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UNIVERSITY OF ROCHESTER

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NO IRD FOR ESTATE OR UBTI FOR CHARITY WITH TESTAMENTARY GIFT ANNUITY

The Internal Revenue Service has ruled that a beneficiary designation in a decedent's individual retirement account (IRA) will not cause the estate to recognize any income in respect of a decedent (IRD) nor will it cause the donee charity to realize unrelated business taxable income (UBTI) (Ltr. Rul. 200230018).

Under the proposed scenario set out in the ruling, a taxpayer would enter into a "gift annuity agreement" with a charitable organization under which the taxpayer would execute a beneficiary designation form transferring the entire IRA account balance to the charity at the taxpayer's death. The IRA proceeds would be deposited in the charity's general funds; and if the designated annuitant survives the taxpayer, the annuitant would receive an annuity based on the then-current rates offered by the charity. If the annuitant predeceases the taxpayer, the IRA proceeds will pass to the charity outright with no further obligation on the charity's part.

The request for the ruling first asked the IRS to determine that receipt of the fund would not adversely affect the charity's tax-exempt status and would not cause the charity to recognize any taxable income as a result of its receipt of the proceeds. IRC §501(m)(1) provides that an organization described in IRC §501(c)(3) or §501(c)(4) shall be exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance.

IRC §501(m)(3)(E) provides that the term "commercial-type insurance" shall not include charitable gift annuities, as described in IRC §514(c)(5). Under that section, a transaction qualifies as a charitable gift annuity if the value of the annuity is less than 90% of the value of property received by the charity in the exchange; if it is payable for one or two lives; if the agreement does not guarantee a minimum amount of payments or specify a maximum amount of payments; and if the agreement does not provide for any adjustments of the amount of the annuity payments by reference to the income received from the transferred property or any other property.

The IRS determined that the charity met all of the requirements of IRC §514(c)(5). Consequently, issuing the gift annuity will not affect its tax-exempt status and it will not be deemed to be engaged in any unrelated business. As such, the charity will recognize no UBTI. The ruling also determined that since the annuity is payable out of the general funds of the charity rather than the IRA proceeds, the transfer qualifies for a charitable estate-tax deduction.

Under IRC §691(a)(1), the IRA proceeds, less any nondeductible contributions, are IRD in the hands of the recipient of the funds. Since the charity is named as the designated beneficiary of the IRA, the proceeds of the IRA will be IRD to the charity and not to the estate, according to the ruling.

The IRS declined to rule on whether the annuitant's "investment in the contract" would be equal to the IRA proceeds less the charitable-contribution estate-tax deduction. It did so on the basis that it would have to assume the annuitant would survive the taxpayer, creating a hypothetical rather than factual situation. This leaves open the issue of the character of distributions that are deemed to come from the

proceeds of the IRA in the hands of the annuitant. It seems likely that since the entire amount constituted ordinary income, the entire distribution would be treated as taxable rather than partially tax-exempt income.

IRA FUNDS ARE IRD TO ESTATE BUT DEDUCTIBLE AS PERMANENTLY SET ASIDE

In a ruling that stands somewhat in contrast to **Ltr. Rul. 200230018**, the IRS has determined that IRA funds to be distributed to charity but not specifically earmarked for charity in a beneficiary designation are IRD to the estate (**Ltr. Rul. 2002221011**). The IRS did, however, determine that under the facts set out in the ruling the funds are deductible by the estate in the year of receipt as gross income permanently set aside for charitable purposes.

The decedent's will provided that the residue of his estate was to be distributed to a charity selected by the executor according to criteria set out in the will. After making specific bequests and paying taxes and expenses, the executor sought a ruling that the distribution of the IRA proceeds to charity would be deductible by the estate in the year of receipt under **IRC §642(c)(2)**.

According to **Rev. Rul. 92-47 (1992-1 CB 198)**, distribution of IRA proceeds is IRD to the beneficiary to the extent of the balance of the IRA account less any nondeductible contributions. However, if an estate is the beneficiary of the IRA, the estate is allowed a deduction in computing its taxable income for any gross income permanently set aside for charitable purposes.

To qualify for deductibility, the possibility that any amount set aside will not be used for charitable purposes must be so remote as to be negligible, according to **Reg. §1.642(c)-(2)(d)**. The IRS determined that the funds in this case had been permanently set aside and therefore qualified as a deduction from the taxable income of the estate in the year of receipt.

IRS GIVES GREEN LIGHT TO VEHICLE-DONATION PROGRAM

In recent years, the IRS has indicated that it is targeting vehicle-donation programs for increased scrutiny. Apparently the IRS believes that there is the potential for abuse in such programs, particularly in terms of overstating the value of donated vehicles. The IRS seems to be concerned that the procedures used by charities in administering and acknowledging such gifts could exacerbate the potential problems.

Such programs are not inherently flawed, though, according to a pair of recent private letter rulings (**Ltr. Rul. 200230005** and **Ltr. Rul. 200230007**). These rulings give insight as to what charities and donors should do to pass IRS muster for deductibility of vehicle gifts.

Many charitable organizations participate in vehicle-donation programs. Usually the administration of the program is handled by a third-party entity that arranges for pick up and disposal of donated vehicles. In many cases, such third parties are also responsible for promoting the program. Typically, the third party receives a fee for its services and distributes the proceeds of the sale, less other costs and expenses, to the donee charity.

These two rulings involved the adequacy of the donor's program in the one case and the deductibility of the donor's gift in the other. The charity proposed to use a third party as its agent to administer the program and solicit donations. The agent would also pick up or accept donated vehicles, arrange for qualified appraisals, provide minor repairs, and dispose of the vehicles, all subject to review and approval of the charity. The charity would continue to be the equitable owner of the vehicles until they were sold.

A key portion of the rulings involved the proposed procedures for valuation and verification of the gift. The agent would provide the donor with a printout of the "blue book" value of the vehicles, accompanied by a disclosure that

the printout does not in any way represent the opinion of the agent or the charity. For vehicles valued at more than $5,000, the agent will arrange for professional appraisals by an unaffiliated appraiser, apparently to meet the requirements of **IRS Form 8283 (Noncash Charitable Contributions)**. The donor will be responsible for paying the costs of the appraisal.

The agent may sign the **Form 8283** on behalf of the charity pursuant to a power of attorney. The agent is also authorized to send *thank you letters* on behalf of the charity, and the charity will issue an *official receipt* separately.

Based on these facts, the **IRS** ruled that a gift of a vehicle can qualify for a charitable deduction. The gift will be deemed to be a gift **to** a charity (as opposed to **for the use of** a charity). The ruling noted that it is "well established that an organization described in **§170(c)(2)** may receive contributions through its agent."

An important part of the ruling focuses on the requirements of **Reg. §1.170A-13(b)(1)** and **IRC §170(f)(8)**. The regulations set forth the general rule that a receipt shall set out: (i) the name of the donee; (ii) the date and location of the contribution; and (iii) a description of the property in detail reasonably sufficient under the circumstances.

IRC §170(f)(8) provides that no deduction shall be allowed for any contribution of $250 or more unless the taxpayer substantiates the contribution by a "contemporaneous written acknowledgment" of the contribution by the donee that states: (i) the amount of cash and a description (but not value) of any property other than cash contributed; (ii) whether the donee organization provided any goods or services in consideration, in whole or in part, for any property received; and (iii) a description and good faith estimate of the value of any goods or services received.

In the situation of the above letter rulings, the **IRS** determined that the proposed *thank you letter* from the agent meets the requirements of **Reg. §1.170A-13(b)(1)** but does not contain language regarding provisions of goods or services. The proposed *official receipt* from the charity does not provide a sufficient description of the vehicles but does adequately address the issue of goods and services. If these communications are appropriately modified and sent in a timely manner (for the donor to receive them prior to the earlier of the date the donor files the tax return on which the deduction is claimed or the due date of such return, including extensions), either or both could satisfy all the relevant requirements.

The **IRS** also concluded that participating in such a vehicle-donation program will not adversely affect the charity's tax-exempt status in **IRC §501(c)(3)**. Specifically it found that the payments to the agent were reasonable compensation for services provided and did not constitute prohibited "private inurement." Finally, the ruling found that participating in the program did not constitute an unrelated trade or business for the charity.

PROPOSED REGULATIONS WOULD ALLOW DEDUCTION FOR CHARITABLE ANNUITY OR UNITRUST INTEREST PRECEDED BY PRIVATE INTEREST

The **IRS** has announced proposed regulations that would bring the income-, gift-, and estate-tax regulations in line with a prior Tax Court decision that held that portions of the estate-tax regulations were invalid. Unless it is a remainder interest, a charitable interest in a split-interest gift must be in the form of either a guaranteed annuity or a fixed percentage of the annual net fair-market value of the property (unitrust interest) under **IRC §170(f)**, **§2522(c)(2)**, and **§2055(e)(2)** to be deductible.

However, if such interests are payable for both private and charitable purposes from a trust and the private interest is payable before the expiration of the charitable interest, then in order for the charitable annuity interest or unitrust interest to be deductible, the charitable interest must begin either before or at the same time as the private interest.

A conflict between the Code and case law arose in the *Estate of Boeshore v. Commissioner*, **78 T.C. 523 (1982)**. In that case, the decedent devised the residue of her estate to a charitable remainder unitrust that was to pay a 6% unitrust amount annually. During the life of the decedent's spouse, 70% of the distribution was to be paid to the surviving spouse and the remaining 30% to the decedent's daughter and two grandchildren. Upon the surviving spouse's death, 58% of the unitrust amount was to be paid to the decedent's daughter and two grandchildren and the remaining 42% was to be paid to a qualifying charity. Upon the death of the last of the four individual beneficiaries, the remainder interest was to be paid to the charity.

The decedent's estate claimed a charitable estate-tax deduction for the present value of both the charitable remainder interest and the charitable unitrust interest that was set up to begin at the spouse's death. The **IRS** disallowed the deduction for the present value of the charitable unitrust interest under the authority of **Reg. §20.2055-2(e)(2)(vi)(e)** (currently **§20.2055-2[e][2][vii][e]**) because it was preceded by a noncharitable-unitrust interest.

The court noted that the intent of the rules contained in **IRC §2055** was to ensure that the value of the charitable interest is not subject to manipulation through trustee investment practices and the actual benefit the charity receives bears a reasonable relationship to the deduction allowed for the value of the charitable interest. The court reasoned that since all nonremainder interests in the *Boeshore* trust were in the form of unitrust interests, there were no incentives to manipulate the income interests. Accordingly, the court could not find any congressional intent to preclude a charitable deduction for the value of the charity's unitrust interest and held that **Reg. §20.2055-2(e)(2)(vi)(e)** was invalid.

The proposed regulations bring the regulations in line with that holding by eliminating the requirement that a charitable interest cannot be preceded in point of time by a noncharitable interest that is in the form of a guaranteed annuity or unitrust interest. The regulations will continue to require that any amounts payable for private purposes before the expiration of the charitable annuity or unitrust interest must either be in the form of a guaranteed annuity or unitrust interest or be payable from a separate group of assets devoted exclusively to private purposes.

Coordinated changes are proposed for the income-, gift-, and estate-tax regulations, respectively. All of the proposed changes will affect the changes noted earlier.

The income-tax regulations will be amended by revising **Reg. §1.170A-6(c)(2)(i)(E)** and removing the example following that existing paragraph and by revising **§1.170A-6(c)(2)(ii)(D)**. The estate regulations would be amended by revising **§20.2055-2(e)(2)(vi)(f)** and **§20.2055-2(e)(2)(vii)(e)** and removing Example (4) in **§20.2055-2(f)(2)(iv)**. In the gift-tax regulations, **§25.2522(c)-3(c)(2)(vi)(f)** and **§25.2522(c)-3(c)(2)(vii)(e)** are to be revised and Example (4) in **§25.2522(c)-3(d)(2)(iv)** is removed.

From a planning standpoint, it may be desirable to create an annuity trust or unitrust interest for a charity following a prior interest of a noncharitable beneficiary and claim a deduction for the value of that interest. For instance, a donor with two children may want to create one trust to benefit them as long as both are alive, but may want to direct the interest of a deceased child to charity when that beneficiary dies. These proposed regulations would allow this type of planning, consistent with the holding in the *Boeshore* case.

***Financial Strategies** is intended for a select group of attorneys, accountants, trust officers, insurance advisors, investment counselors, and financial planners. It is designed to keep philanthropic planners up-to-date on developments in estate planning as they relate to testamentary and lifetime plans of support of qualified charities.*

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