Gift Planning Now

A Newsletter for Berkeley's Donor Advisors

Spring 2014

Charitable Trusts and Split Interest Gifts with No Estate Tax Deduction – Options to Consider

Most life-income and split-interest gifts come with strict criteria that must be met to qualify for a charitable deduction. But with the increased estate tax exemption ($5.34 million for 2014) making fewer estates subject to tax, new avenues may be opening for non-qualified testamentary charitable gifts. For example:

• A testator wants to establish a trust that will pay all the income to a child before assets are distributed to charity at the child's death. With a qualified charitable remainder trust, only a specific annuity or unitrust percentage may be payable to the child, subject also to the 10% remainder requirement of Code §664(d)(2)(D) and the 5% probability test for annuity trusts (Rev. Rul. 77-374). With a nonqualified trust, a testator can direct that all the income be paid or even provide for payments to be skipped in certain years. Because the remainder value of the trust is not an issue for estate tax purposes, it's also possible to have the trust continue for the lives of multiple beneficiaries, which might not be possible with qualified charitable remainder trusts that have to be valued using the §7520 rates.

• Reg. §1.664-3(a)(1)(i)(c) allows charitable remainder unitrusts to "flip" from a net-income to a standard unitrust on a specific date or upon the happening of a triggering event whose occurrence is outside the control of the trustees or any other persons. That would preclude a qualified trust where the income beneficiary is able to direct the flip to occur at his or her discretion. However, with a nonqualified trust, the trustee could pay the lesser of a specified percentage or the trust's net income annually until the beneficiary selects a date for the flip to occur. In addition, any make-up from previous

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Record Number of Students Seek Admission to Berkeley

Newly released figures show that more than 73,700 high school students are seeking admission to Berkeley's 2014-15 freshman class. That's 6,000 more than last year – a 9% increase over the 2013-14 applicant pool – making another record year for applications. Transfer applications grew as well, with more than 16,570 students seeking admission, up about 4% from the previous year. Freshman admission decisions will be announced on March 27 and transfer admissions decisions will be announced April 25.

No Estate Tax Deduction . . . *(continued from page 1)*

years when the full percentage payment is not made would not have to be lost, as it is with a qualified flip trust. Note: The trust would be taxable on undistributed income.

• It might be possible to fund a nonqualified charitable remainder trust with mortgaged property or jointly owned property, actions that would jeopardize a qualified trust.

• Under the partial interest rule [Code §170(f)(3)], with very limited exceptions, no charitable deduction is allowed for a transfer (not made by a transfer in trust) of any interest in property that is less than the donor's entire interest.

One exception to the partial interest rule is for remainder interests in personal residences and farms [Code §170(f)(3)(B)(i)]. Generally this involves a donor transferring an interest in a home or farm while retaining the right to live in, rent or farm the property for life. Under California law, it can be a term of years as well. These split-interest gifts can also be arranged for survivors through an estate plan. Where the testator is not concerned about the charitable deduction, it would be possible to arrange a similar split-interest gift where commercial property (e.g., office or apartment building) was involved. Charity could own the property outright at the death of the individual or after a period of years.

• No deduction is allowed for a future interest in tangible personal property (e.g., artwork, antiques, collections) until all intervening noncharitable interests have ended. Without the need for an estate tax

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UC Berkeley Planning Pointer:

Do IRA Gifts Still Make Sense?

With the expiration on December 31, 2013 of the tax code provision permitting qualified charitable distributions from IRAs, donors may be wondering whether or not to make charitable gifts from their IRA. This can be especially true for donors who have made IRA gifts over the last several years. While legislation has been introduced in Congress to extend Internal Revenue Code §408(d)(8), there is no way of knowing whether that legislation, or other legislation to extend this provision, will be enacted for 2014. The popular provision, originally enacted in 2006, has been re-authorized several times, most recently as part of The American Taxpayer Relief Act of 2012 for 2012 (retroactively) and 2013.

IRC §408(d)(8) permitted donors to make charitable gifts to public charities from their IRA accounts without having to include the IRA distribution in their adjusted gross income. The key requirements of the recently expired provision were that: (i) the IRA account holder be at least age 70½ at the time the distribution is made to the charity; (ii) the distribution be made directly from the IRA custodian to the charity; and (iii) the gift not exceed $100,000 per donor per year.

With the legislative result uncertain, how can advisors counsel their clients now about gifting from their IRA? Depending on the individual circumstances, it may make good sense for the client to go ahead and make the charitable gift from his or her IRA assets. Here's why:

If the provision is extended and the donor has complied with the requirements noted above (and they remain essentially the same), then the IRA gift could be made without incurring income tax on the distribution. (Of course a charitable deduction would not be allowed since the distribution would not be included in the donor's gross income.)

Alternatively, if the law is ultimately not extended for 2014, the IRA distribution would not qualify for exclusion from gross income but the gift would qualify for an income tax charitable deduction, subject to the standard limitations on charitable deductions. Thus, if a donor needs to take their required minimum distribution for 2014 in any event and wants to make a charitable gift of that amount, then arranging for it to be directly contributed to their favorite charity in accordance with the above requirements should not adversely impact the donor and may be beneficial if the tax code provision is extended for 2014.

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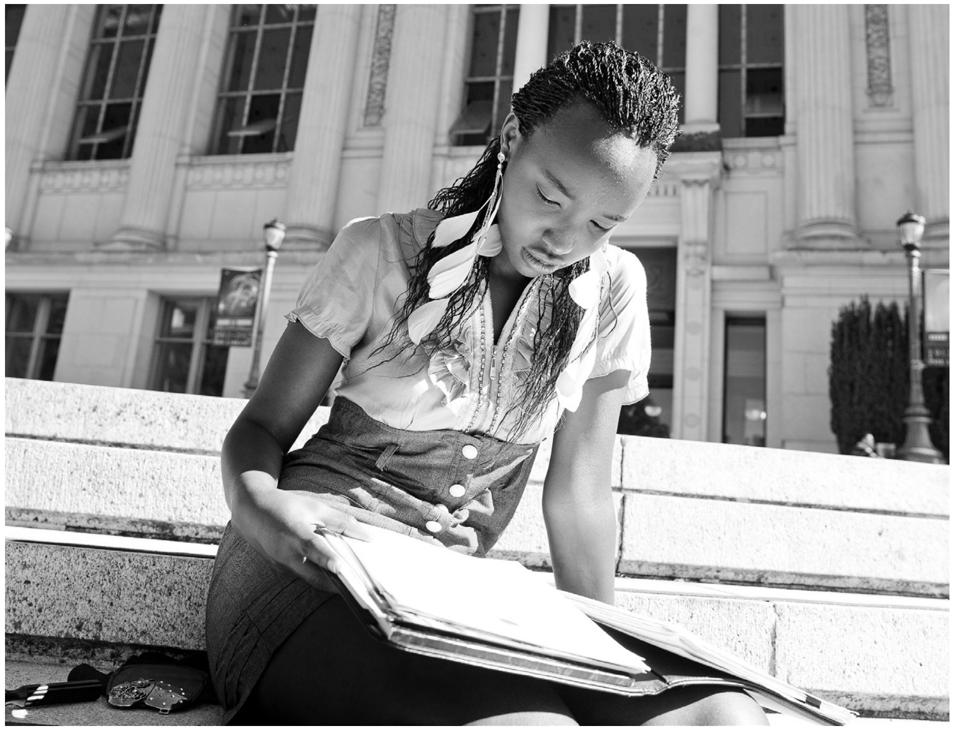
charitable deduction, a testator could leave personal property to family members, with the items passing to charity at the death of the survivors or after a period of years.

The larger estate tax exemption may allow more flexibility for clients wishing to split the benefits of their bequests between charity and family members. However, it is important to involve charity in the planning, to determine whether the organization wants to be a party to some of these arrangements.



Executor, Not Decedent, Made Gift

In 1993, Helen Trombetta established a qualified personal residence trust (QPRT) with a term of 15 years. If Trombetta was living at trust termination, the residence was to pass to her children. After a cancer diagnosis in 2005, she reduced the QPRT term, making the termination date the last day of the month before the month of her death. She also amended her will to provide for the funding of a charitable remainder unitrust with the residence. The income beneficiary of the unitrust was her estate. Her goal was to have approximately $250,000 pass to charity at the end of the trust.

Trombetta died in September 2006. Her executor created a charitable remainder unitrust with a 19.9105% payout rate and a term of five years. When the trust ended in 2011, $344,000 was distributed to charity. In 2010, Trombetta's estate filed for a refund, claiming a $250,000 charitable deduction. The IRS disallowed the deduction, saying that the QPRT ended the month before Trombetta's death and she therefore did not possess the right to transfer the property to the unitrust.

Under Reg. §20.2055-1(a), a deduction is allowed only for transfers made by the decedent during life or by will. Trombetta's QPRT, both before and after the amendment, provided that if she were living at the trust's termination, the property would be distributed equally to her children. If the trust terminated after her death, the trustee was to distribute the property under the terms of her will. The Tax Court held that because the QPRT terminated before her death, amounts passing to the charitable remainder unitrust were at the direction of her executor, not her will. The estate was therefore not entitled to a charitable deduction (*Est. of Trombetta v. Comm'r.*, T.C. Memo. 2013-234).

Tax Planning Pointer

Just before the market took its recent dip, your client bought shares of stock. Now that prices have recovered and are beginning to climb again, the client wants to sell, before another tumble. The problem: Any gain on the shares held one year or less is taxed at rates up to 39.6%, compared with the long-term capital gains rate of 15% or 20%. For philanthropically inclined clients, a bargain sale to charity might be the answer. If the shares were given to charity, the charitable deduction would be limited to the donor's basis [Code §170(e)(a)(A)]. If the shares are instead sold to charity for a price equal to the donor's basis, the bargain sale rules would apply. But because there is no gain, there is no tax. No charitable deduction would be allowed, but charity actually realizes a "gift" in the amount of the difference between the price paid and the fair market value of the shares.

Hidden Traps Lurk When Creating Charitable Remainder Trusts

Suppose clients come to your office for estate planning advice, saying they wish to benefit a favorite charity. After they leave, you review Code §664 and related regulations, dealing with charitable remainder trusts, but hidden obstacles may jeopardize trust qualification.

Ruby and Pearl, two elderly sisters, own ranch land inherited from their parents. They have been renting the acreage, but now want to increase their income. They've heard about charitable remainder trusts and want to use the land to fund a trust that would make distributions for their lifetimes before the assets would pass to several favorite organizations.

At first glance, a unitrust appears to be an ideal solution to selling the land and reinvesting for greater income. And nothing in Code §664 would seem to prevent the arrangement. However, the IRS has ruled on two occasions that a trust with multiple grantors constitutes an "association," not a charitable remainder trust (Ltr. Ruls. 9547004, 200203034). (The issue does not appear to be a problem where spouses are involved.) In Ltr. Rul. 9547004, grandparents and their six grandchildren proposed to contribute to a unitrust for their joint benefit. The IRS said the grantors were associates who "pooled their assets with an object to carry on business and divide the gains therefrom."

Each sister could, instead, contribute her 50% undivided interest in the land to individual, two-life trusts. By retaining the right to revoke the other's interest at death [Reg. §§1.664-2(a), 3(a)(4)], the survivorship benefits would be incomplete gifts for gift tax purposes.

Leon wants to create a net-income with make up charitable remainder unitrust paying to him for his life and then to his daughter, Sally, for her life.

Again, Code §664 doesn't seem to present any obstacles to the plan. However, in valuing Sally's income interest for gift tax purposes, Leon's income interest would be zero, making the entire income interest subject to gift tax. (Under Reg.25.2702-1(b), the value of the gift in trust is determined by subtracting the value of the interest retained by the transferor. Unless the retained interest is a qualified interest, the retained interest is generally valued at zero.) Further, because Sally does not have a present interest, the annual exclusion would not apply to this gift.

There are exceptions for certain charitable remainder unitrusts. Leon can create a standard unitrust or a net-income unitrust without a make-up provision. Leon can create a net-income with make-up unitrust only if (i) he is the second of two consecutive non-charitable beneficiaries; or (ii) the only permissible unitrust recipients are Leon and/or his U.S. citizen spouse [Reg.25.2702-1(c)(3)].

Genevieve, who recently remarried, wants to include a testamentary charitable remainder annuity trust in her estate plan. She wants the annuity to be paid to her husband for his life and then to her son for his life.

The estate tax marital deduction is available where the decedent transfers a qualified income interest for life, but the surviving spouse must be entitled to all income [Code §2056(b)(7)]. Because Genevieve's husband would receive only the annuity amount, it might appear that his interest would not qualify for the marital deduction. A special exception exists, however, for an income interest in a charitable remainder trust [Code §2056(b)(8)], provided the surviving spouse is the only noncharitable income beneficiary. By including her son, the marital deduction would be lost.

Instead, Genevieve could create a QTIP trust that, at her husband's death, would pour into a charitable remainder trust with her son as the sole income beneficiary.

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