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REFORMATION OF THE CHARITABLE CONTRIBUTION DEDUCTION

AREAS FOR REFORM: OTHER ISSUES

I. Valuation and Substantiation

The income tax rules for substantiation and valuation have become increasingly complex, largely in response to taxpayer abuses. But in some respects the rules discourage charitable gifts without increasing compliance.

Treasury Regulation §1.170A-13(c) requires that donors obtain a so-called qualified appraisal no later than the due date of the tax return on which the deduction is claimed if the donor claims a charitable deduction of more than \$5,000 for any non-cash gift other than marketable securities, as defined.¹ In addition, a Form 8283 must be attached to the return and the charitable organization must report any sale of the gifted property within two years of the gift on a Form 8282.

In some cases, the appraisal requirement is unnecessary and should be eliminated.

SUGGESTION FOR REFORM: The regulations should be changed to provide that if the charitable donee sells the contributed property before the due date of the donor's tax return, the sale price realized by the charity would be prima facie evidence of

¹ \$10,000 for gifts of non-marketable securities

fair market value. The value could be rebutted by the Internal Revenue Service by a showing that the value was lower at the date of gift, which would be unlikely except in unusual circumstances. Not only is a sale the best evidence of fair market value, but if the charity in fact realizes a certain amount from the sale of the property, it is hard to see what abuse has been permitted if the donor is allowed a deduction in that amount. To prevent abuse, the sale would be prima facie evidence of fair market value only if it were to an unrelated party in an arm's length transaction. The regulations could provide that if the donor wishes to obtain an appraisal, he could still do so, but it would not be necessary if there has been an actual sale before the due date of the tax return.²

Such a rule would be particularly useful in cases of contributions of closely held stock followed by redemption – the Palmer-type transaction. Appraisals of closely held corporations are expensive. A \$25,000 fee is not unusual for a fairly routine appraisal of the stock of a closely held corporation. Again, if the charity in fact realizes X dollars from the redemption, what difference does it really make if the stock is in fact “worth” something less than the amount distributed to the charity? If a million dollars in cash passes from the corporation to the charity in exchange for the stock, is any tax abuse possible if the stock is really “worth less” than a million dollars?³ This change would undoubtedly encourage gifts of corporate stock which are often discouraged now because of the burdensome and, in many cases unnecessary, appraisal requirements. Again, unless the redemption would occur before the due date of the donor's tax return or some other

² Alternatively, the regulations might provide that no appraisal is necessary if the charitable donee sells the property with a certain time after the gift—90 days for example.

³ The only abuses I can dream up involve relations with other shareholders rather than tax abuses.

date reasonably proximate to the date of the gift, an appraisal would be required and any such redemption price would be only rebuttable evidence of value rather than dispositive.

Another example of unnecessary application of the appraisal rules is a gift of a life insurance policy. Regulation §1.170A-13(c) requires an appraisal for any gift of property above the threshold amounts other than marketable securities. Regulation §1.170A-13(c)(iv) defines a qualified appraiser and provides that among the persons who cannot be qualified appraisers with respect to particular property are:

“(B) a party to the transaction in which the donor acquired the property being appraised (i.e., the person who sold, exchanged or gave the property to the donor, or any person who acted as an agent for the transferor or for the donor with respect to such sale, exchange or gift), unless the property is donated within two months of the date of acquisition and its appraised value does not exceed its acquisition price.”

This means that neither the insurance agent who sold the policy nor the insurance company which issued the policy can be qualified appraisers. A Form 712 issued by the insurer is the usual way of valuing life insurance policies for gift and estate tax purposes, and should be permitted without the requirements of a qualified appraisal in the case of a gift of life insurance to charity.⁴

II. Useless Distinctions Between Income, Estate and Gift Tax Charitable Deductions

The tax law makes numerous distinctions in the treatment of charitable gifts for income and for transfer tax purposes.⁵ In some cases, the distinctions can be explained by the fact that estates are entitled to a new basis at death under Code section 1014, at least

⁴ Since life insurance is ordinary income property, the cutdown rules of section 170(e)(1)(A) limit the deduction to the lower of cost or fair market value.

⁵ A complete comparison may be found in the Appendix to this paper.

for the next decade or so. Therefore, the cutdown rules of section 170(e) have no place in an estate tax scheme with stepped up basis. Other distinctions may be justifiable on policy grounds, such as the existence of percentage limitations for income but not for transfer tax purposes. However, many other distinctions are difficult to explain and probably result simply from different statutes being drafted at different times. These are largely difficult to justify and unduly complicate the tax law.

Among the distinctions which make little obvious sense to this author are the following:

1. Internal Revenue Code section 170(f)(3) denies an income tax deduction in the case of certain charitable contributions of split interest gifts. Among the exceptions to the general rule is the exception provided in section 170(f)(3)(B)(i) for a contribution of a remainder interest in a personal residence or farm. Section 170(f)(4) provides that for purposes of section 170, in determining the value of a remainder interest in real property, depreciation is to be taken into account and the value discounted at 6% per annum, except that the Secretary may prescribe a different rate. The regulations now require that the interest rate provided by Section 7520 shall be used.⁶

Internal Revenue Code section 2055 includes provisions which parallel those of 170 with regard to split interest gifts. Section 2055(e)(2) disallows split interest gifts “other than an interest described in section 170(f)(3)(B)” which includes gifts of

⁶ Regulation section 1.170A-12(b)(2). The regulations also provide the actuarial formula for the depreciation factor for one or two lives, one of the few places in which the regulations include an actuarial formula. It is interesting to note that although the regulations were last amended in T.D. 8886, June 9, 2000, Regulation section 1.170A-12(e)(3) still provides that requests for a two-life factor must be accompanied by “a statement of the sex and date of birth of each person the duration of whose life may affect the value of the remainder interest...” despite the fact that since 1983 the actuarial tables used by the Service have been unisex.

remainders in a personal residence or farm. However, nothing in section 2055 or the regulations under section 2055 requires that depreciation be taken into account for estate tax purposes and, in fact, that interpretation is clearly mandated by the Code since the special rule requiring that depreciation be taken into account – Code section 170(f)(4) – provides that depreciation must be taken into account for purposes of “this section”, i.e., section 170. It is difficult to see why the tax law should make this distinction.⁷ The theory of requiring depreciation to be taken into account is, of course, that the property will not really be worth as much at the end of the term if depreciation is taken into account. This ignores the fact that most residential property appreciates in value. It is also inconsistent with the rules governing depreciable property in charitable remainder trusts: the regulations do not require that a depreciation reserve be created and part of the annuity or unitrust amount diverted to a reserve.

2. Another distinction which is difficult to understand is the special rule of Internal Revenue Code section 2055(e)(4) which treats contributions of works of art and the copyright on such works of art as separate properties for purposes of the split interest rule.⁸

Some background on this may be useful.

A copyright and an artwork are separate property interests. If a donor (other than the creator of the work or someone whose basis derives from the creator) contributes a

⁷ It is difficult, in fact, to understand why depreciation needs to be taken into account at all. The fact that property is depreciable will already have been taken into account in determining the property’s fair market value.

⁸ The contribution must be to a public charity, which would use the property in a way that is related to its exempt purpose – a similar rule to the income tax rule of Section 170(e)(1)(B).

work of art to a museum for a related use, the gift is fully deductible for income tax purposes.⁹ However, if the donor also owns the copyright and does not transfer the copyright to charity, the donor is not allowed a charitable deduction for income tax purposes for the gift of the art work because it is a contribution of a split interest. In 1981, the Economic Recovery Tax Act amended Internal Revenue Code section 2055 to provide that solely for estate and gift tax purposes, art and copyrights on art are separate interests so that a bequest of one without the other will be deductible for estate tax purposes. (If the “split” art is bequeathed to a charity which sells the art because it has no suitable use for it, no deduction will be allowed in that case.)¹⁰

The gift tax regulations note that similar rules apply for gift tax purposes. Why was this same rule not extended to the income tax deduction? It is not clear. Here is what the Joint Committee report to the Economic Recovery Tax Act of 1981 had to say about this subject:

Reasons for Change

The restrictions on deductibility of split interest transfers to charity were added by the Tax Reform Act of 1969 to insure that there was a reasonable correlation between the amount of the charitable deduction and the value of the property received by charity. The rules provided by the Congress to accomplish this result disallowed the charitable deduction if interests in the same property were transferred for both charitable and noncharitable purposes unless the charitable interest was in certain specified forms.

However, recent changes in copyright law treat the tangible object (i.e., the original art work) and the intangible copyright as separate items of property. These two items of property typically are not transferred together.

⁹ Code section 170(e)(1)(B)

¹⁰ Code section 2055(e)(4)

Moreover, the use or exploitation of the art work or copyright generally does not affect the value of the other property. As a result, it will be possible to determine the value of the tangible object (i.e. the original art work) apart from its related copyright interest by reference to values of similar objects which are sold without their copyright interest. Accordingly, the value of the art work which is used to determine the amount of the charitable deduction should provide a high degree of correlation with the value of property received by charity.

The Congress concluded, therefore, that the disallowance rule for transfers of split interests in property should not apply to a work of art and the related copyright in cases where the work of art but not the copyright is transferred to charity and where there are restrictions to insure that the public will benefit from the transfer. However, the Congress believed that this rule should apply only for estate and gift tax purposes and not for income tax purposes. Thus, the provisions of the Act allow gifts and bequests of works of art for the benefit of the general public without imposition of tax, but do not provide the unnecessary tax incentive that could occur if the provision were extended to the income tax.

Explanation of Provision

Under the Act, if a donor or decedent makes a qualified contribution of a copyrightable work of art to a qualified organization, the work of art and its copyright are treated as separate properties for purposes of the estate and gift tax charitable deductions. Thus, a charitable deduction generally is allowable for the transfer to charity of a work of art, whether or not the copyright itself is simultaneously transferred to the charitable organization.

A qualified organization is a public charity (i.e., an organization described in sec. 501(c)(3) which is not a private foundation under sec. 509) or a private operating foundation (under sec. 4942(j)(3)). The Act provides that a qualified contribution is any transfer to a qualified charitable organization provided the use of the property by the organization is related to its charitable purpose or function.

What are this “unnecessary tax incentive”?

Part of the problem is that the copyright law creates a real trap here. Under the copyright laws that existed prior to the 1977 copyright revision, if the owner of art conveyed art and was silent regarding transfer of copyright, the copyright transferred with

the tangible object.¹¹ For works of art created after that date, the law is the opposite – the copyright does not automatically transfer. So a donor might own a painting and copyright now and transfer it without considering the transfer of copyright. The result will be no income tax deduction, even though the gift is related use property for purposes of the income tax deduction.

Some of the differences between estate and gift tax treatment, on the one hand, and income tax treatment on the other turn on distinctions in types of assets, because of the cut down rules of section 170(e). One of the ones that makes least sense to me is the distinctions that arise from the fact that a copyright is not a capital asset (Code section 1221(e)(3)) but a patent is. Therefore, a patent can be contributed to charity during lifetime with full fair market value deduction. A gift of a copyright during lifetime produces a deduction limited to basis for income but is fully deductible for estate tax purposes. The fact that patents are capital assets but copyrights are not has obvious implications beyond the charitable area but illustrates some of the complexities in these distinctions.

III. Issues involving the Marital Deduction.

The operation of the marital deduction in charitable planning is a subject ripe for reform. Some of the rules create unnecessary traps and others merely unnecessary complications with little or no policy justification. Under current law we have three different marital deduction treatments for what are structurally the same gift.

¹¹ The case of *Pushman v. New York Graphic Society, Inc.*, 287 N.Y. 302, 39 N.E.2d 249 (1942) illustrates this doctrine, by which authors or artists were generally presumed to transfer common law literary property rights when they sold their manuscript or work of art, unless those rights were specifically reserved. This presumption was reversed by section 202 of the 1977 Copyright Act revision.

In some case, the marital deduction works seamlessly with the charitable deduction. The simplest case is the married couple with no non-charitable interests which desires that the entire estate pass to charity on the second death. In such cases, the first spouse typically leaves the entire estate outright to the surviving spouse, and the surviving spouse can leaves the entire estate on the second death to the charity. The marital deduction is assured in such cases on the first death as is the charitable deduction on the second death.

Where one spouse wants some portion of his or her estate to pass to charity immediately on the first death, a charitable bequest by the first spouse to die is simple and straightforward but also wastes the income tax deduction, forcing practitioners to engage in more circuitous planning. A typical strategy in that case is a bequest of a specific dollar amount to the surviving spouse with a non-binding request that the surviving spouse use the bequest to make a charitable gift. In this manner, the surviving spouse will receive an income tax deduction, and the cost of the gift substantially reduced. Where the first spouse to die creates a credit shelter trust or marital trust for the surviving spouse, the will may also provide that if the survivor spouse has not made the gift by the time of the survivor spouse's death, the bequest will come out of the trust. Jumping through these hoops ought to be unnecessary but fashioning a legislative fix for the problem is far from simple.

Where the first spouse to die is unwilling to leave the entire estate to the surviving spouse because of uncertainty that the surviving spouse will honor the first spouse's desires, the usual solution is the QTIP for surviving spouse with remainder to charity. This works quite well: the trust will qualify for the marital deduction in the first spouse's estate, be includable in the second spouse's estate under Section 2044 and qualify in the

surviving spouse's estate for an offsetting charitable estate tax deduction. Section 2044(c) provides that for all purposes of Chapters 11 and 12, the QTIP property will be treated as passing from the decedent. The regulations make this clear:

“...property included in a decedent's gross estate under section 2044 is considered to have been acquired from or to have passed from the decedent to the person receiving the property upon the decedent's death. Thus, for example, the property is treated as passing from the decedent for purposes of determining the availability of the charitable deduction under section 2055...” Reg. §20.2044(b)

Unfortunately, however, things become more murky where a charitable remainder trust rather than a QTIP is desired. This will especially be the case for lifetime transfers when the qualified split interest trust is most likely to be created because of the income tax benefits of lifetime gifts.

Code section 2056(b)(8) provides a marital deduction for the donee spouse's interest in a qualified charitable remainder trust. The parallel gift tax section, section 2523(g), provides a marital deduction for gift tax purposes as well. But, perhaps because of a drafting oversight, both of those sections provide a marital deduction only if after the transfer "the donee spouse is the only non-charitable beneficiary other than the donor". An income tax charitable deduction will be available for the remainder and the trust will be a qualifying charitable remainder trust, but no gift or estate tax marital deduction will be permitted for the spouse's interest, even though the actuarial value of all of the interests can be easily determined. Those sections deny, therefore, a marital deduction to the donor to a charitable remainder trust for the joint lifetime of the donor and the donor's spouse, followed by the donor's elderly parent.

The Service confirmed this reading in Private Letters Rulings 8742001 and 8730004 and in the subsequent final regulations.

"In the case of a charitable remainder trust where the decedent's spouse is not the only non-charitable interest beneficiary (for example, where the non-charitable interest is payable to the decedent's spouse for life and then to another individual for life), the qualification of the interest as qualified terminable interest property is determined solely under section 2056(b)(7) and not under section 2056(b)(8)." Reg. §20.2056(b)-8

It is difficult to discern a policy justification for denial of the marital deduction in this situation for the portion of the trust passing to the surviving spouse. If I wish to create a charitable remainder trust for my spouse and then for my aged parent if living with remainder to charity, I ought to get a marital deduction for my spouse's interest, a charitable deduction for the remainder and be taxable on the parent's survivorship interest.¹² The less-satisfactory drafting solution in the meantime is a QTIP for the surviving spouse followed by a CRAT or CRUT for the third beneficiary.¹³ On the plus side however—and in contrast to the treatment of the marital deduction in other split interest situations—the marital deduction is automatic and the terminable interest rule

¹² The actuarial value of the parent's survivorship interest is easily calculated by computing first the two-life value of the unitrust or annuity trust interest and then subtracting the one-life value of the spouse's interest. Provision would need to be made in the instrument for payment of tax on the parent's interest from other assets, as is already required in two-life inter vivos charitable remainder trusts.

¹³ The final regulations provided that although section 2056(b)(8) appears to preclude a marital deduction under that section in cases where the spouse is not the only non-charitable beneficiary, the marital deduction may be available for trusts created before the effective date of the Energy Policy Act of 1992 (generally October 24, 1992), not under 2056(b)(8) but under the QTIP provisions. The Service asked for comments as to whether a unitrust or annuity interest for spouse followed by another non-charitable beneficiary may qualify under the QTIP provisions in view of the 1992 statutory amendments. This seemed to the author at the time more likely for annuity trusts than unitrusts: the last sentence of 2056(b)(7)(B)(ii) provides that to the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property regardless of whether the property from which the annuity is payable can be separately identified.

does not apply, thus permitting a marital deduction for a term of years charitable remainder trust or a trust terminating on the happening of an event earlier than the death of the spouse.¹⁴

Gifts of Remainders in a Personal Residence.

Marital deduction rules in other split interest situations are an even more extreme morass of unnecessary complexity brought about by the fact that there is no automatic marital deduction under 2056(b)(8) for split interest gifts other than charitable remainder trusts.

Take the case of a bequest of a remainder interest in a personal residence to charity, reserving a prior life estate for the donor's spouse. The interest of the surviving spouse is a terminable interest but it qualifies for QTIP treatment if a QTIP election is made. The spouse will not receive income from the property, but the regulations under section 2056(b)(7) confirm that a marital deduction is available for the surviving spouse's legal life estate in the personal residence. See Reg. § 20.2056(b)-6(g)—Example (1):

"Life estate in residence. D owned a personal residence valued at \$250,000 for estate tax purposes. Under D's will, the exclusive and unrestricted right to use the residence (including the right to continue to occupy the property as a personal residence or to rent the property and receive the income) passes to S for life. At S's death, the property passes to D's children. Under applicable local law, S must consent to any sale of the property. If the executor elects to treat all of the personal residence as qualified terminable interest property, the deductible interest is \$250,000, the value of the residence for estate tax purposes."

The marital deduction should be automatic in this case as it is for the spouse's interest in a charitable remainder trust. Is there ever a case when an executor would not

¹⁴ Section 2056(b)(8) provides that paragraph (1)—the terminable interest rule—"shall not apply to any interest in such trust which passes or has passed from the decedent to such surviving spouse."

want the marital deduction in this situation? How many personal representatives remember to elect QTIP treatment in these situations?

For the more typical lifetime transfer of a jointly held residence, the requirements are even more Byzantine – and unnecessary. If the property is jointly held, the parties may deed it to charity reserving for themselves a legal life estate. Each spouse is making a gift to the other spouse of the other spouse's survivorship interest and no lifetime QTIP election can be made for that interest because of the lifetime QTIP requirement that no person other than the spouse may have an interest in the property during the lifetime of the spouse. Where the property is titled in the name of one spouse only, the same problems arise.

The current requirements for dealing with these problems seem to be as follows:

Where the donor spouse owns the entire residence, the deed must permit the donor spouse to revoke the successor beneficiary spouse's interest by will in order to prevent a gift to the spouse for gift tax purposes. No gift tax marital deduction is available for the spouse's interest because of the intervening interest of the donor spouse. Where the property is held jointly, the deed must provide that each spouse reserves the right by will to revoke the surviving spouse's survivorship interest in the first spouse's contribution. When the first spouse dies, his or her interest will be includable in his or her estate and a QTIP election should be made on the estate tax return to qualify the survivor spouse's interest.

And even this may not be enough! To qualify as a QTIP, the surviving spouse must have what under state law is equivalent to a legal life estate. A right to occupy the residence is not enough: In the regulation quoted above, the spouse also had the right to

rent the property. The extent of rights in a legal life estate is a question of state law. In Private Letter Ruling 9033004, the Service noted that use must include both the right to occupy the property as a personal residence and the right to convey the life estate to others. The deed must make clear that what is being retained is a full legal life estate, including the right to occupy the property, lease the property and convey the life interest. Merely reserving the right to use and occupy the property may be insufficient in many states to obtain a marital deduction.

All of this complexity is simply a useless trap without any policy justification. The marital deduction should be automatic in this case as it is with the charitable remainder trust and available even if both spouses have an interest in the property.

Pooled Income Fund.

Pooled income funds pose similar problems. Section 2056(b)(8) and section 2523(g) do not provide automatic marital deductions for a gift to a pooled income fund. However, the spouse's interest qualifies as a QTIP and, again, the QTIP election must actually be made to secure the marital deduction. See Reg. § 20.2056(b)-6(g), Example (13):

"Pooled Income fund. D's will provides for a bequest of \$200,000 to a pooled income fund described in section 642(c)(5), designating S as the income beneficiary for life. If D's executor elects to treat the entire \$200,000 as qualified terminable interest property, the deductible interest is \$200,000."

This is another unnecessary trap and a legislative fix to make the marital deduction automatic would be advisable. Again, it is difficult to conjure up a situation where the donor would not want the marital deduction.¹⁵

In the two-life situation, the successor spouse's interest does not qualify for a gift tax marital deduction because it has not yet vested in the surviving spouse. (See Reg. § 25.2523(F)-(1)(c)(2) on the question of an intervening interest between the donor and the spouse.) This requires retention of the right to revoke the surviving spouse's interest by will.

Unlike the charitable remainder trust situation, there is no problem with pooled income gifts for the donor and the donor's spouse, followed by third beneficiary. In the charitable remainder trust situation we saw that section 2056(b)(8) denies a marital deduction in that situation. There is of course no such issue with the QTIP/pooled income fund gift. The entire fund will be includable in the surviving spouse's estate under section 2044, and the surviving spouse's estate would receive a charitable deduction based on the then determined actuarial value of the remainder interest taking into account the age at that time of the third beneficiary.

¹⁵ Note that if a QTIP election is made, the surviving spouse's interest in the QTIP/pooled fund will be includable in the surviving spouse's estate, receive a stepped up basis, and be deductible as a charitable deduction. The result is a wash for estate tax purposes. But the step-up in basis for the assets in the pooled income fund may be relevant where there are short-term capital gains, since short-term gains are taxable to a pooled income fund. How many pooled fund trustees adjust basis on the surviving spouse's death? Will they even know whether a QTIP election was made?

Charitable Gift Annuities.

Here the story is still different! Section 2056(b)(7) and section 2523(f) provide for a marital deduction in the case of a joint and survivor annuity where only the donor spouse and the donee spouse have the right to receive payments until the death of the last spouse to die. In such case, the donee spouse's interest is treated as a qualifying interest for life and the donor spouse is treated as having made an election with respect the annuity unless the donor spouse elects out. Note that the statutory language includes the same requirement as 2056(b)(8) that no marital deduction is permitted if there is a non-charitable interest following the spouse's interest.¹⁶ As with charitable remainder trusts, the donor may retain the right to revoke the successor spouse's interest.

The amendments allowing the marital deduction for annuities were passed in 1988, retroactive to 1981. The Service has issued regulations outlining the procedure for refunds of gift or estate tax paid. The final regulations reserved judgment on joint and survivor annuities, and those regulations will be issued later. This important question needs to be resolved and the Service should be encouraged to allow a gift tax marital deduction if a donor creates a charitable gift annuity for the donor, followed by donor's spouse. Although a present gift for gift tax purposes can be avoided by retention of a power to revoke the surviving spouse's interest, this complexity should not be required and it is simply unclear whether under current law a marital deduction is available in that situation because of the use of the term "joint and survivor annuity".

¹⁶ This is of little significance with gift annuities since sections 501(m) and 514(c)(5) already require that gift annuities be for not more than two lives in order to avoid unrelated business taxable income.

IV. Pooled Unitrust.

The pooled income fund has become an albatross for many charitable organizations because low income rates make existing pool participants unhappy and because such pool funds attract few new donors. Income only unitrusts were given a window to convert to standard unitrusts, but absent changes in the Internal Revenue Code, it has generally been believed it is not possible to create a pooled unitrust. The pooled unitrust would be a very useful tool for charitable organizations. Donors who want to make smaller split interest gifts are limited to the pooled income fund or the charitable gift annuity, and neither is very satisfactory. The charitable gift annuity is typically fixed in amount and doesn't adjust to compensate for inflation. The pooled income fund is unsatisfactory in times of low interest rates.

In its proposed definition of income regulations under section 643(b), published February 15, 2001, the Internal Revenue Service addressed numerous issues arising from new state statutory definitions of income. Many states are now defining income as a unitrust amount. The proposed regulations would amend Section 1.642(c)-2(c) to provide that net long term capital gain would not qualify for the charitable deduction provided pooled income funds under section 642(c)(3) if, under the terms of the governing instrument and applicable state law, income may be a unitrust amount. However, there is a simple solution to this problem, which would both satisfy the Service's legitimate concern regarding the capital gains set aside and provide charitable organizations with a useful tool. The solution is to provide that a pooled income fund may define income as the lesser of a unitrust amount or fiduciary accounting income and may allocate capital gains to income, but only to the extent that the gains are realized during the taxable year.

Any gains in excess of those amounts realized and required to be distributed during the taxable year would be permanently set aside for charity. By following a practice of realizing long term gains in each calendar year in an amount sufficient to pay out the unitrust amount, charities could, in effect, have a pooled unitrust without creating the §642(c)(3) problems the Service correctly noted in the proposed regulations. The deduction, pursuant to Code section 642(c)(5), must be based on the highest income in the previous three years, which could in these cases be simply income defined as a unitrust amount.

V. Charitable Pledges.

The treatment of charitable pledges by the regulations and rulings is not only inconsistent but creates problems for taxpayers without preventing abuses. Charitable pledges are strange animals—most promises to make gifts require consideration beyond the mere making of the pledge. The common law of many states, however, has treated charitable pledges as enforceable under the theory that the charity and other donors will rely on the gift in planning.¹⁷

Although satisfaction of a pecuniary obligation with appreciated property normally is treated as a sale or exchange, the Internal Revenue Service in Revenue Rulings 55-410 (1955-1 C.B. 297) and 64-240 (1964-2 C.B. 172) ruled that satisfaction of a charitable pledge with appreciated assets will not result in realization of gain. The Service reasoned that because no deduction is allowed until payment of the pledge, it would be inconsistent to treat the payment or transfer as a contribution or a gift and at the same time the

¹⁷ See, generally, the annotation, Lack of Consideration as Barring Enforcement of Promise to Make Charitable Contribution or Subscription Modern Cases, 86 A.L.R. 4th, 241 (1991) for a collection of recent cases.

satisfaction of a debt with the tax consequences which would ordinarily follow with the use of appreciated or depreciated property to pay a debt. On the other hand, the Service has consistently held that a private foundation's payment of a disqualified person's charitable pledge is an act of self dealing. See Regulation section 53.4941(d)-2(1). In Revenue Ruling 77-160 (1977-1 C.B. 351), the Service ruled that although payment of so-called dues by a member of a religious congregation is deductible as a charitable contribution because the dues confer no significant rights on the individual members and are paid for the purpose of supporting the congregation, payment of the same dues by a private foundation on behalf of a disqualified person is an act of self dealing, on the theory that membership is a direct benefit and payment of the dues by a private foundation relieves the donor of the obligation to pay it. Wealthy individuals frequently make charitable pledges and it is difficult to understand what abuse is possible if the donor's private foundation makes the payment in satisfaction of the pledge instead of the donor. This is a trap, in fact, only for the uninformed philanthropist. The well-advised donor will simply make certain that the charitable pledge is a joint pledge of the donor and his or her private foundation, with the pledge specifically stating that the pledge may be paid by either or both of the parties, all or in part.

The Service's treatment of charitable pledges means that there are unanswered questions. For example, if a donor makes a charitable pledge and satisfies it by naming a charity the death beneficiary of retirement benefits, will this cause the donor's estate to be taxed on the income in respect of a decedent? The answer is not clear. A valuable reform would be to provide that charitable pledges are ignored for all income tax purposes, regardless of their enforceability under state law. Payment of the pledge with appreciated

property would continue to be a nonevent for tax purposes, and payment of the charitable pledge by a donor's private foundation or by establishment of a charitable remainder unitrust would not be an act of self dealing.

VI. Income Distributions to Charity by Estates and Trusts—Section 642(c) issues.

Another area ripe for reform is section 642(c) and I suggest two specific reforms.

A brief recital of the rules under 642(c) may be useful. 642(c) provides that an estate or trust may deduct in computing its taxable income any amount of gross income, without limitation, which is distributed to charity or for a charitable purpose pursuant to the terms of the governing instrument during the taxable year. Thus, unlike the rest of Subchapter J, an income tracing requirement is imposed. Generally, of course, Subchapter J is constructed so that tracing sources of income is not necessary, which vastly simplifies taxation of trust and estate income and distributions.

In addition, if an estate accumulates income for future distribution to charity, section 642(c)(2) allows a deduction for amounts permanently set aside for charity. This can be useful in the case of estates which cannot make immediate distribution because of a will contest, the need to resolve creditors' claims or other valid administrative reasons. This deduction is not available, however, to trusts created after October 9, 1969, including garden-variety testamentary-substitute revocable trusts.

I suggest two reforms.

1. Since the charitable set aside can now be obtained for a revocable trust by the simple expedient of a section 645 election to treat a revocable trusts as part of a probate estate, there seems to be no policy reason not to permit directly what can easily be obtained indirectly. The same criteria used in section 645 could be used here. In the case

of any qualified revocable trust as defined in section 645(b)(1), income set aside for charity should be deductible for the periods permitted by section 645 without the necessity of an election treating the revocable trust as an estate for all purposes.

2. Another reform of section 642(c) also suggests itself because of recent changes in the Internal Revenue Code, namely the denial of a section 661 distribution deduction for amounts not qualifying for the section 642(c) deduction. An example where the deduction might not be available under section 642(c) is a distribution of half of the assets of the estate – in other words a residuary distribution of principal. Although such distinguished authorities as Ferguson, Freeland and Ascher in their definitive treatise *Federal Income Taxation of Estates, Trusts and Beneficiaries* believe that under existing law a distribution deduction should be available where a charitable deduction under section 642(c) is not, the courts have disagreed. See Mott v. United States, 462 F.2d 512 (Ct. Cl. 1972), cert. denied, 409 U.S. 1108 (1973) and Estate of O’Conner v. Commissioner, 69 T.C. 165 (1977).

But the concerns which may have motivated the Service to litigate Mott and O’Conner no longer apply. In Mott, decedent died with a gross estate in excess of \$36 million, two-thirds of which was left to a private foundation and the rest of which was left in a trust for decedent’s spouse. Distributions were made to the charitable foundation which all parties agreed did not qualify under section 642(c) because they were not made out of the estate’s gross income – in fact, the payments were made out of corpus of the estate. Although the parties agreed that none of the provisions of section 663(a) expressly excluded the payments from being deductible under section 661, the Court of Claims held that distributions to charity must be deductible under section 642(c) or they are not

deductible at all. What the Court and the Service were concerned about was the ability to manipulate income. The estate could deduct essentially all of the income in its enormous distribution to the charity, and early in the next year could distribute remaining assets, including income accumulated but in fact credited to the charity in the previous year, to the taxable beneficiaries tax-free.

Similarly, in O’Conner, the Tax Court came to the same conclusion.

Ferguson, Freeland and Ascher reasoned as follows:

“*Mott’s* following is no doubt due to the fact that it contains an attractive (if unpersuasive) alternative analysis. The amounts passing to charity in *Mott* were huge, well in excess of the estate’s DNI. Moreover, they were principal, rather than income, under local law. Under §661, amounts of principal clearly can generate distribution deductions. But following the mandate of §661 on the facts of *Mott* would have resulted in shifting almost all of the estate’s DNI to a charity, which would have paid no tax on it. Thus the estate and its other beneficiaries would have paid very little tax on the estate’s income, all of which they retained or received. It is hardly surprising that a court would try to avoid this sort of obvious unfairness. Yet unfairnesses of this sort necessarily arise when a quasi-conduit system of taxing income abandons the notion that tracing income is important to the imposition of the tax. And that is clearly what Congress intended in Subchapter J. What is surprising is that the same court that *during the same year* correctly decided *Harkness v. United States*, another case in which blatant unfairnesses occurred as a result of Congress’s decision to abandon tracing in the income taxation of Subchapter J entities, would have so openly defied the statute in *Mott*.”

This result leads to the opposite unfairness, with all of the income being taxed in many cases to the taxable beneficiaries even though they may be entitled only to a portion of it.

So what has changed? What has changed is that the abuse which concerned the Service—disproportionate distributions resulting in shifting of income from taxable to non-taxable beneficiaries—is no longer possible. What has made this result unnecessary was the amendment in 1997 of Code section 663(c) to apply the separate share rule to estates. That section now treats the separate shares of the charitable and non-charitable beneficiaries as separate entities for purposes of calculating the amount of DNI and should, in this author’s opinion, make impossible the kind of abuses which the Court and Service were concerned about in Mott and O’Connor. Mott and O’Connor were probably wrong when decided. Now they serve no purpose at all.

VII. Compliance Problem With Charitable Gift Annuities.

Charitable gift annuities present an interesting compliance problem which, although charities face it each year at tax reporting time, I have never seen discussed in the literature. Charities issuing charitable gift annuities inform annuitants about the amount of income each is to report on Form 1099-R. (In fact, after input from professional tax groups, the Service now includes a box to show the amount of reportable capital gain.)

The form looks like this:

| | | | | | | | | | |
|---|--|--|--|--|--|---|--|--|--|
| 9898 <input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED | | | | OMB No. 1545-0119 | | 2001 Form 1099-R | | Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. | |
| PAYER'S name, street address, city, state, and ZIP code | | 1 Gross distribution | | Total distribution <input type="checkbox"/> | | | | | |
| | | \$ | | | | 2a Taxable amount | | | |
| PAYER'S Federal identification number | | RECIPIENT'S identification number | | 3 Capital gain (included in box 2a) | | 4 Federal income tax withheld | | File with Form 1096. | |
| | | | | \$ | | \$ | | | |
| RECIPIENT'S name | | 5 Employee contributions or insurance premiums | | 6 Net unrealized appreciation in employer's securities | | For Privacy Act and Paperwork Reduction Act Notice, see the 2001 General Instructions for Forms 1099, 1098, 5498, and W-2G. | | | |
| | | \$ | | \$ | | | | | |
| Street address (including apt. no.) | | 7 Distribution code | | 8 Other | | 9a Your percentage of total distribution % | | 9b Total employee contributions \$ | |
| | | | | % | | | | | |
| City, state, and ZIP code | | 10 State tax withheld | | 11 State/Payer's state no. | | 12 State distribution | | | |
| Account number (optional) | | \$ | | \$ | | \$ | | | |
| | | \$ | | \$ | | \$ | | | |
| | | 13 Local tax withheld | | 14 Name of locality | | 15 Local distribution | | | |
| | | \$ | | \$ | | \$ | | | |

Form **1099-R** Cat. No. 14436Q Department of the Treasury - Internal Revenue Service

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The amount of income reportable for a charitable gift annuitant is calculated under the section 72 annuity rules and a portion of each annuity payment is considered a non-taxable return of the donor's investment in the contract. This "exclusion ratio" is calculated by dividing the actuarial value of the annuity by the expected return, the latter being simply the amount of the annual annuity times the years of annuitant's life expectancy. The excess of the amount contributed by the donor over the actuarial value of the annuity is a charitable deduction. However, the charitable deduction and the value of the annuity are dependent upon the section 7520 rate elected by the annuitant on his or her income tax return. The practical problem this creates is that when a charity issues a

1099-R by January 31, it has no way of knowing what section 7520 rate the donor will elect on the donor's income tax return, which is not due until the following April.

It cannot always be assumed that the donor will elect to use the highest interest rate (which produces the greatest charitable deduction). Although use of a higher section 7520 rate generates a greater charitable deduction, it also results in a lower exclusion ratio and, therefore, greater income tax on each annuity payment. Some donors will prefer greater non-taxability of the annuity to a greater charitable deduction. In addition, of course, some donors may simply not elect the higher section 7520 rate through inadvertence. A simple solution would be to amend the regulations to provide that for purposes of calculating the exclusion ratio, the interest rate in effect for the month of the gift must be used. For purposes of calculating the charitable deduction, an election under section 7520 would be permitted, but it would not change the amount of the exclusion ratio. This rule of convenience would eliminate a serious practical problem all issuers of gift annuities face. I suspect that most charities simply assume the interest rate for the month of the gift or, in some cases, assume the highest interest rate, will be elected.

VIII. Abandon Assignment of Income Doctrine

A final, more controversial suggestion for reform is to abandon the assignment of income doctrine in cases of contributions of appreciated capital gain property to charity. Those of us who advise charitable organizations and their donors are frequently confronted with assignment of income issues. Small differences in the specific facts, not all of which are always known, may affect the outcome.

A typical case is the donor who owns shares of a public company being acquired in a taxable transaction. When has the transaction progressed to the point that the shares

cannot be contributed to charity without running afoul of the assignment of income doctrine? If the shareholders have approved the transaction, but the sale is still subject to regulatory approval, is it too late to avoid assignment of income? Or, a donor may have negotiated a sale of real estate but not signed a formal contract. Is it too late to contribute the land to charity and avoid assignment of income?

I propose that we simply abandon the assignment of income doctrine in cases of contributions of appreciated capital gain property to charity. The charity is, after all, going to receive 100% of the proceeds of sale, and one must wonder whether there is any important policy reason not to carve out an exception to the usual assignment of income rules in this situation where the donor is going to receive none of the proceeds. This reformation in the law would encourage many charitable gifts which do not get made now because donors are concerned that they will have given the entire property away (including the proceeds to pay the tax) but may not have avoided the capital gains tax on the sale.

Appendix

The following discussion provides a comparison between the income tax charitable deduction (under Code section 170), the gift tax charitable deduction (under Code section 2522) and the estate tax charitable deduction (under Code section 2055). For purposes of this discussion, the term “contributions” shall mean a gift, contribution, bequest, devise, or legacy.

Entities to Which Contributions May be Made

A deduction is permitted for the following:

1. Contributions to the United States or a Political Subdivision Thereof. Under all three Code sections, a deduction is allowed for contributions to or for the use of the United States, any State, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes. Code sections 170(a)(1), 2522(a)(1) and 2055(a)(1). The language of Code section 170(c)(1) also permits a deduction for contributions made to or for the use of “a possession of the United States.” It is unclear whether this language is meant to be a distinction between the income tax charitable deduction and the gift and estate tax charitable deductions. See Section 7 below for a discussion of contributions to foreign entities.

2. Contributions to a Corporation, Trust, Community Chest Fund or Foundation.

- Corporation or Trust. All three Code sections permit a deduction for contributions to or for the use of a corporation or a trust as long as such corporation is (1) organized and operated exclusively for a permitted

purpose (see “Permitted Use of Contributions” below), (2) no part of the net earnings of which inures to the benefit of any private stockholder or individual, and (3) which is not disqualified for tax exemption under Code section 501(c)(3) by reason of attempting to influence legislation and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office. Code sections 170(c)(2), 2522(a)(2), and 2055(a)(2) and (a)(3).

- Community Chest, Fund or Foundation. Code sections 170(c)(2) and 2522(a)(2) permit a deduction for contributions to a “community chest, fund or foundation,” in addition to a corporation or a trust. Interestingly, Code section 2055 does not list community chests, funds or foundations as entities to which contributions may be made. The regulations do not list these entities, either. However, contributions to a foundation are necessarily contributions to a trust or a corporation, and therefore an estate tax deduction is allowed for such contributions. See also Code section 170(b).

3. Contributions to a Fraternal Society, Order, or Association Operating Under the Lodge System. All three Code sections permit a deduction for a contribution to or for the use of a fraternal society, order, or association, operating under the lodge system, but only if such gifts are to be used exclusively for certain permitted purposes (see “Permitted Use of Contributions” below). Code sections 170(c)(2), 2522(a)(3) and 2055(a)(3).

4. Contributions to a Post or Organization of War Veterans. Code sections 170(c)(3) and 2522(a)(4) permit a deduction for contributions to or for the use of “a post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization organized in the United States or any of its possessions and no part of the net earnings of which inures to the benefit of any private shareholder or individual.” Code section 2055(a)(4), on the other hand, limits deduction to contributions “to or for the use of a veterans’ organization incorporated by Act of Congress, or its departments or local chapters or posts (no part of the net earnings of which inures to the benefit of any private shareholder or individual).”

5. Qualified Conservation Contributions. All three Code sections permit a deduction for a qualified conservation contribution. Under sections 2522(d) and 2055(f), the deduction is permitted if the contribution is of a qualified real property interest to a qualified organization. Section 170(h) adds a requirement that the contribution be exclusively for conservation purposes.

Code section 2031(c) permits the executor to elect to exclude the lesser of (1) a certain percentage of the value of land subject to a qualified conservation easement, reduced by the deduction under Code section 2055(f) with respect to such land, or (2) the exclusion limitation (which is \$400,000 for the year 2001 and \$500,000 thereafter). Before the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA 2001), Code section 2031 had restrictions on what constituted “land subject to a qualified conservation easement” depending on where such land was located. Section 551(a) of EGTRRA 2001 removes this restriction, however, so that the election is permitted for such land as long as it is located “in the United States or any possession of the United

States.” In addition, Section 551(b) of EGTRRA 2001 clarifies that in the case of a qualified conservation easement established prior to a decedent’s death, the easement is valued as of the date of the contribution, rather than on the date of death.

6. Contributions to a Foreign Entity. Both the gift tax and the estate tax provide that the charitable deduction is not limited to gifts within the United States or to transfers to entities within the United States. See Treasury Regulation §25.2522(a)-1 and Treasury Regulation §20.2055-1. In contrast, the income tax requires that the entity be “created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States.” Code section 170(c).

A gift tax charitable deduction is also permitted for contributions by nonresidents who are not United States citizens; provided, however, that gifts made to or for a corporation must be made to a corporation created or organized under United States laws and gifts made to or for another entity must be for use within the United States. Code section 2522(b) and Treasury Regulation §25.2522(b)-1.

However, an individual cannot deduct transfers to foreign charitable organization of remainder interest in charitable remainder trust or pooled income fund. Treasury Regulation § 20.2055-2(e)(2)(v).

What Can Be Contributed

Special rules apply to contributions of partial interests in property and to contributions of artwork.

1. Partial Interest, In Trust and Not In Trust. Where an individual transfers an interest in property to an entity and either (1) retains an interest in the property, or (2) transfers an interest in the same property (for less than full and adequate consideration) to a person for a noncharitable use, the contribution is deductible under all three Code sections if, and only if, it is one of the following:

- Undivided portion, not in trust, of donor's entire interest.
- Irrevocable remainder interest, not in trust, in a personal residence.
- Irrevocable remainder interest, not in trust, in a farm.
- Qualified conservation contribution.
- Charitable remainder trusts and pooled income funds.
- Guaranteed annuity interests, whether or not such interest is in trust.
- Unitrust interest, whether or not such interest is in trust.

Code sections 170(f)(2) and (f)(3), 2055(e)(2) and 2522(c)(2). See also Treasury Regulations §§1.170A-6 and -7, 25.2522(c)-3 and 20.2055-2. For a contribution of a partial interest not in trust, Code section 170(f)(3) permits a deduction if the contribution would have been deductible had it been transferred in trust, but only to the extent that the value of the interest would have been deductible had it been transferred in trust. Finally, for a contribution of an income interest in a trust (for example, a charitable lead trust), Code section 170(f)(2) adds the requirement that the grantor of the trust is treated as owner of such interest for purposes of Code section 671.

2. Works of Art. Code sections 2522(c)(3) and 2055(e)(4) permit you to deduct contributions of works of art and the copyright on such work of art. They are

treated as separate properties for purposes of partial interest rules. Under Code section 170, however, a work of art and its copyright are not treated as separate properties. An income tax charitable deduction is denied for split interest transfers of copyrighted artworks.

Permitted Use of Contributions

When contributions are made to a corporation, trust, fraternal society, order, or association operating under the lodge system, such contributions must be made exclusively for certain types of purposes. All three Code sections permit the purposes to be “religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.” Code sections 170(c), 2522(a) and 2055(a).

1. **Encouragement of Art.** Code sections 2055(a)(2) and 2522(a)(2) contain additional language permitting contributions to entities for “the encouragement of art.” Code section 170 does not list this as a permissible purpose. However, contributions to an entity for the encouragement of art may also be characterized as for an educational purpose, which is permitted under Code section 170.

2. **Foster National and International Amateur Sports Competition.** All three Code sections permit contributions to certain entities to foster national and international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment). However, Code section 2055(a)(2) only contains this language in reference to corporations, whereas Code sections 170(c)(2)(B) and 2522(a)(2) contain this language in reference to corporations, trusts, community chest funds and foundations.

3. Maintaining Certain Students. An income tax charitable deduction is permitted for contributions to certain entities may be deducted if they are made for the purpose of maintaining a full-time student (12th grade or lower) in the United States and there is a written agreement between the entity and the taxpayer to implement a program “to provide educational opportunities for pupils in private homes.” Code section 170(g). Code section 170(g) contains restrictions on the amount that is deductible.

Other Restrictions

1. Sections 508(d) and 4948(c)(4). None of the sections allow a deduction for a gift to or for the use of an organization or trust described in section 508(d) or 4948(c)(4) subject to the conditions specified in such sections. Section 508(d) refers to gifts or bequests to organizations subject to section 507(c) tax and gifts or bequests to taxable private foundations. Section 507(c) is a tax on the termination of private foundation status. Section 4948(c)(4) denies a deduction for a contribution to a foreign organization that has engaged in a prohibited transaction. Code sections 170(f)(1), 2522(c)(1) and 2055(e)(1).

2. Additional requirements for Income Tax Charitable Deduction. Some of the additional requirements for the income tax charitable deduction that are worth noting are the following:

- Substantiation. A contribution of \$250 or more must be substantiated by contemporaneous written acknowledgment of contribution by donee organization. Code section 170(f)(8).

- Percentage limitations on deductions. Depending on the type of entity to which a contribution is made, the income tax charitable deduction has varying percentage limitation on the deduction. Code section 170(b). However, the amount of contribution disallowed under the preceding sentence may be carried over and deducted (subject to certain limitations) in the five succeeding years. Code section 170(d).
- Lobbying Activities. Code section 170(f)(9) denies a deduction for lobbying activities.
- Split-Dollar Life Insurance, Annuity, and Endowment Contracts. Under Code section 170(f)(10), a charitable deduction is not permitted for a contribution to an entity if in return the entity “pays any premium on any personal benefit contract with respect to the transferor, or if there is an understanding or expectation that any person will pay any premium on any such contract.” There is a limited exception for charitable gift annuities.
- Amounts Paid to Institutions of Higher Education. Contributions to or for the use of an certain educational organizations that would otherwise be deductible are limited if the taxpayer, in return, is given the right to purchase tickets to an athletic event in the organization’s stadium. Code section 170(l). In such cases, only 80% of the contribution is deductible.