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CHARITABLE PLANNING

A. Charitable Deduction Limitations

1. Income tax deduction limitations for lifetime charitable gifts: the income tax charitable deduction for an individual donor is subject to limitations depending upon a number of factors, including but not limited to the following:

a. "Contribution base" means the individual's adjusted gross income without regard to any net operating loss carryback to the year. §170(b)(1)(F)

b. The maximum income tax deduction is 50% of the contribution base in any year, for contributions to a 50% organization that is made in cash or non-appreciated property

c. 50% organizations are defined in §170(b)(1)(A) and are essentially public charities

d. Contributions to 50% charities are limited to 30% of the contribution base if the asset contributed is long-term capital gain property

e. Contributions for the benefit of 50% charities are limited as a contribution to a 30% organization, below, ie charitable lead and remainder trusts

f. General rule: the deduction is at the fair market value of the asset contributed

g. Exceptions to FMV rule:

i. tangible personal property that is put to an un-related use by the donee organization is reduced by any long-term gain that would have been realized if the property had been sold. §170(e)(1)(B)(i).

ii. long-term capital gain property reduced to its basis for deduction purposes to use the 50% limitation in place of the 30% limitation. §170(e)(1)(C)(iii)

h. Charitable organizations that do not qualify as 50% organizations are 30% organizations

i. Contributions to 30% charities are currently deductible up to 30% of the contribution base, except
ii. if the asset contributed is long-term capital gain property, the deduction

is limited to 20% of the contribution base

i. Carryover of excess gift: contributions that exceed the above deduction limitations may be carried over for deduction in the next 5 succeeding years for a total of 6 years to take the deduction

    i. exception: contributions for the use of a private foundation do not qualify for the carryover, based on a PLR issued by the IRS 8824039, but a contribution to a CLT was allowed carryover status PLR 200010036
    ii. Note: if donor dies with unused carryovers, they are lost

2. There are no percentages limitations for the gift and estate tax charitable deductions – the full amount of the charitable component of the gift or bequest to charity is deductible for gift or estate tax purposes, respectively.

B. Gifts Currently Enjoyed by Charity.

1. Outright Transfers.
    a. Subject to certain limitations, outright transfers of cash, tangible and intangible personal property, and real property are deductible for income, gift and estate tax purposes. §170, §2055, §2522

2. Bargain Sales. §1011(b); Reg. 1.170A-4(c)(2); Reg. 1.1011-2
    a. A sale of a capital asset to charity for a price less than the fair market value of the asset is treated as a part sale and part gift.
    b. The amount received by the donor may in part be treated as a capital gain. The donor's basis in the property is allocated proportionately between the portion of the asset given and the portion sold based on the relative values of the two portions by comparing the sales price and the fair market value of the property.
    c. The donor will have gain in the amount realized reduced by the allocable share of the basis. The donor will have a charitable contribution deduction in the amount of the fair market value of the property transferred reduced by the amount realized.
    d. If any nonrecognition provision of the tax law is applicable, the donor would not pay any tax, i.e. like-kind exchange, $250,000/$500,000 exclusion on the sale of a principal residence.
    e. If property subject to indebtedness is given to charity, the transaction is treated as a bargain sale. The amount realized is the amount of such indebtedness of which the donor is relieved. Guest 77 T.C. 9 (1981)

3. Gifts of Undivided Interest in Property. §170(f)(3)(B)(ii); Reg. 1.170A-7(b)(1)(i).
    a. An undivided interest in property must include an undivided portion of each and every substantial right or interest owned by the donor and must extend over the same term as the donor's interest in the property, i.e. 20% undivided interest in real property, 1/2 interest in donor's life estate in real property, and 20% interest in remainder of trust owned by donor.

4. Charitable Lead Trust. §170(f)(2)(B).
    a. A charitable lead trust is a trust from which a charity (or charities) receives a fixed dollar amount (annuity) or a fixed percentage of the net fair market value of the trust assets (unitrust) annually, and upon the end of a term of years or upon the death of an individual, the remainder passes to the donor or another

non-charitable beneficiary (or beneficiaries).

b. Certain requirements.

(1) There is no minimum percentage that must be paid to charity if the trust payment is in the form of an annuity or unitrust amount. However, the amount must be paid at least annually to the charity.

(2) The trust cannot provide that the charity is to receive all the income, or any other provisions other than an annuity or unitrust to obtain the income tax benefits of the CLT.

(3) The term of the trust may be for any number of years or may be measured by the life or lives of individuals alive at creation of the trust.

(4) The trust agreement must contain specific provisions and private foundation rules.

c. Income Tax Aspects. §170(f)(2)(B); Reg. 1.170A-6(c).

(1) The donor is allowed an income tax deduction for the actuarial value of the income interest on the date of funding of the trust, <u>but only</u> if the trust is considered a grantor trust. The deduction is limited to 20% of the donor's contribution base as it is a gift "for the use of" and not "to" charity, and no carryover is permitted.

(2) If the trust qualifies for the income tax deduction, then each year of the term of the trust during the lifetime of the grantor any taxable income of the trust is taxable to the donor as it is earned, in effect recapturing the deduction.

(3) If the trust is a testamentary trust or is not a grantor trust, undistributed income is taxed to the trust each year, if any,, and there is no income tax deduction in the year of the funding for the grantor.

(4) Under the grantor trust rules, if the assets of the trust revert to the grantor or the grantor's spouse at any time (if the value of the reversion is at least 5% of the value at the time of the transfer), the trust is considered a grantor trust.

(5) The longer the term of the trust, or the larger the annuity or unitrust amount, the larger the amount the current income tax deduction will be.

d. Gift Tax Aspects. §2522(c)(2)(B).

(1) Whether the CLT is a grantor trust or not, a gift tax charitable deduction is allowed in the amount of the actuarial value of the annuity interest or unitrust interest. The value is determined by the dollar annuity or percentage unitrust amount and the term of years or life expectancy using the IRS tables.

(2) The gift tax charitable deduction is available whether or not the CLT is a grantor trust and is not limited as the income tax deduction.

(3) The value of the remainder is a taxable gift to the remainder beneficiary(ies), not eligible for the $13,000 annual gift tax exclusion as it is a future interest. The remainder passing to a spouse qualifies for the gift tax marital deduction. §2523. The value of the remainder is the value of the entire transfer to the trust reduced by the value of the charitable annuity or unitrust interest.

e. Estate Tax Aspects. §2055(e)(2)(B).

(1) If the CLT was established during the lifetime of the grantor, the gift of the remainder interest is an adjusted taxable gift for estate tax purposes.

(2) If the CLT is established upon the death of the grantor by will or in a revocable living trust, the estate tax charitable deduction is allowed in the amount of the value of the annuity interest or unitrust interest established in the trust, calculated as described above in d.
(3) If the remainder passes to a spouse, that gift qualifies for the estate tax marital deduction under §2056.
(4) There is no limitation on the amount of this estate tax charitable deduction.

f. Advantages of CLT.
(1) The CLT permits the transfer of assets to the individual beneficiary at a later date with a greatly reduced estate or gift tax cost, i.e. for minor children or grandchildren.
(2) The lifetime CLT is useful to an individual who has high income tax in the year of the transfer to the CLT and not in the future, i.e. retiree, or someone with a large severance package or capital gain in a given year and lower income in the future, since it produces an income tax deduction in the year of the transfer to the trust and taxable income in later years.

g. IRS sample safe harbor forms for CLUTs and CLATs:
(1) inter vivos CLUT: Rev. Proc. 2008-45, 2008-30 IRB 224 (7/25/08)
(2) testamentary CLUT: Rev. Proc. 2008-46, 2008-30 IRB 238 (7/25/08)
(3) inter vivos CLAT: Rev. Proc. 2007-45, 2007-29 IRB 89
(4) testamentary CLAT: Rev. Proc. 2007-46, 2007-29 IRB 102

5. Gifts of tangible personal property
a. Old rule: taxpayer could obtain a charitable deduction for a contribution of an undivided portion of an item of tangible personal property, ie artwork for part of the year. This allowed the taxpayer to give portions of the item over a period of years with a new charitable deduction with each gift and providing increased deductions as the item appreciated in value
b. The Pension Protection Act of 2006 ("PPA") (modified by the Technical Corrections Act of 2007) severely limited and possibly closed this opportunity by adding provisions to §170(o)(1) providing as follows:
(1) no income tax charitable deduction is allowed for a contribution of an undivided portion of an item of tangible personal property unless immediately before such contribution all interests in the item are owned
(A) by the donor, or
(B) by the donor and the donee organization
(2) To determine the deductible amount for income tax purposes of each additional contribution of an interest in the same item, the fair market value is the lesser of:
(A) the value used for purposes of determining the charitable deduction for the initial fractional contribution; and
(B) the fair market value of the item at the subsequent contribution date
(3) If the donor makes an initial contribution of an undivided portion to a charitable donee and then fails to contribute the balance of the interests in the item to the same donee by the earlier of 10 years after the initial gift and the death of the donor, then the income and gift tax

charitable deductions are recaptured (plus interest) plus 10% of the amount recaptured as additional tax. §170(o)(3), §2522(e)(3)

(4) If the donee organization of a contribution of a fractional interest in an item of tangible personal property fails to take substantial physical possession of the item by the earlier of 10 years after the initial gift and the death of the donor, or fails to use the item for an exempt purpose during that period, then the donor's income and gift tax charitable deductions are recaptured (plus interest) plus 10% of the amount recaptured as additional tax. §170(o)(3)(A) and (B), §2522(e)(3)(A) and (B)

(5) This new rule only applies to partial interest gifts made after enactment, even if a prior partial interest gift was made

(6) Although initially this limitation was to apply to the gift and estate tax charitable deduction as well as the income tax charitable deduction, the above Technical Corrections Act removed that provision due to the punitive consequences of that

6. Qualified Charitable Distributions from an IRA (QCD) §408(d)(8)

a. IRA charitable rollover: as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRA 2010"), signed December 17, 2010, §408(d)(8)(F) was amended to extend the IRA charitable rollover through 12/31/11 – Qualified Charitable Distribution or QCD

b. Requirements for QCD:

i. individual at least 70½ years old

ii. may direct a transfer of up to $100,000 in a given year

iii. from IRA only (not employer sponsored retirement plans, SIMPLE IRAs or SEPs)

iv. to qualified charity(ies) (ie public charities as defined in §170(c)(1)(A) other than support organizations and donor advised funds)

v. then the distribution amount is not included in the donor's federal taxable income and there is no charitable deduction

vi. only direct transfers to charities – no split interest gifts

vii. must be otherwise fully deductible – ie no quid pro quo for the gift

c. Distributions excludable under this provision are not taken into consideration in determining the deduction for charitable contributions under §170 and its limitations

d. Distributions excludable under this provision are taken into consideration as satisfying all or part of the donor's MRD for the year

e. The QCD is better than a withdrawal from the IRA and then contribution because the QCD is not included in the taxable income with a deduction since the deduction may not fully offset the income due to things such as charitable deduction limitations, partial disallowance of excess itemized deductions for high income earners, AMT, etc.

C. <u>Deferred Gifts to Charity</u>.

There are several types of split interest remainder transfers to charity which qualify for the income, gift and estate tax charitable deduction, which may also be paired with marital planning and the marital deduction. If the transfer is not in one of the specified forms, no charitable deduction will be allowed, even though there is an actual transfer to a charity at some time. These forms include the following: remainder interest in personal residence or farm, remainder interest in pooled income funds, charitable gift annuity, remainder interest in charitable remainder annuity trusts and unitrusts, and private foundations.

1. Remainder Interest in Personal Residence or Farm. §170(f)(3)(B)(i).
    a. Donor gives to charity a remainder interest in a personal residence or farm subject to a non-charitable interest for the life of individual(s) or for a term of years. Reg. 1.170A-7(b)(3)
    b. Reserved life estate can be for donor and spouse so that after first death, the surviving spouse may continue to live in the property
    c. "Personal residence" means any residence even though it is not the principal one, including stock in a co-op if the apartment is used by the donor. Reg. 1.170A-7(b)(3).
    d. "Farm" means any land used for the production of crops or livestock. Reg. 1.170A-7(b)(4).
    e. The amount of the deduction for income, gift and estate tax purposes is the actuarial value of the remainder interest after the life estate or term of years computed using the IRS tables for income interests in the month of the transfer.
    f. If the reserved life estate is for donor and spouse, then there is a charitable gift tax deduction for the actuarial value of the remainder interest, no gift for the value of the donor's life estate and marital deduction for the incremental value of the spouse's life estate after donor, if any, or if the property was in joint names, no gift for the reserved life estates. On the death of the first spouse, the property is included in the federal taxable estate eligible for estate tax marital deduction for the spouse's life estate and charitable deduction for the remainder interest, so no tax. Inclusion in the second spouse's estate is totally offset with the estate tax charitable deduction when the property then passes to the charity.
    g. The remainder interest cannot be in a trust, other than possibly a grantor trust.
    h. The charity must receive the property after the death of the life tenant(s). The document of transfer cannot require the sale of the property with the proceeds to go to the charity.
    i. The basis in the property is stepped up at the death of the life tenant(s) since the property is included in the taxable estate under §2036. This could be important if there is a sale of the property during the lifetime of a life tenant if the life tenant can no longer reside there. The proceeds would be divided between life tenant and charity remainderman based on the actuarial values of the respective interests at the time of the sale.

2. Pooled Income Funds. §642(c)(5); Reg. 1.642(c)-5.

    a. A pooled income fund is an investment fund created and maintained by a public charity (i.e. educational institution, church, hospital) which consists of property contributed by more than one donor which is commingled. Each donor transfers property to the PIF and either retains in himself or herself and/or creates for another individual a life income interest therein, thereby creating a charitable remainder interest. All property so transferred is invested together. Each donor (or donor's designated life income beneficiary) receives the pro rata share of the income of the PIF each year for life. On the death of the income beneficiary, (or successor individual beneficiary) the charity withdraws the donor's share of assets from the PIF and uses them for its charitable purposes.
    b. Certain Requirements. Reg. 1.642(c)-5.
        (1) The transfer to the PIF creates an irrevocable remainder interest in a charity.

(2) Donor either retains for himself or herself or creates for another individual(s), who is alive at the time of the transfer, a life interest in the income of the PIF.
(3) All property in the PIF is commingled with property transferred by other donors.
(4) Neither the transferred property nor investments by the fund may include tax exempt securities.
(5) The fund must be maintained by the same charity to or for the use of which the remainder interest is contributed.
(6) No donor or beneficiary may be a trustee of the fund.

c. Income Tax Aspects. §170(f)(2)(A); Reg. 1.642(c)-6(a)(1) and (2).
(1) The donor is allowed a charitable income tax deduction in the amount of the value of the remainder interest based on the age of the income beneficiary (or beneficiaries) and actuarial tables found in the Regulations.
(2) The donor does not recognize any capital gain upon transferring appreciated non-mortgaged assets to the PIF. The fund takes the property with the donor's basis and holding period, which are important in the event the asset is sold in the PIF due to the income pass through to the beneficiaries of the PIF.

d. Gift Tax Aspects. §2522(c)(2)(A).
(1) The transfer to a PIF has two components, namely the gift of the income interest(s) and the gift of the remainder interest to charity, calculated based on the age of the income beneficiary and the tables in the month of the transfer.
(2) The value of the charitable remainder is deductible.
(3) The value of the income interest is a taxable gift eligible for the $13,000 annual gift tax exclusion since it is a present interest of income for life. If the donor is the income beneficiary, there is no taxable gift. If the donor's spouse is the income beneficiary, the donor may elect to qualify this as QTIP property for the gift tax marital deduction. §2523(f).

e. Estate Tax Aspects. §2055(e)(2)(A).
(1) Transfer inter vivos
i. If the donor was the sole income beneficiary, the value of the fund is includible in the donor's gross estate. The estate then receives a charitable deduction for the full value of the fund passing to charity. §2055(a).
ii. If the income beneficiary is other than the donor, the fund is not includible in the gross estate as it was a completed gift upon the transfer to the PIF.
iii. If the donor retained the income interest and on donor's death the income interest goes to another income beneficiary, then the fund is includible in the donor's gross estate under §2036 and the estate is entitled to a charitable deduction in the amount of the value of the charitable remainder (or the entire amount if the second income beneficiary does not survive the donor). §2055(e)(2)(A), leaving the value of the life estate as a taxable devise.

iv. The marital deduction is available where the spouse is the income beneficiary, if the decedent or the decedent's executor makes the election for this QTIP property. §2056(b)(7).

(2) Testamentary transfer:

i. The amount of the devise to the PIF is includible in the gross estate and the estate is entitled to a charitable deduction in the amount of the value of the charitable remainder. §2055(e)(2)(A).

ii. If the spouse is the income beneficiary, the executor can make the §2056(b)(7) QTIP election to get the marital deduction. On the spouse's death, the fund is included in the spouse's estate under §2044 and then the full amount is deductable as a charitable contribution. §2055(a).

3. Charitable Gift Annuity: Certain charities have qualified to issue gift annuities to donors in exchange for donations to the charity. The donor receives an annuity (fixed dollar amount distributed per quarter) for life (or directs the annuity be paid to another individual) and upon the death of the annuitant, any balance remaining belongs to the charity for its purposes. If the donor purchases an annuity from a charitable organization, the donor is allowed an income tax charitable deduction for the excess of the amount paid for the annuity over the value of the annuity. If there is no excess, there is no deduction. Reg. 1.1011-2(a)(4). This is usually used for relatively small gifts from individuals who want or need to retain cash flow from the assets but want to irrevocably dedicate the balance to the charity, and who either are not giving enough or do not want to be bothered with a charitable remainder trust, below.

4. Charitable Remainder Annuity Trust and Unitrust.

a. A charitable remainder annuity trust or unitrust is a trust from which a non-charitable beneficiary receives a fixed dollar amount (not less than 5% nor more than 50% of the initial fair market value of the transferred property) (annuity) or a fixed percentage (not less than 5% nor more than 50%) of the net fair market value of the trust assets (unitrust) at least annually, and upon the death of the income beneficiary(ies), or after the specified term of years, charity(ies) receives the remainder of the trust. §664.

b. The unitrust may provide that the trustee pay the amount of trust income if that amount is less than the unitrust amount ("NI-CRUT").

(1) The trust may also provide that any deficiencies so created, when the income is less than the specified unitrust percentage, may be made up in later years ("NIM-CRUT"). §664(d)(3).

(2) The trust may flip from one type to another, or combine methods of determining the unitrust amount, if certain criteria are met, as provided in the Regulations. Reg. 1.664-3(a)(1)(c)

c. Certain Requirements – new model forms found in Rev. Proc. 2005-52 to 59 give us even more guidance.

(1) A sum certain, in the case of an annuity trust, or a specific percentage of the trust assets valued each year, in the case of a unitrust, must be designated as payable at least annually to a non-charitable beneficiary(ies) living at the time the trust is created for the life (lives) of the beneficiary or a term of years (not in excess of 20 years). §664(d)(1)(A) and (d)(2)(A).

(2) The annual amount paid to the non-charitable beneficiary cannot be less than 5% nor more than 50% of the initial fair market value of all assets placed in trust for an annuity trust, or must be a stated percentage of at least 5% but not more than 50% of the fair market value of the trust assets valued annually for a unitrust. §664(d)(1)(A) and (d)(2)(A).

(3) The remainder must have an actuarial value of at least 10% of the value of the assets transferred to the trust. §664(d)(1)(D) and (d)(2)(D).

(4) The remainder must be transferred to, or for the use of, qualified charitable organization(s), or retained by the trust for such use. No part of the remainder can go to or for anyone other than a charity. §664(d)(1)(C) and (d)(2)(C).

(5) The trust must provide that if at the time of distribution the remainderman is not a qualified charitable organization, the remainder is to be paid to one or more alternative qualified charitable organizations. Reg. 1.664-2(a)(6)(iv); Reg. 1.664-3(a)(6)(iv).

(6) The donor may retain for him or herself, or grant to the non-charitable beneficiary, the right to change the charitable remainder beneficiaries (add and delete charities, alter percentages, etc.) during life or by will, so long as the new beneficiary is a qualified charity.

(7) No amounts other than the specified annuity or unitrust may be paid to or for the use of anyone other than a charitable organization. No invasions of principal for the benefit of the non-charitable beneficiaries are permitted, except those necessary to make the payment of the annuity or unitrust. §664(d)(1)(B) and (d)(2)(B).

(8) No additions are permitted to an annuity trust. Unitrust governing instruments must either prohibit additions or make specific provisions therefor. Reg. 1.664-2(b) and Reg. 1.664-3(b).

d. Income Tax Aspects.

(1) The CRT is exempt from federal income tax on the income earned in the trust. §664(c).

(2) Under the Regulations, distributions to beneficiaries retain the income tax character to the beneficiary as to the trust and are taxable to the receiving beneficiary even though the income would not have been taxed in the trust. Distributions to non-charitable beneficiaries are characterized in the following order of priority:

i. First, ordinary income to the extent the trust has ordinary income for the year and undistributed ordinary income for prior years;

ii. Next, capital gain to the extent the trust has capital gains for the year and undistributed capital gains for prior years;

iii. Next, other income to the extent of the trust's other income for the current year and undistributed income for prior years;

iv. Lastly, tax-free distribution of trust corpus;

v. but, within each category of income, if there are separate classes of income in the category, the distribution from that category is treated as being made from each class, until exhaustion of that class, beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest Federal income tax rate (ie non-qualified dividends before qualified 15% dividends)

§664(b).

(3) If the CRT is funded during the lifetime of the donor, an income tax charitable deduction is allowed to the donor in the amount of the value of the remainder interest, calculated actuarially based on the age of the income beneficiary(ies) or the term of years, percentage unitrust or annuity, §7520 IRS discount rate for the month of the transfer, all in accordance with the Regulations under §170(f)(2)(A).
    i. If the remainder beneficiary is a 50% charity, the 50% deduction ceiling applies if the remainder is distributed to the charity and not held in further trust for the charity. Reg. 1.170A-8(a)(2).

(4) The donor does not recognize any capital gain on the transfer of appreciated property to the trust.

(5) No capital gain is recognized by the donor on a subsequent sale of assets by the trust unless assets are sold and the proceeds are invested in tax exempt securities pursuant to an express or implied agreement between the donor and the trustee.

(6) Until just recently, NJ had taken the informal position that the CRT is also exempt from NJGIT even though the statute provides that only a wholly charitable trust is exempt from NJGIT. A CRT is not wholly charitable due to the annuity or unitrust interest of one or more individuals but the Division followed the federal rule informally. The NJ Division of Taxation has announced that the CRT is not a tax exempt entity for NJGIT, and has started assessing income tax on the income of a CRUT that has not been distributed to the unitrust or annuity beneficiary

e. Gift Tax Aspects. §2522

(1) As with a pooled income fund, the donor makes two gifts: the income interest and the remainder interest to charity, calculated actuarially based on the age of the income beneficiary or term of years and the IRS tables.

(2) The value of the charitable remainder is deductible under §2522(c)(2)(A).

(3) The value of the income interest is a taxable gift eligible for the $13,000 annual gift tax exclusion. If the donor is the income beneficiary, there is no taxable gift. If the donor's spouse is the income beneficiary, the gift qualifies for the gift tax marital deduction. §2523(g). Note: for the marital deduction to be available, the CRT must have no non-charitable beneficiary other than the donor and spouse.

(4) The value of the charitable remainder is calculated using the §7520 rate for the month of the gift (funding of the CRT), or, at the election by the donor made on the Form 709, for either of the two months prior to death. The donor should determine which §7520 rate provides the largest charitable deduction for the donor – ie the higher the §7520 rate, the larger the charitable remainder. Note: if the donor and/or spouse is the sole lifetime beneficiary, the combination of no gift to donor, the marital deduction for the gift to the spouse and charitable deduction will zero out the trust and this election is not necessary.

f. Estate Tax Aspects. §2055

(1) Inter vivos trust
    i. If the donor was the sole income beneficiary, the value of the trust assets is includible in the donor's gross estate under

§2036(a); Reg. 20.2036-1(c)(1)(i). The estate then receives a charitable deduction for the full value of the trust assets under §2055(a).

ii. If the income beneficiary is other than the donor, the trust is not includible in the donor's gross estate, as a completed gift at the time of creation and funding.

iii. If the donor retained the income interest and on the donor's death the income interest goes to another lifetime beneficiary, the value of the trust assets is includible in the donor's gross estate. §2036(a). If the second income beneficiary has not survived the donor, the full amount of the trust assets is deductible as passing to charity at that time. If the second income beneficiary survives the donor, the estate has a deduction in the amount of the value of the remainder based on the age of the income beneficiary or the term of years and the amount of the annuity or percentage unitrust, leaving the beneficiary's life estate as a taxable devise. §2055(e)(2)(A). If the second income beneficiary is the donor's spouse, the marital deduction is allowed for the assets in the trust. §2056(b)(8). Note: for the marital deduction to be available, the CRT must have no non-charitable beneficiary other than the donor and spouse.

(2) Testamentary Trust: If the trust is created by the donor's will or at donor's death, the donor's estate is entitled to a charitable deduction in the amount of the value of the remainder interest based upon the age of the income beneficiary or term of years and the amount of the annuity or percentage unitrust. §2055(e)(2)(A). If the donor's spouse is the income beneficiary the marital deduction is allowed for such income interest. §2056(b)(8). Note: for the marital deduction to be available, the CRT must have no non-charitable beneficiary other than the donor and spouse. Note: the marital deduction is under §2056(b)(8), not §2056(b)(5) or (7), so the trust is not then includible in the spouse's estate under §2044, which could be beneficial as not impacting the possible use of §303 redemption, §6166 installment payment of tax, filing requirements, etc.

(4) This §2056(b)(8) marital deduction is not as a QTIP or power of appointment trust so that there is no inclusion in the spouse's estate when the second spouse dies.

(3) The value of the charitable remainder is calculated using the §7520 rate for the month of death, or, at the election by the executor made on the Form 706 Schedule O, for either of the two months prior to death. The executor should determine which §7520 rate provides the largest charitable deduction for the estate – ie the higher the §7520 rate, the larger the charitable remainder. Note: if the spouse is the sole lifetime beneficiary, the combination of the marital deduction and charitable deduction will zero out the trust and this election is not necessary.

g. PLR 200441024 provides guidance regarding the consequences of the early termination of a CRUT and pay-out of the balance in the trust to the unitrust beneficiary and remainder charities actuarially under Reg. 1.664-4 using the §7520 rate at the time of termination. The IRS concluded that the plan did not violate the self dealing or taxable expenditure rules nor did it constitute the termination of a private foundation (so that nothing could go back to the donor), and that the amount realized by the donor constituted long term capital gain.

h. PLR 200502037 deals with the division of a CRUT established to provide the unitrust to husband for life and then to wife, in connection with their divorce. The CRUT was divided into two separate CRUTs with each spouse as the sole non-charitable beneficiary of his or her respective CRUT. The IRS ruled that the old and new CRUTs were qualified CRUTs, §1041(a) avoided <u>Cottage Savings</u> gain to the parties, the successor trusts tacked their holding periods to the original CRUT's holding period, and the division was not an act of self-dealing or taxable expenditure.

i. IRS sample safe harbor forms for CRUTs and CRATs:
   (1) CRUT: Rev. Proc. 2005-52 to 59, 2005-34 IRB 412
   (2) CRAT: Rev. Proc. 2003-53, 2003-2 CB 230 and Rev. Proc. 2003-60, 2003-2 CB 274

j. Warning: under <u>Atkinson v. Comm'r</u>, 309 F.3d 1290 (11 Cir. 2002), aff'g 115 T.C. 26 (2000), if a charitable remainder trust is not properly administered during the lifetime of the donor, then the estate is denied the estate tax charitable deduction in the donor's estate by finding the CRT was not a valid CRT. A CRT must be set up under §664 of the Code and then also comply with the statutory and regulatory requirements of a CRT.

5. <u>Certain Marital Trusts (QTIP Trust) with Remainder to Charity</u>.

a. A QTIP trust is a trust established for the benefit of the spouse of the donor so that all income of the trust is paid to the spouse for life. The QTIP trust may have certain other provisions, as well. Upon the death of the spouse, the balance of the trust passes as provided in the trust agreement, which may be charity or partially to charity. A QTIP trust with a remainder to charity does not qualify for the income, gift or estate tax charitable deduction for the donor. However, if the donor (inter vivos) or the donor's executor (transfer at death), makes the QTIP marital deduction election, the full value of the trust (or the portion so elected) would qualify for the gift or estate tax marital deduction. §2523(f) for an inter vivos transfer and §2056(b)(7) for a trust upon the death of the donor. On the death of the second spouse, the assets are included in the spouse's estate under §2044, but that estate is allowed a charitable deduction for the portion or all of the remainder as property passing to a charity under §2055(a).

b. Advantages of QTIP over CRTs.
   (1) The surviving spouse will receive all the income of the trust, not just the annuity or unitrust amount.
   (2) The principal of the trust may be invaded for the benefit of the spouse.
   (3) The trust document is simpler to draft and the trust is simpler to administer.
   (4) The remainder can be split among charitable and non-charitable beneficiaries.

c. Disadvantages of QTIP as compared with CRTs.
   (1) A qualified charitable remainder trust is an income tax exempt entity and pays no income tax on income earned in the CRT, both ordinary and

capital gains. The unitrust or annuity beneficiary has income up to the amount of the distribution, with the same character as earned inside the CRT. But a QTIP is subject to tax on capital gain and the spouse pays income tax on all ordinary taxable income, and any capital gain that passes to the spouse with a distribution of principal.

(2) No income tax deduction is available upon the creation of the QTIP with remainder to charity. The donor spouse (or executor of donor spouse's estate) may make the QTIP election to obtain the benefit of the gift or estate tax marital deduction for the gift or devise.

(3) If the QTIP election is made, the value of the trust assets is included in the surviving spouse's estate, which could have an impact on special use valuation §2032A, extension of time to pay taxes §6166, or a §303 redemption of stock due to percentage limitations, and other matters relating to the gross estate.

6. <u>Private Foundation</u>

a. The typical private foundation is established by the donor as a trust or non-profit corporation which satisfies the requirements of §501(c)(3) with respect to purposes but whose support is limited in the number and type of donors so as not to meet the §509(a) public support tests.

b. There are many types of Private Foundations.

c. There are very strict rules that must be observed in the operation of a Private Foundation under §4940 et seq., i.e. no self dealing, minimum distributions, no excess business holdings, etc.

d. Donor obtains an income and gift or estate tax deduction up front and the funds are paid out to charity or charities over many years.

e. Private Foundations are useful in the year of high income where the donor does not want to decide which charities to give to or does not want to give the full amount in year one.

f. The private foundation also allows for junior family members to be involved in the charitable and philanthropic activities of the senior family members and ultimately continue these activities in the name of the family

g. Note the income tax deduction limitations above

7. <u>Donor Advised Funds</u>

a. Certain community foundations (ie New Jersey Community Foundation) and other organizations (ie Fidelity Charitable Services and certain brokerage houses) offering the equivalent of community foundations offer a type of account called a donor advised fund.

b. The donor establishes a fund with the foundation and retains the right to the donor (and/or other specified individuals, such as spouse and children) to make requests as to the recipients of distributions from the fund from time to time.

c. Although the foundation is not obligated to make the requested distributions, unless there is a compelling reason not to do so, the foundation usually follows the request.

d. This is the equivalent of a simplified private foundation since the donor obtains the benefit of the administrative services of the foundation and the investment expertise for the donor's separate fund at the foundation and most, if not all, distributions are made at the request or with the approval of the donor.

e. The other benefit of using the donor advised fund is that the foundation qualifies as a public charity and so is not subject to the private foundation rules and excise taxes, and the income tax deduction limitations for the donor are those of a public charity and not the lower limitations of gifts to a private foundation.

8. Special uses of CRTs and Private Foundations
   a. Appreciated property
      (1) Sale and donation of proceeds vs. donation of property and sale by CRT
      (2) Since the CRT is exempt from federal income tax, when the asset is sold, the proceeds remain in the trust for reinvestment, undiminished by federal income tax on any gain upon the sale (but subject to NJ income tax)
      (3) Useful for diversification of holdings at little tax cost
      (4) Convert low basis/low income producing assets into higher yielding assets for increased cash flow free of federal income tax (but not NJ income tax) – possibly to better cover expenses of an aging donor or spouse

   b. Large qualified employee benefits or IRA
      (1) If the individual has substantial qualified employee benefits, the family may net as little as 20% after estate, inheritance, income, etc. taxes
      (2) If there is any charitable intent, the CRT for family and charity may be an excellent source for such bequest
      (3) All or a portion of the qualified benefits passing to charity outright on death by beneficiary designation
         i. No estate, GST or inheritance tax, and
         ii. Charity pays no income tax – federal or NJ
      (4) All or a portion passing to the CRT
         i. Depending on the age of the individual beneficiary and the amount of the annuity or unitrust, the estate tax deduction may be substantial – but it is not total so there may be some estate tax, which must be paid from other assets
         ii. CRT pays no federal income tax on benefits received and reinvests the entire amount (net of NJ income tax)
         iii. Since the CRT pays no federal income tax, the annuity or unitrust payments may be more than an outright payment in just a couple of years, and if the individual(s) live a long time, the additional amounts may be substantial - the beneficiaries and charities get more and only the IRS gets less
         iv. Potential creditor protection for the CRT beneficiaries

9. IRAs, §401(k) plans, qualified plan benefits

   a. An IRA, §401(k) or other qualified plan benefits can be a great source of charitable giving by the designation of a charity as beneficiary of all or part of such benefits
   b. This can be accomplished by a percentage of fractional interest, but generally not a specific dollar amount
   c. The designation of a charity results in the Federal Estate Tax charitable deduction, New Jersey Estate Tax charitable deduction, probably other state estate tax charitable deduction, and charity is a Class E exempt beneficiary for New Jersey Transfer Inheritance Tax purposes
   d. In addition, the charity does not pay any income tax when it receives the benefits.

10. <u>Replacing amounts passing to charity for the family</u>

a. Concern: although charitable gifts result in substantial tax savings, the family of the donor may feel cheated out of part of their "inheritance"

(1) With a CRT, if the donor lives a long time, the donor may replace assets passing to charity through investing the distributions but if the donor dies shortly after establishing the trust, the estate may suffer depletion. Similarly, a CRT for the benefit of a child allows the child to reinvest the distributions for the child's beneficiaries.

(2) One solution: the donor may use the income tax savings from the income tax deduction on creation to buy life insurance in an amount to replace (in whole or part) the amount passing to charity, and similarly, the other non-charitable beneficiary may use some of the annuity or unitrust distributions to pay for life insurance on the beneficiary's life for such beneficiary's intended beneficiaries

(3) Single life insurance on the life of the donor or second to die insurance on the lives of donor and spouse

(4) When the CRT is established, also establish an irrevocable life insurance trust with Crummey powers

(5) Recall: if the ILIT is properly established and maintained, the proceeds of the life insurance will be outside donor's (or child or other beneficiary's) estate

(4) Hence, the assets in the CRT pass to charity free of estate and inheritance tax due to the estate tax charitable deduction and inheritance tax exemption for gifts to charity, and the insurance proceeds pass to the family free of estate and inheritance tax

D. Lifetime donations vs. testamentary gifts

1. Income tax deductions

a. A charitable gift made during life may be eligible for an income tax charitable deduction, subject to the limitations of §170 as to the type of organization and percentage of adjusted gross estate limitations per year, with carryovers for up to five years thereafter

b. A split interest trust may be eligible for a current income tax deduction in the amount of the actuarial value of the charitable portion of the gift while the donor retains certain significant benefits from the property (ie CRT, gift annuity, gift of remainder interest in a residence) if it qualifies under §170 and §664

c. There is no income tax deduction allowed to an estate for a charitable bequest or charitable transfer as a result of the death of the donor (ie beneficiary of IRA, life insurance, etc.)

d. See above discussion of the income tax consequences of the various forms of gifts

e. A charitable gift during life may result in income tax savings immediately, and then keep all or a portion of the assets out of the taxable estate thereby obtaining the equivalent of an estate tax charitable deduction for the same gift or bequest – a double benefit

f. A charitable gift during life which keeps the assets out of the gross estate may also have the benefit of permitting the estate to qualify for certain benefits based on the percentage of the estate consisting of certain assets, ie §303 redemption, §6166 installment payment of taxes, etc.

2. Gift tax deductions
    a. A charitable gift made during life may be eligible for a gift tax charitable deduction, subject to the limitations of §2522
    b. A split interest trust may be eligible for a gift tax deduction in the amount of the actuarial value of the charitable portion of the gift while the donor retains certain significant benefits or grants such benefits to another under §2522(c)(2)
    c. The value of the charitable gift or charitable portion of a split gift is deductible in full, not subject to percentage limitations as with the income tax deduction
    d. There is no gift tax or gift tax deduction to an estate for a charitable bequest or charitable transfer as a result of the death of the donor as it is not considered a gift – the transfer tax is the estate tax
    e. See above discussion of the gift tax consequences of the various forms of gifts

3. Estate tax deductions
    a. A charitable bequest or transfer as the result of the death of the donor (ie under a trust, by beneficiary designation, etc.) may be eligible for the estate tax charitable deduction if it satisfies the requirements under §2055
    b. A split interest gift may be eligible for the estate tax charitable deduction in the amount of the actuarial value of the charitable portion of the gift while one or more individuals are granted benefits of the assets under §2055(e)(2)
    c. The value of the charitable bequest or transfer or charitable portion of a split gift is deductible in full, not subject to percentage limitations as with the income tax deduction, even to the full amount of the residuary estate
    d. A bequest or transfer to charity at death may have the benefit of the estate tax deduction, but did not get the benefit of an income tax deduction during the lifetime of the donor
    e. See above discussion of the estate tax consequences of the various forms of gifts.

E. Allocation of estate and inheritance taxes

1. Limitation on federal estate tax charitable deduction
    a. §2055 provides for the estate tax charitable deduction for funds passing to charity (ie outright) or for charity (ie CRT, CLT, remainder interest in personal residence or farm, charitable trust, etc.) in the amount actually passing to or for charity, determined actuarially for split interest gifts
    b. If the charitable bequest is charged with any estate or inheritance or other death tax on the estate, then the charitable deduction is reduced by the amount of such tax
    c. Split interest trusts (CRT, CLT) must specifically provide that no estate, inheritance or other death tax will be paid from the trust funds or funds passing from the donor or the estate to the trust or the trust will not be a qualified split interest trust

2. New Jersey Transfer Inheritance Tax treatment of charitable gifts
    a. Charities are Class E beneficiaries, not subject to NJ Transfer Inheritance Tax N.J.S.A. 54:34-4(a) and (d)
    b. Charities include tax exempt entities and organizations, including the State of NJ and its political subdivisions, educational, charitable, scientific, religious organizations, hospitals, public libraries and other non-profits.
    c. Charitable organizations of foreign jurisdictions are not exempt for NJ Transfer Inheritance Tax purposes unless the foreign jurisdiction offers an equal and like

exemption for transfers to or for NJ organizations.

d. The United States government or any agency thereof is not exempt.

3. Care should be taken in drafting the tax clause for a decedent making a charitable provision, especially if all or a portion of the residuary estate is to pass to charity
   a. If charity is to receive all or a portion of the residue, a circular computation results and a payment of tax on the tax
   b. If a portion of the "residue" is desired, the bequest should be defined as a percentage or fraction of the gross estate or gross estate reduced by all §2053 deductions, before taxes, to avoid the circular computation
   c. If the will is silent as to the allocation of death taxes due from the estate, then the New Jersey Apportionment Statute N.J.S.A. 3B:24-1 et seq. applies allocating the death taxes among all beneficiaries of the estate (beneficiaries of both probate and non-probate taxable assets) in proportion to their shares of the gross estate. However, the charitable beneficiary obtains the benefit of the tax exempt status under N.J.S.A. 3B:24-4(b) so that the charity does not pay any of the death taxes.

F. Pecuniary vs. residuary devises: income tax aspects
   1. Pecuniary devise: specific dollar amount or specific percent of the gross estate as determined for federal estate tax purposes or gross estate reduced by §2053 deductions
   2. Residuary devise: entire residue or percent or fraction of the residue
   3. Funding of pecuniary devise with assets of the estate
      a. Treated as if the estate sold the asset at the fair market value on the date of distribution and distributed cash so that the estate realizes and recognizes capital gain or loss on the distribution
      b. Beneficiary takes the asset with a basis equal to the value on the date of transfer as a result of the recognition of gain or loss to the estate
   4. Funding of portion of residue with assets of the estate
      a. Fairly representative share of the assets of the estate
      b. Generally no income tax consequence to the estate
      c. Beneficiary takes the assets with the basis to the estate, ie date of death or alternate value

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