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DEDUCTION FOR A CHARITABLE REMAINDER

— by Neil E. Harl*

Before 1969, it was relatively simple to obtain a charitable income tax, gift tax or estate tax deduction for gifts of remainder interests to eligible charitable organizations following a life estate or term interest.[1] The rules were tightened up significantly in the Tax Reform Act of 1969.[2]

Current requirements in general

At the present, a charitable deduction is available for remainder interests following a life estate or other term interest held by a non-charitable beneficiary only if the arrangement qualifies as a charitable remainder annuity trust, unitrust or pooled income fund.[3] In general, the interest of the non-charitable beneficiary must be a five percent or greater interest.[4] With a charitable remainder annuity trust, the principal value of assets is determined initially and that value governs throughout the term of the arrangement.[5] For unitrusts, the principal value is redetermined each year so the annual payment varies throughout the term of the unitrust.[6]

Special rule for farms and personal residences

For a personal residence or a farm, a charitable income tax, gift tax or estate tax deduction is available following a life estate or term interest to a non-charitable beneficiary where the life estate or term interest is left without use of one of the special trusts.[7] Thus, a deduction for a charitable remainder may be claimed following a legal life estate.

For couples wishing to retain the use of a farm or personal residence until death of the survivor and then to pass the property to a favorite charity, this is a relatively simple arrangement.

For this purpose, a "farm" includes the improvements and is defined as "any land used by the decedent or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock."[8] A gift of a remainder interest in a farm leased to a tenant has qualified for the deduction.[9] For residences, the term is *personal* residences, not *principal* residences,[10] so a vacation home is eligible.

Points to watch

Leaving a qualified charity an interest in the *proceeds* of sale of a farm or personal residence may not qualify for the special exception, however.[11] In a 1993 private letter ruling, a remainder interest in farmland to be sold was not eligible for the charitable deduction.[12] In that ruling, the surviving spouse was entitled to the income from the proceeds of sale during administration of the estate.[13] If local law permits the charitable organization to take the property itself, the charitable deduction may be allowed.[14] A deduction has been allowed even though state law required divestiture of the farm within 10 years.[15] The Tax Court has allowed the deduction even in the face of a will provision to sell the property at the death of the life tenant.[16]

Ironically, placing the farm or personal residence in a trust with a remainder interest to a charity disqualifies the remainder for the charitable deduction unless the property is left in a charitable remainder annuity trust, unitrust or pooled income fund.[17]

Under a 1987 ruling, a charitable deduction is allowable where a charity is given an undivided portion of a remainder interest.[18] This reversed the prior IRS position.[19]

Defective split interest arrangements can be reformed if specified conditions are met.[20]

Depreciation adjustment

If a remainder interest in a farm or personal residence is transferred during life to a qualified charity, the amount of the allowable federal *income tax* deduction must be adjusted to take into account straight line depreciation or depletion.[21] Thus, an adjustment must be made for all depreciable improvements at straight line depreciation rates if a charitable income tax deduction is to be claimed.

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FOOTNOTES

1 See generally 5 Harl, *Agricultural Law* § 44.04[3] (1994), Harl, *Agricultural Law Manual* § 5.04[4][a] (1994).

2 Pub. L. 91-172, Sec. 201, 83 Stat. 549-565 (1969).

3 I.R.C. § 2055(e)(2). See Estate of Hoskins v. Comm’r, 71 T.C. 379 (1978); Estate of Brock v. Comm’r, 71 T.C. 901 (1979); Estate of Hall v. Comm’r, 93 T.C. 745 (1989) (attempted reformation not successful).

4 I.R.C. § 664(d).

5 I.R.C. § 664(d)(1).

6 I.R.C. § 664(d)(2).

7 I.R.C. § 170(f)(3)(B). See Estate of Proctor v. Comm’r, T.C. Memo. 1994-208 (charitable deduction allowed for value of ranch left to charitable organization less value

of lifetime lease at fair rental value to employee); Ltr. Rul. 8812003, Dec. 17, 1987 (charitable deduction allowed for transfer of farmland and equipment subject to leases with option to purchase where rent was adequate consideration for use of farmland and equipment).

8 Treas. Reg. § 20.2055-2(e)(2)(iii).

9 Rev. Rul. 78-303, 1978-2 C.B. 122.

10 Treas. Reg. § 20.2055-2(e)(2)(ii).

11 Rev. Rul. 77-169, 1977-1 C.B. 286.

12 Ltr. Rul. 9347002, July 29, 1993.

13 *Id*.

14 Rev. Rul. 83-158, 1983-2 C.B. 159; Ltr. Rul. 8141037, July 9, 1981.

15 Rev. Rul. 84-97, 1984-2 C.B. 196.

16 Estate of Blackford v. Comm'r, 77 T.C. 1246 (1981), *acq*., 1983-2 C.B. 1.

17 Rev. Rul. 76-357, 1976-2 C.B. 285.

18 Rev. Rul. 87-37, 1987-1 C.B. 295 (charity given undivided interest in personal residence donated to charity as tenant in common with non charitable donee).

19 See, e.g., Rev. Rul. 76-544, 1976-2 C.B. 288, *revoked by* Rev. Rul. 87-37 (remainder interest held by charity and individual as equal tenants in common).

20 I.R.C. § 2055(e)(3).

21 See Treas. Reg. § 1.170A-12.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

AVOIDABLE TRANSFERS. Prior to filing bankruptcy, the debtors fraudulently transferred their farm homestead to third parties. One of the debtors' creditors filed suit in state court and received a judgment of fraudulent transfer which was filed prior to the debtors' bankruptcy filing. In the bankruptcy case, the trustee also moved for avoidance of the transfer as fraudulent. The trustee objected to the creditor's judgment lien claim against the homestead, arguing that the judgment lien did not attach to the property because the debtors did not have ownership and possession of the property when the lien was recorded. The court held that, under state law, the judgment attached to the property when filed and remained a senior interest against the property after the bankruptcy filing and during the trustee's avoidance of the transfer. ***In re* Mathiason, 16 F.3d 234 (8th Cir. 1994), *aff'g*, 170 B.R. 662, *aff'g*, 129 B.R. 173 (Bankr. D. Minn. 1991)**.

CHAPTER 13-*ALM* § 13.03.*

PLAN. The debtor had filed 11 years of "protest tax returns" and paid federal income taxes only to the extent withheld by the debtor's employer. When the IRS attempted to levy against the debtor's wages, the debtor filed a Chapter 7 case and later a Chapter 13 case. The taxes were not discharged in the first case and the second case was dismissed. The debtor filed the current case again in an attempt to stop the wage levy. The debtor's plan proposed to pay only the priority tax claims and a small portion of the unsecured tax claims. The court held that the plan was not proposed in good faith because the tax claims arose from the frivolous tax returns. The court cited several precedents upholding the principle that Chapter 13 could not be used as part of a scheme to avoid paying taxes. ***In re* Paulson, 170 B.R. 496 (Bankr. D. Conn. 1994)**.

FEDERAL TAXATION-*ALM* § 13.03[7].*

ADMINISTRATIVE CLAIMS. The debtor originally filed for Chapter 13 but converted the case to Chapter 7. The IRS filed a claim for post-petition but pre-confirmation taxes owed by the debtor. The debtor sought to have the IRS claim be given administrative expense status to be paid from the estate. The court held that only the entity possessing a claim may file for administrative expense status of the claim; therefore, the debtor could not affect the status of the IRS claim. ***In re* McNitt, 170 B.R. 706 (D. Idaho 1994)**.

AUTOMATIC STAY. The debtor filed for Chapter 7 bankruptcy in March 1989 and gave notice to the IRS. In April 1989, the IRS made a post-petition assessment of taxes in violation of the automatic stay but the violation was not challenged. The IRS also applied the debtor's post-petition tax refunds against the assessed tax liability. The debtor sought avoidance of the assessment, recovery of the refunds and sanctions. The IRS sought retroactive relief from the automatic stay for the assessment and argued that sanctions were not allowed because the IRS had not filed a claim in the case. The court denied the IRS application for retroactive relief from the automatic stay because the IRS failed to show any circumstances warranting the relief. The court held that the IRS had waived its immunity against suit because the IRS had made the assessment and had offset the refund against the assessment, in effect making a claim against the debtor. ***In re* Fingers, 170 B.R. 419 (S.D. Cal. 1994), *aff'g*, 148 B.R. 586 (Bankr. S.D. Cal. 1993)**.

OFFSET. When the debtor corporation filed for bankruptcy, the IRS was in the process of auditing the debtor's past 13 taxable years. The IRS filed a claim for taxes based on the audit which showed that the debtor had underpaid taxes in some years and overpaid taxes in other years, resulting in a net tax due. The IRS calculated the amount due by offsetting refunds against taxes due chronologically. The debtor's plan provided for full payment of federal taxes but barred any setoffs. The court characterized corporate tax returns as fluctuating over several years such that a corporation's tax obligations over several tax years could be grouped together into one long tax period; therefore, the offsetting of refunds against underpayments was not an impermissable setoff. The court

Agricultural Law Manual (ALM). For information about ordering the *Manual*, see the last page of this issue.