2008 Year in Review for Charitable Planning

We're a patient people, but ...

The charitable community has adapted to the changes made by the Pension Protection Act of 2006 (PPA), yet still awaits major legislation to clarify the arena in which the community operates. For example, it has been eight years since the tax law changes of 2001, and we still have no clear guidance on the future of the federal estate tax law. While multiple bills have been introduced on the subject in Congress, the 2001 law remains unchanged. This year, the federal estate exemption amount is $3.5 million, the lifetime gift tax exclusion amount is $1 million, and there is a flat federal estate tax rate of 45 percent. If no change is made to the current law, the federal estate tax will expire for one year in 2010 and then return in 2011, with a $1 million unified estate and gift tax exemption amount and a 55 percent maximum tax rate. There are indications that the Obama administration may favor retaining the current 2009 exemption levels and rate, rather than allowing this to happen. Yet it remains unclear exactly what may transpire. Also, President Obama's FY2010 budget contains a provision that would limit itemized deductions for households making more than $250,000 per year, beginning in 2011. This may put a strain on charitable donations if it takes effect. As we close out the first quarter of 2009, it remains a challenging and interesting time for the charitable community. We take this opportunity to review the major changes in the tax laws affecting charitable planning in 2008 and early 2009.

Substantially Revised Form 5227 Released

In response to changes enacted by the PPA, the IRS released in February 2008 a substantially revised Form 5227 (Split-Interest Trust Information Return) for reporting by split-interest trusts described in Code Section 4947(a)(2). This includes charitable remainder trusts, pooled income funds and charitable lead trusts. Split-interest trusts are no longer required to file Form 1041-A. The new Form 5227 – except for Schedule A, which includes private beneficiary information – states explicitly that it is open for public inspection. The Internal Revenue Code makes clear that individual donor/beneficiary information may not be publicly disclosed; however, in practice, this conflicts with the statutory requirement that the IRS disclose the name of the trust (which would generally include the individual donor's name). So far, attempts to work around this conflict with representatives of the IRS have produced no results (other than an assurance that the IRS does not intend at present to image and make available all Forms 5227 on DVD but instead will respond to requests on a trust-by-trust basis when the requester knows the specific name of the split-interest trust entity).

Private Foundation Classification for Certain Supporting Organizations

Before the enactment of the PPA, a supporting organization (SO) structured as a trust could meet the responsiveness test for "Type III" SO status by virtue of naming charitable beneficiaries in its governing instrument, provided those beneficiaries had the power to enforce the trust and compel an accounting under state law. Effective August 17, 2007, trusts that qualified as SOs by virtue of this special rule lost their SO status and immediately became classified as private foundations unless they could otherwise establish public charity status. On January 22, 2008, the IRS issued Notice 2008-6, which provided transitional relief to trusts affected by this change. If the trust is able to meet the so-called "significant voice" test by virtue of the fact that the officers or trustees of the charities it supports have a significant voice in investment policies, grant-making and direction of the use of income or assets of the SO, then it may retain Type III status. Otherwise, it must either establish a closer Type I or II relationship or become a private foundation. These former SOs may file the Form 990 for taxable years that began before January 1, 2008, but must file the Form 990-PF and pay private foundation excise taxes for taxable years beginning on or after January 1, 2008. In other SO news, we are still waiting for the study on donor-advised funds and SOs required by the PPA (technically due in August 2007).

Regulations Regarding Effect of UBTI Earned by Charitable Remainder Trust

On June 19, 2008, the IRS released final regulations under Code Section 664 reflecting the 2006 change to Section 664(c) of the Code relating to taxation of unrelated business taxable income (UBTI) earned in a charitable remainder trust (CRT). Treas. Reg. § 1.664-1(a)(1)(i). Under the new rules, for tax years beginning after December 31, 2006, a CRT earning UBTI remains exempt from federal income tax, but is subject to a 100 percent excise tax on the UBTI. (And this is a *relief* provision!) These regulations clarify that the excise tax is treated as paid from corpus or principal of the trust but that, for purposes of determining the character of distributions made to the beneficiary, the CRT income that is UBTI is considered income of the trust, without diminution for the excise tax. Accordingly, UBTI remains fully taxable to the individual beneficiary of the CRT under the tiering system, even though the trust itself pays a tax equal to the UBTI as well.

Published Ruling on Dividing Charitable Remainder Trusts

On July 8, 2008, the IRS issued Rev. Rul. 2008-41, which provides long-awaited guidance regarding the division of CRTs. The ruling outlines two scenarios in which CRTs are divided, each of which involves division of a CRT equally into two separate CRTs on a pro rata basis, one with the assets passing to charity at the death of each income beneficiary and the other with the assets being added to the remaining CRT at the death of the first income beneficiary and then to charity at the second death. In both cases, the IRS concluded that: (1) the division does not cause the original trust or successor trusts to fail to qualify as CRTs under Code Section 664; (2) the division is not a sale or other disposition producing gain or loss, the basis of each successor trust's share of each asset is the same share of the basis of that asset in the hands of the original trust immediately before division, and each successor trust's holding period for such assets includes the original trust's holding period; (3) the division does not result in the imposition of a termination tax under Code Section 507; (4) the division does not constitute self-dealing; and (5) the division is not considered a taxable expenditure.

Some questions remain as to the complete implications of the ruling on each case. For example, in the situation in which each beneficiary gives up a successor interest in the other's half of the trust, the IRS states that there is no additional income tax deduction (although there is clearly an additional charitable gift). If no income tax deduction is allowed, the question of whether there can be a gift tax deduction arises. Similarly, the ruling does not provide adequate details on the impact of payment of legal fees or a non-pro rata distribution of the assets. Interestingly, the ruling blesses a pro rata division of each and every asset in the CRT but does not mention whether the non-pro rata division of each asset would lead to taxable gain or result in self-dealing. In the past, the IRS (in various private letter rulings) has approved divisions where the assets were divided on a pro rata basis with respect to "each major asset class held at the time of division and within each class the division has been fairly representative of the overall appreciation or depreciation of the assets in that class." Ltr. Ruls. 200525008 and 200808018. Despite the outstanding questions, this published ruling provides welcome guidance for the situations it covers, particularly in the not uncommon case of divorcing spouses wishing to divide a CRT.

Regulations on Estate Tax Inclusion of Charitable Remainder Trusts for Life of Donor

On July 11, 2008, the IRS issued final regulations that address the estate tax inclusion of an inter vivos charitable remainder annuity trust or unitrust created for a donor's lifetime. Treas. Reg. § 20.2036-1; Treas. Reg. § 20.2039-1. The regulations provide that, when a decedent transfers property during his lifetime to a trust and retains the right to an annuity, unitrust or other income payment from the trust for life (or for a period that does not in fact end before his death or is not ascertainable without reference to his death), the interest is includable in his estate under Code Section 2036. Although Code Section 2039 might otherwise be applicable in such a situation, the regulations make clear that it does not apply to an annuity, unitrust or other payment retained by a decedent in a CRT. The regulations further provide that the portion of the trust that is includable under Section 2036 is that portion of the trust corpus, valued as of the date of death (or alternate valuation date, if applicable), necessary to yield the annual payments provided under the trust, using the Section 7520 rate in effect on the date of death (or alternate valuation date, if applicable). The effect of these regulations is that less than the entire amount of the trust may be includable in the donor's estate for federal estate tax purposes. It should be noted, however, that if the donor retains a testamentary right to revoke the interest of a successor unitrust or annuity beneficiary, the entire value of the trust corpus will be includable in the donor's estate. The regulations also deal with the calculation of the amount includable in the estate of a pooled income fund donor.

Some Early Terminations of Charitable Remainder Trusts are "Transactions of Interest"

In Notice 2008-99, the IRS expressed its concern over transactions in which donors attempt to terminate a CRT early, while receiving most of the assets back from the CRT and avoiding capital gains tax on the sale of the assets originally donated to it. The baseline scenario is as follows: (1) A donor establishes a CRT and donates appreciated assets to it, retaining a unitrust or annuity interest in the trust and claiming an income tax charitable deduction for the fair market value of the contributed assets attributable to the charitable remainder; (2) the trustee of the CRT then sells the appreciated assets and, because the trust is tax-exempt, no gain is recognized on the transaction and the trust obtains a basis equal to the purchase price of the new assets; and (3) the donor and charitable remainder beneficiary then together sell (or otherwise dispose of) their respective interests in the CRT to a third party and terminate the trust. Under Code Section 1001(e)(1), if only the donor's term interest in the trust had been sold, the donor would not be treated as having any basis for income tax purposes, so the entire value of the interest would be considered capital gain to the donor. However, there is an exception to this rule in Code Section 1001(e)(3) if the entire interest in the trust is sold. Relying on this exception, the donor claims that the gain on the sale of his term interest is determined by taking into account a portion of the uniform basis in the assets that were sold – that is, of the assets in the CRT, rather than of the originally contributed appreciated assets. If successful, the donor would have avoided capital gains on the assets originally contributed to the CRT, while receiving a significant portion of their value back upon the sale. Effective October 31, 2008, the IRS has labeled transactions involving the sale of all of a CRT's assets as "transactions of interest" for purposes of Section 1.6011-4(b)(6) of the regulations and Code Sections 6111 and 6112. As such, persons entering into such transactions and advising on them are now subject to strict disclosure requirements. Harsh penalties apply for failure to disclose. This Notice should have the effect of largely curtailing this seemingly abusive revolving-door type transaction. However, it may also quell otherwise appropriate activities, such as the dissolution of a long-established CRT, whose gains have largely been passed out to the beneficiary through regular distributions, or the sale of a CRT funded with cash or other high basis assets.

Clearly the area of early termination of CRTs demands more focus. The matter can pose problems on both ends of the spectrum. It is an issue in the commutation context, where a taxpayer is treated as having zero basis in his or her unitrust or annuity interest even when the CRT was funded originally with cash, and in the situation described in the Notice, where a donor may be able to receive a tax-free principal payment even where the CRT was funded with zero basis assets. Moreover, the IRS has ruled privately that, upon early termination of a net-income CRT, the net-income provisions must be taken into account when calculating the actuarial values of the income and remainder beneficiaries. In doing so, the IRS used a payout method based on the lesser of the Section 7520 rate in effect on the date of termination and the unitrust amount in the trust agreement, resulting in a less favorable calculation for the taxpayer than that used with the early termination of a standard CRT. Ltr. Ruls. 200809044, 200725044 and 200733014. Confirming its insistence on this position, the IRS has listed the determination of the amount and recognition of gain related to the early termination of a CRT as among the areas in which rulings and determination letters will no longer ordinarily be issued. Rev. Proc. 2009-3.

One approach to resolving this dilemma would be to treat a terminating distribution – be it from a commutation of the beneficiary's interest alone or a sale of the entire trust – as a distribution to the beneficiary subject to the regular CRT tiering rules under Code Section 664. In this way, the income and capital gain in the trust would pass out to the beneficiary, and be taxed, while at the same time the remainder of the distribution to that beneficiary would be treated appropriately as a return of principal. Other approaches may also emerge, such as that suggested by the American Council on Gift Annuities (ACGA) in comments submitted to the IRS. In the end, we are hopeful that Congress and the IRS will come up with a more sensible structure to handle these situations.

Trustee's Discretion to Allocate Portion of CRT Unitrust Amount to Qualified Charity

Code Section 664(d)(2)(A) defines a CRT as a trust from which an annuity amount or a unitrust amount is to be paid, not less often than annually, to one or more persons (*at least one of which is not an organization described in section 170(c)*). By this definition, a CRT can include one or more qualified charities as co-income recipients. In several recent rulings, the IRS has approved unitrusts that grant a special independent trustee the discretion (commonly referred to as a "sprinkling power") to allocate a percentage of the annual unitrust amount to one or more section 170(c) organizations of the trustee's choice or to any of the trust's noncharitable lead recipients. Ltr. Ruls. 200813023, 200813006 and 200832017. The key to these rulings – and the avoidance of the grantor trust rules under Code Section 674 – was the presence of the special independent trustee (defined in the trust instrument as a trustee other than the donor or a person who is related or subordinate to the donor as that term is defined by Code Section 672(c)). The second and third rulings also contain an interesting conclusion with respect to the estate tax marital deduction. Despite the fact that the spouse was not entitled to the entire unitrust distribution – because up to a certain percentage was distributable to charity – the IRS nonetheless concluded that the spouse's interest qualified for the estate tax marital deduction under Code Section 2056(b)(8) because the surviving spouse was the only non-charitable beneficiary of the CRT. Contrast this with the situation where a child or other family member has a succeeding interest to the surviving spouse in a CRT, leading to the loss of the marital deduction.

IRS Issues Safe Harbor Charitable Lead Unitrust Samples

Following up on sample charitable lead annuity trusts issued in 2007, samples of *inter vivos* grantor and nongrantor, as well as testamentary, charitable lead unitrusts (CLUTs) were issued on July 28, 2008. See Rev. Procs. 2008-45, 2008-46 and 2008-30 I.R.B. 224. Interestingly, the comments indicate that a CLUT may provide for a unitrust amount that is initially stated as a fixed percentage amount but then increases or decreases during the term, provided that the value of the unitrust interest is ascertainable at the time the trust is funded.

Proposed Regulations Regarding Provisions Designating Source of Payments

On June 18, 2008 (corrections published July 16, 2008), the IRS released proposed regulations under Code Section 642(c), REG-101258-08, clarifying that ordering provisions in an estate or trust indenture which attempt to determine the tax character of amounts paid to charitable beneficiaries will be respected for federal income tax purposes only when the provisions have an economic effect independent of their tax consequences. If an ordering provision does not have an independent economic effect, then the amount of income distributed to each charitable beneficiary will consist of the same proportion of each class of items of income as the total of each class bears to the total of all classes. The proposed regulations affect estates, CLTs and other trusts making payments or permanently setting aside amounts for charitable purposes. They state that a provision can only have independent economic effect if the amount paid to the charity is dependent upon the type of income that is allocated. The Partnership for Philanthropic Planning and the ACGA have filed comments criticizing these proposed regulations.

Chief Counsel Advice Denies Charitable Deduction for Modified Trust

In another Section 642(c) related matter, Chief Counsel Advice 200848020 addressed a trust that was modified by a state court in order for the trust to qualify as a designated beneficiary of the decedent's IRA. After the reformation, the trust provided that a certain percentage of the assets was to be paid to named charities outright, with the balance being held in trusts for the decedent's six children. In the Chief Counsel Advice, the IRS concluded that no Section 642(c) charitable income tax deduction was allowed for the amounts paid to charity because the payments were not made pursuant to the governing instrument. While the IRS acknowledged that in some cases a settlement agreement can be considered the governing instrument for purposes of Section 642(c), it declined to expand that reasoning to court-modified trusts in which the modification did not arise from a conflict.

Many Charitable Giving Incentives, Including IRA Rollover, Extended Through 2009

The popular IRA charitable rollover enacted by the PPA expired at midnight on December 31, 2007, along with other provisions allowing for favorable treatment of contributions by S corporations, and gifts of inventory such as food and books. Luckily, these provisions were extended through December 31, 2009 by the Emergency Economic Stabilization Act of 2008. In addition, a proposal to make the IRA charitable rollover permanent was introduced in Congress on March 2, 2009 by Rep. Earl Pomeroy (H.R. 1250). The bill also includes provisions to expand the rollover to include contributions to charitable remainder trusts and pooled income funds, as well as to organizations in exchange for charitable gift annuities.

New ACGA Gift Annuity Rates

At its April 2, 2008 meeting, the Rates Committee for the ACGA recommended, and the ACGA board approved, a new, lower schedule of gift annuity rates for immediate gift annuities and deferred gift annuities. The committee again lowered the suggested rates at a December 29, 2008 meeting. The newest rates are effective February 1, 2009 through June 30, 2009. They reflect a significant reduction in rates since 2007. For example, in the case of a 70-year-old donor creating a single life annuity, the ACGA rate was 6.5 percent from July 1, 2007 through June 30, 2008, 6.1 percent from July 1, 2008 through January 31, 2009, and as of February 1, 2009 is 5.7 percent – an overall reduction of 80 basis points.

Historically Low Section 7520 Rates Affect Split-Interest Gifts

Similarly, recent historically low Section 7520 rates have a significant impact on some split-interest planning. To date, the rates in 2009 have been: 2.4 percent for January, 2.0 percent for February and 2.4 percent for March. When making split-interest gifts, donors generally may choose the Section 7520 rate for the month of the gift or either of the two preceding months.

In some cases, such as a charitable lead annuity trust, the low rates are beneficial because they translate into a higher value for the charitable interest and a greater charitable gift or estate tax deduction upon creation. In the CRT context, while the interest rate has little effect on a charitable remainder unitrust (CRUT), it can have significant impact on a charitable remainder annuity trust (CRAT). In the case of a CRUT, the income beneficiary receives a fixed percentage of the trust assets, determined annually. Thus, the payouts rise and fall with the assets of the trust, making the actuarial calculation for the remainder interest less susceptible to changes in interest rate assumptions. In fact, if a CRUT pays the unitrust amount to the individual beneficiary only once a year and at the beginning of the year, changes in the Section 7520 rate have no impact whatsoever on the value of the charitable remainder and the amount of the tax deduction. With a CRAT, however, the income beneficiary receives a fixed amount each year based on the initial fair market value of the trust assets, regardless of the fluctuation in year-to-year trust asset values. As a result of the fixed payout, the higher the Section 7520 rate, the more is expected to pass to charity at the end of a CRAT term, and the higher the corresponding income tax deduction for the donor. When the interest rate is very low, the expected remainder in a CRAT is also low, and with it the donor's deduction.

In the current environment, it is increasingly challenging for a CRAT to satisfy two of the critical qualification tests set forth by the IRS and the Code. These are the 10 percent remainder interest requirement, set forth in Code Section 664, under which the value of the remainder interest must be at least 10 percent of the fair market value of the property transferred to the CRT, and the 5 percent exhaustion test, set forth in Revenue Ruling 77-374, under which, if there is more than a 5 percent chance that the assets of the CRAT will be exhausted by payment of the annuity, no charitable deduction is permitted and the CRAT fails. For example, a 5 percent CRAT for life created by a 70-year-old donor fails the 5 percent exhaustion test, using either a 2.0 percent or a 2.4 percent Section 7520 rate. If instead the Section 7520 rate is 3.4 percent, a 70-year-old donor can create a valid 5 percent CRAT for life, but cannot create a valid 6 percent CRAT. In contrast, when the Section 7520 rate is 5.0 percent, even a 30-year-old donor can establish a valid 5 percent CRAT for life. In order to satisfy both tests, older donors may be forced to create a CRAT for a term of years rather than life, lower the desired payout rate (subject to the 5 percent minimum), or eliminate successive interests of other income beneficiaries.

Lower interest rates also mean that a donor funding a charitable gift annuity with cash receives a lower income tax charitable deduction than in the past. However, a greater portion of each annuity payment will be made up of return of principal and, therefore, will be income-tax-free during the donor's life expectancy. This aspect of the lower rates may be attractive to donors who do not itemize their income tax deductions and are more interested in the tax-free payments.

Proposed Regulations on Charitable Contribution Substantiation and Appraisal Rules

Finally, on August 7, 2008, the IRS published proposed regulations generally implementing changes to the substantiation and reporting rules for charitable contributions resulting from the American Jobs Creation Act of 2004 and the PPA. REG-140029-07; 73 FR 45908. Among other things, the proposed regulations implement the record-keeping requirements imposed by the PPA for all cash contributions and the new definitions of a "qualified appraisal" and "qualified appraiser" applicable to noncash contributions. Among the provisions of note:

- No deduction is allowed for any contribution of cash, a check, or other monetary gift unless the donor maintains a record of the contribution. The record can be in the form of a bank record or written communication from the donee; the record must show the name of the donee and the date and amount of the contribution. Where a bank statement does not include the name of the donee, a monthly bank statement and a photocopy or image obtained from the bank of the front of the check indicating the name of the donee are satisfactory. However, an exception to the substantiation requirement is provided by the proposed regulations for unreimbursed expenses of less than $250 incurred incident to the rendition of services to a charitable organization.
- As under the present rules, the proposed regulations provide that donors who claim deductions for noncash contributions of less than $250 are required to obtain a receipt from the donee or otherwise keep reliable records of the transaction. The proposed regulations provide that donors who make noncash contributions of $250 or more, but not more than $500, are required only to obtain a contemporaneous written acknowledgment (CWA) and are not required to maintain any other written records.
- For claimed noncash contributions of more than $500 but not more than $5,000, the donor must obtain a CWA and must file a completed Form 8283 (Section A) with the return on which the deduction is claimed.
- For claimed contributions of more than $5,000, in addition to a CWA, a qualified appraisal is generally required, and the donor must file a completed Form 8283 (Section A or B depending on the type of property contributed) with the return on which the deduction is claimed.
- For claimed contributions of more than $500,000, the donor must attach a qualified appraisal to the return.

- A qualified appraisal means an appraisal document prepared by a qualified appraiser in accordance with generally accepted appraisal standards (GAAS). The GAAS are the substance and principles of the Uniform Standards of Professional Appraisal Practice.
- A qualified appraiser must be an individual with verifiable education and experience in valuing the relevant type of property for which the appraisal is performed, which generally requires successful completion of professional or college-level coursework in valuing the relevant type of property and two or more years of experience in valuing such type of property. The relevant type of property is determined by what is customary in the appraisal profession.
- An exception in Code Section 170(f)(11)(A)(ii)(II) overrules the above-stated noncash substantiation requirements if the donor can show that failure to meet the requirements was due to reasonable cause rather than willful neglect. Under the proposed regulations, to satisfy the exception, the donor must submit a detailed explanation with his or her return, stating why the failure to comply was due to reasonable cause and not willful neglect, and he or she must have timely obtained a CWA and a qualified appraisal, if applicable. Consistent with congressional intent of reducing valuation abuses, the "reasonable cause" exception will most likely be strictly construed. In addition, the good-faith omission provision found in Reg. §1.170A-13(c)(4)(H) has been superseded.
- No deduction is allowed for any contribution of clothing or a household item unless it is in good used condition or better. However, this rule does not apply to a contribution of a single item of clothing or a household item for which a donor claims a deduction of more than $500 if the donor submits a qualified appraisal with the return. If the donor claims a deduction of less than $250, the donor must obtain a receipt from the donee or maintain reliable written records of the contribution including a description of the condition of the item.

A public hearing was held on these proposed regulations on January 23, 2009. While, in general, documentation of charitable donations is already required, the detailed mechanism for such substantiation found in these regulations will not come into effect until they are published as final in the Federal Register and will then apply only to contributions occurring after that date.

If you have any questions about this update, please contact your usual Ropes & Gray attorney or one of the following:

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