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[Texas Governor's Committee on Employment of the Handicapped] [1982]

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STANFORD UNIVERSITY MEDICAL CENTER

OFFICE OF MEDICAL DEVELOPMENT
780 WELCH ROAD
PALO ALTO, CALIFORNIA 94304
(415) 497-6158

July 9, 1982

Mr. Justin W. Dart, Jr.
Chairperson
Texas Governor's Committee on Employment
of the Handicapped
2012 Lear Lane
Austin, TX 78745

Dear Justin:

I enjoyed our conversation very much. Enclosed are the following materials:

1. "Tax-wise Giving," a videocassette tape designed to give a quick overview of the subject, the planning, timing and gifting of large gifts. In this tape we stressed the additional tax savings available to a person making a gift in the present. We also called attention to the fact that these gifting techniques have been used for many years but that the use had been generally limited to the larger educational institutions.

2. "Types of Gifts and Ways of Giving - Tax Savings" is the official publication of Stanford University. I think this material is over and under detailed. There is too much detail for the layman and not enough for the attorney.

3. I favor "Gifts That Pay You Now and Stanford Later." This was put together as a "partnership" publication stressing the theme: You can help yourself -now- and Stanford later.

4. "Minimizing the Estate Tax Through the Charitable Deduction" was written before the new law. However, the principles still apply.

5. Harold Boyd had a prospective donor in Modesto. Harold and I made the call. During our first visit we talked with the couple and tried to establish what their objectives were. Upon our return we discussed the situation with our staff attorney and asked him to investigate the subject of "deferred gift annuity." This situation helped bring about Stanford's entrance into the area of "deferred gift annuities."

6. This is an example of the gift of a home but retaining a life interest for the donor.

The fifth and sixth items are included to give you an idea of the highly personalized emphasis of a large gift program.

When your plans to visit the coast are solidified, please let me know. I would be delighted to meet you. If there are questions I could answer by telephone, I would be happy to do so.

Take care. See you.

Sincerely yours,

George

George Kwong
Director, Trusts and Bequests
Stanford University Medical Center

Encls.

STANFORD UNIVERSITY
STANFORD, CALIFORNIA 94305

OFFICE OF THE GENERAL SECRETARY
301 Encina Hall
(415) 328-8880

February 25, 1982

[illegible], M.D.
457 [illegible]
Danville, California 94526

[illegible]

[illegible] I enclose suggested forms for a bequest from you to Stanford of your grand piano, prayer rug, and a maintenance fund for the piano, and your bequest to endow a professorship in the Division of Urology of our School of Medicine. I am sending a copy of this letter and its enclosures to your attorney, Mr. Brunwasser. If you or he have any question about the enclosures, or if I can be of further help with them, please do not hesitate to let me know.

You also asked that I write to you about a possible gift of your home reserving a legal life estate to yourself. Here is what I think you and Mr. [illegible] will want to consider in that regard:

> If you make such a gift to Stanford, you may continue to occupy the house or you may rent it out, and the rents will be yours. In either case, as the life tenant, you would continue to have the duty of keeping the house and grounds in repair, and paying the real property taxes, insurance, and other regular, ongoing upkeep expenses.
>
> For federal income tax purposes, you will be entitled to a current income tax deduction for the value of the remainder gift to Stanford (the provisions for this deduction are set forth in IRS Regulation Section 1.170 A-12(a)). You may deduct the value of Stanford's remainder interest in an amount up to 30% of your adjusted gross income in the year you make your gift; any excess deduction that you cannot use that year may be carried over for up to five subsequent tax years, if necessary. To support the claim for your deduction, all relevant values (i.e., not just the total fair market value of the property, but a separately stated value for any buildings on the property, and a separate value for the land; you will need to state a salvage value of the building(s)

and their useful life -- I believe that 45 years is presently allowed. These valuation factors should be based on a detailed appraisal report by a qualified appraiser. If you make the gift, we would appreciate receiving a copy of such appraisal for our records.

Because your property is still indebted, a gift reserving a legal life estate would also constitute a bargain sale -- i.e., the IRS would assume that you had sold the property to Stanford for the amount still owing on it, and had made a gift to the University of the balance of its value, subject to your life estate. I enclose a schedule on which I have made certain assumptions about the value of your house and land, and about its useful remaining life and salvage value. Based on those assumptions, if you gave Stanford your home retaining a legal life estate, the charitable portion of the transaction would be valued at $79,838 (.54684 x $146,000 equity I assumed you have in the house). In computing the taxable capital gain from such a transaction, you are allowed to use only that part of your basis in the house that relates to the sales portion. Assuming that the debt on the house is presently $34,000, that is the sales portion. Using $180,000 as the total value of the property, you would compute your capital gain by subtracting $\frac{34}{180}$ x your basis in the house from the $34,000 sales portion. For example, if your basis in the house is $50,000, your gain would be $34,000 minus ($\frac{34}{180}$ x $50,000) equals $24,556.

You would, of course, avoid any tax on this capital gain by applying your once-in-a-lifetime exclusion of $125,000. However, that would not be advisable unless you were certain you would never have another occasion during your lifetime to use the exclusion. Only you and your own tax advisor can determine that. In any case, the charitable deduction of $79,838 should save you far more taxes than you will have to pay on the relatively small capital gains part of this transaction.

To compute your actual charitable deduction and capital gain on this kind of transaction, we will need the appraisal, salvage value and useful life information that are applicable to your home. With that information, I will be very happy to compute what I believe is the proper deduction and the proper taxable gain.

If you decide to go ahead with the gift of the house, I will be happy to work with Mr. [illegible] in preparing a gift deed and a gift letter for you.

We are deeply grateful for the generous plans you have for Stanford. Please let me know if I can be of further help in any way.

With best wishes.

Sincerely,

[illegible]

MAM:kg

Enclosures

cc: [illegible]
Attorney at Law
[illegible] Street
Third Floor
San Francisco, CA 94108

bcc: [illegible]
Dr. [illegible]

DATE: January 11, 1982

TO : Harold Boyd
George Kwong ✓

FROM : Myrl A. Meyer

SUBJECT: Dr. and Mrs. John Wooley -- Deferred Charitable Gift Annuity

Dear Harold and George:

Here is the memorandum you requested on a possible deferred charitable gift annuity from Dr. and Mrs. Wooley to Stanford. The memorandum deals with an annuity in which the first payment is deferred for 5 years, and one in which the first payment is deferred for 10 years.

Since we do not offer charitable gift annuities, I did a considerable amount of reading before preparing this memorandum. What I read has led me to believe that before Stanford signs an annuity contract with anyone, the University should obtain the necessary license from the State of California. That will necessitate taking the matter to our Board of Trustees, and then working with state insurance officials to qualify, if the Board approves. This process would take at least two or three months. Therefore, it will be best if we do not give the Wooleys the impression that Stanford can issue an annuity to them within a few days, if they decide to go ahead.

Please also draw the attention of the Wooleys to the final paragraph of the memorandum. If there were some bar to selling the property interest, and if Allan Lee thought we could not do anything to make the property soon produce a reasonable income, the University would not be well served by taking this kind of gift in return for the promised income payments.

Good luck, and let me know if you have questions.

Russ

MAM

MAM:kg

Attachment

Memorandum: Gift to Stanford University for Deferred Charitable Gift Annuity

Date: January 8, 1982

By: Myrl A. Meyer, Associate Staff Legal Counsel

This memorandum is concerned with an annuity contract by which a husband and wife transfer a certain property to Stanford University in exchange for Stanford's agreement to pay them an annuity until both have died. In this case, the arrangement is called a deferred charitable gift annuity, because the annuity payments will start five years (Situation A) or ten years (Situation B) after the property exchanged for the annuity has been conveyed to the University.

. . . .

Assumptions: (1) Husband (age 59) and wife (age 58) own free and clear an undivided interest in an apartment building, which they have owned for longer than 1 year.

(2) Their interest in the building has a tax basis of $10,000, and a fair market value of $300,000 -- if they sold their interest, the long term gain would be $290,000.

(3) They give their interest to Stanford University in exchange for a deferred charitable gift annuity, to pay an annuity to them jointly while both live, and then to the survivor for the balance of his/her life.

Situation A -- The annuity gift is made March 15, 1982, but annuity payments to the donors are deferred for 5 years, to commence on March 15, 1987, and will be payable quarterly thereafter.

Here are the results of such a deferred annuity:

(1) The annuity payment to the donors, and then to the survivor, would be $26,676 per year, in quarterly installments.

(2) The $26,675 per year would be taxed as follows:

(a) As ordinary income - - -	$ 4,329
(b) As long term capital gain - - -	$10,983*
(c) Tax free, as return of principal -	$11,364
	$26,676

*This $10,983 will be taxed as long term gain for 23.3 years, then will become tax free, as return of principal.

(3) The charitable contribution amount for this gift is $35,267. That amount is deductible by the donors, subject to the 30% of adjusted gross income limitation on the charitable deduction for federal income tax purposes, and the 20% limitation for California income tax purposes. Any amount that cannot be deducted in the year of the gift may be carried forward and deducted (as rapidly as possible) over 5 additional tax years, subject to the same 30% (federal) and 20% (California) limitations each year. The amount of income tax savings from the charitable deduction will depend upon the top tax brackets of the donors. For donors high in the 50% tax bracket, the federal income tax savings will be one-half of the deductible amount.

<u>Gift Tax Consequences</u> -- There is, of course, no gift tax on Stanford University's interest in the charitable gift annuity. Gift tax on the income interest of each spouse in that one-half of the property put into the annuity by the other can be avoided if each retains the power to revoke the interest of the other by Will. It is contemplated that this power will not be exercised, and that the surviving spouse will succeed to the entire annuity income.

<u>Estate Tax Consequences</u> - Though there is no estate tax upon Stanford's interest, upon death of the first spouse to die, the value of the survivor's life interest in one-half of the annuity amount will be included in the first spouse's estate for tax purposes. The only way to avoid this under present law would be for each spouse to set up an annuity, with himself/ herself as sole life annuitant, from his/her own one-half of the gift property. However, if that were done, when the first spouse died, his/her annuity would end, and the survivor would receive an annuity based on only one-half of the property.

<u>Situation B</u> -- The annuity income is deferred for 10 years, to commence on March 15, 1992, payable quarterly thereafter.

Here are the results of such a deferred annuity:

(1) The annuity payment to the donors, and then to the survivor, would be $35,400 per year in quarterly installments.

(2) The $35,400 per year would be taxed as follows:

(a) As ordinary income --	$12,361
(b) As long term capital gain --	$11,322*
(c) <u>Tax free</u>, as return of principal -	$11,717
	$35,400

*This $11,322 will be taxed as long term gain for 19.8 years, then will become tax free, as return of principal.

(3) The charitable contribution amount for this gift is $68,102. See Par. (3) of Situation A above for discussion of its deductibility and tax benefits.

Gift Tax Consequences -- See discussion above on five year plan.

Estate Tax Consequences -- See discussion above on five year plan.

The figures in this memorandum are based upon the assumption that, shortly after issuing the annuity, Stanford can either realize at least 10% per year income from the gift property, or that the property can soon be sold and reinvested to earn at least that return.

TYPES OF GIFTS AND WAYS OF GIVING— TAX SAVINGS

1982

Office of the General Secretary
301 Encina Hall
Stanford, California 94305

Delivering Gifts of Cash or Securities

Gifts of cash

Checks may be made payable to Stanford University and mailed to the Office of Development, Gift Section, 301 Encina Hall, Stanford, California 94305.

Gifts of securities

Gifts of securities may be made to Stanford in three ways:

by mail
through the donor's broker
by hand delivery

By mail. The donor may endorse the stock certificate to Stanford University and send it by registered or insured mail, or mail the *un*endorsed certificate in one envelope and a stock power endorsed *in blank* in another. (Both should not be put in one envelope.) Gifts of securities should be sent to: Office of Development, Gift Section, 301 Encina Hall, Stanford, California 94305.

Through the donor's broker. Securities should be delivered to the broker for the account of Stanford University and the broker requested to ask Stanford for instructions immediately by telephone at (415) 326-5782. If the broker already holds the securities for the donor, he should be instructed (1) to transfer the gift shares irrevocably to Stanford's account and (2) to immediately request instructions from Stanford by telephoning (415) 326-5782.

By hand delivery. Stock certificates may be delivered to either of the addresses below:

Office of Development
301 Encina Hall
Stanford University
Stanford, California 94305
(415) 497-1357

Stanford Regional Office
818 West 7th Street
Suite 1020
Los Angeles, California 90017
(213) 627-0653

Or, if more convenient for the donor, stock certificates may be delivered to the trust department of any bank. The donor should ask the trust officer there to telephone a report of the gift to a Stanford office immediately.

If special handling of a gift is required the University will be happy to make such arrangements for the donor's convenience, including personal pickup and delivery to University representatives.

For additional information, inquiries may be directed to the Office of the General Secretary, 301 Encina Hall, Stanford, California 94305 (telephone: (415) 497-1357).

The donor should be sure that the University is advised of the intended purpose of the gift at the time the gift is made.

TYPES OF GIFTS AND WAYS OF GIVING—TAX SAVINGS 1982

The pages in this section describe various methods of giving to Stanford and the federal income tax consequences generally associated with them. A summary of the material covered includes:

The Individual Charitable Deduction

To encourage private philanthropy, Congress has traditionally granted favored tax treatment to charitable contributions by individuals. This booklet illustrates some of the ways in which this favorable treatment can be utilized by donors wishing to make a gift to Stanford in 1982.[1]

Gifts come off the top of income

In computing taxable income, the taxpayer is allowed a deduction for contributions to tax-exempt charities. A gift to Stanford, therefore, whether from capital or from income, reduces income subject to tax at the donor's *highest* rates. The result: less tax for the donor and a dollar benefit to Stanford substantially greater than the donor's out-of-pocket cost.

Example A: Mr. and Mrs. Andrews, who file a joint return and have taxable income[2] of $100,000 before the contribution, give $20,000 to Stanford. Nearly 50 percent of the cost of the gift—$9,944—is offset by federal income tax savings. The donors' out-of-pocket cost in making a $20,000 gift is $10,056.

Example B: Mr. Brown is single and has taxable income (before making the contribution) of $40,000. A $4,000 gift to Stanford costs him only $2,240. Because the gift reduces income taxed at the donor's top bracket (44 percent), the tax saving from the $4,000 charitable deduction is $1,760.

One can determine the approximate tax saving resulting from a gift to Stanford by multiplying the amount of the gift by the donor's highest tax rates.

Table I shows the approximate net cost of a $1,000 gift from donors in various tax brackets filing joint returns.

Table I—Net Cost of Gifts

Taxable income before contri-bution ($)	*Percent of $1,000 gift offset by tax savings (%)*	*Approximate cost of $1,000 gift to the donor ($)*
10,000	16	840
15,000	19	810
20,000	22	780
26,000	29	710
31,000	33	670
37,000	39	610
47,000	44	560
61,000	49	510
87,000 and over	50	500

Valuation of Gifts

In calculating the charitable deduction, gifts are normally included at fair market value—the price at which property would change hands between a willing buyer and a willing seller, neither being under compulsion to deal and both knowing the relevant facts. Special factors may affect valuation in certain cases such as gifts of appreciated tangible personal property (see p. 10),

[1]For gifts made in 1983, 1984 and thereafter, the tax savings resulting from charitable deductions will be less because of the tax rate reductions provided for in the Economic Recovery Tax Act of 1981. All illustrations in this booklet will be based on 1982 tax rates and assume the donor itemizes deductions.

NOTE: *Donors who do not itemize deductions may, under the 1981 tax act, deduct 25 percent of the first $100 of charitable gifts (maximum deduction is $25) made in 1982.*

[2]Taxable income is essentially adjusted gross income less itemized deductions and personal exemptions. For this and all subsequent examples, the computation of tax ignores the zero bracket amount.

ordinary income property (see p. 11), or appreciated long-term capital gain property for which an alternative valuation election has been made (see p. 8).

Percentage Limitations

The extent to which charitable contribution deductions may reduce a donor's taxable income is limited by law. Gifts to Stanford and to certain other charities, including educational institutions, churches, and hospitals, qualify for the highest deduction—50 percent or 30 percent of adjusted gross income,[3] depending on the type of property given. Deductions for gifts to most private foundations and some other charities are limited to 20 percent of adjusted gross income.

Gifts qualifying for the 50 percent deduction limitation

A donor may deduct cash gifts up to 50 percent of adjusted gross income. The market value (or cost-basis, whichever is less) of gifts to Stanford in the form of unappreciated property also may be deducted up to a maximum of 50 percent of adjusted gross income.

> *Example C: Combining 50 and 30 percent gifts.* Mr. Carson has adjusted gross income of $40,000 a year. In a single year, he may deduct gifts to Stanford totaling $20,000. He may take advantage of the special benefit of giving long-term capital gain property by giving appreciated securities worth $12,000 (30 percent of his adjusted gross income) and $8,000 in cash. The full $20,000 will be deductible in the gift year.

Gifts of property subject to the 30 percent deduction limit may be made to qualify for the 50 percent ceiling if the taxpayer elects to reduce the value of the gift property by 40 percent of its appreciation (see p. 8).

Gifts qualifying for the 30 percent deduction limitation

For gifts of appreciated long-term capital gain property to Stanford,[4] the donor may deduct the market value of the gift up to 30 percent of adjusted gross income. Cash gifts (or others qualifying for the 50 percent deduction limit) are deducted first, and thus may reduce the 30 percent otherwise available for appreciated property gifts in any given year.

Gifts of long-term capital gain property limited by the 30 percent ceiling may be combined with gifts of cash or unappreciated property that qualify for the 50 percent limit in order to take advantage of both the overall 50 percent deduction limitation and the increased savings realized by giving appreciated capital gain property.

Gifts to 20 percent charities

The deduction for gifts to certain charities (such as private foundations that do not satisfy federal distribution requirements) is limited to 20 percent of adjusted gross income.[5] The deduction is further limited to the excess (if any) of 50 percent of adjusted gross income over all other charitable gifts made in the year of gift or carried over to it, whether or not deductible in that year. Gifts to 20 percent organizations cannot be carried over.

> *Example D: Loss of charitable deduction.* Suppose Ms. Davis has an adjusted gross income of $100,000 this year and gives $50,000 in appreciated long-term securities to Stanford and $5,000 cash to a private foundation. Because her Stanford gift is equal to 50 percent of

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[3]More precisely, the relevant statute, I.R.C. Section 170 (b) (1) (E), provides that the percentage limits apply to the donor's "contribution base," which is the same as adjusted gross income computed without regard to any net operating loss carryback.

[4]With the exception of certain tangible personal property (see p. 10).

[5]In computing the deduction for gifts to such charities, the value of any long-term appreciated capital gain property donated is reduced by 40 percent of the appreciation. If the gift is from a corporation, the reduction is 61 percent of the appreciation.

adjusted gross income, she may not deduct the gift to a 20 percent organization (the private foundation), even though she may deduct only $30,000 of the Stanford gift in this year because of the 30 percent rule. She may carry forward to subsequent years the unused portion ($20,000) of the Stanford gift (see next section), but the $5,000 gift to the foundation may not be deducted at any time. A tax adviser can help plan a charitable gift program that will avoid such loss of tax benefits.

NOTE: *Whenever it is stated that an individual's gift is deductible, such deduction is subject to the applicable percentage limitations.*

Five-Year Carryover

If a donor makes gifts qualifying for the 30 percent or 50 percent deduction and the value of the gifts exceeds the applicable percentage limitation in the year given, the excess can be carried forward and deducted in the five succeeding tax years.[6] The same percentage limitation applies to the deduction in each of the carryover years. Once commenced, the maximum allowable carryover deduction must be used in each succeeding year, after first deducting other qualifying 30 percent or 50 percent gifts made in that year.

The carryover can be particularly useful if the donor wishes to support a Stanford program or project that requires an immediate gift larger than can be deducted in one tax year. The University can use the gift at once, and the donor may deduct the maximum allowable amount for that year and the balance over succeeding years. The carryover is also useful when making a gift of property, such as real property or a note, that is too large to deduct in one year.

Example E: Carryover of gift of securities. Mr. and Mrs. Edwards file a joint return on adjusted gross income of $35,000 a year. They give Stanford long-term appreciated securities worth $50,000, a gift that qualifies for the 30 percent deduction.

In the year of gift, they deduct $10,500 (30 percent of $35,000). Assuming they make no other significant charitable gifts in succeeding years, they will deduct the remaining $39,500 over the next four years ($10,500 in each of the first three years and $8,000 in the fourth).

When income varies during the period of the carryover, the deduction also fluctuates. In Example E, if the family income rises to $45,000 in the third year, the donors will use up $13,500 of the carryover (30 percent of $45,000) that year instead of $10,500.

Example F: Carryover of gift of cash and securities. Mr. Foster has an annual adjusted gross income of $100,000. He gives Stanford $210,000 to endow a scholarship fund—$60,000 as a cash gift and the remaining $150,000 in long-term appreciated securities. In the year of gift, he deducts $50,000 (cash, deductible up to 50 percent) from his adjusted gross income.[7] He carries forward $160,000 ($10,000 cash and the $150,000 in appreciated securities). Assuming his income remains constant, in the first carryover year he deducts $40,000 consisting of $10,000 cash and $30,000 of the securities carried forward. (The securities, because appreciated, are limited to the 30 percent deduction ceiling). In each of the next four years, he will deduct the carryover gift up to 30 percent of his adjusted gross income until the deduction is completed. In each of these years, he may also make charitable gifts of cash or unappreciated property worth up to $20,000 to qualifying charities such as Stanford. These gifts will be fully deductible and will not result in any loss of deduction for the original gift. The $210,000 gift will be fully deducted at the end of the six-year period.

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[6]In contrast, contributions to 20 percent-type charities that exceed the amount allowable in a taxable year cannot be carried over.

[7]Fifty percent gifts are always deducted first.

Gifts of Long-Term Capital Gain Property

When donors make gifts to Stanford, it will often be to their advantage to give appreciated securities, land, or other capital assets that have been held more than twelve months, instead of either selling or retaining them and giving cash. There is no capital gain tax on such a gift, and the gift will qualify for a charitable deduction for full market value[8] up to 30 percent of adjusted gross income.[9] The carryover privilege is available for gifts exceeding the 30 percent limitation.

If sale of the securities or property would result in a deductible loss, it will be more advantageous to the donor to sell the property and contribute the proceeds. He will then realize a deductible loss that would not be recognized had he given the property itself.

> *Example G: Gifts of low-cost appreciated securities.* Mr. and Mrs. Gordon have taxable income of $100,000 before contribution. They give Stanford stock purchased for $2,000 in 1957 and worth $20,000 on the date of the gift. In making this gift to Stanford, they save $9,944 in federal income tax, as noted in Exampe A. In addition, they save the $3,600 of capital gain tax they would have incurred if they had sold the securities. In their bracket, therefore, it costs only $6,456 to give the University $20,000 in securities, compared with selling them and keeping the proceeds. If the Gordons decide to buy new shares of the same securities with the cash they otherwise would have used for the gift, they will have a new, higher tax base and save capital gain tax on subsequent resale.

Alternative Valuation Election

A donor may elect an alternative valuation for gifts of appreciated long-term capital gain property, and thereby increase the deduction ceiling from 30 percent to 50 percent. The alternative valuation is obtained by subtracting 40 percent of the appreciation from the market value of the gift.

If a donor elects this alternative method of valuation, it must be used for *all* gifts of appreciated property in the year the gift is made. Any carryover resulting from earlier gifts of long-term appreciated property will also be affected if the donor did not make this election in the earlier gift year. The amount of such carryover must be redetermined as though the alternative valuation was effective in the year in which the carryover arose. The adjusted carryover, if any, is deductible up to 50% limit in the current year. Tax returns (including the charitable deductions) for previous years are not affected; the only thing affected is the carryover to the current year.

In most situations, a donor would not elect the alternative valuation because 40% of the appreciation element of the gift property is lost forever as a charitable deduction. However, the election can be advantageous for certain taxpayers. It should be considered when:

(1) *the amount of appreciation is relatively small.* Because the election accelerates the deduction (increasing the deduction ceiling from 30% to 50%), the increase in the current year's deduction may be worth more than the appreciation portion lost. See Example H.

(2) *the gift's value cannot be fully deducted using the 30% limitation.* If the gift is so large that the donor will not be able to fully deduct it over the carryover period, utilization of the alternative valuation election could not only accelerate the deduction but also increase the total amount of the deduction. See Example I.

(3) *the donor's tax bracket will be much lower in subsequent years.* Even though a gift is fully deductible over the carryover period using the 30% ceiling, if the donor is in a much higher tax bracket in the gift year than he will be in the carryover years the accelerated deduction provided by the 50% election may result in tax savings. See Example J.

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[8]With the exception of certain tangible personal property (see p. 10).

[9]*Short-term* appreciated property, on the other hand, is valued for deduction at the donor's cost-basis but qualifies for the 50 percent deduction limitation.

If it is decided that it would be advantageous to increase the deduction ceiling from 30% to 50% it should be noted that electing the alternative valuation is not the only way to achieve this result. Another, indirect way is for the donor to sell the long-term appreciated asset and contribute the sale proceeds to Stanford. Although the sale will generate a capital gain the cash gift will qualify for the 50% deduction limitation.[10]

Example H: Alternative valuation with small capital gain. Assume that the donor has annual adjusted gross income of $100,000 and wishes to give Stanford $40,000 in appreciated securities that he has owned for more than twelve months. The donor is entitled to deduct $30,000 and carry forward $10,000. If the stock cost $35,000 it might be advantageous to use the alternate valuation of $38,000 ($40,000 less 40% of the $5,000 of appreciation) and deduct the entire amount in the gift year.

Example I: Alternative valuation for large gift. Frank Irwin and his wife, Mary, who is a Stanford graduate, have an adjusted gross income of $100,000. In memory of Mary's father, they give Stanford a building component that bears his name. The gift is from securities purchased at $200,000 in 1968 and now worth $300,000. Even using the carryover, the gift cannot be fully deducted. (A deduction of $30,000 a year will, at the end of six years, result in a total deduction of $180,000). Instead, they elect the alternative valuation of $260,000 ($300,000 less 40 percent of the $100,000 capital gain) deducting $50,000 in each of the first five years and $10,000 in the sixth year. A $260,000 deduction will result—$80,000 more than could have been taken by using market value and deducting 30 percent of adjusted gross income each year.

Bargain Sales

A bargain sale is a sale of property to charity for an amount less than fair market value.[11] The difference between the sale price and fair market value is a charitable gift and is deductible. If the transaction involves capital gain property, capital gain tax is due on a portion of the appreciation; the gain realized is computed by allocating the donor's tax basis between what has been sold and what has been contributed.

The bargain sale is a useful device when a donor wishes to give a portion of property that is not easily divisible and receive cash for the rest.

Example J: Use of the bargain sale. Mr. Jones wants to give $5,000 to the Stanford Annual Fund. He owns a note, worth $10,000, which he bought two years ago for $9,000. If he were to sell the note and give Stanford $5,000 in cash from the proceeds, he would have a charitable deduction of $5,000 and a taxable capital gain of $1,000. Instead, Jones sells the note to Stanford for $5,000 in cash; he has made a deductible gift of $5,000 to Stanford and his capital gain is only $500, calculated as follows:

Ratio of Selling price ($5,000) to market value ($10,000) = ½	
Selling price	$5,000
Less (ratio × basis) (½ × $9,000)	- 4,500
Taxable capital gain	$ 500

[10]The donor generally receives the same tax result by giving the appreciated asset and electing the alternative valuation as he does by selling the asset and giving the proceeds. However, the sale does *increase* the donor's adjusted gross income by 40% of the gain—which can be advantageous (e.g., increases his contribution base; eliminates need for reducing the valuation of other long-term appreciated property gifts made this year or being carried over from prior years) or disadvantageous (e.g., reduces the allowable medical expenses deduction; could trigger the alternative minimum tax), depending upon the donor's particular situation.

[11]Gifts of mortgaged property are also treated as bargain sales (see p. 10).

Gifts of Life Insurance

If one has a life insurance policy that is no longer needed for its original purpose, there are tax advantages in irrevocably naming Stanford as the owner and sole beneficiary of the policy.

(1) An amount roughly equivalent to the cash surrender value[12] of the policy at the time of the gift is deductible as a charitable gift.

(2) Premium payments made on the policy after the date of the gift are deductible as educational contributions.

The donor could instead take out a new policy, irrevocably naming Stanford as the owner and beneficiary. In this case, since the policy has no initial cash surrender value, there would be no immediate charitable deduction, but the premium payments would be deductible. The proceeds are not subject to estate tax in either case. The donor's insurance agent can describe other plans for gifts through life insurance.

Gifts of Art Objects or Other Tangible Personal Property

When a donor gives tangible personal property, such as paintings, sculptures, book collections, or historical manuscripts to Stanford, a charitable deduction is available. The five-year carryover may be used if the gift exceeds the donor's percentage limitation. In cases where the property, if sold, would give rise to long term capital gain, the following rules apply:

(1) If the donated property is retained for Stanford's educational purposes, the donor may deduct the full, appreciated value of the property, subject to the 30 percent of adjusted gross income limitation.

(2) If the property is not itself used for Stanford's educational purposes (for example, a diamond ring that will be sold to provide funds for scholarships), the donor may deduct only his tax basis plus 60 percent of the appreciation. However, the deduction qualifies for the 50 percent limitation.

If the property has not appreciated during the donor's ownership, the fair market value (or cost-basis, whichever is less) of the gift (subject to the 50 percent limitation) may be deducted, regardless of Stanford's sale or retention of the property.

Because of tax questions regarding use, the University should be consulted before gifts of tangible personal property are made.[13]

Gifts of Real Property Interests

Gifts of *unencumbered* real property interests, such as land, mineral rights, or growing timber, are deductible in the same manner as gifts of other property: the 30 percent limitation applies if there is long-term appreciation, the 50 percent if there is not; values in excess of the percentage limitations can be carried forward and deducted in the five subsequent years.

The Internal Revenue Service treats gifts of *encumbered* (mortgaged) appreciated real property interests as bargain sales (see p. 9) whether or not the charity assumes the mortgage. The mortgage is considered to be an amount realized by the donor and thus, for tax purposes, such a gift has the same effect as if the donor had sold the property to Stanford for the outstanding mortgage amount: the appreciation is allocated proportionally between the gift portion (the fair market value less the mortage amount) and the sale portion (the mortgage amount). Capital gain tax is due on the gain attributed to the sale portion.

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[12] In some special cases, such as gifts of endowment policies close to maturity, the deduction may be limited to cost, if less than cash value.

[13] As to gifts of art, manuscripts, or personal papers prepared by or for the donor, another special rule applies (see p. 11).

Gifts of Ordinary Income Property

The deduction for gifts of property that, if sold, would produce ordinary income is limited to the lesser of the donor's adjusted basis or market value. Such gifts qualify for the 50 percent limitation. This kind of property includes capital assets held for twelve months or less, Code §306 stock,[14] inventory property,[15] and certain depreciable property.

Under the Tax Reform Act of 1969 "ordinary income property" also includes works of art created by the donor, letters written to him, and letters and papers prepared by him or under his direction. Deductions for gifts of such property are limited to the donor's basis. For example, an artist who gives his own painting to the Stanford Museum can deduct only his cost (for canvas, paint, etc., to the extent not previously deducted as business expense), regardless of the market value of the painting.

Table II—Summary of Deductibility of Charitable Gifts to Stanford University

Type of Property	*Value for Deduction*	*Percentage Limitation**
Cash	Face amount	50%
Non-appreciated property	Fair market value or cost-basis, whichever is less	50%
Ordinary income property**	Fair market value or cost-basis, whichever is less	50%
Appreciated long-term capital assets	Fair market value	30%
—Same, but alternative valuation elected	Fair market value less 40% of the appreciation	50%
Appreciated long-term tangible personal property:		
—Use not related to Stanford's function	Fair market value less 40% of the appreciation	50%
—Use related to Stanford's function	Fair market value	30%
—Same, but alternative valuation elected	Fair market value less 40% of the appreciation	50%

*The percentage limitation refers to the percent of adjusted gross income ceiling on charitable deductions.

**Ordinary income property is property, gain of which on a sale would be taxed at ordinary income rates. E.g. inventory, art work created by donor, Section 306 Stock, certain depreciable property and capital assets held 12 months or less.

Life Income Gifts

A life income trust enables a donor to make a substantial gift to Stanford while retaining income from the property for himself and others. The donor receives an immediate charitable

[14]i.e., stock acquired in a nontaxable transaction, which produces ordinary income if sold. An example would be preferred stock received as a stock dividend and not qualifying for treatment as a capital asset under the Code.

[15]Special rules permit deduction of corporation gifts of inventory property used for care of children, the ill, or the needy, and corporation gifts of scientific inventory property used for research (see p. 16).

deduction and may achieve important savings in income, capital gains and estate taxes, as well as removing the property from his probate estate. After the termination of the life income interests, the donor's charitable gift will be used for the University purpose designated when he created the trust. Three types of life income gift arrangements are possible:[16]

(1) *Pooled Income Fund Gift.* The donor may make a gift of cash or securities to Stanford's Pooled Income Fund. The Pool consists entirely of life income gifts, invested together in a diversified portfolio. The income, an amount based on his proportional share of the Pool, will be paid quarterly to the donor.

(2) *Charitable Remainder Unitrust.* A unitrust may be established by transferring assets irrevocably to Stanford or to the donor's bank as trustee. Each year the donor will receive either a fixed percentage of the trust's annual value or the net income of the trust, whichever is less.[17] The donor sets the percentage initially; for the gift to qualify under federal tax law the percentage must be 5 percent or more. If the fund income is lower than the fixed percentage for one or more years and is higher in a later year, the excess income will be paid to the donor at the latter time up to the amount of the past deficiencies. Payments will be annual or at more frequent intervals, as the donor prefers.

(3) *Charitable Remainder Annuity Trust.* An annuity trust is similar to unitrust in most respects, except that the donor will receive a fixed dollar amount that does not fluctuate with the annual value of the trust. The donor sets the amount, which must be at least 5 percent of the value of the property at the time it is transferred into trust. Payments continue at the same figure unless the entire trust is exhausted, in which case payments would cease.

The donor may make additional gifts to a unitrust or to the pooled income fund at any time. No additions may be made to an annuity trust; a separate annuity trust must be established for each new gift.

The Internal Revenue Service has formulas for calculating the charitable deduction for life income gifts. These divide the gift into two parts: the life interest and the remainder interest. The life interest is the value of the right to payments during the donor's life or the life or lives of other individual interests in the gift. The remainder interest is the value of Stanford's right to the principal after the life interests terminate, and is deductible from the donor's income as a charitable contribution in the year the trust is created. The value of the remainder depends on the sex and ages of the life beneficiaries at the time of the gift and on a mathematical factor: the historical rate of return in the case of a pooled income fund gift,[18] the percentage or the dollar amount in the case of unitrust or annuity trust payments.

Example K: Mr. Kelly is a retired widower of 70, with taxable income well into the 50 percent bracket. He transfers long-term appreciated securities worth $60,000 to Stanford's Pooled Income Fund, specifying that the income be paid to him during his life and that the gift be used for University purposes after his death. Suppose that the highest rate of return of the Pooled Income Fund has been 9.54 percent in the three years preceding the gift. Mr. Kelly may claim $27,534 as a charitable deduction for the University's remainder interest (45.89% of $60,000—see Table III, ONE LIFE). This saves him $13,767 of income tax—almost one-fourth the value of the property transferred. Moreover, Kelly incurs no capital gains tax on the transfer; he will receive income for life on the full value of his gift; he pays no fee for investment and management of the trust property services; and he has taken $60,000 out of his taxable estate.

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[16] These life income gifts can also be made by bequest. See p. 17.

[17] Under special circumstances, Stanford may accept a unitrust under which a fixed percentage of annual value is always paid to the donor, even if the income is less.

[18] This is defined as the highest return in the three years immediately preceding the gift, or 6 percent in the case of a pool that has not been in existence for three years.

The following table gives examples of the deductible portion of pooled income fund gifts with life income beneficiaries of specified ages.

Table III—Charitable Remainder Values: Pooled Income Fund Gifts

Portion of Pooled Income Gift constituting a charitable deduction, assuming pool earns 9.54 percent.

ONE LIFE		
	Remainder (Deductible Portion) of a Gift	
Age	Male Beneficiary %	Female Beneficiary %
50	19.848	13.465
60	31.694	23.546
70	45.890	38.804
80	62.486	58.645

TWO LIVES		
Ages[19]		Remainder (Deductible Portion) of a Gift
Older (Male)	Younger (Female)	%
50	48	6.915
60	58	14.212
70	68	26.753
80	78	45.520

The donor may want payments from the life income gift fund made to more than one person—for example, to himself and his spouse. With two or more lives involved the value of Stanford's remainder interest, and thus of the donor's charitable deduction, will be smaller in proportion to the gift. (Table III, TWO LIVES gives the charitable deduction percentages for two beneficiaries at various ages). Also, when two or more lives (other than donor and spouse) are involved, gift and estate taxes may be incurred in some cases because of the income interest given non-charitable beneficiaries.

Charitable remainder unitrusts and annuity trusts may be established for terms of up to twenty years as an alternative to lifetime trusts.

NOTE: *Before the Internal Revenue Code was amended in 1969, life income gifts could be made to a charity simply by transferring assets to the charity or to a trust, reserving income for life. Such gifts are no longer tax deductible; in fact, a gift tax would be payable on the charitable portion of the gift. Current law provides that no charitable contribution deduction will be allowed for income, estate or gift tax purposes for the value of a remainder interest transferred in trust unless the gift is made in the prescribed form of a pooled income fund gift, charitable remainder unitrust or charitable remainder annuity trust.*

Income Trust Gifts (Charitable Lead Trusts)

It may be advantageous for the donor to create a trust with an income interest payable to Stanford for a term of years. The donor may direct that the trust property be returned to him or distributed to another person at the end of the trust period.

This method is particularly suitable if the donor:

(1) wants to give charity more than he can currently deduct; or
(2) will have unusually high income in one year, and much lower income for a period thereafter; or
(3) is willing to part with income-producing property for a time, but wants the property to revert to him or his family; or

[19]If both beneficiaries are male, or if the younger is male and the older female, the charitable deduction is larger. If both beneficiaries are female, the deduction is smaller.

(4) can afford to dispense with part of current income and wants to make gifts to his children or others in a way that can save gift and estate taxes.

There are several varieties of charitable lead trusts, each type achieving different tax objectives for the donor.

Long-term lead trusts, assets returned to donor

The donor may convey property irrevocably to a trustee, such as a bank or Stanford, for a period of ten years or more and provide that an income interest be paid to Stanford during the term of the trust. At the end of that time, the trust property will return to the donor. The benefit to the donor—though he receives no income tax deduction—is that the payments made to Stanford out of the trust are not included in his taxable income.

The long-term lead trust is especially useful for the donor who makes charitable contributions exceeding the percentage limitations. Since the payments to Stanford are excluded from his taxable income rather than deducted from it, the donor has obtained a deduction otherwise unavailable. In effect, this device enables him to give charity as much as he chooses, without considering the 20/30/50 percent deduction limitations.

The payments to Stanford must be made annually or more frequently and must be either a fixed percentage of the fair market value of the trust property, determined annually, or a specified dollar amount. (If Stanford's interest is determined by any other method, the donor will incur gift tax on Stanford's interest in the trust, and the net tax benefit from this method of giving will be reduced.) Any income in excess of the payments to Stanford remains in the trust, but is taxed to the donor in the year earned.

The use of appreciated property in funding the trust does not incur capital gains tax. However, any undistributed capital gain on subsequent sale of such property by the trustee is taxable to the donor, in the year of sale.

Short-term lead trust, assets returned to donor

If a qualified trust is created for a term less than ten years, with the trust assets to be returned to the donor when the trust ends, the donor will obtain an immediate income tax charitable deduction for the computed actuarial value of Stanford's interest. The deduction is limited to 20 percent of adjusted gross income, and carryover is not available for any excess.[20] The trust income is taxable to the donor in the year earned.

To qualify for the income tax deduction,

(1) The trust instrument must provide that payments to Stanford are made not less often than annually and are either a fixed percentage of the fair market value of the trust property, determined annually, or a specified dollar amount.

(2) The trust income must be taxable to the donor.[21] One way to ensure this is to provide that the trust property will return to the donor or his spouse upon termination of the trust.

Short or long-term lead trust, assets to go to donor's family

If a qualified trust is created for any number of years, with the trust property to be distributed to persons other than the donor or his spouse upon termination of the trust, no income tax charitable deduction is available. However, the gift-estate tax charitable deduction that the donor receives makes this gift method a very useful planning tool for persons with large estates.

[20]The 20 percent rule applies to gifts "for the use of" instead of "to" a charity. Charitable lead trust gift are considered "for the use of" charity.

[21]More accurately, the donor must be treated as the owner of the income interest, for there is no taxable income if the trust is funded with tax-exempt bonds.

A gift to Stanford in this form of a lead trust can be very advantageous to the donor who wishes to help the University in a way that substantially reduces or eliminates the usual gift or estate tax on a transfer of assets to his family. By synchronizing the lead trust's term of years with the specified annuity amount to be paid to Stanford during the trust term, it may be possible for the donor to transfer property to his loved ones without incurring any transfer taxes. Moreover, if the trust property appreciates substantially during the term of the trust, that appreciation in value is also not subject to gift or estate tax.

Example L: Mr. Lewis, who is in high income, gift and estate tax brackets, would like to make a substantial income gift to Stanford using assets that will eventually be given to his son. If he makes an outright gift now to his son, he will incur substantial gift tax. If he defers making his gift and the assets meanwhile appreciate in value, the eventual gift tax (or estate tax if given by Will) will be even higher because the tax will be based upon the appreciated value of the assets at the time of the gift. Instead of giving the assets directly to the son, either now or in the future, Mr. Lewis sets up a charitable lead annuity trust in such a way as both to benefit Stanford and to transfer the assets to his son without incurring gift or estate tax. He accomplishes this in the following manner:

Lewis funds a charitable lead annuity trust with suitable assets currently valued at $1.5 million. The trust provides for a term of twenty years and an 8¾ percent annual annuity payment to Stanford. Thus, each year for the next twenty years Stanford will receive $131,250, for a total of $2,625,000. At the end of twenty years the trust will terminate and the son will receive all of the trust property. If the trust assets appreciate in value during the trust term and if the trust earns enough to make the payments to Stanford, the son should receive assets worth considerably more than the original $1.5 million.

The tax consequences of this charitable lead trust gift are as follows:

Income tax—the donor receives no income tax charitable deduction for this type of lead trust but he does remove income from his highest tax bracket because he is not taxed on the income from the trust assets.

Gift tax—Mr. Lewis receives a gift tax charitable deduction in the amount of $1.5 million so there is no gift tax incurred on the gift to his son. This is because, using the appropriate Internal Revenue Service tables, with an 8¾ percent annuity payout to charity for twenty years the value of the son's remainder interest is zero.

Estate tax—the lead trust gift takes the gift assets out of Mr. Lewis' estate so no estate tax is incurred on the gift to his son.

Testamentary charitable lead trusts

A charitable trust can be used to make a charitable bequest of an income interest in property, with the trust property passing to the donor's heirs after a period of years. This is advantageous for the donor who wishes to benefit Stanford and family members, with the latter not receiving the assets until some period after the donor's death.

The estate receives a charitable deduction for the value of Stanford's income interest, decreasing the estate tax and thus the liquidity needs of the estate. As with the lifetime income trusts, discussed above, the testamentary income trust bequest must provide that payments to Stanford are made at least annually and are either a specified dollar amount or a fixed percentage of the fair market value of the trust property, determined annually. The income paid to Stanford need not be taxed to the donor's estate in order to get the estate tax charitable deduction, even if the trust term is for less than ten years.

At the end of the trust term, the donor's heirs will receive all of the trust property, the value of which at that time may be substantially in excess of the value at which it was included in the donor's estate.

A corporation may deduct the value of charitable contributions up to 10 percent of taxable income in any tax year. Any excess may be carried forward into the five succeeding tax years, with the total deduction in each tax year limited to 10 percent. If the gift is properly within the corporate purposes, a corporation can usually make a gift to Stanford more economically than its shareholders can, because of the saving in corporate income tax.

Example M: The corporation gift. The example that follows compares (1) the amount available for a $20,000 direct gift to Stanford out of corporate earnings with (2) the amount available if the gift is made by the shareholders out of its dividends, assuming the corporation is in the 46 percent income tax bracket:

	(1) Gift directly from corporation	*(2) Gift from shareholders out of dividend*
Earnings available for gift	$20,000	$20,000
Corporate tax (on $20,000)	----	9,200
Amount available for gift	$20,000	$10,800

Accordingly this corporation's gift to Stanford can be nearly twice the amount the corporation shareholders could give from the company's dividends at the same after-tax cost. For corporations taxed at less than 46 percent, the savings will be less, but a direct gift from a corporation with any taxable income should cost less than the same gift made out of the corporation's dividends.

Subject to the percentage limitation, corporate gifts of cash or capital gain property[22] may be deducted at market value. The deduction of gifts of ordinary income property, such as inventory, is usually limited to the corporation's basis. However, a special rule applies to corporate gifts of scientific inventory property used for research if the following requirements are met:

(1) The property contributed must have been constructed by the corporation;
(2) The gift must be made within two years of completion of the property;
(3) Stanford must be the original user of the property;
(4) The property must be scientific equipment or apparatus used for research, experimentation, or research training in the United States in the physical or biological sciences;
(5) Stanford must not exchange the property for money, other property or services; and
(6) Stanford must furnish to the corporation a written statement that the University will hold and use the property in accordance with requirements 4 and 5 above.

The allowable deduction for gifts of such property is the sum of the corporation's tax basis plus one-half of the unrealized appreciation, provided that the deduction may not exceed twice the tax basis. The same deduction amount is also allowed for corporate inventory gifts used for the care of children, the ill, or the needy.

[22]With the exception of certain appreciated personal property (see p. 10), the value of which must be reduced by 61 percent of the inherent gain.

FOUNDATIONS

Stanford qualifies as a foundation distributee for all purposes, including distributions required from private foundations. Several foundations have chosen Stanford as a donee to which foundation assets are distributed in accordance with the special rules on tax-free termination of private foundation status.

BEQUESTS

Bequests to Stanford University, whatever the amount, are entirely free from federal estate tax and California inheritance tax. The tax savings are substantial; in a large estate these savings may be more than half the value of the bequest to Stanford. In California, as in some other states, there is no restriction on the amount that may be given to Stanford by Will.

Use of the Bequest

The bequest to Stanford may be unrestricted or the testator may designate the University purpose for which it is to be used. If a specific use is designated, inclusion of the following language will make certain that the bequest will always remain useful:

> If, in the judgment of the Board of Trustees, changed circumstances should at some future time render the designated use of this Fund no longer appropriate, then the Board shall use the Fund to further the objects and purposes of Stanford University, giving consideration to my special interest as evidenced by the purpose described above.

Bequests may be used to establish an endowed fund in the testator's name or in memory of a person or persons he wishes to honor. Endowed funds provide continuing support for a variety of needs including library book funds, scholarships, and endowed professorships. The amounts required to provide such permanent support may vary from $10,000—the minimum required for a named endowed book fund—to $1,000,000 or more to endow a professorship.

Bequests may also be designated for purposes other than endowment — for example, for the construction or reconstruction of buildings, for spendable funds for research projects, or for unrestricted use.

Bequests reserving life income to survivors

A testamentary unitrust, annuity trust or pooled income fund bequest has special appeal for the philanthropically minded donor who is unable or disinclined to create such trusts during his lifetime and who cannot make a sizable outright testamentary gift to charity because he wishes to provide for one or more family members. Such bequests allow a donor to make a deferred gift to Stanford while ensuring that his survivor receives periodic payments for life. The bequest may also result in valuable tax and other estate planning benefits.

See pages 11-12 for a discussion of life income gifts. If a donor is considering this kind of bequest, the terms should be discussed with the University.

Bequests of income (charitable lead trusts)

Just as donors can make charitable remainder trust gifts either during lifetime or by bequest, so also a donor can make either lifetime or testamentary gifts of charitable income interests. See page 13 for a discussion of charitable lead trusts in general, and page 15 for testamentary charitable lead trusts specifically.

TECHNICAL NOTE

Provisions of law that involve detailed examination of the taxpayer's situation are beyond the scope of this book and are omitted from the main text. The reader should be aware, however, that some of these omitted provisions—such as the minimum and alternative minimum taxes and state tax laws on charitable deductions—may affect the net tax savings available to particular donors. Lawyer members of the General Secretary's staff welcome inquiries from R-Planners about these or other questions concerning the tax consequences of gifts or bequests to Stanford. Telephone (415) 497-1357 or write:

Office of the General Secretary
301 Encina Hall
Stanford, California 94305

The following discussion of some of the tax law provisions omitted in the text is not intended to be comprehensive but rather to alert the reader to their potential implications for charitable giving.

Add-on minimum tax

The law imposes an add-on minimum tax on certain tax preferences that must be added to a taxpayer's regular income tax to determine his total tax. The add-on tax is 15 percent of the total amount of tax preferences in excess of the greater of $10,000 or one-half of the regular taxes paid.

The 1978 Tax Act removed the capital gain deduction and the excess itemized deductions from the tax preference items subject to the add-on minimum tax. Tax preference items remaining subject to the add-on tax include:

accelerated depreciation in excess of straight-line depreciation on real property and leased personal property;

excess amortization of certified pollution control facilities, railroad rolling stock and child care facilities;

qualified stock options (excess of fair market value, at time of exercise, over the option price);

percentage depletion in excess of adjusted basis of property;

intangible drilling costs in excess of net income from oil and gas properties.

The add-on minimum tax has no direct application to charitable giving. However, if a particular donor has substantial tax preference deductions, a charitable gift may not lower his total tax obligation to the extent otherwise obtainable.

Alternative minimum tax

The 1978 Tax Act imposed a new penalty tax, the alternative minimum tax, singling out two items of tax preference—the capital gain deduction and excess itemized deductions. The alternative minimum tax is computed under special rules, and is payable only if it exceeds the total of the taxpayer's regular income tax and the 15 percent add-on minimum tax; it then becomes the individual's tax liability in place of the regular and add-on taxes.

An occasional donor can be significantly affected by the alternative minimum tax if he makes substantial charitable gifts, realizes large capital gains and has itemized deductions that offset a major part of his adjusted gross income. Counsel for such donors should examine their clients' specific tax situation with care to determine the ultimate tax results of contemplated contributions.

State income tax charitable deduction

State income taxes have become increasingly significant in recent years. For example, in California, at present, a taxable income of $40,950 or more reported on a joint return places the taxpayer in the 11 percent state income tax bracket.

Since most states permit an income tax deduction for charitable contributions,[23] there is usually a net increase in income tax savings attributable to charitable giving because the charitable deduction lowers the state income tax. The donor's federal income tax deduction for state income tax paid is thus reduced, but that reduction is more than offset by the state income tax saving.

[23]California allows charitable deductions generally up to a limit of 20 percent of adjusted gross income, with a five-year carryover permitted.

Gifts That Pay You Now and Stanford Later

Medicine At Stanford

On September 17, 1959, the Stanford University Medical Center was dedicated to use, an act that physically and philosophically linked the School of Medicine—founded one hundred years before as Cooper Medical College in San Francisco—to the main campus of Stanford University.

The Medical Center, like the University itself, is a monument to those who have supported it by gifts. Its future—and that of its individual components, the School, the Clinics, the Hospital—depends upon the philanthropy of a widening body of friends who support its broad missions: patient care, medical education, and biomedical research.

Every year, hundreds of medical alumni, former patients, patients' families, and friends send annual gifts to the Center. Others make occasional or one-time gifts. Many, who are beginning to plan their estates, have inquired about the benefits of deferred gifts. This booklet discusses life income trusts, one form of deferred giving.

The Rewards of Giving to Stanford

Donors to medicine at Stanford have the satisfaction of knowing that they are supporting the best in higher education and advanced biomedical research. Many forms of gifts provide such satisfaction; one form—a life income trust gift—offers the donor additional attractions.*

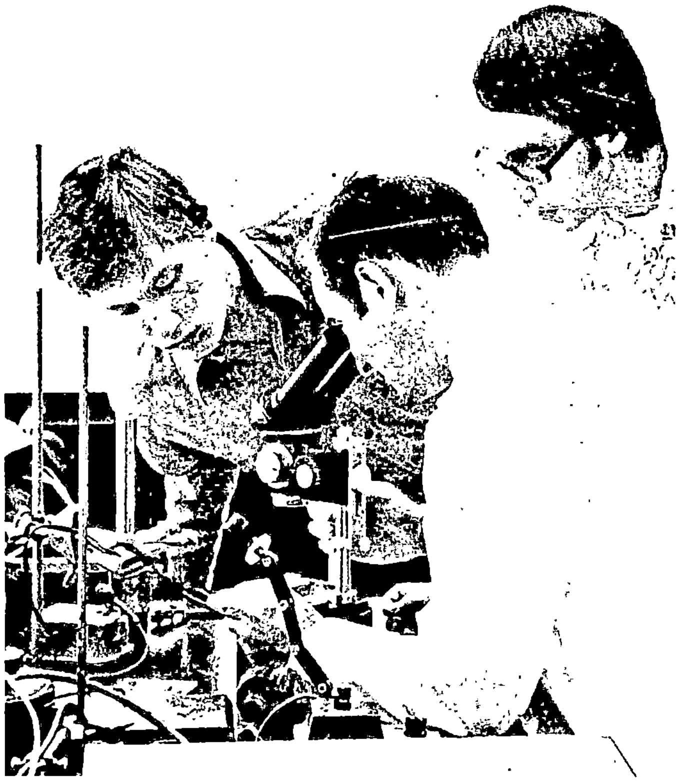
A Stanford life income trust pays you, your beneficiary, or both, an income for life—in some cases a larger income than the gift property is earning for you now.

It offers significant tax advantages in the form of an immediate charitable deduction, in some cases a capital gains tax saving, and an eventual estate tax saving.*

It relieves you of the burdens of asset management.

And it enables you to support—in a major way—a Stanford program in which you are especially interested.

*For federal income tax purposes, the annual charitable deduction for a donor's total combined gifts of appreciated securities or other long term capital gains property to public charities is usually limited to 30 percent of the donor's adjusted gross income. However, any excess deduction that the donor cannot use in the year he makes his gift may be carried forward and deducted in the five succeeding tax years (using up the excess deduction as fast as possible). Throughout this discussion, including the examples, it is assumed that the donor's total gifts of appreciated property to public charities does not exceed the allowable 30 percent of adjusted gross income ceiling.



Endowing a professorship through a life income gift to Stanford underwrites the work of generations of distinguished scholars and scientists.

Alice Pemberton, of Palo Alto, has established a life-income fund, which will eventually support the Division of Ophthalmology. At present, the fund provides her with Stanford-managed income.

Establishing a Life Income Trust

You may make a life income gift to Stanford by irrevocably transferring securities, money, or other property to the University, a bank, or other institution as trustee.

The trustee manages the investment of the trust assets and pays an income for life to you, your designated beneficiaries, or both.

Thereafter, the trust principal goes to Stanford to support the educational or research program of your choosing—in your name or in the name of someone you wish to honor.

There are four principal types of life income gifts, giving you a range of choices in your investment and estate planning. One of them may be ideally suited to your particular circumstances. The four are described briefly in the next few pages.

Unrestricted gifts are the most valuable of all, enabling Stanford Medical Center to cope flexibly and imaginatively with the changes that are certain to come in so rapidly changing a field as medicine.

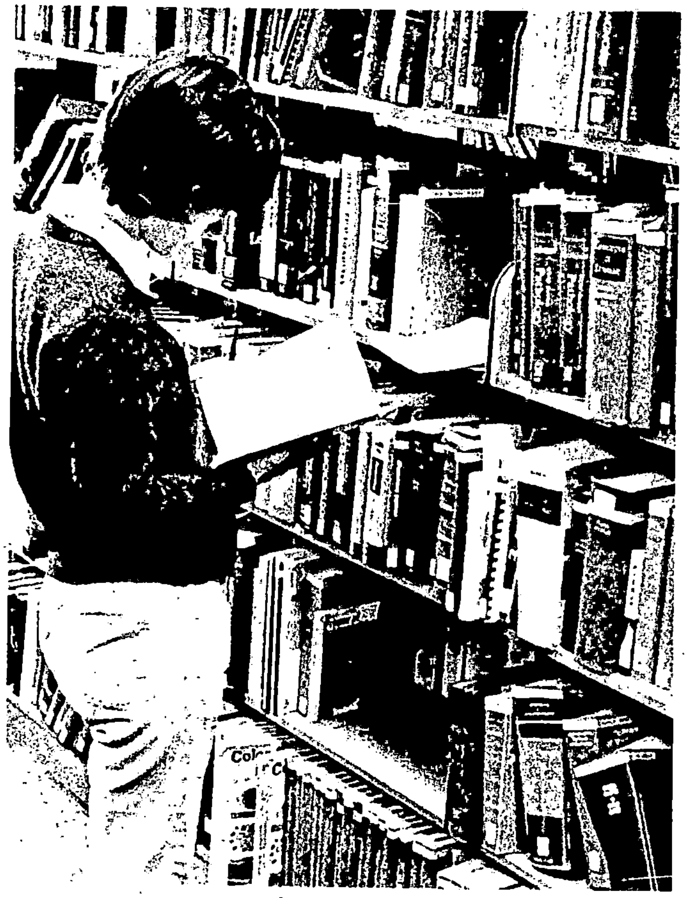
The Pooled Income Fund

If you want the greater investment diversification safety offered by a large asset pool, a transfer of cash or securities to Stanford's Pooled Income Fund may be the best plan. The fund consists entirely of life income gifts invested together in common and preferred stocks, corporate bonds, and a small share of the Stanford Shopping Center, providing a more diversified base than would be possible with a modest individual investment.

The entire net income of the fund is paid out to beneficiaries. Payments are based on the gift's proportionate share of the total value of the Pooled Income Fund.

EXAMPLE:
Mr. Andrews, age 65, and in the 60 percent federal income tax bracket, has stocks worth $50,000, which he bought for $5,000 and which pay a dividend of 4 percent per year. He would like to sell the stocks and diversify his investment base but hesitates because of the capital gains tax of $10,800 that would be payable.

Suppose that Stanford's Pooled Income Fund earns 8.8 percent (the actual annual return varies; the current rate will be furnished upon request). By transferring the stocks to Stanford's Pool, Mr. Andrews increases his annual earnings by almost 5 percent and gains his objective of a wider investment base. In addition, he receives a charitable contribution deduction of $20,405 and saves $10,800 in capital gains tax. Thus his net cost of establishing a $50,000 life income trust, as compared to selling the stock and reinvesting the net proceeds, is only $26,957.



Each medical scholarship established by a life income gift to Stanford, carries in perpetuity, the donor's name or that of another person the donor wishes to honor; and widens educational and career opportunities for student after student.

The Annuity Trust

If you want a fixed return, a Stanford Annuity Trust is a means of providing you an income for life and then supporting the Stanford educational program of your choice.

In an annuity trust, the dollar income that will be paid is specified when the trust is established. It can be any amount mutually agreeable to you and Stanford, but must be at least 5 percent of the initial net fair market value of the property transferred to the trust. Payments of the stated amount are made each year regardless of the income earned by the trust and are backed by the total amount of the assets in your trust.

EXAMPLE:
Mr. Jones, age 70, owns securities worth $100,000, which he bought several years ago for $10,000 and which pay a total cash dividend of $2,000. He would like a greater current return but has hesitated to sell because of the large capital gains tax that would be due.

By transferring his shares to a Stanford Annuity Trust at 6 percent, he increases his current income to $6,000 and avoids capital gains tax, even if Stanford should subsequently sell the securities. In addition, he receives a charitable contribution deduction of $57,789, which will result in substantial current income tax savings.

The Income Unitrust

If you want more flexibility, a Stanford Income Unitrust provides for payments of either a fixed percentage of the fund's annual value (at least 5 percent) or the net income of the trust, whichever is less.

If the income is lower than the percentage for one or more years and is higher in a later year, the excess income will be paid to the beneficiaries up to the amount of past deficiencies.

The advantage of the income unitrust is that it enables the trustee, within the limits allowed by tax and trust law, to change the investment policy of the trust to meet your specific needs. It is particularly suited to the younger donor who does not need large income payments now, but who wants a means of building a fund for retirement income. It is also suited to gifts of nonincome-producing property (unimproved real estate, for example), which is not expected to be sold for some time, perhaps a year or more after the gift. The Income Unitrust avoids the necessity of distributing principal while the property is held and builds up income credits for the future.

EXAMPLE:
Mr. and Mrs. George, both age 50, are in a 60 percent federal income tax bracket. They own a stock worth $100,000, which they would like to sell, but to do so would incur capital gains tax of $21,600 on their $10,000 cost basis. They want to make a gift to Stanford to further its educational programs, and they are more interested in building a fund for retirement income than in additional current income.

They transfer the stock to a 5 percent Stanford Income Unitrust. Their charitable contribution deduction of $21,519 gives them an immediate tax saving of $12,911, and they avoid the $21,600 capital gains tax. Their net cost of establishing the $100,000 trust is only $65,489.

Until they are age 65, the trust assets can be invested for capital growth rather than current income. After they attain age 65, the trust can be invested to provide greater current income. Thereafter, Mr. and Mrs. George will not only receive 5 percent of the trust assets' market value; if trust income exceeds 5 percent, they will also receive payments from the income credits that have accumulated over the years.

The Percentage Unitrust

If you want an income not fixed to a specific dollar amount at the time it is given, nor limited to the income of the trust property, a percentage unitrust provides an opportunity (but no guarantee) for income growth as the trust assets appreciate. Generally, cash or marketable securities must be used to fund a percentage unitrust.

Payments are expressed as a percentage of the trust's annual net fair market value, and they change each year as the trust assets increase or decrease. This type of gift will be of particular interest if you are concerned about the effect of future inflation on a fixed dollar income.

When the trust is created, you make an agreement with Stanford as to the percentage that will be paid out each year. It must be at least 5 percent. If trust income exceeds the required payment, the excess is added to the principal. If required payments exceed income, a portion of the principal will be distributed.

EXAMPLE:
Mr. Smith, age 65, is in the 70 percent federal income tax bracket. He owns stock with a current market value of $100,000, which he bought some years ago for $10,000. Mr. Smith would like to sell the stock, but if he does, he will have to pay capital gains tax of $25,200.

By transferring the stock to a 6 percent Stanford Unitrust, he is assured of an income of 6 percent of the annual value of the trust assets for life. In addition, he receives a charitable contribution deduction of $50,015, which saves him $35,010 of income tax and avoids the capital gains tax. Thus his net cost of establishing the stock and reinvesting the net proceeds is only $39,790.

Is a Stanford Life Income Gift Right for You?

This brochure outlines some of the tax advantages and other financial benefits that you and your family might receive from a life income gift to the Stanford Medical Center.

If you would like additional information about Stanford life income trusts, so that you and your tax adviser can determine whether such a gift would be a wise move in your particular circumstances, please write or call:

Office of the Vice-President for
Medical Affairs
Room M–121
Stanford University Medical Center
Stanford, California 94305

(415) 497–6158

MINIMIZING THE ESTATE TAX
THROUGH THE CHARITABLE DEDUCTION

A. Outright Charitable Gifts

Internal Revenue Code (hereafter "IRC") Section 2055(a) allows a deduction from the value of the gross estate the amount of all property passing for religious, charitable, scientific, literary or educational purposes. IRC Section 2055(d) provides the only limitation: that the amount of the deduction shall not exceed the value of the decedent's gross estate.

For the super wealthy, those taxpayers in the 70% estate tax bracket, the amount of an outright charitable bequest reduces the taxable estate, saving $.70 in tax for each $1 gifted to charity. The family estate, however, is reduced by the $1 bequest.

As an alternative to the outright bequest, the testator may consider gifts to a private foundation or to split-interest trusts.

B. Private Charitable Foundations

One alternative to outright charitable bequests is a gift to a family private charitable foundation created by the family during the testator's life.

The "private foundation" is an organization exempt from taxation under IRC Section 501(c)(3). It includes by definition all organizations other than public charities, publically-supported organizations, satellite or supporting organizations for such public charities and organizations engaged in testing for public safety (Underwriters Laboratories). The primary differences between the private foundation and public charity are the limitations on the deductibility of the contributions and the penalty taxes applicable to all private foundations.

With respect to the limits on deductibility of contributions to private foundations, individual donors may deduct contributions only to the extent of 20% of their contribution base (IRC Section 170 (b)(1)(B)). This is the lowest limitation applicable to any charitable contribution. Furthermore, excess contributions over and above the 20% limitation do not carry over to subsequent taxable years; they are wasted and produce no tax benefit (IRC Section 170 (d)(1)). Also, wastage of contributions can occur even where the contribution to the private foundation does not exceed the 20% limit where there is a carry-over of a 30% or 50% contribution from prior years (IRC Section 170(b)(1)(B)). Contributions of appreciated property are reduced by 40% of the appreciation, regardless of the use made of the property by the foundation (IRC Section 170(e)(1)). The above rules are in sharp contrast to the rules covering outright contributions to public charities which allow for a 50% deduction (30% in the case of appreciated property).

The penalty taxes are applicable to all private foundations. These taxes are as follows:

1. 2% tax on net investment income (IRC §4940);

2. Tax on acts of self-dealing (IRC §4941);

3. Tax on failure to distribute all net income (or, if greater, 5% of investment assets) (IRC §4942);

4. Tax on excess business holdings (IRC §4943);

5. Tax on investments which jeopardize the foundation's charitable purpose (IRC §4944); and

6. Tax on taxable expenditures (IRC §4945):

   a. Grants for lobbying and propagandizing;

   b. Grants to influence elections or to conduct voter-education campaigns;

   c. Certain grants to individuals;

   d. Grants to organizations, unless the granting foundation exercises expenditure responsibility (i.e., monitors the grantee's use of the grant funds); and

   e. Grants for non-charitable purposes.

Once classified as a private foundation, an organization cannot directly abandon its status as such without incurring severe tax, amounting to the lesser of its net assets or all tax benefits accruing to all parties as a result of the foundation's exemption since inception.

Extra reporting requirements are imposed on private foundations: the foundation must file both an annual return (Form 990-PF) and a separate annual report (Form 990-AR). The annual report also must be filed with the appropriate state offices and be made available to the general public at the foundation's principal office. The availability of the report must be advertised in a "newspaper having general circulation," and a $10 per day penalty is imposed for failure to file.

Although the private foundation limits the amount of annual contributions, it does provide a vehicle whereby the wealthy individual may insulate the family from the direct demand of charities. In other words, the foundation would act as a buffer between the family and the charities.

A "stand-by foundation" can be established during an individual's life. Though formed and in active operation during the individual's life, it would be intended primarily as a testamentary beneficiary of the estate. This is not really a separate type of foundation, but merely represents one common use of a foundation.

The foundation's organizational details, tax exemption, staffing and related matters can be resolved to the individual's satisfaction during the individual's lifetime. Furthermore, agreements and arrangements with grantees can be negotiated by the individual or with the individual's knowledge and assistance.

Under IRS rulings, property transferred to a foundation which is controlled by the donor until the donor's death is includible in the donor's gross estate under IRS Section 2036(a)(2) on the theory that the donor has retained the right to designate the persons who shall possess or enjoy the property or the income therefrom. However, the amounts included in the donor's gross estate under the principle described above are deductible under Section 2055 as a charitable transfer.

Where charitable transfers are brought back into the estate, as in the case of gifts in contemplation of death under IRC Section 2035 or because of the retention of income interest or right to designate the persons who are to possess or enjoy the income under IRC Section 2036, the courts and the Internal Revenue Service have held that since such transfers are to be includible in the decedent's gross estate, the marital deduction may be computed on the basis of the increased gross estate.

Russell v. Comm., 70 T.C. 40 (1978); Treas. Rpt. on Private Foundations, 2/2/65, page 63. In planning the charitable transfer, you may want to consider intentionally violating one of the statutory provisions in order to increase the base for determination of the marital deduction. In most instances, however, this technique at best would result in tax deferral rather than tax savings.

C. Charitable Remainder Trusts

IRC Section 2055(e)(2)(A) allows an estate tax charitable deduction for property left to a charitable remainder trust which meets the requirements of IRC Section 664. There are two types of charitable remainder trusts: the unitrust and the annuity trust.

The amount of the charitable deduction is determined by subtracting, from the value of the property passing to the trust, the present value of the non-charitable interest. The present value of the non-charitable interest is determined under the tables contained in Treas. Regs. §20.2031-10(f), which are based on 6% discount factors and 6% rates of return.

1. Unitrust

There are three types of unitrusts authorized (Regs. §1.664-3):

a. The most common type specifies that the beneficiary's payments are determined by multiplying a fixed percentage (not less than 5%) by the net fair market value of the trust revalued each year. The percentage is fixed at creation and remains constant. The life beneficiary receives the unitrust amount each year, regardless of trust income.

b. Net income with makeup is a variation of the common type; however, the trustee pays the beneficiary only the trust income if the actual income is less than the unitrust amount. Deficiencies are made up in later years if trust income in later years exceeds the unitrust amount (IRC Section 664(d)(3)).

c. The last type is that of the net income with no makeup, whereby the trustee pays only the trust income if it is less than the unitrust amount. Deficiencies are never made up, and the excess income is added to the trust corpus.

2. <u>Annuity Trust</u>

An alternative to the charitable remainder unitrust is the charitable remainder annuity trust which provides for the payments of a fixed dollar amount (at least 5% of the initial net fair market value of the trust), the "annuity amount", to the designated beneficiary each year for the trust term or life of the beneficiary (Treas. Regs. §1.664-2). Any income earned by the annuity trust and not paid in satisfaction of the annuity amount is added to the trust principal and re-invested. If trust income is insufficient to pay the annuity amount, principal is used to pay any deficit.

The requirements for charitable remainder unitrusts and charitable remainder annuity trusts are set forth in Treas. Regs. §1.664-1 through §1.664-3. The requirements are quite complex. The Service has published prototype mandatory and optional clauses for inclusion in charitable remainder trusts in Revenue Ruling 72-395, 1972-2 Cum. Bull, 340.

The Service has ruled in a private letter ruling that a trust will not qualify as a charitable remainder unitrust under IRC Section 664(d)(2), and consequently no Federal estate tax deduction under IRC Section 2055 will be allowed, where the trust contains a "no contest" or "in terrorem" provision (Pvt. Ltr. Rul. 7942073). The position of the Service is that a contest could obviate the term in which unitrust amounts are to be paid. Treas. Regs. §1.664-3(a)(5) requires that the unitrust amount is to be paid either for the life or lives of a named individual or individuals or for a term not to exceed 20 years. The ruling is questionable, but nevertheless should be considered at the drafting stage.

A charitable remainder trust is not subject to income tax, except on its unrelated business taxable income under IRC Section 512. Distributions to the noncharitable beneficiary are taxable, first as ordinary income to the extent of the current and accumulated ordinary income of the trust; next as capital gain to the extent of the current and accumulated capital gain of the the trust; next as other income to the extent of other income of the trust; and finally as a distribution of trust corpus. (IRC Section 664(b)).

Although the charitable remainder trust generates an estate tax deduction to the extent of the value of the charitable remainder interest, there are two serious drawbacks with such trusts:

a. The property ultimately passes to charity and thus escapes the family fortune, as does the outright bequest; and

b. The actuarial tables promulgated by the Treasury for the valuation of an annuity, life estate and remainder interests for decedents dying after December 31, 1970, increased the assumed rate of return from 3-1/2% to 6% a year, compounded annually, thereby increasing the value of a term or life interest and decreasing the value of the remainder (Regs. §20.2031-10; §25.2512-9).

D. Charitable Lead Annuity Trusts

1. Introduction

Three alternatives to the confiscatory estate tax levied on the estates of the super wealthy have been discussed: (1) outright charitable gifts; (2) private charitable foundations; and (3) charitable remainder trusts. All of these techniques have one thing in common -- permanent loss of wealth to the family. There is a fourth route which offers as much, if not more, in tax savings and provides more assets for successor lower generations of the family. The technique or device is the "charitable front-end annuity trust" or "charitable lead annuity trust."

The concept is just the opposite of the remainder trust: property is held in trust to pay a fixed sum annually to charity for a period of time, and at the end of the term full ownership of the property and all accumulated income pass to noncharitable beneficiaries, i.e., the next generations of the family. If the trust produces income at least equal to the charitable annuity, the principal remains intact, possibly even appreciates; thus, in after-tax dollars, by foregoing the use and benefit of 30%* of the income generated by the property, the family wealth remains intact.

2. Gift or Estate Tax Deduction

When the property is placed in trust, whether by a gift or bequest, the creator of the trust receives a charitable deduction for the actuarial value of the annuity interest determined under the IRS tables (IRC Section 2522(c)(2)(B); IRC Section 2055(e)(2)(B); Regs. §25.2512-9; §20.2031-10).

For example, if $10 million is placed in trust to pay $600,000 per year (6% of initial value) to charity for twenty-four years, the charitable deduction is $7,530,240, or roughly three-quarters of the gift or estate tax liability on the trust property. A lead trust providing for payment of income to a charitable organization for 15 years, with remainder passing to lower family generations, results in a charitable deduction of over 58% of the original value of the trust at a 6% annuity rate. As a further example, payments to a charitable organization for a period of 24 years at an annuity rate of 8% would result in a taxable deduction to the extent of 100%

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* It is assumed that if the income produced by the property were taxed to the family, it would be taxed at the maximum 70% federal rate.

of the original value of the trust. The charitable deduction is simply a function of the percentage of the trust property payable annually to charity and the term over which it is paid (see Exhibit A for further examples). The amount of the charitable deduction cannot exceed the value of the property placed in trust (Treas. Reg. §20.2055-2(f)(2), Ex. (1)).

Returning to the example of the $10 million trust which pays an 8% annuity over 24 years, by establishing the trust, there is a savings of approximately $5 million in estate taxes. Over the 24-year period, the charity actually will receive $19,200,000 (24 X $800,000).

The beneficiaries in turn have foregone 30% of the net income which the trust principal, less the estate or gift taxes, would have generated, to receive the entire principal (plus appreciation and accumulated income) at the end of the 24-year period.

Viewing the estate or gift tax savings alone perhaps exaggerates or distorts the benefits of the lead trust. Assume we have a gross estate of $10 million and $5 million is to be set aside in a charitable lead trust. The trust term is for 16 years at an annuity rate of 10%, resulting in a 100% federal estate tax deduction. The savings in estate tax would be approximately $3.5 million (.70 X 5). If, rather than creating the lead trust, the lower generation beneficiaries were to receive the $1.5 million ($5 million less $3.5 million in taxes) and invest that sum at 6% compounded annually, net of income tax, after 16 years the beneficiaries would have $3.8 million. In some instances the lower generation beneficiaries may be better off it they pay the tax and invest their net inheritance. Of course, appreciation and accumulations of excess income in the lead trust also would be a factor. Using the above example, the real difference appears to be whether $3.5 million goes to federal estate or gift taxes, or $8 million goes to charity over the 16-year period.

3. Inter Vivos Lead Trusts

As in the case of a testamentary disposition, the principal objective is to reduce the amount of tax on the transfer ultimately for the benefit of noncharitable remaindermen.

a. Income Tax Deduction

Generally, there is no income tax deduction. IRC Section 170 (f)(2)(B) allows an immediate income tax deduction only if the donor is treated as the owner of the income interest under the grantor trust rules of IRC

Sections 671-679 for the entire trust term, thereby including the trust income in the donor's own return each and every year of the trust.

(i) This route is valuable to a wealthy individual who needs a substantial deduction in one year.

(ii) There would be no further charitable deduction as the income is earned and distributed to charity (IRC Section 170(f)(2)(B)).

(iii) The IRC Section 170 deduction upon creation is limited to 20% of the adjusted gross income: deemed to be "for use of charity" under 170(b)(1)(B).

(iv) The deduction is based on the commuted value of future payments; whereas income earned by the trust must be reported by the Grantor at current value.

b. <u>Non-Grantor Inter Vivos Trusts</u>

Generally, the grantor will forgo the income tax deduction and create a non-grantor trust: the grantor then parts with control over the property for at least 10 years, and the trust income will be removed from the grantor's taxable income.

c. Private Rulings

Rev. Procs. 72-1 and 72-3, 1972-1 CB 693 and 698 afford the donor the opportunity to obtain a private ruling in advance as to valuation of income interest and deductibility for income and gift tax purposes.

4. Income Taxation of Charitable Lead Trusts

A charitable lead trust is subject to the ordinary rules of taxation that apply to complex trusts under Subchapter J of the Code (see IRC Sections 661,662) unless it qualifies as a grantor trust, in which case the income is taxable to the grantor. By comparison, the charitable remainder unitrust or annuity trust is exempt from income tax unless it has unrelated business income (IRC Section 664(c)).

a. Charitable Deduction to the Trust

The Internal Revenue Code, however, does provide for a deduction for amounts paid or permanently set aside for a charitable purpose. Any amounts not so paid or set aside would be subject to tax.

There is no limit to the lead trust's charitable deduction. Section 642(c) clearly provides that the deduction is unlimited:

"(c) DEDUCTION FOR AMOUNTS PAID OR PERMANENTLY SET ASIDE FOR A CHARITABLE PURPOSE.--

> (1) GENERAL RULE. --In the case of an estate or trust (other than a trust meeting the specifications of subpart B), there shall be allowed as a deduction in computing its taxable income (in lieu of the deduction allowed by Section 170(a), relating to deduction for charitable, etc., contributions and gifts) any amount of gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in Section 170(c) (determined without regard to Section 170(c) (2)(A))....."

b. Alternative Minimum Tax

There is some question as to the applicability of the newly enacted alternative minimum tax where income in excess of the annuity amount is accumulated and added to principal. The Revenue Act of 1978 amended the provisions of the minimum tax to provide for an alternative minimum tax applicable to taxpayers other than corporations. After 1978, the 15% add-on tax is no longer applicable to the capital gains or the excess itemized deductions preference items. Instead, the two items become part of the new alternative minimum tax which became effective in 1979.

Under Section 57(b)(2)(A)(i), however, in the case of a trust or estate, adjusted itemized deductions do not include "the deductions allowable in arriving at adjusted gross income." Section 57(b)(2)(B)(ii) in turn provides that "to the extent provided in subparagraph (C), the deductions under Section 642(c) shall be treated as allowable in arriving at adjusted gross income. Subparagraph (C), enumerating the Section 642(c) deductions which are treated as deductions allowable in arriving at adjusted gross income, includes the following deduction:

> "(v) deductions allowable to a trust, all of the income interest of which is devoted solely to one or more of the purposes described in Section 170(c)(2)(B), which are attributable to transfers pursuant to a will or pursuant to an inter vivos trust in which the grantor had the power to revoke at the date of his death."

Item (v) quoted above would appear to exempt 642(c) deductions of a testamentary charitable lead trust from the application of the minimum tax by treating the deduction as being allowable in arriving at adjusted gross income; however, the phrase in Item (v), "...income interest of which is devoted solely to one or more of the purposes..." raises some doubt in the situation where excess income is added to principal for the benefit of the noncharitable remaindermen. Clearly, if the instrument provides that all income, including income in excess of the annuity or unitrust amount, is to be paid to the charitable organization, there would be no question regarding the exemption from the alternative minimum tax.

Item (v) was not part of the original Technical Corrections Bill reported out of the Senate Finance Committee April 19, 1978. Under that Bill, only transfers made prior to December 31, 1976, would have been exempted from the old minimum tax. Item (v) first appeared in the Conference Report (October 15, 1978) to the Revenue Act of 1978 with only the following joint explanation:

> "Charitable distributions by certain testamentary trusts would not be treated as an itemized deduction for purposes of the minimum tax preference for excess itemized deductions." P-H Federal Taxes, Revenue Act of 1978 Conference Report, p. 283

The "Blue Book" prepared by the staff of the Joint Committee on Taxation would seem to indicate that income of the testamentary charitable lead trust is to be exempted from the minimum tax:

> "The Act clarifies in several respects the treatment of trusts and estates under the minimum tax in the case of the preference for adjusted itemized deductions. ... Third, the Act provides that the deduction for administration expenses and, in the case of estates, wholly charitable trusts, testamentary charitable lead trusts, transfers in trust before

January 1, 1977,[1] and pooled income funds, the deductions for charitable contributions are treated as deductions in determining adjusted gross income. For this purpose, a transfer to a trust after January 1, 1977 from an estate of a decedent dying before that date shall be treated as a transfer in trust before Janaury 1, 1977. [Emphasis supplied]

There is no other legislative history on the provision, nor have any of the commentators spotted the issue. The most probable explanation is that in using the phrase "all of the income interest of which is devoted solely to one or more of the..." charitable purposes, Congress simply intended to comply with the overriding requirement that any amounts of income not paid to the charity cannot be paid to noncharitable remaindermen during the term of the trust. This requirement is found in Regulation §20.2055-2(e)(2)(v)(f):

> "(f) Where a charitable interest in the form of a guaranteed annuity interest is in trust, the charitable interest will not be considered a guaranteed annuity interest if any amount other than an amount in payment of a guaranteed annuity interest may be paid by the trust for a private purpose before the expiration of all the income interests for a charitable purpose..."

1/ Charitable remainder trusts (sec. 664) created after the Tax Reform Act of 1969 are generally exempt from both the income tax and the minimum tax and, consequently, no exception is necessary for these trusts."

Under this interpretation of Item (v), all of the income interest of a charitable lead trust would be deemed to be "devoted solely" to a Section 170(c) purpose so long as no amount (other than a guaranteed annuity) is paid for a private purpose before the expiration of the charitable income interest. In other words, accumulating the excess income above the annuity amount would not be considered a private purpose.

c. Transfer of Appreciated Property to an Inter Vivos Lead Trust

In considering the creation of an inter vivos lead trust, the donor must take into account the potential application of IRC Section 644 added by the 1976 Tax Reform Act. IRC Section 644 provides that if appreciated property is given to a trust and thereafter disposed of by the trust within two years of the transfer, any gain on the disposition (to the extent of the unrealized appreciation at the time of the gift to the trust) will be taxed to the trust at the donor's effective tax rate in that year. In other words, the tax is computed as if the donor disposed of the property, although the trust pays the tax. Property passing to a testamentary lead trust is specifically exempted from the application of IRC Section 644 by Section 644(e), as are charitable remainder trusts.

5. Private Foundations and Other Rules

Unlike the charitable remainder trusts, there is very little statutory guidance on the requirements for charitable lead trusts.

a. IRC Section 2055(e)(2) provides that the charity's interest must be in the form of a guaranteed annuity or a fixed percentage distributed yearly of the fair market value of the property (to be determined yearly). The trust, therefore, may be either a charitable lead annuity trust or a charitable lead unitrust. In an inflationary or unpredictable economy, an annuity trust better protects the donor's interest and objective of maximizing the value of the property passing to other generations.

b. Treas. Regs. §20.2055-2(e)(2)(v) contains further requirements for the annuity trust and §20.2055-2 (e)(2)(vi) provides further requirements for the unitrust.

c. Pursuant to IRC Section 4947(a)(2) a lead trust, referred to in that section as a "split-interest trust," is treated as a private foundation and subject to certain rules applicable to foundations. The following private foundations rules generally will be imposed upon such trusts:

(i) §4941 - prohibition on self-dealing;

(ii) §4943 - prohibition on excess business holdings;

(iii) §4944 - prohibition in investments jeopardizing charitable purposes;

(iv) §4945 - prohibition on taxable expenditures;

(v) §507 - termination of private foundation status; and

(vi) §508(e) - requirements of governing instruments.

d. The excess business holdings restriction under IRC Section 4943 prohibits a lead trust from holding more than 20% of the voting stock of a corporation or 20% of the profits interest in a partnerhip and prohibits the holding of a proprietorship. Furthermore, the 20% limitation is reduced by the percentage of voting stock or profits interest owned by disqualified persons. IRC Section 4943(d) defines a disqualified person to include the spouse, ancestors, lineal descendants and spouses of lineal descendants of the creator of the trust. The 5% excise tax on the business holdings is imposed unless the trust divests itself of the excess holdings generally within five years after the trust has received the asset.

If it will not be possible to divest the closely held business, IRC Section 4947(b)(3)(A) excepts from the business holdings prohibition a charitable lead trust where the value of the charitable interest is not more than 60% of the aggregate fair market value of the property placed in trust. Accordingly, the annuity rate and trust term may have to be adjusted to avail the trust of this exception.

e. In some instances Congress has enacted retroactive legislation in the estate tax and income tax areas. The most recent estate tax retroactive legislation was the generation-skipping tax enacted in October, 1976, applicable to instruments executed after June 11, 1976. Accordingly, testamentary trusts should be conditioned on obtaining the Federal estate tax charitable deduction. Further provisions should be drafted to allow the trustees to amend the trust to comply with new laws, as was allowed by the 1969 Tax Reform Act to comply with IRC Section 664. Trustees also should be granted the discretionary authority to distribute principal in commutation of future installments of annuity amounts, if necessary terminating the charitable interest, or to distribute excess income to the charitable beneficiaries in commutation of future annuity installments in inverse order commencing with the final installment. This procedure has been approved in private letter rulings; however, we have been informed that the Service is in the process of reconsidering the matter. Accordingly, the trustee should seek a private ruling prior to effecting the commutation.

If excess income is earned in the lead trust, it will be deemed after taxes to be an accumulation of income. This in turn will result in a subsequent throwback distribution to the ultimate remaindermen upon termination of the trust, even if subsequently used to satisfy income deficiencies in future years. Regs. §1.665(b)-1A(c)(2) deem such later payments not to be accumulations distributions. A specific provision directing the use of excess current income to prepay future annuity installments should avoid the throwback rules (IRC Section 642(c)).

f. In selecting a trustee, consideration must be given to the generation-skipping tax. A power held by a trustee, who is not an "independent" trustee, to allocate income among charitable beneficiaries will create a beneficial interest in the trustee, and upon termination of the power may precipitate generation-skipping tax. To avoid attracting tax, the trust may be drafted either to require mandatory payments to the selected charity or to require the appointment of an "independent" trustee as definded in IRC Section 2613(e)(2).

Payments may be made to a private foundation controlled by the family; under IRC Section 2611(c)(7) generation-skipping tax does not look through a charitable organization to determine the generation assignment of trust beneficiaries.

Federal Estate Tax Deductions

For Selected Annuity Rates and Terms

Annuity Rate	Annuity Term (Years)	Federal Estate Tax Deduction
6%	10	44%
	15	58%
	20	69%
	25	77%
	30	83%
7%	10	52%
	15	68%
	20	80%
	25	89%
	30	96%
8%	10	59%
	15	78%
	20	92%
	24	100%
9%	10	66%
	15	87%
	19	100%
10%	10	73%
	15	97%
	16	100%
12%	5	51%
	10	88%
	12	100%

EXHIBIT A