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CHARITABLE FOUNDATIONS AND ESTATE PLANNING

by
*Robert K. Sands**

ESTATE planning is the planning of the wealth of a family as a unit to provide for its most efficient use in terms of family objectives and in terms of the federal income, estate and gift tax laws. The objective is to provide for the arrangement, disposition and administration of an individual's assets (including business interests) to take care of and protect his family and to conserve his estate. An estate is preserved by minimizing income taxes during lifetime, by reducing estate taxes at death, together with minimizing income and estate taxes following death.

From a tax standpoint, charitable foundations are useful in estate planning because the income of a qualified charitable foundation is exempt from income taxation and contributions to it are deductible for income, estate and gift tax purposes and because a charitable foundation established as part of an estate plan may be controlled by the donor and his family.[1] The ability of the donor and his family to control the charitable foundation and its wealth and to perpetuate that control has probably been the main reason for the rapid growth in the use of private charitable foundations.

A charitable foundation is also useful as a medium for assisting in the preservation of control of a closely held corporation where the stock of the corporation forms a relatively large part of a decedent's estate. The manner in which charitable foundations can be used in planning an estate, during life and at death, together with the problems encountered in organizing and operating a charitable foundation is the subject of this Article.

Such planning has become extremely important, even for small estates, because of the impact of continuing inflation. An estate worth $60,000 in 1942 would have paid no estate tax. If the value of such an estate merely kept pace with the decline in the value of the dollar, it would now be worth approximately $100,000. The $100,000 will not purchase any more than the $60,000 did in 1942, but an estate tax is payable on the $100,000 of $4,800. Inflation has the

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[1] In Barber v. Edwards, 130 F. Supp. 83 (M.D. Ga. 1955), a taxpayer established a charitable trust and made a contribution to it. The District Court held that the fact that the taxpayer's wife and adult son were two of the three trustees of the charitable trust did not affect the validity or qualification of the charitable trust. In fact, in argument and in its brief, the government abandoned its contention that the contribution by the taxpayer to the charitable trust should be disallowed.

same income tax effect because of the progressive nature of the income tax. For example, if a person earned $600 in 1942, there would be little or no tax because of his personal exemption. If his wages have increased to keep pace with inflation to $1,000, this year he would pay a tax of $80 to $100 on his inflated wages, with no real increase in purchasing power. In effect, inflation has caused an unlegislated increase in the amount of taxes required to be paid. Thus, inflation makes income and estate tax planning imperative, and charitable foundations can play an important part in such planning.

I. CONTRIBUTIONS TO CHARITABLE FOUNDATIONS—GENERAL RULES

An individual who itemizes his deductions may deduct in his individual income tax return twenty per cent of his adjusted gross income for charitable contributions made and paid within a taxable year.[2] An additional deduction up to ten per cent of adjusted gross income is allowed to an individual for charitable contributions made directly to a religious organization, a regular educational institution, or a hospital. Since these latter organizations are, of course, also included within the broad definition of charitable organizations contained in Section 170(c) of the Code, it is possible for an individual to (a) contribute up to thirty per cent of his adjusted gross income to schools, churches or hospitals, or (b) contribute up to ten per cent of his adjusted gross income to schools, churches or hospitals and up to twenty per cent of his adjusted gross income to other types of charitable organizations specified in Section 170(c).

The type of charitable foundation discussed in this Article will not usually be a hospital, a church or an educational institution. Therefore, the maximum amount deductible against taxable income for contributions made to the type of charitable foundation discussed will be twenty per cent of adjusted gross income for any contribution made to the foundation during a donor's lifetime.

By virtue of the progressive nature of the income tax, the cost of charitable giving decreases as an individual's taxable income increases, since deductible contributions reduce otherwise taxable income. In other words, amounts which would otherwise be paid in income taxes to the federal government are diverted to the charitable foundation.

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[2] Int. Rev. Code of 1954, § 170(b)(1)(c), allows an individual an unlimited deduction for charitable contributions for the current year, if in eight of the ten preceding taxable years, charitable contributions and income taxes for each such year exceeds 90% of such individual's taxable income. Since partners, and not the partnership of which they are members, are subject to the income tax, each partner must take into account separately his distributive share of charitable contributions made by the partnership. Int. Rev. Code of 1954, § 702(a)(4). A partner's share of such contributions is added to contributions made by him individually in computing allowable charitable deductions.

The actual cost to an individual of a contribution to a charitable foundation is the amount which would be left to him after taxes if the contribution had not been made and the income tax deduction taken. For example, if an individual is in the seventy-five per cent tax bracket, each dollar contributed to charity would cost him twenty-five cents. As taxable income decreases, the cost of charitable giving increases, so that if an individual is in the twenty-five per cent tax bracket, a charitable contribution would cost him seventy-five cents of every dollar given.

An estate or trust is entitled to an *unlimited* deduction for charitable contributions required to be made by the governing instrument, and they are not subject to the percentage limitations applicable to individuals. Section 642(c) provides that an estate or trust in computing taxable income may deduct any amount of its gross income, without limitation, which pursuant to the terms of the governing instrument is paid or permanently set aside for the charitable purposes specified in Section 170(c), or which is to be used exclusively for religious, charitable, scientific, literary or educational purposes. The deduction allowed for amounts paid to charities by an estate or trust is from gross income. In this connection, it should be noted that distributable net income of an estate or trust is presently computed by adjusting taxable income, which is determined after the charitable deduction has been allowed.[3]

Under present law, where a trust instrument requires that current income be paid to a charity and an equal amount of corpus be paid to a non-charitable beneficiary, the non-charitable beneficiary is not taxed on the amount he receives. In other words, if a trust has $5,000 of income, which is distributed to a charity and $5,000 of corpus is distributed to a non-charitable beneficiary, the non-charitable beneficiary will not be deemed to have received any income as a result of the $5,000 corpus distribution since the amount paid to the charity is a deduction in arriving at taxable income, which completely eliminates taxable income in the example given.[4]

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[3] Two separate computations have to be made when distributions are made to both charitable and non-charitable beneficiaries, so that each type of beneficiary will receive a proportionate part of the various items of estate or trust income. Adjustments have to be made so that a certain portion of all items, including tax exempt income and capital gains, will be considered to have been distributed to the charity.

[4] The "Trust and Partnership Income Tax Revision Act of 1960," which was not enacted by Congress, would have changed this result by providing that the deduction for charitable distributions of an estate or trust was no longer to be allowed from gross income, but, instead, an estate or trust was to be allowed a deduction for distributions to charities to the extent provided in Section 661. In other words, charitable distributions were to be treated in the same way as non-charitable distributions under the rules contained in Section 661 relating to complex trusts. This legislation expanded the tier system, and

Under present law, tax savings possibilities exist by providing for the payment of charitable bequests out of the income of an estate rather than out of corpus. If the bequest is paid out of estate income, income taxes will be avoided and corpus distributions may be made tax free to the non-charitable beneficiaries.

All contributions to a charitable foundation are a gift, and would be taxable as a gift, except that Section 2522 allows a deduction in computing taxable gifts for any amount given to qualified charitable organizations. If a deduction for a contribution is denied because a charitable foundation does not qualify as an exempt organization, a gift tax may result, as well as the loss of the income tax deduction. For this reason, it is wise to keep contributions to a foundation relatively small until the organization has been ruled to be tax exempt by the Internal Revenue Service.

In determining the estate tax, the value of the gross estate is reduced by the value of bequests to or for the use of charitable foundations.[5] However, the amount of the charitable deduction cannot exceed the value of the property transferred which is included in the gross estate. A private charitable foundation is useful because it allows the donor and the donor's family the *control over wealth* which otherwise would have been paid into the United States Treasury in the form of estate or gift taxes. This type of control over wealth may be as important as the actual outright ownership of the property itself.

A taxable estate of ten million dollars will generate an estate tax of approximately six million dollars, with a top rate of seventy-seven per cent. If the entire ten million dollar estate is given to a private charitable foundation, controlled by the donor and his family, they would control and manage ten million dollars in wealth, as opposed to four million dollars in wealth they would have owned outright if the gift to the charitable foundation had not been made. Usually only a portion of a large estate is given to a charitable foundation, and this portion comes off of the top estate tax brackets. If, in the above example, only two million had been given to the charitable

charitable distributions were placed in the third tier, as were corpus distributions to non-charitable beneficiaries. The effect of this proposed legislation on the example set out above would be to distribute the distributable net income equally between the charity and the non-charitable beneficiary, since they were both in the same tier. Thus, in the example given, the beneficiary receiving the corpus distribution under the proposed law would be required to include in his gross income one-half of the trust's distributable net income, even though he clearly received a corpus distribution. Similar legislation will undoubtedly be proposed and enacted in the future, and this fact should be kept in mind in planning bequests of trust and estate income to charitable foundations where non-charitable beneficiaries are also to receive distribution of trust or estate income and/or corpus.

[5] Int. Rev. Code of 1954, § 2055.

foundation, approximately one and one-half million dollars in wealth would be diverted from the United States Treasury into a private charitable foundation controlled by the donor and his family. Thus, for giving up the outright control over $500,000, the family retains control over two million dollars of wealth.[6]

There may be an additional saving in this situation in state inheritance taxes. Whether additional inheritance taxes could be saved would be determined by the operation of the federal estate tax credit for state inheritance taxes. In other words, an additional saving will result to the extent that no estate tax credit would have been allowed for all or a part of the state inheritance taxes that would have been paid if the charitable gift had not been made.

Many economic benefits arise from the right to vote shares of corporate stock. An individual in control of a large block of corporate stock as Trustee of a foundation can vote the stock to elect himself a director or an officer. Furthermore, the charitable foundation is also useful to assist a stockholder of a closely held corporation in avoiding a sale of the stock to pay estate taxes with the possible result of loss of control of the corporation as a result of the sale.

The decision to use a private charitable foundation as part of an estate plan should be motivated primarily by charitable motives, and, to a lesser extent, by tax motives. Once a decision has been reached that a charitable foundation is to be established, it should be accomplished in the most economical manner from the standpoint of the existing federal and state tax laws, including income, estate, gift and inheritance tax laws. Of primary concern will be the federal income and estate tax deductions allowed for contribution to charitable foundations.

II. Inter Vivos Transfers to Charitable Foundations

A. *Property And Interests In Property*

If a gift is to be made to a private charitable foundation, it is usually more advantageous to establish the foundation during the donor's lifetime, and have the donor make annual gifts to the foundation up to twenty per cent of the donor's adjusted gross income, so that an income tax saving, as well as an estate tax saving, will result. Not only will an income tax saving result, but the donor will have

[6] The retention by family members of the control over wealth and the right to dispense charity, even though intangible, may be far more valuable to a wealthy family unit than the absolute right to the after tax dollars given up. A family power, influence and prestige in a community or area may be better served by the use of the charitable foundation than the outright retention of a lesser dollar amount.

the pleasure of seeing the charity in operation and will be able to supply the organization with charitable principles that will assist the directors or trustees in their operations after the donor is dead. In terms of establishing a foundation that will carry out the charitable impulses of the donor, this advantage may be far more important than the monetary income tax advantage derived.[7]

There are many other advantages in establishing a charitable foundation during the lifetime of the donor. Since the income of a qualified charitable foundation is tax exempt, its income can be accumulated faster for a specific charitable project. There is also the intangible value of naming the foundation after the donor. The donor and his family may gain valuable experience in the art of philanthropy by establishing a foundation during lifetime.

If an inter vivos charitable gift program is adopted, so that the corpus of the foundation will be built up with an income tax advantage, as well as an estate tax advantage to the donor, a provision should be placed in the donor's will making a bequest to the charitable foundation of the balance of the contemplated total gift to provide for the contingency that the donor may die before the program is completed. The following language is illustrative:

> I hereby give, devise and bequeath the sum of FIVE HUNDRED THOUSAND DOLLARS ($500,000) to the CHARITABLE FOUNDATION, a charitable organization established by me during my lifetime, less any amounts contributed by me to such foundation during my lifetime. Such amount may be used by the Directors of such foundation for any of its authorized charitable purposes except that such amount, its income and accretions thereto, shall be used for charitable purposes exclusively within the State of Texas. This bequest may be satisfied in cash or in property of my estate[8] and for purposes of deter-

[7] All of the donor's charitable thoughts and impulses as well as all of the important business of the foundation, should be reduced to minutes, and carefully preserved for the guidance of present and future managers.

[8] What will be the income tax consequences to the estate if a pecuniary gift to a charitable foundation is satisfied by a distribution in kind? In this situation, the estate would recognize gain or loss to the extent the value of the property distributed exceeded or was less than its value as of the date of the estate tax valuation. See Suisman v. Eaton, 15 F. Supp. 113, aff'd, 83 F.2d 1019 (2d Cir.), cert. denied, 299 U.S. 573 (1936); Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940). This is an especially undesirable result if the property distributed would probably never have been sold. If 2,000 shares of stock was worth $10 per share at the valuation date, and is worth $50 per share at the date it is distributed in satisfaction of a $100,000 bequest, a taxable gain of $80,000 would result, to the estate from the distribution. If a distribution of this type is contemplated, then the property used to satisfy the cash bequest should be property which has not appreciated in value since the valuation date.

This result can also be avoided by making gifts of fractional or percentage amounts to a charitable foundation rather than specific amounts. A distribution in kind in satisfaction of a fractional or percentage gift will not cause the estate to realize a taxable gain as a result of the distribution.

mining the amounts of property I have contributed to such foundation during my lifetime the value used and/or accepted for Federal gift tax purposes shall be controlling.

If property other than money is transferred to a charitable foundation, the amount of the deduction is the fair market value of the property at the time of the transfer. If a remainder interest in property is transferred, a deduction is allowed for the present value of the remainder interest.

Whether property other than cash should be donated to a charitable foundation depends on whether the property has appreciated or depreciated in value. Although a deduction for a gift of property to a charitable foundation is allowed to the extent of the property's fair market value on the date of the gift, no taxable gain is recognized by the donor on the unrealized appreciation.[9] If property which has appreciated in value is first sold and the proceeds donated, the donor would be taxed on the gain from the sale, and the amount which he could give to the charitable foundation would be reduced and his own tax liability would, as a result, be increased. After the appreciated property is contributed to the charitable foundation, it can sell the property and, since it is tax exempt, will pay no tax on the capital gain. If the donor's top bracket is over 75 per cent, the donor may actually make money by contributing an appreciated asset, rather than selling it and realizing a capital gains tax.

For example, if a donor in the 80 per cent bracket has property worth $10,000 for which he paid $1,000, he would pay a capital gains tax of $2,250 if he sold it, and after payment of taxes would retain $7,750. If he had contributed the property to a charitable foundation, he would have a tax saving of $8,000 and would come out with $250 in cash more than if he had sold the property. If the property is transferred to his own charitable foundation, he will still retain control over the property transferred, in addition to making $250 on the transaction.

If, however, the fair market value of the property is less than the adjusted basis, the property should be sold and the proceeds donated. If property is transferred which has depreciated in value below its tax basis, an available income tax loss is needlessly thrown away. If this type of property is donated without a sale, the loss would not be allowed.

It is often desirable to give an undivided interest in property, such as land, when the value of the entire property exceeds twenty per

[9] Rev. Rul. 55-410, 1955-1 Cum. Bull. 297.

cent of the donor's adjusted gross income. Additional undivided interests in the property can be given to the charitable foundation in subsequent years to obtain maximum benefit of the charitable deduction for income tax purposes.[10]

Art objects, like all non-liquid assets, generate estate taxes, but not the funds required to pay such taxes. The estate tax cost of keeping such art objects in a family has to be borne by other liquid assets. A private charitable foundation is a very useful repository for valuable art objects, since upon death a charitable deduction will be allowed for the value of art objects thus transferred. If such objects are given during lifetime to a charitable foundation controlled by the donor, an income tax saving of the type previously discussed will result. Furthermore, the donor, by virtue of his control over the foundation, will continue to control the use and display of the art objects. In this connection, Rev. Rul. 57-293[11] provides that if a donor retains a life interest in art objects and gives a remainder interest in such objects to a charitable foundation, a charitable deduction of the present value of the remainder interest transferred will be allowed (subject to the percentage limitation). That ruling also discloses that an undivided interest in art objects may be given to a charitable foundation, provided "the deed contains unequivocal language of a present gift and transfers to the organization rights to possession, dominion and control of the art object consistent with the creation of a tenancy in common as between the donor and the organization." To comply with this requirement, the deed should provide that the charitable foundation is entitled to possession, dominion and control of the art object for that number of months during any period of twelve months which the interest given to the charitable foundation bears to the entire interest.

Since a deduction is allowed in an amount equal to the fair market value of property transferred and is not limited to its adjusted basis at the time of transfer, a double deduction will be allowed for contributions to charitable foundations to the extent that depreciation or depletion has been taken with respect to the donated property in the donor's income tax return in prior years. In Rev. Rul. 59-196,[12] the question presented was whether, when a gift of an undivided interest in oil and gas leases is made to a charitable foundation, the intangible drilling and development costs which had previously been deducted on the donor's income tax return had to be deducted from

[10] Rev. Rul. 58-455, 1958-3 Cum. Bull. 100.
[11] 1957-2 Cum. Bull. 153.
[12] 1959-1 Cum. Bull. 56.

the value of the charitable contribution reported by the donor. The Internal Revenue Service ruled that since the property interest in the donated oil and gas leases did not constitute property held for sale in the course of the owner's business but was a capital asset, no adjustment had to be made to the fair market value of the property donated, and that the fair market value of the donated interest was not includable in the gross income of the donor. It is stated in this ruling that it has been a long-standing interpretation of the Internal Revenue Service that the full fair market value of capital items are allowed as charitable deductions without adjustment for deductions such as depreciation.

Can an individual donate to a charity property such as cattle or crops and receive a deduction for its fair market value, even though he has already deducted expenses connected with such property which have produced the greater part of the value of the property? In an early ruling[13] with respect to farm crops, the Internal Revenue Service announced that in such a situation, the fair market value of the property was included in the donor's gross income, relying on the anticipatory assignment of income theory in general and the case of *Helvering v. Horst*[14] in particular.

Two district court decisions, one of which has been affirmed on appeal, held contrary to the Commissioner's position as set forth in the above ruling. In *White v. Broderick*,[15] a cash-basis farmer donated grain to a charitable organization, but took no charitable deduction for such donation. The Commissioner contended that the fair market value of the grain at the date of transfer was taxable income to the donor. The court held that the donor did not realize taxable income or gain by reason of the contribution of the wheat to the charity.

In *Campbell v. Prothro*,[16] the Fifth Circuit upheld the district court's determination that a donor of a calf crop to a charitable organization did not realize taxable income by such a gift. The donor had deducted the expenses connected with maintaining and raising the calf crop and, for the year in which the contribution was made, had also deducted on his income tax return the fair market value of the calf crop as a charitable contribution. The Commissioner, again relying on the *Horst* case and several earlier rulings, argued that the donor's gift of the calf crop was an anticipatory assignment of income, and, therefore, such income was taxable to the donor. The Fifth Circuit found the anticipatory assignment of income cases in-

[13] I.T. 3910, 1948-1 Cum. Bull. 15.
[14] 311 U.S. 112 (1940).
[15] 104 F. Supp. 213 (D.C. Kan. 1952).
[16] 209 F.2d 331 (5th Cir. 1954).

applicable to the facts and held that for tax purposes the donor did not realize taxable income by the gift transaction. The court reasoned that the calves did not constitute income in the hands of the donor, and the gift of them would not cause the unrealized appreciation to be taxed to the donor.

In *Lester A. Nordan*,[17] taxpayers, husband and wife, transferred a carved-out oil payment to a charity on December 1, 1949. The taxpayers deducted the value of such oil payment on their income tax return for the year 1949. The Commissioner added the value of the oil payment to the taxpayers' income for the year 1949, but allowed them a charitable deduction of the same amount and 27½ per cent depletion. The Commissioner argued, in support of the inclusion, that income, rather than property, had been transferred. The Tax Court in a very succinct opinion held that the transfer was of property, rather than income, and thus the Commissioner incorrectly included the value of the oil payment in the taxpayers' income for 1949.

However, in *Eugene T. Flewellen*,[18] the Tax Court, on the authority of the Supreme Court's decision in *Commissioner v. P. G. Lake, Inc.*,[19] held that the assignment to a charitable donee of an oil payment carved out of a royalty interest constitutes, for Federal tax purposes, an anticipatory assignment of rights to receive future income, and was, therefore, taxable income to the donor when, and as, received by the donee. In other words, the *Nordan* case has been overruled by the Supreme Court's decision in the *Lake* case.

The Commissioner, in Treas. Reg. Section 1.170-1(c), now takes the position that if a contribution is made to a charitable foundation of property of a kind which the taxpayer sells in the course of his business, the amount of the deduction is the fair market value of the property, which is defined to be "the price which the taxpayer would have received if he had sold the contributed property in the lowest usual market in which he customarily sells." The Commissioner had previously taken the position in Rev. Rul. 55-138[20] that the fair market value for such purposes would be the amount it would cost the taxpayer to replace the products in his most favorable market.

The Commissioner also makes the requirement that the costs and expenses incurred in the year of contribution in producing or acquiring the contributed property are not deductible and are not a part of the cost of goods sold. Thus, to the extent that costs and expenses incurred in a prior taxable year in producing or acquiring the con-

[17] 22 T.C. 1132 (1954) (Acq. 1959-1 Cum. Bull. 4).
[18] 32 T.C. 317 (1959).
[19] 356 U.S. 260 (1958).
[20] 1955-1 Cum. Bull. 223.

tributed property are reflected in the cost of goods sold in the year of contribution, cost of goods sold must be reduced by such costs and expenses. The regulations do not require that the amount of the contribution be reduced by expenses which have been deducted in prior years, but which are not included in cost of goods sold. This was required in Rev. Rul. 55-138, but apparently this requirement was purposely omitted from Treas. Reg. Section 1.170-1(c).

B. *Income And Remainder Interests*

An income tax deduction subject to the percentage limitations is allowed for the transfer of income and remainder interests to a charitable foundation.[21] To determine the amount of the deduction generated by the income or remainder interest transferred, Tables I and II found in the Gift Tax Regulations at Section 20.2031-7(f) should be consulted.

1. *Gift of an Income Interest*

A gift to a charitable foundation of the right to income from property may be for a term of years, or for the life of the donor, or for the life of some other individual. The present value of the right to receive the income for a term, or for the life of the donor, or another determined in accordance with Tables I and II contained in the Gift Tax Regulations mentioned above may be deducted by the donor as a charitable deduction against current income and as a charitable deduction for gift tax purposes.

Prior to the enactment of the 1954 Code, it was possible for a donor to obtain a double deduction by virtue of a gift in *trust* of income from property to a charitable foundation. Such a gift could actually be used to increase a high-bracket donor's spendable income because the donor's taxable income was reduced each year by the amount of income transferred to the charitable foundation, and because a deduction was allowed against adjusted gross income (subject to the percentage limitation) in the year of the transfer for the present value of the income transferred. This deduction, of course, reduced taxable income and the amount of income taxes that would have to be paid in that particular year.

An example will illustrate how this operated:

> Assume that a taxpayer in the 90% bracket transferred stock worth $100,000 to a trust to pay the income from the stock to a charitable foundation for a term of ten years. At the end of the ten-year term, it was provided that the stock would return to the donor. For income tax purposes, the value of the charitable deduction was the present value

[21] Treas. Reg. § 1.170-1(d) (1958).

of the right of the charity to receive the income from the trust for a period of ten years, or $29,108. At the 90% rate, this charitable deduction reduced the donor's income tax by $26,197.20 (90% of $29,108). If the donor had not made the gift, and over the ten-year period he received cash dividends of $5,000 each year, he would have received a total of $50,000, but he would only have retained $5,000 of the $50,000 because the other $45,000 would go to pay income taxes since he was in the 90% bracket. By having made this gift of income to charity, the donor made $21,197.20, and at the end of the ten year period, the transferred stock returned to him.

Section 170(b)(1)(D) of the Code has eliminated the usefulness of trusts for this purpose if the *donor* retains a reversionary interest in the property which at the time of transfer exceeds five per cent of the value of the property transferred. If the reversionary interest exceeds five per cent, Section 170(b)(1)(D) expressly denies the income tax charitable deduction to the donor. It would take a trust with a term of approximately eighty years to obtain a reversionary interest of five per cent or less.

The prohibition contained in Section 170(b)(1)(D) relates to transfers made to *trusts*. If the charity is a corporation, the limitations with respect to the five per cent rule do not apply since it is expressly applicable to transfers in trust. Therefore, it may be possible to achieve the income tax advantage discussed above by having the donor transfer an interest in the income of property for a term in excess of ten years, with the reversionary interest retained by him. The charitable deduction for the present value of the income interest for the term would not be denied by Section 170(b)(1)(D) because it is applicable only to transfers in trust. For this reason, it may be desirable that a charitable foundation be organized as a corporation rather than as a trust.

The type of income tax savings possible prior to the enactment of Section 170(b)(1)(D) is still possible with respect to transfers in trust if the donor is willing to give the remainder interest away so that he will have no reversionary interest. By giving the remainder interest to a family member, a gift will have been made for gift tax purposes with possible gift tax consequences depending on the amount of the specific exemption previously taken and other factors. Because of the intervening gift of income to the charitable foundation, the value of the gift of the remainder for gift tax purposes will be reduced by the value of the income gift to the charity. The gift tax will probably be less than the estate tax in any event, and, therefore, this technique is an attractive one because the donor will also obtain the double deduction benefits previously discussed. In the example

given, if the remainder interest in the stock was given to a family member, his income tax saving would still be $21,107.20, and he would have to pay a gift tax on the value of the remainder interest, the value of which is $70,892. If the donor and his wife had not yet used up their $30,000 specific exemption, the gift tax on the transfer would be negligible.

Before using this technique, it should be understood that Section 9 of the so-called Mills Bill provided for the extension of Section 170(b)(1)(D) to prohibit the charitable deduction for gifts in trust made after December 31, 1956, when the donor's spouse, ancestors or descendants have remainder interests in the property transferred worth more than five per cent. This provision of the Mills Bill has not yet been enacted into law, but there is a possibility that it may be enacted sometime in the near future.

Section 673(b) provides that, where the income of a trust is irrevocably payable for a period of at least two years to a qualified charity, the income of the trust will not be taxable to the grantor. If such a trust is established, the income tax charitable deduction will not be allowed the creator because, as pointed out above, Section 170(b)(1)(D) does not allow the charitable deduction when the donor retains a reversionary interest in excess of five per cent. The short-term charitable trust is useful, however, in a situation where a donor's intended gifts to a charity exceed the charitable deduction to which he is entitled. The amount of the excess will be taxable to him. By establishing a two-year, short-term charitable trust, the income is shifted to the charity, and he avoids paying income tax on it during the two-year period.

If there is any possibility that the charitable foundation may not receive the benefit of the income interest transferred, a charitable deduction will not be allowed. Treas. Reg. Section 1.170-1(3) states in part:

> For example, assume that assets placed in trust consist of stock in a corporation the fiscal policies of which are controlled by the donor and his family, that the trustees and remaindermen are likewise members of the donor's family, and that the governing instrument contains no adequate guarantee of the requisite income to the charitable organization. Under such circumstances, no deduction will be allowed. Similarly, if the trustees were not members of the donor's family but had no power to sell or otherwise dispose of closely held stock, or otherwise insure the requisite enjoyment of income to the charitable organization, no deduction would be allowed.

2. *Gift of a Remainder Interest in Property*

A donor may transfer a remainder interest in property to a chari-

table foundation and retain the income from the property for himself or for a third party for a term of years, or for life.[22] The value of the remainder interest computed in accordance with the Tables I and II found in the Gift Tax Regulations at Section 20.2031-7(f) will be allowed as a charitable deduction for income and gift tax purposes. If the income from the property is transferred to someone other than the donor for a term of years or for life, the value of the income interest at the time of the transfer will have to be included in the donor's total gifts for purposes of determining the gift tax.

The gift of a remainder interest in property to a charitable foundation is advantageous because the donor gets an immediate charitable deduction against current income for the value of the remainder interest transferred, which produces an immediate income tax saving. It is also desirable because it reduces the gift tax on a gift to a family member or relative. It also makes possible a larger gift or larger fund for the production of income.

The usefulness of making a gift of a remainder interest to a charitable foundation can be illustrated by the following example:

> Assume an individual has property worth $200,000 earning 4% and that he would like to put this property in trust giving the income to his only relative, a dependent sister, age 55. If he gives her a life interest in the property and leaves the remainder to a charitable foundation, he will receive a current charitable deduction of $108,148, the present value of the remainder interest. He will have made a gift to his sister of a life interest in property worth $91,852. If he had given the property outright to his sister, he would have had to pay a gift tax on $200,000 rather than on $91,852, the value of the life interest. This means that more property can be put in trust to produce income for a dependent relative for the gift tax cost which would have been incurred if the entire fee interest had been given. Without taking into account the specific exemption or the donee exclusion, the gift tax if the entire $200,000 had been transferred to the sister would be $41,025, leaving $158,975 of principal to produce income for the sister which, at 4%, would produce $6,359 per year income. If a remainder interest is given to a charitable foundation, the gift tax on $91,852, assuming no part of the specific exemption is available, and not taking into account the donee exclusion, would be $13,814, leaving an income-producing principal sum of $185,185, which, at 4%, would produce $7,447, or approximately $1,088 more income per year. Of course, if the entire property is left to the sister, she would have available to her the principal as well as the income.

If the donor wants to provide for the invasion of the principal for the benefit of the life beneficiary or beneficiary for a term of years,

[22] Ibid.

care will have to be taken so that the remainder will be capable of valuation. If the provisions with respect to invasion of principal make the value of the remainder so indefinite as to make its valuation impossible, no charitable deduction for its value will be allowed.[23]

C. Geographical Considerations

To be deductible, contributions by an individual must be to an organized, domestic charitable foundation. A contribution by an individual to an individual or an unorganized group will not be deductible no matter how worthy the particular project may be. Nor will a deduction be allowed if the contribution is to a charitable foundation organized and operating under the laws of a foreign country.[24] Although an income tax deduction is not allowed for gifts to a foreign charitable foundation, for gift tax and estate tax purposes, a deduction is allowed.[25] The fact that a domestic charitable foundation distributes, or may distribute, its funds in foreign countries for charitable purposes will not defeat the right of an individual to deduct his contribution to such organizations, nor will it cause such organization to lose its tax exempt status.[26]

A charitable trust, in pursuance of its charitable purposes, may distribute its income to individuals and is not required to make distributions to organized charities. No restriction as to the geographical destination is placed on distributions of the income of a charitable trust.[27]

III. Testamentary Dispositions to Charitable Foundations

An estate tax deduction is allowed for charitable bequests made to a qualified charitable foundation in determining the taxable estate of

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[23] Treas. Reg. 1.170-1(e) (1958), provides in part:

> If as of the date of a gift a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an interest passes to or is vested in the charity on the date of the gift, and the interest would be defeated by the performance of some act or the happening of some event, the occurrence of which appeared to have been highly improbable on the date of the gift, the deduction is allowable.

[24] Section 170(c)(2) requires that the contribution to be deductible for income tax purposes must be to "a corporation, trust, or community chest, fund or foundation—(A) *created or organized in the United States or in any possession thereof, or under the laws of the United States, any State or Territory, the District of Columbia, or any possession of the United States.*" (Emphasis added.)

[25] Section 2522(a)(2) which permits a deduction for charitable gifts and Section 2055(a)(2) which permits an estate tax deduction for charitable bequests contain no language requiring that the recipient be a domestic organization.

[26] Treas. Reg. § 1.170-2 (1958).

[27] Int. Rev. Code of 1954, § 642(c).

a decedent.[28] In making a bequest to a charitable foundation, federal estate taxes and state inheritance taxes should not be payable out of a charitable bequest, because any death taxes payable out of a charitable bequest reduces the amount of the charitable deduction.[29] The payment of federal estate taxes out of the amount passing to a charitable foundation needlessly complicates the computation of the estate tax, since the estate taxes thus paid reduce the amount of the charitable deduction, which in turn increases the estate tax, which in turn reduces the amount of the charitable deduction, and so forth *ad infinitum.* This is the same type of problem that arises when estate taxes are payable out of a marital deduction bequest. To avoid this complication, the charitable bequest should be excepted from the payment of estate and inheritance taxes.

As in the case of inter vivos gifts previously discussed, a testamentary gift to a charitable foundation may be a gift of an income interest or may be a gift of a remainder interest.[30] The value of the income or remainder interest transferred is to be determined in accordance with Table I and II found in the Gift Tax Regulations at Section 20.2031-7(f).

As in the case of an inter vivos gift of an income interest in property to a charitable foundation, a testamentary gift of income produces a double deduction. The present value of the income gift to the charitable foundation is deductible in computing the estate tax, which produces an estate tax savings. In addition, the income during the term of the gift is non-taxable, since it is paid to a tax exempt charitable foundation. A testamentary gift of an income interest to a charitable foundation is very useful, especially in relatively large estates.[31]

A testamentary charitable remainder given to a charitable foundation may be used to increase the principal of the estate available for the production of income for a particular beneficiary. This result is achieved because the bequest of a remainder interest allows the estate to retain the principal amount equal to the estate tax that would

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[28] Int. Rev. Code of 1954, § 2055.

[29] Int. Rev. Code of 1954, § 2055(c) provides:

> If the tax imposed by Section 2001, or any estate, succession, legacy, or inheritance taxes, are, either by the terms of the will, by the law of the jurisdiction under which the estate is administered, or by the law of the jurisdiction imposing the particular tax, payable in whole or in part out of the bequests, legacies, or devises otherwise deductible under this section, then the amount deductible under this section shall be the amount of such bequests, legacies, or devises reduced by the amount of such taxes.

[30] Treas. Reg. § 20.2055-2(a) (1958).

[31] For a comprehensive discussion of testamentary gifts of income to charitable foundations, see Drye, Testamentary Gifts of Income to Charity, 13 Tax L. Rev. 49 (1957).

have been paid on the remainder interest if it had not been transferred. This retained principal sum can be used to produce more income for a particular beneficiary.

Assume the testator has property worth $1,000,000, and his only living relative is a sister, age fifty-five. If he left this property to his sister outright, the estate tax would be approximately $303,500, leaving a principal sum of $696,500 to provide income for the sister for the rest of her life. If this property yielded four per cent, the annual income for the sister would be $27,860. If, instead of leaving the property outright to his sister, the testator left her the income from such property during her lifetime, with the remainder to a charitable foundation, his estate would receive an immediate deduction for the value of the remainder interest given to the foundation. Instad of paying an estate tax on $1,000,000, the estate would pay an estate tax on $459,260, or $132,663. This would leave a principal income producing sum of $867,337, which at four per cent would yield $34,693, or $6,833 more per year than if the gift of the charitable remainder had not been made. Of course, if the testator did not care if his sister depleted the principal, the sister would probably enjoy a better standard of living during her lifetime if she were given the property outright, since she would then have available to her the principal as well as the income. This device is most useful in a situation where a testator wants to ultimately favor a particular charity but also wants to provide a life income for a surviving family member.

If a bequest is made to a charitable foundation of a remainder interest in property, its deductibility from the gross estate will depend upon whether the interest is capable of valuation. Valuation, in turn, depends upon the relative certainty that the charitable foundation will actually receive the remainder interest given.[32]

A charitable remainder following a simple life estate or successive life estates would present no insuperable problem of valuation. Problems of valuation and deductibility of remainder interests arise where a contingency or power, relative to a prior interest, makes it uncertain whether the charitable foundation will ever receive anything, or makes the amount the charitable foundation will ultimately receive uncertain. If a bequest to a charitable foundation is dependent upon the performance of some act, or the happening of some event, the deduction will not be allowed for estate tax purposes unless the possibility that the charitable foundation will not receive the bequest "is so remote as to be negligible."[33] This determination is to be made

[32] Treas. Reg. § 20.2055-2(b) (1958).
[33] Ibid.

on the basis of the facts existing at the date of the testator's death, and not on the basis of subsequent developments. This problem is frequently litigated where a remainder interest, which has been bequeathed to a charitable foundation, takes effect only if a life beneficiary dies without issue.[34]

In giving a remainder interest to a charitable foundation, care should be exercised so that it will be given in such a manner that a present estate tax charitable deduction will be allowed. Where a power to invade principal in favor of a life beneficiary is unlimited, a charitable remainder following the life interest will not be deductible in determining the taxable estate, even though the possibility of invasion is remote or does not, in fact, occur. However, if the power of invasion is limited by fixed external standards, and the exercise of such power is remote, the charitable remainder can be valued and will be deductible.[35] This problem has been the subject of frequent

[34] In Hoagland v. Kavanagh, 36 F. Supp. 875 (E.D. Mich. 1941), a life estate was left to the testator's daughter, and upon her death to her issue or in default of such issue to certain charitable organizations. Detailed evidence was submitted to show that it was extremely unlikely that the daughter would ever have issue. The court held that the charitable remainder was not deductible for federal estate tax purposes since it was not shown that it was impossible for the life beneficiary to have children. See also Humes v. United States, 276 U.S. 487 (1928). In United States v. Provident Trust Co., 291 U.S. 272 (1934), it was held that a charitable remainder contingent on the life tenant's dying without issue was held to be deductible because the life tenant had had an operation that had rendered her incapable of having children, and it was certain that the charity would receive the remainder interest.

[35] In Ithaca Trust Co. v. United States, 279 U.S. 151 (1929), the Supreme Court held that a remainder interest to a charity was deductible where the residue of an estate was given to the testator's wife for life with authority in the trustee to use from the principal any sum "that may be necessary to suitably maintain her in as much comfort as she now enjoys." Justice Holmes stated, "The principal that could be used was only so much as might be necessary to continue the comfort then enjoyed. The standard was fixed in fact and capable of being stated in definite terms of money." The charitable deduction was not allowed in Merchants Nat'l Bank v. Commissioner, 320 U.S. 256 (1943), and Henslee v. Union Planters Nat'l Bank & Trust Co., 335 U.S. 595 (1949). In the Merchants National Bank case, the trustee was authorized to invade the corpus of the trust for the comfort, support, maintenance and/or happiness of the testator's wife, and the trustee was requested to be liberal and to consider the wife's happiness prior to the claims of the charitable remaindermen. Because of the use of such broad language, it was held that the value of the charitable remainder was unascertainable. In the Henslee case, the trustees were authorized to expend any portion of the trust estate in their discretion for the pleasure, comfort and welfare of the life tenant. This language was also held to be so broad as to render the charitable remainder unascertainable.

In Rev. Rul. 54-285, 1954-2 Cum. Bull. 302, the Internal Revenue Service allowed an estate tax charitable deduction where the trust agreement provided that the trustee could pay to the testator's wife such amounts as the trustee in its sole discretion deemed necessary for her comfort, support, hospital or medical expenses. At the date of the decedent's death, his widow was 79 years of age and had an independent income which was more than adequate to take care of her modest needs. In ruling that the bequest of the charitable remainder was deductible, it was stated:

> Where the power of invasion is limited by such words as 'comfort and support' with no express standard or limitation in the will or instrument, such words should be interpreted as meaning the comfort and support according to the standard of living enjoyed by the beneficiary prior to the decedent's death, if such interpretation is consistent with applicable local law, and other termi-

litigation; and the draftsman of a will who wants to provide for an invasion of principal in favor of a life beneficiary, and also desires to preserve the estate tax deduction for a charitable remainder, should limit the power to a definite external standard.

Where a power of invasion is so broad as to threaten the loss of the charitable remainder as a deduction in determining the estate tax, an irrevocable disclaimer of such power made before the date for filing the estate tax return will operate to preserve the deduction.[36] Furthermore, if a power to invade property for the benefit of an individual is terminated without being exercised before the prescribed date for filing the estate tax return, by reason of the death of such individual, the Internal Revenue Code specifically provides that such power shall be considered to be irrevocably disclaimed.[37]

The use of a power of invasion in these circumstances should be most carefully thought out and should not be used unless absolutely necessary. In this respect, wills containing such a power should be periodically reexamined to determine whether the need for such a power continues to exist.

A. *Closely Held Stock*

When closely held stock of a corporation is the major asset of an estate, a difficult problem is presented to the executor, since liquid funds are needed to pay the estate tax generated by the inclusion

nology in the will or instrument does not require some different interpretation. (The inclusion of the words 'hospital or medical expenses' does not enlarge the power of invasion as hospital and medical care are included within the broad meaning of comfort and support.) If it is considered that a standard is fixed by the will or instrument, there remains for determination the probability of invasion of corpus for the stated purposes. If there is very little or no probability of invasion, the deduction should be allowed. If the facts indicate the probability of invasion to a limited extent which is calculable in accordance with an ascertainable standard, the deduction should be denied only to such extent.

The trust instrument in the instant case impliedly fixes a definite standard, as the trustee is not authorized to use principal except for the proper comfort and support of the widow. As of the date of decedent's death the likelihood of any invasion of the principal for the proper comfort and support of the widow was so remote as to be negligible.

In view of the foregoing it is held that a charitable deduction under section 812(d) of the Internal Revenue Code may be allowed on account of bequests or gifts of remainder interests to charity in cases where the will or instrument authorizes invasion of corpus for the comfortable maintenance and support of life beneficiaries if (1) there is an ascertainable standard covering comfort and support which may be either express or implied, and (2) the probability of invasion is remote or the extent of the invasion is calculable in accordance with some ascertainable standard.

[36] Int. Rev. Code of 1954, § 2055(a); Treas. Reg. § 20.2055-2(c) (1958) provides: "Ordinarily, a disclaimer made by a person not under any legal disability will be considered irrevocable when filed with the Probate Court. A disclaimer is a complete and unqualified refusal to accept the rights to which one is entitled."

[37] Ibid.

of the closely held stock. Usually such an estate will consist of only a small percentage of liquid assets, since most of the available liquid funds have probably been put into, or retained by, the closely held corporation.

Where an estate lacks liquidity, the problem can usually be solved by converting assets into more liquid form, *i.e.*, by increasing liquidity. The problem may also be solved by reducing the amount of the estate tax required to be paid at death. When closely held stock is involved, liquidity can be increased by a merger of the closely held corporation with a company whose stock is listed on a national exchange, or by the outright sale of such stock. If certain percentage requirements are met, a portion of the closely held stock could be redeemed by the corporation, pursuant to Section 303 of the Code, which allows certain stock to be redeemed without dividend consequences to meet death taxes.[38] Another possibility is to make lifetime gifts of such stock within the family (using the $3,000 annual exclusion) thereby reducing the amount of estate taxes required to be paid.

A charitable foundation can be extremely useful when the major asset of an estate is the stock of a closely held corporation, since it can be used to prevent a forced sale of such stock to pay estate taxes by reducing estate taxes to a point where they can be paid with existing liquid assets of the estate. When the stock is given to the charitable foundation, the estate will, of course, receive a charitable deduction for the value of the stock given. If, for example, the stock is separate property worth $500,000, and one half of it is given in a qualified marital deduction trust to the surviving spouse, and the other half is given to a charitable foundation, the estate will owe no estate tax whatsoever, since it would receive a $250,000 marital deduction and a $250,000 charitable deduction thereby completely eliminating the estate tax. In the above example, even though the marital deduction could not be utilized, the estate taxes would be reduced considerably since the charitable gift comes off of the top brackets.

In addition to helping solve the liquidity problem just discussed, a gift to a charitable foundation is useful in preserving the control and management of a closely held corporation. The control, of course, would be lost if part of the stock had to be sold to pay death taxes, or if a merger is effected with a company whose stock is traded on

[38] Section 303 is applicable only if the value of all of the stock of such corporation which is included in determining the value of the decedent's gross estate is either more than 35% of the value of the gross estate, or more than 50% of the taxable estate of such decedent.

a national exchange. It is also possible to recapitalize the corporation and transfer non-voting common stock or preferred stock to the charitable foundation with the retention of voting stock by the family. Thus, control by the family would be preserved by the retention of the voting common. The leverage factor may also operate so that the retained voting common stock will receive the main increase in later value. Such a gift will transfer a large part of the value of the corporation out of the taxable estate, reducing the estate taxes required to be paid. This can be accomplished by an inter vivos or testamentary gift.

It is also possible to recapitalize the corporation and provide that at the testator's death all voting common will pass to the charitable foundation, and all preferred stock would pass to family members, assuring them of a fixed income. There are any number of possible variations and each situation should be analyzed to determine which technique achieves the desired objective.

B. *Trust Or Corporation*

Should a corporation or a trust be used when a charitable foundation is to be formed? Although any organization which creates an entity (including an association) can be used for a charitable foundation, usually a trust or a corporation is formed as the vehicle to create the charitable foundation. In Texas, a charitable corporation is formed by preparing and filing with the Secretary of State appropriate articles of incorporation pursuant to the "Texas Non-Profit Corporation Act." On the other hand, a trust is formed by the preparation and execution of a trust indenture. These are the required formalities under local law. A charitable corporation is relatively easy to form and, by virtue of the new Act, most of the problems which will arise during the life of the corporate charitable foundation can be easily answered under the new Act.

However, the trust indenture, which will be the constitution of the charitable foundation established as a trust, will be an irrevocable instrument (difficult to amend without raising serious tax problems for the creator) that will have to cover all possible contingencies ab initio. Unless a practitioner has already carefully worked out the charitable trust indenture, the corporate form is probably the easiest way to get started.

Even though exculpatory provisions are placed in the indenture, there may still be a danger that the trustees of a charitable trust will incur personal liability. In other words, the trustees of a charitable trust may have the customary fiduciary duty with respect to

the management of the assets of the trust. Individuals may be unwilling to serve as trustees if this danger exists. The corporate form on the other hand usually guarantees limited personal liability and thus avoids the danger of personal liability.

Furthermore, the trust device is probably surrounded by more legal restrictions and is a less flexible device, since all contingencies must be anticipated at the time of the drafting of the trust indenture; whereas a corporate charter may be amended at any time.

When making the choice of a trust or corporation, you may also want to consider the differing tax consequences if the particular entity chosen is held to be non tax-exempt. Corporations pay a normal tax of 30 per cent and a surtax of 22 per cent, but the first $25,000 of income is exempt from the surtax.[39] Trusts are taxed in the same manner as individuals except as otherwise provided in Part I of Subchapter J of the Code.[40] The individual rates are progressive and extend from 20 per cent to 91 per cent. It should also be kept in mind that if a charitable foundation is going to have any unrelated business income by virtue of Sections 511 through 515 of the Code, the tax imposed on such income will differ depending on whether the foundation is a corporation or a trust.

There seem to be more tax traps when using a trust as a charitable foundation. For example, if the trust indenture does not expressly provide that the trust is irrevocable under the Texas Trust Act, the trust will be revocable. Thus, the corpus of the trust will be included in the donor's estate and the trust income will be taxable to him. Furthermore, the Internal Revenue Service apparently takes the position that where the settlor of a trust can designate the charities to receive income and can terminate the trust at any time by a distribution of the corpus to charities, the value of the trust property will be includable in the settlor's gross estate under Sections 2036 and 2038.[41]

Since most lawyers are perhaps more familiar with the corporate form, fewer errors will be committed in using a corporation for the charitable foundation. This, and the other factors discussed above, seems to lead to the inescapable conclusion that the corporate form is generally more desirable than the trust when establishing a charitable foundation.[42]

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[39] Int. Rev. Code of 1954, § 11.

[40] Int. Rev. Code of 1954, § 641(b).

[41] See Casner, Estate Planning 250 n.20a (Supp. 1960).

[42] This may not be true when there is a danger that the organization will not qualify as tax exempt. If the organization was organized as a trust and distributes all of its income for charitable purposes, it would be able to escape taxation of its income even though it was held to be non-exempt, since Section 642(c) allows a *trust* an unlimited deduction for amounts paid or permanently set aside for charitable purposes. This was an alternate argument made by the petitioner in John Danz Charitable Trust, 32 T.C. 469 (1959).

C. *Creation Of The Charitable Foundation*

The term "charitable foundation" means an entity, either a trust or a corporation, whose income is exempt from Federal income taxation and contributions to which are deductible for income, estate and gift tax purposes. In other words, in establishing a foundation, we have as our goal the creation of an entity, usually controlled by the donor and his family, whose income will not be taxable, and testamentary gifts made to it will be deductible for estate tax purposes and inter vivos gifts made to it will be deductible for gift tax purposes and for income tax purposes. The deductibility of a testamentary gift to such a foundation under the Texas inheritance tax law is also an objective.

A qualified private charitable foundation, whether corporation, trust, association or other entity, is exempted from the payment of income taxes by virtue of Sections 501(a) and 501(c)(3) of the Code unless it engages in certain prohibited transactions[43] or unreasonably accumulates its income[44] or is a "feeder organization."[45] Even though an organization is exempt, it is nevertheless taxable on its "unrelated business taxable" income.[46] To qualify as an exempt foundation pursuant to Section 501(c)(3), there are three basic requirements:

(1) The foundation must be *organized and operated exclusively* for religious, charitable, scientific, literary or educational purposes, for the prevention of cruelty to children or animals, or for the purpose of testing consumer products for public safety.
(2) The foundation's net income must not inure, in whole or in part, to the benefit of private shareholders or individuals.
(3) The foundation must not by any substantial part of its activities attempt to influence legislation by propaganda or otherwise.

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[43] Section 503(c) provides that the creator of the foundation, an individual who has made a substantial contribution to the foundation, a member of the family of the creator or such contributor or corporation controlled by the creator or such person cannot engage in a prohibited transaction with the foundation. The prohibited transactions are:

1. The foundation cannot lend any part of its income or corpus without adequate security and a reasonable rate of interest to such individuals or corporation.
2. The foundation may pay reasonable compensation for services actually rendered to such individuals or corporations, but a payment of an unreasonable compensation is a prohibited transaction.
3. It may not make its services available on a preferential basis.
4. It cannot make a substantial purchase of property for more than an adequate consideration.
5. It cannot sell a substantial part of its property for less than an adequate consideration.
6. It cannot engage in any other transaction which results in a substantial diversion of its income or corpus to such individuals or corporation.

[44] Int. Rev. Code of 1954, § 504.

[45] Int. Rev. Code of 1954, § 502.

[46] Int. Rev. Code of 1954, §§ 511-15.

The regulations[47] to Section 501(c)(3) set out organizational and operational tests, both of which must be met before a charitable foundation will be ruled exempt. Under the organizational test, the Commissioner now requires that a foundation's articles of organization must limit the purposes of the foundation to one or more exempt purposes and must not expressly empower the organization to engage, except to an insubstantial extent, in activities which in themselves are not in furtherance of one or more exempt purposes. These regulations expressly state that, "an organization that is empowered by its articles to engage in a manufacturing business; or to engage in the operation of a social club does not meet the organizational test regardless of the fact that its articles may state that such organization is created for charitable purposes within the meaning of Section 501(c)(3) . . . ."[48]

These regulations, however, indicate that an organization will meet the organizational test even though it is created solely to receive contributions and pay them over to exempt charitable organizations.

The purposes of the organization cannot be broader than the purposes specified in Section 501(c)(3), and, if they are, the Commissioner will hold that the organization is not exempt even though the actual operations are limited to exempt purposes.

Furthermore, an organization will not meet the organizational test if its articles of organization authorize it to devote more than an insubstantial part of its activities to attempting to influence legislation by propaganda or otherwise; or directly or indirectly to participate in or intervene in (including the publishing or distributing of statements) any political campaign on behalf of or in opposition to any candidate for public office; or to have objectives and to engage in activities so that it is an "action" organization.[49]

An organization will not meet the organizational test if upon

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[47] Treas. Reg. § 1.501(c)(3)-1 (1959).

[48] Ibid. Cf. John Danz Charitable Trust, 32 T.C. 469 (1959):

> The petitioner's deed of trust specifically empowers the trustees to carry on any trade or business 'whether or not speculative' and to invest in any property 'whether or not speculative in character.' Where such powers have existed, and the activities engaged in pursuant to those powers did not constitute a trade or business in the usual sense of that phrase and were not speculative, and the taxpayer otherwise qualified, this Court has held the taxpayer exempt. Forest Press, Inc., 22 T.C. 265 (1954); Alan Levin Foundation, 24 T.C. 15 (1955); Cummins-Collins Foundation, 15 T.C. 613 (1950); Edward Orton, Jr. Ceramic Foundation, 9 T.C. 533 (1947), affirmed sub nom. Commissioner v. Orton, 173 F.2d 483 (C.A. 6, 1949); Unity School of Christianity, 4 B.T.A. 61 (1926). The respondent's contention that the petitioner is not 'organized exclusively' for charitable purposes because of the mere existence of such powers in the deed of trust cannot be sustained.

[49] For a detailed definition of "action" organization, see Treas. Reg. § 1.501(c)(3) (1959).

dissolution any of its assets can be distributed to its members or shareholders. However, if such assets upon dissolution will, by virtue of the foundation's articles of organization or by operation of law, be distributed for one or more exempt purposes, the organization will meet the organizational test. The laws of the state in which the organization is organized will be controlling in this respect. A specific provision should be inserted in the articles of organization covering the distribution of the foundation's assets upon dissolution to or for another exempt charitable foundation or purpose.

Apparently the Internal Revenue Service takes the position that a charitable foundation is not exempt if its articles of organization contain an unlimited power to accumulate income. The Bulletin of the ABA Section on Taxation for April 1960 states:

> The Service has indicated that it will not approve articles of incorporation or indentures of trust of organizations claiming exemption under Sec. 501(c)(3) of the Code if they contain an unlimited power to accumulate income. The Service recognizes that such an organization must have some power to accumulate income but holds it must be limited by some standard such as reasonableness before exemption will be granted. In effect, therefore, the Service is imposing the limitations of Sec. 504 in determining qualification under Sec. 501(c)(3).

The organizational tests set out above will be applied only with respect to those organizations not yet exempt as of July 26, 1959. If an organization has previously been ruled exempt, the fact that such an organization currently does not meet the organizational tests set out in the new regulations will not be a basis for revoking the previous determination.

In view of these new organizational tests, the preparation of the articles of organization of the foundation (the trust instrument if a trust, the corporate charter if a corporation, the articles of association if an association) should be done with careful regard to each of these requirements.

In addition to being organized in a carefully defined manner, a private charitable foundation must also be operated in a manner prescribed by the Commissioner in his regulations. In the first place, the organization must be operated *primarily* for one or more exempt purposes. Secondly, it will lose its exemption if it is operated so that its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

With respect to organizations carrying on a trade or business, Treas. Reg. Section 1.501(c)(3)-1 provides as follows:

> An organization may meet the requirements of Section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in Section 513. In determining the existence or non-existence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes. An organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under Section 501(c)(3) even though it has certain religious purposes, its property is held in common, and its profits do not inure to the benefit of individual members of the organization.

These regulations expressly declare that a charitable foundation is not organized or operated exclusively for charitable purposes *unless it serves a public rather than a private interest.* An organization must establish that it is not organized or operated for the benefit of private interests. It should be obvious that although many private tax benefits may be derived from the use of a charitable foundation, the foundation must be organized and operated for strictly charitable non-profit purposes.

In connection with the continued operation of the charitable foundation, it should be kept in mind that the tax exemption granted by the Internal Revenue Service is effective only so long as there are no material changes in the nature of the organization. Rev. Rul. 58-617[50] expressly provides that the District Director of Internal Revenue for the district in which the organization is located must be advised immediately of any material changes in the nature of the organization. This allows a determination to be made as to the effect the changes may have on the exempt status of the foundation. All material changes in the nature of a foundation's activities should be made carefully and with this requirement in mind.

All charitable foundations which make distributions for charitable purposes to individuals are required to keep careful records and case histories to show the name and address of each recipient, the amount distributed, the purpose for which aid was given, the manner in which the recipient was selected and his relationship to the foundation, its creator or substantial contributor, or a corporation controlled by the creator or a substantial contributor.[51]

1. *Application for Exemption*

After a charitable foundation is organized and has been in actual

[50] 1958-2 Cum. Bull. 261.

[51] Rev. Rul. 56-304, 1956-2 Cum. Bull. 306.

operation for at least twelve months, in order to establish its income tax exemption, the foundation must file an application on Form 1023.[52] The organization must have been in actual operation for at least twelve months, unless it is a public or community type organization, before it is eligible to apply. Mere existence for a twelve month period is not sufficient. In other words, the organization must have some activity during the twelve month period. Consideration of the application for exemption will be postponed until there is sufficient activity for the Internal Revenue Service to apply its so-called "operational" tests. A tentative exemption for public or community type foundations can be obtained without waiting for the twelve month period to elapse.[53]

The application for exemption contains numerous questions which have to be answered. It must also be accompanied by a copy of the articles of organization and the bylaws of the foundation, together with a balance sheet for each annual accounting period, a statement of receipts and expenditures for each annual accounting period of operation, a brief statement of the specific purposes for which the organization was formed, a statement concerning each fund-raising activity and each business activity engaged in, a statement describing the nature of the foundation's activities and other statements. The information required is designed to elicit whether the charitable foundation is organized and operated exclusively for charitable purposes and is thus entitled to exemption.

The Internal Revenue Service takes the position that the filing of an application for exemption does not relieve the organization from filing a regular income tax return and paying the tax. If the organization is a corporation, a corporate income tax return must be filed. If the organization is a trust, a fiduciary income tax return must be filed. When the exempt status of the organization is established, the organization may file a claim for refund of income tax paid for the period for which its tax-exempt status is established.[54]

2. *Publicity Given to Applications for Tax Exemption*

Section 6104(a) of the Code provides that the exemption applications of charitable foundations already held to be tax-exempt at the time of the enactment of that Section, together with any papers submitted in support of the application, shall be open to public inspection at the national office of the Internal Revenue Service in Washington, D.C. This section also provides that copies of

[52] Treas. Reg. § 1.501(a)-1(a)(2) (1959).
[53] Rev. Rul. 54-164, 1954-1 Cum. Bull. 88.
[54] Rev. Rul. 60-144, 1960 Int. Rev. Bull. No. 16, at 44.

applications filed after the date of the enactment of Section 6104(a) shall be open to public inspection at the appropriate field office of the Internal Revenue Service. The Commissioner, upon application of the requesting organization, may withhold from public inspection any information contained in the application and related papers which he determines relates to any trade secret, patent, process, style of work, or apparatus of the organization if he determines that public disclosure of such information will adversely affect the organization. The Commissioner is also authorized to withhold information which, if divulged, would adversely affect the national defense.

Section 6104(a) virtually makes the affairs of a charitable foundation an open book because of the vast amount of organizational and operational data which have to be submitted in and with the exemption application.

This provision can be avoided by the formation of an inter vivos or testamentary trust whose income is distributable for charitable purposes. Such a trust would not have to be ruled to be exempt to avoid the income taxation of its income. However, its exempt status would have to have been passed on if a deduction is to be obtained for the contribution to the trust. In a situation where public inspection is not desired, a trust can be used in this fashion providing the donor is willing to forego his charitable deduction for both income and gift tax purposes. Section 6034 requires charitable trusts to file certain information with the Internal Revenue Service, but this information is not open to public inspection.

D. *State Law Considerations In Establishing A Charitable Foundation*

Some states have percentage limitations on the amount of property that may be given by will to a charitable foundation when family members survive. In New York, for example, only fifty per cent of an estate can be bequeathed to a charity if certain family members are still living.[55] Texas laws contain no such restriction, and a Texas testator could give his whole estate to a charitable foundation and not leave his family anything. Of course, the surviving spouse would have a vested interest in one-half of the community estate which could not be willed away from her without her consent.

Some states, *e.g.*, Ohio, provide that a bequest to a charity will be invalid unless made in a will executed within one year prior to the date of death.[56] Texas has no such limitation on testamentary charitable dispositions.

[55] N.Y. Deced. Est. Law § 17 (1947).
[56] Ohio Rev. Code Ann. § 2107.06 (Baldwin, 1953).

Perhaps the most important Texas law to consider when establishing a charitable foundation is Article 14.06 of the Texas Inheritance Tax Laws. This Article exempts from the Texas inheritance tax property passing "to or for the use of the United States, or to or for the use of any religious, educational or charitable organization, incorporated, unincorporated or in the form of a trust, *when such bequest devise or gift is to be used within this state*."[57]

If a bequest is not so limited, Article 14.06 further provides that the bequest to a charity will be exempt from the Texas inheritance tax if the bequest is irrevocably committed for use exclusively within the State of Texas or transferred to a religious, educational or charitable organization for use exclusively within the State of Texas. The exemption is also allowed if the bequest is to or for the use of a charitable organization which conducts its operations on a regional basis, and one such region includes the State of Texas or any such part of the state. A region is defined to mean not more than five contiguous states, one of which is Texas.

When a charitable foundation is established in Texas, a decision will have to be made as to whether the use of the funds is to be restricted to the State of Texas. Since Texas does not have a gift tax law with a geographical limitation similar to that contained in Article 14.06 of the Texas Inheritance Tax Laws, contributions made during lifetime by a donor to his charitable foundation do not have to be restricted to use within the State of Texas. The restriction as to use within the State of Texas can be placed in any testamentary bequest made to the charitable foundation. Although the funds received from testamentary bequests have to be used within the state, the funds given during lifetime can be more flexibly used within and without the State of Texas. This factor, together with the income tax advantage previously discussed, makes the establishment of a charitable foundation during the lifetime of the donor in Texas very desirable.

If the foundation is to receive bequests from many sources, a testamentary bequest which is not earmarked for use within the state will still be entitled to the inheritance tax charitable deduction by the making of an irrevocable commitment in writing of such property to charitable use within the state prior to the payment of the inheritance tax.

In view of the allowance of the charitable exemption for regional organizations, care should be taken in drafting the articles of organization to allow operation on a regional basis if that is desired. The planner's responsibility is to give the charitable foundation as flexible

[57] Tex. Tax-Gen. art. 14.06 (1960).

a base as possible consistent with the exemption requirements of Article 14.06.

Care should be exercised in drafting a testamentary bequest to a charitable foundation. If the foundation has not yet been established, the will should provide for its creation. Specific provisions requiring the establishment of the foundation should be placed in the will, and giving the executor too much power with respect to determining the nature of the foundation should be avoided. If the executor is given too much power, needless complications may arise, from the standpoint of state inheritance and federal estate taxes. For example, in *G. A. C. Halff Foundation v. Calvert*,[58] the will gave the trustees the right to pay a certain portion of the residuary estate to a charitable organization to be chosen by the trustees. The trustees formed a Texas non-profit charitable corporation and in its charter restricted the property to use within the State of Texas. The State of Texas denied the exemption on the ground that the will created a charitable trust, and no exemption was allowed because the use of the property was not restricted to Texas. The court held that the trustees had a power of appointment and upon its exercise, the property passed from the testator directly to the charitable corporation formed by the trustees.

Anytime an executor or trustee is given a choice concerning a charitable bequest, there is a danger that both state and federal taxing officials will claim that the property passed first to the executor or trustee and then to the charitable organization and, since it did not pass directly, the charitable deduction or exemption will be disallowed. Provisions which breed litigation should be avoided.

If a charitable foundation is to be established by will, it should be decided whether a testamentary charitable trust or a charitable corporation is going to be established. From a drafting standpoint, it will be easiest to require the formation of a charitable corporation for the reasons previously stated.

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[58] 281 S.W.2d 178 (Tex. Civ. App. 1955) error ref. n.r.e.