# Gift Planning Now

A Newsletter for Berkeley's Donor Advisors

Summer 2012

## Gifts of Income Interests May Yield Unexpected Bonus

Clients who created charitable remainder trusts several years ago may be in a unique position to capitalize on all-time low Internal Revenue Code §7520 rates. A gift of part or all of the client's income interest is tax deductible. Furthermore, the income tax charitable deduction for the income interest, when added to the initial remainder interest deduction, may actually exceed the amount originally transferred to the trust.

Consider a 6% charitable remainder annuity trust funded with $250,000 at age 65 in August 2006. The trust has paid $15,000 annually since then – a total of about $90,000. In 2006, the charitable deduction, calculated using the August 2006 Code §7520 rate, was $103,276 (assuming quarterly payments). Today, at age 71, income payments are no longer needed. If the client makes a second gift to the charitable remainderman of the remaining life income interest in the trust, he or she will be entitled to a deduction of $183,906. The two deductions total $287,182 – more than the $250,000 transferred into the trust. This financial benefit is in addition to the payments received over the past six years.

Deduction totals will not be as dramatic for clients who funded charitable remainder trusts at lower Code §7520 rates, but they will still be attractive. For example, if the above trust was created when the client was age 67 using the December 2007 Code §7520 rate of 5%, the initial charitable deduction would have been $97,312. The two deductions would total $281,218 – still more than the original transfer. The client would

have received more than $65,000 in payments from the trust.

How is it possible that the gifts equal more than the original amount transferred? When the trust was created, Code §7520 rates were higher, which resulted in a higher charitable deduction for a gift of a remainder interest. Now, when rates are at historic lows (1.2% for June 2012), the value of a gift of the income interest will be greater.

*(continued on page 2)*

### A Builder of Berkeley – Quite Literally

*King Wai David Woo, a successful architect and Hong Kong businessman, has returned to Cal after 40 years to honor his late father, Woo Hon Fai, founding chairman of the Hong Kong Stock Exchange, with a $15 million gift to the historic Berkeley Art Museum/Pacific Film Archive building. In 1967, the BAM/PFA building was David's first resident architect job after graduating from the College of Environmental Design. In appreciation of the gift, the building has been named Woo Hon Fai Hall. "I was guided tremendously by the example of my father, whose hard work and contributions were crucial toward building the Hong Kong that we cherish today. By enshrining his memory, it is my hope that future generations will learn a little bit more about him and his legacy."*

## Gifts of Income . . . *(continued from page 1)*

The IRS has ruled that a subsequent gift of the income interest in a charitable remainder trust is not a partial interest because it is the donor's entire interest in the property (Ltr. Rul. 8221078). Under state merger doctrines, because charity would own both the income and remainder interests in the trust, the interests would merge and assets would be distributed outright to charity.

The IRS has also ruled that it's possible to give only a portion of the income interest in a charitable remainder trust. In Ltr. Rul. 9550026, the IRS said that donors who gave a 20% undivided interest in a charitable remainder unitrust were entitled to a second charitable deduction. A portion of the trust corpus was severed and paid out to the remainderman. The income beneficiaries continued to receive their original 9% unitrust payout on the remaining corpus. This gift – although not a gift of the donor's entire interest in the trust – likewise avoided running afoul of the partial interest rule because it was a gift of an undivided fractional interest. Because this is considered a noncash gift, clients who contribute an income interest in a remainder trust are required to obtain a qualified appraisal if they claim a charitable deduction of $5,000 or more.

## Charitable Gifts of Tangible Personal Property

Gift planning is fairly simple for clients who contribute cash or appreciated securities. Generally, the only rules that apply are the deduction limits under Code §170(b) (50% of Adjusted Gross Income for cash gifts, 30% of AGI for gifts of appreciated property, with a five-year carryover of any excess deductions) and the substantiation requirements of Code §170(f)(8).

### Tax Planning Pointer

For some homeowners, the $250,000/$500,000 capital gains exclusion on the sale of a principal residence means they can downsize without owing tax [Code §121(b)]. For clients whose homes have appreciated beyond the exclusion levels, one way to reduce the gain is to give charity an undivided interest in the home prior to a sale. A portion of the donor's basis will be allocated to the gift, but the amount of sales proceeds received by the client may fall within the exclusion limit. There will also be a charitable deduction.

Gifts of tangible personal property, on the other hand, may require more planning to ensure that clients receive the maximum charitable deduction. Here are some special considerations that should be addressed before making a gift:

*Valuation*

Personal property gifts in excess of $500 must be reported on Form 8283, and if the value exceeds $5,000, a qualified appraisal is required. The appraisal must be made no earlier than 60 days prior to the date of the gift and no later than the due date of the tax return. It is the obligation of the donor to pay for the appraisal. The cost may be deductible as a miscellaneous itemized deduction, not as an additional charitable gift. Donors who contribute works of art valued at $20,000 or more must submit a color photo of the item for review by the IRS's Art Advisory Panel.

*Deductions*

The deduction for a gift of tangible personal property that is capital gain property is limited to 30% of the donor's AGI, with a five-year carry-over [Code §170(b)]. If the gift is ordinary income property (e.g., art in the hands of the artist), the deduction is limited to the donor's basis in the property. Corporate donors often make gifts of tangible personal property. Corporations generally are entitled to charitable deductions of up to 10% of taxable income, with five-year carryovers. If the gift item is property subject to depreciation, the deduction is reduced by depreciation previously taken. If the gift is ordinary income property (e.g., inventory), the corporation's deduction is generally limited to basis [Code §170(e)(1)(A)].

*Special deduction limits*

An individual who contributes appreciated assets to charity may elect, under Code §170(b)(1)(C)(iii), to reduce the deduction to the property's basis and deduct up to

50% of AGI, rather than the usual 30%-of-AGI limit. There are enhanced deductions for companies that contribute inventory items "for the care of the ill, needy or infants" under Code §170(e)(3)(A) or make gifts of research equipment to colleges, universities and tax-exempt scientific research organizations under Code §170(e)(4). If certain criteria are met, the deduction may be increased to basis plus one-half the unrealized appreciation, up to twice the basis.

*Unrelated use*

The deduction for a gift of tangible personal property that is unrelated to the charitable recipient's exempt purposes is limited to the donor's basis or fair market value, whichever is less. For example, a coin collection contributed to a hospital might be considered an unrelated use. If the donor of personal property is required to file the appraisal portion of Form 8283 in connection with the deduction, the charity is obligated to file Form 8282 ("tattletale" form) if the property is sold within three years of the gift. A sale of the property may raise the presumption that the property was unrelated to the charity's exempt purposes [Reg. §1.170A-4(b)(3)(i)]. A deduction for fair market value will be allowed, despite a sale within three years, if, at the time of the gift, it was reasonable for the donor to believe that the property would be put to a related use. Because of the special rules that apply to gifts of tangible personal property, clients should be advised to discuss with the charity in advance of a contribution how the property will be used.

## IRS Issues Ordering Instructions

Provisions in an estate or trust or under local law that contain ordering clauses for payments to charitable beneficiaries will not be given effect for federal tax purposes unless there is an economic effect independent of income tax consequences. The IRS issued final regulations (T.D. 9582), that provide that if a provision does not have an economic effect independent of tax consequences, income distributions will consist of the same proportion of each class of the items of income as the total of each class bears to the total of all classes.

According to the IRS, ordering provisions in charitable lead trusts will never have economic effect independent of their tax consequences "because the amount paid to the charity is not dependent upon the type of income it is allocated." Permitting an ordering rule with no economic effect independent of income tax consequences to supersede a pro rata allocation rule would "permit taxpayers to deviate at will from the general rule" imposed on all kinds of complex trusts.

The final regulations add an example of a provision in a governing instrument that would have economic

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### Did You Know...

- 35% of all Cal undergraduates are eligible for federal Pell grants (generally for families with income of $45,000 or lower)
- 5,400 undergraduates received privately funded scholarships in 2010-11
- $35 million was given to undergraduates through privately funded scholarships in 2010-11
- An estimated 4,000 undergraduates will qualify for middle-class scholarship support, which goes into effect this fall through MCAP (Berkeley's Middle Class Action Plan)

## IRS Issues Ordering Instructions (continued from page 3)

effect independent of income tax consequences [Reg. §1.642(c)-3(b)(2)]. In the example, a trust provides that 100% of the trust's ordinary income be distributed currently to a charity and all remaining items of income must be distributed currently to a noncharitable beneficiary. This income ordering provision has economic effect independent of income tax consequences, say the regulations, because "the amount to be paid to the charitable organization each year is dependent upon the amount of ordinary income the trust earns within that taxable year."

## Bequests Must Come From Decedent, Not Executor

Dwight Fujishima's estate tax return included a charitable deduction of $130,000. Fujishima died intestate. His executor claimed that the charitable contributions were consistent with conversations she had with the decedent. Estate tax charitable contributions are permitted under Code §2055, but Reg. §20.2055-1(a) requires that the transfers be made during the decedent's lifetime or by will. The Tax Court denied the deduction, saying that amounts passing to charity cannot be based on the actions of an estate's personal representative. In addition, noted the court, the amounts were determined after Fujishima's death and were not adequately substantiated. *Estate of Fujishima v. Comm'r.*, T.C. Memo. 2012-6

## Deduction For Home Extinguished

Theodore Rolfs claimed a charitable deduction of $76,000 for the value of a home contributed to a fire department, to be used for training exercises. Following the destruction of the home, the land was to be returned to Rolfs, who planned to build a larger home on the lakefront property. He had previously obtained an estimate that it would cost $10,000 to demolish the home.

The IRS disallowed the deduction, saying that the value of what Rolfs received in return exceeded the value of the home. The Tax Court agreed (*Rolfs v. Commissioner*, 135 T.C. 471), finding that the only value for the home would be to relocate it to another parcel. However, due to the age of the home and the logistical difficulties, it was unlikely anyone would pay more than a negligible amount for the house.

The U.S. Court of Appeals (7th Cir.) affirmed, noting that the condition placed on the transfer of the home – that it be destroyed – meant that the home "had essentially no value." The court added that no one was disputing that $76,000 of home value was lost in the fire, but by making the destruction of the home a condition of the transfer, the taxpayer became responsible for the decrease in value. The fire department was merely "the mechanism" to accomplish that result, said the court, adding that none of the value of the house, as a house, was actually given away. *Rolfs, et al. v. Commissioner, 2012-1 USTC ¶50,186*

University of California, Berkeley Foundation
Office *of* Gift Planning
2080 Addison Street #4200
Berkeley, California 94720-4200

**Telephone**: 510.642.6300
**Toll Free**: 800.200.0575
**Fax**: 510.643.8066
**E-mail**: **ogp@berkeley.edu**
**Web**: **planyourlegacy.berkeley.edu**

To subscribe to our electronic version, please contact **ogpm@berkeley.edu** and provide us with your e-mail address.