XVI. CHARITABLE GIVING

A. Introduction

The charitable deduction is allowed by three separate areas of the Internal Revenue Code: the income tax, Internal Revenue Code ("IRC") §§ 170 and 642(c); the estate tax, IRC § 2055; and the gift tax, IRC § 2522. Although these Sections cover the same basic areas, there are differences among them. Therefore, one must carefully review these Sections to determine whether contributions to an organization will qualify for the desired deductions. If the donee organization qualifies under the appropriate Sections, lifetime gifts that meet the requirements of both the income and gift tax provisions will be entitled to both an income tax and a gift tax charitable deduction, while gifts at death will be entitled to an estate tax deduction.

This Chapter will address the basic rules for qualifying a transfer for an income, gift and estate tax charitable deduction, will illustrate how the charitable deduction is calculated and will review several charitable planning techniques. Along the way, this Chapter will discuss the following topics:

- The requirements for income, estate, and gift tax charitable deductions.
- Outright gifts to public charities, private foundations, donor advised funds, and charitable gift annuities.
- Restrictions on split-interest trusts, which include charitable remainder trusts and charitable lead trusts, and the requirements for qualifying such trusts for the charitable deduction.

B. Income Tax Charitable Deduction

For federal income tax purposes, an individual who itemizes deductions is allowed a charitable deduction for gifts to charitable organizations if the requirements of IRC § 170 are met. IRC § 170 sets forth the types of organizations to which deductible contributions may be made, the types of property that will qualify for an income tax deduction, the percentage limitations on income tax deductions, and the valuation rules for determining the deductible amount. Generally, any gift of money, property (*e.g.*, stock, real estate, tangible personal property) or a right with value qualifies as a charitable gift. If a donor receives value in return (*e.g.*, dinner or a prize), the contribution may not be wholly deductible.

1. Organizations for Which an Income Tax Deduction is Permitted

Generally, contributions to an organization organized and operated exclusively for charitable, scientific, educational, literary or religious purposes are deductible for federal income tax purposes. IRC § 170(c)(2)(B). Specifically, under IRC § 170(c), an income tax deduction is allowed for transfers to the following types of recipients:

- IRC § 501(c)(3) corporations and trusts organized and operated exclusively for religious, charitable, scientific, literary or educational purposes, no part of the net earnings of which inures to the benefit of a private individual, and that do not attempt to influence elections and are not substantially engaged in influencing legislation;
- Federal government, state government or subdivisions thereof, if the contribution is made for exclusively public purposes;
- IRC § 501(c)(3) fraternal or veterans organizations; and
- Cemetery corporations.

The income tax deduction is limited to gifts to domestic organizations. However, gifts to a foreign organization for which an income tax deduction is desired may be made to a "Friends of" domestic organization.

Contributions to organizations that have certain discriminatory policies or engage in certain activities, such as gifts to organizations with racially discriminatory policies or to an organization a substantial portion of whose activities is participating in any political campaign, carrying on propaganda, or otherwise attempting to influence legislation, are not deductible. IRC § 170(c)(2)(D); Treas. Reg. § 1.170A-1(j).

2. Gifts of Partial Interests

As a general rule, gifts of partial interests in property are not deductible for federal income tax purposes. A partial interest is any interest in property that consists of less than the donor's entire interest in the property. IRC § 170(f)(3)(A); Treas. Reg. § 1.170A-7(a)(1). For example, the right to use the property is a gift of a partial interest. *Id*.

> **<u>EXAMPLE</u>:** Donor owns a building and allows a charity to use one floor of the building rent-free for administrative purposes. Donor's gift of the right to use the space is a gift of a partial interest that is not deductible.

a. <u>Partial Interest Gifts Not in Trust</u>. The general rule is subject to several exceptions, the application of which depends on whether the gift of the partial interest is outright or in trust. For example, an outright gift of a donor's entire interest in property (*e.g.*, a life estate or a remainder interest), even if it is a partial interest in the property, will be deductible. Treas. Reg. § 1.170A-7(a)(2)(i).

> **<u>EXAMPLE</u>:** Donor owns the remainder interest in stock while another party owns the right to the income from the stock for life. If Donor contributes her remainder interest to charity, she has made a deductible contribution.

Another exception exists for the contribution not in trust of a remainder interest in a personal residence or a farm if the remainder interest is not the donor's entire interest in the property. IRC § 170(f)(3)(B)(i). "Personal residence" includes any property used by the donor as a personal residence and is not limited to the donor's principal residence. Treas. Reg. § 1.170A-

7(b)(3).

<u>EXAMPLE</u>: Donor transfers to charity the remainder interest in his personal residence, retaining the right to use the residence during his life. Donor is entitled to a deduction for the gift of the remainder interest.

Other exceptions exist for a gift to charity of all interests a donor has in the property (Treas. Reg. § 1.170A-7(a)(2)(ii)), an undivided portion of the donor's entire interest (IRC § 170(f)(3)(B)(ii)), a qualified conservation contribution (IRC § 170(f)(3)(B)(iii); Treas. Reg. § 1.170A-7(b)(5)), and future interests in tangible personal property (IRC § 170(a)(3); Treas. Reg. § 1.170A-5(a)(1)). A qualified conservation contribution is a contribution of a qualified real property interest, to a qualified organization, exclusively for conservation purposes. IRC § 170(h). A qualified real property interest is the entire interest of the donor other than a qualified mineral interest, a remainder interest or a perpetual conservation restriction. IRC § 170(h)(2). A qualified organization is a governmental unit, a publicly supported charity or a supporting organization of a governmental unit or publicly supported charity. IRC § 170(h)(3). Conservation purposes mean preservation of a land for outdoor recreation by or education of the general public, protection of relatively natural habitat, or preservation of open space which will yield a significant public benefit. IRC § 170(h)(4).

b. **<u>Denial of Deduction for Certain Contributions of Partial Interest Property</u>**. The Pension Protection Act of 2006, Pub. L. 109-280 (Aug. 17, 2006) (the "PPA"), provides that no income or gift tax charitable deduction is allowed for a contribution of a partial interest in an item of tangible personal property unless immediately before such contribution all interests in the item are owned (1) by the donor or (2) by the donor and the donee organization. The Secretary is authorized to make exceptions to this rule in cases where all persons who hold an interest in the item make proportional contributions of undivided interests in their respective shares of such item to the donee organization. This provision of the PPA amends IRC §§ 170, 2055 and 2522. Thus, it not only applies for income tax charitable deduction purposes, but for gift tax and estate tax charitable deduction purposes as well. These deductions are discussed below.

c. **<u>Recapture Provisions</u>**. The PPA also provides a recapture rule for donations of partial interests in donated property. If the donor makes an initial fractional contribution, then fails to contribute all of the donor's remaining interest in such property to the same donee before the earlier of 10 years from the initial fractional contribution or the donor's death, then the donor's charitable income and gift tax deductions for all previous contributions of interests in the item will be recaptured (plus interest). A special rule is provided for donees of the initial contribution that are no longer in existence. If recapture occurs, an additional tax is imposed equal to 10% of the amount recaptured.

In addition, if the donee of a fractional interest in an item of tangible personal property fails to take substantial physical possession of such item during such 10 year period or the donor's earlier death, or fails to use the property for an exempt purpose during such period, then the donor's charitable income and gift tax deductions for all previous contributions of interests in the item will be recaptured (plus interest). The 10% additional tax is imposed in this situation as well.

➔ **<u>Planning Point</u>:** Thus, the decision in *Winokur v. Comm'r*, 90 T.C. 733 (1988), which provided that a donor may take a deduction for a charitable contribution of a fractional interest in tangible personal property, provided that donor satisfies the requirements for deductibility, and in subsequent years make additional charitable contributions of interests in the same property, even though the donee never exercises possession over the property, is effectively overruled. Katzenstein, Steve Leimberg's Charitable Planning Newsletter #103 (August 21, 2006) at http://www.leimbergservices.com.

A contribution that was made before the date of enactment will not be treated as an initial fractional contribution for purposes of this new rule. The first fractional contribution by the taxpayer after the date of enactment will be considered the initial fractional contribution, even if a prior fractional interest contribution was made to the same donee.

This provision of the PPA amends IRC §§ 170, 2055 and 2522. Thus, it not only applies for income tax charitable deduction purposes, but for gift tax and estate tax charitable deduction purposes as well. These deductions are discussed below.

d. <u>Partial Interest Gifts in Trust (Split-Interests)</u>. A split-interest trust is a trust that has both charitable and noncharitable beneficiaries. The deductibility of gifts to split-interest trusts is subject to strict limitations. See Treas. Reg. § 1.170A-6. If a donor creates a trust and gives or retains a life or term interest for the taxpayer or another individual and gives the remainder interest to charity (a charitable remainder trust), no deduction is available for the charitable remainder interest unless the noncharitable beneficiary's interest takes a specific form. If a donor creates a trust and gives a life or term interest to charity and gives the remainder interest to the donor or another individual (a charitable lead trust), no deduction is available for the charity's lead interest unless the interest qualifies as an annuity or unitrust interest. The requirements for the deductibility of split-interest gifts will be discussed in greater detail below.

3. Limitations on Deductibility

The amount of the income tax charitable deduction allowed for a contribution to a charitable organization depends in part on the type of organization to which the gift is made and in part on the type of property being contributed.

a. <u>Percentage Limitations</u>. The amount deductible depends on whether the organization is a public charity or a private foundation. Contributions, whether to private foundations or public charities, that exceed the percentage limitation in the year of the gift may be carried over for five succeeding taxable years. IRC § 170(b)(1)(B), (b)(1)(D)(ii). Any unused carryover is lost at the donor's death.

(1) <u>Public Charities</u>. Public charities include churches, educational organizations (*e.g.*, high schools, colleges and universities that are publicly supported), hospitals, governmental units, and organizations that generally receive a substantial amount of their support from governmental units or from the general public. IRC § 170(b)(1)(A)(i)-(vi), (viii).

(a) **Fifty Percent Limitation**. The income tax charitable deduction for gifts to public charities of cash and ordinary income property generally is limited to 50% of the donor's contribution base (generally, the donor's adjusted gross income ("AGI")). IRC § 170(b)(1)(A).

(b) **Thirty Percent Limitation**. The income tax charitable deduction for a gift to a public charity of long-term capital gain property (*e.g.*, stock held for more than one year) is limited to 30% of the donor's AGI. Additionally, a contribution "for the use of" a public charity is deductible only to the extent of 30% of the donor's AGI (versus a 50% limitation on contributions "to" a public charity). IRC § 170(b)(1)(B); Treas. Reg. § 1.170A- 8(a)(2). A contribution is made "for the use of" a public charity if property is transferred in trust and is held for the continuing benefit of the charity. Treas. Reg. § 1.170A-8(a)(2).

➔ **Planning Point:** A contribution of an income interest in property is made "for the use of" charity, whether or not the interest is transferred in trust. *Id.*

➔ **Planning Point:** A contribution of a remainder interest in property is made "to" the charity, whether or not such interest is transferred in trust, and, therefore, qualifies for the 50% limitation, provided that the remainder interest is to be distributed outright to the charity when the noncharitable term ends. If the trust property is to be held further in trust for the benefit of the remainder beneficiary, then the gift is "for the use of" the charity and is subject to the 30% limitation. *Id.*

In the case of contributions to a public charity of long-term capital gain property, a donor can avoid the 30% limitation by electing to limit the income tax charitable deduction to the donor's cost basis in the property (the deduction generally is equal to the fair market value of the property, as discussed below). If the election is made, then the contribution is subject to the 50% limitation rather than the 30% limitation. IRC § 170(b)(1)(C)(iii). The election must be made by attaching a statement to the donor's income tax return for the year to which the election applies.

Unrealized capital gains generally are not subject to income tax when a gift of appreciated assets is made to a public charity, even though they may be part of the income tax charitable deduction.

(2) **Private Foundations**. A private foundation generally is a charitable organization that has been established by an individual donor or family.

(a) **Thirty Percent Limitation**. The income tax charitable deduction for gifts of cash or ordinary income property to private foundations generally is limited to 30% of the donor's AGI in the year of the contribution. IRC § 170(b)(1)(B).

(b) **Twenty Percent Limitation**. The income tax charitable deduction for a gift of long-term capital gain property to a private foundation generally is limited to 20% of a donor's AGI in the year of the contribution. IRC § 170(b)(1)(D)(i).

The maximum deduction allowable for contributions to a private foundation must be determined after the donor's contributions to public charities are considered. As noted above, the deduction for contributions to public charities is limited to 50% of donor's AGI. IRC § 170(b)(1)(A). Therefore, the maximum deduction allowable for a contribution of cash to a private foundation would be equal to the lesser of (i) 30% of donor's AGI or (ii) the amount of donor's 50% limitation remaining after donor's contributions to public charities are considered.

> **EXAMPLE:** If the donor contributes cash equal to 40% of donor's AGI to a public charity, then the donor is limited to a deduction equal to 10% of his or her AGI for contributions to which the 30% limitation applies, such as the donor's contribution to a private foundation.

b. Valuation Limitations. The value of the property that is deductible depends on the nature of the property and may depend on whether the gift is made to a public charity or a private foundation.

(1) Ordinary Income Property. Contributions of ordinary income property, such as stock held for less than one year, are reduced by the amount of ordinary income that would have been realized had the contributed property been sold at its fair market value at the time of the contribution. IRC § 170(e)(1); Treas. Reg. § 1.170A-4(b)(1). This means that the income tax deduction is limited to the donor's cost basis in the property. This rule applies regardless of the identity of the charitable donee (*i.e.*, public charity or private foundation).

(2) Long-Term Capital Gain Property. Generally, the amount of a charitable deduction for a contribution of long-term capital gain property is the property's fair market value. Treas. Reg. § 1.170A-1(c)(1). For example, securities that are held for more than one year are deductible for income tax purposes at their full fair market value. The deduction for contributions to a private foundation of appreciated long-term capital gain property, however, must be reduced by the amount of long-term capital gain that would have been realized had the property been sold at its fair market value at the time of the contribution, so the donor receives a deduction in an amount equal to the donor's basis in the property.

> **EXAMPLE:** A donor contributes to a private foundation land held for investment for more than one year. The land has a fair market value at the time of the contribution of $90,000, and an adjusted basis of $30,000. The donor's charitable deduction is limited to $30,000 ($90,000 fair market value less $60,000 long-term capital gain).

There is an exception for contributions of "qualified appreciated stock" to a private foundation, which are not subject to the long-term capital gain reduction. Thus, the donor receives a deduction for the stock's full fair market value. Qualified appreciated stock is stock for which market quotations are readily available on an established securities market and that is long-term capital gain property. IRC § 170(e)(5).

(3) Tangible Personal Property. The deduction for gifts of tangible personal property (*e.g.*, works of art, books, antiques) held long term is the full fair market value of the property if use of the property is related to the charity's exempt function. IRC

§ 170(e)(1)(B)(i); Treas. Reg. § 1.170A-4(b)(3). If the gift is not related to the charity's exempt function, the deduction must be reduced by the amount of gain that would have been long-term capital gain if the property were sold at its fair market value (*i.e.*, the deduction is limited to the donor's basis). IRC § 170(e)(1)(B). Gifts of tangible personal property held short term are deductible at their cost basis. IRC § 170(e)(1)(A).

The PPA also provides new rules for the valuation of fractional interest in tangible personal property. The value of a donor's charitable deduction for the initial contribution of a fractional interest in an item of tangible personal property is still based on the fair market value of such property at the time of the contribution of the fractional interest. To determine the deductible amount for income, gift and estate tax purposes of each additional contribution of an interest (whether or not a fractional interest) in the same item of property, the fair market value of the item is the lesser of: (1) the value used for purposes of determining the charitable deduction for the initial fractional contribution; or (2) the fair market value of the item at the time of the subsequent contribution.

c. **<u>Recapture Provision for Charitable Contributions of Exempt Use Property Not Used for an Exempt Purpose</u>**. The PPA amended IRC § 170(e) to provide that, if a donor contributes appreciated tangible property for which a fair market value deduction of more than $5,000 is claimed ("applicable property") and the donee disposes of the property within three years of the date of donation, the donor generally must include in income the excess of the deduction over the donor's basis in the property, unless the donee certifies in detail to the IRS how the property was used for exempt purposes. In addition to other penalties that may apply, a penalty of $10,000 applies to a person that identifies applicable property as having a use that is related to a purpose or function constituting the basis for the donee's exemption knowing that it is not intended for such a use. As a consequence of this new provision, Form 8282, which is the information return that must be filed upon the disposition of contributed property by a charitable organization, is extended to dispositions made within three years after receipt.

4. Substantiation Rules

The substantiation requirements for charitable contributions vary depending on the nature and value of the property contributed.

a. **<u>Contributions of Money</u>**. As amended by the PPA, no deduction is allowed for cash, check or other monetary gift, regardless of the amount, unless the donor substantiates the contribution by cancelled check, bank record or receipt from the donee showing the name of the donee, the date of the contribution and the amount of the contribution. IRC § 170(f)(17).

b. **<u>Contributions of Property With a Value Less Than $250</u>**. Contributions of property other than money in an amount less than $250 must be substantiated by a receipt from the donee showing the donee's name, the date and location of the contribution, and a description of the property. Treas. Reg. § 1.170A-13(b)(1). A receipt may consist of a letter from the donee acknowledging receipt of the contribution. The fair market value of the donated property need not be stated in the receipt. If a receipt is impractical to obtain, for example, if property is deposited in a charity's unattended drop box, the donor must maintain written records with respect to the property that contain the required information. *Id.*; Treas. Reg. § 1.170A-13(b)(2)(ii).

c. **Contributions of $250 or More**. No income tax deduction is allowed for any charitable contribution of money or property of $250 or more unless the donor has a contemporaneous written acknowledgment of the contribution from the charity. IRC § 170(f)(8)(A); Treas. Reg. § 1.170A-13(f)(1). In order to be "contemporaneous," the substantiation must be obtained by the time the donor files his or her income tax return for the year the contribution was made. Treas. Reg. § 1.170A-13(f)(3).

Separate contributions of less than $250 to one charitable donee are not subject to the substantiation requirements of IRC § 170(f)(8), and, therefore, do not require a contemporaneous written acknowledgment, regardless of whether the sum of the contributions during the taxable year equals $250 or more. Treas. Reg. § 1.170A-13(f)(1).

> **EXAMPLE:** Donor makes monthly contributions to her church of $200. Because each separate contribution is less than $250, a contemporaneous written acknowledgment is not required, even though the aggregate contributions exceed $250.

The written acknowledgment may take any form, such as a letter, receipt or postcard. It must include the amount of the cash contribution and must describe any property donated, but need not include the value of the property donated. If the charity has provided goods or services to the donor, the charity must provide a description and a good faith estimate of the value of the goods or services provided, which reduces the amount of the charitable contribution. Treas. Reg. § 1.170A-13(f)(2).

> **EXAMPLE:** A donor pays $100 for a ticket to charity's fundraising event. The ticket entitles the donor to dinner with a fair market value of $40. The donor's payment of $100 exceeds by $60 the value of the goods and services he will receive, so the donor has made a charitable gift of $60.

(1) **Split-Interest Trusts**. The IRC § 170(f)(8) substantiation rules do not apply to transfers to charitable remainder trusts or charitable lead trusts, which are split- interest trusts. Treas. Reg. § 1.170A-13(f)(13). The exemption of such trusts from the substantiation rules reflects the fact that such trusts do not have to identify the charitable beneficiary at the time the trust is created. Contributions to pooled income funds, another form of split-interest trust, however, are subject to the substantiation rules of IRC § 170(f)(8). *Id.* The donee organization maintaining the fund provides the contemporaneous written acknowledgment.

(2) **Charitable Gift Annuities**. A charitable gift annuity is a transaction in which a donor transfers money or other property to a charity in exchange for the charity's promise to pay an annuity to the donor or other person. The donor is entitled to a charitable deduction for the excess of the value of the property transferred to the charity over the value of the annuity. Treas. Reg. § 1.170A-1(d)(1). The substantiation rules apply if the deduction equals or exceeds $250. Treas. Reg. § 1.170A-13(f)(16). The donor's right to receive the annuity is not treated as goods or services furnished in consideration for the transfer. *Id.*

d. <u>Additional Requirements for Contributions of $500 or More</u>. Donors who make contributions of property with a claimed deduction of more than $500 and not more than $5,000, and donors of certain publicly traded securities with a claimed deduction of more than $5,000, must maintain reliable written records containing the information specified in Treas. Reg. § 1.170A-13(b)(2)(ii) (relating to the written records for contributions of property of $250 or less). Treas. Reg. § 1.170A-13(b)(3)(i). Additionally, the records must contain information on the manner and approximate date of acquisition of the property and the donor's adjusted basis in the property. *Id*. A donor must disclose on his or her income tax return most of the information required to be maintained in the written records.

In applying the valuation limitation, the amount claimed as a deduction is the aggregate amount claimed for all similar items of property contributed to the same donee in the same year. Treas. Reg. § 1.170A-13(c)(1). The term "similar items of property" means property in the same generic category or type, such as books, stamp or coin collections, jewelry, toys and clothing. Treas. Reg. § 1.170A-13(c)(7)(iii).

➔ **<u>Planning Point</u>:** A donor must file Form 8283, Noncash Charitable Contributions, if the amount of the deduction for all noncash gifts is more than $500 and attach it to the income tax return. A donor lists on Schedule A items for which the donor claims a deduction of $5,000 or less per item or group of similar items and certain publicly traded securities, even if the deduction is more than $5,000. For all such items, the donor must furnish the name and address of the donee organization and a description of the donated property. If the amount claimed as a deduction with respect to an item exceeds $500 but is less than $5,000, additional information must be supplied, including the date of the contribution, the date on which the donor acquired the property and the manner of acquisition, the donor's adjusted basis in the property, the fair market value of the property, and the method used to determine the fair market value.

(1) <u>Qualified Appraisal for Contributions of $5,000 or More</u>. A donor who claims a deduction in excess of $5,000 for property other than certain publicly traded securities must obtain a "qualified appraisal" prepared by a "qualified appraiser" and attach an appraisal summary to the return, in addition to maintaining written records. Treas. Reg. § 1.170A-13(c)(2)(i). The qualified appraisal must be made no earlier than 60 days prior to the date of the contribution, and it must be received before the due date, including extensions, of the income tax return on which the deduction is claimed. Treas. Reg. § 1.170A-13(c)(3)(i). One qualified appraisal is sufficient in the case of a group of similar items contributed in the same year. Treas. Reg. § 1.170A-13(c)(3)(iv)(A). The income tax regulations set forth the information that must be included in a qualified appraisal, such as a description of the property, the date of the contribution, the appraisal date and the valuation method used. Treas. Reg. § 1.170A-13(c)(3)(ii); <u>see also</u> IRC § 170(f)(11)(E) (as amended by the PPA).

➔ **<u>Planning Point</u>:** A donor lists on Schedule B of Form 8283 items for which the donor claims a deduction of more than $5,000 (omitting publicly traded securities reportable on Schedule A). Generally, items reported on Schedule B will require a "qualified appraisal" prepared by a "qualified appraiser."

The PPA amended IRC § 170(f)(11)(E) to provide that a qualified appraiser is an individual who has met certain minimum education and experience requirements, regularly performs appraisals for which the individual receives compensation and meet other requirements that the IRS may prescribe. The PPA also provides that an individual shall not be treated as a qualified appraiser with respect to any specific appraisal unless: (1) the individual demonstrates verifiable education and experience in valuing the type of property subject to the appraisal; and (2) the individual has not been prohibited from practicing before the IRS at any time during the 3-year period ending on the date of the appraisal.

The regulations provide that a qualified appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis. Treas. Reg. § 1.170A-13(c)(5)(i). Certain persons cannot serve as a qualified appraiser, including the donor, the donee or a party to the transaction in which the donor acquired the property (*e.g.*, the dealer who sold the property to the donor) unless the property is donated within two months of the date of acquisition and its appraised value does not exceed its acquisition price. Treas. Reg. § 1.170A-13(c)(5)(iv).

On October 19, 2006, the IRS released Notice 2006-96, 2006-46 I.R.B. 1, which provided transitional guidance relating to the new definitions of a qualified appraisal and a qualified appraiser, as well as guidance concerning substantial or gross valuation misstatements. The notice will be in effect until the promulgation of regulations and applies to all tax returns filed on or after August 19, 2006.

(2) **<u>Substantiation Rules for Certain Securities</u>**. The extent of substantiation required for contributions of securities depends on the nature of the securities. The term "publicly traded securities" generally refers to securities for which market quotations are readily available on an established securities market (*e.g.*, the security is listed on the New York Stock Exchange or the American Stock Exchange or is traded in an over-the-counter market for which published quotations are available). Treas. Reg. § 1.170A-13(c)(7)(xi)(A). The additional substantiation rules in Treas. Reg. § 1.170A-13(c) do not apply to gifts of such securities, even if the claimed deduction exceeds $5,000. Treas. Reg. § 1.170A-13(c)(1)(i). If the value of the securities is $250 or more, however, the donor must obtain a contemporaneous written acknowledgment.

C. Estate and Gift Tax Charitable Deductions

IRC § 2055(a) allows an estate tax charitable deduction, and IRC § 2522(a) allows a gift tax charitable deduction, for transfers to the following types of recipients:

- IRC § 501(c)(3) corporations and trusts organized and operated exclusively for religious, charitable, scientific, literary or educational purposes that do not attempt to influence elections and are not substantially engaged in carrying on propaganda or influencing legislation;

- Federal government, state government or subdivisions thereof, if the contribution is made for exclusively public purposes;
- IRC § 501(c)(3) fraternal or veterans organizations; and
- For estate tax purposes only, certain employee stock ownership plans if the transfer is a gratuitous transfer of qualified employer securities from a charitable remainder trust.

➔ **Planning Point:** The gift tax does not apply to transfers to political organizations (defined in IRC § 527), meaning that the transfer is never subject to the gift tax. IRC § 2501(a)(5). In the case of transfers to charitable organizations, the transfer is subject to gift tax but is entitled to a deduction. Of course, the effect is the same. Gifts at death to political organizations are subject to estate tax.

The charitable deductions for income, estate and gift taxes cover the same basic areas, although they are not identical. For example, the estate and gift tax charitable deductions are not limited to gifts for use in the United States or to domestic corporations, as is the case with the income tax deduction. Treas. Reg. §§ 20.2055-1(a), 25.2522(a)-1(a). Therefore, it is important to consult the applicable Code sections to determine the exact parameters of the desired deduction.

1. Deduction is Unlimited

Unlike the rules governing the income tax charitable deduction, no distinction is made for estate and gift tax charitable deduction purposes among the types of qualified donees or between long-term and short-term capital gain property. Thus, none of the percentage and valuation limitations on the income tax charitable deduction under IRC § 170 apply to the estate tax or gift tax charitable deduction. In this sense, the gift tax and estate tax charitable deductions are "unlimited." For estate tax purposes, however, charitable deduction property must be property that was included in the decedent's gross estate, and the amount of the deduction cannot exceed the value of the transferred property required to be included in the gross estate. IRC § 2055(d). Generally, the value of the gift or estate tax deduction is the value of the property on the date of gift or on the date of death, as the case may be.

A charitable deduction may be denied if the charitable gift is indefinite or discretionary. A deduction will not be disallowed, however, if the testator designates a third party to select the charitable organizations and to allocate the bequest among them. See Rev. Rul. 81-20, 1981-1 C.B. 471. In addition, a number of provisions enacted by the PPA, some of which are discussed above, provide for the denial of the estate and gift tax charitable deduction in certain circumstances.

2. Split-Interests

As discussed above, a split-interest trust is a gift in which a charitable beneficiary and a noncharitable beneficiary share interests in the same property. The estate tax or gift tax charitable deduction is limited to the charitable interest in a split-interest, and a charitable deduction will not be allowed for transfers to a trust that has both charitable and noncharitable beneficiaries unless the trust meets certain requirements for split-interest trusts. IRC §§ 2055(e)(2), 2522(c)(2).

Under IRC §§ 2055(e)(2) and 2522(c)(2), gift tax and estate tax charitable deductions are allowed for: (a) the remainder interest in a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund; (b) the income interest in a charitable lead annuity trust or a charitable lead unitrust; and (c) the nontrust remainder interest in a personal residence or a farm. Split-interest gifts will be discussed in detail below.

D. Outright Gifts to Charity

This section will discuss several charitable planning techniques that do not involve the use of a trust.

1. Public Charities

Outright gifts to public charities will qualify for the income tax and/or gift tax or estate tax charitable deductions. The types of organizations that qualify as public charities include churches, educational organizations, hospitals, governmental units, and organizations that generally receive a substantial amount of their support from governmental units or from the general public. IRC §§ 170(b)(1)(A)(i)-(vi), (viii). As discussed above, the income tax deduction is limited to 50% of the donor's AGI, or 30% if long-term capital gain property is donated or if the gift is "for the use of" the public charity. The estate and gift tax deductions are unlimited.

2. Private Foundations

A private foundation is a charitable organization that is not publicly funded. That is, it is funded primarily by a single donor or a small number of major donors. A private foundation uses its assets to carry out the charitable giving program of the people contributing to the foundation. The private foundation does so by making grants to the public charities that the contributors wish to support rather than engaging directly in a charitable activity. Contributors to the private foundation receive an immediate income tax deduction for the contribution, yet the funds may be held in the foundation for distribution over time.

➔ **Planning Point:** A private foundation is a way for the donor to fund a charitable gift-giving program without surrendering control of investment of assets. By using a private foundation, the donor and the donor's family members can centralize the management of the family's charitable giving and pool the family's resources to make a larger impact in that giving. A private foundation also allows the donor to establish an endowment that will appreciate, permitting funds to be accumulated and distributed in the future for charitable purposes. Potentially significant estate, gift and income tax deductions may be available for contributions to a private foundation.

a. **Taxation of Contributions to a Private Foundation.**

(1) **Estate and Gift Taxes**. Contributions to a private foundation will qualify for a charitable gift tax deduction if made during a donor's lifetime, or a federal estate tax deduction if made at a donor's death under the donor's will or revocable trust. The donor can make a contribution to a foundation already in existence or to a foundation to be created at the donor's death under the terms of his or her will or revocable trust. As discussed above, the gift and estate tax charitable deductions are unlimited.

(2) **Income Taxes**. Unlike the estate and gift tax charitable deductions, the donor's income tax charitable deduction for gifts to a private foundation during his or her life is subject to percentage limitations, which are discussed above. Subject to the percentage limitations, a donor can deduct contributions of cash in full. A donor generally can deduct contributions of appreciated property only to the extent of his or her tax basis in the property, although an exception to this rule exists for "qualified appreciated stock" contributed to a private foundation, which can be deducted at its full fair market value at the time of the contribution. IRC § 170(e)(5).

b. **Private Foundation Restrictions**. Private foundations are subject to several operating rules and restrictions not applicable to public charities. Failure to follow these rules results in additional taxes and penalties. If the foundation fails to correct the activity, then the Internal Revenue Service ("IRS") may impose punitive second-tier taxes. These rules are summarized below.

(1) **Self-Dealing**. A private foundation cannot engage in "self- dealing" with any person or organization that might be classified as a "disqualified person" in relation to the private foundation. IRC § 4941. As amended by the PPA, this section imposes an excise tax equal to 10% of the amount involved in the act of self-dealing, which is payable by any disqualified person who participates in the act of self-dealing. IRC § 4941(a)(1). A "disqualified person" includes substantial contributors (the creator of a foundation, for example), foundation managers (*e.g.*, officers, directors and trustees), family members, and entities subject to more than 20% control by any such persons and members of their families. IRC § 4946(a). The individual who creates a private foundation, the founder's spouse, the founder's children and their spouses would all be disqualified persons in relation to the founder's private foundation.

As amended by the PPA, an additional initial tax of 5% of the amount involved may be assessed against the trustee or other foundation manager who has actual knowledge that an act constitutes self-dealing. IRC § 4941(a)(2). Ignorance is a defense to the foundation manager's initial tax. If the self-dealing is not corrected (which requires reversal of the transaction to the extent possible), then a "second-tier" tax of 200% of the amount involved is imposed on the disqualified person. IRC § 4941(b)(1). The second-tier tax on a trustee or other foundation manager who refuses to correct the act of self-dealing is 50% of the amount involved. IRC § 4941(b)(2).

In general, a disqualified person may not have any financial dealings with, and may receive no financial payments from, the private foundation. Acts of self-dealing include: (a) the sale, exchange, or leasing of property between a private foundation and a disqualified person;

(b) the lending of money or other extension of credit between a private foundation and a disqualified person; (c) the furnishing of goods, services, or facilities between a private foundation and a disqualified person; (d) the payment of compensation by a private foundation to a disqualified person; (e) the transfer to, or for the benefit of, or use by, a disqualified person of the income or assets of a private foundation; and (f) the agreement by a private foundation to make any payment of money or other property to a government official. IRC § 4941(d)(1); Treas. Reg. § 53.4941(d)-2.

➔ **Planning Point:** Exceptions to the self-dealing rules exist for gifts the founder makes to the foundation, reimbursement of expenses incurred in conducting the private foundation's grant-making programs, and reasonable compensation for services as a trustee or director of the foundation.

(2) Excise Tax on Investment Income. An excise tax of 2% is imposed each year on the net investment income of a private foundation. IRC § 4940(a). This tax may be reduced to 1% if the foundation makes sufficiently large distributions to public charities.

(3) Minimum Distribution Requirements. A private foundation is required to make qualifying distributions for each taxable year equal to 5% of the net fair market value of the foundation's assets (other than those used in carrying out the foundation's charitable purposes). If such amount is not distributed, a tax will be imposed on the undistributed income of the foundation. IRC § 4942(a). This required distribution amount is reduced by any income and excise taxes for the year. In general, "qualifying distributions" include any amount paid to accomplish exempt purposes, other than payments to an organization controlled by the foundation or by disqualified persons or to a non-operating foundation, or any amount paid to acquire an asset used in carrying out charitable purposes. IRC § 4942(g). Charitable distributions in excess of the amount required to be distributed for a given year generally reduce the required distributions in subsequent years. The foundation must pay the required distribution amount before the beginning of the second year following the taxable year. Thus, the foundation must distribute the year one amount by the end of year two, the year two amount by the end of year three, and so forth.

(4) Excess Business Holdings. A foundation that owns more than 2% of the outstanding stock of any company may be subject to restrictions on excess business holdings. In general, combined holdings of the foundation and disqualified persons in any "business enterprise" are limited to 20%, or 35% if unrelated third parties have control of such business enterprise. IRC § 4943.

(5) Jeopardizing Investments. Generally, the law imposes a tax on high-risk investments, on the assumption that these investments jeopardize the carrying out of the exempt purposes of a foundation. IRC § 4944. The IRS has indicated that the following types of investments will be scrutinized closely: trading in securities on margin; trading in commodity futures; investments and working interests in oil and gas wells; purchase of puts, calls and straddles; purchase of warrants; and selling short. A standard portfolio of stocks and bonds should not violate the jeopardy investment restrictions. Treas. Reg. § 53.4944-1(a)(2).

(6) Taxable Expenditures. As amended by the PPA, a foundation generally is subject to a 20% tax on the amount of a taxable expenditure. IRC § 4945(a). Taxable expenditures are payments by the foundation other than qualifying distributions and payments of taxes and expenses. Specifically, taxable expenditures include: lobbying expenditures; political campaign expenditures; most grants to individuals unless made pursuant to programs pre-approved by the IRS; grants to organizations other than public charities unless the foundation exercises "expenditure responsibility"; and expenditures for noncharitable purposes. IRC § 4945(d).

c. <u>Creating a Private Foundation.</u>

(1) <u>Corporation or Trust</u>. A private foundation may be created and organized as a wholly charitable trust or as a not-for-profit corporation under state law and receives its federal tax-exempt status under the Code. The not-for-profit corporation may be formed by founders known as "members" who elect directors of the corporation to choose officers and supervise management of the foundation. A not-for-profit corporation also may be formed with directors and officers but without members. If a corporate entity is used, various documents must be filed with the Secretary of State of the state in which the corporation is incorporated. A board of directors operates the foundation and decides on the charitable distributions to be made each year.

If an individual uses a trust, the individual creating the trust enters into a trust agreement with one or more designated trustees who are responsible for the management of the trust assets. The trustees or other persons selected in the trust agreement will operate the foundation and decide on the charitable distributions to be made each year.

(2) <u>Filing Requirements</u>. A private foundation must file federal Form 1023 with the IRS to obtain recognition of its tax-exempt status. A private foundation also must file federal Form 990-PF annually with the IRS. Form 990-PF reports income earned, includes details of the foundation's expenses of operation, lists charitable grants made, lists names and addresses of the foundation's directors and officers or its trustees and otherwise provides details on the foundation's activities.

Charitable organizations generally are subject to the supervision and control of the Attorney General of the state in which they are organized and operated. Many states require a private foundation to file with the Attorney General an initial registration statement and an annual return containing detailed financial information.

3. Donor Advised Funds

The PPA amends IRC § 4966 to provide, for the first time, a definition of a donor advised fund. A donor advised fund is defined as a fund or account that is: (1) separately identified by reference to contributions of a donor or donors; (2) owned and controlled by a sponsoring organization; and (3) with respect to which a donor (or any person appointed or designated by such donor (a "donor advisor")) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the separately identified fund or account by reason of the donor's status as a donor. The Joint Committee of Taxation's report, entitled *Technical Explanation of H.R. 4, the "Pension Protection Act of 2006," as Passed by the House* *on July 28, 2006, and as Considered by the Senate on August 3, 2006*, provides further guidance for meeting each of the three prongs of the definition. Among other exceptions, a donor advised fund does not include a fund or account that makes distributions only to a single identified organization or governmental entity.

The donor's contributions are accounted for separately within the public charity's records, and often the donor is permitted to "name" a fund after the donor or the donor's family, thus providing the name recognition benefit of a private foundation. The public charity must control the gift in all respects, including the right to control investments and to control the disposition of the donated funds for charitable purposes. The donor or his or her designees, however, generally exercises the privilege of making nonbinding recommendations to the governing body suggesting which public charities should receive grants from that particular fund. Treas. Reg. §§ 1.507-2(a)(8)(iv)(A)(2), (3) (listing factors indicating whether the donor retained control of the gift). Control is sacrificed because the donor's recommendations can be advisory only, and the right to advise generally is limited by life spans of the advisors. Although the public charity must retain control over investments, donors may be given the option of selecting types of investments within the overall investment portfolio of the public charity.

➔ **Planning Point:** Individuals reluctant to subject themselves to the private foundation rules and limitations frequently find that the creation of a donor advised fund permits them to achieve their charitable goal successfully. However, the PPA enacted a number of provisions that impose requirements upon donor advised funds that are similar to the requirements imposed upon private foundations. See Sections 1231-1235 of the PPA. A donor advised fund program also is attractive to many donors who want advice and administrative services and are willing to sacrifice ultimate control over their funds. Others may prefer to exert more control over the disposition of the funds to other charities, as the public charities are not bound to follow the recommendations made by the donors of advised funds.

➔ **Planning Point:** Because the donor advised fund is a bookkeeping entry within the records of the public charity, the donor advised fund keeps all records and the donor is not required to keep records or prepare separate tax returns, as is the case with a typical private family foundation.

a. Income Tax Consequences. The gift to a donor advised fund is a gift to a public charity. Therefore, the donor's income tax deduction is subject to the percentage limitations applicable to public charities.

A disadvantage of the donor advised fund is the lack of clear rules governing its operation. The problem was alleviated somewhat by the PPA, which enacted a number of provisions primarily focused on curbing the use of donor advised funds to improperly avoid taxes. See Sections 1231-1235 of the PPA. Other rules governing donor advised funds are found in the private foundation termination provisions. See Treas. Reg. § 1.507-2. If a donor advised fund contains any "material restriction" or condition, it may fail to be treated as a public charity and may instead be reclassified by the IRS as a private foundation or supporting organization and subject to a lower percentage limitation.

b. **<u>Where to Find Donor Advised Funds</u>**. The community foundation is the traditional home of the donor advised fund. A community foundation is an organization established to receive gifts or bequests from the public and to administer them for charitable purposes, primarily in the community or area where it is located. The community foundation generally has a governing body comprised of representatives of the particular community or area it benefits. A donor can make a gift directly to open a donor advised fund account or indirectly by creating a supporting organization to the community foundation donor advised fund account. All contributions are subject to the ultimate authority of the governing board.

➔ **<u>Planning Point</u>:** Some donor advised funds may be limited geographically to giving to a particular community or state. Others have policies against funding public charities unfamiliar to staff members. Almost all have policies against making grants to private foundations (except, in some cases, to private operating foundations because they already offer public-charity-sized deductibility) or to individuals.

Many public charities have, or will create upon request, donor advised funds dedicated to the furtherance of the public charity's exempt purposes. Some for-profit entities also have established donor advised funds (*e.g.*, the Fidelity Charitable Gift Fund).

4. Supporting Organizations

A supporting organization is organized and operated exclusively for the benefit of a church, educational organization, hospital, governmental unit or publicly supported charity (a "supported organization," <u>see</u> IRC § 509(f)(3)), is operated, supervised or controlled by or in connection with the supported organization, and is not controlled directly or indirectly by disqualified persons. IRC § 509(a)(3); <u>see also</u> IRC §§ 509(f); 4943(f)(5); Section 1241(c) of the PPA.

> **<u>EXAMPLE</u>**: A supporting organization may support a specific charity, such as a school, or may have a broader scope by supporting a community foundation.

For this purpose, a disqualified person is a person defined in IRC § 4946, or an employee of a disqualified person. A donor's non-employee advisors are generally not disqualified persons.

➔ **<u>Planning Point</u>:** A donor may be more comfortable with a supporting organization with a majority of the Board of Directors consisting of family members and advisors than with a donor advised fund. For example, a Board of Directors consisting of a donor, his spouse, his financial advisor and two representatives of the community foundation would qualify.

A supporting organization is treated as a public charity for all purposes. Thus, contributions to a supporting organization may include private company stock valued at full fair market value, and the higher percentage limitations apply.

The supporting organization generally avoids the private foundation excise taxes. However, the PPA provides for the imposition of the excess benefit rules under IRC § 4958 for certain transfers to a substantial contributor of a supporting organization. Notice 2006-109 provides applicability dates for the imposition of these excise taxes. Furthermore, certain supporting organizations are potentially subject to the excess business holding rules of IRC § 4943 and may be deemed a private foundation upon acceptance of any gifts from certain persons who could exert control over the supporting organization.

5. Charitable Gift Annuities

A charitable gift annuity is a contract between a donor and a charity in which the donor transfers money or other property to a charity in exchange for the charity's promise to pay the beneficiary a fixed dollar amount each year for the beneficiary's lifetime. The annuity may be a single life annuity, or a joint and survivor annuity, and payments may be made annually, semiannually, quarterly, monthly or more frequently. The annuity payments may be either immediate or deferred (*i.e.*, payments beginning now or payments beginning at a future date).

The Committee on Gift Annuities (a representative body of philanthropic organizations) recommends rates of return for gift annuities. The annuity rate depends on the age of the beneficiary. The annuity rates are conservative in order to ensure that the charity receives a significant benefit from the transaction and to minimize the possibility that the charity will be required to use its assets to make annuity payments.

a. **Income Tax Consequences**. The transfer of appreciated property for a charitable gift annuity is deemed to be a bargain sale. Treas. Reg. §§ 1.170A-1(d)(3), 1.1011-2(a)(4)(i). A bargain sale is a transfer of property to a charity in exchange for consideration that is less than the fair market value of the property. For tax purposes, the transfer is treated in part as the purchase of an annuity and in part as a charitable gift.

(1) **Amount of the Charitable Deduction**. The donor can claim an immediate charitable income tax deduction for the portion of the transaction that represents the charitable gift element, which is the amount of money or fair market value of the property transferred to the charity less the present value of the annuity. Treas. Reg. § 1.170A-1(d)(1). The present value of the annuity is determined under IRC § 7520. The IRC § 7520 rate is published monthly. In determining the amount of the charitable deduction, the donor may elect to use either the rate for the month in which the valuation date falls, or either of the immediately preceding two months, whichever is the most favorable. In fact, because the IRC § 7520 rate is published on the 20th or 21st day of the preceding month, a donor may consider four months' rates. The charitable deduction for the gift portion is subject to the percentage limitations.

> **EXAMPLE:** Donor, age 60, purchased a charitable gift annuity from a museum, a public charity. Donor transferred to the museum stock qualifying as long-term capital gain property with a value of \$1,000,000 and a basis of \$200,000. The museum will pay Donor an annual annuity of \$20,000, payable quarterly for Donor's life. Assuming an IRC § 7520 rate of 5.4%, the present value of the annuity is

$233,305. The amount of Donor's charitable contribution is $766,695 ($1,000,000 - $233,305).

(2) **Recognition of Capital Gain**. In computing the amount of the capital gain, the basis of the transferred property is allocated between the gift portion and the actuarial value of the annuity. IRC § 1011(b). The amount of gain is the difference between the value of the annuity and the cost basis allocated to the value of the annuity. If certain requirements are met, the gain determined under the bargain sale rules need not be reported in full in the year the annuity is purchased, but may be reported ratably over the donor's life expectancy. Treas. Reg. § 1.1011-2(a)(4)(ii). This is accomplished by treating as gain the appropriate portion of each annuity payment that would otherwise be excluded from income. Treas. Reg. §§ 1.1011-2(a)(4)(ii), 1.1011-2(c), Ex. 8. To qualify for this method of reporting gain, the annuity must be nonassignable or assignable only to the charity to which the property was transferred. Treas. Reg. § 1.1011-2(a)(4)(ii). In addition, the annuitants must be either the donor only or the donor and a designated survivor annuitant.

EXAMPLE: Building on the example above, under the bargain sale rules, the portion of the basis of the stock allocable to the sale portion of the annuity transaction is $46,661 ($233,305/$1,000,000 x $200,000). Donor must recognize long-term capital gain of $186,644 ($233,305 - $46,661). The gain is reported ratably over Donor's life expectancy so long as the annuity is nonassignable or assignable only to the museum.

(3) **Taxation of Annuity Payments**. The income tax consequences of a charitable gift annuity are governed by the annuity rules in IRC § 72. The annuity rules treat the annuity payments as having three elements for income tax purposes: a tax-free recovery of basis; a capital gain portion (if gain can be deferred); and ordinary income (the annuity amount). Treas. Reg. § 1.72-1(a).

(a) **Tax-Free Portion**. A portion of each annuity payment will represent a tax-free recovery of basis until the donor has fully recovered his or her basis in the property. After the donor has fully recovered his or her basis, which occurs if the donor lives for his or her actuarial life expectancy, as determined under Table V of Treas. Reg. § 1.72-9, the balance of the payments received will be taxable as ordinary income. IRC § 72(b)(2). In the event that the donor dies before recovering his or her entire basis, the unrecovered amount can be taken as a deduction on his or her final income tax return. IRC § 72(b)(3).

The tax-free return of basis portion of each payment is determined by multiplying the exclusion ratio by each annuity payment received. The exclusion ratio is the ratio of the donor's investment in the contract (the present value of the annuity) to the expected return. The expected return is determined by multiplying the total annual annuity payment to be made by the donor's life expectancy, as determined under IRC § 72. Treas. Reg. § 1.72-9.

EXAMPLE: Building on the examples above, Donor's life expectancy under the life annuity tables in Treas. Reg. § 1.72-9 Table V is 24.2. Therefore, his expected return is $484,000 ($20,000 x 24.2).

The exclusion ratio is 48.2% ($233,305 value of the annuity divided by $484,000 expected return). Therefore, $9,640 ($20,000 x 48.2%) of each annuity payment Donor receives is treated as a tax-free return of investment.

(b) **Capital Gain Portion**. Because property was transferred to purchase the annuity, a portion of each excludable amount must be reported as long-term capital gain. This amount will be reported ratably over the donor's life expectancy. If the donor lives at least as long as his or her life expectancy at the time of the transfer, the donor eventually will pay a tax on his or her entire realized gain.

EXAMPLE: Continuing the example above, the gain is reported over Donor's 24.2-year life expectancy, so that each year $7,713 is reported as capital gain ($186,644 divided by 24.2). Thus, of the $9,640 that is excludable, Donor must report $7,713 as long-term capital gain. The balance, $1,927, is excluded from income as a return of basis.

(c) **Ordinary Income Portion**. The ordinary income portion is the difference between the annuity payment and the return of basis portion.

EXAMPLE: Continuing the preceding example, the balance of each annuity payment, $10,360 ($20,000 less $9,640), will be ordinary income.

b. **Gift Tax Consequences**. The donor is entitled to a gift tax charitable deduction for the value of the charitable gift element.

c. **Deferred Gift Annuities**. With a deferred payment gift annuity, a donor transfers money or property to a charitable organization in exchange for its promise to pay an annuity to the donor to begin at a future date. The donor is able to make a gift now and get an immediate income tax charitable deduction when he or she is in a high tax bracket, deferring distributions to the donor until those years when the donor may need the income more and may be in a lower income tax bracket. A portion of each annuity payment, when the payments begin, will be excludable from gross income over the donor's life expectancy. See Treas. Reg. § 1.72- 1(a).

E. Use of IRC § 7520 Rate to Value Split-Interest Gifts

The charitable deduction for income, estate and gift tax purposes is equal to the present value of the charity's interest, determined using the IRS's mortality tables and 120% of the annual federal mid-term rate determined pursuant to IRC § 7520. The IRC § 7520 rate is published monthly. In determining the amount of the charitable deduction, the donor is allowed to use either the rate for the month in which the gift occurs, or either of the immediately preceding two months, whichever is the most favorable. In fact, because the IRC § 7520 rate is published on the 20th or 21st day of the preceding month, a donor may consider four months' rates when planning the date on which to establish a charitable remainder trust or charitable lead trust.

F. Charitable Remainder Trusts

A charitable remainder trust ("CRT") allows an individual (the "donor") to donate assets to a charity while retaining an interest in the donated assets or providing another individual or entity with an interest in the donated assets for a specified period of time. The donor transfers property to an irrevocable trust that provides that the noncharitable beneficiary of the CRT will receive a stream of payments for a specified period of time, and at the expiration of this period, the remaining assets will be transferred to the charitable beneficiary. Thus, a CRT is a "split-interest" gift because both a charitable beneficiary and a noncharitable beneficiary receive interests in the same property. The donor will obtain an income tax charitable deduction and a gift tax charitable deduction or an estate tax charitable deduction based on the present value of the remainder interest ultimately passing to charity.

1. Requirements for Charitable Estate, Gift and Income Tax Deductions

A charitable deduction is allowed only if the noncharitable beneficiary's interest is in the form of an annuity interest or a unitrust interest. Accordingly, a CRT may be established as a charitable remainder annuity trust (a "CRAT"), a charitable remainder unitrust (a "CRUT"), or a net income CRUT.

a. **<u>Annual Payments</u>**. The annual payment must be either an annuity or a unitrust amount, which must be fixed and may not change over time. No amount other than the annuity or unitrust payment may be distributed to any person except a charitable organization. IRC §§ 664(d)(1)(B), (2)(B).

(1) **<u>Rules Common to CRATs and CRUTs</u>**. Certain rules apply to both CRATs and CRUTs, and they are discussed below.

(a) **<u>Distributions for Emergencies</u>**. No distributions for emergency needs or other purposes may be made from a CRT. Treas. Reg. §§ 1.664-2(a)(4), 3(a)(4). <u>See also</u> Rev. Rul. 77-58, 1977-1 C.B. 175.

(b) **<u>Proration in Short Years</u>**. The annuity or unitrust payment must be prorated in the case of a short taxable year other than the final year. Treas. Reg. §§ 1.664-2(a)(1)(iv)(a), 3(a)(1)(v)(a).

(c) **<u>Incorrect Valuations</u>**. All CRUTs, and all CRATs basing the annuity amount on a percentage of the value of the CRAT assets, must include language directing the trustee to correct improper distributions made, or not made, due to the incorrect valuation of CRT assets. Treas. Reg. §§ 1.664-2(a)(1)(iii), 3(a)(1)(iii). Where there is an incorrect valuation, the trustee must pay to the beneficiary (in the case of an undervaluation) or receive from the beneficiary (in the case of an overvaluation) an amount equal to the difference between the amount paid to the beneficiary and the correct payment amount.

(d) **<u>Distributions to Charity</u>**. Interim distributions to charity may be permissible if within certain parameters. For example, income exceeding the annuity or unitrust amount could be paid to charity. Treas. Reg. §§ 1.664-2(a)(4), 3(a)(4). Alternatively, periodic distributions of principal or principal distributions at the death of one of the CRT beneficiaries is also permissible, provided that the adjusted basis of any distributions in kind is fairly representative of the adjusted basis of the property available for distribution. Treas. Reg. §§ 1.664-2(a)(4), 3(a)(4). This provision prohibits the trustee from distributing low basis assets to the charity, which is exempt from income tax, thereby benefiting the noncharitable beneficiary by retaining high basis assets. A donor is not entitled to an additional income tax deduction for any portion of an annuity or unitrust payment that is paid to charity. Treas. Reg. §§ 1.664-2(d), 3(d).

(e) **Minimum and Maximum Payments**. The amount paid must be equal to at least 5%, but not more than 50%, of the initial fair market value of the assets of the trust, in the case of a CRAT, and of the value of the trust revalued annually, in the case of a CRUT. IRC §§ 664(d)(1)(A), (d)(2)(A); Treas. Reg. §§ 1.664-2(a)(2)(i), 3(a)(2)(i). The present value of the remainder interest that passes to charity must be equal to at least 10% of the initial fair market value of the assets contributed to the trust. IRC §§ 664(d)(1)(D), (d)(2)(D).

➔ **Planning Point:** Note that the 10% minimum value for the charitable remainder trust may restrict the use of such trusts with younger generation beneficiaries, such as children of the grantor or for multiple beneficiaries. A CRT to be held for the life of a young beneficiary raises a significant risk of failing the 10% remainder test.

> **EXAMPLE:** Assuming an IRC § 7520 rate of 5.6%, a 6% annuity for the life of a 35-year-old fails the 10% remainder test. The value of the remainder is only 5.283%.

➔ **Planning Point:** The requirement that the remainder interest be at least 10% of the value of the property transferred to the trust could cause a problem in the case of a testamentary CRT because the value of the remainder cannot be determined until the death of the donor. A trust that does not meet the 10% test can be reformed to do so. IRC § 2055(e)(3)(J). Thus, a testamentary CRT should include a provision allowing the trustee to amend the trust by decreasing the payment or the term of the noncharitable interest in order to meet the 10% requirement.

(2) **CRATs**. A CRAT pays a defined annuity, either a fixed dollar amount or a fixed percentage of the initial fair market value of the trust assets, to the noncharitable beneficiary, at least annually, regardless of the value of the trust assets or the income generated by the trust. Treas. Reg. §§ 1.664-2(a)(1)(ii), (iii).

When the CRAT is created, there must be no more than a 5% chance that the required payments will exhaust the principal of the trust. Rev. Rul. 77-374, 1977-2 C.B. 329. If the chance exceeds 5%, no charitable deduction will be allowed. The basis for this position is language in the estate and gift tax regulations that prohibits a deduction where a charitable transfer is subject to a condition "unless the possibility that the charitable transfer will not become effective is so remote as to be negligible." Treas. Reg. §§ 20.2055-2(b)(1), 25.2522(c)- 3(b)(1).

➔ **Planning Point:** The 10% remainder test is in addition to the 5% probability of exhaustion test, and it is possible to pass one yet flunk the other.

<u>EXAMPLE</u>: Assuming an IRC § 7520 rate of 5.6%, an annuity for the life of a 30-year-old paying a 5.64% annuity passes the probability of exhaustion test but fails the 10% remainder test. The probability of exhaustion is 3.81%, but the value of the remainder is only 8.29%.

<u>EXAMPLE</u>: Still assuming an IRC § 7520 rate of 5.6%, an annuity for the life of a 60-year-old paying a 7% annuity fails the probability of exhaustion test but passes the 10% remainder test. The probability of exhaustion is 23.13%, and the value of the remainder is 19.77%.

The IRC § 7520 regulations contain a separate exhaustion rule for income, gift and estate tax purposes that applies to CRATs in which the annuity is measured by a life and the trust will be exhausted if the measuring life outlives his or her life expectancy. Treas. Reg. §§ 1.7520- 3(b)(2), 20.7520-3(b)(2), 25.7520-3(b)(2). The rule is that if the trust will be exhausted if the measuring life lives until age 110, the annuity interest cannot be valued under IRC § 7520.

(3) **<u>CRUTs</u>**. A CRUT pays a defined percentage of the net fair market value of the assets of the trust, valued as of a certain day each year, to the noncharitable beneficiary, at least annually. This amount is called the "unitrust amount." Treas. Reg. § 1.664- 3(a)(1)(i). The valuation date can be any date during the year, provided that the same date is used each year. Alternatively, the valuation could be made on several different dates to produce an average valuation, as long as the same valuation dates and valuation methods are used each year. Treas. Reg. § 1.664-3(a)(1)(iv). The unitrust amount fluctuates as the net fair market value of the CRUT assets fluctuates, even though the defined percentage is fixed. Therefore, unlike the CRAT, a CRUT will not be exhausted by distributions to the noncharitable beneficiaries because the unitrust amount will decrease as the value of the assets of the trust decreases.

(a) **<u>Net Income CRUT</u>**. A variation of the CRUT, called a net income CRUT, is a CRUT that pays the noncharitable beneficiary the lesser of the income of the trust or the unitrust amount. IRC § 664(d)(3); Treas. Reg. § 1.664-3(a)(1)(i)(b)(1). Income is trust accounting income as determined by the governing instrument and state law.

(b) **<u>Net Income With Make-Up CRUT</u>**. The Code allows a net income CRUT to include a "make-up" provision, specifying that any deficits between the required unitrust amount that would otherwise have been payable and the net income of the CRUT shall be made up in later years, to the extent that the CRUT income in those later years exceeds the required unitrust amount for such later years. Treas. Reg. § 1.664-3(a)(1)(i)(b)(2). A CRUT with a "make-up" provision is sometimes called a "NIMCRUT." The charitable deduction for the net income CRUT, whether or not it has a "make-up" feature, is determined by assuming that the unitrust amount will be paid each year.

➔ **<u>Planning Point</u>:** The make-up feature means that a CRUT that holds low-yielding assets that are sold and converted into high-yielding assets may make the CRT beneficiary whole, to an extent. No allowance is made for the time value of money due to the "late" receipt of the required unitrust amounts.

> **<u>EXAMPLE</u>:** Donor transfers $1,000,000 to an irrevocable trust that pays the Donor for life the lesser of 5% of the value of the trust property each year or the net income of the trust. A deficiency in any year will be made up from excess income in later years. In year 1 the trust had income of $40,000. Therefore, only $40,000 would be distributed to Donor, rather than the required payment of $50,000. If in year 2 the trust income was $65,000 and the payment was $55,000 (the trust property having appreciated to $1,100,000), Donor would be entitled to all $65,000, $10,000 of which would be a deficiency distribution.

➔ **<u>Planning Point</u>:** The 5% exhaustion rule discussed above does not apply to a NIMCRUT because the trust principal will not be invaded. It also should not apply to a standard CRUT because the unitrust payment increases and decreases as the value of the trust assets increases and decreases, so that the trust should never be exhausted.

(c) <u>The Definition of Income Under IRC § 643(b)</u>. With regard to charitable trusts, the regulations regarding the definition of income under IRC § 643(b) affect only CRUTs that make distributions partially by reference to "income," including net income CRUTs and NIMCRUTs. They do not affect CRATs or CRUTs that pay only a unitrust interest.

A charitable trust may follow its own definition of trust income or follow the definition under applicable state law. However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law. Treas. Reg. § 1.664-3(a)(1). As provided in IRC § 643(b), capital gains from assets contributed to the trust by the donor or purchased by the trust may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by applicable local law. However, gains from the sale of assets contributed to the trust by the donor must be allocated to principal and not to trust income to the extent of the fair market value of those assets on the date of their contribution to the trust. In addition, capital gains may not be allocated to trust income to the extent of the trust's purchase price of those assets. Further, the trustee's discretionary power to make an allocation to income is acceptable only to the extent that a state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially. Id.

➔ **<u>Planning Point</u>:** It will be important to monitor enabling legislation in states where a practitioner practices with regard to how state law definitions of income will be taken into account in CRUTs. Affirmative steps may be required to protect the tax treatment of existing CRUTs, and revised income and principal allocation language may be needed for newly created CRTs.

(d) <u>FLIPCRUTs</u>. The position of the IRS previously was that a CRUT cannot use more than one of the types of payments during its term, that is, it cannot "flip" from a NIMCRUT to a standard CRUT, for example. This type of CRUT is known as a "FLIPCRUT." In the past, the IRS had indicated that a FLIPCRUT would not qualify under IRC § 664 as a CRUT.

> **EXAMPLE:** A FLIPCRUT is beneficial if the trust is funded initially with illiquid assets that do not produce income. In that case, the CRUT can be an income-only CRUT until the property is sold because of the difficulty in paying the unitrust amount. After the asset has been sold, however, the donor can receive the unitrust payment rather than income only.

In regulations adopted in 1998, however, the IRS changed its position. Treas. Reg. § 1.664-3(a)(1)(i)(c). These regulations allow a trust that uses either the net income or net income with make-up provisions to pay out using such method for an initial period and then flip to a standard CRUT (*i.e.*, the fixed unitrust amount) for the balance of the term. The "flip" must be triggered by a specific date or by a specific event, as long as the date or event is not within the discretion or control of the trustee or any other person. *Id.* The sale of unmarketable assets, or the death, birth of a child, marriage or divorce of any individual will not be considered to be within the discretion or control of the trustee or any person. Treas. Reg. § 1.664-3(a)(1)(i)(d). The flip will be effective at the beginning of the taxable year immediately following the year in which the triggering event or date falls. Treas. Reg. § 1.664-3(a)(1)(i)(c).

➔ **Planning Point:** Any "make-up" amount is forfeited upon the conversion.

The term "unmarketable assets" includes assets that are not "cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents." Treas. Reg. § 1.664-1(a)(7)(ii). Examples include real property, closely held stock, and unregistered securities for which there is no available exemption permitting public sale. *Id.*

b. Timing of Payment. The annuity or unitrust payment may be made after the close of the taxable year if certain requirements are met. See Treas. Reg. §§ 1.664-2(a)(1)(i)(a), 3(a)(1)(i)(g).

A testamentary CRT is deemed created at death even if it is not funded until the end of the period of estate administration. The annuity or unitrust payment may be deferred until the end of the taxable year in which the CRT is funded. Treas. Reg. § 1.664-1(a)(5)(i). The governing instrument must set forth the method for retroactively determining the payments to which the noncharitable beneficiary was entitled from the date of death to the date the CRT was funded. Deferred payments must bear interest at the IRC § 7520 rate. Treas. Reg. §§ 1.664- 1(a)(5)(i), (iv)(a).

c. Reformation of Split-Interest Trusts. Reformation of split-interest trusts is allowed under IRC § 2055(e)(3) if certain requirements are met. The governing instrument must express the noncharitable beneficiary's interest in terms of an annuity or unitrust interest. IRC § 2055(e)(3)(C)(ii). Meeting this requirement demonstrates an intent to comply with the law. If this requirement is not met, reformation also may be accomplished if a judicial reformation proceeding is commenced within ninety days of the due date (including extensions) for the federal estate tax return on which the deduction is claimed. If no federal estate tax return is required, the judicial reformation proceeding must be commenced within ninety days after the last date (including extensions) for filing the first income tax return for the CRT. IRC § 2055(e)(3)(C)(iii).

The reformation may not change the actuarial value of the charitable interest by more than five percent. IRC § 2055(e)(3)(B)(i). Additionally, the durations of the charitable and noncharitable interests may not change. A noncharitable interest in a CRT of more than twenty years, however, may be reduced to twenty years. *Id.* In that case, the annual distribution to the noncharitable beneficiary must be increased so that the actuarial value of the charitable and noncharitable interests remains the same.

CRATs and CRUTs that do not meet the ten percent value of remainder interest test also can be reformed. IRC § 2055(e)(3)(J). Reformation may be necessary in the case of a testamentary CRT because, with such a trust, it is not possible to determine whether the trust satisfies the ten percent requirement until the grantor's death. This is because the IRC § 7520 rate is not fixed until the date of death, and if a noncharitable term has a measuring life, the length of that term will not be determinable until the donor's death.

d. <u>Beneficiaries of the CRT</u>. The noncharitable beneficiaries of a CRT may include individuals, trusts, partnerships, corporations, or other legal entities that are not charities. Treas. Reg. §§ 1.664-2(a)(3), 3(a)(3). If the noncharitable beneficiaries are individuals, all of them must be living when the trust is created.

The remainder must be distributed to or for the use of an organization described in IRC § 170(c) or held as a charitable trust. IRC § 664(d)(1)(C), (d)(2)(C). The CRT may provide that the interests of the charitable beneficiaries be enjoyed concurrently or successively. Treas. Reg. §§ 1.664-2(a)(6)(iii), 3(a)(6)(iii).

> **<u>EXAMPLE</u>:** Trust provides that, upon termination, the remainder will be held in trust, and the income will be payable 50% to each of two charities. The trust qualifies as a CRT.
>
> **<u>EXAMPLE</u>:** Trust provides that, upon termination, the remainder will be held in trust with all the income payable to Charity 1 for 10 years and thereafter the property is to be distributed outright to Charity 2. The trust qualifies as a CRT.

The trust instrument must set forth a method for selecting an alternate charitable remainder beneficiary in the event the designated charity does not qualify as an organization for which an income tax deduction is available. Treas. Reg. §§ 1.664-2(a)(6)(iv), 3(a)(6)(iv).

➔ **<u>Planning Point</u>:** Because IRC §§ 170(c), 2055(a) and 2522(a) differ in the type of organization contributions to which are deductible, the trust instrument should provide that both the designated and the alternate remainder beneficiaries qualify for a charitable deduction under whichever Code sections a deduction is sought.

The donor of an inter vivos CLT may retain the right to substitute the charitable remainder beneficiaries. Rev. Rul. 76-8, 1976-1 C.B. 179; PLR 200034019; PLR 9331043. Additionally, the income beneficiary or a trustee of a testamentary CRT may have the right to designate the remainder beneficiaries. Rev. Rul. 76-7, 1976-1 C.B. 179; PLR 8919016.

e. **Term of the CRT**. If the noncharitable beneficiary is an individual, then the term of the CRT may be for either the duration of the beneficiary's life or not more than twenty years. IRC § 664(d)(1)(A), (d)(2)(A); Treas. Reg. §§ 1.664-2(a)(5), 3(a)(5). If the noncharitable beneficiary is not an individual, then the term of the CRT must be for a term of years not to exceed twenty years. *Id.* An interest that could never exceed both the life interest of named beneficiaries who were living at the creation of the CRT or a term of twenty years would be permissible.

➔ **Planning Point:** The donor to the CRT must choose which measuring period -- a life interest or a term of years -- to use, and the CRT may not later deviate from that original choice. For example, a term of years followed by a life interest, or vice versa, generally is not permissible, because of the possibility that the total duration of the CRT might exceed both the lives of named beneficiaries who were living at the creation of the CRT and a term of twenty years.

> **EXAMPLE:** An interest to A for A's life, followed by an interest to B (who was living at the creation of the CRT), for the shorter of twenty years or B's life, would qualify. In this example, the total term could not exceed A's and B's lives, so that the possibility of a term exceeding both the life interest of named beneficiaries and a term of twenty years is not possible.

In selecting the term of the CRT, the donor must bear in mind the requirements, discussed above, as to the probability of the exhaustion of trust assets and the amount that must be distributed to the charity at the end of the term. As illustrated in an example above, a CRAT for the life of a young beneficiary is unlikely to meet the 10% remainder test.

f. **Valuation of Unmarketable Assets**. If the CRT will hold unmarketable assets, the trust will not qualify for an income, gift or estate tax deduction unless an independent trustee values the unmarketable assets, or, alternatively, the value is determined by a qualified appraisal from a qualified appraiser. Treas. Reg. § 1.664-1(a)(7)(i). For this purpose, a qualified appraisal is defined as it is for purposes of the income tax substantiation rules. An independent trustee is a person who is not the grantor of the CRT, a noncharitable beneficiary, or a person who is subordinate or related to the grantor, the grantor's spouse, or a noncharitable beneficiary. Treas. Reg. § 1.664-1(a)(7)(iii). Unmarketable assets are those that are not cash, cash equivalents, or other assets that can be readily converted into cash, such as real estate, closely held stock, and unregistered securities. Treas. Reg. § 1.664-1(a)(7)(ii).

➔ **Planning Point:** Because with a CRUT the assets must be valued each year, the appraisal requirement must be met each time the assets are revalued.

➔ **Planning Point:** If the transfer of assets to the CRT requires a qualified appraisal for the purpose of the substantiation rules, that same appraisal can be used to satisfy the requirements of Treas. Reg. § 1.664-1(a)(7).

g. IRS Safe Harbor Forms. The IRS has promulgated a number of revenue procedures containing "safe harbor" forms, stating that use of the language in the forms complies with all of the relevant rules and restrictions for CRATs and CRUTs. See Rev. Proc. 2003-53, 2003-2 C.B. 230 - Rev. Proc. 2003-60, 2003-2 C.B. 274; Rev. Proc. 2005-52, 2005-34 I.R.B. 326 - Rev. Proc. 2005-59, 2005-34 I.R.B. 412. The revenue procedures contain sample trust forms, alternative provisions and annotations. Although very helpful, these revenue procedures should be used with caution. Many of the alternative provisions should be considered and integrated into the CRT instrument. Also, because the safe harbor only applies where the CRT instrument is substantially similar to one of the sample trusts or where the document integrates one or more alternative provisions, any changes made by the drafter of the CRT instrument must be clearly consistent with Section 664. For more analysis, see Richard L. Fox, "A Guide to IRS Sample Charitable Remainder Trust Forms," 33 Est. Pln. 13 (Jan. 2006).

➔ **Planning Point:** Because of the safe harbor provisions, the IRS will not ordinarily issue rulings on whether a particular trust qualifies as a CRT. See Rev. Proc. 2008-3, 2008-1 I.R.B. 110 (January 7, 2008).

2. Income, Gift and Estate Tax Consequences

A charitable deduction will be available to the donor for the actuarial value of the charity's remainder interest in the CRT. If the CRT is established during the donor's lifetime, then the donor will be entitled to a charitable deduction for income tax purposes and for gift tax purposes. If the CRT is established upon the death of the donor (under the donor's will or revocable trust, for example), then the donor's estate will be entitled to a charitable deduction for estate tax purposes.

a. Income Tax Consequences.

(1) Charitable Deduction for Value of Charitable Remainder Interest. To qualify as a CRT, the charitable remainder beneficiary must be an organization described in IRC § 170(c). An income tax deduction is available for the actuarial value of the charity's remainder interest, determined under IRC § 7520. The deduction for a CRAT is calculated by subtracting the present value of the annuity from the fair market value of the property transferred to the CRAT. The deduction for a CRUT is the present value of the remainder interest.

➔ **Planning Point:** For CRATs, the higher the IRC § 7520 rate, the larger the charitable deduction. This is because the IRS is assuming that the higher the interest rate, the better the yield of the CRT assets, so that a larger amount is left for charity. The differences caused by rate changes for CRUTs are nominal, because the unitrust amount that is payable will be deemed to increase at the same rate as the CRUT assets are appreciating.

EXAMPLE: Assuming an IRC § 7520 rate of 5.6%, a $1,000,000

CRAT for the life of a 68-year-old donor that pays a 7% annuity quarterly will result in a charitable deduction of $337,539 for the remainder interest. The present value of the annuity is $662,461. The value of the remainder interest is determined by subtracting the value of the annuity ($662,461) from the value of the property transferred to the CRAT ($1,000,000). If the IRC § 7520 rate is 7%, then the charitable deduction for the remainder interest is $399,018.

EXAMPLE: Assuming the same facts as in the previous example except that a CRUT is used, the charitable deduction for the remainder interest is $403,540 at a 5.6% IRC § 7520 rate, and $406,140 at a 7% IRC § 7520 rate. Comparing these results with the previous example illustrates how a change in the IRC § 7520 rate has little effect on the amount of the charitable deduction for a CRUT.

The amount of the deduction will be determined by the type of property contributed to the CRT (cash or capital gain property), the remainder charitable beneficiary (public charity or private foundation), and on whether the remainder interest will pass outright to the charitable beneficiary or be held in further trust for the benefit of the charitable beneficiary. If the property is retained in trust for the beneficiary, the gift is "for the use of" a public charity and is subject to the thirty percent limitation. The percentage limitations for purposes of the income tax charitable deduction are discussed in detail at the beginning of this Chapter.

➔ **Planning Point:** If any person has the right to substitute the charitable remainder beneficiary, and the amount of the deduction depends upon the remainder beneficiary being a public charity, then the right to substitute the charitable remainder beneficiary should be limited to public charities. Rev. Rul. 79-308, 1979-2 C.B. 109.

(2) Character of Income Distributions (the Tier System). Charitable remainder trusts generally are exempt from income taxes. Distributions to the noncharitable beneficiaries of the CRT carry out the CRT's income to the beneficiaries, where it is taxed to the beneficiaries on a tier basis. The purpose of the tier system is to ensure that income taxed at the highest rate is distributed first to the beneficiaries before distributions taxed at a lower rate.

In any year in which the trust has any unrelated business taxable income ("UBTI"), the trust will forfeit its tax-exempt status, and all income realized by the trust for the year will be subject to income tax to the trust as a non-exempt complex trust. IRC § 664(c); Treas. Reg. § 1.664-1(c). See also *Leila G. Newhall Unitrust v. Comm'r*, 104 T.C. 236 (1995). UBTI usually results from income derived from a trade or business carried on by the trust that is unrelated to the charity's tax-exempt purposes.

➔ **Planning Point:** A CRT is often used in order to avoid tax on the sale of the contributed property. In this situation, it is critical to avoid UBTI, at least in the year in which the contributed property is sold. Thus, contributions of property which create UBTI, such as trade or business partnerships and S corporations, should be avoided. Similarly reinvestment of proceeds of sale in investments which create UBTI, such as trade or business partnerships and S corporations, or margined securities, or investment partnerships with leveraged investments, should be avoided.

Every year, the CRT categorizes its distributable income into one of three categories: ordinary income, capital gain income and other income. IRC § 664(b).

(a) **First Tier: Ordinary Income**. All distributions are deemed to carry out first the ordinary income of the CRT for the current year, plus any undistributed ordinary income from previous years. IRC § 664(b)(1); Treas. Reg. § 1.664-1(d)(1)(ii)(*a*)(*1*). Ordinary income means the CRT's trust accounting income that is includible in its gross income. Items of ordinary income are then assigned to different classes based on the tax rates applicable to each type of income in that category. Treas. Reg. § 1.664-1(d)(1)(ii)(*b*). The regulations also specify how ordinary losses offset ordinary income. Treas. Reg. § 1.664-1(d)(1)(iii)(*a*).

(b) **Second Tier: Capital Gain Income**. Once the payments to a beneficiary in a given year have carried out all of the current year's ordinary income and any previous years' undistributed ordinary income, then distributions, to the extent that they exceed this total accumulated amount, are deemed to consist, first, of capital gain income for the current year and then of undistributed capital gain income from previous years. IRC § 664(b)(2); Treas. Reg. § 1.664-1(d)(1)(ii)(*a*)(*2*)&-1(d)(1)(iv). Items of capital gain income are then assigned to different classes based on the tax rates applicable to each type of income in that category. Treas. Reg. § 1.664-1(d)(1)(ii)(*b*). The regulations also specify how capital gains are netted against capital losses. Treas. Reg. § 1.664-1(d)(1)(iv).

(c) **Third Tier: Other Income**. Once the CRT's capital gain income for the current year and all undistributed capital gain income from previous years has been distributed, any additional distributions would be deemed to consist of other income (such as municipal bond income) from the current year and undistributed other income from prior years. IRC § 664(b)(3); Treas. Reg. § 1.664-1(d)(1)(ii)(*a*)(*3*). The regulations also specify how a net loss in this category offsets income in this category. Treas. Reg. § 1.664-1(d)(1)(iii)(*b*).

(d) **Fourth Tier: Return of Capital**. If the third tier of income is exhausted, then any additional payments will be deemed to consist of trust principal. IRC § 664(b)(4); Treas. Reg. § 1.664-1(d)(1)(ii)(*a*)(*4*).

If a CRT makes a distribution to a charity other than a distribution of a portion of the annuity or unitrust amount, the distribution is deemed made out of the same tiers as distributions to the noncharitable beneficiaries, but in the reverse order. Treas. Reg. § 1.664-1(e)(1). That is, distributions to the charitable beneficiary are attributed to principal first, then other income, then capital gains, then ordinary income. Treas. Reg. § 1.664-1(e)(1).

b. **Gift Tax Consequences**. To qualify as a CRT, the charitable remainder beneficiary must be an organization described in IRC § 170(c). Thus, the charitable remainder beneficiary must meet the requirements of both IRC §§ 2522 and 170(c) in order to qualify for the gift tax deduction. Because the category of permissible recipients is not the same in those sections, it is necessary to make sure that the charitable beneficiary qualifies under both sections.

If the CRT is established during the donor's life, the donor is entitled to a charitable gift tax deduction for the actuarial value of the charity's remainder interest. A transfer to a CRT in which the donor retains the annuity or unitrust interest does not have any gift tax consequences. In such a case, the only gift is the gift of the remainder interest, which qualifies for the gift tax charitable deduction.

If the donor gives the annuity or unitrust interest to another person, however, gift tax may be incurred. The value of the gift of the annuity interest is calculated by subtracting the present value of the remainder interest from the value of the property transferred, determined under IRC § 7520. The value of the gift of a unitrust interest is the present value of the unitrust interest. If the only noncharitable beneficiary other than the donor is the donor's spouse, the gift tax marital deduction will be available. IRC § 2523(g). If the noncharitable beneficiary is not the donor's spouse, then the actuarial value of the beneficiary's interest will be subject to gift tax, and as long as the value of the gift is less than the donor's unused gift tax applicable exclusion amount, the donor will not have to pay any gift tax on the transfer of the interest.

> **EXAMPLE:** Assuming an IRC § 7520 rate of 5.6%, a $1,000,000 CRAT for the life of a 68-year-old that pays a 7% annuity quarterly will result in a charitable deduction of $337,539 for the remainder interest. The present value of the annuity is $662,461. Thus, if the noncharitable beneficiary is someone other than the donor or the donor's spouse, the taxable gift is $662,461.

➔ **Planning Point:** If a donor wants to name a successor noncharitable beneficiary who is not a spouse, the donor should retain the right, exercisable by his or her will, to revoke the successor beneficiary's interest at the donor's death. Treas. Reg. §§ 1.664-2(a)(4), 3(a)(4). This renders the successor beneficiary's interest incomplete, so that no gift tax is assessed on the interest. The successor beneficiary's interest will, however, be subject to estate tax at the donor's death, unless that interest is revoked, in which case all of the CRT assets pass immediately to or for charity.

c. Estate Tax Consequences. The remainder beneficiary must be an organization described in IRC §§ 2055(a) and 170(c) in order to qualify for the estate tax charitable deduction. If the donor is a beneficiary of the CRT, then the CRT will be includible in the donor's gross estate for federal estate tax purposes. If the CRT is established at the donor's death, however, an estate tax deduction will be available to the donor's estate for the remainder interest.

If the property is passing outright to charity at the donor's death, then the charitable deduction equals the net fair market value of the property at the time of the donor's death. If the property is remaining in trust for the benefit of another individual, then the estate tax charitable deduction is limited to the actuarial remainder value of the trust assets. The value of the noncharitable interests will be subject to estate tax. If the only noncharitable beneficiary other than the donor is the donor's spouse, then the estate tax marital deduction will be available. IRC

§ 2056(b)(8). If the noncharitable beneficiary is not the donor's spouse, then the actuarial value of the beneficiary's interest will be subject to estate tax, and the donor's unused estate tax applicable exclusion amount may be used to eliminate or reduce any estate tax.

3. Other Considerations

a. Choice of Trustee. The donor may name any person, including the donor, or a corporate fiduciary to act as trustee. If the trustee will have the power to make distributions among a class of noncharitable beneficiaries or if any hard-to-value assets are transferred to the trust, the trust may be disqualified if the donor or a party controlled by the donor is acting as trustee. Under these circumstances, the trust instrument should provide that all discretionary powers will be exercised and valuations of hard-to-value assets will be performed by an independent trustee.

➔ **Planning Point:** A charity that is a designated remainder beneficiary of the CRT may act as trustee if not prohibited by state law. Donors often name charities as trustee of their CRTs to minimize trustee fees, as charities customarily waive such fees. A charitable remainder beneficiary generally may not act, however, where the trust property includes hard-to- value assets, although it may choose to act and obtain an independent appraisal.

➔ **Planning Point:** Trustee fees that are paid may not be charged against the unitrust amount or the annuity amount. Doing so will result in disqualification of the CRT. See Rev. Rul. 74-19, 1974-1 C.B. 155.

➔ **Planning Point:** If the donor is acting as trustee, payment of trustee fees usually will not constitute self-dealing as long as the payments are reasonable. See PLR 8035078.

If the donor is serving as trustee, he or she should not retain any powers that would cause the trust to be subject to the grantor trust rules. Treatment as a grantor trust prevents a trust from qualifying as a CRT. Treas. Reg. § 1.664-1(a)(4).

➔ **Planning Point:** If the donor wants the trustee to be able to "spray" the unitrust or annuity amount among a specified class of beneficiaries, then the donor's serving as trustee will cause the CRT to be treated as a grantor trust for income tax purposes, thereby causing the CRT to be disqualified and its income to be taxable to the donor rather than taxable under the tier system. See Treas. Reg. §§ 1.664-2(a)(3)(ii), 3(a)(3)(ii).

➔ **Planning Point:** The retained power to designate the charitable remainder beneficiaries in the donor's will or other document will not cause the trust to be treated as a grantor trust. See IRC § 674(b)(4).

b. Choice of Assets to Contribute to a CRT. Many CRTs are funded with appreciated property because no gain will be recognized on the transfer of property to the trust.

Caution should be used if the donor wishes to contribute unproductive or low-yield assets, such as land or closely held stock.

➔ **Planning Point:** A net income CRUT, with or without the make-up provision, is a good candidate for such assets because it avoids mandatory unitrust payments in years in which the income yield on the trust assets is low. If the assets are sold and reinvested in more productive assets, then the trustee can begin to pay the full unitrust amount. A CRAT is a bad candidate for such assets because it requires the distribution of the specified amount regardless of whether the assets have generated income. Additionally, while additional property can be added to a CRUT to provide for the necessary payments, no additional property may be added to a CRAT.

As noted above, a CRT forfeits its tax-exempt status for any year in which UBTI is realized by the trust. Therefore, the donor must consider whether property contributed to a CRT will generate UBTI.

➔ **Planning Point:** In most situations, mortgaged property should not be contributed to a CRT, even if the CRT is not liable for the debt. Subject to certain exceptions, the mortgage is treated as acquisition indebtedness. This treatment means that the CRT could realize debt-financed income, which is treated as unrelated business income. IRC § 514(c)(2). If the donor is liable for the debt, the trust's payment of the debt would be self- dealing under IRC § 4941 because it would have the effect of discharging a legal obligation of a disqualified person (i.e., the donor).

➔ **Planning Point:** Even real estate not subject to a mortgage may generate unrelated business income, if real estate taxes are a lien on the property under state law and the real estate taxes are paid late. In that situation, late payment of the taxes would cause the lien on the property to be treated as a mortgage that would be characterized as acquisition indebtedness, thereby possibly generating debt-financed income.

➔ **Planning Point:** Limited partnership interests, including publicly traded limited partnership interests, often generate unrelated business income.

c. **Using a CRAT or a CRUT**. A CRAT may be preferred by individuals who are less tolerant to risk and are worried about deflation because the value of the annual annuity remains constant regardless of any increase or decrease in the value of the trust property. If the property contributed to the trust is difficult to value, a CRAT will be preferable because the asset must be valued only at the time of contribution rather than annually, as with a CRUT.

A CRUT may be preferred by individuals who are more risk tolerant and are worried about the effect of inflation, on the assumption that the fair market value of the assets will increase with inflation. As the fair market value of the assets increases, the unitrust payment increases. If the donor wishes to make additional gifts to the trust, a CRUT should be selected because no additional gifts may be made to a CRAT.

If a net income CRT is desired, then the donor can use only a CRUT. A CRUT offers more flexibility than a CRAT in designing an interest to meet cash flow needs or to deal with property contributed to the CRUT that is not producing income. This flexibility is not available with a CRAT.

➔ **Planning Point:** If older private beneficiaries are involved, a CRAT may be preferable, because of its greater certainty, and because the impact of inflation is not as large a factor if the expected duration of the CRT is shorter. This also means that the CRUT format usually is preferred for younger beneficiaries because of the anticipated longer duration of the CRT.

d. Waiver of Right of Election Against CRT. As discussed above, IRC § 664(d)(1)(B) provides that a charitable remainder annuity trust ("CRAT") may make annuity payments and qualified gratuitous transfers only to or for the use of a person not described in IRC § 170(c). For a charitable remainder unitrust ("CRUT"), IRC § 664(d)(2)(B) provides that no amounts other than (1) the unitrust payments and (2) qualified gratuitous transfers may be paid to or for the use of any person other than an organization described in IRC § 170(c).

In Rev. Proc. 2005-24, 2005-16 I.R.B. 909, the IRS provided a "safe harbor" procedure for these charitable remainder trusts ("CRTs") that, if followed, will cause the right of the grantor's spouse to elect against the grantor's will to be disregarded for purposes of determining whether the CRT meets the requirements of IRC § 664(d)(1)(B) or IRC § 664(d)(2)(B). The safe harbor procedure requires the surviving spouse to waive irrevocably the right of election with respect to the assets of the CRT to ensure that no part of the trust will be used to satisfy the elective share. Without the safe harbor procedure, the requirements of IRC §§ 664(d)(1)(B) and 664(d)(2)(B) would not be satisfied in situations where the grantor's spouse may exercise a right of election against the grantor's will and the elective share could include the assets of the CRAT or CRUT. In those situations, the mere existence of the right of election, whether or not the right is exercised, and the resulting possibility that the CRAT or CRUT could be invaded to satisfy the spouse's elective share, would (in the absence of the safe harbor procedure) cause the trust to fail to qualify as a CRT from inception.

The safe harbor procedure applies to any CRAT or CRUT if, under applicable state law, the grantor's surviving spouse has a right of election exercisable on the grantor's death to receive an elective, statutory share of the grantor's estate, and the share could be satisfied in whole or in part from assets of the CRAT or CRUT. The safe harbor procedure generally applies only to *inter vivos* and not testamentary CRATs and CRUTs.

For any CRAT or CRUT to which the safe harbor procedure applies, the spouse's right of election to receive an elective share of the grantor's estate, if the share could include any assets of a CRAT or CRUT created or funded by the grantor, is disregarded for purposes of determining whether the CRAT or CRUT has met the requirements of IRC § 664(d)(1)(B) or 664(d)(2)(B) continuously since its creation, if all of the following requirements are satisfied:
(1) the spouse must irrevocably waive the right of election to whatever extent necessary to ensure that no part of the trust (other than the annuity or unitrust interest of which the spouse is the named recipient under the terms of the trust) may be used to satisfy the elective share. This requirement

is met if the waiver is valid under applicable state law, in writing and signed and dated by the spouse and the spouse is not required to waive his or her right as the named recipient to receive the annuity or unitrust payment from the CRAT or CRUT; and (2) for CRATs and CRUTs created after June 27, 2005, requirement (1) above must be satisfied on or before the date that is six months after the due date (including extensions of time actually granted) of Form 5227, Split-Interest Trust Information Return, for the year in which the latest of the following occurs: (a) the creation of the trust; (b) the date of the grantor's marriage to his spouse; (c) the date the grantor first becomes domiciled or resident in a jurisdiction whose law provides a right of election that could be satisfied from the assets of the trust; or (d) the effective date of applicable state law creating a right of election. A copy of the signed waiver must be provided to the trustee of the CRAT or CRUT.

No waiver of the right of election is required if: (1) applicable state law does not provide the grantor's spouse with a right of election, exercisable at the time of the grantor's death, to receive an elective share of the grantor's estate; or (2) the spouse's elective share of the grantor's estate may not include any assets of the CRAT or CRUT (other than the annuity or unitrust interest payable to the spouse as the named recipient). The safe harbor procedure is not available to a CRAT or CRUT if the grantor's spouse exercises the right of election.

Whether the spouse's failure to waive the right of election is, by itself, sufficient to disqualify a trust as a CRAT or CRUT depends on the date on which the trust was created. For CRATs and CRUTs created after June 27, 2005, that are within the scope of the safe harbor rules, the spouse's failure to waive the right of election will result in the CRAT or CRUT failing to qualify under IRC § 664(d), whether or not the spouse exercises the right of election. For CRATs and CRUTs created before June 28, 2005, that are within the scope of the safe harbor rules, the spouse's failure to waive the right of election, combined with the spouse's exercise of that right of election, will result in the CRAT or CRUT failing to qualify under IRC § 664(d) continuously since its creation. Thus, for CRATs and CRUTs created before June 28, 2005, the IRS will disregard the right of election, even without a waiver, but only if the spouse does not exercise the right of election.

In response to criticism from commentators, the IRS released Notice 2006-15 on February 3, 2006, which extended this June 28, 2005 "grandfather date" until further guidance is issued. Thus, for any CRAT or CRUT that is established before further guidance is issued, the IRS will disregard a spouse's right of election, even without a proper waiver, but only if the surviving spouse does not exercise the right of election.

e. **<u>Private Foundation Rules</u>**. CRTs are split-interest trusts within the meaning of IRC § 4947(a)(2). This means that the restrictions on the operations of private foundations in IRC § 4941 (self-dealing), IRC § 4943 (excess business holdings), IRC § 4944 (jeopardy investments) and IRC § 4945 (taxable expenditures) may be applicable to CRTs, so the restrictions must be examined in detail to avoid excise taxes. These restrictions are discussed in greater detail above in the section on private foundations.

(1) **<u>Self-Dealing</u>**. IRC § 4941 relating to self-dealing is applicable to CRTs, even during the term of the noncharitable beneficiary's noncharitable interest. The applicability of IRC § 4941 means that CRTs should not enter into any business or other arrangements with the donor of the CRT, members of his or her family, or any other persons who would be disqualified persons with respect to the CRT under the attribution rules of IRC § 4946.

(2) **Excess Business Holdings and Jeopardy Investments**. A special exemption exists for the IRC § 4943 rule on excess business holdings and the IRC § 4944 rule on jeopardy investments if a charitable deduction was allowed for amounts payable to every remainder beneficiary, but not to any income beneficiary. IRC § 4947(b)(3)(B); Treas. Reg. § 53.4947-2(b)(1)(ii). This is the case with most CRTs, which means that most CRTs are exempt from the rules on excess business holdings and jeopardy investments. If any portion of the income interest in a CRT is payable to a charity and a charitable deduction was allowed for the gift of such interest, IRC §§ 4943 and 4944 will apply.

> ➔ **Planning Point:** As discussed above, a CRT may pay a portion of the annuity amount or unitrust amount to charity, but no charitable deduction is allowed for such a payment. Treas. Reg. §§ 1.664-2(d); -3(d). If no deduction is allowed, IRC §§ 4943 and 4944 will not apply. Some CRTs may, however, pay income other than the annuity or unitrust amount to charity for which a charitable deduction is permitted.

Although CRTs may be exempt from the jeopardy investment rules, the trust document must not prevent the trustee from being able to invest the assets in a way that realizes a reasonable amount of income or gain. Treas. Reg. § 1.664-1(a)(3).

> ➔ **Planning Point:** Consequently, directions in the trust document to retain certain assets, or restrictions on the sale or disposal of certain assets, may cause the CRT to be disqualified. See PLR 8041100 (trustee directed to invest assets as investment counsel directed); PLR 7948108 (beneficiary approval required to change CRT's investments); PLR 7802037 (trustee required to invest only in tax-exempt securities).

The consequences of disqualification are that the donor loses the income, gift or estate tax charitable deductions that otherwise would have been available for the transfer of the assets into the CRT, and the CRT is subject to tax on its income just like any other complex trust would be.

G. Charitable Remainder Trusts as Retirement Plan Beneficiary

The income tax-exempt status of CRTs makes retirement assets, also known as income in respect of a decedent ("IRD") assets, particularly good assets for the CRT to receive at the donor's death. An IRD asset is inherited property that, had the decedent received it before death, would have been taxable income to the decedent. Although as a general rule inherited property is not subject to income tax, IRD is an exception to that rule. The individual who receives the IRD, or the decedent's estate if the IRD is distributed to the estate, must include the IRD on the income tax return for the year it was received. Additionally, IRD assets are included in a decedent's gross estate for federal estate tax purposes, and, therefore, are subject to estate tax. Although the recipient can claim an income tax deduction for the federal estate tax attributable to the IRD, the effect of the double taxation is to tax IRD assets at a very high rate.

> ➔ **Planning Point:** The most common sources of IRD are distributions from

a decedent's IRA, 401(k) or profit sharing plan.

1. Naming the CRT as Beneficiary

If an individual wishes to make a charitable bequest, making a gift of IRD to a charity saves income taxes. The trustee of a CRT created under a person's will or revocable trust instrument is designated as primary or contingent beneficiary of such person's qualified retirement plan or IRA proceeds. The individual can give other assets that are not subject to income tax to heirs.

2. Tax Consequences

a. **Income Tax**. The CRT does not realize taxable income upon receipt of the proceeds because the CRT is a tax-exempt entity. IRC § 664(c). The character of distributions out of the qualified retirement plan or IRA means nothing as far as the CRT is concerned (unless the CRT has UBTI). Because the IRD is distributed to the CRT, neither the donor's estate nor the donor's heirs will recognize taxable income when the IRD is distributed to the CRT.

b. **Gift Tax**. There is no gift tax consequence to this transaction so long as the beneficiary designation remains revocable.

c. **Estate Tax**. The decedent's estate will be entitled to an unlimited estate tax charitable deduction for the actuarial value of the remainder interest in the CRT. If the spouse of the participant or employee has an interest in the CRT and is the only noncharitable beneficiary, the marital deduction will shelter from estate tax the actuarially computed value of that interest, and the charitable deduction can be claimed for the balance of the value of the remaining trust property. IRC §§ 2056(b)(8), 2055(e)(2)(A).

If there are noncharitable beneficiaries other than the spouse of the participant or employee, the charitable deduction can be claimed only with respect to the actuarially computed value of the charitable remainder interest, and estate tax may be due on the actuarially computed value of all noncharitable interests. In this case, naming a CRT as the beneficiary will not eliminate estate taxes, but it will allow the children of the participant or employee to receive a benefit from the IRD assets, and the children will be taxed only on the distributions from the CRT rather than on all of the income from the IRD assets.

3. Considerations

a. **Required Distributions from Qualified Plans and IRAs**. Qualified pension and profit sharing plans and IRAs are subject to special rules governing their distribution during life. Under the old proposed regulations, the distribution rules were not favorable for naming a charity as a beneficiary of a qualified plan or an IRA. The old proposed regulations tied the calculation of the minimum amount that must be distributed during the participant's or employee's life to the life expectancy of the participant or employee and a "designated beneficiary." Because a charity is not a "designated beneficiary," the use of a charitable beneficiary limited lifetime distributions from the IRA or qualified plan to a period measured by the single life expectancy of the participant or employee, the effect of which was to increase the amount that must be distributed during life.

Under the final regulations, however, this is no longer the case. The identity of the designated beneficiary is irrelevant in calculating the lifetime distributions from a qualified plan or IRA. Thus, even with a charitable beneficiary, lifetime distributions can be measured using a uniform lifetime table (which generally results in smaller required distributions during life), and the fact that a charity is not a "designated beneficiary" will not affect the amount of the lifetime distributions.

b. Naming a Spouse as the Primary Beneficiary. If the participant or employee has a spouse, it adds flexibility to the estate plan if the spouse is designated as the primary beneficiary of the qualified retirement plan or IRA benefits, and the trustee of the CRT created under the will or revocable trust instrument of the participant or employee is designated as the contingent beneficiary. The spouse can either roll over such benefits and create his or her own CRT (or direct an outright charitable disposition) in his or her will or revocable trust instrument, or the spouse can make a qualified disclaimer to the participant's CRT.

c. Funding the CRT With Retirement Benefits. The CRT could be funded directly in accordance with a qualified retirement plan or IRA beneficiary designation. See, e.g., PLR 200234019. Alternatively, the qualified retirement plan or IRA proceeds could pass by beneficiary designation to the trustee under the will or revocable trust instrument of the participant or employee, and such trustee would then use such proceeds, along with any other available assets, to fund the CRT in accordance with applicable provisions of the will or trust instrument. Such provisions should set out a specific asset allocation or a percentage or fractional share of property to be transferred to the trustee of the CRT rather than designating a pecuniary amount for the CRT. Funding the CRT with a pecuniary amount will result in the acceleration of IRD.

d. Advantages of Naming a CRT as a Retirement Plan Beneficiary. The advantages of naming a CRT as a retirement plan beneficiary, as compared to designating someone other than a spouse (*e.g.*, a child of the participant or employee) as beneficiary of a qualified retirement plan or IRA include the following:

- Estate taxes are reduced because the actuarially computed value of the charitable remainder gives rise to a charitable deduction;
- The immediate recipient of the qualified retirement plan or IRA proceeds (the trustee of the CRT) realizes no taxable income upon receipt of such proceeds. Thus, there is a larger fund to invest from the outset;
- Because the CRT is an income tax-exempt entity, dividends, interest and capital gains are not diluted by income taxes. In sum, if the CRT lasts long enough after the death of the participant or employee, the economic benefits of income tax-free investing and reinvesting within the CRT will outweigh the first disadvantage discussed below; and
- Using a CRT may involve a substantial gift to charity. If the participant or employee is otherwise charitably inclined, this technique may be a good vehicle through which to accomplish part or all of his or her desired charitable giving.

e. Disadvantages of Naming a CRT as a Retirement Plan Beneficiary. The primary disadvantage of naming a CRT as a retirement plan beneficiary, as compared to designating someone other than a spouse (*e.g.*, a child of the participant or employee) as beneficiary of a qualified retirement plan or IRA is that when a CRT terminates, regardless of how long after its creation, all remaining trust property passes to the charitable remainder beneficiary. This issue can be addressed by designating the children of the participant or employee as successor noncharitable beneficiaries. Doing so may have estate tax consequences as described above, but the actuarial joint life expectancy of the children often will be long enough so that the CRT may last long enough to provide a net benefit to the family.

H. Charitable Lead Trusts

A charitable lead trust ("CLT") is another type of split-interest gift because both a charitable beneficiary and a noncharitable beneficiary receive interests in the same property. A CLT allows the donor to donate a limited interest in specified assets to a charity. The donor transfers property to an irrevocable trust that pays the designated charity a stream of payments (the "lead" interest) for a specified period of time. At the expiration of this period of time, the grantor may reclaim his or her interest in the assets or provide for the assets to be transferred to noncharitable beneficiaries.

Depending upon the type of CLT the donor elects to establish, the donor may obtain an income tax charitable deduction and a gift tax charitable deduction or an estate tax charitable deduction.

➔ **Planning Point:** The grantor loses the income from the asset contributed to the CLT. Therefore, a CLT should be established only by a grantor possessing other assets.

1. Requirements for Estate, Gift and Income Tax Charitable Deductions

A charitable deduction is allowed only if the charitable interest is in the form of an annuity interest or a unitrust interest. Accordingly, a CLT may be established as a charitable lead annuity trust ("CLAT") or a charitable lead unitrust ("CLUT"). IRC §§ 170(f)(2)(B), 2055(e)(2)(B), 2522(c)(2)(B); Treas. Reg. §§ 1.170A-6(c)(2), 20.2055-2(e)(2)(vi) and (vii), 25.2522(c)-3(c)(2)(vi) and (vii). There is no minimum or maximum amount that must be paid to charity from a CLT.

a. Annual Payments.

(1) Charitable Lead Annuity Trust. A CLAT provides for the payment of a fixed dollar amount to one or more charitable beneficiaries for a specified period of time, at least yearly, regardless of the income generated by the trust. The amount paid to the charity may be a fixed percentage of the initial fair market value of the trust assets or a stated sum. The stated sum may be for a term of years or for the life of an individual living at the date of the transfer. The amount of the stated sum may be changed by a specified amount at the expiration of a term. Treas. Reg. §§ 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi)(a), 25.2522(c)- 3(c)(2)(vi)(a).

> **EXAMPLE:** The CLT could provide that $50,000 be distributed to charity for 15 years and $100,000 for the remaining 10 years of a 25-year charitable term.

Income in excess of the annuity or unitrust payment may be distributed to the charitable beneficiary. The amount of the charitable deduction, however, is limited to the fair market value of the stated annuity or unitrust interest. Treas. Reg. §§ 1.170A-6(c)(2)(i)(C) and 6(c)(2)(ii)(C), 20.2055-2(e)(2)(vi)(d) and 2(e)(2)(vii)(d), 25.2522(c)-3(c)(2)(vi)(d) and 3(c)(2)(vii)(d).

(2) **Charitable Lead Unitrust**. A CLUT provides for the payment of a fixed percentage of the net fair market value of the assets of the trust, valued at least annually, to one or more charitable beneficiaries for a specified period of time, at least yearly. Because the trust assets are revalued annually, the unitrust payment fluctuates as the assets appreciate and depreciate.

b. **Term of the CLT**. A CLT may be established for a term of years or for the life of one or more individuals who are living at the time the CLT is established. Treas. Reg. § 1.170A-6(c)(2)(i)(A). There is no limit on the number of years a CLT may operate, although the term of the CLT may be restricted by local law. Only the following individuals may be used as measuring lives: the donor, the donor's spouse, and an individual who, with respect to all noncharitable remainder beneficiaries, is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries. Treas. Reg. §§ 20.2055-2(e)(2)(vi)(a) and (vii)(a), 25.2522(c)-3(c)(2)(vi)(a) and (vii)(a).

c. **Beneficiaries**. A charitable lead trust may specify one or more charitable beneficiaries. Additionally, the governing instrument may allow the trustee to allocate the income interest between two or more charitable organizations. The noncharitable remainder beneficiary may be individuals, trusts, estates, partnerships or corporations.

2. Valuing the Charitable Interest

The charitable deduction for income, gift and estate tax purposes is equal to the actuarial value of the charity's annuity interest or unitrust interest, determined under IRC § 7520. As noted above, a donor is allowed to use either the IRC § 7520 rate for the month in which the gift occurs, or either of the immediately preceding two months, whichever is the most favorable. In fact, because the IRC § 7520 rate is published on the 20th or 21st day of the preceding month, a donor may consider four months' rates when planning the date on which to establish a charitable remainder trust or charitable lead trust.

a. **Value of an Annuity Interest**. The value of the annuity interest in a CLAT is determined by subtracting the value of the remainder interest from the value of the property transferred to the CLAT.

> **EXAMPLE:** Donor, age 55, transfers $1,000,000 to a CLAT when the IRC § 7520 rate is 5.4%. The CLAT will pay the charity an annuity of $100,000 for Donor's life. The present value of the annuity (and the amount of the charitable deduction) is $929,008, and the value of the remainder interest is $70,992 ($1,000,000 - $929,008). If the IRC § 7520 rate were 7%, the value of the annuity would equal $916,434.

The IRC § 7520 regulations adopt the conclusion in Rev. Rul. 77-454, 1977-2 C.B. 351 that, in valuing an annuity payable for the life of an individual, the payment of which would exhaust the fund if the fund's total rate of return were limited to the IRC § 7520 rate used to value the annuity and if the measuring life outlived the exhaustion date, the value of the annuity must be calculated using a special method. Treas. Reg. §§ 1.7520-3(b)(2)(i), 20.7520-3(b)(2)(i), 25.2570-3(b)(2)(i). The value of such an annuity will be limited to the value of the right to receive it for the shorter of the measuring life or the period of time over which the trust could be expected to pay the annuity if its total return were limited to the IRC § 7520 rate used to value the annuity.

b. <u>Value of a Unitrust Interest</u>. The value of a unitrust interest is determined by subtracting the present value of all interests in the transferred property other than the unitrust interest from the value of the property on the date of the transfer. Changes in the IRC § 7520 rate have little effect on the valuation of the charitable interest in a CLUT. The exhaustion rules should not apply to a CLUT because it should be impossible to exhaust such a trust.

> **<u>EXAMPLE</u>:** Donor, age 55, transfers $1,000,000 to a CLUT when the IRC § 7520 rate is 5.4%. The CLUT will pay the charity a unitrust amount equal to 8% of the value of the trust for Donor's life. The value of the remainder interest is $200,150, and the amount of the charitable deduction equals $799,850. If the IRC § 7520 rate were 7%, the amount of the charitable deduction would equal $797,440.

c. <u>CLAT Safe Harbor Forms</u>. The IRS has released Rev. Proc. 2007-45, 2007-29 I.R.B. 89, which contains sample forms for *inter vivos* grantor and nongrantor CLATs. Rev. Proc. 2007-45 also contains annotations to the sample trusts and alternate provisions that may be integrated into the sample trusts. The IRS has also released Rev. Proc. 2007-46, 2007-29 I.R.B. 102, which contains a sample form, annotations and alternate provisions for a testamentary CLAT. The IRS states that, with regard to both releases, CLATs that are "substantially similar" to its sample trusts, or properly integrate one or more of the IRS's sample alternate provisions, will be qualified trusts under the revenue procedures' "safe harbor" and the donor will receive the applicable charitable deductions. The IRS generally will not issue a letter ruling on whether a CLAT is qualified and whether a donor is entitled to income, gift and/or estate tax charitable deductions. However, the IRS generally will issue letter rulings relating to the tax consequences of the inclusion in a CLAT instrument of substantive trust provisions other than those contained in its sample CLATs.

The revenue procedures provide that, for qualification under the safe harbor, only a single donor or a husband and wife can fund a CLAT. Furthermore, the trust must contain a provision that prohibits additional contributions.

3. Income, Gift, Estate and GST Tax Consequences

A donor may be entitled to an income tax deduction and/or a gift or estate tax charitable deduction for the value of the charity's lead interest.

a. <u>Income Tax Consequences</u>. To obtain an income tax deduction, the grantor must be treated as the owner of the lead interest for purposes of the grantor trust rules. That is, the CLT must be a grantor trust. IRC § 170(f)(2)(B).

The recommended method of obtaining grantor trust status is for the grantor or the grantor's spouse to retain a reversionary interest equal to at least five percent of the value of the trust property on the date of transfer. IRC §§ 673(a), 672(e). The reversion is valued under IRC § 7520. Many of the other powers that are used to obtain grantor trust status should not be invoked because they could violate certain of the private foundation rules or other rules that would disqualify the charitable interest.

(1) <u>Grantor CLT</u>. A grantor CLT is established during the lifetime of the grantor, and it is a "grantor trust," which means that the grantor is treated as the owner of the income produced by the trust. Accordingly, all items of income, deduction and credit of the trust are reported by the grantor on his or her personal income tax return rather than by the trust as a separate entity. As a result, the grantor is taxed on the trust's income each year even though the income is being paid to the charitable beneficiary.

The grantor of a grantor CLT is entitled to a charitable income tax deduction upon the creation of the CLT but, as noted above, the grantor is taxed on the trust income each year. The initial charitable deduction is equal to the present value of the charity's annuity interest or unitrust interest upon the creation of the trust. <u>See</u> Treas. Reg. §§ 1.170A-6(c)(3), 20.2055- 2(f)(2)(iv) and (v), 25.2522(c)-3(d)(2)(iv) and (v).

The grantor's charitable income tax deduction is subject to the percentage limitations on charitable gifts to public charities and private foundations. The income tax charitable deduction for a grantor lead trust is equal to the present value of the charity's income interest. For charitable lead trusts funded with cash or ordinary income property that benefit public charities, the charitable deduction for the value of the lead interest is limited to 30% of the donor's adjusted gross income (with a five-year carryover for any excess) because the gift is "for the use of" the charity rather than "to" the charity. IRC § 170(b)(1)(B); Treas. Reg. § 1.170A-8(a)(2). The same 30% limitation applies for cash gifts to CLTs that benefit private foundations. The limit on deductibility is 20% of adjusted gross income when a CLT that benefits a private foundation is funded with capital gain property. IRC § 170(b)(1)(D).

➔ **<u>Planning Point</u>:** A grantor CLT is advantageous for a donor who is in a high income tax bracket in the year the CLT is created, when the donor will be entitled to the income tax deduction, but who is expected to be in a lower income tax bracket in subsequent years, when the donor will be taxed on the trust's income.

(2) <u>Nongrantor CLT</u>. A nongrantor CLT is not a grantor trust, so the income of a nongrantor CLT is not taxed to the grantor. Rather, a nongrantor CLT is taxed as a separate entity, with income taxable to the trust. It is not exempt from income tax. The trust will receive an income tax charitable deduction for the income distributed to charity each year pursuant to the terms of the trust instrument. IRC § 642(c). The trust instrument may specify its own tier system, and if it does not, payments made to the charitable beneficiary will be considered to consist of a pro rata share of all items of the trust's income. Treas. Reg.

§§ 1.643(a)-5(b), 1.662(b)-2. Unlike CRTs, the character of payments made to charitable beneficiaries of CLTs for income tax purposes is not determined by a tier system.

➔ **Planning Point:** Without a specific allocation in the trust instrument, the trust may lose the benefit of the IRC § 642(c) deduction to the extent that capital gain or tax-exempt income is deemed distributed to the charitable beneficiary. Thus, the governing instrument should characterize distributions in the following order: ordinary income, capital gain, UBTI, tax-exempt income, and trust principal.

➔ **Planning Point:** Nongrantor lead trusts are advantageous for individuals who have reached their percentage limitations and, therefore, are not entitled to an income tax charitable deduction. By using a nongrantor trust, the grantor in effect receives an income tax deduction because the grantor is not subject to income tax on the income generated by the assets held by the trust.

➔ **Planning Point:** A charitable lead trust in which neither the donor nor the donor's spouse is taxable on the trust income and which names other family members as the remainder beneficiaries affords other benefits. The creation of the trust during life can result in assets passing to family members at reduced transfer tax costs. Future appreciation is not subject to estate or gift tax. The trust term and the yearly payment to charity often can be set up so that no or a small gift is deemed made to the family remainder beneficiaries even though family members may receive a substantial amount at the termination of the trust.

The tax on UBTI does not directly affect CLTs because CLTs are not tax-exempt trusts. A portion of a CLT's IRC § 642(c) charitable deduction may, however, be disallowed in any year in which the trust realizes UBTI. Treas. Reg. § 1.681(a)-2(b).

There are no percentage limitations on the amount of income that a CLT can deduct for payments made to charity. Thus, if all of the income is payable to a charitable beneficiary, the trust will be entitled to a charitable income tax deduction for the full amount paid. Because the trust has an unlimited charitable deduction, the trust can be used to avoid the percentage limitations applicable to individuals.

b. Gift and Estate Tax Consequences. The charitable gift or estate tax deduction allows a donor to obtain a discount in the value of the gift to the remainder beneficiaries. In the case of a CLAT, if the rate of return on the CLAT assets exceeds the IRC § 7520 rate used to value the charitable gift, then the excess will be transferred to the noncharitable beneficiaries free of estate and gift tax. A CLAT offers a potentially gift tax-free method of shifting future appreciation to beneficiaries while enabling a charitably-inclined client to make a gift to charity. The CLUT does not offer the same transfer tax advantages as the CLAT does. Because the amount of the unitrust payment increases as the value of the CLUT assets increases, any additional value benefits the charity rather than the noncharitable remainder beneficiaries.

(1) Gift Tax Consequences. If the CLT is established during the grantor's life, the grantor is entitled to a charitable gift tax deduction for the value of the charity's interest upon the creation of the trust. If the remainder beneficiaries are individuals other than the grantor, then the value of the remainder interest is a gift that is subject to gift tax when the trust is created. The remainder interest passes to the beneficiaries free of additional gift tax or estate tax, however, at the expiration of the CLT term. If the trust is designed so that the grantor receives the trust assets back at the end of the term of the trust, however, then the grantor has not made a gift, and there is no gift tax.

> **EXAMPLE:** Donor transfers $1,000,000 to a CLAT on January 1, 2003 when the applicable federal rate is 5.0%. The term of the trust is 10 years, and the annual payment to the charity is $50,000. The present value of the annuity payments is $386,085, and the value of the remainder interest is $613,915. Therefore, Donor would receive a gift tax charitable deduction in the amount of $386,085. If Donor designated his children as the remainder beneficiaries, Donor would have a taxable gift in the amount of $613,915. If Donor has not fully utilized his gift tax applicable exclusion amount, however, the remaining exemption may be applied, thereby reducing or even eliminating any gift tax payable.

(2) Zeroed-Out CLATs. It is possible to create a CLAT with a charitable lead interest equal to the entire value of the property transferred to the trust. Thus, the value of the remainder interest, which is the interest gifted to the noncharitable beneficiaries, would equal zero (a "zeroed-out CLAT"). As a result, no gift will be made to the noncharitable remainder beneficiaries even though family members may receive a substantial amount at the termination of the trust. A zeroed-out CLAT can be created only for a term of years because the exhaustion rule under Treas. Reg. § 1.7520-3(b)(2)(i) and Rev. Rul. 77-454, 177 C.B. 351, prevents the creation of a zeroed-out CLAT, the term of which is measured by the life of an individual.

> **EXAMPLE:** Donor transfers $2,000,000 to a 20-year CLAT when the IRC § 7520 rate is 5.4%. The CLAT is zeroed-out, and the annual payment to the charitable lead beneficiary is $165,972. Donor named his children as the remainder beneficiaries. The present value of the annuity payments is $2,000,000, so the value of the remainder interest is $0. Therefore, Donor would receive a gift tax charitable deduction in the amount of $2,000,000 for the charity's lead interest, and Donor would not pay gift tax on the gift to the remainder beneficiaries. If the assets experience a total return of 8% per year, then at the end of 20 years, there will be $1,726,693 available for the remainder beneficiaries.

(3) Estate Tax Consequences. If the CLT is established at the death of the donor, the donor's estate will be entitled to an estate tax charitable deduction in an amount equal to the present value of the charity's interest. If the trust is created during the donor's life and the trust is designed so that the donor receives the trust assets back at the end of the term of the trust, the assets of the trust will be included in the donor's gross estate for federal estate tax purposes.

c. **GST Tax Consequences**. The creation of a CLT is not subject to generation-skipping transfer ("GST") tax. If at the end of the term of the CLT the trust will terminate in favor of grandchildren or more remote descendants, such distributions will be subject to GST tax. Accordingly, to avoid the potential application of the GST tax, the trust assets should be distributed to the grantor's then living children when the CLT term ends.

(1) **Allocating GST Exemption Generally**. The tax rate imposed on a generation-skipping transfer depends on the trust's inclusion ratio, which in turn depends on the trust's applicable fraction. The inclusion ratio is: 1 minus the applicable fraction. The applicable fraction generally is:

$$\frac{\text{the amount of GST exemption allocated to the property}}{\text{the value of the property.}}$$

The GST tax is determined by multiplying the inclusion ratio by the GST tax rate (the top estate tax rate, which in 2011 will be 55%). The goal is to achieve an applicable fraction of 1 so that the inclusion ratio is zero. In that case, the 55% tax rate multiplied by a zero inclusion ratio equals zero, so there is no GST tax.

(2) **Allocating GST Exemption to CLATs**. Special rules apply for determining the applicable fraction of a CLAT. Treas. Reg. § 26.2642-3(a). The applicable fraction is:

$$\frac{\text{the ``adjusted GST exemption''}}{\text{the value of the property immediately after the termination of the charity's annuity interest.}}$$

The "adjusted GST exemption" is the amount of the donor's GST exemption allocated to the trust, increased by interest on that amount for each year of the charitable lead annuity term at the IRC § 7520 rate used to value the charitable gift or estate tax deduction. Treas. Reg. § 26.2642-3(b). Thus, if the IRC § 7520 rate is 5.4%, the adjusted GST exemption equals the GST exemption (assume the 2011 amount of $1,000,000) times 1.054^{years}.

> **EXAMPLE:** Donor funds a 20-year CLAT with $2,500,000 when the IRC § 7520 rate is 5.4%. At the end of the term of the charity's annuity interest, the assets are worth $6,000,000. Donor allocated all of her remaining GST exemption ($1,000,000) to the CLAT. The applicable fraction is 47.72%, determined as follows:
>
> $$\frac{\$1{,}000{,}000 \times (1.054)^{20}}{\$6{,}000{,}000}$$
>
> The inclusion ratio is 1 - 47.72%, which equals 52.28%. This inclusion ratio is then multiplied by the GST tax rate (55% in 2011), which equals 28.754%. The GST tax due is $6,000,000 x 28.754% =

$1,725,240.

Thus, the determination of the applicable fraction is not made until the end of the charitable term, using the value of the assets then in the trust. The donor does not know, when a CLAT is created that ultimately will pass to grandchildren or more remote descendants, whether or not there will be generation-skipping tax at the expiration of the charitable lead annuity interest. This special rule for CLATs discourages donors from using them with the remainder to grandchildren or more remote descendants because of the uncertainty of the ultimate result and the possibility of wasting GST exemption if the assets do not have a total return equal to the IRC § 7520 rate over the term of the trust.

(3) Allocating GST Exemption to CLUTs. Allocating GST exemption to a CLUT is easier than allocating it to a CLAT. Under IRC § 2642(a)(2), the applicable fraction for a CLUT is:

$$\frac{\text{the amount of GST exemption allocated to the trust}}{\text{the value of the property in the trust minus any estate tax or gift tax charitable deduction allowed.}}$$

EXAMPLE: Donor creates a $100,000 CLUT to pay Charity a 10% unitrust amount for 18 years. At the end of the 18-year term, the trust property will be distributed to Donor's grandchildren. The value of the gift tax charitable deduction is $85,000. Thus, Donor allocates $15,000 of GST exemption to the trust. The applicable fraction is 1, determined as follows:

$$\frac{\$15{,}000}{\$100{,}000 - \$85{,}000}$$

The inclusion ratio is 1 - 1 = 0, which means that no GST tax will be due.

Thus, it is possible to effectively allocate GST exemption to a CLUT. The problem, however, is that if the value of the trust property increases, the amount payable to charity increases, the result of which is that some of the GST exemption allocated to the CLUT may be wasted.

4. Other Considerations

a. Designation of Trustee. The grantor may name any person or corporate fiduciary to act as trustee, and the grantor can act as trustee as long as the grantor's powers as trustee are limited. For example, if the trustee will have the power to select the charitable beneficiaries, the gift to the trust may be incomplete for gift tax purposes, resulting in the inclusion of the trust in the grantor's gross estate for federal estate tax purposes, if the grantor is acting as trustee. Under these circumstances, unless the grantor intends to have the CLT included in his or her gross estate, the trust should provide that the designation of charitable beneficiaries will be done by an independent trustee.

➔ **Planning Point:** In the case of a grantor CLT, this consideration may be less important because it is likely that the trust property will be included in the grantor's gross estate.

b. **Private Foundation Rules**. CLTs are split-interest trusts within the meaning of IRC § 4947(a)(2). This means that the restrictions on operations of private foundations in IRC § 4941 (self-dealing), IRC § 4943 (excess business holdings), IRC § 4944 (jeopardy investments) and IRC § 4945 (taxable expenditures) may be applicable to CLTs, so these restrictions must be examined in detail to avoid excise taxes. These restrictions are discussed in greater detail above in the section on private foundations.

(1) **Self-Dealing**. IRC § 4941 relating to self-dealing is applicable to CLTs. The applicability of IRC § 4941 means that CLTs should not enter into any business or other arrangements with the donor of the CLT, members of his or her family, or any other persons who would be disqualified persons with respect to the CLT under the attribution rules of IRC § 4946.

(2) **Excess Business Holdings and Jeopardy Investments**. The prohibition on excess business holdings could be a problem for CLTs that hold closely held stock or limited partnership interests. There is, however, an exception if certain requirements are met. First, the excess business holdings prohibition can be overcome if the actuarial value of the charitable lead interest does not exceed 60% of the value of all interests in the trust, valued at the inception of the trust. The effect of the lower charitable interest value necessary to qualify for this exemption is to lower the charitable deduction. Second, the entire charitable interest and none of the remainder interest must be devoted to charitable purposes. Because the typical CLT provides that all income be distributed to the charitable beneficiaries, the trust should satisfy the second requirement. An identical exception exists for the jeopardy investment provisions.

I. Pooled Income Funds

A pooled income fund is another type of split-interest gift that is sanctioned by the Code. IRC § 642(c)(5). A donor transfers money or securities to a separately maintained fund created by a public charity, where it is invested with gifts of other donors. The donor retains an income interest for life but makes a gift of the remainder interest. The donor receives a pro rata share from the fund's earnings each year for life. Treas. Reg. § 1.642(c)-5(c)(1). At the donor's death, the donor's percentage of the fund is transferred to the charity. A donor also can name someone else as the income beneficiary of a gift to a pooled income fund.

➔ **Planning Point:** The donor cannot be the trustee and can have no management power over the resources in the trust fund.

1. Income Tax Consequences

The income the donor receives is taxed as ordinary income. The donor is entitled to an income tax charitable deduction for the value of the remainder interest.

The regulations regarding the definition of income under IRC § 643(b) provide that the charitable deduction for a contribution of long-term capital gain property is unavailable if the income beneficiary's right to income may be satisfied either as a unitrust amount or by adjusting between income and principal. Because the regulations allow such a fund's income beneficiaries to receive a unitrust amount that may be paid in part from principal, not all capital gains can be conclusively presumed to be permanently set aside for charity.

2. Gift Tax Consequences

The charitable deduction for the remainder interest is determined by subtracting the present value of the life income interest from the fair market value of the property transferred. The discount rate is equal to the highest yearly rate of return of the pooled income fund for the three immediately preceding taxable years. Treas. Reg. § 1.642(c)-6(e)(3).

The value of the charitable remainder interest is not subject to gift tax. If the donor creates a pooled income fund with payments to another individual other than the donor's spouse, however, the donor makes a gift equal to the present value of the income interest payable to the life beneficiary. The donor can avoid making a gift by retaining the right to revoke the successor life interest by the donor's will. The mere retention of the right to revoke the gift, whether or not exercised, avoids making a completed gift.

3. Estate Tax Consequences

If the donor retains the life interest in the pooled income fund, then the value of the donor's units in the fund at his or her death will be included in the donor's gross estate. The estate is, however, entitled to a charitable deduction, which offsets the amount included. If the successor beneficiary is the donor's spouse, an estate tax marital deduction will be allowed for the spouse's interest. If there is a successor beneficiary other than the donor's spouse, the value of such beneficiary's income interest is subject to estate tax, and the estate is entitled to a charitable deduction for the value of the charity's remainder interest.