LATEST CHARITABLE INCOME TAX AND ESTATE PLANNING STRATEGIES

by

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Columbia Law School

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WARNING: MAY CAUSE DROWSINESS

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Conrad Teitell's Credentials

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

LECTURER
He has lectured in all 50 states and the District of Columbia on taxes and estate planning for thousands of hours at programs sponsored by bar associations, estate planning councils, colleges, universities, law schools, community foundations, hospitals, museums, retirement communities, religious, health, social welfare and other organizations. He lectures annually at Columbia Law School's Stone Circle luncheon. He also teaches ethics in

charitable gift planning.

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

FELLOW
The American College of Trust and Estate Counsel.

A SPEAKER'S SPEAKER
Conrad Teitell founded and taught the American Bar Association's (ALI/CLE's) public speaking courses for over 25 years. He teaches public speaking to other professional advisers and laypeople and teaches public speaking for the Practicing Law Institute and the New York City Bar Association. He taught public speaking in a six-part PBS television series.

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

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

OTHER STUFF
Conrad Teitell, the subject of three lengthy interviews in *U.S. News & World Report*, is regularly quoted in such publications as *The New York Times, The Wall Street Journal* and *Forbes Magazine*. Profiled in *Bloomberg Personal Finance* as one of the nation's lawyers who has reshaped estate planning by helping clients protect wealth, avoid taxes and benefit charities, he is listed in *The Best Lawyers in America, Who's Who in America* and *Who's Who in American Law*. He has been awarded the designation "Distinguished Estate Planner" and is the recipient of the "Hartman Axley Lifetime Service Award" by the National Association of Estate Planners and Councils. He is a fellow of the American College of Trust and Estate Counsel. He is the recipient of the *American Law Institute/American Bar Association's* Harrison Tweed Award for Special Merit in Continuing Legal Education and the recipient of the Connecticut Bar Association—Federal Tax Institute of New England's Outstanding Achievement Award. He has been named the Stamford, Connecticut Trusts and Estates *Lawyer of the Year* by the publication, *Best Lawyers in America*.

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I. INCREASED CHARITABLE DEDUCTIONS FOR 2021

Non-itemizer charitable deduction. The charitable deduction for cash gifts to public charities (except Donor Advised Funds and Supporting Organizations) of the 2020 law is available in 2021 with one improvement. In 2020, the $300 non-itemizer deduction was capped at $300 for both separate and joint returns. For 2021, the cap for a joint return is $600.

Alert. The substantiation rules for cash gifts by itemizers also apply to nonitemizers:

- *Regardless of the amount, recordkeeping requirements are satisfied only if the donor* maintains as a record of the contribution, a bank record or a written communication from the donee showing the name of the donee and the date and amount of the contribution. A bank record includes canceled checks, bank or credit union statements and credit card statements.

- *Bank or credit union statements* should show the name of the charity and the date and amount paid. Credit card statements should show the

name of the charity and the transaction posting date. The recordkeeping requirements will not be satisfied by maintaining other written records. Donations of money include those made in cash, by check, electronic funds transfer, credit card, text message, and payroll deduction.

- *Written communication* includes electronic mail correspondence.

- *Contributions made by payroll deduction.* For a charitable contribution made by payroll deduction, a donor is treated as meeting the substantiation requirements if no later than the date for receipt of substantiation the donor obtains: (1) a pay stub, Form W-2, "Wage and Tax Statement," or other employer-furnished document that sets forth the amount withheld during the taxable year for payment to a donee; and (2) a pledge card or other document

prepared by or at the direction of the donee that shows the name of the donee. However, a blank pledge card is not substantiation.

The IRS points out in IRS Publication 557 *Tax Exempt Status for Your Organization:* "The donor is responsible for requesting and obtaining the written acknowledgment from the donee."

Double Alert. The penalty for overstating these contributions is increased from 20 percent to 50 percent under IRC §6662.

Itemizer 100 percent AGI ceiling for cash gifts to public charities (except Donor Advised Funds and Supporting Organizations) is extended for 2021.

For cash gifts by corporations. The 2020 increased charitable deduction ceiling from 10 percent to 25 percent is extended through 2021.

Corporate food inventory gifts. The 2020 ceiling increase of 15 percent to 25 percent is extended through 2021.

Corporate deductibility requirements before 2020 (presumably, the same requirements will apply to 2020 and 2021 gifts of food inventory):

- *To be eligible for the enhanced deduction.* The contributed property must be inventory contributed to an IRC §501(c)(3) charity (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or minors, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer with a written statement that the donee's use of the property will be consistent with those requirements. For contributed property subject to the Federal

Food,Drugand Cosmetic Act, the property must satisfy the applicable requirements of the Act on the date of transfer and for 180 days before the transfer.

• *Cost-of-goods-sold adjustment.* A donor making an inventory contribution makes a corresponding adjustment to the cost of goods sold by decreasing that cost by the lesser of the fair market value of the property or the donor's basis in the inventory. Thus if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by that value. *Bottom line.* The difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

• *To get the enhanced deduction.* The taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of disputes between taxpayers and the IRS.

For example, in *Lucky Stores Inc.*, 105 T. C. 420 (1995) the Tax Court held that the value of donated surplus bread inventory was the bread's full retail price rather than half the retail price, as the IRS asserted.

• *Apparently wholesome food—definition.* Food intended for human consumption that meets all quality and labeling standards imposed by federal, state, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, etc.

II. LOOKING DOWN THE TAX ROAD—2021 AND LATER YEARS

If income tax brackets are raised, the charitable deduction will result in increased tax savings. **BUT**, Mr. Biden’s campaign proposal would require high-bracket taxpayers to deduct their charitable gifts as if they were in the 28 percent bracket.

The top gift and estate tax rates could be increased and the exemption could be reduced. If enacted, this would be an incentive for increased testamentary charitable gifts. Currently, less than one-tenth of one percent of estates are subject to the estate tax.

Conservation easements. Legislation could cap the charitable deduction for these gifts and increase penalties for overvaluations.

Life-Income Charitable IRAs. Bipartisan legislation could also provide tax-free transfers from IRAs to public charities (other than Donor Advised Funds and Supporting Organizations).

III. THE SECURE ACT—CHARITABLE GIFT IMPLICATIONS

The SECURE* Act kills the stretch IRA for most heirs. Until this new legislation, an heir could generally have required minimum distributions stretched over his or

her life expectancy. And that minimized taxes—plus the assets in the heir's IRA grew tax-free until withdrawn.

The new law—highlights:

• Required Minimum Distributions start at age 72 (up from 70½). • Most heirs' IRA payments can't be stretched out for more than 10 years.

*Setting Every Community Up for Retirement Enhancement Act (effective 1/1/20). The U.S. Bureau of Acronyms must have worked overtime and had to stretch to come up with this acronym.

**How I came up with the CHIPS acronym: Many long showers—where I do my best thinking —didn't help. But then, it hit me while marathon TV football viewing with two grandsons over the holidays. W e consumed bushels of CHIPS. Simply put, Charities and Heirs will be in the CHIPS using Income Plans to Stretch heirs' IRA payments. And that's my story—and I'm sticking to it.

• But these beneficiaries (with some qualifications) qualify for "life-expectancy" IRA payments: (1) the IRA owner's surviving spouse; (2) her or his minor child; (3) disabled beneficiaries; (4) chronically ill individuals; and (5) individuals who aren't more than 10 years younger than the deceased IRA owner.

Among other provisions, the SECURE Act:

• Repeals the prohibition on contributions to a traditional IRA by an individual who has attained age 70½.

• Allows long-term part-time workers to participate in 401(k) Plans. • Allows penalty-free withdrawals from retirement plans up to $5,000 per individual for any "qualified birth or adoption distributions." • Expands 529 education savings accounts to cover costs associated with registered apprenticeships and up to $10,000 of qualified student loan repayments (including those for siblings).

Drum roll—enter the CHIPS IRA (Charity Heirs Income Plan Stretch IRA)—w**orking around the ten-year stretch IRA limitations using charitable remainder trusts:

• Taxwell Smart provides that on his death a charitable remainder unitrust (meeting all the CRUT requirements—e.g., payout of at least five percent, 10 percent minimum charitable remainder interest) pay his grandchild for life or term of years (not exceeding 20 years). This will save estate taxes (estate tax charitable deduction for value of charitable remainder interest) for Mr. Smart if he's subject to that tax.

• Whether Taxwell is or isn't subject to the estate tax, the transfer of his IRA at his death to fund the CRUT won't subject the heir to tax on Income in Respect of a Decedent (IRD). Payments to the grandchild will be taxable under the four-category taxation regime. And a charitable gift is made at the trust term's end.

- Keep in mind that the Stretch CRT has to pass the 10 percent minimum remainder interest requirement. For younger heirs, the stretch can't be for life but will be for a term of years (not exceeding 20 years). And for CRATs, the trust must also pass the five-percent probability test of Rev. Rul. 77-374.

- **No surprise, charitable intent is important.** The cost of generosity is reduced by the tax savings to the heir who can have IRA payments stretched more than ten years.

Giving an heir an income tax charitable deduction:

- Suppose Taxwell's grandson is a successful farmer growing hedge funds in Greenwich, Connecticut. Grandson Hedgely is already rich beyond the wildest dreams of avarice.

  Nevertheless, Taxwell creates a testamentary CRUT for Hedgely with his IRA. Several years go by and Hedgely concludes he really doesn't need the CRUT payments. So he gives his remaining life interest to the named qualified public charitable remainder organization (or qualified public charity that Hedgely has named if he has been given that power). Hedgely will then get an income tax charitable deduction for the then value of his life interest. Taxwell has, in effect, given Hedgely an income tax charitable deduction.

  Hedgely on his own figured out how to benefit a charity during the term of his CRUT life interest *and* get an income tax charitable deduction.

- Suppose Taxwell's estate is subject to the estate tax. On his deathbed he tells Hedgely that he's creating a testamentary CRUT for him funded with Taxwell's IRA. Taxwell extracts Hedgely's promise that he'll give his remaining life interest to the named publicly supported charitable remainder organization within two years of Taxwell's death.

  If IRS Agent Seigfried learns of this, he could well deny Taxwell's estate an estate tax charitable deduction for the charitable remainder interest; **and** collect IRD tax from Hedgely. Taxwell and Hedgely had better talk about this in a motel room with the water running.

Parthian shot. Will the age for taking required minimum distributions (RMDs) now age 72 (instead of 70½) keep donors (ages 70½ to 71) from making charitable distributions from their IRAs until age 72?

Time will tell. Remember, distributions from IRAs when the RMD age was 70½ qualified as QCDs even though they weren't RMDs. So donors can still at ages

70½ to 71 make charitable gifts from their IRAs.

IV. CHARITABLE REMAINDER GIFTS OF PERSONAL RESIDENCES AND FARMS

Highlights

- **Enjoy your house for life (a survivor can too)**

- Live on and profit from your farm for life (a survivor can too)

- **Get income tax savings NOW for property not going to charity until after life**

- **Record low 0.6% IRC §7520 rate makes this an incredibly tax smart charitable gift (and that's not puffery)**

Background. The tax plusses and minuses of transfers for charitable remainders in personal residences and farms, charitable gift annuities, charitable remainder trusts and Charitable Lead Annuity Trusts (CLATs) are affected by changes in the IRC §7520 rate. Also affected are the benefits and detriments of general estate planning techniques such as Grantor Retained Annuity Trusts (GRATs), private annuities and Qualified Personal Residence Trusts.

This is an especially opportune time for individuals considering giving their personal residences or farms to charities by will to consider giving those properties to charities now, but retaining life enjoyment. They'll get significant *income* tax savings now for property that goes to charity at death.

Less than one-tenth of one percent of estates are currently subject to the federal estate tax. So getting an *income* tax deduction now is smart planning. And the super-wealthy (rich beyond the dream of avarice*) who are still subject to the federal estate tax, will get *estate* tax savings too.

The charts on the next page show why now is an especially good time for charitably minded individuals to give remainder interests in personal residences and farms while keeping lifetime enjoyment. A primer on these charitable gifts follows the charts.

*Attributed by some to Samuel Johnson or G.E. Moore.

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GIFTS OF $1,000,000 PERSONAL RESIDENCE
ASSUMES VALUE OF RESIDENCE LESS SALVAGE VALUE = $500,000
HOUSE AND VALUE OF LAND PLUS SALVAGE VALUE = $500,000

Age	**This month's** IRC §7520 rate 0.6%	IRC §7520 rate 3%	IRC §7520 rate 5%	IRC §7520 rate 8%	IRC §7520 rate 10%
60	$675,575	$437,580	$319,290	$213,600	$170,345
65	$727,250	$506,325	$388,340	$275,550	$226,310
70	$777,000	$579,040	$465,850	$350,265	$296,615
75	$823,405	$653,100	$549,355	$436,655	$381,245
80	$864,235	$723,350	$632,500	$528,095	$474,005
85	$898,250	$786,370	$710,345	$618,250	$568,690

Ages	0.6% rate	3% rate	5% rate	8% rate	10% rate
60 & 65	$623,255	$360,480	$236,570	$133,105	$94,015
65 & 70	$680,115	$431,125	$303,540	$187,780	$140,280
70 & 75	$735,725	$508,190	$382,130	$258,395	$203,550
75 & 80	$788,170	$588,450	$469,585	$344,140	$284,470
80 & 85	$803,305	$667,135	$560,465	$440,350	$379,540

ASSUMES VALUE OF RESIDENCE LESS SALVAGE VALUE = $100,000 HOUSE AND VALUE OF LAND PLUS SALVAGE VALUE = $900,000

Age	**This month's** IRC §7520 rate 0.6%	IRC §7520 rate 3%	IRC §7520 rate 5%	IRC §7520 rate 8%	IRC §7520 rate 10.0%
60	$839,627	$529,156	$377,946	$245,772	$192,741
65	$865,770	$590,625	$445,964	$309,910	$251,478
70	$890,712	$654,136	$520,450	$385,597	$323,755
75	$913,785	$717,460	$598,903	$471,259	$409,041
80	$933,951	$776,478	$675,556	$560,307	$500,961
85	$950,776	$828,626	$746,165	$647,000	$593,402

Ages	0.6% rate	3% rate	5% rate	8% rate	10% rate
60 & 65	$813,419	$461,960	$298,666	$164,429	$114,539
65 & 70	$842,335	$526,321	$366,300	$222,900	$164,800
70 & 75	$870,329	$594,582	$443,218	$296,071	$231,478
75 & 80	$896,490	$663,946	$526,517	$382,524	$314,518
80 & 85	$919,821	$730,547	$611,101	$477,302	$409,908

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Both sets of examples assume a $1,000,000 residence and 45 year depreciable life. The first set assumes half is house and half is land. The second set assumes a trending case where most of the value is location and the house may even be a teardown. In the second set of examples, the house value is $100,000 and the land value is $900,000, Note: since the IRS equates use of the residence to an income stream, if the IRC §7520 rate declines to zero (not impossible), the deduction for the remainder in the land would be 100 percent.

Lawrence Katzenstein, the creator of the examples on the previous page, is a nationally recognized estate and charitable planning lawyer, writer and lecturer. He is a partner in Thompson Coburn, resident in the firm's St. Louis office. Larry is the creator of Tiger Tables software (tigertables.com) to compute the tax consequences of all types of charitable and other plans.

PRIMER—REMAINDERS IN PERSONAL RESIDENCES AND FARMS

Donor gets income, gift and estate tax benefits by making a charitable gift of his or her personal residence or farm, even though the donor keeps the right to life enjoyment. A life estate may be retained for one or more lives. Or, the donor's right to stay in the property may be retained for a term of years. Always check state rules against perpetuities.

Realty only. The deduction isn't allowed for future interests in furnishings or other tangible personal property. Rev. Rul. 76-165, 1976-1 CB 279. However, property that qualifies as a "fixture" under local law can be included in the value. See Letter Ruling 8529014 (heating and air conditioning system). This favorable ruling hinged on the air conditioning and heating system being considered "real property" under local law. Had the system been deemed "tangible personal property," income and gift tax charitable deductions would have been denied. And it wouldn't qualify for the annual gift tax exclusion because it was a gift of a future interest.

Pointer. A donor who contributes a remainder interest in a personal residence or farm during lifetime, and who also wants charity to have the furniture, farm machinery, or other tangible personal property **and** believes he'll be subject to the federal estate tax should give the tangible personal property by will. As always, take any state taxes into account

DEFINITIONS:

- A personal residence is any property used by a donor as his personal residence, Reg. §1.170A-7(b)(3), though it needn't be his principal residence.

- A donor's vacation home may be a personal residence. 12

- IRC §280A(d)(1) (pertaining to disallowance of certain business expense deductions) defines "personal residence" as a dwelling used for personal purposes for more than: (1) 14 days; or (2) 10 percent of the days during the year for which the unit is rented at fair rental.

  Donors asked IRS to rule a gift of a remainder interest in their vacation home would qualify for the deduction. They used the house 14 days each year, and held it out for rental during the remaining 50 weeks. The house was actually rented only two weeks each year. They "requested a ruling that the actual rental time, as opposed to availability for rental, would be applied in determining whether the house qualifies as a "personal residence." But IRS said that it couldn't rule on the issue "because of the factual nature of the matter involved."

• **The term "personal residence" also includes stock owned by a donor as a tenant-stockholder in a cooperative housing corporation** if the dwelling that he is entitled to occupy as stockholder is used by him as his personal residence.

• **A farm (IRC § E.I.E.I.0**) **is any land used by a donor (or his tenant) for the production of crops, fruits, or other agricultural products, or for the sustenance of livestock.** The term "livestock" includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, **chickens*,** turkeys, pigeons, and other poultry. A farm includes the improvements thereon. Reg. §1.170A-7(b)(4); Rev. Rul. 78-303, 1978-2 CB 122.

General and actuarial principles. For the income tax charitable deduction, depreciation (computed on the straight-line method) and depletion must be taken into account in determining the value of the remainder interest. These values are, under current law, discounted at a rate that changes monthly. **Note.** Depreciation applies only to the structure, not to the land.

For gift and estate tax purposes, the Code doesn't specify that depreciation (or depletion) must be taken into account in valuing the remainder interest. Nor do Treasury regulations [Reg. §1.170A-12(a)].

Pointer. The life tenant's obligation to maintain the property should increase its useful life. The higher the value at the end of the useful life, the larger will be the charitable deduction.

*But not rubber chickens.

Computing the charitable deduction for a remainder interest in a personal residence or farm isn't simple. The easier part is the purely mechanical computation using IRS tables and formulas. The difficult part is the determination of hard fact questions: (1) the fair market value of the property—with the fair market value allocated between the land and the structures; (2) the "estimated useful life" of the structure (the longer the estimated useful life, the larger the charitable deduction); and (3) the value of the structure at the end of its estimated useful life (the greater the value at the end of its estimated useful life, the larger the charitable deduction).

The amount deemed contributed is not necessarily the amount that may be deducted. As always, take into account the various percentage ceilings for public charities and private foundations; and the holding period and carryover rules.

CRUCIAL. The property must be appraised by a "qualified appraiser."

And the qualified appraiser must:

• Break down the valuation between the structure and the land. • State the

estimated useful life of the structure—and how determined. • State the

salvage value—and how determined.

• State the value of the land—and how determined.

A donor who has given a remainder interest in his residence or farm to charity, reserving a life estate for himself, should be entitled to an income tax charitable deduction if he later con-tributes his remaining life interest to the charitable remainder organization thereby accelerating the charitable remainder. The income tax deduction would be for the then value of the donor’s life interest based on the donor’s then age, the then IRC §7520 rate and the then value of the property,

Caution. If the property in which the partial interest exists was divided to create an interest that would avoid the "less than the entire interest" rule, no deduction is allowable. It is a fact question whether a donor created a partial interest for reasons other than avoidance of IRC §170(f)(3)(a). If a donor, for example, can show that she retained a life interest because she wanted to keep living there, but that she no longer wants to, she should .be entitled to a charitable deduction of the current value of her remaining life interest. See, e.g., Rev. Rul 76523, 1976-2 CB 54.

Caution. In Rev. Rul. 77-305, 1977-2 CB 72, IRS disallowed the charitable deduction where a donor and the charity agreed that if the donor was unable

to continue living in the house (due to illness or old age), the house would be sold and the proceeds divided pro rata between the parties.

GIFT TAX RULES:

- **Life estate reserved for donor's life.** The value of the charitable remainder interest in a personal residence or farm is not subject to federal gift tax. IRC §2522(c)(2); Reg. §25.2522(c)-3(c)(2)(ii), (iii). **However,** the donor must report the remain-der gift (regardless of size because it is a future interest) on a federal gift tax return. IRC §6019(b). The donor then takes an offsetting gift tax charitable deduction.

- **Life estate for nonspouse beneficiary.** A donor who gives a remainder in a personal residence or farm creating a life estate in another (e.g., a child) makes two gifts: one to the life beneficiary (the value of his or her life interest), and one to the charity (the value of its remainder interest).

- **Life tenant's interest.** The donor makes a gift to the life tenant of the value of his or her life interest. The life interest is a present interest and qualifies for the annual gift tax exclusion. IRC §2503(b). If the value of the interest exceeds the annual gift tax exclusion and the "tentative" tax on the gift is not offset by unified transfer tax credit, gift tax will be due.

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

• **Life estate retained for two lives.** A donor who makes a gift of a remainder interest using his own separate property, reserving a life estate for his life and then for the life of another, makes two gifts: one to the charity (the remainder interest), and one to the successor beneficiary (her life interest if she survives the donor).

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

Second life tenant's interest when tenant is not donor's spouse. Donor makes a gift to the life tenant of the value of her survivorship life interest. Because the gift is of a future interest, it doesn't qualify for the gift tax annual exclusion. If the "tentative" tax on the gift is not offset by unified transfer tax credit, gift tax will be due.

Pointer. Donor can avoid making a completed gift to the survivor by providing in the deed of transfer that he reserves the right to revoke the survivor's life interest Unlike charitable remainder unitrusts, annuity trusts, and pooled income funds, the right to revoke a survivor's life interest in a personal residence or farm needn't be exercisable only by will. A donor who makes a charitable remainder gift of a personal residence or farm may retain the lifetime right to revoke a survivor's interest without losing the tax benefits for the charitable gift. The donor need not actually exercise the right to revoke; merely retaining the right avoids the donor's making a completed gift, for gift tax purposes, to the survivor beneficiary. Should the donor exercise the right to revoke, the donor should get an income tax charitable deduction for the then value of the successor beneficiary's survivorship interest. Reg. §25.2511-2(c); Letter Ruling 7830103.

Second life tenant's interest when tenant is donor's spouse. A U.S. citizen spouse's future life estate doesn’t qualify for the gift tax marital deduction as qualified terminable interest property (QTIP) because the spouse's life interest starts in the future. Gift tax concerns can be avoided by having the donor reserve the right in the deed to revoke the surviving spouse's life interest. (Note. A noncitizen spouse's life estate can't qualify for the special $157,000 (in 2020) annual gift tax marital exclusion because it's a future interest. The exclusion is adjusted annually for inflation.)

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

Wife and Husband own their house as joint tenants. They contribute a remainder interest to charity retaining a life interest.

The interests of the life tenants. The actuarially older joint tenant makes a gift

to the actuarially younger of the difference in value of their survivorship interests.

To avoid adverse gift tax implications, each life tenant can—in the deed—reserve the right to revoke the survivor's interest in half the joint property. If the right is exercised, half the property will be transferred to the remainder organization outright at the death of the donor who exercised the right. Neither beneficiary generally exercises the right, but keeping the right avoids gift tax concerns.

Caution. If the right is actually exercised, the surviving tenant will be only have a half interest in the property.

The life estate should be retained by the donors jointly for life and then pass to the survivor of them for life.

ESTATE TAX IMPLICATIONS

Background. Regulations proposed by the IRS and Treasury in 2007 detailed the estate tax consequences for charitable remainder annuity trusts and unitrusts (some noncharitable trusts, too) created during a donor's life for the period of his or her life.

In the main the proposals confirmed and amplified revenue rulings issued in 1976 and 1982. The proposed regulations were reasonable.

What the proposed regulations didn't do. They didn't specifically deal with the estate tax implications of inter vivos pooled income fund gifts or inter vivos gifts of remainders in personal residences and farms. On behalf of the American Council on Gift Annuities, I submitted a statement asking the Service to spell out the estate tax consequences of young (less than three years old) and mature (at least three years old) pooled income funds and personal residences and farms, together with examples; plus guidance and examples for CRUTs and CRATs measured by a term of years.

The final regulations were amplified to cover the additional topics requested by the ACGA. As with the proposed regulations, they are reasonable and have no surprises.

Remainder interest in personal residences and farms. Example 2 of Reg. §20.20361(c)(1) was added in the final regulations to confirm that, if the transferor transferred a personal residence to a third person while retaining the right to use the personal residence for life or for a term of years, and if the transferor died during that term, the fair market value of the residence on the date of death is includible in the transferor's gross estate under IRC §2036.

*Example—gift of personalresidence.*Example. D transferred D's personal residence to D's child C (the example, according to the Treasury's explanation also covers the situation where C is a charity), but retained the right to use the residence for a term of years. D dies during the term. At D's death, the fair market value of the personal residence is includible in D's gross estate under IRC §2036(a)(1)

because D retained the right to use the residence for a period that did not in fact end before D's death. **Comment**. If C is a charity, D's estate would be entitled to an offsetting charitable deduction.

The fair market value of the personal residence or farm at the donor's death (or the alternate valuation date) is includable in her gross estate when she retains a life estate in the property. IRC §2036. The estate then deducts as a charitable contribution the amount included in the gross estate, resulting in a wash. IRC §2055(e)(2); Reg. §20. 2055 -2 (e)(2)(ii), (iii).

Noncitizen spouse. Property bequeathed outright or in a garden- variety qualified terminable interest property (QTIP) trust to a non-citizen spouse isn't eligible for the estate tax marital deduction. To get the deduction the property must pass through a qualified domestic trust (QDOT). To qualify as a QDOT, a remainder interest in a personal residence or farm must qualify for the marital deduction under IRC §2056(b)(7) (qualified terminal interest property).

A charitable remainder in a personal residence or farm with a life estate to a noncitizen spouse qualifies for the estate tax marital deduction under the QTIP' rules. Reg. §20.2056(b)7(h), Ex. 1. But it's not clear whether a charitable remainder interest in a personal residence or farm with a life estate to a noncitizen spouse is an ordinary trust. The spouse's interest should be treated as passing in a QDOT if the spouse transfers or irrevocably assigns his or her interest to a QDOT. Reg. §20.2056A-4(b). If that's done by the date the estate tax return is filed and the date by which the QDOT election may be made, the interest should qualify for the estate tax marital deduction.

The donor's estate is entitled to a charitable deduction for the value of the remainder interest, based on the age of the survivor on the donor's death. In making the computations, use the age of the survivor (to the nearest birthday) at the donor's death even if the executor elects the alternate valuation date. Thus, only the value of the survivor's life estate is taxable.

Under current gift and estate tax laws, gift and estate transfer taxes are relevant for less than one-tenth of one percent of taxpayers. But gift tax reporting is required.

A charity's receiving a remainder interest in a toxic waste dump could be costly. Before accepting any land gift (whether outright, in trust, a remainder interest or for a gift annuity), the charity should determine its potential liability under environmental impact laws.

When vesting of the remainder interest in the charity is wholly dependent on some voluntary act of the donor, the contribution is conditional and thus not deductible. Rev. Rul. 77-305, 1977-2 CB 72. If any condition exists that could defeat the charity's remainder interest, the deduction is allowable only if the possibility of the occurrence of the condition is so remote as to be negligible. Reg. §1.170A-1(e). Letter Ruling 9436039.

In Rev. Rul. 85-23, 1985-1 CB 327, a donor's will gave a farm to her son Henry for life, with the remainder to charity. The will provided, however, that if Henry died before his twin sister Henrietta, Henrietta would get the farm and the charity would get nothing. Both children were 45 years old at the donor's death. IRS disallowed the estate tax charitable deduction because the charity's contingent remainder interest flunked the "so remote as to be negligible" test.

How remote is "so remote"? IRS looked to Rev. Ru!. 77-374, 1977-2 CB 329, which holds that "so remote as to be negligible" means the probability is less than 5 percent that the contingency will occur and divest the charity of its interest.

No deduction will be allowed if there are substantial restrictions on the charity's use of the property. However, a deduction is allowable if only incidental restrictions are placed on the charity's remainder interest. See e.g. , Letter Ruling 7807101. Restrictions on the donee's use of the property may also cause IRS to lower the valuation (and thus the charitable deduction) for the gift. Deukmejian, TCM 1981-21; Klopp, TCM 1960-185; Dresser, TCM 1956-54; Rev. Ru!. 85-99, 1985-1 CB 83.

Charitable remainder unitrusts and annuity trusts must provide that a survivor beneficiary's life interest will become effective on the donor's death only if the survivor furnishes funds for payment of any federal estate taxes or state death taxes for which the trust may be liable on the donor's death.

The rationale of Rev. Rul. 82-128, which is specifically directed at charitable remainder unitrusts and charitable remainder annuity trusts, could apply to charitable remainder interests in personal residences and farms. However, IRS has issued several letter rulings and a General Counsel's Memorandum stating that Rev. Rul.82-128 doesn’t apply to pooled income funds. Until an official ruling is issued on remainder interests in personal residences and farms, the donor should state in the deed that no death taxes are to come out of the charity's remainder interest, and that the donor will provide in his will or otherwise for the payment of any death taxes. Should an obligation be imposed on the second life tenant to pay any death taxes (levied against the property) as a condition of receiving his or her life interest?

Propertyimprovements bylife tenant and private foundation isn't self-dealing. In Letter Ruling 200149040, Husband (now deceased) contributed his house to Foundation, retaining a life interest for himself and his wife. Wife, as the life tenant, has continuously used the property as her principal residence for many years. Wife, who is over 90 years old, is a disqualified person under IRC §4946. Wife and Private Foundation want to make much needed improvements—replacement of the driveway, central air conditioning, and water-heater—each paying a proportional share of the costs.

IRS rules. Wife's and Private Foundation's payments of a proportional share of the costs of the improvements (equal to the present value of each party's interest in the improvements at the time of the payments) won't be an act of self-dealing under IRC §4941. If Private Foundation were to pay the entire cost of the improvements, IRS noted, it could be argued that the value of the life tenant's property interest would be increased and that Private Foundation would be making

a prohibited direct or indirect transfer to the life tenant. On the other hand, if Wife, as the life tenant, were to pay the total costs, the payment would constitute a gift to Private Foundation equal to Private Foundation's remainder interest in the improvements. IRS

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

V. CHARITABLE LEAD ANNUITY TRUSTS (CLATs)

- **Annual income stream for charities starting NOW**
- **Confluence of record-low §7520 rates *and*depressed asset values make for smart philanthropy and transfers of assets to heirs**
- **Even better when factoring in the possibility of reduced federal gift and estate tax exemptions**

Background. The tax plusses and minuses of transfers for charitable lead annuity trusts, charitable remainder trusts, charitable gift annuities and charitable remainders in personal residences and farms are affected by changes in the IRC §7520 rate. Also affected are the benefits and detriments of general estate planning techniques such as Grantor Retained Annuity Trusts (GRATs), private annuities and Qualified Personal Residence Trusts. See end of this topic for how the §7520 rate is determined.

This is an especially opportune time for individuals who are "wealthy" (defined soon—in a gift and estate tax context) and charitably minded to create charitable lead annuity trusts.

Reason: the confluence of a historically low IRC §7520 rates, decreased market values, and the gift and estate tax "definition" of wealthy.

The wealthy are a changing target. For purposes of this outline, they are individuals who are subject to the combined 40 percent gift and estate tax (currently only estates valued over $11.58 million (double that for a married couple).

Starting in 2026, however, when the current tax law reverts to the combined gift and estate tax exemption under earlier laws, the wealthy will be those with an estate of over $5 million (adjusted for inflation). Twice that for a married couple.

But wait, a new "wealthy" could emerge sooner than 2026 with federal deficits now ballooning. Congress could well decrease the combined gift and estate tax exemption before 2026. **And some pundits say, depending on the next election,** the combined gift and estate tax exemption could revert to $3.5 million of yesteryear ($7 million for a married couple).

The arithmetic for why now is an especially good time for charitably minded individuals to create charitable lead annuity trusts.

Example: Suppose donor (grantor) in June, 2020 transfers **$1 million** to a 10-year CLAT and sets the annuity at $103,329, **which at a low 0.6% Section 7520 rate** is the annuity necessary to make the actuarial value of the charitable lead annuity interest equal to $1,000,000. Thus the donor makes no taxable gift to the family remainder takers. The actuarial value of the family's remainder is zero. Any amount of total return (income plus appreciation) during the 10 year term in excess of 0.60% will pass to family members at the end of the term completely free of gift or estate tax. If the trust earns just 3 percent total return annually over the trust term there will be $159,365 left for family and if the total return is higher, even more will be left for the family after 10 years:

***The above and following example are by Lawrence Katzenstein, a nationally recognized estate and charitable planning lawyer, writer and lecturer. He is a partner in Thompson Coburn, resident in the firm's St. Louis office. Larry is the creator of Tiger Tables software (tigertables.com) used to compute the tax consequences of all types of charitable and other estate plans.**

Total return	**Amount Left at Trust Termination in 10 Years**
3%	$159,365
4%	$239,665
5%	$329,234
6%	$428,889
7%	$539,512
8%	$662,043
9%	$797,493
10%	$946,944

Note: The June, 2020 IRC §7520 rate of 0.6% can be used for CLATs created in June, July or August, 2020.

VI. CHARITABLE LEAD ANNUITY TRUSTS—PRIMER

CLAT basics. A Charitable Lead Annuity Trust is the converse of a Charitable Remainder Annuity Trust. In CRATs, payments are made to one or more individuals for life (or for a term of years not exceeding 20) with remainder to charity.

For CLATs, payments are made to charity up front for a term of years (or based on an individual's life) with remainder to the donor's heirs.

Who creates a CLAT? An individual who wants to benefit a charity up front and make a gift to family members down the road at greatly reduced—or no—gift or estate tax cost. The value of the family members' remainder interest is reduced by the value of the charity's lead interest.

The charity's lead interest in an inter vivos CLAT qualifies for the IRC §2522(c)(2)(B) gift tax charitable deduction.

The gift of the noncharitable remainder interest. This is a gift by the donor to the family member remainder takers valued at the time the trust is created, reduced by the value of the charity's lead interest.

Two Types of Inter Vivos CLATs

- **Nongrantor CLAT.** The donor isn't entitled to an income tax charitable deduction. Technically speaking, the nongrantor CLAT is subject to the provisions of part I, subchapter J of chapter 1 of subtitle A of the Internal Revenue Code and is allowed a deduction under IRC §642(c)(1) in determining its taxable income for any amount of gross income paid for purposes specified in IRC §170©.

- **Grantor CLAT.** The donor may be entitled to an income tax charitable deduction, but the "price" is that he will be taxable on the income paid to the charity. Technically, a trust is a grantor CLAT if the donor is treated as the owner of the entire CLAT under subpart E, part I of subchapter J, chapter 1, subtitle A of the Code. **This trust is rarely created and isn't in this outline.**

- **Permissible term.** Payments may be to the charity (or charities) for a specified term of years. There is no 20-year cap as for charitable remainder trusts. But check the rule against perpetuities under governing state law.

- **CLAT measured by a life or lives—limitations.** As an alternative to a term-of-years CLAT, the trust instrument may provide for payment of the annuity amount for the life or lives of an individual or individuals. However, only one or more of the following individuals may be used as measuring lives: the donor, the donor's spouse, and an individual who, with respect to all remainder beneficiaries (other than charit able organizations described in IRC §§170, 2055, or 2522), is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries. A trust will satisfy the requirement that each measuring life is a lineal ancestor (or the spouse of a lineal ancestor) of all noncharitable remainder beneficiaries if there is a less than a 15 percent probability at the time of the contribution to the trust that individuals who are not lineal Descendants of an individual who is a measuring life will receive any trust principal. The probability must be computed under the applicable tables in Reg. §20.2031-7. Reg. §§20.2055-2(e)(2) (vi)(a) and 25.2522(c)-3(c)(2)(vi)(a). Each person used as a measuring life for the annuity period must be living on the

date assets are transferred to the trust. Reg. §§20.2055-2(e)(2)(vi)(a) and 25.2522(c)-3(c)(2)(vi)(a).

Why the restrictions on the lives that can be used to measure the trust term? It's the IRS's response to the so-called "ghoul lead trust" where the donor used the measuring life of an individual who was at death's door. The family members would get the remainder interest much earlier because the person whose life measured the trust term died way before the end of his actuarial life expectancy. But the value

of the charity's lead interest for purposes of computing the gift tax charitable deduction was based on his actuarial (not actual) life expectancy. So this short-lived scheme promised the best of all worlds (except for the sick guy who was the measuring life): an inflated gift tax charitable deduction making the actuarial value of the family member's remainder interest much smaller; and the family member got his remainder interest much earlier than if he had to wait until the death of an individual who had a normal life expectancy.

More rules:

- **Payment requirements.** CLATs aren't subject to minimum or maximum payout requirements. Thus there are no 5 percent minimum and 50 percent maximum requirements as there are for CRTs. CRTs have a 10 percent minimum remainder interest requirement. There is no comparable CLAT requirement.

- **The annuity payments may be made in cash or in kind.** If the trustee distributes appreciated property in satisfaction of the required annuity payment, the trust will realize capital gain on the assets distributed to satisfy part or all of the annuity payment. The trust will be allowed an IRC §642(c)(1) deduction for the realized capital gains. Rev. Rul. 83-75, 1983-1 C.B. 114.

- **Generation-skipping transfer tax.** If a CLAT has or may have a skip person, as defined in IRC §2613(a), as a remainder beneficiary, the transfer to the trust will be subject to the generation-skipping transfer (GST) tax. Under IRC §2651(f)(3), a charitable organization is deemed to be in the same generation as charitable lead trust's donor. Thus the GST potential of a charitable lead trust is dependent upon whether any noncharitable beneficiary is a skip person.

- **No additions to CLATs.** For purposes of qualification under the IRS's safe-harbor revenue procedure (discussed soon), the trust must contain a provision that prohibits additional contributions. A CLAT that permits—or doesn't specifically prohibit—additional contributions will not qualify for safe-harbor treatment. See Letter Ruling 8213127.

Suggestion. The ability to add to a CLAT can, in effect, be achieved by creating an additional separate trust.

Comment. Although additional contributions are not allowable for charitable remainder annuity trusts, I believe there is no policy reason for prohibiting additions to CLATs. **But I wouldn't fight the IRS on this.**

More rules:

- **Power to commute. A CLAT isn't qualified if the trustee has the discretion to commute and prepay the charitable interest prior to the termination of the annuity period.** Rev. Rul. 88-27, 1988-1

C.B. 331.

- **Prohibitions against certain investments and excess business holdings.**Prohibitions against retaining any excess business holdings within the meaning of IRC §4943, as modified by IRC §§4947(a)(2) and 4947(b)(3), and against investments that jeopardize the exempt purpose of the trust within the meaning of IRC §4944, as modified by IRC §§4947(a)(2) and 4947(b)(3), are generally required. If (1) the present value of the charitable interest doesn't exceed 60 percent of the aggregate value of all amounts in the trust, (2) the trust instrument doesn't provide for the payment of any of the income interest to a noncharitable beneficiary, and (3) the trust instrument doesn't provide for the payment of excess income to a noncharitable beneficiary, the references to IRC §§4943 and 4944 may be removed from the trust instrument. IRC §4947(b)(3)and Reg. §§53.4947-2(b)(1)(i), 20.2055-2 (e)(2)(vi)(e), and 25.2522(c)-3©(2)(vi)(e).

- **Calendar year.** A charitable lead trust's taxable year must be a calendar year. IRC §644(a).

- **Capital gains.** Gains from the sale or exchange of capital assets may be allocated to the trust's income or principal. If the governing instrument is silent, capital gains are allocated by following local law. Even if gains are allocated to principal, they will be deductible under IRC §642(c)(1) if they are paid to the charitable beneficiary as part of a charitable annuity payment. Rev. Rul. 83-75, 1983-1 C.B. 114.

Basis considerations. The meek shall inherit the earth and with a stepped-up basis. But that's only for testamentary transfers, not inter vivos transfers. Remainderpersons get a carryover basis for assets received from an inter vivos lead trust. IRC §1015(b). Heirs get a stepped-up basis (equal to the estate tax value) for assets received from a testamentary lead trust. IRC §1014(a).

"Safe-Harbor" Help in Drafting Charitable Lead Trusts. IRS, in 2007, issued sample inter vivos (nongrantor and grantor) CLATs; also testamentary CLATs. Rev. Procs. 2007-45 (inter vivos) and 2007-46 (testamentary). Extremely helpful are the numerous alternative provisions and instructive annotations.

The IRS's guarantee. Charitable lead annuity trusts that are "substantially similar" to the Service's sample trusts (or properly integrate one or more of the IRS's sample alternative provisions) will be qualified trusts and the donor will receive the applicable charitable deductions.

As with all guarantees, it's important to read the fine print. So in addition to substantially following the IRS's samples, the trust must be a valid trust under applicable local law, operate in a manner consistent with the trust's terms "and ... all other requirements for deductibility [must be] satisfied."

Not to worry (too much). Trusts that omit, substitute or add provisions not found

in the Service's specimens aren't necessarily disqualified. But you won't have a guarantee in your back pocket as you would if you follow the IRS's sample trusts (or properly substitute its published alternative provisions).

Generally, the rules described above for inter vivos trusts also apply to those created by will (or by a revocable living trust—a will substitute).

Provisions specifically applicable to testamentary CLATs:

- **Computation of estate tax charitable deduction** under IRC §2055(e)(2)(B) for contributions to a CLAT equals the present value of the annuity interest. IRC §7520 requires an annuity interest be valued using the IRS's tables. The method for valuing a charitable lead annuity interest is in Reg. §20.7520-2. If estate or other death taxes are paid from the assets used to fund a testamentary CLAT, the amount deductible under IRC §2055 is the amount that passes to charity, reduced by the amount of estate or death taxes paid. IRC §2055©.

- **Deferral of requirement to pay annuity amount.** The IRS's sample testamentary trust authorizes the trustee to defer the payment of the annuity amount until the end of the taxable year of the trust in which the trust is completely funded.

- **Interest on annuity payments.** The deferral provision in the sample trust provides for the payment of interest, compounded annually, for any underpayment of the annuity amount during the period of estate administration. The sample trust requires that interest be computed at the effective IRC §7520 rate on the date of the decedent's death. To

the extent that interest payable under state law exceeds the applicable IRC §7520 rate, the payment of interest at the rate prescribed by state law will be deemed to satisfy the interest payment requirement provided in the trust.

You can't get a "comfort" ruling. The IRS says that its having issued safe-harbor CLAT samples, it generally will not issue a ruling on whether a CLAT is qualified and qualifies the donor for 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 of substantive trust provisions other than those contained in its sample CLATs (and sample alternative provisions). So you can get a ruling on a specific provision that isn't part of the IRS's safe-harbor package. But the Service won't bless the entire trust.

Parthian shot. Helpful as the IRS's sample trusts are, it's not "just fill in the blanks." Lawyers still have to know what alternative provisions to use and when to substitute and/or add their own handiwork—takinginto account each situation. Hey, that's what they get paid for.

VII. JACQUELINE KENNEDY ONASSIS’S CLAT: HISTORY—NOW YOU SEE IT,

NOW YOU DON'T

Soon after Jacqueline KennedyOnassis's death, newspapers widely reported that Mrs. Onassis's will put her residuary estate in a charitable lead trust—called the C & J Foundation (C & J stood for her children, Caroline and John).

But an investigative journalist after checking with the New York State Attorney General reported that a lead trust hadn't been created.

The following is a discussion of what the benefits would have been had Mrs. Onassis created the trust based on the first press reports of her will. (To this day, many believe the lead trust had been created.)

Spoiler avoidance. Wait until the end of this topic to learn how it came to pass that the CLATs weren't created—contrary to the provisions in Mrs. Onassis's will.

Payments to charity. The Foundation was to have paid to charities for 24 years "an annuity amount" equal to "eight percent (8%) of the initial net fair market value of the assets of the Foundation as finally determined for federal estate tax purposes."

Selecting the charities. The payments were to have been to qualified charitable organizations (described in IRC §§170© and 2055(a)), selected by her trustees in their absolute discretion. "It is my wish, however, that in selecting the particular qualified charitable beneficiaries which shall be the recipients of benefits from the

Foundation the independent Trustees give preferential consideration to such eligible organization or organizations the purposes and endeavors of which the independent Trustees feel are committed to making a significant difference in the cultural or social betterment of mankind or the relief of human suffering."

Remainder to family members. At the end of the Foundation's 24-year term, the assets were to have been distributed to family members. A number of contingencies were covered, but basically the assets were to have gone to the descendants of her children.

What's in a name? Mrs. Onassis's will called the just-described arrangement a Foundation, but it was to have been a charitable lead annuity trust. In any event, it still smelled sweet for the charities that would have benefited handsomely for 24 years. And the estate tax and generation-skipping tax savings were fragrant too.

The trustees. Mrs. Onassis's daughter, Caroline B. Kennedy, her son, John F. Kennedy, Jr., Alexander D. Forger, and Maurice Tempelsman were to have been the trustees.

The Foundation administrator. The will provided: "To assist the independent Trustees I authorize, but do not direct, that they retain my close friend and confidante Nancy L. Tuckerman to assist them in the administration of the Foundation. Should the independent Trustees deem it advisable to retain Nancy L. Tuckerrnan, they shall pay to her from the assets of the Foundation reasonable

compensation for the services she shall render. But such compensation shall not be charged against the annuity amount in any full taxable year of the Foundation nor against the appropriate fraction of said amount, determined as herein provided, payable to the qualified charitable beneficiaries in any short taxable year of the Foundation but shall rather be paid from the assets of the Foundation at large."

The estate tax charitable deduction. The value of Mrs. Onassis's residuary estate that was to have funded the charitable lead annuity trust, based on press reports, was assumed to be a $100 million residuary estate (a nice round number).

Mrs. Onassis died in May1994. When computing the estate tax charitable deduction for the value of the charitable lead interest, her estate could have used the Treasury's midterm federal rate for split-interest gifts for the month of her death, or the rate for either of the two preceding months. Using the March 1994 rate (the lowest rate and thus the largest estate tax charitable deduction for charitable lead trusts), the estate tax charitable deduction for a $100 million charitable lead trust paying charities $8 million a year for 24 years would have been approximately $96.8 million. So only $3.2 million of the $100 million trust would have been subject to estate tax in Mrs. Onassis's estate. Again, the value of the residuary estate was assumed. Whatever the value, however, the estate tax charitable deduction would

have equaled approximately 96.8 percent of the amount funding the charitable lead trust.

Which generation has a rendezvous with Treasury? Looking down the road, the generation-skipping tax would have been payable at the end of the 24-year term. The amount would have depended on the value of the trust at that time and the then-effective interest assumptions. Assuming: (1) the trust was to have been funded with $100 million; (2) it would have used the lowest allowable monthly discount rate—the rate for March 1994-6.4 percent; (3) it would have earned 8 percent each year and appreciated 2 percent annually; and (4) it would have made annual end-of-year payments to charity, the value of the assets after 24 years would have been approximately $213.76 million. The generation-skipping tax at that time (assuming that the GST was still in existence) would be approximately $115.13 million, leaving roughly $98.63 million for the family.

In my sister's house are many lead trusts. Each of Lee B. Radziwill's children were to have been remainderpersons of separate 10 percent lead annuity trusts, each to be funded with $500,000. Each trust would have paid $50,000 annually for ten years to charities selected by the trustees.

And now, the $100 million question. If Mrs. Onassis's will in black and white spelled out the lead trust in great detail, how come it wasn't created? The bulk of her estate was in a revocable living trust with directions for the disposition of her estate on death. That trust provided that if the trust's assets weren't disposed of under the terms of the revocable trust, they were to be poured over to her will. Her revocable living trust gave almost all her estate to her two children— Caroline and John. The revocable living trust then provided that to the extent Caroline and John disclaimed assets given to them, the disclaimed amounts were to be used to fund the lead trust spelled out in her will. The kids didn't disclaim. No criticism of the

children here. If mama had wanted the lead trusts to be created, she would have done so. She wanted to leave it up to her children.

VIII. DIRECT IRA TRANSFERS TO CHARITY

WMD—Weapon of Mass Deduction. A tax-savvy solution to TCJA's collateral damage to charities and taxpayers.

By doubling the standard deduction and capping state and local tax deductions at $10,000, TCJA reduces from 30 percent to 10 percent the taxpayers who itemize. Although the tax benefit for charitable IRA gifts isn't a charitable deduction, otherwise taxable income—includingRequired Minimum Distributions (RMDs)—isn't taxable. That's the equivalent of a charitable deduction.

Tax-free direct charitable/IRA distributions (tax-free charitable IRA rollover). An individual age 70½ or older can make direct charitable gifts annually of up to

$100,000 from an IRA, to public charities (other than donor advised funds and supporting organizations) and not have to report the IRA distributions as taxable income on his or her federal income tax return. Most private foundations are ineligible donees, but private-opera-ting and passthrough (conduit) foundations are. There is no charitable deduction for the IRA distributions. However, not paying tax on otherwise taxable income is the equivalent of a charitable deduction. Tax-free distributions are for (direct) gifts only—not life-income gifts.

Traditional and Roth IRAs only. Distributions from traditional and Roth IRAs are the only ones that are tax free. Distributions from employer-sponsored retirement plans, including SIMPLE IRAs and simplified employee pensions (SEPs) aren't qualified charitable distributions; nor are distributions from Keoghs, 403(b) plans, 401(k) plans, profit sharing and other plans.

Doing a two step to qualify: (1) Roll over a non-qualified pension plan into a qualified IRA. That's generally tax free (make sure that's so). (2) The qualified IRA then makes the distributions directly to the charity.

Pointer on donor-advised funds of community foundations. As noted, IRA distributions to those funds don't qualify. But IRA distributions to a community foundation's endowment and field-of-interest funds do qualify—as long as the donor has no advisory rights.

Distributions from a qualified IRA must be made <u>directly</u> by the IRA's administrator or trustee to a qualified charity. A payment to the donor who one honko-second later gives it to the charity doesn't qualify (a honko-second is the shortest measure of time—the time that elapses between a traffic signal turning green and the driver of the car behind honking his horn).

The entire distribution must be paid to the charity with no quid pro quo. The exclusion applies only if a charitable deduction for the *entire* distribution would have been allowable (determined without regard to the generally applicable percentage limitations). Thus if the donor receives (or is entitled to receive) a

chicken dinner in

connection with the transfer to the charity from the IRA, the exclusion isn't available for *any* part of the IRA distribution.

Watch your step—example. $100,000 from a donor's IRA is distributed to the charity. He receives (or is entitled to receive) a benefit worth $25. The entire $100,000 will be taxable to the donor.

Substantiation required. The exclusion won't be available if the IRA distribution to the charity isn't properly substantiated. The charity must give the donor a timely written acknowledgment that it has received the IRA distribution and that no goods

or services were given in connection with the IRA distribution. **See specimen receipt at the end of this article.**

Favorable rules on charitable distributions when the donor had made earlier deductible and nondeductible contributions to his IRA. If the IRA owner has any IRAs that include contributions that were nondeductible when contributed to the IRA, a special rule applies in determining the portion of a distribution that is includable in gross income (but for the qualified IRA/charitable distribution) and thus is eligible for qualified charitable distribution treatment. The special rule works this way: The distribution is treated as consisting of income first, up to the aggregate amount that would be includable in gross income (but for the qualified charitable distribution) if the aggregate balance of *all* of the donor's IRAs were distributed during the same year. In determining the amount of subsequent IRA distributions includable in income, adjustments are to be made to reflect the amount treated as qualified charitable distributions.

Qualified charitable distributions—examples. These examples illustrate the determination of the portion of an IRA distribution that is a qualified charitable distribution. In each example, it is assumed that the requirements for qualified charitable distribution treatment are otherwise met (e.g., 70½ or older, qualified public charity) and that no other IRA distributions are made during the year.

Example 1. Scott, over 70½, has an IRA with a $100,000 balance, consisting solely of deductible contributions and earnings. He has no other IRA. The entire IRA balance is distributed to an IRC §170(b)(1)(A) charity (other than a supporting organization or a donor advised fund). Under earlier law, the entire $100,000 distribution would have been includable in Scott's gross income. Under the IRA/charitable distribution rules, the entire $100,000 distribution is a qualified charitable distribution and thus no amount is includable in his income. Further, the distribution is not taken into account in determining the amount of Scott's allowable charitable deductions for the year.

Example 2. Zelda, over 70½, has a $100,000 IRA consisting of $80,000 of deductible and $20,000 of nondeductible contributions. $80,000 is distributed directly to charity. She has no other IRA. Notwithstanding the usual treatment of IRA distributions, the distribution to the charity is treated as consisting of income first, up to the total amount that would be includable in gross income (but for the

charitable IRA distribution rules). Under these rules, the entire $80,000 distributed to the charity is a qualified charitable distribution and no amount is included in Zelda's income as a result of the distribution. Further, the distribution isn't taken into account in determining the amount of Zelda's charitable deductions for the year. And when the $20,000 remaining in Zelda's IRA is distributed to her, it will not be subject to tax because it came from nondeductible IRA contributions when placed in her IRA.

You turn 70½ for purposes of qualifying for the IRA/charitable distribution when you are actually 70½. Play it safe. No distributions should be made to charity until at least one or two days after the donor reaches age 70½.

Caveat on year-end charitable distributions. A donor who by U.S. mail sends checks and securities to a charity this year that are received by the charity next year has made a charitable gift this year. Will a distribution mailed by the IRA trustee/custodian to the charity this year, but received by it next year, qualify for tax free treatment? Unless clarified by the IRS, make sure that the charity actually receives the distribution this year.

Death-time distributions to charity from IRAs. The law allows tax-free distributions to charities at death for both outright and charitable remainder gifts. Income in respect of a decedent (IRD) isn't taxable to charities and CRTs. When a CRT beneficiary receives payments, he or she will be taxable on the IRD.

Pointer. Bequeath appreciated stock outright to family members who will get a stepped-up basis, and give the IRA and other IRD "items" to charity. The charity being tax exempt doesn't pay tax on the IRD.

Other IRD items include: salary and wages earned before death but paid after death; accounts receivable; unpaid royalties; commissions and partnership income earned before death but paid after death; unpaid royalties; payments under installment obligations paid after death; and interest or dividends earned before death but paid after death.

For death-time transfers from IRAs, there isn't a ceiling or limitation on the types of charitable donees. Thus distributions to all private foundations and public charities (including supporting organizations and donor advised funds) qualify. **To avoid IRD concerns, the gift must be properly structured.**

Advantages of IRA/Charitable Distributions:

- A gigantic additional pool of funds is available for charitable gifts.

- The approximately nine-tenths of taxpayers who take the standard deduction—and thus can't deduct their charitable gifts—can get the equivalent of a deduction by making gifts directly from their IRAs to qualified charities. Not being taxed on income is the equivalent of a deduction.

• Itemizers who bump into the adjusted gross income ceilings on charitable-gift deductibility can use distributions from IRAs to make additional gifts. Because they won't be taxed on the distributions, they have the equivalent of additional charitable deductions.

• The carryover can be saved. Deductible gifts made in a current year are taken into account before deducting a carryover from earlier years. Making a gift from an IRA (as opposed to making a gift with other funds or assets) means that a carryover can be used in the current year.

• As adjusted gross income increases, the following benefits can be reduced or eliminated: social security; contributions to Roth IRAs; and passive activity losses and credits,

• If a donor's state income tax law doesn't allow charitable deductions (e.g., Connecticut): Making the gift from the donor's IRA to the charity can be the equivalent of a state income tax charitable deduction.

Caution. State laws differ, so check out all the ramifications in your state. For example, in some states IRA distributions directly to the IRA owners aren't subject to state income tax. A distribution from the IRA to charity thus won't save state income taxes and the donor could lose a state income tax charitable deduction that might—depending on state law—be available for a gift from the donor to the charity. Of course, consider both the federal and state tax rules. *You may have heard this before:* Do the arithmetic under various scenarios.

Reminder. It won't be a QCD if the IRA donor gets a chicken dinner or any other benefit. So don't fowl up an IRA distribution with a quid pro crow.

For donors not to be taxed on the IRA transfers, the donee-charity must properly and timely acknowledge the gift from the donor's IRA. And this is **NOT** the usual receipt for gifts of other contributions to charities.

Specimen Receipt for a Gift Received from a Donor's IRA

Charity's Name and Address
Date sent to donor
Name and address of donor

Dear [donor's name]:

Thank you very much for your $ gift to [name of charity] from your Individual Retirement Account (IRA), received on [date]. This acknowledges that we received your gift directly from [Name of IRA Administrator] and that it is your intention for all or a portion of your gift to qualify as a qualified charitable distribution from your IRA under the Internal Revenue Code. Note, that you may exclude the qualified gift amount from your gross income, but if you do so, you may not also claim the gift amount as a charitable deduction on your 2019 tax return.

This confirms that [name of charity] is qualified under IRC §170(b)(1)(A) and that your gift was not transferred to either a donor advised fund or a supporting organization.

No goods or services were provided in consideration of this gift.

Thank you again for your gift.

Sincerely,
s/
Title Date

Retain this letter for your tax records.

As always, consult your own advisers.

IX. MAXIMIZING A SURVIVING SPOUSE'S INCOME TAX CHARITABLE DEDUCTION

Despite filing joint income tax returns, the carryover from one spouse's charitable donations is lost after the year of the death of the spouse who owned the contributed property.

Where most of a married couple's property is held in the name of one spouse, whose life expectancy is considerably shorter than the surviving spouse's, this technique may be helpful. The one whose days are numbered should give property to the other spouse (qualifying for the unlimited marital gift tax deduction), who then makes charitable gifts.

That way, the surviving spouse will be able to make full use of the charitable deduction carryover.

If it isn't clear who will survive whom, bets can be hedged by having the propertied spouse place assets in the spouses' joint names (also qualifying for the gift tax marital deduction). Then they donate that joint property to charity. After one spouse dies, the survivor will still benefit from half of the remaining charitable deduction carryover—the portion attributable to his or her half interest in the donated property.

X. EXTENDING THE INCOME TAX CHARITABLE DEDUCTION BEYOND THE GRAVE

Instead of making testamentary charitable gifts, consider an outright bequest (in the amount of an intended, charitable bequest) to a cooperative spouse, who then makes a gift to charity on his or her own, thereby generating an income tax deduction for the surviving spouse. The decedent's estate gets a

marital deduction for the same amount as it would have gotten with the

charitable deduction.

This technique can also be useful for testamentary charitable remainder gifts. For example, instead of Husband, for example, creating a testamentary charitable remainder unitrust for Wife, he makes an outright bequest to her; she then creates an inter vivos unitrust, thereby getting an income tax charitable deduction.

The same technique can be used with a cooperative family member (not a spouse).

Now that less than one-tenth of 1 percent of estates are subject to the estate tax, this technique gives income tax benefits to the survivors.

XI. DISCLAIMERS BENEFITTING CHARITIES—AWISE ESTATE PLANNING TOOL

How disclaimers work. As the disclaimant, you can't just name the recipient of property you wish to disclaim. Generally, the person who named you as the beneficiary must have specified who gets the bequest if you disclaim. Sometimes state law plays a role. Here are some typical cases:

- The will or other instrument names an alternative beneficiary. ("If X disclaims my stamp collection, it goes to Y instead.")
- The property goes to the alternative beneficiary under a residuary clause of a will. ("If any beneficiary disclaims his or her bequest, the disclaimed property shall pass under my residuary estate.")
- The property goes to the desired recipient under state intestacy law (e.g., a man disclaims and his issue receive the bequest).

Internal Revenue Code requirements for a valid disclaimer. A written refusal must be received by the decedent's representative (e.g., executor) within nine months of the transfer or bequest (generally the date of death). The disclaimant can't accept any benefits from the property—e.g., income. (But that's okay when a spouse disclaims and gets the property in a different way—under another provision of the will or through intestacy law.)

Example of disclaimer in favor of charity. Paul's will gives the bulk of his estate to his wife and children, making a few small charitable bequests. He'd like more to go to charity, but only if the family is "comfortable about it." So his will provides that any part of a bequest disclaimed by a family member shall go to named charities.

XII. BARGAIN SALES

Situation. A college needs additional land to expand its campus. The owner of adjacent land needs some cash and is considering selling the highly appreciated

land. If he sells the land, he'll have a large capital gain.

Although he is a supporter of the college, he can't afford to make a gift of all the land—and, as stated, he needs cash. A part gift, part sale could be the answer. He'll reduce capital gains and get a charitable deduction. This only works if he has "donative intent." He's better off financially with a regular and not a bargain sale. A bargain sale, however, reduces the cost of generosity—tax savings of smaller capital gains tax and a charitable deduction.

The basic rules. A bargain sale is a sale of long-term appreciated property to a public charity at a price lower than its present fair market value. A charitable deduction is generally allowed for the difference between the sales price and the property's fair market value.

The donor must allocate the property's cost basis between the gift element and the sale element, based on the fair market value of each part. The donor incurs gain on the difference between the sales price and the cost basis allocated to the sale element, but isn't taxed on the gain allocated to the gift element.

Example. Donor sells long-term real property that cost $250,000 (and is now worth $1,250,000) to her college for $250,000. Donor's contribution is $1,000,000 ($1,250,000 fair market value minus $250,000 sales price). Donor's capital gain is $200,000 ($250,000 sales price minus $50,000 basis allocated to sale element).

Caveat. If a donor bargain-sells property that is subject to an indebtedness, the amount of the indebtedness is treated as an amount realized on the sale of the property even though the transferee doesn't agree to assume or pay the debt.

Acharitable gift of' mortgaged propertyis considered a bargain sale even though no payment is made to the donor.

Charitable intent. The donor should clearly express her intention to make a bargain sale charitable gift of the difference between the sales price and the property's fair market value. The donor's characterization of the transaction as a bargain sale shouldn't just be oral; written instruments and correspondence will help substantiate the deduction. And the qualified appraisal and substantiation rules must be satisfied.

XIII. GIFT VS. BUSINESS EXPENSE

When does a donor go out of his way to show a calculated, self-serving motive for making a payment to a charitable organization? When he'd rather write it off as a business expense.

Usually, it makes no practical difference how the deduction is labeled. But income

tax charitable deductions are subject to ceilings (20 percent, 30 percent or 50 percent (60 percent for cash gifts from 2018 through 2025)* of adjusted gross income for individual donors, and 10 percent of taxable income for corporate donors), whereas "ordinary and necessary" business expenses are fully deductible. True, there's a five-year carry-over for charitable deductions; however, a business might want to deduct the entire payment in a single year rather than piecemeal over several years. And if the donor takes the standard deduction, the deduction can be saved if it is a legitimate business expense.

Still, no business expense deduction is allowable when the facts indicate that a charitable contribution was intended. IRC §162(b). You can't just call the payment a business expense; you must have a business reason for making the payment. Rather than is interested generosity, the payer must stress more mercenary motives. (That makes for some interesting discourse, especially when one is accustomed to the apple-pious arguments donors usually make to avoid losing their charitable deductions.)

The transfer must bear a direct relationship to the taxpayer's trade or business, and be made with a reasonable expectation of financial return commensurate with the amount of the transfer. See Rev. Rul. 72-314, 1972-1 CB 44; Marquis, 49 TC 695 (1968); Jefferson Mills, 259 F. Supp. 305 (D.C. Ga. 1965), aff'd, 367 F.2d 392 (5th Cir. 1966). See Letter Ruling 9309006, where payments by a grocery chain to charities as part of its promotional campaign were deductible in full as "ordinary and necessary" business expenses. See also Letter Ruling 9335022, where a gas company could deduct payments under a program to help the disadvantaged pay their fuel bills.

If a payment is a business expense, the post-1993 substantiation and disclosure rules don't apply.

XIV. CHARITABLE GIFTS OF WORKS OF ART

First of all, what is art? Like beauty, it may be in the eye of the beholder. But for the contribution rules, art includes “paintings, sculpture, watercolors, prints, drawings, ceramics, antique furniture, decorative arts, textiles, carpets, silver, rare manuscripts, historical memorabilia and other similar objects.” *Rev. Proc. 96-15,* 1996-1 CB 627.

*The ceiling in 2020 for cash gifts to publicly supported organizations (other than donor advised funds and supporting organizations) is 100% of Adjusted Gross Income.

Basic rules. The date the property is actually (not constructively) received by the charity—together with a “deed of gift” meeting state law requirements for transferring personal property—is the *delivery* date.

The deductibility rules for appreciated gifts of artworks held long-term depend on how the public charity will use the gift. Reg. §1.170A-4.

- *Related-use gifts.* When the charity’s use of the property is related to its exempt function (*e.g.*, a painting given to an art museum or to a school for its art gallery), the donor can deduct the full present fair market value. IRC §170(e)(1)(B)(i).

- *Deductibility ceilings.* These gifts are deductible up to 30 percent of adjusted gross income (AGI), with a five-year carryover for any *excess.* IRC §170(b)(1)(D)(i); IRC §170(d)(1). The ceiling can be raised to 50 percent of AGI, with a five-year carryover for any *excess* if the donor makes an election to deduct the gift at its cost basis. That election will then also apply to all gifts of long-term appreciated tangible personal property, securities and real estate. IRC §170(b)(1)(C)(iii).

- *Proof of use.* A donor may treat a gift as put to a related use by the donee if: (1) the donor establishes that the property is not in fact put to an unrelated use by the donee (pure poetry); or (2) at the time of the contribution, it is reasonable to anticipate that the property will not be put to an unrelated use by the donee (more poetry). Reg. §1.170A 4(b)(3)(ii). A letter from the donee stating its intended use can help a donor show that he or she reasonably anticipates that the charity's use will be related "... *if the object donated is of a general type normally retained by such museum or other museums for museum purposes, it will be reasonable for the donor to anticipate, unless he has actual knowledge to the contrary, that the object will not be put to an unrelated use by the donee, whether or not the object is later sold or exchanged by the donee."* Reg. §1.170A-4(b)(3)(ii)(b).

- *De minimis rule.* The regulations say that a charity's sale of donated property can turn what would otherwise be a related use into an unrelated one. Reg. §1.170A-4(b)(3)(i). However, if a collection of tangible personal property is contributed to a charity that sells or otherwise disposes of only an insubstantial portion of the collection, the use is not unrelated.

- *Unrelated gifts.* If the gift is unrelated to the donee's exempt function (*e.g.*, the charity sells the property), the deduction is for cost basis or fair market value, whichever is *lower*. IRC §170(e)(1)(B). In that case,

the gift is deductible up to 50 percent of AGI, with a five-year carryover for any "excess." IRC §170(b)(1)(A); IRC §170(d)(1).

What's related? What's unrelated? Generally IRS won't rule on a related unrelated use fact question prior to the gift. Here are some letter rulings IRS issued prior to changing its ruling policy.

A retirement center in Letter Ruling 8347062 collected paintings, sculpture and graphics for display in its corridors, lounges and other public areas. The purpose of the art collection program was "to enrich and enhance the residents' lives and to provide the stimulation necessary to keep the residents motivated and alert." Further, the display was intended to have therapeutic value for the residents, and to stimulate artistic creativity.

The donor gave a painting to the center; the center displayed it in its facilities. The donor was not a resident of the center, nor did he have any plans to become a resident. IRS ruled the retirement center's use of the painting would be related to

its exempt function of providing care for aged men and women. *See also Letter Rulings 7751044, 7911109, 8143029, 9833011.*

Tangible personal property held short-term (one year or less) is deductible at cost basis or fair market value, whichever is *lower*. IRC §170(e)(1)(A). The ceiling is 50 percent of AGI, with a five-year carryover for any "excess." IRC §170(b)(1)(A); IRC §170(d)(1); Reg. §1.170A-10.

Dealer pitfall. IRS may claim that under some circumstances a donor's art activity is tantamount to being a dealer, or that the fair market value of the property is no greater than the property's cost basis, thus limiting the deduction to the cost basis.

Artist contributes own painting. Deduction limited to lower of basis or FMV. Basis is cost of canvas, paints and brushes.

XV. ART ADVISORY PANEL—LATEST VALUATION REPORT

Art advisory panel—background. A panel of museum directors, curators, art scholars and dealers helps IRS value artwork gifts. At stake are income tax deductions for charitable donors, and gift and estate taxes for gifts to family members and other non-charities. The panel reviews artworks valued at $50,000 or more. If the panel rejects a taxpayer's appraisal, it may suggest a different value, get additional information, or consult a specialist. The panel provides advice and makes recommendations to the Art Appraisal Services (A.A.S.) unit in the Office of Appeals for the IRS. In Fiscal Year 2018, A.A.S. adopted 69 percent of the panel's recommendations. The panel's specialty areas include paintings and sculpture, decorative arts, and antiques. There are currently two subcommittees: the Fine Arts Panel, which reviews paintings, sculpture, watercolors, prints, and drawings; and the

Decorative Arts Panel, which reviews items such as antique furniture, decorative art, ceramics, textiles, carpets, and silver.

How the panel operates. A.A.S. takes steps to ensure objectivity and taxpayer privacy. Information provided to the panelists doesn't include the taxpayer's name, the type of tax, the tax consequences of any adjustments to the value, or who did the appraisal. To minimize the possibility that panelists recognize a taxpayer's entire collection, the art works are usually discussed in alphabetical order by artist or, in the case of decorative art, by object type. If there is a conflict of interest with a panelist and a work of art under review, the panelist doesn't participate in the discussion and is excused from that portion of the meeting.

Before panel meetings, A.A.S. appraisers send photographs and written materials to the panelists about the works of art under review. The materials include information from the taxpayer's appraisal, such as size, medium, physical condition, provenance, any comparable sales, and appraised value, and theA.A.S. appraiser's own research, including available information on public and private sales of relevant art work.

During the panel meetings, the panelists review the information provided, along with the research and findings of both the panelists and A.A.S. appraisers. After

discussing each item individually, the panel reaches consensus on the value of a subject work. Panel discussions are lively and serious. Despite the different perspectives of dealers, museum curators, and scholars, substantial disagreements are rare. When disagreements happen, they generally result from insufficient information. In those cases, the panelists may recommend additional research, such as inspecting the property or consulting with additional experts, before making a recommendation as to value. Once the A.A.S. appraiser completes the additional work, the item may be brought up for review at a subsequent panel meeting.

The panel's recommendations are strictly advisory. The A.A.S. staff reviews all the panel's recommendations, which become the position of the IRS only with A.A.S. concurrence.

The panel's 2018 Annual Report (the latest). The Panel reviewed 251 items with an aggregate taxpayer valuation of $360,866,084 on 67 taxpayer cases. The average claimed value for an item reviewed by the panel was $1,437,713.

The panel recommended accepting the value of 94 items or 37 percent of the items presented. It adjusted 157 items or 63 percent of the appraisals it reviewed. On the 157 items adjusted, the Panel recommended total net adjustments of $(64,621,787) to the appraised values, an 18 percent decrease.

The panel reconsidered ten items originally valued at $7,150,000 by the taxpayers and $12,398,000 by the panel. After reviewing the additional information, the panel revised the original recommendation to $12,273,000 ($125,000 decrease). The items reconsidered were not included in the information above or that follows.

In an intentional break from prior year reports, beginning with the 2015 Annual Report, the items reviewed and adjusted are not broken down to show which adjustments were for estate and gift tax appraisals and which were for charitable contributions.

The 2016 Annual Report noted:
This format . . . avoids potential Internal Revenue Code section 6103 [Confidentiality and Disclosure of Returns and Return Information] disclosure concerns in situations where there may be too few items in a particular category (estate, gift or charitable contribution) to report separately.

In prior reports, where a breakdown of the adjustments was given, it was the immutable pattern year after year: IRS viewed taxpayers' valuations as high for charitable transfers (for which income tax deductions are claimed), and low for noncharitable transfers (on which IRS wants estate and gift taxes). Not surprisingly, taxpayers saw it just the other way around. Although the specific breakdown was not given in this report, it can be presumed that there views of valuations by the IRS and taxpayers, haven't changed and the pattern of adjustments continues.

2018 Art Advisory Panel members: Stephanie Barron, Senior Curator of Modern

Art, Los Angeles County Museum of Art, Los Angeles, CA; Andrew W. Butterfield, President, Andrew Butterfield Fine Arts, LLC, New York, NY; Carol Conover, Kaikodo, LLC, New York, NY; Leon Dalva, Dalva Brothers Inc., New York, NY; Alice Duncan, Director, Gerald Peters Gallery, New York, NY; Michael Findlay, Director, Acquavella Galleries, Inc., New York, NY; Steven P. Henry, Director, Paula Cooper Gallery, New York, NY; Brock Jobe, Professor of American Decorative Arts, Winterthur Museum, Winterthur, DE; Christian Jussel, Independent Scholar/Art Adviser, New York, NY; James Lally, Lally & Co., New York, NY; Barbara Mathes, Barbara Mathes Gallery, New York, NY; Susan Menconi,* Partner, Menconi & Schoelkopf Fine Art, New York, NY; Howard Rehs, Director, Rehs Galleries, Inc., New York, NY; Dr. Andrew Robison, Former Mellon Senior Curator of Prints and Drawings, National Gallery of Art, Washington, DC; Louis Stern, President, Louis Stern Fine Arts Inc., Los Angeles, CA; David Tunick, President, David Tunick, Inc., New York, NY. * Resigned from Panel in 2018

Binding valuation agreement between IRS and donor. By paying a user fee, a donor of a work of art appraised at $50,000 or more, can get a Statement of Value from IRS that establishes the value of art gifts for income, gift, and estate tax purposes. Taxpayers may obtain a Statement of Value from the Service for an advance review of art valuation claims prior to filing the return. The Statement of Value may then be used to complete the taxpayer's return. The donor must request the Statement of Value *after* making the gift, but *before* filing a tax return claiming the charitable deduction. The fee is $7,500 for a Statement of Value for one to three items, plus $400 for each additional item. See *Rev. Proc. 2020-1, Appendix A*, 2020- 1 I.R.B. 1, 83 (Jan. 2, 2020); *Rev. Proc. 96-15*, 1996-1 CB 627.

Method of payment. User fees for Statement of Value requests made pursuant to Rev. Proc. 96-15 must be made by direct debit from a checking or savings account through the Pay.gov website. Payment confirmations are provided through the

Pay.gov portal and should be submitted with the Statement of Value request. Art Appraisal Services will not consider a Statement of Value request complete, and will hold the request in suspense, until the correct user fee is paid through the Pay.gov website. Use of the Pay.gov website replaces the mailing or hand delivering of user fees. The use of the Pay.gov website to submit Statement of Value user fees is mandatory.

Address for Statement of Value requests. Send requests to: Internal Revenue Service/Art AppraisalServices, 1111 Constitution Avenue, Suite 700,C:AP:SO:ART, Washington, DC 20224-0002, ATTN: AAS.

Note from IRS: it is recommended that a private delivery service be utilized, as packages sent via USPS are subject to irradiation which may damage professional photographs.

XVI. UNDIVIDED INTERESTS IN TANGIBLE PERSONAL PROPERTY (WORKS OF ART)

Background. A gift of an undivided portion of a donor's entire interest in property is generally deductible. That interest must consist of a fraction (or percentage) of each and every substantial interest or right owned by the donor and must extend

over the entire term of the donor's interest.

Rights given to donee to quality the gift as an undivided portion of a donor's entire interest. The donee is given the right, as a tenant in common owner with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest.

Future interests don't qualify. A charitable deduction isn't allowable for a gift of a future interest in tangible personal property. That interest is one "in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization which has the effect of reserving to, or retaining in, the donor a right to the use, possession, or enjoyment of the property." Reg. §1.170A-5(a)(4).

Undivided interest isn't a future interest if tests are met. Treasury regulations provide that IRC §170(a)(3); which generally denies a deduction for a gift of a future interest in tangible personal property, "[has] no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than one year." Let's call this the physical possession requirement.

Law applicable to initial fractional gift. The value of a donor's charitable deduction for the initial contribution of a fractional interest in tangible personal property is based, under existing law, upon the fair market value of the artwork at the time of the contribution of the fractional interest, and whether the use of the artwork is related to the donee' s exempt purposes.

Pension Protection Act of 2006—big change for additional fractional interest gifts. The Pension Protection Act of 2006 added an income tax special valuation rule for treatment of contributions of fractional interests in tangible personal property.

Applicable to contributions made after August 17, 2006. A gift made on or before August 17, 2006 won't be treated as an initial fractional contribution for purposes of the law. Instead, the first fractional contribution by a taxpayer after August 17, 2006 is considered the initial fractional contribution.

For determining the deductible amount of each additional contribution of an interest in the same property, the fair market value of the item is the lesser of:

> (1) the fair market 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 additional (and subsequent) contribution.

Example—income tax: In year one, a donor gives a public charity for a related use an undivided one-fifth interest in a long-term appreciated painting valued at

$1,000,000. In each of years two, three, four and five, he gives the charity an additional one-fifth interest, so in year five the charity owns the entire painting. The painting continues to appreciate in value: in year two, it is worth $1,200,000; in year three, $1,400,000; in year four, $1,600,000, and in year five, $1,800,000. Donor's deduction in each of years two, three, four and five, as well as year one (the initial contribution) is limited to $200,000.

Prior to enactment of the Pension Protection Act, the donor would have deducted $200,000 in year one (1/5 of $1,000,000). That rule still applies. But as a result of the Pension Protection Act, in each of years two, three, four and five, his deduction is limited to $200,000. That's one fifth of the initial fair market value. Under prior law, his deduction in year two would have been $240,000 (1/5 of $1,200,000), in year three would have been $280,000 (1/5 of $1,400,000), in year four would have been $320,000 (1/5 of $1,600,000) and in year five would have been $360,000 (1/5 x $1,800,000).

Gift and Estate Tax Consequences. As enacted, the Pension Protection Act applied the same rule for determining the deduction of an additional fractional gift of tangible personal property for gift and estate tax purposes as it did for income tax purposes. However, as the Joint Committee onTaxation noted, the special valuation rule "creates unintended consequences" under the estate and gift tax laws. The Tax Technical Corrections Act of 2007 strikes" that rule for estate and gift tax purposes, but retains it for income tax purposes.

10-year or earlier year death—rule under Pension Protection Act of 2006. If a donor makes an initial fractional contribution, then fails to contribute all of his remaining interest in the property to the same donee before the earlier of 10 years from the initial fractional contribution or the donor's death, the donor's income and gift tax charitable deductions for all previous contributions of interests in the item will be recaptured, plus interest.

If the donee of the initial contribution is no longer in existence. The donor's remaining interest can be contributed to another organization described in IRC §170(c).

Physical possession requirement—penalties. If the donee of a fractional interest in an item of tangible personal property fails to take physical possession within one year of the initial gift (and within one year of any additional gifts)—for a period equal to the donee's fractional ownership—the donor's income and gift tax charitable deductions for all previous contributions of interests in the item will be recaptured, plus interest.

The related-use requirement—penalties. If the donee doesn't use the property for a use related to its exempt purpose, the donor's income and gift tax charitable deductions for all previous contributions in the item will be recaptured, plus interest.

Additional penalty. If deductions are recaptured under the physical possession or related use rules, an additional tax is imposed equal to 10 percent of the amount recaptured.

All interests must be owned by the donor or the donor and the same charitable donee—requirement. Income and gift tax charitable deductions aren't

allowable for a contribution of a fractional interest in tangible personal property unless immediately before the contribution all interests in the item are owned (1) by the donor, or (2) by the donor and the donee charity. The Treasury is authorized to make exceptions to this rule if all persons who hold an interest in the item make proportional contributions of undivided interests in their respective shares of the item to the donee charity.

Example. Able owns an undivided 40 percent interest in a painting and Baker owns an undivided 60 percent interest in the same painting. The Treasury is authorized to provide that Able may take a deduction for a charitable contribution of less than her entire interest, provided that both Able and Baker make proportional contributions. of undivided fractional interests in their respective shares of the painting to the same donee charity. The requirement is met if Able contributes 50 percent of her interest and Baker contributes 50 percent of his interest.

Effective. Contributions made after August 17, 2006. A gift made on or before August 17, 2006 won't be treated as an initial fractional contribution for purposes of the new law. Instead, the first fractional contribution by a taxpayer after August 17, 2006 will, be considered the initial fractional contribution.

Effect on fractional art donations for contemplated gifts after August 17, 2006. Donors who have been considering those gifts—if aware of the new rules for post-August 17, 2006 fractional gifts—are likely to reconsider and not make the gifts.

Effect on additional fractional interest gifts in the same item for a donor who had made a fractional interest gift on or before August 17, 2006. The strong leaning will be toward not making additional gifts. The first fractional interest given after August 17, 2006 will be the initial contribution. Then the donor will be thrown

into the gift and estate tax traps and the requirements of the "10 years or sooner death" rules. A donor may say: "I'm not going to make any more gifts. I don't know anything about art, but I know what I like—and don't like. And I don't like to be clobbered for my generosity."

But what about that pledge? Suppose the donor who made an initial fractional interest gift on or before August 17, 2006 pledged to give additional fractional interests during his life, by will, or both. But now he doesn't want to make additional fractional gifts because of the new rules. It is the duty of the donee's trustees to see that pledges are fulfilled. And the state attorney general can often get into the act and require that the donee and its trustees enforce pledges. In some cases, the penalties for excess benefits (under the intermediate sanction rules) can come into play if an enforceable pledge isn't enforced.

XVII. CHARITABLE REMAINDER TRUSTS

A. IN THE VERY BEGINNING

1. **Donative intent.** Read no further if you believe that a donor will create a charitable remainder trust solely because of the tax and financial benefits. But if the prospect (client) believes in the charity's cause, then a charitable remainder trust might be the appropriate way to

make a gift. If the donor doesn't need income for him- or herself and doesn't wish to provide income for another individual, an outright gift is generally the most appropriate.

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

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

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

(1) donor's wishes
(2) needs and health of beneficiaries
(3) marital status and citizenship of spouses

(4) type of property — securities, real estate, tangible personal property, marketability, Sub-S stock
(5) how property owned — separate, joint, tenants by the entirety, tenants in common, community property
(6) cost-basis and holding period of property
(7) fair market value of property
(8) any mortgages?
(9) any prior negotiations or contracts for sale, options?
(10) corporation about to liquidate, merge, initial public offering?
(11) remainder charity — public charity, private foundation?
(12) for sizable gift, information about donor's (and spouse's) overall estate and financial plan

XVIII. CHARITABLE REMAINDER UNITRUSTS AND ANNUITYTRUSTS HIGH-SPEED OVERVIEW:

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

the remainder interest must be at least 10% of the initial net fair market value of all property placed in the trust. These percentage requirements also apply to the following types of charitable remainder trusts.

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

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

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

FLEX-CRUT. That's my name for a FLIP-CRUT drafted so as to give flexibility in determining when—if ever—a NIM-CRUT or NI-CRUT will flip to a STAN-CRUT. If you want a NIM-CRUT or NI-CRUT to flip on the sale of a parcel of real estate or on a specified date or event say so in the CRT. **BUT** if you want maximum flexibility,

specify that the trust is to flip on the sale of an unimportant unmarketable asset that is one of the assets used to fund the trust. That way you have flexibility in determining when—if ever—a NIM-CRUT or NI-CRUT will flip to a STAN-CRUT.

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

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

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

CHARITABLE REMAINDER ANNUITY TRUST (CRAT). Pays the income beneficiary ("recipient") a fixed dollar amount (at least annually) specified in the

trust instrument. On the death of the beneficiary or survivor beneficiary (or at end of trust term if trust measured by a term of years—not to exceed 20 years) charity gets the remainder. The fixed dollar amount must be at least 5% but not more than 50% of the initial net fair market value of the transferred assets and the remainder interest must be at least 10% of the initial net fair market value of all property placed in the trust. Additional contributions after the initial contribution may not be made to a CRAT. *Caveat.* CRAT must meet "5% probability test" of Rev. Rul. 77-374, 1977-2 CB 329. But see *Moor*, 43 TCM 1530 (1982). For CRATs created after 8/8/17, alternative to Rev. Rul. 77-374: the early termination qualified contingency provision. Rev. Proc. 2016-42. I strongly recommend not using this early termination provision. The beneficiary's annuity payments may end unexpectedly because of a downturn in the market just when the beneficiary really needs the income.

XIX. INCOME TAX RULES

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

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

   First, as ordinary income to the extent of the trust's ordinary income for the year (and any undistributed ordinary income from prior years). There are tiers of income in this category

   Second, as capital gains for the year (and any undistributed capital gains from prior years). There are tiers of capital gain in this category.

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

   Fourth, as a tax-free return of principal.

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

3. **Capital gains.** No capital gain incurred on transfer of appreciated assets to trust. *Rev. Rul. 55-275,* 1955-1 CB 295; *Rev. Rul. 60-370,* 1960-2 CB 203. Nor is there gain to donor on a sale by trust (except as taxable under four-tier system, above). *Exception:* Gain taxable to donor if trust assets sold

and proceeds invested in tax-exempt securities pursuant to express or implied agreement between donor and trustee. *Rev. Rul. 60-370,* 1960-2 CB 203. See below.

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

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

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

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

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

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

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

Foregone conclusion. It is better, of course, for a CRT to pay no tax at all. To do

that, avoid unrelated business taxable income. Easier said than done for CRTs that invest in LLPs, LLCs, for example. LLPs and LLCs are passthrough entities and often have income from an active trade or business and from debt-financed property. That income flows through the LLP and the LLC as UBTI to a CRT. (Don't you just love all this jargon.)

XX. GIFT TAX RULES—INCLUDING MARITAL DEDUCTION RULES

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

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

The charitable remainder interest. Charitable remainder interest is reportable (regardless of size because it is a future interest) on federal gift tax return.

Then deductible as a charitable contribution—resulting in a wash. IRC §2522 (c)(2)(A); Reg. §§25.2522(c)-3(c)(2)(iv) and 1.664-4.

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

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

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

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

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

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

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

Second life beneficiary's interest when beneficiary is donor's spouse. As long as the trust doesn't have any non-spouse beneficiaries, a U.S. citizen spouse's future interest in a charitable remainder unitrust or annuity trust

qualifies for automatic unlimited gift tax marital deduction (no election need be made). IRC §2523(g). Alternatively, gift tax concerns can be avoided as discussed above by having donor reserve right in the inter vivos trust instrument to revoke surviving spouse's life interest by will. See below for alien spouse rules and estate tax concerns if American spouses divorce.

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

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

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

Cautions regarding right to revoke a beneficiary's interest.

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

Right to revoke should not be retained unless the donor is herself a trust beneficiary. For example, in a trust providing payments to donor's son for

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

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

Gifts to alien spouse. An unlimited gift tax marital deduction is not allowed. But gifts to a noncitizen spouse qualify for an annual exclusion of $147,000 in 2015, assuming the usual annual gift tax exclusion requirements are met. The annual

exclusion is indexed for inflation.

To qualify for the noncitizen spouse $147,000 in 2015 annual gift-tax exclusion (or the usual annual gift tax exclusion), a gift must be a present interest. So a survivorship income interest in a trust, for example, doesn't qualify.

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

XXI. ESTATE TAX RULES—INCLUDING MARITAL DEDUCTION RULES

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

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

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

Include value of trust assets at donor's death (or alternate valuation date) in the gross estate whether or not second beneficiary survives donor. IRC §2036.

If second beneficiary does not survive donor, deduct as a charitable contribution the amount that was included in the gross estate—resulting in a wash. IRC §2055(e)(1)(B); Reg. §20.2031-7.

If second beneficiary does survive donor, deduct value of charitable remainder as charitable contribution [applicable factor for survivor's age (at nearest birthday) at donor's death and stated percentage x value of trust assets at death (or alternate valuation date)]. In effect, only value of survivor beneficiary's life interest is subject to tax. If alternate valuation date is elected, in computing value of charitable remainder, use value of assets at

alternate valuation date, but use age of the survivor beneficiary (at the nearest birthday) at the date of donor's death. IRC §2032(b)(2).

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

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

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

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

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

Estate tax marital deduction for spouse's life interest is allowable only if

spouse is sole beneficiary. See *Letter Ruling 8730004*. For example,

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

XXII. Q-TIP/CRUT COMBO

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

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

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

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

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

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

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

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

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

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

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

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

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

WHY YOU SHOULD WATCH THE CMFR LIKE A HAWK—BRIEFLY STATED. The CMFR—like most things financial—goes up and down. In June 2013, the CMFR was on the low end—1.2%.

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

also easily flunked.

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

Consequences. Flunking the 10% MRI requirement for charitable remainder unitrusts and charitable remainder annuity trusts and the 5% probability test for charitable remainder annuity trusts means loss of income, gift and estate tax

charitable deductions—*and* the trusts aren't qualified. Furthermore, if a spouse is involved, the marital deduction will also be lost. And for charitable gift annuities (including deferred payment and flexible starting date gift annuities), if the gift portion doesn't exceed 10%, the *charities* will be taxed under IRC §514(c)(5) and 501(m). Not a good thing.

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

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

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

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

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

Is a charitable lead annuity trust when the CMFR is low an abusive arrangement? The topic came up at the April 3, 2008 U.S. Senate Finance Committee estate tax hearing. In a statement that I prepared for the American

Council on Gift Annuities and the National Committee on Planned Giving for the record of the hearing, ACGA and NCPG pointed out that the CMFR is a two-edged sword. Although it can now be highly advantageous to create charitable lead annuity trusts, the charitable deduction is especially low for charitable remainder annuity trusts. And there are many, many more charitable remainder annuity trusts than charitable lead annuity trusts.

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

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

Information required with the tax return whether or not the lookback election is made. To claim a charitable deduction for a split-interest gift, the tax return must contain: (1) a description of the interest that is transferred, including a copy of the instrument of transfer; (2) the valuation date of the transfer; (3) the names and identification numbers of the beneficiaries of the transferred interest; (4) the names

and birthdates of any measuring lives; and (5) a computation of the deduction showing the interest rate used to value the transferred interest. Also, if a measuring life is of a person who is terminally ill, that should be stated and explained. For a definition of terminally ill, see Reg. §1.7520-2(a)(4).

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

Example. A donor funds her charitable remainder unitrust with securities. The trust pays income to her son for life with the remainder to charity. The donor must use the same month's rate to value both the son's and the charity's interests. If the

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

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

XXIV. TAX-EXEMPT UNITRUSTS AND ANNUITY TRUSTS

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

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

Background. Rev. Rul. 60-370, 1960-2 CB 203 says that, if the trustee is under

an

express or implied obligation to sell or exchange the transferred property and purchase tax-exempt securities, the donor is deemed to have sold the property himself and given the trustee the proceeds. The gain from the sale is imputed to the donor and includable in his gross income.

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

XXV. CRTS—DIVIDING AND SOMETIMES REUNITING

Setting the stage. A recent "published" revenue ruling (on which all can rely and are bound by) tells the tax consequences of a not uncommon situation in which two beneficiaries—typically divorcing spouses—of a CRUT or CRAT split their trust down the middle and then each goes his and her own (perhaps merry) way. The ruling starts out, however, with a not common situation in which a trust with two or more beneficiaries split the original trust into separate trusts for each beneficiary. But in that case, a trust that is split asunder is later reunited. The assets of a beneficiary's separate trust on his or her death are added to the separate trust or trusts of the surviving beneficiaries. Private letter rulings have favorably dealt with

the situation of divorcing spouses. (It is said that half the marriages in the United States end in divorce. The other half, as it turns out, end in death. So I ask you, which is worse?) But reunification after the original split is something new.

Alert to worry warts. (Worry Wart was a character in the comic strip, "Out Our Way." He caused others to worry. But since his first appearance in 1956, the term has evolved to mean an individual who worries on his or her own. So in the classic sense, I am the worry wart—the one who causes you to worry. Sorry.) The published ruling follows the private letter rulings, but adds a potentially troublesome rub. And I have a few concerns about stuff not addressed in the ruling. But first the facts, then the ruling, and finally the concerns and the rub.

The plot—Situation 1. Two or more individuals (recipients) of a qualified charitable remainder annuity trust or a qualified charitable remainder unitrust (Original Trust) are each entitled to an equal share of the annuity or unitrust amount, payable annually, during the recipient's lifetime. On the death of one recipient, each surviving recipient becomes entitled for life to an equal share of the deceased recipient's annuity or unitrust amount. Thus the last surviving recipient wins the tontine. A tontine is an investment (and a lottery) in which each participant pays into a common fund. The funds are invested and each participant receives dividends. When an investor dies, his or her share is divided among the other participants. The last surviving participant then gets the whole kit and caboodle, the whole ball of wax, the whole nine yards, the whole shebang—in short, everything. The tontine is

named after Lorenzo de Tonti who invented the scheme in France in 1653. Tontines have been banned in the United States and Britain because of the potential incentive of participants to murder other participants to increase their shares) and becomes entitled to the entire annuity or unitrust amount for his or her life. On the death of the last surviving recipient, the trust assets are to be distributed to one or more qualified charities (charitable remainder organizations).

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

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

Same after as before—except. Each of the separate trusts has the same

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

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

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

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

> *Example.* Under the terms of Original Trust (a CRUT), Xenophon, Yenta, and Zhlub are entitled to share equally the annual payments of a 15% unitrust amount (unless all three recipients are actuarially close to death's door, the trust will fail the 10% minimum remainder interest requirement. But, hey, this is the IRS's example. Only the names have been changed by me to protect the innocent) amount (5% each) while all three are living, and upon the death of one recipient, the surviving recipients are entitled to the deceased recipient's share. Thus, if Xenophon dies first, the surviving recipients (Yenta and Zhlub) are entitled to share equally in the annual payments of the 15% unitrust amount (7.5% each) while both are living. Thereafter, if Yenta predeceases Zhlub, then upon the death of Yenta, Zhlub is entitled to receive annual payments of the entire 15% unitrust amount for life.

The three recipients and a horse, who is their lawyer, go into a bar and

divide Original Trust into three separate trusts (one for each of Xenophon, Yenta, and Zhlub). Each of the separate trusts holds one-third of the assets of Original Trust. Xenophon, Yenta, and Zhlub are each entitled to annual payments of a 15% unitrust amount from his or her separate trust (15% of one-third of the assets is equivalent to 5% of all the assets of Original Trust). After the division of Original Trust and upon the death of Xenophon, each asset of Xenophon's separate trust is divided pro rata and transferred to Yenta and Zhlub's separate trusts. Yenta and Zhlub each remain entitled to annual payments of a 15% unitrust amount from his or her separate trust, each of which is now funded with the equivalent of one-half the assets of Original Trust (15% of one-half of the assets is equivalent to 7.5% of all the assets of Original Trust). On Yenta's death, the assets of her separate trust are transferred to Zhlub's separate trust, and Zhlub remains entitled to annual payments of a 15% unitrust amount from his separate trust.

These are the same interests to which Xenophan, Yenta, and Zhlub would have been entitled under the terms of Original Trust if that trust had not been divided into separate trusts. (*Note that Xenophon,Yenta and Zhlub have died in alphabetical order.* This is realistic. If you read the obituary pages, you'll see that day after day people die in alphabetical order.)

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

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

Pro rata division—the rub as you shall see. To carry out the division of Original Trust in *Situation 1* and *Situation 2*, each asset of Original Trust is divided on a pro

rata basis among and distributed to the separate trusts. And on a consolidation (*Situation 1*) upon the death of a separate trust's recipient, each asset of that recipient's separate trust is to be divided pro rata and transferred to the separate trusts of the surviving recipients.

Who foots the bill? The recipients pay all the costs associated with the division of Original Trust into separate trusts, including legal fees of any court proceeding, and the administrative costs of the creation and funding of the separate trusts.

The IRS rules—drum roll:

1. In *Situation 1* and *Situation 2*, the pro rata division of Original Trust (a qualified

CRT) into two or more separate trusts doesn't cause Original Trust or any of the separate trusts to fail to qualify as a CRT under IRC §664(d).

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

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

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

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

Rev. Rul. 2008-41

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

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

caught off guard.

• **Gift to other recipient—concern.** In *Situation 2*, the two recipients are divorcing spouses and unlike *Situation 1* after Original Trust is split there is no consolidation of their separate trusts on the death of the first spouse to die. Although not dealt with in the ruling, there could be gift tax implications between the recipients if the younger recipient spouse is not a U.S. citizen or if the two recipients aren't spouses. By

surrendering the right to receive the entire annuity amount or unitrust amount on the death of the first spouse to die, doesn't the younger recipient make a gift to the older recipient equal to the difference in value of their survivorship rights? The facts say that the spouses are U.S. citizens so the gift tax marital deduction comes to the rescue. But for alien spouses there isn't a gift tax marital deduction and the gift wouldn't qualify for the $128,000 gift tax annual exclusion for alien spouses. And if the two recipients in *Situation 2* aren't spouses, the gift wouldn't qualify for the $12,000 annual-per-donee exclusion. Why? Those exclusions are for present interests only.

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

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

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

• **If the trust in *Situation 1* is a CRAT—comment.** Every schoolchild knows that you can't make additional contributions to a charitable remainder annuity trust.

Under the section of Rev. Rul. 2008-41 titled "Law and Analysis," the IRS states: "Section 1.664-2(b) provides that a trust is not a CRAT unless its governing instrument provides that no additional contributions may be made to the CRAT after

the initial contribution."

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

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

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

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

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

In non-charitable areas (such as division of trusts for GST purposes), the rulings require only that the assets fairly reflect net appreciation and depreciation…no class of investments language and no discussion of the capital gain issue. See Reg. §26.2654-1(b)(1)(ii): the severance of a trust that is included in the transferor's gross estate (or created under the transferor's will) into two or more trusts is recognized for purposes of chapter 13 if the governing instrument does not require or otherwise direct severance but the trust is severed pursuant to

discretionary authority granted

either under the governing instrument or under local law; and (among other things) "If severed on a fractional basis, the separate trusts need not be funded with a pro rata portion of each asset held by the undivided trust. The trusts may be funded on a non pro rata basis provided funding is based on either the fair market value of the assets on the date of funding or in a manner that fairly reflects the net appreciation or depreciation in the value of the assets measured from the valuation date to the date of funding."

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

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

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

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

- Will Original Trust and the separate trusts fail to qualify as CRTs under IRC §507©?

- Will excise taxes be imposed under IRC §507©?

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

- Will there be taxable expenditure under IRC §4945?

Iam satis—enough already.

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

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

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

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

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

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

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

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

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Background—gift tax implications for transfer to other income beneficiary. When donors who are spouses fund a two-life unitrust with joint or community property, the actuarially older spouse makes a gift to the actuarially younger

spouse of the difference in value of their survivorship interests. However, the gift qualifies for the gift tax marital deduction—if the actuarially younger spouse is a U.S. citizen. Alternatively, the spouses can reserve the right—exercisable only by will—to revoke the other spouse's survivorship interest in one half of the life income gift. That's what the donors in this letter ruling did.

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

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

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

Gift tax trap—caution. Here the trust was funded with community property and both spouses (donors) were to receive life income. Each disclaimed the right to receive income from the other's share of the community property used to fund the trust. Suppose the husband funded the trust with his own separate property providing unitrust payments for himself for life with payments to his wife if she survived him. Would IRS maintain that no gift tax charitable deduction is allowable if the donor were to give away his remaining life interest and his wife were to give away her survivorship interest? Would IRS maintain that the husband-donor had

already transferred an interest in the trust to a noncharity beneficiary, thus disqualifying him for the gift tax charitable deduction? Would it make any difference if his wife were to first disclaim her survivorship interest? **Comment:** IRS allowed a gift tax charitable deduction when one spouse renounced her survivorship interest before the other in *Letter Ruling 9529039.* IRS stressed that one party was acting before the other. *Reminder:* Letter rulings are not precedent. If in doubt, get your own ruling.

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

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

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

XXVII. TERMINATING ACRUT AND DIVIDING ASSETS BETWEENBENEFICIARY AND CHARITABLE REMAINDER ORGANIZATION

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

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

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

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

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

IRS goes into more detail. *Rev. Rul. 72-243*, 1972-1 CB 233 provides that a sale

of an income interest in a trust is a sale of a capital asset within the meaning of IRC §§1221 and 1222. The holding period for determining whether gain or loss from the disposition of an income interest is long term or short term commences on the date the taxpayer first held the interest. Apparently, the unitrust was created over a year before the unitrust was terminated because IRS ruled that Arnold will have long term capital gain.

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

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

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

Caution. If the remainder is to go to a private foundation (rather than a public

charity) there would be a prohibited act of self dealing. *Letter Ruling 200525014* revoked by *Letter Ruling 200614032*; *Letter Ruling 200616035*.

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

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

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

Adult child is the sole income beneficiary of a “net income with no makeup”

charitable remainder unitrust (NI-CRUT) that pays her 8% of the assets' net fair market value or actual trust income, whichever is lower. Parent (now deceased) created the NI-CRUT so Child is a disqualified person. Church is the charitable remainder organization and Trustee is a Church affiliate.

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

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

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

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

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

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

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

XXIX. NIM-CRUT TERMINATED—VALUING THE INTERESTS

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

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

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

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

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

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

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

IRS rules. The appropriate calculation of the actuarial value of the income recipient's interest must take into account the net-income provisions of the trust.

That requires the use of a reasonable method for the calculation which doesn't inappropriately inflate the income recipient's interest to the detriment of the charitable remainder organizations. One reasonable method to calculate the actuarial value of the income and remainder interests, rules the IRS:

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

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

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

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

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

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

trust is initially funded.

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

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

if you wish to flip the trust earlier than Greenacre's sale, on its sale, or later than its sale, you can flip at will—by selling the shares in cookthebooks.com.

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

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

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

XXX. EARLY TERMINATION OF SOME CHARITABLE REMAINDER TRUSTS— "CLARIFICATION"

Background. The Protecting Americans from Tax Hikes PATH Act of 2015—who names these things?—makes "permanent" retroactive for 2015 these charitable provisions that expired in 2014: direct tax-free charitable IRA transfers; S Corps making contributions; food inventory contributions—expanded; qualified conservation contributions—expanded; and contributions to agricultural-research organizations—new.

But here's a brand-new law that on its face appears favorable to taxpayers:

PATH '15 "SEC. 344. CLARIFICATION OF VALUATION RULE FOR EARLY TERMINATION OF CERTAIN CHARITABLE REMAINDER UNITRUSTS.

"(a) IN GENERAL.— [IRC1 Section 664(e) is amended—

"(1) by adding at the end the following: 'In the case of the early termination of a trust which is a charitable remainder unitrust by reason of subsection

(d)(3), the valuation of interests in such trust for purposes of this section shall be made under rules similar to the rules of the preceding sentence.', and

"(2) by striking 'FOR PURPOSES OF CHARITABLE CONTRIBUTION' in the heading thereof and inserting 'OF INTERESTS'.

"(b) EFFECTIVE DATE—The amendment made by this section shall apply to terminations of trusts occurring after the date of the enactment of this Act."

Translation: The "clarification" provides that the value of a beneficiary's life (or

term) interest on the early termination of a NIM-CRUT or NI-CRUT is to be determined the same way as if the trust were a STAN-CRUT.

The Code amendment and the Joint Committee's explanation don't tell why this "clarification" is important to some trust beneficiaries who want to terminate their trusts before the end of the specified term.

Why are some trusts terminated early?

- Terminated early when a donor gives his remaining life interest to the charitable remainder organization. Letter rulings on this termination method (except for one earlier outlier) haven't required a special way of valuing the donor's life interest in a NIM-CRUT or NI-CRUT when valuing the donor's charitable contribution for the then value of his life interest. Letter Rulings 200124010 and 200140027.

- Terminated early by dividing the trust assets between the life beneficiary and the charitable remainder organization based on the value of their then respective interests. IRS letter rulings hold that the value of the assets to be received by a NIM-CRUT life beneficiary is lower than the value he would receive had the CRT been a STAN-CRUT. This is the case when the IRC §7520 rate is lower than the percentage payout provided in the NIM-CRUT (same rule would apply to a NI-CRUT). Letter Rulings 200725044 and 201325018.

The Code amendment on its face eliminates the low valuation issue. One doesn't always know who is behind a law's modification, repeal or enactment. **No big guess here.** The motivating forces are some life beneficiaries of existing large NIM-CRUTs who wish to terminate their CRTs now by dividing the trust assets with the charitable remainder organization. But they don't want their life interests to be low valued as provided in earlier letter rulings.

Caution. A prudent buyer wouldn't buy a life interest in a NIM-CRUT or NI-CRUT paying the STAN-CRUT valuation amount if he would receive only the value as determined by the IRS in letter rulings when the IRC §7520 rate is lower the unitrust payout amount provided in the CRT. Generally, the charity will benefit by having the trust continue if no or little payments have been paid and will be paid to the life-income beneficiary.

So should a charitable remainder organization agree to terminate a NIM-CRUT or NI-CRUT when the life beneficiarywill receive assets equal to a STAN-CRUT valuation?

Attorneys General in some states must agree to an early termination. Despite the Code's "clarification" of the valuation rules, a state's AG could object to an early termination to protect the charity. And the charity's board, officers and employees

might not (should not?) approve an early termination (based on a STAN-CRUT instead of a NIM-CRUT valuation) because of the potential adverse financial consequences to the charity.

In the film Casataxa, Captain Louis Renault shuts down Rick's Place and Tax Shelter: "I'm shocked, shocked to find that 'self-dealing' is going on here."

Effective: Terminations of trusts starting December 19, 2015. Query. If this is a "clarification" rather than a new rule, why is it effective prospectively and not retroactively?

Parthian shot.A charitable remainder trust of any kind—CRAT, STAN-CRUT, NIM CRUT, NI-CRUT, FLIP-CRUT--can also be terminated early when the life beneficiary and the charitable remainder organization sell their respective life interests to a third party, The NI-CRUT, NIM-CRUT issue hasn't been raised in this situation. But the IRS hasn't been concerned about valuing the respective interests, but rather about shutting down plans designed to avoid or minimize capital gains on the sale of the life beneficiary's interest to a third party. Reg. §1.6111-4.

XXXI. CRAT — COMMERCIAL ANNUITY INVESTMENT OK; BUT MAJOR CAUTIONS

Situation. Donor wants to create a charitable remainder annuity trust with appreciated real property. The CRAT, it is represented to the IRS, qualifies as a CRAT under IRC §664(d)(1) and the corresponding regulations.

Donor asked the IRS to rule that this provision won't disqualify the CRAT:

> The Trustee shall have the discretion to provide for the annuity payment to Trustor [Donor] by allocating a portion of the trust assets to purchase an annuity contract which will guarantee to pay to the trust a sum equal to or greater than the Trustor's computed annual annuity payout for the duration of the trust. If the Trustee chooses to provide for the Trustor's annuity payment in this manner, the Trustee may only purchase such contract from an insurer with an A.M. Best Company Insurer Financial Strength Rating of "Superior" (A++, A+) or "Excellent" (A, A). After securing such contract, the Trustee may distribute any amount other than the amount described in *Treas. Reg. Section 1.664-2(a)(1)* to the charities named in Schedule B any time during the term of the trust. Upon the termination of all noncharitable interests, the Trustee shall distribute all of the principal and income of the trust (other than any amount due to the Annuity Recipient or the estate of

the Annuity Recipient) to the charitable organizations, in the percentages designated, as provided in Schedule B.

More facts. Donor anticipates that Trustee will purchase an annuity contract over which Trust possesses all incidence of ownership and is entitled to all payments,

that the annuity contract will pay the annuity amount annually to Trust, and that Trustee will then pay the annuity amount to Donor for his life.

IRS rules. Inclusion of the provision authorizing the purchase of an annuity will not jeopardize the status of the trust as a CRAT under IRC §664(d)(1). *Letter Ruling 201126007.*

Comment. The IRS ordinarily will not rule whether a charitable remainder annuity trust that provides for payments for one or two measuring lives satisfies the requirements of IRC §664.

Why not? In lieu of seeking the Service's advance approval of a CRAT, taxpayers are directed to follow the sample CRAT provisions outlined in Rev. Proc. 2003-53, 2003-2 C.B. 230. By following the models contained in that revenue procedure, taxpayers can be assured, says the IRS, that it will recognize a trust as meeting all the requirements of a qualified CRAT under IRC §664(d)(1), provided that the trust operates in a manner that is consistent with the terms of the trust instrument and that the trust is valid under applicable local law.

So why a ruling here? The CRAT will contain a provision not addressed in Rev. Proc. 2003-53. Thus the IRS ruled on whether a provision providing for the purchase of a commercial annuity would disqualify the trust. Note that the Service did not otherwise bless the CRAT.

General rules for taxation of a beneficiary's payments (but as you'll see in a moment, they won't apply here). Annuity trust and unitrust payments are taxable under the four-tier provisions of IRC §664(b) and Reg. §1.664-1(d)(1). And the income paid to the income beneficiary retains the character it had in the trust. Each payment is treated as follows:

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

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

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

Fourth, as a tax-free return of principal.

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

Payments received by an individual from a commercial annuity. The

payments 77

are deemed to be part taxable-interest and part tax-free return of principal. IRC §72(b)(1). The ordinary income part of the payment is taxable up to the highest income tax rate — currently 35%. (By contrast, domestic dividends are taxable at 15%, even for tax-payers in higher tax brackets.)

Payments received by a trust from a commercial annuity. The rule that part of each annuity payment is deemed to be a tax-free return of principal doesn't apply if the annuity holder is a trust — even if the trust is acting as the agent for a natural person. IRC §72(u)(1). So the taxpayer in the Letter Ruling under discussion could have all his annuity trust payments taxable as ordinary income — up to the 35% rate.

Caution re sale of real estate. Generally, no capital gain is incurred on transfer of appreciated assets to a CRT. Rev. Rul. 55-275, 1955-1 CB 295; Rev. Rul. 60-370, 1960-2 CB 203. Nor is there gain to donor on a sale by the CRT (except as taxable under four-tier system, above). *One exception:* the gain is taxable to the donor if the trust assets are sold and the proceeds are invested in tax-exempt securities pursuant to an express or implied agreement between the donor and trustee. Rev. Rul. 60-370, 1960-2 CB 203.

More to think about: mortgaged property. If real estate is to be transferred to a charitable remainder trust, it must be unmortgaged. Otherwise the CRT will be disqualified under the self-dealing rules, says the IRS. *Letter Ruling 9015049*.

Be careful about requiring specific investments. The trustee shouldn't be *required* to invest in any particular asset. That must be left to the trustee's discretion. Requiring the trustee of a CRAT or CRUT to make or keep investments — no matter how good — could result in IRS's disqualifying the trust. Reg. §1.664-1(a)(3). The donor would lose the charitable deduction **and** be taxed on any capital gain the trust realized when selling the appreciated assets.

Be sure that payments can be made. Funding an annuity trust with a non productive asset that cannot be readily sold can be hazardous to a donor's wealth. If the asset cannot be sold, and payments aren't made (or not made on time), the trust will be disqualified. *Atkinson,* 115 T.C. 26 (2000), aff'd, 309 F.3d 1290 (11 Cir. th 2002), cert. denied, 540 U.S. 946, 124 S. Ct. 388, 157 L.Ed.2d 276 (2003).

Prearranged sale. If the CRAT sells to a buyer with whom the donor had negotiated, and the sale was virtually a done-deal, the capital gain on a sale by the CRAT (or CRUT) would be taxable — and to the donor out of his pocket, not out of the proceeds of the sale by the trust.

Diversification reminder. It's great when a trust passes muster with the IRS. But make sure that trust investments don't run afoul of state diversification requirements.

Parthian shot. The favorable letter ruling (on which only the recipient can rely) deals with an immediate payment commercial annuity payable to a CRAT. The IRS, however, takes a dim view of NIM-CRUTs that invest in deferred payment commercial annuities. In January 2011, the IRS once again said that it will ordinarily not rule whether a trust that calculates the unitrust amount under IRC §664(d)(3) — a net-income-with-makeup trust (NIM-CRUT) — qualifies as an IRC §664 charitable remainder trust if a grantor, a trustee, a beneficiary (or a person related or subordinate to a grantor, a trustee, or a beneficiary) can control the timing of the trust's receipt of trust income from a partnership or a deferred annuity contract. The IRS is concerned that the trust will take advantage of the difference between trust income under IRC §643(b) and income for federal income tax purposes for the benefit of the unitrust recipient. *Translation:* The Service is concerned that the trust will be able to time the receipt of income for the beneficiary (unitrust recipient).

XXXII. CRT CAPITAL-GAIN-AVOIDANCE PLAN QUASHED—FINAL REGULATIONS

Treasury and the IRS just issued final regulations that thwart a capital-gain avoidance plan. The plan purports to avoid capital gain for a life (or term-of-years) beneficiary of a charitable remainder unitrust or annuity trust on a sale to a third party by the life beneficiary and the charitable remainder organization of their respective interests.

The final regulations adopt last year's proposed regulations and follow up on a 2008 IRS Notice in which the Treasury and the IRS (from now on, I'll mostly just say the IRS) described the plan (scheme*?), required notification to the IRS by participants and imposed costly penalties for non-notification.

IRS Notice 2008-99 said the Donor's basis would be reduced to zero on a trust termination by a sale of a CRT's assets to a third party by the life beneficiary and the charitable remainder organization.

The American Council on Gift Annuities submitted comments, that I prepared, to the IRS on Notice 2008-99. ACGA agreed that abuses should be curbed, but suggested a way to protect the fisc without adversely punishing non-abusive CRT terminations.

ACGA suggested to the IRS that on a sale by the life-income beneficiary and the charitable remainder organization of the trust assets to a third party, the life-income beneficiary's basis be his pro rata share of the charitable remainder unitrust's or annuity trust's basis reduced by any undistributed amounts then in the capital gains category of the four-tier taxation rules. Under Notice 2008-99, the life beneficiary would, in effect, have to pay tax on amounts already distributed to him and which were taxable to him.

Happy to report. The IRS in its proposed 2014 regulations and now in its 2015

final

regulations adopted ACGA's suggestion.

Before getting to the final regulations, here is background helpful in

understanding them and assuaging concerns about early termination of CRTs in typical "non-abuse" situations.

Stepped-up basis—general rule. For appreciated assets inherited at death, an heir gets a basis equal to the then fair market value (rather than taking over the decedent's lower basis). But a decedent had to give his life to achieve this.

Can the beneficiary of a CRUT or CRAT during his lifetime step up the basis of appreciated assets used to fund the trust (and any other trust assets) and then on an early termination of the trust receive proceeds equal to his interest in the trust free of capital gains tax? That's what concerned the IRS in Notice 2008-99, and in the recently issued final regulations that are the subject of this article.

Three situations follow. Situations 1 and 2 don't concern the IRS and shouldn't concern you. Situation 3 won't deliver the hoped-for benefits.

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

Situation 2—no problem. Some beneficiaries terminate their CRTs before the end of the specified term and the trust assets are divided between the beneficiary and the charitable remainder organization according to their respective interests at the CRT's termination. Letter rulings have sanctioned this. The termination is treated as a sale of a capital asset, not to a third party, of the beneficiary's term interest (generally measured by his life but sometimes a term-of-years). The beneficiary is deemed to have a zero basis and have capital gain. If the trust was created more than one year before its termination, the gain is taxed favorably. Although capital gains are taxable, this isn't a penalty situation involving the participants in the transaction. More about this later when the sale is to a third party.

Situation 3—problem. The IRS announced in Notice 2008-99 that it was aware of a transaction (described soon) in which a sale or other disposition of all interests in a charitable remainder trust (subsequent to the contribution of appreciated assets to the trust and their sale and reinvestment by the trust) resulted in the donor or other noncharitable beneficiary getting the value of that person's trust interest and claiming to recognize little or no taxable gain. "The IRS and Treasury Department