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Lawrence P. Katzenstein

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CHARITABLE PLANNING THROUGH DEFERRED GIVING VEHICLES

Lawrence P. Katzenstein
The Stolar Partnership
Suite 700
911 Washington Ave.
St. Louis, Missouri 63101
(314) 231-2800

I Introduction

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

Example: A testator in a 50% estate tax bracket who bequeaths $100,000 to charity recovers 50% of it through the estate tax deduction. If the property had been given to charity during lifetime, not only would the estate tax have been saved (because the property would not have been in the donor’s estate at the date of death) but approximately 31% of the gift would have been recovered through the income tax deduction.

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

C. Historic background:

1. In the good old days (i.e., before the Tax Reform Act of 1969) donors simply established trusts providing for payment of all of the income to the donor or other life beneficiary, prohibiting invasion of corpus, and providing for the remainder to pass at termination of the life interest to the charitable remainderman.

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2. The donor received an income tax deduction based on the actuarial value of the remainder following an income interest for a life or lives.

3. Why did Congress change the rules? Congress was primarily concerned that assets would be invested to produce a high rate of return with little consideration for the protection of corpus for the benefit of the remainderman. The solution was a form of trust which would pay amounts to the income beneficiaries which were not dependent upon investment return.

D. 1. The two types of remainder trusts permitted by Section 664 are charitable remainder annuity trusts, which provide for payment of a fixed amount at least annually, and charitable remainder unitrusts, which require payment of a fixed percentage of the trust, revalued annually.

2. The Code now provides that no charitable deduction is permitted for a charitable remainder in a split interest trust (other than a pooled income fund) unless the life or term interest is a fixed annuity or unitrust amount.

3. This is true for income tax deduction purposes (section 170(f)(2)(A)), federal estate tax charitable deduction purposes (section 2055(e)(2)) and gift tax charitable deduction purposes (section 2522(c)(2)).

II. Tax Effects.

A. The charitable remainder trust is exempt from tax pursuant to Section 664(c) unless it has unrelated business income. The unrelated business income problem can be a real trap. See, for example, the Tax Court decision in Leila G. Newhall Unitrust, 104 Tax Court No. 10, where a unitrust was held not to be qualified because of UBIT during the year in which it had substantial capital gain income. The trust was funded with publicly traded stock. On liquidation of the corporation, the trust received interests in publicly traded partnerships holding various mineral and other rights. The Tax Court held that the business interests and operations of the partnerships would be attributed to the unitrust.

B. Unlike the usual trust rules, which provide for pro rata inclusion in the beneficiary’s income of various classes of income, charitable remainder trust beneficiaries are taxed on a tier system providing for least desirable types of income to be exhausted first in accordance with the tier system.
C. Ordinary income, either from current year earnings or prior year accumulations, is deemed to be distributed first, followed by capital gains, followed by tax-exempt income, followed by return of corpus.

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

1. What this means is that highly appreciated assets paying little income can be sold by the trust and reinvested without capital gains cost either to the beneficiary or to the trust.

2. But if the proceeds are invested in assets producing tax-exempt income, the amounts distributed either from current year earnings or prior-year accumulations are deemed to be taxable capital gains until they are entirely exhausted.

III. Common Elements of Unitrusts and Annuity trusts.

A. Unitrusts and annuity trusts have many common elements, and the two types of payouts may not be combined.

B. Life or term payments. Section 664 requires that payment be made to one or more persons, at least one of whom is not an organization described in Section 170(c) and, in the case of individuals, only to an individual who is living at the time of creation of the trust.

C. 1. It is apparent from reading Section 664 that a person does not have to be a natural person, but may be a corporation, partnership or other entity. See Section 7701 for the statutory definition of person. Charitable remainder trusts for persons who are not individuals are rare.

2. Obviously, in the case of payments to a person who is not a natural person, the payment can only be for a term of years, and may not be for the lifetime of the "person".

3. Payment may be made to multiple beneficiaries, either jointly or concurrently. Additional life beneficiaries will, of course, lower the charitable deduction.

4. Period of Payment.
a. Both charitable remainder annuity trusts and charitable remainder unitrusts must be payable for the life or lives of one or more individuals living at the time of the creation of the trust or for a term of years, not in excess of twenty years. (Charitable lead annuity trusts and charitable lead unitrusts need not be limited to a 20-year term.)

b. The longer the term, the less the tax deduction.

c. Some combinations of life or lives plus term of years will qualify, so long as the term of the trust cannot exceed lives in being at the creation of the trust.

**Example:**

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

**Note:** The key here is that the trust cannot last longer than the lives of the beneficiaries.

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

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

5. The payment period can terminate earlier than it would otherwise terminate, dependent upon any contingency. Earlier rulings had held that trusts did not qualify where the unitrust or annuity payment would end upon a contingency, resulting in earlier payment to the charity. A typical such contingency is remarriage. There is no policy reason to disqualify the trust in the event of early termination since the only effect is that the charity receives the remainder earlier than it would otherwise.

6. a. A 1984 amendment to Section 664 provided that any "qualified" contingency the effect of which is to accelerate the charitable remainder is permitted. A qualified contingency is defined in Section 664(f)(3) as any provision
of a trust which provides that upon the happening of a contingency the unitrust or annuity trust payments will terminate not later than the payments would otherwise have terminated.

b. Thus, a trust providing for payment of a unitrust amount to X for life or until X’s remarriage will qualify, even if the value of the contingency is unascertainable.

c. The qualified contingency will not increase the value of the remainder for charitable deduction purposes. This is true even where the contingency is capable of valuation, as is, for example, the possibility of remarriage. But this means the contingency can be far-fetched without disqualifying the trust.

d. Use of the qualified contingency makes possible a number of planning ideas. In terrorem provisions, for example, are now permitted. In private letter rulings before 1984, the Service ruled that an in terrorem provision disqualified a charitable remainder trust, because the term of the trust would no longer be measured by the lifetime of the beneficiary, but by the lifetime of the beneficiary or, if shorter, the beneficiary’s filing of a will contest. Trusts which end on remarriage are also now permitted. Note that the marital deduction will be available for such trusts, as Section 2056(b)(8) provides that the terminable interest rule does not apply to charitable remainder trusts.

7. The Service has approved a testamentary annuity trust giving an independent trustee the authority to sprinkle the annuity between the annuitant and the charity. See Ltr. Rul. 9052038.

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

8. Further caution: The period of payment provisions can create problems even where the payment terms themselves do not specifically trigger it. For example, to prevent a present gift in a two-life charitable remainder trust, drafters often give the donor the testamentary power to revoke the successor beneficiary’s interest. If the power is held by the donor and he is not an income beneficiary, the Service could disqualify the trust on the
ground that the period of the trust payments is determined by reference to a life other than the beneficiary’s.

D. Payment Amount

1. The payment amount from both unitrusts and annuity trusts must be at least 5%. (Note that there is no minimum payment for lead unitrusts or lead annuity trusts, PLR 9415009 to the contrary notwithstanding. That ruling is wrong.)

   a. In the case of a charitable remainder unitrust, the payment must be at least 5% of the trust revalued annually.

   b. In the case of a charitable remainder annuity trust, the payments must be at least 5% of the initial fair market value of the trust assets.

2. Why does the Code require, as a policy matter, that the payout to the non-charitable beneficiaries be at least 5%? The reason is that the private foundation rules prohibiting accumulations in private foundations, which were also part of the 1969 Tax Reform Act, could otherwise be easily avoided by use of a charitable remainder trust with a very low payout.

E. Calendar year requirement.

1. Code section 645 requires all trusts except wholly-charitable trusts to use a calendar year for tax reporting purposes.

2. Split-interest trusts are not wholly charitable and are therefore required to be on a calendar year.

F. Governing Instrument Requirements.

1. The Service in many rulings has issued governing instrument requirements for charitable remainder trusts. Without going into details of drafting, suffice it to say that the requirements are technical and often nitpicking. In Rev. Procs. 89-20, 89-21, 90-30, 90-31, 90-32 and 90-33 the Service issued sample charitable remainder unitrusts and annuity trusts which include much simpler language than some of the earlier Internal Revenue Service announcements.
2. This is particularly true with regard to proration of partial year payments and similar technical provisions.

3. If the language of the Rev. Procs. is used and if the Rev. Proc. is referred to in the trust instrument, the Service will recognize the trust as satisfying all the requirements and will no longer normally issue rulings as to qualification.

4. The Rev. Procs include sample suggested language for two-life trusts and for various variations such as income-only unitrusts.

IV. Why Use Charitable Remainder Trusts?

A. As noted above, the contribution to the trust generates an immediate income tax deduction even though the donor is able to keep a life income interest.

B. 1. The charitable remainder trust can often enable a donor to diversify his or her assets, increasing the donor’s income without incurring capital gains cost.

2. For example, a donor may have highly appreciated securities paying a 4% dividend. In order to diversify or increase his income, the donor could sell the securities and reinvest the proceeds in higher yielding assets, but the amount reinvested would be reduced by capital gains taxes incurred.

C. The charitable remainder trust makes it possible to achieve diversification without capital gains cost. Stock can be contributed to a charitable remainder trust, sold without capital gains cost and the proceeds reinvested in higher yielding assets.

D. The effect of all of this is to greatly reduce the cost of charitable giving for charitably-inclined donors.

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

F. Unlike a pooled income fund, the CRAT or CRUT investments can be separately managed and tailored to a particular donor’s needs, or can be invested with endowment funds.

V. Differences between Annuity Trusts and Unitrusts.

A. Unitrusts

1. As noted above, the charitable remainder unitrust must provide for payment of a fixed percentage (at least 5%) of the trust revalued annually.

2. The unitrust must explicitly either permit future contributions or must prohibit them.

3. If future contributions are permitted by testamentary addition, the instrument should contain language providing for interest on delayed distributions from the estate at 10% interest or at such other interest rate as may then be required by federal regulation. See Regulation Section 1.664-1(a)(5), T.D. 7955. Generic language incorporating whatever federal rate is then in effect should be included.

B. Annuity trusts must prohibit future contributions.

C. Variations on the unitrust theme.

1. The charitable remainder unitrust, which calls for payment of a percentage of the trust revalued annually, may also provide that if the income of the trust is less than the unitrust amount, only the income need be paid. The valuation of the charitable remainder is not affected.

2. The trust may, but is not required to, provide that if income is less than the unitrust amount in any year, deficiencies can be made up in future years in which income exceeds the unitrust amount. The calculation of the remainder (and therefore the charitable deduction) is made without taking into account the income-only feature.

3. Why use an income-only unitrust?
a. Income-only unitrusts are appropriate where a donor contributes appreciated property paying less than the unitrust amount, with the expectation that the property will be sold and reinvested in higher yielding assets, but it may take some time to make the sale.

b. For example, a donor may contribute unproductive real estate which will be sold by the trust. Until the property is sold, the trust may have little or no income, making it impossible to pay the unitrust amount and at least theoretically requiring a distribution of a portion of the asset in order to make each unitrust payment.

c. The annuity trust may not have an income-only exception. The annuity amount must be paid whether or not the asset produces income. For this reason, annuity trusts are not appropriate where unproductive property may be held by the trust before sale.

4. Some commentators, most notably the late David Donaldson, had suggested use of a so-called "flip" unitrust--an income only unitrust which becomes a straight unitrust upon sale of the unproductive property. This would allow a trustee to invest for total return rather than having to strain to achieve income equal to the unitrust payout percentage. There is no policy reason a flip trust should not be permitted, since the charitable deduction for a unitrust is the same whether or not the income-only feature is included. But there is also no authority for such a provision. In fact, in PLR 9506015 the Internal Revenue Service ruled that such a provision would in fact disqualify a charitable remainder unitrust. In that particular ruling, the trust had been drafted originally as an income only unitrust and the donors went to court to reform it to add the flip provision. The Service ruled that the addition of such a provision would disqualify the trust. That does not mean, however, that given the uncertainty of the question, donors should not use flip unitrusts. If the flip provision (i.e., one providing that in the first year after which the property is sold the trust will convert to a regular unitrust) is included, a challenged unitrust can still be reformed under the reformation provisions. No one has suggested that the flip provision makes the trust in some respect unreformable. The reformation could take the form of removing the income only provision, so that the trust would now owe the donor his or her unitrust percentage back to date of creation. The reformation provisions probably remove most of the
dangers should the Service attempt to disqualify the trust. An alternative may be use of a provision allocating capital gains to income. If permitted under state law (and state law usually permits this if the instrument so provides) when the property is sold there would then be sufficient income (since capital gains are defined as including income) to meet the unitrust payout percent. The Service has in fact approved use of the capital gains allocation to income type provisions in unitrusts. See PLRs 9511029, 9511007 and 9609009.

D. Annuity trust versus unitrust.

1. Which one should the donor use? Where productive property will be contributed, the choice between the annuity trust and the unitrust depends on several factors.

2. Some donors like the idea of a fixed income amount which will never vary, regardless of investment performance. For these donors, the annuity trust may be attractive. Such donors should also consider charitable gift annuities if the charitable institution is an appropriate issuer. The fixed amount may be unattractive to younger donors because of inflation over many years.

3. The unitrust, on the other hand, provides a hedge against inflation. As the assets increase in value, the unitrust amount will increase. It can also, however, work the other way if the assets decrease in value.

4. Generally, the annuity trust will produce a higher charitable deduction. (See discussion below on computation on deduction.)

E. Annuity trust five percent probability test.

Amazingly enough, even though you can compute a charitable factor for the charitable remainder annuity trust, it may still fail to qualify if there is a more than a 5% probability, actuarially determined, that the trust assets will be exhausted before the remainder vests. See Revenue Ruling 77-374, 1977-2 C.B. 329. 10% interest assumptions made it much less likely than the old 6% assumptions that the test would not be met. With the new floating interest rates, the probability of exhaustion test must again be considered. When interest rates are low, it is much easier to flunk the test. For example, with an AFR of 6.0% (which was the actual interest rate for October and November) the youngest permitted age for an 7% quarterly annuity is 66. Many practitioners
were shocked to learn that an 7% annuity payable quarterly to a 66 year old donor flunked the test. You need to worry about the probability of exhaustion test even if the payout rate of the annuity does not exceed the AFR if the payments are made other than annually. For example, a 10% annuity payable quarterly to a donor age 60 flunks the test even in a month when the AFR is also 10%. The reason is the effective payout is actually more than 10% because the payments are made more frequently than annually. Is the ruling correct? It has not yet been litigated. Possible solution: use a charitable gift annuity.

An unanswered question is whether the trust itself is qualified if no charitable deduction is allowed. Will capital gains realized by the trust be sheltered or not? PLR 9532006 says the that to be a qualified CRAT, a deduction must be allowable. There is no other authority, and that ruling represents a reversal of the Service’s original view of the question in PLR 9440010.

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

G. Computing the charitable deduction.

1. Charitable remainder annuity trusts.

Remainder factors for charitable remainder annuity trusts are computed on an actuarial basis. The average practitioner never needs to know the actuarial formulas, as the Service publishes tables to compute many of the factors, both term of years factors and factors dependent upon a life estate. Computer programs (including the author’s) are available to calculate the factors.

2. The actuarial computation of the remainder factor of an annuity trust depends on two components, an interest assumption and mortality table assumptions.
3. Interest Assumptions. The regulations under Section 664 have required the use of varying rates of interest, steadily rising since the 1970's.

a. In the early 1970's the tables were revised to assume a return of 6% and in 1983 the tables were further revised to assume an interest rate of 10%. Section 7520, passed as part of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) requires use of interest assumptions of 120% (adjusted to the nearest two-tenths of 1%) of federal midterm rates, assuming annual compounding. This interest rate is published monthly in numerous tax periodicals and The Wall Street Journal.

b. In the case of charitable gifts, such as computations for a charitable remainder trust, donors may use either the federal interest rate for the month of the gift or may elect the federal interest rate for either of the two months prior to the month of the gifts.

c. Effect on Charitable Deduction. Because the annuity is a fixed amount, a higher interest assumption means that the amount going to charity will presumably be greater. Therefore, a higher interest rate produces a larger deduction. Because the interest rate for the following month is announced on approximately the 20th of each month, donors really have a four month period to choose from: the month of the gift, either of the two months preceding the gift, or the following month if donor can wait until the following month to make the gift.

4. Mortality Assumptions. TAMRA also required the use of updated mortality assumptions for gifts made after April 30, 1989, based on the 1980 census. Data from the 1990 census is apparently not yet available.

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

**Example:** Donor age 75 creates a charitable remainder annuity trust paying an annual annuity of $7000 to himself for life and then to his wife, age 70, for her life. The Federal interest rate for the month of the gift is 10.6%. The published remainder factor for these ages at 10.6% is .24303. That factor subtracted from one equals .75697. That factor divided by 10.6% gives an annuity factor of 7.1413. The annuity factor of 7.1413 when multiplied times the $7000 annual annuity produces a value for annuity of $49,989.00. That figure subtracted from the $100,000 gift produces a value for the charitable remainder of $50,011.

**Note:** If the payment is due more frequently than annually, the annuity factor must be multiplied by a frequency of payment adjustment (also published in volume Alpha) which is itself interest-sensitive.

6. How to compute the remainder in a charitable remainder unitrust.

   a. Because the unitrust payment is a percentage of the entire trust revalued annually, the relative size of the remainder and life estate "pots" stays the same and, therefore, no interest assumption is relevant in determining the deduction.

   b. The only relevant information is the unitrust payout of the trust and the mortality assumptions. Again, published tables show the remainder factors in a charitable remainder unitrust.

   c. If the payment is for any payout frequency other than annually with the first payment due at the time of the gift, the annual payout must be multiplied by an adjustment factor to determine an adjusted payout rate and from that rate, the actual charitable factor is determined. This adjustment factor is interest-dependent, but interest rates will make relatively little difference in the deduction because only the adjustment factor is interest-sensitive. A higher interest rate will produce a lower adjusted payout rate and, therefore, a slightly higher charitable deduction.

VI. Gift and Estate Tax Rules.

   A. One life intervivos charitable remainder trusts.
1. Gift tax. The donor is making an immediate gift of a future interest to charity, which qualifies for the federal gift tax charitable deduction.

2. Estate Tax. On the donor’s death, because the donor retained an interest in the trust which did not in fact end before his death, the trust is includable in his estate under Section 2036, but the estate receives a full dollar for dollar offsetting charitable estate tax deduction under Section 2055, resulting in no tax effect from the inclusion.

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

C. 1. Two life inter vivos charitable remainder trust for donor for life and a successor life beneficiary. Donor is making a charitable gift of a remainder interest after two lives. The donor is also making a present gift to the successor life beneficiary which as a future interest doesn’t qualify for the $10,000 gift tax annual exclusion.

2. A present gift can be avoided, however, if the donor is the first beneficiary, by providing that the donor retains the testamentary power to revoke the successor beneficiary’s interest.

3. The mere presence of the power prevents the establishment of the trust from constituting a present gift. On the death of the donor, the trust will be included in the donor’s estate. If the successor beneficiary survives, the estate has a charitable estate tax deduction for the remainder based on the then-age of the successor beneficiary. The life interest of the successor beneficiary may generate estate tax. If the successor beneficiary predeceased the donor, the remainder is fully deductible for estate tax purposes.

4. Note, however, that if the successor beneficiary is the donor’s spouse, the donor’s spouse’s interest qualifies for the marital deduction despite the fact that it would generally be a terminable interest. Section 2056(b)(8) provides a special marital deduction for the surviving spouse of the decedent where the surviving spouse is the only non-charitable beneficiary of a qualified charitable remainder trust. A similar provision in Section 2523(g) provides a marital deduction for gift tax purposes. This special
marital deduction provision does not, at least literally, apply if there is another non-charitable beneficiary after the spouse’s interest, as the spouse is not then the only non-charitable beneficiary. There is no policy reason for this restriction. In such cases, a QTIP followed by a charitable remainder trust on the surviving spouse’s death should be considered.

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

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

D. Testamentary charitable remainder trust for testator’s spouse.

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

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

3. Which is preferable, a testamentary charitable remainder trust or a qualified terminable interest property trust with remainder to charity?
a. The QTIP has the advantage of flexibility. The testator can permit invasion of principal and give the spouse special powers of appointment to take care of unanticipated changes of circumstance.

b. The big advantage of the charitable remainder trust is that income in excess of the unitrust or annuity payment amount is not subject to tax, and capital gains incurred in the trust will not be subject to tax. In rare cases the inclusion of the property in the surviving spouse’s estate may affect the size of her estate for tax purposes and, therefore, for 6166 or 2032A purposes.

4. A charitable remainder trust can terminate on remarriage, as noted above. A QTIP must last for the spouse’s lifetime.

VII. Charitable Remainderman.

A. The charitable remainderman must be an exempt organization. If the charity named is a public charity, the gift will be deductible with a 50% percentage limitation rather than subject to the private foundation cut down rules.

B. The donor or the beneficiaries can retain the testamentary power to substitute one charity for another charity or to add charities so long as all are qualified charities. This provision should be limited to public charities, unless the donor specifically wants the right to name private foundations. The effect of being able to name private foundations will be to reduce the percentage limitation for long term capital gain property to 20% of adjusted gross income or 30% for cash gifts.

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

VIII. Miscellaneous Items.

A. Section 170(a)(3) had often been interpreted as providing that no future interest in tangible personal property qualifies for a charitable deduction and, therefore, tangible personal property may not be contributed to a charitable remainder trust. Actually, however, Section 170(a)(3) provides that a contribution of a future interest in tangible personal
property shall be treated as made only when all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired or are held by persons other than the taxpayer or there standing in a relationship to the taxpayer described in Section 267(b) or 707(b). That Section should therefore may mean that no deduction is permitted the donor until the trust sells the property. Finally, the Internal Revenue Service has acknowledged that this interpretation of this statute is correct. In PLR 9452026, the taxpayer proposed funding a charitable remainder unitrust with tangible personal property—in this case a violin. There were no other strings attached (if you will forgive the pun). The Service ruled that the deduction would be allowable at the time the property is sold and that the trust qualifies as a charitable remainder trust. What is not answered is whether the donor’s deduction will be limited to basis because of the related use requirements of section 178(e)(1)(b)(i). Can a technical argument be made that since the deduction is not deemed to have occurred until the property is no longer owned by the trust, and since at that point the trust holds cash, that the gift is considered one of cash rather than tangible personal property and therefore the cut down to basis is not required? It is interesting to note that the Service ruled favorably despite the fact that no deduction was permitted at the time the trust was funded. This seems to fly in the face of PLR 9501004. In this ruling, the Service held that a contribution of a deep-in-the-money option to a unitrust disqualified the charitable remainder unitrust because no income or gift tax deduction was allowable at the time the property was contributed to the trust. (Use of an option would be handy in order to keep the trust out of the line of ownership of possibly tainted real estate, or to enable donors to contribute S corporation stock.)

B. If residential property is contributed to a unitrust, the donor should not reside in the property after the date of gift because he will be deemed to have retained an interest other than a unitrust interest. Have the donor move out before the gift.

IX. Qualified Reformations.

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

B. The actuarial value of the reformed interest cannot differ more than 5%
from the actuarial value of the unreformed interest.

C. The fix-up statute even permits reformation of some trusts which did not
attempt to meet the 1969 requirements.

X. Pooled Income Funds.

A. A pooled income fund is a pool of donated funds, somewhat like a
mutual fund. Each donor receives the income from his or her share of
the fund and at the death of the beneficiary or beneficiaries, that portion
of the fund is severed and distributed to the charity. The donor receives
an immediate income tax deduction at the time property is contributed
to the fund.

B. Unlike a charitable remainder trust beneficiary, the pooled income fund
beneficiary actually retains the income from his or her share of the fund
rather than a unitrust or annuity trust interest.

1. Because the charity must control the pooled fund directly or
indirectly, Congress was not concerned that the funds would be
invested without regard to the interest of the remainderman.

2. The charity must maintain control of the fund, but this does not
mean that the charity must be the trustee. As long as the charity
has the right to remove the trustee and name a new trustee, it will
be deemed to have complied with the pooled income fund rules.

C. The trust is not an exempt trust as such. All of the income is deductible
under the regular distribution deduction rules, and long term (as defined)
capital gains are deductible as charitable set asides under Section 642
(c)(3). Gains from the sale of assets held one year or less are subject to
tax.

D. Specific Requirements.
1. Obviously, in order to constitute a pool, there must be more than one donor to the fund.

2. The trust must prohibit the donor or any beneficiary from serving as a trustee of the pooled income fund.

3. The trust must prohibit investment in tax exempt securities.

4. There are a number of other more technical drafting requirements.

5. In Rev. Proc. 88-53, 1982 C.B. 712 the Service issued a sample declaration of trust and announced that it will no longer be necessary for a taxpayer to request a ruling as to qualification of a substantially similar trust and the Service normally will not issue such a ruling.

E. Taxation of Beneficiaries.

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

F. Charitable Contribution.

1. The donor receives a charitable contribution based on the value of the remainder interest. As with charitable remainder gifts, the older donor receives a greater deduction.

2. Instead of an interest assumption, the fund’s highest return in the three previous years is substituted. For funds in existence less than three years, the Service has announced that average interest rates for the three years preceding establishment of the fund, less 1%, should be used.

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

2. Why use a pooled income fund rather than a charitable remainder trust? A main reason, from the charity’s standpoint, is simplicity of administration. No separate trust vehicle is required and much smaller contributions can be economically accepted. For example, many charities have a $50,000 minimum for charitable remainder trusts, but have a limit as low as $5,000.00 for pooled fund gifts and even smaller amounts for subsequent gifts. The pooled fund offers the same advantage of being able to accept appreciated property and sell it without incurring capital gains tax. Many pooled funds achieve 8% or 9% investment returns so the donor can often substantially increase his income. The pooled fund is also a very handy vehicle for the planned giving officer who, on the afternoon of December 31st, finds a donor who wishes to make a last minute gift.

XI. Other Deferred Giving Vehicles.

A. Charitable Gift Annuities. Charitable gift annuities are an under-utilized method of charitable giving. With a charitable gift annuity the donor contributes cash or appreciated property to a charity in exchange for an unfunded, non-trust promise to pay an annuity to the annuitant for life or for the life of the annuitant and one other person. The charitable deduction is computed in the same way as the charitable deduction in a charitable remainder annuity trust. The difference between the value of the retained annuity and the amount contributed is deductible as a charitable contribution. However, the income tax treatment of the gift annuity is often superior to that of the annuity trust. Gift annuities are taxed not under the tier system applicable to charitable remainder trusts, but under the section 72 annuity rules.
These rules treat a portion of each payment received as a return of the annuitant’s investment in the contract, so that a portion of each payment will be tax free. Typically, for cash annuities about half of each payment will be tax free until total recovery of the investment in the contract over the life expectancy of the donor. Appreciated property gifts are treated like a bargain sale to charity. The purchase price is allocated between the gift portion and the sale portion, and the capital gain portion is spread over the annuitant’s lifetime, but will never be more what would have otherwise been tax free. Most charities follow recommended annuity rates issued by the American Council of Gift Annuities, which sets recommended annuity rates so that charities do not have to hire their own actuaries. The rates, which vary from time to time as prevailing interest rates change, are set so that about half of the gift will be necessary to support the annuity and about half should be left for the charitable beneficiary at the end. Gift annuities are attractive because they can be economically tailored to smaller donors. Because there is no separate trust to administer and no separate accounting, most charities have minimums for gift annuities in the $5,000 range, whereas for charitable remainder trusts many charities have minimums in excess of $100,000.

XII. Gifts of Remainder Interests in a Personal Residence or Farm.

A. Section 170(f)(3)(B)(i) includes another exception to the general rules disallowing deductions for split interest gifts to charity by permitting a deduction for the actuarial value of a remainder in a personal residence or farm. Typically this is accomplished by deed of the residence to charity with a reserved legal life estate. Section 170(f)(4) provides that for valuation purposes, the deduction must be computed separately for the depreciable portion of the property (i.e. the house) and the non-depreciable portion (i.e. the land). This will result in a smaller deduction for the portion of the gift allocated to the depreciable property. A gift of a remainder interest in a residence is attractive for donors contemplating testamentary gifts to charity, because the gift does not affect the donor’s liquid assets. It is even possible to structure a gift of a residence so that the actuarial value of the gift is deemed to be the purchase price for a charitable gift annuity, if the charity is willing to advance its funds for this purpose.

Note the marital deduction traps here. If the donor spouse owns all of the property, the donor should retain the right in the deed to revoke the spouse’s successor interest by will because the interest will not qualify for the gift tax marital deduction. There are no special deduction rules for gifts of remainder interests in real property to charity, but legal life estates qualify as QTIP property if an election is made and all of the other requirements are met. For lifetime QTIPs, no person other than the donee spouse can be a beneficiary; as a result, the successor interest of the wife does not qualify for the gift tax marital deduction. A power in the deed to revoke the spouse’s interest avoids the gift tax problem. When the first spouse dies, the property will be includible in the first spouse’s estate, and a QTIP election can be made to
qualify the gift for the marital deduction for the survivor spouse. If the property is jointly held, each spouse should provide for a right to revoke the other spouse’s survivorship interest in one-half of the property. It is important to remember to make the QTIP election for the surviving spouse’s interest on the estate tax return.