FINANCIAL STRATEGIES

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UNIVERSITY OF ROCHESTER

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ACGA DROPS RECOMMENDED RATES AGAIN

For the first time ever, the American Council on Gift Annuities (ACGA) has lowered its recommended maximum gift annuity rates for the second time in the same calendar year. This action comes as interest rates have continued to drift lower and the gap between charitable gift annuity rates and commercial annuity rates has continued to narrow.

The new schedule of recommended maximum rates is recommended for use for gift annuities issued on or after July 1, 2003. The new rates reflect a drop of 0.2% or 0.3% at virtually all ages for single-life annuities when compared to the rates that were issued to be effective January 1, 2003. Under the new schedule, the maximum recommended rate also drops from 11.5% to 11.3% for single-life annuities for all annuitants aged 90 or older.

The following chart shows the changes in recommended maximum charitable gift annuity rates at various representative ages.

ACGA RECOMMENDED MAXIMUM RATES

	One Life			Two Lives	
Age	1/1/03	7/1/03	Ages	1/1/03	7/1/03
60	6.0%	5.7%	60-60	5.6%	5.4%
65	6.3%	6.0%	65-65	5.8%	5.6%
70	6.7%	6.5%	70-70	6.1%	5.9%
75	7.3%	7.1%	75-75	6.5%	6.3%
80	8.3%	8.0%	80-80	7.1%	6.9%
85	9.7%	9.5%	85-85	8.1%	7.9%
90+	11.5%	11.3%	90-90	9.5%	9.3%

The recommended reduction is primarily due to the presumed return a charity will be able to generate that ACGA actuaries use in calculating the rates. ACGA assumes an investment portfolio comprised 60% of ten-year treasury notes, 35% equities, and 5% cash. The assumptions use the historic return on equities and the current return on the two other elements of the portfolio, and the resulting presumed return is rounded to the nearest 0.25%.

Based on these assumptions, the presumed return dropped from 6.25% underlying the January 1, 2003, rates to 6.0% underlying the July 1, 2003, rates. In addition, there is an assumption that a charity will incur expenses of 1.0% per year in administering gift annuities. This expense assumption is combined with the return assumptions to generate recommended rates that will produce a 50% residuum for the charity at the death of the annuitant or annuitants. That is, the charity will ultimately retain one-half of the amount originally transferred for the annuity.

Like their immediate predecessors, these new rates are designed to produce a charitable deduction of more than 10% of the amount transferred for the annuity at all ages when the discount rate is 4.0% or higher. If the discount rate is less than 4.0%–which it has been in several months in 2002 and 2003–the deductible portion of the annuity could be 10% or less, especially at younger ages. In such cases, the

issuing charity will want to be sure to adjust the rates to avoid failing the "10% test." If the deductible portion of the amount transferred for the annuity is not greater than 10%, the charity can be deemed to be realizing unrelated business taxable income (**UBTI**)–jeopardizing any potential economic benefit for the charity.

For more information on the latest recommended rates, visit the **ACGA** Web site at www.acga-web.org.

POSTMORTEM MANEUVERS SAVE DEDUCTION

The **IRS** showed its kinder, gentler side in a recent technical advice memorandum when it allowed a decedent's estate to do some significant–and long over-due–postmortem maneuvering to preserve a charitable estate-tax deduction (**TAM 200352032**).

During his lifetime, the decedent had created a foundation in a foreign country that was to provide scholarships to art students; but he never filed **Form 1023** for recognition of exemption under **IRC §501(c)(3)**. Moreover, the foundation's governing instrument did not contain provisions for exemption required under **IRC §508(e)**. Nevertheless, upon the death of the taxpayer, the estate claimed a charitable estate-tax deduction for the value of the residue of the decedent's estate that was distributed to the foundation.

Upon audit, the **IRS** disallowed the deduction. The estate then took steps to amend the defective document to include the required provisions and filed an application for recognition of exemption. By that time, however, the deadline for filing the application set by **Reg. §1.508-1(a)(2)**–15 months after the end of the month in which the foundation was organized–was well past. **Reg. §301.9100-2** does provide for an extension of that deadline for an additional 12 months, but the application was significantly past even this extended deadline.

Consequently, the estate had to pin its hopes on **Reg. §301.9100-3**, which allows an application beyond the 27 months upon a showing of reasonable action and good faith by the taxpayer and that no prejudice to the interest of the government would result from granting a further extension. The **IRS** consented to allowing the application pursuant to **Reg. §301.9100-3** and recognized the exempt status of the foundation retroactive to the date the foundation was originally organized. These actions, taken together, allowed the foundation to be treated as an exempt organization as of the date of the decedent's death, thereby preserving the deduction.

SETTLEMENT PAYMENT NOT ENOUGH TO SUPPORT DEDUCTION

A decedent's estate does not necessarily get a charitable estate-tax deduction merely because it distributes property interests to a qualified charitable organization. According to a recent technical advice memorandum, the distribution must constitute a qualifying transfer by the decedent for the deduction to be allowable (**TAM 200306002**).

In the case in question, the decedent had executed seven wills and one codicil over a period of 35 years. The charity was named as a beneficiary in only the first of those documents. Following the death of the decedent, the charity and certain descendants contested the probate of the last of the seven wills. Eventually, the charity reached a settlement with the estate.

According to the **TAM**, in order for a deduction to be allowed for property interests passing to a charity that interest must be transferred to the charity pursuant to correctly interpreted and applied state law. In this situation, the **IRS** determined that the charity would need to be able to persuade a court that it had an enforceable right to property under the first of the seven wills. Even if the charity would be able to demonstrate that the first will was properly executed,

it would be unreasonable to believe it could establish that the first will was not revoked by any subsequent will or codicil with provisions to the contrary. As such, the TAM concluded, there can be no legally enforceable right under state law, and, therefore, no charitable deduction.

AGREED-UPON TERMINATION OF CRT PRODUCES GAIN FOR INCOME BENEFICIARY

In a recent private letter ruling the IRS again has acknowledged that the beneficiaries of a charitable remainder trust (CRT) can agree to terminate the trust and divide trust assets in proportion to their respective interests in the trust (Ltr. Rul. 200314021). This particular ruling focused on the tax consequences of the amount realized by the income beneficiary pursuant to the termination.

The taxpayer had created a charitable remainder unitrust (CRUT) naming himself as trustee and a professional fiduciary as special trustee for purposes of valuing hard-to-value assets and making investment decisions regarding such assets. The taxpayer had initially named three charities as remainder beneficiaries but had reserved the power to change the remaindermen. Under the authority of that reserved power, the taxpayer executed an exercise of special power of appointment designating a private foundation as the sole irrevocable remainder beneficiary of the trust.

Subsequently, the income beneficiary and the foundation agreed that it would be in their respective best interests to terminate the trust and distribute the assets. The trust will petition the appropriate court to request an order terminating the trust and stating the date-of-termination value of the assets to be distributed.

Upon termination, the trust proposes to distribute to the taxpayer as the income beneficiary and to the foundation as the remainder beneficiary lump sums equal to the present value of their respective interests on the date of termination. The trust will follow the methodology set out in Reg. §1.664-4 of the income-tax regulations and will use the discount rate in effect under IRC §7520 on the date of termination to determine the value of such respective interests.

In what turned out to be a key element of his request for the ruling, the taxpayer represented that his last physical in January of 2002 revealed no indication of any condition that would cause his life expectancy to be less than the average person of his age. Under all of these circumstances, the taxpayer sought guidance as to the tax consequences of this proposed course of action.

The ruling noted that the characterization of the unitrust distribution is typically determined under the "four tier" provisions of IRC §664(b). According to that section, payments are characterized in the hands of the recipient first as ordinary income, second as capital gain, third as other income, and fourth as trust corpus. Both current and prior undistributed amounts from a tier must be exhausted before distributions are deemed to be from the next tier.

However, the ruling notes, money and property received by a beneficiary upon the termination of a trust do not represent a distribution of an annual unitrust amount and IRC §664 therefore is not applicable to that amount. Instead, the beneficiary is disposing of his interest in the trust in exchange for money or property in a transaction that is governed by IRC §1001.

Under IRC §1001(a), gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in IRC §1011 for determining gain. IRC §1001(e)(1) provides, though, that in determining gain or loss from the sale or other disposition of a term interest in property, the portion of the adjusted basis of such interest which is determined pursuant to IRC §1015 shall be disregarded.

IRC §1001(e)(2) provides that a "term interest in property" includes an income interest in a trust. There is an exception under **IRC §1001(e)(3)** to the general rule of **IRC §1001(e)(1)** if the sale or other disposition of the interest is part of a transaction in which the entire interest is transferred to a third party. Here, however, that exception does not apply.

As such, the ruling concludes that the taxpayer is essentially selling his interest in the trust to the remainderman. It also points out that, under **Rev. Rul. 72-243, 1972-1 C.B. 233**, the sale of an income interest in a trust is a sale of a capital asset within the meaning of **IRC §121**. Accordingly, since the taxpayer has no basis in the property interest, the entire value he receives upon termination will constitute capital gain.

The **IRS** also discussed the issue of whether these circumstances presented any issues of self-dealing. "The critical question is whether early termination may be expected to result in a greater allocation of Trust's assets to the income beneficiary, to the detriment of the charitable beneficiary, Foundation, than would a termination at Taxpayer's death," the ruling said. "Taxpayer's proposed allocation method is reasonable if the income beneficiary has no knowledge of a medical condition or other circumstances likely to result in a shorter life expectancy than that predicted by the actuarial tables."

The **IRS** based its conclusions on several assumptions. First, it assumed that state law allows such an early termination and that all the beneficiaries favor the early termination. It also assumed and accepted the taxpayer's representations that the amounts to be distributed would be determined pursuant to the rules set forth in **Reg. §1.664-4** and **IRC §7520**. It particularly relied on the taxpayer's representation in an affidavit that he was aware of no medical condition expected to result in a shorter-than-average longevity.

Early termination of a **CRT** by mutual agreement of the parties offers some interesting options both to income beneficiaries and to charitable remainder beneficiaries. Unexpected circumstances such as illness or a financial emergency may make it more desirable for an income beneficiary to receive a lump sum representative of the present value of the income beneficiary's interest rather than annual payments over his or her lifetime.

Similarly, there may be circumstances that make it beneficial for the charity to receive a lump sum currently. For example, the remainder beneficiary may undertake a building project or have another major capital expenditure that would make the receipt of a significant lump sum desirable.

The income beneficiary may want to help make a lump sum available by agreeing to an early termination of a **CRT**. Since such a termination will cause the income beneficiary to realize a significant amount of capital gain, the income beneficiary may also want to consider selling other capital assets such as securities with unrealized losses in order to offset the gain produced by the termination. Keep in mind, however, that a private letter ruling is binding only on the party seeking the ruling and cannot be relied on or cited as precedent by any other party.

Financial Strategies *is distributed to 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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