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From the Greedy to the Needy

In some instances when a taxpayer makes a charitable donation, the loss of revenue to the government, and the corresponding gain to the taxpayer, far exceeds the benefit to the charity. Some of these losses may be generated by government-sanctioned complex transactions and even government-created devices. This Article analyzes various charitable donations in terms of the dollars gained by the taxpayer, the dollars lost by the government, and the dollars received by the charity. After considering a sliding scale of benefits to the charities in light of the revenue losses to the government and taxpayer gains, this Article makes some normative conclusions about whether the good a donor does justifies his currently available tax benefits and then proposes some solutions.

INTRODUCTION

There are altruistic donors who make charitable gifts and do not expect anything in return.¹ Indeed, there are many taxpaying

* Professor, University of Baltimore School of Law. I would like to thank Professor Susan Gary for her generous comments on this Article as well as Professors Leandra Lederman, Ajay Mehrotra, Bill Popkin, and all of this year's attendees at the Critical Tax Theory Conference at the Indiana University Maurer School of Law—Bloomington, including Professors Monica Armstrong, Yariv Brauner, Kim Brooks, Neil Buchanan, Allison Christians, Adam Chodorow, Danshera Cords, Charlotte Crane, Bridget Crawford, Joseph Dodge, Mary Louise Fellows, Tony Infanti, Lily Kahng, Rebecca Kysar, Sagit Leviner, Leo Martinez, Stephen Mazza, Lloyd Hitoshi Mayer, Michael McIntyre, Stephanie McMahon, Henry Ordower, Jim Repetti, Diane Ring, Kerry Ryan, and Ted Seto who offered helpful comments and support.

¹ Although there are economists who reject the possibility of “pure altruism” and maintain that the illusion of altruism is actually “the ‘warm glow’ effect—the pleasurable feeling of playing Lady Bountiful and basking in public admiration,” researchers at the University of Oregon have discovered that “[p]aying taxes, according to the brain, can bring satisfaction.” According to the results of their research,

Civil societies function because people pay taxes and make charitable contributions to provide public goods. One possible motive for charitable

donors who cannot,² and some who do not,³ acquire any financial

contributions, called “pure altruism,” is satisfied by increases in the public good no matter the source or intent. Another possible motive, “warm glow,” is only fulfilled by an individual’s own voluntary donations. . . . Both pure altruism and warm-glow motives appear to determine the hedonic consequences of financial transfers to the public good.

John Tierney, *Taxes a Pleasure? Check the Brain Scan*, N.Y. TIMES, June 19, 2007, at F1 (citing the research of William T. Harbaugh, Ulrich Mayr & Daniel R. Burghart, *Neural Responses to Taxation and Voluntary Giving Reveal Motives for Charitable Donations*, 316 SCIENCE 1622 (2007), available at <http://www.sciencemag.org/cgi/content/abstract/316/5831/1622>).

² If a taxpayer does not itemize her deductions, but is limited to the standard deduction, she has no tax benefit for her charitable contribution. From 1982 to 1986, Congress provided for a direct charitable deduction, an “above the line” adjustment to income, for nonitemizers (former I.R.C. § 170(i) (2006)). In 1982 and in 1983, that deduction was equal to 25% of contributions up to a maximum deduction of \$100; in 1984, applying the same percentage, that limit was increased to \$300. In 1985, Congress allowed a 50% deduction and in 1986, a 100% deduction to nonitemizers with no dollar limitation, except for the percentage limitations applicable to both itemized and nonitemized deductions under I.R.C. § 170(b). See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 121(a), 95 Stat. 172, 196 (1981) (additional views of Senators Packwood, Heinz, Durenberger, Bentsen, Moynihan, and Baucus); H.R. REP. NO. 97-215, at 273 (1981) (Conf. Rep.). “The average income for 1981 for itemizers is estimated to be \$31,533. In contrast, the average income for persons taking the standard deduction is estimated to be only \$12,600. This legislation will encourage these 43,000,000 households to participate in giving.” *Id.* Some have called for the return of a nonitemized deduction or for the adoption of a credit for charitable donations for those taxpayers who claim the standard deduction. See, e.g., Ellen P. Aprill, *Churches, Politics, and the Charitable Contribution Deduction*, 42 B.C. L. REV. 843 (2001) (arguing for a nonitemized charitable deduction that exceeds a certain floor or for a credit instead of a full deduction), but some view the deduction as “double dipping” in light of the role of the standard deduction. See, e.g., Ronald A. Pearlman, *Repeal of Charitable Contributions for Nonitemizers Explained*, 28 TAX NOTES 1140, 1140 (Sept. 2, 1985).

³ Besides not receiving a quid pro quo from the charity for their gift, there are probably some taxpayers who could itemize but choose not to do so (perhaps to avoid record keeping or more complicated tax returns).

In the past, the General Accounting Office has found that filers who used the standard deduction instead of itemizing paid the Internal Revenue Service almost \$1 billion a year more than they should have.

....

Critics of the tax code say this is because many people choose to forgo savings for simplicity. Using the standard deduction, regardless of the tax costs, means they can end their annual tax involvement sooner.

....

The GAO says it was mainly lower-income and middle-income taxpayers. Taxpayers in the \$25,000-to-\$50,000 income range accounted for the bulk of those who paid too much; filers earning between \$50,000 and \$75,000 were a close second.

Bankrate.com, *Didn’t Itemize? You May Be Overpaying IRS*, MSN Money, <http://articles.moneycentral.msn.com/Taxes/PreparationTips/DidnotItemizeYouMayHave>

benefit for their largesse. On the other hand, there are taxpayers who want something in return for their charitable donation. That “something” may be a token gift from the charity. In this instance, the donation amount is reduced to reflect the amount the charity actually benefits, resulting in a net gift. The return on the taxpayer’s donation, however, may be derived from the tax system instead of, or in addition to, a financial reward from the charity. The taxpayer may receive this benefit directly as a charitable donation deduction that reduces her tax liability⁴ while at the same time decreasing the government’s revenue. Alternatively, or in addition to that direct tax benefit, a taxpayer may receive a monetary gain through the tax system. This advantage can be accomplished through a series of complex transactions incorporating a charitable gift as an integral element of a tax scheme.⁵ Indeed, there are transactions incorporating

OverpaidIRS.aspx?page=all (last visited July 16, 2009). However, some say the opposite is true, that you can save money by not itemizing and by using the standard deduction instead, particularly if you may be subject to the alternative minimum tax if you choose to itemize. Press Release, The American Institute of Certified Public Accountants, Choosing Standard Deduction Might Cut Tax Bill, AICPA Says; CPAs Offer Tax Tips About AMT and Tax Law Changes, March 25, 2008, http://www.aicpa.org/download/news/2008/AICPA_Tax_Tips_-_3-25-08.pdf.

⁴ The percentage limitations of section 170(b) allow a maximum deduction of 50% of the individual taxpayer’s contribution base (see I.R.C. § 170(b)(1)(F), defining contribution base as adjusted gross income computed without any section 172 net operating loss carryback) in any one year, regardless of the nature or recipient of the charitable contribution, with the excess carried forward into the next successive five years. See I.R.C. §§ 170(b)(1)(A)–(D), (d)(1).

⁵ This Article will not address the quid pro quo receipt of spiritual benefits like those asserted in *Hernandez v. Commissioner*, 490 U.S. 680 (1989), which, after Rev. Rul. 93-73, 1993-2 C.B. 75 (ruling that its Rev. Rul. 78-189, 1978-1 C.B. 68, which was the subject of the Church of Scientology ruling in *Hernandez*, was thereby obsolete), continue to be problematic, especially in the area of parochial school tuition payments in such cases as *Sklar v. Commissioner*, 125 T.C. 281, 298–99 (2005) (“According to a letter sent to petitioners in 1994 from the chief of the adjustments branch, Fresno Service Center, the settlement agreement between the Commissioner and the Church of Scientology allows individuals to claim, as charitable contributions, 80 percent of the cost of qualified religious services.”); *Sklar v. Commissioner*, 282 F.3d 610 (9th Cir. 2002), *amending and superseding* 279 F.3d 697 (9th Cir. 2002), *aff’g* 79 T.C.M. (CCH) 1815 (2000); see also Allan J. Samansky, *Deductibility of Contributions to Religious Institutions*, 24 VA. TAX REV. 65 (2004) (advocating the deductibility of auditing payments but not of training payments). Although an analysis of this issue is beyond the scope of this Article, the IRS considers this area to be one of increased noncompliance and abuse. “IRS examiners are seeing an upturn in instances where taxpayers try to disguise private tuition payments as contributions to charitable or religious organizations.” Internal Revenue Service, *Phishing Scams, Frivolous Arguments Top the 2008 “Dirty Dozen” Tax Scams*, March 13, 2008, <http://www.irs.gov/newsroom/article/0,,id=180075,00.html> [hereinafter 2008 Dirty Dozen]; see Rev. Rul. 83-104, 1983-2 C.B. 46.

charitable donations that, as a practical matter, could not be achieved without a charitable gift as central to the taxpayer's receipt of financial gain. On the other hand, there is evidence that some donors increase the size of their contributions because they receive a greater tax benefit.⁶ According to the government's statistics, contributions decline when the tax rate decreases.⁷ There is a range of financial

⁶ S. REP. NO. 97-144, at 179 (1981), *as reprinted in* 1981 U.S.C.C.A.N. 105 (additional views of Senators Packwood, Heinz, Durenberger, Bentsen, Moynihan, and Baucus) ("For example, the reduction in maximum rate from 70% to 50%, although fully meritorious to stimulate investment, will lead to less giving by persons in those higher brackets. Also, the reductions in estate and gift taxes will decrease the role of charitable giving in estate planning."); *see Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning: Hearing Before the Comm. on Finance*, 110th Cong. 2 (2008) [hereinafter 2008 S. Hearing] (statement of Diana Aviv, President and CEO Independent Sector), available at <http://www.senate.gov/~finance/hearings/testimony/2008test/040308datest.pdf>.

These incentives have had a significant influence on the how—and how much—Americans give to support charitable causes. The Congressional Budget Office found that the estate tax leads affluent people to donate far more than they otherwise would, because such donations—whether made during life or as bequests at death—sharply reduce estate tax liability. The CBO found that about one-sixth of the estates filing estate tax returns in 2000 left a charitable bequest which together totaled \$16 billion. Charitable bequests were heavily concentrated in the largest estates with over 70 percent of the total bequests coming from estates valued at more than \$3.5 million.

The CBO further estimated that if the estate tax had not existed in 2000, donations to charities would have been reduced by \$13 billion to \$25 billion, which is more than the total amount of corporate donations in that year. For example, if a potential donor's assets would be subject to a 45% estate tax rate, then a charitable bequest of \$1 million would reduce the tax liability of the estate by \$450,000. The unlimited deduction for charitable giving provides a valuable incentive for the wealthiest of our citizens to give back to the communities in which they have lived and earned success.

If Congress were to repeal the estate tax or significantly reduce estate tax marginal rates, the significant decline in charitable donations from wealthy Americans forecast by the Congressional Budget Office study would have damaging effects on the nonprofit community and on society as a whole. Donations from individuals, including bequests, make up 84% of all contributions, constituting one-sixth of the total support for charitable nonprofits. Moreover, about two-thirds of all contributions by individuals in 2000 were made by people with a net worth high enough to potentially face the estate tax. If nonprofit groups lost a substantial part of these donations, many of them would have to scale back their activities significantly.

Id. at 2–3 (footnote omitted); *see also* Charles T. Clotfelter, *Tax-Induced Distortions in the Voluntary Sector*, 39 CASE W. RES. L. REV. 663, 686 (1989).

⁷ *See* Darien B. Jacobson, Brian G. Raub & Barry W. Johnson, *The Estate Tax: Ninety Years and Counting*, STATISTICS OF INCOME BULLETIN 118, 126 (Summer 2007), available at <http://www.irs.gov/pub/irs-soi/ninetyestate.pdf> (explaining the drop in charitable contributions following the passage of The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981)). The authors suggested that both the passage of the unlimited marital deduction wherein "gifts to charities no longer provided a

benefits that a donor can derive either from a charity, such as in a net gift, or from the government in a tax benefit. While those that match the benefit to the charity do not raise concerns, there are situations where the donor's considerable financial return far outweighs the benefit that the charity receives.⁸

The concept of *quid pro quo* is usually viewed as a simple two-party transaction between the purported donor and the charity. The issue examined is whether, or to what extent, the transfer between them is a sale or a gift. Under *American Bar Endowment*,⁹ there are two prerequisites for a charitable deduction where the taxpayer has received a benefit: first, she must intend to make a gift;¹⁰ and second, her gift is deductible only if, and to the extent that, it exceeds the consideration she obtains.¹¹ When a taxpayer seeks to use the tax system to benefit from her charitable gift in addition to the tax benefit derived from a commensurate charitable deduction, *quid pro quo* and the examination of donative intent should be expanded to encompass the consequences to the alleged donor, the charity, and the government. This extension is appropriate because the charitable deduction is premised on, or justified by, being a less intrusive means to serve the public good than a direct government expenditure.¹²

tax advantage over bequests to a spouse" as well as the twenty-two point reduction in the maximum estate tax rates likely triggered that effect. "Second, under ERTA, the top marginal estate tax rate was reduced from 77 percent to 55 percent, and, according to some research, tax rates affect the charitable giving at death in both the size of charitable bequests and the number of charitable organizations named as beneficiaries." *Id.* (citing D. Joulfaian, *Charitable Bequests and Estate Taxes*, 44(2) NAT'L TAX J. 169 (1991)).

⁸ Where a taxpayer receives a benefit of equal value for his donation, he is ineligible for a charitable contribution deduction. *United States v. Am. Bar Endowment*, 477 U.S. 105, 117–18 (1986); Rev. Rul. 67-246, 1967-2 C.B. 104, 105.

⁹ *Am. Bar Endowment*, 477 U.S. at 117–18. See Treas. Reg. § 1.170A-1(h) (2008).

¹⁰ Donative intent is pivotal to a gift in an income tax context for a recipient to qualify for the exclusion under section 102. See *Comm'r v. Duberstein*, 363 U.S. 278, 285 (1960). However, since the beneficiary of a charitable gift is a tax-exempt organization, the requirement is unnecessary for this purpose. On the other hand, in the transfer tax context, the lack of donative intent may indicate a bona fide sale in the ordinary course of a trade or business, but donative intent is generally irrelevant for transfer tax purposes where the only criteria to determine a gift is whether or not there is an unequal exchange of value. See I.R.C. § 2512(b) (2006); Treas. Reg. § 25.2512-8 (2008).

¹¹ 477 U.S. at 118 ("The *sine qua non* of a charitable contribution is a transfer of money or property without adequate consideration. The taxpayer, therefore, must at a minimum demonstrate that he purposely contributed money or property in excess of the value of any benefit he received in return.").

¹² The deduction for charitable donations has alternatively been justified. See, e.g., William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 314–15 (1972) ("In the case of many charitable contributions the material goods or

Moreover, in the transfer tax¹³ context, where an unequal exchange constitutes a gift, that exchange is not restricted to a two-party exchange. Where a transaction or a series of integrated transactions affect multiple parties, determining who has made a gift and who has received a gift requires examining what each party has ultimately gained or lost.

Compliance is an element of this problem and legislation continues to be enacted or proposed to deal with this part of the abuse¹⁴ because

services purchased with the contributed funds inure entirely to the benefit of persons other than the donor, and the donor enjoys only the nonmaterial satisfaction of making a gift. . . . A good argument can be made that taxable personal consumption should be defined to include divisible, private goods and services whose consumption by one household precludes enjoyment by others, but not collective goods whose enjoyment is nonexclusive or the nonmaterial satisfactions that arise from making contributions.”). However, the charitable donation deduction has also been criticized. *See, e.g.*, Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377, 378 (1972) (in order to eliminate tax inequity and the bias in favor of the wealthy, “we should substitute for the charitable contribution deduction a system of direct federal assistance for private charitable organizations through a matching grant mechanism”). The literature in this area is extensive; some recent works include: Ilan Benshalom, *The Dual Subsidy Theory of Charitable Deductions*, 84 IND. L.J. (Northwestern Public Law Research Paper No. 08-09, 2008), available at <http://ssrn.com/abstract=1117549>; David E. Pozen, *Remapping the Charitable Deduction*, 39 CONN. L. REV. 531, 545–66 (2006); Douglas A. Kahn & Jeffrey H. Kahn, “Gifts, Gifts, and Gifts” - *The Income Tax Definition and Treatment of Private and Charitable “Gifts” and a Principled Policy Justification for the Exclusion of Gifts from Income*, 78 NOTRE DAME L. REV. 441, 513–14 (2003); David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information and the Private Pursuit of Public Goals* 3 (Columbia Law and Economics Working Paper No. 327), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1097644 (“This Article analyzes three reasons to subsidize charitable contributions, each responding to a different information or incentive problem that is inherent in the pursuit of public goals. First, the subsidy can counter free-riding by encouraging donors to be more generous. A second objective is to measure and respond to popular preferences about public goals. Subsidized charity can encourage experimentation and competition and can empower minority perspectives that are underrepresented in the political process. Yet subsidized charity also disproportionately represents the views of wealthy donors. The third goal, which is new to the academic literature, is to recruit private donors to monitor the quality of nonprofits, so that the government can piggyback on these quality-control efforts.”); Johnny Rex Buckles, *The Case for the Taxpaying Good Samaritan: Deducting Earmarked Transfers to Charity Under Federal Income Tax Law, Theory and Policy*, 70 FORDHAM L. REV. 1243, 1277–97 (2002); Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419, 456 n.162 (1998).

¹³ Transfer taxes include federal gift, estate, and generation-skipping transfer taxes. I.R.C. Chs. 11, 12 & 13.

¹⁴ *See infra* Part II.

the Internal Revenue Service (“IRS”), with its limited resources,¹⁵ has proved inadequate.¹⁶ While acknowledging the role of compliance, this Article will primarily analyze devices and transactions that are government sanctioned¹⁷ and even government created.¹⁸

This Article will analyze various charitable donations in terms of the dollars gained by the taxpayer, the dollars lost by the government, and the dollars received by the charity. After considering a sliding scale of benefits to the charities in light of the revenue losses to the government and taxpayer gains, this Article also makes normative conclusions about whether the good a donor does justifies his currently available tax benefits.

I

COMPLIANCE

Much of the recent legislation regarding charitable deductions has focused on compliance. Abuse in this area has centered on valuation exaggeration of noncash charitable gifts. Although sometimes exposing blatant noncompliance, the legislation often merely reveals the need for the charity to quantify and delineate the benefits split between itself and the taxpayer and to notify the taxpayer of each element of the net gift. Although the last fifteen years have produced legislation to deal with these abuses, problems in this area persist.¹⁹

In 1993, Congress enacted Internal Revenue Code section (“section”) 170(f)(8) increasing taxpayer substantiation requirements²⁰ and section 6115 placing a disclosure requirement on

¹⁵ See Allen Kenney, *IRS Plans Significant Cuts to Estate Tax Program*, 112 TAX NOTES 418, 418 (July 31, 2006).

¹⁶ “The IRS continues to observe the misuse of tax-exempt organizations. Misuse includes . . . attempts by donors to maintain control over donated assets or income from donated property and overvaluation of contributed property.” 2008 Dirty Dozen, *supra* note 5.

¹⁷ For example, taxpayers have realized significant tax benefits from defined value clauses coupled with charitable gifts in transactions where self-interest or greed is paramount to benefiting a charity. Courts have legitimized these abuses. See *infra* Part VII.B.

¹⁸ Techniques such as charitable lead trusts are statutory creations. I.R.C. §§ 170(f), 2055(e), 2522(c) (2006). See *infra* Part V.B.

¹⁹ 2008 Dirty Dozen, *supra* note 5.

²⁰ Section 170(f)(8) provides that:

[n]o deduction shall be allowed under subsection (a) for any contribution of \$250 or more unless the taxpayer substantiates the contribution by a contemporaneous

the charities²¹ to deal with the administrative difficulties involved in a quid pro quo transfer.²² The donor often did not receive notification from the charity that some or all of the transfers were nondeductible before the enactment of the 1993 statutes.²³ Similarly, 2004²⁴

written acknowledgment of the contribution by the donee organization that meets the requirements of subparagraph (B).

(B) Content of acknowledgment. An acknowledgment meets the requirements of this subparagraph if it includes the following information:

(i) The amount of cash and a description (but not value) of any property other than cash contributed.

(ii) Whether the donee organization provided any goods or services in consideration, in whole or in part, for any property described in clause (i).

(iii) A description and good faith estimate of the value of any goods or services referred to in clause (ii) or, if such goods or services consist solely of intangible religious benefits, a statement to that effect.

For purposes of this subparagraph, the term "intangible religious benefit" means any intangible religious benefit which is provided by an organization organized exclusively for religious purposes and which generally is not sold in a commercial transaction outside the donative context.

²¹ Section 6115 provides:

(a) Disclosure requirement. If an organization described in section 170(c) (other than paragraph (1) thereof) receives a quid pro quo contribution in excess of \$75, the organization shall, in connection with the solicitation or receipt of the contribution, provide a written statement which—

(1) informs the donor that the amount of the contribution that is deductible for Federal income tax purposes is limited to the excess of the amount of any money and the value of any property other than money contributed by the donor over the value of the goods or services provided by the organization, and

(2) provides the donor with a good faith estimate of the value of such goods or services.

(b) Quid pro quo contribution. For purposes of this section, the term "quid pro quo contribution" means a payment made partly as a contribution and partly in consideration for goods or services provided to the payor by the donee organization. A quid pro quo contribution does not include any payment made to an organization, organized exclusively for religious purposes, in return for which the taxpayer receives solely an intangible religious benefit that generally is not sold in a commercial transaction outside the donative context.

²² Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §§ 13172-13173, 107 Stat. 312, 455 (1993) [hereinafter 1993 Tax Act].

²³ See H.R. REP. NO. 103-111, at 785 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 553 [hereinafter 1993 H.R. REP.].

Difficult problems of tax administration arise with respect to fundraising techniques in which an organization that is eligible to receive deductible contributions provides goods or services in consideration for payments from donors. Organizations that engage in such fundraising practices often do not inform their donors that all or a portion of the amount paid by the donor may not

legislation inhibits the overvaluation of donations of property, particularly of conservation easements,²⁵ patents,²⁶ and vehicles;²⁷

be deductible as a charitable contribution. Consequently, the committee believes that there will be increased compliance with present-law rules governing charitable contribution deductions if a taxpayer who claims a separate charitable contribution of \$750 or more is required to obtain substantiation from the donee indicating the amount of the contribution and whether any goods, service, or privilege was received by the donor in exchange for making the contribution. In addition, the committee believes it is appropriate that, in all cases where a charity receives a quid pro quo contribution (i.e., a payment made partly as a contribution and partly in consideration for goods or services furnished to the payor by the donee organization), the charity should inform the donor that the deduction under section 170 is limited to the amount by which the payment exceeds the value of goods or services furnished by the charity, and should provide a good faith estimate of the value of such goods or services.

138 CONG. REC. S11246-01 (Aug. 3, 1992).

²⁴ American Jobs Creation Act of 2004, Pub. L. No. 108-357, Title III, § 335(a), Title IV, § 413(c)(30), Title VIII, §§ 882(a), (b), (d), 883(a), 884(a) (2004), 118 Stat. 1418, 1509, 1627, 1631, 1632 (2004). See H.R. REP. NO. 108-755, at 532, 536, 538 (2004) (Conf. Rep.), as reprinted in 2004 U.S.C.C.A.N. 1341 [hereinafter H.R. CONF. REP. NO. 108-755].

²⁵ See *Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities: Hearing Before the Comm. on Finance, 108th Cong. 17* (2004) [hereinafter 2004 Hearing], available at <http://finance.senate.gov/sitepages/hearing062204.htm> (statement of the Hon. Mark Everson, Commissioner, IRS, Washington, D.C.) (“We have seen several abuses in this area [Conservation Easements]. There have been cases where the easement being donated is overvalued. There are also cases in which the donor, or the donor’s successor in interest, takes an action inconsistent with the easement without adverse consequences. The conservation easement rules place the charity in a watchdog role over the easements it possesses. If the charity fails to monitor these properties (another failure in governance), the potential exists for inconsistent use by the landowner of the property upon which the original deduction was premised. In other cases, taxpayers are claiming large deductions when they are not entitled to any deduction at all (e.g., when taxpayers fail to comply with the law and regulations governing deductions for contributions of conservation easements.”); Fred Stokeld, *Major Changes to EO Information Return Under Consideration, IRS’s Miller Says*, 108 TAX NOTES 722, 722 (Aug. 15, 2005) (specifically, Steven T. Miller, IRS Tax Exempt/Government Entities Commissioner described abuses involving donations of conservation and façade easements as stemming from a lack of quality appraisals in support of their deductions); 2004 Hearing, *supra* note 25, at 18 (statement of Diana Aviv, President and CEO Independent Sector) (“While few gifts of tangible property, beyond land donations and a small percentage of fine art objects, are of sufficient financial value to justify the expense involved in ascertaining appraisals to the extent recommended for The Nature Conservancy, all nonprofits should establish and follow clearer standards for accepting the Form 8283 estimates provided by donors to support tax deductions for contributed property. . . . Congress should establish appropriate thresholds for the financial value of those deductions to ensure that it does not create barriers inadvertently to accepting contributions by responsible charities. Further investigation is called for concerning the costs of responsible appraisals and systems for the certification of appraisers to avoid unwanted, unintended consequences of discouraging responsible donors while leaving loopholes for those who would manipulate the system for personal gain.”).

and intensifies enforcement efforts by increasing the reporting requirements for noncash charitable contributions.²⁸

The government focused on the problems of overvaluation,²⁹ quid pro quo transactions, and how much of the property was transferred for patents and similar property. To deal with these issues, the 2004

²⁶ The 2004 legislation added sections 170(e)(1)(iii) and 170(m), and the reporting requirements in section 6050L. These laws are applicable to contributions made after June 3, 2004. See H.R. REP. NO. 108-548(I), at 300 (2004) (“The provision provides that if a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory) to a charitable organization, the taxpayer’s initial charitable deduction is limited to the lesser of the taxpayer’s basis in the contributed property or the fair market value of the property. In addition, the taxpayer is permitted to deduct, as a charitable deduction, certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed property.”).

²⁷ The 2004 legislation dealing with the charitable contributions of vehicles included sections 170(f)(12) and 6720, effective December 31, 2004. See H.R. CONF. REP. NO. 108-755, *supra* note 24, at 598 (“Under the Senate amendment, the amount of deduction for charitable contributions of vehicles (generally including automobiles, boats, and airplanes for which the claimed value exceeds \$500 and excluding inventory property) depends upon the use of the vehicle by the donee organization. If the donee organization sells the vehicle without any significant intervening use or material improvement of such vehicle by the organization, the amount of the deduction shall not exceed the gross proceeds received from the sale.” The vehicle must comply with the reporting requirements of the concurrently enacted section 170(f)(11), however, appraisals are not required where vehicles are sold by the donee organization without a significant intervening use or material improvement of the vehicle by the donee; instead, the charity must provide donor with a certification that the vehicle was sold in an arm’s length transaction between unrelated parties, must include proceeds amount from the sale and a statement that the donor’s deduction may not exceed that value. *Id.* at 538, 541. Under the fraud provisions of section 6720, for an applicable vehicle (i.e., one “sold without a significant intervening use or material improvement”), there is a penalty equal to the greater of its sale proceeds or the amount calculated by multiplying the highest tax rate by the charity’s stated sales price. “For all other acknowledgements, the penalty is the greater of \$5,000 or the product of the highest rate of tax specified in section 1 and the claimed value of the vehicle.” *Id.* at 599.); Fred Stokeld, *Guidance Plan Includes Projects on Vehicle Donations*, 108 TAX NOTES 721, 721 (Aug. 15, 2005).

²⁸ The 2004 legislation increasing the reporting requirements for noncash charitable gifts included section 170(f)(11), effective for contributions made after June 3, 2004. The reporting requirements extend to corporations and partnerships and require the donor to obtain a qualified appraisal if the deduction exceeds \$5000; if that contribution exceeds \$500,000, the donor must attach the qualified appraisal to her tax return. Except for reasonable cause, failure to submit the required appraisal results in the denial of a deduction. See H.R. CONF. REP. NO. 108-755, *supra* note 24, at 536–37.

²⁹ See William A. Drennan, *Charitable Donations of Intellectual Property: The Case for Retaining the Fair Market Value Tax Deduction*, 2004 UTAH L. REV. 1045, 1077, 1079–80 (2004) (concluding that the purpose of the legislation is “to prevent corporations from overvaluing charitable patent donations,” which may be the result of ignoring prior art or, because the value of a patent may be very speculative, the benefits may not be actualized).

legislation allows only a limited current deduction consisting of the lesser of basis or the fair market value of the property.³⁰ By capping the donor's deduction for patents, which may be elusive and difficult to value, Congress reined in unjustifiable gains to the donor that did not match the benefits to the charity. On the other hand, the 2004 legislation allows additional amounts to be deducted later to reflect an increased amount actually recouped from the property.³¹ That is, if the patent should actually produce an additional benefit to the charity in subsequent years, the donor may benefit to the same extent that the charity does.³² To aid in the taxpayer's compliance, a qualified appraisal is required where the amount deducted is more than \$5000; when the deductible amount is greater than \$500,000, the taxpayer must attach the appraisal to her return.³³

Vehicle donations were also inflated³⁴ and the 2004 legislation tightened rules around the charitable donations of used motor vehicles, boats, and airplanes.³⁵ A charity must notify a donor who

³⁰ I.R.C. § 170(e)(1)(B)(iii).

³¹ *Id.* § 170(m). Some have disagreed with Congress's approach and believe that it will reduce important charitable gifts. *See, e.g.,* Drennan, *supra* note 29, at 1152 (arguing for a fair market value deduction for charitable contributions of intellectual property on the basis of social policy that considers the many benefits resulting from those in-kind charitable donations, including encouraging contributions of copyrighted works from collectors and the donation of beneficial patents that the inventor does not or cannot further develop); Don MacBean, *Better to Give Than to Receive: Evaluating Recent IP Donation Tax Policy Changes*, 2005 DUKE L. & TECH. REV. 19, ¶ 25 (2005) (advocating the coupling of a fair market value deduction with the required use of "a third party broker whose primary goal is matching donors with appropriate donees. The broker will be either a government entity or a not-for-profit organization paid by the government for this purpose" (footnote omitted)).

³² MacBean, *supra* note 31, at ¶ 6 ("[V]alue depends on possible future income streams, the property's technical feasibility, and many other factors that are similarly difficult to predict."). The treatment accorded patents is similar to that suggested for charitable lead trusts. *See infra* Part V.B.

³³ I.R.C. §§ 170(f)(11)(C)–(D), 6050L(b).

³⁴ 2004 Hearing, *supra* note 25, at 25 (statement of the Hon. Mark Everson, Commissioner, IRS, Washington, D.C.).

³⁵ I.R.C. § 170(f)(12). This section provides:

In the case of a contribution of a qualified vehicle the claimed value of which exceeds \$500—

- (i) paragraph (8) shall not apply and no deduction shall be allowed under subsection (a) for such contribution unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization that meets the requirements of subparagraph (B) and includes the acknowledgement with the taxpayer's return of tax which includes the deduction, and

contributes a vehicle valued at more than \$500 of the gross proceeds from the sale, and the donor must substantiate that deduction with specified details required on his return.³⁶ Moreover, the 2004 legislation provides penalties for those charities that do not comply with the reporting requirements of section 170(f)(12).³⁷

(ii) if the organization sells the vehicle without any significant intervening use or material improvement of such vehicle by the organization, the amount of the deduction allowed under subsection (a) shall not exceed the gross proceeds received from such sale.

(B) Content of acknowledgement.—An acknowledgement meets the requirements of this subparagraph if it includes the following information:

(i) The name and taxpayer identification number of the donor.

(ii) The vehicle identification number or similar number.

(iii) In the case of a qualified vehicle to which subparagraph (A)(ii) applies—

(I) a certification that the vehicle was sold in an arm's length transaction between unrelated parties,

(II) the gross proceeds from the sale, and

(III) a statement that the deductible amount may not exceed the amount of such gross proceeds.

(iv) In the case of a qualified vehicle to which subparagraph (A)(ii) does not apply—

(I) a certification of the intended use or material improvement of the vehicle and the intended duration of such use, and

(II) a certification that the vehicle would not be transferred in exchange for money, other property, or services before completion of such use or improvement.

(v) Whether the donee organization provided any goods or services in consideration, in whole or in part, for the qualified vehicle.

(vi) A description and good faith estimate of the value of any goods or services referred to in clause (v) or, if such goods or services consist solely of intangible religious benefits (as defined in paragraph (8)(B)), a statement to that effect.

³⁶ *Id.*

³⁷ I.R.C. § 6720. This provision, effective for contributions made after 2004, states:

Any donee organization required under section 170(f)(12)(A) to furnish a contemporaneous written acknowledgment to a donor which knowingly furnishes a false or fraudulent acknowledgment, or which knowingly fails to furnish such acknowledgment in the manner, at the time, and showing the information required under section 170(f)(12), or regulations prescribed thereunder, shall for each such act, or for each such failure, be subject to a penalty equal to—

(1) in the case of an acknowledgment with respect to a qualified vehicle to which section 170(f)(12)(A)(ii) applies, the greater of—

(A) the product of the highest rate of tax specified in section 1 and the sales price stated on the acknowledgment, or

(B) the gross proceeds from the sale of such vehicle, and

The strict rules regarding the donation of vehicles are a response to the excessive and dubious deductions that donors were taking, echoing the aggressive advertising of the donee charities. “Highly troubling is GAO’s [General Accounting Office’s] analysis of 54 specific donations, where it appears that the charity actually received less than 10% of the value claimed on the donor’s return in more than half the cases, and actually lost money on some vehicles.”³⁸ The benefits to the donor in terms of a tax deduction sometimes exceeds any benefit to the charity. Under a quid pro quo analysis of the taxpayer’s and charity’s gains and the government’s losses, no deduction should have been allowed to some taxpayers for their vehicle transfer to the charity. However, this legislation has been effective: “[T]he number of automobile donations decreased 67.0 percent from about 900.7 thousand in Tax Year 2004, to 297.1 thousand in Tax Year 2005. The amount claimed for these donations declined by 80.6 percent from \$2.4 billion in 2004 to \$0.5 billion in 2005.”³⁹

In addition, 2006 legislation⁴⁰ limits the abuses associated with the charitable donations of used clothing.⁴¹ The statute allows a

(2) in the case of an acknowledgment with respect to any other qualified vehicle to which section 170(f)(12) applies, the greater of—

(A) the product of the highest rate of tax specified in section 1 and the claimed value of the vehicle, or

(B) \$5,000.

³⁸ 2004 Hearing, *supra* note 25, at 18. (statement of the Hon. Mark Everson, Commissioner, IRS, Washington, D.C.). However, while “[t]he GAO states that its sample of specific donations was too small to allow generalization to all vehicle donations,” the results were still troubling. *Id.*

³⁹ Janette Wilson, *Individual Noncash Contributions, 2005*, 24 STATISTICS INCOME BULLETIN 68 (Spring 2008).

⁴⁰ Pension Protection Act of 2006, Pub. L. No. 109-280, Title XII, §§ 1202(a), 1204(a), 1206(a), (b)(1), 1213(a)(1), (b)–(d), 1214(a), (b), 1215(a), 1216(a), 1217(a), 1218(a), 1219(c)(1), 1234(a), 120 Stat. 1066, 1068, 1075, 1077, 1079–80, 1085, 1100 (2006) [hereinafter 2006 PPA]. See STAFF OF JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 109TH CONGRESS 170, 597 (Joint Comm. Print 2006) [hereinafter STAFF OF JOINT COMM. ON TAX’N, 2006 GENERAL EXPLANATION]; 2008 S. Hearing (statement of Diana Aviv, President and CEO Independent Sector), *supra* note 6, at 5 (“Those reforms included increased fines and penalties for violations of prohibitions on excessive private benefits, clearer rules for appraisals required to substantiate tax deductions for charitable contributions, and new rules to ensure that assets held in donor-advised funds and supporting organizations are used to benefit the intended charitable purposes.”).

⁴¹ I.R.C. § 170(f)(16) Contributions of clothing and household items.

(A) In general.—In the case of an individual, partnership, or corporation, no deduction shall be allowed under subsection (a) for any contribution of clothing

charitable deduction only if the condition of the clothing or household item is at least considered good. “The Secretary is authorized to deny by regulation a deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and used undergarments.”⁴² While somewhat comical, almost worthless property costs the government a hefty amount, more than

or a household item unless such clothing or household item is in good used condition or better.

(B) Items of minimal value.—Notwithstanding subparagraph (A), the Secretary may by regulation deny a deduction under subsection (a) for any contribution of clothing or a household item which has minimal monetary value.

(C) Exception for certain property.—Subparagraphs (A) and (B) shall not apply to any contribution of a single item of clothing or a household item for which a deduction of more than \$500 is claimed if the taxpayer includes with the taxpayer’s return a qualified appraisal with respect to the property.

(D) Household items.—For purposes of this paragraph—

(i) In general. The term “household items” includes furniture, furnishings, electronics, appliances, linens, and other similar items.

(ii) Excluded items.—Such term does not include—

(I) food,

(II) paintings, antiques, and other objects of art,

(III) jewelry and gems, and

(IV) collections.

(E) Special rule for pass-thru entities.—In the case of a partnership or S corporation, this paragraph shall be applied at the entity level, except that the deduction shall be denied at the partner or shareholder level.

See also George K. Yin, *JCT Chief Discusses the Tax Gap*, 107 TAX NOTES 1449, 1451 (June 13, 2005) (“In the case of used clothing and household goods, the relatively small value of each individual item contributed makes it extremely unlikely that the IRS will ever challenge the amount claimed as a deduction for such items. Moreover, even taxpayers determined to be completely honest may tend to overvalue such items due to the attachment they may have to the item. . . . Under these circumstances, it seemed that the proper amount of deduction for such items is probably just a hope and a prayer. The staff decided that if compliance in this case was really just a hope and a prayer, then at least the potential amount of error should be capped [at \$500].”).

⁴² STAFF OF JOINT COMM. ON TAX’N, 2006 GENERAL EXPLANATION, *supra* note 40, at 599 (“[T]he President’s Advisory Panel on Federal Tax Reform and the staff of the Joint Committee on Taxation both have concluded that the fair market value-based deduction for contributions of clothing and household items present difficult tax administration issues, as determining the correct value of an item is a fact intensive, and thus also a resource intensive matter.”). Many should recall that President and Mrs. Clinton took a charitable deduction for their old underwear. See David Cay Johnston, *Spending It; It Takes a President to Overpay the I.R.S.*, N.Y. TIMES, Apr. 19, 1998 (“When he was Governor of Arkansas, Mr. Clinton deducted \$2 for each pair of used underwear he gave to the Salvation Army.”); Stephen Labaton, *Clinton Taxes Laid Bare, Line by Line*, N.Y. TIMES, Apr. 16, 1994, at A8.

\$9 billion in 2003 alone.⁴³ With excessive deductions from the taxpayer, the benefits to her are much greater than either the benefits to the charity or the loss to the government.

Likewise, in 2006, abuses involving donor advised funds, such as donor private benefit misuse of funds,⁴⁴ prompted legislation.⁴⁵ The study of donor advised funds, also required by that legislation,⁴⁶ may stimulate further corrective measures regarding these charitable gifts.⁴⁷

The IRS has tried to stem the use of charities as complicit accommodation parties in certain tax schemes. The government uses the term “accommodation party” in this context to define a tax-

⁴³ STAFF OF JOINT COMM. ON TAX'N, 2006 GENERAL EXPLANATION, *supra* note 40, at 599.

⁴⁴ 2004 Hearings (statement of the Hon. Mark Everson, Commissioner, IRS, Washington, D.C.), *supra* note 25, at 15 (“We have seen abuses in this area, both in examinations and in applications for exemption from new organizations. . . . In addition, we are aware that some promoters encourage clients to donate funds and then use those funds to pay personal expenses, which might include school expenses for the donor’s children, payments for the donor’s own ‘volunteer work’, and loans back to the donor.”); 2004 Hearings (statement of Diana Aviv, President and CEO Independent Sector), *supra* note 25, at 19 (“[T]he Council on Foundations’ Proposal to Strengthen the Legal Framework of Donor-Advised Funds, based on extensive work by its Community Foundations Leadership Team, recommends the development of a ‘bright line’ test to prevent compensation and other inappropriate financial benefits to donors, their advisors, or their family members; clarification of the distribution rules and requirements for donor-advised funds; and increased penalties for violations of the rules governing donor-advised funds.”).

⁴⁵ 2006 PPA, *supra* note 40, §§ 1231(a), 1234(a), 1234(b), 1234(c), 120 Stat. 1081, 1082, 1095, 1100–01, enacting I.R.C. §§ 170(f)(18), 4966, 2522(c)(5), 2055(e)(5). Section 170(f)(18) provides:

A deduction otherwise allowed under subsection (a) for any contribution to a donor advised fund (as defined in section 4966(d)(2)) shall only be allowed if—

(A) the sponsoring organization (as defined in section 4966(d)(1)) with respect to such donor advised fund is not—

- (i) described in paragraph (3), (4), or (5) of subsection (c), or
- (ii) a type III supporting organization (as defined in section 4943(f)(5)(A)) which is not a functionally integrated type III supporting organization (as defined in section 4943(f)(5)(B)), and

(B) the taxpayer obtains a contemporaneous written acknowledgment (determined under rules similar to the rules of paragraph (8)(C)) from the sponsoring organization (as so defined) of such donor advised fund that such organization has exclusive legal control over the assets contributed.

⁴⁶ The 2006 legislation required a study to be conducted on both donor advised funds and supporting organizations. See I.R.C. § 1226; I.R.S. Notice 2007-21, 2007-9 I.R.B. 611, available at <http://www.irs.gov/pub/irs-drop/n-07-21.pdf> (last visited July 20, 2009).

⁴⁷ See, e.g., <http://www.journalofaccountancy.com/Issues/2008/Jan/DonorAdvisedFundsPreparingforCloserScrutiny.htm> (last visited July 20, 2009).

exempt organization's participation in a transaction that is intended to secure tax benefits for a taxable third party.⁴⁸ In 2004, IRS Commissioner Mark Everson described two such schemes involving a charity as an accommodation party:

The first example is a transaction in which taxpayers donate offsetting foreign currency option contracts to a charitable organization to trigger a loss deduction while avoiding taxation on corresponding gain. The second example involves the purported transfer of S corporation nonvoting stock by a taxpayer to a tax-exempt entity in an attempt to shield income from taxation while allowing the taxpayer to retain the economic benefits of ownership.⁴⁹

According to him, the cost of the first type of abuse may be more than \$1 million for each such transaction; the cost of the second he estimated to entail "the reallocation of hundreds of millions of dollars from shareholders to tax-exempt accommodation parties."⁵⁰ The IRS has listed both types of tax schemes as transactions requiring disclosure.⁵¹

Finally, Congress and the courts have attacked the role of charities in split-dollar insurance arrangements. In *Addis*,⁵² the Ninth Circuit pointed to the taxpayers paying \$36,000 to National Heritage Foundation ("NHF") as an incentive for them to consent to a split-

⁴⁸ 2004 Hearings (statement of the Hon. Mark Everson, Commissioner, IRS, Washington, D.C.), *supra* note 25, at 9.

⁴⁹ *Id.* at 10.

⁵⁰ *Id.* at 11.

⁵¹ See I.R.S. Notice 2003-81, 2003-51 I.R.B. 1223, *modified by* Notice 2007-71, 2007-35 I.R.B. 472; Reg. § 1.6664-2 (c)(5), Ex. 1, 2; I.R.S. Notice 2004-30, 2004-17 I.R.B. 828 ("This notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, and substantially similar transactions, as listed transactions for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations"); 2004 Hearing (statement of the Hon. Mark Everson, Commissioner, IRS, Washington, D.C.), *supra* note 25, at 13 ("In Notice 2004-30, we designated the S Corporation Transaction as a listed transaction and for the first time exercised our authority under the return disclosure regulations to designate specifically the tax-exempt accommodation party as a 'participant' for purposes of those regulations. As a participant, the accommodation party must comply with the disclosure requirements.").

⁵² *Addis v. Comm'r*, 374 F.3d 881 (9th Cir. 2004), *aff'g*, 118 T.C. 528 (2002); *see also* *Weiner v. Comm'r*, T.C.M. (CCH) 1874 (2002) (The court denied the taxpayer a charitable deduction for amounts that were actually charitable split-dollar insurance where, contrary to the substantiation requirement of section 170(f)(8), the charity did not disclose in the taxpayer's receipts the quid pro quo he received from the charity's paying life insurance premiums for policies wherein he or his family would receive some of the death benefits.).

dollar insurance agreement with terms that disproportionately benefited the taxpayers (their quid pro quo):

[T]he split of investment returns compared to investment outlays was remarkably uneven. For twelve years, the NHF would put up 90% of the investment corpus but be entitled to none of the gains from the projected positive investment performance exceeding the NHF's guaranteed \$557,280 in death benefits if Cindi Addis should die. If the Addises [exercised their unilateral power to] surrender[] the policy, the NHF would get back just the amounts it paid in, less the cost of its share of the death benefit—and with no compensation for lost interest and other investment value.

The Addises put up only 10% of the investment corpus but were entitled to all the projected gains in cash value and death benefit amount less the NHF's fixed \$557,280 share of the death benefit or the return—without interest—of the NHF's premium⁵³ outlays exceeding the cost of the NHF's share of the death benefit.

Without the \$36,000 payment, NHF would not have been interested in this lopsided agreement. The court held that because the taxpayers did not comply with the statutory consideration disclosure requirement,⁵⁴ they were not entitled to a charitable deduction.⁵⁵ According to the legislative history of the disclosure statute, as a prerequisite for their charitable deduction, the taxpayers had the responsibility for securing substantiation from the NHF for the quid pro quo they had received for their contribution.⁵⁶

NHF stopped participating in split-dollar insurance transactions when Congress enacted additional legislation⁵⁷ imposing a 100%

⁵³ *Addis*, 374 F.3d at 885–86 (“The split-dollar agreement gave the Addises ownership of the remaining projected gain of close to a million—nearly twice the NHF's fixed share of the death benefit even though the NHF paid nine times more of the annual policy premium. After twelve years, the Addises would also own and be able to borrow on a disproportionate share of the projected cash value of the policy.”).

⁵⁴ I.R.C. § 170(f)(8) (2006); *see supra* note 22.

⁵⁵ *Addis*, 374 F.3d at 881.

⁵⁶ *Id.* at 885 (citing H.R. REP. 103-213, at 563–64 (1993) (Conf. Rep.)). The Tax Court had held that the taxpayers' receipts contained misstatements because the documents claimed that they received no consideration for their charitable transfer despite the fact that “they expected the NHF to make premium payments on a policy that would provide ‘substantial benefits’ to [the taxpayers’] trust.” *Id.* (citing *Addis v. Comm’r*, 118 T.C. 528, 536 (2002)).

⁵⁷ Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, Title V, §§ 532(c)(1)(A), (B), 537(a), 113 Stat. 1930, 1936 (1999). This Act enacted section 170(f)(10), which provides, in part, that:

Nothing in this section or in section 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 shall be construed to allow a deduction, and no deduction

penalty on any charity's involvement in those arrangements.⁵⁸ Congress enacted the legislation to halt the proliferation of the "abusive scheme" of charitable split-dollar life insurance. The taxpayers' contribution, for which they take a charitable deduction, is the cost of premium payments for insurance for them while the proceeds primarily benefit their family members.⁵⁹ Congress wanted the promotion of those transactions exploiting the charitable deduction to cease immediately. "The Committee is also concerned that the charity . . . serves merely as a conduit or accommodation party, which the Committee does not view as appropriate for an organization with tax-exempt status."⁶⁰

shall be allowed, for any transfer to or for the use of an organization described in subsection (c) if in connection with such transfer—

- (i) the organization directly or indirectly pays, or has previously paid, any premium on any personal benefit contract with respect to the transferor, or
- (ii) there is an understanding or expectation that any person will directly or indirectly pay any premium on any personal benefit contract with respect to the transferor.

(B) . . . For purposes of subparagraph (A), the term "personal benefit contract" means, with respect to the transferor, any life insurance, annuity, or endowment contract if any direct or indirect beneficiary under such contract is the transferor, any member of the transferor's family, or any other person (other than an organization described in subsection (c)) designated by the transferor.

⁵⁸ Section 170(f)(10)(F)(i) provides:

There is hereby imposed on any organization described in subsection (c) an excise tax equal to the premiums paid by such organization on any life insurance, annuity, or endowment contract if the payment of premiums on such contract is in connection with a transfer for which a deduction is not allowable under subparagraph (A), determined without regard to when such transfer is made.

⁵⁹ H.R. REP. NO. 106-19 pt. 2 (1999) [hereinafter 1999 H.R. REP.], available at <http://thomas.loc.gov/cp106/cp106query.html> (search "African Growth"; then follow link 4 "African Growth and Opportunity Act" part 2) (African Growth and Opportunity Act, Section 19: Denial of Charitable Contribution Deduction for Transfers Associated with Charitable Split-Dollar Insurance Arrangements (June 17, 1999)); S. REP. NO. 106-54, at 27-28 (1999); Affordable Education Act of 1999, S. 1134, 106th Cong., § 406 (1999), available at <http://thomas.loc.gov/cgi-bin/query/F?c106:1./temp/~c1060nZWDY:e43117:pcs.html>.

⁶⁰ 1999 H.R. REP., *supra* note 59, § 19.

III

THANK YOU GIFTS AND SALES BY OTHER NAMES

A. *Thank You Gifts*

The easiest example of a quid pro quo gift to charity is the token “thank you” gift from a charitable organization after making a cash donation. For example, a taxpayer receives a \$5 coffee mug from the charity for a \$50 contribution resulting in a net gift of \$45. When the taxpayer takes a deduction of \$45, the tax benefit results in a tax savings to her of that amount multiplied by her tax bracket, which assuming the current maximum income tax rate of 35%,⁶¹ results in her benefiting to the extent of \$15.75. A synopsis of this simple transaction reveals that the taxpayer has purchased a \$5 mug from the charity and has \$15.75 in her pocket rather than mailing that amount to the IRS; the charity has \$45 plus whatever profit it made on the sale of its “thank you gift” since the mug is valued at fair market value, the total of which is available for the charity to use for its exempt purpose; and the government has \$15.75 less in revenue. Even if multiple zeroes are added to those dollar figures, the government’s loss and the taxpayer’s gain are both much less than the benefit to the charity, and so this quid pro quo charitable donation is acceptable under the U.S. Supreme Court’s model in *American Bar Endowment* and under traditional tax theories justifying the charitable deduction.⁶²

B. *Entrance Fees*

Another type of “coffee mug” is the conditional gift to charity, which is really purely a commercial transaction.⁶³ Specifically, in order to gain entrance into a nursing home, a charity may require the taxpayer to make a donation.⁶⁴ A 1972 revenue ruling presented a fact pattern wherein all with means had to make a “sustainer’s gift” on admission to the nursing home; the amount of that donation varied by the size of the apartment and the payments were applied to debt retirement. The IRS determined that if the transfer to the nursing

⁶¹ I.R.C. § 1(i)(2) (2006).

⁶² See Andrews, *supra* note 12.

⁶³ There are other types of conditional gifts, such as those conditioned on survivorship: “If A reaches her 25th birthday, the trust shall pay A \$1K and make a \$1K donation to the Red Cross.”

⁶⁴ Rev. Rul. 72-506, 1972-2 C.B. 106.

home is either plainly or de facto required for entrance, there is no donation to the charity and the required payment is purely a sales transaction between the supposed donor and the charity.⁶⁵

Taxpayers in a more recent private letter ruling attempted to distinguish themselves from the 1972 revenue ruling.⁶⁶ The taxpayers asserted that they were not required to make a donation as a prerequisite for admission to the nursing home, their benefit was limited to a monthly rental surcharge waiver, and they had made a net gift to the extent of the excess value of their payment over the present value of the surcharge waiver over their lifetimes. The IRS rejected the taxpayers' position and held that they were not entitled to a charitable deduction for their payment to the nursing home because they obtained certain preferential rights regarding their unit in exchange.⁶⁷ In addition, there was a refund feature of the full value of the payment available to a donor that, whether or not the taxpayers waived it, is indicative of a quid pro quo transaction under both *Hernandez* and *American Bar Endowment*. Thus, the IRS ruled those factors create a strong presumption that the exchange was an even one.⁶⁸

On the other hand, there is case law including *Wardwell*⁶⁹ and *Dowell*⁷⁰ that has held the payment of a nursing home entrance fee was eligible for a charitable deduction. In *Wardwell*, an invalid with Parkinson's disease made a large donation to the facility's building fund only one day before she was accepted for residence in the home's infirmary. In exchange for her \$7500, the amount required "to endow a room in the newer West Building," she or her designee

⁶⁵ *Id.*; see also *Sedam v. United States*, 518 F.2d 242, 245 (7th Cir. 1975) (payments made to secure mother's room and admission to nursing home).

⁶⁶ I.R.S. Priv. Ltr. Rul. 94-23-001 (Aug. 23, 1993), 1993 PLR LEXIS 2736.

⁶⁷ *Id.* at *11-12 ("By putting themselves on the donor list, the Taxpayers expanded their options significantly, and by donating they guaranteed occupancy of a unit with the location, type, and size they desired, without subjecting themselves to the uncertainty of the non-donor waiting lists. . . . Second, by making the payment as 'original donors' of a unit under construction, the Taxpayers were able to review the plans and customize the cottage to their liking. . . . Third, by making the payment, the Taxpayers obtained the right for a surviving spouse to continue to occupy the unit for his or her lifetime, at single-occupant rates.").

⁶⁸ Moreover, the government determined that the taxpayers failed the second requirement that any surplus was paid with a donative intent. *Id.* at *13-14.

⁶⁹ *Estate of Wardwell v. Comm'r*, 301 F.2d 632 (8th Cir. 1962), *action on dec.*, 1974-492 (Apr. 16, 1974).

⁷⁰ *Dowell v. United States*, 553 F.2d 1233 (10th Cir. 1977), *action on dec.*, 1977-83 (June 16, 1977).

was allowed to have a nameplate placed on a room and to occupy the room, if available.⁷¹ However, she did not receive any property rights for her donation. On the date she executed a room rental agreement with the home, she agreed to pay \$7500, but this payment was actually made the day before she moved into the home. The government's deficiency notice denying her a charitable deduction for that amount stated, "The payment to Friendship Haven, Inc., entitled Mrs. Wardwell to preferred treatment as to the availability of a residence room and is now allowing her to live in this institution at a rate which is lower than persons not making a room endowment."⁷² The Eighth Circuit reversed the Tax Court, which held that the payment was a quid pro quo arrangement, and held that since the government had not proved a direct connection between the taxpayer's payment and her admission status, the court would not make an inference from the timing of the contribution. Because her payment pledge constituted a binding legal obligation under local law "regardless of any . . . motive, or expectation that she might then have had in mind as to her admission into Friendship Haven, Inc."⁷³ and the pledge occurred one year before she had intended to move into the nursing home, the court held that the government was confusing motive with consideration when it denied her the deduction.⁷⁴ However, the donor's motive is central to donative intent which, at least since *American Bar Endowment*, is a requirement for the charitable contribution deduction.

Likewise, in *Dowell* the taxpayers made a "sponsorship gift" of \$22,500 to the parent company of Oral Roberts University, Inc., and University Village, Inc.⁷⁵ *Dowell* testified that her objective was to

⁷¹ *Wardwell*, 301 F.2d at 634.

⁷² *Id.* at 635 (emphasis omitted).

⁷³ *Id.* at 636.

⁷⁴ *Id.* at 637–38. The court also noted that the home accepted patients in need who did not have the financial resources to make such a pledge. *Id.*

⁷⁵ The taxpayers had met with a representative of the Village who testified that he had told them about the "sponsorship gift" that was requested in all instances but not a prerequisite for residency. One month after her gift, the Dowells moved into a cottage at University Village and signed a rental agreement, providing also for the health care of Mr. Dowell. *Dowell*, 553 F.2d at 1235–36. University Village's brochure states "that while a 'sponsorship gift' is not a prerequisite for residency, it is requested [and] that a 'sponsorship gift' does not entitle the donor to any 'property rights.'" *Id.* at 1236. However, 89% of sponsorship gifts were from residents and the remaining 11% were from their friends and relatives as well as from nonresidents. The vast majority of the residents gave the suggested amount for the particular housing they selected. More than half (twelve out of nineteen) of the residents moving from the Village received full or partial

obtain housing and treatment for her husband in the Village, but she made the “sponsorship gift” only because she wanted to make a donation “out of charity and generosity” and not for any benefit she might receive in return.⁷⁶ The circuit court emphasized the role of donative intent and held that the trial court’s finding of the taxpayer’s intention to make a gift was not clearly erroneous.⁷⁷ The court held that there was no evidence of a quid pro quo in *Dowell* despite the facility’s advertising brochure, discussions, and statistics all reveal that, except for the very few who cannot afford to make such a payment, the entrance fee was a de facto requirement for admission to the Village. After the transfer, the nursing home had \$22,500 that they would have inevitably received on the Dowells’ admission to the facility; the Dowells received a tax benefit of \$22,500 multiplied by their tax bracket for 1956; and the government lost that same amount in revenue.

Wardwell and *Dowell* are pre-*American Bar Association* cases and may be viewed as aberrations in construing quid pro quo facts as indicative of a charitable donation. However, recently a scholar cited those cases as examples of non earmarked funds qualifying for a charitable deduction and so they still might have some vitality.⁷⁸

C. Litigation Settlements and Awards

Some legal disputes are avoided or resolved by a purported wrongdoer’s payment to a charity. High tech companies,⁷⁹ lying

refunds of their gifts. Almost one-quarter of the residents “either made no gifts, gifts of more than the suggested amount, or gifts of less” than the recommended amount. *Id.* at 1237.

⁷⁶ *Id.* at 1236–37.

⁷⁷ *Id.* at 1238. The court contrasted *Dowell* with *Stubbs v. United States*, 428 F.2d 885 (9th Cir. 1970), wherein “[t]he anticipated economic gain to the taxpayers was found to be the dominant factor or intent generating the conveyance.” 553 F.2d at 1239.

⁷⁸ See Buckles, *supra* note 12, at 1251 & n.35 (“However, several courts have upheld a deduction if the taxpayer presented credible evidence that the non-earmarked donation was not made with the expectation of receiving a material economic benefit in return for the contribution, even though the taxpayer or her family would likely benefit to some degree from the contribution.”).

⁷⁹ Superior Court of California, County of San Francisco, J.C.C.P. No. 4106, Microsoft Settlement Agreement, 31 (June 16, 2003), available at <http://www.microsoftcalsettlement.com/PDF/SettlementAgreement.pdf> (“The purpose of the cy pres program is to benefit public schools in California at which a substantial percentage of the attending students come from low-income households.”). The maximum value of all claims settled by that agreement, which includes those payments to California public schools, was \$1.1 billion. *Id.* at 17.

authors,⁸⁰ billionaires,⁸¹ gas franchises,⁸² and even Sara Lee⁸³ have agreed to make “gifts to charity” in what is increasingly viewed as a win-win type of conflict resolution. It is only the government who loses revenue when a quid pro quo transfer to a charity poses as a qualifying charitable deduction.

A popularized instance of this type of conditional payment is the resolution of several class action suits in different jurisdictions against Microsoft that included the company making a charitable transfer.⁸⁴

⁸⁰ Motoko Rich, *Publisher and Author Settle Suit over Lies*, N.Y. TIMES, Sept. 7, 2006, at E1 (“James Frey, the author who admitted making up portions of his best-selling memoir, ‘A Million Little Pieces,’ and his publisher, Random House, have agreed in principle on a settlement with readers who filed lawsuits claiming they had been defrauded. . . . [T]he settlement still has to be approved by a judge. . . . Under the terms of the agreement, which has been accepted by 10 of the 12 plaintiffs who are part of the consolidated case, both Mr. Frey and Random House will pay out no more than a total of \$2.35 million, which includes the cost of refunding customers, lawyers’ fees for both sides and a yet-to-be-specified donation to charity.” (emphasis added)).

⁸¹ Larry Ellison to Donate \$100 Million to Settle Lawsuit, <http://www.legalradar.com/2006/06/larry-ellison-to-donate-100-million-to-settle-lawsuit.html> (June 28, 2006) (“Oracle co-founder Larry Ellison will settle an insider trading lawsuit that he faces with a \$100 million donation to his non-profit medical foundation. However there are reports that the \$115 million he had pledged to Harvard University last year has not yet been given.”); see also How Much Should High-Tech Give to Charity?, http://www.b-eye-network.com/blogs/white/archives/2006/12/how_much_should.php (Dec. 29, 2006, 12:44 PM).

⁸² Eric Noe, *Gas Station Owners Must Decide on Post-Katrina Gouging Charges: Business Owners Face Choice Between Charity Donation or Lawsuits*, ABC NEWS (Jan. 4, 2005), available at <http://abcnews.go.com/Business/HurricaneKatrina/story?id=1470445> (“The owners of 18 Illinois gas stations face a decision on Thursday: Admit to illegally raising prices at the pump after Hurricane Katrina and make a \$1,000 donation to charity, or declare their innocence and face the possibility of even bigger expenses in the form of a state lawsuit.”).

⁸³ Press Release, Center for Science in the Public Interest, Sara Lee Accused of Whole Grain Whitewash (Dec. 17, 2007), available at <http://www.cspinet.org/new/200712171.html> (“CSPI’s notification to Sara Lee says it wants the company to stop the misleading whole grain claims and to donate to charity the profits it has received from ‘Soft & Smooth Made with Whole Grain White Bread’ that it has earned since its introduction in 2005. Sara Lee has 30 days to respond to CSPI’s settlement offer.”).

⁸⁴ See, e.g., *New York Outlines Options for Microsoft Class Action*, PCMAG.COM (Apr. 12, 2006), available at <http://www.pcmag.com/article2/0,1759,1948956,00.asp> (“In addition, Microsoft agreed to give \$5 million in cash and vouchers to the Minnesota Legal Aid Society.”); Robert W. Wood, *Resolving Litigation by Payments to Charity*, 109 TAX NOTES 633, 633 (Oct. 31, 2005) (arguing that there may be a distinction between a settlement and a judgment, in that with a settlement the plaintiff has no right to income until he signs an agreement relinquishing his rights). In his article, Mr. Wood expressed caution about Larry Ellison’s agreement to pay \$100 million to charity in order to resolve an insider trading lawsuit because such action would necessitate the approval of Oracle’s board of directors.

Because Microsoft lacks donative intent as required by *American Bar Endowment* and because it has received a benefit equal to the transferred amount (i.e., settling the litigation),⁸⁵ the company is not entitled to any charitable deduction. Because the majority agreed to the settlement, each plaintiff has taxable income in the value of her share of the donation.⁸⁶ In theory, each plaintiff is entitled to a charitable donation deduction in that same amount. However, if the plaintiffs parallel taxpayers, many of those plaintiffs in the class action suit do not itemize their deductions and therefore cannot take a charitable contribution deduction.⁸⁷ It is unlikely that the plaintiffs were informed about their potential tax consequences relating to Microsoft's "donation" before they voted in favor of the settlement agreement.

While the charity will benefit in the payment amount, Microsoft should not benefit (at least not as a charitable deduction⁸⁸), the plaintiffs should not benefit unless they itemize, and, to the extent that Microsoft and the plaintiffs received unwarranted tax benefits, the government has lost revenue.

D. Orphan Patents with Fees

There should be a "Lemon Law" for certain charitable "gifts," such as a company's charitable contribution of an orphan patent riddled with high maintenance fees. The purported donor would receive a

⁸⁵ This situation parallels the one in *American Bar Endowment*. "The most logical test of the value of the insurance respondents received is the cost of similar policies. Three of the four individual respondents failed to demonstrate that they could have purchased similar policies for a lower cost, and we must therefore assume that the value of ABE's insurance to those taxpayers at least equals their premium payments. Had respondent Sherwood known that he could purchase comparable insurance for less money, ABE's insurance would necessarily have declined in value to him. Because Sherwood did not have that knowledge, however, we again must assume that he valued ABE's insurance equivalently to those competing policies of which he was aware. Because those policies cost as much as or more than ABE's, Sherwood has failed to demonstrate that he intentionally gave away more than he received." 477 U.S. 105, 118 (1986).

⁸⁶ I.R.C. § 104(a)(2) (2006) (excluding only damages received on account of physical injury or illness).

⁸⁷ See *supra* notes 2–3.

⁸⁸ Assuming, however, that Microsoft improperly took a charitable deduction, the company would receive a tax benefit indirectly in a circumstance where it might not be able to take a business deduction for its payment to the plaintiffs unless that payment qualified as an ordinary and necessary trade or business expense. See I.R.C. § 162 (2006). While the payment might qualify as a business deduction under section 162, that analysis is different from a determination of deductibility as a charitable donation under section 170.

charitable donation deduction in the reported fair market value of the patent; at the same time, the company is relieved of a large financial burden that it transfers to the charity. The quid pro quo involved in those transfers was that the donor gained a charitable deduction and the charity gained an asset that was more of a liability.⁸⁹ “By the year 2000, donees began to realize that some IP [donations] cost more in annual maintenance fees than their alleged value. The University of Virginia, for example, ended up [losing] money on a donated patent valued at more than \$7 million.”⁹⁰ The charities ultimately demanded that the donor assist them with these maintenance fees as a condition for accepting the patent.⁹¹ In such a situation, that quid pro quo illustrates a negative benefit to the charity that should have denied the taxpayer a charitable deduction in the first instance.

IV

THE DOUBLE BENEFIT OF THE CHARITABLE DEDUCTION AND A CAPITAL GAIN EXCLUSION

Donors who give certain in-kind gifts⁹² to a charity in order to receive the double benefit of not recognizing capital gain on their donation, while at the same time receiving a charitable deduction in the full fair market value of their property, are financially adept.⁹³

⁸⁹ MacBean, *supra* note 31, at ¶ 1, ¶ 5 (“For many corporations, donating ‘orphan patents’ and other intellectual property (IP) to tax-exempt entities is much more than just a philanthropic endeavor. Tax deductions for these donations make them an effective means of cutting costs. . . . By the early 1990s . . . many corporations ‘were spending millions of dollars a year on [patent] maintenance fees,’ some of which were protecting orphan patents that were not even being used. Consultants and company executives alike realized that prudent cost management required donating or abandoning these orphan patents.” (footnotes omitted) (third alteration original)).

⁹⁰ *Id.* at ¶ 10 (footnotes omitted).

⁹¹ *Id.* (“A professor involved later commented that ‘[t]he bottom line is that it cost us money with no benefit.’”).

⁹² Wilson, *supra* note 39, at 68 (“For Tax Year 2005, 25.4 million individual taxpayers who itemized deductions reported \$48.1 billion in deductions for noncash charitable contributions. Of these taxpayers, 6.6 million reported \$41.1 billion in charitable contributions on Form 8283, *Noncash Charitable Contributions*.” That reporting requirement applies to in-kind gifts of more than \$500. See I.R.C. §§ 170(f)(11)(A)(i), 170(f)(11)(B)).

⁹³ 26 C.F.R. § 1.170A-1(c)(1) (2008) allows the taxpayer to deduct the fair market value (“FMV”) of the property he donates to the charity, subject to the reductions required under section 170(e)(1). This statute does not require any reduction for gifts of intangible personal property or real property that if sold would have produced long term capital gain as long as the property is donated to a section 501(c)(3) organization. In addition, a taxpayer may receive, to a lesser degree, a double benefit when she sells property to a

Specifically, the statistics indicate that the wealthy often make gifts of appreciated stock to a charity to obtain both benefits.⁹⁴ Congress's preference for charitable gifts of appreciated property over cash gifts is inequitable as it disproportionately benefits wealthier donors.⁹⁵ This bias as aid primarily for wealthy donors is underscored by the removal of charitable gifts of appreciated property as an item of tax preference to compute the alternative minimum tax ("AMT").⁹⁶

charity at an amount less than fair market value. In a bargain sale to a charity, the taxpayer may deduct, as a charitable gift, the difference between the fair market value of the property and the amount realized by the taxpayer from the charity on the sale. Thus, if the value is \$100 and the taxpayer receives \$60 from the charity, she has made a charitable donation of \$40. However, because her basis for that property must be adjusted under I.R.C. § 1011(b), if her basis in the property had been \$50, her recomputed basis under that statute would be \$30, requiring her to recognize \$30 (rather than \$10) of capital gain on the sale (i.e., \$60 (amount she realized on the sale) – \$30 (recomputed basis) = \$30 rather than \$60 – \$50 (original basis)). If she had first sold the property for its FMV, she would have recognized a capital gain of \$50 (\$100 (amount realized if sold at FMV) – \$50 (original basis) = \$50 gain); assuming she had made the same \$40 contribution, that would have been the amount of her donation. Thus, she has benefited to some degree by the bargain sale by not having to recognize an additional \$20 of capital gain, despite that she has the same \$60 left in her pocket.

⁹⁴ Wilson, *supra* note 39, at 68 (In 2005, corporate stock represented the largest donations and amounted to \$16.3 billion.); *see also* Clotfelter, *supra* note 6, at 686–87.

⁹⁵ Subject to the restrictions outlined in *supra* note 88, the charitable deduction provision allows the taxpayer to deduct the date of gift fair market value of donated in-kind property. In 2005, for all groups of taxpayers with adjusted gross income ("AGI") below \$500,000, the aggregate cost of their donated property exceeded the aggregate fair market value. For all groups of taxpayers with AGI at or above \$500,000, the aggregate fair market value of their contribution, and the amount of their deduction, exceeded the aggregate cost of their donated property. For those taxpayers with AGI at or above \$10 million, the aggregate cost of their in-kind donations was \$1,934,100 while their aggregate fair market value was \$13,628,634. *See* Wilson, *supra* note 39, at 76, Table 1a. Note, however, that "Not every donation has a donor cost. The total donor cost is based on 8.9 million out of 16.4 million donations." *Id.* at 80 n.1. Assuming the under-reporting of costs is the same on a percentage basis for both wealthy and less wealthy taxpayers, these statistics validate the claim that wealthy taxpayers benefit more from the double deduction. Moreover, "Figure D shows that the percentage change in donations by AGI, in general, increased in the upper income groups (starting with those making over \$1.5 million) and fell in the middle income groups. Those taxpayers with \$10-million or more AGI increased their donation amounts by 36.5 percent, from \$8.2 billion in Tax Year 2004 to \$11.1 billion in 2005." *Id.* at 68.

⁹⁶ *See* 1993 Tax Act, *supra* note 22, § 13171(a) (deleting former section 57(a)(6) and redesignating former section 57(a)(7) as section 57(a)(6)). The rationale for this change is that it will produce "an additional incentive for taxpayers to make charitable contributions of appreciated property" although no explanation is given regarding the preference for those types of donations over cash gifts to charity. 1993 H.R. REP., *supra* note 23, at 861. Prior to this legislation, the charitable deduction for AMT calculation purposes was disallowed to the extent the contributed property's fair market value exceeded its basis. For 1991 or for gifts made before July 1, 1992, contributions of tangible personal property were exempt from this rule and for 1990, corporate AMT income was "increased by 75

The statutory preference for gifts of intangible personal property or real property is inexplicable, particularly when the donor's gift is unmarketable.⁹⁷ There are additional difficulties where the donor remains in control of her closely held business subsequent to her charitable gift of a minority interest in that company.⁹⁸ The comparative benefits and losses among the donor, charity, and the government are askew and result from both the double benefit described in this section of the article *and* the problem of overvaluation.⁹⁹ "Many taxpayers, in effect, are provided with the equivalent of a deduction equal to much more than 100 cents for each dollar of property value given to charity."¹⁰⁰

On the other hand, the capital gains rates are currently remarkably low¹⁰¹ and net capital gains, except for collectibles, are no longer an item of tax preference themselves.¹⁰² To that extent, the value of this "double" tax benefit has diminished.

V

SPLIT-INTEREST GIFTS TO CHARITY

A split-interest gift to charity refers to the division and donation of only part of that property to charity; that is, an interest in the same

percent of the amount by which adjusted current earnings (ACE) exceeds AMTI (calculated before this adjustment)." 1993 H.R. REP., *supra* note 23, at 630–31.

⁹⁷ See Clotfelter, *supra* note 6, at 676 ("[H]eavy tax subsidies encourage taxpayers to contribute appreciated property instead of cash." While marketable assets do not create problems for a charity, that may not be true of gifts of less marketable property such as "real property, closely-held businesses, or works of art."). By contrast, the statutory preferences (1) for tangible personal property gifts that require them to be property that is consistent with the justification for the charity's exempt status, I.R.C. § 170(e)(1)(B)(i); (2) for gifts to public charities over those to private foundations, I.R.C. § 170(e)(1)(B)(ii); and (3) for gifts of property that if sold would not have produced long term capital gain, I.R.C. § 170(e)(1)(A), are grounded in sounder tax policy.

⁹⁸ Clotfelter, *supra* note 6, at 688–89 (also noting that co-ownership with the donor "may thus have real effects on the range of activities carried out by nonprofit organizations").

⁹⁹ See *supra* Part II.

¹⁰⁰ Yin, *supra* note 41, at 1450 ("[C]ash gifts are less susceptible to noncompliance than are gifts of property with uncertain values, and we see a rather odd outcome. Under current law, the incentive structure encourages gifts that are most vulnerable to noncompliance, and in effect discourages gifts that are less vulnerable.").

¹⁰¹ I.R.C. § 1(h) (2006). Capital gains are generally taxed at 15% although can be at 0% for lower income taxpayers beginning in 2008.

¹⁰² See I.R.C. §§ 1(h), 55(b)(3); Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, Title III, § 301(b)(3), 117 Stat. 752, 759 (2003).

property passes to both a charitable and a noncharitable recipient.¹⁰³ Besides making a gift to a charity, the donor may retain an interest or he may also give an interest in that property to a third party noncharitable beneficiary.¹⁰⁴ Theoretically, this type of transfer is a version of a net gift. The donor has either made only a partial transfer of his interests in the property (by keeping an interest for himself) or he has made two transfers: one to the charity for which he should be entitled to a charitable deduction to the extent of the benefit the charity receives; and the other to his family or other third party, which should be subject to transfer tax in the full value that the noncharitable beneficiary acquires. However, because split interests are most often divided temporally into present and future interests in the same property, valuation is computed by means of the actuarial tables.¹⁰⁵ It is therefore subject to manipulations inherent in employing those tables, particularly the overvaluation of the charitable interest and the undervaluation of the noncharitable transfer.

Beginning in 1970, a donor who makes a split-interest gift to a charity is entitled to a charitable deduction only if she makes that gift in a specific form¹⁰⁶ and courts interpret these statutory rules

¹⁰³ I.R.C. §§ 170(f), 2055(e), 2522(c).

¹⁰⁴ If the donor retains an interest, the trust is known as a grantor trust; if she makes a transfer to third persons, the trust is a nongrantor trust.

¹⁰⁵ Because the use of infrequently updated tables resulted in inaccuracies and exploitation, in 1988 Congress enacted section 7520. *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 5031(a), 102 Stat. 3342, 3668 (1988); H.R. REP. 100-795, at 591 (1988) (“The tables used by the IRS in determining the value of annuities, life estates, terms of years, remainders and reversions use outdated interest and mortality assumptions. The committee believes that updating these assumptions will result in more accurate valuation of such interests.”). This statute requires that (1) partial temporal interests in property, such as life estates or reversions, be calculated by means of the actuarial tables, I.R.C. § 7520(a); (2) the tables themselves be updated every ten years to account for different mortality assumptions, I.R.C. § 7520(c)(3); and (3) the IRS publish monthly interest rates applicable to the valuation of these interests, I.R.C. § 7520(a)(2). The use of tables necessarily incorporates unreal assumptions (specifically, that today’s interest rate is relevant to the eventual payout of a particular investment) and relies on a large sampling of taxpayers for acceptable accuracy. Interest rates will likely vary over the expected term although one interest rate will be used to determine the value of an interest under the actuarial tables, the principal’s growth during the term is ignored in the tables, and mortality assumptions will probably change during the interest’s term (hence, the requirement in section 7520(c)(3) for revision of the tables every ten years).

¹⁰⁶ The Tax Reform Act of 1969, Pub. L. No. 91-172, § 201, 83 Stat. 487, 526–62 (1969) [hereinafter 1969 Tax Act].

strictly.¹⁰⁷ However, despite the goals of the 1969 legislation, the statutes have engendered their own opportunities for abuse. The greatest distortion created by this legislation is the charitable lead trust (“CLT”).¹⁰⁸ By use of this legitimate estate planning method, the taxpayer can obtain an overstated charitable deduction or an excessive tax-free gift to his relatives or friends.

A. The 1969 Legislation

In 1969, Congress amended the income, gift and estate tax charitable deduction statutes to prevent an inflated charitable deduction resulting from the overvaluation of the charity’s interest in a split-interest gift.¹⁰⁹ To receive a charitable deduction for a CLT where the income interest in the trust benefits a charity but the remainder interest has noncharitable beneficiaries, the donor’s transfer must be arranged as a charitable lead annuity trust (“CLAT”) or a charitable lead unitrust (“CLUT”).¹¹⁰ Likewise, to receive a deduction for a charitable remainder interest in trust where the income interest is held by a noncharitable beneficiary, the donor’s transfer must be structured as a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. To determine the donor or decedent’s charitable donation deduction when a split interest complies with the statute, the noncharitable interest is subtracted from the value of the property. When a deduction does not follow the statutory requirements under the split-interest rules, no deduction for the amount benefiting the charitable recipient is allowed.¹¹¹

¹⁰⁷ See Wendy C. Gerzog, *The Strict Rules of Charitable Split Interest Gifts*, 118 TAX NOTES 541, 542–44 (Jan. 28, 2008).

¹⁰⁸ A CLT is a split-interest gift to charity where the charity is given a present benefit and the donor or other noncharitable beneficiary receives a remainder interest in the property. To be deductible, a CLT must be an annuity or unitrust and must satisfy the pertinent statutory requirements. See I.R.C. §§ 170(f), 2055(e), 2522(c) (2006).

¹⁰⁹ H.R. REP. NO. 91-413, at 38–39 (1969) [hereinafter 1969 H.R. REP.]; S. REP. NO. 91-522, at 86–88 (1969) [hereinafter 1969 S. REP.].

¹¹⁰ See I.R.C. §§ 170(f)(2)(B), 2055(e)(2)(B), 2522(c)(2)(B). A CLAT requires a fixed annual payment to the charity; a CLUT pays the charity a fixed percentage of the fair market value of the trust as determined each year.

¹¹¹ See I.R.C. §§ 170(f)(2)(A), 2055(e)(2)(A), 2522(c)(2)(A); see also H.R. REP. NO. 91-782, at 295–96 (1969) (Conf. Rep.); 1969 S. REP., *supra* note 109, at 86–92; 1969 H.R. REP., *supra* note 109, at 38–39. Because the requirements for a deductible split-interest trust are complex, in 1984, Congress provided for the allowance of certain reformations in the trust instrument. The Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 1022(a), 98 Stat. 494 (codified as I.R.C. § 2055(e)(3)) (1984). See H.R. REP. NO. 98-861, at 1242 (1984) (Conf. Rep.) (“The House Bill provides a permanent rule permitting reformation of

Although the 1969 legislation was aimed at correcting abuses inherent in using the actuarial tables to value present and future interests in the same property,¹¹² the words of the statute have been interpreted as applying to other types of split interests.¹¹³ For example, in *Johnson* the decedent created a trust to support his sisters, maintain certain family graves, and provide funding for the education of religious figures in the Catholic Church. The estate contended that the decedent had not created a split interest, but three separate trusts with the one-third charitable purpose trust entitled to an estate tax deduction.¹¹⁴ Rejecting that interpretation, the Fifth Circuit held that the will “unambiguously designates the creation of one trust to serve three separate purposes, only one of which involves a charitable bequest. . . . [and thus] involves a classic split interest, where interest ‘in the same property’ passes to both charitable and noncharitable beneficiaries.”¹¹⁵ Thus, the court held that the trust was not created or reformed in any of the three statutorily required trust forms and that, consequently, the decedent was not entitled to a charitable deduction for any interest in the trust.¹¹⁶ Most recently in *Tamulis*,

charitable split-interest trusts if certain requirements are satisfied. Under this provision of the house bill, the relative values of the charity and the noncharity interests in the trust may not vary by more than 5 percent as a result of the reformation. Additionally, unless reformation proceedings are begun within 90 days after the due date of the federal estate tax return (or the first trust income tax return if no estate tax return is due), the trust must, as executed, provide for an annuity trust or unitrust amount. . . . The Senate Amendment is the same as the House Bill, except the Senate Amendment also provides that a reformation is deemed to occur to the extent that, pursuant to trust provisions, property passes directly to a charity before the due date of the estate tax return.”). Under section 2055, to be a “qualified reformable interest,” either all payments must be expressed as specific dollar amounts or a fixed percentage of the fair market value of the trust property, I.R.C. § 2055(e)(3)(C)(ii), or a judicial proceeding must be initiated by “the 90th day after the last date (including extensions) for filing [the estate tax] return,” I.R.C. § 2055(e)(3)(C)(iii)(I).

¹¹² See 1969 S. REP., *supra* note 109, at 1704 (“The rules of present law for determining the amount of a charitable contribution deduction in the case of gifts of remainder interests in trust do not necessarily have any relation to the value of the benefit which the charity receives. This is because the trust assets may be invested in a manner so as to maximize the income interest with the result that there is little relation between the interest assumptions used in calculating present values and the amount received by the charity.”).

¹¹³ See, e.g., *Estate of Tamulis v. Comm’r*, 509 F.3d 343, 345–46 (7th Cir. 2007), *aff’g* T.C. Memo. 2006-183; *Galloway v. United States*, 492 F.3d 219, 223–24 (3d Cir. 2007); *Estate of Johnson v. United States*, 941 F.2d 1318, 1321 (5th Cir. 1991); *Zabel v. United States*, 995 F. Supp. 1036, 1052 (D. Neb. 1998).

¹¹⁴ *Johnson*, 941 F.2d at 1319.

¹¹⁵ *Id.* at 1320.

¹¹⁶ *Id.* Likewise, in *Zabel*, the district court rejected the estate’s contention that a trust that gave a 50% income interest and a 100% remainder interest to a charity was entitled to

the decedent, a Roman Catholic priest, wanted the vast majority of his wealth to benefit his diocese and he created a trust for this purpose. However, he also provided for nominal gifts to his relatives in the trust.¹¹⁷ While the trust operated as a charitable remainder unitrust and was described as such in the estate tax return, the Seventh Circuit denied the estate any charitable deduction holding that the decedent's noncharitable bequests were not expressed according to the explicit terms of the statute and regulations, efforts at reforming the trust were insufficient, and the doctrine of substantial compliance did not apply.¹¹⁸

a deduction equal to 50% of the principal of the trust. The court held that this was a split-interest trust, that it was not in one of the three prescribed forms for split-interest trusts, that it was not reformed according to rules of the statute, and therefore not deductible. In *Galloway*, the decedent had left his property in trust to two charitable beneficiaries and to two noncharitable beneficiaries, with the first half to be distributed on January 1, 2006, one-fourth to each beneficiary, and the remaining half to be distributed in the same proportions ten years later, with the survivors taking their proportionate share at that later date. 492 F.3d at 220. Concluding that there was no ambiguity in the statute and thus denying the estate a charitable deduction for the split-interest gift, the Third Circuit in *Galloway* held "[t]he Trust divides a single property between charitable and non-charitable beneficiaries, falling directly within the language of § 2055(e)." *Id.* at 224. Denying the estate a charitable deduction for the split-interest gift while acknowledging that the result was "unfortunate" since there was little opportunity for abuse, the court held that the statute refers to "any other interest" and hence, is not limited to trusts creating a remainder interest. *Id.*

¹¹⁷ *Tamulis*, T.C. Slip Op., at 3–4. *Tamulis* created an *inter vivos* trust that provided at his death for the immediate payment of specific bequests to both charitable and noncharitable beneficiaries. The trust also provided for certain conditional annual payments during the term of the trust, which was the greater of ten years or the joint lives of John and Mary, his brother and sister-in-law, in the following amounts: \$5000 to John (or to Mary if John predeceased her) to assist them with current costs associated with the house; \$5000 to Wanda, a niece, if she was "making reasonable progress in pursuit of a Ph.D. in education;" \$1000 each to Erica and Melissa; \$10,000 to Migel, a grandniece, until she graduated medical school; and the remaining net income equally to Erica and Melissa. In comparison to several relatively minor noncharitable transfers, he donated approximately \$1.5 million, the value of the remainder interest in the trust, to the Catholic Church.

¹¹⁸ *Tamulis*, 509 F.3d at 345 (citing *Prussner v. United States*, 896 F.2d 218, 224 (7th Cir. 1990) (en banc)). There was a statement on the decedent's estate tax return describing the remainder as the "residue following 10 year term certain charitable remainder unitrust at 5% quarterly payments to two grand nieces," Erica and Melissa Rodgerson, where during the term, the Trustee holds and operates pursuant to the terms and conditions of I.R.C. section 664 and attached to the return were applicable calculations. Indeed, from 2001 through 2004, the trust actually did distribute 5% of the January 2nd fair market value of the trust assets to the beneficiaries. *Tamulis*, Tax Court Slip Op., at 5–6.

B. Charitable Lead Trusts

The split-interest charitable deduction statute is specific, clear, and strictly construed. However, it does not obviate all manipulation involving split-interest transfers. Indeed, the 1969 legislation has inadvertently provided taxpayers with a tax shelter. The statute created CLTs and CLTs are often used in estate planning by those whose self-interest, rather than charitable intent, is overriding.¹¹⁹ Universities and other charitable organizations court donors to create CLTs, particularly when interest rates are low, by appealing to the donor's noncharitable goals of giving assets to family members free of transfer taxes.¹²⁰ In 2006, the data showed \$16.5 billion in end-of-year total assets for CLTs in 2006, almost \$6 billion more than in 2000 and about a \$1 billion increase from 2005.¹²¹

CLTs are advantageous to reduce or eliminate gift or estate taxes on a large transfer to noncharitable recipients.¹²² By using a CLT

¹¹⁹ See, e.g., KATHRYN G. HENKEL, *ESTATE PLANNING AND WEALTH PRESERVATION: STRATEGIES AND SOLUTIONS* ¶ 35.09 (Warren, Gorham & Lamont of RIA, abridged student ed. 2003). "The plans are advertised to potential donors as a 'powerful tool,' as a device that results 'in little or no taxes,' and more." 2008 S. Hearing, *supra* note 6, at 6 (statement of Diana Aviv, President and CEO Independent Sector).

¹²⁰ HENKEL, *supra* note 119, at ¶ 35.01[3][a] ("The value of an annuity varies inversely with interest rates, so a lower interest rate will produce a higher charitable deduction, all other factors being equal."). See, e.g., BYU Marriott School, Charitable Lead Trust, <http://marriottschool.byu.edu/giving/clt.cfm> (last visited July 29, 2009) ("The real value of using a charitable lead annuity trust is that the original asset values receive a gift and estate tax deduction based on the value of the income stream given to charity. Excess earnings and growth add to the value of the trust corpus. . . . At the end of the trust term, the trust terminates and all the assets in the trust, including growth, are transferred to your heirs without further gift or estate tax."); The Charitable Lead Trust in Today's Low-Interest Environment, http://alumniandfriends.uchicago.edu/atf/cf/{25C2541E-96EB-4E70-947F-ABA13CD89DCD}/CLT_OpportunitiesREV.pdf (last visited July 29, 2009) ("Recent interest rates are the lowest they have been in decades. . . . If you are charitably inclined, you can take advantage of low interest rates by using a charitable lead trust to make a gift to charity and a highly leveraged gift to family members at substantially reduced or no gift tax cost.").

¹²¹ Lisa Schreiber, *Split-Interest Trusts, Filing Year 2006*, 27, No. 3 *STATISTICS OF INCOME BULLETIN* 48, 61 (Winter 2007-2008). For 2000, split-interest trusts contained "approximately \$93.9 billion in book value end-of-year total assets." News Release, IRS, *IRS Issues Spring 2003 Statistics of Income Bulletin* (June 26, 2003). While the vast majority of that was from charitable remainder trusts ("CRT"), "Lead trusts, which comprised only 4.0 percent of the total number of filers, held a surprising 11.5 percent of the total assets." *Id.* That 11.5% represented approximately \$10.8 billion in book value end-of-year assets. *Id.*

¹²² For example, "Dad transfers \$1,000,000 in property to a CLAT with a ten year charitable term and an eight percent payout rate. The property earns ten percent (after-tax) yearly, and the [section] 7520 rate at the time of the transfer is eight percent. The

instead of making a direct gift of the remainder to family members without incorporating a charitable donation, more value passes to your family, free of transfer tax when the property actually grows or earns more than the section 7520 interest rate.¹²³ An *inter vivos* CLT produces a gift tax deduction that leverages the gift.¹²⁴ That is, where the value of the income interest that qualifies for the gift tax charitable deduction equals the value of the remainder that passes to the noncharitable recipient, the gift is “zeroed out.”¹²⁵ To produce a sufficiently large income interest requires a very high income payout and/or a sufficiently long term of the CLT. Thus, CLTs are most attractive to very wealthy families who can wait a long time for family members to possess the trust principal.¹²⁶

remainder interest is valued at \$463,192 at the time of the transfer. At the end of the charitable term, the value transferred to Dad’s children is \$1,318,748.49. Had Dad initially made a gift of property worth \$463,192 rather than creating the CLAT, the gifted property would be worth \$1,201,400.76 at the end of ten years, assuming it grew at ten percent (after-tax) each year.” HENKEL, *supra* note 119, at ¶ 35.09. As between a CLAT and a CLUT, “If the CLT property is expected to appreciate, a CLAT is usually the better choice, since the annuity remains fixed and more property can go to the family beneficiaries.” *Id.* at ¶ 35.08.

¹²³ The section 7520 interest rate for a particular month is the rate rounded to the nearest two-tenths of one percent that is 120% of the applicable federal midterm rate (compounded annually) for the month in which the valuation date falls. The IRS publishes the rates monthly. See, e.g., Rev. Rul. 2008-33, 2008-27 I.R.B. 1. Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520. For July 2008, the rate was 4.2%. *Id.*

¹²⁴ The principal benefits of a CLT are the transfer tax savings. See *supra* note 122 and accompanying text. A grantor CLT is a taxable trust for income tax purposes; while the grantor does not receive an income tax charitable deduction for the actuarial value of the charitable interest, she receives a charitable deduction for current distributions each year as the income is earned and paid to the charity. That is particularly helpful either when the grantor has exceeded the percentage limitations of section 170(b) or when the trust assets produce dividend income that is currently taxed at 15% while the income tax deduction may offset her other income that is taxed at the maximum ordinary income rate of 35%. However, there is a recapture of those deductions if the grantor dies during the trust’s term. A nongrantor CLT is not taxable and not deductible for income tax purposes. It is the more popular type of CLT. See HENKEL, *supra* note 119, at ¶ 35.03. The promise of estate tax repeal in the 2001 Act inhibited the use of a testamentary CLT; however, the *inter vivos* trust remained popular. See *supra* note 121 and accompanying text.

¹²⁵ Some estate planners advise their clients to generate a small taxable gift in order to trigger the running of the statute of limitations on the transfer.

¹²⁶ “Consider the following example:

Donor contributes \$1 million to a charitable lead annuity trust that will make annuity payments to the University of Chicago for a term of years, after which the trust will be distributed in equal shares to Donor’s three children.

Because the taxpayer's transfer tax is assessed when she makes her transfer to a CLAT¹²⁷ and is not determined on a yearly basis, significantly appreciated assets may pass to the noncharitable beneficiary without further transfer tax liability.

Consider, for example, an individual who deposits \$1 million in a twenty-year charitable lead trust, and stipulates that the charity is to receive \$70,000 in income annually, with the remainder going to his sons and daughters. Using the statutory interest rate of 120% of the Federal Midterm Rate, the Treasury tables project the value of the donation as \$777,500 and the remainder as \$222,500, which is then taxed accordingly. In this example, the trust principle [sic] actually grows to about \$2.5 million because actual investment performance far outpaces the statutory rate (which was 3.6% for March 2008). Since the statutory interest rate is so low and the projected value of the remainder has already been taxed, the heirs receive more than \$2 million free of estate or gift taxes.¹²⁸

In this instance, the taxpayer has a substantial transfer tax savings equal to the extent of at least \$900,000 (\$2 million multiplied by the maximum gift tax rate (45%)). In this scenario, the charity is deemed to have received \$70,000 for twenty years, for a present discount value of \$777,500. Yet, if the trust fares poorly so that its income is actually below the statutory discount rate, the stated value of the charitable interest may not materialize and the charity may not receive

If the charitable term is 20 years and the annuity payment to the University is \$70,000/year, the charitable gift tax deduction will be equal to \$1,000,000, meaning there will be zero taxable gift and no gift tax owed. Compare this to the amount of taxable gift that results when the section 7520 rate is higher:

Section 7520 Rate	Taxable Gift
2.0% (February 2009)	\$0
7.2% (historic average of all rates to date)	\$269,810

Under this scenario, the University will receive an aggregate gift of \$1,400,000 over 20 years. In addition, assuming a 7.9% rate of return, the donor's three children will receive an aggregate sum of \$1,100,000, gift tax-free, at the end of 20 years." *The Chicago Initiative, The Charitable Lead Trust in Today's Low-Interest Environment*, http://alumniandfriends.uchicago.edu/atf/cf/%7B25C2541E-96EB-4E70-947F-ABA13CD89DCD%7D/CLT_OpportunitiesREV.pdf (last visited Aug. 6, 2009).

¹²⁷ See, e.g., *supra* note 122.

¹²⁸ 2008 S. Hearing, *supra* note 6, at 6 (statement of Diana Aviv, President and CEO Independent Sector).

a benefit equal to the amount of the taxpayer's deduction.¹²⁹ By means of the CLT, the taxpayer has saved \$900,000 in gift or estate taxes, the charity may or may not receive the charitable donation amount (\$777,500) allowed to the taxpayer,¹³⁰ and the government has lost revenue to the extent of that \$900,000 plus the value of the charitable deduction \$349,875 (\$777,500 multiplied by the 45% transfer tax rate) for a total projected revenue loss of \$1,249,875. Therefore, the taxpayer benefits from a CLT to a much greater extent than the charity. Under an expanded application of quid pro quo, the taxpayer should be denied a charitable deduction. By means of a CLT, the government has sustained a significant revenue loss that cannot be justified by the rationales for the charitable deduction.¹³¹

VI

GIFTS TO ONE'S OWN CHARITABLE FOUNDATION AND DONOR ADVISED FUNDS

According to the IRS, one area of abuse involving charities is donor retained control over donated assets.¹³² While private foundations¹³³ are subject to strict rules,¹³⁴ "donors, nevertheless feel

¹²⁹ *Id.* Of course, the benefits of transfer tax-free consequences of a zeroed-out grantor retained annuity trust ("GRAT"), while not as great as those of its charitable counterparts, are also unwarranted on the same basis that any shortfalls of income production do not result in a parallel detriment to the transferor. See I.R.C. §§ 2702(a)(2)(B), 2702(b) (2006).

¹³⁰ If the asset performs and creates income in that amount, the charity will receive the full donation. If the asset income exceeds that amount, that excess passes to the noncharitable beneficiary transfer tax-free.

¹³¹ A CRT provides additional benefits to the taxpayer because of the use of the actuarial tables, the benefit of no capital gains tax on the sale of assets sold by the trust, and the charitable deduction; however, to gain those benefits, the CRT requires the noncharitable beneficiary to live a long life, a factor less predictable than those attached to a CLT. See HENKEL, *supra* note 119, at ¶ 33.16. With either a CLT or CRT, there is a risk that the asset may not perform as well as expected.

¹³² 2008 Dirty Dozen, *supra* note 5.

¹³³ A private foundation is contrasted with a publicly supported charity and is defined in I.R.C. § 509(a) (2006).

¹³⁴ See STAFF OF JOINT COMM. ON TAX'N, 2006 GENERAL EXPLANATION, *supra* note 40, at 629 ("Because private foundations receive support from, and typically are controlled by, a small number of supporters, private foundations are subject to a number of anti-abuse rules and excise taxes not applicable to public charities."). See, e.g., I.R.C. §§ 4941–4947 (2006). Also, donations of all types of capital gain property to private foundations are generally limited to a deduction in the amount of the donor's basis instead of the property's fair market value. See I.R.C. § 170(e)(1)(B)(ii) (2006). Many of those rules were enacted as part of the Tax Reform Act of 1969, see 1969 Tax Act, *supra* note 106; 1969 H.R. Rep., *supra* note 109, at 1665 ("[Y]our committee has concluded that even

the control they can exercise over a private foundation more than offsets the less favorable tax treatment a foundation receives.”¹³⁵

There are donors who make large contributions to their own, or their family’s, private foundation and without violating the rules against self-dealing, they control the identity of recipients or the amount of those gifts.¹³⁶

When a donor is unhappy with the administrative burdens and restrictions placed on private foundations and gifts to those organizations, a gift to a donor advised fund is an attractive alternative.¹³⁷ Receiving a full deduction in the year the contribution

arm’s-length standards often permit use of a private foundation to improperly benefit those who control the foundation. This is true, for example, where a foundation (1) purchases property from a substantial donor at a fair price, but does so in order to provide funds to the donor who needs access to cash and cannot find a ready customer In order to minimize the need to apply subjective arm’s-length standards, to avoid the temptation to misuse private foundations for noncharitable purposes, to provide a more rational relationship between sanctions and improper acts, and to make it more practical to properly enforce the law, your committee has determined to generally prohibit self-dealing transactions and to provide a variety and graduation of sanctions”).

¹³⁵ JOHN R. PRICE & SAMUEL A. DONALDSON, PRICE ON CONTEMPORARY ESTATE PLANNING § 8.42.1, at 8–91 (CCH 2007 ed.).

¹³⁶ See STAFF OF JOINT COMM. ON TAX’N, 2006 GENERAL EXPLANATION, *supra* note 40, at 629 (“Donors to private foundations and persons related to such donors together often control the operations of private foundations.”). A private foundation can pay reasonable compensation to both the donor and his family if they are its directors or trustees. I.R.C. § 4941(d)(2)(E) (2006).

¹³⁷ A “donor advised fund” is defined in I.R.C. § 4966(d)(2)(A) as

Except as provided in subparagraph (B) or (C), the term “donor advised fund” means a fund or account—

- (i) which is separately identified by reference to contributions of a donor or donors,
- (ii) which is owned and controlled by a sponsoring organization, and
- (iii) with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor’s status as a donor.”

Under I.R.C. § 4966(d)(2)(B), that term

shall not include any fund or account—

- (i) which makes distributions only to a single identified organization or governmental entity, or
- (ii) with respect to which a person described in subparagraph (A)(iii) advises as to which individuals receive grants for travel, study, or other similar purposes, if—
 - (I) such person’s advisory privileges are performed exclusively by such person in the person’s capacity as a member of a committee all of the members of which are appointed by the sponsoring organization,

is made, the donor can then make nonbinding recommendations for distributions from the fund.¹³⁸

On 2005 federal income tax returns, the largest recipients of charitable donations were private foundations, receiving a total value of \$9.8 billion.¹³⁹ Further, donor advised funds, while representing only 3.9% of all itemized deductions in that year had the highest average per donation amount of \$56,452, an increase of 60.4% from the previous year, for a total of \$1.6 billion in 2005.¹⁴⁰

Incredibly, CEOs donate company stock to their family foundations immediately before a steep loss in their value while they retain powers to vote those shares because they are not subject to insider trading laws for charitable deductions.¹⁴¹ “Consistent with their exemption from insider trading law, I find a pattern of excellent timing of Chairmen and CEOs’ large stock gifts to their own family foundations. On average these gifts occur at peaks in company stock prices, following run-ups and just before significant price drops.”¹⁴²

(II) no combination of persons described in subparagraph (A)(iii) (or persons related to such persons) control, directly or indirectly, such committee, and

(III) all grants from such fund or account are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the board of directors of the sponsoring organization, and such procedure is designed to ensure that all such grants meet the requirements of paragraph (1), (2), or (3) of section 4945(g).

See also STAFF OF JOINT COMM. ON TAX’N, 2006 GENERAL EXPLANATION, *supra* note 40, at 635–44; 2004 Hearing (statement of the Hon. Mark Everson, Commissioner, IRS, Washington, D.C.), *supra* note 25, at 15 (“For example, a donor may contribute \$1,000,000 to a donor advised fund and claim the whole amount as a charitable deduction for the year in which the contribution is made. In future years the donor may advise the fund as to desired distributions to qualified beneficiaries (e.g., other charities). In operation these funds allow considerable input from the donor but are not classified as private foundations. Again, in a legitimate donor advised fund, the charity must have legal control over the donated funds and must have the right to disregard the donor’s advice.”).

¹³⁸ PRICE & DONALDSON, *supra* note 135, at § 8.4, at 8–90.

¹³⁹ Wilson, *supra* note 39, at 68, 71.

¹⁴⁰ *Id.* at 70–71.

¹⁴¹ See David Yermack, *Deduction ad absurdum: CEOs Donating Their Own Stock to Their Own Family Foundations* 1 (2008), available at <http://finance.wharton.upenn.edu/department/Seminar/Spring%202008/Yermack%20Paper%20SSRN-id1096257.pdf> (“Unlike open market sales, gifts of stock are generally not constrained by U.S. insider trading law, and company officers can often donate shares of stock to charities during time periods when selling the shares would be prohibited. This exemption has evolved from a combination of federal caselaw, prosecutorial indifference, and recent amendments to SEC rules (Sulcoski, 1989).”).

¹⁴² *Id.* at 2.

Professor Yermack suggests that the CEOs may well be backdating transactions and committing fraud,¹⁴³ but he also castigates the family foundation that allows an immediate charitable deduction for the donation of stock but permits the CEO continued control over those shares.¹⁴⁴ Not surprisingly, Professor Yermack concludes that “two groups may be systematically harmed by opportunistically timed stock gifts: taxpayers and charities. . . .”¹⁴⁵ His data suggests that private foundations provide a great quid pro quo to the CEO donor: “[T]he immediate tax benefits to a donor CEO who contributes appreciated stock may easily exceed the discounted present value of charitable donations made by the foundation over time.”¹⁴⁶ Thus, the benefit of the full current deduction the taxpayer receives may be greater than the benefit derived by the charities who may not receive the funds until future years. Under quid pro quo analysis and *American Bar Endowment*, that CEO should not qualify for a charitable deduction.

VII

MISUSE OF DEFINED VALUE CLAUSES IN GIFTS TO CHARITY

Defined value clauses are routinely used to split an estate into a marital deduction trust and a bypass trust. Whatever exceeds the

¹⁴³ *Id.* at 4 (“While nominally transferring part of their fortunes to charitable foundations for civic purposes, many appear simultaneously to exploit gaps in the regulation of insider trading or even to backdate their donations to increase the value of personal income tax benefits. The results loosely parallel a series of older tax fraud cases . . .”).

¹⁴⁴ *Id.* at 4–5. The facts indicate that the wealthy overwhelmingly choose family foundations as recipients of their charitable contributions. These foundations irrevocably set aside assets for eventual donation to a charity, but trustees are only required to give those assets to the charities at an average rate of 5% per year. In so doing, a wealthy taxpayer receives the same tax benefits as with an immediate transfer of those assets to a charity. However, since many wealthy taxpayers and their families control foundations, they also benefit by retaining control over the choice of ultimate charitable recipient of those assets; as trustee, she can manage them and exercise their voting rights. “This bundle of immediate tax benefits and continuing control rights appeals to many donors, especially top executives of public companies who usually hold large amounts of appreciated equity in their own firms. Most family foundations in the sample, which are invariably controlled by the CEO and his family members as trustees, retain their donors’ stock gifts for long periods rather than diversifying their assets, as would generally be required if trustees followed the prudent man rule of investment management.” *Id.* at 5.

¹⁴⁵ *Id.* at 28.

¹⁴⁶ *Id.*

unified credit against the estate tax¹⁴⁷ at the decedent's death passes to the marital trust. There are no serious valuation issues in that instance because either the decedent's property will not be subject to estate taxes because it qualifies for the unlimited marital deduction¹⁴⁸ or is exempt from tax because of the unified credit. Further, Rev. Proc. 64-19¹⁴⁹ deals with funding issues related to the two trusts so that neither trust will unduly benefit from appreciation or depreciation between the date of decedent's death and the date the executor distributes the estate's assets. Because exemptions and the values of the estate's assets vary between the date a testamentary document is executed and its effective date (i.e., decedent's date of death), defined value clauses are drafted to allow for these fluctuations and can serve positive goals. However, defined value clauses can also be used for more dubious purposes. Specifically, defined value clauses can be used to sanction questionable valuation. When a defined value clause is combined with a charitable transfer, it may produce abusive valuation and transfer tax distortions. Invariably, this permutation creates a greater economic benefit for the donor than for the charity.

The government objects to defined value clauses because they contravene several public policy directives, as enunciated in *Procter*.¹⁵⁰ In *Procter*, a trust provided that a gift would revert to the donor if it was later determined that it would be subject to gift tax. According to the Fourth Circuit, such a clause flouts public policy: it (1) discourages the government's tax collection by making futile the audit of returns, (2) renders the court's decision moot by negating the

¹⁴⁷ See I.R.C. § 2010 (2006). For decedents dying in 2008, the exemption amount is \$2 million and for 2009, \$3.9 million. I.R.C. § 2010(c). The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, Title IV, § 501, 115 Stat. 38 (2001) [hereinafter EGTRRA], repealed the estate and generation skipping transfer taxes for the year 2010; however, under the sunset provision, in 2011 these taxes will reappear as they existed before the 2001 legislation. EGTRRA, § 90.

¹⁴⁸ See I.R.C. § 2056(a) (2006), enacted by the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403, 95 Stat. 172, 302-03 (1981). Section 403(a)(1)(A) repealed I.R.C. § 2056(c) (1954), which contained the dollar and percentage limitations placed on the deduction. The adoption of the unlimited marital deduction and the married couple as the unit of estate and gift taxation has rarely been criticized by scholars or practitioners.

¹⁴⁹ 1964-1 C.B. 682 ("The purpose of this Revenue Procedure is to state the position of the Internal Revenue Service relative to allowance of the marital deduction in cases where there is some uncertainty as to the ultimate distribution to be made in payment of a pecuniary bequest or transfer in trust where the governing instrument provides that the executor or trustee may satisfy bequests in kind with assets at their value as finally determined for Federal estate tax purposes.").

¹⁵⁰ See *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944).

gift the court has examined, and (3) disturbs a final judgment.¹⁵¹ Likewise, when a charity is intermixed with the use of a defined value clause, by requiring any excess value over a fixed amount to pass to charity, the effect of that defined value clause is to increase the charitable deduction that would accompany and parallel an increased valuation of the decedent's estate.¹⁵² If such additional value actually adhered to the charity's benefit, the defined value clause might be considered benign despite that it would reflect the same public policy breaches found in *Procter*.¹⁵³ However, what actually happens in the series of transactions that incorporate a defined value clause, a charitable gift, and the donee's redemption of that gift is an exaggerated charitable deduction and an undervaluation of the donor's noncharitable gift.

*McCord*¹⁵⁴ illustrates how a series of transactions incorporating a charitable gift have been used effectively to benefit the donors and their family more than the charity. Judge Foley found that the taxable gift pursuant to the donors' assignment agreement under Texas state property law was \$6,910,933 and that allowable charitable deduction was \$2,972,899 for a combined value of \$9,883,832.¹⁵⁵ The two charities allowed the noncharitable donees to purchase the charities' interests they received from the donors for \$479,008.¹⁵⁶ Applying the

¹⁵¹ *Id.* at 827.

¹⁵² In *Christiansen*, the Tax Court recognized that such a defined value clause could create an opportunity for an estate to "lowball the value of an estate to cheat charities." *Estate of Christiansen v. Commissioner*, 130 T.C. No. 1 (2008), slip op. at 28–29, available at <http://www.ustaxcourt.gov/InOpHistoric/ESTOFCHRIS.TC.WPD.pdf>.

¹⁵³ There was no abuse in *Christiansen* regarding the defined value clause in allowing the deduction to equal the value of the contribution to the foundation because the family limited partnership ("FLP") discount was disallowed so that the donation consisted of the underlying value of the assets transferred to the FLP and not the heavily discounted and illiquid FLP interest. Those liquid assets in *Christiansen* could easily be sold by the charity so that the donation would produce a benefit to the charity equal to the donated amount. Because there are restrictions on marketability of interests in an FLP, the value of the interest is normally discounted. Also, minority discounts may apply if the holder of an FLP interest owns only a minority share in the FLP.

¹⁵⁴ *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), *rev'g and rem'g*, 120 T.C. 358 (2003).

¹⁵⁵ *McCord*, 120 T.C. at 418 (Foley, J., joined by Chiechi, J., concurring in part and dissenting in part) ("Accordingly, pursuant to section 2501, the entire \$9,883,832 transfer is subject to gift tax, and a charitable deduction is allowed for the \$2,972,899 (i.e., \$9,883,832 – \$6,910,933) transferred to or for the use of the Symphony and CFT.").

¹⁵⁶ *Id.* at 366 ("CFT and the symphony raised no objections to the value found in the HFBE letter and accepted \$338,967 and \$140,041, respectively, in redemption of their interests."). Those two charitable gifts combined equal \$479,008.

total value of the donated partnership interest (i.e., the stated defined value clause plus the donated amount equaled \$9,883,832)¹⁵⁷ and working backwards since the charities received only \$479,008, that excess value should have increased the value of the donors' gift to their children and grandchildren to \$9,404,824.¹⁵⁸ That is, if the charities received only \$479,008, the donees not only received more than the stated amount under the agreement, but also the donors received an unwarranted charitable deduction of approximately \$2.5 million and their children and grandchildren received approximately an additional \$2 million not subject to transfer taxes.¹⁵⁹

In *McCord*, the circuit court refused to look at any transaction that occurred after the date of the gift,¹⁶⁰ regardless how anticipated or planned those actions were;¹⁶¹ a very relevant post-gift event¹⁶² was

¹⁵⁷ I am adopting the amount that both the majority and Judges Foley and Chiechi used to value the aggregate value of the partnership interest that the donors transferred, without commenting on the methodology, the various discounts applied, or the issue of tax affecting the value of the gift. The majority stated that this value was the total amount that the donors transferred to their family members and the charities. *Id.* at 395 (“We conclude that the fair market value of each half of the gifted interest is \$4,941,916” Twice that amount is \$9,883,832). Because the Fifth Circuit rejected the methodology of the Tax Court, adopted the figures of the petitioner’s expert, and allowed the donors’ gift to be tax affected, the appellate court’s valuation is far more generous than both the majority and the trial court judge’s opinion in the Tax Court. “[T]he taxable value of the interests in MIL given by the Taxpayers to the Sons and the GST Trusts is not those determined by the Tax Court but are those determined and used by the Taxpayers” *McCord*, 461 F.3d at 632.

¹⁵⁸ Any time value of money or intervening event adjustments that need to be made should begin with this dollar figure.

¹⁵⁹ Logically, either the gift was greater than the donors had stated it would be or the donors retained that additional value. The extent of the donors’ transfer was fixed and not at issue (“On January 12, 1996, petitioners assigned (as gifts) their partnership interests in MIL (the gifted interest).”). *McCord*, 120 T.C. at 367. And since the charity gained only \$479,008 in a foreseeable transaction, the donors must have transferred \$9,404,824 to the donees. To this extent, the government was correct in stating that “the formula clause in the assignment agreement, designed to neutralize the tax effect of any upward adjustment to the valuation of the gifted interest, is ineffectual.” *Id.* at 369.

¹⁶⁰ *McCord*, 461 F.3d at 626 (“The core flaw in the Majority’s inventive methodology was its violation of the long-prohibited practice of relying on post-gift events.”).

¹⁶¹ Likewise, the court refused to consider expected post-gift events when it concluded, “Specifically, the Majority used the after-the-fact Confirmation Agreement to mutate the Assignment Agreement’s dollar-value gifts into percentage interests in MIL.” *Id.*

¹⁶² Another relevant post-gift fact was the March 1996 Confirmation Agreement, as discussed in the Tax Court opinion in *McCord*. The January 12, 1996, assignment agreement specifically refers to an agreement later to be entered into by the assignees to allocate their interests among themselves, i.e., the Confirmation Agreement executed by the donees in March 1996. *McCord*, 120 T.C. at 365 (“The assignment agreement leaves to the assignees the task of allocating the gifted interest among themselves; in other words,

the sale by the charity to the donees that occurred shortly after the donors' transfer of their family limited partnership interests to their children and grandchildren.¹⁶³ To state that the charities made a bad bargain that was unforeseeable is an unreasonable supposition.

Clearly, the lower court described the real world truth: "Suffice it to say that, in the long run, it is against the economic interest of a charitable organization to look a gift horse in the mouth."¹⁶⁴ Charities will not complain about donations even in much smaller amounts than the donor has claimed as a charitable deduction; it is in the charity's interest to be known as compliant in almost any transaction. As anticipated, the charities did not hire their own valuation experts or otherwise act like an unrelated, disinterested third party.¹⁶⁵ Moreover, it is a wonder that any charity would want to accept such an unmarketable interest as a FLP interest if the charity did not expect that it would soon be redeemed by the donors' family members.¹⁶⁶

The assignment agreement clearly anticipated the June 26, 1996, sale of a partnership interest from a charity to the donees. Thus, making the sale to them a relevant, post-gift event for the value of the donors' charitable contribution and the valuation of the donors' gifts

in accordance with the formula clause, the assignees were to allocate among themselves the approximately 82-percent partnership interest assigned to them by petitioners. . . . In March 1996, the assignees executed a Confirmation Agreement (the confirmation agreement) allocating the gifted interest among themselves . . .").

¹⁶³ *Id.* at 366 ("On June 26, 1996, MIL exercised the call right with respect to the interests held by the symphony and CFT. It did so pursuant to a document styled 'Agreement-Exercise of Call Option By McCord Interests, Ltd., L.L.P.' (the exercise agreement). The purchase price for the redeemed interests was based on a two-page letter from HFBE (the HFBE letter) previewing an updated appraisal report to be prepared by HFBE. The HFBE letter concludes that the fair market value of a 1-percent 'assignee's interest in the Class B Limited Partnership Interests' as of June 25, 1996, was \$93,540. CFT and the symphony raised no objections to the value found in the HFBE letter and accepted \$338,967 and \$140,041, respectively, in redemption of their interests."). As Judge Laro stated in his dissent, joined by Judge Vasquez, "I do not believe that Congress intended that individuals such as petitioners be entitled to deduct charitable contributions for amounts not actually retained by a charity." *Id.* at 427.

¹⁶⁴ *Id.* at 373 n.9.

¹⁶⁵ *See id.* at 430 (Laro, J. joined by Vasquez, J., dissenting) ("[T]he charities never obtained a separate and independent appraisal of their interests (including whether the call price was actually the fair market value of those interests), . . . the charities agreed to waive their arbitration rights as to the allocation of the partnership interests . . .").

¹⁶⁶ *Id.* ("[W]hy a charity would ever want to receive a minority limited partnership interest, but for an understanding that this interest would be redeemed quickly for cash, and find relevant that the interest was subject to the call provision that could be exercised at any time.").

on January 12, 1996.¹⁶⁷ By exercising their rights under the partnership agreement, the donees paid \$479,008 for the charities' partnership interest. Although the government stipulated that "[b]efore the call right was exercised, there was no agreement among Mr. or Mrs. McCord, the McCord brothers, the Symphony or CFT as to when such a buyout would occur or to the price at which the buyout would occur,"¹⁶⁸ such a buyout was foreseeable¹⁶⁹ and not a material change in circumstances that would make the later sale irrelevant to the value of the donors' gift.

The appellate court cited *Ithaca Trust Co., Executor and Trustee v. United States*¹⁷⁰ as controlling its refusal to consider anticipated post-gift events; however, I have maintained that *Ithaca Trust* does not proscribe such review.¹⁷¹ *Ithaca Trust*, a pre-1969 estate tax charitable deduction case,¹⁷² involved the role of facts in a valuation required to be based on actuarial tables.¹⁷³ Specifically, the case involved the fact that the decedent's widow to whom he had bequeathed a life estate, died soon after his own death. Because she died before the estate tax return had to be filed, the true value of her

¹⁶⁷ 461 F.3d at 617 ("MIL may purchase the interest of any [exempt donee] (i.e., a permitted assignee of a partnership interest that is a charitable organization that has not been admitted as a partner of MIL) at any time for fair market value, as determined under the partnership agreement (the call right)." (alteration original)).

¹⁶⁸ *McCord*, 120 T.C. at 423 (Foley, J., concurring in part and dissenting in part).

¹⁶⁹ The partnership agreement provided the following: "Partners may freely assign their partnership interests to or for the benefit of certain family members and charitable organizations (permitted assignees). . . . MIL may purchase the interest of any 'charity assignee' (i.e., a permitted assignee of a partnership interest that is a charitable organization that has not been admitted as a partner of MIL) at any time for fair market value, as determined under the partnership agreement (the call right)." *Id.* at 362–63.

¹⁷⁰ 279 U.S. 151 (1929).

¹⁷¹ See, e.g., Wendy C. Gerzog, *Dealing with Post-Death Events*, 116 TAX NOTES 1005 *passim* (Sept. 10, 2007); Wendy C. Gerzog, *McCord and Postgift Events*, 113 TAX NOTES 349, 350 (Oct. 23, 2006); Wendy C. Gerzog, *Donovan and Davis: Two More Lottery Cases*, 110 TAX NOTES 543, 546–47 (Jan. 30, 2006); Wendy C. Gerzog, *Estate of Noble: Post-Death Sale Is the Best Indicia of Stock's Value*, 106 TAX NOTES 678, 679 (Feb. 7, 2005); Wendy C. Gerzog, *Annuity Tables Versus Factually Based Estate Tax Valuation: Ithaca Trust Re-visited*, 38 REAL PROP., PROB. & TR. J. 745 *passim* (2004); Wendy C. Gerzog, *The Lottery Cases and Ithaca Trust*, 101 TAX NOTES 289 *passim* (Oct. 13, 2003); Wendy C. Gerzog, *Ithaca Trust and Section 2053: Smith, McMorris, and O'Neal*, 95 TAX NOTES 570, 570 (Apr. 22, 2002).

¹⁷² See I.R.C. § 2055 (2006) (providing for an estate tax charitable deduction). The rules regarding the deductibility of split-interest gifts to charity (i.e., donations that also have noncharitable beneficiaries either preceding or following the gift to charity) were significantly revised in 1969. See *supra* Part V.A.

¹⁷³ See *Ithaca Trust*, 279 U.S. at 155.

interest was known after her husband's death. Because the charity actually received more than the value of its remainder interest, following the widow's life estate, calculated by the actuarial tables,¹⁷⁴ the estate argued it was entitled to a larger charitable deduction.

What I believe the court in *Ithaca Trust* said was that where valuation is based solely on calculations under the actuarial tables, all facts, except for those incorporated or necessary in the application of the tables,¹⁷⁵ are irrelevant.¹⁷⁶ Thus, where tables are mandated for valuation,¹⁷⁷ the fact that the person who is the measuring life actually predeceases her life expectancy is extraneous information.¹⁷⁸ According to *Ithaca Trust*, "[t]empting as it is to correct uncertain probabilities by the now certain fact, we are of opinion that it cannot be done, but that the value of the wife's life interest must be estimated by the mortality tables."¹⁷⁹

¹⁷⁴ While the post-death fact of the date of the decedent's surviving spouse's death was known by the time the estate had to file its estate tax return, the Court in *Ithaca Trust* required her interest to be valued by the actuarial tables regardless of the consequence that, in this particular instance—as is true with most particular instances that are calculated by actuarial valuation—the value of the interest computed by means of the tables would, in fact, be wrong because it did not reflect her actual earlier than average, premature death. *Id.* at 155.

¹⁷⁵ See Treas. Reg. § 20.7520-1(c) (1989) (regarding the interest rate and mortality component used in the tables).

¹⁷⁶ See *Ithaca Trust*, 279 U.S. at 155.

¹⁷⁷ Section 7520 provides:

[T]he value of any annuity, any interest for life or a term of years, or any remainder or reversionary interest shall be determined—

- (1) under tables prescribed by the Secretary, and
- (2) by using an interest rate (rounded to the nearest 2/10ths of 1 percent) equal to 120 percent of the Federal midterm rate in effect under section 1274(d)(1) for the month in which the valuation date falls.

If an income, estate, or gift tax charitable contribution is allowable for any part of the property transferred, the taxpayer may elect to use such Federal midterm rate for either of the 2 months preceding the month in which the valuation date falls for purposes of paragraph (2). In the case of transfers of more than 1 interest in the same property with respect to which the taxpayer may use the same rate under paragraph (2), the taxpayer shall use the same rate with respect to each such interest.

¹⁷⁸ The actuarial tables account for all individuals; by representing the average taxpayer, their calculations reflect those who survive, those who pre-decease, and their life expectancies.

¹⁷⁹ 279 U.S. at 155. Applying *Ithaca Trust* in *Sinclair Refining Co. v. Jenkins Petroleum Process Co.*, 289 U.S. 689, 698 (1933), the U.S. Supreme Court stated, "The intention of the lawmakers was held to be that the computation of the tax should be made as of the death of the testator on the basis of a law of averages." See also *Miami Beach First Nat'l Bank v. United States*, 443 F.2d 116, 119 (5th Cir. 1971) ("The use of Treasury

Because the rules regarding charitable split-interest donations were significantly revised in 1969,¹⁸⁰ the U.S. Supreme Court, not surprisingly, has cited *Ithaca Trust* only once after that date, in *Commissioner v. Hubert's Estate*.¹⁸¹ In *Hubert*, the plurality opinion¹⁸² cited to *Ithaca Trust* in the context of section 7520¹⁸³ and the use of annuity tables to determine present value.¹⁸⁴ The Court has not equated the requirement that valuation be made as of the decedent's date of death with a fixed rule that post-death events should never be considered to determine the date of death value.¹⁸⁵

Department actuarial tables for the purpose of determining the present value of future contingent interests in property has been for many years recognized and approved by the Supreme Court.”). In order to provide simplicity and certainty, the actuarial tables displace a factual analysis. Thus, the rule in *Ithaca Trust* ensures those goals only where actuarial tables alone are required to be applied for valuation purposes. On the other hand, where a factual determination must be used to determine value, there is no increased certainty or simplicity in valuation when a court ignores relevant post-death events than when it wrestles with pre-death and moment-of-death events to calculate date of death value.

¹⁸⁰ See *supra* Part V.A. However, even before 1969, the U.S. Supreme Court rarely cited *Ithaca Trust* and when cited, it was mostly in connection with a different charitable deduction issue: where a withdrawal power in a trust might deplete the CRT, it must be subject to a fixed standard in order to be deductible. See, e.g., *Comm'r v. Estate of Sternberger*, 348 U.S. 187, 199 (1955); *Henslee v. Union Planters Nat'l Bank & Trust Co.*, 335 U.S. 595, 598 (1949); *Merchs. Nat'l Bank v. Comm'r*, 320 U.S. 256, 259–63 (1943); *United States v. Provident Trust Co.*, 291 U.S. 272, 281 (1934). With respect to valuation, the Court obliquely referred to *Ithaca Trust* in *Lucas v. Alexander*, 279 U.S. 573, 579–80 (1929), when the Court cited *Ithaca Trust* as deciding a different issue from the one then before the Court. The Court held that, to determine gain for income tax purposes, unlike in *Ithaca Trust*, the value of taxpayer's insurance policies was their actual value on maturity, a certain value not dependent on estimates forecasting future events. *Id.* at 581. In *Detroit Bank v. United States*, the Court cited *Ithaca Trust*, after stating, “[t]he lien attaches at the date of the decedent's death, since the gross estate is determined as of that date and the estate tax itself becomes an obligation of the estate at that time without assessment.” 317 U.S. 329, 332 (1943). The Court was not then concerned with valuation, but rather the time at which the estate tax liability attached to the estate. *Id.* In *Kimball Laundry Co. v. United States*, the U.S. Supreme Court cited *Ithaca Trust* to underline the uncertainty of all valuation. 338 U.S. 1, 10 (1949).

¹⁸¹ 520 U.S. 93, 102 (1997). In *Hubert*, the Court held that the estate did not have to reduce the marital or charitable deductions by the amount of administrative expenses that were paid with post-death income. *Id.* at 99–111; see also I.R.C. § 2056(b)(4) (2006).

¹⁸² Justice Kennedy wrote the plurality opinion in *Hubert*, and Chief Justice Rehnquist and Justices Stevens and Ginsburg joined him.

¹⁸³ See *supra* note 176.

¹⁸⁴ See *Estate of Hubert*, 520 U.S. at 101–02.

¹⁸⁵ Neither the concurring opinion nor the dissenting opinion in *Hubert* considered *Ithaca Trust* helpful in deciding that case. Justice O'Connor, joined by Justices Souter and Thomas, wrote the concurring opinion and stated:

Indeed, in *Hubert*, Justice Scalia stated: “The provisions of the estate tax clearly reject such a notion of symmetry and do not sharply discriminate between date-of-death and postmortem events insofar as the allowance of deductions for claims against and obligations of the estate are concerned.”¹⁸⁶

Because the confirmation agreement and the sale at a bargain rate by the charity to the donors’ children and grandchildren in *McCord* were both expressly anticipated in the donors’ assignment agreement, they should be used to determine the date of the gift value of the partnership interest the donors transferred,¹⁸⁷ and to reconsider the value of the donors’ gift to charity. Like the actual sales proceeds of a vehicle defining the value of that charitable donation,¹⁸⁸ the value of the unmarketable FLP interests that the donors in *McCord* contributed to the two charities should be limited to their sales price to the donors’ children. The donors’ \$2.5 million charitable

The plurality nevertheless believes that these regulations bear *indirectly* on this inquiry by implying an underlying estate tax valuation theory that, in the plurality’s view, dovetails nicely with our decision in *Ithaca Trust Co. v. United States*. It is on the basis of this valuation theory that the plurality is able to conclude that the Tax Court’s analysis was wrong because that analysis did not, consistent with the plurality’s theory, focus solely on *anticipated* administrative expenses and *anticipated* income. But, as Justice Scalia points out, the plurality’s valuation theory is not universally applicable and, in fact conflicts with the Commissioner’s treatment of some other expenses. Because § 25.2523(a)-1(e) and its accompanying provisions do no more than suggest an estate tax valuation theory that itself has questionable value in this context, these provisions do not in my view provide any meaningful guidance in this case.

Id. at 115–16 (O’Connor, J., concurring) (citations omitted). The concurring opinion agreed with the dissent that *Ithaca Trust* did not “provide any meaningful guidance in this case. *Id.* at 116. Likewise, the dissent stated, “[t]he plurality’s reference to *Ithaca Trust Co. v. United States* is unhelpful.” *Id.* at 134 n.2 (citation omitted). However, the dissent stated, “[t]hat case [*Ithaca Trust*] holds that date-of-death valuation is applicable to bequeathed assets, not that it is applicable to claims and obligations that are to be satisfied out of those assets.” *Id.* at 134 n.2.

¹⁸⁶ *Id.* at 134 (Scalia, J., dissenting). Although Justice Scalia wrote the dissent in *Hubert*, in which he was joined by Justice Breyer, the issue of whether after death facts may be considered to value a claim against the estate under section 2053 was not before the Court. Interestingly, not only was Justice Scalia joined by Justice Breyer in his dissent, but Justice O’Connor, who was joined by Justices Souter and Thomas in her concurring opinion in *Hubert*, might have agreed with Justice Scalia on this issue. Justice O’Connor stated, “[b]ut, as Justice Scalia points out, the plurality’s valuation theory is not universally applicable and, in fact conflicts with the Commissioner’s treatment of some other expenses.” *Id.* at 115 (O’Connor, J., concurring).

¹⁸⁷ That value may factor in adjustments, if any are necessary, attributable to “intervening” events or to the time value of money.

¹⁸⁸ I.R.C. § 170(f)(12) (2006); *supra* notes 27, 34–39 and accompanying text.

deduction should have been restricted to the \$479,008 the charities actually received. The donors' benefits, both in terms of the transfer taxes they saved from the undervaluation of their gifts to their family and the overvaluation of their charitable contribution, equal the government's losses and they far exceed the relatively minor benefit the charities received. Under a quid pro quo analysis, the donors lacked donative intent and received economic benefits far in excess of those obtained by the charities.

VIII

NORMATIVE CONSIDERATIONS AND SOME SOLUTIONS

Very simply, as the charitable deduction is constructed, the government should not lose more revenue than a maximum percentage (currently somewhere between thirty and forty-five percent)¹⁸⁹ of the amount that actually benefits a charity. In most of the quid pro quo transactions discussed in this Article, the benefits the donor receives either from the charity or from the government are larger than the benefit the charity obtains. When self-interest outweighs the benefits to the charity, that quid pro quo contravenes the holding of *American Bar Association* and the rationale for the charitable deduction. Under a broader quid pro quo analysis, those donors do not serve the public good and therefore should not be entitled to a charitable deduction.

If the "net benefit" theory consistently applied to conditional gifts like nursing home fees or litigation settlements, the taxpayer would be denied a charitable deduction since the transfers are more sales-like than "donative" and the benefit the donor receives equals his gift to charity. Moreover, donations of in-kind property that present valuation difficulties or are illiquid should be deductible only in the year, and amount actually received when sold by the charity.¹⁹⁰ That

¹⁸⁹ The maximum income tax rate is 35% and the maximum transfer tax rate is 45%. See I.R.C. §§ 1, 2000 (2006). Note that the income tax charitable deduction, unlike the gift or estate tax charitable deduction, is capped at a deduction in the current year of 50% of the donor's contribution base, with a five-year carryover. See *supra* note 4.

¹⁹⁰ An exception to this rule could apply to in-kind property that the charity uses for its exempt purpose. That exception should incorporate some of the language in section 170(e)(1)(B)(i) for tangible personal property and expand it to real property that is unmarketable but actually used by the charity for its exempt purpose.

rule would have made the donors' charitable gift of an FLP interest in *McCord* reflect the actual benefit the two charities received.¹⁹¹

In addition, the taxpayer's deduction should parallel the timing of the charity's benefit. With CLTs, the government's loss stems from the taxpayer's charitable deduction, which may exceed the amount actually given to the charity when there is an income shortfall, and from the loss in revenue from the undertaxation of the noncharitable gift because the principal's actual appreciation and income production exceed their value calculated by means of the actuarial tables. Therefore, this Article recommends reforms for charitable split-interest gifts that echo those applicable to patent donations: "Rather than estimating income and gift/estate tax liabilities at the time of transfer to the charitable lead trust, the tax consequences of the donations could be determined when they are actually received."¹⁹² In addition, the transfer tax liability for the noncharitable remainder should be determined at the end of the charity's interest when the donor's gift to third parties becomes possessory.¹⁹³ Likewise, gifts to private foundations where the donor retains control should be deductible only when funds are actually distributed from the foundation to a charity.

To insure adequate compliance with all of these new rules, there should be additional reporting requirements applicable where necessary to both the charities and taxpayers.¹⁹⁴

¹⁹¹ Insider trading laws should apply to CEOs who donate their company's stock to a charity. However, to the extent that those laws are not revised as they should be, there should be a recapture provision reflecting that kind of abuse.

¹⁹² 2008 S. Hearing, *supra* note 6, at 8. That reform would resemble the treatment accorded patent donations to the extent that with those donations with additional value beyond basis is included in years subsequent to the donation to reflect the actual value that the charity receives. See *supra* Part II, notes 26, 29–33 and accompanying text.

¹⁹³ While abandoning the use of the actuarial tables would eliminate the simplicity and certainty characteristic of those tables, it would satisfy the *American Bar Endowment* requirements that the charity's benefit from the taxpayer's transfer exceed her financial gain and that the taxpayer's transfer reflect donative intent. That rule should also be applied in the context of noncharitable future interests as well in such techniques as a grantor retained annuity trust ("GRAT") or grantor retained unitrust ("GRUT"), but a detailed consideration of that issue is not within the scope of this Article.

¹⁹⁴ While admittedly the extra benefit of unrealized gain is not supported by any cogent tax policy, the double benefit bestowed on certain appreciated in-kind gifts to charity is currently not very expensive in terms of additional revenue loss and may indeed encourage larger donations and, therefore, greater benefits to a charity. Therefore, this article does not recommend any changes to the tax law in this respect at this time.

CONCLUSION

In some instances when the taxpayer makes a charitable donation, the loss of revenue to the government far exceeds the benefit to the charity. The government's loss derives from government-sanctioned complex transactions like those in *McCord* and even government-created devices like the CLT. The rationale for the charitable deduction is that the government is using the tax system to serve the public good indirectly through the charity. Congress should reform the provisions so that the donor's tax benefits correspond to only a small portion of the charity's gains when the deduction primarily serves private financial advantage. To achieve that goal, the taxpayer's deduction should be synchronized with the charity's benefit. In the case of in-kind property donations presenting valuation difficulties, the deduction should be limited to, and timed together with, the property's sale proceeds unless the charity uses the contributed property for the charity's tax-exempt purpose.

