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Charitable Bequests: How to Secure the Estate Tax Deduction

Among the various planned giving techniques, the charitable bequest stands out. The estimated dollar amount of charitable bequests in 2004 is $19.8 billion and bequests accounted for 8.0% of all charitable giving in that year, even when annual giving and capital campaigns are included [Giving USA 2005, AAFRC Trust for Philanthropy, p.69]. A charitable bequest is a popular and powerful way to give. For example, the estate of Joan Kroc, the late wife of McDonald's founder Ray Kroc, earned national attention for a $1.5 billion gift to the Salvation Army.

Certainly, bequests are socially and philanthropically relevant. One reason is that the donor can designate the gift without having to part with the property during life. And, because charitable bequests allow donors to memorialize their commitments to charity, the deliberate writing of a charity into a will has a strong appeal to many donors.

As a professional advisor, you know that a charitable bequest can also provide estate tax relief. While federal law permits an estate tax deduction for the value of a charitable gift made by will or revocable trust, a properly executed bequest is necessary to secure the deduction. The estate tax deduction is definitely important given the severity of the current federal estate tax rate and the financial toll it can take on a large estate.

This newsletter outlines the basics of testamentary charitable gifts and highlights key ideas and practical tips for including a charitable gift in the will. Hopefully, you will find these ideas helpful in counseling your clients.

SECURING THE CHARITABLE DEDUCTION

To qualify for the estate tax charitable deduction under IRC §2055, a bequest generally must be:

1. Included in the decedent's gross estate;
2. Transferred by the decedent by will; and
3. Made to a qualified charitable organization as defined under estate tax rules.

Errors in bequest language and execution can jeopardize the estate tax charitable deduction. Here are several examples of what can go wrong:

UNKNOWN AMOUNT OF CHARITABLE BEQUEST

Testators who do not specify the dollar amount, or asset, or percentage of the available estate to be transferred to a charitable organization may jeopardize their estate tax charitable deduction. Failure on the part of the testator to identify the amount to be transferred forces a third party, such as the executor or personal representative, to decide the amount to transfer. This does not meet the IRC §2055 requirement that the transfer be made by the decedent.

Plainly, the amount of the charitable bequest must be ascertainable at the time of the decedent's death to qualify for an estate tax charitable deduction [Estate of Marine v. Comm'r, 97 T.C. 368 (1991), aff'd 990 F.2d 136 (CA-4, 1993)].The courts tend to strictly interpret these rules and may disallow a charitable deduction even if a distribution is actually made to a charity.

UNKNOWN CHARITABLE BENEFICIARY

Another hazard crops up when bequest language fails to identify the specific charitable beneficiary. If, for example, a testator leaves estate property to a third party with instructions for that individual to choose to make the charitable transfer on the decedent's behalf, the question arises as to whether the decedent or the third party actually made the transfer to charity.

As the IRS noted in a revenue ruling, the decedent will be deemed to have made the transfer if local law provides that: (1) the terms of the will impose a trust over the assets, and (2) the terms of the will require the trustee to distribute the assets to charities [Rev. Rul. 69-285, 1969-1 C.B. 222]. To qualify for an estate tax charitable deduction, the trustee must be restricted under state law and required to distribute the bequest property only to qualified charities.

CONTINGENT OR CONDITIONAL BEQUESTS

Bequest language is considered contingent or conditional if the charitable transfer depends upon the occurrence or nonoccurrence of some event. The use of conditional or contingent language to convey a charitable bequest will not jeopardize an estate's charitable deduction provided the chances the charity will not receive the bequest are "so remote as to be negligible when it is determined on the decedent's date of death" [Reg. 20.2055-2(b)(1)]. If this standard has not been met, the IRS may disallow a charitable deduction.

PROPERTY MUST GO TO QUALIFIED CHARITY

Estate tax rules define "qualified charitable organizations" in a similar fashion to both income tax and gift tax rules. However, there are instances of an entity that is qualified for purposes of the estate tax charitable deduction that would not qualify under the income and gift tax rules. For example, charitable beneficiaries are not required to be domestic corporations for IRC §2055(a) purposes.

The IRS ruled that bequests to a foreign government or political subdivision qualify for an estate tax charitable deduction if the bequest is limited to exclusively charitable purposes [Rev. Rul. 74-523, 1974-2 C.B. 304]. However, nonresident aliens may not take an estate tax charitable deduction for a bequest to a foreign organization unless the property will be used exclusively in the U.S. [TAM 9135003, 5-23-91, IRC §2106(a)(2)(A)(iii)].

Furthermore, the bequeathed property cannot pass through a third party to a charity. Even though the charity ultimately receives the bequest property and the initial beneficiary never had any intention of keeping the property, a 'roundabout' bequest does not secure the charitable deduction [Ltr. Rul. 200437032].

FAILURE TO ACCOUNT FOR BENEFICIARY DESIGNATIONS

Testators often name charitable organizations as the death beneficiaries of qualified retirement plans, IRAs, or life insurance policies. However, it is the beneficiary designation on the contract and not the will provision that controls the disposition of these assets.

QUALIFIED DISCLAIMERS

Estate beneficiaries may not want to accept a bequest for any number of reasons; perhaps the beneficiary is already financially secure, or maybe he or she is unwilling to bear the costs and administrative responsibilities associated with the particular property.

By naming a charitable organization as contingent beneficiary, the testator's estate can qualify for an estate tax charitable deduction if the primary beneficiary makes a qualified disclaimer. By making a qualified disclaimer, the primary beneficiary is treated as never having received the property. Rather, the property is regarded as having passed directly to the charity from the decedent's estate.

A "qualified disclaimer" must be irrevocable, valid under state law, and must meet additional requirements set forth in IRC §2518(b).

Split Interest Charitable Bequest

A split interest charitable bequest is a bequest of less than a full interest and involves both charitable and non-charitable recipients. Additional requirements must be met for split interest charitable bequests to qualify for the estate tax charitable deduction. The permitted types of allowable split interest bequests are:

1. An undivided portion of the decedent's entire interest in property;
2. A remainder interest in a personal residence or farm (not required to be transferred by trust);
3. A qualified conservation contribution;
4. A remainder interest in a charitable remainder unitrust, a charitable remainder annuity trust, or a pooled income fund; and
5. A testamentary annuity interest (charitable lead annuity trust) or unitrust interest (charitable lead unitrust).

Advantages of Certain Bequests

Some types of assets generate greater tax advantages when used to fund bequests rather than lifetime gifts. The following are assets that are generally better suited for bequest giving.

TANGIBLE PERSONAL PROPERTY

In funding a charitable bequest with tangible personal property, the decedent's estate qualifies for a full estate tax charitable deduction based on the property's fair market value. By contrast, under federal income tax rules, the deduction for a lifetime gift of tangible personal property hinges on the related-use rule which requires that the property be put to a use related to the organization's tax-exempt purpose. Under the income tax rules, the deduction for a gift unrelated to the charitable purpose of the organization is limited to the cost basis of the property. So, because the estate tax deduction is unaffected by the related-use rule, a bequest of tangible personal property that does not relate to the tax-exempt purpose may be more beneficial to the donor than a lifetime gift.

ORDINARY INCOME PROPERTY

Ordinary income property is property that would not produce long-term capital gain if sold at its fair market value. Examples of this property include inventory, copyrights, artistic works held by the artist, and recapture property. Charitable bequests of ordinary income property qualify for an estate tax charitable deduction based on fair market value. In contrast, lifetime gifts of ordinary income property are reduced under IRC §170 (e)(l)(A) by the amount of any gain that would have been classified as ordinary income, or short-term capital gain, had the property been sold for its fair market value on the date of the gift. Thus, a bequest of ordinary income property has a significant advantage over a lifetime gift of such property.

DEPRECIATED PROPERTY

Property that has experienced a loss in value may be particularly appropriate for a charitable bequest, since heirs cannot benefit from a step-up in basis. Indeed, an individual heir's basis would "step-down" to the property's fair market value at death [IRC §1014(a), (b)].

INCOME IN RESPECT OF A DECEDENT PROPERTY

Income in respect of a decedent (IRD) is income earned during life, but not included in gross income prior to death. Important examples of IRD include qualified retirement plan accounts, traditional IRAs and savings bonds. When IRD items are bequeathed to charity, they qualify for not only the estate tax charitable deduction, but also negate the adverse income tax consequences of IRD for the recipient because of the charity's tax-exempt status. Since non-IRD items can be bequeathed to individual beneficiaries without income tax consequences, it is often a sound tax strategy to leave IRD assets to charity and non-IRD assets to individuals.

U.S. SAVINGS BONDS

There is another important reason to make a charitable bequest with savings bonds besides avoiding the IRD problem – virtually the only way to donate U.S. savings bonds is through a charitable bequest. The U.S. Treasury Department restricts the lifetime conveyance of U.S. Savings Bonds (Series E, EE, H and HH). A gift may be made only by:

1. cashing in the bonds and donating the proceeds to a chari table organization, or
2. having the bonds reissued to the trustee of a revocable liv ing trust in which the grantor is the income beneficiary and a charitable organization is the remainder beneficiary follow ing the grantor's death.

Treasury restrictions also prohibit a donor from naming a charitable organization as a bond's "co-owner" or death beneficiary.

But U.S. savings bonds can be bequeathed to charity at the bond owner's death. The owner's estate is entitled to an estate tax charitable deduction for the full value of the bequeathed bonds. When the charity redeems the bonds, it will owe no income tax on any accrued interest because of the charity's exempt status. The accrued interest would be taxable to a non-charitable recipient as income in respect of a decedent.

U.S. savings bonds must be directly bequeathed to charity to avoid the deferred income tax. A general charitable bequest satisfied by these bonds at the discretion of the executor, will not qualify [Ltr. Rul. 9507008, Ltr. Rul. 9315016].

TESTAMENTARY CHARITABLE TRUSTS

An irrevocable charitable trust is not necessarily better accomplished through a will as compared to an inter-vivos charitable trust. However, if the federal estate tax is a concern, the benefits created by a testamentary charitable lead trust or testamentary charitable remainder trust can offset some or all of the potential estate tax. And if a donor prefers to retain the use of the assets that would fund the trust during his or her lifetime, a testamentary charitable trust is a sensible choice.

Testamentary charitable lead trusts (CLTs) offer the distinctive advantage of benefiting both charitable and non-charitable beneficiaries while reducing transfer tax costs. Testamentary CLTs are irrevocable trusts that make annuity or unitrust payments to a designated charitable organization for a term of years. At the term's end, the principal is distributed to non-charitable beneficiaries.

The IRS calculates the value of the remainder interest to the donor's heirs at its present value at the time the trust is established. When the trust ends and the assets are distributed to heirs, the assets may be worth considerably more than their valuation at the outset if the trust corpus grows at a rate higher than the payout rate to the charity. But regardless of the amount of growth, there will be no additional estate or gift tax on this appreciated amount. Thus, the CLT benefits charity and enables the donor to:

1. Realize a "tax discount" on the date-of-death value of the principal by virtue of the charitable income interest; and
2. Avoid estate tax on the post-death appreciation.

Charitable Remainder Trusts (CRTs) also distribute funds to both charitable and non-charitable beneficiaries, while sheltering the trust from transfer taxes. Unlike CLTs, CRTs first pay out income to non-charitable beneficiaries (for a term of years up to 20 or for life), with the remainder distributed to a charitable organization. The estate may claim an immediate estate tax charitable deduction for the present value of the remainder interest.

New Tax Developments

New Federal Tax Legislation Signed Into Law

On May 17, 2006, President Bush signed the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). The new law contains several key extensions, including:

1. The capital gains and dividend tax treatments (a 15% rate for most taxpayers) enacted under the Economic Growth and Tax Relief Reconciliation Act of 2003 that had been scheduled to sunset in 2008 has been extended through 2010.
2. The Alternative Minimum Tax (AMT) threshold set at $40,250 for single tax filers was raised to $42,500, and the threshold set at $58,000 for joint tax filers was increased to $62,550 which will keep a significant number of taxpayers out of the AMT regime.
3. Roth IRA conversion income limit currently set at $100,000 of adjusted gross income will be removed in 2009 – effec tively allowing everyone to convert traditional IRA assets into a Roth IRA.

TIPRA is seen as the first of two major income tax laws for 2006. The second tax law will address additional revenue matters and may include the IRA Charitable Rollover which would allow taxpayers to move assets from a qualified retirement plan to a charity without realizing taxable income on the distribution.

Tax Increase Prevention and Reconciliation Act of 2005, P.L. No. 109-222

IRS Publishes New 1098 Form to Comply with Gulf Opportunity Zone Act

The American Jobs Creation Act of 2004 included a provision concerning the deductibility of contributions of motor vehicles: if a taxpayer donates a vehicle to charity, the charitable deduction is limited to the gross proceeds from the charity's subsequent sale of the vehicle. The donor is required to obtain a contemporaneous written acknowledgment from the charitable donee that meets the requirements under IRC §170(f)(12)(B). However, this provision did not require the charitable donee to disclose whether the donor had received anything of value in return for the gift.

The Gulf Opportunity Zone Act of 2005 added two additional provisions under IRC §170 (f)(12)(B) which do require that the charity list the goods or services provided in exchange for a gift to the charity. The IRS has revised its 1098-C form to accommodate the additional disclosures required under the Gulf Opportunity Zone Act. The form can be found at www.irs.gov/pub/irs-pdf/f1098c.pdf

Congress Continues to Debate the Estate Tax

Since Congress enacted the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), politicians have regularly debated the future of the estate tax. Under EGTRRA, the federal estate tax law has moved incrementally toward higher exemptions and lower rates for taxable estates. In 2010, the federal estate tax will disappear altogether – no exemption, no rates, no tax and no stepped-up basis in property. However, Congress included a 'sunset' provision in EGTRRA so the law in effect prior to EGTRRA in 2001 will return in 2011.

On June 22, 2006, the House approved H.R. 5638, the Permanent Estate Tax Relief Act of 2006. Instead of an outright repeal, the House set the exemption at $5 million per estate, and a tax rate equal to the capital gains tax on estates up to $25 million and twice the capital gains tax rate on estates greater than $25 million. Also, the bill maintains "stepped-up" basis for property acquired from a decedent. The Senate postponed its debate until after the July 4th holiday.

This newsletter is only for professional advisors and only for their information and discussion. It is intended only to provide general information about charitable gifts and charitable-gift planning. This newsletter is not (1) legal, tax, accounting, or financial advice, (2) any solicitation of legal, tax, accounting, or financial services, (3) any securities or investment advice, or (4) any solicitation of securities or investment advisory services. Each professional must evaluate the tax and financial consequences of each individual situation.

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