Chapter 6: Charitable Giving

Corrections were made to this workbook through January of 2005. No subsequent modifications were made.

CHARITABLE DEDUCTIONS

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A solid understanding of the limits on charitable deductions helps tax preparers plan strategies for charitable giving by wealthier clients. Generally, an individual's charitable contributions deduction is subject to limitations based on a percentage of adjusted gross income (AGI). Other considerations are the type of organization that receives the contribution and the type of asset that is contributed. All of these factors determine the charitable contribution deduction for the individual. This section focuses on qualified organizations, qualified property, and the reporting requirements necessary to allow charitable deductions under IRC §170.

DEDUCTION LIMITATIONS

Wealthy individuals who contribute significant amounts of cash or large capital assets may have their charitable contribution deduction limited by a percentage of their AGI. The percent limitations are 50%, 30%, and 20%. Factors determining the applicable percentage limitation include the type of asset contributed and the type of organization receiving the contribution. Charitable contributions in excess of the percent limitation can be carried forward for five years.

In addition, the deduction for charitable contributions is an itemized deduction subject to reduction by the lesser of 3% of excess AGI, or 80% of the otherwise allowable itemized deductions.[1] In 2004, the reduction applies for joint, single, and head of household filers with AGI in excess of $142,700 and for married filing separately in excess of $71,350. However, the charitable deduction is not one of the miscellaneous itemized deductions allowed only if its aggregate amount exceeds 2% of AGI.

QUALIFIED ORGANIZATIONS

To be eligible to receive deductible gifts, a recipient organization must be a qualified organization as described in IRC §170(c). These organizations are classified as 30% organizations or 50% organizations. The most common charitable organizations are IRC §501(c)(3) organizations. However, other exempt entities qualify to receive deductible charitable donations, including federal, state, and local government entities. The IRS annually publishes a list of qualified organizations in IRS Pub. 78, *Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986*, or on the internet at www.irs.gov.

Typically, charitable organizations are classified as public charities or private foundations.[2]

Public charities, such as the American Cancer Society, the Easter Seal Foundation, and the American Heart Fund, receive support from a **wide variety** of individuals and organizations. They also receive support from local charities, which include churches, museums, hospitals, and schools.

1. IRC §68
2. IRC §501(c)(3)

Private foundations, such as the Ford Foundation, the Turner Foundation, and the Bill and Melinda Gates Foundation, typically receive most of their support from only **a few sources**.

The distinction between these types of organizations is important, since the deductions allowed for donations to certain private foundations are limited as compared to donations to §501(c)(3) organizations.

50% Limit Organizations

To determine if a charitable organization is a 50% limit organization, taxpayers can either ask the charitable organization or consult IRS Pub. 78. Typically, a charitable organization knows whether it is a 50% limit organization and will share this information with contributors. Only the following types of organizations are considered 50% limit organizations:

1. Churches and associations of churches
2. Schools (i.e., primary and secondary schools, colleges, universities, and nonprofit vocational schools)
3. Hospitals and related medical research organizations
4. Support organizations, whose sole purpose is to receive, hold, invest, and administer property to make expenditures for state colleges and universities, and who receive substantial support from the government or general public
5. Government entities
6. Corporations, trusts, or community chests, funds, or foundations operated only for charitable, religious, educational, scientific, or literary purposes, or to prevent cruelty to children or animals, or to foster certain national or international amateur sports competitions.[3] These organizations must be "publicly supported," meaning they receive a substantial part of their support from government entities or the general public.
7. Organizations that respond to the needs of the general public, even though they are not "publicly supported." These organizations must receive more than one third of their support from organizations listed above, or from persons who are not "disqualified persons."
8. Private operating foundations
9. Private nonoperating foundations that make 100% qualifying distributions within 2½ months following the year the contributions are received
10. Private foundations that pool contributions into a common fund. Contributors have the right to earmark contributions to specific public charities. The foundation must distribute the common fund's income within 2½ months following the tax year-end, and distribute the corpus not later than one year after the donor's death.

30% Limit Organizations

Charitable organizations not included in the 50% limit organizations are typically 30% limit organizations. These types of organizations include:

- Veterans' organizations,
- Fraternal societies,
- Nonprofit cemeteries, and
- Certain private nonoperating foundations.

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3. IRC §170(c)(2)(B)

Private Foundations

Private foundations are divided into two categories:

1. Operating foundations
2. Nonoperating foundations

Operating Foundations. In general, private operating foundations actively conduct their own tax-exempt activities, rather than fulfilling their tax-exempt status by making distributions to other organizations.[4] In order to maintain its qualification as a 50% limit organization, an operating foundation must satisfy an income test and either an asset, endowment, or support test.[5]

> **Note.** A practitioner may assume these tests are satisfied if the organization is listed in IRS Pub. 78.

Nonoperating Foundations. Nonoperating foundations are private foundations that fail to satisfy the tests for an operating foundation. Nonoperating foundations distribute most of their income as grants to other charitable organizations. Qualified nonoperating foundations are generally considered 50% organizations.

Private nonoperating foundations are often family foundations, exclusively with investment assets that generate income for distribution as grants to public charities. The distinction is important for charitable giving purposes. Private operating foundations are 50% organizations, and private nonoperating foundations can be either 50% or 30% limit organizations. The nonoperating foundation may qualify as a 50% organization if it distributes 100% of its contributions to qualifying public charities during the tax year. This distribution must be made no later than 2½ months after it's year end.

There are restrictions on who can receive qualifying distributions from nonoperating foundations. Qualifying distributions cannot be made to:

- An organization controlled by the foundation,
- Disqualified persons, or
- Another nonoperating foundation

Because of these restrictions, many nonoperating foundations are 30% limit organizations.

TYPES OF CONTRIBUTIONS

Cash

The deduction of cash contributions to a 50% limit organization is **limited to 50% of the donor's AGI** for the tax year. The deduction of cash contributions to a 30% limit organization is limited to 30% of the donor's AGI for that taxable year.

Example 1. Debbie contributes $15,000 to the American Red Cross, a 50% limit organization. Her 2004 AGI is $40,000. Her maximum charitable contribution for 2004 is $20,000 ($40,000 × 50%). Since her cash contribution is subject to the 50% limitation and the organization is a qualified 50% limit organization, her entire contribution of $15,000 is deductible in 2004.

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4. IRC §4942(j)(3)
5. *Internal Revenue Manual* §7.26.6, revised May 2, 2002

Example 2. Debbie contributes $15,000 to Centerville's Elks Lodge, a 30% limit organization. Her 2004 AGI is $40,000. Her maximum deduction is limited to 30% of her AGI, or $12,000. She deducts $12,000 in 2004. The balance of $3,000 may be carried forward and deducted in subsequent years (discussed later in the chapter).

Capital Gain Property

When an individual contributes a capital asset (e.g., land, securities, artwork) to a 50% limit organization, **the deduction is limited to 30% of AGI.** This includes IRC §1231 business assets that, if sold by the donor, result in long-term capital gain recognition. The deduction for capital gain property is the property's FMV when donated.

Example 3. Steve makes a $40,000 cash contribution to his local hospital, a 50% limit organization. His 2004 AGI is $130,000. This is his only charitable donation for the year. Steve's charitable deduction is limited to $65,000, or 50% of his AGI. He can deduct the entire $40,000.

If Steve contributed appreciated securities with a $40,000 FMV and a $10,000 basis to his local hospital. His charitable deduction is limited to 30% of his AGI, or $39,000 ($130,000 × 30%). He can only deduct $39,000. The balance of $1,000 may be carried forward and deducted in subsequent years.

Observation. Despite the 30% AGI limit on gifts of appreciated property, these gifts often provide greater tax benefits than cash gifts.

In **Example 3,** Steve not only receives a charitable deduction for the FMV of the appreciated securities; but he is also relieved of any income tax liability for the $30,000 stock appreciation. Consequently, when a taxpayer has a choice and AGI limits are not an issue, gifts of appreciated capital gain property often generate greater tax benefits than cash gifts.

However, gifts of devalued capital gain property can be less beneficial than selling the property and making a cash donation.

Example 4. Steve contributed securities with a $10,000 FMV and a $40,000 basis to his local hospital. His charitable deduction is limited to FMV ($10,000).

Note. In **Example 4,** it is more tax advantageous for Steve to sell the stock and recognize the $30,000 capital loss. He can then deduct the $10,000 cash contribution.

Exception. A taxpayer can elect to reduce the FMV of the contributed property by any long-term gain that would have resulted from a sale.[6] The remaining charitable deduction is then limited to 50% of AGI rather than 30%. This is of particular value to donors making donations of appreciated capital property with a large value in relation to the taxpayer's annual income, and when the property's basis is relatively high.

Example 5. Larry and Lynn are retired and have an AGI of $80,000 per year. They own a tract of land that produces no income. Larry and Lynn received the property several years ago from Lynn's father's estate. The property's basis is $350,000 and the appraised FMV is $400,000. The difference between the basis and FMV is potential long-term capital gain if Larry and Lynn sell the property. Larry and Lynn are sentimentally attached to the land, and they want to contribute it to their community for development as a park. The city government agrees to accept the property.

6. Treas. Reg. §1.170A-8(d)

Larry and Lynn contribute the property to the city **and deduct its FMV**. They are allowed a \$24,000 deduction (30% × \$80,000) in the donation year, and \$24,000 in each of the five carryover years (assuming AGI remains \$80,000). Their total deduction is \$144,000 (6 years × \$24,000). Larry and Lynn's combined marginal federal and state tax rate is 28%. They realize a tax savings of \$40,320 (\$144,000 × 28%) over a six-year period.

Example 6. Use the same facts as **Example 5** except, Larry and Lynn elect to deduct their \$350,000 **basis** in the property. They can deduct \$40,000 (50% × \$80,000) per year for six years or \$240,000 (6 years × \$40,000). The overall tax savings is \$67,200 (\$240,000 × 28%). This saves them \$26,880 in taxes over the six-year period.

20% Limit. There are special limits on contributions of appreciated capital gain property to private nonoperating foundations. Donations to nonoperating private foundations must be reduced by the long-term capital gain that would have been recognized had the donor sold the property.[7] This reduced amount is limited to 20% of the taxpayer's AGI.

Example 7. John's 2004 AGI is \$160,000. He contributes land with a \$50,000 basis and a \$90,000 FMV to a private nonoperating foundation. John owned the land for 10 years. This is his only charitable donation for 2004.

John's deduction is first reduced by the \$40,000 long-term capital gain that would have been recognized had he sold the property. The remaining \$50,000 charitable deduction is limited to 20% of his AGI, or \$32,000 (20% × \$160,000). John carries over the unused \$18,000, and deducts it in a future year.

There is some relief from this severe limitation of donations to private nonoperating foundations. Contributions of "qualified appreciated stock" are deductible at FMV, and unreduced by long-term capital gain. However, such contribution deductions are still limited to 20% of the donor's AGI. Qualified appreciated stock is defined as stock which has market quotations readily available on an established securities market.[8]

In *Todd*, shares of stock in a bank holding company were transferred to a family foundation (nonoperating foundation).[9] The stock was not traded on a stock exchange or any national or regional over-the-counter market for which published quotations were available. There was no active market in the stock, and shares were only available on rare occasions when a stockholder wanted to sell them. On only a few occasions over a 10-year period, a local brokerage firm acted as a placement agent to match buyers and sellers and provided a suggested share price based on the stock's net asset value. The Tax Court found that market quotations were not readily available, and therefore, the shares were not qualified appreciated stock. This reduced the potential charitable deduction by the stock's appreciation from \$553,847 (FMV) to \$33,338 (taxpayer's basis).

Note. The IRS released announcement IR-2004-86 on June 30, 2004, advising taxpayers that they intend to disallow improper charitable contribution deductions for transfers of easements on real property to charitable organizations. Taxpayers claiming improper charitable contribution deductions for such transfers may be subject to accuracy-related penalties. Mark Everson, IRS Commissioner, said: "We've uncovered numerous instances where the tax benefits of preserving open spaces and historic buildings have been twisted for inappropriate individual benefit. Taxpayers who want to game the system and the charities that assist them will be called to account."

7. IRC §170(e)(1)(B)(ii)

8. IRC §170(e)(5)(B)

9. *John C and Tate M Todd v. Commr.,* 118 TC 334, April 19, 2002

Tangible Personal Property: Unrelated Use. If the donated tangible personal property is put to an unrelated use, the taxpayer must reduce the amount of the deduction by the long-term capital gain that would have been recognized had the property been sold.[10] Unrelated use is considered any use unrelated to the charitable organization's tax-exempt purpose. Tangible personal property is property, other than real estate or intangible property (such as stock or debt securities), such as art objects, jewelry, antiques, books, automobiles, and yachts.

The burden of determining whether property is put to an unrelated use is generally on the taxpayer. A taxpayer may treat the property as though it is put to a related use if it is reasonable to assume so at the time of the gift.[11] However, the charitable organization is required to complete Form 8282, *Donee Information Return,* and submit it to the IRS if it disposes of the property within two years of receipt.

To prevent a reduced deduction due to a premature sale of contributed tangible personal property, the taxpayer should ask for a letter from the charity stating its intended use of the property.

Example 8. Ted owns the baseball that Mark McGwire hit for his 62nd home run on September 8, 1998. He holds it as an investment. He decides to donate it to a community hospital. The ball has a zero basis and a $50,000 FMV. On receiving the donation, the hospital immediately sells the ball to the Baseball Hall of Fame. The sale is an unrelated use, and Ted is only eligible to deduct his basis, which is zero.

Example 9. Use the same facts as **Example 8** except, Ted donates the ball to the Baseball Hall of Fame. The Baseball Hall of Fame puts the baseball on display for visitors. Ted receives a $50,000 charitable deduction because the display is a "related use" for the Hall of Fame.

Ordinary Income Property

If donated property could have been sold to derive ordinary income or short-term capital gain, the property's value is reduced by the ordinary income or short-term capital gain that would have been reported as if the property were sold.[12] This limits the deductibility of contributions of ordinary income property including:

- Inventory,
- Works of art, literary compositions, etc., given by the creator,
- Capital assets held one year or less, and
- Business property subject to ordinary income recapture under IRC §§1245 and 1250.

Example 10. Lynette is the sole proprietor of a home furnishings store. A local charity has asked her to contribute a floral arrangement to its annual benefit. Lynette agrees to donate the arrangement with a $100 basis and a $225 net realizable value. Her charitable deduction is limited to the $100 basis.

Example 11. Josh is the sole proprietor of a pet supply store. He has a copy machine that he purchased for $5,000 several years ago. It is fully depreciated. He donates the copier with an FMV of $1,000 to the local humane society. Josh has no charitable deduction, because the sale of the copier would have resulted in a $1,000 IRC §1245 ordinary income recapture if it had been sold at FMV.

Example 12. Jeffrey is a retired physician who owns 10 acres of land that he donates to the local park district for use as a nature walk and playground for children. He owned the land for 20 years. It has a $30,000 basis and a $100,000 FMV. Jeffrey's 2004 AGI is $60,000.

His charitable contribution is $100,000. Since he is donating capital gain property to a qualified 50% limit organization, his 2004 deduction is limited to 30% of AGI ($60,000 × 30% = $18,000). He is entitled to carryover the balance of $82,000 for the next five years.

10. IRC §170(e)(1)(B)

11. Treas. Reg. §1.170A-4(b)(3)(ii)

12. IRC §170(e)(1)(A)

Example 13. Chris is a real estate dealer who buys and sells real estate on a frequent basis. He holds the property as inventory and reports the cost of the land when it is sold. He owns 10 acres adjacent to Jeffrey's land and is also willing to donate the 10 acres to the local park district for use as a nature walk and playground. His AGI for 2004 is $200,000. He has a basis of $30,000 in his 10 acres as well, and it is also valued at $100,000. His charitable contribution is limited to $30,000 because if the acres had been sold, he would have reported the income as ordinary income. Therefore, he must reduce his $100,000 contribution by the amount of gain that would have been ordinary gain. He is allowed the entire $30,000 deduction in 2004.

CARRYOVERS

When a charitable contribution amount is greater than the allowed charitable deduction, any unused amounts are carried forward for a maximum of five years.

Example 14. Lou contributes $30,000 to her church in 2004. Her 2004 AGI is $50,000. Her 2004 charitable contribution deduction is limited to 50% of her AGI, or $25,000. She can carryover her remaining $5,000 contribution to a future year.

Note. If a taxpayer does not itemize in a carryover year, the **carry forward is reduced as if the taxpayer had itemized.**

Ordering Rules

In carryover years, **current-year contributions are deducted before carryover amounts in each category before moving to the next category.** Unfortunately, without good planning, it can be difficult to use carryovers. The order for applying limitations follows:

1. Contributions of cash made to 50% limit organizations
2. Contributions of cash and ordinary income property to 30% limit organizations
3. Contributions of capital gain property, to which the 30% limit applies
4. Contributions of capital gain property to nonoperating foundations, to which the 20% limit applies

Note. The donor's total yearly charitable deduction may never exceed 50% of AGI, regardless of the type of contribution or organization.

Example 15. Peg has a $170,000 AGI in 2004. She donates $90,000 to Habitat for Humanity. Peg's charitable contribution deduction is limited to $85,000 in 2004.

In addition, Peg has a $20,000 unused charitable contribution carryover from 2003. She must carryover $20,000 from 2003 and $5,000 from 2004. None of the 2003 carryover is deductible in 2004. If she is not able to use the $20,000 carryover by 2008, she will lose the deduction.

Deductions for charitable contributions are also subject to the following interrelated limitations:[13]

a. Contributions of cash and ordinary income property to 30% organizations (#2) are limited to no more than the contribution amount, or the **lesser** of:

- 30% of AGI, or
- 50% of AGI less the total of contributions **(cash and capital gain property)** given to 50% organizations. (half of AGI less categories 1 and 3)

b. Contributions of capital gain property given to 50% organizations (#3) are limited to no more than the contribution amount, or the **lesser** of:

- 30% of AGI, or
- 50% of AGI less the cash contributions given to 50% organizations. (Half of AGI less category 1)

Note. The 30% AGI limitation is not reduced for either category 2 or 3 by allowable deductions in the other category.

c. Contributions of capital gain property given to nonoperating foundations (#4) are limited to no more than the contribution amount, or the **lesser** of:

- 20% of AGI
- 30% of AGI less cash and ordinary income contributions to 30% organizations (30% of AGI less #2)
- 30% of AGI less contributions for capital gain property given to 50% organizations (30% of AGI less #3)
- 50% of AGI less the total of all other contributions (Half of AGI less categories 1, 2, and 3)

Example 16. Matt made the following charitable contributions for 2004:

- $5,000 Cash to The Holy Church
- $20,000 Cash to The Elks Lodge
- $50,000 Land (Basis $7,000) to The City of Bloomington for a Playground
- $8,000 Cash and an Apartment Building worth $75,000 (Adjusted basis of $22,000) to the Lanny & Sue Private Foundation, which is considered a nonoperating organization.

Matt's AGI for 2004 is $110,000. In addition, he has a carryforward of $10,000 from 2003 cash donations to The Holy Church that he was unable to deduct last year.

The maximum charitable deduction for Matt for 2004 is $55,000 ($110,000 × 50%). However, he is only allowed to deduct **$48,000** based on the following calculation:

Category	Order	Contribution	04 Deduction	Carryover
1	1st: Current year contribution	$ 5,000	$ 5,000	$ 0
	2nd: Carryover amount	10,000	10,000	0
2	1st: Current year contribution	28,000	0	28,000
	2nd: Carryover amount	0	0	0
3	1st: Current year contribution	50,000	33,000	17,000
	2nd: Carryover amount	0	0	0
4	1st: Current year contribution	22,000	0	22,000
	2nd: Carryover amount	0	0	0
		$115,000	$48,000	$67,000

13. IRS Pub. 526, *Charitable Contributions*

1. **a.** The **$5,000** is allowable in full in 2004 because it is less than 50% of his AGI **and** it was given to a 50% organization.

   b. The **$10,000** carryover is allowed in full in 2004 because it was a carryover of cash donated to a 50% organization **and** the total of the $5,000 plus the $10,000 is less than 50% of his AGI.

2. The **$20,000** to the Elks and the **$8,000** to the Private Foundation are combined since they are both cash contributions to 30% organizations. The deductible contribution is limited to the lesser of:

   - $28,000 total contributions to 30% organizations
   - $33,000 maximum allowable contributions to 30% organizations (30% of AGI)
   - **$0** remaining 50% AGI available after gifts to 50% organizations:

50% of AGI	$55,000
less gifts given to 50% organizations:	
Holy Church (2004 + carryover)	(15,000)
Value of land donated to City	(50,000)

   Because there is no 50% limit remaining, none of the contributions to 30% organizations are allowed in 2004; the total **$28,000 is carried forward** to 2005 subject to the same AGI limitations.

3. The donation of the land to the City qualifies as a **$50,000** contribution because it is qualifying capital gain property donated to a 50% organization. However, the deductible amount is limited to the **lesser** of the following:

   - $33,000 maximum allowable deductions for capital gain property (30% of AGI)

Maximum charitable deductions allowable	$55,000
Less: Holy Church	(5,000)
Less: Holy Church carryover	(10,000)
Possible deductible portion of the land	$40,000

   Only **$33,000** of his land donation is deductible in 2004. The remaining **$17,000 is carried forward** to 2005 subject to the same AGI limitations.

4. Because the apartment building was given to a nonoperating foundation, the deduction is limited to Matt's adjusted basis (the FMV less any depreciation recapture and gains that would be realized if the building were sold). None of the $22,000 adjusted basis of the apartment building will be deductible in 2004, because he has used all of his 30% and 50% limitations. It will be carried over to 2005 still subject to the AGI limitations.

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Example 17. Use the same facts as **Example 16.** In 2005 Matt's AGI is only $30,000 and he makes no charitable contributions.

Category	Order	Contribution	05 Deduction	Carryover
1	1st: Current year contribution	$ 0	$ 0	$ 0
	2nd: Carryover amount	0	0	0
2	1st: Current year contribution	0	0	0
	2nd: Carryover amount	28,000	0	28,000
3	1st: Current year contribution	0	0	0
	2nd: Carryover amount	17,000	9,000	8,000
4	1st: Current year contribution	0	0	0
	2nd: Carryover amount	22,000	0	22,000
		$67,000	$9,000	$58,000

All of his $28,000 deduction for contributions to 30% organizations carries forward because 50% of AGI ($15,000) less the $17,000 carryover from the land contribution is $0.

He will only be able to deduct $9,000 ($30,000 × 30%) of the $17,000 land carryover because the land retains its 30% limitation character. The remaining $8,000 of the land deduction carries forward to 2006.

The $22,000 deduction for the apartment building also carries forward to 2006, because he has already used all of his 30% limitation. If Matt's AGI does not increase appreciably before 2009, he may lose the benefit of the charitable deduction for the assets that were contributed in 2004.

Example 18. Use the facts as **Examples 16 & 17.** In 2006 Matt's AGI is $128,000 and he makes no charitable contributions.

Category	Order	Contribution	06 Deduction	Carryover
1	1st: Current year contribution	$ 0	$ 0	$ 0
	2nd: Carryover amount	0	0	0
2	1st: Current year contribution	0	0	0
	2nd: Carryover amount	28,000	28,000	0
3	1st: Current year contribution	0	0	0
	2nd: Carryover amount	8,000	8,000	0
4	1st: Current year contribution	0	0	0
	2nd: Carryover amount	22,000	10,400	11,600
		$58,000	$46,400	$11,600

He is able to deduct the $28,000 carryover from gifts to 30% organizations, because it is less than 30% of AGI ($38,400) and less than $56,000 ($64,000 [50% of AGI] less the $8,000 land donation.)

He is also allowed to deduct the remaining $8,000 of his land donation, because it is less than 30% of his AGI ($128,000 × 30% = $38,400).

However, he can only deduct $10,400 of his apartment building contribution carryover of $22,000. The deduction allowed is the lesser of:

20% of AGI	$25,600
30% of AGI less cash gifts to 30% organizations ($38,400 – $28,000)	10,400
30% of AGI less capital gain property ($38,400 – $8,000)	30,400
50% of AGI less all other contributions ($64,000 – $8,000 – $28,000)	28,000

The remaining $11,600 of his apartment building contribution carries over to 2007.

Note. IRS Pub. 526, *Charitable Contributions*, contains worksheets to assist with these calculations.

WHEN TO DEDUCT

Contributions can only be deducted in the year in which they were actually made, or in a carryover year. This applies to cash or accrual basis taxpayers. An exception applies for accrual basis C corporations.

Contributions must be unconditional in order to consider them deductible in the current year. Examples of different types of contributions and when they are considered made follow.

Cash. A check mailed to a charity is considered delivered on the date it is mailed.

Credit Card. Contributions charged on a bank credit card are deductible in the year the charge is made.

Pay-by-Phone Account. With a pay-by-phone account, the date a contribution is considered made is the date the financial institution pays the amount. This date is recorded on the financial institution's statement which is sent to the taxpayer.

Stock Certificate. The donation of a properly endorsed stock certificate is completed on the date of mailing or other delivery to the charity or to the charity's agent. However, if the stock certificate is given to an agent or to the issuing corporation to transfer to the charity, the gift is not completed until the date the stock is transferred on the books of the corporation.

Promissory Note. If a promissory note is issued and delivered as a contribution to a charitable organization, it is not a contribution until payments are made on the note.

Option. If an option to buy real property at a bargain price is granted to a charitable organization, a deduction cannot be taken until the organization exercises the option.

Borrowed Funds. If a contribution is made with borrowed funds, the contribution is deducted in the year it is made, regardless of when the loan is repaid.

Conditional Gift. If a conditional gift is contributed and it depends on a future act or event that may not take place, a deduction cannot be taken. If there is a negligible chance the act or event will take place, a deduction can be taken.

OTHER LIMITS ON CONTRIBUTIONS

Contribution of Services

The contribution of services is not a charitable deduction.[14] Donating blood is considered a service and is nondeductible. However, unreimbursed expenses incurred in performing services for a qualified charitable organization are deductible. IRC §170(i) allows the following expenses to be deducted:

- Out-of-pocket travel and transportation costs; car expenses are computed using 14¢ per mile, plus parking fees and tolls
- Costs of distinctive uniforms that are not appropriate for dress outside the charitable activity
- Costs of meals and lodging while traveling away from home, if there is not a significant element of personal pleasure, recreation, or vacation associated with the travel

14. Treas. Reg. §1.170A-1(g)

Benefit-Received Rule

A taxpayer must reduce charitable deductions if he receives a benefit from a charitable organization in exchange for a contribution.[15] The charitable deduction is limited to the FMV of any property transferred to the charitable organization, reduced by the FMV of goods or services received.

Certain goods and services received in exchange for a charitable contribution may be disregarded, including annual membership benefits offered for $75 per year or less, free or discounted admission to an organization's facilities, free or discounted parking and preferred access to, or discounts on, the purchase of goods and services.[16]

> **Example 19.** Kelly pays $50 to the local natural history museum as an annual membership fee. The membership entitles him to free admission to the museum for an entire year. The normal entry fee is $5 per visit. Kelly's charitable deduction is $50.

If a taxpayer makes a charitable contribution and in turn receives goods with an "insubstantial value," he can disregard them. IRS guidelines define "insubstantial value."[17] The 2004 guidelines contain three alternative limits and they are adjusted annually for inflation:

- The FMV of the benefits received does not exceed the lesser of 2% of the amount contributed, or $82 (2004).
- A charitable donation of at least $41is made, and the cost of the items received in exchange for the donation does not exceed $8.20.
- The taxpayer receives free, unordered items having an aggregate cost of not more than $8.20 in connection with a donation request.

Newsletters or program guides (other than commercial-quality publications) have no measurable FMV or cost if their primary purpose is to inform members about an organization's activities, and they are not available to nonmembers by paid subscription or through newsstands.

Colleges and Universities. When an individual makes a charitable contribution to a college or university and in return receives the right to buy tickets for athletic events in the institution's athletic stadium, 80% of the payment is treated as a charitable contribution and 20% is deemed to be the FMV of the right to purchase the tickets and is nondeductible.[18]

The 80% limitation does not apply if the donor receives tickets or seating, rather than merely the right to purchase tickets, in return for her contribution. In this case, the deduction must be reduced by the FMV attributable to the tickets.

Raffles, Chances, etc. Amounts paid for chances to participate in raffles, lotteries, or similar drawings or puzzles or other contests for valuable prizes are not gifts and do not qualify as deductible charitable contributions.

Transfers with Strings Attached

Some gifts are dependent upon a specified event taking place. This event could cause the gift to take place, or it could be required immediately after the gift is consummated. In either case, the contribution is not deductible until the event occurs or the possibility of reclaiming the gift is so remote that it will not happen. This concept can best be understood by looking at an example and some court cases.

> **Example 20.** Samantha transfers land to a city government with the restriction that it be used as a public park. On the date of transfer, the city indicates it plans to use the land for a public park. The chance of the city not using the land for a public park is so remote that it is considered negligible. Samantha is entitled to a deduction under IRC §170 for her charitable contribution.[19]

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15. Treas. Reg. §1.170A-1(h)
16. Treas. Reg. §1.170A-13(f)(8)(i)
17. Rev. Proc. 92-49
18. IRC §170(l)
19. Treas. Reg. §1.170A-1(e)

In *Bennett,* the taxpayer donated a piano to a college. She executed the deed to the piano, but retained possession of the piano under an extended loan agreement. Even though the taxpayer was willing to complete the gift whenever the college requested, the deduction was disallowed.[20]

In *Miller,* a Civil Air Patrol (CAP) officer purchased radios for use by the CAP. The court ruled the cost of the radios was not deductible even though the CAP used the radios almost exclusively. The donor retained title and control of the radios and could have converted them to other uses.[21]

In *885 Investment Co.,* the limited partnership taxpayer donated parcels of land to the city of Sacramento for use as a scenic corridor and claimed charitable contribution deductions for the transfers in 1979 and in 1981. In 1983, the city conveyed the donated parcels back to the partnership. A formal agreement between the city and the partnership indicated the partnership would donate the land. It was doubtful that necessary state funding would be available to develop the land as outlined in the plan, so the agreement indicated the city would deed the real property back to the partnership at no cost to the partnership if the land was not developed into a scenic corridor. In the court's opinion, this portion of the contract showed a realistic possibility that the property could revert back to partnership. Therefore, no charitable contribution was allowed.[22]

PENALTIES ON VALUATION PROCEDURES

The IRS takes the valuation of contributed assets seriously. It can assess penalties against both the taxpayer making the donation and the person who furnishes a false appraisal. The Code allows the IRS to assess a penalty against any person:[23]

- *Who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document,*
- *Who knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws, and*
- *Who knows that such portion (if so used) would result in an understatement of the liability for tax of another person,*

The amount of the penalty is $1,000. If it affects the tax liability of a corporation, it is increased to $10,000.[24]

In a Letter Ruling, the taxpayer (an experienced used car dealer) was held to be liable for penalties under IRC §6701 for providing misleading information about the FMV of autos solicited for charities. In this instance, the taxpayer sent to each donor the Kelley Blue Book retail value of the donor's automobile, in addition to a copy of Form 8283, *Noncash Charitable Contributions*. He provided this information even though he knew that many of the donated vehicles could only be sold for salvage or scrap. He made no attempt to provide donors with the more relevant (and lower) Kelley wholesale or salvage value of the donated automobile. As a direct result of this misleading information, several donors claimed greatly overstated valuations in taking §170 deductions for their vehicle donation.[25]

The following is an excerpt from the Kelley Blue Book website announcing it's disclaimer as to the value a taxpayer would assign to a vehicle:

The specific information required to determine the value for this particular vehicle was supplied by the person generating this report. Vehicle valuations are opinions and may vary from vehicle to vehicle. Actual valuations will vary based upon market conditions, specifications, vehicle condition or other particular circumstances pertinent to this particular vehicle or the transaction or the parties to the transaction. This report is intended for the individual use of the person generating this report only and shall not be sold or transmitted to another party. Kelley Blue Book assumes no responsibility for errors or omissions.[26]

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20. *D. M. Bennett v. Commr.,* TC Memo 1991-604, 62 TCM 1400, December 9, 1991
21. *L. A. Miller v. Commr.,* TC Memo 1975-279, 34 TCM 1207, September 4, 1975
22. *885 Investment Co. v. Commr.,* 95 TC 156, August 16, 1990
23. IRC §6701(a)
24. IRC §6701(b)
25. Letter Ruling 200243057, July 2, 2002
26. www.kbb.com, used with permission

Appraisals

For contributions of property (other than cash or regularly traded securities), the property must be valued at the gift date to determine the donation. Taxpayers are required to have certain donated property appraised by a qualified appraiser.[27] An appraisal is required for property with an FMV of more than $5,000 and for donations of nonpublicly traded stock with an FMV of more than $10,000.

It is necessary to attach Form 8283 to the tax return of the donor. This form requires a signature by a qualified appraiser and a signed acknowledgement by the charitable organization indicating it received the property. In addition, for donations of art with an FMV of $20,000 or more, it is necessary to attach a complete copy of the signed appraisal to the return. The appraisal must be made not earlier than 60 days before the date the property is contributed and before the due date (including extensions) of the return claiming the deduction. Failure to file a properly completed Form 8283, with attachments, results in disallowance of the deduction, unless the disallowance was due to a good-faith omission.

It is in the taxpayer's best interest to comply with this regulation concerning disclosure and substantiation and to obtain an appraisal from a highly qualified, independent appraiser. The appraiser's reputation is important, because on audit the appraiser's qualifications will be analyzed, as will the quality of the appraisal.

Note. More detail on valuations can be found in Chapter 10, Small Business Issues, Issue 8.

CONTRIBUTIONS OF AUTOMOBILES

Taxpayers claim charitable contribution deductions for donations of used automobiles to charities. Such donations are often made in response to advertising campaigns by charitable organizations that actively solicit such donations. The claimed deductions are usually consistent with values listed in used car guidebooks such as the Kelley Blue Book and the National Automobile Dealer's Association (NADA) Used Car Guide. Recipient organizations file Form 8282, *Donee Information Returns,* which may indicate that the donated vehicle was sold within days of receipt for less than the amount reported as a charitable contribution deduction on the taxpayer's return.

Tax deductions for vehicle donations cost the U.S. Treasury $654 million in 2000.[28] One unnamed national charity told the General Accounting Office (GAO) it netted $8.8 million in 2002 from more than 70,000 donated vehicles. While the GAO report did not estimate how much the IRS loses from inflated claims, it discovered evidence that individuals and charities have been taking advantage of the agency's failure to police the program. In one instance, a donor valued his gift of a 1991 Toyota Camry at $4,500, while the charity only realized $285. In six other cases, charities actually lost money after paying transaction costs.

Note. The author of this text found that based upon the answers a taxpayer gave to questions asked by Kelley Blue Book regarding the value of a 1991 Toyota Camry, the price could vary from $4,600 to $0.

The IRS initiated a program to identify overvalued donations. However, it rarely follows up on the leads, according to *USA Today.* Of the suspect returns referred to field office in fiscal year 2001 and 2002, none were audited. In addition, even though charities must file forms documenting the proceeds they receive from items valued at $5,000 or more, the IRS does not ensure strict compliance. Several senators and the Treasury Department are pushing for tightened rules. The Treasury proposal would give taxpayer's a choice of claiming a maximum vehicle value set by the IRS or getting an appraisal.

California is the only state to require charities to give donors a receipt with the mileage and condition of a donated vehicle claimed for a state tax deduction.

27. Treas. Reg. §1.170A-13

28. *USA Today,* January 28, 2004

> **Note.** As of this writing, Congress has not passed any new laws regarding valuation of automobiles for this purpose. The IRS issued IR-2004-84 on June 29, 2004. A summary of this is found in Chapter 13, Rulings and Cases.

For charitable deduction purposes, the FMV of donated used automobiles is the price a willing buyer would pay a willing seller, when neither is compelled to buy or sell and both have reasonable knowledge of all relevant facts.[29]

An argument can be made that the price a charitable organization receives upon disposition of the automobile is an indication of the automobile's FMV for purposes of the taxpayer's charitable contribution deduction. However, the FMV of an automobile donated to charity must be determined on a case by case basis, and in some cases may have little or no relation to the amount the charitable organization receives on disposition of the automobile.

IRS Pub. 4302, *A Charity's Guide to Car Donations,* helps guide charities in operating car donation programs.[30] In addition, IRS Pub. 4303, *A Donor's Guide to Car Donations,* helps individuals who make such donations.

CHARITABLE REMAINDER TRUSTS: IRC §664

GENERAL CHARACTERISTICS

A charitable remainder trust allows a person (the grantor) to make a gift to charity while providing income to the grantor and/or someone else (the "income beneficiaries"). A current charitable deduction can be taken by the grantor for the value of the "remainder" interest that will eventually pass to the charitable organization.

Remainder beneficiaries are always charities. Income beneficiaries are usually individuals, but can also be trusts, estates, partnerships, or corporations. More than one party may be named as income and/or remainder beneficiaries of the trust.

During the term of the trust, the income beneficiary receives a specified percentage or dollar amount each year for life or for a fixed term of years (not to exceed 20.)

At the end of the trust, the remaining property in the trust passes to the named charitable organization(s). Trusts expiring at the death of the beneficiary are commonly called "lifetime" trusts, while those with a set number of years are referred to as "term" trusts.

A charitable remainder trust may be established during the grantor's lifetime or after death as part of the disposition of his estate.

An **inter vivos trust** is established during the grantor's lifetime. It typically names the grantor (and spouse) as beneficiary, with the remainder passing to charity upon death. However, the trust could be established to last for a specified term of years and could name other parties as beneficiaries.

A **testamentary trust** is created after the grantor's death. A third party is named as the income beneficiary. The charitable distribution takes place at the end of the trust. Although there is no income tax deduction to the grantor, an estate tax charitable deduction is allowed on the grantor's Form 706, *Estate Tax Return,* for the value of the remainder interest that ultimately passes to charitable organizations. The portion of the value of the trust **not** attributable to the remainder interest is included in the decedent's taxable estate.

The trust can be funded with cash or with property, but must be drafted to meet the requirements of IRC §664 in order to receive the special income and estate tax treatment allowed to charitable remainder trusts. Sample trust agreements approved by the IRS are set forth in Rev. Proc. 89-20 for a Charitable Remainder Unitrust (CRUT) and in Rev. Proc.'s 2003-53 through 2003-60 for a Charitable Remainder Annuity Trust (CRAT).

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29. Service Center Advice 1998-022, September 9, 1998

30. IR 2004-84 announced the new publication, June 29, 2004.

Among the most important requirements to qualify as a charitable remainder trust are the following:

- The trust must be irrevocable.
- At least one income beneficiary must be a noncharity.
- No payments may be made from the trust other than the specified annual payment.
- The trust may not be invaded, altered, or amended for the benefit of the noncharitable beneficiary.
- One or more charities, qualified under IRC §170(c), must be named as remainder beneficiary(ies).
- The actuarial value of the remainder must be at least 10% of the initial value of the trust.

TWO TYPES OF CHARITABLE REMAINDER TRUSTS

There are two types of charitable remainder trusts, differentiated by how the distribution amount is calculated.

Charitable Remainder Unitrust (CRUT)

The distribution from a CRUT is calculated as a **specified percentage of the FMV** of the trust, called the "unitrust rate." The distribution is recalculated annually, typically using the value of the trust at the beginning of each year.

Although the specified percentage does not change, the amount a beneficiary receives from a CRUT will change each year. If the trust appreciates in value, the distribution amount will increase. However, if the trust decreases in value, so will the beneficiary's distribution amount.

The specified percentage for calculating distributions must be at least 5%. The maximum percentage payout is 50%, but the 10% remainder requirement may place additional restrictions on the allowable percentage. The specified trust term or life expectancy of the beneficiary will also affect the maximum permissible percentage payout.

It is possible with a CRUT to limit the beneficiary's distribution amount to the actual income earned by the trust if the income is less than the percentage distribution. This limitation is particularly useful if the trust is funded with assets that may not earn 5% (e.g., interest, dividends, rent, or net farm income). This income limitation can also be used to limit the amount of income received by a beneficiary in the early years of a trust while increasing it in later years.

The difference between the calculated percentage amount and the actual income amount is not lost to the beneficiary; it is carried forward. If in later years the trust earns more than the percentage amount, the amounts not distributed in earlier years are paid out—they are "made up." This type of trust is frequently referred to a NIMCRUT (Net Income with Make up Charitable Remainder UniTrust.)

Under certain circumstances it is also possible to have an income-only CRUT that switches to a straight unitrust upon a specified "triggering" event. These are known as FLIP Unitrusts.

Charitable Remainder Annuity Trust (CRAT)

The distribution from a CRAT is **a fixed dollar amount**. The amount paid out remains the same each year regardless of any increase or decrease in the value of the trust. The distribution amount must **not** be:

- Less than 5% of the initial value of the trust, or
- More than 50% of the initial value at funding.

No additional contributions may be made to a CRAT after the initial funding. The trust document must prohibit additional contributions.

In addition, there cannot be a greater than 5% probability that the trust will be exhausted before the death of the recipient of the annuity. This requirement does not apply to CRUTs.

DETERMINING THE CHARITABLE GIFT AMOUNT

The grantor of a charitable remainder trust can take a charitable income tax deduction in the year the trust is funded. The deduction is taken for the value of the **remainder interest** that will pass to charity in the future. The remainder interest is calculated by subtracting the value of the **income interest** from the FMV of the property transferred into trust.

The value of the income interest is based upon the length of the trust (life expectancy or term of years) and the amount distributed to the noncharitable beneficiary. The lower the value of the income interest, the higher the charitable deduction. For example, a lifetime trust with an older beneficiary and a low payout amount provides a higher charitable deduction than a trust that has a younger beneficiary or a higher payout rate.

The IRS established tables to be used in valuing charitable remainder interests. Different tables are used for different types of trusts.[31] Table S is used for a single-life CRAT. Table U(1) is used for a single-life CRUT. There are also tables for trusts based on a term of years and for more than one life.

There are two primary factors to the tables:

1. The **time component** is the length of trust. If the trust ends at death, the life expectancy of the beneficiary is based on IRS Table 90CM. The most recent revision of this table is in IRS Pub. 1457, *Actuarial Values, Book Aleph.*
2. The **interest rate component** is the IRC §7520 interest rate, which is equal to 120% of the federal midterm rate, compounded annually, and rounded to the nearest two-tenths of one percent. The rate in effect for the month of the transfer or the rates for either of the two preceding months may be used.

Additional factors considered in valuing the income interest are the **frequency** and **timing** of the payments. These factors affect the computation of the "adjusted payout rate" for a CRUT and are included in Table F.

Computer software is available which calculates the value of the income and remainder interests, thereby determining the amount of the allowable charitable deduction. However, the calculation can also be done manually.

Example 21. Don establishes a $100,000 CRAT, with a $5,000 annual lifetime payment to a single beneficiary (himself). He is 70 years old. The trust is established and funded in January 2004. Payment is made at the end of the year. The §7520 rate is 4.2%, so Table S (4.2) is used to find the annuity factor.

Amount of annuity payment	$ 5,000
One life annuity factor, age 70, Table S	9.7043
Payout frequency factor	1.000 (annual payment)
Present value of annuity interest ($5,000 × 9.7043 × 1.00)	$48,522
Amount of charitable deduction ($100,000 − $48,522)	$51,478

31. IRS Pub. 1457, *Actuarial Values, Book Aleph,* contains actuarial factors for computing the value of a remainder interest in a CRAT. IRS Pub. 1458, *Actuarial Values, Book Beth,* contains the factors for valuing the remainder interest in a CRUT. IRS Pub. 1459, *Actuarial Values, Book Gimel,* include a full set of the IRC §7520 tables. These are available free from the IRS website (www.irs.gov) and for purchase by phone at 1-866-512-1800, by website at bookstore.gpo.gov, or by mail.

Example 22. Assume the same facts as in **Example 21** except, the trust is a CRUT with a 5% annual payment. It is paid quarterly, and is based on the value of the trust at the beginning of the year. Table F (4.2) is used to find the payout frequency factor.[32]

FMV of trust	$100,000
Percentage payout	5%
Payout frequency factor, Table F	.974679
Adjusted payout rate (5.0 × .974679)	4.873%
Remainder factor, age 70, Table U(1)[31]	.53631
Value of remainder interest ($100,000 × .53631)	$ 53,631
Amount of charitable deduction	$ 53,631

IRC §7520 rates are currently (May 2004) at historically low levels. With all other factors remaining the same, lower rates indicate less future growth in value and provide a smaller value for the remainder interest. This means a smaller charitable deduction. Higher rates would help to ensure that there will be at least 10% of the trust remaining at the end of the trust. Higher rates would also decrease the risk that the CRAT would be exhausted before the end of the trust.

DOCUMENTING THE CHARITABLE DEDUCTION

The taxpayer taking a charitable income tax deduction for a charitable remainder trust should attach documentation to his Form 1040 showing the calculation of the charitable deduction amount. The trustee frequently provides this documentation, particularly if the trustee is the remainder beneficiary or a financial institution.

Additional documentation may be required with the taxpayer's tax return to establish the value of the property transferred to the trust if cash is not used. For property other than listed securities, an appraisal is required. A copy of the trust agreement may also be attached.

FUNDING THE CHARITABLE REMAINDER TRUST

A charitable remainder trust can be funded with cash or with property. As with other charitable gifts, the charitable deduction is determined using the FMV of the property transferred. If the asset is not cash or a listed security, an appraisal is required.

Charitable remainder trusts are frequently funded with appreciated property. This provides the benefit of a deduction based on the full FMV of the property, rather than the amount remaining after the payment of taxes. In addition, the trust can then sell the appreciated asset without paying taxes and reinvest the total amount in the trust. This can permit a donor to increase his income without incurring the capital gains tax on the sale of an asset.

Example 23. Don, from **Example 21,** owns stock valued at $100,000, with a cost basis of $10,000. If he sells the stock outside a trust and reinvests the proceeds to produce more income, he incurs a capital gains tax of $13,500 ($90,000 × 15%). This leaves $86,500 to be reinvested. If his investment earns 5% annually, he will receive $4,325 in income.

If he transfers the stock to a CRAT, the stock can be sold tax-free, and the entire $100,000 can be reinvested. If the investment earns 5% annually, the trust will earn $5,000 in income, which Don can receive as his income distribution.

In addition, he will also have a charitable deduction of $51,478 in the year the trust is established. Since the trust is funded with appreciated property, the deduction is limited to 30% of his AGI. Charitable deductions of cash are limited to 50% of AGI. Excess contributions are carried forward for up to five years.

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32. Table U(1) does not list a remainder factor for 4.873%. The factor is calculated from the factors shown under 4.8% (.54084) and 5.0% (.52843). The differences between those rates and those factors are 0.2% and (.01241). The remainder factor of 4.873% is 0.073% above 4.8%. This difference divided by 0.2% equals 0.365, which multiplied by the factor difference of .01241 equals .00453. Subtracting .00453 from .54084 produces the remainder factor of .53631 used in this example.

Note. Readers are reminded that while Don has a greater annual income by establishing the CRAT, at his death the charitable beneficiary to the CRAT will receive the remaining principal. If Don did not establish the CRAT, his annual income would be less, but the remaining principle is available to whomever he specifies in his will.

Caution. A charitable remainder trust should not be funded with property subject to indebtedness. Debt-financed income is treated as unrelated business taxable income. A charitable remainder trust is not exempt from taxation if it has unrelated business taxable income. The trust should not be funded with mortgaged property, and should not incur indebtedness after it is funded.

DISTRIBUTIONS

Distributions to the income beneficiaries must be made at least annually and are usually made on a quarterly basis.

Income-Only CRUT

The trust's actual income may not be known until after the end of the year. This is particularly true for a CRUT that owns farmland or other real estate. Although a distribution may be made after the end of a year, it will be includible by the recipient for tax purposes in the year that the trust earned the income.

Distributions for Short Years

The initial year of a charitable remainder trust is likely a short year. This is also true for the final year. For the initial year, the distribution amount for a CRUT is calculated using the contributed value of the property. For both CRUTs and CRATs, the distribution amount is prorated according to the number of days in the first year.

Example 24. Donita contributed $200,000 to a CRUT established on May 1, 2003. The unitrust rate is 5%, so her annual distribution is $10,000. However, the initial distribution in 2003 is prorated.

$$(\$10{,}000 \div 365) \times 244 = \$6{,}684.93$$

The final year for the trust will also likely be a short year. Typically the trust document provides that payments to a lifetime beneficiary cease with the last payment made prior to death. If not, a prorated payment will need to be made to the beneficiary's estate.

Testamentary Trust Distributions

A charitable remainder trust can also be established after the death of the donor, as part of a testamentary plan included in a will or trust agreement. Special rules apply to testamentary transfers.

Frequently, a testamentary charitable remainder trust is not established and funded until some time after the donor's death. The delay in making distributions to the trust beneficiary does not cause the trust to lose its status as a charitable remainder trust, provided the obligation to pay the annuity or unitrust amount begins as of the date of death of the decedent. The payment may be deferred until the trust is actually funded, provided the funding takes place at the end of a reasonable period of estate administration or settlement.

The calculation method for the required retroactive payment is described in Treas. Reg. §1.664-1(a)(5)(ii). The calculation is done and the payment is made for the year in which the complete funding of the trust takes place. Interest is also then computed using the appropriate §7520 rate and added to the retroactive payment.

Tax Treatment of Distributions

The character of the distributions received by income beneficiaries of charitable remainder trusts is determined in a manner that differs from other types of trusts. The trust's income and capital gain flows through to the beneficiary, up to the amount of the distributions received by the beneficiary in that year.

> **Note.** If the trust has ordinary or capital losses, the preparer should refer to Prop. Treas. Reg. §1.664-1 for the proper treatment of the losses. Losses in excess of gains in each specified class of income do not flow through to the beneficiaries. Instead, they offset previously untaxed and/or future income. The offset method is delineated in the proposed regulation.

Unlike other trusts, the beneficiary does not receive a pro rata share of each type of income. There is a specific order in which income is distributed, generally with the more highly taxed income being distributed first:[33]

1. Ordinary income, to the extent of that year's ordinary income, plus any undistributed ordinary income from prior years (includes interest, nonqualified dividends, net farm income, rental income, etc.)
2. Ordinary income, qualified dividends (taxed at a maximum rate of 15%)
3. Short-term capital gains
4. Long-term capital gains, with the higher rate gains distributed before the lower rate-gains
5. Other income, including tax-exempt
6. Principal

Example 25. A charitable remainder trust, which distributed $5,000 last year, had the following income amounts:

Interest	$ 2,000
Dividends	1,000
Short-term capital gains	5,000
Long-term capital gains	10,000

The Schedule K-1 provided to the beneficiary shows the following:

Interest	$2,000
Dividends	1,000
Short-term capital gains	2,000
	$5,000

The interest, dividends, and short-term capial gains equal the amount distributed.

The remaining $3000 of short-term capital gains and the $10,000 of long-term capital gains are carried forward to future years.

[33] Prop. Treas. Reg. §1.664-1

Example 26. Assume the same facts as **Example 25** except, in 2004 the trust only has $1,000 of interest income and $15,000 of long-term capital gain income. The trust made another $5,000 distribution in 2004. The 2004 K-1 provided to the beneficiary shows the following:

Interest	$1,000
Short-term capital gains	3,000
Long-term capital gains	1,000
	$5,000

Here, the interest and short- and long-term gains equal the amount distributed.

Preparation of Trust Information Returns

A charitable remainder trust is exempt from taxation. It files information returns in order to:

- Report income and valuation information, and
- Determine and report the amounts taxable to the beneficiary.

The following federal tax forms need to be completed for a charitable remainder trust:

- Form 5227, *Split-Interest Trust Information Return*
- Form 1041A, *U.S. Information Return Trust Accumulation of Charitable Amounts*

Included with Form 5227 are all of the schedules and forms needed to report each type of income earned by the trust (e.g., Schedules D, E, and F). A 1041 Schedule K-1 is attached for each beneficiary. The K-1 itemizes the amounts that the beneficiary should report on his personal tax return. A copy of the K-1 is also given to each beneficiary.

In order to complete the returns, the tax preparer needs the following information:

- Income and expense amounts
- A copy of the trust agreement or will
- Values of the trust assets at the beginning of the taxable year and at the end of the year
- The tax basis for all assets

A copy of the trust agreement should be included with the initial return filed for the trust, and a Form 709, *Gift Tax Return,* should be filed when the trust is established.

Caution. Charitable remainder trusts are subject to many of the private foundation rules regarding self-dealing and making taxable expenditures. Pages 3 and 4 of the Form 5227 include a series of questions that must be answered regarding these matters.

Example 27. CRUT. Joe Sample created and funded a CRUT on March 1, 2003, with listed securities (Old stock) worth $100,000. The basis of the stock is $50,000. The trust provides for a 5% unitrust payment based on the value of the trust at the beginning of the year.

The trust earned the following income in 2003:

Interest income	$1,200
Qualified dividend income	1,000
Nonqualified dividend income	100

Other trust transactions included:

- Stock (held over one year) was sold on May 15 for $100,000. Proceeds of the sale were invested as follows:

New stock	$60,000
Bonds	35,000
Money market account	5,000

- $5,000 of new stock was sold on August 25 for $10,000
- Distributions were made to the beneficiaries in the amount of $4,192

The market values of the investments at year end were:

Stocks	$ 72,000
Bonds	35,000
Cash	3,108
	$110,108

The 2003 Form 5227 for Joe Sample follows.

For Example 27

Form **5227** — Department of the Treasury, Internal Revenue Service

Split-Interest Trust Information Return

► See separate instructions.

OMB No. 1545-0196 — **2003**

Full name of trust: JOE SAMPLE CRUT	A Employer identification number: 12 3456789
Name of trustee: YOUR BANK, TRUSTEE	B Type of Entity
Number, street, and room or suite no. (If a P.O. box, see page 2 of the instructions.)	(1) ☐ Charitable lead trust
City, state, and ZIP code	(2) ☐ Charitable remainder annuity trust described in section 664(d)(1)
C Fair market value (FMV) of assets at end of tax year: 110,108 — D Date the trust was created: 03/01/2003	(3) ☑ Charitable remainder unitrust described in section 664(d)(2)
E Check applicable boxes (see instructions): ☑ Initial return ☐ Final return ☐ Amended return; Change in trustee's ► ☐ Name ☐ Address	(4) ☐ Pooled income fund described in section 642(c)(5)
F Did the split-interest trust have any unrelated business taxable income (section 664 trusts only)? If "Yes," file Form 1041 . . . ☐ Yes ☑ No	(5) ☐ Other

6

Part I Ordinary Income (Section 664 trust only)

1	Interest income			1	1,200
2a	Qualified dividends (see instructions)	2a	1,000		
b	Ordinary dividends (including qualified dividends)			2b	1,100
3	Business income or (loss) (attach Schedule C or C-EZ (Form 1040))			3	
4	Rents, royalties, partnerships, other estates and trusts, etc. (attach Schedule E (Form 1040))			4	
5	Farm income or (loss) (attach Schedule F (Form 1040))			5	
6	Ordinary gain or (loss) (attach Form 4797)			6	
7	Other income (state nature of income)			7	
8	**Total** ordinary income (combine lines 1, 2b, and 3 through 7)			8	2,300
	Deductions Allocable to Ordinary Income				
9	Interest			9	
10	Taxes			10	
11	Other deductions (attach a separate sheet listing deductions)			11	
12	**Total** deductions (add lines 9 through 11)			12	0
13	Ordinary income less deductions (subtract line 12 from line 8). Enter here and on line 21, column (a)			13	2,300
	Capital Gains (Losses) and Allocable Deductions				
14	Total short-term capital gain or (loss) for tax year (attach Schedule D (Form 1041))	14	5,000		
15	Deductions allocable to short-term capital gains	15			
16	**Balance** (subtract line 15 from line 14). Enter here and on line 21, column (b)			16	5,000
17a	Total long-term capital gain or (loss) for tax year (attach Schedule D (Form 1041))	17a	50,000		
b	28% rate gain or (loss) — 17b				
c	Qualified 5-year gain — 17c				
d	Unrecaptured section 1250 gain — 17d				
18	Deductions allocable to long-term capital gains	18			
19	**Balance** (subtract line 18 from line 17a). Enter here and on line 21, column (c)			19	50,000

Part II Accumulation Schedule (Section 664 trust only)

Accumulations	(a) Ordinary income	Capital gains and (losses) (b) Net short-term	(c) Net long-term	(d) Nontaxable income
20 Undistributed from prior tax years				
21 Current tax year (before distributions)	2,300	5,000	50,000	
22 **Total** (add lines 20 and 21)	2,300	5,000	50,000	
23 Undistributed at end of tax year		3,108	50,000	

Part III Current Distributions Schedule (Section 664 trust only)

Name of recipient	Identifying number	(a) Ordinary income	Capital gains (b) Short-term	(c) Long-term	(d) Nontaxable income	(e) Corpus
24a JOE SAMPLE		2300	1892			
b						
c						

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In 2004, the trust earned $4,000, and the full unitrust payment of $5,505 (110,108 × 5%) was made. Parts II and III of Form 5227 for 2004 follow:

19 **Balance** (subtract line 18 from line 17). Enter here and on line 21, column (c)			19	50,000

Part II **Accumulation Schedule** (Section 664 trust only)

Accumulations	(a) Ordinary income	Capital gains and (losses)		(d) Nontaxable income
		(b) Net short-term	(c) Net long-term	
20 Undistributed from prior tax years				
21 Current tax year (before distributions)	4,000	3,108	50,000	
22 **Total** (add lines 20 and 21)	4,000	3,108	50,000	
23 Undistributed at end of tax year		1,603	50,000	

Part III **Current Distributions Schedule** (Section 664 trust only)

Name of recipient	Identifying number	(a) Ordinary income	Capital gains		(d) Nontaxable income	(e) Corpus
			(b) Short-term	(c) Long-term		
24a JOE SAMPLE		4,000	1,505			
b						
c						

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Example 28. NIMCRUT. Use the same facts as **Example 27** except, the CRUT is an income only trust. Therefore, distributions to the beneficiary are limited to the accounting income each year. Part V-B of the trust's 2003 Form 5227 follows.

b Enter the total ... recipient if more than one) . . . 48b

Part V-B **Charitable Remainder Unitrust Information** (to be completed **only** by a section 664 charitable remainder unitrust)

49a Enter the unitrust fixed percentage to be paid to the recipients. If there is more than one recipient, attach a schedule showing the percentage of the total unitrust dollar amount payable to each recipient.	49a	5.0000 %
b **Unitrust amount.** Subtract line 43, column (c), from line 37, column (c), and multiply the result by the percentage on line 49a	49b	4,192
Note: *Complete lines 50a through 51b* **only** *for those unitrusts whose governing instruments provide for determining required distributions with reference to the unitrust's income. Otherwise, enter the amount from line 49b on line 52.*		
50a Trust's accounting income for 2003	50a	2,300
b Enter the smaller of line 49b or line 50a here, and on line 52 on page 3, unless the **Caution** below applies	50b	2,300
Caution: *Lines 51a and b need to be completed by those unitrusts whose governing instruments provide for current distributions to make up for any distribution deficiencies in previous years due to the trust income limit. See Regulations section 1.664-3(a)(1)(i)(b)(2). For these trusts, when completing line 52 enter the smaller of line 50a or line 51b.*		

Form **5227** (2003)

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51a Total accrued distribution deficiencies from previous years (see page 9 of the instructions)	51a	
b Add lines 49b and 51a	51b	4,192
52 Unitrust distributions for 2003	52	2,300
53 Carryover of distribution deficiency (subtract line 52 from line 51b)	53	1,892

54 Did the trustee change the method of determining the fair market value of the assets? ☐ **Yes** ☑ **No**
If "Yes," attach an explanation.

55 Were any additional contributions received by the trust during 2003? ☐ **Yes** ☑ **No**
If "Yes," attach a schedule that lists the assets and the date(s) received.

Part VI **Statements Regarding Activities** (see page 9 of the instructions)

STATE INCOME TAX REPORTING

In addition to the federal tax forms filed, state forms may also be required. For the state of Illinois, an initial charitable registration of the trust must be made with the attorney general's office. That filing should be made within six months of the establishment of the trust. It is the trustee's responsibility to file this registration. The trustee must also annually file Form AG990 with the attorney general, including a copy of any federal returns filed. An IL Form 1041 is not usually prepared.

CHARITABLE GIFT ANNUITY

A charitable gift annuity is similar in many respects to a charitable remainder trust. The primary difference is that the initial transfer is made directly to a charity instead of a trust. In exchange, the charity pays the beneficiary(ies) a fixed and guaranteed annuity for life. The annuity may either commence immediately, or be deferred until a specified future time, as agreed by the donor and the charity.

The charity keeps the funds remaining at the end of the annuity, and the donor receives a guaranteed level of income and a tax deduction for the charitable contribution.

FUNDING THE GIFT ANNUITY

A gift of cash is the easiest and most frequent way of giving. Stocks, bonds, mutual funds, and other securities may also be donated.

If the securities have appreciated in value, the donor benefits from not paying capital gains tax on the entire appreciation at the time of the gift, in addition to benefiting from the charitable deduction. Regardless of the income tax bracket, it is generally better to give appreciated securities than to sell them and give cash.

However, if the securities have depreciated in value, it is better to sell the security, take the capital loss for tax purposes, and donate the proceeds.

> **Note.** A number of states regulate the writing of charitable gift annuities, usually through the state insurance commission. For example, in New York, there are limits on the maximum charitable gift annuity rates, and gift annuities funded with real estate are prohibited. Under Illinois law, charitable gift annuities previously fell by default under the jurisdiction of the Illinois Insurance Commission. An annuity written by a charity was automatically considered life insurance. This was changed by legislation passed at the end of 1995. The insurance laws of Illinois now do not apply to a charitable gift annuity written by a qualifying charity that has been in active operation for not less that 20 years and that has an unrestricted fund balance of not less than $2,000,000.

TAXATION OF CHARITABLE GIFT ANNUITIES

Charitable gift annuities generally are taxed under the bargain sale rules. A charitable deduction is allowed in the year of the transfer for the value of the property contributed less the present value of the annuity contract. The present value of the annuity contract is determined from IRS valuation tables, based on the applicable monthly interest rate under §7520.

> **Example 29.** Gary Investor gives stock valued at $120,000 to his favorite charity in exchange for a single-life annuity of $5,000 per year payable until he dies. The present value of the annuity is $72,000. Gary's charitable contribution is $48,000.

The donor must allocate the basis in the transferred assets between the sale portion and the gift portion, and **the donor may realize a gain** on the sale portion.

Example 30. Gary's basis in the stock is $20,000. The sale portion of the transfer is the present value of the annuity. Gary calculates his basis in the sale as follows:

$$\frac{\text{Present value of annuity}}{\text{FMV of the transfer}} = \frac{\$72{,}000}{120{,}000} = 60\% \times \$20{,}000 \text{ basis} = \$12{,}000 \text{ basis in sale portion}$$

His capital gain is $60,000, which is the present value of annuity less basis ($72,000 – $12,000).

If the annuity is nonassignable and the donor is either the sole annuitant for life or is one of the annuitants in a two-life annuity, any capital gain is recognized ratably over the donor's life expectancy.[34] Any unrecognized gain at the donor's death is not reportable if the annuity is a single-life annuity. If the annuity pays over two lives, the succeeding annuitant continues to recognize any remaining gain under the same rules.

Example 31. Use the same facts as **Example 30.** Based on actuarial tables, Gary is expected to live for 20 years. His capital gain of $60,000 is divided by 20 years. He must claim $3,000 each year as capital gains. He may stop claiming the $3,000 once he has claimed the entire amount of the gain. If he dies earlier than actuarially predicted, no one has to claim the remaining gain.

In addition, a portion of the annuity payment received is taxed as ordinary income each year. The method for calculating the ordinary income in explained in the next example.

Example 32. Use the same facts as **Example 30.** Jane, the charity's accountant, must issue Gary a Form 1099-R reporting the annual distribution. To calculate the ordinary income portion of Gary's payment, she first figures his expected return. This is done by multiplying the annual payment ($5,000) by his predicted remaining life of 20 years. If Gary lives as long as the actuarial tables predict, he will receive $100,000.

Jane figures the "annual exclusion" as follows:

$$\frac{\text{Present value of annuity}}{\text{Expected return}} = \frac{\$72{,}000}{100{,}000} = 72\% \times \$5{,}000 \text{ annual payment} = \$3{,}600 \text{ annual exclusion}$$

The ordinary income portion of Gary's payment is $1,400 ($5,000 – $3,600). Gary's Form 1099-R follows.

34. Treas. Reg. §1.1011-2(a)(4)(ii)

For Example 32

9898 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code		1 Gross distribution	OMB No. 1545-0119	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
Favorite Charity		$ 5000.00	2004	
		2a Taxable amount $ 4400.00	Form 1099-R	
		2b Taxable amount not determined ☐	Total distribution ☐	Copy A For Internal Revenue Service Center
PAYER'S Federal identification number 12-3245678	RECIPIENT'S identification number 987-65-4321	3 Capital gain (included in box 2a) $ 3000.00	4 Federal income tax withheld $	File with Form 1096.
RECIPIENT'S name Gary Investor		5 $	6 Net unrealized appreciation in employer's securities $	For Privacy Act and Paperwork Reduction Act Notice, see the **2004 General Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.)		7 Distribution code(s) F; IRA/SEP/SIMPLE ☐	8 Other $ %	
City, state, and ZIP code		9a Your percentage of total distribution %	9b Total employee contributions $	
Account number (optional)		10 State tax withheld $ $	11 State/Payer's state no.	12 State distribution $ $
		13 Local tax withheld $ $	14 Name of locality	15 Local distribution $ $

Form 1099-R Cat. No. 14436Q Department of the Treasury - Internal Revenue Service

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Gary will report:

Ordinary income	$1,400
Capital gain	3,000
Nontaxable return of capital	600
Total annuity received	$5,000

After 20 years, Gary will report:

Ordinary income	$1,400
Nontaxable return of capital	3,600
Total annuity received	$5,000

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