Donors & Taxes
or
Is it Taxes & Donors?

Northern California Planned Giving Council

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Topics

- Repeal of DOMA
- §501(c)(4) and Exempt Org Update
- White House Budget Proposals
- American Taxpayer Relief Act of 2012
- Recent Charitable Giving Cases/Rulings
- Creative Planned Giving Ideas

Repeal of DOMA

- U.S. v. Windsor, S. Ct. No. 12-307 (570 U.S. ___, 2013)
- Federal estate tax refund suit to claim estate tax marital deduction
- Held: Defense of Marriage Act unconstitutional – marital deduction allowed.
- Income Tax Planning Issues

Income Tax Planning Issues

- Joint Tax Returns
- Amended Tax Returns
- IRA Rollovers
- Pension/Profit Sharing Plans
  - Beneficiary designations should be reviewed.
  - Spousal consents may be needed
  - QDROS
- Related Party Transactions (member of family rules)
  - Example: §267 disallows loss recognition of sale or exchange, but related party rules pervade the tax code.

Estate Planning Issues

- Community Property Classification
  - Review community property rules with clients
  - Property agreements should be discussed
- Spousal Intestacy rights
- §2034 Dower or curtesy interests includible in estate
- Marital Deduction – Estate and Gift Tax
  - QTIPs
  - Unlimited Inter Vivos Gift
  - Amended gift tax returns
  - Gift Tax returns beyond statute of limitations

Estate Planning Issues

- Marital Deduction – Estate and Gift Tax
  - QTIPs
  - Unlimited Inter Vivos Gift
  - Amended gift tax returns
  - Gift Tax returns beyond statute of limitations
  - Portability
  - Qualified Domestic Trusts
  - Consider trust reformations to qualify the marital deduction

Estate Planning Issues

- Gift Splitting Election
- Rules that apply when “member of the family” is involved. Notably, Chapter 14 covers:

  – §2701: special valuation rules in case of transfers of certain interests in corporations or partnerships – anti estate freeze provisions
  – §2702: special valuation rules in case of transfers of interests in trusts – covers transfers of term interests (includes qualified personal residence trusts)
  – §2703: certain rights and restrictions disregarded – disallows valuation adjustments due to certain restrictions on transfers, etc; may apply for example to buy-sell agreements
  – §2704: treatment of certain lapsing rights and restrictions – disallows valuation adjustments when rights terminate upon death

§501(c)(4) and Exempt Org Update

- IRS recently released the results of its initial review of its treatment of conservative groups seeking §501(c)(4) status.
  - There were no signs of intentional wrongdoing by agency personnel or involvement by parties outside the agency.
  - However Daniel Werfel (acting IRS Commissioner) stated he is not providing a definitive conclusion that no wrongdoing occurred.

IRS Scandal & Donors

- Tax code lists more than 30 categories of tax-exempt organizations
  - Familiar: schools, religious groups
  - Obscure: cemeteries and title-holding corporations
- TIGTA (Treasury Inspector General for Tax Administration) on May 14 released report regarding organizations applying for §501(c)(4) status which differs from the more familiar 501(c)(3) which cover public charities like the American Red Cross, Stanford University and United Way. These groups can receive tax-deductible contributions, but their political activities are highly restricted.

501(c)(4)

- Less tax-favored and more able to be politically active.
- Examples include the National Rifle Association of America and the Sierra Club. New ones include Crossroads GPS which favors conservative causes and Citizens for Strength & Security which supports liberal ones.
- Donations usually not tax deductible.

501(c)(4)

- Can’t give to federal candidates.
- Can lobby and participate in campaigns.
- Rules are murky and depends on a plethora of facts and circumstances.
- Recent court decisions freed corporations, unions and other groups to make unlimited donations to 501(c)(4)s.
  - Political spending increased to $254 million in 2012 compared to $92 million in 2010.

“BOLO” lists

- TIGTA reported that the IRS Exempt Organizations (EO) office had used so-called "be-on-the-lookout," or BOLO lists in the application process for tax-exempt status. According to TIGTA, EO staff used the inappropriate criteria on these lists to identify applications for § 501(c)(4) status from certain organizations. These BOLO lists reportedly targeted progressive groups as well as conservative leaning organizations. The IRS also burdened these BOLO-listed groups with unnecessary requests for additional information, which resulted in the processing of their applications for § 501(c)(4) status being delayed, TIGTA reported.
- In his review Werfel said that the agency has suspended use of BOLO lists.

Streamlined Process

- To reduce the backlog of tax-exempt applications, the IRS is offering certain organizations that have applied for 501(c)(4) status a faster, optional method to gain tax-exempt status.
- The IRS has indicated that it will offer this expedited option to organizations that have had their applications pending for more than three months and with activities that involve possible political campaign intervention or issue advocacy.
- This "safe-harbor" option will provide such groups an approved determination letter granting them 501(c)(4) status within two weeks if they certify that they devote at least 60% of both their spending and time on activities that promote social welfare as defined by IRC Sec. 501(c)(4). They also must certify that less than 40% of their spending and time is involved in political campaign intervention.
- The IRS promises to treat these groups fairly and review applications promptly.
- For more on this optional method, see the IRS website at www.irs.gov, select the tab for IRS Report, then select "Streamlined Options for Certain 501(c)(4) Groups."

What does it mean to donors?

- Gifts to 501(c)(3) charities are deductible up to certain limits.
- Gifts to 501(c)(4) groups usually are not.
  - However they may be allied with a tax-deductible group. NRA Foundation (deductible), NRA (not deductible)
- Donation disclosure
  - c4: $5,000 or more
  - C3: Unless gifts are disproportionately large
- Donation taxable?
  - Some say donations to c4 groups subject to gift tax.
  - IRS announced it won't apply this tax pending further study or legislation.

White House Budget Proposals

- President released $3.77 trillion budget for 2014 fiscal year.
- Limitation on deductions
- Buffet Rule
- Limit on Accrual of Retirement Benefits
- Estate and Gift Taxes
- Elimination of the stretch IRA
- RMD relief

Limitation on Deductions

- Reduce the value to 28% of specified exclusions and deductions that otherwise would reduce taxable income in the 33, 35 and 39.6% tax brackets
- Reduce the value of charitable deductions.

Buffet Rule

- Individuals whose adjusted gross income exceeds $1 million would pay a minimum tax rate of 30% on the excess of the taxpayer’s adjusted gross income over the taxpayer’s modified charitable contribution deduction for the tax year.
- Tentatively called the Fair Share Tax (FST)

Limit on Accrual of Retirement Benefits

- Limit contributions and accruals on tax-favored retirement benefits, including IRAs, qualified plans, tax-sheltered annuities and deferred compensation plans.
- Currently the maximum permitted accumulation would be $3.4 million for an individual at age 62.
- Based upon the amount required to provided an annuity benefit of $205,000 payable as a joint and 100% survivor annuity starting at age 62.

Estate & Gift Taxes

- ATRA permanently provided for a maximum unified federal estate and gift tax rate of 40% with an inflation-adjusted $5 million exclusion.
- President Obama pressed for a return to a 2009 structure which calls for a 45% rate with a $3.5 million exclusion and a $1 million lifetime gift tax exclusion (both indexed for inflation).
- Begin in 2018.
- However portability of unused estate and gift tax exclusions between spouses would be allowed.

American Tax Relief Act of 2012 (ATRA)

- Qualified Charitable Distribution (QCD)
- Estate Tax Changes
- PEP & Pease
- 3.8% Surtax on Net Investment Income
- Tax Rates

QCD

- Make direct IRA distributions to charity without having to include the distribution in gross income.
- $100,000 limit per individual.
- IRA owner must be at least 70 ½ on the day of the transfer.
- The distribution must qualify under the general charitable deduction rules under IRC §170.
- Must be direct transfer – IRA trustee must draft check in the charity's name.
- Satisfies RMD requirement.

QCD

- Advantages of QCD
  - Deductibility of medical expenses
  - Miscellaneous itemized deductions
  - Social security benefits
  - Medicare premiums
  - Taxpayers who do not itemize
  - Basis goes last
    - Normal distribution-ordering rules are ignored.
  - 3.8% surcharge NII

QCD

- Taxability of Social Security
  - 50% of Social Security benefits are taxable if MAGI exceeds:
    - $25,000 if single, HOH, or qualifying widow; MFS & lived apart from spouse for entire year
    - $32,000 if MFJ
    - $0, if MFS and lived with spouse anytime of the year
  - 85% of Social Security benefits taxable if MAGI exceeds:
    - $34,000 if single, HOH, or qualifying widow;MFS & lived apart from spouse for entire year
    - $32,000 if MFJ
    - $- 0 if MFS and lived with spouse anytime of the year

QCD

- Standard deductions for 2013 over age 65
  - MFJ = $14,600
  - Single = $ 7,600

QCD

- Medicare premiums – see SSA Publication 05-10536
- For 2013 standard Part B premium is $104.90 per month up to $85,000 for individuals and $170,000 for married couples.
- Additional $42 above income amounts with a maximum of $231 additional per month.

QCD

- What about 2014?
  - Congress has not gotten around to extending the QCD for 2014.
  - Send RMD to charity.
    - Congress extends the QCD and the distribution will not be reported as income; or
    - Congress does not extend the QCD
      - Report the distribution as income
      - Claim the contribution as an charitable itemized deduction
        - » PEP & Pease limitations, etc.

Estate, Gift, and GST Tax Rate and Exclusion Amount

- Tax rate is 40%
- Applicable exclusion amount is $5,250,000 for 2013 (with inflation adjustments)
- Portability made permanent
- Applicable exclusion amount will be adjusted for inflation
- GST Provisions extended

Rules & Requirements for Portability

- Portability allows a surviving spouse to carry over the "Deceased Spouse's Unused Exclusion Amount" (DSUEA)
  - Available to surviving spouse in addition to his/her own $5m Basic Exclusion Amount (BEA)
  - Requires an estate tax return to be timely filed
    - Only available for deaths that had occurred after 2010
    - Simplified filing requirements for nontaxable estates
    - No proactive election to be made, beyond actually filing the return
  - Applies to gift and estate tax exemptions
    - Does not apply to GST exemption
    - No state conformity at this point

Additional Rules & Requirements for Portability

- Only counts for the last deceased spouse's exemption
- For example, surviving spouse's exemption will drop back to $5m exemption if new spouse already used the exemption.
  - Also an issue of new spouse leaves property to his/her children instead of surviving spouse

Estate Planning in 2013 & Beyond

- Unwinding estate planning strategies for income tax benefits?
  - Updating documents to remove Bypass trusts?
- Busting QPRTs?
- Causing FLPs to be in parents' estate
  - Asset protection benefits to not unwind?
- ILIT still necessary?
- Estate planning will shift away from estate tax planning
  - Greater attention to POA, Health Care POA, Advanced Medical Directives
- Do we file 706 for everyone?
- Real Estate planning
- Probate avoidance
- Asset, divorce & spendthrift protection

What Can Still Change?

- Tax carried interest as ordinary income
- Require a minimum term for GRATs (10 years)
- Limit the “value” of deductions (28%?)
- Restrictions on FLPs and valuation discount strategies
- Elimination of IDGT strategies
  - Grantor trusts automatically included in estate
- Maximum duration for GST
- Corporate Tax Changes
- State estate tax?
  - California does not have an estate or gift tax.
  - Portability?
  - It’s not where the client lives, it’s the state the client dies in

Phase-out of Personal Exemptions and Itemized Deductions

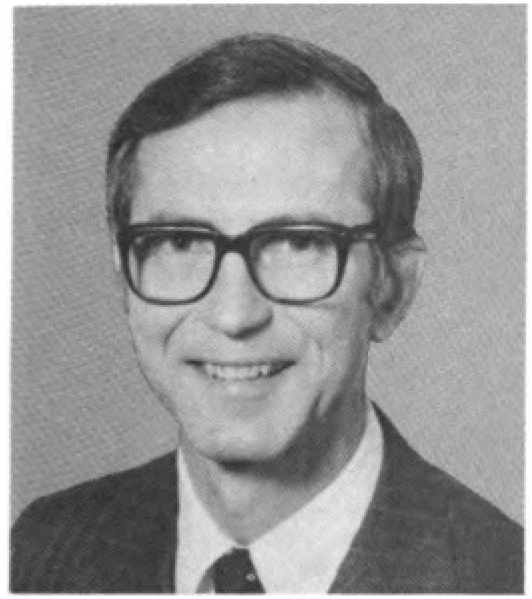
- Phase-out of personal exemptions (PEP) and limitations on itemized deductions (Pease) as income rises above the following threshold amounts:
  - Single taxpayers = $250,000
  - Head of Households = $275,000
  - MFJ or Surviving spouse = $300,000
  - Married filing separately = $150,000
- Amounts will be adjusted for inflation

Phase-out of Personal Exemptions and Itemized Deductions

- PEP reduces personal exemption by 2% for
  - every $2,500 of income above the threshold amount for single taxpayers
  - Every $1,250 of income above the threshold amount for married filing jointly
- Reinstatement of the phase-out could have been worse
  - If the full sunset occurred, the applicable threshold amounts would have been $178,150 for single taxpayers and $267,200 for MFJ

Pease Limitation

- Pease cuts itemized deductions by 3% of AGI above the threshold amounts up to a maximum of 80%
- Deductions not included:
  - Investment interest
  - Medical expenses
  - Casualty, theft and wagering losses
- With the full sunset, the threshold amounts would have been the same $178,150 for single taxpayers and $267,200 for MFJ



Donald J. Pease
Ohio Democrat
House of Representatives 1977-1993

- Ugandan Trade Ban in 1979, Instrumental to Toppling the Genocidal Regime of Idi Amin
- Trade-linked worker rights – child labor
- Authored legislation that partially disallowed itemized deductions for taxpayers with AGI above certain thresholds. Known as Pease Limitation and was considered controversial.

Healthcare Surtax Beginning January 1, 2013

- 3.8% Medicare "Surtax"
    - The Medicare Surtax is equal to:
        - 3.8% X the lesser of:
            - Net Investment Income (NII)

          OR

            - The excess (if any) of "Modified Adjusted Gross Income" (MAGI) – "Threshold Amount"
- On November 30, 2012, the IRS issued proposed regulations on the 3.8% Medicare Contribution Tax. IRS named the tax the Net Investment Income Tax or NIIT.
    - FAQ available on IRS website. Type Net Investment Income Tax FAQ in Search box.

Net Investment Income Includes:

- Interest
- Dividends
- Annuity Distributions
- Rents
- Royalties
- Income derived from passive activity
- Net capital gain derived from the disposition of property

Net Investment Income Does NOT include:

- Salary, wages, bonuses
- Distributions from IRAs or qualified plans
- Any income taken into account for self-employment tax purposes
- Gain on the sale of an active interest in a partnership or S corporation
- Items which are otherwise excluded or exempt from income under the income tax law, such as interest from tax-exempt bonds, capital gain excluded under IRC §121, and Veterans benefits
- Active royalties
- Social Security

Properly Allocable Deductions

- Net operating losses are not taken into account in determining NII for any tax year
- Deductions described in IRC §62(a)(4) allocable to rents and royalties are taken into account in determining NII.
- Deductions described in IRC §62(a)(1) allocable to a business subject to NIIT are taken into account in determining NII to the extent the deductions have not been taken into account in determining self-employment income.
- Early withdrawal penalties on savings accounts
- Investment interest expense
- Investment expenses
- Any deductions subject to the two-percent floor on misc. itemized deduction or the overall limitation on itemized deductions are allowed in determining NII only to the extent deductible for regular income tax purposes after application of IRC §§67 and 68.

Surtax Threshold Amounts

- Single taxpayers = $200,000
- Married taxpayers = $250,000
- Estates/trusts = $11,950 (note – top tax bracket in 2013)

2013 Ordinary Income Tax Rates

- 10%, 15%, 25%, and 28% rates from Bush Administration tax cuts made permanent (Economic Growth & Tax Relief Reconciliation Act of 2001 and JGTRRA of 2003)
- 33% and 35% rates made permanent up to certain threshold levels
  - Single taxpayers = $400,000
  - Head of Households = $425,000
  - Married filing jointly or surviving spouse = $450,000
  - Married Filing Separately = $225,000

2013 Ordinary Income Tax Rates

- Amounts of income above these threshold levels taxed at 39.6%
- Threshold amounts are adjusted for inflation

2013 Long Term Capital Gains Rates and Dividends

- Tax rate increases to 20% for taxpayers with income above the threshold amounts listed in the earlier slide.
  - Please note these taxpayers will be above the threshold amounts for the 3.8% surtax, their capital gain rate will actually be 23.8%
- Maximum rate stays at 15% for taxpayers with lower incomes
- Qualified dividend treatment is made permanent

California Tax Considerations

- Prop. 30 Retroactive Tax Increase
  - $250,000 for single and $500,00 for MFJ
  - Highest tax rate for CA now 13.3%
- IRA to charity conformity

Recent Charitable Giving Cases/Rulings

- Notice 2012-52: Charitable deduction available for contribution to disregarded entity of domestic charity
- Lawrence G. Graev et ux. v. Comm’r
- Carpenter et al. v. Comm’r
- Mohamed, et ux v. Comm’r
- Patel, et us v. Comm’r
- Kaufman et ux. v . Comm’r
- Averyt, et. Al v. Comm’r
- Foster et ux. v. Comm’r
- Irby, et. Al, v. Comm’r
- CRT PLRs – see hand-out

Recent Cases

- Mistaken qualified appraisals meant loss of charitable deduction (Estate of Harvey Evenchick, TC Memo 2013-34)
  - Taxpayers owned shares in a corporation whose only assets were two apartment buildings. Tax Court denied the charitable deduction because the taxpayers incorrectly appraised the buildings rather than the corporate stock that they actually contributed to the charity.

Recent Cases

- Charitable deduction denied for conservation easement where taxpayer received personal benefit (Pollard, TC Memo 2013-38)
  - Taxpayer built a home on the property with the conservation easement. The Tax Court concluded that a deduction should not be allowed on the easement lot with the new home because “it was part of a quid pro quo exchange” for Boulder County’s approving a subdivision exemption request. The key factor was that the taxpayer’s request to build “had little chance of being granted without his promise to grant a conservation easement.”

Recent Cases

- Despite faulty appraisal, charitable deduction still allowed (John Crimi, TC Memo 2013-51)
  - Taxpayer contributed undeveloped land to a New Jersey county in a part-sale, part-gift transaction. The township administrator wrote a letter acknowledging the contribution and specifying the land's value, sales price and contribution amount. Despite IRS objections, the Tax Court held the letter "provided sufficient description to qualify as a contemporaneous written acknowledgement by the donee." In addition, the court confirmed while the appraisal failed to meet the literal requirements of the law, the taxpayer proved that "he relied on the advice of a competent tax advisor, provided necessary and accurate information to the advisor, and actually relied in good faith on the advice."

Creative Planned Giving Ideas

- Charitable Planning with IRAs
- Charitable Lead Trusts
- Charitable Remainder Trusts
- Charitable Remainder Retirement Trusts

Charitable Planning with IRAs

– Charitable Remainder Trust (CRT)
  - No gain on distribution
  - Gain on sale is recognized within the trust
  - Allows for diversification
  - Capital gain distributions
  - CRT for IRA participant’s spouse
  - “Term of years” CRT for participant’s children
  - “Stretch” CRT for children

Selected Updates and Topics of Interest
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American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313 ("ATRA")

The so-called sunset provision of Economic Growth and Tax Relief Reconciliation Act of 2001's § 901 has been repealed. That means:

- ✓ No clawback tax for estates of decedents dying after Dec. 31, 2012 because the applicable exclusion amount will not be reduced
- ✓ We'll never have to figure out what was meant by "*applied and administered … as if [certain] provisions and amendments [of EGTRRA] had never been enacted.*"
- ✓ Applicable Exclusion Amount of $5 million (indexed for inflation) retained
- ✓ Portability of Applicable Exclusion Amount between spouses retained
- ✓ Top estate, gift, and generation-skipping transfer tax rate reduced to 35% (for taxable transfers after Dec. 31, 2012)
- ✓ Provisions set to expire became permanent. Transfer tax provisions included:
  - o Deduction for state death taxes (would have reverted to credit)
  - o Expansion of conservation easements qualifying for estate tax deduction under IRC § 2031(c)

- Expansion from 15 to 45 the maximum number of shareholders/partners that will qualify an interest in a corporation or partnership for IRC § 6166 deferral of estate tax payments

- Expansion of IRC § 6166 relief to certain lending and financing businesses

- Expansion of IRC § 6166 relief to certain holding companies owning "non-readily-tradable stock."

- Portability of unused deceased spouse's applicable exclusion amount

- Repeal of limited credit for state GST tax after EGTRRA's effective date

- Deemed allocation of GST exemption to Indirect Skips "GST trusts"; election into or out of such automatic allocations

- Allowance of retroactive GST exemption allocation where "unnatural" order of death occurs

- GST "qualified severance"

- Automatic GST exemption allocation based on Estate and gift tax value "as finally determined" for federal estate or gift tax purposes, provided underlying return is timely filed

- Authorization for IRS to grant late allocation of GST exemption (or election out of automatic allocation)

- Substantial compliance rule for GST exemption allocation

Did Someone Say "Permanent"? President Proposes Estate Tax Changes In 2014 Budget

The following are among the items appearing in the Treasury Department's "General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals":

- ✓ Restore the Estate, Gift, and Generation-Skipping Transfer (GST) Tax Parameters in Effect in 2009 (45 percent rate, applicable exclusion amount of $3.5 million)

- ✓ Require Consistency in Value for Transfer and Income Tax Purposes

- ✓ Require a Minimum Term for Grantor Retained Annuity Trusts (GRATs)

- ✓ Limit Duration of Generation-Skipping Transfer (GST) Tax Exemption

- ✓ Coordinate Certain Income and Transfer Tax Rules Applicable to Grantor Trusts

- ✓ Extend the Lien on Estate Tax Deferrals Provided Under Section 6166 of the Internal Revenue Code

- ✓ Clarify Generation-Skipping Transfer (GST) Tax Treatment of Health and Education Exclusion Trusts (HEETs)

- ✓ Require Non-Spouse Beneficiaries of Deceased Individual Retirement Account or Annuity (IRA) Owners and Retirement Plan Participants to Take Inherited Distributions Over No More Than Five Years

- ✓ Limit the Total Accrual of Tax-Favored Retirement Benefits

- ✓ Eliminate Minimum Required Distribution (MRD) Rules for Individual Retirement Account or Annuity (IRA)/Plan Balances of $75,000 Or Less

- ✓ Allow All Inherited Plan and Individual Retirement Account Or Annuity (IRA) Balances To Be Rolled Over Within 60 Days

§ 170 Charitable Deductions

Notice 2012-52; 2012-35 I.R.B. 317 (Jul. 31, 2012) Charitable Deduction Available for Contribution to Disregarded Entity of Domestic Charity

A domestic single member limited liability company is generally not regarded as an entity separate from its owner for all purposes of the Internal Revenue Code. See Reg. § 301.7701-2(c)(2)(i). Notice 2011-12 clarifies that the charitable income tax deduction is available for contributions to a SMLLC wholly owned by a qualifying U.S charity (or its branch or division). The Notice also states:

The U.S. charity is the donee organization for purposes of the substantiation and disclosure required by §§ 170(f) and 6115. To avoid unnecessary inquiries by the Service, the charity is encouraged to disclose, in the acknowledgment or another statement, that the SMLLC is wholly owned by the U.S. charity and treated by the U.S. charity as a disregarded entity. The limitations of § 170(b) apply as though the gift were made to the U.S. charity.

Comment: SMLLCs may, for example, exist or be established to accept gifts of real property.

Lawrence G. Graev et ux. v. Comm'r, No. 30638-08, 140 T.C. No. 17 (Jun. 24, 2013)

The Court summarized:

> Petitioner husband ("P-H") contributed cash and a conservation easement to N, a charitable organization. Before the contribution, N at P-H's request issued to P-H a side letter which promised that, in the event [Respondent] disallows Ps' charitable contribution deductions, N "will promptly refund your entire cash endowment contribution and join with you to immediately remove the facade conservation easement from the property's title". Ps claimed charitable contribution deductions for the cash and easement donations. R contends the side letter made those contributions conditional gifts that are not deductible under I.R.C. sec. 170, since the likelihood that N would be divested of the cash and easement was not negligible.

> Held: Ps' charitable contribution deductions are not allowed because at the time of P-H's contributions, the possibility that the deductions would be disallowed and, as a result, that N would return the contributions was not "so remote as to be negligible", under 26 C.F.R. secs. 1.170A-1(e), 1.170A-7(a)(3), and 1.170A-14(g)(3), Income Tax Regs.

Carpenter et al. v. Comm'r, **T.C. Memo. 2012-1 (Jan. 3, 2012)**

Consolidating three similar cases, the Tax Court has held that an extinguishment clause contained in documents granting conservation easements under Colorado law was fatal to qualification for charitable income tax deductions. This was so, because the extinguishment of the conservation easements "by mutual written agreement of both parties" did not meet the requirements of Treasury Regulations Section 1.170A-14(g)(6)(i), that conservation easements be granted in perpetuity.

The court declined to read the regulations together with Section 1.170A-14(g)(3), Income Tax Regs. (so-remote-as-to-be-negligible standard), citing *Kaufman v. Commissioner*, 136 T.C. 294, 311-313 (2011). That regulation provides:

> A deduction shall not be disallowed under section 170(f)(3)(B)(iii) * * * merely because the interest which passes to, or is vested in, the donee organization may be defeated by the performance of some act or the happening of some event, if on the date of the gift it appears that the possibility that such act or event will occur is so remote as to be negligible.

The opinion draws a distinction between the occurrence of unlikely events versus the question of "whether upon the happening of such events the ability to extinguish the conservation easements through mutual agreement of the parties violates the requirements of the extinguishment regulation."

The court rejected a theory advanced by the taxpayers that the easement constituted a trust, based on what the taxpayers argued was the court's authority to interpret of Colorado law in accordance with *Commissioner v. Estate of Bosch,* 387 U.S. 456 (1967). Since there was no pronouncement on this issue by Colorado's state supreme court, the Tax Court was required to apply what it finds to be the State law after giving proper regard to relevant rulings of other courts of the State.

The court also rejected a theory that the doctrine of cy pres would apply to satisfy the perpetuity requirement. The court described that doctrine as allowing "deviation from the terms of a charitable bequest when the particular purpose of the gift becomes impossible or impracticable to accomplish and the donor manifested a more general intention to devote the property to charitable purposes." The court found no demonstrable intention existed to have the donated property put to some other general charitable use.

Mohamed, et ux v. Comm'r, T.C. Memo. 2012-152 (May 29, 2012)

Charitable income tax deductions that married donors claimed on their self-prepared income tax return for contributions of real estate to a charitable remainder unitrust worth in excess of $18 million were denied because no qualified appraisal was obtained, as required by regulations. The Tax Court found regulations requiring independent appraisals and detailed reporting to be valid. That From 8283 was confusing on its face was not a valid defense. The husband failed to read the form's instructions. The court sympathized that this was a harsh result, but also noted: "the authoritative sources of Federal tax law are in the statutes, regulations, and judicial decisions and not in such informal publications." (Citations omitted.)

Patel, et ux v. Comm'r, 138 T.C. 23 (June 27, 2012)
This *pro se* case attracted the attention of the full Tax Court, dividing the panel nine to eight. One of the majority concurred in result only. A dissenting opinion was joined by seven judges (including its author). One judge dissented without opinion.

Mr. and Mrs. Patel purchased real property in Virginia with the intention of demolishing a house situated on that property. They entered into an agreement to permit fire department training exercises leading to destruction of the house by fire. A charitable income tax deduction for the value of the house was denied by the Tax Court because the court found that, under Virginia law a partial interest in real estate was transferred. IRC § 170(f)(3) denies a charitable income tax deduction for such a donation. The dissenting opinion found that property severed from real property, such as here, becomes personal property.

Observation: many houses can be moved. The first step is severance of the house from the land upon which it sits. Would this case have turned out differently if the owners had taken this step before entering into the contract for the training exercises?

Kaufman et ux. v. Comm'r, Nos. 11-2017, 11-2022, CA-1 (July 19, 2012)

Partial summary judgment of the Tax Court was vacated and remanded, primarily because the IRS unreasonably read its own regulations. While it's possible to grant a conservation easement subject to a mortgage that the lender agrees to subordinate (as authorized under Reg. § 1.170A-14(g)(2)), retention by the lender of priority rights to take proceeds of sale or condemnation do not violate Reg. § 1.170A-14(g)(6)(ii)'s mandate to allocate a portion of such proceeds to the holder of the easement rights.

Averyt, et al. v. Comm'r, T.C. Memo. 2012-198 (July 16, 2012)

IRC § 170(f)(8)(A)'s written acknowledgment requirement was satisfied by a deed of conveyance. Failure to provide such acknowledgment is fatal to the charitable income tax deduction. But it not take any particular form, such as a letter. The Court analyzed the deed and found it satisfied all three § 170(f)(8)(B) requirements:

(i) The amount of cash and a description (but not value) of any property other than cash contributed.

(ii) Whether the donee organization provided any goods or services in consideration, in whole or in part, for any property described in clause (i).

(iii) A description and good faith estimate of the value of any goods or services referred to in clause (ii) * * *

Foster et ux. v. Commissioner, T.C. Summ. 2012-90 (Sept. 11, 2012)

The Tax Court denied an income tax deduction for a conservation easement because an appraisal was defective. The appraiser estimated the value of the property after the easement took effect based on a statement of an IRS employee: "Internal Revenue Service Engineers have concluded that the proper valuation of a facade easement should range from approximately 10% to 15% of the value of the property."

***Irby, et al., v. Comm'r.*, 139 T.C. No. 14 (Oct. 25, 2012)**
The Tax Court held that a conservation easement transferred in a bargain sale to Colorado Open Lands qualified for the charitable income tax deduction, finding against all three IRS objections.

The IRS argued the transfer was not a transfer for conservation purposes in perpetuity. The transfer was complex in that several agencies other than COL provided funds to pay for the bargain sale. The court analyzed each of the organizations, their purposes, and their rights and found that the transfer was one in perpetuity.

The IRS also argued that the appraisal wasn't a "qualified appraisal" because the appraisal didn't expressly say it was for purposes of claiming an income tax deduction. But the court found the appraisal contained a reference to the deduction for qualified appraisals accompanied by a specific reference to § 170(h). Because of this and because the appraisal otherwise met the definition of a qualified appraisal, the court held for the taxpayer, noting:

The IRS has not provided to the public a specific form for the tax purpose statement, and respondent has not proffered any instance where a suboptimal tax purpose statement, by itself, invalidated an otherwise qualified appraisal. In sum, we find the appraisal's income tax purpose statement petitioners rely upon to be adequate.

Finally, the IRS objected that no contemporaneous written acknowledgment from the donee organization was provided, as required under § 170(f)(8)(A). The court found all required elements satisfied, stating:

"[R]espondent does not assert, and we have found no authority to indicate, that the contemporaneous written acknowledgment may not be made up of a series of documents. We thus find that, collectively, the documents petitioners provided constitute a contemporaneous written acknowledgment.

COMMENT: Possibly, it would have been easy to comply in a more obvious manner with the appraisal purpose and written acknowledgment requirements. I seems the IRS attempted to deny tax benefits the government intended either on overly technical grounds or because it simply couldn't see how all the factual pieces fit together.

§ 664 Charitable Remainder Trusts

PLR 201113040 Correction of Scrivener's Error Will Not Disqualify Trust
The IRS ruled that a trust could be reformed to fill a gaping hole in one of the most substantive provisions of any charitable remainder trust: the annual non-charitable payout provision. This was not a reformation to correct for disqualification. Rather it was a correction to add a so-called flip provision so that, after disposition of trust property, payments to the life beneficiaries would not be limited to trust income. The IRS allowed that based on the representations of the trust settlors, taken together with a writing from the drafting attorney's notes, reciting in the facts of the ruling:

> Settlors have submitted affidavits stating that when they executed the Trust, they intended and believed that the trust should be drafted so that in the beginning it would be a NIMCRUT and that upon the sale of certain Trust property, the Trust would convert into a CRUT in the taxable year after the year in which the Trust property was sold. Settlors have also represented that from the inception of the Trust until the present day, no deduction has been allowed for any income interest that either Settlor has received or been entitled to receive under Sections 170, 2055, or 2522 of the Code. Also, notes in the handwriting of the drafting attorney, who is now incapacitated, indicate that the Trust was supposed to be a CRUT instead of a NIMCRUT after the property was sold. In addition, all parties to the Trust, including the charitable beneficiary have consented in writing to the reformation of the Trust.

In considering the proposed reformation, the IRS raised the seminal Supreme Court opinion on whether an action under state law will be respected for federal tax purposes, saying:

> In *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), the Court considered whether a state trial court's characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Court concluded that the decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. If there is no decision by that court, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

The IRS concluded:

> A modification or reformation of a charitable remainder trust does not violate Section 664 of the Code if the modification or reformation is necessary to conform the trust instrument to the grantor's intent. In this case, an examination of the trust instrument and the other evidence presented indicates that the provisions of the Trust, as originally drafted, are contrary to the intent of Settlors.
>
> Based on an analysis of the facts submitted and representations made, we have determined that the state court's reformation of the Trust is consistent with applicable state law, as it would be applied by the highest court of the state. We therefore conclude that the judicial reformation of Trust does not violate Section 664 of the Code. Further, the judicial reformation of Trust will not adversely affect Trust's qualification as a valid CRUT under Section 664.

LTR 201126007

Purchase of a commercial annuity by a charitable remainder annuity will not disqualify the purchasing trust. The amount of the annuity will equal or exceed the amount that the trust is obligated to pay for the duration of the trust's term.

PLR 201323007 (Mar. 4, 2013)

The IRS has ruled that a taxpayer's transfer to a charitable lead annuity trust is a completed gift. Such a trust makes periodic payments to a qualifying charity for a fixed term of years. Here, the trust appears to be a non-grantor trust, meaning the trust is a separate taxpayer. Payments from a

CLAT to a qualifying charity are typically structured to qualify for the charitable income tax deduction under IRC § 642(c). When the last payment is made to the charity, the trust terminates and passes to a non-charitable beneficiary, such as a family member, or else goes on in trust for one or more family members.

Assuming that the transfer in trust is a completed gift, the amount of the gift is reduced by the present actuarial value of the charitable payments.

Generally, gift is not a completed gift when the donee is a private foundation and the donor has control over the donated funds. The ruling is a study in how to structure a private foundation's governance with respect to gifts from board members in a way that results in making a completed gift.

Although payments from the trust will be made to a private foundation on whose board the donor sits, the foundation will segregate the funds in a special fund, and the donor will not be able to make any investment or grantmaking decisions.

Portability of $5 Million Exclusion Amount

A. How portability works (inflation adjustments ignored) - Example:

1. H's estate absorbs $3 of $5 million of H's applicable exclusion amount, leaving $2 million Deceased Spouse's Unused Exemption ("DSUE").

2. W survives H. When W dies, her estate benefits from H's $2 million DSUE amount. If W made no lifetime taxable gifts, her applicable exclusion amount will be $7 million instead of $5 million.

B. A decedent's applicable exclusion amount is the sum of:

1. The decedent's own "basic" exclusion amount ($5 million in our example).

2. DSUE of the decedent's last deceased spouse (if there is one), limited to the last deceased spouse's basic exclusion amount ($2 million in our example).

C. Prediction: use in majority of cases (Sam Donaldson, 2013 Heckerling Institute)

D. Temporary Regulations §§ 20.2010-1T through 20.2010-3T, and Proposed Regulations Concurrently Issued in (REG-141832-11), T.D. 9593, 77 F.R. 36150-36163 (June 18, 2012)

1. Effective date: Estates of decedent's dying after 2011

2. Expiration date: "on or before June 15, 2015."

3. Election must be made on a timely filed Form 706 (includes extension of time to file).

    a) Election is irrevocable, once made.

    b) No relief is available under Treas. Regs. § 301.9100-2 or -3 because the deadline is statutory.

4. "Executor" makes the call whether to

    a) Elect portability by timely filing Form 706

    b) Elect out on a timely filing Form 706

    c) Elect out by filing no Form 706

5. "Executor" definitions: "appointed" and "non-appointed"

a) “Appointed” means “An executor or administrator of the estate of a decedent (survived by a spouse) that is appointed, qualified, and acting within the United States, within the meaning of section 2203 (an appointed executor)”.

b) “Non-appointed” means “any person in actual or constructive possession of any property of the decedent”. An appointed executor means that no non-appointed executor has authority to file. Where there are multiple non-appointed executors, the first one to file prevails.

6. Required: computation of the DSUE amount on the estate tax return to elect portability must be included in order to have a valid election. The regulations provide a transitional rule where Form 706 doesn’t include the computation.

7. Relaxed reporting requirements: Not required to formally value marital deduction or charitable deduction property if an estate tax return wasn’t *required* to be filed, but is being filed solely to elect into portability. But there are four exceptions to this relaxed valuation standard:

a) The value of such property relates to, affects, or is needed to determine, the value passing from the decedent to another recipient;

b) The value of such property is needed to determine the estate's eligibility for the provisions of sections 2032, 2032A, 6166, or another provision of the Code;

c) Less than the entire value of an interest in property includible in the decedent's gross estate is marital deduction property or charitable deduction property; or

d) A partial disclaimer or partial qualified terminable interest property (QTIP) election is made with respect to a bequest, devise, or transfer of property includible in the gross estate, part of which is marital deduction property or charitable deduction property.

e) Is this a good idea? What disputes might arise over valuation? How will income tax basis be established?

8. Question: are valuation understatement penalties for valuations in the first estate barred in the second estate?

a) But still relevant in capital gain/loss context, charitable gifts, etc.

9. Amount of DSUE.

a) ***IRC § 2010(c)(4) defines the DSUE amount to mean the lesser of --***

(1) the basic exclusion amount or

(2) the difference between:

(a) The applicable exclusion amount of the last deceased spouse of the surviving spouse and

(b) The amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of that last deceased spouse.

b) The amount with respect to which the tentative tax is determined under section 2001(b)(1) is reduced by the amount of taxable gifts in excess of applicable exclusion amount in year of gift.

c) Where a QDOT election is made, the DSUE amount isn't final until after the final estate tax on QDOT occurs.

E. Surviving Spouse's Use of Portability: Temp. Reg. § 20.2020-3T

1. Lifetime Gifts: DSUE is used first, surviving spouse's basic exclusion amount is used last.

2. Transfers at Death.

a) DSUE is limited to last deceased spouse.

b) Although the DSUE amount is determined by the last Surviving Spouse, a special problem arises when a gift is made that uses DSUE of a prior spouse. A lifetime gift uses DSUE amount before using surviving spouse's own exemption amount. If W, surviving spouse of H1 marries H2, the part of the H1's DSUE used by W's lifetime gift is added to the W's Basic Exclusion Amount. The sum is then added to the H2's DSUE. Example:

(1) W receives $5 million DSUE from H1

(2) W marries H2. During the term of their marriage, W makes a $2 million gift. Since this uses DSUE, W now has $3 million DSUE left from H1.

(3) H2 dies survived by W, whereby W receives $2 million DSUE from H2.

(4) W dies. Her estate has $2 million DSUE from H2 (W's last deceased spouse). The $3 million DSUE from H1 is not available to W's estate.

(5) W's estate's applicable exclusion amount is $9 million, representing the sum of:

(a) W's own $5 million applicable exclusion amount;

(b) $2 million of H1's DSUE used to shelter W's $2 million gift from gift tax (per temporary and proposed DSUE regulation; and

(c) H2's $2 million DSUE.

F. Portability has been incorporated in Estate (and Generation-Skipping Tax) Return Form 706 (Rev. 8/2012)

1. Note under Part 3 – Elections by Executor: "For information on electing portability of the decedent's DSUE amount, including how to opt out of the election, see Part 6— Portability of Deceased Spousal Unused Exclusion."

2. Dig up stuff the decedent wanted to forget: Part 4, Line 3(a): "For all prior marriages, list the name and SSN of the former spouse, the date the marriage ended, and whether the marriage ended by annulment, divorce, or death. Attach additional statements of the same size if necessary."

3. New: Part 2, line 9 includes DSUE in computation of Applicable Credit Amount.

4. All new: **Part 6—Portability of Deceased Spousal Unused Exclusion (DSUE). Sections A-C for passing DSUE to decedent's surviving spouse. Section D for claiming DSUE from decedent's predeceased spouse.**

a) Section A: Check box to affirmatively opt out of portability.

b) Section B: Report whether a Qualified Domestic Trust ("QDOT") transfer exists. Includes warning that DSUE is tentative until QDOT terminates.

c) Section C: Compute DSUE passing to the decedent's surviving spouse.

d) Section D: Compute DSUE from the decedent's last deceased spouse PLUS gift tax utilization of DSUE from predeceased spouse(s) other than last deceased spouse.

G. Portability has been incorporated in Gift Tax (and Generation-Skipping Tax) Return Form 709 (2012)

II. Cons of Electing Portability

A. No cost of living adjustment. In contrast, bypass trust can increase in value without being taxed at surviving spouse's death

B. No GST equivalent

1. QTIP election can be used to take advantage of portability, while, at the same time,

2. Reverse- QTIP election can be used to take advantage of decedent’s GST exemption.

C. Compliance and audit

III. A few hypothetical fact patterns: maybe portability isn't just for small estates

A. “I love you (and I hate lawyers)” estate plan

B. Disclaimer to bypass trust not exercised

C. $200 million community property estate

1. DSUE elected: surviving spouse has over $10 million of exclusion amount for lifetime gifts

2. Surviving spouse establishes grantor trust, makes $10 million gift

3. Surviving spouse makes sale to grantor trust, up to $100 million

D. Large retirement plan payable to surviving spouse

E. Double basis step up produces depreciation benefits

IV. How Should Wills & Trusts Address Portability (if at all)?

A. Review non-tax aspects of leaving bequests in trust

1. Avoid future need for appointing a guardian of the estate

2. Control over disposition (Second marriage; subsequent remarriage)

3. Protection against undue influence

4. Creditor protection

5. Impartial trustee exercises discretion

6. Professional financial management

B. Reconsider mandatory credit shelter/bypass trust bequest because it defeats portability, at least in part

1. Instead, consider these two options for taking advantage of portability:

a) All to survivor’s trust, disclaim to bypass trust

b) Power of Appointment Trust or trust estate. See IRC § 2056(b)(5).

(1) Could provide for disclaimer to defeat, if portability (and therefore the marital deduction) is not desired.

c) QTIP should work, but clarification is needed. QTIP elections are set aside ("null and void") under Rev. Proc. 2001-38, 2001-1 C.B. 1335 when no estate tax is saved. The procedure was issued before portability came into existence.

2. Portability of a deceased spouse's unused estate tax exclusion ("DSUE") was meant to render unnecessary the use of trusts to take full advantage of the exclusion amount of both spouses. While portability is most welcome, it raises planning issues when the spouses' estate plans are not identical. Conflicts can arise because the portability election benefits the devisees (or heirs) of the surviving spouse, who may or may not include those of first deceased spouse.

3. Here's a common fact pattern: an Individual Retirement Account payable on death to the surviving spouse is a significant part of the estate. The surviving spouse will thereby be in possession of property of the decedent and is arguably qualified to file an estate tax return. In that case, both the surviving spouse and the trustee of the deceased spouse's revocable living trust will each have the authority. A race to the post office may result.

4. Under the Temporary Regulations the first return filed controls. The trustee could quickly make an election out of portability while the surviving spouse is delayed by the need to obtain information to file the return. But the return must be complete.

5. If the surviving spouse has no portability election authority, or if several parties will (or might) hold that authority, consider specifying in both the will and the trust who should be able to decide. Specifying in the will is necessary because it can't always be predicted if an executor or administrator will be appointed.

6. In deciding who will have the ability to direct whether the portability election will be made, as well as who will bear the cost of making the election, consider who will benefit. Property of the surviving spouse might benefit, or it might benefit the beneficiaries of a trust under an election on the decedent's estate tax return to qualify for the estate tax marital deduction. The most common marital deduction example is a QTIP election under Internal Revenue Code Section 2056(b)(7).

7. Planning documents could direct who will have authority to direct the direct the executor (in the case of a will) or the trustee (when a trust is used to administer the decedent's property) to make the portability election. Because it can't be predicted whether an executor or administrator of the estate will be appointed and because, if appointed, the executor or administrator will be the only person who can elect portability, ***both*** the will ***and*** the revocable trust should contain such a direction.

8. The ability of a person to direct that a portability election will be made should not extend to any other tax elections the trustee or executor would ordinarily make, most notably the QTIP election.

9. Is a return required without regard to the portability election? If so: Cost shared 50/50? Could have an effect on subtrust funding.

10. If surviving spouse is not involved in preparing the 706 and the portability election is made, what should the trust/will require the filing fiduciary to provide to spouse? Copy of return? DSUE amount only? Note that audit of DSUE has no statute of limitations. In practice, the IRS auditor asks for a copy of the return – the IRS reputedly has terrible file retrieval capabilities.

11. Who has the return prepared? It seems the person who will sign the return should be doing this. What say might the surviving spouse have, or be granted under estate planning documents?

12. Access to information? Finalization of appraisals?

13. Another alternative might be that the spouse will be appointed special administrator by the probate court, thereby obtaining sole authority to file the return. Would probate courts consider the spouse's interest in the portability election in deciding whether to appoint the spouse as special administrator?

14. Should surviving spouse & trustee both approve 706 return before filing? Could cause delays. May need a deadlock breaker.

15. Appraisal conflict is possible over reasonable range of values: maximizing basis v. maximizing DSUE. But there's typically a statement of purpose contained in appraisal report.

16. Appraisal quality and/or cost.

17. Audit of 706/709 – who's involved? How? Surviving spouse (in the case of a gift) or fiduciary (in the case of spouse's 706) does have an interest Temp. Reg. 20.2010-3T(d). But will IRS have the return?

18. Can surviving spouse be restricted as to who can benefit from DSUE?

19. All these possible conflicts might prompt us ask: do DSUE issues require separate counsel? (DeeAnn notes: Likely to have anyway, if there are already conflicts with decedent's other heirs)

20. No directions in docs? How about entering into an agreement after the deceased spouse has died between the executor or trustee and the surviving spouse? Could be a standard postmortem checklist item.

21. Rich spouse/poor spouse alternative to portability: Rich spouse makes lifetime gift, both spouses make gift-splitting election.

V. Client Communications

A. For discussion: What should we be telling clients about portability?

2013 Ushers In 3.8 Percent Medicare Tax

Section 1402(a)(1) of 2010 Health Care and Education Reconciliation Act, Pub. L. 111-152 amended subtitle A of the Internal Revenue Code by inserting after chapter 2 a new chapter 2A, entitled UNEARNED INCOME MEDICARE CONTRIBUTION, consisting of Code section 1411. The new rules apply after Dec. 31, 2012.

The tax applies to “net investment income” of individuals and trusts when income levels exceed specified amounts.

For individuals, the threshold amounts are:

- ✓ Married, filing jointly: $250,000 of modified adjusted gross income
- ✓ Married, filing separately: $125,000 of MAGI
- ✓ All other individuals: $200,000 of MAGI

For estates and trusts, the threshold amount is the dollar amount of adjusted gross income at which the highest tax bracket begins. For 2011, that dollar amount was $11,350.

The amount subject to tax is limited to the lesser of (1) the NII, or (2) the difference, if any, between the NII and the threshold amount.

For example, on a married, filing joint return, if NII is $25,000 but the MAGI is under $250,000, there’s no tax.

But if NII is $25,000 and MAGI is $260,000, the tax applies to $10,000 because the difference between MAGI and the threshold amount is less than NII.

Now, let’s say NII is $260,000 and MAGI is also $260,000. The amount subject to tax is the lesser of:

- ✓ NII, in this case, $260,000,or
- ✓ The difference between MAGI and the threshold amount, in this case, $10,000

Accordingly, the amount subject to tax is $10,000. The amount of the tax is $380 (3.8 percent time $10,000).

Because the threshold is vastly lower for estates and trusts, and because these entities typically produce investment income, they are likely to face higher taxes than individuals.

Investment Income generally includes income from interest, dividends, annuities, royalties, and rents (passive activities only), and business income from passive activities. Net Investment Income is Investment Income after reduction for allowable deductions.

Distributions from certain retirement plans are excluded from NII's definition. NII excludes any distribution from a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b).

Roth IRA conversions are more attractive with the Medicare Tax in effect because there are no lifetime required minimum distributions. RMDs tend to increase an individual's taxable portfolio and thus NII.

For those subject to RMDs, withdrawing no more than required will be attractive.

Large gifts in 2012 will increase the number of trusts subject to the new Medicare Tax. Of course, most donors of large gifts were destined to pay it anyway. Trustees and executors will need to know what can be done to minimize the tax. One answer is: distributions to beneficiaries, but capital gains pose a problem. Many trustees have a policy of allocating capital gains to principal, which can trap taxable net investment income inside the trust, even if distributions of principal are made.

Reg. § 1.643(a)-3, relating to when capital gains and losses are included or excluded from DNI, was revised, effective for tax years ending after January 2, 2004. These rules were updated as part of T.D. 9102, 69 F.R. 12-22 (Jan. 2, 2004).

Reg. § 1.643(a)-3(a) generally provides that gains from the sale or exchange of assets are excluded from DNI.

Exceptions to this general rule are found in Reg. §§ 1.643(a)-3(b) and 1.643(a)-6.

The ground rules basic to all of the cases where capital gains are allocated to income are that the allocation must be made "pursuant to either the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)." The cases where capital gains are allocated to income, discussed below, assume that the ground rules are met.

Gains allocated to income will be included in DNI. However, where income is determined under a unitrust method under a state statute, a discretionary power to allocate capital gains to income must be exercised consistently. For example, if the trustee, in the trustee's discretion, may allocate capital gains to income, the trustee must exercise that discretion in a consistent manner from year to year. The amount of capital gains allocated to income under a unitrust method may not be greater than the difference between the unitrust amount and the amount of DNI, determined by excluding the allocation.

Gains allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary will be included in DNI. Note the absence of any reference to "income" in this rule.

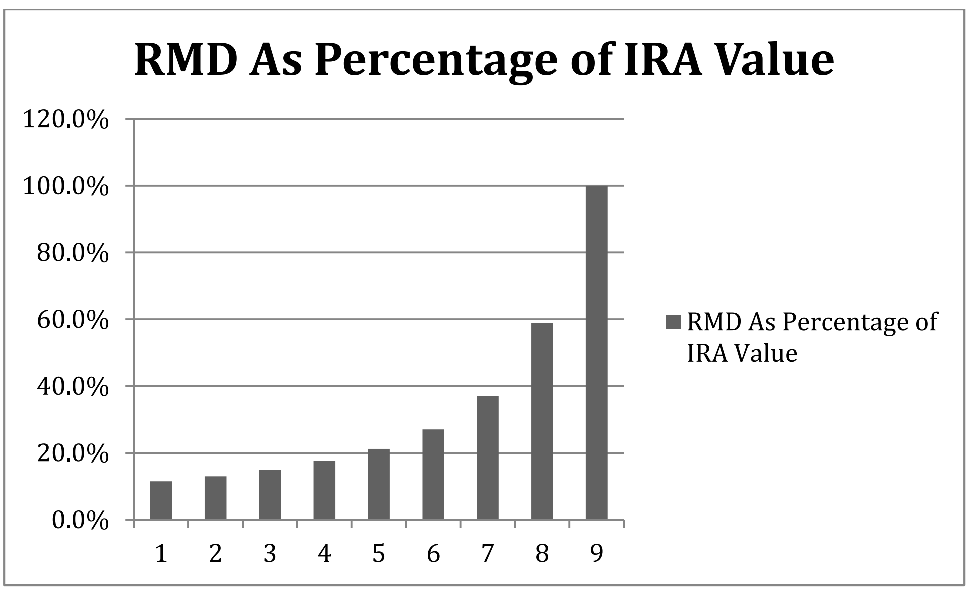
Gains will be included in DNI to the extent allocated to corpus but actually distributed, as will gains utilized by the fiduciary to measure the amount that is distributed or required to be distributed.

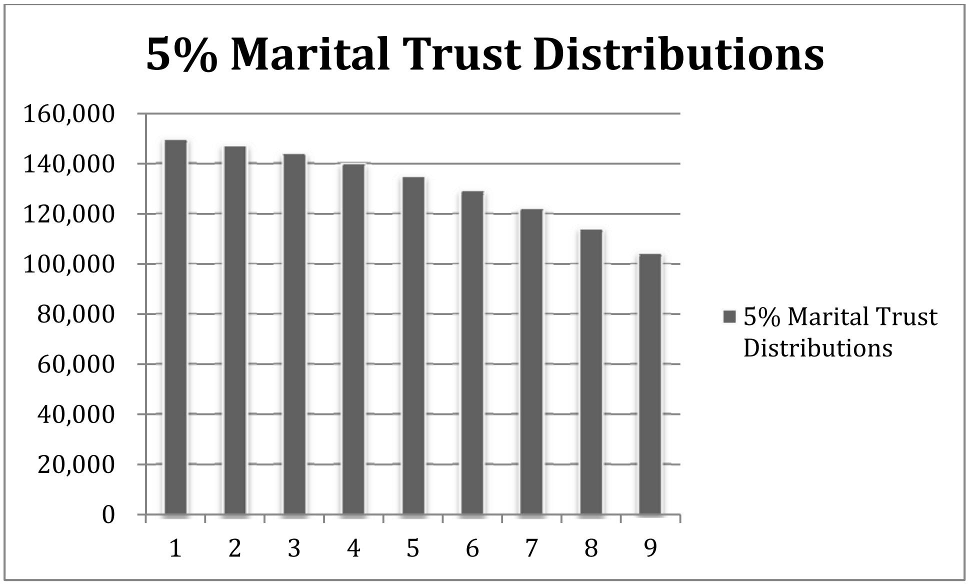
The preamble to T.D. 9102 points out that the above provisions would permit inclusion of capital gains in DNI in the case of a trust that contains terms defining income as a unitrust amount, as well as in the case where trustee may make an adjustment between principal and income. Note, however, that inclusion in DNI does not necessarily affect the definition of income of Reg. § 1.643(b).

Retirement Benefits Charitable Remainder Trust

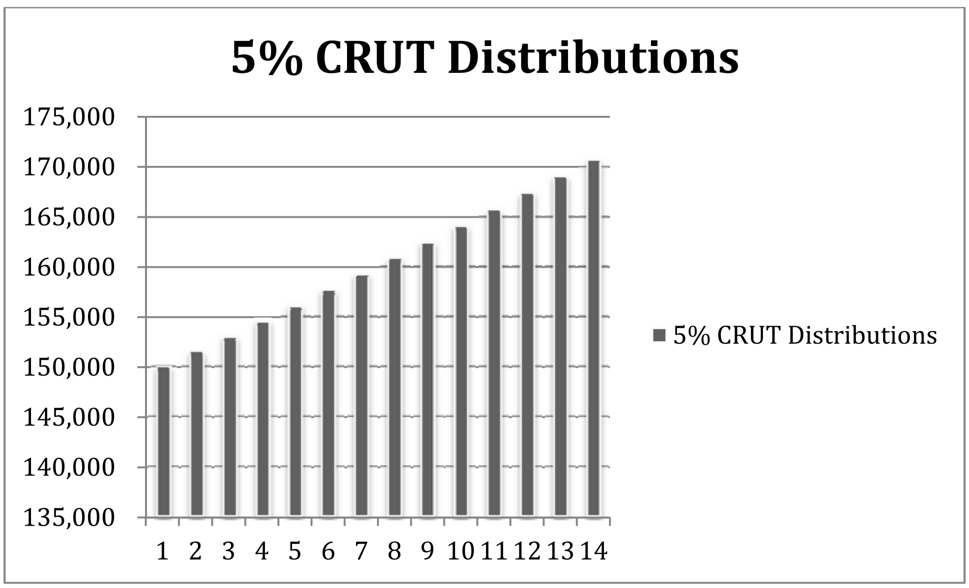
Example:

- $3 million IRA left in trust for surviving spouse
- Spouse has right to 5% Unitrust amount or income, whichever is greater
- No right to any distributions of principal
- § 7520 rate is 1.2% (now 1.4%)
- Spouse's age: 80
- Life expectancy (IRS tables for Required Minimum Distributions) 10.2 years
- Assume total return on investments 6% (50% income, 50% growth)
- Income taxes on total return of taxable investment portfolio: 43%
- Remainder beneficiary: charities
- Distribution period: 8.1 years, based on decedent's age because of charitable beneficiaries





Note: Capital base of trust declines because of income taxes imposed on RMDs and trust investment returns.



Note: CRUT pays no income taxes on IRA distributions or trust investment earnings

RESULTS COMPARING UNITRUST CONVERSION TO NO CHANGE

Surviving Spouse's Age	Increase or (Decrease) in Remainder to Charity, if Death Occurs at End of Year	Increase or (Decrease) in Cumulative Distributions to Surviving Spouse	
80	83,776	0	
81	181,030	4,189	
82	293,305	13,240	
83	422,377	27,905	
84	570,345	49,024	
85	739,799	77,541	
86	934,214	114,531	
87	1,159,235	161,241	
88	1,357,681	219,203	
89	1,371,259	287,087	
90	1,384,972	355,650	
91	1,398,822	424,898	Life expectancy
92	1,412,809	494,839	
93	1,426,937	565,479	
94	1,441,206	636,826	
95	1,455,618	708,886	
96	1,470,173	781,667	

Estate tax notes:

- Charitable deduction is available if trust reformation proceedings begin within 90 days of the extended due date of Form 706. If no estate tax return is required to be filed, the reformation must be commenced by the the last date (including extensions) for filing the income tax return for the 1st taxable year for which such a return is required to be filed by the trust. IRC § 2055(e)(3). These rules are complex and detailed.

- Charitable estate tax deduction is actuarial value of remainder interest.

- Marital estate tax deduction is actuarial value of CRUT payments for life. IRC § 2056(b)(8).