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Gifts, Conversions, and Sales of Income and Annuity Interests

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Introduction

Charities commonly receive gifts of remainder interests in charitable remainder trusts, in pooled income funds, and in personal residences or farms where donors reserve life interests for themselves and/or others. Even in the case of a gift annuity, which is technically a present interest gift, the common practice is to invest the entire contribution for the life of the annuitant(s) (also called “beneficiary(ies)”) and use the residuum only when the annuity obligation terminates. In all of these instances, the charity’s use of the funds is deferred to some future time.

Occasionally an individual beneficiary decides to accelerate a deferred gift by contributing his or her income interest in a charitable remainder trust or pooled income fund, or by assigning to the charity the annuity interest of a gift annuity. In other instances, the beneficiary wants to receive a lump sum in lieu of payments, so the agreement is terminated and the beneficiary receives a cash-out equal to the value of the income or annuity interest. The charity then has immediate possession of the remainder interest, if the termination involved a charitable remainder trust. If it involved a gift annuity, the charity would be able to use the remaining reserves it had been holding to meet payment obligations.

Not all transactions concerning income and annuity interests accelerate a deferred gift. Some are conversions of one interest to another. An example would be an exchange of the income interest of a charitable remainder trust for a gift annuity. These exchanges may serve the charity by halting the erosion of a gift, and protect the beneficiary by providing a more predictable, and, in some cases larger, stream of payments.

This paper is about outright gifts of income and annuity interests, terminations of trusts and annuities resulting in cash distributions to beneficiaries, and conversions of income and annuity interests. It begins with a discussion of the tax aspects and applications of each of these arrangements. Then it describes the procedures for effecting the transactions and the substantiation requirements.

Part One – Tax Aspects and Applications

I. Outright Gift of All or Part of the Income Interest in a Charitable Remainder Trust or in Pooled Income Fund Units

A. Tax Aspects

1. Allowance of income tax deduction

Generally, a charitable gift of a partial interest in property is deductible only if (a) the interest is a remainder in a charitable remainder trust, pooled income fund, or personal residence or farm (IRC Sec. 170(f)(3)(A)) or (b) the contribution is “an undivided portion of the taxpayer’s entire interest in property” (IRC Sec. 170(f)(3)(B)(ii)). An income tax deduction is allowed for a gift of all or part of the income interest in a charitable remainder trust because the income interest constitutes the income beneficiary’s entire interest, and he or she would either be giving all of that interest or an undivided portion of it. However, the deduction will not be allowed if the property was divided to avoid the partial interest rules (Reg. Sec. 1.170A-7(a)(2)(i)).

2. Type of income tax deduction

An assignment of an income interest in a trust is treated as a gift of a capital asset with a zero basis, so the reportable deduction will be limited to 30 percent of the donor's adjusted gross income. See IRC Sec. 1001(e)(1).

3. Allowance of a gift tax deduction

A gift tax deduction is allowed for an assignment of an income interest in a CRAT or SCRUT in all cases, and in a NIMCRUT or NICRUT, except when (1) two people have contributed jointly-owned or community property and they are joint and survivor beneficiaries or (2) the trust is funded with the donor's separate property and another person is named as successor beneficiary.

The problem with NIMCRUTs and NICRUTs in these instances arises from the fact that the Regulations pertaining to the gift tax deduction do not include the income-exception type of unitrust. Thus, the income beneficiaries are not giving a unitrust interest in accordance with the Regulations. Neither are they giving their entire interest, for in instance (1) each has already transferred to the other a contingent life interest in his or her share of the property, and in instance (2) the donor has already transferred to the successor beneficiary such a contingency life interest. This problem can be overcome by having each beneficiary (instance (1)) or the successor beneficiary (instance (2)) disclaim his or her successor interest prior to the assignment (PLR 9529039).

4. Rulings pertaining to gifts of income interests

Numerous rulings pertaining to gifts of all or a portion of the income interest of a charitable remainder trust have been issued. Following are some of them:

Rev. Rul. 86-60, 1986-1CB302

PLRs 9409017, 9529039, PLR 9712013, 9712031, 9721014, 200010035, 200124010, 200140027, 200207026, 200310024, 200525014

5. Gifts of income interests in pooled income funds

The tax implications of a gift of an income interest in a charitable remainder trust should also apply to a gift of an income interest in pooled income fund units. An income and gift tax deduction would be allowed for the present value of the income interest in the units ascribed to the beneficiary. Following the gift, the charity could sever from the fund an amount equal to the value of the beneficiary's units.

B. Examples of Applications

1. Contribution for a charity's capital campaign

In 1996, Mr. and Mrs. L contributed $500,000 to a standard charitable remainder unitrust with a 6-percent payout rate that made payments at the end of each calendar quarter. Realizing that they did not really need the trust income, and wanting to make a present gift to their charity's capital campaign, they decided to assign their entire income interest in the trust to the charity. On July 1, 2007, the date of the assignment, the fair market value of trust assets was $780,000, and they were each nearest age 74.

They received an income tax charitable deduction of $449,077. Considering that they were subject to a 35-percent income tax rate, their tax savings from the gift was $157,177. Upon the merger of the income and remainder interests, the trust was terminated and the charity received $780,000, which it used to establish an endowed fellowship in their names.

2. The overfunded annuity trust

Mr. and Mrs. G established a charitable remainder annuity trust in 1993 with a contribution of stock having a fair market value of $250,000 and named a favorite charity as remainder beneficiary. The annuity trust paid them $15,000 per year. Because of great investment performance during the 1990s and in recent years, the fair market value of the trust's assets had grown to $620,000.

Since the value of trust assets was well in excess of what was needed to assure the annuity payments, they authorized a distribution of $250,000 for their charity's building fund. They were not entitled to an income tax deduction because their income interest was unaffected by the distribution. They continued to receive $15,000 per year as stipulated in the trust agreement. They merely accelerated part of what would have gone to the charity at the end of their lives.

3. Converting part of a unitrust to a donor advised fund

When he established a charitable remainder unitrust 10 years ago, Mr. T named a local community foundation as one of three remainder beneficiaries who were to receive equal portions. He also reserved the right to change the remainder beneficiaries and the amount allocated to each. Not needing all of the income and wanting to support various local charities on a regular basis, he decided to assign one-third of his income interest to the community foundation. The one-third income and remainder interests were merged under local law, and the foundation received $400,000 of trust assets, which it used to establish the T Family Donor Advised Fund. The rest of the remainder interest was divided between the other two charities, and Mr. T's income from the trust decreased by a third.

Mr. T also realized a material benefit. The assignment of part of his income interest generated an income tax charitable deduction of $185,740, which, given his 35-percent income tax rate, will result in tax savings of $65,009. (The trust had a 6.5-percent payout and made payments at the end of each calendar quarter. Mr. T was age 75 at the time of the assignment.)

Note: In all of these applications, and in the ensuing ones, it may be advisable for the donors to secure their own private letter ruling since previous private letter rulings dealing with similar situations are not binding precedents for the IRS.

II. OUTRIGHT GIFT OF THE ANNUITY INTEREST IN A CHARITABLE GIFT ANNUITY TO THE ISSUING CHARITY

A. Tax Aspects

1. Allowance and type of income tax deduction

The amount of the gift is the present value of the remaining annuity payments computed as of the date of assignment. However, in the case of an assignment of an annuity interest to the charity, the income tax charitable deduction will often be less than the amount of the gift.

Suppose, for example, that a few years ago Ms. A contributed $100,000 cash for a gift annuity. At the present time the present value of the annuity payments is $60,000, the unreturned capital is $45,000, and the gain (interest) is $15,000.

If the assignment of a gift annuity interest is analogous to the assignment of a commercial annuity, the annuitant would have to recognize $15,000 of ordinary gain. That is because the owner of a commercial annuity is taxed on the gain in the annuity when transferring it to either an individual or a charity. Since the gain will have already been recognized, the annuitant will be entitled to an income tax charitable deduction of $60,000. The net deduction, $60,000 less $15,000 of ordinary gain offset by the deduction, is $45,000.

If the assignment of a gift annuity interest is analogous to the forgiveness of a loan, then the deduction would be limited to the unreturned investment in the contract ($45,000 in this instance) because of the reduction under IRC Sec. 170(e) for gain that would be other than long-term gain. General Counsel Memorandum 39826 (1990) dealing with IRC Sec. 501(m) states that the issuance of gift annuities has historically been treated “as a borrowing of money by the issuing organization,” and that is why gift annuities that qualify under IRC Sec. 514(c)(5) are exempted from being considered acquisition indebtedness. Thus, it would follow that the assignment of a gift annuity interest is to be treated like the forgiveness of a debt owed by the charity. By this line of reasoning, the assignment would not result in any taxable gain.

Although there are no Revenue or private letter rulings specifically on point, it seems reasonable to conclude (1) that the assignment would not result in taxable gain and (2) the income tax charitable deduction would be limited to the investment in the contract (i.e., the remaining capital that would have been returned tax-free over remaining life expectancy if the annuity interest had not been assigned). This gift should be subject to a 50-percent-of-adjusted-gross-income contribution limitation because the interest transferred to the charity by virtue of the forgiveness of the annuity obligation is cash.

Suppose, in the above example, that Ms. A had originally contributed appreciated stock. At the time of the assignment, the present value of the annuity payments, the unreturned investment in the contract, and the ordinary gain are again, respectively, $60,000, $45,000, and $15,000. However, the unreturned investment in the contract consists of $33,000 of unreported capital gain that would have been so taxed, and $12,000 of basis that would have been returned tax-free. The annuitant would not be taxed on the $33,000 of gain, for Reg. Sec. 1.1011-2(a)(4)(iii) says that unreported capital gain is not included in the gross income of the transferor when the transferor relinquishes the annuity to a charitable organization. The income tax charitable deduction would remain the same at $45,000. However, it would be subject to a 30-percent-of-adjusted-gross-income contribution limitation because the interest transferred to the charity by virtue of the forgiveness of the annuity obligation is a long-term capital asset.

2. Allowance of gift tax deduction

A gift tax charitable deduction would be allowed for the amount of the gift to charity.

B. Examples of Applications

1. Assigning an annuity interest and establishing an endowment now

Ms. H contributed $100,000 cash to a college for a gift annuity on October 1, 2002, and received an annuity of $6,000 paid in installments of $1,500 at the end of each calendar quarter. She had intended that the residuum from the annuity be used for an endowed scholarship in her name, but she would never have seen the scholarship in operation. Realizing that she would not need the payments and wanting to have the satisfaction of actually seeing awards being made to deserving students, she assigned her annuity interest to the college, and the college used the remaining portion of her contribution to create the scholarship.

At the time of her contribution on October 1 of 2002, when she was 64 years old, her income tax charitable deduction was $34,954. On July 1, 2007, when she assigned her annuity interest, the present value of the annuity payments to which she was entitled was $55,175 based on the May Charitable Midterm Federal Rate (CMFR) of 5.6 percent. Her income tax charitable deduction was $50,112, which was the unreturned capital as of the date of the assignment.

2. Getting a very small annuity off the books

A charity wrote a letter to annuitants who were receiving very small payments asking them to consider making gifts of their annuity interests. A number accepted the offer since payments were of little consequence in their budgets. Typical of them was Ms. J, whose payments from the $5,000 annuity she funded on March 31, 1998, when she was 65, were a mere $325 per year paid in installments of $81 at the end of each calendar quarter. At the time of the assignment on July 1, 2007, the present value of her annuity payments was $2,548 (based on the May CMFR of 5.6 percent). The unreturned capital at the time was $1,539, and this is the amount she can claim as an income tax charitable deduction, assuming she itemizes her deductions.

III. CONVERSIONS OF INCOME INTERESTS IN CHARITABLE REMAINDER TRUSTS AND GIFT ANNUITIES TO GIFT ANNUITIES

A. Tax Aspects

1. Allowance of an income tax deduction

In PLR 200152018, the IRS permitted the trustor (who was also the income beneficiary) of a charitable remainder unitrust to transfer his income interest to the charitable remainder beneficiary in exchange for a gift annuity. The annuity payments were to be made from the charity's general funds, the donor of the income interest was to be the sole annuitant, the annuity would be non-assignable except to the charity, and a commutation, prepayment, or refund would be prohibited by the gift annuity agreement.

The annual annuity will be the annuity rate offered by the charity multiplied by the present value of the income interest in the trust, not by the fair market value of trust assets. Suppose that at the time the income interest in the trust is contributed, the fair market value of trust assets is $600,000, the present value of the income interest is $400,000, and the present value of the remainder interest is $200,000. The annual annuity would be $400,000 multiplied by the annuity rate.

The donor will be allowed an income tax deduction for the amount by which the date-of-gift present value of the income interest of the trust exceeds the present value of the annuity payments. Again, the income interest in the trust must not have been created to avoid the partial interest rules of IRC Sec. 170(f)(3)(A).

2. Allowance of a gift tax deduction

The donor will be entitled to a gift tax deduction under IRC Sec. 2522(a), to the extent the date-of-gift present value of the income interest of the trust exceeds the present value of the annuity payments. In the case of a NIMCRUT or NICRUT where a couple have contributed jointly-owned or community property and are joint and survivor beneficiaries, or where a donor has contributed separate property and named a successor beneficiary, each beneficiary should disclaim his or her successor interest prior to the assignment as discussed above.

3. Taxation of annuity payments

The income interest will be treated as a capital asset with a zero basis per IRC Sec. 1001(e)(1). Accordingly, the donor of the income interest (assuming he or she is the annuitant) will have long-term capital gain equal to the present value of the income interest, and it can be ratably reported as provided in Example 8 of Reg. Sec. 1.1011-2(c).

This means that the payments will be partly ordinary income and partly capital gain for the duration of the donor's life expectancy. Then they will become entirely ordinary income. No part of the payments will be tax-free. When operating a planned giving software program, enter the present value of the income interest of the trust as the amount contributed and "0" as the cost basis.

B. Examples of Applications

1. Transforming a "crashing CRAT" into an arrangement with smaller yet sustainable payments

In 2000, Ms. K contributed $1,000,000 for a charitable remainder annuity trust that would pay her $80,000 annually, in $20,000 installments at the end of each quarter, for the balance of her life. The trust was invested heavily in equities and suffered significant losses during the bear market. The fair market value of the trust assets had shrunk to $600,000, so the annual payment was 13.33 percent of current market value. If the net return on trust assets were a constant 6 percent, the trust would run dry in 10 years. Even if the net return were a constant 7 percent, the time to exhaustion would be only 10.7 years. Ms. K worried that the trust might become exhausted and payments cease while she was still alive, and she was also concerned that nothing might remain for the endowed fund she wanted to establish. She was willing to receive less money if the payments would be sustainable for life and a charitable gift could be preserved.

On July 1, 2007, when she was age 79, Ms. K contributed her income interest in the annuity trust to the charitable remainder beneficiary in exchange for a gift annuity.

Total trust assets -	$600,000
Value of income interest -	$505,880
Value of remainder interest -	$94,120

The income interest ($505,880) multiplied by the ACGA rate (7.8 percent) was $39,459. This was only about half of what she had been receiving. However, the payments will continue to the end of her life, however long she lives. Moreover, she received an income tax charitable deduction of $256,046, which can significantly reduce her income tax over the next six years. The charity could establish the endowed fund now with the $94,120 representing the remainder interest, and at the end of Ms. K's life the residuum of the gift annuity could be added to the endowment.

2. Increasing income from a NIMCRUT that did not flip

Several years ago, Mr. and Mrs. Y transferred some of their community property for a NIMCRUT and named themselves as joint and survivor income beneficiaries and a national health organization as the remainder beneficiary. The trust was not "flipped," and their income had been approximately 3.0 percent of trust assets, well below the 6-percent payout rate.

On July 1, 2007, when they were both age 70, they assigned their entire income interest to the remainder beneficiary in exchange for a gift annuity. Before doing so, however, each of them disclaimed his or her successor interest to assure a gift tax charitable deduction. At the time of the assignment the fair market value of trust assets was $620,000. (According to PLR 200725044 and PLR 200733014, when valuing the income interest of a net income unitrust, the payout rate used in the calculation should be the lesser of the actual payout rate or the current CMFR. See below for details. In this particular example the trust payout rate and the current CMFR are the same.)

The present value of the income interest they assigned was $395,895, and the charity agreed to pay them an annuity rate of 6.9 percent. Thus, their annual annuity is $27,317 ($395,895 x 6.9 percent), which was well above the $18,600 they were receiving from the trust.

Although the annual annuity as a percentage of the income interest is higher than the ACGA rate, the annual annuity, as a percentage of trust assets actually received by the charity, was only 4.41 percent ($27,317 ÷ $620,000), which was well below the 5.9-percent ACGA rate. Upon the merger of the income and remainder interests, the trust terminated, and the charitable organization had $620,000 to add to the gift annuity reserve fund. It might have withheld a portion for current needs and still invested an ample amount in the reserve fund.

Mr. and Mrs. Y, in addition to increasing their annual payments, received an income tax charitable deduction of $102,299.

3. Terminating a moribund pooled income fund by having participants contribute their income interests for CGAs

Charity Z had a pooled income fund with only eight participants that it wanted to close. It asked income beneficiaries if they would be willing either to make an outright gift of their income interests or to convert their income interests for gift annuities. Five of the beneficiaries, who were receiving small amounts of income, were willing to make outright gifts of their income interests. The other three were willing to convert their income interests to gift annuities, provided the payments would be approximately equivalent to what they were receiving.

One of these three beneficiaries was Mr. E, age 70, whose pooled income fund units were valued at $40,000. He was receiving in quarterly payments $1,600 per year. The highest annual adjusted rate of return on the pooled income fund during the past three years was 4.6 percent.

The following plan was proposed to Mr. E. He found it to be acceptable, so similar plans will also be proposed to the other two beneficiaries who want to continue to receive payments.

Value of pooled income fund units -	$40,000
Value of income interest -	$17,319
Value of remainder interest -	$22,681

The income interest ($17,319) multiplied by the ACGA rate (6.5 percent) was $1,126, which was substantially below the $1,600 per year that Mr. E had been receiving.

Since the charity was able to invest the entire $40,000 received upon the gift of Mr. E's income interest, it was willing to pay a rate of nine percent, or $1,559. This was only 3.9 percent of the amount the charity would have available for investment in the gift annuity reserve fund.

Although the $1,559 was slightly below the $1,600 Mr. E had been receiving, it would be taxed more favorably. Whereas the pooled income payments were taxed entirely as ordinary income, during Mr. E's life expectancy $851 of the annuity payments would be taxed as long-term capital gain, subject to a maximum rate of 15 percent. Thus, after-tax income should actually increase somewhat as a result of the conversion. Moreover, Mr. E received an income tax charitable deduction of $3,778.

If charity Z is domiciled in a state that regulates gift annuities and to which it has submitted a schedule of rates it intends to follow, it may be unable to pay a gift annuity rate higher than the rate on the schedule. However, the state may consent if the charity demonstrates that the annuity rate, based on the amount it will add to the reserve fund, is actually lower than the schedule rate, and that the donor consents pursuant to full disclosure of the facts.

4. Indirectly reducing the payout rate of a CRT by exchanging the income interest of an existing CRT for a new CRT

When they established their charitable remainder trust a decade or so ago, Mr. and Mrs. S insisted on a 9-percent payout rate, even though they were advised to select a lower one. The combination of significant losses during the intervening bear market and the high payout rate caused the trust to decrease from its original $1,000,000 to $750,000. Concerned that their income would continue to decline and that the remainder for charity would be less than they intended, they approached the charity, which was serving as trustee, and asked if their payout rate could be reduced from 9 percent to 6 percent. They said that trust income in the range of $45,000 per year would be sufficient for their needs, but they could not afford simply to give the income interest. Both Mr. and Mrs. S were age 67 at the time.

At that point, it was not possible to reduce the payout rate even though this would have been beneficial to the charity.

Mr. and Mrs. S could have contributed as an addition to the trust one-third of the trust income they received each year. Then the net distribution of trust assets would be only 6 percent. The problem with this alternative was that the taxable income from the trust would likely exceed the charitable deduction for the additional contribution, resulting in out-of-pocket cost.

Mr. and Mrs. S could also have contributed their income interest to the charitable remainder beneficiary in exchange for a gift annuity.

The income interest ($609,150) multiplied by the ACGA rate (5.7 percent) would have been only $34,722. Such a reduction in their cash flow was unacceptable.

Recognizing that the entire $750,000 would have been available to the charity to invest in its gift annuity reserve fund, the charity might have been willing to pay a rate higher than the ACGA rate, subject to the caveat noted above. This might have brought them closer to their target amount.

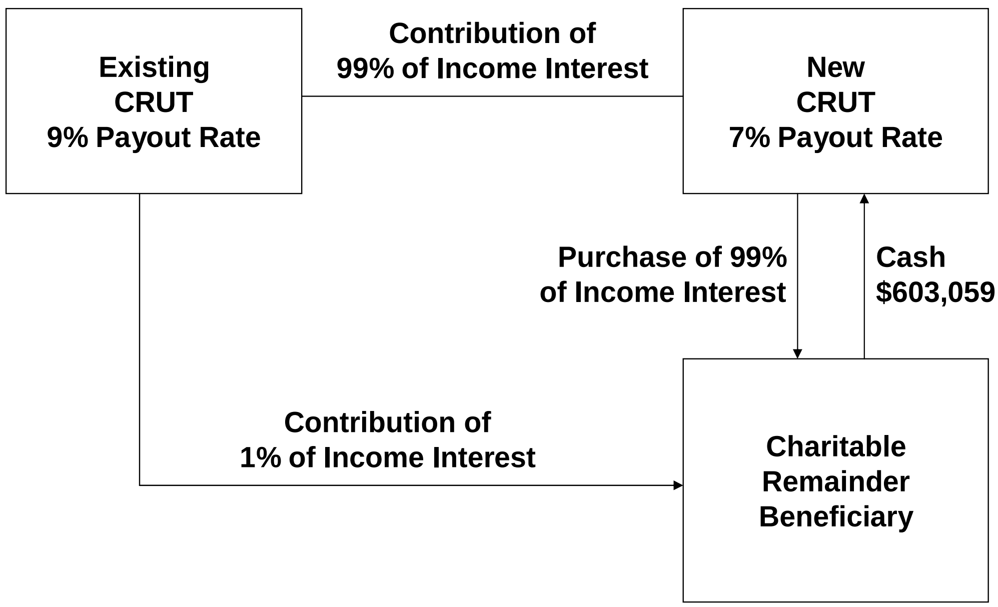
Instead, Mr. and Mrs. S established a new trust following these steps:

a. They created a new standard charitable remainder unitrust with a 6- percent payout rate and transfered to it 99 percent of the income interest in the existing trust.

b. The charitable remainder beneficiary then purchased from the new trust the 99-percent income interest in the existing trust.

c. The income beneficiaries gave the remaining 1-percent income interest in the existing trust to the charitable remainder beneficiary.

d. Since the charity then owned both the entire income and remainder interests, the two interests merged, the first trust terminated, and all trust assets were distributed to the charity.



The beneficiaries receive 7 percent of unitrust assets. Initially this was	$42,214.
They also received an income tax charitable deduction of	$160,221.
The charity realized for current needs	$146,941.

5. Contributing the annuity interest of a CGA for a new CGA that may have different annuitants and/or a different annuity rate

A couple of years ago Mr. B, who was then single, contributed $300,000 for a gift annuity that would pay him $18,000 per year. Earlier this year he remarried, and he decided that he would like for his new wife to receive annuity payments should he predecease her. He also wanted to make a gift to a particular charity's capital campaign. In May of this year, he contributed his annuity interest in the existing contract to the charity for a new joint and survivor gift annuity with himself, now age 67, and his new wife, age 66, as beneficiaries.

The annual payment from the new annuity will be 5.7 percent (annuity rate) x $170,025 (the value of the annuity interest in the old annuity) which equals $9,691. The charity had the residuum of the old annuity less $170,025 to apply to its campaign. Mr. B will receive an income tax charitable deduction of $57,475.

IV. TERMINATIONS OF CHARITABLE REMAINDER TRUSTS AND GIFT ANNUITIES RESULTING IN CASH DISTRIBUTIONS TO BENEFICIARIES

A. Tax Aspects

1. Self-dealing

There have been a number of letter rulings permitting an early termination of a charitable remainder trust and a distribution of the trust's assets to the income and remainder beneficiaries. The amount received by the income beneficiaries is equal to the present value of their payments. It is clear from the rulings that the termination and distribution of assets will not be a prohibited act of self-dealing, provided the remainder beneficiary is not a private foundation. In PLR 200525014, a termination was approved when the remainder beneficiary was a private foundation, but in PLR 200614032 the IRS reversed itself and declared early termination would constitute self-dealing if the remainder beneficiary were a private foundation.

2. Taxation of distributions to income beneficiaries

The proceeds the donor receives are all taxable as capital gain because, per IRC 1001(e)(1), the income interest is regarded as having a zero basis. Provided the beneficiary's holding period for the income interest exceeds one year, the gain will be long-term capital gain.

3. Valuation of the income interest

According to PLR 200725044 and PLR 200733014, if the trust being terminated is a net-income charitable remainder unitrust, the income interest must be valued using as the payout rate the lesser of the CMFR in effect at the month of termination or the stated payout rate. For example, if the trust payout rate is 9 percent, but the CMFR during the time of termination is 6 percent, the calculation would be done entering 6 percent as the payout rate. In the judgment of the IRS, this prevents an inflation of the present value of the income interest. See PLR 200725044 and PLR 200733014.

4. Health of the beneficiaries

It is advisable for the beneficiaries of charitable remainder trusts or annuitants of gift annuities to obtain from their physician a statement that they have no health condition that would reduce their normal life expectancy.

5. Tax aspects of termination (“cash-out” of a gift annuity)

In certain private letter rulings dealing with the so-called “college annuity” (PLR 200233023, for example), the IRS approved an annuity contract under which an annuitant would “sell or assign” his or her annuity interest to the charity “or to a third party in return for a lump sum payment or installment payments over several years.”

If the annuity had been funded with cash, the amount of the lump sum payment in excess of the unreturned capital would be ordinary income. If it had been funded with appreciated property and the gain was being ratably reported, the lump sum payment would be capital gain to the extent of gain not yet reported and tax-free return of capital to the extent of capital that had not yet been paid, with the balance treated as ordinary income.

B. Examples of Applications

1. Termination of unitrust to generate needed cash

Mr. N suffered some financial reverses in his business, and he asked the charitable remainder beneficiary of his unitrust if it would be willing to join him in terminating the trust. The charity was the sole remainder beneficiary, and Mr. N did not reserve the right to make any changes in the beneficiary designation. At the time of the termination, the present value of the income interest was $720,000, and the present value of the remainder interest was $380,000. Mr. N received the former amount, which was taxed to him as capital gain. If he had capital losses, the amount of tax could have been considerably reduced. The charity received $380,000 for current use.

2. Termination of a gift annuity to meet a cash need

Ms. W funded a gift annuity with $100,000 cash a few years ago, and she has been receiving $7,000 per year. The present value of her annuity payments is now $55,000, and her unreturned capital is $35,000. The charity agrees to a cash-out, whereupon she receives $55,000, of which $20,000 is taxed as ordinary income. She applies her settlement towards the down payment on a unit in a retirement community.

Part Two – Procedures and Substantiation

I. Procedures Regarding an Outright Gift of All or Part of the Income Interest of a Charitable Remainder Trust or in Pooled Income Fund Units

A. Procedures for giving the entire income interest.

1. When there is one remainder beneficiary

In the case of a charitable remainder trust, if the charity is not already irrevocably designated as the sole remainder beneficiary, it is best for this to be done before the gift is made so that there will be no doubt about whether some other charity may have been named as a remainder beneficiary pursuant to a retained right to alter the beneficiary designation from time to time. If required, this step is ideally taken at least a day before the gift is made, in order to make clear that the irrevocable designation was in effect at the time of the gift.

When the charity is satisfied that it is entitled to all of the remainder interest, the donor and the charity enter into a relatively simple agreement in which the donor assigns the income interest to the charity and the charity acknowledges its acceptance of the assignment. Once executed, the document should provide the trustee of a charitable remainder trust with an adequate basis for terminating the trust and distributing all its assets to the charity. In the case of a pooled income fund, the trustee would be distributing to the charity the fund principal associated with the number of units in question.

Of course, with respect to either a charitable remainder trust or a pooled income fund, the trustee should be informed of the contemplated gift well in advance of the effective date. This will give the trustee the time needed to arrange for any final prorated payment to the donor, as well as to liquidate trust assets to the extent desired by the parties. Indeed, in the case of a charitable remainder trust there is often considerable merit in having the trust hold nothing but cash by the time the gift is made, in order to simplify the process of determining the net value of trust assets on the date the gift is made. The trustee of a charitable remainder trust will also need to file final income tax returns for the trust, so allowance should be made for this and other expenses associated with termination.

In advance of any of these steps, the donor, the charity, and any third party trustee should satisfy themselves that the desired merger of trust interests will take place under applicable state law. Moreover, it should be noted that a gift of the income interest may not be possible, or may at least require additional steps, if the trust agreement contains a spendthrift provision such as the following:

"The interest of any beneficiary in the corpus or income of the trust created hereunder shall not be subject to assignment, alienation, pledge, attachment or claims of creditors, and shall not otherwise be voluntarily or involuntarily alienated or encumbered by such beneficiary."

2. When there are two or more remainder beneficiaries of a charitable remainder trust

Here again, each charity should first be irrevocably designated as beneficiary of whatever portion of the remainder interest the donor determines is appropriate. Then, preferably by means of separate yet simultaneously effective documents executed by the donor and by the charities, the donor would assign to each charity a share of the income interest in proportion to its share of the remainder interest. If the assignments are not effective simultaneously, then the donor is essentially making a series of assignments of part of the income interest.

B. Procedures for giving part of the income interest.

In the various private letter rulings, three procedures have been used when a donor wishes to contribute only a portion of the income interest to the charitable beneficiary.

1. One possibility is to divide the charitable remainder trust into two trusts, identical to the original trust except in the amount of assets, and give the entire income interest in one of the trusts. That trust would then be terminated and the assets distributed to the charity, and the other trust would continue its existence. See PLR 200140027.

2. A second possibility is to assign a portion of the income interest (20 percent, for example) to the remainder beneficiary, or to one of the remainder beneficiaries. A reservation of the right to change remainder beneficiaries would, of course, maximize the donor's flexibility. (Confirm that under applicable state law the income and remainder interests of the fractional portion of the trust will merge and that the fractional portion of trust assets will become payable to the charitable remainder beneficiary.) See PLR 200207026 and PLR 200310024.

3. A third possibility is to include language in the trust agreement that allows the trustor to instruct the trustee to distribute a portion or all of the trust assets to qualifying charitable remainder beneficiaries. Alternatively, the trustee could be empowered to make such distributions in its discretion. See PLR 9712013.

   This is an example of language that could be included in a unitrust agreement:

   "Upon receiving written instructions signed and dated by the Donor, the Trustee shall distribute all or a portion of the trust assets to one or more of the charitable remainder beneficiaries named in or pursuant to Article ___, provided that any beneficiary designated to receive a distribution of trust assets pursuant to this Article ___ must be an organization described in each of IRC Secs. 170(b)(1)(A), 170(c), 2055(a), and 2522(a) of the Code and provided further that such written instructions must indicate specifically that they are being submitted to the Trustee pursuant to this Article ___.

   "If a beneficiary designated in written instructions submitted to the Trustee pursuant to this Article ___ is not an organization described in each of IRC Secs. 170(b)(1)(A), 170(c), 2055(a), and 2522(a) at the time the distribution is due to be made, no distribution shall be made to it. Instead, the assets directed to be distributed to such beneficiary shall remain in the trust. In the case of distributions in kind, the adjusted cost basis of the property distributed must be fairly representative of the adjusted cost basis of the property within the trust.

"Any distribution to charitable beneficiaries during the term of the trust shall be made on the last day of the taxable year of the trust. After any distribution pursuant to this Article ___, the unitrust amount shall thereafter be calculated based on the remaining net fair market value of the trust assets as of the next succeeding valuation date."

The private letter ruling pertaining to a distribution of part of the corpus of a unitrust provided that the distribution occur on the last day of the taxable year. A distribution at any other time would greatly complicate trust accounting. The requirement that distributions in kind be fairly representative follows from Reg. Sec. 1.664-3(a)(4).

The sample language above presupposes that the donor has reserved the right to change charitable beneficiaries. However, the trust agreement could allow distributions of corpus to remainder beneficiaries when they are vested. In that case, the donor's choice of possible recipients would probably be limited to the named beneficiaries.

II. Procedures Regarding an Outright Gift of All or a Portion of the Annuity Interest in a Charitable Gift Annuity to the Issuing Charity

A. Procedure when the entire annuity interest is contributed.

As with a gift of the income interest in a charitable remainder trust, a determination must first be made that the proposed gift of an annuity interest is not prohibited by the gift annuity agreement. Such agreements will typically include language such as the following: "This annuity is irrevocable and non-assignable, except that it may be assigned to the charity." Clearly, this wording would allow an annuitant to assign his or her interest to the charity. If, however, the agreement were to say simply, "This annuity is irrevocable and non-assignable," then an assignment likely would not be possible, unless legal counsel for the annuitant and for the charity concluded that an exception permitting assignment of the annuity interest to the charity could be inferred or would at least be legally defensible.

Assuming the gift can proceed, it is typically made by means of a simple assignment agreement signed by the donor and acknowledged by the charity. This terminates the payment obligation and frees the charity to withdraw the residuum from its gift annuity reserve fund for use as specified in the gift annuity agreement.

B. Procedure when a portion of the annuity interest is contributed.

Though there is no ruling on point, it should be possible to give the charity only a portion of an annuity interest. One way this might be accomplished is to substitute two new gift annuity agreements for the original agreement. For example, one might provide for payments equal to 40 percent of those in the original agreement, and the other for payments equal to 60 percent of the original payments. In all other respects the two new contracts would be identical with the old one. Having divided the annuity into two annuities, the annuitant could contribute to the charity his or her entire annuity interest in one of the annuities and retain the other.

An alternative would be for the donor simply to assign to the charity an undivided fractional portion of the annuity interest. In general, a charitable deduction is not allowed for a contribution that is less than the donor's entire interest in the property transferred to the charity. See IRC Sec. 170(f)(3)(A). Nevertheless, provided the gift annuity was not established in the first place to avoid this partial interest rule, a gift of an undivided fractional portion of the annuity interest should fall within the exception to the partial interest rule found in IRC Sec. 170(f)(3)(B)(ii).

III. PROCEDURES REGARDING CONVERSIONS OF INCOME AND ANNUITY INTERESTS

A. Procedure in the case of a conversion of the income interest in a charitable remainder trust or pooled income fund for a charitable gift annuity.

The following steps would be taken:

1. In the case of a charitable remainder trust, if the donor has named more than one remainder beneficiary, or has named a remainder beneficiary other than the charity with which he or she wishes to establish the gift annuity, and has reserved the right to change charitable beneficiaries, the donor must execute documentation irrevocably designating the charity that will issue the gift annuity as the sole remainder beneficiary of the trust. As noted above, this is best done at least a day before the gift is made.

2. The donor and the charity execute a document by which the income interest is assigned to the charity.

3. The gift annuity agreement is drafted and signed per the charity's standard procedure. The agreement should specifically state that "X Charity shall pay from the general fund of X Charity an annual annuity of $_____." Also, the agreement should contain a statement stating that in no event shall the annuitant's interest be commuted. (These were provisions in the gift annuity agreement that PLR 200152018 approved.)

4. The income and remainder interests having merged (again, assuming this has previously been confirmed to be the result under applicable state law), the charitable remainder trust is terminated and all of its assets are transferred to the charity, or, in the case of a pooled income fund, the fund principal associated with the number of units in question is distributed to the charity.

5. In the case of a charitable remainder trust, the trustee files a final tax return for the trust.

B. Procedure when a new charitable remainder trust is to be established with the income interest of an existing charitable remainder trust.

The following steps would be taken:

1. The donor, the charity, and any third party trustee(s) should all be acquainted with the overall plan and should satisfy themselves that the eventual merger of the income and remainder interests in the existing trust will occur, thereby enabling all of its assets to be distributed to the charity. The same parties also determine the extent to which it may be desirable to liquidate the existing trust's

investments in advance of the anticipated date for establishment of the new trust, and the trustee of the existing trust begins to proceed accordingly.

2. If the charity is not already the sole vested beneficiary of the existing trust, the donor executes the necessary documentation.

3. A trust agreement governing the new trust is drawn up, along with a document by which the donor assigns to the new trust an undivided 99 percent of the income interest in the existing trust. If Step 2 needs to be taken, then the trust agreement and assignment document are executed at least one day after Step 2 has been completed.

4. Now that there are two beneficiaries of the income interest associated with the existing trust, the trustee of that trust tracks how the amount for the current payment interval is to be prorated between the two beneficiaries.

5. At some point in the days or weeks after the new trust has been established, the charity purchases for cash the new trust's undivided 99-percent of the income interest in the existing trust (once that interest has been accurately valued), pursuant to a bill of sale or other suitable documentation executed by the charity and by the trustee of the new trust. From this point onward, the trust payments associated with first trust are prorated between the donor and the charity, rather than between the donor and the new trust. Also, the cash received from the charity is invested by the trustee of the new trust pursuant to the investment plan settled upon for that trust.

6. At some point in the days or weeks after completion of Step 5, the donor assigns to the charity on an outright basis the donor's remaining portion of the income interest associated with the first trust. Even though this portion is merely one percent of that overall interest, by this time the donor is assigning *all* of his or her remaining interest in that interest. Thus, the assignment document executed by the donor and the charity would indicate the donor is contributing "an undivided one hundred percent (100 percent) interest in all of the donor's right, title, and interest in the donor's income interest in [the existing trust]."

7. All interests in the existing trust having merged in the charity, the assets of that trust are distributed to the charity, net of the final prorated trust payments and other costs, such as preparation of final tax returns for the trust.

C. Procedure when an annuity interest funds a new charitable gift annuity.

The donor and the charity simply execute a document by which the donor assigns to the charity the annuity interest associated with the first gift annuity, and this is followed by execution of a gift annuity agreement for the new gift annuity. The charity may then remove from its gift annuity reserve fund whatever portion of the residuum of the first gift annuity it wishes, consistent with maintaining adequate reserves for the new gift annuity.

IV. PROCEDURES REGARDING THE TERMINATION OF A CHARITABLE REMAINDER TRUST OR A CHARITABLE GIFT ANNUITY AND DISTRIBUTION OF A LUMP SUM TO THE INCOME BENEFICIARY OR ANNUITANT

A. Procedure in general.

With the termination of a trust, much will depend on whether the transaction is structured as a purchase of the donor's interest by the charity or as a division of trust assets between the two parties. In the event the former route is taken, documentation in the nature of a bill of sale or an assignment would be created and executed by the donor and the charity only, whereas the latter would likely entail documentation executed by the trustee as well as by the two parties. Of course, even if the former approach is taken, the parties should advise the trustee well in advance regarding what they have in mind, as the trustee will need to begin making arrangements for termination of the trust.

With the termination of a gift annuity, the charity is simply purchasing the donor's annuity interest, and a document executed by both parties reciting that the donor is assigning that interest to the charity in exchange for a single lump sum payment should suffice. The substance of such a document might be as follows:

"The undersigned irrevocably assigns and transfers to ABC Charity (hereinafter "the Charity") all of the undersigned's interest in the Charity's Gift Annuity Number ___, the terms of which are set forth in the Gift Annuity Agreement made [date] between [name of donor] and the Charity, in exchange for a lump sum payment of $_________, which is equal to the present value of the future payments, determined as of the date of this assignment.

"In making this assignment, the undersigned understands that periodic payments from the Gift Annuity will cease, that a portion of the lump sum payment to be made in lieu of future payments may be taxed as ordinary income [if appreciated property was used to fund the annuity and all of the gain has not yet been reported ratably, add: , that another portion may be taxed as capital gain], and that the undersigned is responsible for the payment of any taxes arising therefrom."

B. Advisability of a physician's statement about life expectancy.

PLR 200725044 and PLR 200733014 are simply the latest of several indications the IRS has provided in recent years that a charitable remainder trust beneficiary who proposes to terminate the trust and receive the present value of its income interest should substantiate the fact that his or her life expectancy is not less than that of the average person of the same age. The following excerpt from PLR 200733014 summarizes succinctly what needs to be documented:

"[The donor's] personal physician has conducted a physical examination and has stated under penalties of perjury that he [i.e., the physician] finds no medical condition expected to result in a shorter-than-average longevity (under section 1.72-9 of the Regulations)."

The letter ruling goes on to indicate that the donor also signed a similar statement, implying that this would be a wise additional step even once the statement of a physician has been obtained. Moreover, the same steps should be taken if an annuitant of a gift annuity intends to liquidate his or her annuity interest.

C. Permission of attorney general.

In the case of a charitable remainder trust, state law may require that the attorney general approve the early termination of the trust if it will result in the charitable remainder beneficiary(ies) receiving less than all of the trust's assets. Such approval, in turn, may need to be obtained through a court process, although perhaps the attorney general's written assent alone would suffice.

V. SUBSTANTIATION

A. When appraisals are required.

If as the result of a gift or a conversion the donor will be entitled to an income tax charitable deduction of more than $5,000, he or she will need to substantiate the deduction with a qualified appraisal. This is because the income or annuity interest being contributed is a non-cash asset, even if, in the case of a charitable remainder trust or a pooled income fund, the trust or fund holds only cash or marketable securities. In addition to obtaining the appraisal (and, if the deduction is greater than $500,000, actually attaching the appraisal to the tax return on which the deduction is claimed initially), the donor will need to file IRS Form 8283 after Section B of the form has been signed by the appraiser and by the charitable donee.

B. Who can do an appraisal.

As revised by the Pension Protection Act of 2006, IRC Sec. 170(f)(11)(E)(ii) defines a qualified appraiser as an individual who "(I) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary, (II) regularly performs appraisals for which the individual receives compensation, and (III) meets such other requirements as may be prescribed by the Secretary in regulations or other guidance." In addition, the individual must demonstrate "verifiable education and experience in valuing the type of property subject to the appraisal." To date, the only regulatory guidance provided by the Secretary has been Section 3 of Notice 2006-96. Nevertheless, actual regulations will be issued at some point, and in the meantime Reg. Sec.1.170A-13(c)(5) continues to be valid.

C. Information that should be contained in the appraisal.

The numerous requirements of a qualified appraisal are set forth in IRC Sec. 170(f)(11)(E)(i) and in Reg. Sec. 1.170A-13(c)(3)(ii). Among other things, the appraisal should describe the gift that resulted in the deduction being claimed by the donor and indicate how the present value of the interest in question was determined. It should also address the qualifications of the appraiser.

D. CMFR to be used in the appraisal.

IRC Sec. 7520(a) indicates that if an income tax charitable deduction is allowable in connection with the transfer of any annuity or any interest for life or a term of years, the deduction may be determined using the CMFR for the month of the transfer or for either of the two months preceding that month. Nevertheless, if calculation of the present value of an annuity interest or an income interest is made other than for the purpose of determining a charitable deduction, then only the CMFR for the month of the transfer may be used.

This means that if the present value of an income or annuity interest is being determined in connection with the sale of that interest, the CMFR used must be the one for the month in which the sale occurs. Similarly, if for example a donor is contributing the income interest in a charitable remainder trust to a charity in order to establish a gift annuity, the present value of that income interest must be determined using the month of the contribution. Yet once that present value has been determined, the charitable deduction associated with establishment of the gift annuity can be determined using the CMFR for the month of establishment or for either of the two months preceding that month.

E. Who pays for the appraisal.

Because the donor is required to have an appraisal in order to substantiate his or her deduction, the donor must bear the cost of obtaining the appraisal. If, however, the donor balks at this, the charity might arrange to obtain the appraisal and then make it available to the donor along with a written indication that the donor's deduction will need to be reduced by the amount the charity paid for the appraisal, on the theory that the appraisal constitutes "goods and services" provided to the donor in exchange for a charitable contribution.

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