PART XVII: CHARITABLE GIFTS

7954. What general rules apply to charitable deductions?

An individual may deduct certain amounts for charitable contributions.[1] The amount of a contribution of property other than money is generally equal to the fair market value of the property.[2] However, under certain circumstances, the deduction for a gift of property must be reduced; see Q 7967. For guidelines concerning the determination of fair market value, see Q 7955.

The amount that may be deducted in any one year is subject to certain income percentage limits that depend on the type of property, the type of charitable organization to which the gift is made, and whether the contribution is made directly "to" the charity or "for the use of" the charity (see Q 7964). An individual who does not itemize deductions may not take a charitable deduction.

As a general rule, a gift of less than an individual's entire interest in property is not deductible, but certain exceptions are provided (see Q 7971, Q 7978, and Q 7996).

For a charitable contribution to be deductible, the charity must receive some benefit from the donated property.[3] In addition, the donor cannot expect to receive some economic benefit (aside from the tax deduction) from the charity in return for the donation.[4] For instance, if a taxpayer contributes substantially appreciated property, and later reacquires it from the charity under a prearrangement, or if the charity sells the appreciated property and uses the proceeds to purchase other property from the taxpayer under a similar arrangement, the taxpayer recognizes gain on the contribution.[5] However, where there is no arrangement, and no duty on the part of the charity to return the property to the donor, the taxpayer is entitled to a deduction. In addition, if the charity does return the property, the taxpayer receives a new basis in the property (i.e., the price he paid to reacquire it).[6]

In determining whether a payment that is partly in consideration for goods or services (i.e., a quid pro quo contribution) qualifies as a charitable deduction, the IRS has adopted the 2-part test set forth in *United States v. American Bar Endowment*.[7] In order for a charitable contribution to be deductible, a taxpayer must (1) intend to make a payment in excess of the fair market value of the goods or services received, and (2) actually make a payment in an amount that exceeds the fair market value of the goods or services.[8] The deduction amount may not exceed the excess of (1) the amount of any cash paid and the fair market value of the goods or services; over (2) the fair market value of the goods or services provided in return.[9]

1. IRC Sec. 170(a).
2. Treas. Reg. §1.170A-1(c)(1).
3. See *Winthrop v. Meisels*, 180 F.Supp. 29 (DC NY 1959), aff'd 281 F.2d 694 (2d Cir. 1960).
4. *Stubbs v. U.S.*, 428 F2d 885, 70-2 USTC ¶9468 (9th Cir. 1970), cert. den. 400 U.S. 1009 (1971).
5. *Blake v. Comm.*, 697 F2d 473, 83-1 USTC ¶9121 (2nd Cir. 1982).
6. *Sheppard v. U.S.*, 361 F.2d 972 (Ct. Cl. 1966).
7. 477 U.S. 105 (1986).
8. Treas. Reg. §1.170A-1(h)(1).
9. Treas. Reg. §1.170A-1(h)(2).

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The Tax Court has held that tuition payments paid by taxpayers to religious day schools for the secular and religious education of their children were not deductible as a charitable contribution, including amounts paid to one of the schools for after-school religious education classes.[1]

Where a company transfers an amount it holds on a taxpayer's behalf to a charity: (1) the payment received by the company from the Internet vendor is a rebate (resulting from prior purchases from the vendor) and, thus, is not includable in the taxpayer's gross income; and (2) the amount transferred is a charitable contribution that is deductible by the taxpayer in the year that the company (acting as the taxpayer's agent) transfers the taxpayer's rebate to charity.[2]

Certain goods or services received in return for a charitable contribution may be disregarded for purposes of determining whether a taxpayer has made a charitable contribution, the amount of any charitable contribution, and whether any goods or services have been provided that must be substantiated or disclosed.[3] These items include goods or services that have an insubstantial value under IRS guidelines, certain annual membership benefits received for a payment of $10.40 or less in 2014, and certain admissions to events.[4]

If an otherwise deductible charitable contribution to a university (or other institution of higher learning) directly or indirectly entitles the donor to purchase tickets for athletic events in a stadium of the institution, the contribution is 80 percent deductible, to the extent that the contribution is not a payment for the tickets themselves.[5] The Service has determined that the portion of the payment made to a state university's foundation, for which the donor (an S corporation) received the right to purchase tickets for seating in a skybox at athletic events in an athletic stadium of the university, was deductible under IRC Section 170(l). The Service reasoned that the portion of the payment to the foundation for the right to buy the tickets for seating was considered as being paid for the benefit of the university; thus, 80 percent of such portion was deductible. The Service also stated that the remainder of the payment (consisting of the ticket purchase, the right to use the skybox, the passes to visit the skybox, and the parking privileges) was not deductible.[6]

The IRS determined that contributions made to a university for the purpose of constructing a building providing meeting space for campus organizations qualified for a charitable deduction under IRC Section 170. With the exception of the meeting rooms leased to individual sororities, the facilities in the building would be open to all students. Because the facts indicated that the contributions were indeed gifts to the college, and not gifts to the sororities using the college as a conduit, the Service determined that the requirements of Revenue Ruling 60-37[7] had been satisfied.[8]

1. See *Sklar v. Comm.*, 125 TC 281 (2005); see also *Sklar v. Comm.*, 282 F.3d 610 (9th Cir. 2002), aff'g TC Memo 2000-118.
2. Let. Rul. 200142019. See also Let. Ruls. 200228001, 200230039.
3. Treas. Regs. §§1.170A-1(h), 1.170A-13(f)(8).
4. Treas. Reg. §1.170A-13(f)(8). See also Rev Proc. 2013-35, 2013-47 IRB 537.
5. IRC Sec. 170(l).
6. See TAM 200004001.
7. 1960-2 CB 73.
8. Let. Rul. 9829053. See also Let. Ruls. 200003013, 199929050.

Charitable split dollar. Responding to perceived abuses, in 1999 Congress passed legislation that denies a charitable deduction for certain transfers associated with split dollar insurance arrangements.[1] Charitable split dollar insurance reporting requirements are set forth in Notice 2000-24.[2] For the split dollar rules, see Treasury Regulation Section 1.7872-15.[3] See also *Roark v. Comm.*[4] (denying charitable income tax deductions where charitable split dollar life insurance policies were involved).

7955. How is fair market value of a gift of property determined?

Where property other than money is donated to charity, it is necessary to determine the property's fair market value.

Fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[5]

The willing buyer has often been viewed as a retail consumer, not a middleman.[6] However, in the case of unset gemstones, the ultimate consumer is generally a jeweler engaged in incorporating the gems in jewelry. Therefore, the fair market value is based on the price that a jeweler would pay a wholesaler to acquire such stones.[7]

It is often helpful to rely on expert appraisals in determining the fair market value of property.[8] In fact, an appraisal is required for some gifts (see Q 7956). However, it is possible that the IRS or the Tax Court will consider factors in addition to those considered by the taxpayer's appraiser(s) which may reduce the value of the gift and, thus, the charitable deduction. See *Williford v. Comm.*[9] (involving oversized artwork); *Doherty v. Comm.*[10] (involving artwork of questionable quality and authenticity); *Arbini v. Comm.*[11] (involving newspapers; and holding that the appropriate market for purposes of determining the fair market value of the newspapers is the wholesale market). The IRS has warned taxpayers that some promoters are likely to inflate the value of a charitable deduction for gemstones and lithographs, thus subjecting the taxpayer to higher taxes and possible penalties.[12] Earlier case law has indicated that an auction price may be helpful in determining the value of art.[13]

1. See IRC Sec. 170(a)(10); see also Notice 99-36, 1999-26 CB 1284.
2. 2000-1 CB 952.
3. TD 9092, 68 Fed. Reg. 54336 (9-17-2003); Notice 2002-8, 2002-1 CB 398.
4. TC Memo 2004-271; *Addis v. Comm.*, 2004-2 USTC ¶50,291 (9th Cir. 2004) (cert. denied) aff'g 118 TC 528 (2002); and *Weiner v. Comm.*, TC Memo 2002-153, cert. denied.
5. Treas. Reg. §1.170A-1(c); Rev. Rul. 68-69, 1968-1 CB 80.
6. See *Goldman v. Comm.*, 388 F.2d 476 (6th Cir. 1967).
7. *Anselmo v. Comm.*, 80 TC 872 (1983), aff'd 757 F.2d 1208 (11th Cir. 1985).
8. See *Tripp v. Comm.*, 337 F.2d 432 (7th Cir. 1964); *Est. of DeBie v. Comm.*, 56 TC 876 (1971), acq. 1972-2 CB 1 and 1972-2 CB 2.
9. TC Memo 1992-450.
10. TC Memo 1992-98.
11. TC Memo 2001-141.
12. IR 83-89.
13. *Mathias v. Comm.*, 50 TC 994 (1968), acq. 1969-2 CB xxiv. But see *McGuire v. Comm.*, 44 TC 801 (1965), acq. in result 1966-2 CB 6.

The burden of proof is on the taxpayer to establish fair market value.[1] Evidence of what an organization is willing to pay for copies of a manuscript is evidence of the value of the original manuscript, but it is not conclusive.[2]

The price paid for hospital equipment purchased from a bankruptcy trustee was not determinative of the equipment's fair market value; instead the substantially higher appraisal established the value of the donated equipment.[3]

For property that is transferred to a charity and subject to an option to repurchase, fair market value under IRC Section 170 is the value of the property upon the expiration of the option.[4] See Q 7965 regarding when a deduction is permitted for a charitable contribution.

Guidelines for valuing property generally can be found in Revenue Procedure 66-49,[5] and Announcement 2001-22.[6] See also *Crocker v. Comm.*[7] (describing the three methods of determining fair market value of commercial real estate: (1) the replacement method, (2) the comparable sales method, and (3) the income capitalization method).

No charitable deduction is allowed for a contribution of clothing or a household item unless the property is in good used condition or better. Regulations may deny a deduction for a contribution of clothing or a household item which has minimal monetary value. These rules do not apply to a contribution of a single item if a deduction of more than $500 is claimed and a qualified appraisal is included with the return. Household items include furniture, furnishings, electronics, linens, appliances, and similar items; but not food, art, jewelry, and collections.[8]

Planning Point: It is a good idea to take photographs of these items prior to donation to document that they are in good used condition or better.

Intellectual property. The American Jobs Creation Act of 2004 (AJCA 2004) provides strict rules for charitable donations of patents and intellectual property.[9] For the temporary regulations providing guidance for the filing of information returns by donees relating to qualified intellectual property contributions, see Temporary Treasury Regulation Section 1.6050L-2T; TD 9206[10]; and Announcement 2005-49.[11]

1. See *Weil v. Comm.*, TC Memo 1967-78; *Schapiro v. Comm.*, TC Memo 1968-44.
2. *Barringer v. Comm.*, TC Memo 1972-334. See also *Kerner v. Comm.*, TC Memo 1976-12.
3. *Herman v. U.S.* and *Brown v. U.S.* (consolidated actions), 99-2 USTC ¶50,889 (E.D. Tenn. 1999).
4. TAM 9828001.
5. 1966-2 CB 1257, as modified by Rev. Proc. 96-15, 1996-2 CB 627.
6. 2001-11 IRB 895.
7. TC Memo 1998-204.
8. IRC Sec. 170(f)(16), as added by PPA 2006.
9. See IRC Secs. 170(e)(1)(B), 6050L; IRC Sec. 170(m). See also Rev. Rul. 2003-28, 2003-11 IRB 594; Notice 2005-41, 2005-23 IRB 1203; Notice 2004-7, 2004-3 IRB 310; and IRS News Release IR-2003-141 (12-22-2003).
10. 70 Fed. Reg. 29450 (5-23-2005).
11. 2005-29 IRB 119. See also Notice 2005-41, 2005-23 IRB 1203.

7956. What verification is required to substantiate a deduction for a charitable contribution of money? What enhanced recordkeeping requirements apply for contributions of money?

A charitable contribution is allowable as a deduction only if verified as required under regulations.[1]

A charitable deduction is not allowed for any contribution of a check, cash, or other monetary gift unless the donor retains a bank record or a written communication from the charity showing the name of the charity and the date and the amount of the contribution.[2]

The IRS has issued guidance on how charitable contributions made by payroll deduction may meet the requirements of IRC Section 170(f)(17). The Service clarified that unlike IRC Section 170(g)(8), which only applies to contributions of $250 or more (see Q 7957), IRC Section 170(f)(17) applies to *any* contribution of a cash, check, or other monetary gift. For a charitable contribution made by payroll deduction, a pay stub, Form W-2, or other employer-furnished document that sets forth the amount withheld for payment to a donee organization, along with a pledge card prepared by or at the direction of the donee organization, will be deemed to be a written communication from the donee organization for this purpose.[3]

7957. What verification is required to substantiate a deduction for a charitable contribution of $250 or more?

Charitable contributions of $250 or more (whether in cash or property) generally must be substantiated by a contemporaneous written acknowledgment of the contribution supplied by the charitable organization.[4]

The acknowledgment must include the following information: (1) the amount of cash contributed and a description (excluding value) of any property contributed, (2) a statement of whether the charitable organization provided any goods or services in consideration for the contribution, and (3) a description and good faith estimate of the value of any such goods or services, or (4) a statement to the effect that the goods or services provided consisted solely of intangible religious benefits.[5] The acknowledgment will be considered "contemporaneous" if it is obtained by the taxpayer on or before the earlier of (1) the date the taxpayer files his return for the year, or (2) the due date (including extensions) for filing the return.[6] Substantiation is not required if the information is reported on a return filed by the charitable organization.[7] An organization can provide the acknowledgement electronically, such as via an e-mail addressed to the donor.[8]

1. IRC Sec. 170(a)(1).
2. IRC Sec. 170(f)(17), as added by PPA 2006.
3. Notice 2006-110, 2006-51 IRB 1127.
4. IRC Sec. 170(f)(8)(A).
5. IRC Sec. 170(f)(8)(B); Treas. Reg. §1.170A-13(f)(2).
6. IRC Sec. 170(f)(8)(C); Treas. Reg. §1.170A-13(f)(3).
7. IRC Sec. 170(f)(8)(D).
8. Publication 1771.

For contributions of property other than money, the taxpayer is generally required to maintain a receipt from the donee organization showing the name of the donee, the date and location of the contribution, and a description of the property. The value need not be stated on the receipt.[1]

Generally, charitable contributions of $250 or more made by an employee through payroll deduction may be substantiated with a combination of two documents: (1) a pay stub, Form W-2, or a document furnished by the taxpayer's employer that sets forth the amount withheld from the taxpayer's wages, *and* (2) a pledge card or document prepared by or at the direction of the donee organization that states that the organization does not provide goods or services as whole or partial consideration for any contributions made by payroll deduction. The amount withheld from each paycheck is treated as a separate contribution. Therefore, the substantiation requirements of IRC Section 170(f)(8) will not apply to such contributions unless the employer deducts $250 or more from a single paycheck for the purpose of payment to a donee organization.[2]

Certain goods or services received by a contributing taxpayer (quid pro quo contributions) may be disregarded for substantiation purposes (see Q 7954).

7958. What verification is required to substantiate a deduction for a charitable contribution of $500 or more?

A deduction for a contribution of property with a claimed value exceeding $500 will generally be denied to any individual, partnership, or corporation that fails to satisfy the property description *and* appraisal requirements.[3] However, there are two exceptions to the general rule. Under the first exception, the appraisal requirements, for property valued at more than $5,000 and at more than $500,000 (see Q 7959 and Q 7960), do not apply to readily valued property, such as cash, publicly traded securities, and any "qualified vehicle" (see Q 7962) for which an acknowledgment is provided. Under the second exception, the general rule does not apply if it is shown that the failure to meet the requirements is due to reasonable cause and not to willful neglect.[4] For purposes of determining the thresholds, property (and all similar items of property) donated to one charity will be treated as one property.[5]

If the claimed value of the donated property exceeds $500, the taxpayer must include with the tax return a *description of the property*.[6] Specifically, the taxpayer must complete and attach to his tax return Form 8283 (Noncash Charitable Contributions), which includes a description of the property and an acknowledgment by the organization of the amount and value of the gift. (The property description requirement does not apply to a C corporation that is not a personal service corporation or a closely held C corporation). In addition, a *qualified appraisal* must be obtained when the claimed value of the property exceeds $5,000 (see Q 7959) or $500,000 (see Q 7960).[7]

1. Treas. Reg. §1.170A-13(b)(1).
2. Treas. Reg. §1.170A-13(f)(11).
3. IRC Sec. 170(f)(11)(A)(i).
4. IRC Sec. 170(f)(11)(A)(ii).
5. IRC Sec. 170(f)(11)(F).
6. IRC Sec. 170(f)(11)(B).
7. IRC Secs. 170(f)(11)(C), 170(f)(11)(D).

Under the special rule for pass-through entities (partnerships or S corporations), the above requirements will be applied at the entity level; however, the deduction will be denied at the partner or shareholder level.[1]

7959. What verification is required to substantiate a deduction for a charitable contribution of $5,000 or more?

In addition to satisfying the requirements described above, the *qualified appraisal* requirement for contributions of property for which a deduction of more than $5,000 is claimed is met if the individual, partnership, or corporation: (1) obtains a qualified appraisal of the property; and (2) attaches to the tax return information regarding the property and the appraisal (as the Secretary may require).[2] Donors who claim a deduction for a charitable gift of property (except publicly traded securities) valued in excess of $5,000 ($10,000 for nonpublicly traded stock) are required to obtain a qualified appraisal report, attach an appraisal summary (containing the information specified in regulations) to their return for the year in which the deduction is claimed, and maintain records of certain information related to the contribution.[3]

A taxpayer who failed to obtain such an appraisal for a gift of nonpublicly traded stock was denied a deduction, even though the IRS did not dispute the value of the claimed gift.[4] The Tax Court distinguished its holding in *Hewitt* from a 1993 decision in which it had permitted a deduction to a taxpayer who substantially, though not fully, complied with the appraisal requirement. In the earlier ruling, the taxpayer had obtained an appraisal from a qualified appraiser, completed and attached Form 8283, but had failed to include all the information required of an appraisal summary.[5] The Fourth Circuit Court of Appeals concurred in the Tax Court's analysis, stating that "*Bond* does not suggest that a taxpayer who completely fails to observe the appraisal regulations has substantially complied with them." The Fourth Circuit further stated: "[I]n *Bond*, the taxpayers made a good faith effort to comply with the appraisal requirement. In the case at bar, the Hewitts utterly ignored the appraisal requirement." (For more information about the appraisal and summary, see the instructions for Schedule A, Form 1040, and IRS Publication 526, Charitable Contributions.)

A qualified appraiser must not be the taxpayer, a party to the transaction in which the taxpayer acquired the property, the donee, an employee of any of the above, any other person who might appear not to be totally independent, or one who is regularly used by the taxpayer, a party to the transaction or the charity, and doesn't perform a majority of his/her appraisals for other persons.[6] See e.g., *Davis v. Comm.*[7] (appraisals upheld where appraiser was determined to be financially independent of the donor, and no conspiracy or collusive relationship was established).

1. IRC Sec. 170(f)(11)(G).
2. IRC Secs. 170(f)(11)(C), 170(f)(11)(E).
3. Treas. Reg. §1.170A-13(c)(2).
4. *Hewitt v. Comm.*, 109 TC 258 (1997), *aff'd*, 166 F.3d 332 (4th Cir. 1998).
5. See *Bond v. Comm.*, 100 TC 32 (1993).
6. Treas. Reg. §1.170A-13(c)(5)(iv).
7. TC Memo 1999-250.

In *Wortmann v. Comm.*,[1] the Tax Court substantially reduced the taxpayers' charitable deduction (from $475,000 to $76,200) after it concluded that the property appraisal was dubious and not well supported by valuation methodology.

The appraiser cannot base his fee on a percentage of the appraisal value, unless the fee is based on a sliding scale that is paid to a generally recognized association regulating appraisers.[2]

If the donor gives similar items of property (such as books, stamps, paintings, etc.) to the same donee during the taxable year, only one appraisal and summary is required. If similar items of property are given during the same taxable year to several donees, and the aggregate value of the donations exceeds $5,000, a separate appraisal and summary must be made for each donation.[3] The appraisal summary is signed and dated by the donee as an acknowledgement of the donation.[4]

Taxpayers making contributions of art appraised at $50,000 or more may wish to request from the IRS a "Statement of Value" (which appears to be the equivalent of a letter ruling as to the value of a particular transfer that is made at death, by inter vivos gift, or as a charitable contribution).[5] The request must include specified information, including a description of the artwork, the cost, manner and date of acquisition, and a copy of an appraisal (which meets requirements set forth in Section 8 of the revenue procedure). The user fee for obtaining a Statement of Value is $2,500 for up to three items of art.[6]

The regulations state that taxpayers need not obtain a qualified appraisal of securities whose claimed value exceeds $5,000 if the donated property meets the definition of "publicly traded securities." Publicly traded securities are those (1) listed on a stock exchange in which quotations are published on a daily basis or (2) regularly traded in a national or regional over-the-counter market for which published quotations are available.[7]

Securities that do not meet the above requirements may still be considered publicly traded securities if they meet the following five requirements:

(1) the issue is regularly traded during the computational period in a market that is reflected by the existence of an interdealer quotation system for the issue;

(2) the issuer or its agent computes the issue's average trading price for the computational period;

(3) the average price and total volume of the issue during the computational period are published in a newspaper of general circulation throughout the U.S. not later than the last day of the month following the end of the calendar quarter in which the computational period ends;

1. TC Memo 2005-227.
2. Treas. Reg. §1.170A-13(c)(6).
3. Treas. Reg. §1.170A-13(c)(4)(iv)(B).
4. Treas. Reg. §1.170A-13(c)(4)(iii).
5. See Rev. Proc. 96-15, 1996-1 CB 627, as modified by Announcement 2001-22, 2001-11 IRB 895.
6. Rev. Proc. 96-15, above, Sec. 7.01(2).
7. Treas. Reg. §1.170A-13(c)(7)(ix)(A).

(4) the issuer or its agent keeps books and records that list for each transaction during the computational period involving each issue covered by this procedure the date of the settlement of the transaction, the name and address of the broker or dealer making the market in which the transaction occurred, and the trading price and volume; and

(5) the issuer or agent permits the IRS to review the books and records.[1]

The "computational period" is weekly during October through December and monthly during January through September. Taxpayers who are exempted from obtaining a qualified appraisal because the securities meet these five requirements must attach a partially completed appraisal summary (section B of Form 8283) to the appropriate returns. The summary must contain the information required by parts I and II of the Form.[2]

7960. What verification is required to substantiate a deduction for a charitable contribution of $500,000 or more?

For property contributions for which a deduction of more than $500,000 is claimed, the individual, partnership, or corporation must attach the qualified appraisal of the property to the tax return for the taxable year.[3]

7961. What requirements apply if a taxpayer makes a donation to charity that is subsequently disposed of by the charity within three years of the donation?

If the charitable donee disposes of "charitable deduction property" that is subject to the rules set forth in Q 7959 or Q 7960 within three years after its receipt, the donee must provide an information return to the IRS. Charitable deduction property includes any property (other than publicly traded securities) for which a charitable deduction was taken under IRC Section 170 where the claimed value of the property (plus the claimed value of all similar items of property donated by the donor to one or more donees) was in excess of $5,000.[4] The return must show the name, address, and taxpayer identification number of the donor, a description of the property, the date of the contribution, the date of disposition, and the amount received on disposition. A copy of the return must be provided to the donor. Failure to file the return may subject the donee to a penalty.[5] However, final regulations will provide that donee reporting is not required upon disposition of donated property within three years of receipt if the value of the property (as stated in the donor's appraisal summary) was not in excess of $5,000 at the time the donee signed the summary. In addition, no reporting will be required if the donee consumes or distributes property without receiving anything in exchange and the consumption or distribution is in furtherance of the donee's charitable purpose (such as the distribution of medical supplies by a tax-exempt relief agency).[6]

1. Treas. Reg. §1.170A-13(c)(7)(ix)(B).
2. Ann. 86-4, 1986-4 IRB 51.
3. IRC Secs. 170(f)(11)(D), 170(f)(11)(E).
4. IRC Sec. 6050L.
5. IRC Sec. 6721; Treas. Reg. §1.6050L-1. See SCA 200101031.
6. Instructions for IRS Form 8282

7962. What verification is required to substantiate a deduction for a charitable contribution of a qualified vehicle?

General

No deduction is allowed for a contribution of a "qualified vehicle" (see below) with a claimed value of more than $500 *unless*:

(1) the taxpayer substantiates the contribution by a "contemporaneous" (see below) written acknowledgement of the contribution by the charity that meets certain requirements (see below), and includes the acknowledgement with the tax return that includes the deduction; *and*

(2) if the charity sells the vehicle without any "significant intervening use or material improvement" (see below) of the vehicle by the charity, the amount of the deduction does not exceed the gross proceeds received from the sale ("gross proceeds limitation").[1]

Note that the substantiation rules under IRC Section 170(f)(8)–applicable to contributions of more than $250 (see Q 7956)–do *not* apply to a contribution described above.[2]

The *acknowledgment* must include the following information:

(A) the name and taxpayer identification number of the donor;

(B) the vehicle identification number (or similar number);

(C) in the case of a "qualified vehicle" to which (2), above, applies: (i) a certification that the vehicle was sold in an arm's length transaction between unrelated parties; (ii) the gross proceeds from the sale; *and* (iii) a statement that the deductible amount may not exceed the amount of such gross proceeds;

(D) in the case of a "qualified vehicle" to which (2), above, does *not* apply: (i) a certification of the intended use or material improvement of the vehicle and the intended duration of such use; *and* (ii) a certification that the vehicle would not be transferred in exchange for money, other property, or services before completion of the use or improvement;

(E) whether the donee organization provided any goods or services in consideration, in whole or in part, for the qualified vehicle; *and*

(F) a description and good faith estimate of the value of any goods or services referred to in (E), above, or if such goods or services consist solely of intangible religious benefits, a statement to that effect.[3]

1. IRC Sec. 170(f)(12)(A).
2. IRC Sec. 170(f)(12)(A)(i).
3. IRC Secs. 170(f)(12)(B).

An acknowledgement is considered "contemporaneous" if the charity provides it within 30 days of the sale of the qualified vehicle, *or* in the case of an acknowledgement including a certification as described in (D), above, the contribution of the qualified vehicle.[1]

The term "qualified vehicle" means any motor vehicle manufactured primarily for use on public streets, roads, and highways, boat, or airplane. But the term does not include any property described in IRC Section 1221(a)(1) (i.e., inventory).[2]

A charity is required to provide an acknowledgement containing the required information to the Secretary. The information must be provided at the time and in the manner prescribed by the Secretary.[3] A charity that knowingly furnishes a false or fraudulent acknowledgment, or that knowingly fails to furnish such an acknowledgment in the manner, at the time, and showing the required information (see above), will be subject to a penalty.[4]

The Secretary will prescribe such regulations or other guidance (see below) as may be necessary to carry out the purposes of these requirements. In addition, the Secretary may prescribe regulations or other guidance that exempt sales of vehicles by the charity that are in direct furtherance of the charity's charitable purposes from the requirements that (1) the donor may not deduct an amount in excess of the gross proceeds from the sale, and (2) the charity certify that the vehicle will not be transferred in exchange for money, other property, or services before completion of a significant use or material improvement by the charity.[5] The Conference Committee conferees intend that such guidance may be appropriate, for example, if an organization directly furthers its charitable purposes by selling automobiles to needy persons at a price significantly below fair market below. The conferees further intend that the Service strictly construe the requirement of "significant use or material improvement."[6]

Charities should report the contribution of qualified vehicles on IRS Form 1098-C (Contributions of Motor Vehicles, Boats, and Airplanes). Form 1098-C may also be used to provide the donor with a contemporaneous written acknowledgement of the contribution.

Interim Guidance on Qualified Vehicle Contributions

The Service has provided interim guidance regarding charitable contributions of qualified vehicles.[7] The guidance is generally effective for contributions made after 2004. The rules stated below apply until regulations become effective.

1. IRC Sec. 170(f)(12)(C).
2. IRC Sec. 170(f)(12)(E).
3. IRC Sec. 170(f)(12)(D).
4. IRC Sec. 6720.
5. IRC Sec. 170(f)(12)(F).
6. H.R. Conf. Rep. No. 108-755.
7. Notice 2005-44, 2005-25 IRB 1287. Notice 2006-001 supplements Notice 2005-44.

Deductions Exceeding $500

Disposition or use by charity. If the claimed value of a donated "qualified vehicle" (see above) exceeds $500, the amount of the deduction may be limited depending on the use of the qualified vehicle by the charity:

(1) If the qualified vehicle is sold by the charity without a significant intervening use or material improvement by the charity, then (except as provided in item (3), below) the deduction claimed by the donor may *not* exceed the gross proceeds received from the sale of the qualified vehicle ("the gross proceeds limitation"). The Service cautions that in no event may the deduction for a donated vehicle exceed the amount otherwise allowable under IRC Section 170(a) (i.e., the fair market value).

(2) If the charity makes a significant intervening use of or material improvement to a qualified vehicle, the donor is not subject to the gross proceeds limitation. However, the deduction claimed by the donor may not exceed the fair market value of the qualified vehicle.

(3) The gross proceeds limitation in item (1), above, does *not* apply to: (a) a sale occurring after 2004, of a qualified vehicle to a needy individual at a price significantly below fair market value; or (b) a gratuitous transfer to a needy individual, in direct furtherance of a charity's charitable purpose of relieving the poor and distressed or the underprivileged who are in need of a means of transportation (pursuant to IRC Section 170(f)(12(F)).[1] Mere application of the proceeds from the sale of a qualified vehicle to a needy individual to any charitable purpose does not directly further a charity's charitable purpose.[2]

For items (1), (2) and (3), above, the donor must obtain an acknowledgment from the charity that meets the contemporaneous written acknowledgment requirements below. Furthermore, with respect to items (2) and (3), above, the donor must also substantiate the fair market value in the manner described below (see "Fair Market Value").[3]

Contemporaneous written acknowledgment. A donor must obtain a contemporaneous written acknowledgment from the charity *and* include the acknowledgment with the tax return on which the deduction is claimed.[4] All acknowledgments must include the name and taxpayer identification number of the donor, the vehicle identification number, and the date of the contribution. Additional information is required depending on the use of the qualified vehicle by the charity, as stated below:

(1) For a contribution of a qualified vehicle that is sold by the charity without any significant intervening use or material improvement by the charity in a sale, the acknowledgment must also contain: (a) the date the qualified vehicle was sold;

1. See H.R. Conf. Rep. No. 755, 108th Cong., 2nd Session 750 (2004).
2. Notice 2005-44, above. Notice 2006-001 supplements Notice 2005-44.
3. Notice 2005-44, above. Notice 2006-001 supplements Notice 2005-44.
4. IRC Sec. 170(f)(12).

(b) a certification that the qualified vehicle was sold in an arm's length transaction between unrelated parties; (c) a statement of the gross proceeds from the sale; and (d) a statement that the deductible amount may not exceed the amount of the gross proceeds. The acknowledgment is considered to be contemporaneous if the charity furnishes the acknowledgment to the donor no later than 30 days after the date of the sale.

(2) For a contribution of a qualified vehicle for which the charity intends to make a significant intervening use of or material improvement to, the acknowledgment must also contain (a) a certification and detailed description of (i) the intended significant intervening use by the charity and the intended duration of the use, or (ii) the intended material improvement by the charity; *and* (b) a certification that the qualified vehicle will not be sold before completion of the use or improvement. The acknowledgment is considered contemporaneous if the charity furnishes the acknowledgment to the donor within 30 days of the date of the contribution.

(3) For a contribution of a qualified vehicle that is (a) sold at a price significantly below fair market value or (b) gratuitously transferred to a needy individual, the acknowledgment also must contain a certification that: (i) the charity will sell the qualified vehicle to a needy individual at a price significantly below fair market value (or, if applicable, that the charity gratuitously will transfer the qualified vehicle to a needy individual); *and* (ii) that the sale (or transfer) will be in direct furtherance of the charity's charitable purpose of relieving the poor and distressed or the underprivileged who are in need of a means of transportation. The acknowledgment is considered contemporaneous if the charity furnishes the acknowledgment to the donor no later than 30 days after the date of the contribution.[1]

Fair Market Value

A donor claiming a deduction for the fair market value of a qualified vehicle must be able to substantiate the "fair market value." Fair market value 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 each having reasonable knowledge of relevant facts.[2]

A reasonable method of determining the fair market value of a qualified vehicle is by reference to an established used vehicle pricing guide. Many factors must be taken into account when using a used vehicle pricing guide to determine fair market value. A used vehicle pricing guide establishes the fair market value of a particular vehicle *only if* the guide lists a sales price for a vehicle that is: the same make, model, and year; and sold in the same area, in the same condition, with the same or substantially similar options or accessories, and with the same or substantially similar warranties or guarantees as the vehicle in question.[3]

1. Notice 2005-44, above. Notice 2006-001 supplements Notice 2005-44.
2. Treas. Reg. §1.170A-1(c)(2).
3. See, e.g., Rev. Rul. 2002-67, 2002-47 IRB 873.

Treasury intends to issue regulations under IRC Section 170 clarifying that the dealer retail value listed in a used vehicle pricing guide for a particular vehicle is *not* an acceptable measure of fair market value of a similar vehicle. The regulations will clarify that for contributions made after June 3, 2005 and before the date regulations become effective, an acceptable measure of the fair market value of a vehicle is an amount that does not exceed the price listed in a used vehicle pricing guide for a private party sale of a similar vehicle. The regulations limiting the fair market value of a vehicle to an amount that does not exceed the private party sale price will apply to contributions of vehicles made after June 3, 2005. In addition, Treasury will consider whether other values (e.g., the dealer trade-in value) are appropriate measures of the fair market value of a vehicle (for purposes of IRC Section 170). Any regulations limiting the fair market value of a vehicle to an amount less than the private party sale value will not apply to contributions made prior to the date that regulations to that effect become effective.[1]

Qualified Appraisal

A "qualified appraisal" is required for a deduction in excess of $5,000 for a qualified vehicle if the deduction is not limited to gross proceeds from the sale of the vehicle.[2] For the explanation of what constitutes a "qualified appraisal," see Q 7956 ("Contributions Exceeding $5,000").[3]

Deductions of $500 or Less

Contemporaneous written acknowledgment. A contribution of a qualified vehicle with a claimed value of at least $250 must be substantiated by a contemporaneous written acknowledgment of the contribution by the charity. For a qualified vehicle with a claimed value of at least $250 but not more than $500, the acknowledgment must contain the following information: (1) the amount of cash and a description (but not value) of any property other than cash contributed; (2) whether the charity provided any goods or services in consideration, in whole or in part, for the cash or property contributed; and (3) a description and good faith estimate of the value of any goods or services provided by the charity in consideration for the contribution (or, if such goods or services consist solely of intangible religious benefits, a statement to that effect).[4]

To satisfy the contemporaneous requirement, the acknowledgment must be obtained by the donor on or before the earlier of the date on which the donor files a return for the taxable year in which the contribution was made, *or* the due date (including extensions) of that return.

Sale of qualified vehicle yields gross proceeds of $500 or less. If a donor contributes a qualified vehicle that is subsequently sold (in a sale not described in item (3), above) without any significant intervening use or material improvement by the charity, *and* the sale yields gross proceeds of $500 or less, the donor may be allowed a deduction equal to the *lesser* of: (1) the fair market value of the qualified vehicle on the date of the contribution; *or* (2) $500 (subject to the terms

1. Notice 2005-44, above.
2. IRC Sec. 170(f)(11)(A)(ii)(I).
3. Notice 2005-44, above.
4. IRC Sec. 170(f)(8).

and limitations of IRC Section 170). Under these circumstances, the donor must substantiate the fair market value, and, if the fair market value is $250 or more, must substantiate the contribution with an acknowledgment that meets the requirements of IRC Section 170(f)(8).[1]

Other Guidance

The Service has released a series of questions and answers concerning the new rules for vehicle donations.[2] In addition, the Service has provided information reporting guidance to donee organizations that receive contributions of certain motor vehicles, boats, and airplanes.[3] For additional information on vehicle donations, see Publication 4303, *A Donor's Guide to Vehicle Donations*, and Publication 4302, *A Charity's Guide to Vehicle Donations*.

The Service has announced its awareness of questionable practices involving charities selling donated vehicles at auction price, but claiming that the sales were to needy individuals at prices significantly below fair market value. By so doing, these charities have claimed that the sales trigger an exception to the general rule that the deduction allowed to the donor is limited to the proceeds from the charity's sale. The Service's position is that vehicles sold at auction are not sold at prices significantly below fair market value. Therefore, the Service will not treat vehicles sold at auction as qualifying for the exception for sales to needy individuals at prices below fair market value.[4]

The charity does not need to sell the vehicle in 2014, for example, in order for the donor who donated the vehicle in 2014 to receive a deduction for 2014. A taxpayer can take a charitable contribution deduction only for the year the vehicle is transferred to the charity, even if the vehicle is not sold by the charity until a later year. However, a taxpayer cannot take a charitable contribution deduction of $500 or more for a vehicle donation unless the taxpayer has received a written acknowledgment of the donation from the charity and attached the acknowledgment to the return. If the taxpayer receives the written acknowledgment after filing the tax return for the year of the donation, the taxpayer may, after receiving the acknowledgment, file an amended return for that year and claim the deduction on the amended return. The taxpayer must attach the acknowledgment to the amended return.[5]

7963. What penalty applies if a taxpayer overvalues property donated to charity?

If a taxpayer underpays his tax because of a substantial valuation misstatement of property donated to charity, he may be subject to a penalty of 20 percent of the underpayment attributable to the misstatement.[6] However, this penalty applies only if the underpayment attributable to the misstatement exceeds $5,000 ($10,000 for a corporation other than an S corporation or a personal holding company).[7] A "substantial valuation misstatement" exists if the value claimed is

1. Notice 2005-44, above.
2. See IRS Information Letter INFO 2005-0129.
3. See Notice 2006-1, 2006-4 IRB 347.
4. IR-2005-145.
5. IR-2005-149.
6. IRC Secs. 6662(a), 6662(b)(3).
7. See IRC Sec. 6662(d).

150 percent or more of the amount determined to be correct.[1] If the value claimed is 200 percent or more of the amount determined to be correct, there is a "gross valuation misstatement," which is subject to a 40 percent underpayment penalty.[2]

For guidance on the circumstances under which the disclosure on a taxpayer's return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under IRC Section 6662(d), see Revenue Procedure 2005-75.[3]

7964. What are the income percentage limits for deduction of a charitable contribution?

The IRC makes a distinction between gifts "to" a charitable organization and gifts "for the use of" a charitable organization.

50 percent limit. Generally, an individual is allowed a charitable deduction of up to 50 percent of his adjusted gross income for any contribution (other than certain property, see Q 7967) *to*: churches; schools; hospitals or medical research organizations; organizations that normally receive a substantial part of their support from federal, state, or local governments or from the general public and that aid any of the above organizations; federal, state, and local governments. Also included in this list is a limited category of private foundations (i.e., private operating foundations and conduit foundations)[4] that generally direct their support to public charities. The above organizations are often referred to as "50 percent -type organizations."[5]

30 percent limit. The deduction for contributions of most long-term capital gain property to the above organizations, contributions *for the use of* any of the above organizations, as well as contributions (other than long-term capital gain property) *to* or *for the use of* any other types of charitable organizations (i.e., most private foundations) is limited to the lesser of (a) 30 percent of the taxpayer's adjusted gross income, or (b) 50 percent of adjusted gross income minus the amount of charitable contributions allowed for contributions to the 50 percent -type charities.[6]

20 percent limit. The deduction for contributions of long-term capital gain property to most private foundations (see Q 7968) is limited to the lesser of (a) 20 percent of the taxpayer's adjusted gross income, or (b) 30 percent of adjusted gross income minus the amount of charitable contributions allowed for contributions to the 30 percent -type charities.[7]

Deductions denied because of the 50 percent, 30 percent, or 20 percent limits may be carried over and deducted over the next five years, retaining their character as 50 percent, 30 percent, or 20 percent type deductions.[8]

1. IRC Sec. 6662(e)(1)(A), as amended by PPA 2006.
2. IRC Sec. 6662(h)(2)(A)(i), as amended by PPA 2006.
3. 2005-50 IRB 1137.
4. See IRC Sec. 170(b)(1)(E).
5. IRC Sec. 170(b)(1)(A).
6. IRC Secs. 170(b)(1)(B), 170(b)(1)(C).
7. IRC Sec. 170(b)(1)(D).
8. IRC Secs. 170(d)(1), 170(b)(1)(D)(ii); Treas. Reg. §1.170A-10(b).

Gifts are "to" a charitable organization if made directly to the organization. Even though the gift may be intended to be used by the charity, and the charity may use it, if it is given *directly* to the charity, it is a gift to the charity and not "for the use of" the charity, for purposes of the deduction limits. Unreimbursed out-of-pocket expenses incurred on behalf of an organization (e.g., unreimbursed travel expenses of volunteers) are deductible as contributions "to" the organization if they are directly related to performing services for the organization (and, in the case of travel expenses, there is no significant element of personal pleasure, recreation, or vacation in such travel).[1]

"For the use of" applies to indirect contributions to a charitable organization.[2] The term "for the use of" does not refer to a gift of the right to use property. Such a gift would generally be a nondeductible gift of less than the donor's entire interest (see Q 7971).

7965. When is the deduction for charitable contributions taken?

Generally, the deduction for a contribution is taken in the year the gift is made.[3] However, in the case of a contribution of a future interest in tangible personal property (e.g., stamps, artwork, etc.), the contribution is considered made (and the deduction allowable) only "when all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired" or are held by parties unrelated to the donor.[4]

This rule does not apply to gifts of undivided present interests, or to gifts of future interests in real property or in intangible personal property.[5] The grant of stock options by a company to a charitable trust resulted in a deduction in the year in which the options were exercised.[6] Where real estate was transferred to a charity and subject to an option to repurchase, the IRS determined that fair market value under IRC Section 170 would be the value of the property *upon the expiration of the option*.[7] A fixture that is to be severed from real property is treated as tangible personal property.[8] The deduction for a charitable contribution made by an accrual basis S corporation is properly passed through to shareholders and taken in the year that the contribution is actually paid.[9]

See Q 7971 for an explanation of the deduction for gifts of partial interests, and Q 7973 to Q 7997 for an explanation of gifts through charitable trusts.

7966. Can an individual deduct the fair market value of appreciated real estate or intangible personal property such as stocks or bonds given to a charity?

If an individual makes a charitable contribution to a public charity of real property or intangible personal property, the sale of which would have resulted in long-term capital gain

1. IRC Sec. 170(j); *Rockefeller v. Comm.*, 676 F.2d 35 (2nd Cir. 1982), aff'g 76 TC 178 (1981), acq. in part 1984-2 CB 2; Rev. Rul. 84-61, 1984-1 CB 39. See Rev. Rul. 58-279, 1958-1 CB 145.
2. See Treas. Reg. §1.170A-8(a)(2). See *Davis v. United States*, 495 U.S. 472 (1990).
3. IRC Sec. 170(a)(1).
4. IRC Sec. 170(a)(3). See also Treas. Reg. §1.170A-5.
5. Treas. Regs. §§1.170A-5(a)(2), 1.170A-5(a)(3).
6. Let. Ruls. 200202034, 8849018.
7. TAM 9828001.
8. IRC Sec. 170(a)(3).
9. TAM 200004001. See also Rev. Rul. 2000-43, 2000-2 CB 333.

(see below), he is generally entitled to deduct the full fair market value of the property, but the deduction for the gift is limited to the lesser of 30 percent of adjusted gross income or the unused portion of the 50 percent limit (see Q 7964).[1] See Q 7967 for the rules that apply to gifts of tangible personal property, and Q 7968 regarding gifts to private foundations.

A deduction denied because it exceeds 30 percent of the individual's adjusted gross income may be carried over and treated as a contribution of capital gain property in each of the next five years.[2]

> *Example*: In 2013, Mr. Copeland had adjusted gross income of $600,000. He made a charitable contribution of long-term capital gain stock worth $200,000 to his church. His deduction is limited to $180,000 (30 percent of $600,000). In 2014, Mr. Copeland's adjusted gross income is $700,000. He contributes $100,000 worth of long-term capital gain bonds to the church. He may deduct $120,000 in 2014 ($100,000 plus $20,000 carried forward from 2013), since the total does not exceed 30 percent of his adjusted gross income for 2014 ($210,000).

An individual may elect to take a gift of long-term capital gain property into account at its adjusted basis instead of its fair market value; if he does so, the income percentage limit for the contribution is increased to 50 percent instead of 30 percent. However, such an election applies to all such contributions made during the taxable year.[3] The election is generally irrevocable.[4]

If the charitable contribution is of property that, if sold at the time of the contribution, would result in income that would not otherwise qualify for long-term capital gain treatment (e.g., short-term capital gain), the deduction must be reduced by the amount of gain that would not be long-term capital gain.[5] If the entire gain would be income other than long-term capital gain (see above), the allowable deduction would be limited to the taxpayer's adjusted basis in the contributed property.

Special rules apply to charitable contributions of S corporation stock in determining whether gain on the stock would have been long-term capital gain if the stock were sold by the taxpayer.[6]

Donors making charitable contributions of the long-term capital gain portion of futures contracts must mark the contracts to market as of the dates the contracts are transferred to the donee and recognize the accrued long-term capital gains as income.[7] The amount of taxable gain or deductible loss recognized by the transferor at the time of the charitable transfer equals the difference between the fair market value of the futures contract at the time of the transfer and the transferor's tax basis in the futures contract, as adjusted under IRC Section 1256(a)(2), to account for gains and losses already recognized in prior tax years under the mark to market rules.[8]

1. See IRC Sec. 170(b)(1)(C); Treas. Reg. §1.170A-8(d)(1).
2. IRC Secs. 170(b)(1)(C); Treas. Reg. §1.170A-10(c).
3. IRC Secs. 170(b)(1)(C)(iii), 170(e)(1).
4. *Woodbury v. Comm.*, 900 F2d 1457,90-1 USTC ¶50,199 (10th Cir. 1990), aff'g TC Memo 1988-272.
5. IRC Sec. 170(e)(1)(A); Treas. Reg. §1.170A-4(a).
6. IRC Sec. 170(e)(1).
7. *Greene v. U.S.*, 79 F.3d 1348 (2nd Cir. 1996).
8. *Greene v. U.S.*,185 F3d 67, 84 AFTR 2d 99-5415 (2nd Cir. 1999).

Taxpayers who transferred appreciated stock to charitable organizations in the midst of an ongoing tender offer and merger were taxed on the gain on the stock under the "anticipatory assignment of income doctrine" where the charitable gifts occurred after the taxpayers' interests in a corporation had ripened into rights to receive cash.[1] But where taxpayers assigned warrants to four charities after receiving a letter announcing that all issued and outstanding stock of the company would be purchased, the Tax Court held that under Revenue Ruling 78-197[2] the Service could treat the proceeds of the sales of the warrants by the charities as income to the donors *only if* at the time the assignments took place, the charitable donees were legally bound or could be compelled to sell the warrants.[3]

A taxpayer who donated stock to a supporting organization, where the voting rights had been transferred for a business purpose to a third party many years ago, was permitted to claim a charitable deduction.[4]

7967. May an individual deduct the fair market value of appreciated tangible personal property, such as art, stamps, coins, and gems given to a charitable organization?

The answer depends on whether the use of the gift is *related* to the exempt purpose of the charity to which the property is given. Generally, a contribution of appreciated tangible personal property whose sale would result in long-term capital gain (see below) is deductible at the property's full fair market value up to 30 percent of the individual's adjusted gross income, *if* the charity makes use of the property in a way that is related to its charitable purpose or function (i.e., it is a "related use" gift).[5] The limit is generally 20 percent in the case of private foundations (see Q 7968). However, if the use by the donee exempt organization is unrelated to its charitable purpose or function (or the gift is to a private foundation, see Q 7968), the amount of the charitable contribution taken into account is generally limited to the donor's adjusted basis.[6]

The regulations provide the following example as to the meaning of "unrelated use": "[I]f a painting contributed to an education[al] institution is used by that organization for educational purposes by being placed in its library for display and study by art students, the use is not an unrelated use; but if the painting is sold and the proceeds used by the organization for educational purposes, the use of the property is an unrelated use." In addition, the regulations state that contributions of furnishings used by the charitable organization in its offices and buildings in the course of carrying out its functions will be considered a related use gift.[7]

The IRS determined that a gift of seeds, plants, and greenhouses to an IRC Section 501(c)(3) school's plant science curriculum was a related use gift, and that a gift of a violin to

1. See *Ferguson v. Comm.*, 174 F.3d 997 (9th Cir. 1999).
2. 1978-1 CB 83.
3. *Rauenhorst v. Comm.*, 119 TC 157 (2002).
4. Let Rul. 200108012.
5. IRC Sec. 170(b)(1)(C); Treas. Reg. §1.170A-8(d)(1).
6. IRC Sec. 170(e)(1)(B).
7. Treas. Reg. §1.170A-4(b)(3)(i).

a charitable organization whose exempt purpose included loaning instruments to music students was a related use gift.[1] The Service has also determined that contributions of art to a Jewish community center for use in the center's recreational, educational, and social activities were related use gifts.[2]

In the case of contributions of long-term capital gain "related use" property to public charities, an individual may elect to value the gift at its adjusted basis instead of its fair market value. If he does so, the 30 percent of adjusted gross income limit does not apply; instead, the donor may deduct the amount of his adjusted basis in the gift, up to 50 percent of adjusted gross income. If the taxpayer makes the election, it applies to all gifts of long-term capital gain property during the year.[3] Such an election is generally irrevocable.[4]

The amount of the deduction for a contribution of tangible personal property must be reduced by the amount of gain that would *not* be long-term capital gain (i.e., gain on a capital asset held for more than one year) if the contributed property had been sold at its fair market value at the time of the contribution. Thus, for example, if the entire gain would be ordinary income, the allowable deduction would be limited to the taxpayer's adjusted basis in the contributed property. It makes no difference, in such a case, whether or not the property is put to a related use.[5] Ordinary income property includes a work of art created by the donor.[6]

The charitable deduction is recaptured by the donor on certain dispositions by the charity of tangible personal property identified by the charity as related use property for which a deduction in excess of basis was allowed. Unless the charity makes the appropriate certification, recapture applies if the charity disposes of the property after the taxable year the property was contributed, but before the end of the three-year period starting on the date of contribution. The certification must be in writing and signed under penalty of perjury by an officer of the charity. The written statement must (1) certify that the use of the property was related and describe the use of the property; or (2) state the intended use at the time of contribution and certify that the intended use has become impossible or infeasible to implement. The amount recaptured (included in income) in the year of disposition is equal to the amount of the charitable deduction minus the donor's basis in the property at the time of contribution.[7]

> *Example*: Amy contributes a painting to an art museum in December 2013. The museum intends to display the painting. Amy claims a charitable deduction for the painting's fair market value of $100,000 for 2013. Amy's basis in the painting was $40,000. In 2014 (within three years of the contribution), the museum sells the painting. Amy must include $60,000 ($100,000 charitable deduction – $40,000 basis) in income in 2014.

A charity is required to report to the IRS any disposition of property (other than publicly traded securities) within three years after its receipt, if the claimed value of the property

1. Let. Ruls. 9131052, 9147049.
2. Let. Rul. 9833011.
3. IRC Secs. 170(b)(1)(C)(iii), 170(e)(1).
4. *Woodbury v. Comm.*,900 F2d 1457, 90-1 USTC ¶50,199 (10th Cir. 1990), aff'g TC Memo 1988-272.
5. See IRC Sec. 170(e)(1)(A); Treas. Reg. §1.170A-4(a).
6. Treas. Reg. §1.170A-4(b)(1).
7. IRC Sec. 170(e)(7), as added by PPA 2006.

(plus the claimed value of all similar items of property by the donor to one or more charities) exceeds $5,000. A copy of the related use certification (see above) would be included with this return.[1] Any person who identifies tangible personal property as related use property and knows that the property is not intended for such use is subject to a $10,000 penalty.[2]

7968. May an individual take a deduction for charitable contributions to private foundations?

Yes, subject to certain limits. Most private foundations are family foundations subject to the special contribution limits described below. Certain other private foundations (i.e., conduit foundations and private operating foundations, which operate much like public charities) are treated as 50 percent -type organizations and subject to the rules for those organizations as explained in Q 7964.[3] The term "private foundations" as used below refers to standard private non-operating (e.g., family) foundations.

The deduction for a gift of long-term capital gain property "to" or "for the use of" a private foundation is subject to an income percentage limit of the lesser of (a) 20 percent of adjusted gross income, or (b) the unused portion of the 30 percent limit.[4] A deduction denied because it exceeds 20 percent of adjusted gross income may be carried over and treated as a 20 percent -type deduction over the next five years.[5]

Ordinarily, the value that is taken into account for a gift of long-term capital gain property to or for the use of a private foundation is limited to the donor's adjusted basis (i.e., the value of the gift is reduced by the amount that would be long-term capital gain if the property were sold at its fair market value at the time the gift was made).[6] However, if the gift is of publicly traded securities that meet the definition of "qualified appreciated stock" and the contribution is made to a private foundation, the gift will be deductible at its full fair market value.[7]

Qualified appreciated stock is generally publicly traded stock that, if sold on the date of contribution at its fair market value, would result in a long-term capital gain.[8] A contribution of stock will not constitute qualified appreciated stock to the extent that it exceeds 10 percent of the value of all outstanding stock of the corporation; family attribution rules apply in reaching the 10 percent level, as do prior gifts of stock.[9]

The Service has determined that shares in a mutual fund can constitute qualified appreciated stock.[10] Restricted stock cannot be qualified appreciated stock, despite the availability of market quotations for other stock of the same class, because a restriction on transferability may

1. IRC Sec. 6050L, as added by PPA 2006.
2. IRC Sec. 6720B, as added by PPA 2006.
3. See IRC Secs. 170(b)(1)(F), 170(b)(1)(A)(vii).
4. See IRC Sec. 170(b)(1)(D)(i).
5. IRC Sec. 170(b)(1)(D)(ii).
6. IRC Sec. 170(e)(1)(B).
7. IRC Sec. 170(e)(1)(B)(ii); IRC Sec. 170(e)(5).
8. See IRC Sec. 170(e)(5).
9. IRC Sec. 170(e)(5)(C). See, e.g., Let. Ruls. 200112022, 200112024, 200112025.
10. Let. Rul. 199925029. See also Let. Rul. 200322005 (American Depositary Receipts (ADRs) constitute qualified appreciated stock).

materially affect the value of the stock.[1] Unlisted stock does not constitute qualified appreciated stock. According to the Service, this is because the legislative history indicates that IRC Section 170(e)(5) is to be applied *only* to situations where price quotations for the contributed stock are readily available on an established securities market.[2] Therefore, it is *not* sufficient merely that market quotations for the stock are readily available (e.g., from established brokerage firms); rather, the market quotations must be readily available on an established securities market.[3]

Private foundation contributions other than long-term capital gain property are subject to an income percentage limit of the lesser of (a) 30 percent of adjusted gross income, or (b) 50 percent minus the amounts contributed to 50 percent -type organizations (see Q 7964).[4] The deduction for a gift of property other than long-term capital gain property (e.g., stock held for one year or less) is limited to the donor's adjusted basis.[5]

7969. How is the charitable deduction computed when property is sold to a charity at a reduced price?

If property is sold to a charity for less than its fair market value (a bargain sale), the individual must first determine whether a charitable deduction is allowable under the general rules governing charitable deductions (see Q 7954 and Q 7964). The taxpayer must then determine the amounts of the allowable deduction and gain (if any) that will result from the transaction. To do this, he must calculate what percentage of the property's fair market value is being contributed and what percentage is being sold. (The fair market value of the contributed portion is the fair market value of the entire property less the amount realized on the sale.[6] The fair market value of the portion sold is the amount realized on the sale.) The taxpayer's adjusted basis in the property is then allocated to each portion in these proportions.[7]

To determine whether there is an allowable deduction for the contributed portion, and the amount of any such deduction, the value of the contributed portion must be reduced by any gain that would *not* have been long-term capital gain that would have been realized had the contributed portion been sold, taking into account the basis allocated to it.[8] If the sale of the contributed portion by the donor would have resulted in long-term capital gain (see example 2, below), no reduction is required unless the gift is tangible personal property the use of which will be unrelated to the function of the charity (see Q 7967), or the gift is to a private foundation (see Q 7968).[9]

After any such reduction required by IRC Section 170(e)(1) has been made, the remaining amount of the contribution is the allowable deduction. For the portion of the property that is

1. Let. Rul. 9320016. Cf. Let. Ruls. 9825031, 9746050.
2. See e.g., Let. Rul. 199915053.
3. See e.g., *Todd v. Comm.*, 118 TC 354 (2002).
4. IRC Sec. 170(b)(1)(B).
5. See IRC Sec. 170(e)(1)(A).
6. Treas. Reg. §1.170A-4(c)(3).
7. IRC Sec. 1011(b); Treas. Regs. §§1.170A-4(c)(2)(i), 1.1011-2.
8. IRC Sec. 170(e)(1)(A); Treas. Reg. §1.1011-2(a).
9. IRC Sec. 170(e)(1)(B).

being sold, the allocated basis is subtracted from the amount realized on the sale to determine the donor/seller's taxable gain on the transaction.

> *Example 1*: Mr. Hagin sells ordinary income property to his church for $4,000, which is the amount of his adjusted basis. The property has a fair market value of $10,000. The contribution portion of the transaction has a value of $6,000 ($10,000 fair market value less $4,000 amount realized) that represents 60 percent of the value of the property. The amount realized represents 40 percent of the value of the property ($4,000/$10,000). The adjusted basis ($4,000) is therefore allocated as follows: 40 percent of it ($1,600) becomes Mr. Hagin's basis in the "sold" portion and 60 percent of it ($2,400) becomes his basis in the "contributed" portion. The $6,000 "contribution portion" of the transaction has an allocated basis of $2,400. If it were sold, he would recognize $3,600 of ordinary income. The deduction for the $6,000 contribution is therefore reduced by $3,600. Mr. Hagin has a charitable deduction of $2,400. Because Mr. Hagin is receiving $4,000 for the "sold" portion and has an allocated basis in it of $1,600, he recognizes $2,400 of ordinary income with respect to the sale part of the transaction. The church's basis in the property received will be $6,400; this consists of the sum of the bargain sale price ($4,000) and the amount of Mr. Hagin's basis ($2,400) in the gift portion.[1]

> *Example 2*: The facts are the same as in Example 1, except that the property was long-term capital gain stock. Mr. Hagin's allocations of basis are the same as above; therefore, he recognizes $2,400 on the sale portion of the transaction. However the contributed portion is not subject to a reduction; thus, he is permitted a deduction of $6,000. The church's basis in the stock will be $6,400, determined the same way as in Example 1.

A taxpayer who makes charitable contributions of long-term capital gain property may elect to apply the provisions of IRC Section 170(e)(1), with respect to all such contributions, thus using adjusted basis instead of fair market value to determine the value of the gifts. This election will permit the individual to take a higher proportion of his income as charitable deductions than would otherwise be allowed (see Q 7966).

If a charitable deduction is permitted under IRC Section 170, the taxpayer must determine whether the bargain sale results in a charitable deduction and, if so, the amount of the deduction. It then requires that the adjusted basis of the property be allocated between the portions contributed and sold, based on their relative proportions of the property's fair market value.[2] Gain is recognized on the sale portion to the extent the amount realized exceeds the allocated basis; however, no loss is recognized if the sale amount is less than the allocated basis of the sold portion.[3] The amount of the deduction for the contributed portion is determined as if property having the allocated basis and allocated fair market value were given (see Q 7966, Q 7967).

The result is essentially two transactions–a sale of property that may result in taxable income, and a deductible contribution of property. In some cases, the application of these rules may result in a taxable gain in excess of the allowed deduction. If the property is subject to a liability, the amount of the liability is treated as an amount realized (see Q 7970).[4]

In a bargain sale, the charitable deduction was properly claimed in the year that the sale was completed, because in that year a sufficient quantity of benefits and burdens of ownership

1. See Treas. Reg. §1.170A-4(d), Example 5.
2. IRC Secs. 170(e)(2), 1011(b); Treas. Reg. §1.170A-4(c)(2).
3. Treas. Reg. §1.1001-1(e).
4. Treas. Reg. §1.1011-2(a)(3).

had passed to the charitable organization.[1] Bargain sale treatment was denied to a taxpayer who inflated his valuation to a figure that would enable him to recover his original investment in the boat (in the form of cash plus tax savings from the inflated tax deduction).[2]

7970. How is the amount of a charitable contribution affected when a taxpayer donates property subject to a mortgage or other debt?

When property subject to a liability is contributed to a charity, the amount of the liability is treated as an amount realized, even if the charity does not assume or pay the debt.[3] The property is considered sold for the amount realized, and the contribution is subject to the bargain sale rules (see Q 7969).

If, in connection with a charitable contribution, a liability is assumed by the charity, or if property is donated that is subject to a liability, the amount of the charitable contribution may not include any interest paid (or to be paid) by the donor for any period after the contribution if an interest deduction for the amount is allowable to the donor.[4] If the property is a bond, the contribution must be reduced by the amount of interest paid by the taxpayer on indebtedness incurred to purchase or carry the bond that is attributable to any period before the making of the contribution. However, the amount of such a reduction is limited to the interest or interest equivalent (e.g., bond discount) on the bond that is not includable in the donor's income.[5]

Example: (a) On January 1, 2002, Mr. Capps, an individual using the cash receipts and disbursements method of accounting, purchased for $9,280 a 5½ percent, $10,000, 20-year Omega Corporation bond, the interest on which was payable semi-annually on June 30 and December 31. The Omega Corporation had issued the bond on January 1, 2002, at a discount of $720 from the principal amount. On December 1, 2012, Mr. Capps donated the bond to a charitable organization, and, in connection with the contribution, the charitable organization assumed an indebtedness of $7,000 that Mr. Capps had incurred to purchase and carry the bond.

(b) During the calendar year 2012, Mr. Capps paid accrued interest of $330 on the indebtedness for the period from January 1, 2012, to December 1, 2012, and an interest deduction of $330 is allowable for such amount. Of the bond discount of $36 a year ($720 divided by 20 years), $33 (11/12 of $36) is includable in Mr. Capps' income. Of the $550 of annual interest receivable on the bond, he will include in income only the June 30, 2012, payment of $275.

(c) The market value of the Omega Corporation bond on December 1, 2012, was $9,902. This value includes $229 of interest receivable that had accrued from July 1 to December 1, 2012.

(d) The amount of the charitable contribution determined without regard to the reduction required by IRC Section 170(f)(5) is $2,902 ($9,902, the value of the property on the date of gift, less $7,000, the amount of the liability assumed by the charitable organization). In determining the amount of the allowable charitable deduction, the value of the gift ($2,902) must be reduced to eliminate from the deduction that portion for which Mr. Capps has been allowed an interest deduction. Although the amount of such interest

1. See *Musgrave v. Comm.*, TC Memo 2000-285.
2. *Styron v. Comm.*, TC Sum. Op. 2001-64.
3. Treas. Reg. §1.1001-2; Rev. Rul. 81-163, 1981-1 CB 433. See Let. Rul. 9329017; *Guest v. Comm.*, 77 TC 9 (1981), *acq.* 1982-2 CB 1; *Crane v. Comm.*, 331 U.S. 1 (1947).
4. IRC Sec. 170(f)(5); Treas. Reg. §1.170A-3(a).
5. IRC Sec. 170(f)(5)(B); Treas. Reg. §1.170A-3(c).

deduction was $330, the reduction required by this section is limited to $229, since the reduction is not to exceed the amount of interest income on the bond that is not includable in Mr. Capps' income.[1]

7971. Can a deduction be taken for a charitable contribution of less than the donor's entire interest?

Generally, a taxpayer may not deduct a charitable contribution that is not in trust, if it is of less than his entire interest in property. (A deduction of a partial interest will be allowed to the extent a deduction would be allowed if the interest had been transferred in trust.[2] See Q 7973 to Q 7997). However, a taxpayer may deduct contributions of partial interests if they are made to each of several charities, with the result that the entire interest in the property has been given to charitable organizations. An individual may make a gift of a partial interest in property if that is his entire interest, but not if partial interests were created to avoid the application of the rule prohibiting gifts of less than the individual's entire interest.[3]

Exceptions: A deduction *is* allowed for a contribution of less than the donor's entire interest in property in the following instances:

(a) The taxpayer donates an irrevocable remainder interest in a personal residence or farm.[4]

(b) The taxpayer makes a qualified conservation contribution (see Q 7999).[5]

(c) The taxpayer donates an undivided portion of his entire interest.[6] An undivided portion is a "fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property and in other property into which such property is converted."[7] The *right* to possession of an undivided portion of the taxpayer's entire interest has been held sufficient to constitute a charitable gift, even where the donee did not actually choose to take possession.[8] The possibility that a charity's undivided fractional interest may be divested upon the occurrence or nonoccurrence of some event has been determined not to defeat an otherwise deductible contribution where the possibility is deemed so remote as to be negligible.[9] A charitable gift of an "overriding royalty interest" or a "net profits interest" in an oil and gas lease did not constitute an undivided portion of the donor's entire interest in an oil and gas lease where the donor owned a working interest under the lease.[10]

1. See Treas. Reg. §1.170A-3(d) Example (2).
2. IRC Sec. 170(f)(3)(A); Treas. Reg. §1.170A-7(a).
3. Treas. Reg. §1.170A-7(a)(2)(i).
4. IRC Sec. 170(f)(3)(B)(i); Treas. Regs. §§1.170A-7(b)(3), 1.170A-7(b)(4).
5. IRC Sec. 170(f)(3)(B)(iii).
6. IRC Sec. 170(f)(3)(B)(ii).
7. Treas. Reg. §1.170A-7(b)(1). See also Rev. Rul. 57-293, 1957-2 CB 153 (undivided ¼ ownership and ¼ possession of art object); Rev. Rul. 72-419 (undivided 20 percent *remainder* interest which was the donor's only interest in the property).
8. See *Winokur v. Comm.*, 90 TC 733 (1988), acq. 1989-1 CB 1. See also Let. Ruls. 200223013, 200223014 (the gift of a fractional interest in any work of the donors' collection accepted by the donee (subject to the gift and loan agreement) would qualify as a gift of an undivided portion of the donors' entire interest in the work, relying on *Winokur*, above; thus, the undivided fractional interest would be deductible).
9. Let. Rul. 9303007.
10. See Rev. Rul. 88-37, 1988-1 CB 522.

The Service privately ruled that a donor's transfer of a policy to a charity, while retaining bare legal title, was not a retention of a substantial interest for purposes of the partial interest rule. Thus, the donor did not violate the partial interest rule, and would be allowed to claim the charitable contribution deduction on the first day following the end of the 30-day cancellation period.[1]

The Service has ruled that a contribution of a patent to a qualified charity will *not* be deductible if: (1) the taxpayer retains any substantial right in the patent; or (2) the taxpayer's contribution of a patent is subject to a conditional reversion, unless the likelihood of the reversion is so remote as to be negligible. On the other hand, a contribution of a patent subject to a license or transfer restriction will be deductible, but the restriction *reduces* what would otherwise be the fair market value of the patent at the time of the contribution and, therefore, *reduces* the amount of the charitable contribution.[2]

A charitable deduction is not allowed for a contribution of an undivided portion of the donor's entire interest in tangible personal property unless, before the contribution, all interests in the property were held by the donor or the donor and the charity. In the case of any additional contribution of interests in the same property, the fair market value (FMV) of such contributions will be equal to the lesser of (1) the FMV at the time of the initial fractional contribution, or (2) the FMV at the time of the additional contribution.[3]

> *Example*: Mark contributed 10 percent of a painting valued at $100,000 to an art museum in 2013. The charitable deduction for the 10 percent interest was $10,000 in 2013. In 2014, Mark contributes another 10 percent interest in the painting to the art museum when the painting is valued at $110,000. However, for charitable deduction purposes, the fair market value of the painting cannot exceed the $100,000 value at the time of the initial contribution. Therefore, the charitable deduction is limited to $10,000 (10 percent of $100,000) in 2014.

The charitable deduction for a contribution of an undivided portion of the donor's entire interest in tangible personal property is recaptured (plus interest) if the donor does not contribute all of the remaining interest in the property to charity within 10 years of the initial fractional contribution or before death, whichever is earlier. Recapture is also required if the charity did not have substantial physical possession or related use of the property during that period. The income tax on the recaptured amount is increased by 10 percent of the amount recaptured.[4]

7972. What charitable deduction is permitted when a taxpayer donates the right to use property to charity?

The right to use property is less than the entire interest in property owned by an individual and is subject to the rules governing a charitable contribution of less than the donor's entire interest.[5] Therefore, generally no deduction will be allowed.

1. Let. Rul. 200209020.
2. Rev. Rul. 2003-28, 2003-1 CB 594.
3. IRC Sec. 170(o), as added by PPA 2006.
4. IRC Sec. 170(o)(3)(B).
5. IRC Sec. 170(f)(3)(A).

However, in some cases, a deduction has been allowed for the costs of repairing and maintaining property owned by the taxpayer but used by the charity. These deductions have been allowed as contributions "for the use of" the charity.[1] But, the Service has also denied a deduction for maintenance and repair costs in other instances.[2] To be deductible, the costs must be unreimbursed expenses "directly attributable to the performance of … volunteer services."[3]

A deduction was denied to a taxpayer who donated a week's use of his vacation home to a charitable auction. The IRS also noted that the successful bidder would not be permitted a charitable deduction to the extent that valuable consideration is received in return (i.e., the bidder paid fair rental for a week's use of the home).[4]

Tenant-stockholders were allowed to exclude $500,000 of gain from the disposition of their shares of stock in their cooperative apartment which was coordinated with a donation of the same shares to a charitable organization.[5]

7973. What is a charitable remainder trust? How are charitable remainder trusts used as planning tools?

A charitable remainder trust (CRT) is a trust instrument that provides for specified payments to one or more individuals, with an irrevocable remainder interest in the trust property to be paid to or held for a charity.[6] CRTs are a notable exception to the general rule that an individual may not take a charitable deduction for a gift of less than his entire interest in property.

The IRC requirements for CRTs are specific and detailed (see Q 7978 to Q 7988). The purpose of these requirements is to assure that a charitable contribution is actually made and that its present value can be determined with accuracy. To be immediately deductible, the gift must be of real property or intangibles; a gift of a remainder interest in tangible personal property is deductible only when all intervening interests have expired or are held by parties unrelated to the donor.[7]

Although the charitable remainder trust provisions were enacted in 1969, the use of them has grown dramatically since the mid-1980s. With the growth in their popularity came widespread use (and sometimes misuse) of CRTs as a planning vehicle. CRTs can be marketed in conjunction with "wealth replacement trusts." A typical plan calls for an individual owning appreciated capital gain property to give the property in trust to a charity, but retain a right to payment for up to 20 years or life (and/or the life of other named individuals). The trust becomes owner of the property; it frequently sells the property and reinvests the proceeds. The proceeds may be invested in tax-exempt securities, which may eventually pass Tier 3 tax-exempt income to the beneficiaries (see Q 7991) after any Tier 1 income and Tier 2 capital gain income from the sale of the appreciated property have been distributed.

1. See *Est. of Carroll v. Comm.*, 38 TC 868 (1962); Rev. Rul. 58-279, 1958-1 CB 145.
2. Rev. Rul. 58-279, above; Rev. Rul. 69-239, 1969-1 CB 198.
3. Rev. Rul. 58-279, above.
4. Rev. Rul. 89-51, 1989-1 CB 89.
5. See FSA 200149007.
6. See Treas. Reg. §1.664-1(a)(1)(i).
7. IRC Sec. 170(a)(3); Treas. Reg. §1.170A-5.

The CRT / wealth replacement trust combination is designed to provide the donor a charitable deduction based in part on the full fair market value of the gift (subject to the limits explained in Q 7966), remove the property from his estate, defer or avoid tax to the donor on the capital gain portion of the gift (see Q 7991), and provide either a fixed or variable stream of payments that may be tailored somewhat to meet the needs of the donor. "Wealth replacement" is then accomplished through funding life insurance in an irrevocable trust for larger estates in an amount equal to or greater than the value of the property given. Ideally, the cost of the premiums is offset in whole or in part by the tax benefit of the charitable deduction, the unused portion of which may be carried over for up to five years (see Q 7964). At the end of the trust's term (usually upon the death of the donor or the last noncharitable beneficiary), the trust property goes to the charity, and the life insurance proceeds to the beneficiaries of the life insurance trust.

Planning Point: The life insurance policy purchased by the trustee of the wealth replacement trust is typically a survivorship policy insuring two lives but payable only at the second death This type of policy is used for two reasons: (1) the premiums are generally more affordable, particularly if one of the donors is otherwise uninsurable; and (2) the payment of the life insurance death benefit typically coincides with the timing when the heirs would normally have received the asset being replaced.

Planning Point: Often the amount of insurance purchased for wealth replacement is equal to the value of the property contributed to the charitable remainder trust. However, this is not a requirement. Depending on the goals of the client, it may be appropriate to purchase less insurance or more insurance. With less insurance, the client's income distributions bear a lesser burden in supporting the premium payments. With more insurance, the client is able to leverage the life insurance to create a greater benefit to the life insurance trust beneficiaries.

Planning Point: While charitable remainder trusts and wealth replacement trusts are sometimes presented as an integrated plan, it is important to note there is a proper order to funding these trusts. The wealth replacement trust is usually implemented first in order to ensure that there is no gap in asset protection between the delivery of the contribution to the charitable remainder trust and the purchase of the life insurance policy. One consequence of this order is that the first life insurance premium must be funded out-of-pocket rather than from the income distributions from the charitable remainder trust. *Ted R. Batson, Jr., MBA, CPA, Senior Vice President of Professional Services for Renaissance.*

The CRT must provide for periodic payments within limits set forth in the Code (see Q 7979, Q 7980) and based on the net fair market value of the trust assets. If the trust is a charitable remainder *annuity* trust (CRAT), the fair market value will be determined only once (at the inception of the trust) and the payout amount will be fixed based on that valuation. If the trust is a charitable remainder *unitrust* (CRUT), the fair market value will be determined annually and the payout amount (not the percentage) will vary from year to year as the value of the trust fluctuates. Most CRTs provide for a payout of between 5 percent and 10 percent. See Q 7991 regarding the taxation of these payments to the incomebeneficiary.

Obviously, the higher the payout and the greater the number of noncharitable beneficiaries, the lower is the value of the remainder interest the charity will ultimately receive. The value of the remainder interest passing to the charity must be at least 10 percent of the net fair market value of the property placed in the trust.[1] See Q 7979, Q 7980.

1. IRC Sec. 664(d).

Annual valuation (which is required for charitable remainder unitrusts and not permitted for any other charitable trust) increases the flexibility of a CRUT considerably. It permits the donor to make additional contributions to the trust, thus providing a certain degree of control over the amount of the resulting payment stream. Assuming the trust investments perform reasonably well, the variable payments provide a hedge against inflation. In contrast, a charitable remainder *annuity* trust provides a fixed payment amount, and additional contributions to the trust are not permitted.

In the absence of authorization to the contrary, a charitable remainder trust may be forced to invade the corpus of the trust if the performance of its investments is such that income is insufficient to meet the payout requirement. One way to alleviate this problem is through the *net income unitrust*, which limits its payout to the trust's net income, if that amount is less than the percentage payout called for by the trust. Another variation is a *net income with makeup unitrust*, in which a net income unitrust is permitted to make up payments that were called for in earlier years but were not made because trust income was less than the required payment. Both of these instruments are specifically authorized by the IRC.[1] *Flip unitrusts* are permitted under regulations, but only under very limited and narrow conditions (see Q 7980).[2] However, no other variations from these prescribed payout structures are permitted.

Planning Point: A common use of the flip unitrust is when a charitable remainder trust is funded with unmarketable assets, such as real property, closely held stock, or some other type of asset for which there is not a ready market. A flip unitrust is used so that the trustee will not be compelled to make a payment without sufficient liquidity to make the payment. In a properly structured flip unitrust, the trustee would not be required to pay the net income of the trust to the income beneficiary until the unmarketable property was sold and the trust's assets became liquid. *Ted R. Batson, Jr., MBA, CPA, Senior Vice President of Professional Services for Renaissance.*

The flexibility of the net income with makeup unitrust (sometimes called a "spigot trust") has led to its use as a retirement planning tool. Under a typical arrangement, a client establishes a net income with makeup unitrust, which then invests the contributed property in growth assets with little or no income, such as zero coupon bonds. Additional contributions are made as often as the donor wishes; inside growth of the trust assets typically occurs tax-free (see Q 7994). In addition, the donor receives a charitable deduction for a portion of each contribution, based on the present value of the remainder interest (see Q 7990), assuming the trust otherwise qualifies as a CRUT (see Q 7980). When the donor nears retirement, trust investments are shifted to income producing assets, and the payout increases as the trust "makes up" the payments that were not made in earlier years.

The Service has privately ruled that a taxpayer would not recognize gain or loss as a result of transferring stock from a qualified plan to a charitable remainder unitrust upon his separation from service. Furthermore, the taxpayer would receive an income tax charitable deduction, subject to the income percentage limits, for the contribution of the stock to the CRUT in an amount equal to the fair market value of the stock at the time of the transfer less the value of the taxpayer's remainder unitrust interest.[3]

1. See IRC Sec. 664(d)(3); Treas. Reg. §1.664-3(a)(1).
2. See Treas. Reg. §1.664-3(a)(1)(i)(c).
3. See Let. Ruls. 200215032, 200202078, 200038050, 199919039.

7974. What considerations impact a taxpayer's choice as to which type of charitable remainder trust to form?

An individual's choice as to which type of charitable remainder trust vehicle to use may depend in large part on the degree of flexibility needed. The majority of charitable trusts use the *charitable remainder unitrust* form, because it offers the greatest degree of flexibility with respect to future contributions, the timing and amount of the payment stream, and the degree to which the individual may have an effect on the administration of the trust. However, charitable remainder unitrusts are the most expensive to administer.

Certain other factors may affect the decision as to which trust form is preferable. A donor who prefers fixed payments over variable payments may prefer a charitable remainder annuity trust; the age of the donor may have a significant impact on this preference and on the degree of flexibility needed. If the property being contributed is illiquid, a trust with an inflexible payout arrangement would be ill-advised. A donor who wishes to avoid set-up and administration expenses may prefer to contribute to a *pooled income fund* (see Q 7978, Q 7988), or a charitable gift annuity.

The 10 percent remainder interest value requirement may prevent some formerly acceptable arrangements from being permissible if established after July 28, 1997, particularly in the case of a younger couple (e.g., under 45) utilizing a payout over two lives. See Q 7979, Q 7980.

One final factor that may affect the donor's choice of CRT vehicles is the extent to which he wishes to maintain control over the administration of the trust assets. Provided the trust adheres to strict limitations, the grantor of a charitable remainder unitrust or annuity trust may be able to successfully act as a trustee; the contributor to a pooled income fund may not.[1] Traditionally, advisors recommended against a grantor's acting as trustee of a charitable remainder trust, fearing that the grantor trust rules (see Q 664) might result in its disqualification. However, the IRS has ruled, as well as indicated in letter rulings, that a CRT that is otherwise properly designed and administered will not be disqualified merely because the grantor acts as a trustee.[2]

Planning Point: The question still remains whether a new trustee understands all the duties of a trustee and can be reasonably expected to accurately perform the necessary functions of a trustee on a timely basis. The duties can be significant and in many cases a professional trustee is the prudent choice.

7975. What safe harbor provisions are available to avoid disqualification of a charitable remainder annuity trust (CRAT) or charitable remainder unitrust (CRUT) if spousal election rights are provided by the grantor?

Spousal Election Rights and Charitable Remainder Trusts. The IRS and Treasury Department issued guidance providing a safe harbor procedure to avoid the disqualification of a charitable remainder

1. IRC Sec. 642(c)(5)(E).
2. Rev. Rul. 77-285, 1977-2 CB 213; Let. Ruls. 200029031, 9048050, 8809085.

annuity trust (CRAT) or charitable remainder unitrust (CRUT) if, under applicable state law, the grantor's surviving spouse has a right of election exercisable upon the grantor's death to receive an elective, statutory share of the grantor's estate, and that share could be satisfied in whole or part from assets of the CRAT or CRUT (in violation of IRC Section 664(d)).[1]

The surviving spouse's elective right to receive an elective share of the grantor's estate (if the share could include any assets of a CRAT or CRUT created or funded by the grantor) will be *disregarded* for purposes of determining whether the CRAT or CRUT has met the requirements of IRC Section 664(d) continuously since its creation if all of the following requirements are satisfied:

(1) *Waiver effective under state law*: The surviving spouse must irrevocably waive the right of election to whatever extent necessary to ensure that no part of the trust (other than the annuity or unitrust interest of which the surviving spouse is the named recipient under the terms of the trust) may be used to satisfy the elective share. A valid waiver of the elective share or elective right will satisfy the requirements in the preceding sentence if the waiver is valid under applicable state law, in writing, and signed and dated by the surviving spouse.

(2) *Timing of waiver*: For CRATs and CRUTs created by the grantor on or after June 28, 2005, the requirements set forth in item (1), above, must be satisfied on or before the date that is six months after the due date (excluding extensions) for filing Form 5227 (the trust's information return) for the year in which the *later* of the following occurs: (a) the creation of the trust; (b) the date of the grantor's marriage to the surviving spouse; (c) the date the grantor first becomes domiciled or resident in a jurisdiction whose law provides a right of election that could be satisfied from the assets of the trust; or (d) the effective date of applicable state law creating a right of election.

(3) *Trustee to retain copy*: A copy of the signed waiver must be provided to the trustee of the CRAT or CRUT. The trustee must retain the copy in the official records of the trust as long as the contents may become material in the administration of any internal revenue law.

Until further guidance is published regarding the spousal right of election on a trust's qualification as a CRAT or CRUT, the Service will disregard the existence of such a right of election—*even without a waiver*—but only if the surviving spouse does not exercise the right of election.[2]

In effect, this provision was so controversial that the IRS basically withdrew the provisions of Revenue Procedure 2005-24 by its issuance of Notice 2006-15.

For details as to the requirements for a charitable remainder annuity trust, see Q 7979, for charitable remainder unitrusts see Q 7980, and for pooled income fund requirements,

1. Rev. Proc. 2005-24, 2005-16 IRB 909.
2. Rev. Proc. 2006-15, 2006-8 IRB 501.

see Q 7988. For the tax treatment of the payments to the noncharitable beneficiary, see Q 7991. To calculate the amount of the deduction for a CRT gift, see Q 7990, and for general limits on all charitable deductions of long-term capital gain property, see Q 7966.

7976. What resources has the IRS provided for charitable remainder trusts to follow in meeting the various qualification requirements?

The IRS generally does not issue rulings concerning whether a charitable remainder trust that provides for annuity or unitrust payments for one or two measuring lives or a term of years satisfies the requirements of IRC Section 664.[1] Instead, taxpayers are directed to follow sample forms for charitable remainder trusts. The IRS stated in 1992 that any CRT that "substantially follows" one of the sample forms, that operates in a manner consistent with the terms of the trust instrument, and that is valid under local law will be recognized by the Service as a valid CRT.[2]

In 2003, the Service released updated sample declarations of trusts and alternate provisions that meet the CRAT requirements under IRC Section 664 and Treasury Regulation Section 1.664-2. The forms for inter vivos CRATs are:

(1) Revenue Procedure 2003-53, 2003-2 CB 230 (one measuring life), *superseding*, Revenue Procedure 89-21, 1989-1 CB 842;

(2) Revenue Procedure 2003-54, 2003-2 CB 236 (term of years);

(3) Revenue Procedure 2003-55, 2003-2 CB 242 (consecutive interests for two measuring lives), *superseding*, Sec. 4 of Revenue Procedure 90-32, 1990-2 CB 546; and

(4) Revenue Procedure 2003-56, 2003-2 CB 249 (concurrent and consecutive interests for two measuring lives), *superseding*, Sec. 5 of Revenue Procedure 90-32, 1990-2 CB 546.

The forms for testamentary CRATs are:

(1) Revenue Procedure 2003-57, 2003-2 CB 257 (one measuring life), *superseding*, Sec. 6 of Revenue Procedure 90-32, 1990-2 CB 546;

(2) Revenue Procedure 2003-58, 2003-2 CB 262 (term of years);

(3) Revenue Procedure 2003-59, 2003-2 CB 268 (consecutive interests for two measuring lives), *superseding*, Sec. 7 of Revenue Procedure 90-32, 1990-2 CB 546; and

(4) Revenue Procedure 2003-60, 2003-2 CB 274 (concurrent and consecutive interests for two measuring lives), *superseding*, Sec. 8 of Revenue Procedure 90-32, 1990-2 CB 546.

1. Rev. Proc. 2009-3, 2009-1 IRB 107, Sec. 4.36.
2. See Rev. Procs. 90-30, 90-31, 90-32 (*but see below*), 90-33, 1990-1 CB 534, 539, 546, 551; Rev. Proc. 89-20, 1989-1 CB 841.

In 2005, the Service released updated sample forms for CRUTs. The forms for inter vivos CRUTs are:

(1) Revenue Procedure 2005-52, 2005-34 IRB 326 (one measuring life);

(2) Revenue Procedure 2005-53, 2005-34 IRB 339 (term of years);

(3) Revenue Procedure 2005-54, 2005-34 IRB 353 (consecutive interests for two measuring lives);

(4) Revenue Procedure 2005-55, 2005-34 IRB 367 (concurrent and consecutive interests for two measuring lives).

The forms for testamentary CRUTs are:

(1) Revenue Procedure 2005-56, 2005-34 IRB 383 (one measuring life);

(2) Revenue Procedure 2005-57, 2005-34 IRB 392 (term of years);

(3) Revenue Procedure 2005-58, 2005-34 IRB 402 (consecutive interests for two measuring lives); and

(4) Revenue Procedure 2005-59, 2005-34 IRB 412 (concurrent and consecutive interests for two measuring lives).

7977. What filing requirements apply to charitable remainder trusts?

Split-interest charitable trusts are required to file each year the form required by the Secretary of the Treasury. Historically this has been Form 1041-A, Trust Accumulation of Charitable Amounts. PPA 2006 eliminates the current exception that exempted such trusts from filing the form if all of the net income of the trust was distributed currently. The exception continues to apply to non-charitable trusts that must file Form 1041-A as a result of claiming a deduction under IRC Sec. 642(c).[1]

Planning Point: This change impacts charitable remainder trusts, charitable lead trusts, and pooled income funds. It remains to be seen whether Treasury will create a new form for split-interest charitable trusts or continue to use Form 1041-A.

In addition, the penalty for failure to file the form (required by IRC Section 6034(a)) is $20 for each day the form is late. The maximum penalty that may be imposed is $10,000. However, for certain large trusts with gross income in excess of $250,000, the penalty is $100 per day up to a maximum of $50,000 [2]

Form 1041-A is subject to public inspection. However, information regarding the non-charitable beneficiaries of charitable split-interest trusts is not subject to public inspection.[3]

1. IRC Sec. 6034, as amended by PPA 2006.
2. IRC Sec. 6652(c)(2)(C), as amended by PPA 2006.
3. IRC Sec. 6104(b), as amended by PPA 2006.

7978. Can a deduction be taken for a contribution to a charitable remainder trust or a pooled income fund?

Yes. An individual may make an immediately deductible gift in trust to a charity, but keep (or give to another person or persons) the right to receive regular payments from the trust before the charity receives any amount. The IRC narrowly defines the types of charitable trusts, in order to assure that an accurate determination can be made of the value of the contribution. To receive this special treatment for a split-interest in trust with a charitable remainder, the gift must be to a *charitable remainder annuity trust* (see Q 7979), a *charitable remainder unitrust* (see Q 7980), or a *pooled income fund* (see Q 7988).[1] Any individual beneficiaries must be alive when the trust is created.

To be immediately deductible, the gift must be of real property or intangibles; a gift of a remainder interest in tangible personal property is deductible only when all intervening interests have expired or are held by parties unrelated to the donor.[2] The IRC also permits a deduction for a gift of regular trust payments to charity in a split-interest trust, generally referred to as a *charitable lead trust* (see Q 7996).

A gift to a charitable remainder trust may be made during an individual's life or at his death by his will. The right of the noncharitable beneficiary (or beneficiaries) to receive payments may extend for life or for a term of up to 20 years. Obviously, however, the value of the charitable deduction will be inversely proportionate to the length of noncharitable payments. The value of the remainder interest passing to the charity must be at least 10 percent of the net fair market value of the property placed in the trust.[3] See Q 7990 for an explanation of the actual calculation of the amount of the deduction.

The extent to which the deduction may be used in any given year is subject to the general limitations on charitable deductions (see Q 7966, Q 7967, Q 7968).[4] See Q 700 regarding the estate tax and Q 757 regarding the gift tax charitable deduction for a gift to a charitable remainder trust.

7979. What is a charitable remainder annuity trust?

A charitable remainder annuity trust provides to a noncharitable beneficiary a fixed payment at least annually of not less than 5 percent nor more than 50 percent of the initial net fair market value of all property placed in the trust, with an irrevocable remainder interest to be paid to or held for a charity.[5] For example, the trust may provide for concurrent payment of $400 monthly to husband for life and $600 to wife for life, or it may provide for payment of $1000 monthly to husband and wife for their joint lives and then to the survivor for life.[6] The payment amount is fixed at the inception of the trust, valuation occurs only once, and the

1. IRC Sec. 170(f)(2)(A); Treas. Reg. §1.170A-6(b).
2. IRC Sec. 170(a)(3); Treas. Reg. §1.170A-5.
3. IRC Sec. 664(d).
4. Treas. Reg. §1.170A-6(b)(2).
5. IRC Sec. 664(d)(1); Treas. Reg. §1.664-1(a)(1).
6. Treas. Reg. §1.664-2(a)(1).

payout cannot be limited to the net income of the trust. Furthermore, the donor cannot make additional payments to the trust.[1]

10 percent remainder interest requirement. The value of the remainder interest (i.e., the deduction) must equal at least 10 percent of the initial fair market value of all property placed in the trust.[2] The value of a remainder interest for this purpose is calculated using the IRC Section 7520 interest rate, which is published every month by the IRS. The calculation of the deduction can be made using the current rate for the month the gift is made or either of the previous two months' rates. See Q 7990 for an explanation of the calculation of the deduction.

Planning Point: For a charitable remainder annuity trust, the charitable deduction increases as the IRC Section 7520 rate increases; therefore, one should choose the highest rate of the three month period for the best charitable deduction.

Noncharitable beneficiary. The IRC requires that the trust payout be made to one or more persons (at least one of whom is not a charitable organization and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not exceeding 20) or for the life or lives of the individual or individuals.[3] All individual beneficiaries must be living at the time of the creation of the trust.[4] The trust may provide that a beneficiary's interest will terminate on the happening of a specified contingency.[5]

IRC Section 664 and regulations thereunder require that to qualify as a charitable remainder trust, a trust must meet the definition of, and function exclusively as, a charitable remainder trust from the time the trust is created. No payments other than those described may be made to anyone other than a qualified charity. Following the termination of all noncharitable payments, the remainder interest is transferred to the charity or retained by the trust for the benefit of the charity.[6]

> *Example*: Patty is 74 years old and owns stock worth $100,000 today that she purchased a few years ago for $40,000. If Patty were to sell the stock, she would incur long-term capital gains of $60,000; assuming a 15 percent capital gains bracket, the tax would equal $9,000. This would leave her with only $91,000 to reinvest. Patty decides to give the stock to a charitable remainder annuity trust. She elects a 6 percent payout or $6,000 each year throughout her lifetime. Patty is entitled to a charitable income tax deduction of $46,144 assuming quarterly trust payments and a 3.4 percent 7520 rate. If Patty is in a 28 percent income tax bracket, this deduction will save her $12,920. In addition, Patty is not subject to up-front capital gains taxes when funding the trust or when the trustee sells her stock and reinvests it. However, the distributions from the charitable remainder annuity trust to the income beneficiaries are subject to tax under a 4-tier structure. See Q 7991.

The IRS has treated the division of a charitable remainder trust into separate trusts as a nontaxable event where the separate trusts are funded pro rata and beneficiaries receive interests that are essentially equal to the original interests.[7]

1. Treas. Reg. §1.664-2(b).
2. IRC Sec. 664(d)(1)(D).
3. IRC Sec. 664(d)(1)(A).
4. Treas. Reg. §1.664-2(a)(3).
5. IRC Sec. 664(f).
6. IRC Sec. 664(d)(1).
7. Rev. Rul. 2008-41, 2008-30 IRB 171.

The IRS permitted the grantor of a charitable remainder annuity trust to terminate the trust by assigning his annuity interest to the charitable remainder beneficiary. The IRS determined that the gift would not retroactively disqualify the trust, and that once "completed" the gift would qualify for a charitable contribution deduction under IRC Section 170. However, the Service stipulated that the gift would be "completed" only (1) when (and to the extent that) assets traceable to the assignment are expended or distributed, or (2) when the grantor permanently resigned as officer and director of the charity to which the assignment was being made.[1]

Payout timing. To qualify as a charitable remainder annuity trust, the trust must pay the sum certain to the noncharitable beneficiary at least annually. See, e.g., *Atkinson v. Comm*.[2] (estate tax charitable deduction denied where the trust had not paid the required annuity payments to the grantor during her lifetime).

The annuity amount may be paid within a reasonable time after the close of the year for which it is due if either of the following occur: (a) the character of the annuity amount in the recipient's hands is income under IRC Section 664(b)(1), (2), or (3); or (b) the trust distributes property (other than cash) that it owned as of the close of the taxable year to pay the annuity amount, and the trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year for which the amount is due. Additionally, for CRATs that were created before December 10, 1998, the annuity amount may be paid within a reasonable time after the close of the taxable year for which it is due if the percentage used to calculate the annuity amount is 15 percent or less.[3]

Planning Point: Assets that are hard to sell are not the best assets to donate to a charitable remainder annuity trust. For these types of assets (e.g., real estate), consider a FLIP charitable remainder unitrust instead. See Q 7980.

7980. What is a charitable remainder unitrust?

A charitable remainder unitrust provides to a noncharitable beneficiary a variable payment stream based on an annual valuation of the trust assets, with an irrevocable remainder interest to be paid to or held for the benefit of a charity. The payout must be a fixed percentage of not less than 5 percent nor more than 50 percent of the net fair market value of the trust assets, and is paid at least annually to the noncharitable beneficiary or beneficiaries.[4] Since the trust is valued annually, the donor may make additional contributions to the trust. To qualify as a charitable remainder trust, a trust must meet the definition of, and function exclusively as, a charitable remainder trust from the time the trust is created.[5] Thus, if a trust does not qualify as a charitable remainder unitrust at its inception, it never will.[6]

The IRS denied both trust and CRUT status to an entity that was proposed to be established by an S corporation essentially to receive its profits and make distributions to its owners.

1. Let. Rul. 9124031.
2. 115 TC 26 (2000), *aff'd*, 2002-2 USTC ¶60,449 (11th Cir. 2002).
3. Treas. Reg. §1.664-2(a)(1)(i).
4. IRC Sec. 664(d)(2)(A); Treas. Reg. §1.664-1(a)(1). (But see Let. Rul. 200108035, where a split-payout was approved).
5. Treas. Reg. §1.664-1(a)(4).
6. See, e.g., Let. Rul. 200122045.

The Service ruled that the proposed entity would not qualify as a trust under Treasury Regulation Sections 1.301.7701-4(a), 1.301-7701-4(c), or as a valid CRUT.[1]

10 Percent Remainder Interest Requirement

The value of the remainder interest (i.e., the charitable deduction) must equal at least 10 percent of the net fair market value of the property as of the date it is contributed to the trust.[2] The value of a remainder interest for this purpose is calculated using the IRC Section 7520 interest rate, which is published every month by the IRS. The calculation of the deduction can be made using the current rate or either of the previous two months' rates. See Q 7990 for an explanation of the calculation of the deduction.

If a transfer to an existing charitable remainder unitrust does not meet the 10 percent remainder interest value requirement, the contribution will be treated as if it were made to a separate trust; thus, the existing CRUT will not become disqualified by a contribution that does not meet this requirement.[3] It appears that the separate trust will be taxed as a complex trust, since it will not meet the requirements for a CRT.

The Service privately ruled that reducing the unitrust payment percentage for additional contributions to ensure that the value of the charity's interest would be no less than 10 percent of the fair market value of the additional property would not cause the CRUT to be disqualified *if* the total annual unitrust payment percentage for the additional contribution did not fall below 5 percent annually.

7981. What is the noncharitable beneficiary requirement for charitable remainder unitrusts?

The IRC requires that the trust payout be made to one or more persons (at least one of whom is not a charitable organization and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not exceeding 20) or for the life or lives of the individual or individuals.[4] The IRS has determined that where unitrust amounts were payable to a separate trust for the life of the grantor's son rather than to the son himself, this requirement was not met.[5]

Any individual noncharitable beneficiary must be living at the time the trust is established.[6] Of course, the longer the trust has to make unitrust payments, the smaller the value of the remainder interest will be. The trust may provide that the interest of a noncharitable beneficiary will terminate on the happening of a particular contingency.[7]

No payments other than those described in IRC Section 664 may be made to anyone other than a qualified charity. A trust will not qualify as a charitable remainder unitrust if it makes

1. Let. Rul. 200203034.
2. IRC Sec. 664(d)(2)(D).
3. See IRC Sec. 664(d)(4).
4. IRC Sec. 664(d)(2)(A).
5. See Let. Ruls. 9710008, 9710009, 9710010, revoking Let. Ruls. 9619042, 9619043, 9619044.
6. IRC Sec. 664(d)(2)(A).
7. IRC Sec. 664(f).

payments on a liability of the grantor.[1] Following the termination of all lifetime and term payments, the remainder interest in the trust must be transferred to or for the use of the charity or retained by the trust for such use.[2]

The Service has ruled that distributions from a CRUT to a separate "special needs" trust for the life of a disabled beneficiary, rather than for a term of years, did not preclude the CRUT from qualifying under the Code. A trust may qualify as a CRUT if: (1) the unitrust amounts will be paid for the life of a financially disabled individual to a separate trust that will administer these payments on behalf of that individual; and (2) upon the individual's death, the trust will distribute the remaining assets to the individual's estate, or, after reimbursing the state for any Medicaid benefits provided to the individual, subject to the individual's general power of appointment.[3]

7982. To qualify as a charitable remainder unitrust, how frequently must the payouts be made?

To qualify as a charitable remainder unitrust, the trust must pay its unitrust amount to the noncharitable beneficiary at least annually. The unitrust amount for fixed percentage CRUTs may be paid within a reasonable time *after* the close of the year for which it is due if either of the following occur: (a) the character of the unitrust amount in the recipient's hands is income under IRC Section 664(b)(1), (2), or (3); or (b) the trust distributes property (other than cash) that it owned as of the close of the taxable year to pay the unitrust amount, and the trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year for which the amount is due. Additionally, for fixed percentage CRUTs that were created before December 10, 1998, the unitrust amount may be paid within a reasonable time after the close of the taxable year for which it is due if the percentage used to calculate the unitrust amount is 15 percent or less.[4]

7983. What are net income unitrusts (NICRUTs) and net income with makeup unitrusts (NIMCRUTs)? How are payouts under these trusts determined?

A payout that is a fixed percentage of asset value will increase if the trust asset value increases. It is possible, however, for a payout of a fixed percentage of trust asset value to exceed trust income; requiring that trust assets themselves be used to make payments. To prevent invasion of the trust corpus, the trust instrument may limit the payout to the amount of the trust income, if that amount is less than the amount of the specified percentage; this is commonly referred to as a *net income unitrust* (NICRUT).[5]

The trust may also limit the payout to the amount of trust income if it is less than the stated percentage, but provide for the deficiency to be made up to the extent trust income exceeds the amount of the specified percentage in later years. This is commonly referred to as a *net income*

1. Let. Rul. 9015049.
2. IRC Sec. 664(d)(2)(C).
3. Rev. Rul. 2002-20, 2002-1 CB 561, *superseding*, Rev. Rul. 76-270, 1976-2 CB 194. See also Let. Rul. 200240012.
4. Treas. Reg. §1.664-2(a)(1)(i).
5. IRC Sec. 664(d)(3)(A).

with makeup unitrust (NIMCRUT).[1] Under this last alternative payout method, a trust with low-income, high-growth assets can pay little or no income to a high-bracket beneficiary; if trust assets produce high income at a later time, larger payouts can be made that include make-up amounts, perhaps when the beneficiary's marginal tax bracket is lower or his income need is greater (see Q 7973). However, the trust provisions may not restrict the trustee from investing trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from disposition of trust assets.[2]

The trust instrument must specify which, if any, of the income exception methods will be used for any year; the method of determining the unitrust payout must not be discretionary with the trustee.[3]

Defining income for trust purposes. State statutes are in the process of changing traditional concepts of income and principal in response to investment strategies that seek total positive return on trust assets. These statutes are designed to ensure that, when a trust invests in assets that may generate little traditional income (including dividends, interest, and rents), the income and remainder beneficiaries are allocated reasonable amounts of the total return of the trust (including both traditional income and capital appreciation of trust assets) so that both classes of beneficiaries are treated impartially. Regulations revise the definition of income under IRC Section 643(b) to reflect changes in the definition of trust accounting income under state laws.[4]

Under the regulations, "trust income" generally means income as defined under IRC Section 643(b) and the applicable regulations. The regulations provide that trust income cannot be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law.[5]

The regulations also provide as follows:

(1) Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal, and not to trust income, at least to the extent of the fair market value of those assets on the date of their contribution to the trust.

(2) Proceeds from the sale or exchange of any assets purchased by the trust must be allocated to principal, and not to trust income, at least to the extent of the trust's purchase price of those assets.

(3) Except as provided in (1) and (2), above, proceeds from the sale or exchange of any assets (a) contributed to the trust by the donor or (b) purchased by the trust *may* be allocated to *income*, pursuant to the terms of the governing instrument, *if* not prohibited by applicable local law. A discretionary power to make this allocation

1. IRC Sec. 664(d)(3)(B).
2. Treas. Reg. §1.664-1(a)(3).
3. See Treas. Reg. §1.664-3.
4. Preamble, TD 9102, 69 Fed. Reg. 12, 13 (1-2-2004).
5. Treas. Reg. §1.664-3(a)(1)(i)(b)(3).

may be granted to the trustee under the terms of the governing instrument, but *only* to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.[1]

Capital gain NIMCRUT. The IRS has approved in numerous situations a NIMCRUT provision granting the trustee the power to allocate post-contribution capital gain on assets that produce no income or limited income to trust income. Such a provision coupled with a provision treating a specific amount of any unitrust deficiency as a liability in valuing the trust's assets complied with the requirements for charitable remainder unitrusts.[2]

Self-dealing. The Service has ruled that the purchase of deferred annuity contracts by the independent trustee of a NIMCRUT did not adversely affect the CRUT's tax-exempt status. Moreover, where the donor received no present value from the contract right to receive annuity payments, and did not control the investment decision, the purchase of deferred annuity contracts did not constitute an act of self-dealing.[3] This technical advice memorandum led to modification of an aggressive approach the Service had taken on the issue of self-dealing by NIMCRUTs in its 1997 Exempt Organizations Continuing Professional Education Text (Topic K).[4]

The Service determined that the transfer of a life insurance policy to an income exception CRUT would not disqualify the CRUT.[5]

7984. What are FLIP unitrusts?

A CRUT that is funded with assets that are illiquid may require special care. Under the conditions described below, the grantor may employ a net income with makeup provision until the assets are sold, thus preventing an ill-timed sale or an invasion of the trust corpus, then switch (i.e., "flip") to a fixed percentage payout once the assets have been sold. A trust that provides first for the use of a net income with makeup payout, followed by a fixed percentage payout is referred to as a *flip unitrust*.

Regulations allow the use of flip unitrusts provided all the following conditions are satisfied:

(a) The trust instrument must provide that the one-time change in payout methods (i.e., the flip) is triggered on a specific date, or by a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other persons.[6] Permissible triggering events include marriage, divorce, death, the birth of a child, or the sale of "unmarketable assets" (i.e., assets other than cash, cash equivalents, or assets that can be readily sold or changed for cash equivalents). For example, unmarketable assets would include real property, closely held stock,

1. Treas. Reg. §1.664-3(a)(1)(i)(b)(3).
2. See Let. Ruls. 9711013, 9511029, 9511007, 9442017.
3. TAM 9825001.
4. See Internal Revenue Service Exempt Organizations Continuing Professional Education Text for Fiscal Year 1999, Chapter P, 30 Years After the 1969 TRA – Recent Developments Under Chapter 42 (IRC Section 4940 – Investment Income Tax).
5. See Let. Rul. 199915045. See also Let. Rul. 200117016 (stock redemptions did not result in self-dealing).
6. Treas. Reg. §1.664-3(a)(1)(i)(c).

and unregistered securities for which there is no available exemption permitting public sale.[1]

(b) Following the "flip," only fixed percentage payouts (i.e., no net income makeup amounts) may be provided under the terms of the trust.[2] Any makeup amounts remaining due at the time of the change in payout methods are forfeited when the trust converts to the fixed percentage method.[3]

(c) The "flip" may be made *only* from the net income method to the fixed percentage method.[4] A CRUT cannot convert from a fixed percentage method to a net income method without losing its status as a CRT.[5]

(d) The change from the net income with makeup amount method to the fixed percentage payout method must occur at the beginning of the taxable year that immediately follows the taxable year during which the triggering date or event occurs.[6]

The regulations for flip unitrusts are effective for CRUTs created after December 9, 1998. Generally, a trust may *not* be amended or reformed to *add* a flip provision.[7]

7985. Can a charitable remainder unitrust be reformed in order to qualify for a charitable deduction?

A trust must qualify as a charitable remainder unitrust at its inception in order to generate a charitable deduction. The extent to which the provisions of a CRUT may be changed in any way after its inception has been the subject of a variety of ruling requests.

In a position consistent with the regulations described above, the IRS has prohibited the reformation of a trust to change from a net income with make-up provision to a fixed percentage provision[8] or to remove a net income limitation.[9]

The Service has ruled that reforming a CRUT by converting the trust from a net income method CRUT (NIMCRUT) to a fixed percentage CRUT would not adversely affect the CRUT's qualification status.[10]

The Service has permitted reformation of a trust instrument with respect to certain characteristics that have little or no impact on its payouts. For instance, the reformation of a unitrust to allow a grantor to change or designate other charitable organizations as the remainder beneficiaries did not affect the trust's qualification as a CRUT.[11] Moreover, an amendment that

1. Treas. Regs. §§1.664-1(a)(7), 1.664-3(a)(1)(i)(d).
2. Treas. Reg. §1.664-3(a)(1)(i)(c)(3).
3. TD 8791, 63 Fed. Reg. 68188 (12-10-98).
4. Treas. Reg. §1.664-3(a)(1)(i)(c).
5. TD 8791, 63 Fed. Reg. 68188 (12-10-98).
6. Treas. Reg. §1.664-3(a)(1)(i)(c).
7. Treas. Reg. §1.664-3(a)(1)(i)(f)(2).
8. Let. Rul. 9506015.
9. Let. Rul. 9516040.
10. Let. Rul. 200002029.
11. Let. Rul. 9517020. See also Let. Ruls. 200002029, 9826021, 9818027.

merely reallocated the unitrust amount between the beneficiaries during their joint lives to comply with the requirements for a CRUT, effective retroactively to the date of the creation of the trust, was permitted under the qualified reformation provisions of IRC Section 2055(e)(3).[1] However, the IRS has determined that a trust would be disqualified by an amendment to change the successive order of the noncharitable lifetime beneficiaries, regardless of the consent of all interested parties.[2]

The IRS has also determined that the division of one CRUT into two CRUTs would not cause the original or resultant trusts to fail to qualify under IRC Section 664.[3] The IRS has treated the division of a charitable remainder trust into separate trusts as a nontaxable event where the separate trusts are funded pro rata and beneficiaries receive interests that are essentially equal to the original interests.[4]

The Service ruled that the assignment of trust principal to three of four named charitable remainder beneficiaries of the CRUT would not disqualify the trust as a CRUT provided that the named charitable remainder beneficiaries were public charities.[5]

The IRS has privately ruled that the donor/unitrust recipient of a CRUT could donate his entire unitrust interest in an existing CRUT to the charitable remainderperson in consideration for a gift annuity that would be payable to him.[6]

The termination of a CRUT and the disposition of the donor/noncharitable beneficiary's interest in the trust resulted in the noncharitable beneficiary having to recognize long-term capital gain on the entire amount realized from the disposition of his unitrust interest in the trust. However, no act of self-dealing resulted from the termination and disposition of the unitrust interest.[7]

The Service determined that the rescission of a CRUT (because of the charity's misrepresentations about the income tax consequences of the trust) would be recognized for federal income tax purposes as of the date the trust was created.[8]

7986. What grantor powers can a trust provide and still qualify as a charitable remainder trust?

The following powers provided by a trust instrument to the grantor did not disqualify a charitable remainder unitrust: (1) the power to terminate all or a portion of the trust early and distribute the trust corpus to any charity, (2) the power to change the charitable remainderpersons, (3) the power to limit the type of assets the trust may accept or hold (provided the

1. Let. Rul. 9845001.
2. Let. Rul. 9143030.
3. See Let. Ruls. 200301020, 200221042, 200143028, 200140027, 200120016, 200109006, 200045038, 200035014, 9851007, 9851006, 9403030. See also Let. Ruls. 200207026, 200205008 (involving partial terminations).
4. Rev. Rul. 2008-41, 2008-30 IRB 171.
5. See Let. Rul. 200124010.
6. Let. Rul. 200152018.
7. See Let. Ruls. 200208039, 200127033.
8. Let. Rul. 200219012.

restriction did not violate Treasury Regulation Section 1.664-1(a)(3)), and (4) the power to remove and replace the trustee.[1]

The IRS has determined that a trustee of a charitable remainder unitrust that was funded with an insurance policy on the grantor's life could pay the premiums on that policy without disqualifying the trust under IRC Section 664. The grantor was not treated as the owner of the trust because the premiums were payable only out of trust principal. In addition, all amounts received under the policy were allocable to trust principal.[2]

The Service has ruled that there is nothing in the rule governing the tax-exempt status of CRUTs,[3] or the applicable regulations, that prohibits a trust from being a permissible grantor/donor for a CRUT.[4]

The Service has determined that a second contribution to a CRUT, whose governing instrument expressly prohibited any additional contributions after the first contribution, would be ignored for federal income tax purposes and would not disqualify the CRUT provided that the grantors amended their tax returns and reported any capital gains and dividend income generated by the second contribution.[5]

In a case of first impression, a bankruptcy court held that a donor's unitrust interest in a self-settled CRUT, and his powers to (1) remove and replace trustees and (2) amend the trust to protect his tax status were the property of the bankruptcy estate.[6]

7987. How are unmarketable assets in a charitable remainder trust treated? Is an appraisal required?

The regulations provide that if the only trustee is the grantor, a noncharitable beneficiary, or a related or subordinate party to the grantor or the noncharitable beneficiary, a CRUT's "unmarketable assets" (defined in Q 7984) must be valued by *either* an "independent trustee" or by a "qualified appraisal" from a "qualified appraiser."[7] An "independent" trustee" is a person who is *not* the grantor, the grantor's spouse, a noncharitable beneficiary, or a party who is related or subordinate to the grantor, the grantor's spouse, or the noncharitable beneficiary. However, a *co-trustee* who is an "independent" trustee may value the trust's unmarketable assets.[8] For an explanation of the application of the Chapter 14 special valuation rules to CRUTs, see Q 781.

The Service has ruled that a CRUT was not disqualified even though the grantors were also the sole trustees because the trust instrument provided that the trust could only accept, invest in, and hold assets with an objectively ascertainable market value.[9]

1. Let. Rul. 9138024.
2. Let. Rul. 9227017; see also Let. Rul. 199915045.
3. IRC Sec. 664.
4. Let. Rul. 9821029.
5. Let. Rul. 200052026.
6. See *Lindquist v. Mack*, 2001-2 USTC ¶50,754 (D. Minn. 2001).
7. Treas. Reg. §1.664-1(a)(7).
8. Treas. Reg. §1.664-1(a)(7).
9. Let. Rul. 200029031.

7988. What is a pooled income fund?

A pooled income fund is a trust maintained by the charity into which each donor transfers property and from which each named beneficiary receives an income interest. The amount of the income is determined by the rate of return earned by the trust for the year. The remainder interest ultimately passes to the charity that maintains the fund.[1]

All contributions to a pooled income fund are commingled, and all transfers to it must meet the requirements for an irrevocable remainder interest. The pooled income fund cannot accept or invest in tax-exempt securities, and no donor or beneficiary of an income interest can be a trustee of the fund.[2]

Special rules apply to contributions (if permitted) of depreciable property. A pooled income fund that is not prohibited (either under state law or its governing instrument) from accepting contributions of depreciable property must (1) establish a depreciation reserve fund with respect to any depreciable property held by the trust; and (2) calculate the amount of depreciation additions to the reserve in accordance with generally accepted accounting principles.[3] The purpose of these requirements is to ensure that the value of the remainder interest is preserved for the charity.[4]

The amount of the charitable contribution deduction allowable for a donation of property to a pooled income fund is the present value of the remainder interest. The present value of the remainder interest is determined by subtracting the present value of the income interest from the fair market value of the property transferred.[5] The present value of the income interest is based on the highest rate of return earned by the fund for any of the three years immediately preceding the taxable year of the fund during which the contribution is made. If the fund has not been in existence for three years, the highest rate of return is deemed to be the interest rate (rounded to the nearest 2/10ths of 1 percent) that is 1 percent less than the highest annual average of the monthly IRC Section 7520 interest rates for the three years preceding the year in which the transfer to the fund is made.[6] The deemed rate of return for transfers to new pooled income funds in 2014 is 1.4 percent.[7]

Under regulations, the definition of "income" for pooled income funds is amended to reflect certain state statutory changes to the concepts of income and principal. (See Q 7980 for additional background.) The regulations provide that the term "income" has the same meaning as it does under IRC Section 643(b) and the regulations, except that income generally may *not* include any long-term capital gains. However, in conformance with applicable state statutes, income may be defined as or satisfied by a unitrust amount, or pursuant to a trustee's power to adjust between income and principal to fulfill the trustee's duty of impartiality, *if* the state statute: (1) provides

1. IRC Sec. 642(c)(5).
2. IRC Sec. 642(c)(5); Treas. Reg. §1.642(c)-5(b).
3. Rev. Rul. 92-81, 1992-2 CB 119.
4. Rev. Rul. 90-103, 1990-2 CB 159; Let. Rul. 9334020.
5. Treas. Reg. §1.642(c)-6(a)(2).
6. Treas. Reg. §1.642(c)-6(e).
7. Rev. Rul. 2014-1, Table 6.

for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust; *and* (2) meets the requirements of Treasury Regulation Section 1.643(b)-1. In exercising a power to adjust, the trustee must allocate to principal, and *not* to income, the proceeds from the sale or exchange of any assets contributed to the fund by any donor or purchased by the fund at least to the extent of the fair market value of those assets on the date of their contribution to the fund or of the purchase price of those assets purchased by the fund.[1]

A group of pooled income funds will be treated as a single community trust if the funds operate under a common name, have a common governing instrument, prepare common reports, and are under the direction of a common governing board that has the power to modify any restriction on distributions from any of the funds, if in the sole judgment of the governing body, the restriction becomes unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served.[2] A pooled income fund is considered maintained by such a trust if, in the instrument of transfer: (1) the donor gives the remainder interest to the community trust with full discretion to choose how the remainder interest will be used to further charitable purposes, or (2) the donor either requests or requires that the community trust place the proceeds of the remainder interest in a fund that is designated to be used for the benefit of specific charitable organizations provided the fund is a component part of the community trust.[3]

Examples of the calculation for the amount of a charitable contribution deduction of property transferred to a pooled income fund are provided below.

> *Example 1*: In July of 2014, Mr. Green transferred property worth $100,000 to a pooled income fund. Income is to be paid to Mrs. Green (age 70) for life. The highest rate of return earned by the fund for any of the three years immediately preceding 2014 was 5.2 percent.
>
> The value of the remainder interest payable to charity is calculated as follows:
>
> (1) Find the single life annuity factor for a person age 70 at a 5.2 percent rate of return – 9.1808 (from Single Life Annuity Factors Table in Appendix A).
>
> (2) Convert the factor in (1) to a remainder factor: 1 – (9.1808 × rate return of 5.2 percent) = .52260.
>
> (3) Multiply the value of the property transferred to the pooled income fund ($100,000) by the factor in (2) (.52260). The amount of the charitable contribution deduction is $52,260. (The same procedure applies to calculating a remainder interest following a pooled income interest for a term certain. However, Term Certain Annuity Factors are used instead of Single Life Annuity Factors.)
>
> *Example 2*: Assume the same facts as in the preceding example except that the highest rate of return earned by the fund for any of the three years immediately preceding 2014 was 5.15 percent. The 5.15 percent rate of return falls between interest rates for which factors are given (i.e., annuity factors for 5.0 percent and 5.2 percent, but not 5.15 percent, can be found in Appendix A). A linear interpolation must be made.
>
> The value of the remainder interest payable to charity is calculated as follows:
>
> (1) Find the single life annuity factor for a person age 70 at a 5.0 percent rate of return – 9.3180 (from Single Life Annuity Factors Table in Appendix A).

1. Treas. Reg. §1.642(c)-5(a)(5)(i).
2. Treas. Reg. §1.170A-9(e)(11)(i).
3. Rev. Rul. 96-38, 1996-2 CB 44; See Treas. Reg. §1.170A-9(e)(11)(ii).

(2) Convert the factor in (1) to a remainder factor: 1 – (9.3180 × rate of return of 5.0 percent) = .53410.

(3) Find the single life annuity factor for a person age 70 at a 5.2 percent rate of return – 9.1808 (from Single Life Annuity Factors Table in Appendix A).

(4) Convert the factor in (3) to a remainder factor: 1 – (9.1808 × rate of return of 5.2 percent) = .52260.

(5) Subtract the factor in (4) from the factor in (2): .53410 – .52260 = .01150.

(6) $$\frac{5.150\% - 5.000\%}{5.200\% - 5.000\%} = \frac{X}{.01150}$$

$$X = .00863$$

(7) Subtract X in (6) from the remainder factor at 5.0 percent from (2): .53410 – .00863 = .52547.

(8) Multiply the value of the property transferred to the pooled income fund ($100,000) by the interpolated remainder factor in (7) (.52547). The amount of the charitable contribution deduction is $52,547. (The same procedure applies to calculating a remainder interest following a pooled income interest for a term certain. However, Term Certain Annuity Factors are used instead of Single Life Annuity Factors).

The deduction is subject to the regular percentage limits discussed in Q 7964. See Q 7973 for a comparison of pooled income funds with charitable remainder trusts. See Q 7978 for an overview of certain requirements applicable to all such gifts.

7989. What is a donor advised fund?

A donor advised fund is a fund or account that (1) is separately identified by reference to the contributions of the donors, (2) is owned by a sponsoring organization, and (3) allows donors to have advisory privileges with respect to distributions and investments. A donor advised fund does not include a fund or account that makes distributions to only one charity. Nor does a donor advised fund include a fund or account with respect to which the donor advisor advises regarding grants for travel, study, or similar purposes if (1) the advice is given as member of a committee appointed by the sponsoring organization, (2) the committee is not controlled by such donor advisors, and (3) grants are made on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the sponsoring organization and meeting certain statutory requirements. A sponsoring organization can generally be any charitable organization other than a governmental entity or a private foundation.[1]

A donor advised fund allows the donor to avoid the expense of starting a private foundation himself. These funds are sponsored by commercial investment or financial companies (e.g., mutual fund companies), and also by community foundations. Donor advised funds differ from pooled income funds in that they do *not* provide for a lifetime income stream to the donor or other beneficiary.

A charitable deduction for a contribution to a donor advised fund is allowed only if (1) the sponsoring organization is not a war veterans organization, a fraternal order or society, a cemetery company, or a type III supporting organization that is not functionally integrated; and (2) the donor receives a contemporaneous written acknowledgment from the sponsoring

1. IRC Sec. 4966(d), as added by PPA 2006.

organization of the donor advised fund that the organization has exclusive legal control over the assets contributed.[1]

The Service has provided interim guidance regarding the application of certain requirements enacted under PPA 2006 that affect donor advised funds.[2]

An important factor when analyzing donor advised funds is the amount of control that can be exercised by the donor over the fund's distribution of his contributed funds.[3] Also see *Styles v. Friends of Fiji*, No. 51642 (Nev. 2011) unpublished opinion. A purported donor advised fund did not qualify as a publicly supported charity, but instead as a private foundation, where: (1) the potential donors had personal connections to the trustee; (2) the trust did not intend to employ a professional fundraiser (or similar fundraising program); (3) the trust did not budget any money on fundraising activities; (3) and no written documents explained how the trust would solicit funds from the general public who were unknown to the trustee.[4] The Court of Federal Claims has ruled that a donor advised foundation does not qualify for tax-exempt status under IRC Section 501(c)(3).[5]

In two private letter rulings approving what the recipient of the letter rulings referred to as "donor managed investment accounts," the Service approved an arrangement where: (1) under agreements between donors and the charity, donations would be placed into an account; (2) each donation would be unconditional and irrevocable; (3) donors would surrender all rights to reclaim ownership, possession, or a beneficial interest in any donation; (4) donors or their investment managers would be permitted to manage the investments in the account for 10 years under a limited power of attorney, subject to certain investment restrictions and limitations; (5) the charity would have the right at any time or for any purpose, and in its sole discretion, to withdraw all of the assets held in the account or to terminate the limited power of attorney and the agreement; and (6) the agreement would terminate automatically in cases of severe loss as determined by the charity in its sole discretion. Approving the arrangement, the Service reasoned that the retention of investment management control by the donors, subject to the restrictions and limitations in the agreements, was not substantial enough to affect the deductibility of the property contributed, and did not constitute the retention of a prohibited partial interest under IRC Section 170(f)(3)(see Q 7971).[6] The Service also concluded that a proposed "online" donor advised fund would be able to treat contributions made through the donor advised fund as support received from the general public for purposes of meeting the public support test under IRC Section 170(b)(1)(A)(vi) and IRC Section 509(a)(1) and also citing Treasury Regulation Section 1.507-2(a)(8).[7] The Service privately ruled that the creation of a donor advised fund by a supporting organization did not adversely affect the tax-exempt

1. IRC Sec. 170(f)(18), as added by PPA 2006.
2. See Notice 2006-109, 2006-51 IRB 1121.
3. See, e.g., *National Foundation, Inc. v. U.S.*, 13 Cl. Ct. 486 (1987); *The Fund for Anonymous Gifts v. Internal Revenue Service*, 97-2 USTC ¶50,710 (1997), *vacated, and remanded*, 194 F.3d 173 (D.C. Cir. 1999).
4. *The Fund for Anonymous Gifts v. IRS*, 88 AFTR2d ¶6040 (D.C. Cir. 2001).
5. See *New Dynamics Foundation v. U.S.*, 70 Fed. Cl. 782, 2006-1 USTC ¶50,286 (Cl. Ct. 2006).
6. Let. Ruls. 200445024, 200445023.
7. Advanced Letter Ruling 2000ARD 203-3 (8-2-2000), *superseding*, Let. Rul. 200037053.

status of the supporting organization.[1] Transfers by donors to donor advised funds established by a public charity were not subject to material restrictions or conditions and, thus, could be treated as public charities.[2]

7990. How much can be deducted for a gift to a charitable remainder annuity trust or unitrust? When is the deduction taken?

An income tax deduction may be claimed for the charitable gift in the year the funds are irrevocably placed in trust, unless the gift is of tangible personal property. (A gift of a future interest, such as a remainder interest, in tangible personal property is deductible only when all the intervening interests have expired or are held by parties unrelated to the donor.[3]) The fair market value of the gift is the present value of the charity's right to receive the trust assets at the end of the intervening interest.[4]

In general, the amount of the charitable contribution deduction allowable for the transfer of property to a charitable remainder *annuity* trust is equal to the present value of the remainder interest. The present value of the remainder interest is determined by subtracting the present value of the annuity payable to the noncharitable beneficiary (see Appendix A) from the fair market value of the property transferred.[5]

Example 1. In September, Mr. Smith transferred property worth $100,000 to a charitable remainder annuity trust. The trust is to make biannual payments (at the end of each 6-month period) of $2,500 to Mrs. Smith (age 85) during her lifetime. Assume the IRC Section 7520 interest rates for September and the two preceding months, July and August, were 3.0 percent, 2.8 percent, and 2.6 percent. Mr. Smith elected to use the 3.0 percent rate.

The value of the annuity payable to Mrs. Smith is calculated as follows:

(1) Find the single life annuity factor for a person age 85 at a 3.0 percent interest rate – 5.3605 (from Single Life Annuity Factors Table in Appendix A).

(2) Find the adjustment factor at a 3.0 percent interest rate for semi-annual annuity payments at the end of each period – 1.0074 (from Annuity Adjustment Factors Table A in Appendix A).

(3) Multiply the aggregate payments received during a year by the factors in (1) and (2) – $5,000 × 5.3605 × 1.0074 = $27,001.

The amount of the charitable contribution deduction is equal to the value of the property transferred to the charitable remainder annuity trust ($100,000) reduced by the value of the annuity payable to Mrs. Smith ($27,001) – $72,999.

Example 2. If in Example 1, payments were to be made to Mrs. Smith at the beginning of each 6-month period (instead of at the end of each period), one payment is added to the value of the annuity payable at the end of each period. The value of the annuity payable at the beginning of each period would be $29,501 ($27,001 + $2,500). The amount of the charitable contribution deduction would be equal to the value of the property transferred to the charitable remainder annuity trust ($100,000) reduced by the value of the annuity payable to Mrs. Smith ($29,501) – $70,499.

1. See Let. Rul. 200149005.
2. See Let. Rul. 200150039.
3. IRC Sec. 170(a)(3); Treas. Reg. §1.170A-5.
4. Treas. Regs. §§1.664-2(c), 1.664-4(a).
5. Treas. Reg. §1.664-2(c).

Example 3. If payments in Example 1 were to be made for 20 years rather than for Mrs. Smith's life, the value of the annuity payable to Mrs. Smith (at the end of each 6-month period) is calculated as follows:

(1) Find the term certain annuity factor for 20 years at a 3.0 percent interest rate – 14.8775 (from Term Certain Annuity Factors Table in Appendix A).

(2) Find the adjustment factor at a 3.0 percent interest rate for semi-annual annuity payments at the end of each period – 1.0074 (from Annuity Adjustment Factors Table A in Appendix A).

(3) Multiply the aggregate payments received during a year by the factors in (1) and (2) – $5,000 × 14.8775 × 1.0074 = $74,938.

The amount of the charitable contribution deduction is equal to the value of the property transferred to the charitable remainder annuity trust ($100,000) reduced by the value of the annuity payable to Mrs. Smith ($74,938) – $25,062.

Example 4. If payments in Example 2 were to be made for 20 years rather than for Mrs. Smith's life, the value of the annuity payable to Mrs. Smith (at the beginning of each period) is calculated as follows:

(1) Find the term certain annuity factor for 20 years at a 3.0 percent interest rate – 14.8775 (from Term Certain Annuity Factors Table in Appendix A).

(2) Find the adjustment factor at a 3.0 percent interest rate for a term certain annuity payable at the beginning of each semi-annual period – 1.0224 (from Annuity Adjustment Factors Table B in Appendix A).

(3) Multiply the aggregate payments received during a year by the factors in (1) and (2) – $5,000 × 14.8775 × 1.0224 = $76,054.

The amount of the charitable contribution deduction is equal to the value of the property transferred to the charitable remainder annuity trust ($100,000) reduced by the value of the annuity payable to Mrs. Smith ($76,054) = $23,946.

In general, the amount of the charitable contribution deduction allowable for the transfer of property to a charitable remainder *unitrust* is equal to the present value of the unitrust remainder interest.[1] If the unitrust payments are made annually at the beginning of each year and the annual payout rate is equal to an adjusted payout rate for which factors are given, the present value of the unitrust remainder interest can be calculated simply by multiplying the value of the property transferred to the charitable remainder unitrust by the appropriate unitrust remainder factor (see Appendix A). If the unitrust payments are made other than annually at the beginning of each year or the annual payout rate falls between adjusted payout rates for which factors are given, the calculation of the deduction for a contribution to a charitable remainder unitrust is more complex.

Example 5. In September, Mr. Smith transferred property worth $100,000 to a charitable remainder unitrust. The trust is to make annual payments (at the beginning of each year) of 5 percent of the value of the trust corpus (valued annually) to Mrs. Smith (age 85) during her lifetime (i.e., a 5 percent annual payout rate).

The present value of the unitrust remainder interest is calculated as follows: Multiply the value of the property transferred to the charitable remainder unitrust ($100,000) by the single life unitrust remainder factor for a person age 85 at a 5 percent payout rate (.74516 – from Single Life Unitrust Remainder Factors Table in Appendix A). The amount of the charitable contribution deduction is $74,516.

1. Treas. Reg. §1.664-4(a).

Example 6. If the unitrust payments in Example 5 were to be made for 20 years (at the beginning of each year) rather than for Mrs. Smith's life, the present value of the unitrust remainder interest is calculated as follows: Multiply the value of the property transferred to the charitable remainder unitrust ($100,000) by the term certain unitrust remainder factor for 20 years at a 5 percent payout rate (.358486 – from Term Certain Unitrust Remainder Factors Table in Appendix A). The amount of the charitable contribution deduction is $35,849.

Example 7. Assume the same facts as in Example 5, except that payments are to be made at the end of each year. Assume the valuation table interest rates for September and the two preceding months, July and August, were 3.0 percent, 2.8 percent, and 2.6 percent. Mr. Smith elected to use the 3.0 percent rate.

The value of the unitrust remainder payable to charity is calculated as follows:

(1) Find the unitrust payout adjustment factor for annual payments to start 12 months after the valuation date at a 3.0 percent interest rate: .970874 (from Unitrust Payout Adjustment Factors Table in Appendix A).

(2) Multiply the factor in (1) by the annual payout rate to obtain the adjusted payout rate: .970874 × 5 percent = 4.854 percent.

(3) Find the single life unitrust remainder factor for a person age 85 at a 4.8 percent adjusted payout rate: .75352 (from Single Life Unitrust Remainder Factors Table in Appendix A).

(4) Find the single life unitrust remainder factor for a person age 85 at a 5.0 percent adjusted payout rate: .74516 (from Single Life Unitrust Remainder Factors Table in Appendix A).

(5) Subtract the factor in (4) from the factor in (3): .75352 - .74516 = .00836.

(6) $$\frac{4.854\% - 4.800\%}{5.000\% - 4.800\%} = \frac{X}{.00836}$$

$$X = .00226$$

(7) Subtract X in (6) from the factor at 4.8 percent from (3): .75352 – .00226 = .75126.

(8) Multiply the value of the property transferred to the charitable remainder unitrust ($100,000) by the interpolated unitrust remainder factor in (7) (.75126). The amount of the charitable contribution deduction is $75,126. [The same procedure applies to calculating a unitrust remainder interest following a unitrust interest for a term certain. However, Term Certain Unitrust Remainder Factors are used instead of Single Life Unitrust Remainder Factors.]

The remainder interest must equal at least 10 percent of the fair market value of the property placed in the trust.[1] See Q 7979, Q 7980.

The deduction is subject to the regular percentage limits discussed in Q 7964. If depreciable real property is given to the trust, the calculation is more complex.[2] If appreciated property is given to the trust, it may be necessary to reduce the value of the gift by the amount of capital gain or ordinary income that would be realized if the property were sold at fair market value (see Q 7966). If so, basis must be allocated between the noncharitable and charitable interests in order to determine the amount of gain or income, if any, that would be realized on sale of the part of the property contributed to the charity.[3] Basis is allocated to the present value of the remainder interest in the same proportion that the present value of the gift bears to the fair

1. IRC Sec. 664(d).
2. See Treas. Reg. §1.170A-12.
3. IRC Sec. 170(e)(2).

market value of the property.[1] If property given is subject to a loan, the transfer can result in a gain to the donor under the bargain sale rules (see Q 7969).

7991. How are the payments from a charitable remainder trust to a beneficiary taxed?

Amounts distributed to noncharitable beneficiaries retain the character (ordinary income, capital gain, and other income such as tax-exempt income) they had when received by the trust (even if the trust is not taxed on the income). However, the income of the trust is deemed to be distributed in the following order:

First, distributions are treated as made out of the ordinary income of the trust to the extent it has ordinary income for the tax year plus its ordinary income not distributed for prior years. Ordinary income not distributed is carried over as such until the next year.[2]

Second, distributions in excess of ordinary income are considered to be distributions of net capital gain, to the extent of the trust's net capital gain not previously distributed.[3] (See Q 608 for a detailed explanation of the calculation of capital gains and losses.)

Third, if distributions exceed both accumulated ordinary income and accumulated net capital gain, the excess is treated as other income, including tax-exempt income, to the extent the trust has other income for the tax year and undistributed other income for prior years.[4]

Finally, to the extent distributions for the year exceed the above amounts, the distribution is deemed a non-taxable return of trust corpus.[5]

> *Example*: Jerry establishes a charitable remainder trust with low basis stock that today is worth $100,000. He elects a 7 percent payout. Jerry's $7,000 payment will be taxed under four different categories depending on the investment performance of the trust over the year. This year, Jerry's payment consists of $3,000 of ordinary income, $2,000 of capital gain, $1,000 of tax-exempt income and $1,000 of tax-free return of principal.

If there are two or more recipients, each is treated as receiving a pro rata portion of each category of income included in the distribution.[6]

The amount of the distribution is includable in income by the recipient for the tax year in which the amount is required to be distributed, even though the amount is not distributed until after the close of the trust's tax year. If the recipient and the trust have different tax years, the amount is includable in the tax year of the recipient in which the trust's tax year (in which the amount is required to be distributed) ends.[7] However, if the trust's distributable net income is less than the percentage payout designated in the trust instrument (as may occur by design

1. Treas. Reg. §1.170A-4(c)(1).
2. IRC Sec. 664(b)(1).
3. IRC Sec. 664(b)(2).
4. IRC Sec. 664(b)(3).
5. IRC Sec. 664(b)(4); Treas. Reg. §1.664-1(d).
6. Treas. Reg. §1.664-1(d)(3).
7. Treas. Reg. §1.664-1(d)(4)(i).

in the early years of a *net income with makeup unitrust* – see Q 7973), each beneficiary takes into account only his proportionate share of distributable net income.[1]

Amounts received are taxed under these rules, even if the trust itself paid tax on any of its income.[2] (See Q 7994 regarding taxation of a charitable trust.) A charitable remainder trust must pay a 100 percent excise tax on its unrelated business taxable income (UBTI). The excise tax is allocated to corpus and does not reduce the taxable income of the trust. The UBTI is considered income of the trust for purposes of determining the character of the distribution to a beneficiary. Trust income is allocated among the trust income categories regardless of whether the income is UBTI.[3]

The IRS privately ruled that amounts treated as consent dividends may be included in a trust's income for purposes of IRC Section 664(b)(1), but do not constitute trust income for purposes of IRC Section 664(d)(3)(A).[4] The IRS determined that where income received by a charitable remainder trust from its ownership of a limited partnership interest constituted rental activity income, such income would be treated as income from a rental activity in the hands of the unitrust beneficiaries.[5]

7992. What are the ordering rules that are used to characterize distributions from a charitable remainder trust?

In 2005, the Service released final regulations on the ordering rules of IRC Section 664(b) for characterizing distributions from charitable remainder trusts. The final rules reflect changes made to income tax rates, including the rates applicable to capital gains and certain dividends, by TRA 1997, IRSRRA 1998, and JGTRRA 2003.[6]

Assignment of income to categories and classes. A trust's income, including income includible in gross income and other income, is assigned to one of three *categories* in the year in which it is required to be taken into account by the trust. These categories are: (1) gross income, other than gains and amounts treated as gains from the sale or other disposition of capital assets (the "ordinary income category"); (2) gains and amounts treated as gains from the sale or other disposition of capital assets (the "capital gains category"); and (3) other income.[7]

Items within the ordinary income and capital gains categories are assigned to different *classes* based on the federal income tax rate applicable to each type of income in that category in the year the items are required to be taken into account by the trust. For example, the ordinary income category may include a class of "qualified dividend income" as defined in IRC Section 1(h)(11) (see Q 608) and a class of all other ordinary income.

1. IRC Sec. 662(a)(1).
2. Treas. Reg. §1.664-1(d)(1)(ii).
3. Treas. Reg. §1.664-1(c).
4. Let. Rul. 199952035.
5. Let. Rul. 9114025.
6. See TD 9190, 70 Fed. Reg. 12793 (3-16-2005).
7. Treas. Reg. §1.664-1(d)(1)(i)(a).

In addition, the capital gains category may include separate *classes* for short-term and long-term capital gains and losses, such as: (1) a short-term capital gain class; (2) a 28 percent long-term capital gain class (i.e., gains and losses from collectibles and IRC Section 1202 gains); (3) an unrecaptured IRC Section 1250 long-term capital gain class (i.e., long-term gains not treated as ordinary income that would be treated as ordinary income if IRC Section 1250(b)(1) included all depreciation); (4) a qualified 5-year long-term capital gain class (as defined by IRC Section 1(h)(9) prior to amendment by JGTRRA 2003); and (5) an all other long-term capital gain class.[1]

After items are assigned to a class, the tax rates may change so that items in two or more classes would be taxed at the same rate if distributed during a particular year. If the changes to the tax rates are permanent, the undistributed items in those classes are combined into one class. However, if the changes to the tax rates are only temporary (for example, the new rate for one class will "sunset" (i.e., expire) in a future year), the classes are kept separate.[2]

Order of distributions. The categories and classes of income (determined under Treasury Regulation Section 1.664-1(d)(1)(i)) are used to determine the character of an annuity or unitrust distribution from the trust in the hands of the recipient regardless of whether the trust is exempt from taxation under IRC Section 664(c) for the year of the distribution. The determination of the character of amounts distributed or deemed distributed at any time during the taxable year of the trust must be made as of the end of that taxable year.

The tax rate or rates to be used in computing the recipient's tax on the distribution will be the tax rates that are applicable in the year in which the distribution is required to be made, to the classes of income deemed to make up that distribution, and *not* the tax rates that are applicable to those classes of income in the year the income is received by the trust.[3]

The character of the distribution in the hands of the annuity or unitrust recipient is determined by treating the distributions as being made from each category in the following order:

(1) First, from *ordinary income* to the extent of the sum of the trust's ordinary income for the taxable year and its undistributed ordinary income for prior years;

(2) Second, from *capital gain* to the extent of the trust's capital gains (determined under Treasury Regulation Section 1.664-1(d)(1)(iv));

(3) Third, from *other income* to the extent of the sum of the trust's other income for the taxable year and its undistributed other income for prior years; and

(4) Finally, from *trust corpus* (with "corpus" defined for this purpose as the net fair market value of the trust assets minus the total undistributed income (but not loss) in Treasury Regulation Sections 1.664-1(d)(1)(i)(a)(1)-(3)).[4]

1. Treas. Reg. §1.664-1(d)(1)(i)(b).
2. Treas. Reg. §1.664-1(d)(1)(i)(b).
3. Treas. Reg. §1.664-1(d)(1)(ii)(a).
4. Treas. Reg. §1.664-1(d)(1)(ii)(a).

If the trust has different classes of income in the ordinary income category, the distribution from that category is treated as being made from each class, in turn, until exhaustion of the class, beginning with the class subject to the highest federal income tax rate and ending with the class subject to the lowest federal income tax rate.[1]

If the trust has different classes of net gain in the capital gains category, the distribution from that category is treated as being made first from the short-term capital gain class and then from each class of long-term capital gain, in turn, until the exhaustion of the class, beginning with the class subject to the highest federal income tax rate and ending with the class subject to the lowest rate.[2]

If two or more classes within the same category are subject to the same current tax rate, but at least one of those classes will be subject to a different tax rate in a future year (e.g., if the current rate "sunsets," or expires), the order of that class in relation to other classes in the category with the same current tax rate is determined based on the future rate or rates applicable to those classes.[3]

Within each category, if there is more than one type of income in a class, amounts treated as distributed from that class are to be treated as consisting of the same proportion of each type of income as the total of the current and undistributed income of that type bears to the total of the current and undistributed income of all types of income included in that class. For example, if rental income and interest income are subject to the same current and future federal income tax rate and, therefore, are in the same class, a distribution from that class will be treated as consisting of a proportional amount of rental income and interest income.[4]

Treatment of losses. In the ordinary income category, a net ordinary loss for the current year is first used to reduce undistributed ordinary income for prior years that is assigned to the same class as the loss. Any excess loss is then used to reduce the current and undistributed ordinary income from other classes, in turn, beginning with the class subject to the highest federal income tax rate and ending with the class subject to the lowest federal income tax rate. If any of the loss exists after all the current and undistributed ordinary income from all classes has been offset, the excess is carried forward indefinitely to reduce ordinary income for future years.[5]

A net loss in the other income category for the current year is used to reduce undistributed income in this category for prior years. Any excess is carried forward indefinitely to reduce other income for future years.[6]

1. Treas. Reg. §1.664-1(d)(1)(ii)(b).
2. Treas. Reg. §1.664-1(d)(1)(ii)(b).
3. Treas. Reg. §1.664-1(d)(1)(ii)(b).
4. Treas. Reg. §1.664-1(d)(1)(ii)(b).
5. Treas. Reg. §1.664-1(d)(1)(iii)(a).
6. Treas. Reg. §1.664-1(d)(1)(iii)(b).

7993. What is the netting procedure applied to determine capital gains (or losses) of a charitable remainder trust?

Capital gains of the trust are determined on a cumulative net basis (under the rules of Treasury Regulation Section 1.664-1(d)(1)) without regard to the provisions of IRC Section 1212. For each taxable year, current and undistributed gains and losses within each class are netted to determine the net gain or loss for that class. The classes of capital gains and losses are then netted against each other in the following order:

(1) *First*, a net loss from a class of long-term capital gain and loss (beginning with the class subject to the highest federal income tax rate and ending with the class subject to the lowest rate) is used to offset net gain from each other class of long-term capital gain and loss, in turn, until exhaustion of the class, beginning with the class subject to the highest federal income tax rate and ending with the class subject to the lowest rate.

(2) *Second*, either:

(a) a net loss from all the classes of long-term capital gain and loss (beginning with the class subject to the highest federal income tax rate and ending with the class subject to the lowest rate) is used to offset any net gain from the class of short-term capital gain and loss; *or*

(b) a net loss from the class of short-term capital gain and loss is used to offset any net gain from each class of long-term capital gain and loss, in turn, until exhaustion of the class, beginning with the class subject to the highest federal income tax rate and ending with the class subject to the lowest federal income tax rate.

Carry forward of net capital gain. If, at the end of a taxable year, and after the application of Treasury Regulation Section 1.664-1(d)(1)(iv), a trust has any net loss or net gain that is not treated as distributed under Treasury Regulation Section 1.664-1(d)(1)(ii)(a)(2), the net gain or loss is carried over to succeeding taxable years and retains its character in succeeding taxable years as gain or loss from its particular class.[1]

For examples illustrating the application of the above rules, see Treasury Regulation Section 1.664-1(d)(1)(viii). For special transitional rules, see Treasury Regulation Section 1.664-1(d)(1)(vi).

7994. Is a charitable remainder annuity trust or unitrust subject to income tax?

Ordinarily, the trust is not taxed on its income.[2] Under prior law, the trust lost its tax-exempt status for any year in which it had unrelated business taxable income (UBTI). The old rule caused the loss of the CRT's exemption for even one dollar of UBTI. TRHCA 2006 modifies

1. Treas. Reg. 1.664-1(d)(1)(v).
2. IRC Sec. 664(c)(1).

the excise tax on unrelated business taxable income of charitable remainder trusts and changes the loss-of-exemption rule. The current law imposes a 100 percent excise tax, but leaves the CRT's exempt status intact.[1] The excise tax is allocated to corpus and does not reduce the taxable income of the trust.[2] See Q 7991 regarding how distributions from a charitable remainder trust are taxed to a beneficiary.

7995. What is unrelated business taxable income (UBTI)? When does a charitable remainder trust have UBTI?

An unrelated trade or business means any trade or business that is not substantially related to the charitable purpose of the trust.[3] In general, UBTI means the gross income derived by the trust from an unrelated trade or business regularly carried on by the trust, reduced by certain modified deductions directly connected to the unrelated trade or business.[4] For example, there is a specific deduction for up to $1,000 of UBTI.[5] Certain unrelated debt-financed income is also treated as UBTI.[6]

Unrelated business taxable income includes income from debt-financed property.[7] Securities purchased on margin have been held to be debt-financed property.[8] An exempt trust that is a limited partner may receive unrelated business income to the same extent as if it were a general partner.[9] A charitable remainder trust that received unrelated business taxable income from its investments in three limited partnerships was held to be taxable as a complex trust under IRC Section 664(c) to the full extent of its income.[10]

Planning Point: A common source of unrelated business taxable income encountered by charitable remainder trusts is an investment in a hedge fund, real estate limited partnership, or other form of pass-through entity. These types of investment products typically rely on debt of some form to achieve their investment goals. The prospectus or other offering statement should be carefully reviewed to determine if the entity will be reporting unrelated business taxable income to its investors. *Ted R. Batson, Jr., MBA, CPA, is Senior Vice President of Professional Services for Renaissance.*

7996. Can a deduction be taken for a charitable contribution to a charitable lead trust of a right to payment to the charity?

Yes, if certain requirements are met. A *charitable lead trust* is essentially the reverse of a charitable remainder trust; the donor grants a right to payment to the charity, with the remainder reverting to the donor (or his named beneficiaries). Such trusts are commonly called charitable "lead" trusts because the first or leading interest is in the charitable donee. Even though a gift of

1. IRC Sec. 664(c), as amended by TRHCA 2006.
2. Treas. Reg. §1.664-1.
3. IRC Sec. 513.
4. IRC Sec. 512.
5. IRC Sec. 512(b)(12).
6. IRC Sec. 514.
7. Treas. Reg. §1.664-1(c).
8. *Elliot Knitwear Profit Sharing Plan v. Comm.*, 614 F.2d 347 (3rd Cir. 1980).
9. *Service Bolt & Nut Co. Profit Sharing Trust v. Comm.*, 724 F.2d 519,84-1 USTC ¶9127 (6th Cir. 1983).
10. *Newhall Unitrust v. Comm.*, 105 F.3d 482, 104 TC 236 (1995), *aff'd*, 97-1 USTC ¶50,159 (9th Cir. 1997).

such an interest in property is less than the entire interest of the donor, its value will be deductible if the interest is in the form of a "guaranteed annuity interest" or a "unitrust interest."[1]

A *guaranteed annuity interest* is an irrevocable right to receive payment of a determinable amount at least annually. A *unitrust interest* is an irrevocable right to receive payment at least annually of a fixed percentage of the fair market value of the trust assets, determined annually. In either case, payments may be made to the charity for a term of years or over the life of an individual (or lives of more than one individual) living at the date of the transfer to the trust.

Only one (or more) of the following individuals may be used as measuring lives: (1) the donor; (2) the donor's spouse; (3) a lineal ancestor of all the remainder beneficiaries; or (4) the spouse of a lineal ancestor of all the remainder beneficiaries. A trust will satisfy the requirement that all noncharitable remainder beneficiaries be lineal descendants of the individual who is the measuring life (or that individual's spouse) if there is less than a 15 percent probability that individuals who are not lineal descendants will receive any trust corpus. This probability must be computed at the time property is transferred to the trust taking into account the interests of all primary and contingent remainder beneficiaries who are living at that time. The computation must be based on the current applicable Life Table in Treasury Regulation Section 20.2031-7.[2]

A guaranteed annuity may be made to continue for the shorter of a term of years or lives in being plus a term of years.[3] The IRS determined that an annuity met the requirements for a "guaranteed annuity" even though neither the term nor the amount was specifically stated; the term was ascertainable as of the death of the grantor, based on a formula described in the trust instrument.[4] The annuity cannot be for the lesser of a designated amount or a fixed percentage of the fair market value of trust assets, determined annually.[5] After termination of the charity's right to payment, the remainder interest in the property is returned to the donor or his designated beneficiaries.

> *Example*: Walter gives $1,000,000 to a charitable lead trust. The trust's term is 21 years paying 5 percent each year to his favorite charity. At the end of the 21 year period, the assets in the trust will be distributed to Walter's three children. The gift tax charitable deduction is $741,870 assuming annual trust payments and a 3.4 percent 7520 rate. Over the course of 21 years, the charity will receive $1,050,000. The children will receive the trust assets free of any further estate or gift taxes.

According to regulations, an income tax charitable deduction is allowable for a charitable annuity or unitrust interest that is *preceded* by a *noncharitable* annuity or unitrust interest. In other words, the regulations eliminate the requirement that the charitable interest start no later than the commencement of a noncharitable interest in the form of a guaranteed annuity or unitrust interest. However, the regulations continue to require that any amounts payable for a private purpose before the expiration of the charitable annuity or unitrust interest must be in the form of a guaranteed annuity or unitrust interest, *or* must be payable from a separate group of assets

1. IRC Sec. 170(f)(2)(B).
2. Treas. Regs. §§1.170A-6(c)(2)(i)(A), 1.170A-6(c)(2)(ii)(A).
3. Rev. Rul. 85-49, 1985-1 CB 330.
4. Let. Rul. 9118040.
5. Treas. Reg. §1.170A-6(c)(2)(B).

devoted exclusively to private purposes. The regulations conform the income tax regulations to the Tax Court's decision in *Estate of Boeshore*.[1]

The IRS determined that the requirements for a charitable lead annuity trust were met even though the trust authorized the trustee, who was the grantor's son, to choose among various charities to receive the annuity interest and apportion the payouts among them.[2]

The Service ruled that so long as a donor was treated as the owner of a guaranteed annuity interest for purposes of the grantor trust rules, the income interest transferred in trust to a private foundation qualified as a "guaranteed annuity interest" under IRC Section 170(f)(2)(B). Even though the present value on the date of the transfer exceeded 60 percent of the aggregate fair market value of all the amounts in trust, the Service reasoned that this did not prevent the income interest from being a "guaranteed annuity interest" because the trust agreement provided that the acquisition and retention of assets that would give rise to an excise tax if the trustee had acquired the assets was prohibited, in accordance with Treasury Regulation Section 1.170A-6(c)(2)(i)(D).[3]

The partition of a charitable lead annuity trust into three separate trusts to address differences of opinion among trustees as to the choice of charitable beneficiaries and the investment of trust assets did not cause the original trust, the new trusts, or any of the trusts' beneficiaries to realize income or gain.[4]

The Service has privately ruled that the sale of assets, which were pledged as collateral for a promissory note to the family's charitable lead annuity trust, to a limited liability company would not constitute self-dealing so long as the value of the collateral remained as required under the terms of the note, and would not give rise to tax liability under IRC Section 4941 to the CLATs, related family members, the estate, or the marital trusts.[5]

Sample Trusts. The IRS has released sample forms, annotations, and alternate provisions for inter vivos and testamentary charitable lead annuity trusts and unitrusts.[6]

7997. Is the deduction for a gift to a charitable lead annuity trust of a right to payment taken in the year of the gift?

An immediate deduction of the present value of all the annual payments to be made over the period may be taken *if* the trust is structured so that the donor is taxable on the income of the trust each year (under the "grantor trust rules"). If the trust is structured so that he is not taxable on trust income, he will not get an income tax deduction for the gift.[7] The IRS has

1. 78 TC 523 (1982), *acq. in result*, 1987-2 CB 1. See Treas. Regs. §§1.170A-6(c)(2)(i)(E), 1.170A-6(c)(2)(ii)(D); TD 9068, 68 Fed. Reg. 40130 (7-7-2003), *revoking*, Rev. Rul. 76-225, 1976-1 CB 281.
2. See Let. Rul. 9748009. See also Let. Ruls 200138018, 200043039, 200030014 (charitable gifts were not incomplete even though one or more family members would serve as directors of the charitable beneficiary of the grantors' CLUTs).
3. Let. Rul. 9810019.
4. Let. Rul. 199930036. See also Let. Rul. 200149016.
5. See Let. Rul. 200124029.
6. See Rev. Proc. 2007-45, 2007-29 IRB 89 (inter vivos CLATs); Rev. Proc. 2007-46, 2007-29 IRB 102 (testamentary CLATs); Rev. Proc. 2008-45, 2008-30 IRB 224 (inter vivos CLUTs); Rev. Proc. 2008-46, 2008-30 IRB 238 (testamentary CLUTs).
7. Treas. Reg. §1.170A-6(c). See, e.g., Let. Rul. 200108032.

determined that a donor was to be treated as the owner of a charitable lead trust where the donor retained the power to substitute trust property. The donor was entitled to a current deduction in an amount equal to the present value of the unitrust interest.[1]

In general, the amount of the charitable contribution deduction allowable for the transfer of property to a charitable lead *annuity* trust is equal to the present value of the annuity payable to the charity (see Appendix A).

Example 1. In September, Mr. Smith (age 85) transferred property worth $100,000 to a charitable lead annuity trust that is a grantor trust. The trust is to make biannual payments (at the end of each 6-month period) of $2,500 to the charity during his lifetime. Assume the IRC Section 7520 interest rates for September and the two preceding months, July and August, were 3.4 percent, 3.2 percent, and 3.0 percent. Mr. Smith elected to use the 3.0 percent rate because the *lowest* 7520 in the 3-month period produces the highest charitable deduction for charitable lead trusts.

The value of the annuity payable to charity is calculated as follows:

(1) Find the single life annuity factor for a person age 85 at a 3.0 percent interest rate – 5.3605 (from Single Life Annuity Factors Table in Appendix A).

(2) Find the adjustment factor at a 3.0 percent interest rate for semi-annual annuity payments at the end of each period – 1.0074 (from Annuity Adjustment Factors Table A in Appendix A).

(3) Multiply the aggregate payments received during a year by the factors in (1) and (2) – $5,000 × 5.3605 × 1.0074 = $27,001.

The amount of the charitable contribution deduction is equal to $27,001.

Example 2. If in Example 1, payments were to be made to charity at the beginning of each 6-month period (instead of at the end of each period), one payment is added to the value of the annuity payable at the end of each period. The value of the annuity payable at the beginning of each period would be $29,501 ($27,001 + $2,500). The amount of the charitable contribution deduction would be equal to $29,501.

Example 3. If payments in Example 1 were to be made for 20 years rather than for Mr. Smith's life, the value of the annuity payable to charity (at the end of each 6-month period) is calculated as follows:

(1) Find the term certain annuity factor for 20 years at a 3.0 percent interest rate – 14.8775 (from Term Certain Annuity Factors Table in Appendix A).

(2) Find the adjustment factor at a 3.0 percent interest rate for semi-annual annuity payments at the end of each period – 1.0074 (from Annuity Adjustment Factors Table A in Appendix A).

(3) Multiply the aggregate payments received during a year by the factors in (1) and (2) – $5,000 × 14.8775 × 1.0074 = $74,938.

The amount of the charitable contribution deduction is equal to $74,938.

Example 4. If payments in Example 2 were to be made for 20 years rather than for Mr. Smith's life, the value of the annuity payable to charity (at the beginning of each period) is calculated as follows:

(1) Find the term certain annuity factor for 20 years at a 3.0 percent interest rate – 14.8775 (from Term Certain Annuity Factors Table in Appendix A).

(2) Find the adjustment factor at a 3.0 percent interest rate for a term certain annuity payable at the beginning of each semi-annual period – 1.0224 (from Annuity Adjustment Factors Table B in Appendix A).

1. Let. Rul. 9247024.

(3) Multiply the aggregate payments received during a year by the factors in (1) and (2) – $5,000 × 14.8775 × 1.0224 = $76,054.

The amount of the charitable contribution deduction is equal to $76,054.

7998. Is the deduction for a gift to a charitable lead unitrust of a right to payment taken in the year of the gift?

An immediate deduction of the present value of all the annual payments to be made over the period may be taken *if* the trust is structured so that the donor is taxable on the income of the trust each year (under the "grantor trust rules"). If the trust is structured so that he is not taxable on trust income, he will not get an income tax deduction for the gift.[1] The IRS has determined that a donor was to be treated as the owner of a charitable lead trust where the donor retained the power to substitute trust property. The donor was entitled to a current deduction in an amount equal to the present value of the unitrust interest.[2]

In general, the amount of the charitable contribution deduction allowable for the transfer of property to a charitable lead *unitrust* is equal to the present value of the unitrust interest. If the unitrust payments are made annually at the beginning of each year and the annual payout rate is equal to an adjusted payout rate for which factors are given, the present value of the unitrust interest can be calculated simply by multiplying the value of the property transferred to the charitable lead unitrust by the appropriate unitrust factor (see Appendix A). If the unitrust payments are made other than annually at the beginning of each year or the annual payout rate falls between adjusted payout rates for which factors are given, the calculation of the deduction for a contribution to a charitable lead unitrust is more complex.

Example 5. In September, Mr. Smith (age 85) transferred property worth $100,000 to a charitable lead unitrust that is a grantor trust. The trust is to make annual payments (at the beginning of each year) of 5 percent of the value of the trust corpus (valued annually) to charity during his lifetime (i.e., a 5 percent annual payout rate).

The value of the unitrust payable to charity is calculated as follows:

(1) Find the single life unitrust remainder factor for a person age 85 at a 5.0 percent adjusted payout rate: .74516 (from Single Life Unitrust Remainder Factors Table in Appendix A).

(2) Calculate the single life unitrust factor for a person age 85 at a 5.0 percent adjusted payout rate by subtracting the factor in (1) from one – 1 - .74516 = .25484.

(3) Multiply the value of the property transferred to the charitable lead unitrust ($100,000) by the single life unitrust factor for a person age 85 at a 5 percent payout rate (.25484) – $100,000 × .25484 = $25,484.

The amount of the charitable contribution deduction is $25,484.

Example 6. If the unitrust payments in Example 5 were to be made for 20 years (at the beginning of each year) rather than for Mr. Smith's life, the present value of the unitrust remainder interest is calculated as follows:

(1) Find the term certain unitrust remainder factor for 20 years at a 5.0 percent adjusted payout rate: .358486 (from Term Certain Unitrust Remainder Factors Table in Appendix A).

1. Treas. Reg. §1.170A-6(c). See, e.g., Let. Rul. 200108032.
2. Let. Rul. 9247024.

(2) Calculate the term certain unitrust factor for 20 years at a 5.0 percent adjusted payout rate by subtracting the factor in (1) from one – 1 - .358486 = .641514.

(3) Multiply the value of the property transferred to the charitable lead unitrust ($100,000) by the term certain unitrust factor for 20 years at a 5 percent payout rate (.641514) – $100,000 × .641514 = $64,151.

The amount of the charitable contribution deduction is $64,151.

Example 7. Assume the same facts as in Example 5, except that payments are to be made at the end of each year. Assume the valuation table interest rates for September and the two preceding months, July and August, were 3.4 percent, 3.2 percent, and 3.0 percent. Mr. Smith elected to use the 3.0 percent rate.

The value of the unitrust payable to charity is calculated as follows:

(1) Find the unitrust payout adjustment factor for annual payments to start 12 months after the valuation date at a 3.0 percent interest rate: .970874 (from Unitrust Payout Adjustment Factors Table in Appendix A).

(2) Multiply the factor in (1) by the annual payout rate to obtain the adjusted payout rate: .970874 × 5 percent = 4.854%.

(3) Find the single life unitrust remainder factor for a person age 85 at a 4.8 percent adjusted payout rate: .75352 (from Single Life Unitrust Remainder Factors Table in Appendix A).

(4) Find the single life unitrust remainder factor for a person age 85 at a 5.0 percent adjusted payout rate: .74516 (from Single Life Unitrust Remainder Factors Table in Appendix A).

(5) Subtract the factor in (4) from the factor in (3): .75352 - .74516 = .00836.

(6) $$\frac{4.854\% - 4.800\%}{5.000\% - 4.800\%} = \frac{X}{.00836}$$

$$X = .00226$$

(7) Subtract X in (6) from the factor at 4.8 percent from (3): .75352 - .00226 = .75126.

(8) Subtract the interpolated unitrust remainder factor in (7) from one – 1 - .75126 = .24874.

(9) Multiply the value of the property transferred to the charitable lead unitrust ($100,000) by the interpolated unitrust factor in (8) (.24874). The amount of the charitable contribution deduction is $24,874. [The same procedure applies to calculating a unitrust interest for a term certain. However, Term Certain Unitrust Remainder Factors are used instead of Single Life Unitrust Remainder Factors.]

If the donor of a right to payment ceases to be taxable on the trust income before the termination of the interest, he must "recapture," that is, include in his income, an amount equal to the deduction less the discounted value of all amounts required to be, and which actually were, paid before the time he ceased to be taxable on trust income.[1]

7999. Is a gift of a "conservation easement" deductible?

The IRC permits a deduction for a contribution of certain real property interests even though the gift is less than the donor's entire interest if the gift is for the preservation of land for recreation or education, the protection of natural habitats, the preservation of open space, or the preservation of historically important land or buildings.[2]

1. Treas. Reg. §1.170A-6(c)(4).
2. IRC Secs. 170(f)(3)(B)(iii), 170(h).

If a donor contributes for any of these purposes his entire interest in real property (he may retain the right to subsurface oil, gas, or other minerals), a remainder interest in the property, or a restriction on the use of the property (a conservation easement), he may be entitled to a deduction. The contribution must be made to a qualified organization (a governmental unit and certain charities), and the restriction on use of the property must be protected in perpetuity.[1] The Tax Court has held that in order to be protected in perpetuity, the deed of gift used to transfer the easement, once properly recorded as required by state law, must not be subordinate to a mortgage holder's security interest.[2]

A trust may not take a charitable deduction (under IRC Sec. 642(c)) or a distribution deduction (under IRC Sec. 661(a)(2)) with respect to a contribution to charity of trust principal that meets the requirements of a qualified conservation contribution (under IRC Section 170(h)).[3]

Conservation Easements

A conservation easement is a restriction on the owner's use of the property. A popular form is the open space or scenic easement, wherein the owner of land agrees to set the land aside to preserve natural, scenic, historic, scientific and recreational areas, for public enjoyment.[4]

The Tax Court held that taxpayers' contributions of conservation easements (encumbered shoreline) were qualified conservation contributions because: (1) they protected a relatively natural habitat of wildlife and plants (in accordance with Treasury Regulation Section 1.170A-14(d)(3)); and (2) were exclusively for conservation purposes.[5]

The Tax Court held that a taxpayer did not make a contribution of a qualified conservation easement because the attempted grant did not satisfy the conservation purposes required (under IRC Sec. 170(h)(4)(A)). Specifically, the deed did not preserve open space, an historically important land area, or a certified historical structure.[6]

The IRS approved a contribution of a conservation easement in which the taxpayer retained limited water rights; the conditions of the use of those rights were sufficiently restricted that the Service determined their exercise would not adversely affect the purposes for which the easement was established.[7] The IRS also determined that the proposed inconsistent use of some of a farm (i.e., construction of eight single-family homes) to be burdened by a conservation easement was not significant enough to cancel the conservation purpose of the easement because the conservation easement would still maintain over 80 percent of the entire tract in its presently undeveloped state, thereby preserving the habitat.[8]

1. IRC Sec. 170(h)(2); Treas. Regs. §§1.170A-14(a),1.170A-14(b), 1.170A-14(c).
2. *Satullo v. Comm.*, TC Memo 1993-614, *aff'd without opinion*, 67 F.3d 314 (11th Cir. 1995).
3. Rev. Rul. 2003-123, 2003-2 CB 1200, *amplifying*, Rev. Rul. 68-667, 1968-2 CB 289.
4. IRC Sec. 170(h); Treas. Reg. §1.170A-14(d).
5. *Glass v. Comm.*, 124 TC 258 (2005), *aff'd*, 2007-1 USTC ¶50,111 (6th Cir. 2006).
6. *Turner v. Comm.*, 126 TC 299 (2006).
7. Let. Rul. 9736016.
8. Let. Rul. 200208019.

Open space easements have been approved by the Service in several instances.[1] (Although some of these rulings were made under prior law, they remain valid under the current IRC Section).

The deductible value of the easement is generally determined using a "before and after" approach. That is, the value of the total property owned by the taxpayer (including adjacent property that is not encumbered by the easement) before granting the easement is determined. Then, the value of the property after granting the easement is subtracted to determine the value of the easement.[2] For purposes of determining the value of the property before granting of the easement, the Tax Court determined that the highest and best use of the property had to be taken into account.[3]

General guidelines for valuing property can be found in Revenue Procedure 66-49.[4] If there is a substantial record of sales of easements comparable to the one donated, the fair market value of the donation can be based on the sale prices of the comparable easements. However, where previous sellers of easements to the county had generally intended to make gifts to the county by way of bargain sales, the Tax Court determined that the comparable sales approach was inappropriate in a bargain sale of a conservation easement.[5] Increases in the value of any property owned by the donor or a related person that result from the donation, whether or not the other property is contiguous to the donated property, reduce the amount of the deduction by the amount of the increase in the value of the other property.[6]

The Service privately ruled that an estate could properly claim an estate tax deduction for the value of a conservation easement attributable to a 68.8 percent tenancy in common interest includible in the decedent's gross estate notwithstanding the fact that the co-tenants would claim an income tax deduction for the conservation easement granted with respect to the interests in the property they owned.[7]

The Service determined that a taxpayer's exchange of a conservation easement in real property under IRC Section 1031(a) would qualify as a tax-deferred exchange of like-kind property, provided that the properties would be held for productive use in a trade or business, or for investment.[8]

In a legal memorandum, the Service analyzed the issues regarding the Colorado conservation easement credit, including: (1) to the extent a taxpayer is effectively reimbursed for the transfer of the easement through the use, refund, or transfer of the credit, whether that benefit is a *quid pro quo* that either reduces or eliminates a charitable contribution deduction under

1. See Rev. Rul. 74-583, 1974-2 CB 80; Rev. Rul. 75-373, 1975-2 CB 77; Let. Ruls. 200002020, 199952037, 9603018, 8641017, 8313123, 8248069.
2. *Symington v. Comm.*, 87 TC 892 (1986); *Fannon v. Comm.*, TC Memo 1986-572; Rev. Rul. 73-339, 1973-2 CB 68; Rev. Rul. 76-376, 1976-2 CB 53. See also *Thayer v. Comm.*, TC Memo 1977-370.
3. *Schapiro v. Comm.*, TC Memo 1991-128.
4. 1966-2 CB 1257, as modified by Rev. Proc. 96-15, 1996-2 CB 627.
5. See *Browning v. Comm.*, 109 TC 303 (1997).
6. Treas. Reg. §1.170A-14(h)(3).
7. Let. Rul. 200143011.
8. Let. Rul. 200201007. See also Let. Ruls. 200203033, 200203042.

IRC Section 170; and (2) whether the benefit of the state conservation easement credit is, in substance, an amount realized from the transfer of the easement under IRS Section 1001, generally resulting in capital gain.[1]

Improper deductions for conservation easements. The Service has determined that some taxpayers have been claiming inappropriate contribution deductions for cash payments or easement transfers to charitable organizations in connection with purchases of real property. In some of these questionable cases, the charity purchases the property and places a conservation easement on the property. Then, the charity sells the property subject to the easement to a buyer for a price that is substantially less than the price paid by the charity for the property. As part of the sale, the buyer makes a second payment – designated as a "charitable contribution" – to the charity. The total of the payments from the buyer to the charity fully reimburses the charity for the cost of the property. The Service warned that in appropriate cases, it will treat these transactions in accordance with their substance rather than their form. Accordingly, the Service may treat the total of the buyer's payments to the charity as the purchase price paid by the buyer for the property. Taxpayers are advised that the Service intends to disallow all or part of any improper deductions and may impose penalties, and also intends to assess excise taxes (under IRC Section 4958) against any disqualified person who receives an excess benefit from a conservation transaction, and against any organization manager who knowingly participates in the transaction. In appropriate cases, the Service may challenge the tax-exempt status of the organization based on the organization's operation for a substantial nonexempt purpose or impermissible private benefit.[2]

Guidance on qualified conservation contributions made from 2006 through 2013. A charitable contribution of a qualified conservation easement is available to the extent the contribution does not exceed 50 percent of adjusted gross income (AGI). (The limit was 100 percent of AGI for certain farmers or ranchers). A qualified conservation easement contribution disallowed because it exceeds the percentage of AGI limitation can be carried over for up to 15 years.[3] The Service has released question-and-answer guidance relating to the increased percentage limitation and increased carryover period for qualified conservation contributions (see above) made in taxable years beginning after 2005. According to the Service, if a taxpayer has made a qualified conservation contribution, which is subject to the special 50 percent limitation (under IRC Section 170(b)(1)(E)), *and* one or more contributions subject to the other percentage limitations (i.e., the 50 percent, 30 percent, or 20 percent limitations under IRC Sections 170(b)(1)(a), 170((b)(1)(B), 170(b)(1)(C), and 170(b)(1)(D)), the qualified conservation contribution may be taken into account only *after* taking into account the contributions subject to the other percentage limitations. The Service also states that the 50 percent limit applies to qualified conservation contributions only, not to all contributions of real property interests. The guidance also includes several questions and answers relating to the rules for qualified farmers and ranchers.[4]

1. IRS CCA 200238041.
2. Notice 2004-41, 2004-28 IRB 31. See also IR-2004-86 (6-30-2004).
3. IRC Sec. 170(b)(1)(E). As added by PPA 2006 and extended by the Food, Conservation and Energy Act of 2008 and the American Taxpayer Relief Act of 2012.
4. Notice 2007-50, 2007-25 IRB 1430.

The qualified easement contribution must be reduced if a rehabilitation credit was taken with respect to the property.[1]

8000. Is a gift of a "facade easement" deductible?

A variation on the conservation easement (see Q 7999) is the use of a "facade easement," wherein the grantor agrees not to alter the facade or modify the architectural characteristics of a building.

If the building, structure, or land is listed in the National Register or is located in a registered historic district, any easement that is a restriction with respect to the exterior of the building must preserve the entire exterior and its historical character.[2] If a deduction in excess of $10,000 is claimed with respect to such an exterior easement, a $500 filing fee is required with the tax return.[3]

The amount of the deduction for the contribution of a facade easement is the full fair market value of the easement at the time of the contribution.[4] The fair market value of the facade donation has been determined by applying the "before and after" approach.[5] A substantial record of sales of easements comparable to the one donated results in valuation of the fair market value of the donation based on the sale prices of the comparable easements.[6] If the donation of a facade easement increases the value of the property it would appear that the donation would be reduced by the amount of such increase.[7]

A taxpayer who claims an investment credit for the rehabilitation of a historic structure may be required to recapture a portion of the credit upon the gift of a facade easement for the rehabilitated building. The qualified easement contribution is reduced if a rehabilitation credit was taken.

8001. What are the tax consequences of a charitable contribution of a partnership interest?

A partnership interest is a capital asset that, if sold, would be given capital gain or loss treatment except to the extent of the partner's share of certain partnership property that, if sold by the partnership, would produce ordinary gain (i.e., his share of "unrealized receivables" and "substantially appreciated inventory").[8] (See Q 7723. See also Q 608 regarding the treatment of capital gains and losses.) Thus, if a taxpayer makes a charitable contribution of his partnership interest, and if he has held the interest for long enough to qualify for long-term capital gain treatment (i.e., more than one year, as defined in IRC Section 1222(3); see Q 7966), he may

1. IRC Sec. 170(f)(14).
2. IRC Secs. 170(h)(4)(B), 170(h)(4)(C).
3. IRC Sec. 170(f)(13).
4. Let. Rul. 8449025.
5. *Hilborn v. Comm.*, 85 TC 677 (1985); *Nicoladis v. Comm.* TC Memo 1988-163; *Dorsey v. Comm.*, TC Memo 1990-242; *Griffin v. Comm.*, TC Memo 1989-130, aff'd 90-2 USTC ¶50,507 (5th Cir. 1990).
6. See *Akers v. Comm.*, 799 F.2d 243 (6th Cir. 1986).
7. See Treas. Reg. §1.170A-14(h)(3).
8. IRC Sec. 741.

deduct the full fair market value of his interest less the amount of ordinary gain, if any, that would have been realized by the partnership for his share of "unrealized receivables" and "substantially appreciated inventory." (His deduction is subject to the applicable limits. See Q 7966.)

If the partnership interest includes a liability (mortgage, etc.), the amount of the liability is treated as an amount realized on the disposition of the partnership interest.[1] Thus, the contribution is subject to the bargain sale rules, and the transfer will be treated, in part at least, as a sale (see Q 7969).[2] (If the partner's share of partnership liabilities exceeds the fair market value of his partnership interest, he may have taxable income, but no deduction under the bargain sale rules.) In *Goodman v. United States*,[3] the taxpayer contributed her partnership interest to charity, subject to her share of partnership debt. The district court held that the taxpayer recognized gain on the transfer equal to the excess of the amount realized over that portion of the adjusted basis of the partnership interest (at the time of the transfer) allocable to the sale under IRC Section 1011(b).[4]

In order to determine the taxable income and the amount of charitable deduction under the bargain sale rules, the following steps must be taken:

1. *Determine the taxable gain on the sale portion*. Under the bargain sale rules, part of the donor's basis is allocated to the portion sold. The basis allocated to the sold portion is the amount of basis that bears the same ratio to his entire basis as the amount realized bears to the market value of the property. Presumably, the sold portion includes the same proportionate part of his share of unrealized receivables and substantially appreciated inventory as it does basis.

   Example. Mr. Jones owns a 10 percent interest in a partnership that he has held for three years. The fair market value of his interest is $100,000 and his adjusted basis is $50,000. His share of a mortgage on partnership property is $40,000, and his share of "unrealized receivables" (potential depreciation recapture on the mortgaged property) is $5,000 in which the partnership's basis is zero. He donates his entire interest to charity. He is deemed to have received $40,000, his share of partnership liabilities, on the transfer. In effect there are two transactions–a sale for $40,000 and a contribution of $60,000.

   Of Mr. Jones' $50,000 basis in his partnership interest, $20,000 is allocated to the sale portion: $40,000 (amount realized)/$100,000 (fair market value) × $50,000 (total adjusted basis). The fair market value of the sold portion is $40,000 (amount realized). Mr. Jones must recognize a gain of $20,000 ($40,000 realized less $20,000 adjusted basis allocated to the sold portion). Of that gain, $2,000 is allocable to unrealized receivables ($5,000 unrealized receivables × $40,000/$100,000). Because the partnership has no basis in the unrealized receivables, the entire $2,000 would be ordinary income. Mr. Jones must report a taxable long-term capital gain of $18,000 and a taxable ordinary gain of $2,000.

2. *Determine the charitable contribution deduction*. As a general rule, the fair market value of the portion given to charity is deductible except to the extent the property would

1. Treas. Reg. §1.1001-2. See *Crane v. Comm.*, 331 U.S. 1 (1947).
2. Rev. Rul. 75-194, 1975-1 CB 80.
3. 2000-1 USTC ¶50,162 (S.D. Fl. 1999).
4. Citing Rev. Rul. 75-194 and Treas. Reg. §1.1001-2.

have generated ordinary income if sold. Consequently, the allowable deduction for the gift portion must be reduced to the extent the portion of the partnership interest given to the charity would produce ordinary income if sold.

Example. The fair market value of Mr. Jones' gift to charity is $60,000. Because 60 percent of the partnership interest was given to the charity ($60,000/$100,000), 60 percent of Mr. Jones' share of partnership "unrealized receivables," or $3,000 ($5,000 × 60% = $3,000), is considered included in the gift. The balance of the gift would be long-term capital gain on sale. Because $3,000 would be ordinary income on a sale, Mr. Jones' contribution is reduced by $3,000, and his charitable contribution deduction is $57,000.

Other special rules may apply under certain circumstances, for example, if the partnership owns property subject to tax credit recapture, if it has made installment sales, or (as might occur in the case of an oil and gas partnership) if it is receiving income in the form of "production payments." See also Q 7970 with regard to prepaid interest.

8002. What is a charitable IRA rollover or qualified charitable distribution?

For tax years 2006 to 2013, a taxpayer age 70½ or older was eligible to make a *qualified charitable distribution* from an IRA that was not includible in the gross income of the taxpayer. This provision has yet to be extended for the 2014 tax year and beyond.[1]

A qualified charitable distribution is any distribution

not exceeding $100,000 in the aggregate during the taxable year (except that gifts for the 2012 year could be made up until January 31, 2013);

Planning Point: Only distributions from a taxpayer's own IRA are includible in determining that a taxpayer has met the $100,000 limit. Therefore, while married taxpayers may make qualified distributions totaling $200,000, each spouse may only make distributions of up to $100,000 from their own IRA. *Ted R. Batson, Jr., MBA, CPA, and Gregory W. Baker, JD, CFP®, CAP, Renaissance Administration, LLC.*

2. made directly, in a trustee-to-charity transfer;

3. from a traditional or Roth IRA (distributions from SEPs and SIMPLE IRAs do not qualify; the prohibition on making a qualified charitable distribution from a SEP IRA or a SIMPLE IRA only applies to "ongoing" SEP IRAs or SIMPLE IRAs. Such an IRA is "ongoing" if a contribution is made to it for the taxable year of the charitable distribution;[2]

Planning Point: A participant in a qualified plan, an IRC Section 403(b) tax sheltered annuity, or an eligible IRC Section 457 governmental plan must first perform a rollover to a traditional IRA before taking advantage of a charitable IRA rollover. *Ted R. Batson, Jr., MBA, CPA, and Gregory W. Baker, JD, CFP®, CAP, Renaissance Administration, LLC.*

1. IRC Sec. 408(d)(8). The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended the law through 2011 and the American Taxpayer Relief Act of 2012 extended the law through 2013.
2. Notice 2007-7, 2007-5 IRB 395.

4. to a public charity (but not a donor-advised fund or supporting organization);

Planning Point: Rollovers to donor-advised funds, supporting organizations, private foundations, charitable remainder trusts, charitable gift annuities, and pooled income funds are not qualified charitable distributions. *Ted R. Batson, Jr., MBA, CPA, and Gregory W. Baker, JD, CFP®, CAP, Renaissance Administration, LLC.*

5. that would otherwise qualify as a deductible charitable contribution—not including the percentage of income limits in IRC Section 170(b);

6. to the extent the distribution would otherwise be includible in gross income.[1]

No charitable income tax deduction is allowed for a qualified charitable distribution.[2]

Planning Point: Rollovers to charities by taxpayers who reside in states that tax IRA distributions and do not have a charitable deduction may not escape tax at the state level. *Ted R. Batson, Jr., MBA, CPA, and Gregory W. Baker, JD, CFP®, CAP, Renaissance Administration, LLC.*

If a qualified charitable distribution is made from any IRA funded with nondeductible contributions, the distribution is treated as coming first from deductible contributions and earnings.[3] This is contrary to the general rule that distributions from an IRA with both deductible and nondeductible are deemed made on a pro-rata basis.[4]

Qualified charitable distributions may count toward a taxpayer's unsatisfied required minimum distributions for the year.[5]

For guidance on qualified charitable contributions (including questions and answers), see Notice 2007-7.[6]

The American Taxpayer Relief Act of 2012 extended the ability to make qualified charitable distributions for tax years 2012 and 2013. Because the law was not passed until January 2013, the law included special provisions for donors to make gifts in January of 2013 to qualify for the 2012 year. The provisions were that an IRA owner can treat a contribution made to a qualified charity in January of 2013 as a 2012 qualified charitable distribution if:

1. The contribution was made in cash from the donor to the qualified charity of all or a portion of an IRA distribution made to the IRA owner in December 2012 provided that the contribution would have been a 2012 qualified charitable distribution if it had been paid directly from the IRA to the qualified charity in 2012, or

2. The contribution is paid directly from the IRA to the qualified charity, provided that the contribution would have been a 2012 qualified charitable distribution if it had been paid in 2012.

1. IRC Sec. 408(d)(8).
2. IRC Sec. 408(d)(8)(E).
3. IRC Sec. 408(d)(8)(D).
4. IRC Secs. 72, 408(d)(1).
5. IRC Sec. 408(d)(8).
6. 2007-5 IRB 395.

A qualified charitable distribution made in January 2013 that is treated as a 2012 qualified charitable distribution will satisfy the IRA owner's 2012 required minimum distribution if the amount of the qualified charitable distribution is equal to or greater than the 2012 required minimum distribution. However, no part of such a qualified charitable distribution can be used to satisfy the 2013 required minimum distribution, even if the 2012 required minimum distribution had already been made. In determining the required minimum distribution for 2013, the 2012 qualified charitable distribution must be subtracted from the December 31, 2012, IRA account balance.