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CHARITABLE CONTRIBUTIONS AND BEQUESTS BY INDIVIDUALS: THE IMPACT OF THE TAX REFORM ACT

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IN Volume 28 of the Fordham Law Review, the authors of this article published an article on the subject of federal tax deductions for charitable contributions.[1] The law on this subject has since experienced an upheaval unequaled in its history of over half a century. The purpose of this article is to explore the changes made by the Tax Reform Act of 1969[2] and, wherever possible, to acquaint the reader with other developments over the past ten years.

I. Introduction

On October 4, 1957, the Soviet Union launched Sputnik I—the first artificial satellite. This event was followed closely by Sputnik II, the first inhabited space capsule, in which a dog named Laika returned safely from space. The shock in the United States from the realization that the Russians had the knowledge and capacity for these feats was profound, since they appeared to evidence an enormous educational and technological gap. The result was a massive infusion of federal aid to higher education through building programs, scholarships, grants, and encouragement for individuals to increase their charitable giving at the expense of income tax revenues.

Two related movements appeared in the sixties. One had as its object the simplification of the hideously complicated federal income tax structure. It was feared that the whole taxing system would fall of its own weight if it were not made less esoteric and more comprehensible to the average citizen, who has since its beginning been the mainstay of the "self-assessment" theory of collecting taxes. The other movement manifested itself through a growing suspicion that social and economic power was becoming dangerously concentrated in the private foundation segment of charitable institutions, and that the laws were incapable of preventing large-scale abuse of the tax exemption.[3]

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1. Quiggle & Myers, Tax Aspects of Charitable Contributions and Bequests By Individuals, 28 Fordham L. Rev. 579 (1960).

2. Act of Dec. 30, 1969, Pub. L. No. 91-172, 83 Stat. 487, amending Int. Rev. Code of 1954 [hereinafter cited as Act].

3. See House Select Comm. on Small Business, Chairman's Report to Subcomm. No. 1, 88th Cong., 2d Sess., Tax-Exempt Foundations and Charitable Trusts: Their Impact on

In 1968, much publicity was given to a Department of the Treasury analysis of the 1967 tax returns of 155 taxpayers with adjusted gross incomes of $200,000 or more who paid no income tax.[4] While accelerated depreciation, depletion, investment in tax exempt income, and other means contributed to the result, the charitable contributions deduction was seen as a tax haven for the wealthy.

The Revenue and Expenditure Control Act of 1968[5] introduced the tax surcharge,[6] which adversely affected the taxpayers. Since their withholding and estimated payments did not initially reflect this additional tax, many taxpayers had underpayments for 1968. The effect in early 1969 was a flood of letters by taxpayers to the Treasury and the Congress with reference to the Treasury study of the 155 returns, inquiring as to why others whose income was far greater managed to pay little or no taxes. To them the whole system of federal taxation was suspect, including those provisions governing deductions for charitable giving. A very real "taxpayer revolt" was underway.[7]

In this atmosphere, the Act could have been a witch hunt in which some of the more noble methods of charitable giving were to be sacrificed to set an example for the few taxpayers who had used them excessively. The product of any such effort would have been a stifling of charitable contributions at a time when this country needed them as never before.

There are subjects of charitable giving that were not generally recognized when our article of a decade ago was written. The study of environmental problems, urban housing, advancement of the underprivileged, and relations between the races are but a few of the efforts to which little attention was paid in 1959, but which demand our undivided attention today. While the federal government promises to be a leader in these endeavors, the burden of treating, through study and research, the ills of today's society must be borne by the private sector. Properly directed charities appear to have a greater role than ever in helping to solve the problems of this discontented nation.

Our Economy (Comm. Print 1964); House Select Comm. on Small Business, Chairman's Report to Subcomm. No. 1, 88th Cong., 1st Sess., Tax-Exempt Foundations and Charitable Trusts: Their Impact on Our Economy (Comm. Print 1963); House Select Comm. on Small Business, Chairman's Report, 87th Cong., 2d Sess., Tax-Exempt Foundations and Charitable Trusts: Their Impact on Our Economy (Comm. Print 1962). These reports are commonly known as the "Patman Reports." See also House Comm. on Ways and Means, 89th Cong., 1st Sess., Treasury Department Report on Private Foundations (Comm. Print 1965).

4. Zimmerman, Political Planets in Taxes Conjunction, Wall St. J., Aug. 15, 1969, at 10, col. 4.

5. Act of June 28, 1968, Pub. L. No. 90-364, 82 Stat. 251.

6. Int. Rev. Code of 1954, § 51.

7. Hopkins, The 91st Congress as a "Tax" Congress: Developments Other than the Tax Reform Act, 23 Tax Law. 637, 638-39 (1970).

While it remains to be seen, the Act will probably be judged on the whole as a wise piece of legislation. To be sure, there are some intemperate provisions that merit correction. Nevertheless, the enactors appear to have been motivated not by an overpowering desire to curb charitable giving, but rather by an intent to rid the area of certain image-degrading practices. Though it will take years to develop a full understanding of the Act, the central and most important means for the encouragement of charitable giving have been left intact.

II. The Legislative History

The first clear indication of the substance of the various changes in the law permitting tax deductions for charitable giving which were ultimately embodied in the Act came in a study prepared by the Department of the Treasury during the administration of former President Johnson. This study comprised three documents, dated Feburary 5, 1969, entitled "Tax Reform Studies and Proposals."[8] The Treasury's effort was ostensibly commanded by the 90th Congress midway through its second session, in section 110 of the Revenue and Expenditure Control Act of 1968,[9] but in fact the Treasury had earlier readied a broad package of tax revision recommendations.

With respect to charitable giftmaking, the general objectives of this study were to preserve and to some extent further stimulate the incentive for chartiable giving, while at the same time eliminating schemes of giving where the underlying motive was tax minimization and the corresponding cost to the federal government was deemed unacceptable. The overriding concerns of the study and of most of the people who were to have influence over the Act were fairness to truly charitable-minded taxpayers, preservation of the important sources of revenue for worthy charities, and continued maintenance of the integrity of the United States tax system.

The 91st Congress convened on January 3, 1969, in the midst of considerable interest in and enthusiasm for tax reform in both Houses of Congress. It became clear that the Congress would at least explore the possibilities of tax reform when, on January 29, 1969, the House Ways and Means Committee announced the scheduling of hearings, to begin on February 18, 1969, on seventeen reform topics (including charitable giving). As the hearings progressed throughout the spring of 1969, Chairman Wilbur D. Mills gave repeated indications that his committee

8. Staffs of the House Comm. on Ways and Means and Senate Comm. on Finance, 91st Cong., 1st Sess., Tax Reform Studies and Proposals (Comm. Print 1969) [hereinafter cited as Tax Reform Studies].

9. See note 5 supra.

was striving to write a comprehensive reform measure.[10] On April 22, 1969, representatives from the Treasury began a presentation of the Nixon Administration's tax reform plans, contained in a document entitled "Tax Reform Proposals."[11] In the week following the conclusion of the hearings on April 24, 1969, the Ways and Means Committee began meeting in executive sessions to complete its process of writing a reform bill.

The House Ways and Means Committee reported[12] its bill on August 1, 1969, and the House, after two days of consideration, passed the bill on August 7.[13] The measure was then referred to the Senate Committee on Finance, where hearings commenced on September 4. The Committee's executive sessions began on October 9, and its version of the bill was formally reported[14] on November 21. After twelve days of debate and 110 proposed amendments (of which 73 were adopted), the Senate passed the measure on December 11.[15] A House-Senate conference committee was convened in the middle of December to adjust the enormous differences between the two versions of the reform legislation. On December 21, the conference report[16] was filed in the House, and the reconciled version passed the House and the Senate on December 22.[17] Despite speculation of a presidential veto because of the Act's revenue-depleting features, the President signed the Act into law on December 30, 1969.

Insofar as the charitable contribution deduction was concerned, the Congress singled out eight areas for attention: the two-year charitable trust, gifts of the use of property, gifts of property, bargain sales, increase of the percentage limitation, the unlimited charitable contribution de-

10. See, e.g., N.Y. Times, Jan. 1, 1969, at 12, col. 8.

11. U.S. Treas. Dep't, Tax Reform Proposals Contained in the Message from the President of April 21, 1969, and Presented by Representatives of the Treasury Department to the Committee on Ways and Means at Public Hearings on the Subject of Tax Reform on Tuesday, April 22, 1969, 91st Cong., 1st Sess. (Comm. Print 1969) [hereinafter cited as Tax Reform Proposals].

12. H.R. Rep. No. 91-413, pts. 1 & 2, 91st Cong., 1st Sess. (1969) [hereinafter cited by part as H.R. Rep.].

13. H.R. 13270, 91st Cong., 1st Sess., 115 Cong. Rec. H7150 (daily ed. Aug. 7, 1969). As is traditionally the case with major legislation reported from the House Committee on Ways and Means, the Act went to the House floor accompanied by a closed rule, H. Res. 513, 91st Cong., 1st Sess., 115 Cong. Rec. H6968 (daily ed. Aug. 6, 1969), which prohibited all amendments except those "offered by direction of" the committee. At the conclusion of the debate, two committee amendments were offered by Chairman Mills and agreed to by voice vote. 115 Cong. Rec. H7148-50 (daily ed. Aug. 7, 1969).

14. S. Rep. No. 91-552, 91st Cong., 1st Sess. (1969) [hereinafter cited as S. Rep.].

15. 115 Cong. Rec. S16,435, S16,459 (daily ed. Dec. 11, 1969).

16. Conf. Rep. No. 91-782, 91st Cong., 1st Sess. (1969) [hereinafter cited as Conf. Rep.].

17. 115 Cong. Rec. H13,067 (daily ed. Dec. 23, 1969); 115 Cong. Rec. S17,605 (daily ed. Dec. 22, 1969).

duction, denial of the deduction, and split-interest trusts. These areas will be discussed in the following text.

III. The Two-Year Charitable Trust

Before the Act, section 673(b) of the Internal Revenue Code of 1954[18] constituted an exception to the "Clifford Rules" of section 673(a) of the Code, whereby a grantor is treated as the owner[19] of any portion of a trust in which he has a reversionary interest in the corpus or income, if the interest can reasonably be expected to take effect in possession or enjoyment within ten years. Section 673(b) provided that a grantor was not to be considered the "owner" if the trust income was irrevocably payable for at least two years to a narrow class of charitable organizations such as churches, operating educational institutions, and hospitals.[20] This provision was intended simply to stimulate the flow of funds to these institutions from private sources.[21]

Both the Treasury and the Congress agreed that section 673(b) caused distortion in the Code.[22] It was therefore repealed,[23] effective as to transfers in trust made after April 22, 1969.[24] Although former section 170(b)(1)(D) usually prevented a charitable deduction for the value of the income interest because of the grantor's reversionary interest, it was thought that section 673(b) presented an opportunity peculiarly available only to the wealthy and constituted a means of circumscribing the percentage limitations on charitable gifts. For example, under prior law a taxpayer having an adjusted gross income (AGI) of $100,000 consisting of dividends and interest, was limited to charitable contributions of 30 percent of AGI, or $30,000. Under section 673(b), however, he could transfer enough property to a charitable institution to produce $70,000 of income. The overall effect was a deduction during the term of the trust of 70 percent—far beyond the normal limitation.

At the present time, grantors who transfer property in trust for the income benefit of charitable institutions while retaining a reversionary interest will be taxed on the income, unless they come within the provisions of section 673(a) and part with their property for a full ten years.

18. Act of Aug. 16, 1954, Pub. L. No. 591, ch. 736, 68A Stat. 3 (codified at 26 U.S.C. §§ 1-8043 (1964), as amended, 26 U.S.C. (Supp. V, 1970)).

19. Because the grantor is treated as the owner, he is taxed on the income from such portion under Int. Rev. Code of 1954, § 671.

20. Described in id. §§ 170(b)(1)(A)(i), (ii) & (iii).

21. S. Rep. No. 1622, 83rd Cong., 2d Sess. 29 (1954).

22. Tax Reform Proposals 174; Conf. Rep. 294; H.R. Rep., pt. 1, at 56; S. Rep. 82-83; Tax Reform Studies 185.

23. Act § 201(c).

24. Id. § 201(g)(3).

They will also have to consider the gift and estate tax provisions with respect to these transfers.[25] If the transfer is not in trust, the donor will have to rely on general law—specifically the *Clifford*[26] and related cases —to see whether he continues to be the owner of the property for purposes of section 61. Under these cases, the donor would be taxed on the income if the duration of the trust did not exceed two years and he retained a reversionary interest.

IV. Gifts of the Use of Property

The Tax Reform Studies especially criticized gifts of the use of property as charitable deductions.[27] As an illustration, a taxpayer owning an office building donated its use to a charitable organization, with the consequence that the rental value went untaxed. He received a charitable contribution deduction based upon the same amount—in effect a double deduction.[28] Suppose the fair rental value was $100,000 and the taxpayer's marginal bracket was 70 percent. Had he included this in income, he would have netted $30,000. Instead, he was not taxed on the $100,000 and in addition received a charitable contribution deduction of $100,000, which to him is worth $70,000. Thus, by donating the space, he saved $40,000.

The problem area here is essentially the same as that discussed later in connection with gifts of ordinary income and appreciated property. By making such a gift, the taxpayer deprives the government of the tax on a segment of income it ordinarily would have received.[29] This, coupled with the additional benefit of a deduction, was too great an advantage.

The Act deals with the problem in section 170(f)(3)[30] by allowing a

25. Prior to the Act, Int. Rev. Code of 1954, §§ 2522(a) and 2055(a) permitted a deduction for gift and estate tax purposes, respectively, for gifts to or for the use of certain charitable institutions. Presently, Int. Rev. Code of 1954, §§ 2522(c)(2)(B) & 2055(e)(2)(B) limit the deduction to gifts in the form of a guaranteed annuity or fixed percentage trusts.

26. Helvering v. Clifford, 309 U.S. 331 (1940).

27. Tax Reform Studies 180.

28. The IRS has held that mere permission to use a building is not a payment required by Treas. Reg. § 1.170-1(a)(1), T.D. 6900, 1966-2 Cum. Bull. 73, but only a privilege. I.T. 3918, 1948-2 Cum. Bull. 33. But when the parties are bound by a contractual arrangement such as a rent free lease, the courts uphold the deduction. Passailaigue v. United States, 224 F. Supp. 682 (M.D. Ga. 1963).

29. The government has long opposed methods of avoiding income by assignment. Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 111 (1930).

30. Int. Rev. Code of 1954, § 170(f)(3) provides:

"(A) In general.

In the case of a contribution (not made by a transfer in trust) of an interest in property which consists of less than the taxpayer's entire interest in such property, a deduction shall be allowed under this section only to the extent that the value of the interest contributed would be allowable as a deduction under this section if such interest had been transferred in trust. For purposes of this subparagraph, a contribution by a taxpayer of the right to use deduction for a contribution not made by a transfer in trust of a partial interest in property only to the extent it would be allowable if made in trust. The right to use property is specifically defined as such a partial interest.[31] Thus, to obtain a deduction for a partial interest such as the use of property (*i.e.*, the income interest), the gift must be in the form of a guaranteed annuity or a fixed percentage of the value of the property, and the grantor must be treated as the owner of the interest.[32]

Two exceptions to section 170(f)(3) were added by the Senate and modified by the conferees. The first[33] applies to the contribution of a remainder interest in a personal residence or farm. The second exception assures that the provision does not cause the disallowance of a gift of an undivided portion of the taxpayer's *entire* interest in property, as for example, an undivided one-fifth of an office building.[34]

Section 170(f)(3) is extremely broad, applying to all forms of interests not in trust—a life interest, remainder interest, leasehold interest, term for years, and the like. If one of these is carved out and contributed, the deduction is disallowed unless the gift complies with section 170(f)(2). Congress specifically disavowed any intent to disturb existing law as to the inclusion of income.[35] Thus, even if the gift fails to comply with the requirements for the contribution deduction, the taxpayer should not be required to report the rental value of the property as income.

Suppose the taxpayer's *entire* interest is a life estate, remainder interest, or any other partial interest. He should be able in such instance to obtain a deduction, even if what he contributes is a partial interest.[36] The term "taxpayer's entire interest" does not seem to require that the interest be a fee simple.

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property shall be treated as a contribution of less than the taxpayer's entire interest in such property.

(B) Exceptions.

Subparagraph (A) shall not apply to a contribution of—

(i) a remainder interest in a personal residence or farm, or

(ii) an undivided portion of taxpayer's entire interest in property." Section 170(f)(3) is effective as to transfers after July 31, 1969. Act § 201(g)(1)(c).

31. Int. Rev. Code of 1954, § 170(f)(3)(A).

32. Id. § 170(f)(2)(B). This kind of trust is discussed infra.

33. Id. § 170(f)(3)(B)(i). The Senate bill excepted remainder interests in any kind of realty. The conferees limited this section to a personal residence or farm. See id. § 170(f)(4), which requires that depreciation and depletion be taken into account in valuing the remainder interest.

34. Id. § 170(f)(3)(B)(ii). See S. Rep. 84. A perpetual open space easement in gross is considered an undivided interest. Conf. Rep. 294.

35. H.R. Rep., pt. 1, at 58; S. Rep. 84.

36. The income should not be taxable to the donor. Blair v. Commissioner, 300 U.S. 5 (1937).

V. Gifts of Property

A. *Appreciated Property*

It was recognized at the outset that one of the main Treasury efforts would be directed against the thoroughly established practice of being able to give property to charity and take a deduction for the fair market value[37] without having to pay a tax with respect to its appreciation.[38] The Tax Reform Studies made one slightly connected recommendation, that where appreciated property is donated to a charity and replaced with substantially similar property within ninety days before or after the gift, the basis of the replacement property would be the same as that of the property contributed.[39] The main thrust of the Treasury in this area, however, was contained in two novel concepts: the minimum individual income tax, and allocation of deductions. These concepts were incorporated in the House bill under different names but were partially abandoned in the Act as passed.

It was observed by the Treasury that people of means were able to take full advantage of many Code provisions not available to others to reduce their tax liabilities.[40] Those provisions originally considered most worthy of attention were the exclusion of interest on state and local bonds, the excluded portion of net long-term capital gain, the appreciation on property contributed to charity, and the percentage depletion deduction claimed after the recovery of the cost of the property. The idea behind the minimum income tax was not to destroy these means for all taxpayers, but to deny their effectiveness as a shelter against taxation.

Simply stated, a taxpayer under the initial Treasury proposal would compute his tax as he always did, but with his non-business deductions reduced by the "allocation of deductions" formula.[41] After the taxpayer

37. Treas. Reg. § 1.170-1(c)(1), T.D. 6605, 1962-2 Cum. Bull. 76. For evaluation guidelines see Rev. Proc. 66-49, 1966-2 Cum. Bull. 1257. When a taxpayer gives away property under a "gentleman's agreement" that he will be able to repurchase it, the IRS will regard the cash paid to reacquire the property as the contribution and disregard the repurchase that would have given the donor a stepped-up basis. Rev. Rul. 178, 1967-1 Cum. Bull. 64. The result is different when the repurchase is made by a third party, though controlled by the donor. Sheppard v. United States, 361 F.2d 972 (Ct. Cl. 1966); Richard P. Makoff, 26 CCH Tax Ct. Mem. 83 (1967).

38. Campbell v. Prothro, 209 F.2d 331 (5th Cir. 1954); White v. Brodrick, 104 F. Supp. 213 (D. Kan. 1952).

39. Tax Reform Studies 180, 188. The point was that a taxpayer in a high bracket could add a small amount of cash to the tax money saved by making the gift, buy similar property, and avoid much of the gain on the sale of the replacement property.

40. Id. at 13.

41. Id. at 142-52. The rationale behind this reduction is attributable to the fact that a taxpayer is entitled to various exclusions from income (i.e., tax-free interest), yet he is permitted to reduce taxable income by the full amount of non-business expenses, some of which

had computed his tax on this basis, he would then enlarge his tax base by the addition of the excluded items, subtract his deductions without the use of the allocation formula or use a substantially increased standard deduction, and apply a tax table designed to cause a tax approximately equal to the rates on one-half as much income. If the minimum individual income tax is greater than the tax otherwise computed, the taxpayer would pay the former. The result would have been a 50 percent ceiling on the amount of an individual's tax-exempt income.

The minimum income tax and allocation of deductions principles appeared in the House bill—the former under the name of Limit on Tax Preferences (LTP). The list of tax preferences was changed, but it included the appreciation in property given to charitable institutions and not included in gross income.[42] Of considerable significance, however, was the fact that the LTP became part of the calculation of gross income, not a type of alternative computation. From the viewpoint of charitable gifts of appreciated property, the result was a striking deviation from a basic principle of taxation that income should be realized to be recognized. If a taxpayer made a substantial gift of appreciated property, he would have been forced to include in income the appreciation, subject to a limitation,[43] as a tax preference. Further, the charitable deduction was reduced by a formula (somewhat like allocation of deductions) that reflected the amount of the tax preference not required to be included in income.[44] Although complicated carryover provisions gave a taxpayer some credit for the disallowed tax preference, the inevitable outcome of any sizable gift of substantially appreciated property, as under the initial Treasury proposal, was to a great extent additional income.

Because of the exceeding intricacy of the House LTP and allocation of deductions formulas, and because two taxpayers having the same amount of preference income might have different tax burdens if their nonpreference income differed, the Senate selected a different approach.[45] It proposed a tax, to be computed completely outside of the normal taxing scheme, of 10 percent of the amount by which various items of tax preference income exceed $30,000 plus the tax as computed without re-

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were undoubtedly paid out of excluded income. Accordingly, a taxpayer would have to multiply non-business deductions by a fraction, the numerator of which is adjusted gross income and the denominator of which is adjusted gross income expanded by those items of exclusion mentioned.

42. See H.R. 13270, 91st Cong., 1st Sess. § 301(a) (1969).

43. The limitation is the amount by which the tax preference exceeded one-half of the adjusted gross income including the tax preference.

44. Unlike the Treasury Studies proposal, the effect of the LTP would be nullified if not used simultaneously with the allocation of deductions principle.

45. S. Rep. 113.

gard to the preferences. Significantly, the Senate eliminated gifts of appreciated property from the list of tax preferences because "the principal effect of including gifts of appreciated property in the minimum tax would be to reduce the benefit of the contribution and thus unduly restrict public support of worthwhile educational and other public charitable institutions."[46] With minor variations, the conferees, and thus both Houses, accepted the Senate's minimum tax proposal.[47] Thus, the appreciation in property per se is immaterial. As will be seen, what does matter is the character of the property given and of the recipient.

B. *Ordinary Income Property*

It has been a particular source of irritation to the Treasury that a high bracket taxpayer could actually make money by contributing ordinary income property.[48] For example, a taxpayer in the 70 percent bracket makes a gift of such property worth $100 having a $50 cost basis. If he had sold the property, he would have retained $65 after the payment of tax. Under prior law, however, if he contributed the property to charity, he received a deduction of $100, reported no ordinary income, and had (as opposed to $65) a $70 tax-savings. The assumption of a tax avoidance motive for every such gift is erroneous, because it assumes that the taxpayer would have sold the property in any event. When the taxpayer gave the property away, he no longer had it and was out-of-pocket $30. Nonetheless, ordinary income property—unlike capital gain property—is ordinarily designed to be sold, and the Congress is justified in overturning the old rules.

Accordingly, under new Code section 170(e)(1)(A),[49] the amount of any gift of ordinary income property must be reduced by the amount

46. Id. at 116.

47. Conf. Rep. 301; see Int. Rev. Code of 1954, §§ 56-58.

48. This advantage came about because the taxpayer received a deduction for the fair market value of the property, but was not required to include the appreciation in income. Rev. Rul. 69, 1968-1 Cum. Bull. 80; Rev. Rul. 531, 1955-2 Cum. Bull. 520; Rev. Rul. 138, 1955-1 Cum. Bull. 223. But any costs incurred in the year of gifts to produce the article were not deductible, and the cost of goods sold had to be reduced to the extent they reflected expenses incurred in prior years. Treas. Reg. § 1.170-1(c)(1), T.D. 6605, 1962-2 Cum. Bull. 76. On a somewhat different point, a gift by a corporation can mean ordinary income to a controlling shareholder when the gift serves the personal objectives of the shareholder. Rev. Rul. 658, 1968-2 Cum. Bull. 119.

49. Int. Rev. Code of 1954, § 170(e) provides: "Certain contributions of ordinary income and capital gain property.

(1) General rule.

The amount of any charitable contribution of property otherwise taken into account under this section shall be reduced by the sum of—

(A) the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution) . . . ."

which would be reportable as ordinary income if the property had been sold.[50] This rule will discourage most such gifts. Therefore, under present law, the taxpayer mentioned in the example above would be entitled to a deduction of only $50. The contributions deduction would be worth $35, and he would be out-of-pocket $65, just as though he had sold the property and donated the proceeds.

A gift of any non-capital asset (such as inventory) listed in subsections 1221(1) through (5) of the Code would be governed by the same rule. For this purpose, Code section 1231(b) property[51] is treated as a capital asset, except amounts that are ordinary income because the gift subjects them to various recapture rules.[52] Property held for not more than six months, the sale of which would give rise to short-term capital gain,[53] is also ordinary income property. Code section 306 stock[54] *may* be ordinary income property.[55] The application of section 170(e)(1)(A) to this kind of property is far from clear. The intent seems to be that the value of the gift is reduced by the ordinary income reportable if the section 306 stock has been *sold*.[56] There is no reason that the exceptions in Code section 306(b) should not be relied upon. One exception would be a disposition to an unrelated party where the taxpayer has terminated his entire stock interest in the corporation.[57] Can we assume, however, that the "disposition" (*i.e.*, gift) to the charitable institution is to an unrelated party?

The fact that stock rights may be ordinary income property may cure one flagrant abuse.[58] As an example, on January 1st a taxpayer buys

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50. This rule is based upon the belief that in the case of gifts of property the charitable contribution deduction is not intended to provide greater—or nearly as great—tax benefits than would be realized if the property were sold and the proceeds retained by the taxpayer. S. Rep. 80. Int. Rev. Code of 1954, § 170(e)(1)(A) applies to contributions made after December 31, 1969, except that it applies to contributions under Code section 1221(3) (letters and memoranda) made after July 25, 1969. Act § 201(g)(1)(B).

51. Int. Rev. Code of 1954, § 1231(b) property consists, in general, of non-inventory depreciable property and realty used in the trade or business and held for more than six months; certain timber, coal, and domestic iron ore; livestock held for draft, dairy, breeding or sporting purposes; and unharvested crops.

52. See id. §§ 617(d), 1245(a), 1251(c) & 1252(a).

53. Id. § 1222(1).

54. Section 306 stock is defined in id. § 306(c). Section 306 stock is generally preferred stock received either as a non-taxable dividend or in a transaction in which no gain or loss is recognized and having substantially the same effect as a stock dividend.

55. H.R. Rep., pt. 1, at 55; S. Rep. 81.

56. Under prior law, a taxpayer "realized" no income from the gift of section 306 stock to a charitable organization. Rev. Rul. 328, 1957-2 Cum. Bull. 229.

57. Presumably the exception in Int. Rev. Code of 1954, § 306(b)(1)(B) with respect to redemption of section 306 stock would not apply.

58. Tax Reform Studies 182.

$20,000 worth of stock in a corporation that has announced it will issue rights on January 30th to stockholders of record on January 15th. After the stock has gone ex-rights and the shares are discounted to, *e.g.*, $19.000, he sells the stock and claims a loss of $1,000. When he receives the rights after January 30th, he donates these to charity and takes a deduction for $1,000. Under the new law, the rights would be ordinary income property since the holding period starts with the acquisition of the stock.[59] If the taxpayer can and does elect under section 307(b)(2) to allocate a portion of the basis of the stock to the rights, the reduction of the charitable deduction by section 170(e)(1)(A) should be minimal. He will, however, have little or no loss on the sale of the stock. Section 170(e)(1)(A) is an impediment to this device only in the case of the premeditated sale and donation. It is not a complete barrier against the possibility of a double deduction.

Under Code Section 1221(3) a copyright, a literary, musical or artistic composition, or similar property[60] is not a capital asset in the hands of a taxpayer whose personal efforts created the property, or in the hands of a person who received the property by gift from the creator. Because of their similarity in nature to this kind of property, Congress added letters and memoranda prepared or produced by or for the taxpayer,[61] though not entitled to copyright protection. It will be significant how the word "for" is interpreted. Is a memo by a low ranking State Department employee for his immediate superior prepared "for" the Secretary of State? In any event, a gift of the section 1221(3) property is a gift of ordinary income property and comes within section 170(e)(1)(A).[62]

C. *Tangible Personal Property*

Gifts of tangible personal property—such as paintings, art objects, books and papers—as to which a great deal of appreciation is usually claimed, have given rise to especially difficult audit problems. There is no reliable method for the valuation of this kind of property, such as exists for stocks and bonds traded on the market.[63] To simplify the audit burden of the Service and to curtail this growing use of the charitable con-

59. Int. Rev. Code of 1954, § 1223(5).

60. Treas. Reg. § 1.1221-1(c) (1957).

61. Int. Rev. Code of 1954, § 1221(3)(B). If the letters or memoranda are addressed to an individual, they are considered prepared for him. H.R. Rep., pt. 1, at 149; S. Rep. 199.

62. S. Rep. 81.

63. In 1968, the Commissioner established a ten member advisory panel to help determine whether realistic appraisals of fair market value are placed on art objects given to charities. IRS News Release (Feb. 1, 1968).

tribution deduction,[64] Congress decided to limit further[65] the inherent tax advantage of donating appreciated tangible property.

Under Code section 170(e)(1)(B)(i),[66] a taxpayer must now reduce his deduction for a gift of tangible personal property[67] by 50 percent of the gain which he would have realized had the property been sold.[68] This rule applies only when the use by the donee is unrelated to the purpose or function constituting the basis for its exemption under Code section 501, or if a governmental unit is the donee, to any purpose or function described in section 170(c)[69] of the Code.

The 50 percent reduction was intended to put a taxpayer who gives tangible personalty in much the same position as one who sells it and contributes the proceeds. This result will be achieved in most instances. However, when the value of an appreciated object reaches the 50 percent limitation on the charitable contribution deduction, a gift of the property will generally be more advantageous than a sale followed by a gift of the proceeds. The reason is that when the object is sold, and the proceeds contributed, every dollar of value over the limitation puts $.50 in income but adds only $.25 to the charitable deduction—a loss of $.25. However, when the object is donated, the same $1 (up to a point where the limitation controls) increases the deduction by $.50 because the deduction is not near the limitation, having been reduced by half the appreciation. In

64. In one case the Tax Court found that one taxpayer had over-valued paintings by about $160,000. Hilla Rebay, 22 CCH Tax Ct. Mem. 181 (1963).

65. Int. Rev. Code of 1954, § 170(f), presently denies a deduction for a gift of a future interest in tangible personal property until the intervening interest expires.

66. Id. § 170(e)(1)(B)(i) provides:

"(e) Certain Contributions of Ordinary Income and Capital Gain Property.—

(1) General Rule.—

The amount of any charitable contribution of property otherwise taken into account under this section shall be reduced by the sum of—

. . . .

(B) in the case of a charitable contribution—

(i) of tangible personal property, if the use by the donee is unrelated to the purpose or function constituting the basis for its exemption under section 501 (or, in the case of a governmental unit, to any purpose or function described in subsection (c)), or

. . . .

50 percent (62½ percent, in the case of a corporation) of the amount of gain which would have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution)."

67. A fixture intended to be severed from real property is to be treated as tangible personal property. H.R. Rep., pt. 1, at 55.

68. The provision applies to contributions paid after Dec. 31, 1969. Act § 201(g)(1)(B).

69. Int. Rev. Code of 1954, § 170(c), was amended by Act § 201(a)(1)(B). If the tangible personal property is ordinary income property, the deduction is governed by Int. Rev. Code of 1954, § 170(e)(1)(A). One example would be a gift of a painting by the artist.

any case, this sort of generalization is subject to many variables (including the minimum tax for tax preferences) and should not replace a detailed calculation using actual figures.

The new provision, however, may not relieve the audit burden as much as expected. A person may still be tempted to over-value a donated object, since the deduction is a measure of the appreciation. Nonetheless, this provision removes much of the incentive for making gifts of tangible personal property.

Exactly what is an "unrelated use" remains to be seen, though some insight may be obtained from the legislative history of the Act.[70] Thus, a gift of a painting or work of sculpture to an art museum would be deductible at full fair market value, provided the donee intends to use and not sell the gift. The same result would probably obtain for a gift of a painting to a college to be used in connection with an art appreciation course. Gifts of these objects to a hospital, however, would probably not be fully deductible.

D. *Gifts to Private Foundations*

The term "private foundation," now defined in the Code in section 509(a),[71] embodies an innovative approach. Private foundations are the class of charitable organizations that historically, because of narrow support and the lack of response to the general public, are supposed to have most abused their exemption. They are now subject to a wide range of restrictions and special taxes.[72] A private foundation is any domestic or foreign organization described in section 501(c)(3) except the following:[73]

(1) Organizations, contributions to which are deductible to the extent of 50 percent of the contribution base, other than certain private foundations described in section 170(b)(1)(E). This class includes churches, schools, hospitals and medical research institutions, certain institutions supporting state colleges, governmental units, and publicly-supported charities.[74]

(2) Publicly-supported organizations that normally receive more than

70. See 115 Cong. Rec. H13,038 (daily ed. Dec. 23, 1969) (remarks of Wilbur Mills, Chairman of the House Ways and Means Committee).

71. Act § 101(a), codified at Int. Rev. Code of 1954, § 509(a).

72. Int. Rev. Code of 1954, §§ 4940-48.

73. The concept of embracing all section 501(c)(3) organizations within a described class is evidently intended to avoid inadvertent escape from private foundation status. See Lehrfeld, Liles, & Middleditch, Private Foundations, 23 Tax Law. 435, 436 (1970).

74. Publicly supported organizations are described in Int. Rev. Code of 1954, §§ 170(b)(1)(A)(i)-(vi).

one-third of their support[75] from (a) gifts, grants, contributions, or membership fees; and (b) gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities,[76] with a limit of $5,000 or 1% of the support (whichever is greater) from any one source. Not more than one-third of the organization's support can come from gross investment income[77]—meaning interest, dividends, rents, and royalties not subject to the tax on unrelated business income.[78] The term "normally" in section 509(a)(2)(A) is intended to enable an organization to maintain non-private foundation status even though in one year it might receive an unusual amount of income, such as a very large grant or bequest.[79]

(3) Institutions organized and operated exclusively for the benefit of one or more organizations in the first two categories and operated, supervised, or controlled by or in connection with them.[80] For purposes of this test the organization being benefitted may be a civic league, labor organization, or business league, if the support tests of section 509(a)(2) are satisfied.[81]

(4) Organizations organized and operated exclusively for testing for public safety.

New section 170(e)(1)(B)(ii) provides for a reduction in the amount of any charitable contribution of property, whether tangible or intangible, to or for the use of private foundations other than "certain private foundations" described in section 170(b)(1)(E).[82] This reduction is the same as that required in the case of gifts of tangible personal property,

75. As defined in section 509(d) of the Code. Support from a disqualified person does not count in the numerator in the one-third fraction but is included in the denominator. For the definition of a "disqualified person," see Code section 4946(a). Support from the government is computed on an agency-by-agency basis and is not lumped together.

76. The support must come from an activity that is not an unrelated trade or business under Code section 513.

77. Gross investment income is defined in section 509(e) of the Code.

78. The tax imposed on unrelated business income is imposed by Code section 511.

79. See S. Rep. 58, where the Senate Finance Committee suggests that one approach might be to determine whether the support test is met in three out of four consecutive years. See also the "mechanical test" for determining whether an organization is publicly supported. Treas. Reg. § 1.170-2(b)(5)(iii)(b) (1966).

80. Some examples are university presses, religious institutions operating for the benefit of a school, and student testing institutions.

81. One example is the American Bar Foundation, a section 501(c)(3) organization, operated by the American Bar Association, a business league.

82. These are private operating foundations; private foundations making qualified distributions; and private foundations, contributions to which are pooled. Under Act § 201 (g)(1)(B), Int. Rev. Code § 170(e)(1)(B)(ii) is effective as to contributions paid after December 31, 1969.

namely, 50 percent of the long-term capital gain reportable if the property were sold. If the gift is ordinary income property, the charitable contribution is controlled by section 170(e)(1)(A) and will be reduced by all of the appreciation.

It is obvious that donors of appreciated property must carefully select their charitable recipients. Although this article cannot discuss at length the status of charitable organizations as private foundations, one or two points are worthy of mention. Any organization relying on section 509(a)(2) to avoid private foundation status must be careful of the support it accepts. Gross receipts from admissions, sales of merchandise, performance of services,[83] or furnishing of facilities from any one person should not exceed $5,000 or 1 percent of the organization's support for the taxable year, since the excess is excluded from the numerator of the support fraction but included in the denominator. Support from a "disqualified person" is also not included in the numerator. One kind of disqualified person is a substantial contributor, which is defined in section 507(d)(2). A substantial contributor is:

> [A]ny person[84] [but not a governmental unit][85] who contributed or bequeathed an *aggregate* amount of more than $5,000 to the private foundation, if such amount is more than 2 percent of the total contributions and bequests received by the foundation before the close of the taxable year . . . in which the contribution or bequest is received . . . from such person.[86]

Despite this somewhat circular reasoning (*i.e.*, gifts by disqualified persons may make a charitable organization a private foundation, but in order to be a disqualified person, gifts must be to a private foundation), it is clear that successive contributions by any person can make him (or it) a substantial contributor and hence a disqualified person. In the case of organizations in existence on October 9, 1969, all contributions and bequests are treated as if received on that date.[87] Once a person is deemed a substantial contributor, he has that characterization forever.[88] As a result, organizations that might be private foundations must examine their records and find out who may now be a disqualified person, because support accepted from him will not be included in the numerator of the fraction.

83. The distinction between a grant and a contract for services will become critical in this area.

84. The term "person" is defined in Int. Rev. Code of 1954, § 7701(a)(1).

85. See S. Rep. 58.

86. Int. Rev. Code of 1954, § 507(d)(2) (emphasis & footnotes added).

87. Id. § 507(d)(2)(B)(ii).

88. Id. § 507(d)(2)(B)(iv).

Under section 508(b), a section 501(c)(3) organization[89] that does not notify the Secretary that it is not a private foundation is presumed to be a private foundation.[90] Temporary regulations[91] have been issued outlining notification procedures with the use of new Form 4653.[92]

VI. Bargain Sales

Before the Act, two similar transactions received dissimilar treatment under the tax laws. Assume a taxpayer bought 100 shares of stock for $25,000, and that they are now worth $125,000. If he sells 20 shares on the market and gives the balance to a charity (not a private foundation), he will have a capital gain of $20,000 and a charitable contribution deduction of $100,000 (assuming permission by the limitation rules). On the other hand, under prior law the taxpayer could sell the property to the charity for an amount equal to his basis. The entire basis was allocated first to the sale, with the balance available for the deduction.[93] Under this practice the taxpayer would sell the 100 shares to a charity for $25,000, report no gain or loss, and be entitled to a deduction of $100,000. He parted with stock worth $125,000 and had received in return $25,000 in cash plus, if his bracket was 70 percent, a tax benefit worth $70,000. The Treasury could not see why the rules should be able to shield from tax "what is essentially a functionally unrelated sale of an additional amount of stock."[94]

Section 1011(b)[95] now provides an allocation-of-basis rule whenever a deduction is allowable under section 170 by reason of a sale.[96] The adjusted basis for gain or loss on the sale to the institution is that amount

89. Exceptions are provided for churches, organizations that are not private foundations having gross receipts normally not exceeding $5,000, and those the Secretary by regulations exempts. Id. § 508(c).

90. The time for notification does not expire until 90 days after the regulations become final. Id. § 508(b).

91. Temp. Treas. Reg. § 13.9, T.D. 7052, 1970 Int. Rev. Bull. No. 31, at 16.

92. T.I.R. No. 1050 (July 14, 1970).

93. William Waller, 39 T.C. 665 (1963).

94. Tax Reform Studies 181.

95. Int. Rev. Code of 1954, § 1011(b) provides: "If a deduction is allowable under section 170 (relating to charitable contributions) by reason of a sale, then the adjusted basis for determining the gain from such sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property."

96. The amendment to Code section 1011 was made by Act § 201(f) and is effective as to sales made after December 19, 1969, pursuant to Act § 201(g)(6). It was reinstated in conference after rejection by the Senate because "[t]he House provision would adversely affect giving to charities, as 'bargain sales' have been a long-accepted form of making contributions of property to charities." S. Rep. 82.

that bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property.

In the foregoing example, $5,000 of the $25,000 basis would be allocated to the sale, and the remainder to the charitable gift. The tax treatment is now parallel between those taxpayers who sell their property to a charitable institution and those who sell their property to others and donate the proceeds.

What happens when the object sold is subject also to section 170(e)? Assume that the $125,000 object is a painting sold for $25,000 to an institution for purposes unrelated to its exemption. It was seen that a bargain sale of the stock for $25,000 causes a capital gain of $20,000, leaving a basis allocable to the gift of $20,000. If the painting had been contributed gratis, the deduction would have to be reduced by 50 percent of the gain ($100,000) or to $75,000. If the painting is sold for its basis, section 170(e) considered alone would seem to require the gift element of $100,000 to be reduced by $50,000, the entire basis having been allocated to the sale. With the allocation-of-basis rule, however, the gift should be reduced only by $40,000—half the difference between $100,000 and the $20,000 basis allocated to the gift.

VII. Restructuring the Deduction

A. *Expansion of Section 170(b)(1)(A)*

Section 170(b)(1)(A) describes that class of charitable institutions [hereinafter referred to as clause A organizations], gifts to which have a preferred status under the deduction provisions. Two important new classes have been added to the prior list of six. The first class deals with certain private foundations,[97] which include the following three categories:

(1) Private operating foundations.[98] These are organizations which spend substantially all[99] of their income for exempt purposes, and (a) devote substantially more than half[100] of their assets directly to the exempt activities; or (b) normally make qualifying distributions of not less than two-thirds of their minimum investment return;[101] or (c) receive

97. Int. Rev. Code of 1954, § 170(b)(1)(E).

98. The definition of an operating foundation is found in section 4942(j)(3) of the Code.

99. I.e., at least 85 percent. S. Rep. 60.

100. I.e., at least 65 percent. Id. at 60. This test is essentially the same as that in the former Code section 170(g)(2)(B) (Pub. L. No. 88-272, § 209(b), 78 Stat. 43 (1964)), describing contributions that qualify for the unlimited charitable contributions deduction. This alternative applies to such organizations as museums, Callaway Gardens, Colonial Williamsburg, and Jackson Hole. S. Rep. 61.

101. For the definition of Minimum Investment Return, see Int. Rev. Code of 1954, § 4942(e). This alternative applies to charities supplying personal services (as opposed to

substantially all of their support[102] from the general public and from five or more exempt organizations, provided that not more than 25 percent of their support is normally received from any one exempt organization and not more than half of it is normally received from gross investment income.[103]

(2) Private foundations that make qualifying distributions of all contributions within two and one-half months after the close of the year in which received.

(3) Private foundations described in section 509(a)(3), all the contributions to which are pooled in a common fund for the benefit of clause A organizations. Income must be distributed annually to these organizations, and the corpus attributable to the donor's contribution must be distributed within one year after his death, or the death of his spouse if she has the right to designate the charitable recipients.[104]

The second class consists of organizations described in section 509 (a)(2) or (3).[105] These are the publicly supported organizations and institutions operated for the benefit of other charities, discussed in connection with Gifts to Private Foundations.

B. *The Percentage Limitation*

An overriding aim of the Treasury under President Johnson's administration, when studying the need for changes to the Code, was simplicity. Accordingly, an increased standard deduction was proposed, which it was hoped would be used by 80 percent of all persons filing returns.[106] Since the charitable contribution deduction is essentially the only itemized deduction over which a taxpayer has any control, an enlargement of the standard deduction without compensating adjustments might have reduced the incentive for charitable giving, and the resulting impact upon institutions throughout the country could have been significant. To preserve and strengthen the charitable deduction as an incentive for donations, the Treasury recommended a highly interesting proposal whereby the charitable contribution deduction would be allowed outside the standard deduction (COSD), along with an increase in the percentage limita-

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making grants), the cost of which cannot be met out of small endowments (e.g., Longwood Gardens, Sleepy Hollow Restoration, and research organizations). S. Rep. 61.

102. I.e., support other than gross investment income. For the definition of this term, see Int. Rev. Code of 1954, § 509(e).

103. This test is intended to cover special purpose foundations which, because of a particular expertise, are used to funnel contributions into certain areas. Examples are learned societies and associations of libraries. S. Rep. 61.

104. This subsection seems designed to protect one specific entity.

105. See text accompanying notes 75-81 supra.

106. Tax Reform Studies 195.

tions to 50 percent.[107] For purposes of avoiding an unacceptable revenue drain and the burden of auditing deductions, charitable deductions would be subject to a 3-percent threshold. The Treasury reasoned that the threshold (actually an exclusion for carry-over purposes) would cover only routine gifts generally uninfluenced by tax considerations, and would have no significant effect on the flow of charitable gifts.[108] It was very apparent from the standpoint of charitable institutions that the 3-percent floor would have a substantial dampening effect on taxpayers in the middle and upper income brackets.[109] For example, a taxpayer with AGI of $50,000 would have to give $1,500 before COSD began to take effect.

The Tax Reform Proposals accepted the idea that a donor to clause A charities should be given additional incentive, but rejected COSD and the 3-percent threshold. It suggested an increase from 10 to 30 percent for gifts to clause A organizations, which meant raising the limitation from 30 to 50 percent.[110] With the inclusion of tax preference income in AGI, however, it was found necessary to use a measuring stick other than AGI. This was called the "contribution base," and meant AGI (including disallowed tax-preference income) increased by allowable tax preferences.[111]

When the Senate placed the tax preference concept outside the tax computation, the way was open to a simplified definition of contribution base. It is now defined in Code section 170(b)(1)(F) as AGI computed without regard to any net operating loss carryback to the taxable year.

With one exception, the deduction is limited to 50 percent of AGI for gifts to clause A charities, and for gifts to other kinds of institutions, the lesser of the following: 20 percent of the contribution base or the excess of 50 percent of the base over the gifts to clause A charities.[112] For example, a taxpayer has AGI of $100,000 and makes cash gifts of $40,000 to a college and $30,000 to a private foundation. The deduction will be $40,000 plus $10,000 (the lesser of (1) $20,000 (20 percent of $100,000) and (2) $50,000 minus $40,000).

The exception mentioned above applies to gifts of capital gain (appreciated) property other than tangible personal property and gifts to private foundations.[113] Under new Code section 170(b)(1)(D), the

107. Id. at 194.

108. Id. at 195.

109. See id. at 200 (Tables 1 & 2).

110. See Tax Reform Proposals 15.

111. H.R. 13270, 91st Cong., 1st Sess. § 201(a)(3) (1969).

112. This is to be determined without regard to subparagraph (D), relating to gifts of capital gain property.

113. See Int. Rev. Code of 1954, § 170(e)(1)(B).

deduction for gifts of capital gain property is limited to 30 percent of the contribution base.[114] It is unfortunate that the conferees did not follow the Senate recommendation[115] of limiting the deduction for the appreciation to 30 percent and of allowing a full 50 percent deduction for the taxpayer's basis in the property. Under the present rule, any appreciation —no matter how small—activates the 30 percent limitation.

The taxpayer has an option, however, which he might wish to consider if the appreciation is small.[116] If the election is made, he may reduce the amount of a gift of capital gain property (to which section 170(e)(1)(B) does not apply) in the manner prescribed by section 170(e)(1).[117] In such case the 50 percent limitation applies. If the gift is large and the appreciation small, it might be wise to exercise the election. It must, however, be remembered that as to gifts to clause A organizations, there is a five-year carry-over (subject to the 30 percent limitation) with respect to the amount by which capital gain property exceeds the 30 percent limitation. This is forfeited if the election is made. In addition, the election may contain a trap. If the election is made, the taxpayer must recompute any carry-overs of capital gain property contributions to the taxable year as though the election had been made in prior years. This rule, of course, could wipe out the carry-over.

It is not especially clear how the percentage limitations will apply to a mixture of appreciated and unappreciated property. Assume a taxpayer has an AGI of $100,000. If he makes one gift of capital gain property worth $40,000 to a clause A charity, the deduction is limited to $30,000, and he will have a carry-over (as capital gain property) of $10,000. If he makes the same gift to a private foundation, he will have a deduction of not more than $20,000,[118] and no carry-over. If he contributes $40,000 in cash and $20,000 in capital gain property to a clause A charity, the deduction should be $50,000, with a carry-over (as capital gain property) of $10,000. The initial phrase in the last sentence of section 170(b)(1)(D)(i), "[f]or purposes of this subsection," should not have the effect of eliminating any deduction when the taxpayer has contributed non-capital gain property to clause A charities of as much as 30 percent of AGI.[119]

Section 170(b)(1)(D) is effective for taxable years beginning after

114. Gifts of ordinary income property and tangible personal property, when the use is not related to the exempt purposes of the donee, are subject to the 50 percent rule if made to clause A organizations, because the deduction is already limited by section 170(e).

115. H.R. 13270 (Senate), 91st Cong., 1st Sess. § 201(a); S. Rep. 78.

116. Int. Rev. Code of 1954, § 170(b)(1)(D)(iii).

117. See Tangible Personal Property, section V(c) supra.

118. The fact that the gift is of capital gain property should not entitle the taxpayer to exceed the 20 percent limitation of section 170(b)(1)(B).

119. See the example in H.R. Rep., pt. 2, at 33.

December 31, 1969.[120] For purposes of the carry-over provision only, contributions paid in a taxable year beginning before January 1, 1970, will be governed by the old rules[121] and, as to these, section 170(b)(1)(D), section 170(e), and section 170(f)(1), (2), (3), and (4) will not apply.

VIII. The Unlimited Charitable Contribution Deduction

Passage of the Act brought repeal of a provision (nearly as old as the charitable contribution deduction itself) that granted a taxpayer an unlimited deduction for contributions to charity where, in the taxable year and in eight of the ten preceding taxable years, the total of his charitable contributions and income taxes exceeded 90 percent of his taxable income.[122] This unlimited deduction, which was introduced into the law by the Revenue Act of 1924,[123] was "designed substantially to free from income taxation one who is habitually contributing to benevolent organizations amounts equaling virtually his entire income."[124]

Since its enactment, the unlimited charitable contribution deduction (UCD) had become a sanctuary in which many of the very wealthy were been sheltered from the income tax. Prior to its repeal, the UCD was being used by an estimated 100 taxpayers who generally had economic incomes in excess of one million dollars.[125] Since the UCD had a particular appeal to taxpayers having large amounts of appreciated capital which could be donated to charitable institutions, with the deduction based on the full market value rather than acquisition value, it not surprisingly became a prime target for tax reformers.

The Treasury, the House, and the Senate all favored repeal of the UCD. Nevertheless, since a minimum of eight years was required before a taxpayer could qualify for the UCD, it was thought only fair to phase out the deduction over a five-year period. For taxable years beginning in 1970, the general percentage limitation will not apply if, in the taxable year and in eight of the ten preceding taxable years, the charitable contributions plus the amount of income taxes exceed the applicable transi-

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120. Act § 201(g)(1)(A).

121. Id. § 201(g)(1)(D).

122. See Int. Rev. Code of 1954, ch. 1, § 170(b)(1)(C), 68A Stat. 58 (repealed 1969).

123. See the unnumbered S. Rep. accompanying H.R. 6715, 68th Cong., 1st Sess. 24 (1924).

124. This provision was inserted to permit an heiress, who had taken a vow of poverty as a nun, to have the advantage of an unlimited charitable deduction to meet her particular situation. She was the beneficiary of a trust, the trustee of which had no discretion but to pay her the income which, because of her vow, she could not accept. Since the trust distributions constituted taxable income to her and her vow had the result of transferring all of her assets to the church, the UCD was devised to enable her to avoid taxation. See 115 Cong. Rec. 16,210 (daily ed. Dec. 9, 1969) (remarks of Chairman Russell B. Long).

125. S. Rep. 79.

tional deduction percentage determined under section 170(f)(6)(B).[126] The transitional deduction percentages begin at 80 percent for a taxable year beginning in 1970 and decrease by six percentage points each subsequent year, until a 50 percent limitation is attained for 1975. The effect of the deduction is governed by a table of transitional income percentages (*i.e.*, that percentage of AGI beyond which a taxpayer's taxable income may not be reduced). For taxable years beginning in 1970, the transitional income percentage begins at 20 percent, and increases by six percentage points each subsequent year until reaching 50 percent for taxable year 1975.

Thus, for the taxable year 1971, the interim deduction will lower an individual's taxable income to no more than 74 percent of his AGI. By 1975, the UCD will have expired, and all taxpayers will be on an equal basis with respect to the percentage limitations for charitable contributions.

Consistent with the goal of easing out the UCD as painlessly as possible, two of the appreciated property rules will not begin to apply to taxpayers on the UCD until taxable year 1975. The special rule in section 170(b)(1)(D), which provides that the deduction for gifts of appreciated capital gain property may not exceed 30 percent of the taxpayer's contribution base, will not be applicable. Also inapplicable in this interim period are the rules of section 170(e)(1)(B) with regard to gifts of tangible personal property and gifts to private foundations.[127]

IX. Denial of Deductions

The Act has new rules that make the denial of a deduction of immense importance to donors. Under prior practice, a gift to listed organizations would generally remain allowable as an itemized deduction until an announcement of revocation or a notice of suspension of advance assurance of deductibility was published.[128] Section 503(e) further denied the deduction when the donee lost its exemption because it had engaged in a prohibited transaction. As a practical matter, however, the wrongful act and the disallowance period could be separated by years because, except in the case of donations by accomplices to flagrant acts, a taxpayer's deduction was not to be denied until the organization's exemption was revoked after notice had been given.[129] In the interim, the organization

126. Int. Rev. Code of 1954, § 170(b)(1)(C).

127. It should be noted that only gifts to organizations described in section 170(g)(2) qualify for the UCD. Some of those could be private foundations.

128. Publication No. 78, Cumulative List, Organizations Described in Section 170(c) of the Internal Revenue Code of 1954, Rev. Proc. 68-17, 1968-1 Cum. Bull. 806. No such policy was followed with respect to the estate and gift tax deduction.

129. Webster, The Mythology of Revocation, N.Y.U. 8th Biennial Conf. on Charitable Foundations 243, 260 (1967).

could have been fully funded and the denial of future deductions rendered meaningless.

The Act repealed section 503(e).[130] The new statutory rules are found in Code sections 170(f) and 508(d) and, except for contributions in the form of split-interest trusts,[131] are aimed mainly at gifts to private foundations.[132]

Section 170(f)(1) disallows the deduction for charitable contributions to or for the use of an organization or trust described in section 508(d) or section 4948(c)(4) (certain foreign trusts not here discussed). Section 508(d) denies the income, gift, and estate tax deduction in four instances:

(1) After notification of the termination of private foundation status;[133]

(2) To a subtantial contributor[134] to a private foundation for any year when it takes action culminating in the section 507(c) tax;

(3) In any taxable year when a private foundation or split-interest trust described in section 4947 fails to meet the rules that its governing instrument contain certain restrictions;[135]

(4) To any institution organized after October 9, 1969, in a period it has not notified the Secretary that it is applying for exempt status.

With respect to the first instance, it was possible for a charity to be organized as a section 501(c)(3) entity, receive deductible gifts, and then, when fully funded, without penalty alter its status to that of an organization under some other subsection of section 501(c). While this abuse may not have been widespread, Congress was determined that taxpayers be prevented from receiving current deductions for charitable gifts to an organization which might never fulfill its charitable obligations. Thus, under section 507, a private foundation may terminate its status only under narrowly described conditions.

The second instance was evidently based on the assumption of a relationship between large contributors and wrongful acts. Assumptions such as this are hard to justify and usually hurt innocent parties, including the charities when their contributors are driven away. It seems that since

130. Act § 101(j)(14) (effective Jan. 1, 1970).

131. Split-Interest Trusts are discussed in section X infra.

132. Presumably the rules of practice mentioned in the text at note 128 supra will remain unchanged.

133. Termination may occur when the organization notifies the Secretary of its intent to accomplish the termination, or when it has been notified by the Secretary that it is liable for the penalty tax under section 507(c) because of a willful and flagrant act (or failure to act) giving rise to liability for tax under Int. Rev. Code of 1954, § 507(a). If the entire amount of the unpaid section 507(c) tax is abated under section 507(g), the deduction will be allowed. Int. Rev. Code of 1954, § 508(d)(3).

134. "Substantial contributor" is defined in section 507(d)(2) of the Code.

135. These restrictions are found in section 508(e) of the Code. See note 198 infra.

the section 507(c) tax will prove difficult to impose, few deductions will be denied under this provision. However, it may have the effect of frightening charities into acting properly.

In the third instance, the taxpayer will not receive a deduction for a gift to a private foundation or a split-interest trust unless its governing instrument contains language requiring the distribution of income and prohibiting acts of self dealing, retention of excess business holdings, and the making of improper investments and taxable expenditures.[136] Fortunately, in the case of institutions organized before January 1, 1970, these rules do not apply to a taxable year beginning before January 1, 1972.[137]

Denial of the deduction in the fourth instance is meant to uncover the operations of charitable institutions and to force the submission of applications for exemption under the Code. It is still probably true that the exemption of an organization from the income tax springs from the Code rather than from the Commissioner. Nevertheless, this principle no longer has much practical relevancy. It is very possible for a charitable organization to be exempt from the income tax whether or not it applies for exemption. There are few such organizations that are uninterested in support, however, and there are few donors who are uninterested in the charitable contribution deduction.

X. Split-Interest Trusts

A. *Charitable Remainder Trusts*

1. In General

Two of the most popular forms of charitable giving, either by inter vivos transfer or testamentary bequest, have been the life income plan and the charitable gift annuity. They have been especially acceptable to those who feel that they cannot abandon the income from their property, but want a charitable institution to share their wealth once their need for it ends. Thus, a husband would convey assets to a charitable institution, reserving a life estate or a fixed dollar income. Upon his or his wife's death, the property would pass to the institution. Most institutions of

136. Int. Rev. Code of 1954, §§ 4941(d), 4942, 4943(c), 4944 & 4945(d).

137. Apparently since sections 508(e)(2)(B) & (C) (concerning judicial proceedings begun before January 1, 1972) do not apply, reformation of the governing instrument must be completed before January 1, 1972. As to private foundations and split-interest trusts organized after January 1, 1970, the rules are immediately effective. Act § 101(k). With respect to the estate tax deduction, this rule is inconsistent with the rule for wills and trusts executed before October 10, 1969, that permit amendment until October 9, 1972. See note 148 infra. Section 4947(a)(2), describing split-interest trusts, does not apply to amounts transferred in trust before May 27, 1969. Query: Does section 508(d) deny an estate tax deduction to a trust funded before this date because it is one that is "described in section 4947"?

higher learning devolved plans for such gifts, which may or may not be trusts in the strict sense. The assets were commonly placed in an institution's general endowment fund or in a pool of similar funds. The return from the life income plan depended upon the particular plan and often was gauged by a fixed percentage of the principal originally transferred, or by the average rate of return in a certain pool.

If the gift of the remainder interest was inter vivos, the donor was entitled to a deduction for the value of the remainder interest given to charity, measured by tables[138] which considered the intervening interest's age (and hence his life expectancy) and assuming a rate of return on the investment of 3½ percent. Correspondingly, the value of the principal was included in his estate but was deductible therefrom as a charitable bequest under section 2055. Further, if the property was sold by the trustee, the gain was not taxable to the donor[139] and the trust received a deduction for the gain as an amount set aside for charitable purposes under section 642(c). If the gift was testamentary, the decedent's estate was entitled to a deduction under section 2055, measured by the same actuarial principles that considered the age of the life tenant and the years he might be expected to enjoy the income interest.

As so often happens, this practical and worthwhile plan was exploited, mainly by ploys to favor the income interest over the charitable remainder. One stated method was to balance the trust corpus in favor of the income interest by investment in high-income, high-risk securities.[140] Another was to permit the trustee to invade the corpus for the benefit of the income interest under certain circumstances.[141] The result was a legion of cases questioning whether the charitable remainder interest was presently ascertainable and, hence, severable from the non-charitable interest.[142] The Tax Reform Studies concluded that under the rules before the Act, the measure of the charitable deduction—whether income,

138. Treas. Reg. § 25.2512-5(f) (Table I), T.D. 6334, 1958-2 Cum. Bull. 656-57. New regulations have been proposed that are based upon a 6 percent rate at modern mortality factors. T.I.R. No. 1038, 35 Fed. Reg. 10,864 (1970).

139. If the trustee was under an implied or express obligation to sell the property and invest in tax-exempt securities, the gain from the sale of the property was includible in the income of the donor. Rev. Rul. 370, 1960-2 Cum. Bull. 203.

140. H.R. Rep., pt. 1, at 58. If investment in mutual funds and the distribution of capital gain dividends to the income beneficiary were permitted, the value of the remainder interest could not be calculated and was, hence, denied. Rev. Rul. 33, 1967-1 Cum. Bull. 62; Rev. Rul. 385, 1960-2 Cum. Bull. 77.

141. See Tax Reform Studies 183.

142. The Service held void and ineffective a savings clause that revoked any power in the trustee that should be construed to render the charitable remainder interest nonseverable. Rev. Rul. 144, 1965-1 Cum. Bull. 442.

gift, or estate—might bear no relation to the property passing in fact to the charitable institution.

The Studies' recommendation to deny a deduction for a remainder interest unless the gift is either in the form of a charitable remainder annuity trust or a unitrust[143] was wholeheartedly accepted by both Houses of Congress. Under the guaranteed annuity concept, the intervening (income) interest must receive annually a stated dollar amount. Under the unitrust principle, the intervening interest must receive annually a fixed percentage of the annual value of the trust property. In addition, it was agreed to permit a deduction for the contribution of a remainder interest in a "pooled income fund," as narrowly defined.[144] The new rules attempt to make the charitable deduction commensurate with what the charitable institution will ultimately receive and minimize the chance of manipulation in favor of the intervening interest.[145]

Under Code sections 170(f)(2)(A), 2055(e)(2), 2106(a)(2)(E), and 2522(c)(2), no deduction is allowed for the value of a remainder interest in trust[146] unless the trust is a charitable remainder annuity trust, a chartiable remainder unitrust, or a pooled income fund.[147] The income and gift tax provisions are effective as to transfers after July 31, 1969.[148]

143. See Tax Reform Studies 183.

144. Int. Rev. Code of 1954, § 642(c)(5).

145. It is interesting to note that under old law a charitable deduction would probably not have been permitted for a gift to either an annuity trust or a unitrust. Valuation procedures did not encompass this kind of gift.

146. The same rules are applicable to transfers not in trust pursuant to section 170(f)(3), with one exception for a remainder interest in a personal residence or farm under section 170(f)(3)(B)(i).

147. The pooled income fund concept was added by the Senate to provide a vehicle for small gifts that would be burdensome to manage separately in trust form. Under Proposed Treas. Reg. § 1.664-1(a)(2), 35 Fed. Reg. 12,467 (1970), a trust must be an annuity trust or a unitrust in every respect. No combinations are to be permitted.

148. See Act §§ 201(g)(1)(C) & (g)(4)(D). The effective date of the estate tax provisions are governed by Act § 201(g)(4). New Code sections 2055(e)(2)(A) and 2106(a)(2)(E) apply in the case of decedents dying after December 31, 1969, except that they will not apply to a bequest passing under the terms of a will executed on or before October 9, 1969, if: (1) The decedent dies before October 9, 1972, without having republished the will by codicil or otherwise; (2) the decedent at no time after October 9, 1969, had the right to change the pertinent provision of the will; or (3) the will is not republished before October 9, 1972, and the decedent is on such date and at all times thereafter under a mental disability to make a republication.

If the instrument governing the gift is a trust, Code sections 2055(e)(2)(A) and 2106(a)(2)(E) do not apply to property transferred in trust on or before October 9, 1969, if: (1) The decedent dies before October 9, 1972, without having amended the instrument after October 9, 1969; (2) the property transferred was an irrevocable interest to or for the use of an organization described in section 2055(a); or (3) the instrument was not amended before October 9, 1972, and the decedent is on such date and at all times thereafter under a disability to change the disposition of the property.

Section 1.664-1(f) of the proposed regulations would consider an imperfect trust created after this date as a charitable remainder trust if, among other conditions, it is amended before January 1, 1971, or 30 days after the finality of judicial proceedings begun before this date. The charitable contribution deduction would not be allowed until all the conditions are met, and then only under a timely-filed claim for refund. A similar transition rule is proposed for pooled income fund remainder gifts.[149]

While the Act does not answer the question whether a gift of a remainder interest is a gift "to" rather than "for the use of" the charity, congressional silence would seem to be an affirmation of present law and Service attitude on the subject.[150] The distinction is crucial since the extra 30 percent deduction is permitted only for gifts "to" a charitable institution.

It should be noted again that, under section 4747(a)(2), all split-interest trusts are considered private foundations in various respects. As such, the following provisions are made applicable: section 507 (termination of private foundation status); section 508(e) (governing instruments); section 4941 (taxes on self dealing); section 4943 (taxes on excess business holdings); section 4944 (investments which jeopardize charitable purpose);[151] and section 4945 (taxes on taxable expenditures).

Proposed regulations with respect to charitable remainder trusts and pooled income funds were recently released. Although the scope of this article does not permit a detailed study of the drafting of these instruments, it should be noted that the proposed regulations require the insertion of a number of specific provisions. It is hoped that before long the Service will approve a form upon which grantors may rely without having to apply for an advance ruling.

2. Charitable Remainder Annuity Trust

Section 664(d)(1) describes an annuity trust as a trust:

> (A) [F]rom which a sum certain[152] (which is not less than 5 percent of the initial

149. Proposed Treas. Reg. § 1.642(c)-7(a), 35 Fed. Reg. 11,484 (1970).

150. A gift of a remainder in trust is a gift "to" the donee. Alice Tully, 48 T.C. 235 (1967); Rev. Rul. 507, 1957-2 Cum. Bull. 511. Rev. Rul. 562, 1957-2 Cum. Bull. 159, is to the contrary but has not been followed by the Service's private rulings. In 1965, the IRS proposed, but later withdrew, regulations which would have classified gifts of remainder interests as "for the use of" the donee. If they are again proposed, the IRS promised a hearing and non-retroactive effect. T.I.R. No. 792 (Dec. 17, 1965).

151. Under Int. Rev. Code of 1954, § 4947(b)(3)(A), sections 4943 and 4944 are not applicable where the deduction was obtained only as to the remainder interest or only as to the income interest where it is valued at no more than 60 percent of the trust.

152. This may be expressed as a fraction of the initial net fair market value of the property if the governing instrument provides for adjusted payments in the case of an incorrect valuation. Proposed Treas. Reg. § 1.664-2(a)(1), 35 Fed. Reg. 12,469 (1970). A deduction under section 1341 would be allowed f`r amounts repaid to the trust. Id.

net fair market value of all property placed in trust) is to be paid, not less often than annually, to one or more persons[153] (at least one of which is not an organization described in section 170(c) and, in the case of individuals,[154] only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,[155]

(B) from which no amount other than the payments described in subparagraph (A) may be paid to or for the use of any person other than an organization described in section 170(c), and

(C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use.[156]

One simple example of an annuity trust would be a gift of $100,000[157] to a trust providing an annuity to the donor (or another) of $5,000 a year, with the remainder to a charity.

Under the law prior to the Act, the Service held that the transfer of appreciated property to a charitable institution in return for an annuity was equivalent to the sale of the property and the purchase of a private annuity.[158] The unconditional promise to pay an annuity is to be distinguished from the "annuity trust," where payments are limited to the assets transferred and the income realized therefrom. The traditional "gift annuity" is, therefore, affected by the statute. If the gift is funded with appreciated property, the transaction may be considered a bargain sale, requiring an allocation of a portion of the basis of the gift.

3. Charitable Remainder Unitrust

In addition to requirements (B) and (C) for the annuity trust, a unitrust under section 664(d)(2) is a trust from which a *fixed percentage*,[159] not less than 5 percent of the net fair market value of the trust

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§ 1.664-1(d)(4). If the estimate of the fixed sum, estimated in good faith, turns out to be less than the required 5 percent, this requirement will be considered met if the estimated value is accepted for purposes of the deduction. Id. § 1.664-2(a)(2).

153. A "person" includes an individual, trust, estate, partnership, association, company or corporation. Int. Rev. Code of 1954, § 7701(a)(1).

154. The individuals must be living at the time of the trust's creation.

155. The following dispositions may be acceptable: To A and B for their joint lives and then to the survivor; to A for not more than 20 years or for his life, whichever is shorter (or longer); to A for not more than 20 years, then to B for life; to A for his life and then to B for his life. Proposed Treas. Reg. § 1.664-2(a)(5), 35 Fed. Reg. 12,470 (1970).

156. Int. Rev. Code of 1954, § 664(d)(1) (footnotes added).

157. No contribution other than the initial one may be made. Proposed Treas. Reg. § 1.664-2(b), 35 Fed. Reg. 12,470 (1970).

158. Rev. Rul. 136, 1962-2 Cum. Bull. 12. For the valuation of these annuities, see Rev. Rul. 137, 1962-2 Cum. Bull. 28.

159. Problems appear when the trust property is difficult of valuation. The deduction will be denied unless an independent trustee has the sole responsibility for making annual determinations of value. H.R. Rep., pt. 1, at 60. The proposed regulations, however, have not adopted this approach.

assets valued annually,[160] is to be paid, not less often than annually, to one or more persons, at least one of which is not an organization described in section 170(c). If the intervening interest belongs to individuals, the payments can be made no longer than for a term not exceeding 20 years or for their life or lives.[161]

To avoid the necessity of invading principal, section 664(d)(3) provides that a unitrust[162] may require the trustee to pay the income beneficiary only the trust income if such is less than required to be distributed, plus any income in excess of the amount required to be distributed (the 5 percent rule), to the extent that the aggregate of the amounts paid in prior years was less than the aggregate of the required amounts. The determination of what constitutes trust income is to be made under local law and does not include items such as capital gain that must be allocated to principal.[163]

As an illustration, assume the following set of figures:

	(1) Required Amount	(2) Actual Income	(3) Amounts Paid	(4) Aggregate Excess of (1) over (3)
1970	$5,000	$4,000	$4,000	$1,000
1971	7,000	5,000	5,000	3,000

If in 1972 the required amount is $6,000 but the trust income is $8,000, the trustee should be able to distribute the full $8,000. Column (4) would then be reduced to $1,000. If in 1973 the required amount is $6,000 but the trust income is $8,000, the trustee should be able to distribute $7,000 if the trust instrument so provides.[164]

Additional contributions to unitrusts are permitted. If one is made after the last valuation date, for purposes of the payout the additional contribution will augment the value of the trust in a proportion that the remaining days of the trust's taxable year bears to the number of days in the whole year.[165]

160. The valuation may be made on any one date or by taking the average value on several dates, provided there is consistency in method.

161. See note 155 supra.

162. The instrument must require this type of payment. The trustee cannot have discretion. Conf. Rep. 296.

163. S. Rep. 89; see Int. Rev. Code of 1954, § 643(b).

164. Proposed Treas. Reg. § 1.664-3(a)(1)(ii), 35 Fed. Reg. 12,470 (1970).

165. Id. § 1.664-3(b).

4. Pooled Income Fund

The third type of trust with respect to which the deduction for the value of a remainder interest is allowed is a pooled income fund, defined in section 642(c)(5) as a trust:[166]

(1) to which each donor transfers property, contributing irrevocably[167] a remainder interest to or for the use of an organization described in clauses (i) through (vi) of section 170(b)(1)(A), and retaining an income interest for the life or lives of one or more beneficiaries living at the time of the transfer;

(2) in which the property transferred is commingled with the property transferred by other donors who have similar transfers;

(3) which cannot make investments in tax-exempt securities;

(4) which includes only amounts transferred that meet the requirements of these rules;

(5) which is maintained[168] by the organization to which the remainder interest is contributed, and of which no donor or beneficiary of an income interest is a trustee; and

(6) in which each beneficiary of an income interest receives income for each year determined by the rate of return earned by the trust for such year.

According to the proposed regulations, the income of the fund must be allocated by shares or units of participation based on the fair market value of the gift at the time of transfer.[169] For example, the income beneficiary may be assigned a number of units equal to the number obtained by dividing the value of the property transferred by the value of a unit just before the transfer. The value of a unit may be obtained by dividing the value of all property in the fund by the total number of units. The income allocated to each unit would be the income of the fund for the taxable year divided by the units in the fund at the end thereof, with adjustments for units outstanding only during part of the year.[170]

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166. Under Proposed Treas. Reg. § 1.642(c)-5(a)(2), 35 Fed. Reg. 11,476 (1970), a pooled income fund is not to be treated as an association taxable as a corporation. No gain or loss is to be recognized on a transfer of property to the fund if only the life interest is reserved and the property is not subject to an indebtedness. Id. § 1.642(c)-5(a)(3), 35 Fed. Reg. at 11,477.

167. The remainder interest cannot be contingent. Id. § 1.642(c)-5(b)(1)(iii).

168. The charitable institution need not be the trustee. S. Rep. 85. "Maintenance" is satisfied by control over the fund, as where the charity has the power to remove the trustee. Proposed Treas. Reg. § 1.642(c)-5(b)(5), 35 Fed. Reg. 11,477 (1970).

169. Proposed Treas. Reg. § 1.642(c)-5(c)(2), 35 Fed. Reg. at 11,478.

170. See id. § 1.642(c)-5(c)(5), 35 Fed. Reg. at 11,478 (illustrations).

B. *Valuation of Remainder Interests*

1. Annuity Trusts and Unitrusts

Under section 664(e), the value of the charitable contribution deduction for the remainder interest must be computed on the assumption that an amount equal to 5 percent of the net fair market value of the assets is to be distributed each year, or a greater percentage if required by the instrument. The purpose behind this rule and the mandatory income payout rules is to prevent circumvention of the income distribution requirement of private foundations. As stated in the Senate Committee report, a taxpayer could otherwise establish a trust with a minimal payout, and the income would accumulate tax free for the future benefit of charity.[171]

Under the proposed regulations, the fair market value of the remainder interest of an annuity trust is the net fair market value of the property placed in trust less the present value of the annuity.[172] The value of the annuity is calculated in accordance with the table found at § 20.2031-10 of the Estate Tax regulations.[173]

The calculation of the fair market value of a remainder interest in a unitrust is somewhat more complicated, depending upon the payout rate prescribed by the instrument, the term of the payout, the valuation date, and the frequency of the payments. The tables in the proposed regulations[174] show the present worth of a remainder interest postponed for a term of years and for the life of a male and a female. Each present worth depends upon the particular adjusted payout rate. This last term is the payout rate under the instrument adjusted by a factor in Table F, which takes into account the number of months the valuation date precedes the first payout and the frequency of the payout. Once the adjusted payout is determined, a factor may be obtained—using linear interpolation, if necessary—corresponding with the duration of the intervening interest.[175]

2. Pooled Income Fund

The present value of a remainder interest in a pooled income fund is determined by subtracting the value of the income interest from the value of the property transferred.[176] The value of the income interest is deter-

171. S. Rep. 90.

172. Proposed Treas. Reg. § 1.664-2(c), 35 Fed. Reg. 12,470 (1970). No adjustment is made when the charity is entitled to a portion of the annuity.

173. Id. § 20.2031-10, 35 Fed. Reg. at 10,862.

174. Id. § 1.664-4(b)(5), 35 Fed. Reg. 12,472-77 (1970).

175. See id. §§ 1.664-4(b)(3) & (4), 35 Fed. Reg. at 12,472 (examples).

176. Id. § 1.642(c)-6(a)(1), 35 Fed. Reg. at 11,478-79.

mined on the basis of the highest rate of return[177] earned by the fund for any of the three taxable years immediately preceding the taxable year of the fund when the transfer is made. In case of funds in existence for less than three taxable years, the rate of return is deemed to be 6 percent, except that the Secretary may prescribe a different rate of return.

Having determined the yearly rate of return for the fund, the remainder interest is calculated by the use of Tables G(1) for males and G(2) for females.[178] The amount contributed is multiplied by the factor shown opposite the age of the life beneficiary and under the column bearing the yearly rate of return. In most cases the yearly rate of return will not correspond precisely with the rate given by the tables, and linear interpolation will be necessary.[179]

The tables show only the present value of a remainder interest where the intervening interest is a single life. The Commissioner has offered to supply factors when the intervening interest spans more than one life.[180]

C. *Taxation of the Trust and Beneficiary*

Neither an annuity trust nor a unitrust is subject to taxation for any year unless for such year there is unrelated business taxable income within the meaning of section 512, as if it applied to the trust.[181] Presumably, the unrelated business income will subject the entire trust to taxation, not just the amount of unrelated business taxable income.[182] Apparently, a trust may purge itself in another year by eliminating this type of income.

The taxation of the income of a charitable remainder trust has been radically changed. Formerly, a beneficiary was taxed to the extent of distributable net income like the beneficiary of a trust whose remainderman was not a charity.

Section 664(b) enumerates rules for determining the character of the

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177. According to Proposed Treas. Reg. § 1.642(c)-6(c), 35 Fed. Reg. 11,479 (1970), the yearly rate of return is obtained by dividing the income earned by the fund for a taxable year by the average fair market value of the property in the fund less the corrective term adjustment. The average fair market value of the property is the sum of the amounts of fair market value on each determination date (i.e., the first day of the taxable year and each date property is transferred to or withdrawn from the fund not greater than three months apart) divided by the number of determinative dates. The corrective term adjustment is the sum of the products obtained by multiplying the income payments made by the fund by certain percentages found in § 1.642(c)-6(c)(4).

178. Id. § 1.642(c)-6(d)(3), 35 Fed. Reg. at 11,480-84.

179. See id. § 1.642(c)-6(d)(2), 35 Fed. Reg. at 11,480 (example).

180. Id. § 1.642(c)-6(a)(2), 35 Fed. Reg. at 11,479.

181. Int. Rev. Code of 1954, § 664(c).

182. Proposed Treas. Reg. § 1.664-1(c), 35 Fed. Reg. 12,468 (1970).

trust income in the hands of a beneficiary. Amounts[183] distributed are considered first as ordinary income, other than capital gain, to the extent of trust income for the year and the undistributed income for prior years. In some years, a trust may have to distribute corpus to make the required distribution. Under this principle, prior income in excess of the distribution requirement would be added to the income for the year the corpus is distributed. Under the second provision, such amounts are considered capital gains (first short-term and then long-term), to the extent of the capital gain of the trust for the year and the undistributed capital gain for prior years. Thus, if all undistributed income is used up and the trust has gain for the year, the beneficiary reports this to the extent of the distribution. Thirdly, they are considered other income (such as tax-exempt income), to the extent of such income of the trust for the year and such undistributed income of the trust for prior years. Lastly, such a distribution is treated as a distribution of the trust corpus.[184]

Perhaps an example of such a calculation may be helpful. Assume that a donor establishes a unitrust having a corpus of $100,000 that requires the trustee to pay out 5 percent of the principal each year. The following figures may be somewhat unrealistic from an investment standpoint, but they would seem to illustrate the principles of section 664(a):

	Trust Income				Income of Intervening Interest			
	Dividends	Capital Gains	Tax-Exempt Interest	Required distribution	Dividends	Capital Gains	Tax-Exempt Interest	Principal
1970	$ 4,000	$2,000	$1,000	$ 5,000	$ 4,000	$1,000	—0—	—0—
1971	8,000	—0—	1,000	6,000	6,000	—0—	—0—	—0—
1972	1,000	—0—	4,000	7,000	3,000	1,000	3,000	—0—
1973	—0—	—0—	1,000	8,000	—0—	—0—	4,000	4,000
	$13,000	$2,000	$7,000	$26,000	$13,000	$2,000	$7,000	$4,000

Losses in any category reduce undistributed gains in the same category, and any excess can be carried forward indefinitely.[185] Expenses of the trust are allocated to that class of income to which they can be reasonably related. If no relationship is discernible, expenses are allocated on the basis of gross income reduced by related expenses.[186]

The taxation of a pooled income fund and the life beneficiary follow

183. If property other than cash is distributed, the trust will be deemed to have sold the property for its fair market value. Id. § 1.664-1(d)(5), 35 Fed. Reg. at 12,469. Payments made within two and one-half months after the close of the taxable year (or such longer period as is reasonable) will be considered made on the last day of the taxable year. Id. § 1.664-3(a)(1), 35 Fed. Reg. at 12,470.

184. Int. Rev. Code of 1954, § 664(b).

185. Proposed Treas. Reg. § 1.664-1(d), 35 Fed. Reg. 12,468 (1970).

186. Id. § 1.664-1(d)(2).

the rules governing trusts and their beneficiaries.[187] The beneficiary would include in income, and the fund would deduct, all amounts properly paid, credited, or required to be distributed during the taxable year of the fund ending within or with his taxable year.[188] The deduction for long-term capital gains permanently set aside for charitable purposes was specifically preserved for pooled income funds.[189] Short-term gains would, however, be fully taxable.[190]

D. *Gifts of Income Interests Where the Grantor is not Taxed*

In the past, another celebrated form of gift was a trust, the income from which would go to a charity for a number of years, with remainder to a third party—usually a member of the grantor's family. It was, of course, particuarly suitable to a taxpayer with unearned income and capital. The tax emoluments were twofold: the elimination of the trust earnings from the grantor's income, and a charitable deduction for the value[191] of the income interest in the year of the gift. The former section 170(b)(1)(D) did not threaten the charitable deduction, since a reversionary interest in the trust was not reserved.

The ground swell of opinion against sophisticated forms of giving was so great that the 91st Congress was persuaded to initiate significant curbs on gifts of income interests. The simple rationale was that the double benefit was an "unwarranted tax advantage which is not a necessary inducement to charitable giving."[192]

Section 170(f)(2)(B)[193] disallows the deduction for gifts of any interest in property (other than a remainder interest transferred in trust) unless:

(1) The interest is in the form of a guaranteed annuity, or the trust instrument specifies that the interest is a fixed percentage, distributed

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187. Id. § 1.642(c)-5(a)(2), 35 Fed. Reg. at 11,476, except that Code sections 671-78, relating to grantors and others treated as substantial owners, do not apply. Id.

188. The amount included may not coincide with actual payments, since a payment made within two and one-half months after the close of the taxable year of the fund is considered made on the last day of such taxable year. Id. § 1.642(c)-5(b)(7), 35 Fed. Reg. at 11,477.

189. Int. Rev. Code of 1954, § 642(c)(3).

190. This conclusion is implied, since the set-aside deduction is reserved for long-term capital gains only. Id.

191. The value of the income interest was ordinarily calculated by using Table II, Treas. Reg. § 25.2512-5(f) (1954), which assumed a rate of return of 3½ percent. For example, the present worth of the income for 20 years on principal of $10,000 under these tables was nearly $5,000.

192. S. Rep. 92.

193. This subsection applies to gifts made after July 31, 1969. Act § 201(g)(1)(C). Both the gift (Int. Rev. Code of 1954, § 2522(c)(2)(B)) and estate (id. §§ 2055(e)(2)(B) & 2106(a)(2)(E)) tax provisions deny a deduction unless the trust is a guaranteed annuity or fixed percentage trust. For their effective dates, see note 148 supra.

yearly, of the fair market value of the trust property (to be determined yearly);[194] and

(2) the grantor is treated as the owner of such interest under section 671 and hence taxed on the income.[195]

If the donor ceases to be treated as the owner of the interest under section 671, he is considered to have received an amount of income equal to the deduction in the year of the gift, reduced by the discounted value of all income earned by the trust and taxable to the grantor until the time he ceases to become the owner of the interest. Lest it be contended that the income taxable to the grantor might be available for a current charitable contribution deduction, section 170(f)(2)(C) denies a deduction to the grantor or any other person for the charitable contributions made by the trust.

Those instances when the grantor and others are taxable on the income of a trust are covered by sections 671 through 678. Under section 671, when the grantor or another person is treated as the owner of any portion of a trust, the income from this portion is taxable to him. Although the general theory behind attributing income to a grantor is his retention of control over the trust, the pertinent provisions of Subpart E must be precisely satisfied before trust income is shifted to the grantor. They are as follows:

1. Section 673(a)

The grantor is considered the owner when he has a reversionary interest, in either the corpus or the income, which may reasonably be expected to take effect in possession or enjoyment within ten years from the date of the transfer. Accordingly, the grantor must have a reversionary interest, and the term of the trust must be less than ten years unless some other section of Subpart E applies. Suppose a grantor establishes a charitable income trust for a period of nine years, with remainder to him if he be then living, but if not then to his son. Clearly there will be no disallowance of the deduction for the charitable interest due to failure to comply with section 671. If the grantor predeceases his son in the fifth year and thus ceases to be the owner, will his last return have to reflect as income the deduction less the discounted value of the income interest?

2. Section 674

Here, a grantor is treated as the owner of any portion of a trust of which the beneficial enjoyment of the corpus or income is subject to a

194. The purpose of this requirement is to assure a correlation between the amount received by the charity and the deduction.

195. The grantor need not be taxed on the income to obtain a deduction for estate or gift tax purposes.

power of disposition exercisable by the grantor or a nonadverse party,[196] or both, without the approval of any adverse party.[197] One such power that would certainly cause the income to be taxable to the grantor would be the power to direct the trustee to distribute the income to some person other than the charitable income beneficiary. If the grantor exercises his prerogative he is nonetheless taxable on the income, since it is control that subjects the grantor to taxation. In theory, the charity could be deprived of its income and the grantor could remain taxable on the income, and yet the provisions of section 170(f)(2)(B) requiring him to report in income the deduction he received would seem not to apply. In this respect, it appears as though reliance upon Subpart E has been misplaced.

3. Section 675

This provision treats a grantor as the owner when he has various administrative powers that enable him to deal familiarly with the trust: for example, a power to borrow without adequate interest or security. Such a power in the instrument would seem to save the charitable deduction for the value of the income interest, yet enable the grantor to erode the integrity of the charitable income interest which the new provisions of the Code so desperately seek to maintain.

4. Section 676

A grantor is treated as the owner of any portion of a trust when he retains the power of revocation. Again, a provision enabling the grantor to revoke the trust causes him to be taxed on the income and may preserve the deduction under section 170. If the grantor in fact revokes the trust, he remains taxable on the income because it is his own, while the charitable income interest has been entirely destroyed. The language of section 170(f)(2)(B) would not seem to require a recapture of the deduction.

5. Section 677

The grantor under this section is treated as the owner of a trust when the income (prior to the period in section 673) may, without the consent of an adverse party, be distributed to the grantor or his spouse, accumulated for the grantor or his spouse, or applied to the payment of premiums on life insurance policies on the life of the grantor or his spouse. Again, what happens to the deduction if the forbidden acts take place?

The regulations will probably (and should) take the position that any act pursuant to the grantor's retained powers under Subpart E that

196. For a definition of this term, see Int. Rev. Code of 1954, § 672(b).

197. "Adverse party" is defined in section 672(a) of the Code.

jeopardizes the value of the income interest should cause recapture of the deduction. On the other hand, the Secretary may put full reliance on section 4947(a)(2), which makes many sanctions against private foundations apply to split-interest trusts.[198] To say the least, section 170(f)(2)(B) is peculiar in that the grantor must have, but cannot use, the power to act improperly.[199]

XI. Conclusion

This article is only the beginning of a new body of thought on the subject of charitable contributions. Proposed regulations on the new provisions will issue shortly to give us the official view of much of the Act that is open to interpretation. In the due course of time the cases will appear to explain further the meaning of the legislation. To be sure, many of the answers blithely assumed in this article may turn out to be less than correct.

It is unfortunate that the 91st Congress found it necessary to chasten some forms of charitable giving. There is no question that the cause can be attributed to the irresponsibility of some who attempted to stretch too far the limits of the charitable contribution deduction. It is significant, however, that by and large the central and most important means for the encouragement of charitable giving has been left intact. With respect to some of the practices curbed by the Act, it may have been, for the sake of simplicity, wiser merely to excise them from the Code rather than make them unattractive through highly complex rules.

The authors extend congratulations to the staffs of the Treasury, the Joint Committee on Internal Revenue Taxation, the House Ways and Means Committee, the Senate Finance Committee, and those concerned in the Internal Revenue Service for a magnificent accomplishment. The imagination boggles at the devotion and technical proficiency displayed and at the pressure under which they worked.

198. E.g., Int. Rev. Code of 1954, § 508(e) relating to governing instruments. See Rev. Rul. 270, 1970 Int. Rev. Bull. No. 22, at 8, for provisions suitable for corporations and trusts. A governing instrument is deemed amended if state law requires a foundation to act, or to refrain from acting so as not to be subject to the taxes imposed by Int. Rev. Code of 1954, §§ 4941-45, and treats the required provisions as contained in the governing instrument. T.D. 7040, 1970 Int. Rev. Bull. No. 23, at 20.

199. For example, by the tax on taxable expenditures if any amount is paid for other than a charitable purpose. Int. Rev. Code of 1954, § 4945(d)(5).