Planning Charitable Bequests That Save Both Income Taxes and Estate Taxes

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AMERICAN INSTITUTE *for* CANCER RESEARCH

Major Gifts, Trusts and Bequests
For the American Institute for Cancer Research

The American Institute for Cancer Research is devoted to the task of conquering our nation's most dreaded illness. Each year, the Institute sponsors important research projects at universities and research facilities across America, focusing on the cause and prevention of cancer. It has long been a leader in providing effective educational programs on the prevention of cancer – directed to both health care professionals and the general public.

The primary focus of the American Institute for Cancer Research – in both its research projects and its educational programs – has been the role of diet and nutrition in the development and prevention of cancer. (There is scientific evidence that estimates an average of 35% of all cancer deaths might be linked to diet and nutrition.)

We are winning the war against cancer. But there is still a great need for additional scientific research on the cause, prevention and treatment of cancer. As we learn more about the role of nutrition in the cause and prevention of cancer, our educational programs become more and more important and rewarding.

Millions of Americans provide financial support to our programs – often through tax-planned gifts, trusts and bequests. To encourage, facilitate and recognize this very important financial support, the Institute has created the League of Willful Cancer Fighters. We will be pleased to enroll in the League any client who has made, or intends to make, a bequest to the Institute or name the Institute as the beneficiary of a trust, life insurance policy, retirement death benefit or other form of estate gift. We invite you or your client to call us at your convenience.

We have prepared this booklet to help attorneys and other financial advisers understand all the important tax and financial rewards Congress has provided. Our staff can provide the exact tax and financial consequences of any gift, trust or bequest your clients may want to consider. Because we are so active in this specialized field, we can provide whatever technical and practical information you may request for planning and drafting a charitable gift arrangement that will provide your clients both the greatest personal satisfaction and the greatest tax and financial rewards.

Please feel free to call the Office of Gift Planning at any time. Our toll-free telephone number is 1-800-843-8114 or contact us by email at gifts@aicr.org. And please . . . if the opportunity presents itself, inform your clients about how a gift, trust or bequest to the American Institute for Cancer Research can help in the fight against cancer, while also enhancing their personal tax, investment, retirement and estate plans.

PLANNING CHARITABLE BEQUESTS THAT SAVE BOTH INCOME TAXES AND ESTATE TAXES

Where possible, clients should bequeath to charity assets that would result in tax problems for other beneficiaries. That generally means *income in respect of a decedent* (IRD) – items of income earned by decedents before death but paid to their estates after death. Such income is includible both in the taxpayer's gross estate and in the estate's income.

Charities usually do not pay income taxes and therefore keep every dollar of such tax-burdened bequests. Furthermore, a bequest of IRD can create both an estate tax charitable deduction and an income tax charitable deduction for the estate [I.R.C., §642(c)(1), plus relief from state inheritance or estate taxes, where applicable.

It's important, from a tax standpoint, for a client's will to make specific bequests of items of IRD to charity, or to have IRD assets pass to charity as a residuary bequest. Alternatively, a client can change the death beneficiary of a qualified retirement plan or IRA to a qualified charity. Satisfying pecuniary bequests to charity out of IRD items will generate an estate tax charitable deduction but the estate will have to include the IRD in its income [See Treas. Reg. §1.691(a)-4(a)].

One commentator suggests the following will or trust provision: "I give and bequeath to XYZ charity all the income in respect of a decedent included in my estate's gross income, or to which my estate is otherwise entitled."

Examples of IRD items include:

- interest on U.S. savings bonds;
- undistributed balances remaining in IRAs and qualified retirement plans;
- accounts receivable of a cash-basis individual;
- renewal commissions of insurance agents;
- deferred compensation, last salary check, bonuses and stock options;
- accrued royalties under a patent license;
- a deceased partner's distributive share of partnership income up to date of death;
- remaining payments on installment obligations.

U.S. SAVINGS BONDS: A COMMON SOURCE OF IRD

Millions of Americans own U.S. savings bonds. Older individuals usually seem to have some, tucked away in a bureau drawer or safe deposit box. Paper bonds are no longer sold, but electronic bonds can be purchased at savingsbonds.gov. Series EE bonds and Series I bonds are purchased at face value and earn interest tax-deferred for up to 30 years, although owners have the option of reporting interest on an annual basis.

Bonds are always free of state and local income taxes and the interest accumulates free of federal income tax, as well, for cash-basis taxpayers who do not elect to report their bond interest annually as it accrues. Taxation generally occurs only when the bonds are cashed, reissued to another person or reach final maturity. Bonds may be subject to heavy federal income taxes and state and federal estate or inheritance taxes in a person's estate. For example, heirs who receive $100,000 in savings bonds from a decedent's estate may one day have to pay income tax on as much as $50,000 or more of built-up interest. Furthermore, the full $100,000 could be subject to federal estate tax, leaving only a fraction of the bonds' value remaining.

Bonds are commonplace among persons who reached adulthood in the 1940s, 1950s and 1960s and elderly people often own substantial quantities, worth hundreds of thousands of dollars or more. An attorney from Ohio reported the existence of a testamentary trust containing $2 million in savings bonds. Many bondholders may not realize that some bonds no longer earn interest: Savings bonds stop producing interest after 30 years. Owners should redeem these "matured" bonds and reinvest the proceeds – although they generally will owe tax on the buildup of interest. Series HH bonds, which are no longer sold, pay interest semi-annually for 20 years. For more information on interest rates and maturity dates, see the Treasury savings bonds website, www.savingsbonds.gov.

Bequests of Savings Bonds by Will or Living Trust

Bonds may be transferred to charity at death in only two ways: under the terms of the client's will or as a distribution from a revocable living trust. Why can't charity be listed as a co-owner or death beneficiary on the bond itself?

> "The issue or reissue of a bond in the name of an organization (charitable and others) as a co-owner or beneficiary is not permitted; such forms of registration are limited to natural persons. Reissue of a bond in the name of an organization to designate another organization as owner is not permitted, but a bond that an organization receives as a distributee of a decedent's estate may be reissued in its name."
>
> "Legal Aspects of U.S. Savings Bonds"
> Bureau of the Public Debt
> Department of the Treasury
> (See Title 31, Code of Federal Regulations, Section 315)

Treasury regulations do permit one particular "organization" to be named co-owner or beneficiary: The U.S. Treasury. [31 CFR 315.7(g)]. Patriotic bondholders are not allowed to change their minds, however:

"Restrictions on reissue . . . (b) United States Treasury. Reissue may not be made to eliminate the United States Treasury as co-owner or beneficiary" (31 CFR 315.48).

Series EE, HH and I bonds may be issued or reissued in the name of a trustee of a revocable trust, if the bondholder is the lifetime (income) beneficiary and is considered the owner of the trust under the grantor trust rules. For example, an HH bond could be registered to: "the American Institute for Cancer Research, trustee under agreement with Mary Jones, dated 12/1/95, 12-3456789." Mary's tax situation would be the same as if the trust never existed. But AICR could be the remainder beneficiary of the trust and thus receive the bonds at her death.

Bonds can be left to charity in a will or through a revocable living trust only if the bonds do not have a surviving co-owner or death beneficiary. Savings bonds registered in either co-ownership or beneficiary form become the sole property of the survivor, irrespective of the terms of any will.

Savings bonds that are specifically bequeathed to a tax-exempt organization (or distributed from a revocable living trust) will avoid income taxes and also qualify for an estate tax charitable deduction.

Caution: It is important that clients specifically identify which bonds they are leaving to charity, including the denominations and serial numbers (unless the will or trust states that "ALL my U.S. savings bonds" are to pass to charity, or if bonds pass to charity as sole residuary beneficiary). Where a decedent directed that a specific dollar amount pass from her revocable living trust to charity and the trustees proposed to satisfy the bequest by distributing Series E and Series H bonds with unreported increments in value, the IRS ruled that the distribution of the savings bonds would be considered a distribution of cash to charity and a purchase of the bonds from the trust, with the increase in value included in the gross income of the trust (PLR 9315016).

In another ruling, the IRS said the trust must recognize the unreported increment as IRD to the extent the bonds are used to satisfy a specific dollar bequest if the bonds are not directed to be paid to charity (PLR 9507008). See, generally, Reg. §1.691(a)-4(a). But, where the entire residuary estate passed to four named charities in varying amounts and savings bonds with unreported interest were included in the residue, the estate was not taxed on the IRD when the executor transferred the bonds to one of the charities. Both the will and state law allowed the executor to make non-pro rata distributions of capital assets, so the transfer was not a disposition by the estate followed by an exchange between beneficiaries (PLR 9537011).

Bequests of Bonds to Charitable Remainder Trusts

Case Study. A 77-year-old woman, who has always lived frugally, amassed the startling sum of just over $600,000 in U.S. savings bonds (Series I and EE). Her estate, including the bonds, exceeds the federal estate tax exemption ($5.25 million in 2013, indexed for inflation). She's unmarried, but has several brothers and sisters she wants to benefit, as well as the American Institute for Cancer Research.

Her adviser didn't know the exact amount of unreported interest tied up in the savings bonds, but it likely exceeded $300,000. The bonds will be treated as IRD in the woman's estate or in the hands of family members who receive the bonds – meaning they will be subject to income tax on all accumulated interest. Part of the bonds' value also could be subject to federal estate tax, assuming her total estate exceeds the exemption in effect at her death.

The adviser suggested the client establish a unitrust in her will and specify that the trust will be funded with the savings bonds. The trust would last for 20 years and make payments to her brothers and sisters (or to the children of any brother or sister who died prior to termination of the trust). The trust will eliminate income taxes on the savings bonds when they are redeemed by the trustee of the unitrust, which is tax exempt. The interest on the bonds will be passed through to the trust beneficiaries as part of their annual unitrust payments, under the four-tier system, and taxed as ordinary income. But there is no depletion of the trust corpus from tax. Furthermore, the client's estate is entitled to an estate tax charitable deduction. If the trust has a 6% payout, roughly 30% of the bonds' value will be a deductible bequest ($180,000). That deduction would save as much as $72,000 in estate taxes, which would pass to her family.

Note: If the client's estate is subject to federal estate taxes, the income beneficiary may not benefit from an IRD deduction for amounts of IRD that are received and distributed by the charitable remainder trust. The IRS has ruled, in the context of a bequest of an IRA to a charitable remainder trust, that the deduction will belong to the trust, not passed through to the income beneficiaries. The result is to convert part of the trust's income (IRD) to tax-free corpus – which the income beneficiaries may be unlikely ever to access, under the four-tier system of CRT taxation (PLR 9901023).

Receipt of Bonds by Donee Charity

Charities that receive bonds from an estate may request payment or reissue in the charity's name upon showing a certified copy of the executor's court-approved final report, the decree of distribution or other pertinent court records. The charity's representative must furnish proof that he or she is an authorized agent.

Private foundations are subject to a 2% excise tax on net investment income [Code §4940(a)]. In Rev. Rul. 80-118 (1980-1 C.B. 254) the IRS ruled that where a decedent's estate distributed Series E U.S. savings bonds to a private foundation, the increase in value of the bonds was gross investment income to the foundation when the bonds were redeemed.

CHARITABLE BEQUESTS OF IRAS AND OTHER RETIREMENT ACCOUNTS

With the exception of qualified charitable IRA distributions by persons over 70½, tax results are poor when clients make lifetime charitable gifts from IRAs and qualified retirement plans. At best, any charitable deductions will simply wash out the taxes donors become liable for when they move funds out of their accounts. But gifts at death are an entirely different proposition. A combination of state and federal income taxes and estate taxes can nearly confiscate the retirement savings accounts of many clients at death, leaving little remaining for heirs (see the following table). Here is a list of taxes that may await a person's retirement savings at death – IRA, pension plan, Keogh, 401(k) account, etc.:

Estate Taxes. The full, date-of-death value of retirement savings is subject to 40% federal estate tax above the exemption level (I.R.C., §§2001, 2031). In some states, estate or inheritance taxes will sap retirement accounts, even where no federal estate tax was due.

State and Federal Income Taxes. Both federal income tax and state income tax (depending on the place of residence of one's heirs) will be due on amounts received from an IRA or other plan – costing up to 50% or more [I.R.C., §691(a)(1)].

Generation-Skipping Transfer Tax of 40% is due when retirement savings pass to a grandchild or other "skip" person (tax applies above the current exemption amount) (I.R.C., §§2601, 2613).

Estate taxes can be postponed when retirement assets pass to a surviving spouse who then establishes a "rollover IRA." But an expensive visit from the tax collector – up to 60% or more – lies ahead when death benefits from retirement savings pass from decedents who lack the estate tax marital deduction. Philanthropic clients, therefore, may be well advised to choose IRAs or qualified plan assets for charitable bequests and leave other assets that are less tax burdened to other beneficiaries.

Erosion from Taxes on Retirement Accounts

	Total Income Taxes	Federal and State Estate Taxes	Generation Skipping Tax	Remaining for Heirs
Harold's Estate ($1,000,000 total estate)				
$100,000 IRA passes to children*	$ 37,690	None	None	$62,330 (62%) from original $100,000 IRA
Sarah's Estate (2013 death) ($7 million taxable estate)				
$1 million IRA passes to children**	$247,540	$392,000 FET + 20,000 State $412,000 total	None	$340,460 (34%) from original $1 million IRA

* The example of Harold's estate assumes children are in a 33% federal income tax bracket and a 7% state income tax bracket (state taxes are deductible against federal).

** The example of Sarah's estate assumes heirs will be in a 33% federal income tax bracket and a 7% state income tax bracket (state taxes and federal estate taxes are deductible against federal income tax).

Illustration for Sarah, Death in 2013

1. Calculate federal estate tax/state estate tax ($50,000) on entire $7 million taxable estate ($730,000 total).
2. Calculate tax omitting the $1 million IRA ($6 million, with $30,000 state tax assumed): $288,000 federal + $30,000 state = $318,000.
3. Subtract line 2 from line 1. Difference ($392,000 estate tax + $20,000 state death tax) is amount of total death taxes (state and federal) attributable to the IRA. State estate tax ($20,000) does NOT provide an IRD income tax deduction. So the IRD deduction is only $392,000.
4. State income tax is based on full $1 million (assuming 7% of federal AGI), equaling $70,000.
5. Federal income tax is $1 million minus $392,000 FET (the IRD deduction) minus $70,000 state income tax, equaling $538,000 x 33% = $177,540. Add state tax of $70,000 = $247,540.
6. Shrinkage of IRA, then, is $1 million minus $412,000 state/federal estate tax minus $247,500 combined state/federal income taxes, for a total of $659,540, leaving only $340,460 for heirs (34¢ on the dollar).

Results of a charitable bequest? All taxes on these IRA assets would be avoided, meaning tremendous benefit to the organization's programs at little cost to heirs. Substantial tax savings also would occur if retirement assets were left to a charitable remainder trust from which income is paid to heirs over a term of years.

Options for Arranging Bequests

Beneficiary Change. Donor gives written instructions to the custodian of the retirement account naming charity or a charitable trust as death beneficiary. The custodian can provide the appropriate forms. Note: If the client is married, his or her spouse's written consent will be required to make charitable gifts from qualified plans (not IRAs).

Will or Living Trust. In the unusual case that no beneficiary is named for an account, clients can change a will or living trust so that retirement assets are specifically designated to pass for the charity's benefit (or as part of the "residue" of the estate if charity is the sole residuary beneficiary).

Qualified Disclaimer. Clients should consider making the American Institute for Cancer Research the contingent beneficiary of retirement plan death benefits and give heirs the right to "disclaim" benefits. Heirs who understand the severity of taxes may decide it best to have retirement assets pass to a worthwhile cause such as AICR.

Planning Considerations for Bequests of IRAs and Other Retirement Accounts

Clients can designate charity as beneficiary of all or part of their IRAs without the need to split the IRA into multiple accounts for family and charity. The regulations suggest that a charity that is a co-beneficiary of a retirement account can "cash out" of the arrangement after the donor's death, permitting a family IRA beneficiary to use his or her own life expectancy to calculate future distributions. In general, designated beneficiaries can stretch out distributions over their life expectancies, according to Table V of Reg. §1.72-9. Charity's "cash-out" needs to occur, however, by September 30 of the year following the year in which the donor died. Otherwise, IRA payments would be accelerated as follows:

Donor dies before required beginning date. IRA funds must be paid out within five years to all beneficiaries, if charity is a beneficiary. As noted, this result can be avoided if a charity (or a charitable trust) cashes out in a timely manner; alternatively, the IRA can be divided prior to death into separate accounts for charity and family members.

Donor dies after required beginning date. Distributions will be made over five years or the life expectancy of someone the donor's age at death, whichever is longer, if the charity has not cashed out. Life expectancy will exceed five years for all individuals up to age 89.

Donors reportedly have had difficulty arranging pecuniary bequests to charity ($25,000, for example) from IRAs, perhaps due to internal policies of custodians or trustees that permit only percentage or fractional distributions. One solution might be to state the pecuniary distribution as a fraction in which the numerator is $25,000 (or whatever amount the donor wishes to leave to charity) and the denominator is the date of death value of the entire account.

Contingent Designations and Disclaimers

Clients should consider what would happen if their designated beneficiary dies before them. Naming charity as a contingent beneficiary would assure the retirement account would pass 100% free of taxes. Giving the beneficiary the right to disclaim benefits, in favor of a named organization, adds even more flexibility. Caution must be exercised in the following areas:

- Except for a surviving spouse, an individual cannot make a valid disclaimer of IRA benefits into a charitable remainder trust if that person will be a beneficiary of the trust [Reg. §25.2518-2(e)(3)].
- Disclaimers of assets to a private foundation will not have desired tax results if the person disclaiming is a director of the private foundation. One alternative would be to provide for a disclaimer to a donor-advised fund of a community foundation.

Charitable Remainder Trusts as Account Beneficiaries

The IRS has approved a testamentary transfer of funds from a retirement account to a charitable remainder unitrust for the benefit of a surviving spouse (PLR 9253038). A husband established the trust during his life, using other assets, and upon his death part or all of his retirement account will be transferred to the trust as an additional contribution. The Service ruled that the value of his wife's interest would qualify for the estate tax marital deduction and that his estate would be entitled to an estate tax charitable deduction for charity's remainder interest.

The donor's wife, if she is a "reliable spouse" could have received the full proceeds of her husband's IRA and rolled them over into a separate IRA, where the assets would have continued to earn income, tax deferred [I.R.C., §402(a)(7)]. In another ruling, the IRS wrote that there would be no immediate income tax results from a *testamentary* charitable remainder unitrust funded with assets from an IRA. IRA amounts would be taxed as received by the income beneficiary (PLR 9237020).

Note: Heirs normally receive an income tax deduction for estate taxes that were owed on an IRA or other retirement account [I.R.C., §691(c)(1)(A)]. Now, says the IRS, if the IRA passes to a CRT, the deduction will belong to the trust, and will not be passed through to the income beneficiaries. The result is to convert part of the trust's income (IRD) to tax-free corpus – which the income beneficiaries may be unlikely ever to access, under to the four-tier system of CRT taxation (PLR 199901023).

IRA to CRT or "Stretch-out" IRA? The "stretch-out" IRA has been touted as superior to the testamentary charitable remainder trust. The primary advantage cited for the stretch-out IRA is that it can provide a tax-deferred account for a half-century or longer, if distributions are spread over the lifetime of a young beneficiary. But estate taxes may deeply erode the IRA and many clients would not be interested in leaving their retirement savings to a person so young. The charitable remainder trust also can offer stretch-out possibilities, with the added bonus of estate tax savings.

Note that a charitable remainder trust is generally not feasible if the trust is to last for the lifetimes of very young beneficiaries, due to the 10% minimum charitable remainder requirement [I.R.C., §§664(d)(1)(D) and 664(d)(2)(D), 664(d)(4)]. If the 10% test is a problem, planners should consider leaving charity a portion of the IRA outright with the remaining portion passing to an eligible "look-through" trust to benefit grandchildren or other young beneficiaries. A term-of-years charitable remainder trust would work for beneficiaries of young ages if the client is content to have distributions continue for a maximum of 20 years.

Where the client wishes to use an IRA to benefit both family and charity, one commentator has questioned whether an account owner should ever establish a testamentary charitable remainder trust, funded with an IRA. The theory was that all parties would be happier with a partial outright distribution to charity from the IRA, with the rest passing under a beneficiary designation or through a family trust. One answer is that the CRT could receive other assets from the estate, including IRD such as U.S. savings bonds, and provide inexpensive trusteeship if the charity is willing to serve as trustee. A term-of-years CRT might be preferable where the client wants to use an IRA to benefit family members with a wide range of ages. The tax-exempt status of the CRT gets around the problem that, with multiple beneficiaries, any stretch-out must be figured over the age of the oldest beneficiary, thus accelerating distributions – and taxes.

Providing for Both Spouse and Charity from an IRA

Clients who wish to use a retirement account to assure benefit for both a spouse and charity have two basic choices:

- Make charity a partial beneficiary of the account and leave the rest to the spouse, who would then roll over the benefits into his or her own IRA or receive distributions over his or her life expectancy under the general stretch-out rules for inherited accounts (because the surviving spouse is not the sole beneficiary, life expectancy can't be recalculated annually). Alternatively, an account can be split into two accounts, one naming charity as beneficiary and the other naming the surviving spouse.

- Leave part or all of the retirement account to a testamentary charitable remainder trust in which the spouse is the sole beneficiary (required for qualification for the estate tax marital deduction).

Leaving the account to a qualified terminable interest property (QTIP) trust with charity as remainder beneficiary will result in accelerated distribution of the account to the trust (and higher trust tax rates), under the "multiple beneficiary rule." That is, the account will be deemed not to have a designated beneficiary [Reg. §1.401(a)(9)-5, Q&A A-7(d)].

Ideally, where both spouses are committed to the same organization, the surviving spouse would be made the sole beneficiary of the IRA, with the expectation that he or she would leave part or all of their rollover IRA to the charity. Of course, the first spouse to die has no absolute certainty that charity eventually will benefit under this "reliable spouse" strategy. So a CRT distribution may have the best practical and tax results.

Overcoming Objections of Heirs

Heirs may not miss the shrunken amounts remaining from retirement accounts after taxes. However, donors could make bequests of retirement accounts and purchase life insurance to replace what a family member would have kept. Or they could arrange for retirement accounts to pass to a charitable remainder trust that would make lifetime payments to family beneficiaries, with eventual benefit to charity. The trust would reduce federal estate taxes and absolutely no income taxes – state or federal – would be triggered upon death. Substantial tax savings also would occur if retirement assets were left to a charitable remainder trust from which income is paid to heirs over a term of years. A private letter ruling also approved a testamentary charitable gift annuity funded by an IRA distribution beneficiary (PLR 200230018).

CHARITABLE BEQUEST PLANNING WITH OTHER TAX-BURDENED ASSETS

Accounts receivable of a cash-basis individual. Doctors and other professionals sometimes are inefficient bill collectors, leaving behind substantial accounts receivable at death. Unpaid bills can be a nuisance for heirs or the estate to collect and they carry the burden of being IRD, as well. Charities may not cherish the role of bill collector, but the rewards may be worth it, to the extent charity can collect.

Renewal commissions of insurance agents. Life agents who sell wealth replacement life insurance (or any other type of policy, for that matter) may find unpaid commissions to be the perfect charitable bequest.

Stock options. Executives and other key employees are often granted options to purchase stock in their companies at a bargain price. Post-death exercise of these options results in IRD. If the employee makes a specific charitable bequest of all rights to exercise these options, including all rights to surrender options, significant income tax savings are possible, plus estate tax savings if the decedent did not have the marital deduction available.

The IRS also ruled favorably on an agreement negotiated between a company and its founder/board chairman that permitted the taxpayer to make a testamentary transfer of nonstatutory stock options to a class of beneficiaries that included charities. The value of the options would be included in the owner's gross estate at death [Code §§2033, 2039(a)], but a charitable deduction would be allowed for the value of the options passing to charity at death. Any income realized by the charities as a result of an exercise of the options after the donor's death is IRD to the charities, not to the estate (PLR 200002011).

The IRS ruled that if an individual died during the 15-year exercise period of nonqualified stock options and the named charitable beneficiary exercised the options during the remaining period, charity, not the heirs or the estate, would recognize the IRD (PLR 200012076).

Payments on installment obligations. Real property purchased on a land sale contract, for example, at death presents both exposure to transfer taxes and income tax liability on the unpaid installments.

Deferred compensation, last salary check and bonuses. Clients should consider earmarking untaxed compensation to satisfy charitable commitments.

Other assets. Accrued royalties under a patent license and a deceased partner's share of partnership income up to date of death also may result in both income taxes and estate taxes unless the beneficiary is a tax-exempt organization.

ADDITIONAL CONSIDERATIONS IN CHARITABLE BEQUEST PLANNING

The tax benefits of charitable bequests can be eroded if an individual fails to provide how death taxes imposed by reason of his or her death are to be paid.

A resident of Ohio bequeathed his entire residuary estate to charity, but his will made no mention of how federal estate tax and state estate tax were to be paid. Under Ohio law, the entire burden of these taxes fell on the residue, reducing the amount passing to charity and the amount of the charitable deduction allowed to the decedent's estate [Rev. Rul. 77-202, 1977-2 C.B. 287]. Had the decedent chosen to, he could have arranged for payment of his death taxes by noncharitable beneficiaries.

Of course, it is quite possible that the decedent's intentions were carried out. But oftentimes, because of careless drafting of a will, the decedent's intentions are frustrated on account of the way the death tax burden is allocated. For example, suppose that an individual's will created a trust clearly intended to qualify as a charitable remainder annuity trust, but the will provides for the payment of all death taxes by the trust. Since such payment disqualifies the trust as a charitable remainder annuity trust, no deduction will be allowed for the remainder interest passing to charity. This kind of situation is not uncommon, based on private letter rulings dealing with charitable remainder trusts.

As far as testamentary charitable remainder trusts are concerned, if it is desired to place the burden of death taxes on the property passing into the trust, the taxes should be paid out of the property before the property comes into the hand of the trustee, and the decedent's will should specifically so provide.

Ordinary Income Property and Tangible Personal Property

Certain kinds of property have poor income tax results if contributed to charity during life. Bequests of such property, on the other hand, can be 100% deductible for estate tax purposes.

Ordinary income property. Several years ago, an artist living in the southwest burned about $1 million worth of his paintings when he found they would be subject to federal estate tax. Had he given some thought to the matter, he might have found it better to bequeath the paintings to a museum, university or other charitable institution. If the artist had given the paintings to charity during life, his charitable contribution would have been limited under I.R.C., §170(e)(1)(A) to his cost basis – what he paid for paint and canvas. Paintings in the hands of the artist are one kind of "ordinary income property," defined as property the sale of which would produce any ordinary income or short-term capital gain. No such reduction applies in the estate tax charitable deduction; thus the artist's estate would have been allowed a deduction for the full fair market value of the paintings had he bequeathed them to charity.

Tangible personal property. If an individual makes a lifetime gift to charity of tangible personal property (e.g., a painting, boat or a coin collection), and the charity puts the gift to an "unrelated use," the donor's contribution will be reduced by 100% of any long-term capital gain present in the property [Reg. §1.170A-4(b)(3)(i)]. No reduction occurs, however, with *bequests* of tangible personal property.

Lifetime Gift by Surviving Spouse in Lieu of Charitable Bequest

Spouses who are both committed to a charitable organization might want to forego a bequest to charity at the death of the first spouse and rely on the survivor to make a lifetime gift to carry out the philanthropic goals of the first spouse to die.

Example: Russell has an estate of $7 million and plans to leave $200,000 to the American Institute for Cancer Research as a gift in memory of his mother and his wife's sister, who were both victims of cancer. The rest of his estate will go to his wife, Ellen, who herself is a longtime supporter of AICR. After discussing the matter with Ellen and his advisers, Russell decided to leave his entire estate to Ellen, with the understanding that she will make a $200,000 contribution to AICR after his death.

Tax results? Russell's federal estate taxes are the same, with or without the charitable bequest, thanks to the 100% estate tax marital deduction. The estate tax charitable deduction is redundant for Russell and other spouses who plan to take full advantage of the marital deduction. But the income tax charitable deduction can still save taxes for the family, assuming Ellen follows through and makes the gift after Russell dies. In Russell's case, Ellen receives the $200,000 from his estate, turns around and makes an outright gift to AICR. The gift could save her as much as $70,000 in a 35% tax bracket.

If Russell is unsure whether Ellen will remember to make the gift after his death, he might consider establishing a charitable remainder trust or other "split interest" gift during his lifetime that provides income to himself during his life, then terminates at his death. Alternatively, he could set up the trust to pay income to both himself and Ellen.

We invite you to call our Office of Gift Planning if you want to know the exact amount of the charitable deduction that will result from a trust a client is considering. Our staff can also answer any questions you may have about the planning or drafting of a charitable remainder trust that will meet the individual needs and personal objectives of a client.

The War Against Cancer

When you have the occasion to draft a trust or a bequest for a client who wants part of his or her estate to support the war against cancer, our correct legal name is:

"American Institute for Cancer Research, a not-for-profit corporation located in Washington, DC."

Please feel free to contact our Office of Gift Planning for additional information about the mission and the future plans of the American Institute for Cancer Research.

Our Office of Gift Planning will be pleased to help you plan a trust or bequest that will accomplish the specific objectives of your client. We can also provide the exact tax consequences of any trust arrangement a client may want to consider. There is no other obligation for this service.

Information for the Attorney or Advisor

- AICR's official name:
  American Institute for Cancer Research
- AICR's mailing address:
  1759 R Street, NW
  Washington, DC 20009
- AICR's phone number:
  202-328-7744 or 800-843-8114
- AICR's email address:
  gifts@aicr.org
- AICR's identification:
  A not-for-profit organization under Section 501(c)(3)
  of the Internal Revenue Service Code
- AICR's tax-exempt IRS number:
  52-1238026

The information and examples provided in this booklet are for information and discussion purposes only. The examples are hypothetical, and the facts and tax consequences of individual transactions may vary from person to person. Each estate planning professional must independently determine and evaluate the tax and financial consequences of each individual situation.

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