# CHARITABLE CONTRIBUTIONS AFTER THE 1969 TAX REFORM ACT

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Since the inception of the Internal Revenue Code, Congress has provided an incentive to charitable giving. The incentive takes the form of an income tax deduction for qualifying gifts made during one's life[1] and an estate tax deduction for charitable contributions made by a testamentary disposition.[2]

The Internal Revenue Code of 1954 as amended by the Tax Reform Act of 1969[3] carries forward this "assistance program," although the 1969 amendments made charitable giving slightly less profitable and considerably more difficult. The purpose of this Article is to cover generally the present "do's and don'ts" of charitable deductions in light of the 1969 Reform Act.

## IN GENERAL

The simplest, and probably most popular, form of charitable giving is an outright gift of cash to a qualifying charitable institution. The only real problems with such a gift are substantiation of the amount of the gift and assurance that the recipient is a "qualifying charity."[4]

Substantiation can be effected by obtaining from the donee a receipt stating that the organization is a "domestic organization." The receipt should include the name and address of the contributor, the amount of the contribution, the

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1. INT. REV. CODE OF 1954, § 170.
2. *Id.* § 2055.
3. Tax Reform Act of 1969, 83 Stat. 487, *amending* INT. REV. CODE OF 1954.
4. INT. REV. CODE OF 1954, § 170(c) defines a "charitable contribution" as a gift to or for the use of various entities, including the United States, the various states, as well as to organizations which meet specific criteria more particularly set forth in § 170(c). Generally speaking, contributions to individuals are never deductible as charitable gifts.

date of receipt of the contribution, "and such other information as the district director may deem necessary."[5] Realistically, it seems doubtful that this degree of detail is generally obtained.

If the contribution is not by check, which would provide much of the necessary information, the Internal Revenue Service has adopted substantiation guidelines to determine the amount of cash contributions which will be accepted upon the oral statements of the taxpayer. An example is the guideline in use in the New York area which allows otherwise unsubstantiated contributions in the amount of 1 dollar weekly for cash contributions to churches, and 50 cents weekly for cash contributions to other charitable donees.[6]

The courts have not felt bound by such guidelines and have accepted taxpayer testimony alone in allowing portions of unsubstantiated contributions. It is clear, however, that substantiation, either in the form of a cancelled check or a receipt, greatly improves the chances of obtaining the full benefit of the claimed contributions.[7]

When property other than money is the subject of a gift, valuation problems may arise. The deductible amount of a property contribution is the fair market value of the property.[8] The term "fair market value" is defined in the Service's regulations as the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[9]

Within this definition, virtually any transfer of property as a charitable gift will produce some type of deduction, assuming

5. Treas. Reg. § 1.170A-1(a)(2)(ii), T.D. 7207, 1972-2 CUM. BULL. 106.

6. Public Information Fact Sheet, 6 CCH 1965 STAND. FED. TAX REP. ¶ 6616.

7. C.A. Doneland, Jr., 30 CCH Tax Ct. Mem. 278 (1971). The court permitted the deduction of $625 of a claimed amount of $905 (the Commissioner had allowed $95). However, in Leonard J. Rubin, 33 CCH Tax Ct. Mem. 967 (1974), all of the unsubstantiated claimed contribution amounts were disallowed by the court. It is crucial to note that in any event a charitable contribution deduction is available only if the taxpayer elects to itemize his deductions, rather than to claim the standard deduction. INT. REV. CODE OF 1954, §§ 62 and 63(b).

8. Treas. Reg. §§ 1.170A-1(c)(1), (2), T.D. 7207, 1972-2 CUM. BULL. 106.

9. *Id.*

that proper substantiation is obtained.[10] The problem is to determine the fair market value of the subject property. The Service requires that an appraisal be made, even if made only by the taxpayer himself.[11] To this end the Service has published "appraisal guidelines" on virtually every type of property to assist taxpayers in determining the proper deduction to take for the donation.[12] Although important, the guidelines are more applicable to professional appraisals than to the usual situation of small item contributions, whose fair market value is determined by either the donor or donee.[13]

### "Free Use" Gifts

Until the 1969 Reform Act, a taxpayer was able to obtain a charitable deduction by permitting a qualifying charity to use the taxpayer's property rent-free.[14] The logical extension of this practice can be seen in a 1957 case, where the owners of a two-story building were permitted to deduct $70,000, considered to be the fair market value of the right given to a charity to build an additional five stories on top of the existing building and to use the space—when constructed—rent free.[15]

The 1969 Reform Act ended this practice by prohibiting a charitable deduction for most property gifts of this type.[16] A right to use property is now expressly categorized as a gift of a "partial interest" and thus not deductible as a charitable contribution.[17]

A gift of services, as contrasted with free use of property,

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10. Treas. Reg. § 1.170A-1(a)(2)(iii) sets forth additional substantiation requirements beyond those required in the case of money donations.

11. *Id.* § 1.170A-1(a)(2)(ii)(e), T.D. 7207, 1972-2 Cum. Bull. 106.

12. Rev. Proc. 66-49, 1966-2 Cum. Bull. 1257. Interestingly, appraisal fees incurred in determining the fair market value of property donated to a charitable organization are themselves deductible as a charitable contribution. Rev. Rul. 67-461, 1967-2 Cum. Bull. 125.

13. Treas. Reg. § 1.170A-1(a)(2)(ii), T.D. 7207, 1972-2 Cum. Bull. 106.

14. John G. Allen, 57 T.C. 12 (1971). In Thriftmart, Inc., 59 T.C. 59 (1973), the Tax Court noted that the charitable contribution deduction was limited to the portion of the premises actually used by the charitable organization, or for which it would have use.

15. Mattie Fair, 27 T.C. 866, 872 (1957).

16. Int. Rev. Code of 1954, § 170(f)(3).

17. Treas. Reg. § 1.170A-7(a) (1972). *See also* S. Rep. No. 91-552, 91st Cong., 1st Sess., 1969-3 Cum. Bull. 423, 477, explaining the rationale behind the provision.

has always been denied charitable deduction status.[18] This has led to some interesting distinctions between a nondeductible "gift of services" and a "gift of property," which is quite deductible. When the distinction is not clear the Service has generally contended that the gift is a service rather than property. For example, a long-standing Service ruling holds that blood donations made to a blood bank on a gratuitous basis are gifts of services and the donation of blood therefore does not support a charitable contribution deduction.[19]

The courts have often been willing to go beyond that which the Service deems reasonable. For example, a gift of essays prior to the effective date of the 1969 Act was held to be a charitable contribution for the value of the essays, despite the contention of the Government that the essays were nothing more than "services" on paper.[20]

The present Code denies, for all practical purposes, contribution deductions for donations of manuscripts, essays, and similar literary and musical compositions to the individual who created or compiled them. The Code explicitly excludes such items from its definition of a "capital asset."[21] Since a deduction for non-capital asset property is limited to the taxpayer's basis in such property[22] and the "basis" in the paper used is likely to be minimal, a deduction is effectively foreclosed.[23]

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18. Rev. Rul. 70-477, 1970-2 CUM. BULL. 62 sought to extend this prohibition to rent-free use of property as well, on the theory that this was similar to a gift of services. As noted in note 14, *supra*, the Service lost most, if not all, of the litigated cases in which it took the position that a rent-free use of property was not eligible for a charitable contribution deduction.

19. Rev. Rul. 162, 1953-2 CUM. BULL. 127.

20. Bernard Goss, 59 T.C. 594 (1973).

21. INT. REV. CODE OF 1954, § 1221(3).

22. *Id.* § 170(e)(1)(A). *See also* "General Explanation of the Tax Reform Act of 1969" prepared by the Staff of the Joint Committee on Internal Revenue Taxation, December 3, 1970 at 78.

23. This particular change in § 170 is, interestingly enough, the particular change of which former President Richard M. Nixon ran afoul in his attempted gift of presidential papers. The gift was purportedly made by delivery to the General Services Administration on April 10, 1970. On his 1969 individual income tax return President Nixon claimed a charitable contribution deduction in the amount of $576,000 for his personal papers and other materials. The change in § 170, restricting such deductions to the taxpayer's basis in such property, took effect for gifts made after July 25, 1969. The Joint Committee on Internal Revenue Taxation determined that the gift was in fact made subsequent to the July 25, 1969 date. "Examination of President Nixon's Tax Returns for 1969-1972," Staff Report prepared for Joint Committee on Internal

## APPRECIATED PROPERTY

Besides eliminating the opportunity for musicians, artists, and former Presidents of the United States to obtain charitable contribution deductions for a gift of manuscripts and memoirs, the 1969 Reform Act also placed severe limitations on the deductibility of some types of appreciated property.[24]

Prior to the 1969 Act it was possible that a donor would be better off, in a real sense, to donate appreciated property to charity rather than to sell it.[25] The 1969 Reform Act limited the advantage of donating appreciated property by restricting a taxpayer's deduction for contributions of property which would have produced ordinary income or short-term capital gain to the taxpayer's basis in such property.[26]

Long-term capital gain property will still produce a charitable deduction based on the fair market value of the property at the time of the contribution.[27] However, a taxpayer's maximum yearly contribution deduction for long-term capital gain property is now less than his maximum contribution deduction for a gift of money. In the case of a money gift, an individual can deduct charitable contributions in a given year of up to 50

Revenue Taxation, 93d Cong., 2d Sess. (1974) CCH STAND. FED. TAX REP., Ex. Ed., No. 18 (April 8, 1974).

24. INT. REV. CODE OF 1954, §§ 170(e), (f), *See also* CONF. COMM. REPORT No. 91-782, 91st Cong., 1st Sess. (1969), 1969-3 CUM. BULL. 644, 654.

25. H. R. REP. No. 91-413, 91st Cong., 1st Sess. (1969), 1969-3 CUM. BULL. 200, 235. The Committee gave as an example of this problem the 70 percent bracket taxpayer who sells inventory for $200, in which he has a basis of $100. Under prior law, his tax deduction was based on the $200 fair market value, resulting in a $140 net tax reduction from his other income. Had he sold the property he would have had a taxable gain at ordinary rates of $70 (the top tax rate on the $100 of gain) and would have $130 remaining. In effect, a net savings of $10 was possible in after-tax dollars by gifting the inventory, rather than selling it.

26. INT. REV. CODE OF 1954, § 170(e)(1)(A). Treas. Reg. §§ 1.170A-4(a)(1) and (b)(1), T.D. 7207, 1972-2 CUM. BULL. 106.

27. INT. REV. CODE OF 1954, § 170. Note, however, that this is limited to long-term capital gain property. It is further limited by § 170(e)(1)(B) if it is tangible personal property whose function is unrelated to the general purposes of the charitable donee. Thus, a painting given to an institution which has no direct use for such an item of property and will sell it to raise revenue will produce a charitable deduction of only one-half of the appreciation in value portion of the fair market value of the property contributed. INT. REV. CODE OF 1954, § 170(e)(1)(B). Depreciation which would be recaptured under the general rules of §§ 1245 and 1250 must also be so treated in the case of depreciable property contributed to a qualifying charity. Treas. Reg. § 1.106A-4(b)(4), T.D. 7207, 1972-2 CUM. BULL. 106.

percent of his contribution base.[28] Unless an election is made by the taxpayer to reduce the total contribution attributable to long-term capital gain property, his maximum charitable contribution for such property in any one taxable year is only 30 percent of his contribution base.[29] Fortunately, a carry forward of excess contributions is permitted.[30]

From a tax planning standpoint gifts of qualifying capital gain assets are more beneficial to the donor than selling the property and donating the proceeds to charity. Assume that an individual holding stock with a basis of $2,000 and a present fair market value of $12,000, sells the property and donates the proceeds to charity. If the donor's upper tax bracket after the sale is 30 percent, he will realize $10,000 of capital gain which, after the capital gains deduction,[31] will leave $5,000 subject to tax. At a 30 percent rate, the donor will pay a tax of $1,500, which will partly offset his charitable deduction of $12,000.[32]

If the donor contributes the property to the charity and the charity makes the sale, the tax to the donor on the disposition is entirely avoided. His charitable contribution deduction is the entire $12,000 fair market value of the property contributed. His maximum deduction will, however, be limited to 30 percent, rather than 50 percent, of his charitable contribution base.[33]

Unlike the income tax deduction, estate tax charitable deductions remain unlimited. The entire fair market value of

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28. INT. REV. CODE OF 1954, § 170(b)(1)(A). A taxpayer's "contribution base" is his adjusted gross income. *Id.* § 170(b)(1)(F).

29. *Id.* § 170(b)(1)(D). By agreeing to reduce his total charitable contribution by 50 percent of the appreciation above the taxpayer's basis in the property, the taxpayer can obtain the maximum 50 percent deduction. *Id.* §§ 170(b)(1)(D)(iii), 170(e)(1).

30. INT. REV. CODE OF 1954, § 170(d)(1)(A).

31. *Id.* § 1202 permits a taxpayer "other than a corporation" to deduct 50 percent of the excess of his net long-term capital gain (over net short-term capital loss) in arriving at gross income. The effect of such a deduction is to render net long-term capital gains taxable to the extent of one-half of such gains. In addition, non-corporate taxpayers have the option of electing to use the "alternative" method of computing the tax on a portion of their net long-term capital gains, generally putting an upper tax limit of 25 percent on the total net long-term capital gain in a particular year. *Id.* § 1201(b).

32. *Id.* § 170.

33. *Id.* § 170(b)(1)(A). The charity may itself sell the property without incurring tax. *Id.* § 501(c)(3).

the property contributed may be deducted.[34] In addition, non-capital gain property may be the subject of a testamentary gift without a reduction in the value of the property given.[35]

## PRIVATE FOUNDATIONS

A detailed analysis of the devastation wrought by the 1969 Reform Act in the field of controlled charitable organizations —designated "private foundations"—is beyond the scope of this Article.[36] However, there are several basic concepts that must be kept in mind with regard to private foundations.

First, private foundation status is defined by exclusion. The Code expressly singles out certain organizations as public charities.[37] Any charitable organization not among those singled out is a private foundation unless certain, detailed tests are met.

Among the tests relieving a charitable organization of private foundation status is one which excludes an organization which "normally" derives more than one-third of its yearly support from a combination of gifts from the general public and internally generated revenues from active operations.[38] This safe harbor from private foundation status will generally protect an active charity which relies on donations from the general public and its own related activities, rather than investment income or grants from "substantial contributors." A "substantial contributor" is any individual who contributes more than $5,000 by gift or bequest in any 1 year if this amount exceeds 2 percent of all contributions and bequests received by the organization in that particular year.[39]

Thus, unless some other exclusion applies, an organization to which only one individual is the contributor would be a private foundation, assuming the donor contributes or bequeaths over $5,000 to the organization in any 1 year. If the

34. *Id.* § 2055(a).

35. *Id.*

36. An excellent analysis of the private foundation rules and their effect on such an organization is found in Halperin, *Private Foundations and Termination,* 29TH ANNUAL N.Y. INSTIT. ON FED. TAXATION 1783 (1971).

37. INT. REV. CODE OF 1954, §§ 170(1)(A)(i)-(iv).

38. *Id.* § 509(a)(2).

39. *Id.* § 507(d)(2)(A).

sole donor contributes less than $5,000, private foundation status may be avoided, provided that the donor retains no control over the organization.[40]

Finally, it should also be noted that a charitable organization, properly established as a non-private foundation, may slip into private foundation status if it relies in future years on investment-related income rather than on gifts from outside sources and revenues generated by virtue of its own operations from sources related to its charitable activity.[41]

## SUPPORTING ORGANIZATIONS

One exemption of particular interest created by the 1969 Reform Act is the "supporting organization."[42] A contributor can transform a private foundation, or create an organization which will not carry this taint, by giving sufficient control over the organization to a public charity. Educational institutions fit nicely into the public charity category by virtue of their express exemption from private foundation status.[43]

The real appeal of the "supporting organization" is the perpetuation of the name and general aims of the donor. The original foundation board members, or board members of the donor's choosing, may continue to participate in determining the disposition of income from the foundation if the other tests of the supporting organization rules are met.[44] With only slight limitations, much that originally could have been done through the private foundation medium can be done under this approach. It would thus seem advisable for existing and prospective private foundations to seriously consider employing the supporting organization approach.

The heart of the supporting organization exclusion lies in the requirement that such an organization provide monetary

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40. *Id.* §§ 509(a)(2), 4946(a)(1)(B), 507 (d)(2)(A).

41. *Id.* § 509(a)(2)(A).

42. *Id.* § 509(a)(3). For a concise and understandable analysis of the possibilities and requirements of such status, there is an excellent article by David L. Paluska, Associate Counsel for Development at the University of Southern California. Paluska, *Transforming a Private Foundation to a Supporting Organization: Why and How*, 42 J. TAXATION 248 (1975).

43. INT. REV. CODE OF 1954, §§ 509(a)(1), 170(b)(1)(A)(ii).

44. *See* Paluska, note 42 *supra*.

support to a charitable entity, such as an educational institution, and that these funds be used to carry out the purposes of the supported entity.[45] Further, the supporting organization may not be controlled by the donor, but must be operated, supervised, and actually controlled by a public charity—the supported institution.[46]

Under the most simple approach, the articles of the supporting organization would designate that an institution, such as a university, receive the income generated by the supporting organization. This would clearly meet the initial test, which requires that such an organization be organized and operated for the benefit of the supported organization.[47] If desired, the articles of incorporation could provide that the income be used exclusively for scholarships, for a new chemistry building, or for the general support of the institution's faculty. All of these designations would be for the benefit of the supported institution or to carry out its purposes.[48]

Control of the foundation by the supported instituton—the second part of the "supporting organization" test—also can be readily met by permitting the supported organization to elect or appoint a *majority* of the members of the foundation's officers, directors, or trustees.[49] This permits the original creator of the foundation to serve on the foundation's governing board, so long as the majority of the board is composed of representatives appointed or elected by the supported institution.[50] In addition, the recipients of the supporting organization's benefits can be varied if certain, rather technical, provisions are inserted into the governing instrument. These provisions, however, are beyond the scope of this Article.[51]

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45. INT. REV. CODE OF 1954, § 509(a)(3)(A).

46. *Id.* §§ 509(a)(3)(B), (C).

47. *Id.* § 509(a)(3)(A).

48. Treas. Reg. § 1.509(a)-4(c)(2). See, for example, the contrast between Rev. Rul. 75-436 and 75-437, 1975 INT. REV. BULL. No. 41, at 11-14 for a comparison of foundations which provide scholarship funds and the results of employing differing types of such organizations. The educational institution's purposes clearly include providing aid to its students.

49. INT. REV. CODE OF 1954, § 509(a)(3)(B); Treas. Reg. § 1.509(a)-4(g)(1)(i)(1972).

50. Treas. Reg. § 1.509(a)-4(j)(1).

51. INT. REV. CODE OF 1954, § 509(a)(3).

A substantial contributor should, however, be concerned with serving on the foundation's governing body. As a "disqualified person," he may not control "directly or indirectly" the supporting foundation.[52] And, even if appointed as the foundation manager by the supported institution, he will remain a "disqualified person."[53] Disqualified persons cannot have a veto power over foundation activities, nor can they have, in the aggregate, 50 percent or more of the voting power on the governing body.[54]

Despite these restrictions, the supporting organization which would otherwise be classified as a private foundation offers the donor or his successors a viable alternative to termination or to the difficult and expensive reporting requirements visited on private foundations by the 1969 Reform Act. It offers in large part, a method of perpetuating the name of the donor and insuring that his initial desires as to distribution of funds will be carried out.

Existing private foundations may become supporting organizations without running afoul of the "termination tax" which could otherwise result if the foundation were simply terminated and its assets distributed.[55] Because the foundation is not terminated, but simply revised, the problem of obtaining an "abatement" of the termination tax can be readily avoided.

## DEFERRED GIVING

A deferred gift is a gift to a qualifying charity of an interest which, although transferred presently, will not be fully available to the recipient until some future date. The most common gift of this type is a transfer in trust of a remainder interest, with a right to the income from the property either retained by the donor or given to some other non-charitable beneficiary.

Prior to the 1969 Reform Act, deferred giving was accomplished with relative ease. A donor would establish a trust, with language somewhat as follows:

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52. *Id.* § 509(a)(3)(C).

53. Treas. Reg. § 1.509(a)-4(j)(1), T.D. 7212, 1972-2 CUM. BULL. 250.

54. *Id.*

55. INT. REV. CODE OF 1954, § 507(c). There are abatement possibilities under § 507(g) of the distribution tax, if the foundation distributes its assets to a properly qualifying charitable recipient.

> I hereby transfer $50,000, in trust, income to be paid to me for my lifetime with the remainder upon my death to go outright to Gonzaga University.

Alternatively the donor's will would contain a provision which might read as follows:

> All of my XYZ stock shall remain in trust for the life of my surviving spouse, income to be paid to her for her life and upon her death the principal to pass to Gonzaga University.

Until 1969 both forms of deferred giving produced charitable contribution deductions—the first an income tax deduction, the second an estate tax deduction. The amount of the deduction in both instances was determined by valuing the remainder interest's present value.[56]

This proved unsatisfactory for a variety of reasons. For example, trustees could invest in high yield securities so speculative that nothing would ultimately pass to charity. Because of these problems, Congress has strictly limited most forms of deferred giving.[57] The majority of deferred gifts to charity must now follow the "annuity trust," "unitrust," or "pooled income fund" provisions of the Code.[58] These are collectively known as "charitable remainder trusts."

## ANNUITY TRUSTS

A form for a typical charitable remainder annuity trust is set forth in Appendix "A". While this form is certainly not the exclusive approach that can be taken by a prospective donor, it does contain the particular language which the Service has ruled will qualify such a trust under the charitable remainder sections of the Code.[59] Any form of charitable remainder trust, including the proposed form in Appendix A, can be the subject of a binding ruling by the Service.[60]

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56. S. REP. No. 91-552, 91st Cong., 1st Sess. (1969), 1969-3 CUM. BULL. 423, 479.

57. *Id.* The new rules do not apply to a deferred gift of one's residence or farm.

58. INT. REV. CODE OF 1954, §§ 170(f)(2)(A). 2055(e)(2). There are gift tax ramifications of a non-qualifying gift of a remainder interest to charity if the charitable remainder trust approach is not followed. *Id.* § 2522(c)(2). A donor who does not obtain an income tax deduction and in fact finds himself faced with a gift tax is unlikely to be a happy donor.

59. *Id.* § 2522(c)(2).

60. Rev. Rul. 72-395, 1972-2 CUM. BULL. 340.

An annuity trust is created by a donor's transfer of property into trust with the remainder to pass ultimately to a qualifying charity. The donor specifies that a fixed amount, which cannot be less than 5 percent of the fair market value of the property transferred, will be paid, not less often than yearly, to a non-charitable beneficiary for the life of the beneficiary or a period not in excess of 20 years.[61] Distribution from the trust in excess of the annuity payment is not permitted, and at the end of the non-charitable interest the remainder must pass to the charitable remainderman.[62]

The present value of the retained non-beneficial interest, determined by Service regulations, is deducted from the actual fair market value of the property transferred.[63] As an example, an annuity trust which is funded with $100,000 by a male, age 60, who retains a 6 percent annuity interest in the trust for his life with remainder to charity, results in a retained annuity interest of $6,000 yearly. Assuming the annuity payments are to be made at the end of each year of the annuity trust, the $6,000 amount is multiplied by 9.1753[64] to arrive at a present retained value of $55,051. This amount is then subtracted from the $100,000 fair market value of the transferred property to arrive at the deductible remainder interest of $44,949.[65] While the same result can be reached by a shorter method[66] in this simplified example, any variance from a yearly, year-end payout requires an adjustment to the actual deductible amount which is best arrived at by use of the former approach.

An annuity trust is relatively straight-forward—a fixed amount is transferred in, a fixed amount is retained. After the initial computation no further adjustments are necessary, and no additional amounts may be added to the trust. In fact, the trust instrument must expressly prohibit the receipt of additional transfers.[67]

61. *Id.* at 342.

62. INT. REV. CODE OF 1954, § 664(d)(1)(A).

63. Treas. Reg. §§ 1.170A-6(b)(2), 20.2055-2(f)(2), 25.2522(c)-3(d)(2), 1.664-2(c).

64. Table A(1), column 2, Treas. Reg. § 20.2031-10 (1974).

65. Treas. Reg. § 1.664-2(c); *id.* table A(1), § 20.2031-10 (1974).

66. Table A(1), column 4, Treas. Reg. § 20.2031-10 (1974).

67. *Id.* § 1.664-2(b)(1972). For this reason a "pour over" from a will to an existing annuity trust will not produce an estate tax charitable remainder deduction. The annuity trust cannot thus be used as a vehicle for later additions.

There is no prohibition against the donor acting as his own trustee of a qualifying annuity trust, but the trust instrument must prohibit the trustee from exercising various "poison" powers generally listed in the private foundation prohibitions.[68] Moreover, trust distributions must be made from principal if income from the trust is insufficient to meet the required annuity payments.[69]

## UNITRUSTS

While the annuity trust approach provides a fairly simple method of establishing a deductible charitable remainder gift, the unitrust provisions of the Code permit more flexibility and slightly more sophisticated planning.[70] While the minimum payout must equal at least 5 percent of the trust assets, as with an annuity trust, the amount of the payout will vary from year to year depending upon the yearly value of the trust assets.[71]

Unlike the annuity trust requirement of a fixed payout on a yearly basis, regardless of actual trust income, a unitrust may be drafted in such a fashion that distributions are limited to the *lesser* of the fixed percentage or trust income.[72] The instrument may further provide for a "catch-up" of underpayments in subsequent years when income is more plentiful.[73]

In this sense the unitrust is a "gambler's trust." The annuitant may receive a greater or lesser payout than would be the case with an annuity trust, depending upon the yearly value of the trust assets. The price for this added flexibility is the necessity of yearly valuations and considerably more complicated computations. Nevertheless, the unitrust approach has an obvious place in the consideration of any form of deferred giving.

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68. INT. REV. CODE OF 1954, § 4947(a)(2); Rev. Rul. 72-395, § 6.06, 1972-2 CUM. BULL. 340.

69. Conceivably, an annuity trust could be exhausted by virtue of the set amount that *must* be paid by its terms. Should this occur, neither the annuitant nor the charity would receive anything further.

70. INT. REV. CODE OF 1954, § 664(d)(2). *See* APPENDIX B.

71. *Id.* § 664(d)(2)(A). Further, because the assets of the trust are to be valued at least yearly, additional assets can be placed in the trust increasing the trust principal and accordingly increasing the annuity amount.

72. INT. REV. CODE OF 1954, § 664(d)(3).

73. *Id.*

POOLED INCOME FUNDS

A "pooled income fund" is very much like a mutual fund. Contributions to such funds must be commingled with other contributions to a particular fund and may not be in the form of, or invested in, tax-exempt securities.[74] The basic concept of a pooled fund is a tranfer of property into an existing fund, with the donor retaining the right for himself or some other non-charitable beneficiary to receive income from the fund for life.[75] At the end of the measuring life the charitable organization administering the fund severs the remainder interest and uses such interest for its charitable purposes.[76]

The non-charitable beneficiaries receive the total income of the pooled fund, their respective portions of the fund income determined by reference to their percentage of ownership in the total "units" of the fund.[77]

Fund unit ownerships are determined by calculating the fair market value of the property already in the fund at the moment of transfer of a new gift, calculating the fair market value of the new gift, and assigning a unit value to the latest transfer based upon a ratio between these values.[78] For example, if property with a fair market value of $50,000 is transferred to such a fund as of the first day of a particular month, and the fair market value of all property in the fund, prior to the transfer is $100,000 with 1,000 units of participation outstanding prior to the transfer, the computation is as follows:

$100,000 divided by 1,000 units equals a per-unit value of $100.
$50,000 (amount contributed) divided by per-unit value of $100 gives the transferor 500 units.

Note that immediately after the transfer there will be $150,000 of assets in the fund, 1,500 units, and a continued per-unit value of $100.[79] If the fund has an annual income of $15,000 for the year of transfer and if the transfer was made on the first day of that year, the transferor will receive five hundred fifteen hundredths of the income, or $5,000.

74. Treas. Reg. § 1.642(c)-5(c)(1).
75. INT. REV. CODE OF 1954, § 642(c)(5).
76. *Id.*
77. Treas. Reg. §§ 1.642(c)(2), T.D. 7105, 1971-1 CUM. BULL. 164.
78. *Id.*
79. *Id.*

A determination as to the amount of the charitable contribution deduction for property transferred to a pooled income fund depends upon the actual performance of the fund in the 3 taxable years prior to the year in which the transfer is made.[80] For funds in existence for less than 3 years prior to the transfer an assumed return rate of 6 percent is employed.[81] These computations may be quite involved. Fortunately, most funds will provide the contribution amount to their donors.

## PRIVATE ANNUITIES

Another approach to income retention and charitable giving is the issuance of a "private annuity" by a charitable organization in exchange for money or other property transferred to the organization by a donor. The organization agrees to pay the donor, or his designee, a set sum for a set period of time.

If the value of the annuity at the time of "purchase" is less than the value of the money or other property transferred, the available charitable deduction, for income tax purposes, is measured by the difference.[82] The value of the annuity contract is determined by reference to the Treasury Regulations.[83] If the annuity value equals or exceeds the payment made therefor, no charitable deduction is available.[84] The actual computation of the value of a gift annuity, as private charitable annuities are generally referred to, is quite complicated and will naturally vary with the life expectancy of the non-charitable measuring life and the annuity amount involved.[85]

So long as the donor is transferring money in exchange for the annuity no particular problem other than valuation of the annuity exists. Where, however, property other than money is given by the donor to the charity, problems do exist.[86] As with

80. INT. REV. CODE OF 1954, § 642(c)(5)(C).

81. Treas. Reg. §§ 1.642(c)-6(b)(2), T.D. 7105, 1971-1 CUM. BULL. 164.

82. Treas. Reg. § 1.170A-1(d) (1972); Rev. Rul. 70-15, 1970-1 CUM. BULL. 20.

83. Treas. Reg. § 1.170A-1(d)(2), referring to Treas. Reg. 1.101-2(e)(1)(iii)(b)(2).

84. Rev. Rul. 55-349, 1955-1 CUM. BULL. 232, 233.

85. An illustration of some possibilities in this regard may be found in a comprehensive article by Conrad Teitell, who is generally considered to be an authority in this field. Teitell, *Federal Tax Implications of Charitable Gift Annuities*, 19 N.Y.L. FORUM 269, 271 (1973).

86. *Id. See also* Garibaldi, *Some Final Problems for the Charitable Taxpayer*, N.Y.U. 30TH INST. ON FED. TAX. 117 (1972).

the case of any transfer of appreciated property which is to result in a charitable deduction, long-term capital gain property will result in a maximum current income tax deduction equal to 30 percent of the donor's contribution base, unless the donor agrees to reduce his total deduction for all capital gain property contributed in the particular year involved.[87]

A further problem exists with the "bargain sale" rules which came into effect as part of the 1969 Reform Act.[88] If the donor is transferring his property to the charitable organization for less than its value he must allocate his basis in the property between the contribution portion and the "sale" portion.[89] The reason for such a requirement is that, unlike the situation discussed earlier where an annuity, unitrust, or pooled income fund is employed, the transfer of appreciated property in exchange for a gift annuity is a *taxable event* and the donor will realize and recognize a gain or loss in such a transaction.[90]

Gift annuities were otherwise not generally affected by the 1969 Reform Act to the same extent as were charitable remainder trusts.[91] Nevertheless, care should be employed in drafting such instruments, particularly if the donor seeks to take a deferred annuity. In such a situation property is presently transferred in exchange for annuity payments which are to begin at some future time.[92]

If all goes well, the donor obtains an immediate income tax deduction, but realizes gain on the transfer only when the annuity payments begin. A private ruling to this effect reportedly exists, but it would clearly be wise to obtain a ruling for each individual case.[93] Otherwise an immediate capital gain tax lia-

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87. INT. REV. CODE OF 1954, § 170(b)(1)(D). *See* text accompanying note 29 *supra*.

88. Tax Reform Act of 1969, 83 Stat. 487.

89. INT. REV. CODE OF 1954, § 1011(b).

90. Treas. Reg. § 1.1011-2(a) (1972). Examples of the computations necessary to determine such gains are set forth in subsection (c) of the cited regulation.

91. *See* text accompanying note 57 *supra*. Because a gift annuity is not a "charitable remainder" trust, existing gift annuity forms may be used without concern for the possible loss of a charitable deduction.

92. Oberlin College of Oberlin, Ohio, suggests such an approach in its Fall, 1975 issue of "The Prompter", a publication admittedly designed to obtain contributions for the college.

93. *See* Teitell, note 85 *supra* at 282.

bility, with no actual annuity income available to offset the tax, could be a possible result.[94]

## SUMMARY

The 1969 Reform Act obviously requires careful planning if the charitable deductions previously available for income, gift, or estate tax purposes are to be obtained, particularly if an intervening life determines when the charity receives the subject property.[95] Failure to comply with such requirements can easily mean the complete loss of a planned charitable deduction and could possibly create a gift tax liability if an intervivos transfer is employed.

Even where the charitable transfer is of a present interest, care must be exercised in selecting the property to be given so that the donor can attain the maximum income tax deduction.[96] As discussed earlier, gifts of property may produce a deduction limited to 30 percent of the donor's contribution base, 50 percent of his contribution base, or simply his adjusted basis in the property, depending upon the type of property being transferred, the period for which it has been held, or the recipient charity involved.[97] A rather careful balancing is necessary if a maximum benefit is to be obtained in a given transfer. To this extent, the 1969 Reform Act has made charitable giving more difficult.

Of course charitable giving is still a viable method of reducing an individual's income tax or estate tax burden while providing for the purposes of a particular charitable institution. Even though more care may be necessary, the benefits of a properly structured charitable program are still as great as ever.

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94. Lloyd Bell, 60 T.C. 469 (1973), resulted in a somewhat analogous result. While the case is clearly different from the usual gift annuity situation, the possible exposure is such that a ruling should be sought.

95. Common to the income tax, gift tax and estate tax "deferred" giving sections are the annuity trust, unitrust and pooled income fund requirements. INT. REV. CODE OF 1954, §§ 170(f), 2055(e), 2522(c).

96. Testamentary charitable transfers of present interests are relatively less affected by the 1966 Reform Act. *See* note 30 and accompanying text *supra*.

97. INT. REV. CODE OF 1954, §§ 170(b)(1)(D) and 170(e).

## APPENDIX A

### SAMPLE OF CHARITABLE REMAINDER ANNUITY TRUST

BY THE TERMS OF THIS AGREEMENT, and , husband and wife (hereafter referred to as the Donors) do establish the and Annuity Trust, for the purposes and under the provisions set forth herein, this day of , 197 . The of , as trustee (hereafter, Trustee) does accept the provisions of this trust and agrees to carry out its duties as trustee.

1. The Donors transfer, from their community property, those assets set forth in Schedule "A", attached. This property and all receipts of every kind shall be managed and invested by the Trustee as a single fund (hereafter called the Annuity Trust). The parties agree that the present net fair market value of the transferred assets is $ .

2. The Trustee shall pay to the Donors, or the survivor thereof, in each taxable year of the trust during the lives of the Donors and continuing during the life of the survivor thereof, an annuity amount equal to percent (not less than five percent) of the initial net fair market value of the assets constituting the trust. In determining such value, assets shall be valued at their values as finally determined for Federal Tax purposes. If the initial net fair market value of the assets constituting the trust is incorrectly determined by the fiduciary, then within a reasonable period after such final determination, the Trustee shall pay to the Donors or the survivor thereof in the case of an undervaluation, or shall receive from the Donors or the survivor thereof in the case of an overvaluation, an amount equal to the difference between the annity amount properly payable and the annuity amount actually paid. The annuity amount shall be paid in equal quarterly installments from income and, to the extent that income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal.

3. Upon the death of the last survivor of the Donors the Trustee shall distribute all of the then principal and income of the trust, other than any amount due to the Donors or the survivor thereof, to Gonzaga University, if it is then a qualifying charity.

4. If Gonzaga University is not a qualifying charity as described in Section 170(c) of the Internal Revenue Code of 1954 at the time when any principal or income of the trust is to be distributed to it, the Trustee shall distribute such principal or income to one or more organizations then described in Section 170(c) as the Trustee shall select in its sole discretion.

5. In determining the annuity amount to be paid to the Donors or the survivor thereof, the Trustee shall prorate the same, on a daily basis, for a short taxable year and for the taxable year of the death of the last survivor of the Donors. The initial taxable year of the trust shall end on December 31. Subsequent taxable years of the trust shall be on a calendar year basis.

6. In no event may any additional contributions be made to the Annuity Trust after the initial contribution.

7. Except for the payment of the annuity amount to the Donors of the survivor thereof, the Trustee is prohibited from engaging in any act of self-dealing as defined in Section 4941(d) of the Internal Revenue Code of 1954, from retaining any excess business holdings as defined in Section 4943(c) of the Code which would subject the trust to tax under Section 4943 of the Code, from making any investments which would subject the trust to tax under Section 4944 of the Code, and from making any taxable expenditures as defined in Section 4945(d) of the Code. The Trustee shall make distributions at such time and in such manner as not to subject the trust to tax under Section 4942 of the Code.

8. The Trustee shall have all powers accorded to a Trustee under applicable state law, except as provided for in this agreement, and in particular, shall not enjoy any power that would render this trust a non-qualifying Charitable Remainder Annuity Trust as defined in Section 664 of the Code. Subject to these restrictions, the Trustee

is authorized to retain the property described in Schedule A, or may sell such property and invest and reinvest the trust assets in any kind of property without diversification as to kind or amount and without regard to the limitations imposed by law on investments. Provided further, however, nothing in this trust instrument shall be construed to restrict the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

9. The Trustee may receive its normal trustee's fee for services actually rendered to the trust, but in no event may any such payment limit or affect the annuity trust amount to be paid to the Donors or the survivor thereof.

10. In creating this Annuity Trust, the Donors intended to obtain the full benefit of any income, gift and extate tax charitable contribution deductions to which they may be entitled under the Code and for the Annuity Trust to qualify as a charitable remainder Annuity Trust under Code Section 664 and the regulations and rulings thereunder. Accordingly, the Annuity Trust shall be interpreted, valued, managed and invested consistent with this intention. While this agreement is irrevocable, the Trustee has the limited power to amend this Agreement for the sole purpose of complying with the requirements of Code Section 664 and the rulings and regulations thereunder.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement this day of , 19 .

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DONORS

Accepted:

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By______________________

TRUSTEE

## COMMENTS TO APPENDIX A

The proposed form for an annuity trust is deriven in substantial part from the suggested clauses found in Rev. Rul. 72-395, 1972-2 CUM. BUL. 340. As indicated below, the trust may contain certain optional provisions and may be adapted quite easily to a testamentary trust for the benefit of a survivor.

In any event, the practice of obtaining an advance ruling as to the qualification of the annuity trust is advisable, due to the adverse tax consequences that can flow from a non-qualifying trust. Rulings may readily be obtained by following the procedures set forth in Rev. Proc. 72-3, 1972-1 CUM. BULL. 698, and addressing the ruling request to the Assistant Commissioner at the address noted in Rev. Rul. 72-395.

## PERMISSIBLE VARIATIONS

If the trust is to be established by will, all references to donors and survivors throughout the instrument must be deleted and the term "beneficiary," must be substituted. In no

event may a beneficiary be named who is not alive at the time the trust is created and beneficiaries must be "named" or designated as such through a class. Thus, a provision providing for an annuity trust payment to children of the testator living at his death would be permissible. Treas. Reg. § 1.664-2(a)(3). If a testamentary annuity trust is desired, the following provisions should be substituted for paragraphs 1 and 2 of the forms:

> "1. All the rest, residue and remainder of my property and estate, real and personal (or a specific amount) of whatever nature and wherever situated, I give, devise and bequeath to my trustee in trust, to invest and reinvest the same during the life of and in each taxable year of the trust to pay to an annuity amount equal to percent (which must be at least 5%) of the initial net fair market value of the trust assets constituting the trust. In determining such value, assets shall be valued at their values as finally determined for federal tax purposes. If the initial net fair market value of the assets constituting the trust is incorrectly determined by the fiduciary, then within a reasonable period after such final determination, the trustee shall pay to (in the case of an under-valuation) or shall receive from (in the case of an over-valuation) an amount equal to the difference between the annuity amount properly payable and the annuity amount actually paid. The annuity amount shall be paid in equal quarterly installments from income and, to the extent that income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal.
> 2. The obligation to pay the annuity amount shall commence with the date of my death, but payment may be deferred from the date of my death to the end of the taxable year in which occurs the complete funding of the trust. Payment of the annuity amount so deferred, plus interest computed at six percent a year, compounded annually, shall be made within a reasonable time after the occurrence of said event."

Rev. Rul. 72-395, § 5.02, *supra*.

A variety of other optional provisions may be inserted in an annuity trust, as set forth in § 5 of the cited revenue ruling. One of the more common variations is a provision terminating the obligation of the trustee to pay annuity amounts to a beneficiary for the period in which occurs the death of the beneficiary.

In particular, note that an annuity trust may *never* receive additional amounts after its formation. Accordingly, a unitrust, not an annuity trust must be used if an inter vivos trust with a pour-over from a donor's will is contemplated.

## APPENDIX B

## SAMPLE OF UNITRUST

BY THE TERMS OF THIS AGREEMENT, and , husband and wife (hereafter referred to as the Donors), do establish the and Unitrust, for the purposes and under the provisions set forth herein on this day of , 197 . The of , as trustee (hereafter, Trustee) does accept the provisions of this trust and agrees to carry out its duties as the Trustee.

1. During the lifetime of the Donors, and continuing so long as either Donor is alive, the Trustee shall pay to the Donors or the survivor thereof in each taxable year of the trust, a Unitrust amount equal to percent of the net fair market value of the trust assets valued as of the first day of each taxable year of the trust. The Unitrust amount shall be paid in equal quarterly installments from income, and to the extent that income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the Unitrust amount shall be added to principal.

2. Upon the death of the last survivor of the Donors, the Trustee shall distribute all of the then principal and income of the trust, other than any amount due the last survivor of the Donors, to charity. If charity is not an organization described in Section 170(c) of the Internal Revenue Code of 1954 at the time when any principal or income of the trust is to be distributed to it, the Trustee shall distribute such principal or income to one or more organizations then described in Section 170(c) as the Trustee shall select in his sole discretion.

3. If the net fair market value of the trust assets is incorrectly determined by the fiduciary for any taxable year, then within a reasonable period after the final determination of the correct value, the Trustee shall pay to the Donors (or the survivor thereof) in the case of an undervaluation, or shall receive from the Donors (or the survivor thereof) in the case of an undervaluation, any amount equal to the difference between the Unitrust amount properly payable and the Unitrust amount actually paid.

4. In determining the Unitrust amount, the Trustee shall prorate the same, on a daily basis, for a short taxable year and for the taxable year of the death of the last survivor of the Donors. The first taxable year of the Unitrust shall begin with the date of this Agreement and shall end on December 31. Subsequent taxable years shall be on a calendar year basis.

5. If any additional contributions are made to the trust, whether by gift, bequest, or otherwise, after the initial contribution in trust, the Unitrust amount for the taxable year in which the assets are added to the trust shall be percent of the sum of: (a) the net fair market value of trust assets (excluding the assets so added and any income from, or appreciation on, such assets), and (b) that proportion of the value of the assets so added that was excluded under (a) which the number of days in the period which begins with the date of contribution and ends with the earlier of the last day of the taxable year or the death of the last survivor of the Donors' bears to the number of days in the period which begins on the first day of such taxable year and ends with the earlier of the last day in such taxable year or the death of the last survivor of the Donors. In the case where there is no valuation date after the time of contribution, the assets so added shall be valued at the time of contribution.

6. Except for the payment of the Unitrust amount to the Donors or the last survivor thereof, the Trustee is prohibited from engaging in any act of self-dealing as defined in Section 4941(d) of the Internal Revenue Code of 1954, from retaining any excess business holdings as defined in Section 4943(c) of the Code which would subject the trust to tax under Section 4944 of the Code, and from making any taxable expenditures as defined in Section 4945(d) of the Code. The Trustee shall make distributions at such time and in such manner as not to subject the trust to tax under Section 4942 of the Code.

7. In the event of an addition to the Unitrust due to the death of one of the Donors or the death of any other person, and an amount thus being added to the Unitrust by will or otherwise, the obligation to pay an increased Unitrust amount by virtue of such addition shall commence with the date of such death, but actual payment of such increased amount may be deferred, at the option of the Trustee, from the date of such death to the end of the taxable year of the trust in which occurs the complete funding of the trust. Within a reasonable time after the occurrence of such event, the Trustee shall pay the amount determined under the method described in Section 1.664-1(a)(5)(ii) of the Federal Income Tax Regulations less the sum of any amounts previously distributed and interest thereon compounded at 6 percent a year, compounded annually, from the date of distribution to the occurrence of such event.

8. In computing the net fair market value of the Unitrust assets, which shall be the responsibility of the Trustee, there shall be taken into account all assets and liabilities without regard to whether particular items are taken into account in determining the income of the Unitrust. All determinations of the Unitrust's net fair market value shall be in accordance with generally accepted fiduciary principles and any United States Treasury Regulations and Internal Revenue Service rulings, procedures and guidelines govering charitable remainder Unitrusts. In any conflict, Treasury requirements shall prevail over generally accepted fiduciary accounting principles and any inconsistent provisions of this Agreement.

9. In creating this Unitrust, Donors intend to obtain the full benefit of any income, gift, and estate tax charitable contribution deduction to which either are entitled under the Code and for the Unitrust to qualify as a Charitable Reminder Unitrust under Section 664 of the Code and the Regulations thereunder. Accordingly, this instrument and the trusts created hereunder are irrevocable, but the Donors or the survivor thereof, or the legal representative of the survivor if both are dead, shall have the limited power to amend this instrument for the sole purpose of complying with the requirements for establishing a Charitable Remainder Unitrust.

10. The Trustee, except as limited herein and as limited by any provision of the Code which would disqualify the trust as a Charitable Remainder Unitrust, shall have those powers conferred upon it by law, and shall be empowered and authorized, subject to such limitations, to retain the property transferred herein on the attached Schedule "A" (or hereafter added to the Trust) or may sell any such property, invest and reinvest the property in any kind of property except as provided for herein, without diversification as to kind or amount, and may otherwise act as a trustee, including payment of a normal trustee's fee to itself for the services actually performed on behalf of the trust. The fee so paid shall in no event alter the Unitrust amounts to be paid to the Donors or the last survivor thereof. Nothing in this Trust instrument shall be construed to restrict the Trustee from investing the Trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of Trust assets.

IN WITNESS WHEREOF, the parties have set their hands this day of , 197 .

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DONORS

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TRUSTEE

By____________________

________, _______, 197___.

## COMMENTS TO APPENDIX B

As is the case with the sample annuity trust (Appendix A) the language of this sample is derived largely from Rev. Rul. 72-395, 1972-1 CUM. BULL. 340. Unlike the annuity trust, a unitrust may contain optional provisions which will permit a variation in annual payments, due solely to income availability. Further, a unitrust, unlike an annuity trust, may be used to receive additional amounts, this permits a pour-over from a will to an existing unitrust.

Again, virtually any charitable remainder trust should be the subject of a ruling request, which can readily be accomplished by following the format suggested in the comments to Appendix A. A unitrust can also be established by will, following language similar to that set forth below.

## PERMISSIBLE VARIATIONS

If the trust is to be established by will, reference to donors and survivors should be replaced by reference to named beneficiaries. In this regard the comments in Appendix "A" are appropriate. Possible language for a testamentary disposition, as suggested in Rev. Rul. 72-395, § 7.02, *supra*, follow:

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"1. All the rest, residue and remainder of my property and estate, wherever situated, I give, devise, and bequeath to my trustee in trust, to invest and reinvest the same during the life of and in each taxable year of the trust to pay in equal quarterly installments to , a unitrust amount equal to % of the net fair market value of the trust assets valued as of the first day of each taxable year of the trust. The unitrust amount shall be paid from income and, to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal."

A variation which limits unitrust distributions to actual trust income may be found in § 7.01 of Rev. Rul. 72-395, *supra*, together with further alternatives permitting a "catch up" of underpayments in future years when income is sufficient.