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CHARITY — DEAD OR ALIVE?

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THOSE of us who keep current with the science columns of the daily newspapers are familiar with the startling aberrations in commonplace physical relationships caused by great stratospheric heights. These extraordinary physical phenomena have their counterparts in the economic-fiscal field, especially in the rarified atmosphere of the upper income and estate tax brackets. This is not to say that the laws of physics and taxes are in any sense interrelated; in fact, for many years tax rates have been successfully defying the basic physical postulate that "what goes up must come down." It is merely a restatement of the well-known fact that as tax rates ascend—with the concomitant decrease of the taxpayer's equity in his earnings or estate—a transaction which would otherwise make little business sense, or which might even result in a financial loss, is consummated largely because the taxpayer is merely risking or forfeiting this ever diminishing equity.

This seeming paradox is recognized and even finds a sort of statutory approval and encouragement in those sections of the Internal Revenue Code which permit the deduction of charitable contributions from taxable income for intervivos gifts and the deduction from the gross estate in respect of testamentary charitable bequests. From the income tax viewpoint the results are comparatively simple to compute; i.e., the taxpayer by applying his appropriate tax rate can easily determine the actual after-tax cost of a charitable contribution. This deceptively simple concept, however, cannot casually be carried over to the field of estate tax planning. A careful appraisal of all the complex and interrelated factors entering into the computation of the estate tax is required in order to determine whether an intervivos or a testamentary gift will best serve the dual purpose of implementing a donor's charitable impulse and conserving the greatest possible portion of his estate for the benefit of his wife and family.

The general aim of this article is (1) to present an analysis of the appropriate tax factors to be considered by an individual of means who desires to devote a substantial portion of his net worth to the advancement of social welfare, education or charitable causes and (2) to aid such an individual in the formulation of a program which will best accomplish this laudable purpose but in a manner consistent with the utmost conservation of his estate. Initially, the single most important element in the conservation of an estate for the benefit of both charity and family is the mitigation of the impact of the estate tax; and a great deal of current

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estate planning must inevitably be oriented toward this objective. The writer's view is no exception to this rule and the rationale of this paper follows the principle that the most generous of donors can be that individual who practices the most successful tax economies.

Commencing, therefore, with some basic facts of tax law—today almost every layman with a potential estate of $60,000 or more is familiar with the term "marital deduction." He is generally aware of the fact that his taxable estate can be reduced by as much as one-half if he bequeaths or devises property to his spouse, either outright or in such manner (e.g. in trust) as will vest in her certain beneficial interests in, and powers over, the property.

There is, however, one very important concept of a technical nature which the estate planner and his philanthropic client must understand; namely, that the 50% limitation placed upon the amount of the allowable marital deduction is measured by the "adjusted gross estate"[1]—i.e., the gross estate less deductions for funeral and administration expenses, claims, mortgages and certain types of losses incurred during the settlement of the estate.[2] The deduction for charitable bequests, however, does not enter into the computation of the adjusted gross estate. It is an entirely independent deduction and, in the actual computation of the estate tax, is taken from the balance remaining *after* giving effect to the marital deduction.[3] Thus the gift to charity, while it is eventually deducted from the gross estate in computing the net taxable estate, remains in the picture long enough so that it constitutes part of the yardstick by which the marital deduction is measured.

Presented herewith, in simplified form, is an illustration of the practical consequences of the interrelation discussed above:

X has a net worth of $1,000,000. He wishes to leave one-half of this to his wife and the balance to charity. If he makes an intervivos gift to charity his probate estate will be reduced to $500,000. In such event his estate tax will be computed in the following fashion:

Adjusted Gross Estate	$500,000.
Maximum Marital Deduction	250,000.
Balance	$250,000.
Exemption	60,000.
Taxable Estate	$190,000.
Liability for Estate Taxes[4]	47,700.

1. Int. Rev. Code § 2056(c)(1) (1954).
2. Int. Rev. Code § 2056(c)(2)(A) (1954).
3. Int. Rev. Code § 2055(a) (1954). See also Schedules M, N, and O, Treasury Dept., Form 706, Revised December, 1953.
4. The tax liability shown here is the gross Federal tax computed without the credit for

X's spouse will, therefore, receive the probate estate, $500,000 less taxes of $47,700 or a net amount of $452,300.

If *X* had not made an intervivos gift but had instead bequeathed the $500,000 to charity in his will—the computation of his taxable estate would show this interesting result:

Adjusted Gross Estate	$1,000,000.
Maximum Marital Deduction	500,000.
Balance	$ 500,000.
Bequests to Charity	500,000.
Taxable Estate	-0-

In other words *X*'s spouse would receive $500,000 free of taxes while the charity would have suffered only by the delay in the receipt of its share up to the date of *X*'s death.

The making of an intervivos gift has, therefore, actually resulted in a tax of $47,700 levied upon *X*'s spouse. In effect *X* has assessed a tax upon his estate by reason of such gift; an ironical result indeed, since even the Internal Revenue Service would not have attempted to collect a gift tax upon such a transfer.

It is obvious, therefore, that where the marital deduction is involved the large intervivos gift is the more expensive one and is to be avoided if at all possible. Where, however, the needs of importuning charities or the desire for recognition and prestige during the donor's lifetime cannot be subordinated to the dry economic factors, an intelligently planned alternative program can be arranged so as to reserve to the donor the maximum benefits over the longest period of time. The simplest procedure, if circumstances permit, might take the form of a non-interest bearing loan to charity, to be repaid upon demand or to be repaid to the donor's estate upon his death. The amount receivable would be included in the lender's gross estate and thus act to expand the maximum allowable marital deduction. The charitable contribution could then be effected by a simple testamentary provision forgiving the loan.

It may also be possible in this connection for the donor to derive some income tax savings under a carefully planned loan program on the basis

any State inheritance or estate taxes. We may safely assume, however, that this figure will generally represent at least the aggregate Federal and State taxes since the minimum State tax in most jurisdictions is fixed at the amount of the credit allowable against the gross Federal tax in respect of such State tax. Subsequent computations will also be made on the assumption that the amount of the gross Federal tax equals at least the combined Federal and State taxes. The amount of a decedent's net worth and his adjusted gross estate (i.e., the gross estate less the various administration expenses, payment of debts, etc.) will also, for convenience sake, be deemed one and the same.

that he is actually giving charity the cost-free use of money for his lifetime. For example, a donor 60 years of age, with a taxable income of \$100,000 and who files a joint return, could make a loan of about \$76,000 to a charity for his lifetime and, on the basis of tables published by the Commissioner, claim a deduction for \$30,000, the present value of the use of \$76,000.[5] In subsequent years of course, as the donor grows older, the amount of the loan necessary to produce a \$30,000 deduction would increase. Thus in a period of between six and seven years such a donor could, by making loans aggregating about \$500,000, realize income tax savings of nearly \$125,000 for such period. At the same time, the maximum marital deduction for estate tax purposes will not have been reduced or jeopardized. It is interesting to note that if, instead of a direct loan to charity, the loan were made to a trust created for charitable purposes no deduction for income tax purposes would be allowed. This is so because under the Internal Revenue Code of 1954, Section 170(b)(1)(D), no deduction is allowed for the value of a property interest transferred to a trust for charitable purposes if the grantor retains a reversionary interest exceeding 5% of the value of the property so transferred.

Another method might be an outright donation to charity each year, sufficient to utilize the donor's maximum charitable deduction, coupled with a testamentary provision giving charity the difference between the aggregate of these annual donations and the total predetermined charitable contribution. This procedure has the merit of retaining in the donor's hands a larger amount of cash or other assets for his own purposes than the prior procedure allows. If the donor is a married man with a taxable income of \$100,000, a direct \$30,000 annual contribution to a hospital could be made at an after-tax cost of only \$9,200 per year. At the end of seven years, such a donor would have reduced his net worth by only \$65,000 whereas under the loan procedure \$500,000 would have been lodged with the charity and compensated for only by approximately \$125,000 of tax savings, or a decrease in available net worth, for practical purposes, of \$375,000.

The direct contribution procedure thus allows the donor to retain the maximum amount for his own investment and business purposes. From an estate tax point of view, however, the direct contribution method is the less favorable since it envisages a constantly decreasing gross estate,

5. In I.T. 3918, 1948-2 Cum. Bull. 33, the Internal Revenue Service stated that the rental value of property donated for the use of a charitable organization could not be the subject of a deduction from gross income. In P.M. Sullivan, 16 T.C. 228 (1951), however, the Tax Court allowed the taxpayer to deduct, for the year of donation only, the estimated value of the use of certain property made available for the American Red Cross for the duration of World War II. The Commissioner has acquiesced in this decision. And interest is, after all, merely the rental paid for the use of money.

and thus a lower marital deduction. Of course, this decrease may in many cases be more than compensated for by the income earned and retained by the donor from the large amount of his estate otherwise transferred to charity under the loan procedure. It should be noted, nevertheless, that the loan procedure permits a greater retention of net worth in the first six or seven years and will in this period create the larger estate. The donor's early death accordingly would make the loan procedure the better of the two and would increase the net after-tax estate passing to the spouse and children. Since the difference is not startling, however, the real criterion should be the need of the charity and the liquid position and business requirements of the donor.

Let us turn now from these aids and supplements to the lump sum intervivos charitable gift and concentrate on the basic point made earlier; namely, that the retention of the amount earmarked for charity in the taxable estate enlarges the allowable maximum marital deduction. We are left then with the unavoidable conclusion that the outright intervivos gift runs counter to sound estate tax planning. As a logical extension of this theory, it is also evident that if it were somehow possible for tax purposes to increase the adjusted gross estate by an amount payable to charity, the maximum allowable marital deduction would be increased and the estate tax decreased, with the temporary addition to the gross estate passing on to the charity free of any tax whatsoever. Again to present a simplified illustration, assuming that *X* had a net worth of $620,000 all of which he desired to pass on to his wife, the estate tax would ordinarily be computed thus:

Adjusted Gross Estate	$620,000.
Maximum Marital Deduction	310,000.
Balance	$310,000.
Exemption	60,000.
Taxable Estate	$250,000
Estate Taxes	65,700.

Now, if from some outside source, we could secure for inclusion in *X*'s adjusted gross estate an amount of $500,000, passing on to charity, the taxable estate would be eliminated entirely, as follows:

Adjusted Gross Estate	$1,120,000.
Maximum Marital Deduction	560,000.
Balance	$ 560,000.
Charitable Bequest	500,000.
Balance	$ 60,000.
Exemption	60,000.
Taxable Estate	-0-

To summarize the theory illustrated by the foregoing schedules, the testamentary charitable bequest may be aptly characterized as a "tax catalyst." Without attracting any tax penalty to itself, it increases the allowable marital deduction and thus, in turn, reduces the taxable estate. The beneficial properties of this catalyst can be most advantageously availed of if, as in the immediately preceding schedule, the donor can create outside of his probate estate a fund (which for convenience sake we may label the "Philanthropic Fund") to discharge the eleemosynary burden which he has placed upon his estate. For the individual with charitable propensities such a transitory increase in his gross estate can achieve these gratifying rewards:

1. Since the Philanthropic Fund will discharge his charitable obligations, the portion of his probate estate otherwise earmarked for such purpose is released for the benefit of his spouse, family or other worthy objective.
2. The maximum allowable marital deduction is increased by 50% of the value of the Philanthropic Fund.
3. The particular charity of his choice will not suffer any decrease in the bequest originally intended for it.

The unique virtues of the Philanthropic Fund have been demonstrated; the obvious questions prompted thereby are (1) how and whence is the Fund to be created and (2) what are the costs of this alleged panacea?

In answer to the first query, the response is—the Life Insurance Contract. Such a contract offers a practical yet simple vehicle for the formation and transfer of a Philanthropic Fund outside of the donor's probate estate—a fund that can be diverted to eleemosynary channels, releasing a like amount for the donor to employ for such other purposes as he may see fit. As to the second query, the cost of the insurance contract, which will eventually ripen into and comprise the Philanthropic Fund, can in a proper situation be reduced to very modest proportions through tax economies. The achievement of this reduction in taxes is premised upon the fact that premiums paid upon a life insurance contract in which a qualified charity is named as the irrevocable beneficiary may be deducted from gross income in the year paid, just as though they were direct gifts to the particular charity involved.[6] The deduction is likewise allowable where premiums are paid on policies which have been transferred to trusts created for charitable purposes, provided that such purposes cannot be defeated or avoided.[7]

In terms of dollars and cents, where an individual in a 70% tax bracket insures his life under an insurance policy the proceeds of which are irrevocably destined for charitable purposes, every dollar expended thereon in premiums will result in a net after-tax cost of only 30¢. Such an indi-

6. O.D. 229, 1 Cum. Bull. 151; see also Mortimer C. Adler, 5 B.T.A. 1063 (1927).

7. Eppa Hunton IV, 1 T.C. 821, acq. 1943-1 Cum. Bull. 12; Ernst R. Behrend, 23 B.T.A. 1037, acq. X-2 C. B. 5 (1931).

vidual can, therefore, create the fund at an actual cash cost of only 30% of the cost attributable to an ordinary policy. The aggregate of the premiums paid, less the income tax savings in respect thereof, will represent the initial cost of relieving the donor's estate of the actual charitable contribution. There is, in addition, a further cost due to the fact that the sum retained in the estate becomes subject to the estate tax. Such additional tax is, however, substantially mitigated since the Philanthropic Fund, while itself tax exempt will, if included in the gross estate, permit the maximum marital deduction to be increased by one-half of the value of the Fund. This increased deduction, by depressing the taxable estate, reduces the tax and, concomitantly, the cost of retaining in the donor's estate the amount comprising his original charitable bequest.

In order to realize the optimum mitigation of tax via an increased allowance of the marital deduction, the inclusion of the Fund in the donor's gross estate must somehow be accomplished. Under the provisions of the Internal Revenue Code of 1939 this would have posed no problem since the inclusion of the proceeds of a life insurance contract in a decedent's gross estate was required merely on the basis of the payment of the premiums thereon by the decedent.[8] Ironically enough, this payment of premiums criterion was excised from the statute by the Revenue Code of 1954, so that the inclusion of insurance proceeds now depends only upon the possession of any of the incidents of ownership in respect of the policy.[9] The statutory amendment to the old Code is not fatal, however, since the simple retention of ownership of the policy, even with a charity named the irrevocable beneficiary, will ordinarily leave a residue of powers in the insured sufficient to require the inclusion of the insurance proceeds in his gross estate.[10] Even if the policy has been contributed to a charitable trust, it is possible by certain technical and proper provisions to insure that the value of the trust corpus is swept into the gross estate. We can, therefore, on the basis of the foregoing analysis accept the proposition that a carefully planned insurance program may cheaply and expeditiously fund a charitable bequest and provide the maximum benefits for the donor, his family, and the charity closest to his heart.

8. Int. Rev. Code § 811(g)(2) (1939).

9. Int. Rev. Code § 2042(2) (1954).

10. Sec. 81.27 of Regulations 105 (Estate Tax) applicable to the I.R.C. of 1939 gives as examples of an incident of ownership a power to surrender or cancel the policy, to assign it, to revoke an assignment, to pledge it for a loan. Although the naming of an irrevocable beneficiary may impose certain procedural and legal restrictions upon the power of the insured to pledge or surrender the policy such powers are not entirely eliminated thereby. Under both Sec. 811(g) I.R.C. of 1939 and Sec. 2042 I.R.C. of 1954, the possession of any of the incidents of ownership, whether exercisable by the insured alone or in conjunction with any other person will serve to make the insurance proceeds includable in the gross estate.

In order to translate the benefit of the program into concrete terms, let us apply the foregoing theoretical discussion to a specific case. Take, for example, the situation of Mr. Jones. He is 60 years of age, married and has two children. He estimates his net worth currently at about $2,000,000; his taxable income from salaries, dividends and other sources averages $100,000 a year and he can reasonably expect this income to continue indefinitely, barring any unforeseen financial catastrophe. In the planning of his estate, his wife and children are naturally the primary objects of his concern; he is, however, active in the affairs of a particular charity and is considering a bequest to it of $300,000. This generosity is prompted not only by his genuine interest in the organization's aims but also by the understandable human desire for prestige and the perpetuation of his memory in the form of a fund or facility bearing his family name. The charity is of a type to which the 30% of adjusted gross income limitation applies under the Internal Revenue Code of 1954.

It is assumed that Mr. Jones utilizes all of his current income after taxes for his living expenses and would be forced to draw upon his capital in the event that his after-tax cash residue fell below current levels. It is also assumed that his current net worth will for the next ten-year period otherwise remain constant and that his adjusted gross estate would equal $2,000,000 at any given point during this period except for any invasions necessary to maintain his standard of living.

There is presented below a set of four schedules comparing the net after-tax amounts available for his wife, children and favorite charity in the event of his death ten years hence. These schedules reflect the results of various methods of effecting the charitable contributions.

I. An immediate outright gift.
II. An annual donation of $30,000 coupled with a testamentary bequest of the difference between the aggregate of the annual donations and the sum of $300,000.
III. A testamentary bequest.
IV. A Philanthropic Fund program utilizing life insurance.

SCHEDULE I

Outright Intervivos Gift of $300,000

Observation—The gift will result in an initial income tax reduction for the year of the gift, based upon the maximum 30% allowance, of roughly $21,000. The net reduction in Jones' estate occasioned by the gift is, therefore, only $279,000.

Adjusted Gross Estate	$1,721,000.
Maximum Marital Deduction	860,500.
Balance	$ 860,500.
Exemption	60,000.
Taxable Estate	$ 800,500.
Estate Tax Liability	251,885.

Recapitulation

Benefits Received by Charity	$ 300,000.
Federal and State Taxes	251,885.
Balance of Estate Available for Wife and Family	1,469,115.

SCHEDULE II

Annual $30,000. Contribution Coupled with Testamentary Bequest

Observation—Since the annual after-tax cost of each charitable contribution is $9,180, it is assumed that Jones will have invaded his capital to such an extent each year for living expenses. At the end of the ten-year period, therefore, his gross estate will have been reduced roughly by $92,000. No further provision is made for charity since after a ten-year period it will have received the entire $300,000 contribution.

Adjusted Gross Estate	$1,908,000.
Maximum Marital Deduction	954,000.
Balance	$ 954,000.
Exemption	60,000.
Taxable Estate	$ 894,000.
Estate Tax Liability	286,480.

Recapitulation

Benefits Received by Charity	$ 300,000.
Federal and State Taxes	286,480.
Balance of Estate Available for Wife and Family	$1,621,520.

SCHEDULE III

Testamentary Charitable Bequest

Adjusted Gross Estate	$2,000,000.
Maximum Marital Deduction	1,000,000.
Balance	$1,000,000.
Charitable Bequest	300,000.
Balance	$ 700,000.
Exemption	60,000.
Taxable Estate	$ 640,000.
Estate Tax Liability	194,700.

Recapitulation

Benefits Received by Charity	$ 300,000.
Federal and State Taxes	194,700.
Balance of Estate Available for Wife and Family	$1,505,300.

SCHEDULE IV

Utilization of Philanthropic Fund and Life Insurance Program.

Observation—Mr. Jones, age 60, can obtain $300,000 in life insurance policies calling for net annual premiums of about $18,000. By making appropriate provisions in the contract, these premiums may qualify as a charitable deduction for income tax purposes. In Mr. Jones' tax bracket, the annual net after-tax cost of such a contribution will be about $5,220. He will, perforce, invade his capital in such amount each year for living expenses so that at the end of a ten-year period, his gross estate will have been reduced by $52,220.

Adjusted Gross Estate (Including the value of the Insurance Policy Payable to the Charity)	$2,247,780.
Maximum Marital Deduction	1,123,890.
Balance	$1,123,890.
Charitable Bequest	300,000.
Balance	823,890.
Exemption	60,000.
Taxable Estate	$ 763,890.
Estate Tax Liability	238,339.

Recapitulation

Benefits Received by Charity	$ 300,000.
Federal and State Taxes	238,339.
Balance of Estate Available for Wife and Family	1,709,441.

The foregoing schedules illustrate, pointedly, the value of the Philanthropic Fund created by life insurance. In each of the cases the charitable beneficiaries received their full $300,000, one way or another. However, if Mr. Jones utilizes the Philanthropic Fund procedure, he will pass on to his wife and family $240,000 more than if he were to make an immediate and outright gift; $204,000 more than if he merely made the usual testamentary charitable bequest; and $88,000 more than would be possible by following a planned annual contribution program. These results, for the sake of realism, have been computed as occurring after a ten-year period. The death of Mr. Jones prior to the termination of such period would serve to emphasize even more dramatically the benefits of life insurance in making charitable bequests since the identical amount in the Philanthropic Fund would have been created at a lesser cost. On the other hand, even if Mr. Jones should survive to achieve the age of 80, the superior benefits of this method would still prevail since his wife and family will, in such case, receive over $1,666,000 free and clear of all estate taxes.

In the foregoing schedules, it has been assumed that the donor's wife survived him in making the computations of estate taxes. Since the vicissitudes of life will not always follow this convenient pattern it is quite possible that in many cases the donor's estate tax must be computed without the benefits of the marital deduction. Even in this type of a situation, the merits of the insured Philanthropic Fund are demonstrable. If we return to Schedule III, for example, and recompute the figures on the assumption that Mr. Jones' spouse has predeceased him, just before the end of the ten-year period, the recapitulation would take the following form:

Benefits Received by Charity	$ 300,000.
Federal and State Taxes	591,200.
Balance of Estate Available for Family	1,108,800.

Now compare this with the recapitulation of the computation in Schedule IV, omitting the marital deduction feature:

Benefits Received by Charity	$ 300,000.
Federal and State Taxes	702,701.
Balance of Estate Available for Family	1,245,079.

Even where an individual originally has no intention of making a charitable bequest, the Philanthropic Fund procedure can be most effective in convincing him to do so since it reduces the actual cash cost of such a bequest to the point where, in a proper case, with no diminution in the amount passing to his wife and family, some deserving charity can receive a handsome endowment. By way of illustration, if Mr. Jones, whose situation has been heretofore discussed, were to make no provision setting aside a portion of his estate for the use of some deserving cause, his entire $2,000,000 estate less taxes of $303,500, or a net amount of $1,696,500, would be passed on to his wife and family. Schedule IV, however, effectively demonstrates the possibility of increasing the benefits retained by the family to $1,709,441 under the Philanthropic Fund procedure. Thus, Mr. Jones could make available for some sorely pressed educational or humanitarian agency the munificent sum of $300,000 and, at the same time, actually increase his family's share of his estate by almost $13,000.

There are any number of permutations and combinations of the Philanthropic Fund procedure which can be worked out—depending upon the age, income tax bracket, marital status and net worth of a particular individual. The benefits will, naturally, vary from case to case but the underlying theory will still hold true even for situations where the net worth and the income are far less imposing than in the examples cited herein. To demonstrate the application of the procedure to a more modest situation, if Schedules III and IV were to be computed on the basis that Mr. Jones had an adjusted gross estate of $1,000,000, an annual taxable income of $40,000 and desired to make a charitable bequest of $100,000, the Philanthropic Fund procedure outlined in Schedule IV would enable Jones' wife and family to retain about $57,000 more than if he had merely provided for an unfunded testamentary charitable bequest.

The procedure should, accordingly, be seriously considered and thoroughly explored in planning the estate of an individual who may reasonably be expected to die with a net worth of even several hundred thousand dollars.

These are trying times, financially, for the great majority of our private colleges, hospitals and social welfare organizations. They are continually clamoring for assistance to meet their current and future needs, and rightly so. The man with a social conscience and the man who cherishes our civilization and culture must consider it his moral obligation to set aside, out of the substance garnered during his lifetme, some portion to provide for the alleviation of human distress, the perpetuation of our institutions and the strengthening of the foundations of the society to which the welfare of his posterity and his estate must be entrusted.

It is the writer's sincere hope that the ideas and procedures propounded herein will prompt and influence those individuals who recognize their obligations but who are anxious to discharge them with the least possible sacrifice. They are after all human and, like the rest of us, constantly struggling to reconcile those two homely saws—"It is better to give than to receive" and "Charity begins at home."