. But is it the number of shares before or after the reallocation?

Now for the human story. Anne's uncle was one of the first investors in what became United Parcel Service of America, Inc. UPS was a privately owned company for most of its existence, and its stock was mostly passed within the families of its employees. When Anne's uncle died in 1982, she inherited his stock, by then worth millions.

Anne had been a schoolteacher most of her life, and after her windfall, she continued to teach in Washington State. She also stayed in the same house and she continued to stay close to her children. By 1998 Anne realized that with all that UPS stock she needed an estate planner. She first went to her own lawyer. But when she told him that she thought her estate would be worth close to $12 million, he had the professional responsibility, the court tells us, to suggest a lawyer more experienced in handling high-value estates. He referred her to a lawyer with 30 years of estate-planning experience and advanced degrees in tax law. (Let's call him Estate Planning Maven or Maven for short.)

I. Future Planning

Maven first asked Anne what she wanted to do with her wealth. She told him that she wanted her estate put "in order" so it could provide a comfortable life for her children and grandchildren, and that she wanted to give some money to charity. She's also wanted her children to learn how to invest and manage the family's assets.

Maven set to work. First, he created an irrevocable life insurance trust (ILIT) in 1998 to cover any estate taxes. Anne contributed enough to the ILIT in September 1998 for it to buy a $3.5-million life-insurance policy, with her children and grandchildren as beneficiaries. The ILIT's purpose was to create a source of ready cash to pay the large estate tax bill that would arise on Anne's death. Anne set up an ILIT instead of simply buying a life insurance policy and naming beneficiaries. That could have estate or gift tax consequences or both. The ILIT buys a life insurance policy on the life of the grantor, and the ILIT then names the beneficiaries. This structure removes the insurance policy from the grantor's estate and can allow the proceeds to flow to the beneficiaries tax free.

Anne, at Maven's suggestion, put $4 million of UPS stock in a charitable remainder unitrust. That was designed to cover Anne's day-to-day expenses for the rest of her life. The CRUT gave Anne an annual income of 5 percent of its assets — dividends being sufficient to fund the payout without generating immediate capital gains tax. After she died, the remainder passed to charity.

II. The Petter Family Limited Liability Company and the Trusts

At the heart of the plan, and the center of this case, were the Petter Family LLC (PFLLC) and the trusts. Maven designed the PFLLC in 1998 to be a limited liability company incorporated in Washington. He planned to have it funded with UPS stock at a later date, but then in November 1999 UPS announced it was going public. That froze Anne's UPS stock so she could not transfer it until the initial public offering was done. After Anne's stock thawed out in May 2001, she discovered that its value had risen to $22.6 million.

Maven and Anne began finishing the plans for the PFLLC. Maven had drawn the "Petter Family LLC Operating Agreement," which Anne, and her children signed. Anne contributed 423,136 shares of UPS stock worth $22.6 million to the PFLLC.

The holders of each class of units had the right to elect a manager by majority vote. This was undoubtedly the most complex transaction for all of the Petters. Her daughter struggled to understand it and even hired an attorney to help her.

Once Anne had all the units in place and divided into classes, it was time to transfer them to her children. In late 2001, Maven set up two intentionally defective grantor trusts. (Although specialists call them “defective,” these types of trusts are widely used by sophisticated estate planners for honest purposes.) Anne’s trusts were “defective” because they allowed the trustee of either trust to purchase and pay premiums on a life insurance policy on the life of the grantor (Anne). This meant that for income tax purposes — though not for any other purpose — Anne would be treated as the owner of the assets even though they were legally owned by a trustee. Thus she would remain liable for income taxes on the trust’s income for the rest of her life. This arrangement was designed to remove the assets held in the trust from Anne’s estate, reducing her estate-tax liability. It also allowed her to make income-tax payments for the trusts without the IRS’s treating those payments as additional gifts to her children.

III. Funding the Trusts

The transfer proceeded in two parts — first a gift, then a sale. On March 22, 2002, Anne gave the trusts PFLLC units meant to make up 10 percent of the trusts’ assets; then on March 25 she sold them units worth 90 percent of the trusts’ assets in return for promissory notes.

As part of these transfers, Anne also gave units to two charities — the Seattle Foundation and the Kitsap Community Foundation. Both are IRC §501(c)(3) public charities.

Now getting to the crux. The division of PFLLC’s units among gifts to the trusts and the community foundations, and gifts and sales to the trusts, meant that Anne had to value what she was giving and selling. Maven used a formula clause dividing the units between the trusts and the two charities. To ensure that the trusts didn’t get so much that Anne would have to pay gift tax, the trusts agreed that, if the value of the units it initially received is finally determined for federal gift tax purposes to exceed the amount described in the trusts, the trustee will, on behalf of the trust and as a condition of the gift to it, transfer the excess units to the charities as soon as practicable. The charities similarly agreed to return excess units to the trust if the value of the units is “finally determined for federal gift tax purposes” to be less than the amount described in the trust.

Anne’s intent. “We have no doubt that behind these complex transactions lay Anne’s simple intent to pass on as much as she could to her children and grandchildren without having to pay gift tax, and to give the rest to charities in her community," said the court.

Anne died after the trial, so the Tax Court's references to her are references to her estate and her son as the estate's personal representative.

Issue before the court. Whether to honor the formula clause for the gift and the sale; if the court honors it, it must also decide when Anne may take an income tax charitable deduction associated with the additional units going to the charities.

Anne denied that the formula clauses were void because of public policy. She pointed to state law, saying that the clauses work under Washington property laws to pass a particular dollar value of money to intended beneficiaries. Because it works under state law, she said, it should also be honored under federal gift tax law as a transfer in 2002.

The IRS countered. The formula clauses are void because they are contrary to public policy. That would create an increased gift tax liability for Anne.

The court holds:

> As in *Christiansen*, we find that this gift is not as susceptible to abuse as the Commissioner would have us believe. Although, unlike *Christiansen,* there is no executor to act as a fiduciary, the terms of this gift made the PFLLC managers themselves fiduciaries for the foundations, meaning that they could effectively police the trusts for shady dealing such as purposely low-ball appraisals leading to misallocated gifts. See Wash. Rev. Code Ann. secs. 25.05.165(1), 25.05.170 (West 2005). The directors of the Seattle Foundation and the Kitsap Community Foundation owed fiduciary duties to their organizations to make sure that the appraisal was acceptable before signing off on the gift — they also had a duty to bring a lawsuit if they later found that the appraisal was wrong. See *id.* sec. 24.03.127 (West 1986).

The court plays the devil's advocate: "We could envision a situation in which a charity would hesitate to sue a living donor, and thus risk losing future donations or the donor's goodwill. However, gifts are irrevocable once completed, and the charities' cause of action most likely would have been against the trusts, rather than against Anne, since the trusts held the additional shares to which the charities laid claim."

Further, said the court, "The Commissioner himself could revoke the foundations' 501(c)(3) exemptions if he found they were acting in cahoots with a tax-dodging donor. See, e.g., sec. 503(b). And Washington's attorney general is also charged with enforcing charities' rights. See Wash. Rev. Code Ann. secs. 11.110.010, 11.110.120 (West 2006). We simply don't share the Commissioner's fear, in gifts structured like this one, that taxpayers are using charities just to avoid tax. We certainly don't find that these kinds of formulas would cause severe and immediate frustration of the public policy in favor of promoting tax audits. See *Tellier*, 383 U.S. at 694."

The court sums up. "Anne's transfers, when evaluated at the time she made them, amounted to gifts of an aggregate and set number of units, to be divided at a later date based on appraised values. The formulas used to effect these transfers were not void as contrary to public policy, as there was no 'severe and immediate' frustration of public policy as a result, and indeed no overarching public policy against these types of arrangements in the first place."

IV. When may Anne claim an income tax deduction for her gift of the additional units to the charities? The amount of the deduction is the fair market value of the property donated at the time of the contribution. Reg. §1.170A-1(c). But the regulations also specify that, absent the delivery of an endorsed stock certificate directly to the donee or its agent, the date of a gift of stock is the date the stock is transferred on the books of the issuing corporation. Reg. §1.170A-1(b). "We don't know when exactly the PFLLC transferred the shares on its books," said the court.

Here, said the court, we have a conundrum, for the events of the gift happened as follows:

- March 22, 2002–-Gift of 940 shares, split between trusts and foundations. Letters of intent to foundations.
- March 25, 2002–-Sale to trusts
- April 15, 2002–-Moss Adams appraisal report
- Later in 2002–-The Seattle Foundation "books" the value of the allocated shares on the basis of the Moss Adams appraisal. The Kitsap Community Foundation's records recognize the A.Y. Petter Family Advised Fund as of December 31, 2002. In May 2003, Richard Tizzano, president of the Kitsap Community Foundation, signed Anne's Form 8283 for 2002, acknowledging receipt of PFLLC units on March 22, 2002.
- Fall 2007–-Bill Sperling notified of new appraisal for PFLLC units and beginning of reallocation
- February 2008–-Tax Court trial. Reallocation ongoing

Anne's position. The entire charitable deduction should be taken at the time of the gift — 2002. The IRS, on the other hand, said that only some of the stock went to the charities in 2002. That means Anne or her estate should take a deduction for the gift of the rest of the stock in some later year not before the court.

"Washington state law confirms this — under Washington law, courts are 'keen-sighted to discover an intention to make an unconditional and immediate gift to a charity,' and will find a condition precedent only when the gift document expresses a clear intention to do so (citing cases). We are also not convinced," said the court, "that the reallocation was a condition precedent, based on Washington law holding that conditions precedent require the donee to perform some action before the property will become vested and because Anne never expressed an intention to create anything but an immediately vested gift."

The court added: "The allocation of units based on the Moss Adams appraisal, as an event occurring after the date of the gift, is outside the relevant date of the transfer, so anything that worked to change that allocation after the fact is not relevant to our current inquiry. We also don't consider dispositive the date when the charities 'booked' the value of the units, or the amounts the charities booked at the time of the initial transfer, both because those actions also occurred after the transfer and because Anne had no control over the Foundations' internal accounting practices."

After all this, the Tax court holds: "We therefore agree with Anne that the appropriate date of the gift for [income] tax purposes is March 22, 2002. The parties will submit calculations reflecting the amount of the gift and corresponding charitable deduction."

Petter, T.C. Memo 2009-280

HH. PERFECTLY DRAWN CHARITABLE REMAINDER ANNUITY TRUST DISQUALIFIED BECAUSE IMPERFECTLY OPERATED

An inter vivos CRAT had all the required provisions spelled out in the trust instrument but didn't honor two of them. Required payments weren't made to the donor, the first income beneficiary. That was enough for the Tax Court to hold that the trust didn't operate as a CRAT and disallow the *estate* tax charitable deduction. Even if the payments had been made, the CRAT would nevertheless have been disqualified because estate taxes were paid from the trust and not, as required, by a survivor beneficiary as a condition of receiving her annuity payments. *Atkinson,* 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002), *cert denied,* 540 U.S. 946 124 S. Ct. 388, 157 L. Ed.2d 276 (2003).

II. SCRIVENER'S ERROR ROUTE TO STAN-CRUT FROM NIM-CRUT OR NI-CRUT

A 1998 letter ruling tells about a donor who intended to create a STAN-CRUT. But his attorney mistakenly drafted a NIM-CRUT. The scrivener's error was discovered after the trust's first tax return was filed. The trustee consistently administered the trust as a STAN-CRUT and the donor considered adding other assets to the trust so that it could meet the payout requirement without having to sell some assets. The trustee got a court order reforming the trust *ab initio* (from the beginning) to a STAN-CRUT. None of the interested parties—the life beneficiaries, the charitable remainder organization and the state attorney general—objected to the reformation. The court's reformation order was conditioned on the trustee's obtaining a favorable IRS private letter ruling.

IRS ruled that reforming the trust from a NIM-CRUT to a STAN-CRUT wouldn't adversely affect the trust's CRT qualification under IRC §664 and would not be an act of self-dealing under IRC §4941(d)(1)(E)—although it generally would be. *Letter Ruling 9804036*.

IRS's rationale. The trust was consistently administered as a STAN-CRUT and the error was discovered—and action taken to correct it—soon after the trust's creation. The attorney who drafted the trust was undergoing cancer treatment at the time and admitted the mistake under oath. Further, the donor sued him for malpractice. There's no evidence that the donor or other income beneficiaries reduced their tax liability or used hindsight in reforming the trust to a STAN-CRUT.

My word processor made me do it—letter ruling. A later 1998 letter ruling tells about spouses who received a letter from a charity explaining the taxation of STAN-CRUTs and a copy of IRS's specimen STAN-CRUT agreement. They asked their lawyer to draft a STAN-CRUT but he mistakenly drafted a NIM-CRUT. Spouses' CPA told them of the mistake soon after they—as trustees—began making unitrust payments to themselves as beneficiaries. The lawyer admitted that he used the wrong word processing form. Further, the husband's notes—taken at a meeting with the lawyer—show that the couple wanted to create a STAN-CRUT and thought the lawyer was doing so. The couple said that they never even heard of a NIM-CRUT. IRS was asked the consequences of a judicial reformation of the trust to a STAN-CRUT. IRS ruled that the trust would continue to qualify under IRC §664, provided the state court determined that a scrivener's (read lawyer's) error was made when the trust was drafted. Further, any additional transfers to the modified trust would qualify for the gift tax charitable deduction under IRC §2522(a). IRS wasn't asked about the income tax charitable deduction. *Letter Ruling 9822041*.

Tale of donors who wanted a NIM-CRUT but ended up with a STAN-CRUT—and how to set things straight. Lucy and Ricky wanted to create a NIM-CRUT, funding it with highly appreciated stock. Unfortunately, due to a lack of communication among their financial planner, their lawyer, and Charity's planned-giving director (who assisted the financial planner), the couple mistakenly created a STAN-CRUT. The couple had filed all tax returns as if the trust were a NIM-CRUT. Lucy and Ricky soon discovered the scrivener's (lawyer's) error and wished to reform the trust under state law. The reformation's sole purpose would be to convert the STAN-CRUT into a NIM-CRUT. IRS ruled that if the state court concludes that a scrivener's error occurred and the modification is made under state law, the proposed reformation altering the payment method wouldn't violate IRC §664 and wouldn't disqualify the trust. IRS based its conclusion on the landmark, *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), holding the decision of a state's highest court on an underlying substantive rule of state law controls when applied to a federal matter. *Letter Ruling 200218008.*

JJ. CRT WITH MULTIPLE MUCK-UPS NOT REFORMABLE

Fixing up a defective charitable remainder trust to get income, gift and estate tax charitable deductions and avoid tax on the trust's sale of appreciated assets generally involves two steps: first, reforming the trust by deleting improper provisions and adding missing ones; and second, getting IRS to go along with the reformation (an approving IRS letter ruling or no challenge from IRS on an audit).

While step one isn't always a gimme, courts are generally liberal in approving reformations to save charitable gifts and attendant deduction. And a trip to the court house to reform a trust can often be avoided if the trust instrument gives the trustee the power to amend the trust to comply with the requirements of IRC §664, the regulations thereunder and any other Treasury or IRS requirements for charitable remainder trusts. A draftsperson who drew a defective CRT may have omitted (as one of his or her sins) such a provision.

Some states allow reformation with the consent of all the parties (the state attorney general may be a necessary party).

The second step—getting IRS to go along with a reformation—is the tougher one. The Code imposes not-always-achievable requirements and meetable deadlines. A New York Surrogate's Court dealt with a case that tells about a trust that gives new meaning to the expression "every mistake in the book" and the Court wouldn't allow a reformation. The surrogate concluded: "What is sought here, however, is not the reformation of one or two provisions of the instrument, but a wholesale rewriting of the instrument. An expressed desire to create a charitable remainder trust will not suffice to create one and the court is not authorized to draft a new instrument under the guise of reformation. *Matter of Antun,* New York Surrogate's Court, Nassau County, NYLJ, 12/14/00, p.34. col 5.

KK. INCOME REDEFINED FOR CRTs, PIFs, OTHER TRUSTS FINAL REGULATIONS

The Treasury and IRS have revised IRC §643(b)'s definition of income to take into account changes in how a state's laws define trust accounting income. These trusts are affected: net-income charitable remainder trusts (NI-CRUTs and NIM-CRUTs), pooled income funds, trusts that qualify for gift and estate tax marital deductions, and trusts exempt from generation-skipping transfer taxes.

Background. IRC §643(b) defines the term income (when not modified by any other term) as the amount of trust or estate income determined under the governing instrument and applicable local law.

But watch out: Trust provisions that depart fundamentally from the concepts of local law in determining income won't be recognized by IRS. Reg. §1.643(b)-1.

In the beginning. The Internal Revenue Code and regulations date back to a time when, under state statutes, dividends and interest were considered income and were allocated to the income beneficiary while capital gains were allocated to the trust principal. (Let's call this: "traditional income and principal allocation" or "traditional laws.")

Today's world. A number of states have revised—and others are considering revising—their traditional laws to reflect modern-day investment philosophies and changes in types of investments.

Enter the "prudent-investor standard" for managing trust assets. Many states have enacted new rules to enable fiduciaries to adopt an investment strategy that maximizes the total return on trust assets. Thus trust assets are invested for total positive return—ordinary income plus appreciation in order to maximize the trust's value. Under some economic conditions, equities—rather than bonds—would constitute a greater portion of the trust assets than under customary investment standards.

A concern. Shifting trust investments toward equities and away from bonds could hurt the income beneficiary under traditional income and principal allocations. The dividend return on equities as a percentage of their value traditionally has been substantially less than the interest return on bonds. To ensure that the income beneficiary is not penalized by a total-return investment strategy, some states have revised—or are considering revising—definitions of income and principal.

Equitable adjustment solution. Some states permit the trustee to make an equitable adjustment between income and principal if necessary to ensure that both the income beneficiary and the remainder beneficiary are treated impartially, based on what is fair and reasonable to all of the beneficiaries.

Thus a receipt of capital gains that customarily would have been allocated to principal, may be allocated by the trustee to income if necessary to treat both parties impartially. Conversely, a receipt of dividends or interest that previously would have been allocated to income may be allocated by the trustee to principal if necessary to treat both parties impartially.

The unitrust amount solution. Other states allow the trustee to pay a unitrust amount to the income beneficiary in satisfaction of his or her right to the trust income. The unitrust amount is a fixed percentage— sometimes required to be within a range set by state statute—of the fair market value of the trust assets determined annually.

Why new regulations under IRC §643(b)? IRS says that questions have arisen on how state statutory changes affect IRC §643(b)'s income definition and the other Code provisions that rely on that section's definition.

Now getting to the guts of the final regs. While the regs generally permit trustees to implement a total return investment strategy and to follow the applicable state statutes designed to treat the income and remainder beneficiaries impartially, the regs impose some limitations to ensure that Code provisions that rely on IRC §643(b)'s definition of income aren't undermined by an unlimited ability of the trustee to allocate between income and principal and redefine income as a unitrust amount.

Charitable remainder unitrusts—background. A fixed-percentage CRUT (STAN-CRUT) provides for a payment that is a fixed percentage (not less than 5% nor more than 50%) of the annual fair market value of the trust assets.

Alternatively, the unitrust amount may be the lesser of this fixed percentage amount or trust income with or without a make-up amount (NIM-CRUTs and NI-CRUTs). For those trusts, trust income means income as defined under IRC §643(b) and Reg. §1.664-3(a)(1)(i)(b).

The problem as seen by IRS. Under some state statutes, trust income for NIM-CRUTs and NI-CRUTs could be a fixed percentage of the annual fair market value of the trust assets, and that percentage could be less than 5%. A net income charitable remainder unitrust using such a state statutory definition of income would in substance be a fixed percentage unitrust with a percentage of less than the 5%. And that's not permissible under IRC §664(d)(2).

The proposed regulations required that net income CRUTs under IRC §§664(d)(2) and 664(d)(3) had to contain their own definition of income if applicable state law provides that income is a unitrust amount. The purpose of this proposed requirement, said IRS, was to avert potential problems with qualification of a net income CRUT in a state that defines income as a unitrust amount. Some commentators, however, pointed out to IRS, that state statutes provide alternative definitions of income and all that should be necessary is that the trust use a definition of income, whether contained in the terms of the governing instrument or applicable local law, that is not a unitrust amount. Thus, the requirement that NI-CRUTs and NIM-CRUTs contain their own definition of income has been eliminated from the final regulations.

Capital gains as accounting income. Several commentators on the proposed regs were concerned, says IRS, about the provision providing that the allocation of post-contribution capital gain to income, if permitted under the terms of the governing instrument and applicable local law, may not be discretionary with the trustee. Some suggested eliminating the prohibition on discretionary powers held by the trustee. Some suggested that a discretionary power should be permitted if held by an independent trustee. Some requested clarification that this prohibition doesn’t apply to a trustee's power to allocate receipts to income or principal pursuant to state law.

The provision in the proposed regulations, says IRS, has no effect on the determination of trust accounting income under applicable state law that grants the trustee a power to reasonably apportion the total return of the trust. The provision is directed at discretion given the trustee under the terms of the governing instrument to allocate capital gains to income in some years and not others. Allowing the trustee this type of discretion is inconsistent, says IRS, with the requirements for net income CRUTs as explained in the legislative history. The settlor has the option of providing in the trust that the trustee is to distribute the lesser of the stated percentage payout or trust income. However, this option must be adopted in the trust instrument and not left to the discretion of the trustee. See H.R. Conf. Rep. No. 91-782, at 296 (1969), reprinted in 1969-3 C.B. 644, 655. A power to allocate capital gains to income in some years and not others in the trustee's sole discretion is similar to having the discretionary ability to pay out either the trust income or the stated percentage payout each year, regardless of their relative values.

The final regulations. A CRUTs post-contribution capital gains may be included in the definition of income under the terms of the governing instrument or applicable local law, but not pursuant to a trustee's discretionary power granted by the trust instrument. However, a discretionary allocation power is permissible to the extent that applicable state law authorizes the trustee to make adjustments between income and principal to treat the income and remainder beneficiaries impartially.

Some final words on allocation of capital gains to income. IRS, in the proposed IRC §643(b) regulations, said the IRC §664 regulations already prohibited the allocation of pre-contribution gains to income. And that they do. When IRS issued those regs in 1998 it said that the rules prohibiting the allocation of pre-contribution capital gain to trust income apply to sales or exchanges after April 18, 1997. Reg. §1.664-3(a)(1)(i)(b)(5). In the preamble to the proposed regulations, IRS said that for sales or exchanges on or before that date, it "will continue to challenge any attempt to allocate pre-contribution gain to trust income as being fundamentally inconsistent with applicable local law and with the amount of the charitable deduction claimed."

I believe that the allocation of pre-contribution capital gain to income from sales or exchanges before April 19, 1997 shouldn't be challenged by IRS if a trust executed before that date provided for that allocation. That's based on the effective date language of the final regulations and the absence in the final regulations of IRS's negative statement in the proposed regulations.

Pooled income funds—special rules address problems arising from potential new state statutes—background. A pooled income fund—defined in IRC §642(c)(5)—is a split-interest trust created and maintained by a qualifying public charity where individuals receive the income from the commingled fund during their lives and the charitable organization receives the remainder interests. Income paid to the individuals is income as defined in IRC §643(b) and Reg. §1.642(c)-5(i).

A pooled income fund trust is taxed under IRC §641 and is entitled to a distribution deduction under IRC §661 for income distributed to the fund's income beneficiaries. And it receives an IRC §642(c)(3) charitable deduction for any net long-term capital gain that the governing instrument requires be permanently set aside for charitable purposes.

A pooled income fund is taxed on any short-term capital gain that isn't required to be distributed to the income beneficiaries under the terms of the governing instrument and applicable state law.

Under traditional income and principal allocations, ordinary income would be paid to the income beneficiaries. Any net long-term capital gain would be allocated to principal to be held for the charitable remainder organization's ultimate benefit (and thus qualifies for the IRC §642(c)(3) charitable deduction).

Potential problem as seen by IRS. If a pooled income fund were to pay the income beneficiaries a unitrust amount in satisfaction of their right to income—if provided in a state statute—long-term capital gains would no longer qualify for the charitable deduction. Any net long-term capital gain not required to be distributed during the current year would be added to principal. However, the amount of the gain would not be permanently set aside for charitable purposes because that amount might be used in the future to make the unitrust payments to the income beneficiaries.

A similar situation arises, says IRS, if the trustee is permitted under state law to make equitable adjustments for unrealized appreciation in the value of the trust assets. A portion of any subsequently realized capital gain may already have been treated as distributed to the income beneficiaries under an equitable adjustment distribution.

IRS's solution. The final regulations provide that long-term capital gain does not qualify for the income tax charitable deduction available to pooled income funds if the amount of income payable to the noncharitable beneficiaries may be either a unitrust amount or an amount that could include unrealized appreciation in the value of trust assets pursuant to the exercise of a trustee's power to adjust.

Important point. The reg doesn't prohibit paying to the noncharitable beneficiaries an amount of income determined under the governing instrument and applicable local law, even if that income is a unitrust amount or is determined pursuant to a power of adjustment that takes into account unrealized appreciation. Rather, the regulation addresses whether long-term capital gains recognized during a year but not distributed during that year are permanently set aside for a charitable purpose as required by IRC §642(c)(3) to allow the PIF to claim a charitable deduction for those amounts.

If income is defined as a unitrust amount, a future payment of income to the noncharitable beneficiaries may be attributable to long-term capital gains realized, but not distributed, in the current year. If income is determined pursuant to a power of adjustment that takes into account unrealized appreciation, a portion of the capital gain recognized during a year may be attributable to appreciation that was the basis for a distribution to the noncharitable beneficiaries in a prior year. In both situations, says IRS, the long-term capital gains are not permanently set aside for charitable purposes and thus don't qualify for the charitable deduction in computing the PIF's income tax liability.

The final regulations—limitation on capital gains as income. The amount of a PIF's proceeds from the sale of assets that may be allocated to income pursuant to a power to adjust is limited to the amount by which those proceeds exceed the fair market value of those assets as of the date those assets were contributed to or purchased by the PIF. This provision, says IRS, ensures that amounts attributable to the fair market value of assets on the date contributed to the PIF cannot be reallocated to income under a power to adjust. In addition, long-term capital gains from the sale or exchange of trust assets do not qualify for the charitable deduction under IRC §642(c)(3) to the extent that any sales proceeds are distributed to the income beneficiaries.

Beyond this article's scope. The proposed regs also cover: (1) capital gains and Distributable Net Income—so-called DNI (more complicated than—and not to be confused with—DNA); (2) trusts qualifying for gift and estate tax marital deductions; and (3) trusts exempt from generation-skipping transfer taxes.

Effective dates. The final regulations are generally effective for taxable years ending after January 2, 2004.

Kind-grandfather effective date for CRUTs. The prohibition of a trustee's discretionary power, granted solely by the governing instrument and not by applicable state statute, to allocate to income the proceeds of attributable appreciation in the value of an asset after the date it was contributed to the trust or purchased by the trust is applicable to trusts *created* after January 2, 2004.

Important special effective date for PIFs. The provision concerning the failure of net long-term capital gain to qualify for the charitable deduction if the income beneficiaries, under the terms of the governing instrument and the state statute, may receive a unitrust amount or an amount based on unrealized appreciation in the value of the fund's assets is applicable to taxable years of PIFs beginning after January 2, 2004. **However:** Provided that income has not already been determined in such a manner, the fund's governing instrument may be amended or reformed to eliminate that possibility.

A judicial proceeding to reform a pooled income fund's governing instrument must be commenced, or a nonjudicial reformation that is valid under state law must be completed, by the date that is nine months after the later of January 2, 2004 or the effective date of the state statute authorizing determination of income in such a manner.

LL. CRTS—UBTI RULES

Background. A provision buried in the Tax Relief and Health Care Act of 2006 (HR 6111—the so-called "extenders" bill) materially changed the tax rules for charitable remainder unitrusts and annuity trusts (CRTs) that have unrelated business taxable income. CRTs were exempt from income tax for a tax year unless the trust had *any* unrelated business taxable income for the year. UBTI includes certain debt-financed income.

Before 2007 a CRT that lost its income tax exemption for a tax year was taxed as a regular complex trust. As such, the trust was allowed a deduction in computing taxable income for amounts required to be distributed in that year (not to exceed the trust's distributable net income for the year).

Example—the way it was before 2007. For the tax year a CRT had $1,000 of ordinary income, including $100 of UBTI. The trust was required to pay out $700 for the year to the noncharitable beneficiary (recipient). Because the trust had some UBTI for the year, it wasn't exempt for the year. Thus the trust was taxable on *all* its income as a complex trust. However, under IRC §661(a), the trust was first allowed a $700 deduction for the amount paid to the noncharitable beneficiary. And under IRC §642(b) the trust was allowed a $100 personal exemption deduction. Thus the trust's taxable income for the year was $200 ($1,000 minus $700 minus $100).

Suppose the trust only had $50 of UBTI, which would have been fully offset by the $100 IRC §642(b) deduction. Would the trust still have been taxable? Apparently, yes. Under Reg. §1.664-1(c), *any* amount of UBTI made the trust taxable on *all* its income. So it didn't matter that the $50 of UBTI was fully offset by the $100 IRC §642(b) deduction.

One taxpayer did battle with IRS on the UBTI issue maintaining that only the unrelated business income was taxable—not all the trust's income. But the Tax Court in *Leila G. Newhall Unitrust,* 104 TC 236 (1995) ruled that a unitrust receiving *any* UBTI is taxable on *all* its income for the year—not just the unrelated income. And a circuit appeals court affirmed the Tax Court. *Leila G. Newhall Unitrust*, 105 F.3d 482 (CA-9) 1997. Wealthy taxpayers in Leila's shoes were no doubt the force behind the new law. What ever Leila wants, Leila gets?

Starting with the 2007 tax year (all CRTs are on a calendar tax year), a 100% excise tax is imposed on the UBTI of a charitable remainder trust. This replaces the rule that took away the CRT's income tax exemption for any year in which it had *any* unrelated business taxable income. UBTI is considered income of the trust for purposes of determining the character of the distribution made to the beneficiary under the four tiers. And, consistent with earlier law, the tax is treated as paid from corpus.

Observation. A 100% tax on unrelated business income will *generally* be better than paying regular taxes on all of a CRT's income—unrelated business income *plus* income from dividends, interest and royalties, for example. **But watch your step.** UBTI includes certain debt-financed income. So if the acquisition indebtedness rules apply on the sale of a highly appreciated asset, a huge capital gain—based on a percentage of the property mortgaged—would be taxable.

Foregone conclusion. It is better, of course, for a CRT to pay no tax at all. To do that, avoid unrelated business taxable income. Easier said than done for CRTs that invest in LLPs, LLCs, for example. LLPs and LLCs are passthrough entities and often have income from an active trade or business and from debt-financed property. That income flows through the LLP and the LLC as UBTI to a CRT. (Don't you just love all this jargon.)

Here's how one donor avoided the UBTI hit under the old law. Admittedly, her situation doesn't come up every day in the week, but you should know about it if you might be in a tax-trivia contest. She funded her unitrust with a condominium unit. On her death, a publicly supported charity will receive the trust principal. The trust conducted a contest in which contestants paid a $50 to $100 entry fee and submitted an essay suggesting ways to reduce teenage pregnancies. The winner—the contestant whose essay demonstrated the most thoughtful solution to the teen pregnancy problem—received the condo. The trust conducted the contest through an agent that included the charity. Everyone helping to run the contest was an unpaid volunteer.

IRS ruled. The contest entry fees weren't UBTI to the unitrust because the contest was run by unpaid volunteers. Under IRC §513(a)(1) a trade or business doesn't include an activity "in which substantially all the work in carrying on such trade or business is performed for the organization without compensation." *Letter Ruling 9517037.*

MM. TO DIVERSIFY OR NOT TO DIVERSIFY?

That is the question state courts answered in two recent cases involving charitable remainder trusts created by heirs to the fortunes of household-name ancestors.

While the cases don't deal with tax issues (e.g., qualification of the CRTs, allowable deductions), they are equally important. At stake was the value of the interests of donors, income beneficiaries and charitable remainder organizations—and trustees' liability. You'll see that the cases involve interesting personal stories.

Let's start with the tale of two charitable remainder annuity trusts involving Eli Lilly & Company stock. Then, I'll tell you about a unitrust funded with Procter & Gamble stock. And at the end, I'll toss in a diversification case involving a charitable lead trust. We'll see that one case held that the trustee didn't have to diversify and two cases said that it did. Why these antipodal holdings? Read on.

THE ELI LILLY CASE

What happened. Ruth Lilly is the sole surviving great-grandchild of Eli Lilly, the founder of Eli Lilly & Company. In 1981, the Marion County Probate Court in Indiana appointed National City, a bank, to be Ruth's conservator. In 2001, the probate court directed the conservator to draft a new estate plan for her. Later that year, National City petitioned the probate court to implement changes in Ruth's estate plan under a statute permitting a court to authorize a conservator to:

[m]ake gifts, outright or in trust, on behalf of the protected person, to or for the benefit of prospective legatees, devisees or heirs, including any person serving as the protected person's guardian, or to other individuals or charities to whom or in which it is shown that the protected person had an interest . . . . Ind. Code §29-3-9-4(a).

National City gave these reasons for the creation of Ruth's new estate plan: (1) Ruth, while subject to conservatorship protection but without court involvement, had executed twenty-two testamentary documents disposing over $1 billion that likely would generate years of costly and burdensome litigation upon her death; and (2) Ruth's existing plan generated significant, unnecessary taxes. National City, therefore, hoped to simplify, streamline, and improve the financial efficiency of her estate plan.

All interested parties were notified and took part. They were, the court noted, represented by sophisticated legal counsel. The opinion named the white-shoe legal eagles and pointed out their $250,000 in legal fees was paid from Ruth's assets. The attorneys collectively spent over 400 hours reviewing the proposed estate plan, proposing a number of changes, and raising extensive objections to the proposed plan. But none of them objected to paragraph 10(b) of the trust documents, the issue in this case (described soon).

Part of Ruth's new estate plan created two charitable remainder annuity trusts. CRAT #1 provides Ruth with a lifetime annuity and CRAT #2 makes payments to six nieces and nephews for five years. Both CRATs name the same three charities as remainder organizations—The Poetry Foundation (Poetry) and Lilly Endowment, each to receive 35% of the remainder. The third charity, Americans for the Arts (AFTA), will receive 30% of the remainder. National City, the trustee, has sole investment discretion for both trusts.

Non-diversification trust language at issue in paragraph 10(b) of both CRATs. In its capacity as trustee, National City:

shall have the following powers and rights and all others granted by law

* * *

(b) To retain indefinitely any property received by the trustee and invest and reinvest the trust property in stocks, bonds, mortgages, notes, shares of stock of regulated investment companies or other property of any kind, real or personal, including interests in partnerships, limited liability companies, joint ventures, land trusts or other title-holding trusts, investment trusts or other business organizations as a limited or general partner, shareholder, creditor or otherwise, and any investment made or retained by the trustee in good faith shall be proper despite any resulting risk or lack of diversification or marketability and although not of a kind considered by law suitable for trust investments. [Emphasis added by court]

CRATs funded with $286 million in Eli Lilly stock. On January 18, 2002, the CRATs were funded as planned—entirely with Lilly stock— 3,155,404 shares in CRAT #1 and 657,376 shares in CRAT #2. On that date, Lilly stock was selling at approximately $75 per share, giving the CRATs a combined initial value of approximately $286 million.

By March 2002, National City had formulated a draft investment policy statement for the CRATs—"to identify and present the investment objectives, investment guidelines and performance measurement standards" for the CRATs' assets. National City sold significant portions of the Lilly stock held by the CRATs by July 2002, and by October 2002 most of the Lilly stock—the value of which had declined significantly since January 2002—had been sold and the CRATs were fully diversified.

Now the controversy begins. In November 2002, National City petitioned the probate court to approve "its formulation and implementation of the diversification of the investment in Eli Lilly and Company stock held by the [CRATs]." Poetry and AFTA objected and counterclaimed, alleging that the National City's delay in diversifying was negligent, a breach of fiduciary duty, and a violation of the Indiana Uniform Prudent Investor Act (PIA). They asked the court to surcharge National City for the resulting loss to the CRATs. Lilly Endowment didn't take sides on the substantive issues. It merely requested that whatever the court's decision, it treat Poetry, AFTA, and Lilly Endowment identically.

National City, the bank trustee, wins in the probate court and in the appellate court. The appellate court affirmed that the bank's actions were permitted by paragraph 10(b) of the CRATs, which gave it the power "to retain indefinitely any property" it received as trustee and provided that "any investment made or retained by the trustee in good faith shall be proper despite any resulting risk or lack of diversification."

National City argued. The first clause eliminated its duty to comply with the PIA and that the latter clause exculpated it from any liability for failing to timely diversify the assets of the CRATs.

Poetry and AFTA countered to no avail that: (1) National City wasn't excused from complying with the PIA; (2) the exculpatory clause is invalid because the bank, as trustee, put it in the trusts to protect itself, and (3) Indiana Code section 30-4-3-32(b) prohibits trustees from being exculpated against liability for "reckless indifference to the interest of the beneficiaries."

Back to the probate court. National City's motion for summary judgment was granted. The exculpatory clause is "valid and binding upon the parties" and that "[t]he investments made or retained by the trustee during the accounting period" were "made or retained in good faith" and were "proper."

Now back to the appellate court. Poetry and AFTA also argued that the lower court erred in granting summary judgment in favor of National City because paragraph 10(b) of the CRATs doesn't override or nullify the default rule set forth in the PIA requiring the trustee to diversity trust assets.

Poetry and AFTA's silence is held against them.

Before addressing the substance of the appellants' arguments, stated the court,"we have concluded that it is incumbent upon us to consider the appellants' silence prior to their responses to the underlying pleading filed by National City. In particular, at no point did the appellants object to the clauses at issue in paragraph 10(b) of the CRATs, which they now argue are inherently unenforceable, or to National City's alleged conflict of interest stemming from the three proverbial hats—Ruth's conservator, drafter of the documents, and trustee—that it has worn throughout the parties' relationship.

Initially, we again emphasize that National City, acting as Ruth's conservator, voluntarily stepped in to overhaul her extraordinarily—and unnecessarily—complicated estate plan that was sure to result in protracted litigation and astronomical tax bills. After it had created a proposed estate plan, the bank notified all interested parties, including the appellants, provided them with a copy of the proposal, and afforded them time to read, digest, comment upon, and, if necessary, object to the document. The interested parties, including the appellants and Ruth, through her counsel, took extensive part in the process and were represented by sophisticated legal counsel. Indeed, the appellants' attorneys proposed a number of changes and raised numerous objections to the proposed plan. But Ruth, the appellants, and their respective attorneys were silent with respect to paragraph 10(b) and National City's relationship to the parties and the process.

* * *

National City and the probate court afforded the appellants and their attorneys every opportunity to question or object to every facet of the proposed estate plan. The appellants chose not to quarrel with any portion of paragraph 10(b), and they are not now entitled to turn back the clock and claim that, in hindsight, the clauses are problematic and unenforceable.

You should have told us—hit us over the head. The appellants also contended that the National City should have called paragraph 10(b) to their attention or to the attention of Ruth, her family members, or the probate court.

The appellate court deals with this:

At the risk of being redundant, we again emphasize that the appellants were all represented by numerous sophisticated attorneys who are experienced in the areas of trusts and estate planning. The attorneys spent well over 400 hours and amassed nearly $250,000 in legal fees poring over the documents, formulating objections and proposed changes, and presenting their objections and suggestions to the probate court. No party was naive, unrepresented, or taken advantage of in this situation. Moreover, paragraph 10(b) is neither buried nor misleadingly labeled. . . . Under these circumstances, we do not conclude that National City was required to call paragraph 10(b) to the attention of any involved parties.

* * *

. . . there is no evidence that National City "benefited" from the insertion of paragraph 10(b). Its failure to diversify the assets of the CRATs did not result in a windfall or a profit of any kind to the bank. Unlike the cases in which a trustee is found to have engaged in self-dealing, here, National City did not receive a profit or benefit at the expense of the beneficiaries of the CRATs.

Appellants' other arguments. The clause in the trust documents providing general authorization for National City to retain investments (the Retention Clause) doesn't override or nullify the statutory provision of the prudent investor rule requiring the trustee to diversify.

The court responds. The PIA provides generally that a trustee "shall manage trust assets as a prudent investor would . . . ." Ind. Code §30-4-3.5-2(a). The Act goes on to mandate that a trustee "<u>shall</u> <u>diversify</u> <u>the</u> <u>investments</u> <u>of</u> <u>the</u> <u>trust</u> unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." Id. §-3 [Emphasis added by court]. The PIA, however, also provides that the prudent investor rule "may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provision of the trust."

The appellants had another argument. The Exculpatory Clause in the CRATs, which purports to relieve National City of liability for investment decisions unless the bank acted in bad faith, is either fully or partially invalid.

The court deals with this. "As noted above, however, there is no evidence in the record supporting a conclusion that National City committed any actions constituting an abuse of its fiduciary or confidential relationship to Ruth. Given the absence of evidence establishing National City's self-dealing, breach of fiduciary duty, or abuse of its confidential relationship with Ruth, we cannot conclude that the Exculpatory Clause is fully invalid."

Americans for the Arts, The Poetry Foundation, and Lilly Endowment, Inc. v. Ruth Lilly Charitable Remainder Annuity Trust #1 National City Bank of Indiana, Trustee, and Ruth Lilly Charitable Remainder Annuity Trust #2, National City Bank of Indiana, Trustee. 855 N.E. 2d 592 (Ct. App. Ind. 2006)

THE PROCTER & GAMBLE CASE

What happened. A large block of P&G stock was stolen from Elizabeth Gamble Reagan, a descendant of one of P&G's founders. Because the stock had been sold and had a low tax basis, she had incurred a $2 million tax liability. (The court's opinion doesn't explain this.) Elizabeth met with her attorneys and a trust officer at U.S. Bank (formerly Firstar Bank) to devise a plan to replace lost income. They decided that she would establish an 8% charitable remainder unitrust with $2 million of her remaining P&G stock, and that U.S. Bank would be the trustee. The remainder is to be distributed to the University of Kentucky Equine Research Foundation, The Hole in the Wall Gang Fund, and Make-a-Wish Foundation. According to Elizabeth, U.S. Bank understood that one purpose of the CRUT was to diversify out of the P&G stock.

The diversification's pace. U.S. Bank began to reduce the concentration of P&G stock by selling shares each month. The sale of P&G stock was postponed when the price of the stock dropped. Diversification was resumed when the price began to go up.

Turns out that slow and steady was the wrong pace. At the end of the first year, the CRUT's value was 50% less than it was at the beginning of the year.

Call in a pinch hitter. Elizabeth appointed Fifth Third Bank (Fifth Third) (Hey Abbott, who's on Fifth Third?) to replace U.S. Bank as trustee and Elizabeth and Fifth Third sued U.S. Bank for breach of fiduciary duty. (It's often a good idea for the trust instrument to authorize replacing trustees.) The jury awarded $1,040,222. U.S. Bank appealed.

Elizabeth and Fifth Third, as successor trustee, served notice of their lawsuit on the Ohio Attorney General maintaining that he was a necessary party because the CRUT was a charitable trust. Over U.S. Bank's objection, the attorney general allied himself with Elizabeth and Fifth Third during the trial, and an assistant attorney general participated in voir dire, gave an opening statement and a closing argument.

U.S. Bank argued on appeal. The trial court erred when it denied its motion to preclude the attorney general's participation.

Ohio law. R.C. 109.25 provides in part that "[t]he attorney general is a necessary party to and shall be served with process or with summons by registered mail in judicial proceedings, the object of which is to: * * * (C) [c]onstrue the provisions of an instrument with respect to a charitable trust[.]"

So was the attorney general a necessary party? U.S. Bank contended that because the CRUT's proceeds were to be distributed to the charities only upon the CRUT's termination, it wasn't a charitable trust.

Ohio law defines a charitable trust: "any fiduciary relationship with respect to property arising under the law of this state or of another jurisdiction as a result of a manifestation of intention to create it, and subjecting the person by whom the property is held to fiduciary duties to deal with the property within this state for any charitable, religious or educational purpose." An earlier version of the statute specifically excluded "trusts until such time as the charitable, religious or educational purpose expressed in such trust becomes vested in use or enjoyment." Despite that exclusion, the Ohio Supreme Court held in *Brown v. Buyer's Corp.* that "[w]here there is a present fixed and irrevocable duty on the holder of trust property to devote it to charitable purposes, such purposes expressed in the trust are vested in use and enjoyment even though the actual enjoyment of the benefits of the trust by the beneficiaries thereof may occur only in the future." Elizabeth's CRUT imposed upon U.S. Bank an irrevocable duty to devote the proceeds to the charities upon her death.

The appellate court holds. The attorney general was a proper party. The CRUT was a charitable trust under the statute. Given that the CRUT was a charitable trust and that resolution of the complaint required the construction of the trust's provisions, the attorney general was a necessary party.

U.S. Bank contended that it wasn't right to incite the jury. The trial court erred, argued U.S. Bank, when it allowed the attorneys representing Elizabeth, Fifth Third and the attorney general to incite the jury by "overt appeals to passion, prejudice and sympathy." But U.S. Bank didn't object to any of the allegedly improper statements during voir dire, the opening statements and closing arguments.

Appellate court holds. Under the circumstances, it wasn't an error by the trial court to fail to, on its own, strike those comments.

U.S. Bank also contended. The CRUT exculpated it from any liability for the losses in the value of the trust assets. It pointed to R.C. 1339.52(C), which provides that the duty to diversity "may be expanded, restricted, eliminated, or otherwise altered, without express reference to these sections by the instrument creating the trust." Thus it maintained that the CRUT restricted the Bank's duty to diversify from the P&G stock, and that, as a matter of law, it shouldn't be liable for the trust's decrease in value.

The appellate court hammers in the final nail. Recently, our appellate court held that "even if the trust document allows the trustee to 'retain' assets that would not normally be suitable, the trustee's duty to diversify remains, unless there are special circumstances. Acknowledging that R.C. 1339.52(C) does allow for the duty to diversify to be altered, we stated such alteration could be accomplished "only * * * if the instrument creating the trust clearly indicates an intention to abrogate the common-law, now statutory, duty to diversify."

In this case, the CRUT provided in part that "[t]he trustee shall have expressly the following powers * * * to retain, without liability for loss or depreciation resulting from such retention, original property, real or personal, received from Grantor or from any other source, although it may represent a disproportionate part of the trust." The appellate court concluded that this language didn't clearly indicate the intention to abrogate the duty to diversify.

Fifth Third Bank and Elizabeth Gamble Reagan v. Firstar Bank, N.A. Ohio App.1 Dist., 2006

THE ESTATE OF ROWE CASE

It isn't just charitable remainder unitrusts and annuity trusts folks. Here's what happened in an earlier case dealing with a charitable lead annuity trust funded with IBM stock.

Frances Rowe's will created a charitable lead annuity trust with 30,000 shares of IBM stock, with the remainder going to her nieces. IBM was trading for $113 a share when she died in April 1989, and $117 a share when the trust was funded in September 1989. The nieces later demanded an accounting in New York Surrogate's Court, claiming that the bank trustee's failure to diversify the trust assets resulted in declining yield and forced sales of trust principal. The market value of the trust assets had dropped from $3.5 million to $ 1.9 million.

Surrogate's Court holds. The trustee is removed and successor co-trustees are appointed. The trustee must refund all its commissions to the trust and pay damages, plus interest to the trust. The bank trustee appealed.

Appellate court affirms. Under New York's prudent investor rule, the bank trustee should have diversified the assets unless it reasonably determined that it was in the beneficiaries' interest not to do so. The court stated that **"neither adverse tax consequences nor any provision of the trust instrument restricted [the trustee's] freedom to sell the IBM stock and diversify the trust's invest-ments."** [Emphasis supplied.] Thus, the court agreed with the nieces that the bank "had acted imprudently in failing to diversify the trust's assets immediately upon receipt of the IBM stock, in furtherance of its initial goal of creating a diversified portfolio of fixed income oriented and equity or growth assets."

Estate of Rowe, 712 NYS2d 662 (N.Y. App. Div. 2000)

LESSON TO BE LEARNED—DIVERSIFY ASAP. What might a reason not to diversify pronto be? Placing a large block of stock on the market would drive the price down. But the trustee had better be prepared to make a strong case for not diversifying or doing so in dribs and drabs.

Another lesson—don't hang your hat solely on a statute that says the trustee's duty to diversify under common law or a prudent investor act can be negated by a provision in the trust instrument. The trustee prevailed in the Eli Lilly case, but another state court may rule differently.

Potential plaintiffs are under every rock. They are the creators of charitable remainder trusts, successor trustees, charitable remainder organizations and individuals who are trust income beneficiaries. Individuals who are the remainderpersons of charitable lead trusts are also potential plaintiffs. In *Estate of Rowe*, the nieces who were to take at the lead trust's termination, were the plaintiffs. In the P&G case, the attorney general was brought in as a party by the trustee. But in many instances, the attorney general can bring the action on his or her own even though all the parties—the trust creator, the income beneficiaries and the remainder charities—don't want to make trouble.

Donor serves as CRT trustee—caution. He or she can end up being an unsuccessful defendant for failure to diversify.

Wait there's more to be concerned about than having a properly drawn trust that is prudently invested. The trustee must make sure that payments are made and are timely lest the trust run afoul of the rule that requires that a CRT not only meet the Code's requirements, but also be administered according to its terms. See *Atkinson,* 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002), *cert denied,* 540 U.S. 946 124 S. Ct. 388, 157 L. Ed.2d 276 (2003). $2 million in unnecessary estate taxes were incurred because of the trust's failure to make seven quarterly payments. It wasn't an issue in the tax case, but a trustee who fails to make required payments that result in the trust's disqualification could be surcharged and dismissed.

This just in. IRS is trying to collect the unpaid taxes from the Atkinson estate. The Tax Court on April 17, 2007 ruled that the IRS's determination to proceed with collection by levy against the estate is not an abuse of its discretion. In effect, full speed ahead. Although not made clear in the court's opinion, apparently the IRS is also laying its gloves on money being returned to the estate by one of the charitable remainder organizations. *Here's a disturbing note.* The value of the estate dwindled from a reported $7 million in January 2000 to $338,720 on April 13, 2004.

Estate of Melvine B. Atkinson, T.C. Memo. 2007-89; No. 2865-05L

UBTI—something else to think about. Before 2007, a CRT that had *any* unrelated business income lost its tax exemption for the year in which it had that income. In effect, any income and/or capital gain that wasn't paid out to the unitrust or annuity trust recipient (beneficiary) was taxable to the trust (it would normally be tax-free to the trust if it hadn't lost its tax exemption for the year).

Starting in 2007, CRTs no longer lose their tax exemption if the trust has any UBTI. But the UBTI is taxed at 100%. Depending on trust investments, a CRT could have high amounts of UBTI and a 100% tax on that could decimate the trust. In that case, even though trust investments are diversified (but in assets that generate UBTI), the trustee can be surcharged and removed for investing without considering the tax consequences.

NN. CHARITABLE GIFT ANNUITIES ARE SECURITIES

- Philanthropy Protection Act inapplicable
- Marketing of legitimate gift annuities now under microscope
- Obvious lesson — don't pay commissions
- Other lessons — crucial to emphasize the charitable gift, avoid terms such as yields and returns; don't compare with stocks, bonds and CDs

"Not only did Robert Dillie promise his investors 'a gift for your lifetime and beyond,' he pledged 'preservation of the American way of life,' 'preservation of your assets,' and 'preservation of the American family.' Unless Dillie meant to refer to the way of life perfected by the Boston swindler Charles Ponzi and his family, we can safely say that Dillie's claims were a bit overstated." So begins U.S. Circuit Court of Appeals Judge Sidney R. Thomas's opinion affirming the district court's holding that the Dillie-controlled Mid-America Foundation's gift annuity contracts were investment contracts under federal securities law.

The facts. Mid-America Foundation from 1996 until 2001 sold charitable gift annuities through financial planners, insurance agents, and others. They all received commissions.

The Foundation's marketing literature assured investors that they would receive a lifetime stream of income, with the money remaining at their death directed to a charity designated by the investor. The promotion was initially an enormous success for Dillie; the return for the investors was not. The Foundation raised $55 million from the sale of more than 400 charitable gift annuities. The business model was simply a Ponzi scheme in which, rather than investing the investors' funds, the Foundation used their funds to make annuity payments to earlier annuitants, commission payments to facilitators, and payments to Dillie and others for personal expenses (including Dillie's gambling expenses). Although it collected millions in investments, the Foundation quickly became insolvent. With a few minor exceptions, no charitable contributions were ever made, and the scheme collapsed in 2001.

Shortly after the collapse, the Securities and Exchange Commission filed a civil complaint against Dillie. He was subsequently indicted, ultimately pled guilty to wire fraud and money laundering, and was sentenced to 121 months in prison.

Observation. Madoff got 150 years for his $55 billion swindle; Dillie got 121 months for his $55 million scheme. You do the arithmetic.

The narrow effect of the circuit court's decision. The sales people are required to return their commissions to the receiver who was appointed to recover any remaining funds to make some payments to the defrauded and hapless donors.

The broad effect of the court's decision is that all annuity programs are now under the microscope. The circuit court didn't base its decision on the Philanthropy Protection Act's prohibition of paying commissions, but took pains to show that the annuities were promoted as investments.

Charitable organizations and their advisers should review gift annuity marketing materials in light of this case. Here's how the court described some of the Foundation's marketing materials:

Our review of the record in this case demonstrates that the Foundation marketed its gift annuities as investments, and not merely as vehicles for philanthropy. One promotional brochure entitled "Maximizer Gift Annuity: A Gift that Offers Lifetime Income . . . and Beyond" states, under the heading "Attractive Returns," that "[y]our annuity payment is determined by your age and the amount you deposit. The older you are, the more you'll receive." The brochure goes on to list the "current average net-yield" rates. Elsewhere, under a heading titled "A Gift that Gives to the Donors," the brochure states:

> To get this same return through the stock market, [the hypothetical investor] would have had to find investments that pay dividends of 19.3%! (Even the most profitable companies rarely pay dividends of more than 5%.) The rate of return on a Mid-America Foundation "Gift Annuity" is hard to beat!

The brochure also includes a chart comparing the benefits of a $200,000 commercial annuity with a $200,000 charitable gift annuity, indicating the superiority of the charitable gift annuity in such categories as annuity rate, annual income, income tax savings, federal estate tax savings, and "partial bypass capital gains." Although the brochure also notes that the investor will "make a difference" through the purchase of the gift annuity, the brochure as a whole emphasizes the income generation and tax savings aspect of the charitable gift annuity. Indeed, a bullet point summary of the advantages of the Foundation's charitable gift annuities states:

"High Rates; Tax Free Income; Capital Gains Tax Savings; Current Tax Savings; Estate Tax Free; Safe; Secure; Simple; Flexible; PAYS YOU NOW!!! HELPS YOU MAKE A DIFFERENCE LATER."

Another brochure entitled "The Charitable Gift Annuity: Preserving Your Family Legacy . . . Now and For Generations to Come" places emphasis on the opportunity for the investor to designate family members as secondary annuitants under the scheme, noting that "[y]ou can easily include your spouse, children, or grandchildren to receive these lifetime benefits." This brochure also emphasizes the stability and security of charitable gift annuities, noting that "[a] gift annuity is one of the OLDEST and SAFEST financial instruments available." On the whole, this brochure pitches charitable gift annuities to an investor whose main concern is to provide a steady stream of income to dependents after he or she is gone. The brochure's emphasis is on the long-term income production potential of the charitable gift annuity. The fact that some purchasers may have been attracted to the gift annuities in part by the Foundation's promise to donate funds remaining after the annuitants' life to a designated charity does not alter the outcome. See Forman, 421 U.S. at 853 n.17 (suggesting that existence of collateral non-investment motive does not shield transaction from securities laws). In sum, when the promotional materials are examined, the investment component of the annuity is evident.

The court of appeals holds. ". . . [W]e affirm the judgment of the district court. The charitable gift annuities sold by Defendants on behalf of the Foundation were investment contracts, and hence securities for purposes of federal and state securities laws. Defendants were not exempt from registration as securities brokers under the terms of the Philanthropy Act. Because the charitable gift annuities were securities, the district court had personal jurisdiction over the non-resident Defendants."

Warfield v. Alaniz, 569 F.3d 1015 (9th Cir. 2009)

Guidance from the American Council on Gift Annuities: "Two important points may be derived by charities and gift planners from this case. First, in case there was still any doubt in anyone's mind, charities should not offer or pay commissions to anyone (employees or independent third parties like financial planners) for solicitation of gift annuities. Second, CGA marketing materials should emphasize the philanthropic, rather than the investment, objectives of this gift vehicle. Of course, it's OK to talk about payments to the annuitant, and to express those payments as a percentage of the amount transferred to the charity. But we should avoid referring to those percentages as 'yields' or 'returns', or comparing CGAs to investments like stocks, bonds and certificates of deposit."

ACGA Online, 9/3/09

OO. CRUT FOR ALIEN SPOUSES

Can a charitable remainder unitrust for an alien spouse qualify for the

estate tax marital deduction? That question was much discussed recently on a blog for savvy trusts and estates lawyers.

Some background. An unlimited *gift* tax marital deduction is allowable for transfers to a citizen spouse. Although there is no *gift* tax marital deduction for gifts to an alien spouse, an annual gift tax *exclusion* of $136,000 in 2011 (indexed for inflation) is allowable for present interest gifts to alien spouses.

An unlimited *estate* tax marital deduction is allowable for outright bequests and QTIP trusts for a citizen spouse. An unlimited estate tax marital deduction is also allowable if the citizen spouse is given a life estate coupled with a general power of appointment.

To qualify for the estate tax marital deduction, a transfer to an alien spouse must be to a Qualified Domestic Trust (QDOT).

To qualify as a QDOT: (1) at least one trustee must be a U.S. citizen or domestic corporation, and that trustee's approval must be required for all trust distributions; (2) the executor must make an election on the estate tax return to qualify the trust for the marital deduction under the QDOT rules; and (3) the trust has to meet Treasury requirements that will assure that the IRS collects estate tax from the QDOT.

The law is scant on whether a charitable remainder unitrust for an alien spouse can qualify as a QDOT. The IRS did rule favorably on this issue in a 1992 letter ruling.

The facts. Scott planned to create an inter vivos unitrust that would pay him a 10% unitrust amount for life, then to his non-citizen wife, Zelda, for life, with the remainder passing to Foundation. The trust provisions were modeled after the specimen two-life, consecutive interest, inter vivos unitrust in Rev. Proc. 90-30, 1990-C.B. 534. (That specimen has been superceded by a specimen in Rev. Proc. 2005-54.)

Scott kept the right to change the remainder organization to any charitable organization described in IRC §§170(c), 2055(a), and 2522(a), during his life or by will. He also kept the right to revoke Zelda's successor unitrust interest — by will only. Assuming that Scott dies without exercising that right, Zelda's lifetime interest will take effect only if she furnishes funds to pay any federal and state death taxes for which the trustee becomes liable on Scott's death. At that point, some other provisions will take effect —

- At least one trustee shall always be an individual citizen of the United States or a domestic corporation.

- The trustee who is an individual citizen of the United States or the domestic corporation shall withhold from any distribution (other than distribution of income) the tax imposed by section 2056A of the Code on such distribution.

- The trustee shall follow such requirements as the Secretary may by regulation prescribe to ensure the collection of any tax imposed by subsection (b) of section 2056A of the Code.

Scott asked IRS to rule: (1) That the trust will qualify as a unitrust under IRC §664; (2) Upon creating and funding the unitrust, Scott won't have made a taxable gift to Zelda; (3) When Zelda dies, Zelda's interest will qualify for a marital deduction even though she isn't a citizen — assuming appropriate elections are made to qualify the trust as a QDOT for the estate tax marital deduction; and (4) When Zelda dies, her estate will get a charitable deduction for the remaining trust property.

IRS ruled. The trust qualifies as a charitable remainder unitrust, and Scott's right to revoke Zelda's interest makes the gift to her incomplete, and thus not subject to gift tax.

Before qualifying as a QDOT, a transfer to an alien spouse must first meet the general marital deduction guidelines. Here, that requirement is met because a unitrust in which a spouse is the only surviving beneficiary qualifies for a marital deduction under IRC §2056(b)(8).

Scott's trust has the provisions required under IRC §2056A(a) so it will be a QDOT — assuming the executor makes the election under IRC §2056(A)(d). That means Zelda's interest will qualify for a marital deduction (under IRC §§2056(b)(8) and 2056A) and the remainder interest will qualify for the charitable deduction (under IRC §2055(a)) in Scott's estate.

And when Zelda dies, her estate will get a charitable deduction for the value of the trust assets at that time. IRC §2056A(b)(10)(A).

The IRS pointed out: "We note however, that to the extent any unitrust payment consists of trust corpus, that part of the distribution will be subject to the additional estate tax imposed under section 2056A(b)(1) and the trustee must withhold from the payment the tax imposed."

Letter Ruling 9244013

Nice ruling; but what about taxing corpus? It's an offshoot of the QDOT rules that essentially impose an estate tax on any distribution of principal (corpus) that an alien spouse receives from the QDOT. IRC §2056A(b)(1)(A). (In IRC §2056A(b)(3) Congress created exceptions for corpus distributions made to an alien spouse on account of hardship.)

Pointer. Rather than a standard unitrust, Scott could have created a net-income-with-makeup unitrust (NIMCRUT). That way, Zelda's payments wouldn't be diminished by the IRC §2056A(b)(1)(A) tax. Of course, then Zelda wouldn't see anything like the specified 10% unitrust amount unless the trust were invested with a guy who has a 150-year lease in a federal gated community.

Why wasn't IRS concerned about the prospect of the unitrust paying that IRC §2056A(b)(1)(A) tax, the way it is about "death taxes" in Rev. Rul. 82-128? Because in this situation, any tax won't be "paid" by the QDOT-unitrust; the tax won't be charged against trust assets. Rather, the trustee would simply withhold the tax from Zelda's unitrust payments.

Reminder. As with the QTIP marital deduction for transfers to citizen spouses, the QDOT deduction requires that the donor's executor make a proper and timely election.

XXX. OUTRIGHT GIFTS

A. REDEMPTION BAILOUT

Background—the Palmer case (62 TC 684). Donor had voting control of both a corporation and a private foundation. He donated his corporate stock to the foundation and then had the corporation redeem the stock from the foundation. IRS argued that the corporation actually redeemed the stock from the donor and that the donor then contributed the proceeds to the foundation. But the Tax Court respected the form of the transaction and did not tax the donor because the foundation was not a sham, the contribution of stock was a valid gift and the foundation was not obligated to go through with the redemption.

Caution. The U.S. Court of Appeals for the Second Circuit said, in dicta, that an "understanding" between the donor and the charity that charity would surrender its shares for redemption is enough to recharacterize the transaction and generate taxable gain to the donor. In *Blake,* 697 F.2d 473 (CA-2, 1982), the charity agreed not only to give up its shares for redemption but also to use the proceeds to purchase donor's yacht. The Court of Appeals could have reached its decision based on a finding that there was a legally binding obligation on the charity to sell the stock and buy the yacht. Yet, it went further and held that a mere understanding between the donor and the charity is sufficient to recharacterize the transactions.

Later developments. In *Letter Ruling 8411029* (issued after *Blake*) IRS followed *Rev. Rul. 78-197* without mentioning *Blake*. But in *Letter Ruling 8431014*, IRS refused to rule whether a legal obligation existed. State law, according to IRS, may give rise to implied obligations to sell (*e.g*., promissory estoppel or detrimental reliance), which would cause the proceeds of the sale to be imputed to the donors. IRS cited *Blake,* until then conspicuously absent from similar rulings. Compare *Letter Ruling 8552009* (gift valuation hanky-panky: *Blake* theory applied) and *Letter Ruling 8623007* ("no evidence that the donor received any value back" from the charity: gain on redemption not imputed to donors).

IRS seems to focus on the potential for abuse, rather than talismanic standard. See, *e.g.*, *Letter Ruling 8639046*, in which IRS approved a gift/redemption "plan" that, although not binding, was proposed by a taxpayer who was the controlling shareholder of the corporation and a director of the donee foundation. Because the redemption would be for fair market value, IRS noted the similarity to *Palmer* and said the donor wouldn't realize any income from the transaction.

Donors not taxed on appreciated warrants gift—IRS Bound by Rev. Rul. 78-197—latest development: Every schoolchild knows that capital gains tax is generally avoided on charitable gifts of appreciated property. But the kid also knows that under the anticipatory-assignment-of-income doctrine (and other doctrines discussed soon) a donor can be taxable on the capital gain on a subsequent sale by the donee-charity (and not out of the profit, but out of the pocket—ouch!).

The anticipatory-assignment-of-income doctrine was raised by IRS in a 2002 Tax Court case. The court, however, granted summary judgment to the donors, saying that IRS couldn't disavow its own favorable-to-taxpayers 1978 ruling—Rev. Rul. 78-197.

What happened. Husband and wife owned stock warrants in NMG, Inc. World Color Press (WCP) wrote to NMG that it intended to purchase all of NMG's outstanding stock. The couple then assigned their warrants (the right to purchase stock at a set price) to the University of St. Thomas, Marquette University, the Mayo Foundation, and the Archdiocese of St. Paul and Minneapolis, Catholic Community Foundation.

When the gifts were made, the donee-charities weren't—according to the donors and the charities—obligated to sell the warrants. However, soon after receiving the gifts, the charities sold the warrants to WCP.

Enter IRS. The contributions by the donors were anticipatory assignments of income and so they owe IRS an additional $1,322,295 in income taxes (on an unreported $4,722,484 capital gain) plus a $264,459 accuracy-related penalty under IRC §6662(a).

On appeal to the Tax Court. The donors argued that the anticipatory-assignment-of-income doctrine didn't apply because the charities weren't legally obligated, and couldn't be compelled, to sell the contributed property. They relied on Rev. Rul. 78-197, 1978-1 C.B. 83. (IRS's acquiescence in *Palmer*). IRS argued that it wasn't bound by its own ruling even though it hadn't withdrawn or modified it.

Tax Court holds. Deciding for the donors, the court noted that IRS, in Rev. Rul. 78-197, said that it will treat proceeds of the sale of contributed stock as income to the donor only if at the time of the gift, the donee is legally bound, or can be compelled, to sell the shares. The court treated Rev. Rul. 78-197 as an IRS concession and granted summary judgment to the donors "as a matter of law." *Rauenhorst*, 119 T.C. No. 9; No. 1982-00 (7 Oct 2002).

Bright-line test. In language to gladden a tax-planner's heart, the Tax Court in *Rauenhorst* noted that IRS—in Rev. Rul. 78-197— acquiesced to *Palmer* and thus proclaimed a "bright-line" test that focuses on the donee's control over the disposition of the appreciated property.

IRS's Chief Counsel (apparently in response to Rauenhorst) issued a reminder to its attorneys: "It has been a longstanding policy . . . that we are bound by our published positions, whether in regulations, revenue rulings, or revenue procedures, and that we will not argue to the contrary. Accordingly, we do NOT take positions in litigation, TAMs, PLRs, CCAs, advisory opinions etc., inconsistent with a position that the Service has taken in published guidance or in proposed regulations. This policy applies even when attorneys disagree with the published guidance or even if there are plans to revoke, change or clarify the position taken in the published guidance. The policy applies regardless of the age of the guidance and regardless of whether courts have chosen to follow the published position. So long as the published guidance remains on the books, the Office of Chief Counsel will follow it. Counsel can, however, take positions inconsistent with prior informal advice, such as TAMs, CCAs, etc., but should never take a position inconsistent with published guidance or proposed regulations. CC-2002-043.

What's the lesson of this case? Courts don't have to follow IRS revenue rulings and other IRS pronouncements whether they are favorable or unfavorable to the taxpayer. The Tax Court, however, said that IRS is bound by its revenue rulings. Rev. Rul. 78-179—the ruling in play in *Rauenhorst*—simply put, says that a donor of appreciated property is not taxed on the gain on a subsequent sale by the charity if the charity wasn't legally obligated to sell the property. IRS's pronouncement in Rev. Rul. 78-197 merely confirms the law. In all cases, however, the factual issue remains:

Was the charity under an obligation (express or implied) to sell the contributed property? Had the gain “ripened” before the gift?

B. ASSIGNMENT OF INCOME DOCTRINE

Background. Donors who gave appreciated stock to charities just before the corporation merged in a tender offer are taxable on the gain under the assignment of income doctrine, held the Ninth Circuit appeals court in *Ferguson,* 173 F.3d 997 (CA-9, 1999), affirming a Tax Court decision. Generally, a shareholder pays no tax on a stock's appreciation unless the shares are sold. But a shareholder can, in effect, have an involuntary sale when the shares are surrendered as part of a tender offer or on a corporate liquidation.

Charitable gifts—timing is crucial. If the shares are donated to charity *before* the tender offer is cemented or the liquidation plan is adopted, the donor won't have to pay capital gains tax on the appreciation. But if the gift is made *after* that time, the donor has made an "anticipatory assignment of income" and is taxed on the capital gain (not out of the profit but out of the pocket).

“Realities and Substance” test. Courts use a "realities and substance" test that ignores formalities and remote hypothetical possibilities to determine whether a tender offer or liquidation plan had been adopted before a donor's charitable gift.

Situation in tax court. The Fergusons gave appreciated Alpha Corp. stock to charities. Before the gifts, Alpha Corp. and Bravo Corp. agreed to merge. Bravo Corp. made a cash tender offer for Alpha Corp.'s shares and enough Alpha Corp. shares were tendered to approve the merger. The charities later sold the Alpha Corp. shares received from the donors as required by the tender offer. IRS claimed that the donors were taxable on the capital gain under the anticipatory assignment of income doctrine because they contributed a fixed right to receive cash rather than an interest in Alpha Corp. The Tax Court agreed with IRS. *Ferguson,* 108 TC 244 (1997).

The issue on appeal. Did the donors give the stock to the charities before it ripened into a fixed right to receive cash under the tender offer? *Ninth circuit's standards of review.* When reviewing conclusions of *law*, the appellate court isn't bound by the Tax Court's findings. But as to conclusions of *fact*, the court must follow the Tax Court's findings unless they're "clearly erroneous." Whether the donors' stock had ripened into a fixed right to receive cash and the likelihood that the merger would be completed are factual questions. It will only reverse clearly erroneous Tax Court findings. *Ninth circuit affirms the tax court.* After considering the realities and substance of the gifts, the court holds that the right to the cash proceeds matured when more than 50% of the outstanding Alpha Corp. shares were tendered because that was, in effect, an Alpha Corp. shareholder vote approving the merger. At that point, it was almost certain that the merger would be completed. Since that occurred before the donors made their gifts, they are taxable on the gain.

Most assignment of income court decisions involve a formal shareholder vote approving a merger or liquidation, but the court rejects the donors' claim that a formal vote is required. And the court rejects the donors' argument that they, the charities or other shareholders could have withdrawn their tendered shares before the merger was effective because it was "unlikely" that the parties would do so or that the tender offer would not be completed. *Tax evasion or tax avoidance?* The court agrees with the donors that there's a difference between tax evasion (choosing an impermissible path) and tax avoidance (choosing the least costly permissible path). "However, simply because [the donors] have the right to choose the least costly path . . . upon which to walk, they do not have the right to be free from taxation if they decide to walk the line between what is and what is not permissible, and happen to stray across it, as they have here. *Timing is key.* Charitable gifts of stock should, of course, be made before a board or shareholders approve a tender offer or liquidation. But that may be easier said than done unless a donor has closely held stock and therefore control over the timing.

So what's the rule? The cases are fact-driven. In the tender offer and liquidation areas, IRS takes a harder line than it does in the *Palmer*-type redemption situation.

C. WHEN IS GIFT DEEMED DELIVERED FOR DETERMINING VALUATION AND YEAR OF DEDUCTION? Reg. §1.170A-1(b)

Gifts of securities. If mailed, date of mailing is delivery date; if hand delivered to charity, date received by charity is delivery date. If securities delivered to donor's bank or broker (as donor's agent) or to the issuing corporation (or its agent) instructing corporation to reissue in charity's name, delivery date is date securities transferred to charity's name on corporation's books (date on new stock certificate having charity's name).

Gifts by check. If mailed, date of mailing is delivery date; if hand delivered to charity, date received by charity is delivery date.

Gifts of art works and other tangible personal property. Date property received by charity is delivery date.

Real estate gifts. Date charity receives properly executed deed is delivery date. But if deed must be recorded to pass title under local law, delivery date is date deed recorded.

Pledges. Deductible in year fulfilled—not when made. IRC §170(a)(1). Satisfying pledge with property does not give rise to taxable gain or deductible loss. *Rev. Rul. 55-410,* 1955-1 CB 297.

Credit card gifts. Charitable contributions made using a bank credit card are deductible when the bank pays the charity; it isn't necessary to wait until the donor pays the bank. Because use of the credit card creates the cardholder's own debt to a third party, it is similar, says IRS, to the use of borrowed funds to make a contribution. *Rev. Rul. 78-38*, 1978-1 CB 67. A process similar to the use of a charge card, but having the opposite result, is the use of a “pay by phone” account with a bank. If a donor directs his or her bank to make a charitable contribution, the gift is deemed made as of the date the bank mails, transfers or delivers the funds to the charity. That date is shown on the bank’s monthly statement. But it might not be the date (or, more important, the year) that the donor directed the transfer. *Rev. Rul. 80-335,* 1980-2 CB 170.

Options. Donors who grant an option to buy real estate at a bargain price to charity cannot take a deduction until the charity exercises the option.

Cautions re checks and securities.

Postage meter. A donor should not rely on a postage meter to establish the date of delivery for a gift that is mailed. In three cases (not in the charitable area) the Tax Court dismissed petitions that were not timely filed, even though the petitions had been stamped on the proper date by a private postage meter. (*Shipley*, 572 F.2d 212 (CA-9, 1978); *Lindenmood*, 566 F.2d 646 (CA-9, 1978); and *Estate of Labovitz*, 50 TCM 1325 (1985).) Not only must the date be correct, but “the document must be received . . . not later than the time when a document contained in an envelope or other appropriate wrapper which is properly addressed and mailed and sent by the same class of mail would ordinarily be received if it were postmarked at the same point of origin by the [U. S.] Post Office . . .” Reg. §301.7502-1(c)(1)(iii)(b).

A donor who depends on a private postage meter places himself or herself at the mercy of the post office. If it is important to establish the date of delivery, the gift should be mailed through the post office, certified or registered mail, return receipt requested. See *Correia*, 58 F.3d 468 (CA-9, 1995).

Private couriers. The "delivered when mailed rule" only applies to the U.S. mail, not to private couriers. *Leith,* 47 TCM 255 (1983).

Certificate of mailing. A Certificate of Mailing is no substitute for certified mail. Unlike registered or certified mail, a Certificate doesn't identify the item sent; it merely vouches that some piece of mail was received by the post office. *Haaland,* 48 TCM 348 (1984).

Postdated check. The date of mailing won't make any difference if the check is postdated.

Insufficient funds. Generally, if a check is dishonored for insufficient funds, the gift won't be deemed made when it was mailed or delivered. But in *Reedy,* 42 TCM 1401 (1981), a check was deductible for the year of mailing, even though it was dishonored for insufficient funds the following year. When the check was written, the donors had enough money in their account to cover the check. Unknown to the donors, IRS served a notice of levy against their account before the check could clear. The check bounced; however, on receiving the return check notice, the donors placed funds in their account to cover the check, and it was honored the next day. The Tax Court held that, on the particular facts of the case, the contribution was deductible in the year of mailing even though it was later dishonored.

D. CHARITABLE GIFT VS. BUSINESS EXPENSE

Transfers of property to a charitable organization that bear a direct relationship to the taxpayer's trade or business and which are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute allowable deductions as trade or business expenses rather than as charitable contributions. See IRC §162 and its regulations. If gift deductible as business expense, no ceiling on deduction except that it be "ordinary and necessary." *Caution.* Fact that gift exceeds the percentage of adjusted gross income ceiling does not in itself make gift deductible as business expense. See *Rev. Rul. 72-314,* 1972-1 CB 44; *Marquis,* 49 TC 695 (1968); *Jefferson Mills,* 259 F. Supp. 305 (D.C. Ga. 1965), *aff'd* 367 F.2d 392 (CA-5, 1966); *Letter Rulings 9309006, 9041009, 9828031, 9431024, 9129043*.

E. EARMARKING GIFTS

An otherwise deductible payment to a qualified charity isn't deductible if the gift is earmarked for a particular individual—no matter how worthy she may be. Whether a transfer is earmarked is a fact question. In a letter accompanying his payment to a college, Donor stated, "I am aware that a donation to a Scholarship Fund is only deductible if it is unspecified, however, if in your opinion and that of the authorities, it could be applied to the advantage of Mr. Robert F. Roble, I think it would be constructive." In denying the deduction, the appellate court (*Tripp v. Commissioner*, 337 F.2d 432 (7th

Cir. 1964) stated, "[i]t is clear from the record that [Donor] intended to aid Roble in securing an education and the payments to the college were earmarked for that purpose." See *Letter Ruling 200250029* for a fact situation where IRS ruled in favor of the donor. *Law of extended consequences.* If a gift is held to be earmarked for an individual, not only will the donor lose the income tax charitable deduction, but he or she could also be subject to federal (and possible state) gift taxes on transfers to individuals. This could be softened by the $11,000-per-donee annual exclusion and in some cases the gift tax exclusion for tuition paid directly to an educational institution. Then there is the $1 million lifetime gift tax exemption, but you don't want to dip into that willy-nilly.

F. RENT-FREE USE OF PROPERTY BY CHARITY

No income tax charitable deduction for value of rent-free use of property. IRC §170(f)(3)(A); Reg. §1.170A-7(a); *Logan*, T.C. Memo 1994-445. Similarly, a donor who contributes rent-free use of her vacation home to a charity isn't entitled to a charitable deduction. Moreover, the donated time counts as the donor's "personal use." *Rev. Rul. 89-51*, 1989-1 C.B. 89. (That's no problem if she treats it as a personal residence when deducting mortgage interest, but it could wreak havoc for a donor who treats the vacation home primarily as rental property.) *Caution.* No gift tax charitable deduction is allowable but qualifies for $11,000 annual exclusion. Also, rent-free use by a private foundation is a prohibited act of self dealing. *Exception:* Artworks loaned to charity. Lenders don't get gift tax charitable deductions; instead, the law pretends that no (taxable) transfer was made at all. IRC §2503(g). That way, neither the donor nor the IRS has to place a value on the loan, as the Joint Committee's explanation of the provision (JCS-10-88, page 393) points out: *"For other transfer tax purposes, the work shall be valued as if the loan had not been made. Thus, even if on loan at the time of the owner's death, the full value of the work of art is includable in the owner's estate."*

G. INSTALLMENT OBLIGATION

Gift of installment (gain is reportable in installments under IRC §453) accelerates remaining deferred gain in year of gift. *Rev. Rul. 55-157,* 1955-2 CB 293.

H. MATURING ENDOWMENT POLICY

Charitable deduction for value minus amount that would be taxed as ordinary income on a sale. IRS §170(e)(1)(A). But no reduction if policy matures in year of gift. Reg. §1.170A-4(a)(3). Donor has ordinary income of difference between cost and maturity value. *Rev. Rul. 69-102,* 1969-1 CB 32; *Friedman,* 41 TC 428. Deduction in year policy donated. Income taxed to (cash-basis) donor in year charity receives proceeds. Better to sell policy, or cash in and give proceeds.

I. ARTWORK BEQUEST DEDUCTIBLE DESPITE RESTRICTIONS

Artie owned a collection of 53 paintings, drawings and water colors. He had already contributed a 50% undivided interest in 32 of the items to Museum; he still owned the remaining one-half undivided interest and 100% of the remaining pieces. Under Artie's will, Museum was to receive the entire art collection subject to an agreement between Artie and Museum requiring Museum to display the entire collection on a permanent basis, and to identify the works according to Artie's specifications. Artie's will also placed conditions on future sales and loans of the artwork; sales were authorized but the proceeds had to be used to acquire similar works.

IRS rules. Artie's entire interest in his art collection will qualify for an estate tax charitable deduction (under IRC §2055) equal to the collection's fair market value. That's the same amount that will be includable in his gross estate (under IRC §§2031 and 2033), so there'll be a wash. IRS noted that the agreement can't divest Museum of its ownership of the collection and doesn't prohibit Museum from loaning the collection. *Letter Ruling 200202032.*

The art of the deduction—comment. Key elements of the ruling are that the restrictions won't result in loss of the estate tax charitable deduction *and* won't reduce its amount. A donor who places restrictions on the use of a charitable bequest could end up getting an estate tax charitable deduction, but for less than the value of the property included in his gross estate. Suppose, for example, that a donor's will gives Green Acre to charity, but restricts its use to current use as farm land. When he dies, the land has a $2 million fair market value based on its highest and best use without a restriction—a shopping center. But as farmland (with the restriction), it is worth only $1.5 million. So $2 million (highest and best use value) would be includable in his gross estate, and his estate would get a $1.5 million charitable deduction—subjecting $500,000 to estate tax. Not a desirable result.

So a possible problem is highlighted—any suggestions? A donor could satisfy his wishes for the land's use and avoid estate tax. While he is still living, he places a restrictive covenant on the land requiring that it is to be used as farmland forever. He then wills the property to the charity with the "built in" restriction. The amount includable in his gross estate would be the property's restricted (instead of highest and best use) value, and the estate tax charitable deduction would be for the same amount includable in his gross estate, resulting in a wash.

J. CHARITABLE GIFT OF GROUP-TERM INSURANCE

Employees can receive group-term life insurance coverage up to $50,000 tax-free but the value of premiums needed to furnish coverage over that amount is taxable income to the employees. In *Letter Ruling 9319026*, a company that provides its employees with group-term life insurance allows them to reduce their coverage to avoid inclusion in their gross income of the cost of the coverage over $50,000. As long as the employees who reduce coverage aren't entitled to cash or any other benefit as a result of the election, the group plan qualifies, rules IRS.

A better and more generous way. The cost of group-term life insurance protection over $50,000 isn't taxed to employees who name a charity as the beneficiary of the "excess" coverage. Donors don't get an income tax charitable deduction for this gift, but they avoid paying income taxes on the value of premiums needed to furnish the excess protection. IRC §79(b)(2)(B).

Caveat. For years, some advisers have wondered whether the value of the premiums required to furnish coverage over $50,000 could be subject to the federal gift tax, due to the "partial interest" rule. Surely Congress didn't intend that although a literal reading of the Code could support that result. The question has not arisen, probably due to the annual gift tax exclusion.

Besides, it seems that the partial interest issue can be side-stepped if the donor simply names the charity as the beneficiary of *all* the policy proceeds—not just the excess. Reg. §1.79-2(c)(3)(ii) allows an employee to donate a fractional interest in the coverage. The donor will want to be sure that the charity is deemed to have an insurable interest in his or her life under state law. Otherwise, there could be some gift tax wrinkles. But that's not a problem in most states.

K. GIFT OF STOCK MINUS VOTING RIGHTS

No income tax charitable deduction is allowed when a donor transfers stock to charity and retains the right to vote the contributed stock. *Rev. Rul. 81-282,* 1981-2 CB 78.

Gift tax consequences. Although not ruled on by IRS, no gift tax charitable deduction will be allowed for charitable gifts of stock without voting rights.

For estate tax purposes, stock transferred without the right to vote is included in donor's gross estate if he or she owned 20% or more of the stock in the corporation. IRC §2036(b). Even though an estate tax charitable deduction will be allowed (the retained voting rights terminate on donor's death), inclusion of the stock in the adjusted gross estate may jeopardize qualification for special use valuation under IRC §2032A, installment payment of estate taxes under IRC §6166.

However, a charitable deduction was allowed for a donor's gift of stock without voting rights in *Letter Ruling 200108012*. Under a corporate agreement, which was to facilitate any future changes in corporate management and control, the donor had transferred her voting rights to a third party. She later donated her stock to charity. IRS ruled that the donor was entitled to a deduction even though her gift only constituted a partial interest. She had already transferred her voting rights to a third party years earlier, but those rights were transferred solely for business purposes; thus, the interests weren't divided in order to circumvent IRC §170(f)(3)(A).

L. SPECIALIZED SMALL BUSINESS INVESTMENT COMPANY (SSBIC)

Capital gain that would otherwise be payable on the sale of publicly traded securities can be rolled over—without payment of tax. How? Use the sales proceeds to buy common stock or a partnership interest in a SSBIC within 60 days of selling the securities. A SSBIC is a corporation or partnership licensed by the Small Business Administration that finances small businesses owned by the disadvantaged. The gain that can be rolled over for any year is limited to $50,000, with a $500,000 lifetime cap. Small Business Investment Act of 1958 (as amended, P.L. 85-699, 15 U.S.C. 681 et seq.).

Day of reckoning. The basis in the SSBIC is reduced by the amount of any gain not recognized on the sale of the publicly traded securities. Thus, any gain protected from tax on the rollover will be taxed on a later sale of the SSBIC stock.

The SSBIC roll over can serve as a capital gains escape hatch for an individual who sold appreciated publicly traded securities and then learned that he or she could have made an outright charitable gift of the securities or transferred them to a charitable remainder trust (for sale and reinvestment) without having to pay capital gains tax.

If the discovery is made within 60 days of the sale of the publicly traded securities, a donor can use the sales proceeds (within the $50,000 annual limit on gain) to buy stock in a SSBIC. Then, the donor either makes an outright gift of the SSBIC stock to charity or contributes the SSBIC stock to a charitable remainder trust. The charity can keep the SSBIC stock or sell it—without capital gains to the charity or the donor. And a charitable remainder trust can keep the SSBIC stock as an investment or can sell the SSBIC stock and reinvest the sales proceeds—without capital gains to the donor or the trust. A directory of SSBIC's is available from: Associate Administrator for Investment, Investment Division, Small Business

Administration, 409 Third St., S.W., Washington, D.C. 20416; (202) 205-6510.

M. QUALIFYING FOR SPECIAL ESTATE TAX BENEFITS

If a donor of a sizable testamentary charitable bequest is close to death and it's questionable whether the estate will qualify for IRC §6166 deferral, the following technique may help: Donor should cancel the testamentary charitable bequest and instead make a charitable pledge, binding under state law. The pledge is deductible under IRC §2053 and thus will reduce the adjusted gross estate for purposes of meeting IRC §§303 and 6166 requirements.

N. EXTENDING THE INCOME TAX CHARITABLE DEDUCTION BEYOND THE GRAVE

Instead of making testamentary charitable gifts, consider outright bequest in amount of intended charitable gift to cooperative spouse who then makes a gift to charity on his own—generating an income tax deduction for surviving spouse. No extra taxes in decedent's estate because she has a marital deduction for the same amount the charitable deduction would have been. Same technique can be used for testamentary charitable remainder gift. Instead of husband, for example, creating a testamentary charitable remainder unitrust for his wife, he makes an outright bequest to her; she then creates an inter vivos unitrust—thereby getting an income tax charitable deduction. Can be used with a cooperative family member (not a spouse) in amount equal to the unified transfer tax exemption. If the spouse or other family member follows the decedent's wishes, possible for a larger gift to be made to the charity (especially if the charity will receive the survivor's estate).

O. GIFT TAX REPORTING

A donor who makes an outright gift to charity of his or her entire interest in property doesn't have to file a gift tax return. However, gift tax reporting is required for outright gifts of undivided interests and for gifts to charities of remainder and lead interests. Offsetting charitable deductions are available for those gifts—resulting in a wash. Taxes may, however, be incurred on a noncharity's interest in those arrangements.

P. TAX BENEFITS HINGE ON WHETHER PROPERTY IS "ORDINARY INCOME" OR "CAPITAL GAIN"

Ordinary income property. Ordinary income property is an asset that would generate ordinary income if the donor sold it (*e.g.*, gifts of inventory, crops, artworks created by the donor). A deduction is allowed for the property's cost basis or its fair market value, whichever is lower. The ceiling is 50% of adjusted gross income, with a five-year carryover for any "excess."

Capital gain property. A capital asset (securities and real estate) held long-term is deductible at the full present fair market value, with no tax on the appreciation—up to 30% of adjusted gross income, with a five-year carryover for any "excess."

Tangible personal property. The rules for gifts of artworks, antiques, books, etc., held long-term depend on how the charity uses the gifts. Reg. §1.170A-4.

Related-use gifts. When the charity's use of the property is related to its exempt function (*e.g.,* a painting given to an art museum or to a school for its art gallery), the donor can deduct the full present fair market value—deductible up to 30% of adjusted gross income, with a five-year carryover for any "excess."

Proof of use. It's up to the donor to determine how the charity will use the property. A donor may treat a tangible personal property gift as put to a related use by the donee if: (1) the donor establishes that the property is not in fact put to an unrelated use by the donee; or (2) at the time of the contribution it is reasonable to anticipate that the property will not be put to an unrelated use by the donee. A letter from the donee stating its intended use can help a donor show that he or she reasonably anticipates that the charity's use will be related.

Special rule for gifts to museums. A donor doesn't always know whether a museum will put a gift of tangible personal property to a related use. There's a safe harbor for gifts of tangible personal property to a museum if the gift is of a general type normally kept by museums for museum purposes. In that case, the donor may reasonably anticipate (unless he or she has actual knowledge to the contrary) that the donated object will not be put to an unrelated use. It doesn't matter if the museum later sells the object.

"De minimus" rule. A charity's sale of donated property can turn what would otherwise be a related use into an unrelated one. Reg. §1.170A-4(b)(3)(i). However, if a collection of tangible personal property is contributed to a charity that sells or otherwise disposes of only an insubstantial portion of the collection, the use is not unrelated.

Unrelated gifts. If the gift is unrelated to the donee's exempt function (*e.g.*, the charity sells the property), the deduction is for cost basis or fair market value, whichever is lower—deductible up to 50% of adjusted gross income with a five-year carryover.

Donation of judicial robe. Chief Justice William Rehnquist donated the robe he wore during President Clinton's impeachment trial to the Smithsonian Institution His financial disclosure report stated that Sotheby's appraised the robe at $30,000. I don't know whether he claimed an income tax charitable deduction. It appears to be a "related use" gift, so if held long term before contributed it would be deductible at the $30,000 fair market value (up to the 30% of his AGE ceiling, with a five-year carryover). If, however, the Justice didn't buy the robe—but made it himself—it would be "ordinary income" property. The deduction would then be limited to cost basis—no matter how related the use or long the holding period. Presumably he was busy with other matters and purchased the robe (but he may have sewed on the gold stripes himself). *Query.* What value would Sotheby's put on a certain dress?

"Dealer" rules. IRS may claim that under some circumstances a donor is a dealer. If so, the deduction is for the lower of the cost or the fair market value. Factors for determining whether property is held for investment (capital asset) or as a dealer's business property (ordinary income): the nature and purpose of the acquisition of the property; the duration of ownership; the extent of the taxpayer's efforts to sell the property; the number, extent, continuity and substantiality of sales; the extent of subdivision, development and advertising to increase sales; the use of a business office for the sale of the property; the degree of supervision exercised by the taxpayer over any representative selling the property; and the time and effort the taxpayer devoted to sales.

Q. INCREASING THE 30% DEDUCTIBILITY CEILING

The election. A donor may elect to increase the 30% ceiling to 50% of adjusted gross income by making the same gift, but: (1) reducing the amount of the deduction for all long-term property gifts during the year by 100% of the appreciation; and (2) similarly reducing the deduction for long-term property gifts being carried over from earlier years. IRC §170(b)(1)(C)(iii) and (e)(1)(B); Reg. §1.170A-8(d)(2).

Should the ceiling be increased? Generally, no—if the donor will be able to deduct the "excess" as a "30% gift" in carryover years. Generally, yes—when the appreciation on the donated property is small, or if the gift alone or combined with other gifts is so large that the donor will not be able to deduct them as "30% gifts" by using the carryover. Sometimes make the election if the donor is in a much higher tax bracket this year than he will be in carryover years. Do the arithmetic in each case.

Always. A donor's executor or administrator should make the 50% election on the decedent's final income tax return (for the decedent's last taxable year) because any remaining carryover will be lost. It's a carryover, not a carryunder.

Yet another way around. If a generous donor won't be able to deduct an entire proposed gift—even using the 50% election and the five-year carryover—he or she could consider this option: First, the donor makes a life income gift (charitable remainder trust, pooled fund transfer, gift annuity) and deducts the value of the charity's interest. Then, some years later, he or she donates his or her life income interest, taking another charitable deduction. There should be no obligation—express or implied—for the donor to do this.

R. GIFT OF APPRECIATED SECURITIES INSTEAD OF CASH, WITH CASH USED TO BUY SAME SECURITIES ON OPEN MARKET

Achieve stepped-up basis without dying. If new securities go down in value, sale produces loss instead of gain that would be incurred on a sale of the original securities.

S. SUBSTANTIATION—RECEIPTS

The substantiation requirements are in addition to other requirements that may apply. For example, a gift of hard-to-value property—for which an income tax charitable deduction of over $5,000 is claimed—requires a qualified appraisal and an appraisal summary. But if a donor gets the appraisal too early or too late—or neglects to attach the appraisal summary to the tax return—IRS denies the charitable deduction. Further, timely obtained and filed appraisals and appraisal summaries are useless if the appraiser is not "qualified"—and that's governed by a host of yet other rules. Further, charities must make disclosures for "quid pro quo" gifts of over $75.

Query. When is the amount "contributed" less than $250? Suppose a donor pays $300 and receives an item with a fair market value of $55 in return. The Code and regulations are clear that the donor's deduction is $245 ($300 less $55). But is $245 also the amount contributed? Yes, according to an IRS's spokesperson's *unofficial* comments. That means the $250 or over substantiation rules don't apply. In any event, all donors should be given receipts. And the receipt in this case should contain the amount paid and a description of the item given to the donor and a good faith estimate of its value. Then no one has to stay up nights worrying about this.

Gifts of $250 or more. No deduction is allowable for a gift of $250 or more unless the donor substantiates the deduction by a contemporaneous written acknowledgment of the gift by the charity. The receipt must state either that no goods or services were given in connection with the gift—or if they were, that only the amount of the gift over the amount received is deductible.

Contemporaneous acknowledgment. For an acknowledgment to be contemporaneous: the donor must obtain a receipt from the charity "on or before the earlier of—(i) the date on which the taxpayer files a return for the taxable year in which the contribution was made or (ii) the due date (including extensions) for filing such return."

Speedy tax return filers can lose their income tax charitable deductions if they are unaware of the substantiation requirements and the timing of meeting those requirements. Take the case of a donor who mailed her gift of cash or securities on December 31, 2010. (Under the mailing-is-delivery rule, this is a 2010 gift.) The charity received the gift on January 3, 2011 and pronto mailed a proper receipt that very day. The donor—an eager beaver—prepared and mailed her Form 1040 for 2010 to IRS on January 3, 2010. (The date of mailing the return is the filing date.) She received the receipt for her charitable gift on January 4, 2011—the day after it was mailed by the charity. (Even the U.S. Postal Service has rushed to get the receipt to her through rain, snow, etc.). She hasn't complied with the substantiation requirements because the receipt must have been in the donor's possession by the earlier of the filing date or the April 18, 2011 due date for the return.

T. SUBSTANTIATION—APPRAISAL REQUIREMENTS

What must be appraised? An income tax charitable deduction will not be allowed unless the donor complies with strict appraisal requirements. The rules apply to property gifts (other than money and publicly traded securities) if the claimed or reported value of the property exceeds $5,000, $10,000 for gifts of closely held stock. When the rules apply, the donor must get a qualified appraisal and attach an appraisal summary to the income tax return on which he or she first claims the income tax charitable deduction.

The appraisal rules also apply when the aggregate claimed value of all "similar items of property" for which charitable deductions are claimed or reported by the donor in the same taxable year exceeds $5,000, even if the items aren't contributed to the same charity-donee. Similar items of property are items of the same generic category or type, including stamps, coins, lithographs, paintings, books, nonpublicly traded stock, land or buildings.

Substantial compliance with appraisal requirements. In a few cases, donors got their deductions after going to court because they substantially (but not to the letter) complied with the appraisal requirements. See *Bond*, 100 T.C. 32 (1993) and *Fair*, T.C. Memo 1993-377. But not so in *D'Arcangelo*, T.C. Memo 1994-572 and *Hewitt*, 109 T.C. 258, aff'd, 166 F.3d 332 (CA-4, 1998).

U. GIFT OF PROPERTY HAVING FAIR MARKET VALUE LOWER THAN BASIS

Deduction limited to basis. Best to sell and contribute proceeds. The deduction is the same, but sale preserves capital loss deduction (capital loss deduction not available for personal use assets—*e.g.,* personal residence, automobile)

V. FIVE-YEAR CHARITABLE DEDUCTION CARRYOVER—TAX COURT CASE, RULES, STRATEGIES, REPORTING

"We have from time to time complained about the complexity of our revenue laws and the almost impossible challenge they present to taxpayers or their representatives who have not been initiated into the mysteries of the convoluted, complex provisions affecting the particular corner of the law involved . . . . Our complaints have obviously fallen upon deaf ears."— U.S. Tax Court Judge Arnold Raum

Echos of Judge Raum's words can be heard when you read about the tax plight of a generous couple. (Judge Raum served on the Tax Court from 1950-1998, and died in 1999 at age 90.)

Toto, I've a feeling we're not in Kansas anymore. In fact, Kansans Gregory and Terri Maddux were in the U.S. Tax Court where they appeared *pro sese* (when only one person appears for himself, it is pro se. But it is pro sese when more than one person appears without a lawyer.) The IRS was represented by a smart lawyer. Let's call him the Wizard of IRS.

The Madduxes and the Wizard agreed on the facts. The Madduxes were regular and generous contributors to their church, donating $122,214 in 2002; $33,155 in 2003; $16,995 in 2004; and $35,920 in 2005.

Enter the IRS. In 2004 the IRS audited the donors' 2002 income tax return, determined that their 2002 contribution of $122,214 was properly substantiated and they had a carryover of $61,150 from that gift.

How bad tax things happened to good and generous people. The donors didn't claim any part of the carryover from their 2002 gift on their 2003 return; nor did they later amend that return to claim the carryover deduction. On their 2004 income tax return, the donors reported charitable contributions of $16,995 *and* claimed a carryover of $17,033 from 2002. Then in 2005 the donors reported contributions of $35,920. **They also claimed a contribution carryover of $10,000 from 2002.** It's that $10,000 deduction that was at issue. The IRS later conceded that the Madduxes were entitled to a carryover of $1,944 (but not $10,000) from 2002 on their 2005 return.

The court succinctly stated the law. When the amount of the charitable contribution made to a church exceeds 50% of a taxpayer's "contribution base" (that's adjusted gross income without regard to any net operating loss carryback), any excess contribution is to be treated as a charitable contribution paid in each of the five succeeding taxable years in order of time.

The donors maintained that they should not be limited on their 2005 to the $1,944 conceded by the IRS but that they could use the carryover as they saw fit as long as they did so within the five-year period following the original contribution.

Use it or lose it, said the court. ". . . the carryover is good for the 5 years immediately following the charitable deduction, and some portion of the deduction expires each year whether it is actually used or not."

Why didn't the donors amend their earlier tax returns to take full advantage of the contribution carryover? The statute of limitations barred them from doing so. They argued that the IRS didn't tell them that they needed to amend any already-filed returns to take advantage of their contribution carryover.

The donors thought they had the silver shoes. The rules regarding charitable contribution deductions and related carryovers are confusing, they told the court. Thus they should be "permitted to deduct their contribution carryover amounts in ways not contemplated by the statute and the accompanying regulations."

This is a court of law, not of fantasy. "However intricate the rules may be, taxpayers are permitted deductions only as a matter of legislative grace, and then only as specifically provided by statute (citing a slew of cases). And under the rules applicable to charitable contribution carryovers, [donors] were eligible, in 2005, for a carryover of only $1,944, and not $10,000."

Donors urged the court to suspend the running of the statute of limitations as to tax years 2003 and 2004. That would enable them to amend their income tax returns for those years. The court noted that Mr. Maddux was a certified public accountant. He could have gone back and filed an amended return for 2003 after he received the adjustments from his 2002 audit in June 2004; he chose not to do so. "To grant [donors'] request is beyond the purview of this court."

Maddux, T.C. Summ. Op. 2009-30 (March 4, 2009)

Note: This Tax Court decision isn't reviewable by any other court and the opinion can't be treated as a precedent for any other case. *Reason:* The case was decided under the Tax Court's small case procedure. *Comment:* Even if appealable, the Madduxes wouldn't have a snowball's chance in summertime Washington.

Although not already known by every schoolchild and even a CPA donor, the Maddux case deals with one of the simpler situations. The donors gave cash to a church. Cash gifts to churches (and publicly supported charities) are deductible up to 50% of adjusted gross income with a five-year carryover for any “excess.” As the Madduxes learned, you’ve got to use the carryover to the max in each carryover year — up to that year’s adjusted gross income. You can’t pick and choose when you’ll take it.

How else can you lose the carryover?

● If a standard deduction (instead of itemizing) is claimed in any year, any carryover to that year is reduced as if the donor had itemized and claimed the full allowable charitable deduction for that year.

● The carryover is lost by dying. (Where I’m going, they don’t have the concept of adjusted gross income. And it’s a carryover, not a carryunder.) But a carryover from prior years can be claimed on the decedent’s final income tax return for the year of his death (up to the applicable AGI ceiling for that year).

If all gifts were deductible up to 50% of adjusted gross income with a five year carryover, there wouldn’t be much else to say. But because that’s not so, there are still additional rules. Some gifts are deductible up to 20% of adjusted gross income, others up to 30% of adjusted gross income, others up to 50% of adjusted gross income. And the Pension Protection Act of 2006 made gifts of qualified conservation easements by qualified farmers and ranchers deductible up to 100% of adjusted gross income.

Gifts of qualified conservation easements by farmers, non-farmers, ranchers and non-ranchers have a 15- (not five-) year carryover.

More rules — the adjusted gross income-deductibility ceiling and the amount deemed contributed (cost basis or fair market value) depends upon the property’s holding period (long- or short-term), the type of property, the category of donee charity (public charity or private foundation) and for tangible personal property, the use to which the public charity will put the property. And for gifts to operating private foundations, and passthrough (conduit) foundations, the rules for gifts to public charities apply.

Yet more rules. In some cases a donor can elect to have a gift otherwise deductible up to 30% of adjusted gross income (with a five-year-30% AGI carryover) deductible up to 50% of adjusted gross income (with a five-year 50%-AGI carryover). That can reduce the amount eligible as a carryover from earlier years in the election year and following years. (More about this soon.)

Other carryover complications arise when charitable gifts are claimed on a joint return and then a separate return is filed in a carryover year — or vice versa.

Tax life becomes even more complicated because there is a pecking order governing the various AGI-ceiling gifts deemed made first: See Reg. §§1.170A-8, 1.170A-10. Throw into the mix that gifts actually made in a carryover year are deductible before using any carryover. Thus a donor who gives up to the maximum adjusted gross income ceiling each year can end up losing all his or her carryover.

Here are major rules for your walking knowledge:

● The five-year carryover is available for all "excess" gifts. It is an old (1579) proverb that there is an exception to every rule ("There is no rule so general, that it admitteth not exception.") But if this is so, there would be an exception to this rule. So where does this leave us? In any event, there may be an exception to the rule that all "excess" gifts qualify for the carryover. Letter Ruling 8824039 said (mistakenly, in my opinion) that the five-year carryover isn't available when gifts are *for the use of* a private foundation — a foundation's interest in a grantor lead trust. But Letter Ruling 200010036 (when you wade through the thicket of code sections describing qualified charities that will receive the lead trust payments if the named donor advised fund isn't qualified) says that the carryover is available for a grantor lead annuity trust with a private foundation beneficiary.
● Gifts made in the current year must be deducted first.
● Carried-over 50% gifts must be deducted before carried-over 30% or 20% gifts.
● If the "50% election" is made (discussed soon), carryovers of appreciated property gifts from prior years must be reduced the same way.
● If the initial contribution was not properly deductible and would be disallowed had the statute of limitations not expired, any carryovers resulting from the gift (for years when the statute of limitations has not expired) are not allowable.
● **The Old Man and 170(c).** You can't bequeath your unused carryover. A donor's son claimed that he inherited the charitable deduction carryovers on his father's death and deducted them on his income tax return. Agreeing with IRS, the Tax Court held that IRC §170 limits the availability of the income tax charitable deduction to the taxpayer making the gift — in this case, the father. So the father's carryover was not visited upon the son.
● Despite having filed joint returns, the carryover from one spouses's charitable gifts is lost after the death of the spouse who owned the contributed property.

Pointer — giving a surviving spouse an income tax charitable deduction. As just noted, the carryover from one spouse's charitable gifts is lost after the year of the death of the spouse who owned the contributed property. Where most of a married couple's property is held in the name of one spouse — whose life expectancy is considerably shorter than the likely surviving spouse's — this technique may be helpful: The spouse whose days are numbered should give property to the other spouse (qualifying for the unlimited gift tax marital deduction, assuming the spouse is a U.S. citizen). Then on his or her own the surviving spouse decides to make charitable gifts. That way, the surviving spouse will be able to make full use of the charitable deduction carryover.

No one knows for sure whose turn is next. So spouses can hedge their carryovers by having the spouse who owns the assets place them in joint names, tenancy in common or under community property ownership (no gift tax on doing this because the gift tax marital deduction is available). Then *they* donate the joint, tenancy in common, or community property to charity. After one spouse dies, the survivor will still benefit from half of the remaining charitable deduction carryover — the portion attributable to his or her half-interest in the donated property.

Reminder — transfers to noncitizen spouses. A $133,000 annual gift tax exclusion is allowed for present-interest transfers to a non-citizen spouse in 2009. This exclusion is indexed for inflation.

Another pointer — extending the income tax charitable deduction beyond the grave. Instead of making testamentary charitable gifts, consider an outright bequest (in the amount of an intended charitable bequest) to a cooperative spouse who then makes a gift to charity on his or her own — generating an income tax deduction for the surviving spouse. The decedent's estate gets a marital deduction of the same amount as it would have gotten with a charitable deduction.

This technique can be useful for testamentary charitable remainder gifts too. Instead of Husband, for example, creating a testamentary charitable remainder unitrust for Wife, he makes an outright bequest to her; she then creates an inter vivos unitrust for herself — thereby getting an income tax charitable deduction.

The same technique can be used with a cooperative family member (who is not a spouse) by a bequest in an amount equal to the decedent's remaining estate tax exemption. If the family member follows the decedent's wishes and gives his bequest to charity, the income tax savings to the family member can make possible a larger gift to the charity.

The election to increase the 30% AGI ceiling to 50% of AGI; when to make it and how the carryover is affected.

Appreciated securities and real estate held long-term contributed to public charities are gifts of the full present fair market value with no capital gains tax on the appreciation. The ceiling on deductibility is 30% of adjusted gross income, with a five-year carryover.

However, the AGI ceiling can be increased to 50% of AGI with a 50% AGI five-year carryover if the donor makes this election regarding all long-term property contributions during the year or being carried over from previous years: Reduce the amount deemed contributed by all of the gain that would have been long-term capital gain if the contributed property had been sold by the donor at its fair market value. In effect, the gift is deemed to be of basis — not the fair market value.

Because the election requires that the amount of all long-term property gifts for the year must be reduced to basis, it may be preferable to take the 30% deduction and use the five-year-30%-AGI carryover. Do the arithmetic in each case. Here are some guidelines.

Should the ceiling be increased from 30% to 50% of adjusted gross income? Generally, no if the donor will be able to deduct the "excess" as a "30% gift" in carryover years. Generally, yes if the appreciation on the donated property is small. Sometimes, if the donor is in a much higher tax bracket this year than he will be in carryover years. Often, if the donor is elderly or in poor health and not expected to live into carryover years. Once made, the 30% to 50% election can't be retracted after the tax return's due date. Nor can it be made on an amended return after the due date. If there is an extension of time to file the return, the expiration of the extension period is the deadline.

OFTEN OVERLOOKED: A donor's executor or administrator should make the 50% election on the decedent's final income tax return (for the decedent's last taxable year) because any remaining carryover is lost for years after death.

Wait, there's more. As noted earlier, donations of qualified conservation easements give enhanced tax benefits. There is a higher adjusted gross income deductibility ceiling — 50% of AGI for most donors (instead of the usual 30% AGI ceiling) and 100% of AGI for farmers and ranchers. And the carryover is for 15 years (instead of the usual five-year period.) The increased deductibility ceilings and the 15-year carryover are for 2006, 2007, 2008 and 2009. If the law is not extended, the balance of the carryover and higher adjusted gross income ceilings for up to 15 years will still be available.

In 2007 IRS gave guidance (Notice 2007-50) on how to determine the allowable charitable deduction when the 50% and 100% AGI ceilings and the 15-year carryover are taken into account. Below are two questions and answers that deal with those topics. See Notice 2007-50 for questions and answers on whether a gift is a qualified conservation easement and who is a qualified farmer and rancher.

Q-1. How do the percentage limitations and the carryover rules apply in a taxable year in which an individual has made a qualified conservation contribution and one or more contributions subject to the limitations in §170(b)(1)(A), (B), (C), or (D)?

A-1. The qualified conservation contribution may be taken into account only after taking into account contributions subject to the limitations in §170(b)(1)(A), (B), (C), and (D).

For example, in taxable year 2007 individual *B*, a calendar year taxpayer who is not a qualified farmer or rancher in 2007, has [an adjusted gross income] of $100. During 2007 *B* makes $60 of cash contributions to organizations described in §170(b)(1)(A) (that is, contributions to which the 50 percent limitation of §170(b)(1)(A) applies), and a qualified conservation contribution of capital gain property under §170(b)(1)(C)(iv) with a fair market value of $80. Assuming all other requirements of §170 are met, in 2007 *B* may deduct $50 of the cash contributions. The unused $10 of cash contributions is carried forward for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire $80 qualified conservation contribution deduction is carried forward for up to 15 years.

Q-2. How do the percentage limitations and the carryover rules apply if the individual is a qualified farmer or rancher for the taxable year in which the contribution is made?

A-2. Using the example in A-1, if in 2007 *B* is a qualified farmer or rancher eligible for the 100 percent limitation in §170(b)(1)(E)(iv), *B* may deduct $50 for the qualified conservation contribution in addition to the $50 deduction for cash contributions. As in A-1, the unused $10 of cash contributions is carried forward for up to 5 years. The unused $30 of the qualified conservation contribution is carried forward for up to 15 years.

FINALLY: How to claim a charitable deduction for carried-over contributions. Here's an example of how a donor who made a gift in 2007 claims a carryover charitable contribution on his 2008 Form 1040, Schedule A. Attach a statement to the return similar to the following:

[Donor's name, address and Social Security number as they appear on the tax return.]

Statement attached to Schedule A (Form 1040) — "Contributions."

On August 15, 2007, I contributed (my only contribution for the year) publicly traded securities in ABC Corp (which I held long-term) having a fair market value of $160,000 to XYZ College, New Town, New York.

My 2007 adjusted gross income was $100,000.

Contribution deduction on my 2007 tax return ($100,000 x 30% of adjusted gross income): $30,000.

Excess contribution to be carried over: $130,000.

My 2008 adjusted gross income is $200,000.

Contribution carried over from 2007 and deducted on 2008 return ($200,000 x 30% of adjusted gross income): $60,000.

Remaining excess contribution to be carried over to succeeding years: $70,000.

W. TIMESHARE GIFT — NO APPRAISAL, NO DEDUCTION

I'm a Yankee Doodle Dandy
Ain't Got Tax Records Handy

George M. Cohan (pronounced *Coe-han*) was a multi-talented entertainer — a com-poser, lyricist, singer, actor, dancer and producer. Although he died in 1942, his songs live on — "Over There," "Give My Regards to Broadway," "I'm a Yankee Doodle Dandy." **And for tax lawyers, his name lives on as the Cohan Rule,** cited in a footnote in the Tax Court case that follows. First the case, then the Cohan Rule.

Situation. Donor purchased a timeshare interest for $12,396 from Westgate Miami Beach, Ltd. (Westgate) in 2001.

Definition. A timeshare interest is one that an individual has in jointly owned or rented property (e.g., a vacation condominium) and is shared by several persons who take turns occupying the property. *Black's Law Dictionary.*

In 2006, Donor gave her timeshare to Tracets Foundation and claimed a $12,900 charitable deduction. The IRS disallowed the deduction because she failed to properly substantiate her gift with an appraisal. Donor, representing herself, appealed to the Tax Court.

More facts. Tracets "partnered" with Wholesale Timeshare Services and eMidsouth, Inc., to coordinate the transfer of the timeshare from Donor. On November 30, 2006, Donor signed a general warranty deed transferring ownership of her timeshare to eMidsouth, Inc. She didn't have an appraisal of the value of the timeshare made when it was transferred. But she attached a Form 8283 (Noncash Charitable Contributions) to her 2006 tax return and in the section for donated property of $5,000 or less, she listed her donation of the timeshare to Tracets, stating that it had a $12,900 fair market value and that an appraisal was used to determine that value.

At the trial. Donor testified that she never received an appraisal from Westgate when she purchased the timeshare in 2001.

Tax law background — fun reading. Regulations issued before the addition of IRC §170(f)(11) required the qualified appraisal to be made not earlier than 60 days before the date of contribution and before the due date of the original return, plus extensions, on which the contribution is first claimed, or in the case of an amended return, the filing date. Reg. §1.170A-13(c)(3)(i)(A), Income Tax Regs. On October 19, 2006, the IRS issued transitional guidance to provide a safe harbor for taxpayers in conjunction with new IRC §170(f)(11)(E). The transitional guidance provided that the requirements of Reg. §1.170A-13(c), that are consistent with IRC §170(f)(11) still apply, including the time limits.

Sec. 170(f)(11)(E) was amended by the Pension Protection Act of 2006, Pub. L. 109-280, sec. 1219(c)(1), 120 Stat. 1085. As amended, sec. 170(f)(11)(E) codifies the definition of qualified appraisals and appraisers and is effective generally for appraisals prepared with respect to returns or submissions filed after Aug. 17, 2006. Id. sec. 1219(e). As petitioner's return was filed after Aug. 17, 2006, the amended sec. 170(f)(11)(E) applies.

Tax Court analysis. Regardless of whether Donor received an appraisal from Westgate in 2001, she never obtained a qualified appraisal of her timeshare in conjunction with her 2006 contribution to Tracets. See IRC §170(f)(11)(C). Moreover, Donor didn't offer any reason for her failure to obtain a qualified appraisal; therefore, she hasn't proved that her failure to meet the requirements of IRC §170(f)(11) was due to reasonable cause and not willful neglect.

Tax Court holding. The IRS's denial of Donor's claimed deduction for a $12,900 noncash charitable contribution is sustained.

Towell, T.C. Summ. Op. 2010-141; No. 8002-09S (9/21/10)

Note: This is a "small claims" Tax Court decision (under IRC §7463), not reviewable by any other court and isn't a precedent for any other case.

Now for the Cohan Rule. Simply put, it stands for the proposition that if a taxpayer doesn't properly substantiate his deductions — and can't prove the amount of his expenditure — he may nevertheless be entitled to at least a partial deduction by showing that he actually made a deductible expenditure. The IRS conceded that Donor contributed her timeshare. In a footnote, the Tax Court wondered whether an estimate of the allowable deduction could be made under Cohan v. Commissioner, 39 F.2d 540, 543-544 (2d Cir. 1930): "The [Tax] Court has not definitively decided whether Cohan is available to estimate charitable contributions. See Kendrix v. Commissioner, T.C. Memo. 2006-9 (finding that the Court has not yet squarely addressed the inherent conflict between sec. 170(a)(1) and the application of Cohan to unverified or inadequately substantiated charitable contributions). However, because [Donor] presented no evidence on the value of the timeshare, there is no basis on which to estimate an allowable amount."

Let's go back in tax history to 1930, a case involving Mr. Cohan's appeal of the disallowance of his business entertainment expenses. The legendary Judge Learned Hand (can't ask for a better name than that) wrote:

> In the production of his plays Cohan was obliged to be free-handed in entertaining actors, employees, and, as he naively adds, dramatic critics. He had also to travel much, at times with his attorney. These expenses amounted to substantial sums, but he kept no account and probably could not have done so. At the trial before the Board he estimated that he had spent eleven thousand dollars in this fashion during the first six months of 1921, twenty-two thousand dollars, between July first, 1921, and June thirtieth, 1922, and as much for his following fiscal year, fifty-five thousand dollars in all. The Board refused to allow him any part of this, on the ground that it was impossible to tell how much he had in fact spent, in the absence of any items or details. The question is how far this refusal is justified, in view of the finding that he had spent much and that the sums were allowable expenses. Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making [ah, pure poetry]. But to allow nothing at all appears to us inconsistent with saying that something was spent. True, we do not know how many trips Cohan made, nor how large his entertainments were; yet there was obviously some basis for computation, if necessary by drawing upon the Board's personal estimates of the minimum of such expenses. The amount may be trivial and unsatisfactory, but there was basis for some allowance, and it was wrong to refuse any, even though it were the traveling expenses of a single trip. It is not fatal that the result will inevitably be speculative; many important decisions must be such. We think that the Board was in error as to this and must reconsider the evidence.

Comment. For charitable gifts, the detailed substantiation rules of the Code, the regulations and IRS pronouncements will trump the Cohan Rule. So if the substantiation rules aren't met, for the donor — it's over, over here.

X. HOUSE GIVEN TO FIRE DEPARTMENT FOR DEMOLITION

This case is about spouses who arranged to have their house burned down and who then claimed a charitable deduction. To learn about their story and tax fate, read on.

James and Lori Hendrix owned their Upper Arlington, Ohio house since 2000. After a number of years, they decided to demolish the house and build a new one. They got two demolition estimates, each for approximately $10,000. They must have wondered — how can we avoid the demolition fee and get a sizable charitable deduction to boot? They retained the accounting firm, Deloitte & Touche about a possible donation of the house to the city, with its demolishing the structure and then returning the real estate to them. A Deloitte & Touche advisor analyzed the possible transaction and concluded that "[d]onation of property to a fire department is aggressive and not explicitly sanctioned by the Internal Revenue Code."

The Hendrixes then got an appraisal of the land and the house stating a $520,000 value. Their tax-planning juices really got smoking. Why not give the house to the city's fire department for training and that would include burning down the house.

The next step. They granted the city the right "to use" their land and house for Fire Division training. The contract with the city provided that "the structure is to be burned and/or demolished as seen fit by the Fire Division for said training."

Another contract provision. "[T]he City of Upper Arlington does not express any opinion regarding the tax consequences of this transaction" and advised the Hendrixes "to consult with a tax advisor regarding the availability of and requirements for taking any tax deduction."

The city used the house starting June 29, 2004 and demolished it on October 29, 2004. The Hendrixes then built a new, larger house on their lot. They also took a $287,400 charitable deduction on their 2004 income tax return — the claimed value of the house. The IRS disallowed the deduction and assessed a $100,590 tax deficiency.

The next chapter in this saga takes place in a U.S. District Court. "The parties' disputed four core issues, each of which, said the court, "is arguably potentially dispositive of this litigation." **Whether:** (1) the Hendrixes have met the requirement of submitting a sufficient qualified appraisal; (2) they filed a sufficient contemporaneous acknowledgment of the purported donation; (3) the Internal Revenue Code precludes a deduction for this transaction; and (4) the Hendrixes have otherwise established that they are entitled to a deduction.

U.S. District Court holds — 1. The Hendrixes failed to meet the appraisal requirements of the Code and the regulations. The court's opinion has a lengthy analysis of the qualified appraisal rules. The Hendrixes conceded that their appraisal "lacks several areas of content." But they argued that they had "substantially complied." The court then discussed the substantial compliance doctrine finding that it didn't apply in their case. But then added this legal zinger.

> Assuming *arguendo* that the doctrine indeed *could* apply in such taxpayer actions, the Court finds that the appraisal at issue wholly lacks even a modicum of content in critical areas to say that it substantially complies with numerous statutory and regulation mandates. The substantial compliance doctrine is not a substitute for missing entire categories of content; rather, it is at most a means of accepting a nearly complete effort that has simply fallen short in regard to minor procedural errors or relatively unimportant clerical oversights. The required content [the Hendrixes] neglected does not constitute such instance of technicalities.

U.S. District Court holds — 2. Even had the Hendrixes had a proper appraisal or substantially complied, they didn't substantiate their contribution of $250 or more with the required contemporaneous acknowledgment by the donee organization — including whether the donee provided any goods or services in consideration of the transfer.

> First, the statute is neither unclear nor confusing about the need for a written acknowledgment. It explicitly defines the situations in which a contemporaneous written acknowledgment is required (for any contribution of $250 or more), and it spells out chapter and verse as to what must be included in the acknowledgment and as to when the acknowledgment must be received (IRC §170(f)(8)(A)- (C)).
>
> Nor can it be said that the statutory requirement is "unimportant." To begin with, its very inclusion in the Code provision itself, rather than in accompanying regulations promulgated by the Treasury Department, signals a negative answer to that inquiry. And that result is underscored by the nature of the statutorily stated consequence: "No deduction shall be allowed . . . unless the taxpayer substantiates the contribution" by the specified contemporaneous written acknowledgment by the donee organization. Lacking that, the IRS is faced with the absence of even a prima facie showing of the existence of a substantial charitable contribution. Even though our tax system is basically one of self-reporting, the statutory establishment of a watershed –$250–beyond which validation is required in addition to a taxpayer's self-declaration cannot be said to be unimportant.

The court sums up.

> "Either of the foregoing grounds ends this litigation. Thus, as noted, the Court declines to reach the remaining moot issues involved in the parties' dispute. [See issues 3 and 4 listed earlier.] The consequent result of the foregoing analysis is that, regardless of whether

taxpayers may be able to claim a deduction for the type of donation involved in this case — a question this Court need not ultimately answer today — the deficient manner in which [the Hendrixes] pursued such a donation here proves dispositive."

Hendrix, U. S. District Court, Southern District of Ohio
Eastern Division (No. 2:09-cv-132)

Y. ANOTHER HOUSE GIVEN TO FIRE DEPARTMENT FOR DEMOLITION — NOT DEDUCTIBLE

Donating a house to a fire department for demolition and then claiming a charitable deduction is spreading like wildfire.

The above case tells about a couple whose claimed charitable deduction was put out by the IRS and when a U.S. District Court arrived on the scene, it too stamped out the deduction.

Now for the latest case.

What happened. In 1998 Donors (although, as you shall see, the IRS and the Tax Court, in effect, said they weren't worthy of that appellation) gave their house to the volunteer fire department (VFD) to be used for firefighter and police training and eventual demolition. Several days after the house transfer, the VFD conducted two training exercises at the house and then burned it to the ground and removed the debris.

Donors claimed a $76,000 charitable deduction. But wait, it gets better. When they were in the Tax Court appealing the IRS's denial of that deduction, they amended their petition and maintained that they were entitled to deduct $235,000, the house's reproduction cost. **Makes sense.** If the IRS denies a $76,000 charitable deduction, claim $235,350.

The IRS contended that Donors weren't entitled to any deduction. Not one penny. They received, in exchange for the property donated, the substantial benefit of demolition services and those services exceeded the property's value (quid pro quo argument).

Penalties. The IRS imposed an accuracy-related penalty under IRC §6662(a) and in the alternative, an accuracy-related penalty under IRC §6662(h).

More facts. In 1996, Donors paid $600,000 for the three-acre lake-front property in Chenequa, Wisconsin. After acquiring the house, they were undecided whether to remodel it or tear it down, finally deciding on demolition and building a new house. It would cost $10,000 to $15,000 to demolish the house and remove the debris.

But wait, there is a better way. Donors donated the house to the Volunteer Fire Department for firefighter training and demolition and claimed, as already noted, a $76,000 charitable deduction for the house's value. Soon we'll see how they arrived at that value.

Five weeks after the house's destruction, Donors contracted to have a new house built on the property for $383,000.

The Donors' tax return. To their timely filed joint return for 1998 they attached Form 8283, Noncash Charitable Contribution, reporting that the house had a $100,000 basis and had an appraised fair market value of $76,000.

Enter the experts —
Donors' appraiser used the before and after approach to determine the house's value, treating its fair market value as equal to the difference between fair market value of the property with the house and its value without the house. As part of his analysis, Donors' expert also estimated that the house's reproduction cost was $235,350.

The IRS's expert was a professional house mover. He had contracted to move numerous houses throughout Wisconsin. The court found him to be qualified to give an opinion on the value of houses that are sold for the purpose of moving them to other locations. The IRS's expert concluded that it would cost approximately $100,000 to move the house to another location in the Chenequa area. However, he also concluded that in view of the high cost of land in that area in comparison with the modest nature of Donors' house, no one would purchase it to move it to any land close enough to render a move feasible. It would be too expensive. Further, any salvage value attributable to the structure and its interior components would be offset by the cost of labor.

The IRS's other expert was a real estate specialist employed by the Wisconsin Department of Transportation. Her primary responsibilities were to arrange for the clearing or removal of all improvements, including houses, from real estate designated by Wisconsin for highway construction projects. She concluded that it would be very costly to attempt to move Donors' house, and doubted that anyone would buy it to move to another property.

Tax court holding. Donors' charitable deduction is disallowed but they are not subject to the accuracy-related penalty under IRC §6662(a).

Tax Court's analysis:

> The Supreme Court has defined "contribution or gift" for purposes of Section 170: The legislative history of the "contribution or gift" limitation [of section 170], though sparse, reveals that Congress intended to differentiate between unrequited payments to qualified recipients and payments made to such recipients in return for goods or services. Only the former were deemed deductible. The House and Senate Reports on the 1954 tax bill, for example, both define "gifts" as payments "made with no expectation of a financial return commensurate with the amount of the gift." * * * [Hernandez v. Commissioner, 490 U.S. 680, 690 (1989).]
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> If a charitable contribution is made in property other than money, the amount of the contribution is generally the fair market value of the property at the time of the contribution. Sec. 1.170A-1(c)(1), Income Tax Regs. "[F]air market value" for this purpose "is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts." Sec. 1.170A-1(c)(2), Income Tax Regs. Restrictions on the property's use or marketability on the date of the contribution must be taken into account in the determination of fair market value.

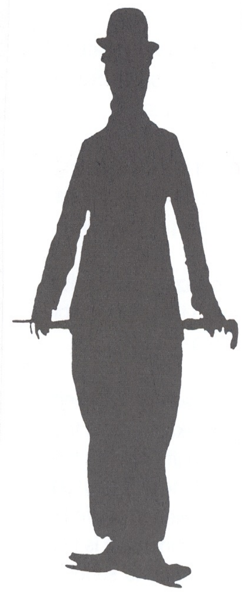
The Tax Court found that the appraisal made by Donors' expert was unpersuasive evidence that the house had a $76,000 fair market value as donated. While the "before and after" method used by Donors' appraiser has been accepted as an appropriate measure of the fair market value of donations of restrictive covenants on real property (e.g., conservation easements), Donors cited no authority for the use of a "before and after" method in valuing a structure that has been severed from its underlying land and encumbered with additional restrictions on use.

Donors alternatively contended that the fair market value of the house as contributed to the VFD was $235,350, its reproduction cost. But Donors offered no expert testimony in support of this valuation. Their expert did not so opine; Donors merely borrowed his estimate of reproduction cost and asserted it on brief.

Rolfs, 135 T.C. No. 24 (11/4/10)

I have a confession to make. Half of what we have taught you is in error, and furthermore we cannot tell you which half it is.

—Sir William Osler addressing a graduating medical class



In the end, everything is a gag.—*Charlie Chaplin*