



Gift Planning Now

A Newsletter for Berkeley's Donor Advisors

Winter 2012

Low-Interest Rates? These Gifts Shine

The \$7520 rate, used to calculate deductions for split-interest charitable gifts, has been historically low in recent months. Low rates make income tax deductions for charitable remainder trusts and charitable gift annuities look anemic. Because of the requirement for a 10% remainder interest [Code §664(d)(1)(D) and (d)(2)(D)] and the 5% probability test that applies to charitable remainder annuity trusts, donors under age 75 will not be able to establish an annuity trust (even at the minimum 5% payout rate) if the \$7520 rate returns to November's 1.4%.

However, there are a number of split-interest gifts that generate higher charitable deductions in times of low interest rates. For example:

■ The deduction is larger for charitable lead trusts that make annuity or unitrust payments to charity for a period of time before trust assets

are returned to the donor or pass to family members. By adjusting the payout rate and the term of the trust, it is possible to zero out the transfer tax owed when the trust distributes assets to family members.

■ Donors who give a home or farm while retaining a life estate in the property enjoy larger income tax charitable deductions with lower interest rates. Donors can continue using the property, farming the land, or receiving rental income from the property for life.

■ Although the charitable deduction is lower for charitable gift annuities funded in periods of low interest rates, the tax-free portion of the annuities is larger. This can be attractive for donors who are unable to use the full charitable deduction, as a larger share of their annuity will be free of income tax.

■ Donors who established a charitable remainder trust several years ago but no longer need the payout from the trust may find it attractive to contribute all or a portion of the income interest in the trust to the



remainder beneficiary. The original charitable deduction taken when the trust was established, plus the additional charitable deduction for the gift of the income interest, may exceed the value of the assets originally placed in the trust.

Berkeley Professor Awarded 2011 Nobel Prize in Physics

Saul Perlmutter, who led one of two teams that simultaneously discovered the accelerating expansion of the universe, has been awarded the 2011 Nobel Prize in physics. He is UC Berkeley's 22nd Nobelist and a faculty senior scientist at the Lawrence Berkeley National Laboratory. He led the Supernova Cosmology Project that, in 1998, discovered that galaxies are receding from one another faster now than they were billions of years ago.

Formula Clause Gets Tax Court OK

John and Karolyn Hendrix were owners of closely held JHHC stock. They wished to transfer some of the shares to their three daughters and give some to charity. They established a donor advised fund with the Greater Houston Community Foundation to which each spouse contributed shares equal to \$50,000. They also transferred JHHC stock to a generation-skipping trust and to trusts for their daughters in a part gift, part sale transaction. The Foundation's attorney worked with the couple's advisers on an agreement that irrevocably assigned shares based on a formula under which a portion of the shares having a specific dollar value was assigned to the trusts and any remaining portion of the shares was assigned to the donor advised fund at the Foundation. The Hendrix's appraiser placed the value of the stock at \$36.66 per share. An ap-

praiser retained by the Foundation agreed with that value. Based on the number of shares assigned pursuant to the formula, the couple claimed a \$100,000 charitable contribution.

The IRS claimed that the formula clauses were invalid because they were not reached at arm's length and are contrary to public policy. The IRS also claimed that the value of the stock was \$48.60 per share and that, therefore, the portion of the shares assigned to the daughters' trusts had a value far in excess of the amount the Hendrixes had reported as gifts for gift tax purposes. Interestingly, under the IRS view, the shares transferred to the Foundation by the Hendrixes also would have had a higher value (\$66,285 each) for a total charitable contribution of \$132,570.

The Tax Court found the value of the shares to be \$36.66 and said the burden of proof as to the validity of the formula clause was on the IRS. Courts are free to disregard the form of a transaction where there is collusion or the agreement is not at arm's length, but the Foundation exercised due diligence in negotiating the terms of the agreement, was represented by independent counsel, conducted its own appraisal, and had a fiduciary duty to ensure it received the number of shares to which it was entitled under the formula clause. Furthermore, said the court, the use of a formula clause here does not frustrate any national or state policy. To the contrary, said the court, the formula clause supports the fundamental public policy of encouraging gifts to charity. *Hendrix v. Commissioner*, T.C. Memo. 2011-133

Form 990 Cannot Replace Receipt

A donor discovered that he had failed to obtain the contemporaneous written acknowledgment needed to claim a charitable deduction of more than \$250. Code §170(f)(8)(A) requires that the donor have the letter from the charity by the earlier of the date the return is filed or the due date of the return for the year of the gift.

Because there was no way to correct the lack of an acknowledgment, the IRS was asked whether the donee organization could file an amended Form 990, attaching a statement that includes the information required under Code §170(f)(8)(B).

Code §170(f)(8)(D) provides

that a contemporaneous written acknowledgment is not required if charity files a return, "on such form and in accordance with such regulations" as the IRS prescribes. Although authorized to establish regulations allowing charities to satisfy the substantiation requirements by filing a return with the required information, the IRS and Treasury "have decided not to implement this suggestion at this time." Because the IRS has not provided for donee reporting as an alternative to donors obtaining acknowledgments, the charitable deduction cannot be salvaged by having the charitable recipient file an amended Form 990. (Ltr. Rul. 201120022)

Tax Planning Pointer

Several courts have upheld the use of formula clauses despite IRS arguments that they violate public policy. The IRS complains that it has no incentive to audit transfers if an increased value of assets merely results in a larger charitable deduction.

[See, for example, *Estate of Christiansen v. Commissioner*, U.S. Court of Appeals (8th Cir.) No. 08-3844; *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280.]



Donor's Goals Survive Obstacles

Elizabeth Lucas deeded two undivided interests in a property – totaling just over 52% – to the Hawaiian Humane Society (HHS). The land was to be used “for the benefit of the public for the operation of an educational preserve for flora and fauna, to be made accessible as an educational experience for the public.” If the land was not used as specified, it was to pass to the State of Hawaii for use as a public park. When Lucas died in 1986, the remaining interest in the land passed to her family.

The HHS and the state determined that, due to terrain and access issues, the land was unsuitable for any public use. A three-way land exchange and sale was proposed, under which HHS would receive about \$1 million that would be used to establish a public education fund in Lucas’s name. The probate court denied the parties’ petition to approve the arrangement, saying that the cy pres doctrine did not apply, since Lucas had provided for an alternative transfer in the deeds.

The Intermediate Court of Appeals of Hawaii found the cy pres doctrine did apply, noting that cy pres is applicable where a settlor creates a charitable trust of real property to be used for a specified purpose, but the property turns out to be unsuitable for that purpose. Lucas’s deeds provided an alternative charitable purpose – use of the land by the state for a public park – which showed her intent that the land be used for a charitable purpose, even if the original purpose failed. Where the alternative distribution is unfeasible, impracticable or impossible, the fact that she designated an alternative use for the land does not preclude the application of cy pres to save the first charitable purpose, said the court.

Where both the primary and alternative charitable distributions are impracticable, it is proper to presume that the settlor would have intended one or both purposes to survive under cy pres. The proposed use of the funds from the land exchange and sale closely conforms to Lucas’s intended purpose of providing an educational experience for the public (*In re Lucas Charitable Gift*, No. 30306).

Feline Foster Care Provider Needed Substantiation

The IRS disallowed the \$12,000 Jan Van Dusen claimed as a charitable contribution in 2004 for unreimbursed expenses for her work with Fix Our Ferals (FOF). Van Dusen served as a temporary foster care provider for 70 to 80 feral cats that were trapped and neutered prior to release back to the wild.

The Tax Court found that Van Dusen was working on behalf of FOF when she performed the services and that her work was in furtherance of the organization’s mission. The

expenses included cat food, cleaning supplies, extra water to clean cat bedding, extra electricity to operate a special ventilation system, veterinary bills, and cleaning supplies. Because Van Dusen had seven cats of her own and did not have separate bills for the items she purchased or paid for, the court said she was entitled to deduct 90% of veterinary expenses, pet supplies, and cleaning supplies. She was entitled to deduct 50% of the expenses for laundry and dish detergent and

(continued on back)

Did You Know...

You can now create a donor advised fund with the University of California, Berkeley Foundation. The minimum to establish a fund is \$100,000. Fifty-one percent (51%) of annual income and remainder must be dedicated to UC Berkeley; the other 49% may be distributed to other public charities. Contact us for more details.

Feline Foster Care Provider Needed Substantiation *(continued from inside)*

household utility bills, although the court admitted that the foster cat activities probably accounted for more than 50% of those items.

Van Dusen was entitled to the deduction, but only to the extent the expenses were properly substantiated [Reg. §1.170A-13(f)(1)]. The court said that the unreimbursed expenses

of less than \$250 could be substantiated in a manner similar to cash gifts of less than \$250. Instead of a canceled check, she could provide receipts for purchases and veterinary bills. However, for expenses of more than \$250, donors are required to obtain a contemporaneous written substantiation of volunteer service from the charity that also indicates

that no goods or services were provided by the charity, or makes a good faith estimate of the value of any goods or services provided [Code §170(f)(8)(a)]. Because Van Dusen had no acknowledgment from FOF, she was not entitled to deduct those expenses where the value exceeded \$250, the court ruled.

Van Dusen v. Commissioner, 136TC No. 25

Gift Annuity Payouts Driven Down by Low §7520 Rates

Just six months after raising recommended gift annuity rates for most annuitants age 73 and older, the American Council on Gift Annuities has lowered rates across the board. Annuitants age 69 and younger saw rates drop on July 1, 2011, and now face an additional decline. The change is due primarily to the downward spiral of §7520 rates, which hit a historic low of 1.4% in October and November of 2011.

One-life annuities will now range from 4% at age 55 to 9% (age 90 and older). Previously, rates ranged from 4.4% at age 55 to 9.8% (age 90 and older). Two-life annuities will range from 3.5% (two annuitants age 55) to 8.8% (annuitants age 91 and older).

From the charity's standpoint, a 10% minimum present value for the gift amount is important to avoid problems with unrelated debt-financed income. Under Code §515(c)(5), charitable gift annuities are not considered acquisition indebtedness if "the value of the annuity is less than 90% of the value of the property received in the exchange" [Code §514(c)(5)(A)]. (Charitable remainder trusts are subject

to a similar 10% remainder value requirement [Code §664(d)(1)(D) and (d)(2)(D)]. A trust that does not satisfy the requirement is not a qualified charitable remainder trust.)

The new recommended rates are designed to produce at least a 10% deduction for all ages, even at the 1.4% §7520 rate. The following table shows the effect of the lowered rates on deductions at various ages, assuming a \$10,000 transfer and quarterly payments:

Age	Pre-2012 Annuity Rate	Deduction	2012 Annuity Rate	Deduction
55	4.4%	\$ 791.28	4.0%	\$1,628.44
60	4.8	1,322.61	4.4	2,045.72
65	5.3	1,893.44	4.7	2,811.16
70	5.8	2,701.28	5.1	3,582.16

Donors are not required to use the 1.4% §7520 rate to calculate the charitable deduction. Under Code §7520(a), the donor may choose the rate for the month of the transfer or the rate for either of the two previous months, whichever is most favorable. The new recommended annuity rates are designed to qualify, even for younger annuitants and even at the 1.4% rate.

Note: Many gift annuity donors do not itemize deductions and would be unable to use all or part of their

deductions, in any event. Low §7520 rates provide high tax-free payments.

The American Council on Gift Annuities has also lowered the compound interest assumption – from 4% to 3.25% – meaning deferred payment charitable gift annuities will also be impacted.

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 ogp@berkeley.edu and provide us with your e-mail address.

Gift Planning Now is designed to provide accurate and authoritative information in regard to the subject matter covered. It is published with the understanding that neither the publisher nor the authors are engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought. (From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers.)

©2011 by The Regents of the University of California.