THE CATHOLIC FOUNDATION

Testamentary Charitable Gifts:
Bringing Peace to a Stressful World

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Endless traffic. Constant deadlines. Family pressures. Business goals. Sometimes, the modern world feels like a relentless pressure cooker. Fortunately, successful, hard-working people find ways to reduce the pressures of modern life. Some retreat to peaceful pursuits to relax. Others do the exact opposite, engaging in sports or rigorous exercise to let off steam.

Planning related to end-of-life matters presents another stressful challenge. Unfortunately, clients often choose to cope with this stress by procrastinating or postponing planning decisions, even when they understand, intellectually, how important it is to address these concerns. For stressed and reluctant clients who are philanthropically inclined, testamentary charitable gifts might just be an ideal option.

Charitable Bequests: The Basics

The most fundamental of all human actions is, of course, breathing. We take thousands of breaths every day—each breath is a little miracle to which we give little or no thought. Yet, becoming intentional about each breath can actually reduce stress. According to the American Institute of Stress, deep breathing triggers a "relaxation response" that decreases metabolism and blood pressure, slows the heart, relaxes muscles, and increases the levels of nitric oxide in the blood.[1]

Careful planning can also reduce stress. When it comes to estate planning, the most fundamental of all tools is a will. A will lets clients distribute estate assets at death, name a personal representative (or executor) for the estate, and designate a guardian for minor children. Though a will provides two methods for disposing of property—the bequest (a gift of personal property) and the devise (a gift of real property)—in some modern statutes, there is no longer a distinction between "devise" and "bequest," and devise may, by statute, mean a gift of real or personal property.[2]

Bequests are divided into three categories:

- **A specific bequest** is a gift of a specific asset to a named beneficiary—say, the gift of a particular work of art to a museum.
- **A demonstrative bequest** is one that identifies a specific amount of money from a particular source—perhaps a gift of $25,000 from a personal checking account to the donor's favorite religious institution.
- **A general bequest** directs that a gift (a specific dollar amount or a percentage of the remaining estate) be made from the general funds of the estate. A general bequest is fulfilled after all specific and demonstrative bequests.

A charitable bequest is a popular giving method because bequests are an easy way for clients to create a legacy, qualify for an estate tax deduction, and support charity. While simple to make, the impact of a bequest on the donor and the charity cannot be ignored, especially when charitable organizations regularly report testamentary gifts of $1 million, $10 million, or more.

Deductibility

When properly made, a bequest in any form—a specific dollar amount, a particular asset, a certain percentage of the available estate, or the estate residue—will qualify for an estate tax charitable deduction under IRC §2055(a) if it is:

- 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]

A "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]

Drafting the Bequest

The donor must draft the bequest with care, since errors in bequest language and execution can jeopardize the deduction.

Incorrect identity. The will must identify the charity with its correct legal name and address. Incorrect identification may cause both the gift and the deduction to fail.[5] Even if the bequest is initially correct, however, the charity may change names, reorganize, merge with another organization, or even cease to exist. The donor can plan for this by naming a contingent charitable beneficiary to accept the donation only if the original charity cannot.

Third-party involvement. Bequeathed property cannot pass through a third party to a charity. Let's say Brenda leaves estate property to her sister, May, with instructions for May to use that property to make a charitable gift on Brenda's behalf. This invites the question of who has actually made the gift—Brenda or May? 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.[6] Even if the donor makes a bequest gift to a fraternal organization, and that organization specifically uses it 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.[7]

WHAT ABOUT AN UNNAMED CHARITY?

While this would appear to be a problem, the testator can take steps to secure the estate tax charitable deduction even without naming an exact beneficiary.[8] 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 require the trustee to distribute the bequest property only to qualified charitable organizations (as stated in IRC §2055).[9]

Unspecified amount. If testators do not specify the dollar amount, asset, or percentage of the available estate to be transferred to a charitable organization, they jeopardize the estate tax charitable deduction. In the case of *Humes v. United States*, the Supreme 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.[10]

A failure to specify the amount of a charitable bequest may force the executor or personal representative to make that decision, or may prevent the gift value from being ascertained at all.[11]

Contingent bequest language. Bequest language is considered contingent (or conditional) if the charitable transfer depends on the occurrence or non-occurrence of some event.[12] The use of contingent language to convey a charitable bequest will not jeopardize an estate's charitable deduction provided 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."[13]

Testamentary Gifts of Retirement Assets

Regular exercise throughout the years not only combats stress—it increases the chances of good physical and mental health in old age. Financial planning may sound stressful, but much like exercise, those who practice solid retirement planning over the years increase their chances of having strong financial health in retirement. This, in turn, relieves stress and lets the retiree enjoy the results of a lifetime of work. It also provides an opportunity to realize charitable giving goals through a testamentary gift of retirement assets—perhaps an even more significant gift than would otherwise have been possible.

A Beneficiary Designation

The most straightforward method of making a testamentary charitable gift of retirement assets is to name the charity as the beneficiary of an IRA or retirement plan. The donor simply completes a new beneficiary form. Of course, it is important to confirm with the plan administrator or custodian that there are no restrictions on designating a charity as a beneficiary. Also, married donors may be required to obtain spousal consent.[14] Because the amount in an IRA or retirement account will change over time, it is prudent for the donor to specify a percentage gift rather than a dollar amount.

Income in Respect of a Decedent (IRD)

IRD refers, of course, to income earned during life but not included in the decedent's gross income prior to death.[15] Traditional IRAs, qualified

retirement plan accounts, and savings bonds all fall into this category—in fact, these items represent a significant percentage of IRD in most estates.

Because it hasn't been taxed yet, IRD is generally includible in the gross income of the recipient (estate or individual) and taxed at the recipient's income tax rate. Whether the property passes through the probate estate or outright to the recipient, it retains the same character it would have had in the decedent's hands.

If the income in respect of a decedent represents gain (capital or ordinary) on the sale of an asset, the recipient may utilize the decedent's basis to offset the gain. The basis of appreciated property does not step up to the fair market value at death, even though the IRD is included in the gross estate. IRD is includible in the decedent's gross estate as a property interest or right that passes at death.

IRD items left to charity qualify for the estate tax charitable deduction and also negate the adverse income tax consequences for the recipient because of the charity's tax-exempt status. It is often a sound tax strategy for a donor to leave IRD assets to charity and non-IRD assets to individuals.

Testamentary Gifts by Trust

When traffic is maddeningly slow, stressed-out drivers may daydream they are pushing their way through in a tank instead of idling in a car or SUV. Commuters stuck on I-285 around Atlanta are in luck because Tank Town USA is nearby. Visitors can drive a full-sized tank around a course and finish by crushing a car—a unique and powerful form of stress relief![16]

A well-planned testamentary trust may not provide the excitement of a car-crushing tank, but it is a unique and powerful planning tool that can relieve stress for those who are committed to controlling the distribution of their assets in a variety of very specific ways. A client can create a testamentary trust in a will or will substitute that sets out the terms of the trust. Unlike an inter vivos trust, a testamentary trust does not go into effect until the grantor's death, which gives the grantor more flexibility to change the trust terms at will during life. Testamentary trusts are frequently used to provide for minor children or individuals with special needs. And in the realm of charitable giving, these trusts allow the donor to support meaningful charities while offsetting some or all of any applicable estate tax.

Charitable Lead Trusts (CLTs)

Testamentary CLTs are irrevocable trusts that make annuity or unitrust payments to a designated qualified charitable organization for a specified term of years, then distribute the remaining assets to non-charitable beneficiaries (often the donor's children or grandchildren).[17] CLTs benefit charity, but they also allow the grantor to transfer appreciated assets to beneficiaries without paying tax on the property's appreciation inside the CLT. The greater the asset's appreciation, the greater the tax benefit.[18]

Grantor vs. Non-grantor. In a grantor CLT, the grantor may take an immediate income tax deduction for the present value of the future trust payments made to the qualified charity, subject to the annual applicable deduction limitation (for a public charity or private foundation). In a non-grantor CLT, the trust owns the property, not the grantor. As a result, the trust pays taxes on undistributed net income and may claim an unlimited income tax charitable deduction for the distributions to the qualified charity. The grantor is not eligible to take an income tax deduction for the present value of the lead interest of the gift to charity. The non-grantor CLT is taxed as a complex trust—and a testamentary CLT will, by nature, always be a non-grantor CLT.[19]

Reversionary vs. Non-reversionary. Whether the grantor opts to make the CLT reversionary (assets revert to the grantor at trust termination) or non-reversionary (assets go to a beneficiary other than the grantor) also greatly impacts the tax treatment—but, of course, a testamentary CLT will always be non-reversionary, since the grantor is deceased. 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.

Charitable Lead Annuity Trust (CLAT) vs. Charitable Lead Unitrust (CLUT). A CLAT pays the qualified charity an unchanging annuity payment each year—a specified percentage of the initial trust assets.[20] A CLUT pays the charity a specified percentage of the annually revalued trust

assets, so the payment varies as the value of the trust assets changes.[21]

Taxation. If the trust corpus grows at a rate higher than the payout rate to the charity, the assets distributed to the heirs at the end of the trust term may be worth considerably more than their valuation at trust creation. Regardless of the amount of growth, there will be no additional estate or gift tax on this appreciation. 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.

A testamentary CLT can provide donors with a tremendous opportunity to make a gift that minimizes taxes on the property transferred to the beneficiaries at the trust's termination. It is particularly useful in situations where the grantor wants to maintain control of the assets during life, transfer the assets to children at death, and provide support for a charitable organization.

Important Drafting Considerations. There are a number of issues that can cause the trust to fail and become subject to additional taxes:

Minimum payout. The CLT has no minimum payout requirements. However, since the annual payouts come from the trust corpus, the grantor must make sure the CLT has sufficient assets to fulfill the charitable obligations while maintaining the level of property the grantor hopes to provide to beneficiaries.

Unrelated Business Taxable Income (UBTI). UBTI is income from a trade or business regularly carried on by the trust and unrelated debt-financed income from certain property acquired with borrowed funds.[22] The grantor of a testamentary CLT must consider the amount of UBTI that may come into the trust and draft the trust to maximize deductions.[23]

Prohibited transactions. There are a number of prohibited transactions for CLTs that can create issues and perhaps result in the imposition of additional taxes.

- *Self-dealing.* The CLT may not participate in particular transactions (including sales, leases, money lending with interest, or furnishing of goods and services) with certain disqualified persons (including the donor and donor's family).[24]
- *Excess business holdings.* The IRC limits the CLT from owning more than "permitted holdings" in an incorporated business.[25] A"permitted holding" with respect to a private foundation's interest in such a business is defined as ownership of no more than 20% of the voting stock, reduced by the percentage of the voting stock owned by all disqualified persons. Where all disqualified persons together do not own more than 20% of the voting stock, any nonvoting stock held by the private foundation will be treated as permitted holdings.[26]
- *Investments which jeopardize the charitable purpose.* Any investment which may jeopardize the charitable purpose will result in the imposition of additional taxes.[27]
- *Taxable expenditures.* Grantors should avoid taxable expenditures (such as influencing legislation or public elections, voter registration, or providing certain grants for individuals to travel or study unless the grant meets the Code requirements).[28]

Specified term. To be valid under the Code, the CLT must make payments for a specified term.[29] While this seems like a straightforward requirement, planning realities sometimes prove otherwise. For example, a formula may be used to determine the specified term. However, a recent letter ruling provided some insight into IRS thinking on the matter. The IRS reviewed a question about an estate plan that used a marital trust to fund a CLAT, where the trust instrument did not expressly provide for a term but instead provided a formula for calculating the term. The IRS noted that this provision was permissible because "the term, although not expressly stated in the instrument, is determinable as of the date of death of the survivor of Grantor and Spouse, based on the formula in the instrument."[30]

Charitable Remainder Trusts (CRTs)

A CRT is similar to a CLT in that it also distributes funds to both charitable and non-charitable beneficiaries while sheltering the assets in part from transfer taxes. It is an irrevocable trust in which the donor (or one or more individuals designated by

the donor) receives income during the trust term (life, joint lives, or a period of up to 20 years), after which the trust distributes the remaining property to a qualified charitable organization—essentially, the opposite of a CLT.[31] The estate may claim an estate tax charitable deduction for the present value of the remainder interest, provided the trust is a qualifying charitable remainder unitrust or charitable remainder annuity trust.[32] If a grantor creates a testamentary CRT, the grantor's estate is entitled to receive an estate tax deduction for the fair market value of the charitable remainder interest.[33]

There are two general types of CRTs—charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs), both of which have a number of variations, and both of which can be created as testamentary trusts. Whether inter vivos or testamentary, the CRT term must be:

1. for a period not to exceed 20 years,
2. measured by individual lives in being at the time the trust is created, or
3. determined by some combination of years and lives but limited by life expectancy.[34]

The 10% Test. An important requirement for a CRT is the 10% test required under the IRC.[35] The present value of the charitable remainder interest must be at least 10% of the fair market value of the assets contributed to the CRT.

Beneficiaries. The ultimate charitable beneficiary must be a qualified charity under §170(c). The income beneficiary (receiving income during the trust term) may be any person or persons, as long as one person receiving income is not a charitable organization.[36] The grantor may also identify a class of persons to be income beneficiaries, so long as all members of the class are alive at the time the CRT is created.[37]

Income Payments. Income payments to the non-charitable beneficiaries cannot be less than 5% or greater than 50% of the fair market value of the trust assets. For a CRAT, this applies to the initial value of trust assets.[38] For a CRUT, this applies to the annually re-valued trust assets.[39] These requirements apply to all CRTs, whether inter vivos or testamentary. In addition, a CRAT must meet the 5% test, which requires greater than a "remote possibility" that the remainder will vest in the charity.[40] This means that there cannot be greater than a 5% chance that the trust principal will be exhausted prior to the charitable remainder distribution at the end of the trust term.

Both CRATs and CRUTs allow the trustee to make income payments annually, semi-annually, monthly, or weekly, either at the beginning or end of the year.[41] However, failing to make the required payments may result in an excise tax on the CRT.[42] It is important to note that for purposes of IRC §2055, a testamentary trust is deemed to be created as of the date of death of the decedent, despite the fact that the CRT may not yet be funded.[43] This results in a deferral of payments until the CRT is fully funded.

Taxation. One general purpose of a testamentary CRT is to shift income away from the estate and into the CRT, since the CRT has a tax advantage both for the charitable remainder portion of the trust as well as the tax deferral that results from taxation at the distribution to the income beneficiaries rather than at contribution.

Important Drafting Considerations. Like other testamentary trusts, the grantor must take care to correctly draft the trust. A number of these considerations are the same as those affecting CLTs.

Unrelated Business Taxable Income (UBTI). While the CRT is not subject to tax, a CRT that earns UBTI is subject to a 100% excise tax on the UBTI earned during the year.[44]

S-Corporation Stock. A CRT is not a pass-through entity and is not an eligible shareholder of S corporation stock.[45] The grantor who wants to transfer an S corporation will have to choose another testamentary tool.

Mortgaged Property. A property with a mortgage is considered a donor trust rather than a charitable trust since the income interest from the trust is being used to satisfy an obligation of the donor (unless the debt is a non-recourse debt).[46] The grantor should take other planning steps to satisfy any mortgage on a property that the grantor wants in the CRT.

Prohibited Transactions. Like the CLT, the CRT has similar list of transactions that may result in the imposition of additional taxes for the CRT (whether inter vivos or testamentary), including

self-dealing, excess business holdings, investments that jeopardize the charitable purpose, and taxable expenditures.

Testamentary Trusts: In Conclusion

It is important to remind grantors that a testamentary trust may not remove an asset from the estate like some other irrevocable trusts do. Instead, the property goes into the testamentary trust following the grantor's death and is included in the decedent's gross estate. However, the testamentary trust allows the grantor to continue controlling the property during life and then distribute the property to named beneficiaries and a qualified charity as set out in the trust instrument. With proper planning and thoughtful guidance, a testamentary trust can be a key component of a stress-free estate plan that accomplishes the grantor's charitable and estate planning goals.

Stress and the Five O'clock Hour

"It's five o'clock somewhere!" This common expression heralds the end of work—even when the actual clock says otherwise. For successful individuals who have navigated the shoals of a stress-filled life, the prospect of retirement years brings the same sort of anticipation. During the dreaming, planning, and re-evaluating of the pre-retirement years, clients may decide that a testamentary gift is the best way to realize a charitable legacy. While these clients are "calling it a day," a charitable gift will continue working long after they are sailing into the sunset.

ENDNOTES

1 stress.org/take-a-deep-breath

2 For example, the Florida Probate Code defines devise as follows:

> "Devise," when used as a noun, means a testamentary disposition of real or personal property and, when used as a verb, means to dispose of real or personal property by will or trust. The term includes "gift," "give," "bequeath," "bequest," and "legacy." A devise is subject to charges for debts, expenses, and taxes as provided in this code, the will, or the trust.

3 See also Reg. 20.2055-1(a).

4 Reg. 20.2055-1(a)(2). The IRS maintains a non-exclusive informational listing of qualified charitable organizations in Publication 78.

5 *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 provision 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."

6 Ltr. Rul. 200437032.

7 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."

8 *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 designated 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."

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

10 *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).

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

12 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).

13 Reg. Sec. 20.2055-2(b)(1).

14 IRC §417(a)(2).

15 IRC §691.

16 https://tanktownusa.com/

17 IRC §170(f)(2)(B), 2055(e)(2)(B) and 2522(c)(2)(B).

18 IRC §§170(c), 2055(a) and 2522(a).

19 IRC §661.

20 Reg. Secs. 1.170A-6(c)(2)(i); 20.2055-2(e)(2)(vi); 2522(c)-3(c)(2)(vi).

21 Reg. Secs. 1.170A-6(c)(2)(ii); 20.2055-2(e)(2)(vii); 25.2522(c)-3(c)(2)(vii).

22 IRC §512(a)(1), 512(b)(4) and 514(a).

23 See IRC §681, §512(b)(11) and §512(c)(2).

24 IRC §4941.

25 IRC §4943.

26 IRC §4943(2)(A).

27 IRC §4944.

28 IRC §4945.

29 IRC §2055(e)(2)(B).

30 PLR 201933007, pg7.

31 IRC §664.

32 Reg. Secs. 1.664-2(a)(5) and 1.664-3(a)(5).

33 IRC §2055(e)(2)(A).

34 IRC §§664(d)(1)(A) and 664(d)(2)(A); Reg. Secs. 1.664-2(a)(5)(i) and 1.664-3(a)(5)(i).

35 IRC §664(d)(1)(D) and 664(d)(2)(D).

36 IRC §664(d)(1)(A) and 664(d)(2)(A).

37 Reg. Secs. 1.664-2(a)(3)(i) and 1.664-3(a)(3)(i).

38 IRC §664(d)(1)(A); Reg. Secs. 1.664-1(a)(1)(i), 1.664-2(a)(1)(i), and 1.664-2(a)(2)(i).

39 IRC §664(d)(2)(A); Reg. Secs. 1.664-1(a)(1)(iii)(c), 1.664-3(a)(1)(i), 1.664-3(a)(1)(i), and 1.664-3(a)(2)(i).

40 See: Rev. Ruls. 77-374 and 70-452. See also Rev. Proc. 2016-42 for additional guidance related to ensuring passage of the 5% test.

41 See: IRC §664(d)(2)(A) and Reg. Sec. 1.664-3(a)(1)(i); Reg. Sec. 1.664-2(a)(1)(i)(a)(1).

42 Reg. Secs. 1.664-3(a)(1)(i)(g) - 1.664-3(a)(1)(i)(l).

43 Treas. Regs. §1.664-1(a)(5)(i).

44 IRC §664(c); Reg. Sec. 1.664-1(c), and P.L. 109-432.

45 Rev. Rul. 92-48.

46 PLR 9015049.

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