**FINANCIAL STRATEGIES**
For estate planning and planned giving.
• Legislation
• Court decisions
• IRS developments

UNIVERSITY OF ROCHESTER

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## WHEN COUPLE SPLITS CRUT DOES TOO

A divorce may present some unique challenges if both spouses have interests in the same charitable remainder trust. A couple proposed a plan to the Internal Revenue Service to deal with those challenges in a recent private letter ruling (Ltr. Rul. 200502037).

During the marriage the husband created a charitable remainder unitrust (CRUT) and named himself income beneficiary for life. At his death, the income interest was to be paid to his wife if she survived him, provided he did not exercise a right to revoke her survivorship interest in his will. At the death of the survivor of the husband and wife, or at the death of the husband if he exercised the power to revoke the wife's interest in his will, the remaining trust assets were to pass to charity.

The couple subsequently divorced and entered into a property-settlement agreement under which the husband agreed to irrevocably renounce his power to revoke the wife's survivorship interest in the CRUT by will. He also agreed that the original trust would be split into two new equal trusts. The husband and the wife would each be the sole beneficiary of one of the trusts. All components of ordinary income, capital-gain income, and other income were to be divided equally between the two new trusts.

In all other regards, the new trust would be identical to the original trust. The representative of the original trust asked the IRS to rule on the tax implications of the trust's proposed division.

The ruling quickly disposed of the threshold issue of whether the new trusts would constitute qualified CRUTs under IRC §664. The IRS concluded that the new trusts would satisfy all the statutory requirements for a CRUT since none of the terms of the trust would differ from the original trust.

Next, the ruling turned to the issue of whether the division would result in the realization of gain or loss to any entity under IRC §1001(a). An exchange of property results in gain or loss under §1001 if the properties exchanged are materially different. Citing *Cottage Savings Association v. Commissioner,* 499 U.S. 554, the ruling noted "that payments are 'different' in a sense that is 'material' to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent."

Here, according to the ruling, the nature of the interest before and after the division would clearly be different. The husband owned the entire income interest while the wife had a future contingent interest prior to the division. Afterwards, each would have a present 50% interest. This would normally be sufficient to give rise to recognition of gain or loss except that IRC §1041(a) provides that no gain or loss will be recognized on transfer of property to (or in trust for the benefit of) a spouse, or a former spouse if the transfer is *incident to the divorce.*

Under IRC §1041(b), the transferee is treated as having acquired the property by gift with a carryover basis from the transferor. Accordingly, the husband will recognize no gain or loss and the wife will receive the new interest as a gift with a carryover basis since the trust assets were divided on a *pro rata* basis.

IRC §1015(a) provides that the basis of property acquired by gift is the same as in the hands of the donor or last preceding owner by whom it was not acquired by gift, except that if such basis is greater than the fair-market value at the time of the gift (in which case for determining loss the basis shall be

the fair-market value). IRC §1015(b) says that if property is acquired by a transfer in trust (other than by a transfer in trust by a gift, bequest, or devise) the basis is the same as in the hands of the grantor, increased by the amount of gain or decreased by the amount of loss recognized to the grantor on the transfer. Under IRC §1223(2) the holding period for the new trusts would be the same as the original trust because the basis is the same for the new trusts.

The ruling went on to conclude that the division of the trust would not cause the trust to have terminated its private foundation status as described in IRC §507(a) nor cause the husband and wife —as disqualified persons—to have engaged in any actions of self-dealing. Furthermore, the division will not violate the taxable expenditure provisions of IRC §4945.

## VARIABLE STARTING DATE ANNUITY GETS ANOTHER 'THUMBS UP' FROM IRS

Donors are often attracted to the idea of a deferred annuity that will begin making payments at a point in the future, such as when the donor retires. The problem is, the donor does not always know exactly when that will be. A recent private letter ruling has given a taxpayer considerable latitude in such planning by once again approving a deferred gift annuity with a variable starting date (Ltr. Rul. 200449033).

A charity sought approval of a deferred annuity contract under which a donor would have an eight-year window to select a starting date for payment of a charitable gift annuity. When the election is made, the annual annuity payment will be determined on the beneficiary's age at the time the annuity payments start. The longer the beneficiary waits for payments to start, the larger the payments will be.

The specific starting date for the annuity would also determine the actuarial value of the annuity and—in typical situations in which the starting date is determined at the time the gift annuity contribution is made—the amount of the charitable deduction as well. In this situation, since the value of the annuity will vary according to the starting date chosen, the charity proposed to use the highest possible value of the annuity —and therefore the lowest possible charitable value—for purposes of determining the charitable deduction to which the donor is entitled.

***Example:*** John G, aged 50, makes a gift of $100,000 in exchange for a deferred charitable gift annuity. Under the terms of the agreement, John may elect to have the annuity begin at any time beginning with a date *10 years from the date of the gift* to a date *18 years from the date of the gift.*

An election to begin the annuity payments on each of the subsequent anniversary dates would yield the following results:

| Years Deferred | Beneficiary Age | Annual Payment | Value of Annuity | Charitable Value |
|---|---|---|---|---|
| 10 | 60 | $ 9,200 | $68,213 | $31,787 |
| 11 | 61 | 9,800 | 67,067 | 32,933 |
| 12 | 62 | 10,500 | 66,201 | 33,799 |
| 13 | 63 | 11,000 | 63,767 | 36,233 |
| 14 | 64 | 11,700 | 62,229 | 37,771 |
| 15 | 65 | 12,300 | 59,887 | 40,113 |
| 16 | 66 | 13,200 | 58,692 | 41,308 |
| 17 | 67 | 14,000 | 56,702 | 43,298 |
| 18 | 68 | 15,000 | 55,186 | 44,814 |

Under this ruling, it would be assumed for purposes of determining the charitable deduction that John's payments would begin in 10 years and that the deduction would be $31,787.

Clearly, a donor could generate a larger deduction by choosing a specific starting date up front. However, many donors may find a potentially lower deduction to be a fair tradeoff to retain the flexibility to defer income until needed and/or to increase the amount of future payments.

## DONOR CAN MANAGE INVESTMENT OF GIFT

In order to be entitled to a charitable deduction a donor typically must give charity all of his or her interests in contributed property. If the donor retains any substantial interest, he or she generally runs afoul of the partial interest rules of IRC §170(f)(3), rendering the gift nondeductible.

Under IRC §170(f)(3)(A) a donor is denied a deduction for a contribution of an interest that consists of less than the taxpayer's entire interest in such property except to the extent the value of the interest would have been deductible had the interest been transferred in trust—such as to a charitable remainder trust. There is an exception to this partial interest rule under IRC §170(f)(3)(B) that allows a deduction for a contribution not in trust of an undivided portion of the taxpayer's entire interest in the property. However, when a taxpayer transfers some specific rights and retains other substantial rights, that will not be considered to be a gift of an undivided interest.

The IRS dealt with the question of what constitutes "substantial rights" in a pair of recent private letter rulings (Ltr. Rul. 200445023 and Ltr. Rul. 200445024). In each of these circumstances donors proposed to transfer cash and securities to a college that was a qualified charity. The contributions were to be irrevocable and the assets were to become the property of the charity. However, the donors would retain the right to manage the investment of the donated assets pursuant to separate agreements entered into at the time of the gift.

Under the terms of the agreements, the donations would be placed in a brokerage account. The donor or the donor's investment manager could manage the investments in the account pursuant to a limited power of attorney. Each respective donor would be prohibited from engaging in acts of self-dealing and must operate within the bounds of restrictions and limitations in the agreement.

The donor would only be allowed to hold or invest in United States equities, U.S. open- or closed-end mutual funds, U.S. fixed-income securities, offshore/onshore hedge funds, REITs, and private placements. No investment would be permitted in companies in which a donor owns, directly or indirectly, more than 5% of the outstanding shares of stock. The donor or the donor's advisor may not pledge or otherwise encumber the account in any manner to satisfy any liability of the donor.

Furthermore, the donor may not commingle assets in the account with any asset outside the account or invest in short sales, forward settling transactions, derivatives, or any borrowings. The donor will have no right to vote any stock or other securities held in the account.

For its part, the college will have the right to withdraw any or all of the account and to terminate the limited power of appointment and the agreement in its sole discretion. The agreement will automatically terminate if the account experiences severe loss, as determined in the sole discretion of the college. Absent any earlier termination, the agreement will terminate in 10 years.

In analyzing whether the retained investment rights would cause these gifts to fail the partial-interest test, the IRS noted that it was essential that the donor had no right to vote the stock, noting that such a power was deemed to be substantial in Rev. Rul. 81-282, 1981-2 C.B. 78. By contrast, the IRS pointed out that the right of the donor to continue to train his hunting dog on donated land was deemed not to be a substantial right in Rev. Rul. 75-66, 1975-1 C.B. 85.

STRATEGIES

The IRS concluded that the investment rights retained by the donors in this case were not substantial enough to cause the gift to fail the partial-interest test for income-tax purposes. The restrictions in the agreement provide adequate safeguards to ensure that the donors would not realize any personal economic benefit from their investment rights. Similarly, the ruling determined that the rights retained by the donor would not preclude a charitable deduction for gift-tax purposes under IRC §2522.

## BRIEFLY...

**Charitable Mileage Rate Unchanged.** The IRS has announced that taxpayers may take a deduction of 14 cents per mile for use of a vehicle for charitable purposes in 2005. This amount is unchanged from 2004. The rate for business use of a vehicle has increased from 37.5 cents to 40.5 cents per mile—a reflection of significantly higher fuel costs. Those who use their cars for moving or medical expenses can deduct 15 cents per mile.

**Estate Assigns IRAs, Annuities to Charity: No Tax.** The executor of a decedent's estate proposed to assign certain IRAs and deferred annuities to a charity named as a residuary beneficiary under the decedent's will. The probate court had determined that the will permitted a *non-pro rata* distribution.

Based on those facts, the IRS concluded that the assignment of the IRAs and the annuities to charity in satisfaction of its share of the residuary estate will not cause the estate or any beneficiary to have any taxable income or cause the estate to include any amount in its distributable net income (Ltr. Rul. 200452004).

**Reimbursement Not Income.** A nonprofit corporation provides services to developmentally disabled persons pursuant to legislation intended to prevent or minimize the institutionalization of the clients and dislocation from their families and communities. One of the ways it provides the services is by reimbursing qualified individuals for the cost of their actual and necessary transportation and respite care (not to exceed specified limits).

IRC §6041(a) provides that all persons engaged in a trade or business who pay another person $600 or more of fixed or determinable income must file an information return reporting such payments. Although IRC §61 provides, generally, that gross income includes all income from whatever source derived, the IRS has ruled that certain payments made under legislation for the promotion of the general welfare are not includible in the gross income of the recipient.

In this case, the IRS ruled that the payments for transportation or respite care were for the promotion of general welfare. Therefore, they did not constitute income to the recipients under IRC §61. Consequently, the nonprofit organization did not have to report the payments pursuant to IRC §6041(a).

*__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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