PROFESSIONAL Tax & Estate Planning NOTES

Issues in this series :

JUNE 2001

1 MARCH 2001 - Planning for Retirement Plan Assets.

2 JUNE 2001 - Gifts of Partial Interests in Property.

3 OCTOBER 2001 - Timing of Charitable Contributions.

2 Gifts of Partial Interests in Property

Your client decides to give an insurance policy to his favorite charity, but wants to retain the right to borrow against it. Another client wants to donate an original motion picture film, but keep the copyright, allowing her to make reproductions and sell them. Yet another client wants to give a charity the right to rent-free use of two floors of a building that he owns.

Most people expect to get an income tax deduction any time they donate property with value to a charity—even if the gift is a partial interest in a property. But in each of the three cases above, no deduction is allowed. This issue of *Professional Notes* reviews the rules related to gifts of partial interest, under what circumstances a client can donate them to charity *and* get a charitable income tax deduction, and why The New York Community Trust is an ideal beneficiary for them.

DEDUCTIBLE TRANSFERS OF PARTIAL INTERESTS

A charitable income tax deduction is permitted for partial interests if the gift is a remainder or income interest. These can only take the form of a pooled income fund, charitable remainder trust ("CRT"), or a charitable lead trust.

Code Section 170(f)(3)* allows deductions for charitable contributions of partial interests *not* in trust of (i) an undivided portion of the taxpayer's entire interest in the property, (ii) a remainder interest in a personal residence or farm, or (iii) a qualified conservation contribution.

GIFTS IN TRUST

A **pooled income fund**, operated much like a mutual fund, is maintained by a public charity. A number of donors make gifts, and the assets are pooled together for investment purposes. The donor retains an income interest either for himself or for designated individuals. Income earned by the pooled income fund, which depends upon the current yield of assets in the fund, is paid out to the income beneficiaries, and at the death of the income beneficiary, his principal is withdrawn and transferred to the charity.

Charitable remainder trusts ("CRTs") are arrangements that provide income to one or more noncharitable beneficiaries for a period of time, with property eventually going to charity. They are important income tax and estate planning tools. As discussed in the March 1998 issue of *Professional Notes*, CRTs are strictly defined under the Internal Revenue Code and Treasury Regulations; in order to qualify as a charitable remainder trust, the requirements of Code Section 664 must be met. An attempted CRT that fails to meet these requirements (i.e., which is not "qualified"), will be subject to tax on its income and capital gains, and no charitable deduction is allowed for contributions to a non-qualifying CRT.

A CRT takes one of two basic forms, providing for an annual payment in the form of either (1) an annuity or (2) a unitrust amount.

Charitable Remainder Annuity Trust. Annual payments from an annuity trust are a fixed amount,

* All "Code Section" references are to sections of the Internal Revenue Code of 1986, as amended.

set as a fixed dollar amount or a percentage of the initial trust value. Principal additions are not permitted.

Charitable Remainder Unitrust. Annual payments are a percentage of the annual value of the fund. The unitrust amount will increase or decrease from one year to the next with the value of the trust's assets. Because property tends to appreciate in value over time, a unitrust may provide a hedge against inflation for the income beneficiaries. Unlike the annuity trust, principal additions are permitted.

Variations on the Charitable Remainder Unitrust. In addition to the standard form of unitrust, there are two important variations that are widely used. The first of these is the *Net Income Charitable Remainder Unitrust*, which provides for an annual payment equal to the lesser of the unitrust amount or actual income (using fiduciary accounting income as determined under local law). The net income trust often is drafted to provide for a "make-up" provision, so that if trust income is lower than the fixed percentage in one or more years and is higher in a subsequent year, the shortfall may be paid to the beneficiary at the later time.

A second variation is the *FLIP trust*, which may provide for "flip" from a net income charitable remainder unitrust to a standard unitrust during the term of the trust. The regulations require a Flip CRT to use a net income method (with or without make-up) until the flip occurs, typically upon the sale of a specified asset or group of assets contributed at the time the trust was created and that the trust hereafter is required to convert to a standard charitable remainder unitrust for calculating distributable amounts. Any deficit not "made up" by the time of the flip is lost.

Among the rules charitable remainder trusts must meet are the following:

• The term of a charitable remainder trust must be measured by the lifetime of the beneficiary, or for a term of years not to exceed 20 years. The trust instrument may name one or more charitable beneficiaries to receive the trust assets upon termination, or provide that the grantor or income beneficiary may name the charity.

• The payout rate of a charitable remainder annuity trust must be at least five percent of the initial trust corpus, and additions to trust principal are not permitted. The law also requires that there not be a more than five percent probability that the trust assets will be exhausted before the termination of the trust. Similarly, the payout rate of a charitable remainder unitrust cannot be less than five percent.

• In addition, the payout rate may not exceed 50 percent and the value of the charitable remainder must be at least 10 percent of the fair market value of the assets. The 10 percent minimum value of the charitable remainder must be met on the trust's creation and, in the case of a unitrust, upon subsequent additions. Unfortunately, some taxpayers may inadvertently run afoul of the 10 percent rule, particularly where the CRT is to be established at death, because the life expectancy of the income beneficiary is unknown until that time. The statute permits a trust to be reformed to comply with this requirement, and the draftsman will want to consider giving the trustee the power to decide whether to amend the trust or to declare the trust void.

In funding a CRT, it is important to note that Code Section 170(a)(3) provides that a charitable contribution of a future interest in tangible personal property is considered to be made only when all intervening interests in the property have expired or are held by persons other than the donor. The Service has ruled privately that a donor who contributed a violin to a CRT of which he was the income beneficiary had retained an interest in the violin. As a result, the charitable deduction was permitted only when the trustee sold the instrument. Moreover, the charitable income tax deduction for gifts of tangible personal property to a CRT are limited to the property's basis.

Charitable lead trusts provide an annuity interest or unitrust interest to charity for a period of time, and the remainder is returned to the donor or, typically, his or her children. A charitable income tax deduction is permitted upon creation of a lead trust only if the grantor is treated as the owner of the trust assets under Code Section 671. A grantor trust is one from which the income, deductions, and credits are attributed directly to the grantor. In effect, the person who creates a charitable lead trust that is a grantor trust trades a current income tax deduction for the future imputation of income from the trust.

The annual payment from the lead trust to charity must be in the form of either an annuity payment or a unitrust payment. Unlike the charitable remainder trust, if the unitrust form is chosen, payment from a lead trust cannot be limited to the lesser of the unitrust amount or income. In addition, the unitrust or annuity percentage for a lead trust may be less than 5 percent or may be greater than 50 percent, and there is no minimum value for the remainder interest.

Although The New York Community Trust does not maintain a pooled income fund, it frequently is the charitable beneficiary of charitable remainder and lead trusts. Creating a fund at The Trust is an easy and effective way to address a single charitable concern, or to take care of several philanthropic interests at once, such as the donor concerned about housing issues who also wants to provide annual gifts to his church. Trust staff are expert in carrying out the sometimes complicated charitable interests of donors.

PARTIAL INTERESTS NOT IN TRUST

Undivided portion of donor's entire interest. An undivided portion of a donor's entire interest in property must include a 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 and in other property into which it is converted. A typical example is the transfer to charity of a 50 percent interest in land owned by the donor.

A deduction is permitted for a contribution of a partial interest in property if that interest is the donor's entire interest. The Service has recognized that a charitable gift of a remainder interest after a gift had been made of the life interest qualifies for an income tax deduction, where the property was not divided to create an interest that would avoid the "less than the entire interest rule." *See Rev. Rul. 76-523, 1976 C.B. 54* and *Rev. Rul. 87-37, 1987-1 C.B. 295*. In a recent private letter ruling, the Service concluded that the transfer of stock, where voting rights previously had been transferred for a business purpose, qualified for a charitable income tax deduction.

In addition, the regulations permit a charitable deduction where all interests in property are given to charity, even though each charity received only a partial interest. These include limited partnerships and movie and book copyrights. Such gifts should be discussed with us to ensure that we can accept them.

Remainder interest in personal residence or farm. A contribution of a remainder interest in a personal residence or farm has the obvious advantage of allowing the donor to remain in his or her home or farm for life, while providing for charity. Such a gift qualifies for an income tax deduction for the present value of the interest where the gift is of an irrevocable remainder interest (not in trust) that follows a life estate of the donor and/or another, or which follows an interest for a term of years. Code Section 170(f)(3)(B)(i) and Treas. Reg. Section 1.170A-(7)(b)(3). "Personal residence" is not limited to the property used as the donor's principal residence, and may include a vacation home. In addition, coop shares owned by a tenant-shareholder may qualify.

It is not necessary that the entire remainder interest be transferred to charity. An undivided interest in a portion of the remainder interest in a personal residence, where the donor retains a life interest and another individual receives the balance of the remainder, qualifies for an income tax deduction for the present value of the gifted interest. *Rev. Rul. 87-37, 1987-1 C.B. 295.* The value of the transferred interest must be reduced to reflect an appropriate valuation discount for the co-tenancy arrangement.

The Service has ruled that a gift of the entire remainder interest coupled with a fractional interest in the retained life estate also qualifies for a charitable income tax deduction. In *Rev. Rul. 75-420, 1975-2 C.B. 78,* a donor conveyed a second home to a local college, reserving the right to use the property for a six-week period each summer and to store his personal property year-round in the home. The property was substantial, a 25-room house on 20 acres with a caretaker's cottage, pool, gymnasium, and tennis court. The college could not make alterations without the donor's consent or sell its interest in the property prior to the donor's death. The Service ruled that the donor had contributed a remainder interest in a personal residence, qualifying for a deduction under Code Section 170(f)(3)(B)(i), and an undivided portion of his entire interest within Code Section 170(f)(3)(B)(ii). The ruling noted, however, that had the remainder interest been transferred to a relative, and an interest in the life estate been transferred to the college as a tenant in common, no deduction would be allowed if the life estate had been created to avoid the partial interest limitation.

The Tax Court has held that, under Code Section 2055(e) (which limits estate tax charitable deductions for split interest gifts) a remainder interest in a residence, where the executor was instructed to sell the residence at the end of the life estate and remit the proceeds to charity, qualifies for the estate tax charitable deduction. The IRS acquiesced where local law gives a charity the option of taking the property itself, despite the terms of the gift. *Estate of Blackford v. Commissioner, 77 T.C. 1246 (1981), acq. in result, 1983-2 C.B. 1.* In *Rev. Rul. 84-97, 1984-2 C.B. 196*, the Service ruled that a gift of the remainder interest in a farm qualified even though the applicable state mortmain statute required the charitable recipient to dispose of the farm within 10 years of acquisition.

Qualified conservation contribution. A gift of an open space easement or other real property interest for conservation purposes is deductible if it is given to a governmental unit or a public charity (or a support organization controlled by a public charity). Code Sections 170(b)(3)(B)(iii) and 170(h). The donor may retain a qualified mineral interest, but not the right to engage in surface mining. "Conservation purposes" includes the preservation of areas for outdoor recreation by, or the education of, the general public; protection of a natural habitat; preservation of open space; or preservation of a historically important area or a certified historic structure. Such a gift may be accomplished by transferring the donor's entire interest (other than a qualified mineral interest), a remainder interest or a restriction, in perpetuity, on the use which may be made of the real property.

CONCLUSION

Gifts of partial interests offer income tax planning opportunities for the charitably minded client who wants to provide for charity where it may not make economic sense to give away the whole asset. The New York Community Trust is particularly skilled at translating donors' charitable interests and is an ideal beneficiary of such gifts. Professional advisors will want to review the technical requirements for such gifts with their clients, so that the charitable income tax deduction will not be denied.

For more information, call: Jane L. Wilton, General Counsel, at **(212) 686-2563.**

For further reference, see:
Code Section 170(f)(2): Gifts of split interests in property in trust
Code Section 170(f)(3): Contribution of partial interests in property not in trust
Code Section 170(h): Qualified conservation contributions
Code Section 642(c)(5): Pooled income funds
Code Section 664: Charitable remainder trusts
Code Section 671: Grantor trusts
Code Section 2055(e): Bequests of split interests
Code Section 2522(c): Gift tax deduction for charitable gifts
Treas. Reg. Section 1.170A-6
Treas. Reg. Section 1.170A-7
Treas. Reg. Section 1.170A-14
Treas. Reg. Section 1.642(c)-5
Treas. Reg. Section 1.664-2
Prop. Treas. Reg. Section 1.664-3
Rev. Rul. 76-523,1976-2 C.B. 54
Rev. Rul. 81-282, 1981-2 C.B. 78
Rev. Rul. 83-158, 1983-2 C.B. 159
PLR 9452026
PLR 200108012

If you would like a list of past issues, please refer to the March 2001 issue or call our receptionist at (212) 686-0010, Ext. 0.

About The Trust

For 77 years, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust is an aggregate of funds created by individuals, families, and businesses to support the voluntary organizations that are crucial to a community's vitality.

Grants made from these funds —which now number more than 1,500—meet the needs of children, youth and families; support community development; improve the environment; promote health; assist people with special needs; and bolster education, arts, and human justice.

In addition to reviewing proposals from nonprofit agencies and responding to the grant suggestions of donors, The Trust is alert to emerging issues and develops strategies to deal with them, works collaboratively with other funders and with government, and gets out information to the public. Recent initiatives have included programs that address youth violence, managed health care, immigration, child abuse, and public school reform.

The Trust is governed by a 12-member Distribution Committee composed of respected community leaders. Its staff is recognized for its expertise in grantmaking, financial administration, and donor services. Local divisions are located on Long Island and in Westchester.

The New York Community Trust
NYCT
2 Park Avenue
New York, NY 10016
(212) 686-0010

Long Island Community Foundation
Elias Hicks House, 1740 Old Jericho Turnpike
Jericho, NY 11753
(516) 681-5085

Westchester Community Foundation
470 Mamaroneck Avenue, Suite 304
White Plains, NY 10605
(914) 948-5166