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Conrad Teitell's Guide to Tax Benefits For Charitable Gifts

The federal government helps our clients be philanthropists with tax incentives that greatly reduce the out-of-pocket cost of charitable gifts and in many instances, enable donors to contribute much more than they originally imagined.

In these troubled economic times, many of our clients believe that it's more important than ever to support worthwhile causes. Charities' endowments are down and the demand for their services has increased.

But, as the great Roman playwright Publius Terentius Afer (known as Terence) said more than 2000 year ago, "Charity begins at home." So for clients who want to help others, but need income themselves, charitable remainder trusts (CRTs) and charitable gift annuities (CGAs) are now more important than ever.

For those who are still wealthy (although, perhaps, a tad less than a few years ago), a charitable lead annuity trust (CLAT) is a savvy way to provide support for your favorite charities (including their own private foundations) for a term of years with a gift of the trust's assets to family members at the end of the trust term. Low asset values and low Internal Revenue Code Section 7520 rates make a CLAT a perhaps once-in-a-lifetime way to benefit charities and pass megabucks on to family members at no federal gift-tax cost.

Having said this, advisors need to know every jot and tittle of the tax law to assure clients' tax benefits. So, here's a rundown of the major rules, together with the relevant IRC sections, Treasury regulations, revenue rulings and court cases. Unless otherwise stated, it's assumed that an individual is making the gift to a public charity (for example, to a school, church, hospital or community foundation) or a private operating foundation (for example, a museum). Currently, only itemizers can deduct their charitable gifts.

CAUTION: Beginning Jan. 1, 2010, the estate and generation-skipping transfer (GST) taxes expired. We expected that Congress would enact some estate tax legislation to extend both the estate and GST taxes before the end of 2009, but that didn't happen. Several proposals to reinstate the estate and GST taxes for 2010 have been made but as of Aug. 18, 2010, nothing has been enacted. In addition, several charitable income tax benefits expired at the end of 2009. The House of Representatives passed legislation that

would extend these benefits through 2010. That extenders package is currently pending in the Senate, with changes from the legislation passed by the House. The below discussion reflects the law as it existed in 2009, noting where benefits expired in 2009.

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OUTRIGHT GIFTS

GIFTS OF CASH—Deductible up to 50 percent of donor's adjusted gross income (AGI). IRC Section 170(b)(1)(A) and Treasury Regulations Section 1.170A-8(b). Five-year carryover allowed for any "excess." IRC Section 170(d)(1) and Treas. Regs. Section 1.170A10(b).

Caveat: When the amount of the charitable contribution exceeds 50 percent of a taxpayer's "contribution base," any excess contribution is to be treated as a charitable contribution paid in each of the five succeeding taxable years in order of time. The carryover is good for the five years immediately following the charitable deduction, and some portion of the deduction expires each year, whether it is actually used or not. The maximum amount of the carryover must be used in each carryover year, up to that year's adjusted gross income. The taxpayer cannot pick and choose when to take the deduction. See *Maddux*, T.C. Summ. Op. 2009-30 (March 4, 2009).

APPRECIATED SECURITIES AND REAL ESTATE HELD LONG-TERM—Deductible at the full present fair market value (FMV), with no tax on appreciation. *Campbell v. Prothro*, 209 F.2d 331 (5th Cir. 1954). Deductible up to 30 percent of AGI. IRC Section 170(b)(1)(C)(i) and Treas. Regs. Section 1.170A8(d)(1). Five-year carryover allowed for any "excess." IRC Section 170(b)(1)(C)(ii).

DEPRECIATED IN VALUE—If capital loss deduction is available, sell the property to establish that deduction. Then

contribute the sales proceeds.

CEILING ELECTION—Under an election, a donor can increase the ceiling to 50 percent of AGI (with a five-year carryover for any “excess”) by making the same gift, but:

- reducing the amount deemed contributed for all long-term property gifts during the year by 100 percent of appreciation, and
- reducing the deemed contribution for long-term property gifts being carried over from earlier years. IRC Section 170(b)(1)(C)(iii), IRC Section 170(e)(1) and Treas. Regs. Section 1.170A-8(d)(2).

SECURITIES AND REAL ESTATE HELD SHORT-TERM—Deduction is for cost basis or current FMV, whichever is lower. IRC Section 170(e)(1)(A) and Treas. Regs. Section 1.170A-4(a)(1). Deductible up to 50 percent of AGI. IRC Section 170(b)(1)(A). Five-year carryover for any “excess.” IRC Section 170(d)(1) and Treas. Regs. Section 1.170A-10.

ORDINARY INCOME PROPERTY—Sale results in ordinary income. Treas. Regs. Section 1.170A-4(b)(1). For gifts of inventory, IRC Section 306 stock, collapsible-corporation stock, crops, artworks created by the donor and other “ordinary income” property gifts, deduction is allowed for property’s cost basis or current FMV, whichever is lower. IRC Section 170(e)(1)(A) and Treas. Regs. Section 1.170A-4(a)(1). Deductible up to 50 percent of AGI. IRC Section 170(b)(1)(A). Five-year carryover allowed for any “excess.” IRC Section 170(d)(1) and Treas. Regs. Section 1.170A-10(b).

The Court of Appeals for the Tenth Circuit has determined that the discovery material in the case against Timothy McVeigh (who was known as the Oklahoma City Bomber), which was donated by McVeigh’s lead counsel, is ordinary income property. The material included copies of FBI witness statements, FBI lab notes, photographs, and computer discs. The court ruled that the deduction was limited to the donor’s cost or basis in the property. However, the court concluded that the donor had no basis in the discovery material and was precluded from claiming any income tax deduction for his charitable donation. *Jones v. Commissioner*, 560 F.3d 1196 (10th Cir. 2009), cert. denied, 2009 U.S. LEXIS 7007 (Oct. 5, 2009).

DEPRECIABLE PROPERTY—Deduction for depreciable real estate and/or tangible personal property is reduced by what would have been taxed as ordinary income (under IRC Sections 1245 or 1250) if property had been sold. IRC Section 170(e)(1)(A).

APPRECIATED TANGIBLE PERSONAL PROPERTY—This includes works of art, antiques and books, held long-term. Treas. Regs. Section 1.170A-4.

RELATED GIFTS—Deduction is full present FMV, with no

tax on the appreciation, if use of the property is related to donee’s exempt function (for example, a gift of a painting to an art museum or to a school for its art gallery.) Deductible up to 30 percent of AGI. IRC Section 170(b)(1)(C)(i). Five-year carryover allowed for any “excess.” IRC Section 170(b)(1)(C)(ii). Deductible up to 50 percent of AGI (with five-year carryover for any “excess”) if same election made as for gift of long-term securities or real estate. See “Ceiling Election,” in this guide.

UNRELATED GIFTS—If gift is unrelated to donee’s exempt function (See Treas. Regs. Section 1.170A-4(b)(3) for a general definition of “unrelated use”), deduction is for the cost basis or current FMV, whichever is lower. IRC Section 170(e)(1)(B)(i). Deductible up to 50 percent of AGI. IRC Section 170(b)(1)(A). Five-year carryover allowed for any “excess.” See IRC Section 170(d)(1).

The IRS recaptures related use tax benefits (FMV deductibility) if the property is not put to a related use by the donee. The rule applies to property that is identified by the donee on Form 8283 as made for a use related to the donee’s exempt purpose and for which a deduction of over \$5,000 is claimed. IRC Sections 170(e)(1)(B), 170(e)(7) and 6720(B).

GIFT OF WORK OF ART WITHOUT THE COPYRIGHT—Gift or bequest of work of art qualifies for gift and estate tax charitable deductions (but not income tax deduction) even though copyright isn’t transferred to charity, when the donee is a public charity described in IRC Section 501(c)(3), that is not a private foundation (under IRC Section 509), and the use is related to the donee’s charitable purpose. IRC Section 2055(e)(4); Treas. Regs. Section 20.2055-2(e)(1)(ii), IRC Section 2522(c)(3) and Treas. Regs. Section 25.2522(c)(3)(1)(ii).

TANGIBLE PERSONAL PROPERTY HELD SHORT-TERM—Same as gifts of short-term securities and real estate.

CLOTHING AND HOUSEHOLD ITEMS—No deduction is allowed for a charitable gift of clothing or household items unless the clothing or household item is in good used condition or better.

Exception: A deduction may be allowed for a gift of an item of clothing or a household item not in good used condition or better if the amount claimed is more than \$500 and the taxpayer includes a qualified appraisal with his return. IRC Section 170(f)(16).

FRACTIONAL INTEREST GIFTS OF TANGIBLE PERSONAL PROPERTY; INCOME TAX TRAPS—A gift of an undivided portion of a donor’s entire interest in property is generally deductible. That interest must consist of a fraction (or percentage) of each and every substantial interest or right owned by the donor and must extend over the entire term of the donor’s interest. A charitable deduction isn’t allowable for a gift of a future interest in tangible personal property. IRC Section 170(a)(3) and Treas. Regs. Section 1.170A-5(a)(4). However, IRC Section 170(a)

(3) has no application to a transfer of an undivided present interest in property. The value of a donor's charitable deduction for the initial contribution of a fractional interest in long-term tangible personal property is based upon the FMV of the related-use artwork at the time of the contribution of the fractional interest.

Additional contributions: For determining the deductible amount of each additional contribution of an interest in the same property, the Pension Protection Act of 2006 added an income tax special valuation rule for treatment of contributions of fractional interests in tangible personal property. Under this rule, the FMV of the item is the lesser of the FMV used for purposes of determining the charitable deduction for the initial fractional contribution, or the FMV of the item at the time of the additional (and subsequent) contribution. IRC Section 170(o). The special valuation rule created unintended consequences under the gift and estate tax laws. The Tax Technical Corrections Act of 2007 strikes the rule for estate and gift tax purposes, but retains it for income tax purposes.

TEN-YEAR OR EARLIER YEAR DEATH—If a donor makes an initial fractional contribution, then fails to contribute all of his remaining interest in the property to the same donee before the earlier of 10 years from the initial fractional contribution or the donor's death, the donor's income and gift tax charitable deductions for all previous contributions of interests in the item will be recaptured, plus interest. IRC Section 2522(e).

AUTOMOBILES WHEN CLAIMED VALUE EXCEEDS \$500—If a charity sells an auto worth more than \$500 without "any significant intervening use or material improvement by the charity," the deduction can't exceed the gross proceeds received from the sale. Under an exception, a donor may claim a FMV deduction if the vehicle is sold at a price significantly below FMV to a needy individual in direct furtherance of the donee's charitable purpose of relieving the poor and distressed or the underprivileged who are in need of a means of transportation.

The deduction is not allowed unless the taxpayer substantiates the contribution by contemporaneous written acknowledgment by the charity. See IRC Section 170(f)(12). The charity may use a completed IRS Form 1098-C to comply with this requirement. The charity must also report the information in the acknowledgment to the Internal Revenue Service by filing Copy A of Form 1098-C.

GIFTS OF TAXIDERMY—The charitable deduction for gifts of taxidermy property contributed by the person who prepared, stuffed or mounted the property—or by any person who paid for those services—is the lesser of the taxpayer's basis or the FMV. IRC Sections 170(e)(1) and 170(f)(15).

PATENTS—Initial deduction is limited to the lesser of the taxpayer's basis in the patent or its FMV. An additional charitable deduction allowed in year of contribution and subsequent years based on a specified percentage ranging from 100 percent and

reduced to 10 percent over a 12-year period of the "qualified donee (charity) income" received or accrued by the charity on the patent. IRC Section 170(e)(1)(m).

CAUTION: Tax lawyers, in addition to keeping up with the ever-changing laws, have to be sure that advice given to clients doesn't infringe a tax- or business strategy patent. It's no defense that the lawyer was unaware of the patent and came up with the strategy on his own. So, attorneys must research patents and patent applications. In 2008, the Court of Appeals for the Federal Circuit in *In re Bilski*, 545 F.3d 993 (Fed. Cir. 2008) ruled (9-3) that to be eligible for a business method patent either a "machine- or transformation-test" must be met. Under this test, most tax- and business-planning strategies would not be patentable. On June 28, 2010, in *Bilski v. Kappos*, the Supreme Court ruled unanimously that the patent involved was properly rejected, on the ground that it was an "abstract idea." However, the Court split 5-4 on whether a "business method" was patentable. The majority held that while the machine-or-transformation test is a useful investigative tool, it's not the sole test for deciding whether an invention is a patent-eligible "process." Some business methods may be patent-eligible, though to receive patent protection, any invention, including a business method, must be novel, non-obvious and fully and particularly described. The majority didn't further define what would constitute a patentable "process." In an opinion concurring in the judgment, Justice John Paul Stevens, while agreeing that the machine-or-transformation test was not the exclusive test, would have held that methods of doing business are not patentable. Bills are pending in both the Senate and House of Representatives that would disallow most tax- and business-strategy patents.

BARGAIN SALES—Charitable contribution is the difference between FMV and sale price of long-term securities and real estate. IRC Section 170(e)(2); *Magnolia Dev. Corp.*, 19 T.C. Memo 934; *Waller v. Comm'r*, 39 T.C. 665 (1963); *Gladstein v. Comm'r*, 68-1 USTC (D.C. Cir. 1968), para. 9197; and *Gamble v. Comm'r*, 681 USTC 9393 (D.C. Cir. 1968), para. 9393.

CAPITAL GAIN IMPLICATIONS—Cost basis of property must be allocated between the portion of property "sold" and the portion of property "given" to charity, based on the FMV of each. Appreciation allocable to the sale is subject to capital gains tax; appreciation allocable to the gift is not. See IRC Section 1011(b), Treas. Regs. Sections 1.1011-2 and 1.170A-4(c)(2).

Caveat: Outright gift of mortgaged property is considered a bargain sale. Treas. Regs. Section 1.1011-2(a)(3) and *Guest v. Comm'r*, 77 T.C. 9 (1981).

PRIZES AND AWARDS—Before the Tax Reform Act of 1986, prizes and awards for charitable, religious, scientific, educational, artistic, literary, or civic achievement could be excluded from gross income if the recipient had not applied for the award and was not required to render substantial services to receive it. But since the

Tax Reform Act of 1986, even if a prize meets those requirements, it can be excluded from gross income only if the recipient assigns it to a governmental unit or charity entitled to receive deductible charitable contributions. (IRC Section 74(b)(3)). Amounts assigned by the prize recipient are not deductible charitable contributions.

The prize recipient has three choices (not mutually exclusive):

1. Accept the prize and pay the income tax;
2. Accept the prize and contribute it to charity. Although the prize will be includible in gross income and AGI, an itemizer gets an income tax charitable deduction of up to 50 percent of AGI for gifts to public charities and up to 30 percent of AGI for gifts to non-operating private foundations. “Excess” 50 percent- and 30 percent-type gifts are deductible up to the applicable AGI ceiling in each of the five following years; or
3. Assign the award to charity before accepting it (if it meets the requirements described above).

PARTNERSHIP GIFTS—Contributions are not deductible on a partnership return, but are deductible by individual partners. IRC Section 702(a)(4) and Treas. Regs. Section 1.170A-1(h)(7).

CORPORATE GIFTS—Ceiling on deductibility is 10 percent of corporation’s taxable income. IRC Section 170(b)(2). Five-year carryover for any “excess.” IRC Section 170(d)(2).

A corporation on accrual basis may elect to deduct a gift on this year’s tax return even though the payment is to be made in the next tax year, if the gift is authorized by the board this tax year and payment is made within two and a half months of the close of this tax year. IRC Section 170(a)(2) and Treas. Regs. Section 1.170A-11(b).

Corporations meeting certain tests get enhanced deductions for gifts of inventory (used by charity for the ill, needy or minors), or scientific equipment (used by colleges, universities or qualified scientific research organizations for research, experimentation or research training). The deduction is for the property’s basis plus half of the appreciation, or twice the property’s basis, whichever is lower. IRC Sections 170(e)(3), (4) and Treas. Regs. Section 1.170A-4A.

Gifts of computer technology and equipment for educational purposes from kindergarten through 12th grade and for public libraries can qualify for the enhanced deduction (when tests are met), provided the gifts are made before the end of 2009.

FOOD INVENTORY GIFTS—For 2009, any taxpayer (not solely C corporations) engaged in trade or business is eligible to claim an enhanced deduction for donations of food inventory. IRC Section 170(e)(3)(C).

BOOK INVENTORY GIFTS—For 2009, a C corporation is

entitled to an enhanced deduction for a gift of books to a public school that provides elementary education or secondary education (kindergarten through 12th grade) and is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on. IRC Section 170(e)(3)(D).

For food and book inventory gifts, the property must be inventory contributed to an IRC Section 501(c)(3) charity (except for private non-operating foundations) and the donee must use the property consistent with the donor’s exempt purpose solely for the care of the ill, the needy or minors; not transfer the property in exchange for money, other property or services; and provide the taxpayer a written statement that the donee’s use of the property will be consistent with those requirements.

CONSERVATION GIFTS

Qualified conservation contributions aren’t subject to the rules that generally bar deductions for gifts of partial interests in property. A qualified conservation contribution is a gift of a qualified real property interest to a qualified organization exclusively for conservation purposes. IRC Section 170(b)(E). A qualified real property interest is: the entire interest of the donor other than a qualified mineral interest; a remainder interest; or a restriction, granted in perpetuity, on the use that may be made of the real property.

Qualified organizations include public charities, governmental units and certain supporting organizations (an organization created and operated exclusively for the benefit of, to perform the functions of, or carry out the purposes of a charity.)

Conservation purposes include:

- the preservation of land areas for outdoor recreation by, or for the education of, the general public;
- the protection of a relatively natural habitat of fish, wildlife, plants, or similar ecosystem;
- the preservation of open space (including farmland and forest land) where that preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or under a clearly delineated federal, state or local governmental conservation policy; and
- the preservation of an historically important land area or a certified historic structure.

For 2009, the usual 30 percent AGI ceiling on deductibility for individuals doesn’t apply to qualified conservation contributions. Instead, individuals may deduct the FMV of any qualified conservation contribution to a charity described in IRC Section 170(b)(1)

(A) to the extent of the excess of 50 percent of AGI over the amount of all other allowable charitable contributions. These contributions aren't taken into account in determining the amount of other allowable charitable contributions. Individuals are allowed to carry over any qualified conservation contributions that exceed the 50 percent of AGI limit for up to 15 years instead of the usual five-year period. See IRC Section 170(b)(E)(i), (ii).

For an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a deduction for a qualified conservation contribution is allowable for up to 100 percent of the excess of the taxpayer's AGI over the amount of all other allowable charitable deductions. IRC Section 170(b)(E)(iv).

IRA ROLLOVERS

For 2009, an individual age 70½ or older can make direct charitable gifts from a traditional or Roth individual retirement account—including required minimum distributions (RMDs)—of up to \$100,000 to qualified public charities (other than donor-advised funds and supporting organizations) and to operating and pass-through foundations, and not have to report the IRA distributions as taxable income on his federal income tax return. This is for outright gifts only—not life income gifts. There is no charitable deduction for the distributions. However, not paying tax on otherwise taxable income is the equivalent of a charitable deduction. IRC Section 408(d)(8).

WAIVER OF RMD FOR 2009—The Worker, Retiree, and Employer Recovery Act of 2008 waived any RMDs for 2009 from retirement plans that hold a participant's benefit in an individual account such as 401(k) and 403(b) plans, certain 457(b) plans and IRAs. As a result, most participants and beneficiaries who might otherwise have been required to take minimum distributions from such accounts were not required to withdraw any amount in 2009. If they did make a withdrawal in 2009, they might have been able to roll over the withdrawn amount into another eligible retirement plan. However, any previously untaxed portion of the withdrawal that is not rolled over had to be included in their gross income. There is no indication at this time that this waiver provision will be extended.

And as of Aug. 18, 2010, the IRA/charitable rollover hasn't been extended to 2010.

Distributions from a qualified IRA must be made directly by the IRA's administrator or trustee to a qualified charity. A payment to the donor who then one second later gives it to the charity doesn't qualify.

The exclusion won't be available if the IRA distribution to the charity isn't sufficiently substantiated. The charity must give the donor a written acknowledgment that it has received the IRA distribution and that no goods or services were given in connection with the

IRA distribution. See IRS Notice 2007-7.

The entire distribution must be paid to the charity with no quid pro quo. The exclusion applies only if a charitable deduction for the entire distribution would have been allowable (determined without regard to the generally applicable percentage limitations.) Thus, if the donor receives (or is entitled to receive) a rubber chicken dinner in connection with the transfer to the charity from the IRA, the exclusion isn't available for any part of the IRA distribution. That's a "quid pro crow!"

OUTRIGHT GIFTS TO PRIVATE FOUNDATIONS

For outright gifts to private foundations (other than private operating foundations):

SECURITIES, REAL ESTATE AND TANGIBLE PERSONAL PROPERTY HELD LONG-TERM—Deduction is for cost basis or current FMV, whichever is lower. IRC Section 170(e)(1)(B)(ii).

Exception: For pass-through foundations, deduction allowed for full present FMV when the private foundation, within two and a half months after the year of receipt, gives an amount equal to all gifts to public charities (schools, churches, etc.) or private operating foundations. IRC Sections 170(b)(1)(A)(vii), (E)(ii) and (iii) and Treas. Regs. Section 1.170A-9(g)(2)(iv), (v).

Note: Unless tangible personal property is put to a "related" use, deduction is limited to the lesser of current FMV and cost basis. IRC Section 170(e)(1)(B)(i).

LONG-TERM APPRECIATED PUBLICLY TRADED SECURITIES (SPECIAL RULE)—A deduction for the full FMV is allowable for contributions of stock for which, as of the contribution date, market quotations are readily available on an established securities market. This special treatment is available to the extent that the contribution—along with all prior contributions of stock in the same corporation by the donor and the donor's family—don't exceed 10 percent of the value of the corporation's outstanding stock.

CAUTION: Appreciated publicly traded stock subject to Securities and Exchange Commission Rule 144 is deductible at cost basis. Private Letter Rulings 9247018, 9320016, 9734034 and 9746050. But SEC Rule 145(e) stock (allowed to be sold under that rule) is deductible at present market value. PLR 9320007.

ORDINARY INCOME AND SHORT-TERM PROPERTY GIFTS—Deduction is for the lesser of cost basis and current FMV. IRC Section 170(e)(1)(A).

CEILINGS ON DEDUCTIBILITY—Thirty percent of AGI for cash and ordinary income property. IRC Section 170(b)(1)(B). Twenty percent of AGI for gifts of capital gain property. See IRC Section 170(b)(1)(D)(i).

EXCEPTION FOR PASS-THROUGH FOUNDATIONS—If certain distribution requirements are met, ceiling may be 30 percent or 50 percent of AGI, with five-year carryover for any “excess.” IRC Sections 170(b)(1)(A)(vii), (C)(iii).

CARRYOVER—Five-year carryover for “excess” gifts. IRC Section 170(b)(1)(B).

FORMER REDUCTION FOR SOME ITEMIZERS—BUT ALIVE AGAIN STARTING IN 2011

In 2009, taxpayers had to reduce their itemized deductions (except medical expenses, casualty and theft losses, and investment interest) by 1 percent of AGI over \$166,800 (over \$83,400 if married, filing separately). This amount was adjusted annually for inflation. In any event, the 1 percent rule wouldn’t take away more than 80 percent of the itemized deductions subject to that rule. Pursuant to the Economic Growth Tax Relief Reconciliation Act (EGTRRA) 2001, beginning in 2006, the overall limitation on itemized deductions was gradually reduced from the original 3 percent until 2010, when it’s eliminated. However, it returns in 2011 at 3 percent.

DELIVERY DATE

The delivery date determines valuation and year of deduction. Treas. Regs. Section 1.170A-1(b). Here are the rules:

SECURITIES—If mailed by U.S. mail, date of mailing is the delivery date; if delivered by other means (including private delivery services, such as FedEx) or if hand-delivered, date received by the charity is the delivery date. To be effective, the delivery must be unconditional and the stock certificate must be properly endorsed. If the stock certificate is not endorsed, the donor should give the charity a properly endorsed power and the stock certificate. If securities are delivered to the donor’s bank or broker (as donor’s agent) or to the issuing corporation (or its agent) instructing the corporation to reissue in charity’s name, the delivery date is the date securities transferred to the charity on the corporation’s books (date on new stock certificate having charity’s name.)

For Depository Trust Company electronic transfers, the gift is “delivered” when the transfer to the charity’s account is completed.

CHECKS—If mailed by U.S. mail, date of mailing is delivery date; if delivered by other means (including private delivery services, such as FedEx), date received by charity is delivery date.

ARTWORK AND OTHER TANGIBLE PERSONAL PROPERTY—Date charity receives the property (and a deed of gift, if required by state law) is the delivery date.

REAL ESTATE—Date charity receives the properly executed deed is the delivery date (unless state law requires the deed to be recorded for title to pass; in that case, recording date is delivery date.)

PLEDGES—Deduction is taken in year fulfilled—not when made. IRC Section 170(a)(1). Satisfying pledge with property does not give rise to taxable gain or deductible loss. Revenue Ruling 55-410, 1955-1 C.B. 297.

FAIR MARKET VALUE

SECURITIES—When there is a market for securities on a stock exchange or over the counter, FMV is the mean between high and low on date of delivery (bid and asked prices on date of delivery if quoted selling prices not available.) Treas. Regs. Section 20.2031-2. Same rule for closed-end investment company shares.

VALUATION OF MUTUAL FUND SHARES (OPENED INVESTMENT COMPANIES—FMV is the redemption price (bid). See *U.S. v. Cartwright*, 411 U.S. 546 (1973).

REAL ESTATE, WORKS OF ART AND OTHER PROPERTY NOT TRADED ON AN EXCHANGE OR OVER THE COUNTER—FMV is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Treas. Regs. Section 1.170A1(c)(2). Valuation is substantiated by expert appraisals. (See “Substantiating Deductions,” below.) Cost of appraisal is an IRC Section 212(3) deduction (subject to 2 percent floor on miscellaneous itemized deductions.) Percent of AGI ceiling on charitable contributions is inapplicable. Rev. Rul. 67-461, 1967-2 C.B. 125. For guidelines on appraisals, see Rev. Proc. 66-49, 1966-2 C.B. 1257 and Treas. Regs. Section 1.170A-13(c). See *Wortman v. Comm’r*, T.C. Memo. 2005-227, for an excellent primer on valuing real estate. In *Kiva Dunes Conservation, LLC*, T.C. Memo. 2009-145, the Tax Court recited several additional rules for determining FMV, with regard to the donation of a conservation easement (see also *Hughes*, T.C. Memo. 2009-94):

- In determining FMV of property, not only the current use of the property must be taken into account, but also its highest and best use.
- A property’s highest and best use is the highest and most profitable use for which it is adaptable and needed or likely to be needed in the reasonably near future.

- The highest and best use can be any realistic, objective potential use of the property.
- If there is a substantial record of sales of easements comparable to a donated easement, the fair market value of the donated easement is based on the sale prices of those comparable easements. Treas. Regs. Section 1.170A-14(h)(3)(i).

Where there is no established market for similar conservation easements and no record exists of sales of those easements, the fair market value of a perpetual conservation restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction. Treas. Regs. Section 1.170A-14(h)(3)(i). Further, any enhancement in the value of a donor's other property resulting from an easement contribution, or of property owned by certain related persons, reduces the value of the charitable deduction. Treas. Regs. Section 1.170A-14(h)(3)(i).

SUBSTANTIATING DEDUCTIONS

To deduct any gift of \$250 or more, a donor must have contemporaneous written substantiation from the charity (including a good faith estimate of the value of any goods or services given to the donor in exchange for the gift.) IRC Section 170(f)(8). If no goods or services were provided, the acknowledgment must so state. IRC Section 170(f)(8) and Treas. Regs. Section 1.170A-13(f)(2). The substantiation rules don't apply, however, to charitable remainder unitrusts (CRUTs) or charitable remainder annuity trusts (CRATs). A contemporaneous written acknowledgment means that the donor must have the receipt in hand before filing his or her timely income tax return. A letter to donors from a church in January 2008 stating that it had received donations in 2005 was not contemporaneous and the donors could not deduct the amounts claimed for 2005. *Gomez*, T.C. Summ. Op. 2008-93 (July 30, 2008).

Strict appraisal, appraisal summary (Section B to IRS Form 8283) and information reporting requirements are imposed when property gifts (other than marketable securities) are claimed as income tax charitable deductions. The rules apply to property contributions claimed at over \$5,000 per item or group of similar items, whether or not donated to the same charity (\$10,000 for closely held stock, but appraisal summary is required if claimed value is over \$5,000.)

COMPLETED FORM 8283 (Section B)—A completed Form 8283 (Section B) includes: (1) the donor's name and taxpayer identification number (social security number if the donor is an individual or employer identification number if the donor is a partnership or corporation); (2) the donee's name, address, taxpayer identification number, and signature, the date signed by the donee, and the date the donee received the property; (3) the appraiser's

name, address, taxpayer identification number, appraiser declaration, signature, and the date signed by the appraiser; (4) the following information about the contributed property: (a) the fair market value on the valuation effective date (as defined in Treas. Regs. Section 1.170A-17(a)(5)(i)), (b) a description in sufficient detail under the circumstances (taking into account the value of the property) for a person who is not generally familiar with the type of property to ascertain that the described property is the contributed property, (c) in the case of real or tangible personal property, the condition of the property; (5) the manner of acquisition (for example, by purchase, gift, bequest, inheritance, or exchange), and the approximate date of acquisition of the property by the donor, or, if the property was created, produced, or manufactured by or for the donor, the approximate date the property was substantially completed; (6) the cost or other basis, adjusted as provided by IRC Section 1016; (7) a statement explaining whether the charitable contribution was made by means of a bargain sale and, if so, the amount of any consideration received from the donee for the contribution; and (8) any other information required by Form 8283 (Section B) or the instructions to Form 8283 (Section B).

SUBSTANTIATION OF NONCASH CHARITABLE CONTRIBUTIONS OF MORE THAN \$500,000—

Generally, no income tax charitable deduction is allowed for a noncash charitable contribution of more than \$500,000 unless the donor: (1) substantiates the contribution with a contemporaneous written acknowledgment (as described in IRC Section 170(f)(8) and Treas. Regs. Section 1.170A-13(f)); (2) obtains a qualified appraisal (as defined in Treas. Regs. Section 1.170A-17(a)(1)) prepared by a qualified appraiser (as defined in Treas. Regs. Section 1.170A-17(b)(1)); (3) completes Form 8283 (Section B) and files it with the return on which the deduction is claimed; and (4) attaches the qualified appraisal of the property to the return on which the deduction is claimed.

GIFTS OF \$5,000 OR LESS—Easier (but still detailed) reporting rules apply for property gifts valued at \$5,000 or less. See Treas. Regs. Section 1.170A-13 and Form 8283. No deduction is allowed for a noncash charitable contribution of more than \$500 but not more than \$5,000 unless the donor: (1) substantiates the contribution with a contemporaneous written acknowledgment; and (2) completes Form 8283 (Section A), "Noncash Charitable Contributions," or a successor form, and files it with the return on which the deduction is claimed. A completed Form 8283 (Section A) includes: (1) the donor's name and taxpayer identification number (social security number if the donor is an individual or employer identification number if the donor is a partnership or corporation); (2) the name and address of the donee; (3) the date of the contribution; and (4) the following information about the contributed property: a description of the property in sufficient detail under the circumstances (taking into account the value of the property) for a person who is not generally familiar with the type of property to ascertain that the described property is the contributed property; in the case of real or personal property, the condition

of the property; in the case of securities, the name of the issuer, the type of security, and whether the securities are publicly traded securities within the meaning of Treas. Regs. Section 1.170A-13(c)(7)(xi); and the fair market value of the property on the date the contribution was made and the method used in determining the fair market value.

C corporations must now meet the substantiation requirements that have long been required of individuals, closely held corporations, personal service corporations, partnerships and S corporations. IRC Section 170(f)(11). For quid pro quo gifts over \$75, the charity must inform donor that gift deduction is limited to excess of amount (or value of property transferred) over the value received by donor. IRC Section 6115, Treas. Regs. Sections 1.170A-1(h)-13(f), 1.6115-1 and IRS Pub. No. 1771.

For cash gifts, regardless of the amount, recordkeeping requirements are now satisfied only if the donor maintains as a record of the contribution, a bank record (such as a cancelled check, bank or credit union statements and credit card statements) or a written communication from the donee showing the name of the donee and the date and amount of the contribution. The recordkeeping requirements will not be satisfied by maintaining other written records. Effective for contributions made in taxable years beginning after Aug. 17, 2006. For calendar year taxpayers, this means starting in 2007. IRC Section 170(f)(17). See also IRS news release IR 2006-192.

CASH CONTRIBUTIONS MADE BY PAYROLL DEDUCTION—A charitable deduction will not be allowed unless the donor receives a “written communication from the donee organization.” That communication includes a pay stub, Form W-2 or other document furnished by the employer that states the amount withheld during a taxable year by the employer for the purpose of payment to a donee organization, together with a pledge card or other document prepared by or at the direction of the donee organization that shows the name of the donee organization. An organization described in IRC Section 170(c), or an organization described in 5 CFR 950.105 (a Principal Combined Fund Organization for purposes of the Combined Federal Campaign), and acting in that capacity, that receives a payment made as a contribution will be treated as a donee organization for purposes of IRC Section 170(f)(17). See also IRS Notice 2006-110, 2006-151 IRB 1127.

APPRAISALS

QUALIFIED APPRAISER—A “qualified appraiser” is an individual with verifiable education and experience in valuing the relevant type of property for which the appraisal is performed. IRC Section 170(f)(11); Treas. Regs. Sections 1.170A-16(d)(1)(ii), 1.170A-16(e)(1)(ii). An individual is treated as having education and experience in valuing the relevant type of property, as of the

date the individual signs the appraisal, if the individual has: successfully completed (for example, received a passing grade on a final examination) professional or college-level coursework in valuing the relevant type of property, and has two or more years of experience in valuing the relevant type of property; or earned a recognized appraisal designation for the relevant type of property. The coursework must be obtained from: a professional or college-level educational organization described in IRC Section 170(b)(1)(A)(ii); a generally recognized professional appraisal organization that regularly offers educational programs in the principles of valuation; or an employer as part of an employee apprenticeship or educational program. A recognized appraisal designation is a designation awarded by a recognized professional appraiser organization on the basis of demonstrated competency. For example, an appraiser who has earned a designation similar to the Member of the Appraisal Institute (MAI), Senior Residential Appraiser (SRA), Senior Real Estate Appraiser (SREA), or Senior Real Property Appraiser (SRPA) membership designation has earned a recognized appraisal designation. The relevant type of property means the category of property customary in the appraisal field for an appraiser to value. Education and experience in valuing the relevant type of property are verifiable if the appraiser specifies in the appraisal the appraiser’s education and experience in valuing the relevant type of property, and the appraiser makes a declaration in the appraisal that, because of the appraiser’s education and experience, the appraiser is qualified to make appraisals of the relevant type of property being valued.

The court in *Kiva Dunes Conservation, LLC*, T.C. Memo. 2009-145, provides a primer on valuations and appraisals and analyzes what the court looks for in evaluating the experience, ability and credibility of the parties’ expert witnesses. See also *Hughes*, T.C. Memo. 2009-94. These conservation easement cases demonstrate the importance of selecting an expert who not only has excellent general qualifications, but also knows the facts on the ground.

QUALIFIED APPRAISAL—An appraisal is qualified if it is prepared by a qualified appraiser (as defined above) following generally accepted appraisal standards and Treas. Regs. Section 1.170A17(a). Generally accepted appraisal standards comply with the substance and principles of the Uniform Standards of Professional Appraisal Practice, as developed by the Appraisal Standards Board of the Appraisal Foundation. A qualified appraisal is one that, among other things: is made not earlier than 60 days before the date of contribution and not later than the due date (including extensions) of the return on which an income tax charitable deduction is first claimed; is prepared, signed, and dated by a qualified appraiser.

A qualified appraisal must include the following information about the contributed property: a description in sufficient detail under the circumstances (taking into account the value of the property) for a person who is not generally familiar with the type of property to ascertain that the appraised property is the contributed property;

for real or tangible personal property, the condition of the property; the valuation effective date; and the fair market value (within the meaning of Treas. Regs. Section 1.170A-1(c)(2)) of the contributed property on the valuation effective date.

A qualified appraisal must also include: (a) the terms of any agreement or understanding by or on behalf of the donor and donee that relates to the use, sale, or other disposition of the contributed property, including, for example, the terms of any agreement or understanding that: restricts temporarily or permanently a donee's right to use or dispose of the contributed property; reserves to, or confers upon, anyone (other than a donee or an organization participating with a donee in cooperative fundraising) any right to the income from the contributed property or to the possession of the property, including the right to vote contributed securities, to acquire the property by purchase or otherwise, or to designate the person having income, possession, or right to acquire; or earmarks contributed property for a particular use; (b) the date (or expected date) of the contribution to the donee; (c) the following information about the appraiser: name, address, and taxpayer identification number; qualifications to value the type of property being valued, including the appraiser's education and experience; if the appraiser is acting in his or her capacity as a partner in a partnership, an employee of any person (whether an individual, corporation, or partnership), or an independent contractor engaged by a person other than the donor, the name address, and taxpayer identification number of the partnership or the person who employs or engages the qualified appraiser; (d) the signature of the appraiser and the date signed by the appraiser (appraisal report date); (e) the following declaration by the appraiser: "I understand that my appraisal will be used in connection with a return or claim for refund. I also understand that, if a substantial or gross valuation misstatement of the value of the property claimed on the return or claim for refund results from my appraisal, I may be subject to a penalty under section 6695A of the Internal Revenue Code, as well as other applicable penalties. I affirm that I have not been barred from presenting evidence or testimony before the Department of the Treasury or the Internal Revenue Service pursuant to 31 U.S.C. section 330(c);" (f) a statement that the appraisal was prepared for income tax purposes; (g) the method of valuation used to determine the fair market value, such as the income approach, the market data approach, or the replacement-cost-less-depreciation approach; and (h) the specific basis for the valuation, such as specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.

PROHIBITED APPRAISAL FEES—The fee for a qualified appraisal cannot be based to any extent on the appraised value of the property.

APPRAISER PENALTIES—A civil penalty is imposed on any person who prepares an appraisal that is to be used to support a tax position if the appraisal results in a substantial or gross valuation

misstatement. The penalty is equal to the greater of \$1,000 or 10 percent of the understatement of tax resulting from a substantial or gross valuation misstatement—up to a maximum of 125 percent of the gross income derived from the appraisal. The penalty doesn't apply if the appraiser establishes that it was "more likely than not" that the appraisal was correct. IRC Section 6695A.

SUBSTANTIAL AND GROSS OVERSTATEMENT OF PROPERTY VALUATIONS—Accuracy-related penalties are imposed on a taxpayer for substantial or gross valuation misstatements relating to an underpayment of income, gift and estate taxes. IRC Sections 6662, 6695A.

INCOME TAX—A substantial valuation misstatement exists when the claimed value of any property is 150 percent or more of the amount determined to be the correct value. A gross valuation misstatement occurs when the claimed value of any property is 200 percent or more of the amount determined to be the correct value.

ESTATE AND GIFT TAXES—A substantial estate or gift tax valuation misstatement exists when the claimed value of any property is 65 percent or less of the amount determined to be the correct value. A gross estate or gift tax valuation misstatement exists when the claimed value of any property is 40 percent or less of the amount determined to be the correct value. IRC Sections 170(f)(1)(E), 6662, 6664 and 6695A.

GIFT TAX REPORTING

OUTRIGHT GIFTS—Gifts that qualify for the \$13,000 annual-per-donee exclusion aren't reportable whether made to an individual or a charity.

Outright charitable gifts of cash regardless of the amount and property gifts (regardless of the value) qualify for the unlimited gift tax charitable deduction and generally aren't reportable. A direct charitable gift from a traditional or Roth IRA of up to \$100,000 by an individual 70½ or older to a qualified charity, doesn't qualify for a charitable deduction but such distribution doesn't have to be reported as taxable income. Unless extended, the IRA/charitable rollover ends after 2009.

An outright charitable gift of a partial interest (for example, an undivided one-fifth interest in Greenacre) is reportable. But no gift tax is payable because it qualifies for the unlimited gift tax charitable deduction.

If a gift tax return is required to report noncharitable gifts and there were also gifts to charities, these gifts to charity must also be included on the return.

SPLIT INTEREST GIFTS—Gift tax reporting is required for gifts to charities of remainder and lead interests. Offsetting gift

tax charitable deductions are available for those gifts resulting in a wash. Taxes may, however, be incurred on a non-charity's interest in those arrangements if the gift is not offset by the \$13,000 annual exclusion and the lifetime \$1 million gift tax exemption. The rules differ—depending upon whether the gift is a unitrust, annuity trust, pooled income fund, gift annuity, deferred payment gift annuity, remainder interest in a personal residence or farm or charitable lead trust. And different rules often apply when the beneficiaries are spouses. There are different rules for citizen and non-citizen spouses. And to make things even more complicated, how the property is owned (separate property, joint ownership, tenancy in common, community property) and whether an income beneficiary is the first, joint or successor beneficiary must be taken into account. Also, the type of life-income plan must be considered.

REPORTING BY DONEES—The donee of any “charitable deduction property” that sells, exchanges, consumes or otherwise disposes of the property within three years after the gift must file an information return (Form 8282). IRC Section 6050L(a). “Charitable deduction property” is any property (other than money or publicly traded securities) valued at more than \$5,000 for which a donee-charity signs an appraisal summary (Section B of Form 8283). IRC Section 6050L(b); Treas. Regs. Sections 1.6050L-1(e), 1.170A-13(c)(4)(ii).

Form 8282 need not be filed by a charity if, at the time of the charity's signature, the appraisal summary it signed for the item contained the donor's signed statement that the appraised value of the item does not exceed \$500 (Treas. Regs. Section 1.6050L-1(a)(2)(i)); or when the charity's consumption or distribution of the charitable deduction property is in furtherance of its exempt purpose and without consideration (related use) (Treas. Regs. Section 1.6050L-1(a)(3)). The donee must file the information return within 125 days of disposing of the property. Treas. Regs. Section 1.6050L-1(f)(2)(i). But if, on the date it received the property, the donee had no reason to know that it would have to report its disposition, the due date for reporting is extended to 60 days after it learned that reporting was necessary. Treas. Regs. Section 1.6050L-1(f)(2)(ii). A copy of the donee information return must be provided to the donor, IRC Section 6050L(c); the charity must keep a copy as well. Each failure to file can subject the charity to penalties.

“Successor donees” must also report. A successor donee is one who receives property from an “original donee” (or another successor donee) for less than FMV. Treas. Regs. Section 1.170A-13(c)(7)(vii). A successor donee that receives charitable deduction property from a preceding donee must report its disposition of property transferred by the original donee. Treas. Regs. Section 1.6050L-1(c)(1).

PENALTIES—Penalties are imposed for failure to comply. IRC Sections 6721, 6722 and 6724. Civil and criminal penalties are imposed for negligence, fraud and valuation overstatements. IRC Sections 6662, 6663, 7206 and 7207. The ultimate penalty is called “Leavenworth.”

PERSONAL DEDUCTIONS AND EXPENSES

PERSONAL SERVICES—No charitable deduction for value of personal services rendered free for charity. *Grant v. Comm'r*, 84 T.C. 809 (1985), *aff'd*, (4th Cir. 1986) (unpublished opinion). Treas. Regs. Section 1.170A-1(g), Rev. Rul. 57-462, 1957-2 C.B.C.B. 157 and Rev. Rul. 1967-2 C.B.C.B. 103.

VOLUNTEER EXPENSES—Deductible when unreimbursed and incurred in rendering services for charity. Rev. Rul. 55-4, 1955-1 C.B.C.B. 291. The optional standard mileage rate is 14¢ per mile for unreimbursed automobile expenses. IRC Section 170(i). Unreimbursed parking and toll costs are also deductible.

Ceiling is 50 percent of AGI, with a five-year carryover. *Rockefeller v. Comm'r*, 76 T.C. 178, *aff'd*, 676 F.2d 35 (2d Cir. 1982) and Rev. Rul. 84-61, 1984-1 C.B. 39. No deduction is allowed for charitable travel expenses if “there is a significant element of personal pleasure, recreation or vacation” in the travel. IRC Section 170(j).

Unreimbursed babysitting expenses incurred to render volunteer services are not deductible. See Rev. Rul. 73-597, 1973-2 C.B. 69.

PATRON'S GIFTS—Contribution is amount transferred by donor minus value of theater ticket, meal or other privilege donor is entitled to receive. Rev. Rul. 67-246, 1967-2 C.B. 104; Rev. Rul. 86-63, 1986-1 C.B. 88; Rev. Proc. 90-12, 1990-1 C.B. 471; Rev. Proc. 92-49, 1992-1 C.B. 987 and Rev. Proc. 2009-50, 2009-45 IRB 617, for special de minimis rule.

PAYMENTS FOR RIGHT TO PURCHASE ATHLETIC TICKETS—A special rule applies when a donor makes a charitable contribution to or for a college or university and is thereby entitled to purchase tickets to athletic events. A deduction is allowable for 80 percent of the amount paid to a tax-exempt institution of higher education for seating options—the right to buy tickets—at the institution's stadium (but not for the price of the tickets themselves.) Twenty percent of the amount paid for the right to buy tickets for seating at college or university athletic events is treated as the right's FMV. IRC Section 170(l), Treas. Regs. Sections 1.170A-13(f)(14) and 1.6115-1(c).

DEBTS AND LOANS

INSTALLMENT OBLIGATIONS—Gift of installment obligations (gain reported under IRC Section 453) accelerates remaining deferred gain in year of gift. Rev. Rul. 55-157, 1955-1 C.B. 293.

CHARITABLE LOANS—No income, gift or estate tax deductions for interest-free loan or rent-free use of property. IRC Section 170(f)(3)(A), Treas. Regs. Section 1.170A-7(a), IRC Sections 2522(c)(2) and 2055(e)(2).

Exceptions: Although uncharged interest is generally imputed to lender of interest-free loan, regulations exempt charitable loans up to \$250,000 per charity. Temp. Regs. Section 1.7872-5T(b)(9). Rent-free loan of artwork to public charity for a related use is exempt from gift tax. IRC Section 2503(g).

LIFE INSURANCE GIFTS

Donor names charity beneficiary of his insurance policy and irrevocably assigns incidents of ownership to it.

CAUTION: State law must permit a charity to have insurable interest in a donor's life. PLR 9110016.

GIFT OF POLICY ON WHICH PREMIUMS REMAIN TO BE PAID—Income tax deduction is slightly above cash surrender value. Treas. Regs. Section 25.2512-6(a). However, if that amount exceeds policy's cost basis, deduction is for cost basis. IRC Section 170(e)(1)(A). Continued payment of premiums gives donor deduction for annual premiums. *Awrey v. Comm'r*, 25 T.C. 643 (1955).

GIFT OF FULLY PAID POLICY—Income tax deduction is generally replacement cost. Treas. Regs. Section 25.2512-6(a). But if that amount exceeds the policy's cost basis, deduction is for cost basis. IRC Section 170(e)(1)(A).

ENDOWMENT POLICY—Charitable deduction for value minus amount that would be taxed as ordinary income on a sale. IRC Section 170(e)(1)(A). But see Treas. Regs. 1.170A-4(a).

Caveat: Donor has ordinary income of difference between cost and maturity value in year charity receives proceeds. Rev. Rul. 69-102, 1969-1 C.B. 32 and *Friedman v. Comm'r*, 41 T.C. 428, *aff'd*, 346 F.2d 506 (6th Cir. 1965).

CAUTION: Congress and the IRS have clamped down on “charitable” insurance schemes. The strategy enables private investors to buy life insurance on other individuals' lives by making a charity a minor partner in the venture.

A temporary reporting requirement was imposed on the acquisition of interests in such life insurance policies. The penalty for failure to file the return was 10 percent of the value of the benefit of any contract with respect to which information is required to be included on the return. The law was applicable to transactions occurring after Aug. 17, 2006 and before Aug. 18, 2008.

CHARITABLE REMAINDER TRUSTS

CRUTS—Specifies that the income beneficiary will receive annual payments determined by multiplying a fixed percentage (at least 5

percent but not more than 50 percent) by the net FMV of the trust assets determined each year. For each contribution to the trust, the value (determined under IRC Section 7520) of the remainder interest must be at least 10 percent of the net FMV of the property as of the date the property is contributed. IRC Section 664(d)(2)(D). On the death of the beneficiary (or survivor beneficiary, if there is more than one), the charity gets the remainder. IRC Section 664(d)(2).

A variation, net income with makeup charitable remainder unitrust (NIMCRUT), calls for the trustee to pay only trust income if actual income is less than the stated percentage. Deficiencies in distributions (when trust income is less than the stated percentage) are made up in later years if trust income exceeds the stated percentage. Under another variation, net income charitable remainder unitrust (NICRUT), deficiencies are not made up. IRC Section 664(d)(3) and Treas. Regs. Section 1.664-3(a)(1)(i)(b). The regulations prohibit pre-contribution capital gain as NIMCRUT and NICRUT income. Treasury Decision 8791.

Regulations authorize “flip” unitrusts (FLIPCRUT), a NIMCRUT or NICRUT that switches to a standard (fixed percentage) CRUT (STANCRUT) on an allowable triggering event specified in the trust agreement. Treas. Regs. Section 1.664-3(c)-(f). An allowable triggering event may be: (a) the sale of unmarketable assets, such as, real property, closely held stock or unregistered securities, held by the trust; (b) a specific date; or (c) a single event whose occurrence is not discretionary with, or within the control of, the trustee or any other persons. For maximum flexibility, use a FLEXCRUT, which is a FLIPCRUT drafted to give great flexibility in determining when, if ever, a NIMCRUT will flip to a STANCRUT. If the CRT is to flip on the sale of a parcel of real estate, on a specified date or event, that should be specified. However, for maximum flexibility, specify that the trust is to flip on the sale of an unimportant unmarketable asset that is one of the assets used to fund the trust.

Appraisal requirements on CRUTs funded with “unmarketable assets” are imposed for determining the trust's annual payment when the donor, the donor's spouse, a beneficiary or a related or subordinate party is the trustee.

CRATS—Specifies a fixed dollar amount (at least 5 percent but not more than 50 percent of the initial net FMV of transferred property) paid annually to the income beneficiary for life. The value of the charitable remainder interest, determined under IRC Section 7520, must be at least 10 percent of the initial net FMV of all property placed in the trust. IRC Section 664(d)(1)(D). On the death of the beneficiary (or survivor beneficiary, if there is more than one), the charity gets the remainder. IRC Section 664(d)(1). It's also essential that a CRAT pass the 5 percent probability test of Rev. Rul. 77-374.

For charitable remainder trusts (CRTs), the 50 percent maximum annual payout requirement applies to transfers to trusts after June 18, 1997. The 10 percent minimum remainder interest requirement

is effective for transfers to trusts after July 28, 1997. The 10 percent requirement doesn't apply to transfers in trust under a will executed before July 29, 1997 if the decedent died before 1999 without having republished the will or, on July 28, 1997, was under a mental disability preventing him from changing the disposition of his property and didn't regain competence to dispose of the property before he died.

Regulations give a host of rules for CRUT and CRAT payments after year-end (by April 15) to satisfy the prior year's required payout. See T.D. 8791 and T.D. 8926.

In Rev. Proc. 2005-24, 2005-16 IRB 909, the IRS ruled that inter vivos CRUTs and CRATs were disqualified if a spousal right of election existed under state law. The IRS provided safe harbor procedures for avoiding disqualification by obtaining a waiver of the right of election. For trusts created before June 28, 2005, the Service ruled it would disregard the right of election, even without a waiver, but only if the spouse did not exercise the right of election. Rev. Proc. 2005-24, 2005-16 IRB 909. However, Rev. Proc. 2005-24 created many practical problems for donors, trustees, advisors and charities. In IRS Notice 2006-15, 2006-8 IRB 501, the Service stated that, until further notice, a spousal waiver of a right of election is no longer needed for CRUT and CRAT qualification. The Service extended the June 28, 2005 grandfather date indefinitely. Therefore, a spouse's right of election, even without a waiver, will be disregarded, but only if the surviving spouse doesn't exercise that right.

GOVERNING INSTRUMENT REQUIREMENTS—To assure charitable deductions and avoid adverse tax consequences, a governing instrument must contain specific provisions. Treas. Regs. Sections 1.664-1 through 1.664-3; IRC Sections 508(e) and 4947(a)(2).

The IRS has issued specimen CRAT agreements, Rev. Proc. 2003-53 through Rev. Proc. 2003-60, and specimen charitable remainder unitrust agreements, Rev. Proc. 2005-52 through Rev. Proc. 2005-59.

DEFECTIVE CRUT—substantial compliance doctrine inapplicable. The Court of Appeals for the Seventh Circuit ruled that a defective CRUT couldn't qualify based on the substantial compliance doctrine. Although the defective CRUT could have been patched up by a timely brought judicial proceeding, no proceeding was brought and the trust was never reformed, with or without a judicial proceeding. The IRS denied the charitable deduction on the ground that the charitable remainder, as defined in the trust, was not in a qualified CRT because the trust didn't specify either a fixed dollar amount or a percentage of the trust's FMV. The trust, as drafted, was clearly and fundamentally defective. However, the trust was administered by following the Code's CRUT requirements and this was stated on the estate tax return. The trustee argued that the statement on the estate tax return, coupled with the trustee's continued administration of the trust as if it were a qualified unitrust, should be deemed substantial compliance. The appellate court rejected this argument, ruling that the substantial compliance doctrine should

not extend beyond cases in which the taxpayer had a good excuse for failing to comply with either an unimportant requirement or one "unclearly or confusingly" stated in the regulations or statute. The court ruled that the failure to bring the required judicial proceeding to reform the trust was neither an unimportant requirement nor was it stated unclearly or confusingly in the Code. The substantial compliance doctrine was, therefore, inapplicable. See *Estate of Tamulis*, 509 F.3d 343 (7th Cir. 2007).

Substantial compliance with the appraisal requirements. See e.g., *Bond*, 100 T.C. 32 (1993); *Fair*, T.C. Memo 1993-377; *D'Arcangelo*, T.C. Memo 1994-572; *Hewitt*, 109 T.C. 258 (1997).

Caveat: CRUTs and CRATs must be operated according to their explicit terms. In *Atkinson v. Comm'r*, 309 F.3d 1290 (11th Cir. 2002), cert. denied, 540 U.S. 946 (2003), a CRAT's failure to comply with the required annual payment regulations resulted in complete loss of the estate tax charitable deduction where seven quarterly payments weren't made. An additional estate tax of \$2,654,976 was incurred. That certainly got everyone's attention. And in Technical Advice Memorandum 2006280268, a CRUT that wasn't operated according to its terms was not qualified and was disregarded, even though the trust document met all the requirements of a CRUT. The trust should also meet state law investment requirements, such as the prudent investor rules. See *Estate of Rowe*, 712 N.Y.S.2d 662 (N.Y. App. Div. 3d Dept. 2000), motion for leave to appeal denied, 725 N.Y.S.2d 637 (2001).

CRT—DRAFTING CHECKLIST

1. Understand the meaning of every provision.
2. Double check that the trust contains all the required governing instrument provisions.
3. A specimen—no matter how good—is lousy if it doesn't cover or isn't amended to cover the client's situation.
4. Yesterday's form—no matter how good—is terrible if it doesn't take today's changes in the law into account.
5. CRTs must, of course, comply with the federal tax laws. But state laws must also be taken into account.
6. The trust should reflect how the funding assets are owned—separate property, joint property, tenancy by the entirety, tenancy-in-common, community property.
7. Has the trust been drawn to avoid gift taxes (when possible) on an income beneficiary's life interest?
8. Confirm that the spouses are U.S. citizens. If they aren't, take the special rules that apply to alien spouses into account.

9. No matter how skillfully the trust is drawn, make sure that CRUTs and CRATs pass the 5 percent minimum payout requirement, the maximum 50 percent payout requirement, the 10 percent minimum remainder interest requirement and for CRATs, the 5 percent probability test of Rev. Rul. 77-374.
10. Make sure the trust has an appropriate trustee—such as, an independent trustee for hard-to-value assets in a unitrust (or provide for a qualified appraiser) and for a sprinkling trust.
11. Make sure the payments are made and are timely lest you run afoul of the rule that requires that a CRT not only meet the Code's requirements, but also be administered according to its terms. See *Atkinson*, discussed above.
12. The trust should meet state law investment requirements—such as the prudent investor rules. See *Americans for the Arts, The Poetry Foundation, and Lilly Endowment, Inc. v. Ruth Lilly Charitable Remainder Annuity Trust #1 National City Bank of Indiana, Trustee, and Ruth Lilly Charitable Remainder Annuity Trust #2, National City Bank of Indiana, Trustee*, 855 N.E. 2d 592 (Ct. App. Ind. 2006). See also *Fifth Third Bank and Elizabeth Gamble Reagan v. Firstar Bank, N.A.*, Ohio App.1 Dist., 2006 (unpublished opinion); *Estate of Rowe*, 274 A.D.2d 87 (N.Y. App. Div. 3rd Dept), involving a charitable lead trust.
13. Check whether there is a patent or patent application on a tax strategy plan involving the contemplated CRT. See *Bilski v. Kappos*, discussed above.
14. Don't fund the trust with sub S Corp stock. Doing so will kill the S election.
15. Check if there are any SEC restrictions on transferring securities.
16. If life insurance—wealth-replacement is part of the plan, make sure that the insurance is obtained before signing and funding the CRT. See *Smallegan v. Kooistra*, 2007 WL 840123 (Mich. App. 2007).
17. Is a right retained to substitute public charities for named private foundation remainder organizations? That can avoid self-dealing concerns on terminating a CRT and dividing the assets between the income beneficiary and the charitable remainder organization. Also, this can enable the client to get a larger charitable deduction on the contribution of the existing life interest to the charitable remainder organization.

CRTs—TAXATION

FOUR-TIER TAXATION OF CRT BENEFICIARIES—For CRUTs and CRATs, amounts paid to the recipient retain the character they had in trust. Each payment is treated as:

- First, ordinary income to the extent of the trust's ordinary income for the year and undistributed ordinary income for prior years;
- Second, capital gain to the extent of the trust's capital gain for the year and undistributed capital gain for prior years (which can be offset by any capital losses the beneficiary may have from other investments);
- Third, tax-exempt income to the extent of the trust's exempt income for the year and undistributed exempt income for prior years; and
- Fourth, a tax-free distribution of principal.

Ordering rules also apply for classes of income within first and second categories. IRC Section 664(b) and Treas. Regs. Section 1.664-1(d).

Regulations, which apply retroactively, revise IRC Section 643(b)'s definition of income for NIMCRUTs, NICRUTs and FLIPCRUTs (before they flip) to take into account changes in how a state's laws define trust accounting income. Treas. Regs. Section 1.643(b)-1.

UNRELATED BUSINESS TAXABLE INCOME—For taxable years beginning before Jan. 1, 2007, IRC Section 664(c) provided that a CRUT or CRAT wouldn't be exempt from income tax for any year in which the trust had any unrelated business taxable income (UBTI) (within the meaning of IRC Section 512). Instead, the trust was taxed for each such year under subchapter J as though it were a nonexempt, complex trust. For taxable years beginning after Dec. 31, 2006, CRTs that have UBTI remain exempt from federal income tax, but pay a 100 percent excise tax on their UBTI. IRC Section 664(c)(2)(A) provides that the amount of UBTI is determined under IRC Section 512. Under that section, UBTI is computed with the modifications in IRC Section 512(b) including the \$1,000 deduction in IRC Section 512(b)(12). The excise tax imposed under IRC Section 664(c)(2)(A) is treated as imposed under the excise tax rules that apply to private foundations and other tax-exempt organizations other than the rules for abatement of first and second-tier taxes (chapter 42, other than subchapter E of chapter 42). The IRS has issued regulations that provide guidance under IRC Section 664 on the tax effect of UBTI on CRUTs and CRATs. These regulations reflect the changes made to IRC Section 664(c) by Sections 424(a) and (b) of the Tax Relief and Health Care Act of 2006.

Taxation of CRT Beneficiaries. As noted above, IRC Section 664(b) provides for four-tier treatment of distributions from a charitable remainder trust for the year that the annuity or unitrust amount is required to be distributed. Income of the charitable remainder trust is allocated among the trust income categories without regard to whether any part of that income constitutes UBTI under IRC Section 512. The regulations pro-

vide that the excise tax is reported and payable “in accordance with the appropriate forms and instructions.” The appropriate form to report and pay the excise tax on charitable remainder trusts with UBTI is Form 4720, “Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code.” The regulations clarify that, consistent with Treas. Regs. Section 1.664-1(d)(2), the excise tax imposed upon a charitable remainder trust with UBTI is treated as paid from corpus and the trust income that is UBTI is income of the trust for purposes of determining the character of the distribution made to the beneficiary. See TD 9403, 73 Fed. Reg. 35583.

INCOME TAX CHARITABLE DEDUCTION—Allowed for value of remainder interest; computed using Treasury tables. IRC Section 170(f)(2)(A).

CAPITAL GAIN—No capital gain incurred on transfer of unmortgaged appreciated assets to trust. Rev. Rul. 55-275, 1955-1 C.B. 295 and Rev. Rul. 60-370, 1960-2 C.B. 203. Similarly, there’s no capital gain to donor on a sale by trust, except as taxable under four-tier system.

Exception: Gain taxable to donor if trust assets sold and invested in tax-exempt securities pursuant to agreement between donor and trustee. See Rev. Rul. 60-370, 1960-2 C.B. 203.

CAUTION: Don’t fund unitrusts or annuity trusts with mortgaged property or donor-created undivided interests. PLRs 9015049 and 9114025.

VALUING PLANNED GIFTS

LONGER LIFE EXPECTANCY TABLES—In valuing charitable life-income and charitable lead gifts measured by one or more lives, the IRS’ tables take into account life expectancies and a prescribed interest rate for the month of the gift or either of the two prior months, at the taxpayer’s election. Although the prescribed interest rates change monthly, the life expectancy component of the IRS’ tables change once every 10 years. The Treasury has issued tables reflecting longer life expectancies. These tables apply to transfers starting May 1, 2009.

Temporary regulations incorporate revised Table S (Single Life Remainder Factors) and Table U(1) (Unitrust Single Life Remainder Factors), effective for transfers for which the valuation date is on or after May 1, 2009 based on data compiled from the 2000 census as set forth in the recently issued Life Table 2000CM. The old tables, effective for transfers for which the valuation date was after April 30, 1999, and before May 1, 2009, were moved to sections containing actuarial material for historical reference. Table B, Table D, Tables F(4.2) through F(14.0), Table J, and Table K, which are not based on mortality experience, are not changed. With slightly longer life expectancies, the value of charitable remainders will

be slightly lower and the value of lead trust remainders to family members will also be slightly lower.

UNITRUSTS—Treas. Regs. Sections 1.664-3(d) and -4; IRS Pub. 1458 (Actuarial Values—Book Beth, Version 3B, Revised May 2009).

ANNUITY TRUSTS—Treas. Regs. Sections 1.664-2(c) and 20.2031-7; IRS Pub. 1457 (Actuarial Values—Book Aleph, Version 3A, Revised May 2009).

Caveat: Annuity trusts must meet “5 percent probability test” of Rev. Rul. 77-374, 1977-2 C.B. 329. But see *Moor*, 43 TCM 1530 (1982). A 1978 General Counsel’s Memorandum (GCM 37770) proposed a ruling to the IRS (but was not issued by IRS) that would in limited circumstances, depending on the facts of each case, apply Rev. Rul. 77-374 to CRUTs.

CAUTION: Low charitable mid-term federal rates (CMFR) may result in not meeting the 10 percent minimum remainder interest requirement for CRTs, the more than 10 percent gift portion for charitable gift annuities, and flunking the 5 percent probability test of Rev. Rul. 77-374 for CRATs.

SPECIALIZED SMALL BUSINESS INVESTMENT COMPANY

A specialized small business investment company (SSBIC) is one way to avoid capital gain on an earlier sale. An SSBIC is a corporation or partnership licensed by the Small Business Administration, which finances small businesses owned by the disadvantaged. You can rollover tax-free up to \$50,000 of gain on publicly traded securities in any year (with a \$500,000 lifetime cap.) IRC Section 1044 and Small Business Investment Act of 1958 as amended, P.L. 85-699, 15 U.S.C. 681 et seq. The basis in the SSBIC is reduced by the amount of any gain not recognized on the sale of the publicly traded securities. Thus, any gain protected from tax on the rollover will be taxed on a later sale of the SSBIC stock. The SSBIC rollover can serve as a capital gains escape hatch for an individual who sold long-term appreciated publicly traded securities and then learns that he could have made an outright charitable gift of the securities—or transferred them to a charitable remainder trust for sale and reinvestment—without having to pay capital gains tax. The donor within 60 days of the sale of his publicly traded stock can use the sales proceeds (within the \$50,000 annual limit on gain) to buy stock in an SSBIC. Then, the donor either makes an outright gift of the SSBIC stock to charity or contributes the SSBIC stock to a CRT. The charity can keep the SSBIC stock or sell it—without capital gains to the charity or the donor. And a CRT can keep the SSBIC stock as an investment or can sell the SSBIC stock and reinvest the sales proceeds without capital gains to the donor or the trust.

ESTATE AND GIFT TAXES

ESTATE TAX REGULATIONS—The IRS has issued regulations that detail the estate tax consequences for CRATs and CRUTs created during a donor's life for the period of his or her life. The regulations confirm and amplify revenue rulings issued in 1976 and 1982 (see Rev. Ruls. 76-273 and 82-105). The proposed regulations didn't deal with the estate tax implications of inter vivos pooled income fund gifts or inter vivos gifts of remainders in personal residences and farms. The final regulations were amplified to cover these additional topics and provide additional relevant examples. The regulations provide that if a decedent transfers property during life to a trust and retains the right to an annuity, unitrust, or other income payment from the trust for his life or for a period that doesn't in fact end before his death, or for a period not ascertainable without reference to his death, he has retained a right to income described in IRC Section 2036. The portion of the trust corpus includible in the decedent's gross estate is that portion of the trust corpus, valued as of the date of his death (or the alternate valuation date, if applicable) necessary to yield that annual payment using the appropriate IRC Section 7520 interest rate. Because the specific portion of corpus includible in the gross estate is properly determined as of the decedent's death, the appropriate IRC Section 7520 rate is the rate in effect on the decedent's date of death (or on the alternate valuation date, if applicable).

The IRS and Treasury noted that in many cases both IRC Sections 2036 and 2039 may be applicable to annuity and unitrust interests and to other payments retained by a grantor. However, the IRS and Treasury believe that in the interest of ensuring similar tax treatment for similarly situated taxpayers, the applicable provision is IRC Section 2036 and IRC Section 2039 shall not be applicable. See T.D. 9414, 73 Fed. Reg. 40173 (July 14, 2008).

GIFT TAX—IRC Section 2522(c)(2)(A). Value of the charitable remainder is fully deductible, so a charitable gift is immune from gift tax. When there is a life interest other than donor's, there is a gift by donor to non-charity beneficiary of value of beneficiary's life interest. Value of that gift depends on type of property ownership and when other beneficiary's payments are to begin. It's often possible for donor to avoid gift tax (when donor is one of the beneficiaries) by reserving the right to revoke life beneficiary's interest by will only. Treas. Regs. Section 1.664-3(a)(4) and Rev. Rul. 74-149, 1974-1 C.B. 157.

GIFT AND ESTATE TAX MARITAL DEDUCTIONS—When donor's U.S. citizen spouse is the only other beneficiary, a marital deduction is allowed for the spouse's life interest. IRC Sections 2056(b)(8) and 2523(g). And a charitable deduction is allowed for the remainder interest. IRC Sections 2055(e)(2) and 2522(c)(2). Thus, there is no transfer tax. For 2010 gifts to alien spouses, an annual exclusion of \$134,000 in gift tax (adjusted annually for inflation) may be available and estate tax marital deduction may be available if qualified domestic trust (QDOT) rules are met.

Treas. Regs. Section 20.2056A-2(b).

TERMINATION OF CRTs

EARLY TERMINATION OF CRT—The IRS has approved the early termination of a CRT and division of the assets between the life tenant and the charitable remainder organizations (based on the value of their respective interests) where all the remainder organizations were public charities and the IRS has been assured that the life beneficiary had a normal life expectancy. Such termination would not be self-dealing by the donor or trustee under IRC Section 4941(a)(1). See PLR 200616035. See also PLRs 200252092, 200408031. In PLR 200912036, the IRS approved the early termination of a NIMCRUT where one of the four beneficiaries had a shorter-than-normal life expectancy. The life expectancy of this beneficiary was disregarded and the life interest valuation was based on the lives of the other three beneficiaries, all of whom had normal life expectancies.

CRT CAPITAL GAIN AVOIDANCE PLAN ON IRS RADAR—Notice 2008-99 deals with the Treasury and IRS' concerns about early terminations of CRTs by some donors who attempt to get back most of the assets of their CRTs and avoid capital gains taxes by using the CRT to step-up the basis of the returned assets. Both the IRS and Treasury believe that this transaction has the potential for tax avoidance or evasion and are seeking information to determine whether the transactions should be identified as a tax avoidance transaction. The IRS identifies this transaction and substantially similar transactions as transactions of interest for purposes of Treas. Regs. Section 1.6011-4(b)(6) and IRC Sections 6111 and 6112. The IRS also alerts persons involved in these transactions to certain responsibilities that may arise from their involvement. The IRS and Treasury are concerned about the manipulation of the uniform basis rules to avoid tax on gain from the sale or other disposition of appreciated assets. Transactions that are the same as, or substantially similar to, those described in Notice 2008-99 are identified as transactions of interest effective Oct. 31, 2008, the date Notice 2008-99 was released to the public. Persons entering into these transactions on or after Nov. 2, 2006, must disclose the transaction. Material advisors who make a tax statement on or after Nov. 2, 2006, with respect to transactions entered into on or after Nov. 2, 2006, also have disclosure and list maintenance obligations.

NIMCRUT TERMINATED; VALUING THE INTERESTS—Donor created a 10 percent NIMCRUT. Donor is the income beneficiary. Donor is trustee along with an independent special trustee. The remainder organizations are publicly supported charities. Donor wishes to terminate the NIMCRUT before the life beneficiary's death with the assets being divided between the income beneficiary and the charitable remainder organizations. The primary thrust the IRS' ruling is that the termination won't involve a prohibited act of self-dealing. However, the real significance of the ruling is how the IRS rules on the valuation

of the income and remainder interests, which is not favorable to the donor/income beneficiary. Under an agreement with the taxpayer, the payout rate to be used in calculating the respective interests will be the lesser of the IRC Section 7520 rate in effect at the time of termination of the trust and the stated interest rate (unitrust amount) contained in the agreement.

Using the IRS methodology in this letter ruling, the donor's income interest is calculated as follows: The IRC Section 7520 rate for May 2006 is 5.8 percent. Assuming the termination occurred in May 2006, the lesser of this rate and the trust's stated payout percentage is 5.8 percent. The assumed taxpayer's age as of the nearest birthday is 75. Based on Table 90CM (see above for discussion of Table 2000CM), interest at 5.8 percent, and quarterly payments made at the end of each quarter, the present value of the remainder interest in a unitrust which falls in at the death of a person aged 75 is \$0.56904 for each \$1.00 of the trust estate. The present value of the payout interest in the same unitrust until such death is \$1.00, less \$0.56904, or \$0.43096 for each \$1.00 of the trust estate. The income recipient is not expected to receive more than he would during the full term of the trust under this methodology for valuing his interest in a charitable remainder trust with a net income make-up feature. See PLR 200725044.

CHARITABLE LEAD TRUSTS (CLATs AND CLUTs)

A donor irrevocably transfers assets to a trustee who makes payments to a charity for a predetermined number of years (or for a term measured by one or more lives), with either a reversion to the grantor or a remainder to family members or other noncharitable remaindermen. The lead trust is the converse of the CRT, in which the grantor, other noncharitable beneficiaries or both ("recipients") receive trust payments for life or a term of years (not to exceed 20 years), with a remainder interest to one or more charitable institutions.

IRS issues safe-harbor sample trusts. The IRS has issued sample inter vivos (non-grantor and grantor) and testamentary CLATs and CLUTs. There are numerous alternate provisions and instructive annotations. The IRS guarantees that CLATs and CLUTs that are "substantially similar" to the sample trusts or properly integrate one or more of the IRS' sample alternate provisions will be qualified trusts and the donor will receive the applicable charitable deductions. See Rev. Proc. 2007-45 (inter vivos non-grantor and grantor CLATs), Rev. Proc. 2007-46 (testamentary CLAT), Rev. Proc. 2008-45 (inter vivos non-grantor and grantor CLUTs) and Rev. Proc. 2008-46 (testamentary CLUT).

CHARITABLE GIFT ANNUITY

A donor irrevocably transfers money or property to a charity and

receives a guaranteed income for life. The donor's income is a fixed percentage of the gift and remains constant for life. The transfer is part charitable gift and part purchase of an annuity.

Immediate payment charitable gift annuity: An annuity providing payments that begins within one year of the transfer.

Deferred payment charitable gift annuity: The annuity payments begin at a specified date more than one year after the transfer, usually starting at retirement.

Flexible starting date deferred charitable gift annuity: The donor's annuity agreement allows the donor, during a specified period in the future, to choose when the annuity payments are to begin. See PLR 200449033. See also PLR 9743054 and PLR 9017071 (two-life flexible payment gift annuity). The capital gains incurred when the gift annuity is funded with appreciated assets are not reportable until payments begin and would then be reported ratably over the life expectancy determined as of the starting anniversary date. See PLR 200742010.

Annuity payout rates: A charity decides the rates it will pay. The rate must meet state law requirements. Many charities use the rates recommended by the American Council on Gift Annuities. CAUTION: Low CMFR rates may result in not meeting the more-than-10 percent-gift portion for charitable gift annuities.

Tax treatment of payments: A significant portion of each payment the annuitant receives is tax-free. Capital gain is incurred when a gift annuity is funded with appreciated property. However, the capital gain is not all reportable in the year of the transfer for the gift annuity. It is reported ratably over the annuitant's life expectancy when the annuity is non-assignable and donor is an annuitant.

CAUTION: In *Warfield v. Alaniz*, 569 F.3d 1015 (9th Cir. 2009), the Ninth Circuit found that the charitable gift annuities were sold as investment contracts and commissions were paid for solicitation of the gift annuities. Consequently, they were securities for the purposes of federal and state securities law and the sellers were required to register as securities brokers.

CHARITABLE GIFT ANNUITY—DRAFTING CHECKLIST

1. Understand the meaning of every provision in the annuity agreement.
2. A specimen—no matter how good—is lousy if it doesn't cover or isn't amended to cover the client's situation.
3. Yesterday's form—no matter how good—is terrible if it doesn't take today's changes in the law into account.

4. Double check that the gift annuity agreement contains all the provisions required by state law. The ACGA website has excellent state-specific resources (www.acga-web.org).
5. If the annuity is for the donor's life alone or if it is a two-life annuity and the donor is one of the annuitants, the capital gain when funded with appreciated property can be spread over the donor's life expectancy if the annuity is non-assignable. Make sure the annuity agreement states: This is non-assignable. Or, the agreement can state that the annuity is non-assignable except that it may be assigned to the charity that issues the annuity.
6. A non-assignable two-life annuity funded with a donor's separate property providing payments first to the donor and then to a survivor results in the capital gain being spread ratably over the donor's life expectancy whereas a two-life one-annuity funded with joint, tenancy in common or community property has the capital gain spread ratably over the two-life expectancy. Consider changing ownership of the property to co-ownership before funding the annuity and the fund with the co-owned property. That way the gain will be reportable ratably over the two-life expectancy. Be mindful of the gift tax implications—generally not a concern if the conversion to co-ownership involves spouses who are U.S. citizens.
7. Make sure that the gift annuity agreement reflects how the property is owned. Otherwise, bad gift tax things can happen to good people.
8. Has the annuity agreement been drawn to avoid gift taxes (when possible) on the survivor annuitant's interest?
9. Confirm that both spouses are U.S. citizens. If they aren't, take the special rules that apply to transfers to non-U.S. citizen spouses into account.
10. No matter how skillfully the annuity agreement is drawn, make sure that the gift portion is more than 10 percent and that the three other requirements of IRC Section 514(c)(5) and 501(m) are met. If not, the charity will be taxed on debt-financed income, as an insurance company and in extreme cases can lose its tax exemption. Not a good thing.
11. Make sure the payments are made and are timely. A rule governing CRTs requires that a CRT not only meet the Code's requirements, but also be administered according to its terms. See Atkinson, discussed above.
12. Unlike CRTs, gift annuities can be funded with S corp stock without losing the S election. BUT, there can be adverse tax implications for the charity. If you're representing the charity, consider these issues carefully.
13. Check if there are any SEC restrictions on transferring securities.
14. If—wealth-replacement life insurance is part of the plan, make sure that the insurance is obtained before signing and funding the gift annuity agreement. See *Smallegan v. Kooistra*, 2007 WL 840123 (Mich. App. 2007).
15. One of the elements taken into account in determining the amount deemed contributed for the income tax deduction is the Section 7520 rate for the month of the gift or either of the two prior months at the donor's election. The higher the section 7520 rate, the greater is the contribution deduction. But the excludable amount of each payment is greater with the lowest Section 7520 rate. Another “but”: the capital gain is smallest with the highest Section 7520 rate. So weigh all of this in determining which Section 7520 rate to select. Many gift annuity donors take the standard deductions so the size of the deduction shouldn't be a factor. Or an itemizer may have hit the deductibility ceiling and is making full use of the carryover.

CAVEAT ADVISOR

I hope that the above is helpful. But the law changes frequently. And although this Guide goes into considerable detail, this is just the tip of the IRSberg. So be careful out there. — *Conrad Teitell*