

# **A PRIMER ON CHARITABLE GIVING**

**NATIONAL ASSOCIATION OF INSURANCE  
&  
FINANCIAL ADVISORS  
SPRINGFIELD, MISSOURI**

**DECEMBER 18, 2009**

**PRESENTED BY  
ROBERT G. INGOLD, JD, MBA, CLU, ChFC  
2830 E. ROCKLYN ROAD  
SPRINGFIELD, MO 65804  
PHONE: 417-877-1600  
FAX: 417-877-1795  
E-MAIL: [robertingold@sbcglobal.net](mailto:robertingold@sbcglobal.net)**

**ACKNOWLEDGMENT:** This outline was adapted from *Tax Economics of Charitable Giving, 2004/2005*, by Joseph P. Toce, Jr., Byrle M. Abbin, William M. Pace, and Mark L. Vorzatz, published by Warren, Gorham & Lamont of RIA. The reader is commended to this publication as an excellent source of in-depth treatment of the tax issues related to charitable giving.

## **I. History of Charitable Deductions**

In 1917, the United States entered the First World War and it became necessary to provide revenue to defray war expenses.<sup>1</sup> That was the express purpose of the Revenue Act of 1917, which was intended to raise \$1.8 billion of additional taxes.

Along the way to its passage by Congress, the 1917 Act was amended in several ways. The purpose of one such amendment was to allow

a deduction in computing net income under the income tax of such amount, not to exceed 15% of the taxpayer's taxable net income, as the taxpayer contributes during the taxable year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals.<sup>2</sup>

As finally adopted, the amendment allowed U.S. citizens and residents to deduct, in computing taxable income,

contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals, no part of the net income of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's taxable net income as computed without the benefit of this paragraph.<sup>3</sup>

Enactment of the income tax charitable deduction was soon followed by an estate tax charitable deduction. Originating in the Estate Tax Act of 1921, the estate tax charitable deduction had retroactive application to the estates of all decedents who died after December 31, 1917.<sup>4</sup> Finally,

---

<sup>1</sup> Report of the Comm. on Ways and Means Accompanying HR 4280, 1939-1 CB (pt. 2) 48.

<sup>2</sup> Statement of the Managers on the Part of the House in Explanation of the Effect of the Actions Agreed Upon by the Conferees of HR 4280, 1939-1 CB (pt. 2) 72.

<sup>3</sup> 1 Barton & Browning, Barton's Federal Tax Laws Correlated 101, 103 (Federal Tax Press 2d ed.).

<sup>4</sup> 2 Barton & Browning, Barton's Federal Tax Laws Correlated 498, 500 (Federal Tax Press 2d ed.)

the gift tax charitable deduction came into being as part of the Gift Tax Act of 1932.<sup>5</sup>

## **II. Income, Gift, and Estate Tax Charitable Deductions**

In any discussion of the tax rules on charitable giving, it is appropriate to first emphasize that the charitable deduction is a feature of three different tax statutes - the income tax,<sup>6</sup> the gift tax,<sup>7</sup> and the estate tax.<sup>8</sup> This is important because donors who recognize the need to qualify a charitable gift under the income or estate tax laws, as appropriate, sometimes fail to recognize that it is also important to qualify lifetime gifts for the gift tax charitable deduction.

## **III. Charitable Organizations**

### **A. Overview**

Although many types of organizations engage in a wide range of charitable, religious, and educational activities, it is common practice to refer to them collectively as charitable organizations. While this term is adequate for general usage, it is insufficient for determining whether a donor will achieve the tax results anticipated from a charitable gift to a particular organization. In that case, it is important to know with certainty the donee's standing under tax law. This is necessary because

- Gifts to some organizations may qualify for a particular charitable deduction while gifts to others may not;
- Gifts to certain organizations may qualify for the maximum income tax charitable deduction while gifts to others may not; and
- The classification of the donee under the tax law may determine whether the donor is allowed an income tax deduction for the full value of the gift.

### **B. Income Tax Charitable Organizations**

The internal Revenue Code expressly allows an income tax charitable deduction for individuals and

---

<sup>5</sup> 2 Barton & Browning, Barton's Federal Tax Laws Correlated 548 (Federal Tax Press 2d ed.).

<sup>6</sup> IRC §§ 170, 642(c). References in this outline to "IRC" and to "Section" refer to the Internal Revenue Code of 1986, and references to "Reg." refer to the regulations promulgated under the Internal Revenue Code of 1986.

<sup>7</sup> IRC §§ 2522.

<sup>8</sup> IRC §§ 2055

corporations<sup>9</sup> and attempts to define what constitutes a deduction.<sup>10</sup> The law, however, does not really define “charitable contributions,” at least not in the dictionary sense of a definition. Instead, it defines “charitable contributions” simply as a contribution or gift to or for the use of certain types of organizations.

The law limits the extent to which an individual is allowed an income tax benefit for charitable contributions made during any year.<sup>11</sup> The most generous limitation (50 percent of a taxpayer’s contribution base) applies to contributions to certain organizations specified by the law.<sup>12</sup> These organizations can be generally described as

- Churches
- Educational organizations that normally maintain a regular faculty and student body;
- Hospitals and medical research organizations;
- Governmental units;<sup>13</sup>
- Certain organizations<sup>14</sup> that normally receive a substantial part of their support from direct or indirect contributions from the general public or from a governmental unit;
- Organizations that receive more than one third of their support from a combination of gifts, grants, contributions, and membership fees and gross receipts from admissions, sales of merchandise, performances of services, or furnishing of facilities and that do not receive more than one third of their support from gross investment income and unrelated business income (net of tax);
- Supporting organizations, i.e., organizations the purpose of which is to support other publicly supported charitable organizations;
- Operating foundations, i.e., private foundations that expend substantially all of their income directly for the active conduct of the activities constituting the purpose or function for which they are organized or operated;
- Pass-through foundations, i.e., nonoperating private foundations that, not later than two and one-half months after the close of the tax year in which they receive contributions, make qualifying distributions out of corpus equal

---

<sup>9</sup> IRC § 170(a)

<sup>10</sup> IRC § 170(c).

<sup>11</sup> IRC § 170 (b)(1).

<sup>12</sup> IRC § 170(b)(1)(a).

<sup>13</sup>A city hospital is an integral part of the city so charitable contributions to the hospital are deductible under IRC § 170(h). Ltr. Rul. 200403026.

<sup>14</sup> IRC § 170 (c) (2).

- to such contributions; and
- Pooled fund foundations, i.e., nonoperating private foundations, organized and operated exclusively for the support of one or more public charities, that pool into a common trust fund all the contributions of their donors, who retain the right to designate the public charities that will receive the income from their contributions.

#### C. Estate Tax Charitable Organizations

The charitable deduction allowed for federal estate tax purposes, like that allowed for income tax purposes, depends on the type of organization to which a gift is made.<sup>15</sup> These organizations, bequests to which yield an estate tax charitable deduction, are much the same for both income tax and estate tax purposes. But there are differences.

For example, gifts to certain cemetery companies qualify for the income tax charitable deduction while such organizations are not names as qualified recipients for estate tax purposes.<sup>16</sup>

#### D. Gift Tax Charitable Organizations

Another group of organizations that is important in charitable giving consists of organizations that are qualified recipients for purposes of the federal gift tax charitable deduction.<sup>17</sup> Qualified donees are essentially the same as those for the estate tax charitable deduction; however, gift tax law recognizes a community chest, fund, or foundation as a qualified donee, without any requirement that it be in corporate form.

#### E. Private Foundations

A final group of organizations, the tax status of which is important for purposes of the income tax charitable deductions, consists of organizations generally referred to as private foundations. In general, the main characteristic that distinguishes these organizations from other charitable organizations under the tax law is the absence of a broad base of public support.

Although a private foundation may be equally as charitable in its operations as any other charitable organization, deductions for gifts to most of these organizations are more severely limited for income tax purposes than are those to other charitable organizations.

---

<sup>15</sup> IRC § 2055(a).

<sup>16</sup> Rev. Rul. 67-170, 1967-1 CB 272; *Mullen Bank, N.A. v. United States*, 762 F2d 283, 56 AFTR2d 85-6481 (3d Cir. 1985), cert. denied, 475 US 1032 (1986).

<sup>17</sup> IRC. § 2522(a).

## F. List of Qualified Organizations

Unless an organization is a well-known public charity, a potential donor may be concerned about the status of a contribution to the organization for income tax purposes. To remove uncertainty as to the deductibility of a gift, the IRS publishes a book (*Publication 78*, often referred to as *The Cumulative List* or *The Blue Book*) that lists all organizations that are qualified to receive gifts for which an income tax charitable deduction is allowable.<sup>18</sup>

## IV. What Is a Charitable Gift?

### A. Overview

One might think that a tax deduction that has been a part of the income tax law for almost ninety years would be almost wholly free of any ambiguity regarding its meaning. Yet court cases and IRS rulings about this deduction continue to arise. The central question of these cases and rulings is deceptively simply. What is (is not) a charitable contribution?

### B. Statutory Definition

Much of the confusion that has surrounded the charitable contribution question is attributable to the wording of the law granting the deduction. The statute allows an income tax deduction for any “contribution or gift to or for the use of” certain types of qualified charitable organizations.<sup>19</sup> This wording is vague at best, and the underlying regulations are no more specific.<sup>20</sup>

The dictionary does a better job of defining the term “gift.” According to Webster, “gift” means “something that is voluntarily transferred by one person to another without compensation.”<sup>21</sup> One can find little fault with that definition and wonders then why it has been so difficult for taxpayers, the government and the courts to distinguish a charitable gift from a nongift.

### C. Objective Test Adopted by the U.S. Supreme Court

In moving to an objective test of a payment as a charitable contribution, courts now consider whether the payment is in fact a quid pro quo. This objective test has been adopted by the U.S. Supreme Court, which held that:

---

<sup>18</sup> Cumulative List, Organizations Described in Section 170 (c) of the Internal Revenue Code of 1986, IRS Publication 78, U.S. Government Printing Office, Washington, D.C., also available at [www.irs.gov/charities](http://www.irs.gov/charities).

<sup>19</sup> IRC §§ 170(a)(1), 179(c)

<sup>20</sup> Reg. § 1.170A-1(a).

<sup>21</sup> Webster’s Third New International Dictionary of the English Language, Unabridged (G. & C. Merriam Co. 1976).

[t]he sine qua non of a charitable contribution is a transfer of money or property without adequate consideration. The taxpayer, therefore, must at a minimum demonstrate that he purposely contributed money or property in excess of the value of any benefit he received in return.<sup>22</sup>

#### D. Dual Character Allowed

In reaching the decision noted above, the Supreme Court recognized that payments to charities are not always all-or-nothing transactions. Accordingly:

Where the size of the payment is clearly out of proportion to the benefit received, it would not serve the purpose of [the law] to deny a deduction altogether. A taxpayer may therefore claim a deduction for the difference between a payment to a charitable organization and the market value of the benefit received in return, on the theory that the payment has the “dual character” of a purchase and a contribution.<sup>23</sup>

#### E. Problems with Quid Pro Quo

It is clear that a transfer does not qualify as a charitable contribution for tax purposes, regardless of how it is styled by the parties to the transfer, if it is in fact a quid pro quo, i.e., if the transferor receives or expects to receive a bargained-for benefit.

##### 1. Payments to Private Schools

When parents send their children to private or church-affiliated schools, the question that sometimes arises is whether payments made to the school and/or church are charitable contributions or tuition payments. When the question has been litigated, the government generally has been successful - no charitable deduction is allowable unless the payments exceed the value of the educational instruction received.<sup>24</sup>

##### 2. Token Benefits Permitted

Charitable organizations sometimes offer their donors small items of merchandise or other benefits

---

<sup>22</sup> United States v. American Bar Endowment, 477 US 105, 106 S. Ct. 2426, 58 AFTR2d 86-5190 (1986)

<sup>23</sup> United States v. American Bar Endowment, 477 US 105, 106 S. Ct. 2426, 58 AFTR2d 86-5190 (1986).

<sup>24</sup> For several of many such cases, see Channing v. United States, 67 F2d 986, 13 AFTR 428 (1<sup>st</sup> Cir. 1933); DeJong v. Comm’r, 309F2d 373, 10 AFTR2d 5863 (9<sup>th</sup> Cir. 1962); Winters v. Comm’r, 468 F2d 778, 30 AFTR2d 72-5696 (2d Cir. 1972); Oppewal v. Comm’r, 468 F2d 1000, 30 AFTR2d 72-5599 (1<sup>st</sup> Cir. 1972); Haak v. United States, 451 F. Supp. 1087, 41 AFTR2d 78-1168 (D. Mich. 1978). See also Rev. Rul. 54-580, 1954-2 CB 97; Rev. Rul. 83-104, 1983-2 CB 46.

when they contribute to the organization. These benefits may be of token value in relation to the amount contributed, and it may be difficult or burdensome for the donee organization to inform each donor of the amount of the payment that is deductible.

#### F. Other Nondeductible Gifts

In addition to the clear quid pro quo that is fatal to a charitable deduction, other factors may defeat (or at least delay) the deduction of a charitable gift. Examples include:

1. Gifts involving contingencies
2. Gifts of services
3. Gifts of income interests
4. Gifts of partial interests
5. Gifts of future interests in tangible personal property
6. Gifts of the right to use property
7. Involuntary transfers
8. Gifts to individuals (earmarked gifts)
9. Gifts of the right to use property
10. Gifts to certain tax-exempt organizations
11. Gifts to foreign organizations
12. Payments considered to be business expenses rather than charitable donations

### V. When Is a Contribution Deductible?

#### A. Overview

A charitable contribution can be deducted by an individual for income tax purposes only in the year in which it is actually paid, irrespective of the donor's accounting method.<sup>25</sup>

---

<sup>25</sup> IRC § 170(a)(1); Reg. § 1.170A-1(a). Consult counsel as to the impact of local law when transferring realty and other assets to charity and, if the transfer involves a trust, to assure that the trust and trustee are in place to receive any transfer prior to sale

A charitable gift generally is effective for income tax purposes at the time the gift property is delivered to the donee.<sup>26</sup>

## B. Delivery Required

Ordinarily delivery is required to effect a gift, so retention of the donated property by the donor typically makes the donation ineffective. Thus, a deduction is denied when the donor retains the item and the deed of gift is held invalid<sup>27</sup> or control is not given up even though donor argues he or she was acting as donee's agent for delivery.<sup>28</sup>

## C. Checks

### 1. Unconditional Delivery or mailed

Regulations provide that a charitable contribution made by check is effective for income tax purposes when the check is unconditionally delivered or mailed, as long as the check subsequently clears the donor's bank in due course.<sup>29</sup>

### 2. Postdated Checks

A postdated check is not an unconditional payment; it is a mere promise to pay on the date shown. For that reason, it is no deductible until the day of its date.<sup>30</sup>

### 3. Checks Outstanding at Death

A check in payment of a charitable contribution may be outstanding at the time of the donor's death and paid by the drawee bank after that date. In such case, the gift is effective for income tax purposes at the time the check was unconditionally delivered or mailed by the donor.<sup>31</sup> A logical

---

<sup>26</sup> Reg. § 1.170A-1(b)

<sup>27</sup> *Bennett v. Comm'r*, TC Memo. 1991-604.

<sup>28</sup> *Estate of Miller v. Comm'r*, TC Memo. 1991-515, aff'd without published op., 983 F2d 232 (5<sup>th</sup> Cir. 1993).

<sup>29</sup> Accordingly, a gift by check may be effective in one year even though the check is not charged to the donor's bank account until the following year. Reg § 1.170A-1(b); *Estate of Speigel v. Comm'r*, 12 TC 524 (1949), acq. 1949-2 CB3; Rev. Rul 54-465, 1954-2 CB 93

<sup>30</sup> *Griffin v. Comm'r*, 49 TC 253 (1967).

<sup>31</sup> *Estate of Speigel v. Comm'r*, 12 TC 524 (1949), acq. 1949-2 CB 3.

extension of this rule would require that such checks be excluded from the decedent's bank balance in determining the gross estate tax purposes, and one court has so ruled.<sup>32</sup>

#### D. Credit Card Gifts

Many charitable organizations accept payment of contributions by credit card. The IRS has ruled that a contribution charged to a bank credit card is deductible by the donor in the year the charge is made.<sup>33</sup>

#### E. Securities

A contribution of stock is completed on the unconditional delivery of a properly endorsed stock certificate to the charitable donee or the donee's agent. If such stock is mailed and is received by the charitable organization or its agent in the ordinary course of the mail, the gift is effective on the date of mailing.

#### F. Promissory Note

A charitable organization may accept a donor's own promissory note as payment of a charitable contribution. The issuance of the donor's note, however, does not constitute payment for tax purposes; accordingly, a charitable deduction is not allowed for such a contribution. The tax deduction must be deferred until the note is satisfied by payment of cash or other property by the donor.<sup>34</sup>

## VI. Percentage Limitations on Deductions

### A. Overview

While the income tax law encourages charitable contributions, it imposes limitations on the extent to which they may be deducted currently against taxable income of individuals and corporations. (No such limitations apply for fiduciary income tax or for estate and gift tax purposes.) These

---

<sup>32</sup> Estate of Belcher v. Comm'r, 83 TC 227 (1984). acq. 1989-2 CB 1.

<sup>33</sup> Rev. Rul. 78-38, 1978-1 CB 67, revoking Rev. Rul. 71-216, 1971-1 CB 96, which held that a taxpayer who uses a bank credit card to make a charitable contribution may not deduct any part of such contribution until the taxpayer makes a payment of the amount of the contribution to the bank.

<sup>34</sup> Rev. Rul. 68-174, 1968-1 CB 81; Petty v. Comm'r, 40 TC 521 (1963); Guren v. Comm'r, 66 TC 118 (1976); O'Neil v. United States, 50 AFTR2d 5227 (unpublished op.) (D. Cal. 1982), aff'd without published op. (9<sup>th</sup> Cir. 1982). See also the Supreme Court's decision in Don E. Williams Co. v. Comm'r, 429 US 569, 97 S. Ct. 850, 39 AFTR2d 77-743 (1977), which held that the delivery of an employer's own promissory demand note to the trustee of a qualified profit-sharing plan did not constitute payment of such amount for tax purposes.

percentage limitations are the subject of this chapter.

## B. Contributions by Individuals

The extent to which an individual taxpayer may deduct charitable contributions in any year is determined by the application of as many as four separate percentage limitations (depending on the circumstances) to the taxpayer's "contribution base." (An individual's contribution base for a year is adjusted gross income without regard to any net operating loss carryback to the year.<sup>35</sup> )

### 1. Deductions limited to 50% of Contribution Base

Moving from the general rules stated above to the specifics of their operation, contributions of the following types of property (when made to 50-percent-type organizations) are always deductible under the maximum 50 percent limitation:

- Cash
- Property the sale of which on the date of contribution would yield either ordinary income or short-term capital gain
- Long-term capital-gain property where the contribution deduction must be reduced by the unrealized long-term capital gain

Although contributions in excess of 50 percent limitations cannot be deducted in the year of contribution, they are not necessarily lost as deductions. The amount of the excess can be carried over for deduction in the five succeeding tax years, again subject to the 50 percent limitation.<sup>36</sup>

### 2. Deductions limited to 30% of Contribution Base

Thus, a taxpayer who makes contributions of long-term capital-gain property to 50-percent-type organizations is subject to a more restrictive limitation; these contributions are currently deductible only to the extent of 30 percent of a taxpayer's contribution base.<sup>37</sup>

### 3. Contributions to 30-Percent-Type Organizations

#### a. Deductions Limited to 30% of Contribution Base

Contributions made to 30-percent-type organizations are deductible to the extent they do not exceed 30 percent of a taxpayer's contribution base for the year. That does not

---

<sup>35</sup> Reg. § 170 (b)(1)(F).

<sup>36</sup> IRC § 170(d)(1); Reg. § 1.170A-10(b)(1)

<sup>37</sup> IRC § 170(b)(1)(C)(i); Reg. § 1.170A-10(b)(1).

mean, however, that contributions within this limitation can always be deducted currently because their deduction may be limited by current contributions made to 50-percent-type organizations. Thus, after applying these ordering rules, the actual limitation on the deduction for contributions to 30-percent-type organizations is the *lesser* of the following amounts:

- 30 percent of the taxpayer's contribution base for the tax year
- the excess of 50 percent of the taxpayer's contribution base for the tax year over the allowable amount of deductions for charitable contributions made to 50-percent-type organization.<sup>38</sup>

With that type of property excluded, contributions of the following types of property, when made to 30-percent-type organizations, are subject to the 30 percent limitation:

- Cash
- Property the sale of which on the date of contribution would yield either ordinary income or short-term capital gain

Contributions to 30-percent-type organizations that are not currently deductible because of the percentage limitations are not necessarily lost as deductions. Like such contributions to 50-percent-type organizations, they may be carried over for deduction in the five succeeding tax years, again subject to the 30 percent limitations.<sup>39</sup>

#### b. Deductions Limited to 20% of Contribution Base

Like contributions of long-term capital-gain property 50-percent-type organizations, such contributions to 30-percent-type organizations are subject to a special limitation in determining the amount that is currently deductible. Although that limitation generally is 20 percent of a taxpayer's contribution base, it may sometimes be a lesser amount. Like the general limitation imposed on contributions to 30-percent-type organizations, the special limitation on the deduction of contributions of long-term capital-gain property to such organizations is a *lesser of* limitation. Thus, the deduction is limited to the *lesser of* the following amounts:

- 20 percent of the taxpayer's contribution base for the year
- The excess of 30 percent of the taxpayer's contribution base for the year over the amount of contributions to 50-percent-type organizations of long-term capital-gain property that is subject to the special 30 percent limitation imposed on such contributions<sup>40</sup>

---

<sup>38</sup> IRC § 170(b)(1)(B).

<sup>39</sup> IRC § 170(b)(1)(B).

<sup>40</sup> IRC § 170(b)(1)(D)(i).

#### 4. “For the Use of” Contributions

The foregoing discussions of the percentage limitation imposed on the deduction of charitable contributions have centered on those made to qualified charitable organizations. But contributions can also be made *for the use of* charitable organizations (both 50 percent types and 30 percent types).<sup>41</sup> These contributions are subject to the same general limitation that applies to contributions to 30-percent-type organizations—30 percent of an individual’s contribution base (or the excess of 50 percent of the contribution base over contributions made to 50-percent-type organizations if that amount is less).<sup>42</sup>

### VII. Valuation

The income tax benefits derived from gifts of property in which there is unrealized long-term capital gain make such gifts common in charitable giving. From a logistical standpoint, property gifts are not as easy to make as cash gifts. For example, they often require legal assistance to ensure that title to the gift property is properly passed from the donor to the donee. And they pose other problems that must be dealt with, such as valuation of the gift and its substantiation for tax purposes. In return, these problems can lead to other concerns, such as overvaluation of the property and certain penalties that may be incurred by donors.

#### A. Valuation

The contribution deduction for any gift of property is based on the property’s fair market value (FMV), although the deduction may be less than that amount due to the reduction rules. As noted there, 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 a reasonable knowledge of relevant facts.”<sup>43</sup>

##### 1. Listed Securities

In cases where there is a market for listed securities - on a stock exchange, in the over-the-counter market or otherwise - the value is the mean between the highest and lowest quoted selling prices on the valuation date.<sup>44</sup>

---

<sup>41</sup> IRC § 170 (c).

<sup>42</sup> IRC § 170(b)(1)(B).

<sup>43</sup> Reg. §§ 1.170A-1(c)(2), 25.2512-1, 20.2031-1(b); IRS Publication 561; Rev. Rul. 68-69, 1968-1 CB 80; *Holmes v. Comm’r*, 57 TC 430 (1971).

<sup>44</sup> Reg. §§ 25.2512-2(b)(1), 20.2031-1(b)(1).

## 2. Closely Held Stock

The IRS has outlined the approaches, methods, and factors that should be considered in these valuations. The value of a gift of closely held stock must sometimes be supported by an appraisal performed by a qualified appraiser.

## 3. Life Insurance Policies

Life insurance policies are often used to make charitable gifts and must be valued for that purpose. If a policy is a paid-up policy (i.e., one that requires no further payment of premiums), its FMV is generally its replacement cost. That value is the amount that the insurer would charge for a single-premium contract of the same face amount on the life of a person of the same age as the insured.<sup>45</sup>

If premiums remain to be paid on a life insurance policy, its FMV may, in most circumstances, be approximated by the “interpolated terminal reserve” value of the policy (an amount slightly in excess of cash surrender value) plus that part of the last premium payment that covers any period extending beyond the date of the gift.<sup>46</sup>

## 4. Real Estate

Another kind of property commonly used to make charitable contributions is improved or unimproved real estate. The FMV of real estate depends on many factors, especially its location. Various methods may be used to value real estate, such as comparable sales and income capitalization.

Because the valuation of real estate requires special knowledge and experience and because of certain appraisal requirements, the services of a professional appraiser ordinarily are required to determine the FMV of a contribution of real estate. To assist in the valuation process, the IRS has issued two revenue procedures: one is for use as a guideline in making appraisals of all donated property<sup>47</sup> and the other provides guidance in using the market data approach in appraising unimproved real estate.<sup>48</sup>

---

<sup>45</sup> United States v. Ryerson, 312 US 260, 61 S. Ct. 479, 25 AFTR 1164 (1941); Reg. §§ 25.2512-6(a), Ex. (3). 20.2031-8(a)(3), Ex. (2).

<sup>46</sup> Reg. §§ 25.2512-6(a), 20.2031-8(a)(2).

<sup>47</sup> Rev. Proc. 66-49, 1966-2 CB 1257, as modified by Rev. Proc. 96-15, 1996-1 CB 627, relative to valuations of art.

<sup>48</sup> Rev. Proc. 79-24, 1979-1 CB 565.

The definition of “FMV” previously quoted requires that contributed property be valued as its highest and best use, regardless of how the donor was using the property before the gift and how the donee expects to use it.<sup>49</sup>

#### 4. Mortgaged Property

The value of a gift of mortgaged property must be reduced by the amount of the debt.<sup>50</sup> Such a gift has additional tax consequences to a donor because it is treated as a bargain sale.

#### 5. Fractional Interests

The contribution of a fractional interest (e.g., a 10 percent undivided interest) in any type of property presents a difficult valuation question: Is the value of the contributed interest simply its proportionate part of the value of the whole? From a charitable-deduction standpoint, the preferred answer is affirmative, because that would maximize the charitable deduction. But the IRS and some courts have found that the value of a fractional interest must be discounted to recognize various negative factors such as the difficulty of selling such an interest, the disadvantages of co-tenancy and the expense of partitioning the property.<sup>55</sup>

##### B. Overvaluation and Undervaluation

It is well known that taxpayers have sometimes overstated the value of property contributions for income tax purposes. To address cases of abuse, the IRS uses a panel of art dealers and other are experts (the IRS Are Advisory Panel) to review and evaluate appraisals used by taxpayers to support the values claimed for art objects for income, gift and estate tax purposes.

##### C. Substantial Valuation Misstatement Rules

A taxpayer can incur a significant penalty for substantially misstating the value or tax basis of property in an income tax return. A “substantial valuation misstatement” occurs when the value or tax basis of any property claimed on an income tax return is 200 percent or more of the correct amount.<sup>56</sup> If such a misstatement causes an underpayment of income tax that exceeds \$5,000, that

---

<sup>49</sup> McGuire v. Comm’r, 44 TC 801 (1965); Gen. Couns. Mem. 39380 (July 9,1985).

<sup>50</sup> Rev. Rul. 70-626, 1970-2 CB 158; Rev. Rul. 75-194, 1975-1 CB 80; Guest v. Comm’r, 77 TC 9 (1981), acq. 1982-1 CB 1; Alexander v. United States, 640 F2d 1250, 47 AFTR2d 71-1600 (Ct. Cl 1981).

<sup>55</sup> Rev. Rul. 87-37, 1987-1 CB 295; Estate of Fawcett v. Comm’r, 64 TC 889 (1975); Knapp v. Comm’r, TC Memo. 1977-389; Zable v. Comm’r, TC Memo. 1990-55; Estate of Williams v. Comm’r, TC Memo. 1998-59; Priv. Ltr. Rul. 9336002.

<sup>56</sup> IRC § 6662(e)(1)(A).

underpayment is subject to a penalty of 20 percent.<sup>57</sup>

The underpayment penalty is more severe in the case of a “gross valuation misstatement,” one where the value or tax basis of any property claimed on a return is 400 percent or more of the correct amount.<sup>58</sup> In this case, the penalty is 40 percent of the resulting tax underpayment.<sup>59</sup>

#### D. The Reduction Rules

The amount of the income tax charitable deduction that results from a gift of property (other than money) generally is determined by the property’s fair market value (FMV) on the date of the gift.<sup>60</sup> That value has been defined for tax purposes as “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 a reasonable knowledge of relevant facts.”<sup>61</sup>

Even though the contribution amount is the property’s FMV, a property contribution is not a sale or exchange of the property for tax purposes, so the transaction does not result in the recognition of gain or loss for tax purposes.<sup>62</sup> Therefore, a taxpayer who contributes appreciated property can obtain a contribution deduction for a gain that is never subject to income tax (regular tax or the alternative minimum tax (AMT)).<sup>63</sup>

Important exceptions apply to the general rule that the amount of a property contribution is measured by FMV. Under certain circumstances, the amount of the income tax charitable deduction (but not the estate or gift tax charitable deduction) is reduced to a lesser amount.

---

<sup>57</sup> IRC §§ 6662(a), 6662(b)(3), 6662(e)(2). The threshold amount is \$10,000 in the case of a corporation other than an S corporation or a personal holding company. The taxpayer may also incur a penalty under Section 6662(b)(2) for substantial underpayment of income tax by the greater of 10 percent of the tax or \$5,000. The latter penalty may be avoided by adequate disclosure. See Reg. §§ 1.6662-4(e), 1.6662-4(f); Rev. Proc. 98-62, 1998-2 CB 816. Concerning the relationship of Sections 6662(b)(2) and 6662(b)(3), see Reg. §§ 1.6662-1, 1.662-2(c).

<sup>58</sup> IRC § 6662(h)(2)(A).

<sup>59</sup> IRC § 6662(h)(1).

<sup>60</sup> Reg. § 1.170A-1(c)(1); LO 1118, II-2 CB 148 (1923).

<sup>61</sup> Reg. §§ 1.170A-1(c)(2), 20.2031-1(b), 25.2512-1; Rev. Rul. 68-69, 1968-1 CB 80.

<sup>62</sup> LO 1118, II-2 CB 148 (1923); Rev. Rul. 55-138, 1955-1 CB 223, modified by Rev. Rul. 68-69, 1968-1 CB 80; Rev. Rul. 55-275, 1955-1 CB 295; Rev. Rul. 55-531, 1955-2 CB 520; *White v. Brodrick*, 104 F. Supp. 213, 41 AFTR 1253 (D. Kan. 1952); *Campbell v. Prothro*, 209 F.2d 331, 45 AFTR 131 (5<sup>th</sup> Cir. 1954); Priv. Ltr. Rul. 8533006

<sup>63</sup> The 1993 Tax Act eliminated the contribution of appreciated property as an item of tax preference under the alternative minimum tax.

## C. Substantiation Rules

If a charitable contribution deduction is to be allowed for income tax purposes, the donor must substantiate that the contribution was actually made and, in the case of a contribution of property, its value.

### 1. Cash Contribution

In general, a taxpayer is required to maintain one of the following forms of documentation in support of each cash contribution:

- A canceled check
- A receipt from the donee charitable organization showing the name of the donee, the date of the contribution, and the amount of the contribution (a letter or other communication from the donee charitable organization acknowledging receipt of a contribution and showing the date and amount of the contribution constitutes a receipt for this purpose)
- In the absence of a canceled check or receipt from the donee charitable organization, other reliable written records showing the name of the donee, the date of the contribution and the amount of the contribution.

### 2. Property Contributions

For each contribution of property other than money, a taxpayer must have a receipt from the donee organization showing all the following information:

- The name of the donee
- The date and location of the contribution
- A description of the property in detail reasonably sufficient under the circumstances.

A letter or other written communication from the donee charitable organization acknowledging receipt of the contribution, showing the date of the contribution and containing the required description of the property contributed constitutes a receipt for this purpose.

### 3. Contributions of Property Over \$500

If the claimed value of all property contributions exceeds \$500 (regardless of their individual value), the donor must complete the appropriate parts of Form 8283, Noncash Charitable Contributions, and attach it to his or her return.

### 4. Contributions of Property over \$5,000

When a taxpayer makes a charitable contribution of property (other than money or publicly traded

securities) and the amount claimed or reported as a charitable deduction with respect to the property exceeds \$5,000, certain additional substantiation requirements generally must be met.<sup>64</sup>

- A qualified appraisal must be obtained for the property contributed. If the contributed property is a partial interest, the appraisal must be of the partial interest.
- A fully completed appraisal summary must be attached to the return on which the deduction for the contribution is first claimed.<sup>65</sup>
- Records containing the information required for property contributions (see prior discussion) must be maintained.<sup>66</sup>

#### a. Qualified Appraisal

A qualified appraisal is an appropriate document that

- Related to an appraisal made not earlier than 60 days before the date of contribution of the appraised property nor later than the due date (including extensions) of the return on which a deduction for the contribution is first claimed (the deduction is first claimed on an amended return, the appraisal cannot be made later than the date the amended return is filed);
- Is prepared, signed, and dated by a qualified appraiser;
- Includes the information generally required in a qualified appraisal (see below); and
- Does not involve a prohibited appraisal fee.<sup>67</sup>

#### 5. The “Tattle Tale” Rule

In addition to the reporting burdens imposed on donors of property contributions, additional requirements are imposed on the donees to which the property is given. If “charitable deduction property” is sold, exchanged, consumed, or otherwise disposed of by the donee within two years after the date of its contribution, the donee must file an information return (form 8282) with the IRS that discloses that fact.<sup>68</sup> The return must show the following information:

- The donee’s name, address, and taxpayer identification number

---

<sup>64</sup> Reg. § 1.170A-13(c)(1)(i)

<sup>65</sup> Reg. §§ 1.170A-13(c)(2)(i)(A), 170A-13(c)(2)(i)(B); *Bond v. Comm’r*, 100 TC 32 (1993).

<sup>66</sup> Reg. § 1.170A-13(c)(2)(i)(C).

<sup>67</sup> Reg. § 1.170A-13(c)(3)(i).

<sup>68</sup> IRC § 6050L(a); Reg. § 1.6050L-1(a)(1).

- The donor’s name, address, and taxpayer identification number
- A description of the property (or portion disposed of) in sufficient detail to identify the charitable-deduction property
- The date of the contribution
- The amount received on the disposition
- The date of the disposition
- Any other information specified by the form or its instructions<sup>69</sup>

In addition to providing the above information to the IRS, the donee must also furnish a copy of the return to the donor.<sup>70</sup>

### **VIII. The Bargain Sale**

A “bargain sale” is a sale of property in which the amount of the sales proceeds is less than the property’s fair market value (FMV). When a bargain sale is made to a qualified charitable organization, the excess of the property’s FMV over the sales price is treated as a charitable contribution to the organization. The transaction is also known as a donative sale, i.e., part donation and part sale.

The tax results of bargain-sale transactions differ according to the facts of each sale. Generally speaking, each part of a bargain sale is reported separately according to its tax consequences. Thus, the donor reports both a sale and a contribution.

### **IX. Charitable Gift Annuities**

A charitable gift annuity is a contractual agreement between the donor and a qualified charity whereby the donor makes a gift of cash or property in exchange for the promise of the charity to pay the donor or his designee a fixed dollar amount in regular monthly, quarterly, semi-annual or annual installments. Rates for gift annuities are established by a national committee represented by national charities and nationally prominent attorneys, accountants, and actuaries. Their objective is to set a rate which will secure for the charitable donee a remainder amount of 50% of the original contribution. Because the assumptions used by the committee in establishing rates are conservative, it is not unusual for charities to receive close to 100% of the original contribution after the donor’s lifetime.

Unlike charitable remainder trusts where the charitable donee does not receive any benefit until after the death of the donor, the gift annuity provides an immediate gift to charity. Theoretically, the charity could use the proceeds from the gift annuity for its charitable purposes during the donor’s lifetime, as long as the charity honors its contractual obligation to make the annuity payments. Most

---

<sup>69</sup> IRC § 6050L(a); Reg. § 1.6050L-1(b)

<sup>70</sup> IRC § 6050L(c); Reg. § 1.6050L-1(d)

charities however, take the prudent approach of using the donor's gift as an investment fund to produce income with which to service the annuity obligation.

While rates vary from time to time, donors in their 70's usually receive a rate of more than 6.5%, donors in their 80's receive a rate of more than 7.5%, and donors in their 90's receive a rate of more than 8.5%.

As with commercial annuities, the annuity payment is considered part interest and part return of principal.

The amount of the charitable deduction can be calculated using software which takes into account the applicable government life expectancy tables, interest rate assumption and other variables. Crescendo is one of the most popular of these software programs and the illustrations produced for the case studies at the end of this outline were prepared using Crescendo. The charitable deduction amount is essentially the present value of the charitable organization's future interest in the original amount paid by the donor after deducting annuity payments over the annuitant's life expectancy.

## **X. Other Deferred Giving Techniques**

One of the most significant forms of charitable giving is commonly referred to as deferred giving. That term, however, is a misnomer because it implies that the gift itself is deferred when, in fact, it is not. The charitable donee unquestionably receives an immediate gift of an interest in the donated property. It is only the donee's enjoyment of the gift that is deferred to a sometimes certain, sometimes uncertain, future time.

### **A. The Concept**

Here is how deferred giving works. Suppose an investor, age 53, inherits \$100,000 of securities and adds them to his investment portfolio. Anticipated financial needs require that the investor retain the income from those securities during his lifetime. The investor could leave the securities to his favorite charitable organization at death, a result that could be assured simply by providing for it in the investor's will - truly a deferred gift. (And not a certain one, either, as the investor's intentions could change at any time.) However, instead of making a bequest, the investor can make an immediate gift of the remainder interest in the new securities to the charitable organization and retain an income interest for life. In this case, the donor has made a deferred gift.

### **B. The Deferred-Giving Triad**

The three approved trust forms that may be used for qualifying charitable gifts of remainder interests are

- Charitable remainder annuity trust
- Charitable remainder unitrust

- Pooled income fund<sup>67</sup>

In general terms, both a charitable remainder annuity trust (CRAT) and a charitable remainder unitrust (CRUT) pay to one or more individuals (noncharitable beneficiaries) a certain amount for either life or lives or for a fixed term and thereafter distribute the remaining trust property to one or more charitable institutions.

A CRAT pays annually to the noncharitable beneficiary a percentage of the trust principal based on the value of the trust at creation. A CRUT pays a percentage of the trust principal revalued each year.

A pooled income fund is similar to a common trust fund. A donor makes an irrevocable transfer to a fund where the assets are invested together with assets of other donors. The donor either retains an interest for life or creates a retained interest for the life of another. On the death of the income beneficiary, the principal interest is severed from the fund and paid to the charitable remainderman.

## **XI. Definition and Additional Requirements for Annuity Trusts and Unitrusts**

The income tax regulations describe a “charitable remainder trust” as follows:

Generally, a charitable remainder trust is a trust which provides for a specified distribution, at least annually, to one or more beneficiaries, at least one of which is not a charity, for life or for a term of years, with an irrevocable remainder interest to be held for the benefit of, or paid over to, charity.<sup>68</sup>

Whether a CRT is an annuity trust or a unitrust depends essentially on how the specified distributions to the beneficiaries are determined. In the case of an annuity trust, the specified distribution must be a sum certain that is not less than 5 percent nor more than 50 percent of the fair market value (FMV) of all assets initially placed in trust.<sup>69</sup> For a unitrust, the specified distribution must be a “fixed percentage” that is not less than 5 percent nor more than 50 percent of the net fair market value of the trust assets, valued annually.<sup>70</sup>

For both forms of charitable remainder trust - CRAT's and CRUT's - the charitable remainder interest (i.e., the amount of the tax deduction) must have a present value that is at least

---

<sup>67</sup> IRC §§ 170(f)(2)(A), 2055(e)(2)(A), 2522(c)(2)(A).

<sup>68</sup> Reg. § 1.664-1(a)(1)(i).

<sup>69</sup> IRC § 664(d)(1)(A), Reg. §§ 1.664-1(a)(1)(i), 1.664-2(a)(1)(i), 1.664-2(a)(2)(i).

<sup>70</sup> IRC § 664(d)(2)(A), Reg. §§ 1.664-1(a)(1)(i), 1.664-3(a)(1)(i), 1.664-3(a)(2)(i).

10 percent of the total amount transferred into the trust.<sup>71</sup> The present value is determined by applying prescribed present-value tables.

#### A. Additions or Substitutions of Remaindermen

In some charitable trust arrangements, a donor may retain the power to change or to add charitable remaindermen or may give that power to the income beneficiaries of the trust. While permissible,<sup>72</sup> such an arrangement also can create problems when the added or substituted remaindermen are restricted only to Section 170(c) organizations. Here again, the opportunity exists for naming a remainderman that would not qualify the gift for the deduction sought, as this IRS ruling shows:

The allowable charitable deduction for property transferred to a valid CRT is subject to the 20 percent contributions limitation when the organization designated to receive the remainder interest may be redesignated from an organization qualifying for the 50 percent limitation to an organization subject to the 20 percent limitations, for example, a private foundation.<sup>73</sup>

To give the trustee the power, however, during the donor's lifetime, to add and/or substitute charitable remaindermen described in Section 170(b)(1)(A) (rather than those described in Section 170(c) does not jeopardize a gift tax charitable deduction, since all qualified gift tax donees are described in that section.

#### B. Concurrent or Successive Remaindermen

A charitable remainder interest in a CRT need not be given solely to one charitable organization. Such an interest can be given to more than one organization and may be enjoyed by such remaindermen either concurrently or successively.<sup>74</sup>

#### C. Tax Treatment of the Trust

A CRT has a special tax-exempt status and retains that status during the period that payments must be made to noncharitable beneficiaries (except in years when the trust has unrelated business income). Once that period expires, the trust either terminates or continues to hold the trust property for the benefit of the charitable remainderman.

---

<sup>71</sup> IRC §§ 664(d)(1)(D) (for CRATs), 664(d)(2)(D) (for CRUTS).

<sup>72</sup> Rev. Rul. 76-8, 1976-1 CB 179.; Rev. Rul. 76-7, 1976-1 CB 179.

<sup>73</sup> Rev. Rul. 79-368, 1979-2 CB 109

<sup>74</sup> Reg. § 1.664-2(a)(6)(iii)

## D. Specimen CRT Agreements

As noted previously, the governing instrument of a CRT provides the rules by which the trust operates during the term. It is extremely important that the provisions of the governing instrument adhere to the requirements prescribed by the law and the regulations for CRTs. Failure to do so can cause the trust to be disqualified.

To provide donors with assurances that their CRTs are qualified charitable trusts for tax purposes, the IRS has issued a series of revenue rulings and revenue procedures that provide specimen trust agreements for various types of CRTs. See Appendix A, Governing Instrument Provisions - Charitable Remainder Annuity Trusts (Revenue Ruling 72-395)<sup>75</sup>, Appendix B, Governing Instrument Provisions - Charitable Remainder Unitrusts (See Revenue Ruling 72-395)<sup>76</sup>, Appendix C, Types of Charitable Remainder Annuity Trusts for Which Sample Forms for Declarations of Trust Have Been Provided by Revenue Procedures, and Appendix D, Types of Charitable Remainder Unitrusts for Which Sample Forms for Declarations of Trust Have Been Provided by Revenue Procedures.

## XII. Pooled Income Fund

A charitable gift of a remainder interest in property can also be made through the third member of the deferred-giving triad - the pooled income fund. In a deferred-giving transaction that uses a pooled income fund, a donor transfers property to the fund, retains a life-income interest in the property for one or more individuals, and contributes the remainder interest in the property to a 50-percent-type charitable organization.

Pooled income funds generally appeal to individuals who want to diversify their investments on a tax-free basis and gain investment management, but who have few if any heirs to provide for on their demise. From an economic standpoint, the recent, dramatically low interest rates are a mixed blessing for contributors to pooled income funds. On the one hand, lower interest rates increase donors' charitable deductions, but on the other hand, those same low rates decrease the amounts of distributions from the fund (the rate of return) to the income beneficiaries.

Like gifts to charitable remainder trust (CRTs), gifts to a pooled income fund generally qualify for the income tax gift tax charitable deductions or the estate tax charitable deduction. To qualify, however, the gifts must comply with requirements prescribed by the tax law and regulations.

## XIII. Considerations Related to Gifts of Various Property Interests

### A. Gifts of Life Insurance Policies

Donors often overlook the use of life insurance policies for charitable giving, even though

---

<sup>75</sup> Rev. Rul. 72-395, 1972-2 CB 340.

<sup>76</sup> Rev. Rul. 72-395, 1972-2 CB 340.

an outright contribution of all rights of ownership in a life insurance policy may yield a substantial income tax deduction.

A paid-up policy, i.e., one for which no premiums remain to be paid, yields a deduction generally equal to its replacement value.<sup>77</sup> If that value exceeds the donor's tax basis in the policy, however, the deduction is limited to basis, as a sale or exchange of the policy would not yield long-term capital gain.<sup>78</sup> Under certain circumstances (where substantial loans have been made against the policy, where it appears unlikely that the donee will take the policy as an investment but will surrender it for its net cash value, and where the donor is not the insured), the deduction may be limited to the policy's cash surrender value, generally a lesser amount than replacement value.<sup>79</sup>

If premiums remain to be paid on a life insurance policy, the policy's fair market value (FMV) and the deduction available generally may be approximated by the interpolated terminal reserve value of the policy (an amount slightly in excess of cash surrender value), plus that part of the last premium paid by the donor that covers any period of time beyond the date of the gift.<sup>80</sup>

Again, the deduction cannot exceed the donor's tax basis in the policy. If the donor continues to pay the premiums on the policy, a contribution deduction is allowed for the payments.

### 1. Insurable Interest

Donors of life insurance policies should be aware that the insurance laws of some states may prohibit a person who lacks an insurable interest from obtaining a life insurance policy on the life of another person. In a private letter ruling, the IRS used such a law to deny tax benefits to a donor of a life insurance policy when the beneficiary charity did not have an insurable interest.<sup>81</sup>

### 2. Incidents of Ownership

To ensure an income tax charitable deduction for a gift of a life insurance policy, a donor must relinquish all incidents of ownership in the policy (something the donor in the ruling discussed above could not do under the circumstances); otherwise, the deduction is disallowed by the rule that denies a deduction for a gift of a partial interest.<sup>82</sup> A partial interest gift also does not qualify for the

---

<sup>77</sup> *United States v. Ryerson*, 312 U.S. 260, 61 S. Ct. 479, 25 AFTR 1164 (1941); Reg. § 25.2512-6(a), Ex. (3).

<sup>78</sup> IRC § 170(e)(1)(A).

<sup>79</sup> *Tuttle v. United States*, 436 F.2d 69, 27 AFTR2d 71-354 (2d Cir. 1970).

<sup>80</sup> Reg. § 25.2512-6(a); Rev. Rul. 59-195, 1959-1 CB 18.

<sup>81</sup> Priv. Ltr. Rul. 9110016.

<sup>82</sup> IRC § 170(f)(3); Rev. Rul. 76-143, 1976-1 CB 63.

gift tax charitable deduction.<sup>83</sup> Incidents of ownership in a life insurance policy include, but are not limited to, the power or right to

- Change the policy's beneficiary;
- Surrender or cancel the policy;
- Assign the policy;
- Revoke an assignment of the policy;
- Pledge the policy as collateral for a loan; and
- Borrow against the policy's cash-surrender value.<sup>84</sup>

Also included is a reversionary interest - the possibility that the transferred property will return to the decedent or the estate - in a policy or its proceeds, whether arising by terms of the policy or operation of law, but only if the value of the reversionary interest immediately before the death of the decedent exceeds 5 percent of the value of the policy.<sup>85</sup>

### 3. Naming a Charitable Beneficiary

The mere naming of a qualified charitable organization as the beneficiary of a life insurance policy does not yield an income tax charitable deduction because the donor has not relinquished ownership of the policy. Under those circumstances, the proceeds of the policy are includable in the donor's estate at death; however, an offsetting estate tax charitable deduction is allowable.

### 4. Group-Term Life Insurance

A fringe benefit enjoyed by many employees is group-term life insurance. Under a nondiscriminatory plan, an employer may provide up to \$50,000 of group-term insurance to an employee, free of tax. While the employer is allowed a tax deduction for the premium, the employee recognizes not taxable income.<sup>86</sup> To the extent an employer provides more than \$50,000 of insurance, the employee must recognize taxable income measured by the cost of the excess coverage.<sup>87</sup> No income is recognized from such excess coverage, however, if the employee names a charitable organization as sole beneficiary of the insurance in excess of \$50,000.<sup>88</sup> This fact allows an employee to make, with no cash outlay, a potentially significant contribution.

---

<sup>83</sup> Rev. Rul. 76-200, 1976-1 CB 308.

<sup>84</sup> Reg. § 20.2042-1(c)(2).

<sup>85</sup> Reg. § 20.2042-1(c)(3).

<sup>86</sup> IRC § 79(a); Reg. § 1.79-2(a)(2).

<sup>87</sup> IRC § 79(a); Reg. § 1.79-2(a)(2).

<sup>88</sup> IRC § 79(b)(2)(B); Reg. § 1.79-2(c)(3).

## 5. Charitable Split-Dollar Arrangements

One popular structure that was used for many years was to make a charitable donation using “split-dollar” life insurance. This arrangement typically involved a transfer of money to a charity, which then used the money to pay premiums on a split-dollar life insurance policy. Usually the split-dollar agreement provided that the majority of the policy’s death benefit was payable to beneficiaries who were directly or indirectly related to the transferor. The charity received a much smaller portion of the death benefit. If the policy was surrendered, the charity received a portion of the policy’s cash value. Proponents of this type of transaction claimed the transferor was entitled to a charitable contribution deduction for the entire amount contributed to charity.

The IRS disagreed and announced that no charitable deduction is allowed under the theory that the amount transferred by the donor is less than the entire interest in the policy.<sup>89</sup> The IRS also says the tax-exempt status of the charity may be jeopardized as a result of entering the transaction. This IRS announcement essentially ended the use of charitable split-dollar arrangements as a means of making a charitable transfer. Courts have recently added a concurring view, though denial of the deduction was due to the taxpayer’s failure to disclose the benefit they received as consideration for their contribution.<sup>90</sup>

Current law<sup>91</sup> defines in more detail the type of situations that preclude a deduction. The law provides that no charitable deduction is allowed on the transfer of any “personal benefit contract” to a charity in which (1) the charity directly or indirectly pays (or has paid) any premium or (2) there is an understanding or expectation that any person will directly or indirectly pay any premium on the policy on behalf of the transferor.

A personal benefit contract with respect to the transferor would be any life insurance contract, annuity, or endowment contract, if any direct or indirect beneficiary under the contract is the transferor, any member of the transferor’s family, or any other person (other than a Section 170(c) charitable organization) designated by the transferor. These prohibitions apply equally as well to charitable remainder trusts. Excepted are gift annuity contracts, as well as life insurance, annuity, or endowment contracts held by a CRT solely because its distributee beneficiary is entitled to annuity or unitrust payments and the trust possesses all the contract’s incidents of ownership and the trust is entitled to all payments under that contract.

Also, a charity is subject to a 100 percent excise tax on any premiums paid on a personal benefit contract. This change does not affect the deductibility of a life insurance contract contributed to a charity or impose the excise tax if one or more Section 170(c) organizations are designated as the sole beneficiaries under the contract.

### B. Out-of-Pocket Expenses

Unreimbursed expenses incurred by individuals on behalf of charitable organizations

---

<sup>89</sup> Notice 99-36, 1999-1 CB 1284.

<sup>90</sup> *Addis V. Comm’r*, 118 TC 528 (2002), *aff’d*, 374 F3d 881 (9<sup>th</sup> Cir. 2004).

<sup>91</sup> IRC § 170(f)(10).

generally are deductible as charitable contributions, unless the facts and circumstances show that the individual taxpayer is the primary beneficiary of the payments.<sup>92</sup>

In lieu of actual expenses, a donor may use a standard mileage rate for calculating the allowable deduction for the cost of operating an automobile for charitable purposes; that rate for 2004 is fourteen cents per mile.<sup>93</sup> As this rate does not include an allowance for depreciation, no adjustment to the tax basis of the automobile is required as a result of using the standard rate.<sup>94</sup> The standard rate does not cover parking fees and tolls incurred in the operation of the automobile; to the extent such costs are incurred for charitable purposes, they are deductible as separate items.<sup>95</sup>

### 1. Personal Pleasure, Recreation or Vacation

No contribution deduction is allowable for travel expenses (including meals and lodging) while away from home unless there is “no significant element of personal pleasure, recreation or vacation in such travel.”<sup>96</sup> The IRS has issued the following illustrations to help taxpayers comply with this disallowance rule:

For example, a taxpayer who sails from one Caribbean island to another and spends eight hours a day counting whales and other forms of marine life as part of a project sponsored by a charitable organization generally will not be permitted a charitable deduction. By way of further example, a taxpayer who works on an archaeological excavation sponsored by a charitable organization for several hours each morning, with the rest of the day free for recreation and sightseeing, will not be allowed a deduction even if the taxpayer works very hard during those few hours. In contrast, a member of a local chapter of a charitable organization who travels to New York City and spends an entire day attending the organization’s regional meeting will not be subject to this provision (the disallowance provision) even if he or she attends the theater in the evening.<sup>97</sup>

#### C. Gifts Subject to an “Understanding”

Special tax benefits flow to a donor who contributes corporate stock, especially if unlisted (i.e., closely held), that is then redeemed while held by the charitable donee. The donor obtains a

---

<sup>92</sup> Reg. § 1.17A-1(g); Rev. Rul. 55-4, 1955-1 CB 291; Rev. Rul. 56-508, 1956-2 CB 126; Rev. Rul. 56-509, 1956-2 CB 129; Rev. Rul. 58-240, 1958-1 CB 141, clarified by Rev. Rul. 71-135, 1971-1 CB 94.

<sup>93</sup> IRC § 170(i).

<sup>94</sup> Rev. Proc. 2002-61, 2002-36 IRB 616.

<sup>95</sup> Rev. Proc. 2002-61, 2002-36 IRB 616

<sup>96</sup> IRC § 170(j)

<sup>97</sup> Notice 87-23, 1987-1 CB 467.

FMV deduction (both for regular tax and alternative minimum tax) and does not incur tax on the appreciation, and the donee ends up with cash. For a period of time, the IRS strenuously challenged this arrangement on a “step transaction” basis, compressing the steps into a deemed sale (redemption) by the donor to the corporation (usually resulting in dividend, ordinary income treatment) followed by the donor’s contribution of cash directly to the charity.

The IRS litigated several cases where stock of a closely held corporation was redeemed shortly after its contribution to a charitable organization, taking the position that the gain realized on the redemption should be attributed to the donors. However, absence of an obligation to redeem by the corporation was considered by the courts to be sufficient to have independent significance of the two steps. The IRS finally announced in 1978 that it would no longer challenge these transactions, even in those cases where the redemption is pursuant to a prearranged plan, unless the donee is legally bound or can be compelled by the corporation to surrender the shares to the corporation for redemption.<sup>98</sup>

#### D. Works of Art

The amount of the contribution deduction resulting from gifts of artwork has been the subject of much tax litigation. Some taxpayers have been prone to exaggerate the value of such contributions and the IRS has countered by assuming the role of the harshest and unkindest of art critics. Although the deduction for gifts of artwork by their creator (or by donees of the creator) is limited to cost,<sup>99</sup> valuation problems often arise in cases where the amount of the deduction is based on FMV. As previously noted, the IRS has, since 1969, used a panel of art dealers and other art experts (the Art Advisory Panel) to review and evaluate appraisals used by taxpayers in support of the values claimed for various art objects for income, gift and estate tax purposes.

#### E. Legal Fees

A donor who incurs legal fees to preserve the original purpose for which property was contributed to a qualified charitable organization is allowed to deduct those fees as charitable contributions.<sup>100</sup>

#### F. Installment-Sale Contracts

Contributions of installment-sale contracts, where recognition of taxable income has been deferred, are treated as “dispositions.” This treatment causes the donor to recognize the deferred

---

<sup>98</sup> Rev. Rul. 78-197, 1978-1 CB 83. See also Priv. Ltr. Ruls. 8123069, 8307134, 8639046, 8701029, 9550026, 9611047, 9652009, 8411029, where the donee would sell the stock to an employee of the closely held corporation.

<sup>99</sup> IRC §§ 170(e)(1), 1221.

<sup>100</sup> *Archibold v. United States*, 444 F2d 1120, 28 AFTR2d 71-5262 (Ct. Cl 1971).

income, just as if the contract had been sold for its FMV at the date of donation.<sup>101</sup> The donor is, however, entitled to a charitable contribution deduction equal to the value of the contract.

#### G. Contributions By Employer

The IRS has endorsed a plan designed to alleviate, through employer contributions, the increasing demands of charitable giving on employees. An employer corporation may permit its employees to suggest qualified charities of their choice as the beneficiaries of the employer's charitable gifts. The company's contribution checks are given to the appropriate employees, who present them to the selected charitable organizations. The employer is allowed charitable contribution deductions for the gifts; the employees have the satisfaction of helping a favorite charity, without realizing taxable income.<sup>102</sup>

#### H. Property Encumbered By Debt

Disposition of property encumbered by debt through a charitable contribution of the property may create tax problems for the donor and possibly for the donee. In determining the amount of the contribution, the property's FMV must be reduced by the debt associated with it.<sup>103</sup> The debt also is considered to be an amount realized by the donor. Accordingly, the transaction is part gift and part sale, and it must be treated as a bargain sale. Allocation of part of the donor's tax basis in the property to the gift element increases the donor's taxable gain on the transaction by the amount so allocated.

#### I. Spreading Gifts Over a Period of Years

While a contribution of property cannot be managed as easily, with proper planning, it can also be spread over several years. One such plan was approved many years ago by the IRS. In that situation, a donor wished to give certain land and improvements to a charitable organization. The value of the property, however, exceeded the taxpayer's percentage limitation. To avoid the loss of part of the deduction, it was necessary that the gift be made over a period of years. Accordingly, the donor initially gave a 40 percent undivided interest in the property to the charitable organization and rented the remaining 60 percent to the charity at a fair rental under a three-year lease with an option to buy. The lease agreement provided that should the donor contribute any of the remaining 60 percent to the charity, the rent would be reduced proportionately.

The IRS approved this plan and ruled the donor was entitled to a charitable contribution deduction for the FMV of the 40 percent undivided interest initially contributed. The donor also would be entitled to deductions in the future to the extent additional contributions of undivided

---

<sup>101</sup> IRC § 453(a); Rev. Rul. 60-352, 1960-2 CB 208.

<sup>102</sup> Rev. Rul. 67-137, 1967-1 B 63.

<sup>103</sup> Rev. Rul. 70-626-, 1970-2 CB 158; *Alexander v. United States*, 640 F2d 1250, 47 AFTR2d 81-1600 (Ct. Cl. 1981).

interests in the property were made.<sup>104</sup> The IRS and some courts have found that the value of a fractional interest must be discounted to recognize various negative factors such as the difficulty of selling such an interest, the disadvantages of co-tenancy, and the expense of partitioning the property.

#### J. Limited Partnership Interests

The tax consequences resulting from a charitable contribution of an interest in a limited partnership are somewhat uncertain. One issue is the question of what is being contributed (i.e., whether the donor is contributing a single item of property or multiple items representing an undivided interest in each partnership asset). The IRS ruled in one instance, for example, that a contribution of a limited partnership interest results in the realization by the donor of the deferred gain included in partnership receivables arising from installment sales.<sup>105</sup>

#### K. Granting A Stock Option

It is possible for a corporation to obtain a substantial income tax charitable deduction without disturbing its cash or other assets. This can be accomplished by granting a qualified charitable organization an option to purchase the corporation's stock at some future time at a price fixed at the time the option is granted. On exercise of the option, the corporation is allowed a charitable contribution deduction measured by the excess of the stock's FMV on the exercise date over its option price.<sup>106</sup>

#### L. Interest-Free Loans

Granting an interest-free loan (or a loan at a below-market interest rate) to a charitable organization once had no federal income tax consequences. Under a present law, however, such a transaction is recast as a gift of the below-market interest element and a receipt of interest by the lender. Although those two amount ordinarily should offset each other, that is not the case when the lender/donor's current charitable contributions are not fully deductible because of the percentage limitations. Fortunately, the regulations provide an exception to the general rule that restores most interest-free loans to charities to their former standing. Under those regulations, the "phantom interest" provision does not apply to gift loans to a qualified charitable organization, provided that the aggregate amount of loans to the organization does not exceed \$250,000 anytime during the tax year.<sup>107</sup>

---

<sup>104</sup> Rev. Rul. 58-261, 1958-1 CB 143.

<sup>105</sup> Rev. Rul. 60-352, 1960-2 CB 208.

<sup>106</sup> Rev. Rul. 82-197, 1982-2 CB 72; Rev. Rul. 75-348, 1975-2 CB 75; Priv. Ltr. Ruls. 8340058, 8505012 8714013, 8825069, 882008.

<sup>107</sup> Temp. Reg. § 1.7872-5T(b)(9).

#### M. Loans of Artworks

Owners of artworks may sometimes be willing to lend such items to charitable organizations. In the past, such a transaction could cause tax problems for the donor because it constituted a gift but did not qualify for the gift tax charitable deduction. Fortunately, the law now provides that certain loans of this type are not treated as transfers for gift tax purposes.<sup>108</sup>

#### N. Gifts of Futures Interests

Accordingly, taxpayers making gifts of futures contracts to charity will find that the transfer triggers income under Section 1256. Taxpayers attempting to shift only the long-term capital-gain portion of such contracts to charity will realize gain on such portion. In the latter circumstance, there is also the risk that the government will resurrect the partial-interest argument as a challenge to the charitable deduction.

#### O. Gifts of Gold Coins

Special beneficial treatment is afforded the charitable contribution of noncollectible (i.e., not rare) coins such as Krugerrands (and others such as the Canadian maple leaf and U.S. Mint gold coins). The IRS concluded that Krugerrands are like currency<sup>109</sup> without numismatic value and so can be donated in a charitable transfer without the special tangible personal property rules and limitations<sup>110</sup>

#### P. Gifts of Memorabilia

Unexpectedly high auction values of "memorabilia" of famous persons have been highly publicized in recent years. In general, taxpayers should consider the potential value of "memorabilia" and any "celebrity value" associated with assets from the perspective of unexpected estate tax problems and determine whether wholly or partially charitable dispositions during one's life or at death may help alleviate such concerns.

#### Q. Gifts of Vehicles

One charitable-giving program that has gained in popularity is the donation by individuals of their used cars. In July, 2004, the IRS issued publications in response to two bills passed by the House and Senate. Both bills, though varying slightly in specifics, propose more restrictive rules for obtaining a charitable deduction for donations of vehicles. To claim a deduction for the donation

---

<sup>108</sup> IRC § 2503(g)

<sup>109</sup> Rev. Rul. 69-63, 1969-1 CB 63,

<sup>110</sup> Priv. Ltr. Rul. 9225036.

of a vehicle, the charity must be a qualified organization. Additionally, the deduction is limited to the fair market value.

#### R. Anatomical Gifts and Body Fluids

With rapid medical and technology advancements, issues confronting organ donors and donors of blood (or other bodily fluids) are becoming more frequent. In 1953, the IRS ruled that no charitable contribution deduction is allowable for donating blood, concluding that the donation was the performance of a service as opposed to a donation of property.<sup>111</sup> In a 1975 general counsel's memorandum, the IRS challenged its reasoning given the existing commodity market for blood, but concluded similarly regarding the contribution of breast milk.<sup>112</sup> Consistent with that conclusion, in one case the Tax Court held blood is property in the instance where the taxpayer incurred expenses through donating her plasma.

#### S. Intellectual Property

Taxpayers with patent rights may consider contributing those rights to a charity. Provided the contribution is not subject to any restrictions that are not so remote as to be negligible (for example, a right retained by the donor to license the patent to others or a reversion of the patent rights to the donor under certain circumstances), a charitable contribution deduction should be allowed based on a published IRS ruling.<sup>113</sup>

---

<sup>111</sup> Rev. Rul. 162, 1953-2 CB 127.

<sup>112</sup> Gen. Couns. Mem. 36418 (Sept. 15, 1975).

<sup>113</sup> Rev. Rul. 2003-28, 2003-11 IRB 594.

## APPENDIX A

### Governing Instrument Provisions - Charitable Remainder Annuity Trusts (Revenue Ruling 72-395)<sup>114</sup>

#### Mandatory Provisions

- Creation of annuity amount for a period of years or life
- Creation of remainder interest in charity
- Selection of alternate charitable beneficiary if remainderman is not a tax-qualified charity at time of distribution
- Computation of annuity amount in short and final tax years
- Prohibition of additional contributions
- Prohibitions governing private foundations
- Deferral of annuity amount during a period of administration or settlement (originally optional but subsequently made mandatory by Revenue Ruling 80-123)

#### Optional Provisions

- Dollar amount annuity may be stated as a fraction or a percentage.
- Annuity amount may be allocated to class of noncharitable beneficiaries in discretion of trustee.
- Reduction of annuity amount if part of corpus is paid to charity on death of first recipient.
- Distributions may be made to charity in kind.
- Annuity amount must terminate on payment date next preceding death of recipient.
- Testamentary power must be retained to revoke noncharitable interest.
- Investment restrictions on trustee are prohibited.
- Distribution from trust used to administer an estate may be made to a CRT.

---

<sup>114</sup> Rev. Rul. 72-395, 1972-2 CB 340.

## APPENDIX B

Governing Instrument Provisions - Charitable Remainder Unitrusts (See Revenue Ruling 72-395)<sup>115</sup>

### Mandatory Provisions

- Creation of unitrust amount for a period of years of life
- Creation of remainder interest in charity
- Selection of alternate charitable beneficiary if remainderman is not a tax-qualified charity at time of distribution
- Adjustment for incorrect valuations.
- Computation of unitrust amount in short and final tax years
- Additional contributions
- Prohibitions governing private foundations
- Deferral of unitrust amount during a period of administration or settlement (originally optional but subsequently made mandatory by Revenue Ruling 80-123)

### Optional Provisions

- Unitrust amount must be expressed as the lesser of income or a fixed percentage.
- Unitrust amount may be allocated to class of noncharitable beneficiaries in discretion of trustee.
- Reduction of unitrust amount is allowed if part of corpus is paid to charity on death of first recipient.
- Distributions may be made to charity in kind.
- Termination of unitrust amount is made on payment date next preceding death of recipient.
- Testamentary power must be retained to revoke noncharitable interest.
- Investment restrictions on trustee are prohibited.
- Distribution from trust used to administer an estate may be made to a CRT

---

<sup>115</sup> Rev. Rul. 72-395, 1972-2 CB 340.

## APPENDIX C

### Types of Charitable Remainder Annuity Trusts for Which Sample Forms for Declarations of Trust Have Been Provided by Revenue Procedures

Rev. Proc. 2003-53<sup>116</sup>

- Inter vivos charitable remainder annuity trust: one life

Rev. Proc. 2003-54<sup>117</sup>

- Inter vivos charitable remainder annuity trust: term of years

Rev. Proc. 2003-55<sup>118</sup>

- Inter vivos charitable remainder annuity trust: two lives, consecutive interests

Rev. Proc. 2003-56<sup>119</sup>

- Inter vivos charitable remainder annuity trust: two lives, concurrent and consecutive interests

Rev. Proc. 2003-57<sup>120</sup>

- Testamentary charitable remainder trust: one life

Rev. Proc. 2003-58<sup>121</sup>

- Testamentary charitable remainder trust: term of years

Rev. Proc. 2003-59<sup>122</sup>

- Testamentary charitable remainder trust: two lives, consecutive interests Rev. Proc. 2003-60<sup>123</sup>
- Testamentary charitable remainder annuity trust: two lives, concurrent and consecutive interests

---

<sup>116</sup> Rev. Proc. 2003-53, 2003-31 IRB 230.

<sup>117</sup> Rev. Proc. 2003-54, 2003-31 IRB 236.

<sup>118</sup> Rev. Proc. 2003-55, 2003-31 IRB 242.

<sup>119</sup> Rev. Proc. 2003-56, 2003-31 IRB 249.

<sup>120</sup> Rev. Proc. 2003-57, 2003-31 IRB 257.

<sup>121</sup> Rev. Proc. 2003-58, 2003-31 IRB 262.

<sup>122</sup> Rev. Proc. 2003-59, 2003-31 IRB 268.

<sup>123</sup> Rev. Proc. 2003-60, 2003-31 IRB 274.

## APPENDIX D

### Types of Charitable Remainder Unitrusts for Which Sample Forms for Declarations of Trust Have Been Provided by Revenue Procedures

Rev. Proc. 89-20<sup>124</sup>

- Inter vivos charitable remainder unitrust: one life

Rev. Proc. 90-30<sup>125</sup>

- Inter vivos charitable remainder unitrust: two lives, consecutive interests
- Inter vivos charitable remainder unitrust: two lives, concurrent and consecutive interests
- Testamentary charitable remainder unitrust: one life
- Testamentary charitable remainder unitrust: two lives, consecutive interests

Rev. Proc. 90-31<sup>126</sup>

- Provides sample forms for declarations of trust for the six types of unitrusts listed above with specific application solely to net-income-with-makeup unitrusts.

---

<sup>124</sup> Rev. Proc. 89-20, 1983-1 CB 841

<sup>125</sup> Rev. Proc. 90-30, 1990-1 CB 534.

<sup>126</sup> Rev. Proc. 90-31, 1990-1 CB 539

## **CASE STUDY #1**

### **A Better Alternative to CD's: Charitable Gift Annuities**

Mrs. W, age 85, is the widow of a transportation worker who worked most of his career for the state highway department. Mr. W and Mrs. W had no children and before Mr. W died he and Mrs. W made out their estate plans to benefit an area college. While they were not graduates of the college, they were impressed with it because it provided free tuition to economically disadvantaged students. Mrs. W has a monthly income of \$3,000 and a net worth of \$400,000, most of which is invested in certificates of deposits. What would be the advantages of putting some or all of her savings into charitable gift annuities with her favorite charity?

## **CASE STUDY #2**

### **A Better Alternative to Rental Real Estate: Charitable Remainder Unitrust**

A recently retired electrical engineer and his wife, Mr. and Mrs. K, have invested in residential real estate through the years. They are 68 and 60 years of age. Their adjusted gross income is \$100,000. There is no debt on the duplexes and the duplex produce fairly good income, but Mr. and Mrs. K are getting tired of dealing with problem tenants. They would like to make a significant gift their local community foundation. What advice do you have for Mr. and Mrs. K?

### **Wealth Replacement Trust**

#### **And/Or**

### **“Give It Twice” Plan: The Testamentary Charitable Remainder Trust**

How would your advice be different if you knew Mr. and Mrs. K have two children and want to leave most of their estate to their children?

## **CASE STUDY #3**

### **Gift of Remainder Interest in Personal Residence**

#### **Gift of IRA**

Mrs. B, age 75, lives in Dexter, Missouri at her personal residence which she owns free of debt. Her home is valued at \$150,000. She has a comfortable retirement income and plans to leave her estate to her local hospital foundation and to her nieces and nephews, since she has no children of her own. Mrs. B is wondering if she should name her trust as the beneficiary of her \$150,000 IRA account. She understands there is no tax advantage to leaving part of her estate to charity after her lifetime since the value of her estate is well under the current exemption equivalent amount of \$3.5 million. What could she do to obtain tax benefits from her charitable interests during her lifetime?

## **CASE STUDY #4**

### **The Bargain Sale**

Not far from Nixa, Missouri in rural Christian County, Missouri lives Mr. and Mrs. C on their 120 acre farm. Mr. and Mrs. C purchased their farm in the 1950's for \$25 per acre. Land around them is selling for \$10,000 per acre. Mr. and Mrs. C would like to sell the farm and move to town, but hate the idea of paying more than \$150,000 in Capital Gains Tax. Mr. and Mrs. C have been approached by the church in Nixa where they are members about selling 20 acres from their farm to the church as a new building site. Mrs. C had planned to leave 10% of their estate to the church through their will. Would a gift or bargain sale of the 20 acres to the church be a better way for Mr. and Mrs. C to achieve their charitable goal?

## **CASE STUDY #5**

### **The Taxable Estate**

Mr. H has operated a very successful construction business for many years. His net worth is \$17 million. Mr. and Mrs. H plan to leave their children \$7 million estate tax free by taking full advantage of the \$3.5 million exemption equivalent amount upon the death of each of them. Mr. and Mrs. H are concerned about the exposure of the remaining \$10 million of their estate to estate taxes. What strategies could they employ to minimize or eliminate estate taxes in the amount of \$4.5 million?

- A. Irrevocable Life Insurance Trust
  
- B. Outright gifts to charity
  
- C. Family Charitable Foundation
  
- D. Charitable Lead Trust