THE CHARITABLE GIVING TECHNIQUES MOST CHARITIES OVERLOOK

An awareness of their appeals to donors can make these techniques powerful fundraising tools.

WENDELL R. BIRD

In the wake of November's election and the administration's claim of a mandate, charitable giving legislation appears likely for 2005. It could include a nonitemizer deduction, charitable contributions of IRAs, and possibly the regulation of abuses.

Estate and gift tax changes are likely as well, since the 2001 estate tax repeal only lasts through 2010. The House has passed several times a provision to make the repeal permanent, but the Senate, while having a majority, was short of the 60-vote margin needed to defeat a filibuster. The November elections appear to have changed the Senate to the point that it will also vote to make estate tax repeal permanent, though subsequent changes in Congress could result in estate taxes being reinstituted.[1]

Forthcoming legislation is likely to leave a number of charitable giving techniques unaffected, and perhaps even encouraged. Thus, many charities will continue the use of more widely used techniques such as charitable remainder trusts and bargain sales. They may, however, continue to underuse—or even remain unaware of—charitable bailouts of C corporation earnings, charitable gifts of S corporation stock, the new donor-managed accounts, charitable remainders in residences and farms, conservation easements, charitable lead trusts, charitable gift annuities, contributions of retirement assets, and capital gains planning for years after 2010.

To be most effective in their fundraising, charities should be aware of all the arrows that potentially could be in their quivers. The discussion below examines some of those arrows, and some of the implications of their use.[2]

Contributions of appreciated securities

Contributions of appreciated securities to a public charity, or contributions of appreciated publicly traded securities to a private foundation, can provide a charitable deduction equal to their fair market value while avoiding tax on the appreciation. In either case, though, the donated securities must be capital assets that have been held for more than a year.[3]

A charity can successfully appeal for a contribution of appreciated securities at any time, because such a contribution nearly always offers the donor tax advantages over a contribution of cash (so long as the donor has not exceeded contribution percentage limits).[4] Such a gift can be particularly appealing to a donor who is about to try to sell the securities or the business, because:

- It avoids any tax on the capital gain or ordinary income that would arise from a sale.
- A charitable deduction is available equal to the fair market value of the long-term capital gain stock that is contributed to a

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public charity. This is true even though that gain is excluded from income.

The benefit to the charity of such contributions is that it receives and can sell most contributed stock without tax. Charities generally are not subject to capital gains tax, except a tax on appreciated S corporation stock.[5]

Requirements. The donated stock must have been held for more than a year to be long-term capital gain property that is eligible to be deducted at fair market value.[6] It must be completely delivered, must not involve retained interests,[7] must be the donor's entire interest in the shares given rather than a partial interest,[8] and must be appraised if not publicly traded.[9] The donor must obtain a contemporaneous written receipt if the gift is valued at more than $250.[10]

The donated stock should not be preferred stock received as a stock dividend, or the fair market value deduction will be reduced by the portion of the stock that is deemed to be ordinary income rather than long-term capital gain. In that situation, only the adjusted tax basis will be deductible.[11]

Income tax deduction. Contributions of appreciated securities that have been held for more than a year are deductible in an amount up to 30% of the individual donor's adjusted gross income (AGI) if made to a public charity or a 50% foundation (e.g., a pass-through or pooled fund foundation qualifying under Section 170(b)(1)(E)), and up to 20% of the donor's adjusted gross income if to a grantmaking private foundation.[12] When donated to a grantmaking private foundation, contributions of publicly traded securities are deductible at fair market value,[13] while contributions of other securities are deductible only up to their adjusted tax basis,[14] subject to these percentage limits. By contrast, contributions of cash are deductible up to 50% of the individual donor's AGI if to a public charity or a 50% foundation, and up to 30% of the donor's AGI if to a grantmaking private foundation,[15] in either case also counting contributions of appreciated property. Excess contributions can be carried forward for up to five succeeding tax years.[16]

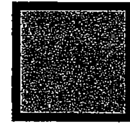
Contributions of appreciated real estate

A contribution of appreciated real estate to a public charity, if the real estate has been held more than one year and is a capital asset, provides a charitable deduction equal to its fair market value while avoiding tax on its appreciation.

A contribution of appreciated real estate nearly always offers the donor tax advantages over a contribution of cash (so long as the donor has not exceeded contribution percentage limits), and can be particularly appealing if the donor is ready to sell the real estate.

Income tax deduction. Contributions of real estate that has been held for more than a year are deductible up to 30% of the individual donor's AGI if made to a public charity. Contributions of real estate are rarely made to grantmaking private foundations, because the charitable deduction is equal only to the adjusted tax basis,[17] not the fair market value.

Requirements. Most of the requirements for contributions of appreciated stock apply here



A CONTRIBUTION OF APPRECIATED SECURITIES NEARLY ALWAYS OFFERS THE DONOR TAX ADVANTAGES OVER A CONTRIBUTION OF CASH.

[1] See generally Bird, "Charitable Gift Planning after 'Repeal' of the Federal Estate Tax," 14 Exempts 114, at 122-24 (Nov/Dec 2002).

[2] This article cannot be comprehensive while maintaining its present length, and so does not attempt to cover every possible technique. Charitable remainder trusts, bargain sales, donations of tangible property, and insurance-based contributions are not addressed, nor are the uses of donor-advised funds, supporting organizations, and private foundations. See generally Bird, "Donor Advised Funds and Community Foundations," 13 Exempts 68, (Sep/Oct 2001). Neither does this article discuss state tax deductions, which can vary, or substantiation requirements.

[3] Bird, "Charitable Giving Techniques and Other Estate Techniques," 5 Jnl. of Practical Est. Plan. 17 (Oct/Nov 2003).

[4] This article does not cover tax preferences subject to alternative minimum tax (AMT), and AMT should always be considered and calculated before making irrevocable charitable contributions.

[5] Section 512(b)(5), except inventory and property held primarily for sale to customers in the ordinary course of business; Section 512(e)(1)(A).

[6] Section 170(e)(1)(A).

[7] Rev. Rul. 81-282, 1981-2 CB 78 (retained right to vote stock); Stark, 86 TC 243, 251-52 (1986) (substantial retained rights).

[8] Sections 170(f)(2), (3); Reg. 1.170A-7(b)(1)(i); Stark, *supra* note 7 at 251-52. Among permitted partial interests are the donor's entire interest in the property (not created in order to make the contribution) and a qualified conservation interest.

[9] The appraisal must be by a qualified appraiser if the non-public securities are valued at more than $10,000 (or if other property is valued at more than $5,000), contain specified information on Form 8283, and be made within 60 days before or after the donation. Reg. 1.170A-13(c)(3)(ii).

[10] Section 170(f)(8).

[11] Section 306, unless the taxpayer carries the burden of showing the preferred stock did not have a principal purpose of tax avoidance, Section 306(b)(4).

[12] Section 170(b)(D)(i)(I).

[13] Section 170(e)(5), provided also that a donor may not contribute more than 10% of such "qualified appreciated stock" of a corporation.

[14] Section 170(e)(1)(B)(ii).

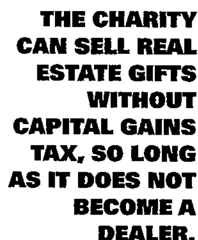
[15] Sections 170(b)(1)(A), (B).

[16] Section 170(d).

[17] Section 170(e)(1)(B)(ii).

as well. The real estate should be unmortgaged, because a contribution of mortgaged or encumbered property is treated as a bargain sale, and generates income equal to the mortgage assumed by the charity.

Real estate can carry liabilities under environmental laws. For this reason, it is advisable for charities to form supporting organizations to receive donations of real estate,[18] and to decline to receive title directly. It is also advisable for charities to do visual inspections, and at least Phase I environmental tests, before accepting real estate.



THE CHARITY CAN SELL REAL ESTATE GIFTS WITHOUT CAPITAL GAINS TAX, SO LONG AS IT DOES NOT BECOME A DEALER.

Advantages. The benefit to the charity of such contributions is that it can sell real estate without capital gains tax, so long as it does not become a dealer. This advantage may be offset by the difficulty of selling the property, especially if extensive repairs are needed or the location is undesirable.

The tax advantages to the donor are similar to those for gifts of appreciated stock:

- Avoidance of any tax on the capital gain or ordinary income that would arise from a sale.
- A charitable deduction equal to the fair market value of the long-term capital gain property contributed to a public charity, even though that gain is excluded from income.

Charitable bailouts

Charitable bailouts (or contributions of C corporation accumulations) are contributions of C corporation stock, followed by the redemption of that stock by the corporation, without any obligation by the corporation to redeem the stock at the time of the contribution.[19] In effect, the problem cash is bailed out of the C corporation and contributed to the charity.

C corporations often build up cash that invites a corporate tax on excess accumulations—effectively a double tax on those dividends if they cannot be "qualified dividends." C corporations typically cannot contribute enough of the excess cash to solve the problem themselves, because their deductible charitable contributions may not exceed 10% of taxable income.[20]

A charity can most effectively appeal for a contribution of C corporation stock, and ultimately cash, from a donor who has a profitable closely held C corporation and a potential excess accumulation problem. Besides avoiding the second tax, the donor can also transfer control and future appreciation to children or other shareholders, because after the redemption the donor's ownership is reduced and the children's ownership is increased.[21] A donor considering sale of a C corporation, or of his or her stock, can donate it under the rules outlined in the discussion of gifts of appreciated securities, above.

The charity benefits from this technique by receiving the cash after the redemption, and perhaps by receiving a contribution that it otherwise would have received only at the donor's death.

Requirements. To avoid constructive dividend treatment, the contribution must be made without any legal obligation or understanding for the charity to seek redemption of the stock, or for the corporation to redeem it.[22] The owner of the C corporation stock may donate it to charity, and the C corporation may redeem its stock with accumulated cash.[23]

There must be no restriction, which could make the transaction an incomplete gift, and no reservation of rights such as voting rights, which would make it a gift of less than the donor's entire interest and thus nondeductible. The donated stock should not be preferred stock received as a stock dividend, unless adverse tax consequences are considered.[24]

Income tax deduction. A fair market value deduction is possible only if the stock is donated to a public charity, rather than a private foundation (and only if it has been held for more than a year and is a capital asset). Only

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[18] Title holding organizations under Section 501(c)(2) or (c)(25) are not the donees, because gifts to such organizations are not deductible, though they are used to acquire title by charities buying real estate.

[19] Rev. Rul. 78-197, 1978-1 CB 83. See generally Bird, "Taxable Subsidiaries of Exempt Organizations," 4 Practical Tax Lawyer 53, 1990. If the donated stock is S corporation stock, the charity owning it will be taxed on its share of net income, and on any appreciation over tax basis when the stock is sold or redeemed. Section 512(e). If the donated interest is C corporation stock, income has already been taxed, so dividends are not taxed to the charity. Section 512(b)(1). If the donated interest is partnership or LLC units, the charity owning them will be taxed on its share of net income that is not excluded as dividends, interest, qualifying rents, annuities, and capital gains. Section 512(c). Special rules apply to payments from controlled entities. Section 512(b)(13).

[20] Section 170(b)(2).

[21] The IRS, however, can refuse to apply Rev. Rul. 78-197, *supra* note 19, if the purpose is to make an indirect gift. TAM 8552009.

[22] Blake, TCM 1981-579, *aff'd*, 697 F.2d 473, 51 AFTR2d 83-445 (CA-2, 1982); TAM 8552009; Rev. Rul. 78-197, *supra* note 19.

[23] Rev. Rul. 78-197, *supra*, note 19.

[24] Section 306, unless the taxpayer carries the burden of showing the preferred stock did not have a principal purpose of tax avoidance, Section 306(b)(4).

the tax basis is deductible when stock that is not publicly traded is donated to a private foundation. In that situation, the owner-donor often gets an IRS private letter ruling to confirm that the redemption will not cause private foundation excise taxes to apply.[25]

Benefits and drawbacks for donor. The advantages to the donor of charitable bailouts include:

- Getting business cash to the charity without double taxation as both a dividend and an unreasonable accumulation.
- A charitable deduction for the owner for contributing the stock to charity, equal to the fair market value of the stock,[26] even though he or she was not taxed on receiving a dividend or salary.
- No dilution of a sole owner's equity (after the redemption he or she still owns 100%), and no effective transfer from a parent to other family members (after the redemption the donor owns a lower percentage and the family members own a higher percentage).

There are disadvantages, however. These include:

- Having to keep the contribution separate from the redemption, and having appropriate corporate documents for a redemption.
- The risk of treatment as a dividend if the transaction is not done carefully—for example, if there is an existing binding agreement to redeem the stock.[27]
- The inability to contribute to a private foundation and enjoy a fair market value deduction if the stock is not traded publicly.

Contributions of S corporation stock

Contributions of S corporation stock to Section 501(c)(3) organizations allow donors to take a charitable deduction and potentially receive other tax advantages. The old rule that charities could not hold S corporation stock without destroying the S election was repealed in 1996 (effective in 1998) to allow Section 501(c)(3) organizations to be S corporation shareholders.[28]

A charity can most effectively appeal for a contribution of S corporation stock when:

- A donor who is seeking to sell an S corporation, or his or her stock in it, can deduct the fair market value of the stock (except to the extent any of the gain would not be long-term capital gain if the corporate assets were sold[29]), while avoiding capital gains tax on the gain, by contributing some or all of the S corporation stock.
- A donor who is already contributing more than his or her 50% limit on current deductions can continue to contribute an amount equal to S corporation distributions, without it counting toward the deductible percentage limit, by contributing the underlying S corporation stock and continuing to have the S corporation make distributions in excess of the taxes the charity will pay on its share of corporate income.

The goals in the first situation are not achieved as well by the S corporation itself contributing assets such as cash to the charity. The charitable deduction would then be split pro rata among the shareholders and, if appreciated assets were contributed, there would be a net reduction in each shareholder's basis in their shares.

In the second situation, a contribution is advantageous to the charity only if the donor is exceeding percentage limits on charitable deductions, and so is reducing his or her giving. The Section 501(c)(3) organization that owns S corporation stock will be taxable on its share of corporate net income (whether or not distributed),[30] while it would not be taxable on that income if the donor received it and donated it.

The benefit to the charity of such contributions is that it receives its pro rata share of any distributions of the S corporation before the company is sold, and receives its pro rata share of the sale price if the company is sold.

Requirements. A completed contribution must occur, by delivery of a stock certificate or an irrevocable assignment of stock ownership. Any restriction could be treated as an incomplete gift, and any reservation of rights (such as voting rights) would be treated as a gift of less than the donor's entire interest, which is nondeductible.

'PROBLEM' CASH CAN BE 'BAILED OUT' OF A C CORPORATION AND CONTRIBUTED TO CHARITY.

[25] E.g., Ltr. Rul. 200230004.

[26] A fair market value deduction always requires that a one-year holding period be met, Section 170(e), and that the stock or other intangible asset be a capital asset, given to a public charity or a 50% foundation, under current federal tax law.

[27] Palmer, 62 TC 684 (1974), *aff'd on other grounds,* 523 F.2d 1308, 36 AFTR2d 75-5942 (CA-8, 1975), *acq.,* 1978-2 CB 2; Rev. Rul. 78-197, *supra* note 19; see Blake, *supra* note 22.

[28] Sections 1361(b)(1)(B), (c)(6).

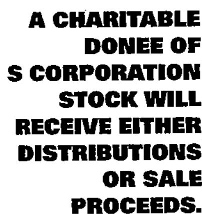
[29] Section 170(e)(1).

[30] Section 512(e).

The IRS has stated that it will challenge contributions of S corporation nonvoting stock, where the donor or others retain S corporation voting stock, as shams lacking economic substance and also as violating the single-class-of-stock requirement if warrants are also issued.[31] An example of an abusive transaction is an S corporation's purporting to issue nonvoting stock that would be deemed to receive and be taxable on 90% of the corporate income, which stock would be given to charity, coupled with the issuance of warrants that would enable the shareholders to purchase the contributed stock at what was expected to become a discounted price, when distributions were stopped and profits were retained.

Income tax deduction. The rules described under charitable bailouts apply here as well.

Advantages and disadvantages to the charity. The advantage to the charity of a donation of S corporation stock is the receipt either of distributions or, if the company is sold or the stock is redeemed, sale proceeds.



A CHARITABLE DONEE OF S CORPORATION STOCK WILL RECEIVE EITHER DISTRIBUTIONS OR SALE PROCEEDS.

The disadvantages include:

- Needing to ensure that distributions are made at least equal to taxes on the charity's share of the S corporation's net income, because the charity's share will be taxable to it whether or not net income is paid out.
- Having to pay corporate tax on the sale proceeds if the S corporation's stock or assets are sold (which can be reduced if the charity is a trust or takes title to the S corporation stock via a trust).

For this second reason, it is advisable for charities that are corporations rather than trusts (and so do not enjoy reduced tax rates for capital gains) to form trusts that are supporting organizations to receive donations of S corporation stock. Such trusts can enjoy capital gains rates when the S corporation stock is sold, and possibly can also reduce the amount of taxable income by 50% because of an offsetting charitable deduction against the unrelated business taxable income[32] upon distributing that amount to the supported public charity.

Donor-managed accounts

Donor-managed accounts enable a donor to make a contribution while making investment decisions for a specified number of years. They came onto the scene in 2004 when two favorable private letter rulings were issued.[33]

A charity can most effectively appeal for a contribution when it offers a donor-managed account to those donors who would otherwise delay contributing securities out of concern that the charity would unwisely sell them too soon or too late. Using a donor-managed account, such donors can contribute the securities for an immediate deduction, while retaining limited investment control for up to ten years.

The donor cannot enjoy this investment authority with a donor-advised account or community foundation account, because the retained investment authority would make the contribution incomplete and would delay the charitable deduction.[34] The donor's choice upon establishing an account with the large donor-advised funds is typically among a handful of investment pools with no choice of specific securities. The donor can retain investment authority with a private foundation, but only at the cost of less attractive limits on charitable deductions and more restrictions on operation.

The donor cannot use a donor-managed account with sale of a business, unless in a future ruling the IRS modifies the requirement that the donor not own more than 5% of any stock held by the account.

One benefit to the charity of this technique is in increasing the donor's comfort, and thereby perhaps receiving the contribution sooner than it otherwise would. In addition, it may net a larger amount from the securities by the donor's using superior knowledge of the securities to make the decision about when to sell them.

Requirements. Ltr. Rul. 200445023 and Ltr. Rul. 20445024, which are identical, set out the requirements for donor-managed funds. In those rulings:

- The contributed cash and securities were placed in an investment or brokerage account, in the name of the donee public charity (an exempt college) and exclusively for its benefit.
- The donor entered into the management agreement with the public charity at the time of the donation. The management

[31] IRS Notice 2004-30, 2004-17 IRB 828.

[32] Section 512(b)(11).

[33] Ltr. Ruls. 200445023, 20445024; see "A New Strategy for Giving Away Your Money," Wall St. J., 10/6/04, page D1.

[34] Fund for Anonymous Gifts, 79 AFTR2d 97-2520 (DC D.C., 1997), *vacated in part*, 194 F.3d 173, 83 AFTR2d 99-1796 (D.C. Cir., 1999), *remanded*, No. 95-CV-1629 (DC D.C., 1999).

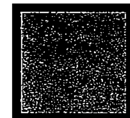
agreement involved the donor, or the donor's investment manager, managing the investments pursuant to a limited power of attorney.
- The term was ten years, but the public charity had the right at any time and for any reason to withdraw any or all of the assets, or to terminate the limited power of attorney and the management agreement. The agreements also would terminate automatically in case of severe loss, as determined by the public charity in its sole discretion.
- The contribution was irrevocable and unconditional, and the agreements prohibited donor benefits or inurement. The donor was prohibited from any self-dealing, use of the securities to satisfy any debt, or voting the securities. Moreover, "no investment may be made in companies in which the Donor owns, directly or indirectly, more than 5 percent of the outstanding shares of stock."
- A broad range of investments was permitted. "[T]he Donor will hold or invest only in [U.S.] equities, U.S. open-end mutual funds, U.S. closed-end mutual funds, U.S. fixed income securities (including, but not limited to treasures [sic] and mortgage-backed, asset-backed and high-yield securities), offshore/onshore hedge funds, REITs, and private placements...."
- The investment restrictions included no use of margin, no short sales, and no other encumbrances. "[A]ssets in Account may not be pledged or encumbered by the Donor or advisor...; the Donor may not commingle assets in Account with any assets outside Account;... and the Donor may not invest in short sales, forward settling transactions, derivatives, or any borrowings."[35]

Private rulings may not be relied on by other taxpayers, of course. To have the protection of a private letter ruling for a donor-managed account, the donor either must contract with the consulting firm that obtained the ruling, or apply for a new ruling.[36]

Tax consequences. The IRS, in the two letter rulings, said that there was a deductible contribution for income tax purposes, and that gift tax would not apply because there was a completed charitable gift. This was true whether the donor was an individual or a limited liability company.[37]

Advantages and disadvantages to the charity. The advantages include:
- The opportunity to receive additional contributions irrevocably, instead of procrastinating in making the donation or changing his or her mind about the donee.
- The opportunity to receive the donor's experience, knowledge, and continued guidance about the securities.

Among the disadvantages are:
- The unavailability of the contribution for up to ten years as opposed to a gift that is received and immediately sold, and the need to establish and monitor a separate account.
- The possibility that some accounts will suffer significant losses (though others may enjoy significant profits) because they likely will be invested in more aggressive securities than the charity's own endowment.



DONOR-MANAGED ACCOUNTS ENABLE A DONOR TO MAKE A CONTRIBUTION WHILE MAKING INVESTMENT DECISIONS.

Charitable remainders in residences and farms

The charitable contribution of a remainder interest in a residence or farm allows the donor to take a charitable deduction now, while continuing the use of the property for life. The number of second homes—even third homes—is on the rise, and likely will continue to rise so long as the economy is healthy. That rise could make this underutilized technique more significant.

A charity can most effectively appeal for a contribution of charitable remainders in residences and farms from the following:
- Donors whose estates exceed the amount they wish to leave to their children, but who do not want to part with substantial assets before the first or second death. They can receive an income tax deduction now while continuing to use the residence or farm until the death of both husband and wife.
- Donors who need a charitable deduction now against taxable income, which they

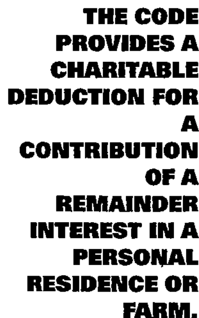
[35] Ltr. Ruls. 200445023, 20445024.

[36] The firm that obtained the private letter ruling, Winklevoss Consultants, has filed a patent application for a "Donor Managed Investment Account." If it is successful, it will argue that license fees must be paid to use the concept. They currently offer such an account. Wall St. J., *supra* note 33.

[37] Ltr. Ruls. 200445023, 20445024.

would not enjoy if they contributed the residence or farm at death under their will or revocable living trust. They can receive that deduction now, while continuing to enjoy the residence or farm until death.

- Donors who want to give lifetime use—but not complete ownership—of a resort home or farm to a relative, can do so with a steeply reduced taxable gift to that relative.



THE CODE PROVIDES A CHARITABLE DEDUCTION FOR A CONTRIBUTION OF A REMAINDER INTEREST IN A PERSONAL RESIDENCE OR FARM.

The benefit to the charity from this technique is the receipt of irrevocable title to the remainder in an asset that typically appreciates rather than depreciating. There is also the possibility of being given the remainder before the donors' death if they stop using the property. If the remainder is commuted, the donors receive an additional charitable deduction.

The charity will need to have a clear understanding that the donor will keep property insurance in place, and will pay for repairs, taxes, and any improvements.

Requirements. Contributions of charitable remainders in residences and farms are made by deed, not by trust.[38] One Tax Court case holds that the year in which the donor delivers the signed deed, rather than the year in which the charity records it, is the year of the deduction.[39]

To qualify, the residence must be the donor's residence (but not necessarily the principal residence),[40] and the farm must be used by the donor or the donor's tenant.[41] A yacht can qualify as a personal residence if it has facilities for residing and is used by the donor as a residence.[42]

There must not be restrictions on the gift other than its limitation to a life estate. Substantial restrictions can cause denial of the charitable deduction.[43]

If the property is mortgaged, the property will be treated as sold to the charity for the mortgage balance, unless possibly the charity is indemnified and held harmless from the mortgage, or unless possibly the percentage of the property reflected by the mortgage is not donated. If the charity is liable under the mortgage, that may meet the definition of acquisition indebtedness and render the property subject to UBIT.[44]

Income tax deduction. The Code provides a charitable deduction for a contribution of a remainder interest in a personal residence or farm, based on the present value of the remainder interest, adjusted by straight-line depreciation until the donor's death.[45] This is an exception to the general rule that gifts of partial interests do not enjoy charitable deductions.[46]

Avantages and disadvantages to the donor. The advantages of this technique include:

- Life use of the home or farm.
- A charitable deduction now against income, rather than no income tax deduction at death, for the remainder value that is given to charity.
- The option of giving life use to a relative or friend at a steeply discounted value for gift tax purposes. Such a gift does not qualify for the annual exclusion, however, and does not qualify for the marital deduction if made to a spouse.

The disadvantages include the unavailability of the home or farm to the children or other heirs, though the value of that use can be replaced by insurance. Moreover, if the donation of the furnishings is to take effect at death, there is no immediate charitable deduction for their contribution.

Conservation easements

The charitable contribution of qualified conservation easements allows a charitable deduction currently, continued use of the property for life, and inheritance of the property by family. Conservation easements have been so widely used since their creation in 1980 that almost 2.6 million acres are now protected.[47] Regrettably, these easements also have been abused, and have drawn scrutiny from the IRS[48] and Senate Finance Committee, where there is talk of legislation against abusive donations. The Administration has proposed replacing deductions for conservation easements with an

[38] Other requirements for deductible contributions must be met as well, such as the irrevocablity of the contribution and the satisfaction of the substantiation requirements.

[39] Douglas, TCM 1989-592.

[40] Reg. 1.170A-7(b)(3); Rev. Rul. 75-420, 1975-2 CB 78.

[41] Reg. 1.170A-7(b)(4).

[42] Ltr. Rul. 8015017.

[43] Darling, 43 TC 520 (1965); Rev. Rul. 77-305, 1977-2 CB 72.

[44] See generally Bird and Reach, "Unrelated Debt-Financed Income," 8 CCH's Federal Tax Service J: Chapter 6 (1988).

[45] Sections 170(f)(3)(B)(i), (f)(4).

[46] Sections 170(f)(2), (3). Other permitted partial interests are the donor's entire interest in the property (not created in order to make the contribution) and a qualified conservation interest.

[47] "Questionable Conservation Easement Donations," 18 Probate & Property 40 (Sep/Oct 2004).

[48] IRS Notice 2004-41, 2004-28 IRB 31; see Stokeld, "IRS Official Sounds Warning on Facade Donations," 2004 Tax Analysts 227-3 (11/24/04); "Nonprofit Sells Scenic Acreage to Allies at a Loss," Wash. Post, 5/6/03, page A1.

exclusion of 50% of the gain on conservation sales.

A charity can most effectively appeal for a contribution of qualified conservation easements from the following:

- Donors who own land that can be used for a wildlife habitat or public recreation, including the enjoyment of scenery or an historic structure, and who would like to take a charitable deduction while retaining ownership.
- Donors who wish to prevent buyers or heirs from developing property, or from tearing down a historic structure.
- Donors who are facing unaffordable property taxes, and can use the gift of a conservation easement to reduce the property's taxable value.
- Donors who need a tax deduction now, and are willing to reduce the marketable value of qualifying property by subjecting it to a conservation easement.

In each case, a charity formed for conservation purposes can preserve additional lands without having to buy them.

Requirements. To be deductible, a qualified conservation contribution must be (1) of a qualified real property interest, (2) made to a qualified organization, and (3) made exclusively for conservation purposes.[49] A qualified real property interest can be of the donor's entire interest (except mineral rights), a remainder interest, or a permanent restriction.[50] A qualified organization can be a governmental unit, a public supported charity, or a supporting organization of a public charity.[51] The coordinating organization for government entities is the Land Trust Alliance, and the Nature Conservancy is the largest private organization.

A conservation purpose is any one of four:

- Preservation of land areas for outdoor recreation by, or the education of, the general public.
- Protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem.
- Preservation of open space (including farmland and forest land) for the scenic enjoyment of the general public, or pursuant to a clearly delineated federal, state, or local governmental conservation policy, with a significant public benefit.
- Preservation of a historically important land area or certified historic structure.[52]

Tax deductions. The Code provides charitable income, estate, and gift tax deductions for a qualified conservation contribution, but the estate and gift tax provisions are not coextensive with that for income tax.[53]

Advantages and disadvantages to the donor. As with gifts of retained interests, the benefits center around control of the property. Contributing a charitable contribution easement allows:

- Retained ownership of the property.
- The ability to bequeath the property to heirs.
- Reduced valuation for gift or estate tax purposes, when the property is given to the next generation.
- The option of contributing through a charitable remainder trust.

The disadvantages are procedural, and perhaps political:

- The need to find a qualified donee organization, and to appraise the easement.
- The reduced value and marketability of the property because of the easement's restrictions.
- The possibility of the IRS challenging the valuation of the easement, something it is doing more often because of excessive valuations.

THE BENEFITS OF DONATING A CONSERVATION EASEMENT CENTER AROUND CONTROL OF THE PROPERTY.

Charitable lead trusts

Charitable lead trust (CLTs) provide income to charity from the trust assets for a specified number of years or during the lives of specified people, with the remainder going to a family member or other beneficiary. CLTs are the opposite of charitable remainder trusts (CRTs), under which the charity benefits from the remainder.[54]

There are two broad types of CLTs. Charitable lead annuity trusts (CLATs) pay a fixed dollar amount per year to charity (though that fixed amount can change year to year if specified at the outset in the trust document). Charitable lead unitrusts (CLUTs) pay a fixed percentage of the trust's value each year, which can vary up or down in dollar amount. In both cases, the payment must be made whether or not income is

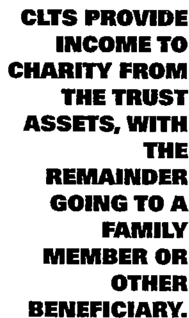
[49] Section 170(h)(1).
[50] Section 170(h)(2).
[51] Section 170(h)(3).
[52] Section 170(h)(4).
[53] Section 170(h)(4), Section 2031(c), Section 2522(d).
[54] See generally Schumacher, "The Taxation of Charitable Lead Trusts," 9 JTEO 76 (1997).

that high.[55] Either type can be a either a "grantor trust"—in which the grantor is treated as the trust's owner because he or she may be a trust beneficiary—or a "nongrantor trust." Nongrantor CLTs are the more commonly used, and the following discussion focuses on them.

There are two types of nongrantor CLTs—qualified and nonqualified. A qualified CLT pays an annuity or unitrust interest to charity, while a nonqualified CLT pays all income to charity (and so generally never owes trust-level tax).

The prospect of creating a CLT will be most appealing to:

- Donors who are giving, or want to give, more than 50% of their income annually to charity. They can effectively do so by removing some income-producing assets and the income from their tax return for the duration of a nonqualified nongrantor CLT.
- Donors who wish to give assets to heirs beyond what the gift tax exclusion and estate tax exclusion will permit. They can give much larger amounts within those limits because of the steep discounts provided by qualified nongrantor CLTs resulting from the income paid to charity and the delay of the remainder.[56]
- Donors who wish to transfer a large family business to the next generation, and are willing to devote its income to charity for some years, can benefit from the steep discount of a qualified nongrantor CLT, particularly in times of low interest rates.



CLTS PROVIDE INCOME TO CHARITY FROM THE TRUST ASSETS, WITH THE REMAINDER GOING TO A FAMILY MEMBER OR OTHER BENEFICIARY.

A grantor CLT is most useful (1) in a year in which the grantor has a high income that he or she does not expect to see duplicated, or (2) where the grantor makes an effectively tax-free gift to the family members who pay income taxes on trust income each year.

Requirements. In addition to the definitional attributes of the various CLTs, the payment to charity must be for a specified term of years (which is not limited to 20 years as is a CRT) or for a specified life or lives (of the donor, the donor's spouse, ancestors of the beneficiaries, or a spouse of such ancestors who are living when the CLT is created[57]).

Income tax deduction. There is no income tax charitable deduction for a nongrantor CLT, but on the other hand, trust income is taxed to the trust, not the donor.[58]

Grantor CLTs provide an income tax charitable deduction to the donor,[59] who is also taxed on the trust income[60] (without deducting charitable contributions for the annuity[61]). That charitable deduction comes under the 30% limit if the charity is a public charity, or under the 20% limit if it is a private foundation, because the contribution is treated as "for the use of" rather than "to" to the charity or foundation.[62] Unused deductions can be carried forward for up to five years, unless the income beneficiary is a private foundation. If the donor dies during the term of a grantor CLT, the final income tax return must treat as taxable the charitable deduction minus pre-death annuity amounts paid to charity.[63] If the donor dies during the term of a qualified nongrantor CLT, there is no tax consequence to the grantor or the estate.

If the charitable interest goes to a private foundation, the regulations had required the foundation to include in its distributable amount the entire income part of the CLT distribution.[64] The Tax Court held that requirement was invalid, however,[65] and the IRS has stated that it will amend the regulation.[66]

Advantages and disadvantages. The advantage of a CLT to the charity is the immediate receipt of income as promised by the trust instrument.

Advantages of nongrantor CLTs to the donor include:

- A reduction in gift taxes resulting from a steep reduction in the taxable gift when the remainder interest is given to a child or other heir. This is particularly true if the adjusted federal rate is low,[67] or if the

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[55] Regs. 20.2055-2(e)(2)(vi), 20.2055-2(e)(2)(vii), 25.2522(c)-3(c)(2)(vi), 25.2522(c)-3(c)(2)(vii).

[56] This is particularly true where the donor has a serious medical condition that does not meet the definition of terminal illness under Reg. 20.7520-3(b)(3)(i).

[57] Regs. 1.170A-6, 20.2055-2, 25.2522(c)-3.

[58] Section 642(c)(1). While the nongrantor CLT is taxed on all trust income, it has a charitable deduction for amounts that must be paid to charity, though not to the extent that the amount paid to charity is unrelated business taxable income (Section 681) or is in excess of the required amount under the trust governing document (Crown Income Charitable Fund, 8 F.3d 571, 72 AFTR2d 93-6524 (CA-7, 1993)).

[59] Sections 170(f)(2)(B), (C).

[60] Unless assets are invested in tax-free bonds, in which case the income is nontaxable to the donor. If there is no income at all (because assets are invested in real estate or the like), distributions in kind will cause realization of built-in gain.

[61] Unless excess income, if contributed to the charity, allows the donor to deduct the excess. Reg. 1.170A-6(d)(2)(ii).

[62] Section 170(b)(1)(B).

[63] Section 170(f)(2)(B).

[64] Reg. 53.4942(a)-2(b)(2).

[65] Ann Jackson Family Foundation, 15 F.3d 917, 73 AFTR2d 94-1023 (CA-9, 1994).

[66] IRS Notice 2004-35, 2004-19 IRB 889.

charitable payout is high. It is possible to reduce the taxable gift value to zero for a CLAT, and to nearly zero for a CLUT, by a high charitable payout.

- A reduction in estate taxes, not only by the asset's value, but also by its future appreciation.[68]
- The option of paying the charitable payout by distributing property (although, if appreciated property is used, the gain is taxable[69]).
- The option of setting a very high or very low payout (unlike CRTs, for which a high maximum and a 5% minimum applies).
- The option of making additional contributions a CLUT (but not to a CLAT).

The disadvantages to the donor include:

- No guarantee of any particular level of remainder to the heirs, though that risk can be reduced by a lower charitable payout or by additional life insurance.
- No charitable deduction for nongrantor CLTs, or donor taxability of income in the case of grantor CLTs.
- Potential tax on a nongrantor CLT if income exceeds the promised charitable income interest, though that can be avoided by carefully limiting interest, dividends, capital gains, and other income to the charitable annuity each year.
- If the remainder goes to grandchildren or other skip persons, the generation skipping transfer (GST) tax will apply.
- The private foundation rules apply.[70]
- The trust is complex, and an annual trust return must be filed in addition to the gift tax return.

Gift and estate tax considerations. A qualified CLT normally qualifies for a gift tax charitable deduction. If the power is retained to select the charity, there is not a completed gift (or gift tax deduction) until each gift is made or until a charity is irrevocably selected. If a CLT is nonqualified, there is no gift tax deduction at the time of formation, so the CLT needs to be an incomplete gift to avoid gift tax on creation. If a CLT is nonqualified, there also is no estate tax deduction at the time of formation, so a testamentary CLT should always be qualified.

A grantor CLT normally is included in the grantor's estate; a nongrantor CLT is not, unless the draftsman makes a mistake. A grantor CLT potentially can be kept out of the grantor's estate by making the grantor power something that triggers income tax but not estate tax, such as the power to substitute assets of equal value (so long as it would not be self-dealing[71]).

Where the distribution of the remainder skips generations, a taxable termination or taxable distribution is subject to the GST tax. If the CLT potentially involves generation skipping, a nongrantor CLUT is normally used, because the GST inclusion ratio can be calculated at the time it is established (the applicable fraction is the GST exemption allocated to the CLUT, divided by the fair market value of the remainder interest).[72] Nongrantor CLATs are not normally used, because the GST inclusion ratio cannot be calculated at the time they are established, but only when the trust terminates,[73] at which time there may be waste of some GST exemption or unexpected GST tax at high rates. For a nongrantor CLUT, the GST exemption can be, and must be, allocated at the time the nongrantor CLUT is funded,[74] and the GST tax is applied based on the inclusion ratio when the trust terminates or otherwise distributes to skip persons.

Thus, advantages of a nongrantor CLUT trust include:

CGAS ALLOW AN IMMEDIATE CHARITABLE DEDUCTION, AND LIFETIME INCOME TO THE DONOR, WITH THE REMAINING PRINCIPAL GOING TO A CHARITY.

[67] This is so in the case of a nongrantor CLAT. It does not have much effect on a nongrantor CLUT.

[68] Nongrantor CLTs do not provide an income tax deduction, whereas grantor CLTs do (subject to (1) the 30% charitable deduction limit (Section 170(b)(1)(B)(i)) and (2) all CLT income each year being taxable to the grantor with no offsetting charitable deduction). On the other hand, nongrantor CLTs are completed gifts that remove assets from the donor's estate, while grantor CLTs are not and do not. Some commentators believe that it is possible, by retaining certain grantor provisions, to have grantor treatment for income tax purposes (a charitable deduction) and nongrantor treatment for estate and gift tax purposes (discounted transfers out of the estate).

[69] Kenan, 114 F.2d 217, 25 AFTR 607 (CA-2, 1940); see Rev. Rul. 83-75, 1983-1 CB 114; Reg. 1.661(a)-2(f). The nongrantor CLT gets a charitable deduction for the charitable payout. Section 642(c).

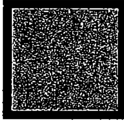
[70] The minimum distribution rule of Section 4942 does not apply. The excess business holdings and jeopardy investment rules do not apply if the charitable interest is less than or equal to 60% of the trust assets. Sections 4947(b)(3), 508(d)(2). The private foundation rules do not apply at all to a nonqualified nongrantor CLT because there is no income, gift, or estate tax deduction when it is established. The governing instrument of a CLT, except a nonqualified nongrantor CLT, should list the private foundation prohibitions.

[71] Ltr. Rul. 199936031 found this power not to be self-dealing.

[72] Section 2642(a)(2); Ltr. Rul. 9532007.

[73] Section 2642(e) for CLATs.

[74] The GST tax, however, is only imposed when the trust terminates or otherwise distributes to skip persons (such as grandchildren). It is not applicable if a grandparent funds a GST trust when a parent is already dead and the grandchild is the beneficiary and actually receives the distribution. The 2001 Act further expanded this exception.



TESTAMENTARY CONTRIBUTIONS OF RETIREMENT ASSETS GENERALLY ARE THE MOST TAX-ADVANTAGED APPROACH.

- Avoidance of éstate tax and GST tax for the estates of the skipped generation, up to the amount of the GST exemption.
- Avoidance of both taxes for appreciation in asset value after the GST trust is funded and after the GST tax is measured, assuming there is a completed gift and an inclusion ratio of zero for appreciation.
- Provision for grandchildren or other skipped generations, after the term of the trust.

Disadvantages include the possibility that the GST tax will be repealed (other than for 2010), so that the effort was for naught.

Charitable gift annuities

Charitable gift annuities (CGAs) allow an immediate charitable deduction, and lifetime income to the donor, with the remaining principal going to a charity.[75] They would hold the greatest appeal for:

- A donor who seeks a retirement income or other fixed income, without any responsibilities for investment management, and is willing to forgo the higher payment of a commercial annuity for the sake of making the gift.
- A donor who seeks an income tax deduction now, rather than having no income tax deduction from a charitable bequest at death (the contribution can be made now with a deferred start date for the annuity).
- A donor who seeks to reduce his or her taxable estate, and prefers to do that by contributing for an annuity during his or her life rather than by contributing at death.
- A donor who is willing to transfer a large amount for specially negotiated terms, which involve a higher payout than the typical American Council on Gift Annuities rates but meet the 10% requirement for the present value of the charitable interest.

New variable start date annuity. The IRS also just approved a variable start date annuity in Ltr. Rul. 200449033. This allows the donor-annuitant to elect the start date during a prespecified eight-year period, which will help those donors who want a charitable deduction now for an annuity to begin later, but do not know the exact time when they want the annuity to begin. In the ruling, the donor-annuitant could make that election between certain ages (e.g., ages 60-68). The donor's annuity payments will still increase if the later start date is elected, but the donor's charitable deduction is reduced to assume the annuity starts on the earliest possible date.

Requirements. The Code defines a charitable gift annuity as an annuity that meets the following requirements:

- A portion of the amount paid in connection with the issuance of the annuity is allowable as a deduction under Section 170 or 2055.
- The annuity is described in Section 514(c)(5) (determined as if any amount paid in cash in connection with such issuance were property).[76]

Meeting these requirements is important, because failing to do so makes the annuity "commercial-type insurance" under Section 501(m), and providing such insurance can cost a Section 501(c)(3) or (c)(4) organization its exemption.

To be described under Section 514(c)(5) the annuity must be:

1. The sole consideration issued in exchange for property if, at the time of the exchange, the value of the annuity is less than 90% percent of the value of the property received in the exchange.
2. Payable over the lives of one or two individuals in being at the time the annuity is issued.
3. Payable under a contract that (a) does not guarantee a minimum amount of payments or specify a maximum amount of payments, and (b) does not provide for any adjustment of the amount of the annuity payments by reference to the income received from the transferred property or any other property.

In addition to taking the CGA out of Section 501(m), meeting these additional requirements means the annuity will not be treated as acquisition indebtedness, and so will not create unrelated debt-financed income for UBIT purposes.

Item 1 means that the present value of the charitable interest must be at least 10%, which is similar to the requirement for a CRT. Item 3 means that a variable or unitrust-type interest is not possible.[77]

The donor is taxable on a portion of each payment as an annuity, and receives the remainder tax free as a return of principal (based on the

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[75] See generally Bird, "Charitable Gift Annuities," Charitable Giving and Solicitation (Warren Gorham & Lamont, 1998), page 712.

[76] Section 501(m)(5). See also Regs. 1.170A-1(d), 1.1011-2(a)

[77] There is limited authority for a CGA with a payment that increases each year. Ltr. Rul. 8322068.

annuity exclusion ratio).[78] If the donor outlives the life expectancy, the additional annuity payments are fully taxable; no portion is a tax-free return of principal. If the donor dies early, a deduction for the unrecovered principal can be taken on the final income tax return.[79]

Income tax deduction. The charitable deduction is the difference between the value of the contributed property and that of the annuity.[80] The annuity's present value is determined in the same way as that of a charitable remainder annuity trust (CRAT), and most commercial software that performs charitable gift calculations can do so for CGAs. The calculation is based on IRS actuarial tables and an interest rate of 120% of the midterm applicable federal rate (for the current month or one of the two prior months).[81] The IRS actuarial tables do not apply, however, if the donor has a terminal illness.[82]

Gift and estate tax considerations. A taxable gift occurs if the annuity is payable to anyone except the donor or the donor's spouse who is a U.S. citizen. A survivor's annuity for the donor's spouse is a taxable gift unless a right is retained, such as a right to revoke the spouse's interest, making the gift incomplete. An annuity is not taxed in the donor's estate, but a survivor annuity following the donor's annuity is included in the donor's estate, and a retained right to revoke the survivor's interest is similarly included.[83]

Benefits to the charity. The charity immediately receives and books an asset, and has the ability to spend or use up to 50% of the contribution if state law permits (though the general practice is not to expend any charitable gift annuity funds until the donor dies). The charity will ultimately receive the amounts remaining after the annuity ends, which the recommended rates of the American Council on Gift Annuities generally set at a present value of 50% of the contribution.

Advantages and disadvantages to the donor. The advantages of a CGA include:

- A fixed income payment for life.
- Escape from the burdens of investment management.
- A charitable deduction upon funding, typically equal to 50% (meaning that the present value of the annuity is only worth 50%), but at least equal to 10% (if the CGA is negotiated so that the annuity is worth up to 90%).
- Removal of the asset from the donor's taxable estate.[84]
- No tax on asset growth and sale.[85]

The disadvantages for the donor include:

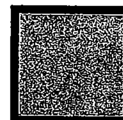
- A lower annuity payment than a commercial annuity would give, unless the annuity is large enough to be specially negotiated.
- Loss of control over the investment, which goes to the charity.
- Taxability of the annuity in part as ordinary income.[86]
- The risk that the charity could fail to honor the CGA, which is an unsecured promise.
- Taxability of any appreciated property used to fund the CGA as capital gain at the time of funding if the annuity is paid to the donor's spouse or another person,[87] though that tax can be deferred over the donor's life expectancy if the annuity is first paid to the donor and is nonassignable.[88]

Comparison to qualified retirement plans. CGAs offer certain advantages over qualified retirement plans:

- They can benefit a single person or couple, and do not have the coverage requirements of qualified plans.
- They do not have the dollar limits of qualified plans, and can be unlimited in size.
- They lack the complexity of qualified plans, such as coverage tests.

On the other hand::

- The remainder goes to charity, whereas a qualified plan's or IRA's remainder goes to the surviving spouse or other heirs.
- They do not allow loans to beneficiaries, whereas qualified plans do.



MINIMIZING CAPITAL GAINS TAXES IS AN ISSUE FOR ANYONE NOT CERTAIN TO DIE BEFORE 2010.

[78] Reg. 1.72-4 to -6.

[79] Sections 72(b)(2), (3).

[80] Reg. 1.170A-1(d)(1); Rev. Rul. 70-15, 1970-1 CB 20.

[81] Section 7520; Notice 89-24, 1989-1 CB 660.

[82] Regs. 1.7520-3(b), 20.7520-3(b), 25.7520-3(b).

[83] Section 2039.

[84] Unless the donor gives a survivor annuity to a person other than a U.S. citizen spouse.

[85] Except as appreciated assets are contributed, as discussed below.

[86] The donor's tax basis is allocated between the gift value and the annuity value. Reg. 1.1011-2(a)(4); Rev. Rul. 84-162, 1984-2 CB 200. Consequently, part of each annuity payment is a tax-free return of capital (Section 72) and the remainder is taxable income. If the donor contributes appreciated property that is long-term capital gain property, the appreciation is taxable as short-term or long-term capital gain.

[87] A portion of the capital gain is taxable at the time of contribution, as short-term or long-term capital gain, under the bargain sale rules.

[88] See Section 1011(b).

- Funding is not fully deductible (typically 50% is deductible), whereas it is fully deductible for qualified plans and some IRAs.
- Lump-sum distributions and favorable averaging are not possible for CRTs or CGAs, whereas they are for qualified plans and deductible IRAs.

Contributions of retirement assets

Contributions of retirement assets, so long as they comply with strict rules, use the highest-taxed assets from a person's estate to fund charitable gifts, and so generally are the most tax-advantaged approach.[89] Donors making charitable contributions at death generally can reduce income taxes more (even if they do not have taxable estates), and leave more to their heirs, by contributing IRAs, 401(k)s, and qualified plan interests rather than contributing other assets. If proposals to remove the penalties on lifetime contributions are enacted, gifts of various retirement plans will become even more favorable for income tax purposes.[90]

Requirements for testamentary contributions of retirement assets. Currently, contributions of IRAs, 401(k)s, and qualified plan interests generally ("retirement assets") cannot be made before age 59 1/2 without penalties,[91] and do not offer tax benefits after that date except offsetting income and charitable deduction. Until and unless the President's tax plan is enacted, only testamentary contributions have favorable tax consequences, so this section deals only with testamentary contributions.

Contributions outright. Retirement assets can be contributed outright to charity at death,[92] or at the surviving spouse's death. Contributions should be made on designation of beneficiary forms naming the charity as the primary (or secondary) beneficiary, rather than by will.[93] If contributions have not been made by a designation of beneficiary form, however, they can be made by assignment from the decedent's estate to charity.[94]

Contributions of some but not all of a retirement account should be made by rolling the charitable contribution portion to a separate IRA that is entirely designated for charity as the beneficiary, to avoid complications with pecuniary bequests and gifts of partial interests.[95] Such contributions at death can avoid all federal estate tax, and all income tax on income in respect of a decedent (IRD), with respect to those retirement assets. For people with estates large enough (or unplanned enough) to be taxable, there is double taxation of retirement assets (estate tax plus IRD tax), which can be avoided by proper charitable contributions of the retirement assets.[96]

Contributions with spousal benefit. Retirement assets instead can be contributed to the surviving spouse, and then to charity, via a CRT.[97] In that situation, there would be no estate tax at the first death because of the marital deduction,[98] or at the second death because of the estate tax charitable deduction.[99] The assets would grow tax-free in the CRT except as income was paid out, which would accomplish the same deferral that an IRA permits. The main disadvantage is that no distribution of principal based on need is possible, though the income payout can be set higher than the IRA level.[100] Such distributions of principal are possible, though tax-free growth is lost, by instead placing retirement assets in a QTIP trust with a charitable remainder.[101]

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[89] See generally Bird and Treadwell, "Estate Tax Savings for Retirement Plan and IRA Assets," 1 National Lawyers Association Review 5 (1997). CRTs can be added to only if they are CRUTs; otherwise a new CRAT or a CRUT must be formed.

[90] Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals," BNA Daily Tax Report, 2/8/05, S-3.

[91] Sections 72(t), 401(a)(13)(A).

[92] This principle does not apply to contributions of retirement assets to pooled income funds, or to other nonexempt entities. Section 642(c)(5).

[93] A married person must have the spouse's consent in writing to the designation of a charity, or of any beneficiary other than the spouse. Sections 417(a)(2), 401(a)(11)(B)(iii)(I).

[94] Ltr. Rul. 200452004.

[95] Section 402(c).

[96] See generally Hoyt, "Transfers from Retirement Plans to Charities and Charitable Remainder Trusts: Laws, Issues, and Opportunities," 13 Va. Tax Review 647 (1994); Magowan, "Doing Right by Doing Good: Giving IRAs to Charity," 16 Probate & Property 17 (Sep/Oct 1997).

[97] See Section 2055(e)(2)(A); Rev. Rul. 77-374, 1977-2 CB 329; Ltr. Rul. 8419005. See generally Bianculli, "Testamentary Contributions of Retirement Plan Assets to Split-Interest Charitable Arrangements: A Primer," 16 Practical Tax Lawyer 35 (Fall 2002). Any CRT must comply with all requirements of Section 664.

[98] Sections 2056(b)(7), (8); Ltr. Rul. 9704029.

[99] Sections 2055(a), 2055(e)(2); Reg. 20.2055-2.

[100] Hoyt, "When a Charitable Trust Beats a Stretch IRA," 16 Trusts & Estates (May 2002).

[101] A QTIP trust is one holding "qualified terminable interest property" (QTIP). With such a trust, a donor may have a gift of a life estate to his or her spouse qualify for the unlimited marital deduction

Contributions with child benefit. Retirement assets alternatively can be contributed to the children or other beneficiaries, and then to charity, via a CRT.[102] For taxable estates, a separate CRT should be set up for a child, in order to use less estate tax credit.

Estate and gift tax deduction. Contributions of retirement assets at death, via a designation of beneficiary form, enjoy favorable estate tax treatment.

Benefits to the charity. A charity receives the full value of these retirement assets, and generally does not pay any tax on them, though an estate would pay income tax on IRD in addition to any estate tax. (A taxpayer making an inter vivos donation of a retirement asset during life, under the proposals allowing that, would pay tax on ordinary income). The dollar amount of retirement assets is massive—nearly $3 trillion in IRAs alone.

Advantages and disadvantages to the donor. A testamentary gift of retirement assets avoids double taxation (estate tax and IRD tax), though use of a CRT will bring the usual CRT taxes on distributions. It leaves more assets in the estate for heirs or charity, and a simpler estate without the retirement assets. It also avoids probate for retirement assets given by a designation of beneficiary form. The disadvantages include the costs and compliance requirements for a CRT, if one would not otherwise be used.

Minimizing capital gains taxes if estate taxes are repealed

Minimizing capital gains taxes is an issue for anyone not certain to die before 2010, because in that year untaxed appreciation in assets will become subject to capital gains tax when heirs sell assets, and the stepup in basis at death will end.[103] A charity can also effectively appeal for a contribution of appreciated assets knowing that most donors expect to live to 2010 and beyond. As 2010 approaches, donors will become more and more concerned about assets losing stepped-up basis and becoming subject to capital gains tax when sold by their estates. Their emphasis will shift from estate tax to capital gains tax

Requirements for capital gains reduction. Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the repeal of estate tax beginning in 2010 is accompanied by capital gains tax when assets left at death are sold (unless two new basis increases, totaling up to $4.3 million, apply and are enough to eliminate the gain). If this capital gains provision is not changed, it will make planning to reduce post-death capital gains tax important. That new area of planning will feature several charitable techniques, including the following ways to reduce capital gains tax:

Inter vivos charitable gifts. Lifetime charitable gifts of a donor's most appreciated assets can be used by charitably minded people to eliminate pre-death and post-death capital gain tax. If lifetime charitable gifts of cash are regularly made or planned, they instead should be made with the donor's most appreciated assets that qualify for a fair market value deduction.[104] If the assets are not needed for retirement but only for the children's inheritance, the assets can be replaced with insurance, which can avoid not just capital gain tax but estate tax if owned by and benefiting a proper irrevocable life insurance trust or the child directly.

Testamentary charitable gifts. Testamentary charitable gifts of a donor's most appreciated assets also can be used to eliminate post-death capital gain tax. If testamentary charitable gifts are planned, they generally should be made first with retirement assets and then with the most appreciated other assets.

CRTs. Lifetime CRTs provide another way to defer or eliminate capital gains tax on high-appreciation assets, particularly when those assets need to be sold before 2010 or when a lifetime income tax charitable deduction is desired. If estate tax repeal becomes permanent, lifetime CRTs benefiting another person will tend to be limited to the donor's life, since any post-death support could then be given free of estate and gift tax by will, unless the assets

[102] For example, Ltr. Rul. 9634019 involved a donor designating as beneficiary of a qualified retirement plan a CRT. The Service ruled that the designation of the CRT as beneficiary did not trigger any tax on IRD to the trust, with tax occurring as distributions were made to the CRT's life beneficiaries. Ltr. Rul. 9901023 involved a qualified retirement plan designating a CRT as beneficiary upon death. The IRS ruled that the CRT would not be taxed on the distribution from the qualified plan, so long as the qualified plan did not have unrelated business income, and that the IRD distributed by the plan would be taxed to the beneficiary as tier-one income.

[103] See generally Bird, *supra*.

[104] For lifetime gifts to qualify at fair market value for an income tax charitable deduction, the assets need to be long-term capital gain assets, tangible personal property needs to be for a related use by the charity, and only publicly traded securities should be given to private foundations. For testamentary gifts to qualify for an estate tax charitable deduction, most of these restrictions do not apply.

to be given have high appreciation and the donor has remaining gift tax exclusion.

Testamentary CRTs can similarly defer or eliminate post-death capital gains tax on high-appreciation assets. If estate tax repeal is made permanent, an unlimited amount could be given via testamentary CRTs, and a 10% minimum interest for charity would avoid a 15% federal capital gains tax as well as (in most states) state capital gains tax, as well as immediate tax on income and gains in the trust.

However, people leaving gifts to spouses generally will find it better to use a QTIP trust, with or without a charitable remainder, than a CRT. Under current law, the $1.3 million and $3 million stepups in basis applicable in 2010 cannot be allocated to CRTs, while they can be allocated to a QTIP trust.

Charitable gift annuities. Charitable gift annuities like CRTs provide another way to avoid capital gains tax on post-contribution appreciation (though they generally are taxed on pre-contribution appreciation if appreciated assets are donated). They generally will not be as tax-efficient as CRTs, however, not only because of the normally larger charitable element, but because most income is paid out as ordinary income unless it is a return of principal.

Charitable deduction. Lifetime contributions enjoy the charitable deductions described earlier. Testamentary contributions offer a similar estate tax charitable deduction, but more importantly remove assets with built-in gains from the estate.

Benefits to the charity. Charitable gifts and bequests of capital gain assets, which help donors leave their no-gain or low-gain assets to heirs, can offset any reduction in charitable giving if estate tax repeal becomes permanent, and can otherwise bring an overall increase in charitable giving if estate taxes revive for 2011 and after.

Advantages and disadvantages to the donor. Capital gains tax planning:

- Reduces or eliminates post-death capital gains that heirs would otherwise have to pay on selling the assets.
- Reduces the donor's taxable estate by charitable contributions, in case estate tax repeal is not made permanent or is itself repealed.
- Creates charitable deductions from income tax from inter vivos contributions.

Among the disadvantages of these planning techniques:

- Approaches that are irrevocable (such as CRTs and CGAs) cannot be changed if estate tax changes make them less tax-efficient.
- Charitable gifts reduce bequests to heirs, though it is possible for the capital gains savings and growth to exceed the charitable gift.

Conclusion

As a general matter, the optimum goal for planning is to make contributions during life with the most appreciated assets that generate a fair market value deduction. The best course for testamentary gifts is, first, to make charitable contributions with retirement assets (via the designation of beneficiary form) and, second, with the most appreciated assets.

Charities can stop missing out on contributions by becoming aware of the benefits of the techniques described above, and by becoming aware of when potential donors will find it most advantageous to make the contributions.[105] ■

[105] This article is not intended to offer legal advice, and is intended to summarize some cases and rulings under federal law in this legal area. All of the authorities cited, and all other authorities in this and related areas of the law, are subject to change by the legislatures and courts of individual states as well as the federal government. Reliance should be placed only on one's own legal, accounting, and tax advisors, and readers should consult those advisors before taking any action.