Committee Report: Insurance

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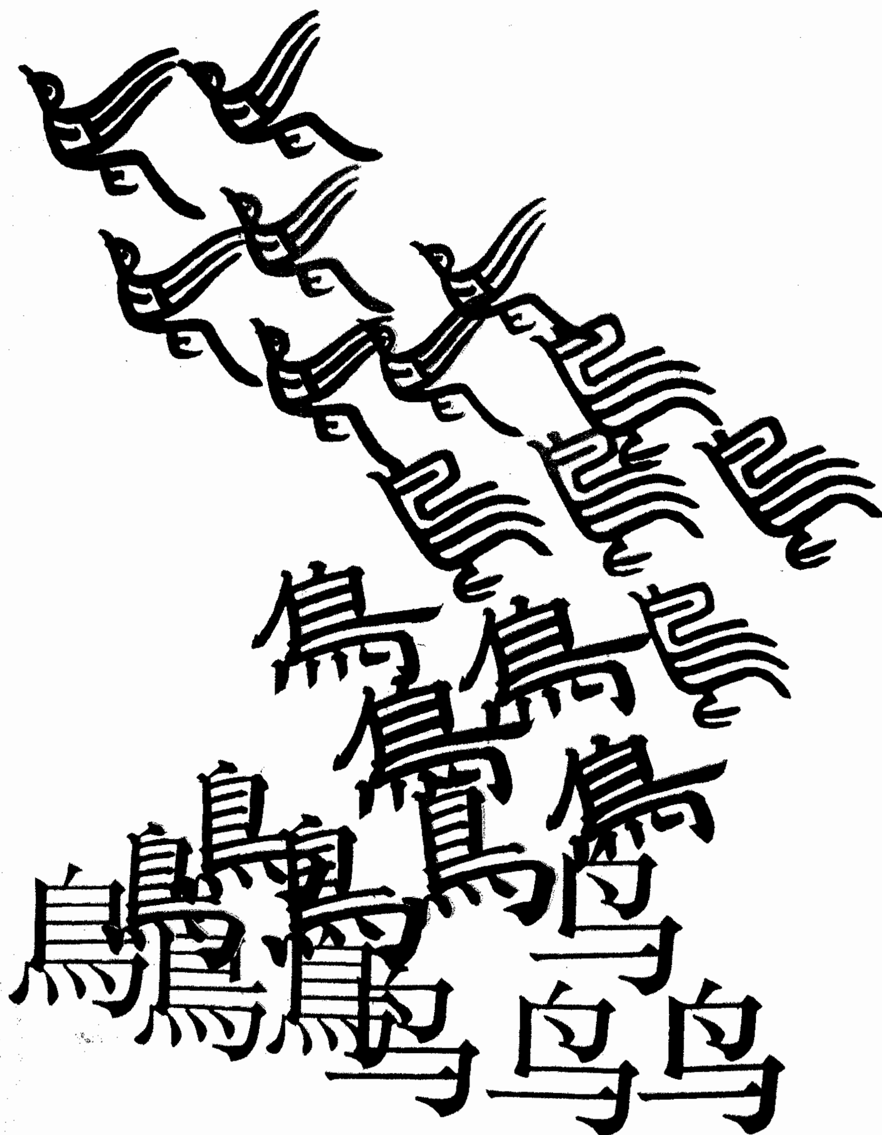

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FEATURES

ESTATE PLANNING & TAXATION

20 **The Booby Prize**

By Noel C. Ice and Robert W. Goff, Jr.

If your client is an heir to an estate with lottery prize money or other such annuities, he could get the biggest tax shock of his life. Estates primarily comprising property characterized under IRC Section 691 as "income in respect of a decedent" are subject to the combined federal income and estate tax liability that is often so disproportionate as to be confiscatory. Authors Noel C. Ice and Robert W. Goff, Jr., suggest a possible solution.

Noel C. Ice is a partner with Cantey & Hanger, L.L.P. in Fort Worth, Texas. He is also a fellow and the Texas Chair of the American College of Trust and Estate Counsel, as well as the reviewing editor of the Guide to Practical Estate Planning *(Practitioners Publishing Company, Fort Worth, Texas), 2000-2001.*

Robert W. Goff, Jr. is a shareholder at Sherrill, Crosnoe & Goff, PC, Wichita Falls, Texas.

30 **Eliminate a Trust's State Income Tax**

By Thomas R. Pulsifer and Todd A. Flubacher

Many practitioners are not aware that their high-net-worth clients living in certain states can use Delaware trusts to minimize or even avoid state income taxes. That's because there is no Delaware income tax on Delaware trusts benefiting individuals who reside outside of the state. And that works particularly well for people residing in such places as New York. Authors Thomas R. Pulsifer and Todd A. Flubacher explain how this works—and warn advisors against the temptation to abuse the Delaware trust option.

Thomas R. Pulsifer is a partner at Morris, Nichols, Arsht & Tunnell LLP in Wilmington, Del., and specializes in state and federal income tax law as well as the taxation of exempt organizations.

Todd A. Flubacher is an associate at Morris, Nichols, Arsht & Tunnell LLP in Wilmington, Del. His practice emphasizes unique aspects of Delaware's trust law, trust operations, state taxation, and estate and gift taxation.

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By Avi Z. Kestenbaum

Although most advisors know the difference between the limits on income tax deductions for contributions to private foundations and to public charities, the devil is in the very complicated details. But knowing the differences between (1) the income tax charitable contribution deductions for individuals and for trusts and estates, and (2) the income tax charitable contribution deductions and the gift and estate tax charitable contribution deductions, can help advisors create tax-saving strategies.

Avi Z. Kestenbaum is an attorney with Meltzer, Lippe, Goldstein & Breitstone, LLP, in Mineola, N.Y. He is the founder and former chair of the Tax-Exempt Organizations Committee of the Taxation Section of the New Jersey Bar Association.

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By Henry Steinway Ziegler

When resident aliens in the United States choose to move back to their home countries, it's vital that they plan a tax-efficient exit. The

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Know the Differences

Why all charitable contribution deductions are not equal

By **Avi Z. Kestenbaum**, attorney, Meltzer, Lippe, Goldstein & Breitstone, LLP, Mineola, N.Y.

Many tax and estate-planning professionals are aware of the basic tax rules governing deductions for charitable contributions. They know the general distinctions between the limits on income tax deductions for contributions to private foundations, and for contributions to public charities. But the devil is in the detail: Many of these rules are intricate and complicated. Also, advisors sometimes fail to adequately notice the differences between (1) the income tax charitable contribution deductions for individuals and for trusts and estates, and (2) the income tax charitable contribution deductions and the gift and estate tax charitable contribution deductions.

Understanding the fine print for all these deductions is essential for creating strategies for increasing tax savings.

DIFFERENCES, PART 1

The Internal Revenue Code allows individuals and corporations[1] as well as trusts and estates[2] to take an income tax deduction for their charitable contributions. A deduction is afforded for donations to charities[3] of both cash and property, but the deduction can be no greater than the fair market value of the donated property. There are many articles and treatises explaining these complicated and cumbersome rules in detail.[4]

So let's focus on the important differences between deductions for individuals' and for trusts and estates' charitable contributions.

While the rules governing these two deductions are mostly similar, there are several major differences. For example:

- The trust and estate income tax charitable deduction is potentially unlimited,[5] while the deduction for individuals is capped at 50 percent of an individual's adjusted gross income.[6]
- Only a trustee of a trust may elect to claim the deduction in the year prior to the year in which the donation is made, thereby accelerating the deduction. An individual may not claim a deduction in the year prior to when the donation was made.[7]
- Estates are afforded a deduction for amounts permanently set aside for charitable purposes.[8] Individuals (and generally trusts) receive a deduction only for amounts actually paid to charities.
- Individuals are permitted a charitable deduction only for donations to U.S. charities, while trusts and estates also can take deductions for donations to foreign charitable organizations.
- Individuals are permitted a charitable deduction for donations from any source, while trusts and estates are afforded a charitable deduction only for donations made from gross income, and not for those made from *corpus* or funds traceable to tax-exempt income.[9]
- Fiduciaries of trusts and estates must have the authority to make charitable donations in the respective governing instruments,[10] but individuals need only to own the property donated.

Internal Revenue Code Section 2055 provides the general rules for the estate tax charitable contribution deduction and IRC Section 2522 provides them for the gift tax charitable contribution deduction. While these rules are similar, there are some differences. But let's keep it simple and focus on the estate tax charitable contribution deduction, pointing to only some noteworthy differences with the gift tax charitable contribution deduction.

First, let's consider the categories of deductions that can be taken from estate tax for charitable contributions. Under Section 2055, the estate tax charitable contribution deduction is limited to five general categories of charitable recipients:[11]

(1) The United States, or any of its states or political subdivisions and the District of Columbia—but only if the gift or bequest is made for "exclusively public purposes." This category is substantially similar to the one in IRC Section 170(c)(1), which governs the income tax charitable deduction and to the one in IRC Section 2522(a)(1), which governs the gift tax charitable deduction.

(2) Corporations "organized and operated exclusively for religious, charitable, scientific, literary or educational purposes." The term "corporation" is generic and includes unincorporated entities.[12] There is no requirement that the corporation should actually be formed at the time of the decedent's death.[13]

Qualifying bequests under this category also must meet three additional requirements: (a) no part of the charitable corporation's earnings may inure to a private individual; (b) the corporation may not engage in substantial propaganda or lobbying activities; and (c) the corporation may not participate or intervene in political campaigns on behalf of, or in opposition to candidates for public office.[14] These requirements are similar to the requirements for organizations to qualify as exempt from income tax under IRC Section 501(c)(3) and eligible for donors to receive an income tax charitable contribution deduction for contributing to them under IRC Section 170.[15]

(3) The trustee or trustees, or a fraternal society, order or association operating under the lodge system. But this is true only if such contribution or gifts are to be used by these trustee or trustees, or this fraternal society order or association exclusively for religious, charitable, scientific, literary or educational purposes, or for the prevention of cruelty to children or animals. The prohibitions against lobbying and intervening in a political campaign also apply, but the prohibition against inurement is not specifically mentioned.[16]

(4) Veterans organizations incorporated by

Individuals get charitable deductions for donations from any source, but trusts and estates can get them only for donations made from gross income.

an act of Congress or its departments or local chapters or posts. The prohibition against inurement is applicable to this category, but there is no prohibition against lobbying or intervening in political campaigns.[17]

(5) Transfers to an employee stock ownership plan (ESOP)—but only if such a transfer qualifies as a gratuitous transfer of qualified employers securities within the meaning of IRC Section 664(g). This is a very limited category, which was added as part of the Taxpayer Relief Act of 1997.

BASICS

There are other important basic rules and requirements for a bequest to qualify under IRC Section 2055 for an estate tax charitable deduction, including, but not limited to:

- the estate tax charitable deduction is limited to the value of the assets that would otherwise be included in the gross estate.[18] Consequently, a testamentary exercise of a limited or special power of appointment in favor of an IRC Section 2055 organization will not qualify for an estate tax charitable deduction, as the property is not included in the decedent's estate;
- the estate tax charitable deduction is calculated based on the value of the assets actually passing to a qualified charity and is reduced by the amount of death taxes payable out of the estate assets allocable to the charitable bequest.[19] State law is critical, as it typically determines the allocation of death taxes, which may reduce the estate tax charitable contribution deduction;[20]
- either an estate tax charitable contribution deduction on the federal estate tax return or an income tax charitable contribution deduction on the estate's fiduciary income tax return is permitted, but not both (except in limited cases of a "deduction in respect of a decedent" (DRD)). An illustration of this is the case of *Crester Bank v. Internal Revenue Service* in which an estate was not entitled to an income tax deduction for a charitable gift that had been previously deducted for estate tax purposes;[21]
- the charitable bequest cannot be indefinite if it is to qualify under Section 2055. Accordingly, an estate is not entitled to a charitable deduction when the executor merely has the authority, but is not required to make a charitable distribution, even though a qualified charity ultimately receives the distribution.[22] Generally, the more certainty there is that the bequest will ultimately benefit a charity, the more likely that it will qualify under Section 2055;[23] and
- an estate tax charitable deduction is not allowed if the charitable bequest is void under local law.[24] However, a charitable deduction is allowed if the bequest is merely voidable but no objection is in fact raised.[25]

A testamentary exercise of a limited or special power of appointment in favor of an IRC Section 2055 organization will not qualify for an estate tax charitable deduction.

DIFFERENCES, PART 2

It's also critical for planning purposes to note the key differences between the income tax and the gift and estate tax charitable contribution deductions:

- The charitable deduction for gift and estate taxes is determined by the value of the property transferred to the eligible IRC Section 2055 organization. Unlike the income tax charitable deduction, there are no limitations on the value of the deduction (for example limiting the charitable income tax deduction to cost basis with respect to ordinary income property).
- Unlike the charitable income tax deduction, there are no percentage limitation restrictions on the amount of the gift and estate tax charitable deduction.
- The estate tax charitable deduction is not limited to charities in the United States. Bequests to foreign charitable organizations qualify for the estate tax deduction.[26]
- Bequests to foreign governments also may qualify for the estate tax deduction if used exclusively for charitable purposes. The same applies to lifetime charitable donations to foreign governments for the gift tax deduction, if used exclusively for charitable purposes.[27]
- There is no requirement that the charitable corporation actually be formed at the time of the decedent's death in order to qualify for the estate tax charitable deduction.[28]
- The test used to determine whether the donor has released sufficient control over the donated property to allow a deduction is different for the income tax and the gift tax charitable deduction. The test used for the income tax charitable deduction is governed by IRC Section 170(f) and hinges on whether a prohibited "partial interest" was retained whereas the determining factor for the gift tax deduction is tied to the cessation of "dominion and control" as set forth under Treas. Regs. Section 25.2511-2.[29]
- A donor is only permitted an income tax charitable deduction if the cumbersome IRS "substantiation and disclosure" requirements are met. These requirements do not apply to the estate tax charitable deduction.

STRATEGIES, TIPS

Knowing the extensive rules and requirements helps us plan our strategies. It's also helpful to keep these issues in mind:

(1) Is it more advantageous to

donate during lifetime or after death?

Generally, the benefit of a charitable devise is that it is fully deductible for estate tax purposes to the extent that the property devised is included in the decedent's gross estate. However, a charitable devise is generally not the most advantageous contribution method for the taxpayer, as it takes advantage only of the estate tax charitable deduction and not the income tax charitable deduction. Making a lifetime donation to a charitable organization takes advantage of the income tax charitable deduction and the gift tax charitable deduction, as can be illustrated with a simple example:

The estate of John, who is unmarried, is valued at $4 million. John's will provides for a $1 million bequest to a qualified charity. If John dies in 2006, his estate's federal estate tax liability will be reduced by about $46,000 as the estate tax charitable deduction eliminates the value of his bequest from the gross estate.[30] But if John had donated the $1 million to a charity in 2006, prior to his death, not only would the $1 million be removed from his gross estate resulting in the same estate tax benefit, but also a charitable income tax deduction would be available, subject to the percentage limitations.[31]

While the example illustrates that a lifetime donation to charity is generally more advantageous than a charitable bequest, this isn't always the case if you look at the bigger picture. For example, assets devised to charity are subject to a step-up in basis,[32] while assets donated during lifetime are subject to a carryover basis.[33] The step-up-in basis could be extremely beneficial, even to a charity (which is generally not subject to income tax), if the devised asset later subjects the charity to an income tax upon its final settlement (for example, any unrelated business taxable income (UBTI), loss of exempt status, for-profit conversion, taxable subsidiary or joint venture).[34]

Additionally, if the client is married, he can take further advantage of the charitable bequest. For example, if the taxpayer makes a lifetime donation of ordinary income property[35] to a public charity, the deduction is limited to the cost-basis of the property and is also subject to the 30 percent adjusted gross income limitation.[36] A better result is achieved if such property is devised to a surviving spouse. As a result of the marital deduction,[37] the property will pass to the surviving spouse without being subject to the estate tax. The surviving spouse will then take the property with a stepped-up basis.[38] A subsequent charitable donation by the surviving spouse will enable the spouse to take an income tax charitable deduction for the full fair market value of the asset. Therefore, instead of a limited charitable deduction on a lifetime donation, a deduction equal to the fair market value of the assets will be achieved at death.

With a rising federal estate tax exemption and the uncertainty of permanent repeal, these advantages can be better illustrated in the context of the use of a qualified disclaimer.[39] A taxpayer who wishes to make a charitable bequest could instead make the bequest to his relative (for example, his child) with a contingency clause directing the assets to charity if that relative disclaims the bequest. If the taxpayer dies after the estate tax is repealed, or the taxpayer's applicable exclusion amount is sufficient to eliminate the estate taxes, the relative will accept the assets that the decedent intended for charity, and then make the charitable donation with the stepped-up basis. If an estate tax liability was generated without the estate tax charitable contribution deduction, the relative will disclaim as much as necessary to reduce the estate taxes to a minimum. This approach is often referred to as a "reduce-to-zero" charitable bequest.

This disclaimer approach might be more advantageous than a lifetime donation if it is unclear whether the taxpayer will have a taxable estate. If the relative accepts the bequest and then makes the donation to charity, he may better utilize the income tax deduction due to the step-up in basis. This also works if the relative is in a higher income tax bracket than the taxpayer. There are many other variations of this concept, but it is clear that the whole picture must be understood before determining whether it is more advantageous to donate during lifetime or at death.

(2) Does the trustee have the authority to make donations?

During life or after death, a trust is only permitted a charitable contribution deduction if the trustee is authorized in the trust document to make such a contribution. This appears to limit tax planning with charitable contributions from trusts under many circumstances. But a trustee, who is not authorized to donate trust assets to a charity may still be authorized to distribute such assets to the trust beneficiaries. The beneficiaries can then make a charitable donation of such assets.

(3) The gross income limitation may be sidestepped.

More planning opportunities arise if a trustee is permitted to make charitable donations and there's a choice of making such donations directly or through the beneficiaries. Trusts may not be able to take full advantage of the charitable contribution deduction because that deduction is limited to contributions from the trust's gross income and not the *corpus*; the income cannot be traceable to tax-exempt income; and there are percentage limitations if the trust has UBTI. But trustees of a trust that owns appreciated assets could make distributions of these assets to the trust's beneficiaries. The beneficiaries then could donate the assets to a charity and claim a deduction unhampered by the trust's limitations. Also, the trust's holding period in the assets should be tacked on to the holding period of the

beneficiaries, allowing for earlier capital gains treatment.[40] This way the beneficiaries could make full use of the charitable contribution deduction upon the donation of the assets without running afoul of the trust's gross income limitation.[41]

(4) Donations to special donees may still qualify for the estate tax charitable deduction.

If donors want to make a contribution to a charitable organization outside the United States or to other charitable entities that do not qualify for the income tax charitable contribution deduction, they should remember that these contributions still might qualify for the gift and estate tax charitable contribution deduction if used exclusively for charitable purposes. There are many organizations which may qualify for the gift and estate tax charitable deduction, but not the income tax charitable deduction, including, but not limited to: foreign charities; charitable organizations which have not requested nor received an IRS Determination Letter confirming exempt status; charities not yet formed; and foreign governments.

(5) Bequests are free of substantiation and disclosure requirements.

There are many rigid substantiation and disclosure requirements that both donor and charity must satisfy in many circumstances for the donor to claim a charitable income tax deduction. These requirements may include appraisals and disclosures from the charity to the donor, disclosures from the donor to the IRS, and disclosures from the charity to the IRS. Fortunately, these rules do not apply to trusts and estates. Therefore, a donor (and a charity) wishing to avoid the burden of these requirements should leave a charitable bequest or donate through a trust rather than make an outright donation. Also, if the charitable bequest is in the form of a split-interest trust (for example, charitable remainder unitrusts, charitable lead annuity trusts, charitable remainder annuity trusts and charitable lead unitrusts), the valuation of the transferred property affects not only the tax deduction, but also the annuity or unitrust to be paid to the term beneficiaries. Only a bequest will lessen the cumbersome substantiation and disclosure requirements in this situation (though under state law there may be similar notice requirements to the state attorney general).

(6) A charity need not be established at death.

For an estate to claim an estate tax charitable deduction, the charitable recipient need not be formed when the donor dies. If the donor wishes to establish a charitable organization that for some reason cannot be created until after he's gone, he should make a charitable bequest rather than set aside during his lifetime the funds which will not qualify for an income tax charitable deduction. It's important to note that although funds set aside during life for charitable purposes don't qualify for an income tax deduction, they still may qualify at death for an estate tax charitable contribution deduction if sufficient control over the assets is retained and the assets are included in the decedent's estate. Therefore, it may not be necessary to wait until death to set aside such a contribution.

ALWAYS IN MIND

Too often tax planners overlook the distinctions between the income tax charitable contribution deduction for individuals and for trusts and estates, as well as the income tax and the estate tax charitable contribution deduction. A prudent practitioner must be fully aware of all the finer details and differences, in order to maximize tax savings, and help their clients preserve and use their wealth more effectively. Furthermore, practitioners must utilize these distinctions both from the outset of the estate plan, as well as during the ongoing implementation of their clients' wishes and objectives. Failure to do so may hinder the charitable intentions of their clients and the benefits to potential charitable recipients. ▮

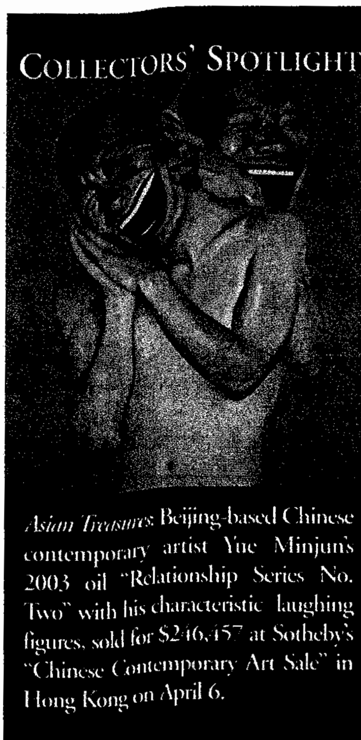
—In helping him prepare this article, the author thanks and acknowledges the guidance and assistance of Michael Kessel, partner, Herrick Feinstein, LLP, New York, and Erica J. Hirsch, attorney, PricewaterhouseCoopers LLP, New York.

Endnotes

1. Internal Revenue Code Section 170 governs the charitable contribution deduction for individuals and corporations. The charitable contribution deduction for corporations is beyond the scope of this article.
2. IRC Section 642 governs the charitable contribution deduction for trusts and estates.
3. For purposes of this article, the term "charities" is defined as entities recognized as exempt from federal income tax pursuant to IRC Section 501(c)(3).
4. *See, for example,* Jill Lockwood and Leslie B. Fletcher, "An Array Of Rules Govern Charitable Contributions," 72 *Practical Tax Strategies,* p. 87 (February 2004) and Howard M. Zaritsky, "Donor's Investment Strings Do Not Preclude Charitable Deduction," 32 *Estate Planning,* p. 56 (March 2005).
5. IRC Section 642. However, if any of the trust's income is unrelated business taxable income (as defined in IRC Section 512), IRC Section 681 and Treasury Regulations Section 1.681-2 limit the deduction to 50 percent or 30 percent of the trust's unrelated business taxable income for the year of the donation (depending upon the classification of the recipient organization). *See* note 6.
6. IRC Section 170 generally caps a taxpayer's aggregate charitable contribution deduction in any taxable year to 50 percent of a taxpayer's adjusted gross income (cash contributions) and 30 percent of a taxpayer's adjusted gross income (contributions of appreciated property).
7. IRC Section 642(c)(1).
8. The amount must be set aside for a specified purpose set forth in IRC Section 170(c) or used exclusively for charitable, religious, scientific, literary or educational purposes.
9. IRC Section 642(c).
10. *Ibid. See Old Colony Trust Co. v. Comm'r,* 301 U.S. 379 (1937).
11. IRC Section 2055(a).
12. IRC Section 7701(a)(3).

13. *See Smith Estate v. Comm'r*, 20 T.C.M. 1268 (1961).
14. IRC Section 2055(a)(2).
15. IRC Section 170(c)2.
16. IRC Section 2055(a)(3).
17. IRC Section 2055(a)(4).
18. IRC Section 2055(d).
19. IRC Section 2055(c).
20. *See, for example,* Technical Advice Memorandum 9126005 and Revenue Ruling 76-358, 1976-2 C.B. 291.
21. *Crestar Bank v. Internal Revenue Service*, 47 F. Supp.2d 670 (E.D. Va. 1999).
22. *See Paris v. United States*, 381 F. Supp 597 (N.D. Ohio 1974). *See also Estate of Lockett v. Comm'r.*, 75 T.C.M. 1731, T.C. Memo 1998-50 and Rev. Rul. 55-335, 1955-1 C.B. 455.
23. *See* Private Letter Ruling 9631021. *See also Marine Estate v. Comm'r*, 990 F.2d 136 (4th Cir. 1993).
24. *See Riddle Estate v. Comm'r*, 21 T.C. 1109 (1954).
25. *See, for example, Longue Vue Foundation v. Comm'r*, 90 T.C. 150 (1988).
26. *See, for example,* PLRs 9821044 and 9853037.
27. IRC Section 2522(a)(1) and Treas. Regs. 20.2055-1(a)(2). *See* PLRs 199911050 and 8318043. *See also* Rev. Rul 74-523, 1974-2 C.B. 304.
28. *See Smith, supra* note 13.
29. *See* PLRs 20445023 and 200425024.
30. This assumes John made no lifetime gifts and there were no state death taxes.
31. *See* IRC Section 170(b)(1).
32. IRC Section 1014.
33. IRC Section 1015.
34. There are many examples of a charity being subject to tax on the later disposition of its asset, but they are beyond the scope of this article.
35. Property other than that which would give rise to long term capital gains if sold by the taxpayer on the date of the deduction. For example, inventory, dealer property, self-created intangibles or short term capital gain property.
36. IRC Section 170.
37. IRC Section 2056.
38. IRC Section 1011.
39. IRC Section 2518. *See* Avi. Z. Kestenbaum and Kevin R. Ghassomian, "Use Disclaimers to Add Flexibility and Hindsight to Estate Plans," 74 *Practical Tax Strategies*, p. 324 (June 2005).
40. IRC Section 1223.
41. While it seems that a beneficiary could make a donation of the asset immediately after its receipt from the trust, taxpayers should take note that in the case of an appreciated asset, the Internal Revenue Service may argue that the taxpayer never had investment intent with respect to that asset. Therefore, the asset may not constitute a capital asset in the hands of the taxpayer and the IRS could seek to limit the charitable deduction to the basis of the asset. *See* IRC Section 170(e). Additionally, it might be construed as a step transaction.

COLLECTORS' SPOTLIGHT



Asian Treasures: Beijing-based Chinese contemporary artist Yue Minjun's 2003 oil "Relationship Series No. Two" with his characteristic laughing figures, sold for $246,457 at Sotheby's "Chinese Contemporary Art Sale" in Hong Kong on April 6.

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