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Tax Savings by Means of Charitable Gifts

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TAX SAVINGS BY MEANS OF CHARITABLE GIFTS

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I. CAN TAXES BE "SAVED" BY CHARITABLE BEQUESTS?[1]

A. The title of this paper is, to a considerable extent, a misnomer. Taxes can be "saved" by charitable bequests only in the sense that, if such bequests are made, the result is that a smaller proportion of the total estate is paid to the government. However, the result also is that a smaller proportion of the total estate is paid to the individual objects of the testator's bounty.

B. For example, if the net estate (before the $60,000 and $100,000 exemptions) is $150,000 of which $20,000 is left to charity, the federal tax will be $5,000 less than if the entire estate were left to taxable beneficiaries; but the latter will receive, net, $15,000 less than if there were no charitable bequests. As the size of the estate increases, the proportion of the charitable bequest which is made at the expense of the government increases and the proportion made at the expense of taxable beneficiaries decreases, but there is always a net cost to taxable beneficiaries.

C. In cases in which decedent takes advantage of the "marital deduction," the charitable bequest is deducted from gross estate *after* it has been reduced by the marital deduction.[2] Therefore, the marital deduction reduces the "tax saving" attendant upon a charitable bequest only by affecting the bracket in which the charitable bequest would otherwise fall.

II. CHARITABLE BEQUESTS COMPARED WITH CHARITABLE INTERVIVOS GIFTS

A. With possible minor exceptions, a charitable intervivos gift will incur no gift tax if the same transfer, made by way of bequest, would incur no estate tax. Hence, though the theoretical cost to the government may vary as between the two taxes, it makes no difference (other than loss of interest) to the donor or his estate whether the gift is intervivos or testamentary.

B. A charitable intervivos gift may reduce future income taxes of the donor, but only at the cost of reducing his income (net after taxes)

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[1] Throughout this paper "charitable bequest" is used as generally descriptive of all bequests deductible from gross estate under INT. REV. CODE §812(d).

[2] INT. REV. CODE §812(e)(2)(A).

below what it would have been had the donor retained the money or property and paid the tax on the income produced by it. However, if a taxpayer intends to make intervivos gifts to charity, he should consider whether a gift in high-value, low-basis property will produce better total income tax results than a gift in money.

III. The Recipient Must Qualify as a Proper Charity

A. An attorney drafting a will should warn the testator if there is a question as to whether a legatee, assumed by the testator to be a proper charity, will qualify as such under the law. A preliminary investigation may be in order. The prospective legatee may have, or be able to secure, a Treasury Department letter ruling upon its current status. Of course, the testator must determine, in the last analysis, whether he wishes to take a chance, but the attorney should not allow him to take the chance without realizing that it exists. Few testators will wish to invite litigation.

It should be borne in mind in drafting wills that, in the case of certain qualified beneficiaries, such as fraternal societies, the will should confine the purposes for which the bequest may be used to purposes approved in the statute.[3]

B. For those testators willing to take the risk of litigation in an attempt to have their cake and eat it, too, consideration may be given to the scheme of setting up a trust to provide scholarships, with relatives included or preferred as recipients.[4] However, a scheme so obviously open to abuse must necessarily be regarded with something of a jaundiced eye, as likely at any moment to incur emphatic legislative or judicial inhibition.

C. When the testator owns control of a large business, it is possible for him to leave a major portion of his holdings to a charitable foundation created by him. If a majority of the trustees of the foundation are his relatives, the result is that, though the income will go to charity, the family will retain control of the business. The charitable bequest will reduce the death tax to the point where it is unnecessary to sell control of the business in order to raise money with which to pay the tax. However, this seems worthy of serious consideration only where the estate is very much larger than that ordinarily encountered. Even though the estate is substantial and consists primarily of the testator's business, the testator would be well advised first to consider: (1) provision of insurance to provide funds for the purchase from the estate of a controlling interest in the business; or (2) the use of voting and

[3] Int. Rev. Code §812(d); U. S. Treas. Reg. 105, §81.44.

[4] See Estate of Sells, 10 T.C. —— (1948) (such a bequest, to be ladled out "first to relatives or other boys and girls," qualified as deductible).

non-voting shares of corporate stock, so that the non-voting shares can be sold to provide tax money without sacrificing control.

IV. The Charitable Deduction as Affected by the Type of Transfer

A. *Contingent Bequests to Charity*

1. Contingencies other than power to invade corpus

In the case of a contingent remainder to charity (as, for instance, a remainder contingent upon an individual life tenant dying without issue), the Regulations,[5] speaking as of the time of the testator's death, provide that: If it is a condition precedent, there is no deduction "unless the possibility that charity will not take is so remote as to be negligible"; if it is a condition subsequent, there is no deduction unless the happening of the contingency is "highly improbable." In general, the courts have accepted the validity of these Regulations, but have not been willing to follow the Commissioner in his more extreme applications of them.[6]

2. Power to invade corpus for benefit of a life tenant

If there is a remainder to charity, but the will permits an invasion of corpus for the benefit of a life tenant, then, unless the power to invade is very carefully circumscribed, either the remainder is clearly taxable or litigation is just around the corner.

If the power to invade is confined to part of the corpus (e.g., to 50%, or to a sum not exceeding $50,000) the part which cannot be invaded will not be affected by the existence of the power.[7] The part which is subject to the power may be considered in determining the charitable deduction "only when the conditions on which the extent of the invasion of the corpus depends are fixed by reference to some readily ascertainable and reliably predictable facts."[8] No deduction can reasonably be anticipated unless the estate can show convincingly: (1) that the will fixes a reasonably definite standard governing exercise of the power to invade; and (2) that the status of the life tenant as to other income and spending habits, considered in connection with the standard so fixed, permits reasonably definite measurement of the ex-

[5] U.S. Treas. Reg. 105, §81.46.

[6] See United States v. Provident Trust Co., 291 U.S. 272 (1933) (charitable remainder deductible when contingent upon death of life tenant without issue, and tenant, by virtue of operation, incapable of having issue); Allen v. First Nat. Bank, 169 F. 2d 221 (C.C.A. 5th 1948) (remainder deductible when contingent on testator not having posthumous child, and proof showed testator's widow not pregnant when he died). See also Farrington v. Commissioner, 30 F. 2d 915 (C.C.A. 1st 1929), *cert. denied*, 279 U.S. 873 (1928); City Bank Farmers Trust Co. v. United States, 74 F. 2d 692 (C.C.A. 2d 1935).

[7] U.S. Treas. Reg. 105, §81.46.

[8] Merchants Nat. Bank of Boston v. Commissioner, 320 U.S. 256 (1943). See also U.S. Treas. Reg. 105, §81.44.

tent to which the corpus will not actually be invaded. These generalities are of little help, but no draftsman should venture into this field without a thorough review of the cases.[9]

3. Moral

Contingencies should be avoided in the absence of very strong reasons for their existence.[10] When such strong reasons exist, every effort should be made to draft the provision in such a way as to leave the smallest portion possible subject to controversy. The draftsman must remember that disallowance of the deduction does not affect the validity of the remainder. Hence, the contingency may mean that, while the charity actually takes the remainder, it is taxed as if it had gone to non-charitable beneficiaries.

B. *Gifts in Contemplation of Death*

Though a gift in contemplation of death, made to charity, will be included in gross estate, it is deductible.[11] Hence, as between such a gift and a bequest, the former involves no additional tax hazards.

C. *Transfers Involving Powers of Appointment*

1. Estate of the donor of the power

A will may conceivably leave property: (a) in trust for A for life with power in A to appoint the remainder only among a named group of qualified charities; or (b) in trust for A for life with power in A to appoint the remainder among properly qualified charities which are not specifically named; or (c) in trust for A for life with power in A to appoint the remainder to qualified charities or to others; or (d) to A outright, with the request (assumed to be not binding on A) that A transfer all or part of the property to qualified charities.

Provision (a) or (b) would permit deduction of the remainder value from the gross estate of the donor of the power. Provision (c) or (d) would authorize no deduction.[12] Stated in another way, if the donee

[9] See Ithaca Trust Co. v. Commissioner, 279 U.S. 151 (1928); Nat. Bank of Commerce v. Scofield, 169 F. 2d 145 (C.C.A. 5th 1948); Union Planters Nat. Bank v. Henslee, 166 F. 2d 993 (C.C.A. 6th 1948), *cert. granted,* 17 U.S.L. WEEK 3090 (U.S. Oct. 12, 1948); Newton Trust Co. v. Commissioner, 160 F. 2d 175 (C.C.A. 1st 1947); Commissioner v. Robertson's Estate, 141 F. 2d 855 (C.C.A. 4th 1944); Helvering v. Union Trust Co., 125 F. 2d 401 (C.C.A. 4th 1942), *cert. denied,* 316 U.S. 696 (1941); Berry v. Kuhl, 77 F. Supp. 581 (E. D. Wisc. 1948); Price v. Rothensies, 67 F. Supp. 591 (E. D. Pa. 1946).

[10] This is not intended to have reference to the deliberate use of a remote contingent remainder to charity to avoid the rule of Helvering v. Hallock, 309 U.S. 106 (1940). In such a case there is no serious thought of attempting to secure a charitable deduction.

[11] U.S. Treas. Reg. 105, §81.44.

[12] Mississippi Valley Trust Co. v. Commissioner, 72 F. 2d 197 (C.C.A. 8th 1934) (an excellent analysis of the law). See also Brown v. Commissioner, 50 F. 2d 842 (C.C.A. 3d 1941); Beggs v. U.S., 27 F. Supp. 599 (Ct. Cl. 1939); Estate of Berger, 12 B.T.A. 1391 (1928).

may decide only *which* qualified charities take, there may be a deduction in the estate of the donor; but if the donee may decide *whether* qualified charities take, there is no deduction.

2. Estate of the donee of the power

When a power of appointment is confined to power to appoint among qualified charities, the property subject to the power is not included in the gross estate of the donee of the power.[13] And though the power is of a type which requires inclusion of the property in the donee's gross estate, a deduction is allowed to the extent that the property passes to qualified charities by exercise, non-exercise or release of the power.[14]

D. *Property Passing to Charity by Virtue of a Disclaimer*

If a will leaves property to A for life, with remainder to a qualified charity, and A disclaims his life estate, with the result, under state property law, that the charity immediately takes the property, the charitable deduction includes the entire value of the property and not merely the value of the remainder. The rule applies to any interest passing to a qualified charity by virtue of "an irrevocable disclaimer of a bequest, legacy, devise, transfer, or power, if the disclaimer is made prior to the date prescribed for the filing of the estate tax return."[15]

The Regulations[16] elaborate on this by providing that: (a) the date for filing disclaimers is correspondingly extended if an extension of time for filing the return is granted; (b) a disclaimer will ordinarily be considered irrevocable if filed with the probate court; (c) the disclaimer must be a complete and unqualified refusal, *made without consideration*[17] and (d) no disclaimer will be recognized after express *or implied* acceptance of the rights. The reference to implied acceptance is likely to be a litigation breeder.

As to powers, the Regulations also draw a distinction between disclaimer (which permits the deduction in the estate of the donor of the power if the interest then passes to charity) and release or exercise (which permits no deduction in the estate of the donor unless it would be permitted without reference to the disclaimer provisions). The line so drawn between disclaimer and exercise will usually be clear enough. For example, if the will gives property to A for life, with a general power of appointment by deed or will in A, it is clear that no renunciation of the power by A would send the property to charity (except, possibly, in case such a renunciation would result in the property

[13] INT. REV. CODE §811(f).
[14] INT. REV. CODE §812(d); U.S. Treas. Reg. 105, §81.44.
[15] INT. REV. CODE §812(d).
[16] U.S. Treas. Reg. 105, §81.44.
[17] See Selig v. United States, 73 F. Supp. 866 (E.D. Pa. 1947), *aff'd per curiam*, 166 F. 2d 299 (C.C.A. 9th 1947).

escheating). And exercise of the power by A, in favor of a charity, immediately after the death of the donor of the power, would not authorize any deduction.

But what of the line between disclaimer and release of a power? Suppose the limitation is to A for life, with remainder to a qualified charity, subject to power in A to appoint the remainder among his children? A renounces his power. Is this disclaimer or release? The truth would seem to be that no distinction should be drawn here, as a matter of labels, between "disclaimer" and "release." Whatever it is called, if its effect is to pass the interest to charity, the interest would seem to qualify for the deduction under the law.

Where there is a life estate in trust, with a remainder to charity, with power in a disinterested trustee to invade the corpus for the benefit of the life tenant, normal usage might imply a consequential difference between the two terms. The life tenant, holding no power, could only disclaim his right or privilege to have the trustee act in his behalf. The trustee, holding no beneficial rights, would normally be said to release the power. But if this is taken literally, and the Regulations are valid as literally applied, the result would be to prevent application of the disclaimer provision to this situation, unless disclaimer by the tenant, regardless of action by the trustee, is deemed sufficient. However, it seems that if the life tenant disclaims and the trustee (fortified by such disclaimer) releases or renounces the power, the statutory provision should be regarded as satisfied.

However, in an attempt to minimize difficulties, the wary attorney will see that the renunciation is labeled a "disclaimer" and not a "release."

E. *Compromises*

If a will contest is compromised, the amount actually going to charity under the compromise agreement puts a ceiling on the charitable deduction.[18] However, it does not follow that what a charity takes by compromise agreement will be deductible. There can be a deduction only to the extent that the charity is held to take by legacy or devise and not by purchase.[19]

[18] Thompson's Estate v. Commissioner, 123 F. 2d 816 (C.C.A. 2d 1941); Sage v. Commissioner, 122 F. 2d 480 (C.C.A. 3d 1941), *cert. denied,* 314 U.S. 699 (1942); U.S. Treas. Reg. 105, §81.44.

[19] Dumont's Estate v. Commissioner, 150 F. 2d 691 (C.C.A. 3rd 1945); Robbins v. Commissioner, 111 F. 2d 828 (C.C.A. 1st 1940); Estate of Gilbert, 4 T.C. 1006 (1945). *Cf.* Watkins v. Fly, 136 F. 2d 578 (C.C.A. 5th 1943), *cert. denied,* 320 U.S. 769 (1943); Estate of Varick, 10 T.C. —— (1948).

F. *Charitable Pledges*

By statute, pledges to qualified charities, "enforceable against the estate," may be deducted.[20]

V. WHERE TAX IS PAYABLE FROM BEQUEST TO CHARITY

When there is a bequest to charity, but death taxes, federal or state, must be paid from it, the charitable deduction is limited to the amount actually passing to charity after payment of such taxes.[21] This is of most frequent occurrence in connection with residual bequests to charity. Application of the provision requires determination of two interrelated unknowns, but I am assured that this presents no insuperable obstacle to a veteran formula hound.

VI. RELATION OF STATE AND FEDERAL CHARITABLE PROVISIONS

The above discussion relates entirely to the federal tax and no attempt has been made to point out differences in the state law and practice. However, it is possible for a bequest to qualify as a charitable bequest under the federal law and fail to qualify under the state law. For example, the state exemption might be denied because of the geographical location of the legatee.[22] This is a factor to be considered, as the result of such a discrepancy would be to reduce the 80% credit allowed against the federal tax without any corresponding reduction in the state tax.

[20] INT. REV. CODE §812(b); U.S. Treas. Reg. 105, §81.36. This supplants the rule of Taft v. Commissioner, 304 U.S. 351 (1937).
[21] INT. REV. CODE §812(d).
[22] See N. C. GEN. STAT. §105-3(b), (c) (1943).