THE CATHOLIC FOUNDATION

WINTER 12
VOLUME XXIII
ISSUE I

THE Good Advisor

The Charitable Bequest: Finding the Recipe for Bequest Giving

Legendary New Orleans chef and TV personality Emeril Lagasse is reported to have said, "I had these recipes that say do this, do that. Who MAKES these rules?"[1] When considering that cooking is a balance of science and art, it seems true that simply following the recipe may not lead to the delectable wonders Emeril creates. However, when advising a client on charitable bequests, there is a complete framework of laws that provide us with a "recipe" for a successful bequest. In fact, failing to follow the "recipe" guidelines on bequests may prove to be damaging to your client's estate plans!

Of the many different ways to give to charity, the charitable bequest stands out. Under the statutes of the donor's home state, the testator creates a will and memorializes a commitment to charity with a testamentary gift through a bequest. In recent years, charitable bequests such as those found in the estates of Leona Helmsley and Joan Kroc have made news headlines, and have illustrated the continued popularity that charitable bequests enjoy.

Given the strong appeal of the charitable bequest, your clients may consider including a gift to charity when they make or revise their will. Often, the estate planning fact-finder or organizer you provide to clients specifically asks about the client's intentions to benefit charity through a testamentary gift. In this issue of ***The Good Advisor***, we review key ingredients in the recipe for advising clients about charitable bequests, including the estate tax deduction, choosing the proper asset to leave to charity, and understanding the potential of a split-interest or deferred charitable bequest.

I. THE KEY INGREDIENT: HOW TO SECURE THE CHARITABLE DEDUCTION

A bequest made to a qualified charity is deductible by the estate for estate tax purposes if it meets the requirements set out in the Internal Revenue Code ("IRC").[2] To qualify for the estate tax charitable deduction under IRC §2055, a bequest generally must be:

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

The term "qualified charitable organization" generally means any domestic or foreign "corporation or association organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes" that will use the asset exclusively for charitable purposes.[4]

Although the applicable exclusion amount has increased in recent years (up to $5,120,000 in 2012), the availability of a charitable deduction against estate taxes is a welcome benefit for many estates. Estates which are in excess of the applicable exclusion amount face the imposition of the federal estate tax at a 2012 top tax rate of 35%, and the charitable deduction allowed for a bequest can provide a measure of relief from this burden.[5]

Advising a client to take advantage of the charitable deduction for a bequest is obvious, but the preparation for and drafting of the bequest should be done with care. Errors in bequest language and execution can jeopardize the estate tax charitable deduction. Discussed below are several examples of what can go wrong with a bequest.

Unknown Amount of Charitable Bequest

A testator who does not specify the dollar amount, or asset, or percentage of the available estate to be transferred to a charitable organization may jeopardize the estate tax charitable deduction.[6] If the testator fails to identify what exactly is to be given to charity through the bequest, this may force the executor or personal representative to make that decision, or may simply prevent the value of the amount given to charity from being ascertained.[7]

The courts tend to strictly interpret these rules and may disallow a charitable deduction even if a distribution is actually made to a charity under such a bequest provision.[8] Unfortunately, if the testator leaves the choice of what or how much to give to someone else, or fails to clearly specify the gift or the amount of the gift, the gift will not meet the IRC §2055 requirements, and will cause the loss of the charitable deduction.

Unknown or Imprecise Charitable Beneficiary

Testators who do not identify a particular charity also jeopardize the estate tax charitable deduction.[9] For example, a testator leaves estate property to a third party with instructions for that individual to make a charitable gift with the property on behalf of the decedent. This invites the question of whether the decedent or the third party has actually made the transfer to charity.

However, the testator can take steps to secure the estate tax charitable deduction even though the exact beneficiary is not named.[10] As the IRS noted in a Revenue Ruling, the decedent will be deemed to have effectively made the transfer if local law provides that:

- The terms of the will impose a trust over the assets, and
- The terms of the will require the trustee to distribute the assets to charitable organizations.[11]

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 charitable organizations as stated in IRC §2055.

Intermediary Beneficiary Not Permitted

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.[12] Even if a bequest is given to a fraternal organization (not a charitable organization), and the fraternal organization uses it for charitable work, without the clear stated intent of the testator the bequest does not qualify for a charitable deduction.[13]

Contingent (or Conditional) Bequests

Bequest language is considered contingent (or conditional) if the charitable transfer depends upon the occurrence or non-occurrence of some event.[14] The use of contingent language to convey a charitable bequest will not jeopardize an estate's charitable deduction, providing the chance that the charity will not receive the bequest is "so remote as to be negligible when it is determined on the decedent's date of death."[15] The regulation actually provides an illustration of what is considered so remote as to be negligible: C dies, leaving a tract of land to a city government for as long as the land is used by the city for a public park.[16] If the city accepts the tract and if, on the date of C's death, the possibility that the city will not use the land for a public park is so remote as to be negligible, a deduction will be allowed.

II. USING THE HIGHEST QUALITY INGREDIENTS: ADVANTAGES OF CERTAIN TESTAMENTARY GIFTS

Some types of assets are better suited for bequests instead of giving them as lifetime gifts, since the asset transferred as a bequest can generate greater tax advantages for the estate or the beneficiaries. Guiding a client through the asset review process is beneficial both to the client and to the charitable beneficiary.

Tangible Personal Property

A lifetime charitable gift of tangible personal property can be limited under federal income tax rules. The amount of the deduction depends on the related-use rule, which requires that the property be put to a use related to the donee charity's tax-exempt purpose.[17] If this test is not met, the donor's deduction is limited to his or her cost basis in the property.

A testamentary gift of tangible personal property does not depend on a related-use rule. The decedent's estate qualifies for a full estate tax charitable deduction based on the property's fair market value. Thus, a bequest of tangible personal property could be more beneficial than a lifetime gift.

Ordinary Income Property

Although not as radical as the changes to estate Ordinary income property is property that would not produce long-term capital gain if sold at its fair market value. Examples of this sort of property include inventory, copyrights, artistic works held by the artist, and recaptured depreciation property. Any lifetime gift of ordinary income property must be reduced 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.[18]

A testamentary gift of ordinary income property qualifies for an estate tax charitable deduction based on fair market value. 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.[19] Thus, if the donor has a choice in the type of asset to give to charity, leaving the basis-challenged depreciated property would be preferable to the asset of equivalent value that has appreciated.

Property Comprised of Income in Respect of a Decedent

Income in respect of a decedent (IRD) is income earned during life, but not included in gross income prior to death.[20] 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 the same income tax consequences, it is often a sound tax strategy to leave IRD assets to charity and non-IRD assets to individuals.

III. SHARING THE RECIPE: SPLIT-INTEREST CHARITABLE BEQUEST

A split-interest charitable bequest is a bequest that gives less than a full interest in an asset to a beneficiary and involves both charitable and non-charitable recipients. This split interest may be used for such purposes as providing a life estate to a relative and giving the remainder to a charity.

A split-interest bequest must be made in specified form to qualify for the estate tax charitable deduction.[21] According to the IRC, the types of permitted split-interest bequests are:

- An undivided portion of the decedent's entire interest in property;
- A remainder interest in a personal residence or farm;
- A qualified conservation contribution;
- A testamentary charitable gift annuity;
- A remainder interest in a charitable remainder unitrust, a charitable remainder annuity trust, or a pooled income fund; and
- An annuity interest (charitable lead annuity trust) or unitrust interest (charitable lead unitrust).[22]

The Recipe for a Successful Charitable Bequest

Creating a sumptuous dinner is much easier if you follow a recipe. Few diners would appreciate or even attempt to eat a meal where ingredients (such as salt instead of sugar) were switched without regard. A properly conceived estate plan using a charitable bequest must likewise follow the "recipe" guidelines to be successful.

Advising a philanthropically minded client making a will about the process and benefits of a charitable bequest will help that client to create a complete document that will provide a financial boon for their loved ones while making a statement about what the client values. An advisor knowledgeable to speak about the ways to make this philanthropic legacy possible will be able to help each client create a personal successful recipe for a charitable bequest.

Endnotes

1 http://www.brainyquote.com/quotes/keywords/recipes.html

2 IRC §2055(a)(2).

3 See IRC §2055(a), Reg. §20.2055-1(a).

4 Reg. 20.255(a)(2). To help identify such organizations, the Internal Revenue Service ("IRS") maintains a non-exclusive informational listing of qualified charitable organizations in IRS Publication 78, Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986. Online version of Publication 78 can be found at: http://www.irs.gov/app/pub-78

5 IRC 2001. Of course the top estate tax rate of 35% is scheduled to sunset December 31, 2012, and a top tax rate of 55% will be in effect on January 1, 2013, unless Congress takes action.

6 Humes v. United States, 276 U.S. 487 (U.S. 1928); Estate of Marine v. Comm'r, 97 TC 368 (1991), aff'd 990 F2d 136, 71 AFTR2d 93-2182 (4th Cir. 1993).

7 Florida Bank at Lakeland v. United States, 443 F.2d 467 (5th Cir. Fla. 1971).

8 See also: Mississippi Valley Trust Co. v. Commissioner, 72 F.2d 197 (8th Cir. 1934); and Knoernschild v. Commissioner, 97 F.2d 213 (7th Cir. 1938), affg. 35 B.T.A. 886 (1937)

9 Levey v. Smith, 103 F.2d 643 (7th Cir. Ind. 1939).

10 United States v. First Nat'l Bank, 74 F.2d 360, 363 (5th Cir. Ala. 1934).

11 Rev. Rul. 69-285, 1969-1 C.B. 222

12 Ltr. Rul. 200437032

13 Levey at 646. The court said "The right to a deduction depends upon what a testator has willed respecting the use of a legacy and not upon the use which a legatee is willing to make of it."

14 Reg. 20.2055-2(b)(1); Commissioner v. Estate of Sternberger, 348 U.S. 187 (U.S. 1955); Bach v. McGinnes, 333 F.2d 979 (3d Cir. Pa. 1964)

15 Reg. 20.2055-2(b)(1).

16 Reg. 20.2055-2(b)(2).

17 IRC §170(e)(1)(B)(i)

18 IRC §170(e)(1)(A)

19 IRC §1014(a) and (b)

20 IRC §691.

21 Reg. 20.2055-2(e)(2).

22 Id.

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Charitable Bequests and Different Aspects of Testamentary Giving

In This Issue:

- The Ground Rules
- Mistakes in Crafting Bequest Language
- Reduction of the Charitable Bequest
- The Ground Rules
- Post-mortem Preservation of the Charitable Bequest
- Advantages of Certain Testamentary Gifts
- Split-Interest Charitable Bequest
- Estate Planning with a QTIP and Charitable Bequest

Charitable bequests are by far the most popular kind of planned gift. By including a charitable bequest in a will, a testator makes a final statement in support of a qualified charity. Yet, the importance of charitable bequests is often understated; some view a bequest as simpler and less substantial compared to lifetime planned giving arrangements. However, it is difficult not to be impressed by the impact of bequests when charitable organizations regularly report testamentary gifts of $1,000,000, $10,000,000 or more.

Whatever form the charitable bequest takes – a specific dollar amount, a particular asset, a certain percentage of the available estate or the estate residue – the donor should benefit from a charitable deduction for estate tax purposes. Keep in mind that an improperly made charitable bequest can both defeat your client's good intentions and result in a denial of the charitable deduction which increases the taxable estate. This booklet explores different opportunities and pitfalls in making charitable bequests.

I. The Ground Rules

A bequest made to a qualified charity is deductible by the estate for estate tax purposes if it meets the requirements set out in the Internal Revenue Code ("IRC").[1] To qualify for the estate tax charitable deduction under IRC §2055, a bequest generally must be:

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

The term "qualified charitable organization" generally means any domestic or foreign "corporation or association organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes" that will use the asset exclusively for charitable purposes.[3]

Although the applicable exclusion amount has increased in recent years (up to $5,120,000 in 2012), the availability of a charitable deduction against estate taxes is a welcome benefit for many estates. Estates in excess of the applicable exclusion amount face the imposition of the federal estate tax at a 2012 top tax rate of 35%, and the charitable deduction allowed for a bequest can provide a measure of relief from this burden.[4]

II. Mistakes in Crafting Bequest Language

Advising a client to take advantage of the charitable deduction for a bequest is obvious, but the preparation for and drafting of the bequest should be done with care. Errors in bequest language and execution can jeopardize the estate tax charitable deduction. Discussed below are several examples of what can go wrong with a bequest.

Unknown Amount of Charitable Bequest

A testator who does not specify the dollar amount, or asset, or percentage of the available estate to be transferred to a charitable organization may jeopardize the estate tax charitable deduction.[5] If the testator fails to identify what exactly is to be given to charity through the bequest, this may force the executor or personal representative to make that decision, or may simply prevent the value of the amount given to charity from being ascertained.[6]

In Estate of David N. Marine v. Commissioner, the decedent was a physician whose will included a bequest giving the residue of his estate to a charitable beneficiary.[7] However, Dr. Marine executed a codicil which allowed his personal representatives to distribute a portion of his estate to those "who have been otherwise helpful to me during my lifetime," limited so that "(n)o single bequest, however, shall exceed one percent (1%) of my gross probate estate ..." Following a long line of precedent, the Tax Court held that the "value of the charitable bequest was not ascertainable at the time of Dr. Marine's death," and as such the charitable deduction was not allowed.[8]

The courts tend to strictly interpret these rules and may disallow a charitable deduction even if a distribution is actually made to a charity under such a bequest provision.[9] Unfortunately, if the testator leaves the choice of what or how much to give to someone else, or fails to clearly specify the gift or the amount of the gift, the gift will not meet the IRC §2055 requirements, and will cause the loss of the charitable deduction.

Unknown or Imprecise Charitable Beneficiary

Testators who do not identify a particular charity also jeopardize the estate tax charitable deduction.[10] For example, a testator leaves estate property to a third party with instructions for that individual to make a charitable gift with the property on behalf of the decedent. This invites the question of whether the decedent or the third party has actually made the transfer to charity.

However, the testator can take steps to secure the estate tax charitable deduction even though the exact beneficiary is not named.[11] As the IRS noted in a Revenue Ruling, the decedent will be deemed to have effectively made the transfer if local law provides that:

- The terms of the will impose a trust over the assets; and
- The terms of the will require the trustee to distribute the assets to charitable organizations.[12]

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 charitable organizations as stated in IRC §2055.

Intermediary Beneficiary Not Permitted

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.[13] Even if a bequest gift made to a fraternal organization is specifically used for charitable purposes, the bequest does not qualify for a charitable deduction without the testator's clear stated intent that the gift be used exclusively for charitable purposes.[14]

Contingent (or Conditional) Bequests

Bequest language is considered contingent (or conditional) if the charitable transfer depends upon the occurrence or non-occurrence of some event.[15] The use of contingent language to convey a charitable bequest will not jeopardize an estate's charitable deduction, providing the chance that the charity will not receive the bequest is "so remote as to be negligible when it is determined on the decedent's date of death."[16] The regulation actually provides an illustration of what is considered so remote as to be negligible: C dies, leaving a tract of land to a city government for as long as the land is used by the city for a public park.[17] If the city accepts the tract and if, on the date of C's death, the possibility that the city will not use the land for a public park is so remote as to be negligible, a deduction will be allowed.

III. Reduction of the Charitable Bequest

Even if the charitable bequest is correctly drafted, the amount of the bequest may be reduced due to unrelated reasons. As with all other bequests, a charitable bequest is not necessarily immune from the legal priorities of estate administration, particularly the payment of required expenses of the estate. Additionally, will contests, where a party challenges all or some part of the will, may cause more problems. Thus estate expenses or a will contest may reduce or eliminate a charitable bequest and/or the related estate tax charitable deduction.

Reduction Due to Administrative Expenses

A charitable bequest may be properly drafted, show the charitable intent of the testator, and have all the elements that qualify it for the estate tax deduction, and yet still be a target for paying certain administrative expenses of the estate. If taxes are made payable from the charitable share or the interest is encumbered in any manner, the charitable deduction may be reduced. The Supreme Court noted this fact in Commissioner v. Estate of Hubert, but the Court also differentiated between the payment of expenses from the estate principal and the payment of expenses from estate income.[18]

In Estate of Hubert, the Supreme Court held that a charitable residuary bequest should not be reduced by administrative expenses paid out of income; instead, a charitable deduction made from the estate residue would only be affected by administrative expenses as charged to principal.[19] In response, the IRS issued Reg. 20.2055-3(b) in an effort to comply with the Supreme Court position: expenses would be allocated in terms of estate transmission expenses and estate management expenses:

- ***Transmission*** expenses are defined as expenses that would not have been incurred but for the decedent's death. Transmission expenses are also defined as any administration expense that is not a management expense.[20]
- ***Management*** expenses are defined as expenses related to investment, preservation, and maintenance of the assets during a reasonable period of estate administration. Management expenses attributable to the marital or charitable share do not reduce the marital or charitable share except to the extent that the expense is deducted under IRC §2053 as an administration expense. The "except" portion of this rule prevents an estate from taking a double deduction for estate tax purposes.[21]

It is important to note that Reg. 20.2055-3 also applies to the reduction of a charitable deduction as a result of any death taxes which are, either by the terms of the will or by local law, assessed against an otherwise deductible bequest or other transfer.

In preparing an estate plan with a bequest, make sure the administrative expenses of the estate, both transmission expenses and management expenses, are covered. Preparation and planning for such expenses will allow the charitable and non-charitable beneficiaries to receive the full amount of any bequest the testator intended them to receive.

Contested Wills

While a will contest is not a certainty for every will, it is a possibility that must be considered. From a charitable bequest standpoint, a contested will may jeopardize a deduction for a charitable bequest.

A challenge to the validity of the charitable bequest can reduce or eliminate a charitable bequest deduction. If there is a resolution to the will contest, the deduction is limited to proceeds actually received by the charity pursuant to the compromise agreement; and, if during the course of a compromise agreement or settlement, a charitable organization assigns or surrenders a part of the proceeds originally transferred to it, the amount foregone is not deductible by the estate.[22] Furthermore, if a gift is made by the settlement that was not outlined in the original will, the amount transferred to the charity is not deductible as it is effectively a gift made by the interested parties and not the estate.[23]

When preparing an estate plan with a will, or when negotiating a resolution to a will contest, keep in mind the impact of the will contest on the deduction for the charitable bequest.

IV. Post-mortem Preservation of the Charitable Bequest

In certain estate situations, the charitable bequest can be preserved by taking appropriate measures even after the death of the testator. Tools such as reformation and disclaimer provide additional opportunities for estate tax planning.

Reformation of Transfer Documents

If a bequest involves a split-interest charitable bequest (discussed more fully below), the split-interest bequest must meet certain requirements to be deductible.[24] However, if the split-interest fails to meet the requirements, all is not lost. A non-deductible charitable split-interest can be reformed in order to accommodate an estate tax charitable deduction if the proposed split-interest has the following attributes:

- **Qualified Interest –** a charitable interest that would have qualified under IRC §2055(a).
- **Qualified Reformation –** a reformation that preserves both the actuarial value of the intended charitable interest and the termination date of both the charitable and non-charitable interest so that the changes are made effective as of the date of the decedent's death.
- **Reformable Interest –** the interest must be that which would have qualified for a charitable deduction; and, the interest for the beneficiaries, before the remainder interest vests in possession, must be expressed as either a specified dollar amount or as a fixed percentage of the fair market value of the property, taking into account the rules of IRC §664(d)(3).[25]

For example, a trust that fails to qualify as a charitable remainder trust by reason of the failure to satisfy the 10% minimum charitable benefit requirement may be reformed to increase the value of the remainder interest. This can be accomplished by reducing the payout percentage or reducing the trust term, or both.[26]

Disclaimer

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 contingent beneficiary (the charitable organization) 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):

- The disclaimer must be irrevocable and unqualified;
- The disclaimer must be in writing;
- The disclaimer must be received by the transferor of the interest, the legal representative of the transferor, or the holder of the legal title to the property, within nine months after the later of the date of the transfer creating the interest or the

disclaimant's 21st birthday;

- The disclaimant must not have accepted the interest or any of its benefits before making the disclaimer; and
- The interest disclaimed must pass without any direction by the disclaimant either to a spouse of the decedent or to a person other than the disclaimant.

In addition, §2055(a) states that a complete and timely termination of a power to consume, invade, or appropriate property for the benefit of an individual before such power has been exercised can also be treated as a qualified disclaimer.

V. Advantages of Certain Testamentary Gifts

Some types of assets are better suited for bequests instead of giving them as lifetime gifts, since the asset transferred as a bequest can generate greater tax advantages for the estate or the beneficiaries. Guiding a client through the asset review process is beneficial both to the client and to the charitable beneficiary.

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A lifetime charitable gift of tangible personal property can be limited under federal income tax rules. The amount of the deduction depends on the related-use rule, which requires that the property be put to a use related to the donee charity's tax-exempt purpose.[27] If this test is not met, the donor's deduction is limited to his or her cost basis in the property.

A testamentary gift of tangible personal property does not depend on a related-use rule. The decedent's estate qualifies for a full estate tax charitable deduction based on the property's fair market value. Thus, a bequest of tangible personal property could be more beneficial than a lifetime gift.

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A testamentary gift of ordinary income property qualifies for an estate tax charitable deduction based on fair market value. Thus, a bequest of ordinary income property has a significant advantage over a lifetime gift of such property.

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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.[29] Thus, if the donor has a choice in the type of asset to give to charity, leaving the basis-challenged depreciated property would be preferable to the asset of equivalent value that has appreciated.

Property Comprised of Income in Respect of a Decedent

Income in respect of a decedent (IRD) is income earned during life, but not included in gross income prior to death.[30] Important examples of IRD include qualified retirement plan accounts, traditional IRAs and savings bonds. When IRD items are bequeathed to charity, they not only qualify for 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 the same 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 charitable organization, or (2) having the bonds reissued to the trustee of a revocable living trust in which the grantor is the income beneficiary and a charitable organization is the remainder beneficiary following 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 noncharitable recipient as income in respect of a decedent. U.S. savings bonds must be directly bequeathed

to charity to escape the deferred income tax. A general charitable bequest, satisfied by these bonds in the discretion of the executor will not qualify.[31]

VI. Split-Interest Charitable Bequest

A split-interest charitable bequest is a bequest that gives less than a full interest in an asset to a beneficiary and involves both charitable and non-charitable recipients. This split interest may be used for such purposes as providing a life estate to a relative and giving the remainder to a charity.

A split-interest bequest must be made in specified form to qualify for the estate tax charitable deduction.[32] According to the IRC, the types of permitted split-interest bequests are:

- An undivided portion of the decedent's entire interest in property;
- A remainder interest in a personal residence or farm;
- A qualified conservation contribution;
- A testamentary charitable gift annuity;
- A remainder interest in a charitable remainder unitrust, a charitable remainder annuity trust, or a pooled income fund; and
- An annuity interest (charitable lead annuity trust) or unitrust interest (charitable lead unitrust).[33]

Note that a split-interest bequest to charity may initially resemble a charitable remainder trust, or pooled income fund or other qualifying split-interest gift, but, on reconsideration, the gift may fail. Despite clear charitable intent, a split-interest bequest will not qualify for the charitable deduction unless it follows the specific requirements outlined in the IRC.[34]

Testamentary Charitable Trusts

The benefits created by a testamentary charitable lead trust or testamentary charitable remainder trust can offset some or all of the potential estate tax applicable to the estate. If a donor prefers to retain the use of the assets that would fund the trust during the donor's lifetime, a qualified testamentary split-interest charitable trust is a good choice in estate and gift planning.

Charitable Lead Trusts (CLTs)

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 conclusion of the term, 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 the 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 not only benefits charity but enables the donor to:

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

Charitable Remainder Trusts (CRTs)

CRTs also distribute funds to both charitable and non-charitable beneficiaries, while sheltering the assets in part from transfer taxes. Unlike a CLT, a CRT first pays out income to non-charitable beneficiaries (for a term of years up to 20 or for life), then the remainder is distributed to a charitable organization. The estate may claim an estate tax charitable deduction for the present value of the remainder interest, provided the trust is either a qualifying charitable remainder unitrust or charitable remainder annuity trust.

VII. Estate Planning with a QTIP and Charitable Bequest

A decedent may use qualified terminable interest property (QTIP) to make a bequest of a remainder interest to charity. Under this arrangement, the decedent may leave a qualifying income interest in property to the surviving spouse, with the remainder interest to a qualified charity. The value of the entire property is shielded from the estate tax because the entire transfer qualifies (by election of the executor) for the marital deduction in the decedent's estate.

A terminable interest qualifies as a QTIP by meeting the following conditions:

- The property interest must pass from the decedent to the surviving spouse;
- The surviving spouse must have a qualifying income interest for life; and
- The executor must elect to qualify the interest for the marital deduction.[35]

If the decedent creates a QTIP trust for the spouse and names a charity as the remainderman, the entire value of the property will qualify for the marital deduction and, therefore, no estate tax will be due. Upon the death of the spouse, the property will be

included in his or her estate, but will also qualify for a full charitable deduction. Thus, the QTIP provisions provide an identical net tax result to that of a charitable remainder trust created from the entire estate assets.

Closing

Bequest gifts are a significant source of funding for U.S. charities (Giving USA 2011 reported $22.83 billion in bequest gifts for 2010).36 Advisors can help their clients understand the best way to realize their own philanthropic goals through a charitable bequest. Most people who leave significant gifts through a will have consistently given during their lifetimes. Thus, the charitable bequest provides the capstone on a personal legacy built by their generosity.

ENDNOTES

1 IRC §2055(a)(2).

2 See IRC §2055(a), Reg. 20.2055-1(a).

3 Reg. 20.2055-1(a)(2). To help identify such organizations, the Internal Revenue Service ("IRS") maintains a non-exclusive informational listing of qualified charitable organizations in IRS Publication 78, *Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986*. Online version of Publication 78 can be found at: http://www.irs.gov/app/pub-78.

4 IRC §2001. Of course, the top estate tax rate of 35% is scheduled to sunset December 31, 2012, and a top tax rate of 55% will be in effect on January 1, 2013, unless Congress takes action.

5 Humes v. United States, 276 U.S. 487 (U.S. 1928); Estate of Marine v. Commissioner, 97 TC 368 (1991), aff'd 990 F2d 136, 71 AFTR2d 93-2182 (4th Cir. 1993). In Humes, the Court said, "Did Congress in providing for the determination of the net estate taxable, intend that a deduction should be made for a contingency, the actual value of which cannot be determined from any known data? Neither taxpayer, nor revenue officer–even if equipped with all the aid which the actuarial art can supply–could do more than guess at the value of this contingency. It is clear that Congress did not intend that a deduction should be made for a contingent gift of that character."

6 Florida Bank at Lakeland v. United States, 443 F.2d 467 (5th Cir. Fla. 1971). The appellete court upheld the district court ruling that the taxpayer was not entitled to a charitable deduction for the charitable remainder because the requirement that the trustee pay over all capital gains to the life beneficiaries prevented the value of the charitable remainder from being ascertainable.

7 Estate of Marine v. Commissioner, 97 TC 368 (1991), aff'd 990 F2d 136, 71 AFTR2d 93-2182 (4th Cir. 1993).

8 Id. at 375.

9 See also: Mississippi Valley Trust Co. v. Commissioner, 72 F.2d 197 (8th Cir. 1934); and Knoernschild v. Commissioner, 97 F.2d 213 (7th Cir. 1938), affg. 35 B.T.A. 886 (1937).

10 Levey v. Smith, 103 F.2d 643 (7th Cir. Ind. 1939). The court said, "The meaning of this language is that the testator and he alone must provide for the charitable bequest. It means that the provisions by the testator must be one that is definite in ascertainment and that is legally enforceable; it must possess the quealities [sic] of a definite command which will define the legal rights of all parties to the property intended to be affected."

11 United States v. First Nat'l Bank, 74 F.2d 360, 363 (5th Cir. Ala. 1934). The 5th Circuit Court of Appeals stated: It is well settled in Alabama that "a charitable trust will not fail on account of any uncertainty as to the ultimate beneficiaries, within a properly designat-

ed class, if there is a competent trustee to make a selection and thereby render certain the beneficiaries who are to enjoy the bounty provided by the trust."

12 Rev. Rul. 69-285, 1969-1 C.B. 222.

13 Ltr. Rul. 200437032.

14 IRC §2055(a)(3); Levey at 646. The court said, "The right to a deduction depends upon what a testator has willed respecting the use of a legacy and not upon the use which a legatee is willing to make of it."

15 Reg. 20.2055-2(b)(1); Commissioner v. Estate of Sternberger, 348 U.S. 187 (U.S. 1955); Bach v. McGinnes, 333 F.2d 979 (3d Cir. Pa. 1964).

16 Reg. 20.2055-2(b)(1).

17 Reg. 20.2055-2(b)(2).

18 Commissioner v. Estate of Hubert, 63 F3d 1083, 76 AFTR2d 95-6448 (11th Cir. 1995), aff'd, 520 US 93, 117 S. Ct. 1124, 79 AFTR2d 97-1394 (1997). In Hubert, the Court, in its plurality opinion, the concurrence and the dissent, pointed out that "[t]he parties here agree that the marital and charitable deductions had to be reduced by the amount of marital and charitable residue principal used to pay administration expenses."

19 Id.

20 Reg. 20.2055-3(b)(1)(ii). The Regulations state that examples of transmission expenses would be: executor commissions and attorney fees (except to the extent of commissions or fees specifically related to investment, preservation, or maintenance of the assets), probate fees, expenses incurred in construction proceedings and defending against will contests, and appraisal fees.

21 Reg. 20.2055-3(b)(1)(i). The Regulations state that examples of management expenses would be: investment advisory fees, stock brokerage commissions, custodial fees, and interest.

22 Reed v United States, (1970, SD Ill) 317 F Supp 1242, 70-2 USTC P 12709, 26 AFTR 2d 6042; Emanuelson v. United States, 159 F. Supp. 34, 1 AFTR2d 892 (D. Conn. 1958); Wright v. United States, 677 F2d 53 (9th Cir. 1982 (cert. denied, 459 US 909 (1982); Rev. Rul. 59-15, 1959-1 CB 164.

23 See Estate of Antonio J. Palumbo v. United States, 788 F. Supp. 2d 384 (W.D. Pa, April 11, 2011): the Court decided a transfer made to a charitable trust based on a residuary estate which was left out of the will as a result of a scrivener's error would be deductible under IRC §2055.

24 Reg. 20.2055-2(e)(2).

25 IRC §2055(e).

26 IRC §2055(e)(3)(J).

27 IRC §170(e)(1)(B)(i).

28 IRC §170(e)(1)(A).

29 IRC §1014(a) and (b).

30 IRC §691.

31 Ltr. Rul. 9507008, Ltr. Rul. 9315016.

32 Reg. 20.2055-2(e)(2).

33 Id.

34 Galloway v. United States, 492 F3d 219, 97 AFTR2d 2006-2458 (W.D. Pa), aff'd 492 F3d 219, 99 AFTR2d 2007-3412 (3d Cir. 2007): the Court disagreed that the split-interest trust was essentially four separate funds to benefit the two non-charitable beneficiaries and two charitable beneficiaries. Rather, the court decided that all the beneficiaries shared an interest in a single property, the trust did not comply with the requirements under IRC §2055(e)(2), and no deduction was allowed.

35 IRC §2056(b)(7).

36 *Giving USA 2011: Annual Report on Philanthropy*, researched and written by the Center on Philanthropy at Indiana University.

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