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# DRAFTING CHARITABLE BEQUESTS—

## Estate Tax Considerations

LAWRENCE X. CUSACK\*

**I**N ADVISING on testamentary planning, we are constantly reminded that we should not permit the tail of death taxes to wag the dog. Yet, without doing his client an equal disservice, the estate planner cannot close his eyes to the erosive effect of death taxes when he is drafting will provisions designed to achieve non-tax objectives. This is no less true in the framing of charitable bequests where, once there is a departure from the routine, the tax problems are numerous and often complex.

From the standpoint of death taxes, the paramount consideration in most cases is to assure the deductibility of the charitable bequest for purposes of the federal estate tax. The applicable federal rates are usually higher than those of the particular state, and, moreover, in many states the death tax provisions on the deductibility of charitable bequests are the same as or closely modeled upon the federal law, or the state tax is a percentage of the federal tax.

### **The Draftsman's Approach**

The most practical suggestion is that the draftsman approach the problem of assuring deductibility in the frame of mind of a technician. Section 2055 of the Internal Revenue Code, which allows the deduction, does not sketch a rule in broad, simple strokes. Rather, it specifies with particularity in six subsections and many qualifying clauses the only types of transfers that will be recognized as deductible, and the challenge to the draftsman is increased by the presence of treasury regulations that enumerate a number of pitfalls inferrible from the statute only by the most careful study and familiarity with the judicial history of the statute and predecessor enactments. While it is true that the statute is sympathetically administered by the Internal Revenue Service in the general run of cases, and that the courts have often stretched their power of interpre-

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tation to sustain the deductibility of bequests that have not strictly adhered to the specified criteria, allowance of the bequest is, nevertheless, a question of statutory compliance, not one of equity. If the draftsman wishes to obviate administrative controversy or litigation he will, whenever he has occasion to draft a bequest that varies from a simple legacy for a recognized charity, formulate the provision with strict adherence to the statute or regulations, preferring the assurance of technical compliance to the uncertainty of administrative or judicial grace.

#### Bequests to Individuals

A problem frequently encountered is the desire of the testator to include a bequest to a named clergyman or member of a religious order. The client regards the individual as the personification of the church or order and assumes the bequest will qualify for the charitable deduction. The draftsman who approaches the problem as a technician will advise that the bequest must be made in a different way or the estate tax deduction may be lost.

The kinds of charitable bequests that will qualify for the deduction are set forth in four subdivisions of subsection (a) of section 2055. They describe five categories, three of which (transfers to governments and political subdivisions, certain fraternal societies, orders or associations and certain veterans' organizations) will be passed over here. The remaining two, which are discussed here, deal with bequests that may generally be described as transfers for charitable purposes.<sup>1</sup>

<sup>1</sup> Subdivision (2) of § 2055(a) of the Internal Revenue Code, relating to transfers to or for the use of corporations, requires that the entity be

A study of the statute shows that if a bequest for charitable purposes is to be deductible, it must be made either "to or for the use of any corporation organized and operated exclusively" for charitable purposes,<sup>2</sup> or "to a trustee or trustees . . . to be used by such trustee or trustees . . . exclusively" for such purposes.<sup>3</sup> From this it is evident that a bequest to an individual as such is not deductible, regardless of the laudable motive of the testator and the commendable occupation of the beneficiary. The testator who insists that the clergyman or member of a religious order be named as the beneficiary must either reconcile himself to the probability that deduction of the bequest will be denied, or permit the draftsman to make it clear that the individual is named as the agent or conduit for a corporation or association of the kind specified, or as the trustee of a trust for the purposes specified.

#### Effect of Vow of Poverty

Until 1955, there was widespread belief that a bequest to an individual was nevertheless deductible for federal estate tax purposes if the donee happened to be a member of a religious order who had taken a vow

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"organized or operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals." Subdivision (3), relating to transfers to a trustee or trustees, provides that the contributions or gifts must be used for the same purposes except that there is no explicit reference to "encouragement of art." These purposes are herein collectively referred to as "charitable."

<sup>2</sup> INT. REV. CODE OF 1954, § 2055(a)(2). The treasury regulations broaden the statute by adding "association." Treas. Reg. § 20.2055-1(a)(2) (1958).

<sup>3</sup> INT. REV. CODE OF 1954, § 2055(a)(3).

of poverty. The reasoning behind this view was that the bequest was in practical effect to or for the religious order of which the donee was a member, since, by reason of the vow of poverty, the organization would be the ultimate recipient. The member of the religious order was looked upon as merely a conduit who, because of his vow, had no beneficial interest in the bequest. This reasoning seemed consistent with a 1919 income tax ruling that held the income of members of religious orders to be non-taxable when such income was turned over to their orders because of vows of poverty, or because they received the income as agents of the orders.<sup>4</sup> This thinking was apparently strengthened by a 1948 tax court decision which allowed an income tax deduction for a charitable contribution with respect to a gift to a member of the Society of Jesus on the ground that the contribution was to or for the use of the Order inasmuch as the donee, under his vow of poverty, was required immediately to turn it over to the Order.<sup>5</sup>

The apparent soundness of this reasoning was shaken in 1955 by the issuance of two federal estate tax rulings dealing with property passing to members of religious orders who had taken vows of poverty. One ruling concerned a situation where property passed pursuant to a bequest,<sup>6</sup> and the other a situation where property passed by intestacy.<sup>7</sup> Both rulings held that the value of the property so passing was not deductible. The rationale expressed in the first was that "the property bequeathed to *B* passed to the religious order by virtue of *B*'s contractual

agreement with the order rather than by way of bequest, legacy or devise under the decedent's will."

Initially, the rulings met with some skepticism, but this has since been dispelled by four decisions<sup>8</sup> consistent with the position taken in the revenue rulings. In the first case, the Court of Appeals for the Second Circuit denied a deduction for a bequest to a member of the Society of Jesus who had taken his solemn perpetual vow of poverty, remarking that it was the donee's "renunciation and assignment which was to be the operative dispositive act — as the testatrix plainly recognized. She did not, as she might readily have done, by her will create any interest of any kind, equitable or legal, conditional or executory, in the Society."<sup>9</sup>

#### Bequests for Masses

Although there appears to be no published decision or ruling on the subject, there seems no cause to question the deductibility of a bequest for masses where the named beneficiary is a church or other bona fide religious corporation or association, or the trustee of an express trust for that purpose. Such organizations are among the types mentioned in section 2055(a)(2), and the requisite religious purpose is evidently present where the transfer is in trust.

Such a bequest to an individual not expressly denominated a trustee raises questions, but in most, if not all, cases a deduction would appear warranted because of the nature of the bequest. Unless the will shows clearly to the contrary, it seems evident that the primary motive of the trans-

<sup>4</sup> O.D. 119, 1 CUM. BULL. 82 (1919).

<sup>5</sup> L.F. Ratterman, 7 CCH Tax Ct. Mem. 476, 496 (1948).

<sup>6</sup> Rev. Rul. 55-759, 1955-2 CUM. BULL. 607.

<sup>7</sup> Rev. Rul. 55-760, 1955-2 CUM. BULL. 607.

<sup>8</sup> *Cox v. Commissioner*, 297 F.2d 36 (2d Cir. 1961); *Estate of Charles J. Barry*, 34 T.C. 160 (1960); *Estate of Mary A. Callaghan*, 33 T.C. 870 (1960); *Estate of George W. Dichtel*, 30 T.C. 1258 (1958).

<sup>9</sup> *Cox v. Commissioner*, *supra* note 8, at 38.

fer is not to benefit the donee but to obtain spiritual benefits for all mankind as well as for the particular person or persons on whose behalf the masses are to be said.<sup>10</sup> There is authority in the decisions of many state courts for the conclusion that, even if the individual is not expressly named as a trustee, the legal effect of such a bequest is to create a trust for a religious purpose, and that the individual donee is either a trustee or a holder of a power in trust.<sup>11</sup> Accordingly, such a bequest would appear to comply with the statutory requisite that a deductible bequest be "to a trustee or trustees . . . to be used by such trustee or trustees . . . exclusively for religious . . . purposes."<sup>12</sup>

Where the bequest for masses is to an individual, it would seem immaterial whether the donee is under a vow of poverty. If the bequest is phrased in such a way that it is clear that the individual is the real beneficiary of the bequest, the existence of a vow of poverty should be insufficient to merit the deduction in view of the rulings and cases referred to above. On the other hand, if the language of the bequest admits the conclusion that it is made to the individual, either expressly or impliedly, as a trustee or a holder of a power in trust for the religious purpose of having masses said, a deduction

would seem to be authorized by the statute, regardless of the absence of a vow of poverty. Indeed, in the latter case, it would not seem to matter that the individual was neither a clergyman nor a member of a religious order. For example, a deduction would appear warranted for a bequest to an executor, whether corporate or individual, who is directed to apply it for the purpose of having masses said for the repose of the soul of the testator. A trust or power in trust for an exclusively religious purpose would doubtless be deemed to have been created.

The draftsman who has satisfied the statutory requirements that a charitable transfer be either to or for the use of a charitable corporation or association or to a trustee or trustees for exclusively charitable purposes has by no means come to the end of the list of problems involved in qualifying the bequest for the federal estate tax deduction. The balance of the list is long and includes three other problems — mixed purpose bequests, conditional bequests, and powers of diversion — which are discussed below.<sup>13</sup>

### Mixed Purpose Bequests

Where a bequest is made for both a charitable and a private purpose, no deduction will be allowed unless the value of the charitable beneficial interest is "presently ascertainable, and hence severable from the noncharitable interest."<sup>14</sup> One type of charitable interest that can be separately valued and, therefore, severed is a gift of a life estate to an individual, or a gift in trust with

<sup>10</sup> If the priests who will celebrate the masses are not subject to vows of poverty, it has been stated that the stipends received by them will be taxable income (but this would seem to be merely an incidental effect). *Cf.* Treas. Reg. § 1.61-2(a) (1958); *YOUR FEDERAL INCOME TAX 33* (Int. Rev. Serv. Publication No. 17, 1964).

<sup>11</sup> SCOTT, TRUSTS §§ 124.4, 371.5 (2d ed. 1956); O'Brien & O'Brien, *Seventy Years of Bequests for Masses in New York Courts, 1883-1953*, 23 *FORDHAM L. REV.* 147 (1954); 1 *CATHOLIC LAW*. 156 (1955).

<sup>12</sup> INT. REV. CODE OF 1954, § 2055(a)(3).

<sup>13</sup> Not discussed here are such matters as the effect of powers of appointment, death taxes payable out of charitable transfers, and disallowance because of "prohibited transactions." See Treas. Reg. §§ 20.2055-1(b), -3, -4 (1958).

<sup>14</sup> Treas. Reg. § 20.2055-2(a) (1958).

income payable to an individual for life or a term of years with the remainder interest in either case given to charity. Since the present value of the charitable remainder interest can be ascertained by reference to appropriate valuation factors, it is deductible under the statute.<sup>15</sup>

A bequest to individuals with a provision that they make suitable charitable gifts out of the property received by them, but without a direction as to the amount or portion of the bequeathed property that must necessarily be given to charity, will not, however, qualify, since the extent to which charitable organizations will benefit is left solely to the judgment of the legatees. At the time of decedent's death, there is no assurance that the charitable beneficiaries will receive any allocable part of the bequest and there is, therefore, no basis upon which the value of the charitable beneficial interest can be ascertained. This is so even if the legatees comply with the wish of the testator and actually distribute sums to charitable corporations. As the owners of the property, they would have made charitable contributions which could be recognized for purposes of their own income tax liabilities, but no estate tax deduction would be allowable to the estate of the testator.<sup>16</sup> Such a bequest is, however, distinguishable from one where executors are directed to distribute the entire amount of a bequest or a specified part among charitable corporations or associations referred to in the statute since, in the latter case, there is the requisite assurance that a definite amount will pass to charity. This would appear to be so even

if the executors have discretion to select the particular charitable beneficiaries, and even if they also have the discretion to determine the proportions in which selected charities would benefit.<sup>17</sup>

### Conditional Bequests

The inclusion in a charitable bequest of a condition that might prevent or interfere with that charitable use jeopardizes deductibility for federal estate tax purposes unless the circumstances are such that there is an assurance that charity will receive the bequest or some determinable part of it.<sup>18</sup>

If the contingency is stated in the form of a condition precedent, requiring the performance of some act or happening of a stated event in order for the bequest to become effective, the bequest will not be deductible "unless the possibility that the charitable transfer will not become effective is so remote as to be negligible."<sup>19</sup> The evaluation of such possibility is to be made as of the date of decedent's death and, as a general rule, it is immaterial if in fact the charitable transfer later becomes effective.<sup>20</sup>

<sup>17</sup> See Parsons, *How Specific Must A Charitable Bequest Be To Be Deductible?*, N.Y.U. 16TH INST. ON FED. TAX 923 (1958).

<sup>18</sup> Commissioner v. Estate of Sternberger, 348 U.S. 187 (1955).

<sup>19</sup> Treas. Reg. § 20.2055-2(b) (1958).

<sup>20</sup> See First Trust Co. v. Reynolds, 137 F.2d 518 (8th Cir. 1943), where deductions were disallowed for bequests to charity subject to the widow's express written consent despite the fact that such consent was given and the bequests were in fact paid to charity before the due date of the federal estate tax return. See also Rev. Rul. 64-129, 1964 INT. REV. BULL. No. 17, at 11, to the same effect, since such a bequest lacks "the necessary completeness and reality at the date of testator's death because of its dependency upon the volitional act of a third party." It should be noted, however, that § 2055(a) also allows a deduction for an interest which becomes part of a

<sup>15</sup> *Ibid.* This section contains a cross-reference to tables in § 20.2031-7 relating to the valuation of annuities, life estates, terms for years, remainders and reversions.

<sup>16</sup> Rev. Rul. 55-335, 1955-1 CUM. BULL. 455.

A deduction will not be allowed, for example, for a gift of a charitable remainder interest that is to take effect only if a named person predeceases other named persons, at least where the actuarial chance that the charity will not take is substantial.<sup>21</sup>

There is a similar rule with respect to the imposition of conditions subsequent. If a bequest is vested in a charity at the time of decedent's death, but could be defeated by the later performance of some act or the happening of some event, a deduction will not be allowed, unless the occurrence "appeared to have been highly improbable at the time of decedent's death."<sup>22</sup> One example of a disqualifying condition subsequent would be a bequest of a remainder interest to charity, subject to being defeated if the life tenant, who had no living issue at the time of the decedent's death, were survived by issue,<sup>23</sup> unless at the time of decedent's death such issue was a medical impossibility.<sup>24</sup>

### Powers of Diversion

In keeping with the philosophy that the allowance of a deduction will depend upon

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charitable bequest as a result of an irrevocable disclaimer "if the disclaimer is made before the date prescribed for the filing of the estate tax return." The subsection also provides that the complete termination before such date of "a power to consume, invade, or appropriate property for the benefit of an individual before such power has been exercised" will be considered and deemed to be an irrevocable disclaimer.

<sup>21</sup> See *United States v. Dean*, 224 F.2d 26 (1st Cir. 1955), which denied a deduction where the actuarial chance of the charity not taking was one in eleven.

<sup>22</sup> Treas. Reg. § 20.2055-2(b) (1958).

<sup>23</sup> *Commissioner v. Estate of Sternberger*, *supra* note 18.

<sup>24</sup> See *United States v. Provident Trust Co.*, 291 U.S. 272 (1934), where there was inability to bear children because of surgery.

the existence at the time of testator's death of assurance that charity will receive the bequest or some determinable part of it, the Treasury Regulations provide that where anyone is empowered to divert the bequest in whole or in part to a noncharitable use or purpose, "the deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of the power."<sup>25</sup> One quite obvious example would be a bequest to charity of all of the furniture and furnishings located in the decedent's residence at the time of his death, coupled with a provision giving a named relative the right at any time within two years after the date of death to select any part or all of such property for his own use and benefit.<sup>26</sup>

In the case of bequests in trust, the limitation on the deduction can operate both as to the principal and the income. While a bequest to charity of the income of a trust for a term of years would ordinarily be susceptible of valuation and consequently deductible, the deduction would be defeated if there was a discretionary power in the trustee or anyone else to pay the trust income to or for a noncharitable beneficiary.<sup>27</sup> Similarly, a charitable remainder interest will not be deductible if there is a discre-

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<sup>25</sup> Treas. Reg. § 20.2055-2(b) (1958).

<sup>26</sup> An irrevocable disclaimer could preserve the deduction if it became effective before the due date of the federal estate tax return. The period presently prescribed is fifteen months after the decedent's death, unless an extension of time has been granted. See Treas. Reg. § 20.6075-1 (1958), relating to the time for filing the return. *But see* note 19 *supra*.

<sup>27</sup> The regulations give the less obvious example of a trust funded by stock of a closely-held corporation where there is no assurance that there will be the requisite enjoyment of income by the charity. Treas. Reg. § 20.2055-2(b) (1958).

## CHARITABLE BEQUESTS

(Continued)

tionary power to invade the principal of the trust for a noncharitable beneficiary, unless the power of invasion is limited by a definite standard and as of the date of decedent's death the likelihood of any invasion is so remote as to be negligible.<sup>28</sup> A deduction for the charitable remainder is also jeopardized where a trustee is authorized to distribute to a noncharitable life tenant capital gains dividends received on stock of regulated investment companies.<sup>29</sup>

### Conclusion

These observations on some important federal estate tax considerations in drafting charitable bequests have been offered only

<sup>28</sup> Rev. Rul. 54-285, 1954-2 CUM. BULL. 302. See also the appendix to the opinion in *Kline v. United States*, 202 F. Supp. 849 (N.D.W. Va. 1962), where the cases on invasion of charitable remainders are collected and analyzed in tabular form.

<sup>29</sup> Rev. Rul. 60-385, 1960-2 CUM. BULL. 77.

as a brief review for those who are already familiar with the subject and as an introduction for others. For those interested in reading further, there is a substantial body of literature available.<sup>30</sup>

If one were to single out a recommendation for estate planning in this area, it would be that the lawyer approach the drafting of all but the most routine bequests as one challenged to conform the product of his draftsmanship to the provisions of highly technical statutory and regulatory provisions. Working with the Code and the estate tax regulations at one's elbow gives reasonable assurance of solving all but the most abstruse problems.

<sup>30</sup> E.g., Fraser, *Charitable Giving as an Element in Planning Lifetime and Testamentary Giving*, N.Y.U. 19TH INST. ON FED. TAX 751 (1961); Golden, *Use of Charitable Gifts in Estate and Tax Planning*, 100 TRUSTS & ESTATES 898 (1961); Quiggle & Myers, *Tax Aspects of Charitable Contributions and Bequests by Individuals*, 28 FORDHAM L. REV. 579 (1960); and Richardson, *Gifts of Property to a Charity*, 1957 SO. CAL. TAX INST. 705.