Chapter 8.

Gifts of Forestry Assets

OVERVIEW

Estate planning frequently focuses on the transfer of property at death; however, gifts also offer a powerful tool to achieve planning objectives. With a program of giving, the "ability to afford the gift" should be the first consideration. Stated another way, do not give away money or timberland that someday might be needed. Many gifting objectives are personal and do not involve tax saving, but they are just as, or perhaps more important than tax and financial considerations. However, careful attention to the tax rules permits the donor to stretch the benefits of his (her) gifting program.

Some Reasons for Gifts

The foremost reason for a program of gifting is to benefit family members. When most of the assets are owned by one spouse, a substantial gift equalizing the family assets is a statement of trust. Other beneficial effects that follow as a result of gifting are discussed in chapters 6 ("Use of the Marital Deduction in Estate Planning") and 10 ("Role of Trusts"). Gifts to the adult children, especially of timberland, may help promote a sense of financial maturity in the donees and may provide the motivation for them to learn the business of managing the tree farm. Thus, the donor can see the responsibilities for managing a going concern transferred to the next generation with efficiency and effectiveness. It follows that the donor will gain a general feeling of satisfaction in seeing the timberland used and enjoyed. The process can assist the donees' personal growth and, properly done, influence their behavior in favorable directions.

Gifts from senior family members who are in higher income tax brackets can improve the total family income tax burden by moving income-producing property into the hands of family members who are in lower tax brackets. Charitable gifts provide an income tax benefit while at the same time benefiting organizations that are personally important to the donor--churches, colleges, museums, and others. Gifting reduces (thins) the size of the donor's gross estate and, in so doing, reduces both Federal and State death taxes. This also lowers estate settlement costs and avoids the delays and fees of the probate process with respect to the property gifted. In some cases, the transfers can put the property out of reach of creditors.

Because of the power of gifting to reshape the donor's estate, a program of gifting should be pursued cautiously because there are also disadvantages. Perhaps the most important is the loss of control. Thus, important business entities and key parcels of timberland may not be the best candidates for a gift. Gifts of income-producing assets reduce the donor's income. A gift also transfers the donor's basis to the donee, with possibly adverse income tax implications that would not be the case with testamentary transfers. Additionally, special use valuation (see chapter 13) is not available for lifetime gifts. Most of these points will be discussed more fully in the following sections of this chapter.

GIFTING TAX CONSIDERATIONS

Any transfer of property or an interest in property, without adequate and full consideration in money or in kind, may involve a gift. The goal of gift and estate tax minimization has been made more difficult by recent changes in the tax laws. For example, Clifford and spousal remainder trusts can no longer be used as effective income-splitting devices. These short-term trusts with reversionary interests of income or principal were formerly used to shift income from the grantor to beneficiaries in lower tax brackets. Such income is now taxed to the grantor, effectively nullifying the benefit of these types of trusts. The so-called "kiddie tax" affects gifts to children under age 14 because their unearned income over $1,100 per year is taxed at the parent's top rate. Children 14 years and older with unearned income of $550 or more are taxed at their own rate. This provides a considerable incentive to increase an older child's income with income-producing gifts.

Incomplete Gifts

If a donor retains an interest in or power over the property gifted, it results in the gift being incomplete. A complete gift requires: a competent donor and donee, a clear intent to make a gift, an irrevocable transfer of legal title, the delivery of the gift to the donee, and the donee's acceptance.

Gifts with no strings attached are complete gifts. Incomplete gifts are more likely to occur in transfers to trusts than in outright transfers (see chapter 10 on trusts). If provisions are included in a deed to the effect that "If I outlive you, the property will become mine again," the gift is called "the possibility of a reverter." The gift is considered complete, but the restriction reduces its value. Along similar lines, a parent who gives the family tree farm to the children, but tells them, "I plan to live here and hunt and fish until I die," has made a gift of a remainder (future) interest. Again, the gift is considered as being complete, but its value has been reduced, and it is not eligible for the annual $10,000 exclusion.

Gifts of property are valued as of the date of the gift. Any appreciation of the property while in the donee's hands is excluded from the donor's estate. In addition, gift taxes on property transferred more than 3 years before the donor's death are excluded from the donor's gross estate, probate administration expenses will be avoided on the value of the gift property and the gift taxes paid, income from the gifted property will be excluded from the donor's estate, and State death taxes may be reduced in some States.

Gifts of Land and Timber Rights.--The Internal Revenue Service (IRS) will treat the gift of underlying land with retention of the timber rights by the donor as an incomplete gift. This means that the value of the land will be included in the donor's estate. Revenue Ruling 78-26 held that the entire value of forest land given to an individual by a donor who reserved for 10 years all timber rights, which constituted personal property under the law of the State in which the timber was located, with the donor dying during the 10-year period without having removed any timber, was included in the decedent's gross estate. The U.S. Fourth Circuit Court of Appeals has upheld the IRS position. The court held that under South Carolina law, when the decedent transferred her land to a corporation in exchange for shares of its stock, reserving timber rights on a portion of the land for 2 years, she also reserved an interest in the soil necessary to nourish the timber growing on it. The court ruled that to the extent that the transfer to the corporation was not for an adequate and full consideration, the timberland was includable in her gross estate as a gift with a retained life estate (*Estate of Graham* v. *United States*, U.S. Court of Appeals, Fourth Circuit, No. 83-1068, Sept. 30, 1983).

Gift Tax Rates, Credits, and Exclusions

The unified gift and estate tax transfer schedule applies to all gifts. As discussed in chapter 3, a single rate schedule exists with respect to both lifetime gifts and estates of decedents. The marginal tax rate begins at 37 percent of the taxable amount in excess of $600,000. The top rate following the passage of the Revenue Reconciliation Act of 1993 is 55 percent on gifts and estates in excess of $3 million (see table 3.1). The amount of gift tax payable in any calendar year is calculated by taking the cumulative lifetime taxable transfers and applying the unified transfer tax schedule. The tax on previous transfers is then subtracted from this amount, as is whatever has not previously been used of the $192,800 unified gift and estate tax credit.

Internal Revenue Code (IRC) Section 2504(c) sets a 3-year statute of limitations for revaluation of lifetime gifts for gift tax purposes. It does not, however, bar the revaluation of lifetime gifts for estate tax purposes. Thus, a gift of timberland that does not have a readily determinable market value should be supported by a qualified appraisal to establish its fair market value (see chapter 4 for a detailed dis-cussion of timberland valuation).

Annual Exclusion.--The annual exclusion permits the first $10,000 in gifts, based on fair market value, to each donee (other than the donor's spouse) during each calendar year to be transferred tax free. The gift must be of a present interest; that is, it cannot comprise property or a right that cannot be utilized until some future date by the donee.

Example 8.1. Parents have four adult, married children. One parent, in this case the father, owns 2,000 acres of timberland in fee simple, which has an average value of $1,000 per acre. The father (donor) can give each child (donee) $10,000 in value each year. That is, he could give each child either 10 acres or a fractional, undivided joint interest in the timberland (see chapter 15) worth $10,000 each, for a total of $40,000 per year for the family. He could also give each child's spouse a similar 10 acres or $10,000 interest in the timberland each year. This could be transferred as 20 acres or $20,000 in joint family ownership to each child and spouse for a total annual family transfer of $80,000.

As long as the donor makes the gift outright, the annual exclusion should not present a problem. However, with timberland, a qualified appraisal is necesary to verify the fair market value of the transfer.

In addition to the annual gift tax exclusion of $10,000, there is an unlimited gift tax exclusion for qualifying payments of tuition and medical care. The deduction for tuition is limited to direct tuition costs, and the payment must be paid directly to the institution. The deduction for medical costs is for those unreimbursed by insurance as defined in IRC Section 213(d).

Marital Deduction.--The marital gift tax deduction is unlimited. For gift transfers to a spouse to qualify, the following requirements must be satisfied: the man and woman must be married at the time the gift is made, the donor spouse must be a U.S. citizen or resident, the donee spouse must be a U.S. citizen, and the gift cannot be a "nondeductible" terminal interest except for QTIP's (see chapter 6 for a dis-cussion of QTIP's and terminal interests).

Although an effective planning tool in the right situation, the question remains as to what extent should the unlimited gift tax marital deduction be used? A lifetime transfer saves estate administrative expenses and probate costs for the donor spouse who dies first and it may permit full utilization of the unified credit if the other spouse were to die first. The QTIP election (see chapter 6) can be utilized if the donor feels that it is necessary to insure that the children ultimately receive the property. These decisions should be carefully analyzed with expert coun-sel and with the family's goals fully in mind.

Reporting Procedures.--A Form 709 gift tax return (see appendix) is required for transfers of property greater than $10,000 in fair market value and for split gifts (see below), regardless of value. Returns are due on April 15 with the Federal income tax returns for the tax year, or as extended.

Other Considerations.--Approximately one-fourth of the States have a gift tax on the transfer of property (see chapter 19). These provisions, if applicable, should be considered.

Split Gifts

A married person who makes a gift to a child or any other person can treat that transfer as though one-half had been made by him (her) and one-half by his (her) spouse, if the spouse agrees. The gift is split for the purposes of computing the gift tax. Thus, the gift is taxed at a lower rate than if the transfer had been a single gift by one spouse. The $10,000 annual exclusion and unified credit are applied jointly, but the actual donor must file the gift tax return.

Example 8.2. Assume the same facts as in example 8.1, but now the mother (assetless spouse) agrees to make a split gift to the children. Each child will now receive a split gift of either $20,000 in undivided value or 20 acres. This can be increased to $40,000 or 40 acres by making split gifts to the child and his (her) spouse. In that case, the total transfer for four children and their spouses would be $160,000. A practical way to make the transfer would simply be to draft a deed for each family member for 40 acres in joint ownership.

Split spousal gifts are allowed only if: (1) each spouse is a citizen of the United States at the time the gift is made, (2) the parties are married at the time, and (3) both spouses agree to split all their gifts for the calendar year.

BASIC GIFTING STRATEGIES

In this section, attention is focused on the question of the economic impact of giving an asset; the effective use of the unified credit, annual exclusion, marital deduction, and gift-splitting; and whether cash, or its equivalent should be the gift property. Timberland is emphasized, but other assets usually found in timbered estates are included.

What Type of Property to Give

Choosing the right property for a gift is an important part of the gift plan. A gift may be of personal property--art, cash, business interests, securities (stock), personal effects, cars, and other tangible assets. It could be real estate--rental property, timberland, timber and hunting leases, personal residences, easements, or other rights in real property. Or, the gift could be of life insurance--cash value, cash refunds, or other benefits associated with the policy. Considerations in selecting gifts should, of course, be meshed with the overall estate planning goals.

There are some basic considerations to bear in mind in choosing gift property.

Low Gift Value.--For lifetime gifts, it makes sense to give property that has a low gift tax cost but a high potential estate tax cost. Appreciating assets, such as timberland in zones I and II, fit this category (see figure 2.4 and the trust example in chapter 10). Timberland with high growth potential is a good candidate for gifts because it is likely to become an

estate tax problem for the donor if held.

Appreciated Property.--Timberland often fits into the appreciated property category. Assume that a donor is in the 32-percent marginal income tax bracket--28 percent Federal and 4 percent State. If he (she) sells a property for $10,000 net gain, the income tax will be $3,200. However, if the donor gives the property to a son or daughter (older than 14) who is in the 15-percent marginal income tax bracket, the tax on the sale of the same property by the donee would be only $1,500. This transfer should also be compared with a gift of cash while carrying the timberland through the estate for a stepped-up basis.

High-yield Assets.--Senior family members in the new 36.0- or 39.6-percent brackets may consider transferring high income-producing assets to children (over age 14) who are just getting started in their careers and who are currently in a low marginal tax bracket. Alternatively, a retired parent in the 15- or 28-percent bracket should consider gifts to children of low income-producing assets with good growth potential, such as rapidly appreciating young timber stands.

Keeper Assets.--Timberland is often low-basis property that will remain in the family. Many times senior family members who worry about control of their tree farm will consider taking the timber income and parting with the land. If it will cause future estate problems, the donor could harvest the mature timber and transfer the cutover, bare land to the children. This transfer can be coupled with gifts of some of the liquid assets to cover the cost of reforestation. In such a case, it is important to make sure that the donees have the resources to handle the management costs and carrying charges associated with the property while it is unproductive.

Problem Property.--If timber property will cause problems for the owner's estate executor because it is hard to divide, value, or sell, the owner could give the property during his (her) lifetime. Sometimes the family home, the lake property, or the shore cottage will fit into this category. Art, antique guns and clocks, and jewelry also fit into this mold.

Jointly Held Property.--If timberland is held jointly, it may be advantageous to retitle the prop-erty to make it easier to handle for testamentary disposition. For example, if a parent and child hold timberland jointly, the parent may wish to gift his (her) interest to the child. This avoids the problem of having the property fully valued in the estate of the first to die due to inadequate records for proof of proportionate contributions.

Life Insurance.--In order to keep life insurance proceeds out of the decedent's estate, it may be beneficial to transfer ownership of the policy to a junior family member or to a life insurance trust (see chapter 11). The gift tax cost is based on the value of the policy, but it is likely to be lower than for other assets with approximately the same expected value at the decedent's death because of insurance's "tax-favored" status.

Income Tax Basis

The donee's basis in gifted property is the donor's basis plus any gift tax paid on the net appreciated value of the gift while in the donor's hands. For this reason, highly appreciated property should often be held in order to receive a stepped-up basis on the death of the owner. This strategy, however, must be balanced with the further appreciation potential of the property.

Installment Sales and Gifting of Installment Notes

A strategy of selling property to a son, daughter, or other related person with installment reporting of gain and periodic forgiveness of all or part of the payments as they come due should be used with considerable caution. This runs the risk of having the sale recharacterized as a gift. Because the pay-ments under the installment contract are treated as income to the seller, a possible solution is to treat the payment as income and make gifts of cash to the children who then make the payments from an entirely separate account (see chapter 12).

GIFTS TO MINORS

Gifts within families are the most common type of lifetime gifts, such as from parents to children and from grandparents to grandchildren. Many are gifts to minors that are made without much thought being given to the legal or tax consequences. As long as such gifts are small, there is generally no serious problem.

As gifts increase in value, however, the so-called "kiddie tax" has a major impact on minors under the age of 14 (see page 47). On the other hand, State law is often more concerned about protection of the minors' rights and the minors' legal capacity to own,

manage, and sell property. Many States require guardians for minors who own real property, place restrictions on a minor's power to make contracts, and otherwise restrict a minor's ability to conduct business on his (her) own behalf. These constraints complicate gifting to minor children, especially of real property, such as timberland. Vehicles, such as trusts, custodianships, and guardianships, are utilized for protecting minors' interests. These differ in a number of important respects and their advan-tages and disadvantages should be understood before embarking on a substantial gifting program involving minors.

Two pieces of legislation have been widely adopted that make the process of gifting to minors more uniform across State boundaries. The Uniform Gift to Minors Act (UGMA) and more recently the Uniform Transfer to Minors Act (UTMA) have made it easier and legally safer to make gifts of all types of property to minors.

When making gifts to minors, the legal, tax, and practical management aspects of the transfer all need to be considered, especially where timberland is concerned. The Revenue Reconciliation Act of 1993 increased the spread between the lowest and highest noncorporate income tax bracket by more than 50 percent. This in turn has increased the motivation for tax shifting. State income taxes also have to be considered.

Example 8.3. Assume that a parent who is in the 36-percent income tax bracket gives a child (over age 14) an interest in timberland that is under a long-term lease to a forest products company. The interest transferred provides an income of $10,000 per year. The lease payment is treated as ordinary income for income tax purposes. If it is assumed that the child has enough additional unearned income from other sources to utilize his (her) $550 standard deduction, the family has saved $2,100 in income taxes [($10,000 × .36) versus ($10,000 × .15)].

However, the issue of parental obligations for legal support must be taken into account. A legal obligation of support makes the child's income attributable to support taxable at the parent's rate. In addition, trust income actually applied to the support of a beneficiary whom the grantor is legally obli-gated to support is taxable to the grantor (IRC Section 677). The IRS treats custodial accounts similarly, and many State laws treat a guardian-ship as a trust, which would subject it to treatment under Section 677. State law should be carefully considered with respect to the definition of support because expenses for private schools, a college education and, in some cases, a graduate education may be considered as required for support.

Custodianship

Under the UGMA and UTMA laws for transferring property to minors, custodians have the same power over the property that an unmarried adult could exercise over his (her) own property. These laws permit all types of property to be transferred, including timberland. The custodian can enter into business transactions that are required for managing the property. Such actions, however, are subject to the laws governing fiduciary obliga-tions.

State statutes should be checked for the specific requirements concerning transfers, for the exact responsibilities of the custodian and for the age of majority. The custodial control of a minor's property is usually given over to the full control of the donee at the age of majority, but the applicable State law should be reviewed.

Estate Tax.--If the minor child dies before the custodial account is transferred to his (her) control, the property is includable in his (her) estate. It may be included in the donor's estate if the donor is the custodian and dies before the child reaches the age of majority. Therefore, it is *not* a good idea for the donor to also serve as custodian and risk having the assets included in his (her) estate, especially if the value is large. Similar problems exist with regard to the donor's spouse serving as custodian. These problems suggests that a reliable aunt, uncle, or cousin would be a safer choice.

Gift Tax.--Gifts under the UGMA and UTMA qualify for the annual gift tax exclusion of $10,000 ($20,000 for split gifts). However, the parent-donors should not be custodians because there is a risk that the transfer to the child-donee at majority could be treated as a release of a general power of appoint-ment and, therefore, taxable to the parents.

Guardianships

A legal guardian takes custody of and manages a minor's property. He (she) has fiduciary responsi-bilities similar to those of a trustee; however, the guardian does not hold legal title to the property. The guardian can be the recipient of gifts to a minor.

Example 8.4. Assume the same facts as in example 8.3. The parent is appointed as the child's guardian and, in addition, is also legally obligated for his (her) support. The $10,000 annual lease income would continue to be taxed at the parent's 36-percent marginal tax rate, even though it is now the property of the child, if used for the child's support. The portion (if any) not used for the child's support, but rather for his (her) benefit, is taxable to the child. The guardian files the income tax return for the child.

For estate purposes, the property that is given to the child is removed from the donor's estate, subject to the provisions for gifts within 3 years of death that are discussed below on pages 52 and 53.

A guardianship provides the greatest protection for the child's property rights. This includes bonding, accounting, and court supervision. The price for this extra measure of security for the child often means added operating costs and constraints on the flexibility of operations, as compared to a custodial or trust arrangement. Potential disadvantages include terminations at majority, which may be earlier than what is in the best interests of the child's welfare, and adverse estate tax consequences if the child dies within the term of the guardianship.

Trusts for Minors

Trusts can provide a very flexible means of making larger gifts. The general applicability of trusts as an estate planning tool is addressed in chapter 10. Certain specific issues related to gifts to minors will be discussed here. The grantor has con-siderable freedom to design a trust instrument that meets his (her) objectives. It can be established to distribute income to a minor during its term, accumu-late income for the minor, or both. The grantor can establish the term of the trust, select the trustee (and successor), specify when and how the principal will be distributed, and fulfill other functions discussed in chapter 10. If substantial gifts are involved, this is probably the most effective method of handling a gift transfer to minors, assuming that the size of the gift warrants the expense of setting up and operating a trust.

Two basic types of trusts are in most common use as instruments for making gifts to minors. Trusts written to conform to the provisions of IRC Section 2503(b) make the annual gift tax exclusion possible because the transfer will be a gift of a present interest. This type of trust requires the current distribution of income to the minor but does not require distribution of the principal when the minor reaches majority. Trusts written in accordance with IRC Section 2503(c) also insure the availability of the annual gift tax exclusion on gift transfers for the benefit of minors. Current distribution of income is not required, but the distribution of the principal and income is required when the minor reaches majority--or sooner if specified in the trust instrument. The annual exclusion will additionally be available if the income "may" be used by the beneficiary before he (she) reaches age 21, with the remaining principal paid to him (her) at age 21. If the minor dies before reaching age 21, it will be paid to his (her) estate (*Gall*, CA-5 75-USTC ¶ 13,107, 521 F2d (1975), aff'g DC Tex., 75-1 USTC ¶ 13,067). With these types of trusts, the income portion is considered as a gift of a present interest and the principal portion as a gift of a future interest. The income tax treatment for the beneficiary is as discussed above.

A trust written under the provisions of IRC Section 2503(c) is a separate taxable entity. The income tax treatment of trusts is discussed in chapter 10. The trust property will generally not be included in the donor's estate.

Trusts have considerable flexibility as tools for making gifts to minors, but they require careful attention to draftsmanship in order to qualify for the annual gift tax exclusion and also to make practical sense for management of property such as timberland. A qualified estate planner should be consulted.

GIFTS WITHIN 3 YEARS OF DEATH

The value of gifts made within 3 years of the donor's death is generally not includable in his (her) gross estate. Such gifts are valued on the effective date of transfer, and the appreciation in value after that date is not subject to the estate transfer tax.

There are certain exceptions to this rule, however, which apply whether a gift tax return is required or not. The value of a life insurance policy transferred by the decedent within 3 years of death will be included in the gross estate. In addition, all gift transfers within 3 years of death will be included in the calculation of estate value for purposes of determining the estate's qualification for special use valuation under IRC Section 2032A (see chapter 13), deferral and extension of tax payments under IRC

Section 6166 (see chapter 14), and qualifications for special stock redemption (IRC Section 303). Such gift transfers made within 3 years of death are not effective for meeting the statutory percentage requirements under these statutes. In addition, gift taxes paid on gifts within 3 years of death are includable in the donor's estate.

In spite of these few restrictions, there are still good reasons for proceeding with a gifting program within 3 years of death. As noted above, the appreciation after the gift's transfer is not taxable to the donor; therefore, properties with high appreciation potential, such as young plantations in zones I and II (see discussion of timber zones in chapter 2), are good candidates for gifts. Similarly, subsequent income generated from the gift is not includable in the donor's estate although the gift tax paid on the transfer is included. For spouses the unlimited marital deduction may be used without incurring a gift tax. Gifts to donees in lower income tax brackets may save on income taxes if not subject to the "kiddie tax." In States with a gift tax, the State gift taxes paid are deductible on the Federal estate tax return.

Certain negative factors must be considered in making gifts within 3 years of death. One is the gross-up provision, which takes all previous taxable transfers into account when computing the transfer tax. Also, as discussed earlier, the gift does not get a stepped-up basis as does a testamentary transfer. This is particularly disadvantageous for timberland because timber is a long-term investment. The basis for most timber assets held for long periods of time is low.

CHARITABLE GIFTS

Overview

With the peace of mind that comes from knowing that one's spouse and children will be adequately provided for, a plan for charitable giving of additional assets may bring great personal satisfaction. A donor can benefit both his (her) family and the charity in a variety of ways. The affordability of the gift depends on its after-tax cost, which is affected by the donor's filing status, taxable income, and overall tax rate (that is, the sum of Federal, State, and local marginal rates, as adjusted).

Fulfills Dreams.--Charitable gifts can help fulfill dreams of things that the donor would like to have done to help others, given different circumstances. For example, a scholarship could be provided for a talented young person to help him (her) achieve things not able to be done directly.

Sets Example.--Giving sets a powerful example of generosity and humanitarian concern for others--a message of incentive and motivation to a generation with sufficient wealth for survival. It also refutes the mind set that implies, "I have mine and I don't care about you!"

Uses Resources Efficiently.--Gifts permit efficient uses of resources. For example, churches and scholarships provide large benefits for the community and for society by combining voluntary labor and a rapid turnover of resources. The gift enables the charity to leverage its resources.

Permits Choice.--Gifts permit a choice of charitable opportunities, such as churches, forestry research, youth programs and community efforts. These may be combined in a number of ways that meet the donor's objectives.

Satisfaction.--Gifts should be viewed as a source of satisfaction rather than a cost. The donor should feel good because he (she) has contributed to the betterment of one or more persons or organizations that benefit the community.

Charitable Income Tax Deduction

Taxpayers can deduct amounts contributed to religious, charitable, educational, scientific, and other organizations for income tax purposes. The tax effects depend on *when* assets are given, *how* they are given, *how much* is given, and *to whom* they are given. For substantial gifts, the donor should understand the different categories of charitable giving and their effects on deductions. These categories include: (1) public charities--such as churches, universities, hospitals, and foundations that have received considerable public support; (2) semipublic charities--such as veterans organizations, nonprofit cemetery associations, and others that do not fit into the public charity category; (3) private charities--such as private, nonoperating, or distributing foundations; (4) contributions for the use of a charity (rather than "to" a charity); and (5) capital gain property--that is, highly appreciated property.

Churches and subdivisions of government are

automatically viewed as charitable, but private charitable organizations must meet the requirements of Section 501(c)(3) of the IRC and have an exemption letter from the IRS to prove their status in order to assure a tax deductible contribution.

The percentage limitations on charitable contribution deductions are based on the charitable category of the organization and the nature of the gift. The charitable contribution deduction for the tax year is limited to a percentage of the donor's "contribution base." The donor's contribution base is defined as his (her) adjusted gross income without regard to any net operating loss carryback.

A 50-percent limitation on charitable contribution deductions applies jointly to so-called "50-percent" charities, which include a number of organizational categories, both public and private. It is applied to public charities first, then to private charities, and any contributions in excess are carried over for 5 succeeding taxable years. There is a 30-percent limitation on deduction of contributions to private charities classified as so-called "30-percent" charities, as well as contributions "for the use of" charities. Examples of the former include fraternal orders and veterans organizations. Deductions for contributions of capital gain property to semipublic and private charities is limited to 20 percent of the donor's contribution base. There is also a special 30-percent limit on certain capital gain property given to a public charity, and there are further limitations based on the ratios among these various categories.

Valuation of the Contributions.--A deduction for donated property is measured by its fair market value, subject to certain reductions for appreciated property as discussed below. No problems exist for securities that are publicly traded. However, for large gifts of real estate or timber property a qualified appraisal must be obtained and a summary must be attached to the tax return (Section B, Form 8283) if the value of the property exceeds $5,000 ($10,000 for nonpublicly traded property). The appraisal must be made within 60 days prior to the date of the gifts. The appraiser must be qualified to make appraisals of the type of property being gifted. For example, tim-berland should be appraised by a person who meets the federal appraisal standards. The appraiser must sign the appraisal form, must not be related to the donor, and must not work on a percentage basis.

There are penalties for overvaluation of property. If an audit determines the reported value to be 200 percent more than the correct value, a 20-percent penalty can be imposed. Additional penalties can be levied for more blatant overvaluation.

Appreciated Property.--The charitable deduction depends on the property's fair market value, the type of property (real or personal), the holding period, the character of the charity, and the use of the property. Capital gains property and ordinary income property retain their different characters for charitable purposes.

Capital gain property held by the donor for more than 1 year is given favorable tax treatment. That is, the donor gets a deduction of fair market value and does not have to pay tax on the appreciation, subject to the alternative minimum tax. For real estate, including timberland, the donor is entitled to a deduction based on the property's fair market value on the date of the contribution. The deduction is generally limited to 30 percent of the donor's contribution base, as noted above, if made to a public charity, such as a church or university. If the contribution is to a semi-public charity the limitation drops to 20 percent. Contributions of capital gain property to certain private foundations that do not make distributions may be limited to the property's basis.

However, there is also a special rule on contributions of appreciated property that permit the donor to deduct up to 50 percent of his (her) contribution base if an election is made to reduce the value of the contribution by the amount of the appreciation. The election decision should be based on the amount of the appreciation (timberland often has a very low or zero basis and may not be a good choice), the importance of a deduction greater than the 30-percent limit, and the donor's exposure to the alternative minimum tax (AMT) provision of the Federal income tax. The appreciation is a preference item that is included in the base of AMT taxable income.

Charitable Estate Tax Deduction

Lifetime charitable contributions generate not only an income tax deduction but also an estate tax deduction. In addition to the income tax deduction discussed above, the estate tax deduction depends on the marginal tax rate. At the estate's taxable threshold (that is, just over $600,000 in taxable estate value) the saving would be 37 percent of the value of the charitable contribution. When the value of the taxable estate exceeds $3 million, the donor saves 55 percent of the value of the contribution. If the

transfer is a testamentary bequest or includable in the donor's estate by virtue of a retained interest, only the estate tax deduction will be available.

Gifts with Retained Interests--Charitable Remainders

A timberland owner may be thinking of giving a particular property to a charity, but he (she) may feel that the income from the property is needed for the present time. The transfer could take effect at death, but there may be a spouse or other family member who would need the benefit of the income value after the donor is gone. For example, there are many parents who own woodlands in rural, often remote areas of the country with children who are professionals and live in distant cities, and who often have little interest in the tree farm. However, the children may feel that they need the income for educating their children or for some other reason.

Such a landowner can make a present gift to a charity of a future interest. This is known as a charitable remainder. If the gift is money or liquid assets, the transfer should be in trust. For real prop-erty, however, the remainder interest can be created without using a trust. The remainder can be constructed to take effect at the end of a set term of years, at the donor's death, on the death of the surviving spouse, or perhaps on the death of other persons as well. The donor of the gift gets a current income tax deduction based on the present value of the remainder interest. There are, of course, some strict limitations.

The value of the remainder interest is deductible for Federal gift tax and income tax purposes, if given to a qualified charity. The amount of the gift is the fair market value of the property less the value of the retained "life interest," determined from actuarial tables.

Charitable Remainder Trusts.--The donor can get an income, estate, or gift tax deduction for a charitable contribution to a charitable remainder trust that has one or more noncharitable beneficiaries *only* if the trust qualifies as an annuity trust or a unitrust under the IRC. The annuity trust provides a "fixed annuity payment" to the income beneficiaries. A unitrust provides a "variable annuity payment" based on a percentage of the trust's earnings. Both trusts can be established during a donor's lifetime or by the donor's will. The donor is required to set aside certain assets with payments--either fixed or variable--made for either a fixed term (not to exceed 20 years) or for the life of the donor-grantor, his (her) spouse, or other named persons with the remainder to go to a qualified charity. Distributions to the beneficiaries must be made at least annually, and the principal must not be used for the beneficiaries' benefit except in accordance with specific payout requirements in the trust.

Both the annuity trust and the unitrust require a payment rate of at least 5 percent. The payment under an annuity trust is calculated on the basis of the initial fair market value of the trust assets, updated annually. With a unitrust, the beneficiaries have a variable annuity. For example, if the assets are timberland, the payments may fluctuate with the cyclical nature of the market. With a unitrust, the instrument may, but is not required, to have a provision permitting use of the principal if the annual income is insufficient. Furthermore, additional contributions can be made to a unitrust during the grantor's life or by terms of the grantor's will under specified terms and conditions [Treasury Regulation § 1.664-3(b)] and (Revenue Ruling 74-149). On the other hand, with an annuity trust, once the payment schedule is established, the annual payments are made from principal, if current earnings are insufficient and no additions to the trust are accepted. In fact, if the payment rate is set too high for an annuity trust, the remainderman--the charity--may get a smaller gift than expected or none at all. This situation has been noted as an opportunity that invites abuse and thus merits Congressional attention.

The unitrust may be created with an income-only or makeup option. Under this arrangement, the trustee pays the beneficiary only the current income, but as earnings increase in future years the deficit in previous payment amounts is made up [IRC Section 664(d)(3)].

Tax Consequences.--The remainder interest under an annuity trust for tax purposes is the net fair market value of the trust property less the present value of the annuity. If two or more bene-ficiaries are involved, the computations are based on the life expectancies of each individual. The present values are computed using the IRS tables in IRC Section 7520 and are based on a floating interest rate--120 percent of the midterm applicable Federal rate. Examples of the procedure can be found in IRS publication 1458.

The annuity trust and the unitrust are exempt from Federal income taxes except for unrelated business taxable income. The distributions to trust beneficiaries are taxed as ordinary income first, and then as capital gains to the extent of the trust's undistributed capital gains.

For estate tax purposes, the trust property's value will be includable in the grantor's estate if he (she) is the sole beneficiary.

Pooled Income Fund.--This is an IRS-designed vehicle for charitable contributions that meets a donor's needs and provides him (her) with a tax deduction. It operates within safe guidelines for valuation of the contributions and for the protection of the government and the charity. Whereas the annuity trust and unitrust are private endeavors, pooled income funds pull together several contri-butors to benefit both the charity and the individual contributors. In a word, a pooled income fund is a public trust that is controlled by the charity. Most of the provisions are similar to the annuity trust and the unitrust; however, with pooled income funds, the property of all donors are commingled. The pooled income trust cannot receive or invest in tax-exempt securities. The income tax deduction is based on the present value of the remainder interest to the charity.

A Charitable Lead Trust.--This is the reverse of the charitable remainder annuity trust. Property is left to create income for the charity, with the remain-der interests passing to the family. It reduces death tax liability; however, there is a gift tax on the pre-sent value of the remainder interest when the trust is created.

Charitable Remainder in a Personal Residence or Farm.--Generally, a donor can obtain a charitable contribution deduction for a gift of a future interest in property only through a charitable remainder trust or a pooled income fund. However, the IRC makes an exception for the gift of a personal residence or farm [IRC Section 170(f)(3)(B)]. Under these circumstances, a donor can contribute the property to charity but reserve the right to live on it or use it for the rest of his (her) life and for that of the surviving spouse, if applicable. The gift must be irrevocable. The personal residence can be a second home or cooperative apartment. A "farm" means land and improvements used by the donor or tenant to pro-duce crops, fruits, or other agricultural products or livestock or poultry [Regulation § 1.170A-7(f)(4)]. The regulation does not explicitly include or exclude a tree farm. But if a taxpayer is considering using this provision of the IRC for a tree farm, it would be prudent to obtain a letter ruling (see page 33) from the IRS. If this fails, other alternatives should be considered. For example, this type of asset can be transferred by deed during life or by will at death, with the surviving spouse having income and right of possession for life, and the property then passing to the charitable organization at his (her) death.

Qualified Conservation Contribution

A charitable contribution of any interest in property that is less than the donor's entire interest does not qualify for a deduction unless it is an undivided part of the donor's entire interest, or a gift of a partial interest in property that would have been deducted if it had been in trust.

A charitable contribution of an open space easement in gross and in perpetuity is treated as a contribution of an undivided portion of the entire interest of the donor in the property [Regulation § 1.170A-7(b)(1)(ii)]. An easement in gross is defined as a personal interest in, or right to use, the land of another. A deduction is allowed for the value of a restrictive easement gratuitously conveyed to the United States in perpetuity. Special rules apply to easements and remainder interests granted for conservation purposes.

Gifts of partial interests in real estate generally do not qualify for a charitable contribution deduction; however, a qualified conservation contribution is an exception [IRC Section 170(f)(3)(B)(iii)]. A qualified conservation contribution is defined as a qualified real property interest donated to a qualified conservation organization exclusively for conservation purposes [IRC Section 170(h)]. A qualified real property interest is defined as the entire interest of the donor other than a qualified mineral interest, a remainder interest, or a restriction granted in perpetuity on the use that may be made of real property. The term"conservationpurpose" is defined to include any one (or more) of four objectives: (1) the preservation of land areas for outdoor recreation by the general public or for the education of the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space, including farmland and forest land, where such preservation (a) is for the scenic enjoyment of the

general public and will yield a significant public benefit or (b) is pursuant to a clearly delineated Federal, State or local conservation policy and will yield a significant public benefit, and (4) the preservation of a historically important land area or certified historic structure.

The conservation purpose must be protected in perpetuity. Qualified organizations are limited to government and publicly supported charities or organizations that they control. The value of the conservation easement is based on the sales of similar easements to the government if such records exist. If such records do not exist, the conservation easement is based on the difference between the fair market value of the property before and after the easement [Regulation § 1.170A-14(h)(3)]. After the conservation easement is made, the donor must reduce the basis of the retained property by the proportional part of the basis allowable to the easement.

Example 8.5. Talloak owns a 200-acre parcel of timberland in the path of a suburban leap frog development. The property has been in the family since the original land grant from the King, and it is the owner's objective to keep the property in the family and in timber production. The market value of the property for timberland is $300,000, including the current growing stock which has been well managed for timber and wildlife. The fair market value in the "highest and best use" in 1993 had risen to $900,000. Talloak gave the USDA Forest Service a permanent conservation easement subject to the restrictions that the prop-erty would be managed on a sustained-yield basis, that no more than 20 percent of the forest could be harvested in a 5-year period, and that it would be promptly regenerated within 2 years. The $400,000 charitable deduction is limited by the income tax contribution rules discussed above. The income tax deduction is limited to 30 percent of adjusted gross income because it is appreciated property given to a public charity. Since Talloak's adjusted gross income is $200,000, the current income tax deduction is $60,000 ($200,000 × 30 percent). With a 5-year carryover for excess contributions, Talloak's adjusted gross income is expected to increase sufficiently to fully absorb the deduction over this period. The estate's value is also reduced by $400,000 due to the restriction. The appraisal was made by a qualified consulting forestry company that specializes in forest appraisals.

Examples of Charitable Giving

The following are recent actual case examples, with the persons' names changed.[1]

Example 8.6. Case 1--A Gift of Timber.

Mr. Plen T. Trees, a bachelor in his mid-50's, was interested in a plan that would save taxes and pay him income for life.

He owned a stand of timber, deeded to him by his parents 20 years earlier, and now worth $300,000 to $350,000. He owned only the timber, not the land.

Working with his CPA and Linfield's development office, he established a charitable remainder trust with the timber. This made it possible for him: (1) to avoid the capital gain on the sale of the timber,(2) to obtain a charitable income tax deduction in the year of the gift, (3) receive an income for life, and (4) to save on estate taxes by reducing his taxable estate.

A unitrust was chosen because Mr. Trees wanted a vehicle that would keep up with inflation. A unitrust pays a fluctuating income based on the value of the assets in trust, revalued annually. As the trust assets increase/decrease in value, Mr. Trees receives a higher/lower income. The specific unitrust is an "income only with makeup provisions" instrument. In periods when the trust assets do not earn enough to pay the agreed upon percentage, Mr. Trees receives the actual income earned. The balance will be "made up" and paid to him later in years when the trust earns more than the agreed upon percentage.

The results are that the trust sold the timber for $330,000, neither Mr. Trees nor the trust had to recognize a capital gain on the sale, he was allowed a charitable income tax deduction in the year of the gift of $34,000, and he began receiving an annual income equal to 12 percent (when the trust was established in 1988 interest rates were higher than currently) of the value of the trust, which will continue throughout his lifetime. At Mr. Tree's death, Linfield College will receive the trust principal that remains as a charitable gift and will set up an endowed scholarship fund in his name.

Example 8.7. Case 2--A Gift of Land and Timber.

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[1] Prepared by Ms. Elizabeth Holden, Director of Planned Giving, Linfield College, McMinnville, OR, and used with permission.

Mr. Well D. Zerved, a recently retired businessman who had developed a very successful company, wanted to make a major contribution to the educational programs of Linfield College. He and his wife, ages 68 and 70, had several children and many grandchildren for whom they wished to provide in their estate plan. They had sufficient financial wealth from his work to leave substantial amounts for their heirs as well as their charitable interests.

Working with his attorney to determine which assets to use and the best way to make the contribution, Mr. Zerved established a charitable remainder unitrust and named Linfield College as the charitable remainderman. He funded the trust with a large tract of land, timber, and mineral rights that he had held for many years. The property would have been subject to a considerable capital gain if sold directly.

Since Mr. Zerved wanted to make sure that his wife was well provided for if he should predecease her, he chose a two-life trust that would make payments throughout both their lifetimes. Specifically, it is a unitrust with a "net income with makeup provision." The payout rate is set at 10 percent of the assets of the trust, revalued each year.

The results were that the property, appraised at $550,000, was sold by the trust for a much higher price with no tax obligation. Mr. Zerved was allowed a charitable gift deduction of $96,700 in the year of the gift, he avoided income tax on the sale of the appreciated value of the property, and he reduced the taxable value of the estate. Mr. and Mrs. Zerved are receiving an annual income, set at a payout rate of 10 percent, until the death of the survivor beneficiary. At that time, Linfield College will receive the proceeds of the trust and establish a named endowment as requested by Mr. Zerved at the time the trust was created.

Example 8.8. Case 3--A Gift of Timber with Timberland Retained.

Mr. and Mrs. Juan A. Travel, farmers approaching retirement (ages 55 and 53), were interested in freeing themselves from some of their farm responsibilities. They wanted to retire, have their son take over the responsibility of running the farm, and have as much income as possible to do a little traveling.

They owned a tract of timber valued at approximately $150,000 together with the land they farmed. It had such a low basis that they would have had to pay what seemed like an enormous amount of capital gains tax if they sold it. Mr. Travel had heard about charitable trusts, so they came to Linfield College to find out more about this life income arrangement. Because they wanted to pass the land to their children when they died, they decided to retain the land, but give the timber to establish a charitable remainder trust.

The results were that in 1990 the trust sold the timber tax free to a buyer who logged and replanted the tract. The Travel's have a lifetime income from the two-life unitrust with an annual payout rate of 7.5 percent of the trust's assets, revalued annually. Because they avoided a capital gain tax, they had $45,000 more invested for income than they would have had if they had sold the timber themselves. Their children will receive the reforested land with growing timber when they die. Linfield College will receive the principal in the trust to establish a scholarship fund in the Travel's memory.