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CHARITIES, IN THEIR QUESTS for contributions today, are making more people conscious of the complexities of the tax laws concerning gifts to charities and the importance to the taxpayer donor of choosing the correct path in the labyrinth of the Internal Revenue Code. Most prospective donors in the high income tax brackets, and their attorneys, are fully aware of the advantages of contributing assets, especially securities, which have increased in value.

Within recent years the use of trusts has received considerable attention in tax institutes and law review articles.[1] Charities, particularly educational institutions, have sought to capitalize on the provisions of the tax laws to promote greater largess on the part of the prospective donors. Their efforts have included extensive advertising campaigns focusing attention on these tax laws and their advantages. Fear of resulting wholesale tax avoidance, with consequent shifting of tax burdens to others, has caused the Internal Revenue Service, in recent months, to review its position on many matters affecting gifts to charities.

Most of the advertising involving the use of trusts in making charitable contributions properly suggests that the prospective donors consult their attorneys. The purpose of this article is to review for the general practicing attorney the benefits to clients available in this area, together with some of the possible problems encountered in the various methods of making charitable contributions through the use of trusts.

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1 See generally Rudick & Gray, *Bounty Twice Blessed: Tax Consequences of Gifts of Property to or in Trust for Charity*, 16 TAX L. REV. 273 (1961); Lowndes, *Tax Advantages of Charitable Gifts*, 46 VA. L. REV. 394 (1960); Quiggle & Myers, *Tax Aspects of Charitable Contributions and Bequests by Individuals*, 28 FORDHAM L. REV. 579 (1960); Golden, *Use of Charitable Gifts in Estate and Tax Planning*, 100 TRUSTS & ESTATES 898 (1961).

Short-Term Charitable Trusts

With Reversionary Interests

So-called short-term trusts can be used to increase charitable contributions in two ways. The first is a rather simple avoidance, with congressional blessing, of the percentage limitation on charitable contributions and can be used when a person has income-producing property. For some time, the limitation on deduction of general charitable contributions for individuals has been 20% of the taxpayer's adjusted gross income.[2] In the 1954 Internal Revenue Code, an additional deduction of 10% was added if the contribution is "to" a church, hospital, or educational institution. It will be noted that transfers "for the use of" these organizations do not qualify for the additional deduction.[3] For practical purposes, the maximum limitation is 30% in the ordinary situation, since most people would be giving at least one-third of their contributions to one of the three favored types of charitable organizations. However, people who want to give more than 30% of their adjusted gross income to charitable organizations can do so and obtain the resulting tax benefit through the use of a short-term trust by depositing income-producing assets in trust, with the direction that the income be paid to charity for a period of years. At the end of the period, the property can revert to the donor.

If the charity is one of the above-mentioned three favored types of charities, the trust need only last for a period of two years. For other charities, the trust must last for ten years.[4] There is really no practical reason for the creation of such a trust unless the donor is giving more than his maximum charitable contribution, since the only advantage is that the income for the term of the trust is excluded from the income of the donor. A deduction for the present value of the charitable interest at the time of the creation of the trust is specifically disallowed.[5]

For example, let us suppose that the donor has income-producing assets worth $20,000 which yield $700 annually. He transfers these into trust for at least a two-year period, with the income to be paid to one of the favored charities. At the end of that period the property reverts to him. The income will not be taxed to the grantor so long as he is not treated as a substantial owner under other sections of the Internal Revenue Code,[6] but he is not entitled to any charitable deduction.

Without Reversionary Interests

The second possible use of short-term trusts follows the first in that income-producing property is transferred in trust, with the income being paid to a charity, but instead of reverting to the donor, the property is to be distributed to someone other than the donor at the end of the prescribed period. This type of trust has the advantage of the first-mentioned trust, but in addition, a deduction is allowed in the year of transfer for the present value of the charitable interest transferred. This has been called a double deduction and the propriety of its allowance has been questioned.[7] However, its availability was ef-

[2] INT. REV. CODE OF 1954, §170(b)(1)(B).
[3] INT. REV. CODE OF 1954, §170(b)(1)(A).
[4] INT. REV. CODE OF 1954, §673.

[5] INT. REV. CODE OF 1954, §170(b)(1)(D).
[6] INT. REV. CODE OF 1954, §§671-78.
[7] Neuhoff, *How to Make Money by Giving It Away: Tax Consequences of Creating a Charitable Trust*, 23 U. PITT. L. REV. 105 (1961). Mr. Neuhoff presents various exhibits, showing how

fectively confirmed by Congress in 1958 when the Senate rejected a provision of the House bill which would have denied the deduction if the corpus were eventually to go to a closely related person. The conference committee accepted the Senate action.

Assuming, for example, the same facts as in the reversionary trust described above, but having the property eventually pass to others, the donor would obtain in the year of transfer a current income tax deduction of $1,330[8] (the actuarial value of the right to the income from $20,000 for two years), in addition to having the income excluded from his tax return. If the period of the trust were for ten years, the amount of the current income tax deduction would be $5,820.

This device may be used where the donor may wish to pass property to his children or others at a future time. The remainder interest is subject to gift tax, but the income tax savings may be used to apply against any such gift taxes. If the trust is a two-year trust, the gift to the remaindermen would amount to $18,670. If it were to continue for ten years, the gift would amount to $14,180.

a taxpayer may make money by the creation of such a trust. However, the same results can be accomplished by an outright contribution to charity equal to the value of the income interest and outright gifts to others equal to the value of the remainder interest. The exhibits merely show the tax value of making gifts when a person is in a high tax bracket. An outright gift of income-producing property to a charitable organization in itself could be called a double deduction under the same theory, in that the donor not only gets a deduction but is not taxed on the income from the property in subsequent years.

[8] Treas. Reg. §20.2031-7, Table II (1958). For convenience, the amounts shown in examples are rounded off to the closest $10.00.

Another benefit is that any tax on the gain on the sale of the assets would be taxed to the trust or trusts so that the capital gains tax would normally be less than where it would be taxed to the donor, who would usually be in a higher income tax bracket. Assuming the assets had a basis of $4,000, and were sold by the trustee over a two-year tax period for $20,000, the tax on the capital gains would amount to $1,360, as against a possible tax of 25% of the gain, or $4,000 if sold by the donor. These computations assume that two trusts are used, one for each of two children, and that $5,000 of assets were sold in each trust in each tax year. The two-year tax period could be obtained by choosing a fiscal year closing at the end of any month after the creation of the trust so that, in effect, the assets could be sold in the first two months of the existence of the trust.

Thus, it can be seen there are many benefits to this plan, but it is felt by the authors that they are not unintended benefits and, as noted, Congress agrees. Similar tax results can be obtained by making current outright gifts of the dollars involved (for example, $1,330 outright to charity, and $18,670 outright to the children) rather than splitting the property into a term for years and a remainder interest. But the use of the trust has several advantages, including a delayed gift to the children until they may be better equipped to manage the property and preservation of the property intact under a single management.

Charitable Remainder Trusts

The converse of giving an income interest to charity is the gift of a remainder interest to charity. This relatively simple and painless method has received quite a bit of publicity in recent years. An attorney drawing wills is in a good position to recommend the use of such a trust. For example, if a man indicates that he wants to bequeath $10,000 to his alma mater by his will, he should be advised that he can create an inter vivos trust reserving the income for his lifetime and that, at his death, the corpus of the trust would pass to his alma mater, thus accomplishing what he was thinking of accomplishing in his will, but, in addition, giving him certain immediate income tax benefits. The estate tax result would be the same as if he had made the charitable contribution by will.[9]

Because he is giving up the right ever to use the corpus, our donor is entitled to a current income tax deduction for the value of the remainder interest. This is computed in accordance with tables furnished by the Treasury Department as a part of their regulations. For a man sixty years of age depositing $10,000 into such an inter vivos trust, the charitable deduction, that is, the value of the remainder interest, will amount to $6,030. If the donor includes his wife as a successive income beneficiary and she is also sixty years of age, the value of the charitable remainder drops to $5,040.[10] If the donor includes a daughter thirty years of age as a successive income beneficiary, the value of the charitable remainder drops to $2,680. If there are more than two income beneficiaries, the actuarial value must be obtained from the Commissioner of Internal Revenue.

Since the charitable deduction reduces the donor's current income tax, in effect it increases his spendable income.[11]

If property which has appreciated in value over its basis is used to fund the trust, additional income tax advantages result, in that there is no taxable realization of gain to the donor caused by the transfer to the trust and, if the trustee sells the property, there is, in effect, no tax on the capital gain. The gain on sale is included in the income of the trust, but then the trustee may take a deduction for it because it is permanently set aside for charity.

The trustee may invest in whatever assets he deems prudent.[12] If the donor is in a high income tax bracket, it may be advantageous for the trustee to invest in tax-exempt municipal bonds. The income resulting therefrom will be tax-free to the donor or to any other income beneficiaries because of the conduit rule set up in the 1954 Internal Revenue Code. As the fortunes and the tax brackets of the income beneficiaries may change, the trustee can adjust between taxable and tax-exempt investments.

Within the past year and a half, certain problems have arisen concerning this type of gift. The first indication that there might be a problem was noted in the *Wall Street Journal,* issue of September 16, 1960. Several colleges had set up plans whereby the gift was made directly to them and they, in turn, contractually agreed to pay the donor either:

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[9] Because he has reserved the income during his lifetime, the trust will be included in his gross estate. INT. REV. CODE OF 1954, §2036(a)(1). But it will not result in any estate tax since he will get a charitable deduction for the value of the trust. Additionally, he will not lose any marital deduction.

[10] *Actuarial Values for Estate and Gift Tax,* Int. Rev. Serv. Pub. No. 11 (Rev. May 1959).

[11] Brown, *Increasing Spendable Income by Gifts to Charity,* 97 TRUSTS & ESTATES 1168 (1958).

[12] Assuming the usual prudent man rule, *e.g.*, CAL. CIV. CODE §2261.

(1) income at a rate equal to the available net income earned on all pooled investment funds; or

(2) income from tax-exempt bonds purchased after the assets transferred to the charity were sold.[13]

The Treasury Department had given private rulings to these colleges. The rulings, using the same theory as if the property had been transferred in trust, held that all the heretofore-discussed tax benefits were available. On the basis of these rulings, extensive advertising campaigns were entered into espousing the tax benefits of the plan. Because certain colleges were going about this in a commercial manner, there has been speculation that the Treasury Department might attempt to treat the pooled investment fund as an association taxable as a corporation, with the resulting tax disadvantages to the donors. Because of this, it has been suggested that it may be best to use an independent trustee until there has been some clarification in this area.[14]

Actually, it would seem to the advantage of both the charity and the donor to have an independent fiduciary act as a trustee in any event. As far as the charity is concerned, it does not have the expenses of managing the trust property. As far as the donor is concerned, the trust can be tailor-made to his own wishes and desires and he can be assured of independent professional investment management. Even though there are charges incurred, the use of an independent trustee should net him as much income over the average lifetime of the trust. It is not unusual to have yields of more than 10% of the amount of the original transfer where the trust has been in existence for a few years. If an independent trustee is used, the donor can also reserve the right to change the charities during his lifetime.

The second problem relating to charitable remainder trusts involves the avoidance of income tax on capital gains where property has appreciated in value. It was thought by some authorities that the Treasury Department was going overboard in allowing the capital gain to go tax-free where the gift was to the charity with the understanding that the charity would sell the assets.[15] Confirming these fears, the Treasury Department, in December 1960, published Revenue Ruling 60-370, which held that the gain on sale of appreciated securities deposited in the so-called tax-free life income plan set up by certain colleges would be taxed to the donor on the apparent theory that the proceeds from the sale of the securities were being transferred rather than the securities themselves. The ruling goes on to state that when there is an obligation, either expressed or implied, imposed upon the trustee to sell or exchange the transferred property and invest in tax-exempt securities, the gain on the sale of the securities will be taxed to the donor. No advance rulings will be issued on the question as to whether there is such an obligation. The ruling was made prospective in its effect, thus applying only to transfers after December 2, 1960. This

[13] The gift annuity contract is not considered here. The reserved income plan is more attractive in the usual situation. Bowe, *Taxes and Charitable Giving to the University*, 33 ROCKY MT. L. REV. 298 (1961).

[14] Toll, *Tax Problems in Connection with Contributions to Colleges*, U. SO. CAL. 1962 TAX INST.

[15] Bowe, *supra* note 13, at 309, citing Commissioner v. Court Holding Co., 324 U.S. 331 (1945). Prof. Bowe, incidentally, notes that reliance on private rulings in this area might prove foolhardy.

ruling has been considered as a blessing in disguise as it states in effect that any further tightening up in this area will also be prospective.[16] An independent corporate trustee having full investment discretion would not be under any obligation to sell the assets deposited and invest in tax-exempt securities, so there should be no problem if such a trustee is used.

Shortly thereafter, the Treasury Department published Revenue Ruling 60-385, which reversed a previous ruling which held that the capital gain dividends of mutual funds could be treated as income in such charitable remainder trusts. The new ruling thus poses a new problem in holding that, as to transfers made after January 1, 1961, where there is a possibility that capital gain dividends might be treated as income, the valuation of the charitable remainder is not ascertainable and therefore no charitable deduction will be allowed. This ruling affects all trusts with charitable remainders, both as to income tax and estate tax aspects.

It has been suggested that, in view of the foregoing, a specific clause be inserted in a trust instrument indicating clearly that capital gains dividends of regulated investment companies shall not be treated as income and that the matter not be left as a question of state law.[17] The insertion of such a clause would be especially important if the trustee were given any discretion as to determining what is income or principal.

[16] Brown, *The Tax Use of Charitable Trusts,* 39 TAXES 748 (1961). For a complete critical analysis of the ruling, see Trautman, *Taxation of Gifts in Trust to Charities Reserving a Life Income Interest,* 14 VAND. L. REV. 597 (1961).

[17] Colgan, *"Remainder to Charity" Wills May Lose Tax Exemptions if Mutual Funds Are Used,* 15 J. TAXATION 43 (1961).

A minor problem, which relates both to charitable remainder and short-term nonreversionary trusts, concerns whether the interest given qualifies for the 10% additional deduction. As noted previously, the extra deduction for contributions to the favored charities applies only if the gift is "to" the charity. It does not apply to gifts "for the use of" the charity, which includes gifts in trust for charity. The Internal Revenue Service has ruled that where the college is, in effect, the trustee, the deduction applies.[18] Even though an independent trustee is used, the deduction should also apply if the trust corpus is to be distributed to the favored charity upon termination, since the remainder interest in that event is a gift to charity. This area awaits additional clarification.

Conclusions

The types of trusts described herein are extremely useful in estate planning and should be investigated whenever a client is considering substantial gifts to charities. The trust device enables the division of property in terms of time, *i.e.,* life estates, estates for years and remainder interests, while keeping the management of the property under one roof.

An awareness of possible problems and a realization that this is a dynamic area where future rulings may come at any time will make one cautious and avoid extreme applications. But careful planning and draftsmanship will permit the practicing attorney to assist his client in making charitable transfers in trust in a manner which will produce the greatest benefits to the donor, his family, and his favorite charities.

[18] Letter Ruling to Pomona College, Feb. 11, 1959.