“CHARITABLE GIVING: BIG BUSINESS – BIG BENEFITS”

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Endnote:

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I. HISTORY AND SCOPE OF AMERICAN PHILANTHROPY

A. Historical Perspective

1. Colonial period – Community-based effort to create a better life

2. Industrial philanthropy of the late 19th and early 20th centuries (esp. Andrew Carnegie and John D. Rockefeller)

3. Entrepreneurial philanthropy – DotCom millionaires

B. Scope of Philanthropy

1. In 2020, $471.4 billion dollars were donated to charitable causes. GIVING USA 2021: THE ANNUAL REPORT ON PHILANTHROPY FOR THE YEAR 2019.

2. Individuals gave the lion's share (77.5%): $324.1 billion (68.8%) in lifetime gifts and $41.2 billion (8.7%) in bequests.

3. Corporations: $16.9 billion (3.6%)

4. Foundations: $88.6 billion (18.8%)

C. Where the Contributions Go

1. Religious organizations: $131.1 billion (27.8%)

2. Educational institutions: $71.3 billion (15.1%)

3. Human services: $65.1 billion (13.8%)

4. Health care: $42.1 billion (8.9%)

5. Arts, culture and humanities: $19.5 billion (4.1%)

6. Public/society benefit groups: $48.0 billion (10.2%)

7. International affairs: $25.9 billion (5.5%)

8. Environment/wildlife: $16.1 billion (3.4%)

9. Individuals: $16.2 billion (3.4%)

10. Foundations: $58.2 billion (12.3%)

11. Unallocated giving: -$22.1 billion (-4.7%)

D. The Role of Tax Benefits

1. Basic Premise

Our tax laws are so complex that often even the seasoned tax professional does not fully understand all of the tax aspects of charitable giving. Time learning the area is time well spent. Within the subject of charitable giving exist a number of planning opportunities that can help a wide variety of taxpayers satisfy their interest in assisting a favorite charity.

2. National Policy

The tax laws reflect national policy to encourage, impede, or channel the use of income or property.

a. High estate and gift taxes have made it difficult to pass on the benefits of family assets and business holdings.

b. Inflation and capital gains taxes reduce real capital available for the production of future income.

3. The Role of the Charitable Deduction

a. As a matter of national policy, tax savings spur voluntary giving in a pluralistic society.

b. A charitable tax deduction provides a sharing of cost between the donor and the government.

c. There is a multiplier effect of increasing funds for charity.

4. Historical Perspective

a. Income Tax Deduction

In 1917, only four years after enacting the modern income tax, Congress created the charitable contribution deduction. Then, as now, the deduction was subtracted from gross income to determine the base against which tax rates were applied. Despite extensive debate since 1917 about the practical and theoretical underpinnings of the charitable deduction, the scope of the deduction generally has been expanded. However, true fundamental tax reform could have a substantial impact on historic patterns of charitable giving.

b. Transfer Taxes

The Revenue Act of 1918 provided, in part, that the value of the net estate be determined by deducting the amount of all bequests, legacies, devises, or gifts (for religious, charitable, scientific, literary or educational purposes) from the value of the gross estate.

E. Economic Rationales for Tax Deduction of Charitable Contributions

1. See Present Law and Background Relating to the Federal Tax Treatment of Charitable Contributions, Senate Committee on Finance, Joint Committee on Taxation, JCX-55-11, Oct. 14, 2011.

2. Tax deductibility of charitable contributions reduces the economic cost to the donor and therefore encourages charitable giving.

3. The community may derive value from donations made to charity.

    a. Many charitable organizations provide goods and services with significant spillover benefits to the public at large.

    b. EXAMPLES:

        i. Charity that provides vaccinations to individuals indirectly helps prevent the spread of disease.

        ii. Individuals who donate artwork to a museum, enables the public to view and enjoy the artwork.

4. Charitable organizations provide goods or services that the government might otherwise provide, hereby alleviating some of the burden on the government.

F. Correlation Between the Tax Price of Charitable Contributions and the Quantity of Giving

1. The deduction for charitable contributions lowers the after-tax cost of giving; theoretically, this should increase the ability and willingness of donors to increase donations.

2. Short-term Effects: Taxpayers may shift the timing of their charitable giving in anticipation of changes in tax rates and their overall tax exposure.

3. Distributional Effects

    a. The amount of charitable giving generally increases as a taxpayer's income increases.

    b. Charitable contribution deductions can only be taken if a taxpayer itemizes deductions.

        i. In general, a taxpayer who does not itemize receives no tax benefit from charitable contributions.

        ii. Charitable deduction favors higher bracket taxpayers because they are typically the taxpayers that otherwise benefit from itemizing deductions.

        iii. Individual charitable deductions claimed as itemized deductions generally have grown annually since 1984 and have grown more rapidly than the rate of inflation over this period of time.

        iv. Those who do not itemize still give generously. In 2017, nearly $45 Billion in charitable contributions were made by individuals that were not claimed as itemized deductions. Among other changes, the 2017 Tax Cuts and Jobs Act ("TCJA") doubled the standard deduction for income tax purposes, creating uncertainty as to whether and to what extent charitable giving by individuals who previously itemized their charitable deductions would reduce their future giving. Initial reports appear mixed, with the Treasury Department concluding charitable giving was largely unchanged, but with independent analysts expressing concerns about negative impacts of the TCJA. An understanding of the actual impacts will likely require an analysis of several more years of charitable giving data to reach any firm conclusions.

c. The higher the applicable marginal tax rate, the more valuable the charitable deduction becomes to a taxpayer; therefore, higher income taxpayers generally have a lower tax cost of giving than lower income taxpayers.

d. Some studies suggest high-income taxpayers are more responsive to tax incentives associated with charitable giving than low-income taxpayers.

i. Low-income taxpayers often give to churches and religious organizations.

ii. High-Income taxpayers often donate to education, health care, and arts institutions.

iii. Result: Education, health care, and arts institutions may be more impacted by tax policy.

G. Planning Basics – A Short Tax Course

1. What Do I Want to Give?

a. Ordinary Income Property

b. Capital Gain Property

c. Income in Respect of a Decedent

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b. Private Foundation

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2. Somebody Helped Me – Now It Is My Turn to Help Others

3. Religious or Family Tradition

4. Doing Well (In Business) by Doing Good

5. It Keeps Me Busy and I Enjoy It

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      i. *See* The U.S. Trust Study of the Philanthropic Conversion: Understanding Advisor Approaches and Client Expectations.

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A. Presumed Classification as Private Foundation

1. Types of 501(c)(3) Organizations

a. There are essentially four types of Section 501(c)(3) organizations:

i. Private foundations;

ii. Organizations engaging in inherently public activity;

iii. Publicly supported organizations; and

iv. Supporting organizations.

2. Presumed Classification

A charitable organization is presumed to be a private foundation unless it can establish that it meets the requirements of one of the categories of public charities. Internal Revenue Code "IRC" § 509(a).

B. Disadvantages of Private Foundation Classification

1. As a general rule, status as a private foundation is not preferred given a multitude of rules that apply to private foundations, including, but not limited to:

a. Limitations on the income tax charitable deduction for contributions to a private foundation (IRC § 170(b)(1)(B)(i), (D)(i));

b. A two-percent excise tax on net investment income (IRC § 4940);

c. Excise taxes on self-dealing transactions, excess business holdings, jeopardy investments and taxable expenditures (IRC §§ 4941, 4943, 4944, 4945);

d. A prohibition against any lobbying activities (IRC § 4945); and

e. A mandatory charitable distribution requirement in each year (IRC § 4942).

C. Inherently Public Charities

Inherently public charities are those that are considered public by virtue of the type of activity they conduct and include churches, qualified educational organizations—such as colleges, universities, and private schools—qualified hospitals, and foundations and other organizations that support a public college or university.

D. Publicly Supported Organizations

There are two types of publicly supported organizations under IRC Section 509(a).

1. Publicly Supported Organizations. IRC §§ 170(b)(1)(A)(vi), 509(a)(1).

a. The Public Support Test

An organization described in IRC Sections 509(a)(1) and 170(b)(1)(A)(vi) is treated as publicly supported if the total amount of support that it normally receives from governmental units or the general public is at least one-third of the total support received by the organization. For purposes of this support test, support does not include amounts received by the charitable organization for services rendered or "gross receipts."

i. The public support test is computed over a five-year period on the organization's annual information return (Form 990).

ii. Gifts from "disqualified persons" (generally persons or businesses contributing $5,000 or more and officers and directors of the organization) are counted in full in the denominator of the support fraction.

iii. Public support includes support from governmental units and contributions from other publicly supported organizations described in IRC Section 170(b)(1)(A)(vi) and certain other Section 170(b)(1)(A) organizations (numerator value).

A. Direct or indirect contributions from any other source, such as an individual, trust, business entity, or private foundation, are included within public support (i.e., the numerator) only to the extent that those contributions do not exceed 2% of the organization's total support. Treas. Reg. § 1.170A-9(e)(6).

B. This limitation ensures that support will come from a broad cross-section of the general public rather than from a few substantial donors.

iv. The public support test under Section 170(b)(1)(A)(vi) can be met on either the objective basis of actual public support or a more subjective facts and circumstances test.

b. Facts and Circumstances Test

Even if an organization cannot meet the public support test, it can still be treated as a publicly supported organization under IRC Section 170(b)(1)(A)(vi) if it can meet the facts and circumstances test. To meet the facts and circumstances test, the organization must establish that it normally receives a substantial part of its support from governmental units, from direct or indirect contributions from the general public, or from a combination of these sources. There are two facets of meeting this test:

i. The organization must show that, under the facts and circumstances, it normally receives a substantial part of its support from these sources.

A. Under this requirement, the required public support under the public support test can be as low as 10%.

B. In addition, the organization must be so organized and operated as to attract new and additional public or governmental support on a continuous basis, which requires a continuous and bona fide program for solicitation of funds from the general public. Treas. Reg. § 1.170A-9(e)(3)(i) & (ii).

ii. In addition, the organization must establish that it is in the nature of a "publicly supported" organization taking into account certain factors set forth in the regulations. Treas. Reg. § 1.170A-9(e)(3). Relevant factors for consideration include:

A. Percentage of financial support from public or governmental units;

B. Sources of support;

C. Representative governing body; and

D. Availability of public facilities or services and public participation in programs or policies.

c. Definition of Support

i. The following items are included in the organization's total support as used in the denominator of the support calculation:

A. Gifts, grants (including governmental grants), and contributions;

B. Membership fees;

C. Gross income from interest, dividends, and amounts received from payments on securities loans, rents, royalties, and unrelated business taxable income;

D. Net income from unrelated business activities to the extent not included in item (iii) above;

E. Tax revenues levied for the organization's benefit and paid to or expended on behalf of the organization; and

F. The value of services or facilities (exclusive of services or facilities furnished to the public without charge) furnished by a governmental unit to the organization without charge.

d. Total support does not include contributions of services for which a deduction is not allowable, exempt function income, the value of any exemption from any federal, state, or local tax, capital gains, loan repayments, and unusual grants.

2. Publicly Supported Charities Under IRC Section 509(a)(2)

a. These organizations must meet two support tests.

i. Investment income cannot exceed one-third of the organization's total support.

ii. Over one-third of the organization's total support must be received from one or more of the following sources:

A. Gifts, grants, contributions, and membership dues from non-disqualified persons;

B. Admission fees to exempt function facilities or performances;

C. Fees for the performance of exempt function services;

D. Sales of goods related to the organization's activities.

b. An organization that receives the majority of its support from activities related to its exempt functions (such as a museum charging admission fees) rather than from contributions from the general public will usually try to qualify under IRC Section 509(a)(2).

c. Rules similar to those described for the IRC Section 170(b)(1)(A)(vi) facts and circumstances test described above also apply under IRC Section 509(a)(2) with the exceptions noted.

E. General Overview of Supporting Organizations

1. A supporting organization is a tax-exempt organization described in Section 501(c)(3) that supports one or more tax-exempt organizations described in Sections 509(a)(1) or 509(a)(2) (hereinafter referred to as "publicly supported organizations" or "public charities" respectively).

2. For tax purposes, the supporting organization receives the favorable tax treatment afforded to public charities without being required to meet the strenuous public support tests that must be met by some publicly supported organizations and all public charities because of the close relationship between the organizations. *Roe Found. Charitable Trust v. C.I.R.*, T.C. Memo 1989-566.

IV. BASIC TAX RULES FOR CHARITABLE CONTRIBUTIONS

A. Overview

1. No One Gives to Charity Solely to Get a Tax Deduction

a. A person may refuse to make a gift if he or she cannot obtain a charitable deduction for tax purposes, but under today's tax rates, no one gives solely to get a deduction.

b. Some charitable motivations must be present before a person will give.

c. A charitable gift is unlikely to be made if it does not fit the donor's overall estate and financial planning objectives.

2. The Complexity of the Tax Laws Discourage Many Donors and Their Advisors

a. Gifts in kind frequently require qualified appraisals and reporting requirements.

b. Predicting the exact taxes to be saved through a charitable gift is almost impossible.

c. More complex substantiation rules further complicate the availability of a charitable deduction for even the simplest gifts.

d. Rules which reduce the itemized deductions (including the charitable deduction) of certain higher income taxpayers further discourage charitable gifts by limiting the tax benefits associated with the gift.

B. Overview of the Tax Rules

1. Applicable IRC Section

a. Section 170: Income tax charitable deduction rules and percentage limitations.

b. Section 501: Enumeration of categories of exempt organizations, for example, Section 501(c)(3).

c. Section 509: Rules classifying Section 501(c)(3) organizations as private foundations or public charities.

d. Section 642(c): Income tax charitable deduction rules for trusts and estates.

e. Section 2055: Estate tax charitable deduction rules.

f. Section 2522: Gift tax charitable deduction rules.

g. Sections 4940 through 4947: Private foundation excise tax rules that apply to private foundations and in some cases to supporting organizations and donor advised funds.

h. Section 4948: Excess benefit transactions.

2. Income Tax Charitable Deduction for Individuals

a. Donor Must Itemize Deductions

A donor who itemizes deductions is entitled to an income tax charitable deduction for contributions to qualified charitable organizations. IRC § 170(a).

b. Pease Limitation on Itemized Deductions Repealed

Prior limitation on itemized deductions was repealed by the Tax Cuts and Jobs Act applicable in 2018 through 2025. IRC § 68(f).

c. Not all tax-exempt organizations qualify as charitable organizations.

d. 50% Limitation

For a gift of cash or unappreciated property to a "50 percent-type" organization (generally 509(a)(1), (2), or (3) organizations, private operating foundations, and conduit private foundations but not private foundations), the donor is generally entitled to deduct the full amount of the contribution up to 50% of the donor's contribution base (essentially adjusted gross income) (the "50 percent ceiling"). IRC § 170(b)(1)(G).

For taxable years beginning after December 31, 2017 and ending before January 1, 2026, the 50% deduction is increased to 60% but only for contributions of all cash. IRC § 170(b)(1)(G). In addition, the Coronavirus Aid, Relief, and Economic Security Act temporarily allows a taxpayer to deduct up to 100% of the taxpayer's contribution base for tax year 2020 but only for contributions of all cash. This incentive was extended again for 2021 only.

e. Rockefeller Case

The 50% limit also applies to an individual's non-reimbursed out-of-pocket expenses incurred in rendering services to charity. In *Rockefeller*, the Tax Court held that the non-reimbursed expenses incurred by Mr. Rockefeller in paying employee salaries and for travel and entertainment expenses connected with conducting his charitable activities constituted gifts "to" charity (and were thus deductible in the same manner as direct contributions). *Rockefeller v. C.I.R.*, 76 T.C. 178 (1981), *aff'd.*, 676 F.2d 35 (2d Cir. 1982); *see also* Rev. Rul. 84-61, 1984-1 C.B. 39.

f. Charitable deduction is denied for travel expenses (including amounts expended for meals and lodging) while away from home, whether paid directly or by reimbursement <u>unless there is no significant element of personal pleasure, recreation or vacation in such travel</u>. IRC § 170(j).

g. For purposes of computing the charitable deduction for the use of a passenger automobile, the standard mileage rate under Section 170(i), most recently amended by the Taxpayer Relief Act of 1997, is 14 cents per mile effective for taxable years beginning after December 31, 1997. *See* Rev. Proc. 2002-61, 2002-2 C.B. 616, *mod. by* Rev. Proc. 2010-51 and Notice 2019-02, 2019-2 I.R.B. 281.

h. 30% Limitation for Private Foundations

For a gift of cash or unappreciated property to a "30%-type" organization (a private foundation other than a private operating foundation or a conduit private foundation) and gifts for the use of a 50%-type organization, the donor is generally entitled to deduct the full amount of the contribution up to 30% of the donor's contribution base.

i. Limitations for Gifts of Capital Gain Property

For gifts of long-term capital gain property (which has appreciated) to a 50 percent-type of organization, the donor may deduct the full fair market value of the gift only up to 30% of the donor's contribution base.

j. Definition of Capital Gain Property

Capital gain property is any capital asset the sale of which at its fair market value at the time of contribution would have resulted in gain that would have been long-term capital gain. IRC § 170(b)(1)(C)(iv). In turn, long-term capital gain is defined as property held more than one year. IRC § 1221.

k. Election Out

In the case of a gift to a 50%-type Organization, a donor can elect to use the 50% limitation, instead of the 30% limitation, if the donor reduces the value of the gift by the amount of gain which would have been long-term capital gain had the contributed property been sold. IRC § 170(b)(1)(C) and § 170(e)(1)(B).

i. Generally, depreciated property should be sold rather than given to charity because this gives rise to a Section 165 loss deduction. *See Withers v. C.I.R.*, 69 T.C. 900 (1978).

l. Table: Charitable Contribution Percentage Limits for Individual Taxpayers:

	Ordinary Income Property and Cash <u>to</u> the Recipient	Capital Gain Property <u>to</u> the Recipient	Ordinary Income Property and Cash <u>for the use of</u> the Recipient
Public Charities	50%/60%/100%	30%	30%
Private Operating Foundations, Pass-through foundations, Pooled Income Funds	50%	30%	30%
Private Grant-making Foundations	30%	20%	30%

m. Five-Year Carryover

A five-year carryover generally applies to any portion of a charitable deduction that cannot be deducted because of the percentage limitations. IRC § 170(b)(1)(D) (ii).

n. Special Rules for Gifts of Appreciated Property to Private Foundations

i. In addition to the deduction limitation discussed above, the contribution deduction for gifts of appreciated property to a private foundation is further limited. If an individual contributes capital gain property, such as real estate held for more than one year, the amount of the deduction is limited to the lesser of the property's basis and its fair market value. IRC § 170(e)(1)(B)(ii).

ii. There is a special rule, however, that allows a deduction at fair market value (rather than tax basis) for a contribution of "qualified appreciated stock," which is stock for which market quotations are readily available on an established securities market. The value of such gifts for purposes of a charitable contribution deduction is the fair market value of the stock. IRC § 170(e)(5).

o. Contributions of Related Use Tangible Personal Property

i. A donor is entitled to a charitable deduction equal to the greater of fair market value or basis for a contribution of tangible personal property the use of which is related to the donee's exempt purpose.

A. If the property is not related to the donee's exempt purpose, the donor's deduction is limited to the basis (or FMV if less).

ii. To prove "related use" of tangible personal property, a written statement is required, signed by an officer of the donee under penalty of perjury either:

A. Certifying that the use of the property was related to the donee's exempt purpose or function and describing how the property was used and how such use furthered such purpose or function of the donee; or

B. Stating the intended use of the property by the donee at the time of contribution and certifying that such use has become impossible or infeasible to implement.

iii. If the property is disposed of after the close of the taxable year of the contribution and within three years of the date of the contribution (unless the donee makes the certification described above), the charitable deduction must be recaptured in an amount equal to the difference between the amount claimed as a deduction and the property's basis. IRC § 170(e)(7).

A. The donor must include this amount in ordinary income in the year in which the disposition occurs.

iv. The rule applies to property that was identified as related use property by the donee on Form 8283 (Noncash Charitable Contributions) and for which a deduction of more than $5,000 is claimed by the taxpayer.

v. A $10,000 penalty (in addition to any criminal penalties) is imposed on any person who identifies property as exempt use property knowing that the property is not intended for such a use.

p. Limitations for Gifts of Ordinary Income Property

i. The amount of the charitable deduction for gifts of property, the sale or exchange of which would produce a gain, other than a long-term capital gain, is reduced by the amount of the non-long-term gain. IRC § 170(e).

ii. Included in this category are inventory, crops, dealer property, and works created by the donor.

A. In the case of a painting donated by the artist, for example, the deduction is limited to the artist's cost of materials.

iii. *Note*: This applies to property that would yield a short-term capital gain, as well as to property that would yield ordinary income.

iv. Normally, this means that if the asset is not a long-term capital asset, a charitable deduction is limited to basis (fair market value, less potential non-long-term capital gain).

q. Capital Gain/Ordinary Income Property, (e.g., personal property with Section 1245 recapture potential)

i. Both the capital gain and the ordinary income rules apply.

ii. This is the one situation in which the deduction may be more than basis, because it would be basis plus the potential capital gain, but without the potential recapture income. *See* Treas. Reg. § 1.170 A-4(d) (ex. 2).

r. Special Rules for Certain Contributions

i. Gifts of Clothing and Household Items

IRC Section 170(f)(16) denies a deduction for charitable contributions of clothing and household items after August 17, 2006, unless such items are in "good used condition or better." This provision does not apply to items which are the subject of a qualified appraisal.

ii. Taxidermy

Section 170(e)(1)(B) limits a charitable contribution of so-called taxidermy property, after July 25, 2006, to the donor's basis in such property if the donor was the taxidermist or paid the taxidermist.

iii. Inventory and Scientific Property

A. Contributions of inventory property by corporations for the care of the ill, the needy, or infants are deductible. IRC § 170(e)(3).

B. Certain corporate contributions of scientific equipment constructed or assembled by the taxpayer may be deducted provided the initial use of such donated equipment is by the donee (post-secondary educational institutions, scientific research organizations, and certain other organizations that support scientific research) for research or research training in the United States in physical or biological sciences. IRC § 170(e)(4).

C. Under these special rules, the amount of the augmented deduction available to a corporation making a qualified contribution is equal to its basis in the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold. However, the augmented deduction cannot exceed twice the basis of the donated property.

iv. Guidance on Automobiles Donated to Charity

A. On June 3, 2005, the Treasury and the IRS announced new rules on the tax treatment of donations of automobiles to charity. Notice 2005-44, 2005-25 I.R.B. 1287. Additional guidance is found in Notice 2006-1, 2006-4 I.R.B. 347; *see also* Notice 2007-70, 2007-40 I.R.B. 735.

B. The American Jobs Creation Act of 2004 generally limits the deduction for vehicles to the actual sales price of the vehicle when sold by the charity and requires donors to get a timely acknowledgement from the charity in order to claim the deduction.

C. Limited exceptions exist under which a donor may claim a fair market value deduction:

1) If the charity makes a significant intervening use of vehicle – such as regular use to deliver meals on wheels – the donor may deduct the full fair market value. The guidance explained what a significant intervening use may include, for example, driving a vehicle a total of 10,000 miles over a one-year period to deliver meals.

2) A donor may claim a fair market value deduction if the charity makes a material improvement to the vehicle. Under the guidance, a material improvement means major repairs that significantly increase the value of a vehicle, and not mere painting or cleaning.

3) The guidance also provided an additional exception to the sale price limit that was not included in the legislation itself. The guidance permits a donor to claim a deduction for the fair market value of a donated vehicle if the charity gives or sells the vehicle at a significantly below-market price to a needy individual, as long as the transfer furthers the charitable purpose of helping a poor person in need of a means of transportation.

D. The guidance also explains how to determine fair market value if one of these three exceptions applies. Generally, vehicle pricing guidelines and publications differentiate between trade-in, private-party, and dealer retail prices. The guidance provided that the fair market value for vehicle donation purposes will be no higher than the private-party price.

E. A donor is required to substantiate a deduction with an acknowledgement from the charity that the deduction either reflects the sale price or that one of the three exceptions applies. There is a penalty on the charity for failure to provide a proper acknowledgement. The guidance also explains the requirements for the content and the due dates for acknowledgements.

v. Regulations on Qualified Intellectual Property Contributions

A. A taxpayer who contributes a "patent, copyright (other than a copyright described in Section 1221(a)(3) or 1231(b)(1)(C)), trademark, trade name, trade secret, know-how, software (other than software described in Section 197(e)(3(A)(i)), or similar property, or applications or registrations of such property," to a donee described in Section 170(c) (other than to a private foundation referred to in Section 170(e)(1)(B)(ii)) may be allowed an initial charitable contribution deduction limited to the lesser of the taxpayer's basis or the fair market value of the qualified intellectual property. IRC § 170(e)(1)(B)(iii).

1) The American Jobs Creation Act of 2004 provided rules that enable taxpayers who donate qualified intellectual property to receive additional charitable contribution deductions <u>if and when</u> their donated property produces net income for the donee (qualified donee income) under specified conditions. IRC § 170(m)(2), (8), (9).

B. The IRS has issued final regulations that provide guidance to recipients of qualified intellectual property contributions on filing information returns. In addition, the IRS issued related guidance, including notification requirements, on additional deductions for contributions of qualified intellectual property. Notice 2005-41, 2005-23 I.R.B. 1203.

C. Section 6050L requires a donee to make an annual information return that reports the qualified donee income for the taxable year and other specified information relating to qualified intellectual property contributions. The IRS has issued Form 8899 on which a donee will report qualified donee income.

D. Under Section 170(m)(8)(B), a donor must notify the donee of the donor's intent to treat a charitable contribution as a qualified intellectual property contribution under Sections 170(m) and 6050L. Unless timely notice is provided, the donor has not made a qualified intellectual property contribution, and the donee has no reporting obligation under Section 6050L or these regulations.

E. The donee is not required to make an information return if the qualified intellectual property produced no net income for the donee's taxable year.

1) Under Section 170(m)(5) and (m)(6), income received or accrued during the donee's taxable year is not treated as allocated to qualified intellectual property if such income is received or accrued after the 10-year period beginning on the date of the contribution or after the expiration of the legal life of the qualified intellectual property.

2) Thus, the donee is not required to make a return with regard to a qualified intellectual property contribution for taxable years beginning after the expiration of the legal life of such qualified intellectual property.

3) Additionally, Section 6050L(b) requires a return only for specified taxable years of the donee, which years are defined in Section 6050L(b)(2)(B) as any taxable year any portion of which is part of the 10-year period beginning on the date of contribution of the qualified intellectual property.

4) Therefore, the donee is not required to make a return for taxable years beginning more than ten years after the date of the qualified intellectual property contribution.

F. Under these regulations, the donee generally is required to file an information return (with a copy of such return to the donor) on or before the last day of the first full month following the close of the donee's taxable year. Transition rules are provided to take into account these filing requirements before a form is prescribed by the IRS and for the donee's taxable years ending prior to or on the date of issuance of these regulations.

s. 5-Year Carryover for Contributions that Exceed Contribution Base

i. For contributions to which the 50%/30% limitation applies. IRC §§ 170(d)(1)(A), 170(b)(1)(C)(ii).

ii. For contributions to which the 30%/20% limitation applies. IRC §§ 170(b)(1)(B), 170(b)(1)(D)(i)(I).

3. Estate and Gift Tax Charitable Deductions

Generally, contributions to organizations that qualify for the income tax charitable deduction also qualify for the estate and gift tax charitable deductions. For estate and gift tax purposes, there are <u>no limitations</u> on the amount of the deduction for qualifying contributions and the classification of the charity as a public charity or private foundation is irrelevant. IRC §§ 2055(a), 2522(a).

a. The estate tax charitable deduction is allowed for an amount that becomes or is added to a charitable bequest or transfer as a result of a "qualified disclaimer" under Section 2518.

i. In addition, Section 2055(a) provides that the complete and timely termination of a power to consume, invade, or appropriate property for the benefit of an individual before such power has been exercised is treated as a qualified disclaimer.

b. Property includible in the gross estate of a decedent by reason of a general power of appointment and received by a qualified recipient is considered a bequest made by the decedent.

c. The estate tax charitable deduction is reduced by the amount of any death taxes that are, either by the terms of the will or by local law, assessed against an otherwise deductible bequest or other transfer.

d. The amount of the deduction may not be more than the value of the transferred property that is required to be included in the gross estate.

e. No deduction is allowed for a transfer to, or for the use of, a non-exempt organization or trust described in Sections 508(d) or 4948(c)(4), subject to the conditions specified in those sections.

f. Where an interest in property is split between a charitable and a non-charitable recipient, special rules must be followed or the deduction will not be allowed.

i. A remainder interest must be in the form of a charitable remainder annuity trust ("CRAT"), a charitable remainder unitrust ("CRUT"), or a pooled income fund.

ii. An income interest must be in the form of a guaranteed annuity or must be a fixed percentage of the fair market value of the property, determined yearly.

iii. These requirements do not apply to a remainder interest in a personal residence, farm, or to an undivided portion of a decedent's entire interest.

g. A work of art and its copyright are treated as separate properties where the transfer is to a special class of charities and the recipient's use of the transferred property relates to the purposes or function underlying the recipient's tax-exempt status.

h. A deduction is permitted for certain limited interests in real property given to appropriate organizations for purposes of recreation or scenic enjoyment, historical preservation, or environmental protection.

i. The Gift Tax Deduction

Section 2522 allows an unlimited gift tax deduction for lifetime transfers to qualifying recipients for public, charitable, religious, and other similar purposes. In effect, the deduction operates as an exclusion. With minor exceptions, the definition of eligible recipients and qualifying transfers are identical to those applicable for federal estate tax purposes. For gifts made after August 5, 1997, a donor need not file a gift tax return if the entire value of the donated property qualifies for a gift tax deduction. IRC § 2522(d). However, if a gift tax return is otherwise required to be filed by a taxpayer, the charitable gifts must be disclosed on the return.

j. The Generation Skipping Transfer Tax

Section 2642(a) provides that in determining the Inclusion Ratio, the denominator of the fraction is reduced by "any charitable deduction allowed under Section 2055 or 2522 with respect to such property." In essence, this reads charitable gifts out of the equation for calculating the tax.

4. Valuing the Charitable Interest

a. The present value of an annuity is determined by multiplying the amount of the annuity by factors which are dependent on the applicable rate under Section 7520. *See* Internal Revenue Service "IRS" Pub. No. 1457.

b. The present value of a unitrust interest is determined by subtracting the present value of the remainder interest from the value of the property contributed to the

Charitable Lead Trust ("CLT"). Treas. Reg. §§ 1.170A-6(c)(3), 20.2055-2(f)(2), 25.2522(c)-3(d)(2).

c. Under Section 7520, the value of an annuity interest for life or for a term of years, or remainder or reversionary interest for valuation dates occurring on or after May 1, 1989, is determined under tables that are prescribed by the Secretary of the Treasury. Treas. Reg. §§ 1.7520, 20.7520, 25.7520. *See* IRS Pub. No. 1457 (Actuarial Values – Book Aleph), 1458 (Actuarial Values – Book Beth).

i. With respect to the interest rate component, the valuation tables under this Section are based on the interest rate that the IRS announces monthly in a news release and publishes in the Internal Revenue Bulletin.

A. This rate is 120% of the applicable federal midterm rate in effect under Section 1274(d)(1) for the month in which the valuation date falls, using semi-annual compounding, adjusted to produce an equivalent yield for annual compounding (rounded to the nearest two-tenths of 1%).

B. For example, the applicable federal midterm interest rate for November 2021 (as set forth in Rev. Rul. 2021-21), is 1.08%; 120% of this amount, once adjusted, is 1.3%.

ii. If an income, an estate, or a gift tax charitable contribution is allowed for any part of the property transferred, the taxpayer may use the federal midterm rate for the month of the transfer or for either of the two months preceding the month in which the valuation date falls.

A. In the case of transfers of more than one interest in the same property, each interest must be valued on a basis consistent with the valuation of all other such interests.

B. For example, if a taxpayer transfers property to a charitable trust in November 2021 the taxpayer may use an interest rate based upon the applicable federal midterm rate for September (0.86%), October (0.91%), or November (1.08%); however, the taxpayer must use the same rate for both the non-charitable lead interest and the charitable remainder interest.

d. Regulations provide the 7520 tables which apply to "ordinary" beneficial interests.

i. A "restricted" beneficial interest is an interest that is subject to one or more additional conditions, powers, or restrictions.

The governing instrument may impose these limitations, or they may exist based on surrounding circumstances.

ii. Restricted beneficial interests are valued based on all relevant facts and circumstances, rather than the standard actuarial tables, even though the tables may be one useful fact in valuing such interests. Treas. Reg. §§ 1.7520-3(b)(1)(ii) and (iii), 20.7520-3(b)(1)(ii) and (iii), 25.7520-3(b)(1)(ii) and (iii).

e. The standard tables are not available if the individual who is a measuring life is terminally ill at the time of the transaction.

i. An individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50% probability that the individual will die within one year.

ii. An individual who survives for eighteen months after a transfer is presumed not to have been terminally ill at the time of the transfer, "unless the contrary is established by clear and convincing evidence." Treas. Reg. §§ 1.7520-3(b)(3), 20.7520-3(b)(3), 25.7520-3(b)(3).

iii. Nevertheless, regulations provide that the measuring lives used for a CLT may only be that of the donor, the donor's spouse and/or, with respect to all of the remainder beneficiaries, a lineal ancestor or the spouse of such lineal ancestor. T.D. 8923; Treas. Reg. §§ 1.170A-6(c)(2)(i)(A) and (ii)(A), 20.2055-2(e)(2)(vi)(a) and (vii)(a), 25.2522(c)-3(c)(2)(vi)(a) and (vii)(a).

5. Substantiation Requirements

a. Cash Contributions

No income tax charitable deduction is available for a separate contribution of $250 or more unless the taxpayer has a written receipt or other acknowledgment from the charity (which must be received before the tax return claiming the deduction is filed) of the contribution (including a good faith estimate of the value of any goods or services provided to the taxpayer in exchange for making the gift).

i. To substantiate a contribution, the taxpayer must maintain a bank record (such as a bank statement, credit card statement, or cancelled check) or other written communication from the donee showing the name of the donee, the date of the contribution, and the amount of the contribution.

ii. IRS Notice 2006-110 sets forth guidance for the new recordkeeping requirements in the case of charitable gifts made through payroll deductions.

b. Property Contributions

To claim an income tax deduction for a contribution of property (other than cash) valued at $500 or more, the donor must obtain a receipt from the donee organization showing the name of the donee, the manner and date of the acquisition, and the adjusted basis of the property. The donor must also complete and file Section A of Form 8283 with the IRS. Treas. Reg. § 1.170A-13(b)(3).

c. In the case of a gift of artwork with an aggregate value of $20,000 or more, a complete copy of the signed appraisal must be submitted with Form 8283. An 8 x 10-inch color photograph of the artwork must be provided upon request. IRS Pub. No. 561.

d. Other Important Requirements

i. Subject to certain de minimis safe harbors, charities are required to inform donors when some part of the amount paid by the donor to the charity is not deductible because there is some valuable consideration paid or provided by the charity. Treas. Reg. § 1.170A-13(f)(8)(A) and Rev. Proc. 99-42, 1999-2 C.B. 568.

ii. For 2021, no disclosure is necessary if the benefits do not exceed 2% of the contribution or $113, whichever is less, or if the contribution is $56.50 or more and the value of other items does not exceed $11.30.

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iii. Charities that provide token benefits as part of a fund-raising campaign are permitted to advise contributors that their donations are fully tax deductible if benefits received by the contributors had an insubstantial market value.

iv. In the case of a solicitation where the charity mails or otherwise distributes an item to potential donors, the charity is permitted to advise that a contribution will be fully deductible only if the item was:

A. Free;

B. Not distributed at the patron's request or express consent; and

C. Is a low-cost item.

e. Quid Pro Quo Disclosure

i. A charitable donee must provide a written statement to all donors who make a so-called "quid pro quo contribution" in excess of $75.

ii. The threshold is determined by the total amount paid, not by the amount that is determined to be deductible.

iii. A quid pro quo contribution is defined as a payment made partly as a contribution and partly as consideration for goods or services provided to the payor by the charitable donee. An incidental benefit, such as the promotion of good will or the naming of a building or a professorship in honor of the donor, is not considered the type of consideration that will disqualify a gift for the charitable deduction.

A. Intangible religious benefits are not included.

iv. The written statement must inform the donor that the amount of the sum paid (which is deductible for federal income tax purposes) is limited to the excess of the value of any money and property contributed less the value of the goods and/or services provided.

A. The statement also must include a good faith estimate of the value of such goods and services. IRC § 6115; Treas. Reg. § 1.6115-1.

B. The entire price for a raffle (or lottery) ticket is construed as a payment for goods or services. Rev. Rul. 83-130, 1983-2 C.B. 148; *Goldman v. C.I.R.*, 46 T.C. 136 (1966), *aff'd*, 338 F.2d 476 (6th Cir. 1967).

v. If a charitable donee fails to provide such disclosures it is subject to a fine of $10 for each contribution not so disclosed up to a maximum penalty of $5,000 per mailing or fund-raising event.

A. No penalty will be imposed if the charitable donee can show the failure to disclose was due to a reasonable cause. IRC § 6714.

vi. For 2021, no disclosure is necessary if the benefits do not exceed 2% of the contribution or $113, whichever is less, or if the contribution is $56.50 or more and the value of other items does not exceed $11.30.

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vii. A charity may always advise a donor in writing that the donor has the right to decline any goods or services that may be provided in consideration for a gift. If the donor declines, the quid pro quo rule will not apply.

f. Charity Must Report Disposition Within Two Years

If property to which the qualified appraisal rules applies is sold or otherwise disposed of by the donee charity within two years, the disposition (and the proceeds, if any) must be reported to the IRS and the donee via Form 8282 (Donee Information Return). *See* IRC § 6050L.

6. Property Contributions

a. Overvaluation Abuses

Excessive valuation claims for charitable contributions of property has been a potential problem since the creation of the charitable deduction. It remains a concern of the IRS despite tightening the valuation rules over the years, particularly with the imposition of the qualified appraisal requirement, notification to the IRS of the disposition of contributed property by the donee (so-called "tattletale" rule), and ever-increasing penalties.

b. Appraisers and Valuations

The Internal Revenue Code provides qualification rules for appraisers and high penalties for valuation misstatements.

c. Appraisals and Expert Witnesses

Revenue Procedure 66-49, 1966-2 C.B. 1257 (modified by Revenue Procedure 96-15 regarding valuation of art), sets forth minimal information that should be included, for income tax purposes, in a competent appraisal report:

i. A summary of the appraiser's qualifications;

ii. A statement of the value and the appraiser's definition of the value he or she has obtained;

iii. The bases on which the appraisal has been made, including any restrictions, understandings, or covenants limiting the use or disposition of the property;

iv. The date as of which the property was valued; and

v. The signature of the appraiser and the date the appraisal was made.

vi. *See also* Treas. Reg. § 20.2031-6(a) (IRS not required to accept expert appraisals); IRS Pub. 561 (IRS may reject valuation of taxpayer's appraiser); *Estate of Roberts v. C.I.R.*, 28 T.C.M. 40, 47 (1969) (upholding taxpayer's appraiser who was highly qualified as to the nature of the paintings and art in question); *Isbell v. C.I.R.*, 44 T.C.M. 1143 (1982) (holding that the taxpayer's appraiser must be discounted due to lack of appraiser's expertise and failure to factually support the description of a ceramic jar); *Weil v. C.I.R.*, 26 T.C.M 388 (1967) (discounting the expert's testimony for lack of knowledge about the subject painting and artist); *Posner v. C.I.R.*, 35 T.C.M. 943 (1976) (relying on the IRS' appraisal where the taxpayer's appraisal contained a large discrepancy); *Furstenberg v. U.S.*, 595 F.2d 603 (Cl. Ct. 1979) (discussing the credibility of art appraiser, including the Art Advisory Panel who provides appraisals for the IRS).

d. Appraisals - General Principles

The IRS has indicated, in Revenue Procedure 66-49, that a typical appraisal of art objects, particularly paintings, should include:

i. A complete description of the object, indicating the size, the subject matter, the medium, the name of the artist, and approximate date created;

ii. The cost, date, and how it was acquired;

iii. A history of the ownership and public exhibitions of the item including proof of authenticity, such as a certificate of authenticity and citations in literature;

iv. A photograph of a size and quality fully showing the object, preferably a 10 x 12" or larger print, or color transparency;

v. The facts on which the appraisal was based, such as:

A. Sales or analyses of similar works by the artist, particularly on or around the valuation date;

B. Prices in dealers' catalogs for the artist's works, or of other artists of comparable stature;

C. The economic state of the art market at the time of valuation, particularly with respect to the specific property;

D. A record of any exhibitions at which the particular art object had been displayed; and

E. A statement as to the standing of the artist in his profession and in the particular school or time period; and

vi. The interests (life interest, reversionary interest, etc.) transferred and those kept.

See also IRS Pub. No. 561, Determining the Value of Donated Property (2007).

e. Appraisal Penalties for Overstatements and Understatements

i. The threshold for imposing accuracy-related penalties for a substantial valuation misstatement is 150% (lowered from 200%), while the gross valuation misstatement threshold is 200% (lowered from 400%). IRC §§ 6662(e), (h).

ii. Penalties on understatement of values for estate tax purposes are similarly beefed up. The threshold for imposing accuracy-related penalties for a substantial estate and gift tax understatement is 65% (increased from 50%) or less of the correct value, while the gross understatement threshold is 40% (lowered from 65%) or less. IRC §§ 6662(g), (h).

iii. Appraisers are subject to strict oversight. A civil penalty of the greater of $1,000 or 10% of the understatement resulting from a valuation misstatement (up to a maximum of 125% of the gross income derived from the appraisal) applies to the person who prepared the appraisal. The disciplinary rules for appraisers also were expanded. The IRS no longer needs to apply a civil penalty before it can discipline appraisers by suspending or barring them from appearing in tax matters.

f. Qualified Appraisers

In addition, the definition of qualified appraiser was expanded to require verifiable education and experience in valuing that type of property for which the appraisal is being performed.

g. "Qualified Appraisals" Requirements

i. Donor must obtain a qualified appraisal and attach a summary (Form 8283) to his or her return if the claimed value of donated property (other than cash or publicly traded securities) is over $5,000. For closely held stock, the threshold is $10,000.

A. To be a qualified appraisal:

1) The appraisal must be made no earlier than 60 days before the date of the contribution;

2) The appraisal document must be prepaid, signed, and dated by a "qualified appraiser"; and

3) Generally, the fee for the appraisal must not be based upon a percentage of the appraised value. Treas. Reg. § 1.170A-13(c).

These rules apply to individuals, partnerships and corporations.

ii. In the case of appraised contributions with a value of more than $500,000, the qualified appraisal itself must be attached to the taxpayer's return.

Note: A couple who contributed non-publicly traded stock and who failed to obtain a qualified appraisal were limited to a charitable contribution deduction equal to their basis in the stock. The taxpayers' ability to prove the fair market value of the stock was insufficient without a qualified appraisal and did not constitute substantial compliance with the substantiation requirements. *Hewitt v. C.I.R.*, 109 T.C. 258 (1997).

V. PRACTICAL GIFT PLANNING

A. Outright Charitable Gifts

1. Cash Gifts

a. Due to the income tax savings from making the gift, the true cost to the donor can be 63% or less of the face value of the gift.

b. Substantiation for Cash – *See* foregoing cash substantiation requirements at Section IV(B)(5)(a).

c. A gift made by check is deductible when the check is delivered or mailed, provided that the check subsequently clears. Treas. Reg. 1.170A-1(b). In contrast, a gift made by credit is deductible in the year the charge is made to the donor's account. A contribution made through a pay-by-phone transaction, in which the donor instructs her bank to make a contribution, is deductible when the bank makes the payment to the charity as shown on the statement provided to the donor.

2. Gifts of Closely-Held Stock

a. Donors who plan a gift of closely held stock should be careful to ensure that the gift is made with no strings attached, for if it is suspected that there is any implied understanding or agreement pursuant to which the charity is required to tender the stock for redemption, the IRS may attack the transaction by imputing any gain on the sale to the donor. *See Rauenhorst v. C.I.R.*, 119 T.C. 157 (2002); *Blake v. C.I.R.*, 42 T.C.M. (CCH) 1336 (T.C. 1981), *aff'd*, 697 F.2d 473 (2d Cir. 1982).

b. Non-mandatory redemption of the stock after being gifted presents significant benefits to the charity, corporation, donor, and the donor's family without the loss of the charitable contribution deduction. *Palmer v. C.I.R.*, 62 T.C. 684 (1974), *aff'd*, 523 F.2d 1308 (8th Cir. 1975).

c. Same result as above for stock sold to a third party or redeemed by a corporate issuer if the transactions were still reversible at the time the gift was made.

d. In general, business corporations are treated as separate taxable entities and are subject to tax on a graduated rate structure. However, a domestic corporation that meets certain requirements can, at the election of the corporation and its shareholders, be treated as a pass-through entity for income tax purposes. IRC §§ 1361–1363. Under these circumstances, the corporation's income is taxed to its shareholders. Such corporations are known as "S" corporations.

i. One of the qualifying requirements for an S corporation is that only individuals, bankruptcy, decedents' estates, and certain trusts may be shareholders. IRC § 1361(b)(1).

A. Since 1998, a charitable organization has been considered one shareholder for purposes of the 100-shareholder limitation for S corporations.

e. Income received by a charity from an S corporation is treated as unrelated business taxable income ("UBIT"), regardless of the nature of the income. IRC § 512(e)(1)(B). The law includes a rule for determining how much of the value of contributed S corporation's shares will not be deductible because it represents unrealized ordinary income or short-term capital gain. Thus, the income tax deduction for a contribution of S corporation shares is reduced to the extent of the taxpayer's pro-rata share of the gain that would be recognized by the corporation were it to sell all of its assets for their fair market value, except to the extent that the gain would be long-term capital gain.

f. Section 1367 provides that the amount of a shareholder's basis reduction in the stock of an S corporation, by reason of a charitable contribution made by the corporation, is equal to the shareholder's pro rata share of the adjusted basis of the contributed property. See Treas. Reg. 1367(a)(2)(B).

3. Bargain Sales

a. A sale of property to a charity at a bargain price results in a charitable deduction for the bargain element. The transaction is treated as a part-sale, part-gift. IRC § 1011(b).

b. The amount received for the property is treated as an amount realized on the sale of the property, and to the extent it exceeds an allocable share of the income tax basis (allocated by the relative size of the sale and gift portions), there is a taxable gain. The rule applies to long- and short-term capital gain as well as to ordinary income gain.

c. The excess of the value of the property over the amount received is a deductible gift to the charity.

d. If the property sold is subject to a mortgage, the amount of the debt, whether or not the charity assumes it, is included as part of the amount realized for tax purposes. Treas. Reg. § 1.1011-2(a)(3). It has been held that a purported charitable gift of property subject to a nonrecourse mortgage does not allow the donor to escape tax on the excess of the amount of the mortgage over the adjusted basis of the property. *Guest v. C.I.R.*, 77 T.C. 9 (1981). A gift of encumbered property is automatically a bargain sale, to the extent the charity assumes or takes the property subject to the encumbrance. Rev. Rul. 75-194, 1975-1 C.B. 80; Treas. Reg. § 1.1011-2(a)(3).

e. Section 170(e) provides that the amount of any charitable contribution otherwise taken into account under Section 170 is reduced by the amount of gain that would have been recognized if the property contributed had been sold by the taxpayer at its fair market value. However, the reduction is based on the appreciation attributable only to the "contributed" portion of the property. *Estate of Bullard v. C.I.R.*, 87 T.C. 261 (1986).

B. Gifts of a Partial Interest

1. Trust

a. Remainders – Charitable remainder trusts and pooled income funds. Discussed below.

b. Income Interests – Charitable lead trusts. Discussed below.

2. Gifts Not in Trust

a. Deductible Non-Trust Split Interests

The types of split interest transfers discussed below are deductible notwithstanding the general prohibition on deductions for charitable transfers that also provide benefits for the donor or another beneficiary.

b. Remainder Interest in a Personal Residence or Farm

A contribution of a remainder interest in a personal residence or farm qualifies for income tax, estate tax, and gift tax charitable deductions under Sections 170(f)(3)(B)(i), 2055(e)(2), and 2522(c)(2), respectively.

Note: Computation of the deduction for income tax purposes is complex, and straight-line depreciation must be taken into account. *See* IRC §§ 170(f)(4); Treas. Reg. § 1-170A-12. While the examples there are sufficiently complicated to confuse many readers, note that the situation is further complicated by the current actuarial system mandated by Section 7520 and the monthly rate adjustments required thereunder. Most practitioners prefer to rely upon computer assistance and software to meet this challenge.

The requirements for qualification are fairly simple: The interest conveyed to a charity must be an irrevocable remainder interest following either a life interest or a term of years.

i. A remainder interest held in a trust that holds such property will not qualify unless the trust is a charitable remainder annuity trust, unitrust, or pooled income fund as defined in IRC § 664 and § 642(c)(5). *See* Rev. Rul. 76-357, 1976-2 C.B. 285.

ii. It is generally not sufficient for the property to be sold and the proceeds given to the charitable donee at the termination of the life or term-of-years interest. However, such an approach will produce a deduction if, under state law, the charitable remainderman may compel the life tenant's executor to distribute the property instead of selling it. *See Estate of Blackford v. C.I.R.*, 77 T.C. 1246 (1981), *acq.* 1983-2 C.B. 1; *see also* Rev. Rul. 83-158, 1983-2 C.B. 159.

iii. A fraction of the remainder may be given to charity with the balance held either by other charities (Rev. Rul. 83-158, 1983-2 C.B. 159) or by individuals (Rev. Rul. 87-37, 1987-1 C.B. 295).

iv. Can the donation of the remainder interest be contingent? The answer is a clear "it depends." Although a remainder interest in the residence or farm must vest in the donee charity, it may be subject to a condition subsequent that would cause title to vest in another charity. *See* Priv. Ltr. Rul. 1994-36039, approving a deed of transfer providing that the initial donee's interest would terminate and vest unconditionally in another qualified donee if the initial donee should attempt to sell or encumber the residence, lease it to any entity for any use other than historic preservation, or change the configuration of the first floor of the residence.

v. The residence in question need not be a principal residence.

A. A vacation home or similar temporary residence may be used. This is often a convenient way to provide for the ultimate disposition of such a property and at the same time obtain a current income tax deduction.

B. A cooperative apartment or condominium will also qualify.

vi. A farm will qualify in its totality. That is, the deductible interest will include the improvements and acreage, and not merely the living quarters.

A. A farm is defined in Treasury Regulation Section 1.170A-7(b)(4) as any land used by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock (including cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry).

vii. The donee may be a private foundation, although this may require a reduction of the allowable income tax deduction under Section 170(e)(1)(B)(ii). *See* Priv. Ltr. Rul. 1997-14017, 1995-38040.

viii. If a remainder interest is given to charity under this rule, the donor will be entitled to additional deductions upon making subsequent capital improvements (e.g., installation of a new heating and air conditioning system). *See* Priv. Ltr. Rul. 1985-29014.

3. Undivided Portion of Taxpayer's Entire Interest

A contribution of an undivided portion of the taxpayer's entire interest in property likewise qualifies for income tax, estate tax, and gift tax charitable deductions under Sections 170(f)(3)(B)(ii), 2055(e)(2), and 2522(c)(2), respectively.

To qualify, the charitable donee must receive a fractional or percentage of each and every substantial interest or right owned by the donor, and that interest or right must extend over the entire term of the donor's interest in the property and in any other property into which the property is converted. The charity is thus made a co-tenant or co-owner of the property.

EXAMPLES:

a. Donor's father bequeaths to him a life estate in an office building. Subsequently, Donor contributes to his university a 25% undivided interest in his life estate in the office building. Donor's contribution is deductible.

b. Donor contributes to his university a life estate in an office building owned by him. This contribution is not deductible, since it is not an undivided portion of the Donor's entire interest in the building.

Allocation of possession (based on time) is generally necessary. *See* Treas. Reg. § 1.170A-7(b)(1)(i); Priv. Ltr. Rul. 1977-33075.

This is sometimes used as a means of sharing artworks or other similar property by a donor and a charitable institution on a deductible basis.

EXAMPLE: Collector gives a university museum an undivided 25% interest in a sculpture valued at $200,000. This will normally produce a deduction of $50,000 or somewhat less, and the museum will be entitled to the unrestricted use and possession of the sculpture for 25% (i.e., 3 months) of each year.

a. In *Winokur v. C.I.R.*, 90 T.C. 733 (1988), *acq.* 1989-1 C.B. 1, the Tax Court held that the donee's right to possession of contributed artwork during its proportionate period of ownership is sufficient, even if it does not actually take possession.

b. Even though the IRS has acquiesced in the *Winokur* case, a donor should not undertake such an arrangement unless the parties agree to conduct themselves in accordance with the terms of their shared ownership arrangement.

   i. As a practical matter, this should be undertaken only where the donee actually desires to eventually own the works in question outright, and the donor contemplates eventually contributing them in their entirety.

   ii. Note also that Treasury Regulation Section 1.170A-5(a)(2) requires that the donee's initial period of possession begin within one year, unless the gift is classified as one of a future interest (potentially giving rise to a delayed deduction under Section 170(a)(3)).

c. Section 170(o) limits fractional gifts. Charities which receive fractional interests in <u>tangible personal property</u> must take complete ownership of the item within ten years of the initial fractional gift or the death of the donor, whichever occurs first. In addition, the donee must have:

   i. Taken possession of the item at least once during the 10-year period as long as the donor remains alive; and

   ii. Used the item for the organization's exempt purpose.

Failure to comply with these requirements results in the recapture of all tax benefits, plus interest, and the imposition of a 10% penalty on the recaptured amount. These changes were effective for contributions made after August 17, 2006.

d. “Commissioner's longstanding position that fractional interests in art are not discounted for purposes of valuing charitable contributions thereof under section 170. See, for example, Rev. Rul. 58-455 , 1958-2 C.B. 100 , and Rev. Rul. 57-293 , 1957-2 C.B. 153 , both of which involve the transfer of either a fractional interest or a remainder interest in a work of art to a section 170(c) organization, and both of which determine the value of the gift without requiring any discount.” *Elkins* v. *Commr.* (140 TC 86):

4. Qualified Conservation Contributions

The final type of deductible split-interest transfer is the qualified conservation contribution, which is defined in Section 170(h). The qualifications are quite technical, but may be summarized as follows:

a. There must be a contribution of a “qualified real property interest:”

i. The most familiar of these is the so-called “conservation easement” (also sometimes called a facade easement or preservation easement). This is not a traditional easement, but rather consists of a restriction (in perpetuity) on the use that may be made of the subject property.

ii. A remainder interest may also qualify.

iii. Also, the donor may contribute his or her entire interest in the property other than a “qualified mineral interest” (defined in Section 170(h)(6) as subsurface oil, gas, or other minerals, and the right of access to them).

b. The contribution must be made to a “qualified organization,” basically, a governmental unit or a publicly supported charitable organization. See Section 170(h)(3) for the full definition.

c. The contribution must be made “exclusively for conservation purposes.” See Sections 170(h)(4) and (5) and the extensive regulations thereunder for the very technical list of requirements for qualification.

d. Some Special Planning Considerations:

i. The conservation purpose must be “protected in perpetuity.” Hence, any mortgage or other indebtedness must be subordinated to the rights of the donee organization. *See Satullo v. C.I.R.*, T.C. Memo 1993-614 (disallowing a deduction for the value of an easement that was not recorded until after a subsequent mortgage had been entered into and recorded, thus taking priority over the easement such that the easement was not protected in perpetuity).

ii. The amount of the donor’s deduction for a conservation easement is generally determined by a before-and-after approach (i.e., the value of the property before the easement is imposed, less the value of the property with the easement in place).

iii. Any enhancement in the value of other nearby property held by the donor as a result of the conservation contribution will reduce the deduction otherwise available. For example, by contributing an easement that obligates him to preserve the unspoiled nature of a wooded lake-site, the donor may increase the value of an adjacent cottage also owned by him. The deduction for the easement is reduced by the amount of this increase in value, and it would not be unheard of for the IRS to allege that such an increase (which is often hard to value) is sufficient to eliminate the deduction.

e. Although the conservation contribution is usually thought of in terms of the familiar restrictive easement, note that a donor wishing to transfer the bulk of the subject property while retaining subsurface oil, gas, and other mineral rights, may also utilize it. *See* Priv. Ltr. Rul. 1993-18027.

f. To encourage certain contributions for conservation purposes, IRC Section 170(b)(i) allows a more favorable percentage limitation in some circumstances.

A. In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100% of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

B. In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100% of the excess of the corporation's taxable income (as computed under Section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to fifteen years as a contribution subject to the 100% limitation.

The qualified real property interest must include a restriction that the property remains generally available for agriculture or livestock production. For both individuals and corporations, a qualified farmer or rancher means a taxpayer whose gross income from the trade or business of farming (within the meaning of Section 2032A(e)(5)) is greater than 50% of the taxpayer's gross income for the taxable year. These changes apply to contributions made in taxable years beginning after 2005.

ii. To better match the amount deductible with the true value of an easement in a registered historic district, Section 170(h)(4) provides that after July 25, 2006, an easement in a historically registered district must provide that no portion of the exterior of the building may be changed or altered in any manner inconsistent with the historical character of the exterior. Further, the deduction claimed must be reduced by any rehabilitation credit previously claimed by that taxpayer with respect to the donated property.

C. Life Income Vehicles

1. Charitable Remainder Trusts – General

A charitable remainder trust is an irrevocable trust created inter vivos or upon death in which a non-charitable beneficiary receives an interest for life or over a period of not more than twenty years and a charity receives the remainder. IRC § 664.

a. Income Taxation of Trust and Beneficiaries

i. Deduction allowed to donor

A. For income, estate and gift tax purposes, a deduction is allowed for the present value of the charitable remainder interest. Treas. Reg. §§ 1.664-2(c), 1.664-4(b)(5), 20.2031-7.

B. For income tax purposes, a gift of the remainder interest is treated as a gift "to" the remainderman. If the remainderman is a public charity, the maximum deduction is allowed (up to 30% or 50% of donor's adjusted gross income). Treas. Reg. § 1.170A-8(a)(2).

b. Income Tax Treatment of the Trust

i. Exempt from income tax (including from alternative minimum tax).

ii. Section 664 imposes a 100% excise tax on the unrelated business taxable income of a charitable remainder trust. The tax is treated as paid from corpus. The unrelated business taxable income is considered income of the trust for purposes of determining the character of the distribution made to the beneficiary. Accordingly, the rule is considerably more punitive when a CRT has considerable unrelated business taxable income than when it has very little. It is not clear whether this second level of taxation was anticipated or is appropriate.

iii. Section 6652(c) provides for increased penalties relating to filing information returns for split-interest trusts. For such returns filed for taxable years beginning after 2006, the per-day penalty for failure to include required information will be $20 or $100 if the gross income of the trust is more than $250,000. The maximum penalties are $10,000 and $50,000, respectively, and the penalty applies to any responsible person who knowingly fails to file a complete return.

c. Additional CRT Regulations

i. Amounts paid to a trust beneficiary retain the character they had when received by the trust. For regular trusts, the characterization is done by reference to the trust's activities during the year of any particular payment. Generally, charitable remainder trusts characterize payments by reference to the entire history of the trust. IRC § 664(b); Treas. Reg. § 1.664-1(d). The annuity or unitrust amount is taxed as ordinary income, to the extent of the trust's current and past undistributed income. Thereafter, payments are characterized as follows:

A. As *capital gain* to the extent of current and past undistributed long-term capital gains;

B. As *other income* (e.g., tax-exempt income) to the extent of the trust's current and past undistributed other income; and

C. As a tax-free distribution of *trust corpus*.

ii. Following a historical hierarchy makes it difficult to provide tax-exempt income to a beneficiary, particularly where the trust is funded with significantly appreciated property, since all recognized capital gains must be distributed before payments can be considered tax-free income. Similarly, funding a CRT at death with the balance of a qualified retirement account will make it difficult for any distributions from the CRT to have a tax character other than that of ordinary income, as the account balance will be considered "income in respect of a decedent" under IRC 691.

iii. The Jobs and Growth Tax Relief Reconciliation Act of 2003 created a lower 15% bracket for taxing certain gains as well as a preferential rate of 15% on qualified dividend income. The special CRT ordering system can be found in Treasury Regulation Section 1.664-1(d).

iv. Under the regulations, items within the ordinary income and capital gains categories are assigned to different classes based on the federal income tax rate applicable to each type of income in that category in the year the items are required to be taken into account by the trust.

A. For example, the ordinary income category may include a class of qualified dividend income as defined in Section 1(h)(11)(B) and a class of all other ordinary income.

B. In addition, the capital gains category may include separate classes for short-term capital gains and losses, for 28% rate gain as defined in Section 1(h)(4), for unrecaptured Section 1250 gain as defined in Section 1(h)(6), and for all other long-term capital gains and losses.

C. In turn, if the trust has different classes of income in the ordinary income category, the distribution from that category is treated as being made from each class until exhaustion of the class, beginning with the class subject to the highest federal income tax rate and ending with the class subject to the lowest federal income tax rate.

D. If the trust has different classes of net gain in the capital gains category, the distribution from that category is treated as being made first from the short-term capital gain class and then from each class of long-term capital gain, in turn, until exhaustion of the class, beginning with the class subject to the highest federal income tax rate and ending with the class subject to the lowest rate.

E. The regulations also include rules for treating losses with respect to ordinary income and other income as well as the netting of capital gains and losses. For example, the netting rule provides that the gains and losses of the long-term capital gain classes are netted prior to netting short-term capital loss against any class of long-term gain. The determination of the character of amounts distributed or deemed distributed at any time during the taxable year of the trust is made as of the end of that taxable year.

F. Finally, the tax rate to be used in computing a recipient's tax on a distribution is the rate applicable in the year in which the distribution is required to be made. In general, the regulations were applicable for taxable years ending after November 20, 2003; however, those portions of the regulations dealing with the treatment of capital gain property that were the subject of earlier Notices were applicable for distributions made in taxable years ending on or after December 31, 1998. Treas. Reg. § 1.664-1(d); 1997-2 C.B. 309; 1998-1 C.B. 776; 1999-1 C.B. 871.

d. Calendar Year Requirement

i. In general, for taxable years beginning after 1986, the taxable year of any trust is the calendar year. IRC § 645.

ii. There is an exception for wholly charitable trusts exempt from taxation under Section 501(a). IRC § 645(b).

iii. Charitable remainder trusts are not described in Section 501(a) and thus report on a calendar year basis.

e. Annuity Interest

i. The annuity interest may be either a fixed percent of the annual value of the trust assets (a unitrust amount) or a fixed sum or percent of the initial value of the trust assets (an annuity amount). No other formula is permitted.

A. *Note*: A fixed dollar amount constitutes an annuity amount, even if expressed as a percent of the initial value of the trust assets.

ii. The annuity interest may continue for the life of the non-charitable beneficiary or for a term of not more than twenty years. Treas. Reg. § 1.664-2(a)(5).

iii. Payments may be made "to or for" the benefit of the non-charitable beneficiary, thus permitting payments for the care of an incompetent beneficiary. Indeed, payments can be made directly to another trust for the sole benefit of a beneficiary, even though payments could thus be withheld during periods of disability or incapacity. Rev. Rul. 76-270, 1976-2 C.B. 194, *amp. and mod. by* Rev. Rul. 2002-20, 2002-17 I.R.B. 794, Priv. Ltr. Rul. 96-19-042. In Rev. Rul. 2002-20, the IRS held as follows: "A trust may qualify as a charitable remainder unitrust under section 664 if the unitrust amounts will be paid for the life of a financially disabled individual to a separate trust that will administer these payments on behalf of that individual and, upon the individual's death, will distribute the remaining assets either to the individual's estate or, after reimbursing the state for any Medicaid benefits provided to the individual, subject to the individual's general power of appointment."

iv. The donor can receive an interest for his or her life and then designate a group of others to receive amounts, subject to the donor's general testamentary power to revoke their interests. Priv. Ltr. Rul. 90-15-029.

f. Time for Paying Annuity or Unitrust Amount

i. Generally, trustees have been permitted to make an annuity or unitrust payment within a reasonable time after the close of the year for which the payment was due. Treas. Reg. §§ 1.664-2(a)(1), 1.664-3(a)(1).

ii. For CRATs and fixed percentage CRUTs, the annuity or unitrust amount may be paid within a reasonable time after the close of the year for which it is due if:

A. The character of the annuity or unitrust amount in the recipient's hands is income under Section 664(b) and not a distribution of trust corpus; and/or

B. The trust distributes property (other than cash) that it owned as of the close of the taxable year to pay the annuity or unitrust amount and the trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year for which the amount is due.

The regulations state that to do otherwise (i) may be deemed an act of self-dealing, (ii) may cause unrelated debt-financial income, (iii) may result in the receipt of an additional contribution or (iv) may cause the trust to fail to function as a CRT. Treas. Reg. §§ 1.664-2(a)(1)(i)(a), 1.664-3(a)(1)(i)(g). For trusts created before December 10, 1998, the regulations follow Notice 97-68, 1997-2 C.B. 330, and now state that such negative result will not apply if:

1) A CRAT under which the annuity is 15% or less of the initial net fair market value of all property placed in the trust, or

2) A CRUT under which the fixed percentage of the net fair market value of the unitrust's assets is 15% or less.

For all such purposes a "reasonable time" ordinarily will not extend beyond the date by which the trustee is required to file Form 5227, "Split-interest Trust Information Return," (including extensions). Treas. Reg. §§ 1.664-2(c), 1.664-3(k).

g. Charitable Remainder

i. The remainder must go to a charity described in Section 170(c). In order to secure gift and estate tax deductions and the income tax deductibility limitations applicable to public charities, it is advisable to comply with Sections 170(b)(1)(A), 2055(a), and 2522(a) as well.

A. Multiple charities are permitted, as long as the relative shares are determined when the trust ends.

B. A fallback provision is a good idea; i.e. if the designated charity is not a qualified organization at the critical date, the trust principal will go to another qualified charity.

C. The charity may be a private foundation, but the 30% limitations could be a problem.

ii. For transfers after July 28, 1997, the value of the remainder interest in each contribution of property to a charitable remainder trust (as determined under Section 7520) must be at least 10% of the net fair market value of such property as of the date of its contribution. IRC § 664(d)(1), (2).

A. The 10% requirement does not apply to a charitable remainder trust created by a testamentary instrument (e.g., a will or revocable trust) executed before July 29, 1997, if the instrument is not modified after that date and the settlor died before 1999, or could not be modified after July 28, 1997, because the settlor was under a mental disability on that date (i.e., July 28, 1997) and all times thereafter.

h. Spousal Election Rights and Charitable Remainder Trusts

In Revenue Procedure 2005-24, 2005-1 C.B. 907, the IRS issued controversial guidance in the form of safe harbors to avoid the disqualification of charitable remainder trusts based on the existence of spousal rights under state laws, provided that the spousal rights are not exercised. The safe harbor rules are effective indefinitely, until such time as the IRS provides further guidance. Notice 2006-15, 2006-1 C.B. 501.

i. Gift Tax Considerations

i. Payments to Donor

When the donor retains the right to lifetime payments, the interest is not subject to gift tax. An irrevocable gift of the charitable remainder interest must be reported on a timely return, in accordance with Section 6019, but will not be subject to gift tax. IRC § 2522(c)(2)(A); Treas. Reg. § 25.2522(c)-3(c)(2)(v).

ii. Payments to Others

A. When the donor designates someone other than himself or herself to receive the initial annuity or unitrust interest, the gift constitutes a present interest and thus qualifies for the gift tax annual per donee exclusion. IRC § 2503(b); Treas. Reg. § 25.2503(b).

B. For gifts by married persons to others, marital gift splitting is available to create additional exclusions. IRC § 2513(a).

C. If the annuity or unitrust interest is greater than the available per donee exclusion, a taxable gift results, subject, however, to any available applicable credit. IRC § 2505.

D. If the donee's spouse is the sole non-charitable beneficiary, the gift of the annuity or unitrust interest will not be taxable since it will qualify for a gift tax marital deduction. IRC § 2523(g).

iii. Successor Interests

A. The gift tax marital deduction will apply if the only other non-charitable beneficiary is the donor's spouse.

B. Successor interest is subject to gift tax unless the donor reserves the right to revoke the interests of successor non-charitable beneficiaries by will. Treas. Reg. § 1.6642(a)(5); T.D. 7202, 1972-2 C.B. 313.

j. Estate Tax Considerations

i. Lifetime Transfers

A. If the donor is the sole beneficiary of a lifetime transfer, the value of the trust's assets generally will be included in his or her gross estate. Section 2036. However, to the extent the assets are included in the estate, they will qualify for an offsetting estate tax charitable deduction. IRC § 2055(e)(2)(A).

B. Lifetime transfers solely for the benefit of others are not included in the gross estate unless the donor reserves the right or power to revoke by will the interests of non-charitable beneficiaries. IRC §§ 2035, 2038.

C. Where an annuity or unitrust is first created for the donor for life (or for a term of years that does not expire before his or her death) followed by such an interest in another non-charitable beneficiary, the entire trust will be included in the donor's estate, but a partially (or wholly) offsetting charitable deduction will be allowed for the charitable remainder interest as of the donor's death. The actuarial value of non-charitable annuity or unitrust interest is taxable in the donor's estate.

ii. Testamentary Type Transfers

A. Post death charitable remainder trust transfers, of which the donor's surviving spouse is the sole non-charitable beneficiary, do not result in estate tax at the donor's death (Section 2056(b)(8)), nor at the spouse's death (Section 2055(e)(2)(A)).

B. Post death transfers for the benefit of individuals other than the donor's spouse qualify for a partially offsetting estate tax charitable deduction based on the actuarial value of the charitable remainder interest. Treas. Reg. § 1.664-4 (unitrust); IRC § 20.2031-7 (annuity trust).

iii. Faulty Transfers

A. Transfers immediately payable to a charity under the terms of the will or trust entirely for charitable purposes are deductible regardless of the nature of the interests. Rev. Rul. 75-414, 1975-2 C.B. 371. However, transfers of a partial interest to a charity generally will not qualify for a deduction (unless the trust interest is a qualified annuity or unitrust interest) even if the non-charitable trust interests are clearly separable. Rev. Rul. 77-97, 1977-1 C.B. 285.

B. The Taxpayer Relief Act of 1997 expanded the reformation provisions to accommodate the new requirement that at least 10% of the value of the transfer to the charitable remainder trust must be attributable to the charitable remainder interest.

1) First, where a transfer is made after July 28, 1997 to a charitable remainder trust that fails the 10% test, the trust can be amended to cure the requirements by reducing the payout rate or duration (or both) of any non-charitable beneficiary's interest. All amendments must be commenced within the period permitted for reformations of charitable remainder trusts under Section 2055(e)(3). The statute of limitations applicable to a deficiency of any tax resulting from reformation of the trust shall not expire before the date one year after the Treasury Department is notified that the trust has been reformed. In substance, this rule relaxed the requirements of Section 2055(e)(3)(B) to the extent necessary for the reformation for the trust to meet the 10% requirement.

2) Second, a transfer to a trust will be treated as if the transfer never had been made where a court having jurisdiction over the trust subsequently declares the trust void (because, e.g., the application of the 10% rule frustrates the purposes for which the trust was created) and judicial proceedings to revoke the trust are commenced within the period permitted for reformations of charitable remainder trusts under Section 2055(e)(3). Under this provision, the effect of "unwinding" the trust is that any transactions made by the trust with respect to the property transferred (e.g., income earned on the assets transferred to the trust and capital gains generated by the sales of the property transferred) will be income and capital gain of the donor (or the donor's estate if the trust was testamentary), and the donor (or the donor's estate) will not be permitted a charitable deduction with respect to the transfer. The statute of limitations applicable to a deficiency of any tax resulting from "unwinding" the trust shall not expire before the date one year after the Treasury Department is notified that the trust has been revoked.

3) Third, where an additional contribution is made after July 28, 1997, to a charitable remainder unitrust created before July 29, 1997, and that unitrust would not meet the 10% requirement with respect to the additional contribution, the conference agreement provides that such additional contribution will be treated, under regulations to be issued by the Secretary of the Treasury, as if it had been made to a new trust that does not meet the 10% requirement, but which does not affect the status of the original unitrust as a charitable remainder trust.

C. The Tax Reform Act of 1984 included permanent "reformation" rules that permit the amendment of certain charitable remainder trusts that otherwise would not qualify for an estate tax charitable deduction. IRC § 2055(e)(3). These reformation rules pertain, in large part, to charitable remainder trusts that do not comply with the requirements for such trusts enacted in the Tax Reform Act of 1969.

The following three requirements apply to reformations under IRC § 2055(e):

1) First, the entity must either be a Charitable Remainder Annuity Trust, Charitable Remainder Unitrust, or Pooled Income Fund, and the charitable gift must otherwise have been deductible but for failing the technical requirements to be one of these types of qualified entities.

2) Second, the reformation must be considered "qualified," which requires that (1) the actuarial variance between the values before and after reformation cannot exceed 5%, (2) the non-charitable lead portion cannot be extended beyond the originally stated term, and (3) the effective date of the reformation must be the date of the decedent grantor's death.

3) Third, judicial reformation must be commenced in a timely manner. For estates with no estate tax return filing requirement, the deadline is the due date (including any extensions) for the filing of the first fiduciary income tax return for the decedent's estate. For estates required to file an estate tax return, the deadline is 90 days after the due date (including any extensions) for the filing of the estate tax return.

k. Allocation of Estate and Inheritance Taxes

For charitable remainder trusts created after October 3, 1982, the Service requires that the trust agreement expressly prohibit the payment of any federal estate and state death taxes which the trustee may otherwise be liable to pay after the donor's death. Rev. Rul. 82-128, 1982-2 C.B. 71. It suggests language that obligates the surviving income beneficiary of a two-life trust to pay any such taxes. Nonetheless, a donor may shift the burden from the surviving beneficiary to his or her estate by directing by will that the obligation be paid from his or her estate.

l. Private Foundation Rules

i. Private foundation restrictions under Sections 507, 508(e), 4941 (self-dealing) and 4945 (taxable expenditures such as lobbying and improper grant-making) apply to charitable remainder trusts. IRC § 4947(a)(2).

ii. Restrictions as to jeopardy investments and excess business holdings under Sections 4943 and 4944 do not apply to charitable remainder trusts. IRC § 4947(b)(3)(B). *But see* Treas. Reg. § 53.4943-3(b)(4) (indicating that excess business holdings of a trust are included when determining whether the private foundation can rely on the de minimis safe harbor).

m. Investments

i. The trustee of a charitable remainder trust must invest in a manner that could result in a reasonable amount of income or gain from the sale or disposition of capital assets. Treas. Reg. § 1.664-1(a)(3).

ii. EXAMPLE: A charitable remainder trust provided that the trustee had to retain certain antiques for the lifetime use of the non-charitable beneficiary (the grantor's spouse) for life. Since the trustee had to retain these assets, it could not invest in income producing assets and could not sell or dispose of all of the assets, and the trust lost its qualified status. Rev. Rul. 73-610, 1973-2 C.B. 213.

n. Trustee

i. The grantor or anyone else may be the trustee, subject to the normal grantor trust rules.

ii. The legislative history suggests that if the assets of the trust are without objective, ascertainable market values, "such as closely held stock or realty," the lack of an independent trustee can cost the trust its qualified status. H.R. Rep. 91-413.

iii. Traditionally, good drafting provided for a so-called "special" or "independent" co-trustee to operate, at least with respect to the valuation of hard to value assets.

iv. The regulations define an independent trustee as a person who is not the grantor, the grantor's spouse, a non-charitable beneficiary or a person who is related or subordinate party (within the meaning of Section 672(c)) to any one of such persons.

v. Special arrangements can be costly and burdensome and have been considered by some to be unnecessarily intrusive. The regulations permit an alternative valuation of unmarketable assets by a "qualified appraisal" by a "qualified appraiser" as defined in Section 1.170A-13(c)(3) and (c)(5). Treas. Reg. § 1.664-1(a)(7). Unmarketable assets are defined as assets other than cash, cash equivalents, or assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely held stock and unregistered securities for which there is no available exemption permitting public sale. Trusts that were created before December 10, 1998 which require an independent trustee may be amended or reformed to permit the qualified appraisal alternative.

o. A Charitable Remainder Trust created by Several Family Members is Disqualified Because It is an Association, Rather than a Trust.

A husband and wife and their six grandchildren each contributed to a CRUT. The trust was to pay a unitrust amount (or income, if less) to the husband and wife for their lives, and then to the six grandchildren, until all of them had died. In Letter Ruling 1995-47004, the IRS ruled that the trust could not be a CRT because it was not really a trust. The IRS noted that the key issues for distinguishing a trust from an association is the existence of a business purpose and associates. *See* Treas. Reg. § 301.7701-2(a).

p. Charitable Remainder Trust Can Never be A QSST or an ESBT

The IRS says that a charitable remainder trust cannot be a Qualified Subchapter S Trust (QSST). The IRS has noted that a beneficiary of a QSST must elect to be treated as the owner of the trust under Section 678, but that the beneficiary of Charitable Remainder Trust must be taxed under the rules of Section 664, which differ substantially from those of Section 678. Rev. Rul. 92-48, 1992-1 C.B. 301.

The term "electing small business trusts" under Section 1361(e)(1)(B)(iii) does not include a charitable remainder trust.

q. Charitable Remainder Trust May Not Be Disqualified Because Principal Can Be Used to Pay Insurance Premiums

The IRS has ruled that a trust would not be treated as a grantor trust under Section 677(a)(3) where the trustee was authorized to pay insurance premiums on the life of a non-charitable beneficiary from principal but not from income.

r. Life Insurance

Section 677(a)(3) taxes the grantor of a trust as the owner of any portion of the trust whose income may be used to pay premiums on policies of insurance on the life of the grantor or the grantor's spouse, "(except policies of insurance irrevocably payable for a purpose specified in Section 170(c) (relating to definition of charitable contributions))." The IRS said Section 677(a) did not apply because the insurance policy was tied to principal, and principal was irrevocably designated to the charity holding the remainder interest.

The applicable state law had no statutory provision concerning "underproductive property" that could result in allocation to income a portion of the proceeds received from the sale or other disposition of the life insurance policy. In states with the Uniform Principal and Income Act (UPIA) or the Revised UPIA, this ruling might have concluded differently.

2. Charitable Remainder Annuity Trust ("CRAT")

a. Income distribution to the non-charitable beneficiary must be fixed at a sum or a percentage that is not less than 5% nor more than 50% of the initial net fair market value of the initial corpus. IRC § 664(d)(1).

b. Inflation or deflation generally does not impact non-charitable beneficiary, but does impact the charitable remainder beneficiary, given the annuity amount is fixed.

c. A CRAT's income tax deduction is larger than would be available for a comparable unitrust if the value of the trust grows.

d. No later contributions may be made to the trust. If more deductions and/or higher annual income distributions are desired, another trust must be established.

e. Corpus cannot be invaded other than to meet the payout requirements.

f. Corpus must be a sum certain, and it cannot be reduced by fees.

g. Value of a remainder interest under an annuity trust is the net fair market value of the property placed in trust, less the present value of the annuity computed under the IRS tables in Treasury Regulation Section 20.2031-7(f).

i. Term of years. Treas. Reg. § 20.2031-7(f), Table B.

ii. Life of One Beneficiary. Treas. Reg. § 20.2031-7(f), Table A.

iii. Lives of Two Beneficiaries. IRS Pub. No. 723E, Table A (2).

h. IRS Guidance (Rev. Proc. 2003-53 through 60)

i. Guidance

Prior to 2003, the IRS provided guidance in the form of illustrated forms. In 2003, the IRS issued eight Revenue Procedures which provide sample forms for charitable remainder annuity trusts. The current Revenue Procedures replace and revoke the earlier guidance. Each Revenue Procedure is structured in six Sections. After providing a statement of purpose, general background material, and statements of scope and objective, each Revenue Procedure provides a basic sample form, annotations to the form, and then alternate provisions to the basic form. The factual situations addressed are:

A. Inter-vivos charitable remainder annuity trust for one measuring life – Rev. Proc. 2003-53.

B. Inter-vivos CRAT for a term of years – Rev. Proc. 2003-54.

C. Inter-vivos CRAT with consecutive interests for two measuring lives – Rev. Proc. 2003-55.

D. Inter-vivos CRAT for concurrent and consecutive interests for two measuring lives – Rev. Proc. 2003-56.

E. Testamentary CRAT for one measuring life – Rev. Proc. 2003-57.

F. Testamentary CRAT for a term of years – Rev. Proc. 2003-58.

G. Testamentary CRAT with consecutive interests for two measuring lives – Rev. Proc. 2003-59.

H. Testamentary CRAT with concurrent and consecutive interests for two measuring lives – Rev. Proc. 2003-60.

ii. Content

These Revenue Procedures contain annotated sample declarations of trust and alternative provisions that meet the requirements of Section 664(d)(1) for various inter vivos and testamentary CRATs.

iii. Effect of the Revenue Procedures

The service will recognize a trust as a qualified CRAT meeting all of the requirements of Section 664(d)(1) if the trust operates in a manner consistent with the terms of the trust instrument, if the trust is a valid trust under applicable local law, and if the trust instrument is: (i) substantially similar to the sample in the revenue procedures; or (ii) properly integrates one or more alternate provisions from the revenue procedures into a document substantially similar to the sample.

A trust instrument that contains substantive provisions in addition to those provided in the revenue procedures (other than properly integrated alternate provisions or provisions necessary to establish a valid trust under applicable local law that are not inconsistent with the applicable federal tax requirements), or that omits any of the provisions of the sample will not necessarily be disqualified, but neither will that trust be assured of qualification under the provisions of this revenue procedure.

The Service generally will not issue a letter ruling on whether an inter vivos trust created by an individual and with one measuring life qualifies as a CRAT. The Service, however, generally will issue letter rulings on the effect of substantive trust provisions, other than those contained in Sections of the revenue procedures, on the qualification of a trust as a CRAT.

iv. Issues to Consider

A. Stating the annuity;

B. Prorating and paying the annuity;

C. Designating the charity;

D. Multiple private beneficiaries;

E. Qualified contingencies and the right to revoke; and

F. Illiquid and hard-to-value assets.

i. The 5% Probability Test

If the possibility that the required annuity payments might consume the trust corpus is not so remote as to be negligible, the IRS has taken the position that a deduction should be denied. For this purpose, the test is whether there is more than a 5% probability that a non-charitable beneficiary will survive the exhaustion of the corpus. Rev. Rul. 77-374, 1977-2 C.B. 329. However, neither the law nor the applicable regulations support this position. See Estate of George H. Moor, T.C. Memo 1982-299. This rule has no application to charitable remainder unitrusts. Priv. Ltr. Rul. 1979-15038 and 1984-19005.

Due to the low interest rate environment in recent years, it has become difficult to create a CRAT which satisfies the 5% probability of exhaustion test. To encourage the creation of CRATs when interest rates are low, the IRS promulgated Rev. Proc. 2016-42, which includes a sample trust provision which qualifies as an alternative to the 5% probability of exhaustion test. Such trust provision requires early termination of a CRAT if it is actuarially anticipated that less than 10% of the initial trust corpus will remain at the time of the next scheduled annuity payment.

j. Advantages and Disadvantages

i. This form of charitable trust is most beneficial for a grantor with appreciated property who may intend to make a significant bequest upon death, but who wishes to use the income during his or her lifetime.

ii. When the IRS's assumed valuation tables on discount rates exceed the actual rates of return on the annuity assets, the trust's charitable remainder tends to be over-valued.

iii. A fixed annuity stream can be set up to benefit the non-charitable recipients other than the grantor.

iv. CRATs will generally provide a higher charitable deduction than CRUTs, which are discussed below.

v. The corpus cannot be invaded on a discretionary basis to meet unanticipated future needs.

vi. CRATs have the potential for loss of family wealth if actual returns are less than IRS assumed returns.

3. Charitable Remainder Unitrust

a. Income distribution to the non-charitable beneficiary is fixed at a percentage of the annual value of the assets and is re-valued each year. IRC § 664(d)(2). As of June 19, 1997, the requirement was changed to read "not less than 5% nor more than 50%."

i. A variable payment each year, protects the lifetime beneficiaries against the negative impact of inflation.

ii. Provides a lower income tax deduction than would be available for a comparable annuity trust.

iii. Valuation of remainder interest for unitrust is calculated under Treasury Regulation Section 1.664-4(e)(6).

iv. Terms of years. Treas. Reg. § 1.664-4(e)(6), Table D.

v. Life of one beneficiary. Treas. Reg. § 1.664-4(e)(6), Table F.

vi. Lives of two beneficiaries. IRS Pub. No. 723C, Table E (2).

b. No invasion of principal is permitted other than to meet income payout requirements.

c. Additions to corpus may be made in later years to increase deduction and income payments. The instrument must contain a formula for valuing the additional contributions and adjusting the unitrust amount for the balance of that year.

d. Income-only unitrust. IRC § 664(d)(3); Treas. Reg. § 1.664-3(a)(1)(i)(b); Rev. Rul. 76-310, 1976-2 C.B. 197)

Income beneficiary receives only the amount of the trust income if such amount is below the fixed percentage yield (a "NI-CRUT").

i. Utilized in situations where trust will receive illiquid assets with a yield below projected unitrust amount.

ii. Can include "make-up" provisions if subsequent year has "excess" (a "NIMCRUT").

iii. "Capital gains" can be allocated to "income" if permissible under local law and an adjustment is made in the annual revaluation of the trust for the amount of any deficiency in unitrust payments for prior years. Priv. Ltr. Rul. 1996-09009.

iv. Generally, the governing instrument may provide either for the payment of the annual income if less than the fixed percentage under Section 664(d)(3)(A) ("income only") or for the payment of that amount plus the make-up amount for prior years under the combination of Sections 664(d)(3)(A) and 664(d)(3)(B) ("income only with a make-up option"). Treas. Reg. § 1.664-3(a)(1)(i)(b); Priv. Ltr. Rul. 1995-06015.

v. Now, a donor can establish a so-called "flip unitrust" that qualifies as a CRUT (a "FLIP-CRUT"). The governing instrument of a CRUT may provide that the CRUT will convert once from one of the income exceptions to a fixed percentage if the date or event triggering the conversion is outside the control of "the trustees or any other persons." Treas. Reg. § 1.664-3(a)(1)(i)(c), (d), (e).

A. The regulations include examples of permissible and **impermissible triggering events**.

1) For example, permissible triggering events include marriage, divorce, death, and the birth of a child or the sale of an **unmarketable asset**.

2) Examples of impermissible triggering events include the sale of marketable assets and a request from the unitrust recipient or the unitrust recipient's financial advisor that the trust convert to the fixed percentage method.

B. **Unmarketable assets** are defined as assets other than cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents.

1) For example, unmarketable assets include real property, closely-held stock and unregistered securities for which there is no available exemption permitting public sale.

The "flip" must occur at the beginning of the taxable year that immediately follows the taxable year in which the triggering date or event occurs. Any make-up amount described in Section 664(d)(3)(B) is forfeited when the trust flips.

These rules were effective for CRUTs created on or after December 10, 1998. However, existing income exception CRUTs could be reformed to add provisions allowing a conversion to the fixed percentage method provided the triggering event did not occur in a year prior to the year in which the court issued an order reforming the trust. Adding the conversion provisions did not cause the CRUT to fail to function exclusively as a CRT and was not considered an act of self-dealing if the trustee initiated legal proceedings to reform the trust by June 8, 1999.

vi. Also, the IRS will not allow an allocation of pre-gift appreciation to income. Treas. Reg. § 1.664-3(b)(3). However, permitting pre-gift appreciation to support post-gift payments is not inconsistent with congressional intent.

e. Application of Section 2702 to NIMCRUTS and FLIP-CRUTs

Under Section 2702 an individual's retained interest generally is valued at zero, unless the interest is a "qualified interest" – usually consisting of the right to either an annuity or a unitrust amount. The new Regulations provide that interests in income exception unitrusts (but not straight percentage payout unitrusts or annuity trusts) retained by the donor or any applicable family member will be valued at zero when someone other than the donor or his or her U.S. spouse or both of them is a non-charitable beneficiary of the trust unless the interest of a donor follows the interest of the other person. Treas. Reg. § 25.2701-1(c)(3).

f. Guidance

Prior to 2005, the IRS provided guidance in the form of illustrated forms. In 2005, the IRS issued eight Revenue Procedures which provide sample forms for charitable remainder annuity trusts. The current Revenue Procedures replace and revoke the earlier guidance. In 2005, the IRS issued eight Revenue Procedures that provided sample forms for charitable remainder unitrusts in factual situations similar to sample forms provided earlier for CRATs. Rev. Proc. 2005-52-59. Each Revenue Procedure is structured in six Sections. After providing a statement of purpose, general background material and statements of scope and objective, each Revenue Procedure provides a basic sample form, annotations to the form and then alternate provisions to the basic form. The factual situations addressed are:

i. Inter-vivos CRUTs for one measuring life – Rev. Proc. 2005-52.

ii. Inter-vivos CRUT for a term of years – Rev. Proc. 2005-53.

iii. Inter-vivos CRUT with consecutive interests for two measuring lives – Rev. Proc. 2005-54.

iv. Inter-vivos CRUT for concurrent and consecutive interests for two measuring lives – Rev. Proc. 2005-55.

v. Testamentary CRUT for one measuring life – Rev. Proc. 2005-56.

vi. Testamentary CRUT for a term of years – Rev. Proc. 2005-57.

vii. Testamentary CRUT with consecutive interests for two measuring lives – Rev. Proc. 2005-58.

viii. Testamentary CRUT with concurrent and consecutive interests for two measuring lives – Rev. Proc. 2005-59.

g. If the donor contributes residential property to a unitrust, continued occupancy by the donor will be treated as retaining an interest other than a unitrust interest, and results in a self-dealing violation.

h. Advantages and Disadvantages

i. This form of charitable trust is most beneficial for a grantor with appreciated property who may intend to make a significant bequest upon death, but who wishes to use the income during his or her lifetime.

ii. When the IRS's assumed valuation tables on discount rates exceed the actual rates of return on the unitrust assets, the trust's charitable remainder tends to be over-valued.

iii. A stream of benefits can be set up for the non-charitable recipients other than the grantor.

iv. The corpus cannot be invaded on a discretionary basis to meet unanticipated future needs.

v. CRUTs have the potential for loss of family wealth if actual returns are less than IRS assumed returns.

4. Planning Hints for Charitable Remainder Trusts

a. Careful Selection of Investments

If the income recipient is in a high-income tax bracket, the charitable trust can invest largely in tax-exempt bonds, generating little income tax liability for the grantor/beneficiary. However, care is required to assure compliance with applicable fiduciary standards (since the exempt bonds are held for the convenience of the current beneficiary, which could be viewed as being at the expense of the charitable remainderman). Also, note that tax-exempt bond income will not be deemed distributed to the beneficiary until all capital gain and ordinary income, from all years, has been distributed.

b. As a Redemption Device

When an owner of closely held stock wants to make a charitable gift and wants the stock redeemed (so-called "charitable bailout"), a remainder trust can be an appealing device. Attention must be given to the private foundation rules.

i. Deduction of the gift of appreciated stock to the trust is subject to the 30% limitation (unless a 100% reduction in capital gain is elected).

ii. A five-year carryover is allowed on excess deductions.

iii. The trust is a tax-exempt organization and pays no capital gain on the redemption (or ordinary income on a partial redemption).

iv. Under Revenue Ruling 78-197, 1978-1 C.B. 83 and *Palmer v. C.I.R.*, 62 T.C. 684 (1974), *aff'd on other issues*, 523 F.2d 1308 (8th Cir. 1975), if the donee is not legally bound to surrender the shares for the redemption and cannot be compelled to submit them to the corporation, the gain is not imputed to the shareholder grantor. *But see Blake v. C.I.R.*, 42 T.C.M. 1336, *aff'd*, 697 F.2d 473 (2nd Cir. 1982), (gift of stock plus charity's redemption plus purchase of yacht from donor equals sale of stock and gift of yacht).

v. Any portion of the distribution not properly charged to the capital account reduces corporate earnings and profits. IRC § 312.

vi. For a roadmap for avoiding self-dealing violations on such a redemption, see Private Letter Ruling 1997-34015 and 1997-19039, both of which apply the exceptions in Section 4941(d)(2)(F) and Treasury Regulation Section 53.4941(d)-3(d).

vii. A charitable remainder trust can be terminated before its term expires with the consent of the private beneficiaries and the charitable beneficiary. The trust's assets can be sold, the values of the respective interests can be commuted, and the trust assets distributed accordingly. The IRS has characterized a termination on such a basis as a sale by the private beneficiaries to the charity of their life interests in exchange for lump-sum cash payments. The private beneficiaries recognized gain as ordinary income and their basis in the life estates was ignored. Priv. Ltr. Rul. 1989-48023.

5. Charitable Remainder in a Qualified Terminable Interest Property ("QTIP") Trust

Since any remainder beneficiary may be designated for a QTIP, it is possible for a surviving spouse to receive an income interest (possibly with principal invasion powers) with the remainder being dedicated to charity.

a. Result: Pursuant to Section 2056, the full amount of the trust principal is deductible (as a marital deduction) when the decedent dies, and when the surviving spouse dies there is no estate tax because the transfer of the remainder qualifies for charitable deduction under Section 2055.

b. Advantages over a charitable remainder trust include:

i. Spouse gets all income, not limited by fixed formula amount; and

ii. Spouse (or trustee) can hold invasion powers over the principal of the trust.

c. Disadvantages relative to a charitable remainder trust:

i. No income tax deduction for lifetime QTIP with a charitable remainder. IRC § 170(f)(2)(A).

ii. With a QTIP, all income must be distributed to the surviving spouse at least annually. With a unitrust or annuity trust, only the payments required under the trust must be made to the spouse. If there is excess income beyond the payment requirements, it is not subject to tax given the trust is tax exempt, and the accumulation may, in the future, benefit the non-charitable beneficiary and/or the charitable remainder beneficiary.

6. Tax Consequences to Early Termination of Charitable Remainder Trust

a. Private Letter Ruling 2004-41024 addressed the early termination of a CRUT designed to operate for a twenty-year term. The trustees filed a petition in state court seeking approval for the trust's early termination, and the attorney general had no objections. Upon the termination of the trust, the trustees planned to distribute the actuarial value of its unitrust interest to be determined using the discount rate in effect under Section 7520 on the date of termination and using the methodology under Section 1.664-4 of the Income Tax Regulations for valuing interests in a CRUT. The balance of the trust estate would be distributed to the charitable remainder beneficiary.

b. The IRS concluded, subject to court approval of the early termination that:

i. The proposed early termination of the trust and the distribution of the trust's property to annuitant and the charitable beneficiary in proportion to the present value of their respective interests would not constitute a termination of a private foundation under Section 507;

ii. The proposed early termination and distribution would not be an act of self-dealing under Section 4941;

iii. The proposed early termination and distribution would not be a taxable expenditure under Section 4945; and

iv. The entire amount realized by the annuitant as a result of the early termination of the trust would be long-term capital gain.

7. Division of Charitable Remainder Trust Incident to Divorce

In Private Letter Ruling 2005-02037 the IRS was asked to rule with respect to a CRUT created by a husband that provided an annuity to him for his life and then to his wife for hers, if she survived him. Incident to divorce, the couple proposed to divide the CRUT in two with each spouse as the sole non-charitable beneficiary of one of the successor CRUTs. All other terms of the original CRUT would carryover. On the facts, the IRS ruled:

a. The division would not cause any of the trusts to fail to qualify as a CRUT under Section 664.

b. While *Cottage Savings* would result in gain or loss recognition, given that the spouses would "enjoy legal entitlements that are materially different in kind or extent from those enjoyed prior to the division," Section 1041(a) applies to defer the recognition, given the division is "incident to the divorce."

c. The successor trusts could tack their holding periods to the holding periods of the original CRUT.

d. The division would not be an act of self-dealing or taxable expenditure under Sections 4941 or 4945. *See also* Priv. Ltr. Rul. 2005-39-058.

8. Pooled Income Funds

Pooled income funds are like charitable remainder trusts in most respects; however, they are maintained by the charities themselves, commingling contributions and giving the donors a percentage of the total trust shares. If contributions to the fund are to qualify for income tax deductions, the fund must qualify under Section 642(c)(5).

a. To qualify, the fund must meet the following conditions:

i. The donor must retain a life income interest for himself or herself or for one or more non-charitable beneficiaries who are alive and ascertainable at the time of the contribution. In Pooled Income Funds, a term of years is not permitted.

ii. All property of the donors must be commingled.

iii. Neither the donor nor a non-charitable beneficiary may serve as a fiduciary.

iv. The fund cannot receive or invest in tax-exempt income producing securities.

v. For each year in which a non-charitable beneficiary is entitled to receive income, he or she must receive an amount determined by the fund's rate of return for that year.

vi. On termination of the life interest, the remainder interest must be separated from the fund and paid to or retained for the charity's use.

vii. There must be an irrevocable remainder to a public charity as described in Sections 170(b)(1)(A)(i) through (vi).

viii. The fund must be maintained or controlled by the charity to which the remainder interests are contributed. Despite this requirement (Section 642(c)(5)(E)), the IRS has approved a pooled income fund created by a community foundation where the donor can require that the remainder pass as an unrestricted contribution to a designated fund maintained by the community foundation for a specific supported charity in the community. Rev. Rul. 96-38, 1996-1 CB 44.

b. Pooled income funds are cheaper for the donor since, generally, there are no legal fees associated with the gift. Some larger charities have several pooled income funds, so the client can choose the character of income (other than tax-exempt) he or she wants.

c. Calculation of Value of Remainder Interest

i. Life of one beneficiary. Treas. Reg. § 1.642(c)-(6)(e)(6), Table S.

ii. Lives of two beneficiaries. IRS Pub. No. 723D, Table G (2).

iii. Examples of remainder interest value calculations. IRS Publication 1457, Actuarial Values – Book Aleph.

iv. Actuarial Valuation Tables. IRS Publication 1458, Actuarial Values – Book Beth.

v. The rate of return for transfers made to pooled income funds in existence for less than three taxable years is deemed to be 1% less than the highest annual average of the IRC § 7520 rates for the three calendar years preceding the year of the transfer, recomputed annually until the pooled income fund has been in existence for three years. Treas. Reg. § 1.642(c)-6(e)(4).

d. Income Tax Treatment of the Trust

i. Trust is taxable –

A. Deduction allowed for income distributions. IRC § 661.

B. Deduction allowed for long-term capital gain set aside for charitable remainderman. IRC § 642(c)(4).

C. Leaving only short-term capital gains, if any, subject to tax.

ii. Special characteristics to be observed to maintain status.

A. No investment in tax-exempt securities is allowed. IRC § 642(c)(5)(C).

B. Trust must be maintained by the public charity remainderman. IRC § 642(c)(5)(E).

iii. Minimum tax for excess itemized deductions is not applicable.

e. Application of private foundation rules to the trust is the same as in the case of charitable remainder trusts, but control by the remainder beneficiary makes violations unlikely.

f. For sample pooled income fund provisions see Revenue Procedure 88-53, 1988-2 C.B. 712.

g. Advantages and Disadvantages of Pooled Income Funds

i. Because a charitable deduction is allowable for the present value of the remainder interest payable to charity and because there is no charitable deduction for amounts paid to an income beneficiary, pooled income funds are not subject to the prohibitions on excess business holdings or jeopardy investments. IRC § 4947(b)(3)(B).

ii. When appreciated property is gifted to a pooled income fund, the donor obtains an immediate tax deduction, avoids the immediate payment of income tax on capital gains generated upon the sale of the property, and recognizes an increase in the cash flow for himself or herself or for other non-charitable beneficiaries.

iii. The corpus cannot be invaded on a discretionary basis to meet unanticipated future needs.

iv. There is a potential for loss of family wealth if actual returns are less than IRS assumed returns.

v. The Donor does not get to select the trustee, and thus the investment strategy cannot be fine-tuned to the needs of the individual donor.

9. Non-Trust Income Vehicle - The Charitable Gift Annuity

a. Many charitable planners turn automatically to the charitable remainder trust when a client's needs dictate the use of a gift vehicle that will produce an income stream for one or more individual beneficiaries. There is one such vehicle, however, the charitable gift annuity, that does not use a trust, and hence may be preferable in some situations. Possible advantages vary with the facts, but may include avoidance of the Chapter 42 private foundation penalty taxes and possible reduced expenses.

b. A charitable gift annuity is a contractual arrangement between a donor and a charity; the donor transfers cash or property to a charity in exchange for the charity's promise to pay the donor (or another designated annuitant) an annuity for life.

i. The value of the annuity stream is less than the amount transferred to the charity, and the excess is a deductible charitable gift.

ii. The annuity may be made payable immediately or may be deferred for one year or more from the date of transfer.

A. A deferred payment annuity provides for tax-free compounding of the amount transferred until payment begins. Thus, the annuitant's payments and the donor's initial deduction are both somewhat larger.

Note: that this is the only income vehicle that permits the beneficiary's income stream to begin at some future date (i.e., a deferred annuity).

c. No specific code provision governs gift annuities, and they are not subject to the private foundation rules.

i. Because they are part-gift part-sale transactions, Section 1011(b) requires that, in computing any capital gain realized, the donor must allocate his or her basis in any property transferred to the donee. *See* Treas. Reg. § 1.1011-2.

ii. Also, a survivorship interest in a spouse will qualify for the marital deduction if no benefits are provided to persons other than the spouse. *See* Treas. Reg. § 20.2056(b)-1(g), Example 3.

D. Charitable Lead Trust

1. Opportunities

a. Opportunities for Private Wealth Planning

Many planners are familiar with the Charitable Lead Trust as a device for avoiding or reducing transfer taxes on large transfers. Currently, the device is useful to reduce or eliminate gift tax exposure for inter-vivos gifting and to reduce estate tax exposure for death time gifting. Similar advantages apply to the generation-skipping transfer ("GST") tax for both inter-vivos and death time transfers. Since the 2001 Tax Act, the ability to reduce gift taxes has become a greater focal point for many clients and, as a result, the utility of the CLT has enjoyed a renaissance.

b. Opportunities for Charities

Every charity runs the risk of missing an opportunity to present the non-tax "case" to its constituency at a time when virtually every person of means has or will review his or her estate plan and consider revisions to existing plans. In the long run, this may serve to refocus a charity's planned giving outreach on its mission rather than exclusively on its ability to provide tax benefits to the donor.

c. Some Preliminary Thoughts

i. The testamentary CLT traditionally has been used as a means of reducing or eliminating estate taxes.

ii. As clients take into account whatever revised federal transfer tax will apply to them, they will be inclined to review and update their estate plans. While the estate tax and the GST tax may cease to be a major factor for many, gift taxes and the transfer of assets to younger family members during life are still a compelling estate planning objective. This has put a premium on gift tax savings and the CLT is (and will remain) a classic means of achieving such savings.

iii. Similarly, the increased GST tax exemption has encouraged some clients to create generation-skipping arrangements. CLTs offer an attractive alternative means of structuring such generation skipping.

iv. The CLT presents a number of useful applications apart from transfer tax savings:

A. As a vehicle for charitable contributions by persons who face disallowance of deductions for personal contributions due to the individual percentage limitations;

B. As a private foundation substitute to fund family charitable giving for a set period; and

C. As a means of facilitating family transfers of real estate and business assets.

d. General Planning Considerations

i. The principal tax advantage of a Qualified Non-Grantor CLT is the possibility to leverage the donor's available gift tax or estate tax applicable exclusion amounts and/or GST exemption amount. With caution this can be done with assets which are in a structure that provides favorable valuations for transfer tax purposes.

ii. In larger estates where there will be a large estate tax deferral through the use of the unlimited marital deduction when the first spouse dies, the creation of a testamentary lead trust at the death of the surviving spouse is a good way to eliminate taxes upon the second death. This may be done in the documents of the first spouse to die by providing a QTIP trust for the surviving spouse followed by a CLT.

iii. Often planners stagger the termination dates for a series of CLTs to provide varying amounts of money to the beneficiaries at various points in time. For example, a planner might establish three CLTs, one to end after five years, another after eight years and another after ten years. The brevity of the shorter terms may preclude a gift or estate tax deduction equal to 100% of the value of the contributed property but should still allow a significant reduction in transfer tax.

iv. Generally, it is better to use a CLT than a marital trust for deferral if there is a strong likelihood of substantial appreciation. With a marital trust the appreciation will be subject to estate tax when the surviving spouse dies while the appreciation in a CLT will drop down a generation (assuming proper selection of remainder beneficiaries).

e. Basic Illustration of Tax Advantages

If a donor contributed four million dollars on November 1, 2021 to a Charitable Lead Annuity Trust paying an annuity of 7.212% ($288,494/year) for a term of fifteen years, the taxable portion of the transaction (gift tax) would be $0.00 (at the October 2021 Section 7520 rate of 1.0%). Presuming that, net after taxes, the corpus grows by 5% each year, approximately $2,090,000 will pass to the donor's private beneficiaries at the end of the 15-year term, free of any additional gift tax. If the growth is 7%, the remainder will increase to approximately $3,786,550. More importantly, during the same fifteen-year period, $4,327,412 will have been paid to the donor's intended charities.

Even if we used a more historically "normal" Section 7520 rate, i.e. 4%, with the same gift ($4 million) and the same fifteen-year term, a "zeroed out" CLAT would provide $5,396,460 million to the intended charities over the term and $552,522 or $1,995,609 million will pass to the private beneficiaries at net growth rates of 5% and 7%, respectively.

2. Charitable Lead Trusts – The Fundamentals

a. A Working Definition

i. Conceptually, a CLT is the reverse of a Charitable Remainder Trust. With a CLT, a fixed or variable annuity is paid to charity for a determinable period which may be measured by a term of years or by reference to the life of one or more individuals; the remainder passes outright or in trust to one or more non-charitable beneficiaries.

A. The charity should qualify under the applicable Sections of the Code, Sections 170, 2055 and 2522, which govern the type of deduction associated with the creation of the charitable lead trust.

ii. The remainder beneficiary can be one or more individuals, partnerships, corporations, estates or trusts. CLTs have been one of the more valuable planning structures available for wealthier individuals who wish to give to charity but also want to provide for the continued affluence of designated family members.

iii. Two separate gifts are made when the CLT is created: a gift of a current interest to one or more charitable beneficiaries; and a gift of the remainder interest to one or more non-charitable beneficiaries. The donor is liable for gift or estate tax on the present value of the non-charitable remainder interest.

iv. The principal tax advantage to a CLT lies in the transfer tax deduction for the present value of the charitable interest. The CLT has been used most appropriately in situations where the donor and his or her family have no immediate need for all of the income that they currently enjoy and are willing to forego some current benefit in exchange for the prospect of long-term capital appreciation.

v. The trust property and any appreciation on that property are removed from the donor's estate, unless the donor retains any powers that could lead to its inclusion in his or her estate under Sections 2036 or 2038 of the Code.

vi. The donor must designate the charitable beneficiary when the trust is created (or provide a method for designating the charity that is beyond his or her legal control). Unless great care is taken with the wording and structure of the charitable benefit, a donor should not designate a private foundation of which he or she is a trustee as the charitable beneficiary of a CLT created by that donor.

vii. The term of the lead interest can be measured in a variety of ways:

A. In years;

B. By the life or lives of individuals living when the CLT is created;

C. A measuring life plus a term of years; or even

D. By the shorter of a term of years or a measuring life plus a term of years.

Treas. Reg. §§ 1.170A-6(c)(2); 20.2055-2(e)(2); 25.2522(c)-3(c)(2) and Rev. Rul. 85-49, 1985-1 C.B. 330. See Ltr. Rul. 1997-21006.

The core requirement is that the term is ascertainable when the CLT is created.

b. *Cautionary Note*: There are two basic varieties of qualified CLTs: those created inter-vivos or at death that are treated as separate taxpayers (often referred to as Qualified Non-Grantor CLTs) and those created inter vivos where the grantor is treated as the owner of the CLT's income for income tax purposes (often referred to as Qualified Grantor CLTs). Another variation is a Non-Qualified Non-Grantor CLT created during life. These materials first address only Qualified Non-Grantor CLTs. Qualified Grantor CLTs and Non-Qualified Non-Grantor CLTs are discussed in Section D.7. of this outline.

c. Qualified CLTs

A Qualified CLT is a trust that meets the various statutory definitions that qualify a donor's transfer to the CLT for one or more tax deductions. IRC §§ 170(f)(2), 2055(e)(2)(B), 2522(c)(2)(B). To be Qualified, the CLT must pay the charitable lead interest in the form of a fixed annuity or unitrust amount. The CLT need not specify a particular charitable recipient; this designation can be left to the trustees and can be changed by the trustees from year to year. Ltr. Ruls. 2000-43029; 1997-48009; 1993-31015; 1980-51159.

d. Charitable Lead Annuity Trust

A charitable lead annuity trust is an irrevocable trust under which a sum certain is to be distributed periodically to one or more charitable beneficiaries not less often than annually for a term of years or during the life or lives of one or more individuals who are living when the trust is created. The principal of the trust must be used to satisfy the annuity if trust income is insufficient. So long as the annuity payments are determinable when the CLT is created, provision can be made to vary them. Treas. Reg. §§ 1.170A-6(c)(2)(i); 20.2055-2(e)(2)(vi) and 25.2522(c)-3(c)(2)(vi).

Unlike the rules governing charitable remainder annuity trusts there is no explicit prohibition against making additional contributions to a charitable lead annuity trust. But see Ltr. Rul. 1993-04020. However, such contributions do not generate additional estate or gift tax deductions because the amount of the annual guaranteed annuity payment must be determinable at the inception of the trust. Treas. Reg. §§ 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi)(a) and 25.2522(c)-3(c)(2)(vi)(a). Furthermore, it is unclear how the annuity amount would be adjusted to take such additions into account. Accordingly, most planners have assumed that such additions must be prohibited and that separate trusts must be created to hold such assets. See Ltr. Ruls. 1980-34093 and 1980-21095.

e. Charitable Lead Unitrust

A charitable lead unitrust is an irrevocable trust under which a fixed percentage of the net fair market value of its assets (valued annually) is to be distributed not less often than annually to one or more charitable beneficiaries for a term of years or during the life or lives of one or more individuals who are living when the trust is created. Corpus must be used to satisfy the unitrust amount if income is insufficient. Unlike charitable remainder unitrusts, a net income limitation is not available. Rev. Rul. 77-300, 1977-2 C.B. 352; Ltr. Rul. 1979-18102. Further, the trust instrument may not provide for the percentage to vary over the term of the CLT. Treas. Reg. §§ 1.170A-6(c)(2)(ii)(A), 20.2055-2(e)(2)(vii)(a) and 25.2522(c)-3(c)(2)(vii)(a).

In computing fair market value of the trust, all assets and liabilities are taken into consideration without regard to whether particular items also are taken into account in determining trust income. The same valuation date and method should be used each year. If these details are not specified in the trust, the trustee must select the date and method on the first income tax return that the trust is required to file. Treas. Reg. §§ 1.170A-6(c)(2)(ii), 20.2055-2(e)(2)(vii), 25.2522(c)-3(c)(2)(vii).

There is no specific prohibition against additional contributions being made to charitable lead unitrusts. The IRS has ruled that a provision that allows additional contributions to be made would not disqualify the trust: in fact, a gift tax deduction may be allowable for such contributions. *See* Priv. Ltr. Rul. 1980-52068 and 1980-43077. However, these are only private letter rulings and should not be relied upon as precedent.

f. Additional Considerations

i. There is no minimum or maximum payout requirement and no limitation on the number of years that the annuity can be paid to charity. IRC § 170(f)(2)(B); Treas. Reg. § 1.170A-6(c)(2)(i)(A).

ii. The trust remainder is distributed to or held for the benefit of the donor's non-charitable beneficiaries.

iii. A clause that "saves" the trust from violating any applicable rule against perpetuities will not disqualify the trust, even if the trust's term is shortened as a result. Ltr. Ruls. 1981-04213 and 1997-21006.

A. However, a charitable lead interest will not qualify as a guaranteed annuity interest if the trustee has the discretion to commute and prepay the charitable interest prior to the expiration of the specified annuity term. *Crown Income Charitable Fund v. C.I.R.*, 98 T.C. 327 (1992) *aff'd*, 8 F.3d 571 (7th Cir. 1993); *see also* Rev. Rul. 88-27, 1988-1 C.B. 331; Priv. Ltr. Rul. 97-34057.

iv. In general, no amounts may be paid for private purposes from the charitable lead annuity trust until the expiration of the charitable annuity term. Treas. Reg. §§ 1.170A-6(c)(2)(i)(E), 1.170A-6(c)(2)(ii)(D).

A. However, in light of the Tax Court's decision in *Boeshore Estate v. C.I.R.*, 78 T.C. 523 (1982), the IRS issued final regulations that acknowledge a non-charitable interest in the form of qualifying annuity or unitrust interest can precede a charitable lead interest. T.D. 9068 (July 7, 2003).

g. Reformation

The transfer of a partial interest to a charity generally will not qualify for a deduction (unless the trust interest is a qualified annuity or unitrust interest) even if the non-charitable trust interests are clearly separable. Rev. Rul. 77-97, 1977-1 C.B. 285. The Tax Reform Act of 1984 included permanent "reformation" rules which permit the amendment of certain charitable trusts which otherwise would not qualify for a charitable contribution deduction. IRC §§ 170(f)(7), 2055(e)(3) and 2522(c)(4). To be eligible for this relief the non-qualifying interest must be "reformable" as defined in the statute. As a matter of practice a provision often is included in CLTs which authorizes the trustee to amend the trust to assure it is and remains a qualified CLT.

3. Tax Consequences to the Donor

a. Lifetime Transfers

i. For income tax purposes, generally no immediate deductions are available and the CLT is treated as a taxpayer separate and apart from the donor. IRC § 170(f)(2)(B); Treas. Reg. § 1.170A-6(c). A current income tax deduction is allowable only if the donor is treated as the owner of the property. If the trust is a Qualified Grantor CLT, all items of income, deduction and credit of the CLT are attributed to the grantor. IRC §§ 671-678.

ii. For gift tax purposes, a deduction is allowable based on the present value of the charitable interest. IRC § 2522(c)(2)(B). The remainder interest does not qualify for a gift tax per donee exclusion. For the gift tax to apply the gift must be complete. If the donor retains the power, directly or indirectly, to affect the charitable recipient the gift is incomplete. Treas. Reg. § 25.2511-2(b) and (c). It appears the donor may be an officer or director of a charitable recipient. Priv. Ltr. Rul. 1981-30033. However, the governing documents of the charity should include provisions that prevent the donor from having control over the property received from the CLT he or she created. *See* Priv. Ltr. Rul. 2001-38018, 2001-08032, 2000-30014. Payment to a donor advised fund operated by the charitable recipient may require additional attention. Priv. Ltr. Rul. 2000-10036, 2000-09048. Similar attention will be required if the payments are made to a private foundation which the donor or the donor's family controls.

b. Testamentary Transfers

i. An estate tax charitable contribution is allowable for the value of the charitable interest. IRC § 2055(e)(2)(B).

ii. However, if a grantor retains a reversionary interest in a lifetime CLT which exceeds 5% of the corpus and dies during the term of the trust, a portion of the value of the CLT will be included in the grantor's estate. IRC § 2037.

c. Valuing the Charitable Interest

i. The present value of an annuity is determined by multiplying the amount of the annuity by factors which are dependent on the applicable rate under Section 7520. *See* IRS Pub. No. 1457.

ii. The present value of a unitrust interest is determined by subtracting the present value of the remainder interest from the value of the property contributed to the CLT. Treas. Reg. §§ 1.170A-6(c)(3), 20.2055-2(f)(2), 25.2522(c)-3(d)(2).

d. Generation-Skipping Transfer Tax

Congress rewrote the GST rules in the Tax Reform Act of 1986. See IRC §§ 2601, et. seq. Subject to a complicated set of exceptions and exemptions, GSTs are taxed at the top marginal estate tax rate in effect at the time of the transfer. *See* IRC §§ 2601, 2602 and 2641.

i. A GST generally occurs when property is transferred to or for the benefit of a "skip person" or when an intervening interest in property terminates in favor of a skip person. A "skip person" is a person who is more than one generation younger than the transferor of the property (e.g., grandchildren or more remote lineal descendants) or a trust for the benefit of such person(s). IRC §§ 2613(a), 2651. A "non-skip person" is any person who is not a skip person. IRC § 2613(b).

ii. A CLT and its charitable beneficiaries are non-skip persons. IRC § 2651(f)(3). Therefore, neither the creation of a CLT nor distributions to its charitable beneficiaries will result in any GST tax consequences.

iii. However, upon termination of the charitable interests in a CLT, a GST tax might be imposed if the remainder beneficiaries are "skip persons" in relation to the donor of the CLT. For example, if the donor of a CLT creates a remainder interest in favor of his grandchildren, a GST tax might be imposed upon the termination of the charitable lead interest. Although a GST exemption may be available to shield part or all of the remainder interest from GST tax, every donor must consider the potential impact of the GST tax (for example, a skip person may succeed to the trust remainder if a primary non-skip remainderman dies before the charitable interest expires). While the so-called "predeceased parent" rule under IRC § 2651(e)(1) provides some relief in the event a parent predeceases his or her own child, this provision only applies if the parent was deceased at the time property was transferred to the trust.

iv. In general, GST tax is paid from the remainder interest. IRC § 2603(b)(2).

v. All individuals are granted a GST exemption, which may be allocated to lifetime and/or testamentary transfers to shield all or part of such transfers from GST tax. IRC § 2631. Allocation of the donor's GST exemption to a charitable lead unitrust that will result in GSTs (where the remainder passes to grandchildren) is relatively simple: to avoid future GST tax, the donor may allocate (on a timely filed gift or estate tax return) that portion of his or her GST exemption which is equal to the value of his or her taxable transfer(s) to skip persons, using the valuation factors provided by the IRS in effect as of the date the unitrust is created. IRC § 2642(b).

vi. The effect of allocating a portion of the donor's GST exemption upon creation of a charitable lead annuity trust cannot be determined until termination of the charitable lead interest using an "adjusted GST exemption" formula. IRC § 2642(e). The formula "adjusts" the donor's initially allocated GST exemption to a projected future value as of the date the charitable lead interest actually expires, using the discount rate applied under the valuation methods provided by the IRS in effect at the time the trust was created.

A. The amount of GST exemption a donor should allocate to a charitable lead annuity trust is based upon

1) The term and payout rate of the charitable lead interest;

2) The projected rate of return on trust property (i.e., the donor's best estimate of the future value of the trust when the charitable lead interest expires); and

3) The discount rate provided by the IRS in effect when the trust is created.

4. Taxation of Trust and Its Beneficiaries

a. The CLT

i. The trust is taxed as a complex trust. IRC § 661.

ii. Any trust income in excess of the income tax deduction allowable with respect to the charitable payout is taxed to the trust. The trust receives an unlimited charitable income tax deduction for items of gross income that, pursuant to the terms of the governing instrument, are paid during the taxable year to a qualified charity. IRC § 642(c)(1).

A. The deduction is not limited by percentage limitations applicable to individuals. However, the CLT's charitable deduction is reduced by any unrelated business income realized by the CLT during the year to the extent the UBI exceeds the percentage limitations attributable to individuals under Section 170(b)(1)(A). IRC §§ 681 and 512(b)(11).

B. The deduction is limited to the extent capital gains or tax-exempt income is deemed distributed. Therefore, the governing instrument should provide for a hierarchy of sources of payments to maximize the income tax benefits of the charitable payouts, for example, by providing for distributions first from ordinary income (including short-term capital gains), next from capital gains, then unrelated business income, then tax-exempt income, with principal last. Rev. Rul. 71-285, 1971-2 C.B. 248. The IRS has interpreted the controlling regulations to require pro rata allocations in the absence of economic substance. GCM 39161; Priv. Ltr. Rul. 1999-08002.

C. To ensure that the income taxable to the trust receives the benefit of any depletion and depreciation deductions, the trust instrument should allocate these deductions to the trust; if such an allocation is not made, those deductions will follow the income distributed to the charity and will be lost.

iii. The CLT is subject to estimated tax payments. IRC § 6654(l).

iv. In general, the taxable year of a trust is the calendar year. IRC § 644. There is an exception for wholly charitable trusts exempt from taxation under Section 501(a). IRC § 644(b). However, CLTs are not described in Section 501(a) and thus report on a calendar year basis.

v. The income of a CLT is reported on Forms 1041, 1041-A and 5227 and a Schedule K-1 is provided to the charitable beneficiary. The returns are filed on or before April 15th of the year following the year with respect to which the returns are filed.

vi. In order to avoid forced sales or adverse tax consequences to the trust, plans should be made for the trust to realize a sufficient level of cash flow to satisfy the regular payment of the annuity or unitrust interest. If there is insufficient cash to satisfy a given annuity or unitrust interest the sale or distribution of appreciated property will result in the CLT realizing capital gain. Borrowing may be a more favorable short-term alternative. However, borrowing is not a long-term solution economically, and the trustee must be careful to avoid creating unrelated business income. Treas. Reg. § 1.514(c)-1(a)(1)(iii).

b. The Charitable Beneficiary

The tax characterization of what the charitable beneficiary receives can be determined by the terms of the CLT. In the absence of direction in the governing instrument, the Code allocates Distributable Net Income ratably. To the extent possible, a draftsperson will want to allocate items taxed at higher rates to the charitable beneficiaries. Similarly, a draftsperson should consider allocating expenses to income. *But see* Rev. Rul. 74-19, 1974-1 C.B. 155.

c. Income Taxation of the Non-Charitable Beneficiary

The non-charitable remainder beneficiary generally is not taxed during the ongoing term of the CLT.

5. IRS Guidance

a. In 2007 the IRS issued two Revenue Procedures designed to illustrate the proper design of inter vivos and testamentary charitable lead annuity trusts, Revenue Procedures 2007-45 and 2007-46.

b. In 2008 the IRS issued two Revenue Procedures, Revenue Procedure 2008-45 and 2008-46, respectively, designed to illustrate the proper design of inter vivos and testamentary charitable lead unitrusts. The distinguishing feature between the two sets of Revenue Procedures is in how the charitable payments are generally described, defined, and explained.

c. Each Revenue Procedure includes a Section describing the scope of the guidance. Like previous guidance with respect to charitable remainder trusts, this guidance includes sample forms, annotations to the forms and alternative provisions. Taxpayers can generally rely on these forms, assuming they are used without major alternation.

d. Despite any reservations one may have about using a sample trust form supplied by the IRS, these forms are quite helpful and complete. However, like any forms, they must be reviewed carefully and adjusted for applicable local law.

e. Under the guidance, the IRS will recognize a charitable lead trust as qualified if three tests are met:

i. The trust is "substantially similar" to the sample forms (or properly integrates one or more of the alternative provisions provided into a document "substantially similar to the sample trust");

ii. The trust is a valid trust under local applicable law; and

iii. The trust "operates in a manner consistent with the terms of the instrument …" creating the trust.

The IRS acknowledges that it is acceptable for the drafter to vary trust wording from the IRS version to comport with local law and practice as necessary to create trusts, define legal relationships, etc. A trust that is not substantially similar merely loses the automatic qualification of the Revenue Procedures; it does NOT necessarily lose its qualification under the Code and Regulations.

f. Thus, there are two levels of qualification to keep in mind in drafting charitable lead annuity trusts:

i. Trusts that conform to the IRS sample trusts will automatically be considered qualified.

ii. A trust that varies from the IRS samples may still be qualified, and private letter rulings will "generally" be issued only on the effect of substantive provisions other than those provided in the Revenue Procedure.

6. Advanced Considerations - Private Foundation Rules

a. Application of the Private Foundation Rules

The CLT is considered to be a private foundation for purposes of certain restrictions placed on such organizations. IRC §§ 508(d)(2), 4947(a)(2). Thus, the trust can be subject to the taxes on self-dealings (§ 4941), excess business holdings (§ 4943), investments jeopardizing charitable purposes (§ 4944), and taxable expenditures (§ 4945). The private foundation limitations may apply automatically to the trust under state law but, if not, the limitations must be spelled out in the governing trust instrument. *See* Rev. Rul. 75-38, 1975-1 C.B. 161; Treas. Reg. § 1.508-3(d).

b. The Penalty Taxes

i. An initial tax is imposed at a relatively low level, followed by a more severe second-level tax which applies if the CLT fails to "correct" the violation which gives rise to the initial liability.

ii. In addition, Section 6684 imposes a penalty equal to the applicable tax if the person liable has previously been liable for a Chapter 42 tax, or if the transgression is both willful and flagrant; the effect is to double the applicable penalty in such cases.

c. Tax on Acts of Self-Dealing (§ 4941)

Self-Dealing can be defined as dealings between the foundation and its substantial contributors, foundation officials and related persons ("disqualified persons).”

i. The prohibition on self-dealing often can create unexpected difficulties.

ii. The prohibition is absolute and, presently, the IRS is without equitable authority to excuse harmless violations.

A. Examples of prohibited transactions include the selling or leasing of property or making of loans between the foundation and a disqualified person.

B. The IRS has issued several letter rulings denoting relationships which will not violate this prohibition. *See* Priv. Ltr. Rul. 1994-25004, 1994-02026, 1987-43085.

C. The IRS also has noted instances when a relationship will constitute self-dealing. *See* Priv. Ltr. Rul. 1994-38045.

d. Tax on Excess Business Holdings (§ 4943)

i. The prohibition on excess business holdings is designed to restrict involvement in the ownership and operation of businesses. While this prohibition may be simple in concept, Section 4943 is an intricate and complex statute.

ii. Generally, holdings are excessive if disqualified persons own 20% (35% where a third party has effective control) or more of the voting stock of incorporated business and the CLT owns more than 2%.

A. The CLT has five years within which to dispose of excess holdings, absent an extension of up to five additional years which can be granted for good cause shown. IRC § 4943(c)(7).

Nevertheless, caution is advised when funding a CLT with interests in a closely held business. As a practical matter, the gifting of low basis interests in closely-held businesses is generally inadvisable because the sale of such interests will ultimately be taxable, either to the CLT itself (in the case of a non-Grantor CLT) or to the donor personally (in the case of a Grantor CLT).

e. Tax on Investments Jeopardizing a Foundations Exempt Purpose (§ 4944)

No investment is per se a jeopardy investment; however, by regulation, several categories of investments are suggested for careful examination. Treas. Reg. § 53.4944-1(a)(2).

f. Taxable Expenditures (§ 4945)

i. The provision prohibits expenditures for:

A. Lobbying and propagandizing;

B. Influencing elections or conducting voter education; and

C. Making grants to certain individuals (unless approved by the IRS in advance). This provision also discourages grants to organizations other than public charities unless the trustees of the CLT monitor grantees' use of distributions and making grants for non-charitable purposes.

g. The 60% Exception

While the taxes on acts of self-dealing and taxable expenditures will apply in all events, the taxes on excess business holdings and jeopardizing investments do not apply if, at inception, the value of the charitable "income interest" is 60% or less of the initial value of the entire trust property. IRC § 4947(b)(3). The regulations define "income interest" to include a guaranteed annuity or a unitrust amount.

i. The IRS has ruled that the less than 60% exception is not applicable unless all of the trust's income, even if it exceeds the annuity or unitrust amount, is made payable to charity. Ltr. Rul. 1982-41098. This ruling appears incorrect in light of Treas. Reg. § 53.4947-2(b)(2). Nonetheless, the apparent position of the IRS should be taken into account whenever funding a charitable lead trust with closely held stock or other assets that cannot or will not be sold.

ii. Moreover, in cases where the present value of all charitable income interests (without regard to whether any deduction is allowed) exceeds 60% of the aggregate value of the net assets of the annuity lead trust computed on the date of valuation, the governing instrument of the trust must prohibit not only the acquisition but also the retention of property the acquisition of which would give rise to a tax under Section 4944. Treas. Reg. §§ 1.170A-6(c)(2)(i)(D), 20.2055-2(e)(2)(vi)(e), 25.2522(c)-3(c)(2)(vi)(e).

7. Advanced Planning Considerations – Variations on the Theme

a. The Qualified Grantor CLT

If the grantor would benefit from a current income tax charitable contribution deduction, a CLT can be created that is taxed as owned by the grantor under the grantor trust rules ("Qualified Grantor CLT").

i. There are several ways to cause a trust to be treated as a grantor trust, but most of the rules lead to results antithetical to the requirements for a qualified CLT annuity or unitrust interest.

ii. Applicable Grantor Trust Code Sections

A. Section 673 taxes the grantor on trust income if the grantor has a reversionary interest with value greater than 5% of the value of the trust assets at the time assets are transferred to the trust. The same result is obtained if the reversion is held by the grantor's spouse. IRC § 672(e). Commentators generally conclude retaining a reversion is the preferred way to secure grantor trust treatment for a CLT. However, the use of a reversion to trigger grantor trust status generally requires inclusion of all or part of the trust assets in the grantor's taxable estate at death.

B. Section 674 generally provides that if the grantor or a non-adverse trustee has the power to alter the beneficial enjoyment of the income or remainder interest in a trust, the grantor is taxed on the trust income. However, the retention of these powers could foil the requirement that the CLT's guaranteed annuity or unitrust interest must be irrevocable.

C. Section 675 provides that a grantor will be treated as the owner of a trust if the grantor, individually or as trustee, retains certain administrative powers. The enumerated powers could violate certain private foundation rules, disqualify the charitable interest or result in an incomplete gift of the remainder interest. However, retaining a power to substitute assets may create some planning opportunities for a CLT.

D. Section 676 provides that if the grantor, either alone or in conjunction with a non-adverse party, retains the power to revoke all or a portion of the trust, the income of the trust will be taxed to the grantor. Retention of such a power should disqualify a CLT *ab initio*.

E. Section 677 provides that if the income of the trust, without the approval of any adverse party, can be distributed to the grantor or the grantor's spouse, or accumulated for either of them, the income of the trust will be taxable to the grantor. However, diverting funds would fail the requirement for a guaranteed annuity or unitrust payout. The Section also addresses using trust income to purchase life insurance on the life of the grantor or the grantor's spouse. While this creates some theoretical possibilities, it is not practical.

F. Section 679 applies the grantor trust rules when a U.S. person transfers property to a so-called foreign trust. The Rule is independent of the other rules noted in Sections A through E, above. A foreign trust is created when the trust provides that no U.S. court is able to exercise primary supervision over the trust and no U.S. person has authority to control substantially all of the decisions of the trust. IRC § 7701(a)(30)(E) and (31)(B).

iii. For a checklist of how a CLT can avoid being treated as a grantor trust, see Private Letter Ruling 2005-36013.

iv. An income tax deduction is available for the present value of the qualified annuity or unitrust interest dedicated to charity. The deduction is equal to the present value of all distributions payable to charity. IRC § 170(f)(2)(B).

A. The gift is considered "for the use of" the charity, so the 30% or 20% limits apply. IRC § 170(b)(1)(D)(i).

B. For each year thereafter the grantor will be taxed on all items of income attributable to the trust. Accordingly, the key tax consideration is a comparison of the value of the current deduction versus the deferral of the tax liability during the term of the trust.

C. In theory, the trust could be invested in nontaxable assets so that, while the grantor would be subsequently taxed as the owner of the trust (the income of which he/she would not receive), there would be no net taxable income.

v. If the trust ceases to be a grantor trust due to the grantor's death or otherwise, there is a recapture of the excess deduction taken over the deduction that would have been allowed had the trust term been clearly known. The grantor is treated as having received, as of such date, income equal to the amount of any deduction that was previously allowed less the discounted value of all amounts that were required to be, and actually were, paid to charitable beneficiaries. IRC § 170(f)(2)(B); Treas. Reg. § 1.170A-6(c)(4). Different from Treasury Regulation Section 1.170A-6(c)(4), under Section 170(f)(2)(B), the recapture amount is calculated in terms of income earned by the trust and taxable to the donor. The IRS recites the same recapture rule contained in the code. *See* Rev. Proc. 2007-45, § 8.01(5); 2008-45, § 8.01(5).

vi. The income of the CLT is taxed to the grantor. IRC §§ 671–679.

vii. For transfer tax purposes (estate and gift taxes), a charitable deduction is allowable where a charitable designation is made after the income is earned.

viii. If a grantor CLT ceases to be treated as a grantor trust prior to termination, the trust will become a non-grantor trust and will be permitted to claim a Section 642(c) deduction on a going forward basis. If a CLT has generated adequate income to offset any potential recapture of the up-front income tax deduction permitted to the donor, the donor should consider relinquishing grantor trust status. At that point, the grantor will no longer be taxable on the income of the CLT and the trust itself will be entitled to offset taxable income with the Section 642(c) deduction. This could be particularly useful when the trust holds appreciated assets that would trigger capital gains tax liability to the donor if distributed in kind to the charity while the trust is taxed as a grantor trust.

b. The Non-Qualified Non-Grantor CLT

i. Instead of defining the charitable interest as a qualifying annuity or unitrust interest a CLT can provide that charity will receive "all net income."

ii. Since the charitable interest is not qualified, the grantor is not entitled to an income or gift tax charitable contribution deduction.

iii. However, the trust's income is not taxed to the grantor, and the trust qualifies for an unlimited income tax deduction for the full amount passing to charity. IRC § 642(c).

iv. In essence, the grantor (by and through the trust) gets the benefit of an unlimited charitable income tax deduction for income distributions from the CLT to the charitable beneficiaries. In addition, the CLT will not be subject to the private foundation rules so long as no deduction was taken when funding the trust. IRC § 4947(a)(2)(A).

8. General Planning Considerations

a. The CLT continues to have a number of useful applications apart from transfer tax savings:

i. As a vehicle for charitable contributions by persons who face disallowance of deductions for personal contributions due to the individual percentage limitations;

ii. As a private foundation substitute to fund family charitable giving for a set period; and

iii. As a means of facilitating family transfers of real estate and business assets.

b. The principal tax advantage of a Qualified Non-Grantor CLT is the possibility to leverage the donor's available gift tax or estate tax applicable exclusion amounts and/or GST exemption amount.

c. In larger estates in which there is large scale estate tax deferral through the use of the unlimited marital deduction when the first spouse dies, the creation of a testamentary lead trust at the death of the surviving spouse is a good way to eliminate taxes upon the second death. This may be done in the documents of the first spouse to die by providing a QTIP trust for the surviving spouse followed by a CLT.

d. Often planners stagger the dates at which the charitable trusts will terminate to provide varying amounts of money to the beneficiaries at various points in time. For example, a planner might establish three CLTs, one to end after five years, another after eight years and another after ten years. The brevity may preclude a 100% deduction but still should allow a significant reduction in transfer tax.

e. Generally, it is better to use a CLT than a marital trust for deferral if there is a strong likelihood of substantial appreciation because in the marital situation the appreciation would be taxed when the surviving spouse dies. In contrast, in the CLT the appreciation is dropped down a generation (assuming proper selection of remainder beneficiaries).

9. Illustrations of Advantageous Use of CLTs

a. Formulas

While the applicable rate under Section 7520 is known when a CLT is created inter-vivos, the same is not true for most testamentary CLTs. If a particular estate tax outcome is desired, such as a so-called zeroed out CLT, the duration or the amount of the qualified payment can be described by a formula. For example, the charitable interest can be described at the duration and level of payout required to produce a taxable transfer of a stated amount using the lowest applicable rate under Section 7520. This can be illustrated by private letter ruling 1999-27031.

i. In this comprehensive and instructive ruling the IRS reviewed a situation where a donor proposed to create various testamentary charitable lead annuity trusts and charitable lead unitrusts and fund them at death based on pecuniary formulas.

ii. Under the donor's proposed Will, the residue of the donor's estate will pour-over into a revocable trust. After donor's death, the trustee is to distribute a set amount, in cash, or property valued as of the distribution date or dates, to each of several charitable lead annuity trusts. These trusts are grouped into two categories, those that would terminate in thirteen years and those that would terminate in nineteen years. Upon termination, the trusts are to pass to or for the benefit of various private individuals. The annuity amounts to be paid from the twelve trusts will be determined under the following formula:

A. For the respective charitable terms, the Trustee shall pay such annuity amount in each taxable year of the trust to [Charity]. . . from each of the "A" Trusts, using a term of thirteen (13) years, and from each of the "B" Trusts, using a term of nineteen (19) years, that will produce a present value under Section 7520 of the [Internal Revenue] Code for the non-charitable remainder interest related to each of the * * * trusts equal to, or as close as possible as equal to without exceeding, [a set amount];

iii. The proposed revocable trust further provides that for purposes of this formula, the trustee is to apply the lowest available interest rate under Section 7520 from among three months, the month of donor's death or the two months preceding donor's death, and the annuity amount will be fixed as of the date of the donor's death based upon the applicable interest rate.

iv. The proposed trust further provides that the trustee is to distribute a stated amount, in cash or in kind, valued as of the distribution date or dates, to each of various charitable lead unitrusts. These trusts are grouped into two categories, those that will terminate in twenty-nine years and those that will terminate in thirty-five years. Upon termination the trusts are to pass to or for the benefit of various private individuals. The unitrust amounts for each trust will be determined under the following formula:

A. For the respective charitable terms, the Trustee shall pay for each taxable year of the trust, to [Charity] . . . such percent of the net fair market value of the trust principal valued as of the first day of each taxable year of the trust, which percent remains unchanged throughout the charitable term and is a certain determined percent for the "C" Trusts which trusts last twenty-nine years and a different percent for the "D" Trusts, which trusts last thirty-five years, as will produce a present value under Section 7520 for the non-charitable remainder interest related to each of the * * * "C" Trusts and "D" Trusts that is the greater of: (1) an amount equal to, or as close as possible as equal to, but not exceeding, * * * of [Taxpayer's] remaining available GST tax exemption (as is required to be allocated among the "C" Trusts and "D" Trusts…

v. The revocable trust further provides that donor intends that all of the donor's remaining available GST exemption at death be applied equally to the various charitable lead unitrusts resulting in an inclusion ratio of zero (or as close as possible to zero) with respect to each trust. For purposes of this formula, in determining the amount of the unitrust payment, the trustee is to apply the lowest available federal interest rate from among three months, the month of Taxpayer's death or the two months preceding Taxpayer's death, and the unitrust amount will be fixed as of the date of Taxpayer's death based upon the applicable interest rate.

vi. The IRS found that with respect to the A Trusts and the B Trusts, the charitable annuity will be determined pursuant to a specified formula. The annuity amounts will be ascertainable and determinable as of donor's date of death, because as of that date, all variables in the formula for determining the charitable annuity amounts will be fixed and determinable. Accordingly, the IRS concluded that the charitable interest in each charitable lead annuity trust will constitute a qualifying annuity interest and the estate tax charitable deduction will be allowed for the present value of each guaranteed annuity interest.

vii. Similarly, the IRS found the amount of the unitrust interest payable with respect to the C Trusts and the D Trusts will be determined pursuant to a specified formula. The unitrust amount will be ascertainable and determinable as of Taxpayer's date of death, because as of that date, all variables in the formula for determining the charitable unitrust amounts will be fixed and determinable. Accordingly, the IRS concluded that the charitable interest in each charitable lead unitrust will constitute a qualifying unitrust amount and an estate tax charitable deduction will be allowed for the present value of each unitrust interest.

viii. The ruling touched most of the issues raised in the creation of testamentary CLTs. For example, the IRS found that the CLTs will be entitled to charitable income tax deductions for the amounts actually paid to charity each year. With respect to the generation-skipping transfer tax rulings requested, the IRS held that

A. The pecuniary bequests to fund the CLTs did not constitute direct-skips for generation-skipping transfer tax purposes because the charitable beneficiaries will be assigned to the same generation as the taxpayer;

B. Taxable terminations for generation-skipping transfer tax purposes will occur upon the expiration of the unitrust term of the charitable lead unitrusts because all of the remainder beneficiaries of those trusts are skip persons;

C. The taxpayer's generation-skipping transfer tax exemption may be allocated separately to each charitable lead unitrust because the pecuniary amounts to be paid to each CLT will be separate and independent shares for generation-skipping transfer tax purposes; and

D. The denominator of the applicable fraction for purposes of applying the generation-skipping transfer tax to each charitable lead unitrust will be equal to the pecuniary amount passing to each such trust under the taxpayer's will minus the amount allowed as a charitable deduction. Therefore, if generation-skipping transfer tax exemption equal to such denominator is allocated to each such trust, the trust will have generation-skipping transfer tax inclusion ratios of zero. For a similar favorable ruling see Letter Ruling 1999-47022.

b. Operating a CLT as the Family's Charitable Pocketbook

A grantor can authorize the trustee of a CLT to sprinkle the lead interest among qualifying charitable beneficiaries. However, if the power is held by the grantor or the grantor's spouse the grantor may be treated as the owner for income tax purposes. IRC § 674(a). Moreover, if the grantor retains the power to sprinkle the lead interest among qualifying charitable beneficiaries, the value of the CLT will be included in the grantor's estate for estate tax purposes. IRC §§ 2036(a)(2), 2038(a)(1). This technique is illustrated in Private Letter Ruling 2002-40027.

i. Donors, a husband and wife, created three irrevocable charitable lead unitrusts ("Trusts"). At the end of the charitable terms, the Trusts are to continue for the benefit of each of their three children. They appointed one of their children as the initial trustee of each Trust.

ii. The Trust documents provide:

a. The trustee shall pay (in cash, in kind, or partly in each) to such organization or organizations selected by the trustee that is/are described in each of Sections 170(b)(1)(A), 170(c), 2055(a), and 2522(a), to be used in furtherance of each organization's religious and charitable purposes, in such proportions as are determined by the trustee, in each taxable year during the trust term, an amount equal to 6% of the net fair market value of the trust assets (valued as of the first day of each taxable year of the trust) (the unitrust amount).

b. The unitrust amount shall be paid on an annual basis on the 31st day of December of each year during the trust term, first from ordinary income (excluding unrelated business income), then from short-term capital gain, then from long-term capital gain, then from unrelated business income, then from tax-exempt income, and, to the extent that the foregoing items for the taxable year are not sufficient, from principal.

c. Any income of the trust for a taxable year that exceeds the unitrust amount shall be added to principal.

d. Notwithstanding any existing or hereafter enacted state law, no amount may be paid during the trust term to or for the use of any person other than an organization described in Section 170(b)(1)(A), Section 170(c), Section 2055(a) and Section 2522(a). However, an amount shall not be deemed to be so paid if the amount is paid for full consideration, such as reasonable trustee fees. (emphasis added).

iii. The Trust documents also include prohibitions against the types of activities and powers that traditionally would cause the Trusts to be treated as grantor trusts.

iv. The Trust documents provide that should the donors' child ever cease to serve as trustee the child is authorized to designate successor trustees. Should there ever be a vacancy not filled under the child's authority, two specific individuals were named to serve as successor trustees, one after the other, with the same power to designate successors. In the event there still is a vacancy the Trust documents provide: "the successor trustee is to be such individual or entity designated in writing by a majority of the then living adult beneficiaries of the trust who are eligible to receive any current income therefrom and who are not incompetent, so long as such individual or entity that is to become the successor trustee is not a related or subordinate party (as defined in Section 672(c)) of either of the Grantors or any adult beneficiary."

The IRS ruled that on the face of the documents Sections 673, 674, 676, and 677 would not apply. It was noted, however, that whether the donors would be treated as grantors under Section 675 is a question of fact, the determination of which would be deferred until the income tax returns of the parties involved had been examined.

Since qualified charitable organizations were given the irrevocable right to receive annually an amount equal to a stated percent of the net fair market value of the assets in the Trusts determined annually (the unitrust amount), the IRS concluded that the unitrust amounts payable under the Trusts are qualified unitrust interests. Accordingly, the donors were allowed a gift tax charitable deduction under Section 2522(a) for the present value of the unitrust amounts in the Trusts.

The IRS noted:

i. The trusts were irrevocable;

ii. The donors had retained no interest or reversion in the Trusts;

iii. The donors had no right to alter, amend, or revoke the Trusts, or to receive an annuity or other payment from the Trusts during their lives; and

iv. The donors held no general power of appointment over the property in the Trusts.

Accordingly, assuming there was no understanding, express or implied between the donors and the trustee regarding the disposition of the amounts received by the Trusts, we concluded that no portion of the assets of Trusts will be included in either Grantor's gross estate for federal estate tax purposes.

There was one negative ruling. Citing regulation Section 1.642(c)-3(b)(2) the IRS noted the ordering provision had no economic effect on the distributions independent of tax consequences. Instead, income distributed to the charitable organizations will consist of the same proportion of each class of the items of income of the Trusts as the total of each class bears to the total of all classes.

c. Funding the Family Foundation with a Charitable Lead Trust

A family that has sufficient wealth to create a family foundation may well consider using one or more charitable lead trusts to minimize transfer taxes on large transfers to younger generations. By directing the ongoing charitable distributions to a family foundation, the tax-saving characteristics of the lead trust are obtained, and the amounts distributed are paid to the foundation, where family members are able to influence, if not control, their ultimate application.

i. Minimum Distribution Requirement

Treasury regulation Section 53.4942(a)-2(b)(2)(iii) takes the position that a private foundation that is the beneficiary of a charitable lead trust must take into account as part of the foundation's minimum distribution, the lesser of (a) the income distributions from the lead trust or (b) 5% of the trust assets. However, this regulation was held invalid in *Ann Jackson Family Foundation v. C.I.R.*, 15 F.3d 917 (9th Cir. 1994), *aff'g* 97 T.C. 534 (1991) (reviewed), where a private foundation disregarded taking into account the assets of the trust or the annuity distributions received from the trust in determining its minimum investment return. In response, the IRS intends to issue proposed regulations modifying the regulations under Section 4942. Until further guidance is promulgated, income distributions received by a private foundation from a non-grantor charitable lead trust will not be included in determining a private foundation's distributable amount for the year the amount is received. Notice 2004-36, CB 2004-1 889; *See also* Notice 2004-35, 2004-1 CB 889.

ii. Estate Tax Treatment of Foundation in Creator's Estate

CLTs that make payments to a foundation in which the creator of the trust has an influential role can be problematic.

A. In Revenue Ruling 72-552, the IRS held that the value of property transferred to a foundation was included in the donor's estate under Section 2036 because the donor/decedent, in his capacity as a member, director and president of the foundation, had the power to direct the disposition of its funds for charitable purposes.

B. Similarly, in Private Letter Ruling 1979-29002 this same rule was applied to a decedent who held multiple fiduciary positions in an organization to which the income from a trust he had created was paid.

C. In *Rifkind v. U.S.*, 5 Cl. Ct. 362 (1984), a foundation was the sole beneficiary of a lead trust, and its settlor in his role as an officer, member and director of the foundation, was able to designate (or at least participate in designating) the recipients of foundation grants. The court found Section 2036(a)(2) applicable and included the CLT in his taxable estate.

iii. This technique is illustrated by Private Letter Ruling 2001-38018.

A. A donor created a charitable lead annuity trust and funded the trust with publicly-traded stock. The trust is designed to pay an amount equal to 8% of the fair market value of the initial value of the trust property to the donor's private foundation each year for ten years. At the end of the term, the balance of the CLT will be paid to or for the benefit of lineal descendants of the donor. The CLT provides that neither the donor nor her husband can serve as a trustee of the CLT. Further, any trustee may appoint an individual, individuals, or a bank or trust company as co-trustee or successor trustee. If ever there is a vacancy and no successor is so appointed, then a majority in interest of the remainder persons (or their guardians) are to appoint a successor trustee.

1) The Bylaws of the donor's foundation provide: (i) the number of directors may not be less than 3 nor more than 15; (ii) the donor will be a director for life; (iii) every other director will serve for a term of one year and until his or her successor is duly elected and qualifies; (iv) any vacancy in the Board of Directors may be filled by a majority vote of the remaining directors or by the sole remaining director; however, the donor may not cast a vote for or appoint an individual as a director that is either related or subordinate to her within the meaning of Section 672(c); (v) any time the foundation is a beneficiary of a charitable lead trust, a charitable remainder trust or other similar trust, and the charitable trust was established by a director, officer or substantial contributor to foundation, the director, officer or substantial contributor establishing the charitable trust is prohibited from acting on matters concerning funds coming to foundation from the charitable trust; (vi) a director, officer, or substantial contributor who establishes a charitable trust for the benefit of foundation may not be counted when establishing a quorum to vote on matters relating to those funds. The director, officer, or substantial contributor will be prohibited from voting on any matters relating to the funds received or anticipated to be received from the charitable trust, including voting on any disbursements or grants of such funds; and (vii) any funds received from a charitable trust are to be segregated into a separate account in the Foundation's books in such a manner as to allow tracing of the funds into and out of that account. The separate account will be administered and distributed by a separate fund committee, and donor may not possess any power over this account or this separate fund committee.

B. The IRS noted the donor had not retained a power over the property transferred to CLT, and she had not retained an interest, reversion, or right to alter, amend or revoke CLT. Moreover, although she will remain one of the directors of foundation, she is not permitted to vote on matters relating to disbursements or grants of funds received from CLT. Since the annuity payable under the CLT is a qualifying annuity for purposes of Section 2522(c), the donor's transfer to the CLT is a completed gift for federal gift tax purposes and is entitled to a gift tax deduction under Section 2522, based on the present value of the guaranteed annuity payable to charity.

C. Noting the donor could not serve as a trustee of the CLT or any successor trust, and could not participate in any vote of the foundation Board of Directors or officers concerning the annuity funds received from the CLT, the IRS found the donor had retained no interest or reversion in trust and no right to alter, amend, or revoke CLT. Accordingly, no portion of the CLT will be included in Taxpayer's gross estate.

d. Combining a CLT with a CRT to Achieve both Short and Long- Term Planning Objectives

While CLTs and CRTs are used to achieve different planning objectives, deploying them in combination can be beneficial. This is particularly true when there is a desire to provide a permanent endowment for charity and a tax-wise gift to family. The use of the CRT provides significant tax benefits to the donor during life and provides a gift to charity at a determined time in the future. In contrast, the CLT provides an immediate stream of benefits to the charity (until the CRT matures) and also transfers wealth to family members at a significantly reduced transfer tax cost.

10. Recent Developments and Emerging Opportunities, Issues and Pitfalls

a. Varying the Charitable Payout

Consider the possible usefulness of a charitable lead annuity trust with a charitable payout that increases during the charitable term. Unlike a charitable remainder annuity trust, a CLAT need not have a fixed payout amount throughout the trust term.

i. Revenue Procedure 2007-45, which provides sample inter vivos non-grantor charitable lead annuity forms, includes the following statement (in Section 5.02(2)):

"The governing instrument of a CLAT must provide for the payment to a charitable organization of a fixed dollar amount or a fixed percentage of the initial net fair market value of the assets transferred to the trust. Alternatively, the governing instrument of a CLAT may provide for an annuity amount that is initially stated as a fixed dollar or fixed percentage amount but increases during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded." [Emphasis supplied]

Thus, for example, a twenty-year CLAT might have a nominal payout for eighteen years, then a large balloon payout (large enough to have a present value at trust inception equal to the amount placed into the trust) for the last two years.

A. This type of CLAT might be referred to as a variable CLAT ("VCLAT"), and if it provides nominal payments for several years followed by balloon payments near the end of the lead term, it might be referred to as a shark-fin CLAT after the appearance of a chart depicting the annuity payments.

B. By retaining a larger trust corpus for the initial low-payout portion of the trust term, the trust corpus has a greater chance of growing and thus benefiting the non-charitable remainder beneficiaries.

C. Although the charitable payout is deferred under this sort of arrangement, the total amount actually paid to charity is larger (as the charitable portion will, in effect, bear interest at the Section 7520 rate).

ii. The key under Rev. Proc. 2007-45 is that the payout must be capable of accurate valuation as of the inception of the trust.

iii. Will this work, and pass IRS muster? There is no authority on this point, but the IRS sample revenue procedures for CLATs and the gift tax regulations (see Section 25.2522(c)-3(c)(2)(vi)(a)) seem to endorse an annuity that is increased during the trust term. Compare, however, to Treasury Regulation Section 2702-3(b)(1)(i) and (ii), which suggests that a "qualified annuity interest" for purposes of Section 2702 cannot increase more than 20% per year.

iv. Some commentators have cautioned the IRS might disregard the lower, earlier annuity payments. It also has been suggested that since CLTs are subject to the private foundation rules, the VCLAT, particularly the shark-fin CLAT, may violate the limitations on self-dealing (§ 4941) since the impetus for paying little to charity early in the term is the donor's desire to create a higher return for the donor's private beneficiaries.

b. Funding Consideration

The application of the private foundation rules can be problematic. Three recent rulings, summarized below, illustrate creative solutions to otherwise troublesome situations.

i. Funding A CLT with A Promissory Note Is Not Self-Dealing.

In Private Letter Ruling 2001-24029 the personal representative of an estate sought rulings with respect to the eventual funding of a series of CLTs. A significant portion of the decedent's estate was comprised of interests in real estate and various real estate partnerships and corporations ("Real Estate").

Under the terms of the decedent's Will, all of his assets passed to a QTIP marital trust with income payable to his surviving wife. The personal representatives split the marital trust into three trusts, each with identical terms.

Upon the death of the wife, the marital trusts will be split among trusts for the benefit of the decedent's descendants and several CLTs. Each CLT will have a 21-year term and is designed to bear the smallest annuity rate that will result in a full estate tax charitable contribution deduction.

The personal representatives proposed to sell the Real Estate to a newly formed limited liability company ("LLC") which will be owned, partially or wholly, by or for the benefit of any or all of the decedent's children and their issue ('Related Family Members"), in exchange for a secured, interest-bearing promissory note ("Note").

The Note (i) will bear interest at the applicable federal rate in effect for the month in which the sale occurs; (ii) will have a term of not greater than thirty years; and (iii) will be secured by the real estate interests.

The fair market value of the Note will be equal to the fair market value of the property as established by a qualified appraisal.

After the transaction, the Note will be included among the assets used to fund the marital trusts for the benefit of decedent's wife.

Upon her death, the Note will be included among the assets used to fund the CLTs. As a result, the Related Family Members will be indebted to the CLTs under the terms of the Note. The State Court must approve the proposed transaction, and the Attorney General of State will represent the interests of the charitable beneficiaries in that proceeding.

The expected effect of the terms and conditions is that the charitable beneficiaries will be in a position which is at least as favorable as their current position and is likely to be more favorable. By entering into the transaction, it was expected the CLTs will be protected from fluctuations in the real estate market that may occur prior to the death of the decedent's wife. The Note will serve to fix the value of the CLTs' assets at the current value of the Real Estate, thus protecting the CLTs from a downturn in the real estate market, and will fix the return of the CLTs through a fixed rate of interest, thus protecting the CLTs from fluctuations in the returns realized by the Real Estate itself.

Also, as a result of the proposed transaction, the cash flow of the CLTs will be improved and stabilized so that the CLTs will be better able to satisfy their annuity obligations. Without the sale, the CLTs would receive the Real Estate interests and would be required to engage in the real estate business. With the proposed transaction, the CLTs and thus the charitable beneficiaries will be less concerned about fluctuations in the real estate market and in interest rates since the CLTs' income will be fixed in accordance with the terms of the Note.

Possibly most important, without the proposed transaction, the CLTs only would have access to the Real Estate in order to satisfy annuity payments to the charitable beneficiaries. With the proposed transaction, the CLTs will have access to (i) the Note, (ii) the real estate interests themselves, and (iii) the capital of the family LLC.

Based on the information and representations submitted, the IRS ruled:

A. The sale of the property by the estate to the Related Family Members is not an act of self-dealing within the meaning of Section 4941 of the Code, and will not give rise to tax under that Section to the Estate, to the marital trusts, to the Related Family Members, or to the CLTs.

B. The eventual receipt and holding of the Note by the CLTs, and the subsequent payment of principal and interest on the Notes by disqualified persons will not constitute acts of self-dealing under Section 4941(d) of the Code, and will not give rise to tax liability under Section 4941 to the Estate, to the marital trusts, to the Related Family Members, or to the CLTs.

C. Notwithstanding that the interests that will be sold to the LLC, a disqualified person, will be pledged as collateral for the Note to the CLTs, the continued operation of the real estate business by the managers of the LLC or any other Related Family Members, including, but not limited to, the leveraging and selling of secured assets, and the acquisition of new assets, will not constitute acts of self-dealing under Section 4941(d) of the Code because the proposed transaction has met the requirements of Section 53.4941(d)-1(b)(3) of the regulations, so long as the value of the collateral remains as required by the terms of the Note, and will not give rise to tax liability under Section 4941 of the Code to the Estate, to the marital trusts, to the Related Family Members, or to the CLTs.

ii. CLT's Investment in a Limited Partnership Was Not Self-Dealing

Letter Ruling 2000-18062 involved the transfer of real estate and interests in a limited partnership to a nine-year testamentary CLT created upon the death of the grantor's surviving spouse. The other limited partners of the limited partnership are a number of individuals and trusts, an estate and another limited partnership. The individuals are all related to the grantor of the CLT by blood or marriage. All of the trusts are for the benefit of those individuals. The partnership has a corporate general partner. Real estate transferred to the CLT will be sold and the proceeds reinvested in additional interests in the partnership. However, the CLT will always own less than 20% of the value of the total partnership interests. The partnership's other investment assets provide dividends, interest and realized and unrealized gains from its investment activities. The partnership charges its limited partners a fee for its investment services, including compensation to an unrelated professional investment manager and reimbursements to the corporate general partner. Another corporation provides accounting, tax and clerical services on a cost-sharing basis to members of the family and various family entities, including the CLT and the partnership. The CLT and the partnership pay a fee for these services. The service corporation subleases office space to the partnership. The partnership, both corporations and many of the limited partners are disqualified persons with respect to the CLT.

Here, the IRS ruled:

A. The CLT's retention of an interest and investment in the partnership are not direct or indirect acts of self-dealing, as defined in Section 4941(d)(1).

B. Payments by the CLT to the service corporation for general accounting, tax and clerical services and to the partnership (i) for investment management and advisory services, (ii) for the reimbursement of the corporate general partner for costs and expenses paid as the general partner, and (iii) for the payment to the service corporation for general accounting, tax and clerical services do not constitute direct or indirect acts of self-dealing by the CLT, as defined in Section 4941(d)(1), or taxable expenditures, as defined in Section 4945(d)(5).

C. A sublease of office space by the partnership from the service corporations does not constitute an indirect act of self-dealing by the CLT, as defined in Section 4941(d)(1).

D. The CLT's limited partnership interest in the partnership does not constitute excess business holdings, as defined in Section 4943(c).

iii. A Delay in Funding A CLT Caused by Protracted Estate Litigation Is Not Self-Dealing

In Letter Ruling 2002-32033 the IRS was asked to rule on a complicated set of facts relating to the delayed funding of two CLTs. After a set term the CLTs were to terminate and the remainder of one CLT was to be divided into trusts for the decedent's children, and the remainder of the other CLT was to be paid outright to the decedent's children. Due to protracted litigation, the CLTs had not been funded, and the decedent's estate lacked sufficient liquid assets to do so. Given the delay in funding, the CLTs owed substantial amounts to the charitable beneficiary. The estate sought to fund the CLTs with tenancy-in-common interests in alternate estate property that was income producing. The transferred property also would include certain related party promissory notes that would be transferred to the charity to make up the CLTs' arrearages. The estate petitioned a local court for approval of the proposed funding and related transactions.

Based on the information submitted and the representations made the IRS ruled that all of the following elements of the proposed transaction met the estate administration exception described in Section 53.4941(d)-1(b)(3) of the regulations and therefore were not acts of self-dealing:

A. The distributions of related notes to the charitable beneficiary in satisfaction of the accrued obligations of the two CLTs;

B. The transfer of liabilities to the charitable beneficiary together with assets earmarked to pay such liabilities, via the residue of the decedent's estate;

C. The reallocation of assets subsequent to partial funding of the CLTs;

D. The assumption of liability by one of the CLTs under an environmental indemnification;

E. The receipt by the other CLT of property subject to a lien created within the ten year period prior to the transfer;

F. The assumption of liability by the charitable beneficiary under a limited liability company operating agreement;

G. The assumption of debt and partial surrender by the children of the decedent of their rights to distributions of assets in exchange for net relief from liability to the estate; and

H. The sale of stock by the decedent's estate to the children of the decedent in exchange for the assumption of debt owed by the estate.

I. Modification of A Successful CLT Can Be Permissible.

c. The following two situations illustrate where investment performance was so strong the trustees were permitted to change the term of the trust.

i. Early Termination

Letter Ruling 1999-52093 involved a twenty-year inter-vivos CLT. The sole charitable beneficiary was the grantor's family private foundation. Originally the CLT was funded with shares of stock in a closely held, non-public bank holding company which was controlled by the grantor's family. The CLT was designed to pay the private foundation a qualified annuity equal to 5% of the fair market value of the stock contributed to the CLT. At the end of the charitable term the remainder is to be distributed to the grantor's four children who also are all of the trustees of the CLT and all of the foundation managers of private foundation.

The bank holding company merged into a public corporation whose common stock is traded on the New York Stock Exchange. The CLT received a number of shares of stock in the new company with a value substantially in excess of the value of the stock originally contributed to the CLT. Also, the dividend the CLT will receive from the new company is well in excess of the amount necessary to pay the annuity to the family foundation.

Because the CLT now had assets that were readily convertible to cash, the CLT's charitable interest could be satisfied much earlier than originally anticipated by the grantor. Accordingly, the grantor, the trustees of the CLT, the foundation managers of the family foundation, and the four remaindermen all wanted to pay the CLT, in one lump sum, the remaining amount due to the CLT, without discount.

The parties filed a petition in state court seeking authorization to pre-pay the CLT and then to terminate the trust by distribution of the remainder interests. Their petition named the state Attorney General as a party to the suit to protect the interests of the charity.

Under these facts the IRS ruled:

A. The Trustees' prepayment of the entire remaining charitable interest without discount to the family foundation as the sole charitable beneficiary of CLT would not constitute the termination of a private foundation under Section 507 of the Code.

B. The Trustees' prepayment of the entire remaining charitable interest without discount to the family foundation as the sole charitable beneficiary of the CLT would not be an act of self-dealing under Section 4941 of the Code since the family foundation was not a disqualified person.

C. The Trustees' prepayment of the entire remaining charitable interest without discount to the family foundation would not be a taxable expenditure under Section 4945 of the Code, but the IRS cautioned that this is not to say that the income payment to the charitable beneficiary of a charitable lead trust will never constitute a taxable expenditure. Here, however, the payment was to be made for the appropriate charitable purpose established by the trust document so there would be no taxable expenditure, and it was understood that neither the CLT, the grantor, the trustees, nor any "disqualified person" within the meaning of Section 4946 of the Code would receive any benefit from the prepayment to the family foundation other than the rights of remaindermen provided in the trust document. The Service ruled favorably on similar facts in Private Letter Ruling 2002-25045.

ii. Term Extension Coupled with Early Distribution to Private Beneficiary

Private Letter Ruling 2002-26045 involved another story of success. The trustees of a charitable lead annuity trust proposed to modify the CLT so the trust's charitable beneficiary, a private foundation, and the remainder beneficiary, a non-exempt limited partnership, would receive different distributions than under the original agreement. The CLT had an initial term of fifteen years of which eleven years remained. Due to appreciation in the value of the CLT's assets, the current value of the assets greatly exceeds the amount needed to fund the remaining annuity obligation to the charitable beneficiary.

The trustees executed an amended and restated agreement which provides that the CLT was to distribute the CLT's assets in excess of 110% of the remaining undiscounted annuity obligations to the limited partnership. The remaining undiscounted annuity obligation would be paid in annual annuity installments over a new fifteen-year term, based on the annuity factor determined in accordance with the applicable regulations and the Section 7520 rate applicable to the date of the amendment, so the remainder interest will be as close to zero as possible.

The purpose of the change was to move excess assets from the restrictions the Code imposes on private foundations so that the assets can achieve greater economic good by producing a greater return on investment while at the same time providing more funds to the charity than originally provided.

The amendment required the CLT to obtain a ruling from the IRS that the distribution to the remainderman of trust of the excess assets would not violate any of the Code's restrictions on private foundations in Sections 4941 through 4945, inclusive. In addition, all parties planned to petition the state court to approve the amendments to the CLT, and the parties planned to make the state Attorney General a party to the proceedings to protect the interests of the charity.

Under this set of facts, the IRS ruled that the CLT's distribution of excess assets to the limited partnership and the payment of the remaining undiscounted annuity obligation to the charity at a new annuity amount based on the current Section 7520 rate for a new fifteen-year period would:

A. Not constitute a termination of a private foundation under Section 507 because Section 53.4947-1(e)(1) of the regulations specifically provides that the provisions of Section 507(a) do not apply to a trust described in Section 4947(a)(2) by reason of any payment that is directed by the terms of the governing instrument of the trust and is not discretionary with the trustee. The trust agreement directed the terms of the payments to the charity and was not discretionary with the trustees.

B. Not be self-dealing under Section 4941 because the CLT, treated as a private foundation described in Section 501(c)(3) of the Code, was not a disqualified person with respect to the charity. Thus, the CLT's payment of the remaining undiscounted annuity obligation to the charity would not be an act of self-dealing. There would be no sale or exchange of property; the charity was merely agreeing to receive more money.

C. Not subject the CLT to tax on the undistributed income of a private foundation under Section 4942 because the CLT already was subject to a payout requirement. Although the CLT's payout requirement would change, the change was required by the amended agreement that was to be approved by court order and the state Attorney General.

D. Not subject the CLT to tax on excess business holdings under Section 4943 because the payments to the limited partnership and the charity would not result in the CLT acquiring interests in business.

E. Not be an investment which jeopardizes charitable purposes under Section 4944 because the payment of the remaining annuities would be made to accomplish charitable purposes. Moreover, the transaction would be based on the amended trust agreement approved by a court order and in a court action in which the state Attorney General is joined to protect the interest of the charity. The charity would be protected from decline in the value of the CLT's assets by the fact that the undiscounted amount of the remaining annuities to the charity plus 10% would remain in the CLT. There was no investment; the CLT is merely paying its obligations.

F. Not be a taxable expenditure under Section 4945 since the CLT's expenditure to the charity as required under the CLT's trust instrument was in furtherance of a Section 170(c)(2)(B) purpose in fulfillment of its charitable lead annuity requirement in its governing instrument.

E. Regulation of Fundraising

1. Regulating Commercial Fundraising

2. The Regulators

a. IRS

b. Federal Trade Commission

c. Various State Agencies

3. The Principal Concerns

    a. Consumer Protection

    b. Preserving charitable resources for charitable purposes and avoiding misuse

4. Regulatory Mechanisms

    a. Registration or Licensing

    b. To Solicit within a given State

    c. To Solicit within a given County or City

    d. Multi-State dilemma; Uniform Registration Form solution

    e. Annual Renewal

    f. Filing Bonding Fees

    g. Reporting

    h. Annual Reports

    i. Financial Disclosures

    j. Sunshine Statutes

5. Exemptions: Statutory-Regulatory

    a. Churches

    b. Educational Institutions

    c. Healthcare Entities

    d. Membership Organizations

    e. Smaller Organizations

6. The "Costs" to Raise Funds

    a. Regulatory Actions

    b. Disclosure

    c. Truthfulness

7. The Biggest Challenge - Controlling costs without violating the Constitution.

    a. *Schaumburg v. Citizens for a Better Env't*, 444 U.S. 620 (1980)

    b. *Riley v. Nat'l Fed'n of the Blind*, 487 U.S. 781 (1988)

c. Electronic Solicitations

VI. SUPPORTING ORGANIZATIONS

A. Avoidance of Private Foundation Limitations

1. An organization classified as a supporting organization avoids the rules and limitations that are imposed on private foundations.

a. For example, the income tax charitable deduction for contributions to a supporting organization is not subject to the limitations that apply to the deduction for contributions to a private foundation.

b. In addition, supporting organizations generally are not subject to the private foundation prohibited transactions rules under IRC Sections 4941 through 4946, which if violated can subject the private foundation and certain persons to substantial penalty taxes (although certain supporting organizations are subject to the excess business holdings rules under IRC Section 4943).

c. Furthermore, a supporting organization is not subject to the excise tax on net investment income imposed on private foundations under IRC Section 4940.

2. Supporting organizations have often been used when a person who might otherwise choose to create a private foundation finds that some aspect of the private foundation environment makes that vehicle impractical.

B. Requirements to Establish a Supporting Organization

1. To be classified as a supporting organization, an organization must meet three tests:

a. The organization must be organized and at all times thereafter operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more public charities (Organizational Test);

b. The organization must be operated, supervised, or controlled by or in connection with one or more public charities (Operational Test); and

c. The organization must not be controlled directly or indirectly by one or more disqualified persons (other than foundation managers) within the meaning of IRC Section 4946 (Relationship Test). IRC § 509(a)(3)(A)-(C); Treas. Reg. § 1.509(a)-4(a)(1).

2. Organizational Test

The organizational test requires that the organization be organized for the benefit of, to perform the functions of, or to carry out the purposes of one or more public charities.

a. To meet the organizational test, the organization's articles of organization must limit the purposes of the organization to benefiting, performing the functions of, or carrying out the purposes of one or more public charities; not expressly empower the organization to engage in any activities which are not in furtherance of benefiting, performing the functions of, or carrying out the purposes of one or more public charities; designate by class or purpose or by name the public charities on whose behalf the organization is to be operated; and not expressly empower the organization to operate to support or benefit any organization other than those specified in the articles of organization. Treas. Reg. § 1.509(a)-4(c)(1)(i)-(iv).

b. The degree of specificity with which the supported organization must be designated depends upon the type of relationship between the supporting organization and the supported public charity or charities. The permissible types of relationships are described below in more detail.

i. Generally, if the organization is "operated, supervised, or controlled by" or "supervised or controlled in connection with" the supported public charity or charities, the supported public charity or charities can be specified by name, by class or purpose. Treas. Reg. § 1.509(a)-4(d)(2).

ii. If the supporting organization is "operated in connection with" one or more public charities, the supported organization as a general rule must be specified by name. Treas. Reg. § 1.509(a)-4(d)(4)(i).

iii. As a general rule, the safest method of ensuring compliance with the organizational test is to designate the supported public charity or charities by name in the supporting organization's governing documents.

3. Operational Test

The operational test requires that the organization be "operated exclusively" to support one or more specified public charities. An organization will meet this operational test only if it engages solely in activities that support or benefit the specified public charity or charities.

a. Permissible activities may include making payments to or for the use of, or providing services or facilities for, individual members of the charitable class benefited by the supported public charities. Treas. Reg. § 1.509(a)-4(e)(1).

b. The organization will not meet the operational test if any part of its activities is not in furtherance of a purpose other than supporting or benefiting the specified public charity or charities. Treas. Reg. § 1.509(a)-4(e)(1).

c. It is not necessary to meet the operational test that the organization pay over its income to the supported public charity or charities. Instead, it may meet the operational test by using its income to carry on an independent activity or program that supports or benefits the specified public charity or charities. Treas. Reg. § 1.509(a)-4(e)(2).

4. Relationship Test

The organization must have one of three types of relationships with the public charity or charities it is to support. The organization must be: (a) operated, supervised, or controlled by the public charity or charities it supports; (b) supervised or controlled in connection with the public charity or charities it supports; or (c) operated in connection with the public charity or charities it supports. Treas. Reg. § 1.509(a)-4(f)(2). Any relationship must insure that the organization will be responsive to the needs or demands of the public charity or charities it supports and will constitute an integral part of, or maintain a significant involvement in, the operations of the public charity or charities it supports. Treas. Reg. § 1.509(a)-4(f)(3).

a. Operated, Supervised, or Controlled by Test (Type I Supporting Organization)

The distinguishing feature of a Type I supporting organization is "the presence of a substantial degree of direction by the publicly supported organizations over the conduct of the supporting organization." Treas. Reg. § 1.509(a)-4(f)(4).

i. This relationship test is the one most commonly used to establish supporting organization status and is most appropriate for donors that have a close, primary relationship with the public charity to be supported.

ii. The operated, supervised, or controlled by test "presupposes a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations." Treas. Reg. § 1.509(a)-4(g)(1)(i).

iii. Essentially, this type of relationship is comparable to that of a parent and subsidiary in which the subsidiary is under the direction of and accountable or responsible to the parent.

iv. The operated, supervised, or controlled by test is met if a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more public charities. Treas. Reg. § 1.509(a)-4(g)(1)(i).

b. Supervised or Controlled in Connection with Test (Type II Supporting Organization)

The distinguishing feature of a Type II supporting organization is "the presence of common supervision or control among the governing bodies of the organizations involved, such as the presence of common directors...." Treas. Reg. § 1.509(a)-4(f)(4).

i. The Type II relationship is usually used by an existing public charity that for fundraising or other reasons desires to establish another charitable organization to carry out certain activities.

ii. To meet the supervised or controlled in connection with test, "there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations to insure that the supporting organization will be responsive to the needs and requirements of the publicly supported organizations." Treas. Reg. § 1.509(a)-4(h)(1).

iii. This relationship test is met by establishing that the control or management of the supporting organization is vested in the same persons that control or manage the public charity or charities it supports. Treas. Reg. § 1.509(a)-4(h)(1).

iv. This type of relationship is similar to that of "brother-sister" corporations in the for-profit corporate context.

c. Operated in Connection with Test (Type III Supporting Organization)

The distinguishing feature of a Type III supporting organization is "that the supporting organization is responsive to, and significantly involved in the operations of, the publicly supported organization." Treas. Reg. § 1.509(a)-4(f)(4).

i. The operated in connection with test is the most flexible type of relationship that can exist between the supporting organization and the public charity or charities it supports. But, it is also the most subjective test, and therefore it can be more difficult to establish that the requirements of the test are met.

ii. Generally, the Type III relationship is more appropriate when the donor and the donor's family have close relationships with multiple publicly supported charities.

iii. Under this test, it is not necessary that the supporting organization be controlled by the supported public charity or charities. Rather, there must be sufficient ties between the supporting organization and the public charity or charities it supports.

iv. To meet this relationship test, the supporting organization must establish that it satisfies a responsiveness test and an integral part test. Treas. Reg. § 1.509(a)-4(i)(1)(i).

A. Responsiveness Test

The responsiveness test is designed to ensure that the supporting organization will be responsive to the needs or demands of the supported public charity or charities. Treas. Reg. § 1.509(a)-4(i)(2)(i). Essentially, the supported public charity or charities must have the ability to influence the activities of the supporting organization. *Roe Found. Charitable Trust v. C.I.R.*, T.C. Memo 1989-566. *See also Nellie Callahan Scholarship Fund v. C.I.R.*, 73 T.C. 626 (1980).

The responsiveness test is satisfied if:

1. One or more officers, directors, or trustees of the supporting organization are elected or appointed by the officers, directors, trustees, or membership of the publicly supported organizations;

2. One or more members of the governing bodies of the publicly supported organizations are also officers, directors, or trustees of, or hold other important offices in, the supporting organization; or

3. The officers, directors, or trustees of the supporting organization maintain a close continuous working relationship with the officers, directors, or trustees of the publicly supported organization; and

4. By reason of either (1), (2), or (3) above, the officers, directors, or trustees of the publicly supported organizations have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making grants, and the selection of recipients by the supporting organization, and in otherwise directing the use of the income or assets of the supporting organization. Treas. Reg. § 1.509(a)-4(i)(2)(ii).

B. Integral Part Test

To meet the integral part test, the supporting organization must maintain a significant involvement in the operations of one or more publicly supported organizations.

Furthermore, the publicly supported organizations must be dependent upon the supporting organization for the type of support the supporting organization provides. Treas. Reg. § 1.509(a)-4(i)(3)(i).

The integral part test can be satisfied in one of two ways depending on whether the supporting organization is a functionally integrated or non-functionally integrated supporting organization.

1. Functionally Integrated Type III Supporting Organizations meet the integral part test if:

    a. The supporting organization engages in activities substantially all of which directly further the exempt purposes of one or more supported organizations;

    b. The supporting organization is the parent of each of its supported organizations; or

    c. The supporting organization supports a governmental supported organization. Treas. Reg. §1.509(a)-4(i)(4)(i).

    d. Under the regulations, a supporting organization meets the above requirements if "substantially all" activities directly further exempt purposes of one or more supported organizations to which the supporting organization is responsive. Treas. Reg. §1.509(a)-4(i)(4)(ii). The activities of the supporting organization must constitute performing the functions of, or carrying out the purposes of the supported organization and, but for the involvement of the supporting organization, would be activities that the supported organization would normally carry on itself. Treas. Reg.

§1.509(a)-4(i)(4)(ii)(1) and (2). Whether the activities are "substantially all" or something less than substantially all is to be determined under a facts and circumstances inquiry. Treas. Reg. §1.509(a)-4(i)(4)(ii)(B).

2. Non-Functionally Integrated Type II Supporting Organizations will meet the integral part test if such organization meets two requirements:

   a. Distribution Requirement. During each taxable year, the supporting organization distributes, to or for the use of the supported organization(s), an amount equaling or exceeding the supporting organization's "distributable amount" for the taxable year. Treas. Reg. §1.509(a)-4(i)(5)(ii).

      i. The distributable amount is generally equal to the greater of 85% of the supporting organization's adjusted net income for the taxable year immediately preceding the taxable year of the required distribution or a "minimum asset" amount defined by a complex formula in the regulations. Treas. Reg. §1.509(a)-4(i)(5)(ii)(B) and (C).

   b. Attentiveness Requirement. During each taxable year, the supporting organization must distribute one-third or more of its distributable amount to one or more supported organizations that are attentive to the operations of the supporting organization and to which the supporting organization is responsive. Treas. Reg. §1.509(a)-4(i)(5)(iii)

      i. The attentiveness requirement is met if 1) The supporting organization distributes to the supported organization at least 10% of the supported organization's total support received during the last taxable year before the beginning of the taxable year in question, 2) the amount of support received from the supporting organization is necessary to avoid the interruption of a particular function or activity of the supported organization, and 3) based on consideration of all facts and circumstances, the amount of support is a sufficient part of a supported organization's total support to ensure attentiveness. Treas. Reg. §1.509(a)-4(i)(5)(iii)(B)

5. Limitations on Control

An organization cannot qualify as a supporting organization if it is controlled directly or indirectly by disqualified persons within the meaning of IRC Section 4946.

6. Additional Limitations

a. Excess Benefit Transactions

i. Because they are not private foundations, supporting organizations are subject to the intermediate sanctions rules, which provide penalty excise taxes on "excess benefit transactions" under IRC Section 4958.

ii. IRC Section 4958(c)(3) provides that an excess benefit transaction automatically includes (i) any grant, loan, compensation, or other payment, such as an expense reimbursement, made by a supporting organization to a substantial contributor or his family members and entities 35% controlled by such persons and (ii) any loan provided by a supporting organization to a disqualified person (which would include a director of the organization).

iii. A person who is a disqualified person with respect to a supporting organization will also be a disqualified person with respect to the supported organization.

iv. These rules apply to all types of supporting organizations.

b. Application of Excess Business Holdings Rules to Supporting Organizations

i. Formerly, supporting organizations were sometimes used as a vehicle to hold family business interests in situations where the private foundation excess business holdings rules would have prevented a family foundation from doing so.

However, subsequent amendments to the code extended the private foundation excess business holdings rules of IRC Section 4943 to certain supporting organizations, including non-functionally integrated Type III supporting organizations and Type I or Type II supporting organizations if the supported organization is controlled by the supporting organization's donors.

ii. The private foundation excess business holdings rules provide that the amount of holdings of the organization in a business enterprise, when combined with the holdings of disqualified persons, cannot exceed 20%. Any holdings in excess of this amount are subject to an excise tax. However, holdings of up to 35 percent are allowed where a third person has effective control of the enterprise if the private foundation and all disqualified persons combined do not own more than 35% of the voting stock of an incorporated business and effective control of the corporation is in one or more persons who are not disqualified with respect to the foundation. IRC Section 4943(c)(2)(B). These rules apply the broader definition of disqualified person, however, that is found under the excess benefit transaction rules of IRC Section 4958.

iii. Further discretionary relief rules are provided. The Secretary of the Treasury may exempt any qualified supporting organization from the application of these rules if the Secretary determines that the excess business holdings of such organization are consistent with the purpose or function constituting the basis for its exemption under IRC Section 501. In addition, in the case of a Type III supporting organization (such as the Hershey Trust), excess business holdings do not include any holdings in any business enterprise if, as of November 18, 2005, the holdings were held (and at all times thereafter are held) for the benefit of the community pursuant to the direction of a State attorney general or a State official with jurisdiction over the Type III supporting organization.

iv. The provisions also adopt certain transitional rules that had applied to private foundations after the enactment of IRC Section 4943 in 1969 to allow a period of time to dispose of these excess business holdings. While these transitional rules are extraordinarily complex, it appears that existing holdings of a supporting organization holding 95% or more of the voting stock in the business enterprise may be held for up to twenty years without imposition of an excise tax.

c. Distributions from Non-Operating Private Foundations to Supporting Organizations

i. IRC Section 4942 excludes from the definition of a "qualifying distribution," for purposes of the minimum distribution rules applicable to private foundations, any amount paid by a private foundation that is not an operating foundation to a Type III supporting organization that is not a functionally integrated Type III supporting organization or to a Type I or Type II supporting organization if a disqualified person with respect to the private foundation directly or indirectly controls the supporting organization or a supported organization of the supporting organization. The IRS may determine, by regulation, that other distributions to supporting organizations should be excluded from the definition of qualifying distributions as well.

ii. A private foundation that makes distributions to a Type III supporting organization that is not functionally integrated must exercise expenditure responsibility over the grant.

7. Additional Requirements for Type III Supporting Organizations under the 2006 Act

The 2006 Act imposed additional requirements on Type III supporting organizations.

i. Disclosures

For each tax year beginning after August 17, 2006, a Type III supporting organization must provide each supported organization with such information as the Secretary of the Treasury may require in order to ensure the supporting organization is responsive to the needs of the supported organization. This information is intended to include a copy of the supporting organization's governing documents and any amendments thereto, the Form 990, the Form 990-T if any, and an annual report. These requirements will become effective upon issuance of final regulations.

ii. Foreign Organizations

A Type III supporting organization cannot support an organization that is not organized in the United States. (This rule did not apply until the first day of the organization's third tax year beginning after August 17, 2006, for existing organizations operated in connection with a foreign organization.)

iii. Limits on Contributors

Type I and Type III supporting organizations cannot receive contributions from certain persons. These persons include (1) a person who directly or indirectly controls (either alone or with other persons described in (2) or (3) following) the governing body of the supported organization, (2) a family member of a person described in (1), and (3) a 35% controlled entity.

iv. Minimum Distribution Requirements

The IRS is required to issue new regulations on payments required by Type III supporting organizations that are not functionally integrated Type III supporting organizations that will require these organizations to make distributions of either a percentage of either income or assets to supported organizations in order to ensure that a "significant amount" is paid to such organizations. A functionally integrated Type III supporting organization is defined as a Type III supporting organization that is not required under regulations to be issued by the IRS to make payments to supported organizations because the activities of the organization are related to performing the functions of, or carrying out the purposes of, such supported organizations.

v. See IRS Notice 2014-4

8. Proposed Regulations on Type III Supporting Organizations

On March 11, 2013, the IRS issued final and temporary regulations regarding the changes made to Type III supporting organizations under the 2006 Act. The regulations address the changes made by the PPA and provide guidance regarding functionally integrated and non-functionally integrated Type III supporting organizations.

a. The regulations set forth the types of information that a Type III supporting organization must provide to the organization(s) it supports.

b. The regulations confirm the elimination of the special rule that allowed certain charitable trusts to meet the responsiveness test for classification as a Type III supporting organization, but retain the transitional rule allowing certain supporting organizations in existence before November 20, 1970, to qualify as Type III supporting organizations.

c. The regulations set forth the criteria that must be satisfied by a "functionally integrated" Type III supporting organization.

d. To be considered a functionally integrated organization, the organization must engage in activities substantially all of which directly further the exempt purposes of the supported organization(s) to which it is responsive. Additional guidance is provided on the types of activities that are considered to "directly further" the exempt purposes of a supported organization.

e. Alternatively, an organization may be considered functionally integrated if it is the parent of, and exercises a substantial degree of control over, each of its supported organizations.

f. The regulations impose a minimum distribution requirement on "non-functionally integrated" Type III supporting organizations. Non-functionally integrated organizations must meet a distribution requirement and an attentiveness test. The proposed regulations retain the transitional rule for trusts established before November 20, 1970.

g. The new regulations are particularly relevant to organizations that conduct certain activities on behalf of their supported organizations, such as fundraising, investment and management of non-exempt-use assets, and grant making. Organizations that support colleges or hospitals, as well as charitable trusts with institutional trustees, will likely be affected by the proposed regulations.

h. *See also* IRS Notice 2014-4 which provides interim guidance for Type III supporting organizations which seek to qualify as functionally integrated by supporting a governmental supported organization.

9. Practical Implications of New Rules

The foregoing rules do not provide a complete listing of the changes with regard to supporting organizations under the 2006 Act, but they are the rules most likely to be encountered by the typical planner. Obviously, the result is an entirely different climate. The following are among the practical issues planners must now be prepared to face:

a. Existing Supporting Organizations May Need Attention

b. Clients with existing supporting organizations created before 2006 may not be aware of the 2006 Act changes. Consider the following situations:

i. The supporting organization was created to hold business interests, perhaps as an important part of the client's estate plan.

ii. The founders' family members serve as paid employees of the supporting organization.

iii. The supporting organization has loans outstanding to disqualified persons (including related business interests).

iv. The Board of Directors of the supporting organization is designed to give the donor(s) a measure of influence that approaches control.

v. The Type III supporting organization structured to support a large number of public charities is now a non-functionally integrated Type III supporting organization.

c. Some Supporting Organization Clients May Want Out

Clients in the situations described above, and others, may now find that they do not want to continue as a supported organization. The following alternatives are available:

i. Devise a public fundraising plan and achieve sufficient public support to qualify the organization as publicly supported under IRC Sections 509(a)(1) and 170(b)(1)(A)(vi).

ii. Terminate by transferring all assets to a fund at a public charity, which fund may be a donor advised fund.

iii. Terminate by distributing all assets to other charities and go out of business.

iv. Become a private foundation, but consider whether local law, the Attorney General, or the IRS may object if the organization seeks to abandon its form as a supported organization. *See* Priv. Ltr. Rul. 9052055.

VII. DONOR ADVISED FUNDS

A. New Regulatory Structure

1. In recent years, donor advised funds have proliferated, becoming a popular alternative to private foundations and supporting organizations. In the early days of the donor advised fund, a lack of IRS regulations led to confusion and some abuses although the vast majority of donor advised fund programs were not involved in such abuses and have been only minimally affected by subsequent changes intended to end certain practices.

2. A donor advised fund is not a separate charitable entity for federal tax purposes. It is normally a type of program or fund offered by a public charity to facilitate charitable gifts by individual donors. The public charity is referred to under the new rules as the "sponsoring organization." The sponsoring organization may be a community foundation or other public charity with an independent charitable program of its own, or it may have no program aside from the donor advised fund operation (the so-called commercial donor advised fund).

B. Definition of Donor Advised Fund

1. A donor advised fund is a fund or account (a) which is separately identified by reference to contributions of a donor or donors, (b) which is owned and controlled by a sponsoring organization, and (c) with respect to which a donor (or any person appointed or designated by the donor (called a "donor advisor")) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of the assets of the separately identified fund or account by reason of the donor's status as donor. IRC Section 4966(d)(2).

a. To be a donor advised fund, the fund or account must meet all three of the requirements listed above.

b. To be a donor advised fund, the fund or account must reference the contribution of a specific donor or donors. A general fund or account or one that receives contributions from multiple donors whose contributions are not separately accounted for within the fund will not be a donor advised fund.

c. The IRS will look to the actual manner of operations of the fund in determining if it is separately identified by reference to contributions of a donor or donors.

d. Advisory privileges do not include enforceable rights or obligations under a gift agreement.

e. Advisory privileges may be set forth in a written agreement, but even in the absence of written agreement, may be inferred from the conduct of the donor and the sponsoring organization. But the donor does not have advisory privileges if the donor provides advice without some sort of reciprocity on the part of the sponsoring organization.

f. It is not necessary that the donor actually provide advice if the donor reasonably expects to have advisory privileges with respect to the fund or account and that expectation is reciprocated by some action on the part of the sponsoring organization.

g. Advisory privileges do not include privileges based upon the donor's position as an officer, employee, or director of the sponsoring organization in the absence of other factors, unless such position resulted from the establishment of the fund.

2. A donor advised fund does not include any fund or account that:

a. Only makes distributions to a single identified organization or governmental entity;

b. With respect to which the donor recommends to the sponsoring organization the selection of the committee members that will provide investment and distribution advice if the recommendations are based on objective criteria related to the expertise of the member; or

c. With respect to which a donor or person appointed or designated by the donor advises as to which individuals receive grants for travel, study, or other similar purposes if

i. The advisory committee for such fund is composed only of members that are appointed by the sponsoring organization and is not controlled by the donor or persons appointed or designated by the donor and

ii. Grants are awarded on an objective and nondiscriminatory basis in accordance with procedures meeting the requirements for similar grants by private foundations and these procedures have been approved in advance by the board of the sponsoring organization.

3. The IRS also is granted the authority to exempt other funds or accounts from the definition:

a. If the fund or account is advised by a committee not directly or indirectly controlled by the donor or any person appointed or designated by the donor; or

b. If such fund benefits a single identified charitable purpose.

4. A sponsoring organization is any organization that is described in IRC Section 170(c) (other than Section 170(c)(1) and without regard to Section 170(c)(2)(A)), is not a private foundation, and maintains one or more donor advised funds.

C. Tax on Taxable Distributions

1. IRC Section 4966(a) imposes a 20% excise tax on a sponsoring organization that makes a taxable distribution. The tax is imposed on the amount of the taxable distribution.

2. There is also a 5% excise tax imposed on any fund manager of the sponsoring organization who agreed to the making of the distribution (but the maximum tax in the aggregate that can be imposed on fund managers is $10,000).

3. A fund manager is defined as an officer, director, or trustee of the sponsoring organization or an individual having similar powers or responsibilities and, with respect to any act or failure to act, the employees of the sponsoring organization having authority or responsibility with respect to such act (or failure to act).

4. A taxable distribution is any distribution from a donor advised fund to (a) an individual or (b) any other person if the distribution is for other than an exempt purpose under Section 170(c)(2)(B) or, if for a charitable purpose, the sponsoring organization does not exercise expenditure responsibility with respect to such distribution.

5. A taxable distribution does not include a distribution to any organization described in Section 170(c)(2)(B) (other than a grant to a Type III supporting organization that is not a functionally integrated Type III supporting organization or to a Type I or Type II supporting organization if the donor or anyone appointed or designated by the donor for the purpose of advising the donor advised fund directly or indirectly controls a supported organization). It also does not include any grant to the sponsoring organization or any other donor advised fund.

D. Taxes on Prohibited Benefits

IRC Section 4967 imposes significant excise taxes on certain transactions that result in prohibited benefits.

1. This Section imposes a 125% excise tax if any donor, donor advisor, or related person provides advice to a sponsoring organization causing a distribution from a donor advised fund that results in that person or any other donor, donor advisor, or related person receiving, directly or indirectly receiving a more than "incidental benefit." The tax is paid by any such person who advises as to the distribution or who receives a benefit as a result of the distribution.

2. Any fund manager who agrees to the making of the distribution, knowing that it would confer a prohibited benefit, is also subject to a 10% excise tax (with a cap on the total tax for fund managers of $10,000).

3. A more than incidental benefit is any benefit that would have resulted in a reduction of the income tax charitable deduction had the person made a direct contribution to the charitable recipient.

4. These taxes do not apply if the transaction results in a tax under the excess benefit transaction rules of IRC Section 4958.

E. Application of Excess Benefit Transaction Rules to Donor Advised Funds and Sponsoring Organizations

1. Section 4958 treats donors, donor advisors, investment advisors to donor advised funds and family members of such persons or entities by which they or their family members have 35% control of as disqualified persons with respect to the sponsoring organization under the excess benefit transaction rules of IRC Section 4958. An investment advisor is any person compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds owned by the sponsoring organization.

2. The new rules treat any grant, loan, compensation, or other similar payment, such as an expense reimbursement, distributed to a donor, donor adviser, or person related to a donor or donor adviser as an automatic excess benefit transaction. The entire amount distributed to such person is treated as an excess benefit for purposes of IRC Section 4958. Any correction amount cannot be held in or credited to the donor advised fund.

3. Amounts paid under a bona fide sale or lease of property are not subject to this special rule, but will instead be subject to the general arm's-length rules of IRC Section 4958, with the special disqualified person definition described above applicable. The technical explanation of the 2006 Act makes it clear that a substance-over-form analysis will apply to determine whether a purchase is made from a donor advised fund (in which case the full amount involved will be deemed the excess benefit) or from the sponsoring organization (in which case an arm's-length standard will apply).

   a. For example, if a donor contributes securities to a donor advised fund, the donor advised fund distributes them to the sponsoring organization, and the donor then purchases the securities from the sponsoring organization, the distribution to the sponsoring organization will be ignored so that the purchase from the sponsoring organization will be subject to tax under IRC Section 4958.

F. Application of Excess Business Holdings Rules to Donor Advised Funds

The private foundation excess business holdings rules of IRC Section 4943 also apply to donor advised funds.

1. The private foundation excess business holdings rules provide that the amount of holdings of the organization in a business enterprise, when combined with the holdings of disqualified persons cannot exceed 20%. Any holdings in excess of this amount are subject to an excise tax. A disqualified person includes any person who is a disqualified person for purposes of the new rules imposing an excise tax on prohibited distributions from a donor advised fund, as well as family members of such individuals and 35% controlled entities.

2. The provision also adopts certain transitional rules that had applied to private foundations after the enactment of IRC Section 4943 in 1969 to allow a period of time to dispose of these excess business holdings. While these transitional rules are extraordinarily complex, it appears that existing holdings of a donor advised fund holding 95% or more of the voting stock in the business enterprise may be held for up to twenty years without imposition of an excise tax.

G. Charitable Contributions to Donor Advised Funds

1. An income, estate, or gift tax charitable deduction is denied for any contribution to a donor advised fund if the sponsoring organization is a Type III supporting organization (other

than a functionally integrated Type III supporting organization), a Type I or Type II supporting organization where the donor or an advisor controls a supported organization, or a private foundation.

2. No income, gift, or estate tax deduction is available for a contribution to a donor advised fund maintained by a veterans' organization or fraternal society and no income tax deduction is available for such a gift to a cemetery company.

3. Further, no deduction is allowed for a contribution to a donor advised fund unless the donor obtains a contemporaneous written acknowledgement from the sponsoring organization that states that the sponsoring organization has exclusive legal control over the assets contributed.

H. Annual Returns and Exemption Applications for Sponsoring Organizations

1. Organizations that intend to maintain donor advised funds are required to disclose detailed information regarding the manner of operating these funds as a component of the organization's application for tax exemption.

2. A sponsoring organization is also required to include certain information on its Form 990, including the total number of donor advised funds owned by it at the end of the taxable year, the aggregate value of assets held in such funds at the end of the taxable year, and the aggregate contributions to and grants made from such funds during the taxable year.

I. Practical Implications

1. Most responsible donor advised funds operate in basically the manner dictated by the new rules. For example, donors to traditional funds were not given an opportunity to receive grants, loans, or compensation, or to contribute business interests or other problematic assets before the Act.

2. Despite this, there are several important points for the planner to consider, including the following:

a. Private Benefit – Be Cautious!

Private benefit rules can have some unexpected effects. For example, some community foundations allow donors to bifurcate some contributions, such as the cost of tickets to a fund-raising dinner or other event. In such instances, the donor may advise a grant from his/her donor advised fund account to pay the portion of the ticket cost that would be deductible if paid directly, but write a personal check for the value of the non-deductible part. Unless and until the IRS clarifies this, such a practice should be approached with caution.

In IRS Notice 2017-73, the IRS solicited comments on certain proposed regulations that the IRS is contemplating. One such regulation is a proposal to provide that certain distributions from a donor advised fund that pay for the purchase of tickets that enable a donor, donor advisor, or related person under IRC Section 4958(f)(7) to attend or participate in a charity-sponsored event result in a more than incidental benefit to such person.

b. Donors – Check Your Receipts

The receipt for a contribution to a donor advised fund now must include language warning that the sponsoring organization has exclusive legal control over the assets contributed.

c. More Rules on the Way?

The 2006 Act directed the Treasury Department to conduct a study of donor advised funds. The Treasury Department concluded the study and issued a report on its findings to Congress in December 2011. However, since the issuance of the report, no new regulations have yet been promulgated.

The report covers the following topics:

1. A description of federal tax law treatment of charities, supporting organizations, and donor advised funds;

2. An empirical description and analysis of supporting organizations and donor advised funds; public comments on supporting organizations and donor advised funds; and

3. Answers to Congressional questions regarding charitable contribution deductions and distribution requirements.

The report concluded that the Pension Protection Act enacted provisions designed to mitigate undue influence on supporting organizations and donor advised fund sponsoring organizations and to increase the required transparency of these organizations. New reporting requirements will make more data available to federal and state regulators, as well as to researchers, the press, and the general public. This report could result in additional legislation.

Yet, in the many years that have passed since the last regulations addressing donor advised funds were issue, the IRS has still failed to clarify many key points. In the 2013, 2014, and 2015 Priority Guidance Plans the IRS shifted away from terminology promising new "regulations" and instead alluded to new "guidance" regarding donor advised funds. In IRS Notice 2017-73, the IRS did solicit comments on some new proposals it is considering. One such proposal concerns the use of donor advised fund to purchase tickets, discussed previously. The new regulations would also clarify under what circumstances certain distributions from a donor advised fund that the distributee charity treats as fulfilling a pledge made by a donor, donor advisor, or related person, do not result in more than incidental benefit. Furthermore, the regulations would change the public support computation to prevent the use of donor advised funds to circumvent the excise tax rules applicable to private foundations under Chapter 42 of the Code.

VIII. PRIVATE FOUNDATIONS

A. General Characteristics of Private Foundations

1. While some publicly supported organizations or supporting organizations will convert to private foundation status if they fail to meet the public support test or the requirements for continuing qualification as a supporting organization, many charitable organizations are established as private foundations because of their limited sources of support.

a. Most family and corporate foundations are private foundations.

b. As a general rule, private foundations are endowed by a single individual or family, a corporation, or a small group of private donors who wish to retain control over the use and management of donated assets.

c. The private foundation's endowment may initially be established through outright contributions or distributions from a trust, such as a charitable lead trust. Ongoing funding is usually derived primarily from investment income and growth in the foundation's underlying assets and not from fundraising activities.

2. Unlike many public charities, a private foundation generally makes grants to other charitable organizations rather than actively conducting charitable programs and services.

3. In the case of family foundations, the donor and the donor's family usually control all decisions. This allows participation by younger family members and perpetuates family control.

4. Because of the lack of public oversight and participation in these foundations, they are closely regulated under the IRC to safeguard against operation for private benefit and ensure operation in furtherance of charitable purposes.

5. Private foundations, like public charities, are exempt from federal income tax because they are organizations described in IRC Section 501(c)(3). Thus, private foundations are subject to all of the rules applicable under Section 501(c)(3), including the private inurement prohibition and limitations on impermissible private benefit.

B. Tax on Net Investment Income

The IRC imposes an excise tax of 2% on the net investment income of a tax-exempt private foundation in each tax year. IRC § 4940(a). The 2% excise tax may be reduced to 1% for certain tax years in which the foundation's payout rate is increased. IRC § 4940(e).

C. Self-Dealing

1. IRC Section 4941 prohibits acts of direct or indirect "self-dealing" between a private foundation and a disqualified person. It does not matter whether the act of self-dealing results in benefit or detriment to the foundation. Treas. Reg. § 53.4941(d)-1(a).

2. Definition of Disqualified Persons

Under IRC Section 4946, disqualified persons are defined as:

a. Substantial contributors (generally, anyone contributing more than $5,000 to the foundation).

b. Foundation managers (officers, directors, or trustees of the foundation).

c. Any 20% owner of a business that is a substantial contributor to the foundation.

d. Any family member of the persons described above (a spouse, ancestors, and children, grandchildren, and great grandchildren, and spouses of children, grandchildren, or great grandchildren).

e. Any corporation, partnership, trust, or estate in which persons described above have more than a 35% interest.

f. Any government official.

3. Self-Dealing Defined

Although there are a number of statutory and regulatory exceptions, acts of self-dealing generally are defined as:

a. Any sale, exchange, or leasing of property, between a private foundation and a disqualified person.

b. Any lending of money or other extension of credit between a private foundation and a disqualified person.

c. Any furnishing of goods, services, or facilities by a private foundation to a disqualified person.

d. The payment of compensation or expenses by the private foundation to a disqualified person.

e. Any transfer to, or use by or for the benefit of, a disqualified person of the private foundation's income or assets.

f. Any agreement to make any payment of money to a government official. IRC § 4941(d)(1).

4. Direct v. Indirect Self-Dealing

IRC Section 4941 applies to any "direct" or "indirect" act of self-dealing. Direct self-dealing occurs when the private foundation is a party to the transaction with the disqualified person. An act of indirect self-dealing occurs when a disqualified person engages in a transaction with an organization controlled by the private foundation or by the foundation managers.

a. The indirect self-dealing rules can apply to transactions between an estate of which a private foundation is a beneficiary and a disqualified person.

b. Indirect self-dealing can arise with respect to an organization controlled by the private foundation or the foundation managers. If the private foundation or its managers can use their votes or authority to cause another organization to engage in a transaction that would be self-dealing if engaged in directly by the private foundation, that transaction constitutes indirect self-dealing and is subject to the excise tax on self-dealing. Treas. Reg. § 53.4941(d)-1(b)(5).

5. Exceptions to Acts of Self-Dealing

a. Certain Loans

The lending of money by a disqualified person to a private foundation is not an act of self-dealing if the loan is interest-free and the proceeds of the loan are used exclusively for exempt purposes. IRC § 4941(d)(2)(B).

b. Certain Leases

The leasing of property by a disqualified person to a private foundation is not an act of self-dealing if the lease is without charge (although the foundation can pay for janitorial services, utilities, or other maintenance costs it incurs for use of the property as long as such payments are not made to the disqualified person (directly or indirectly)). Treas. Reg. § 53.4941(d)-2(b)(2).

c. Certain Furnishing of Goods, Services, or Facilities

The furnishing of goods, services, or facilities by a disqualified person to a private foundation is not an act of self-dealing if the furnishing is without charge and the goods, services, or facilities are used exclusively for an exempt purpose. IRC § 4941(d)(2)(C).

The furnishing of goods, services, or facilities by a private foundation to a disqualified person is not an act of self-dealing if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public. IRC § 4941(d)(2)(D).

d. Reasonable Compensation for Personal Service

Self-dealing does not include the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services that are reasonable and necessary to carrying out the exempt purpose of the private foundation if the compensation or reimbursement is not excessive. IRC § 4941(d)(2)(E).

Whether compensation is reasonable is determined in accordance with the standards for reasonableness under IRC Section 162. Treas. Reg. § 53.4941(d)-3(c). Reasonable compensation is "only such amount as would ordinarily be paid for like services by like enterprises under like circumstances." Treas. Reg. § 1.162-7(b)(3).

In general, "the making of a cash advance to a foundation manager or employee for expenses on behalf of the foundation is not an act of self-dealing, so long as the amount of the advance is reasonable in relation to the duties and expense requirements of the foundation manager." Treas. Reg. § 53.4941(d)-3(c)(1). Such an advance should not ordinarily exceed $500 unless the advance is to "cover extraordinary expenses anticipated to be incurred in fulfillment of a special assignment (such as long distance travel)." Treas. Reg. § 53.4941(d)-3(c)(1).

e. Certain Corporate Transactions

An act of self-dealing does not include any transaction between a private foundation and a corporation that is a disqualified person pursuant to any liquidation, merger, redemption, recapitalization, or other corporate adjustment if all of the securities of the same class as that held by the foundation are subject to the same terms and such terms provide for the receipt by the foundation of no less than fair market value. IRC § 4941(d)(2)(F).

f. Preexisting Business Relationships

The regulations under IRC Section 4941 provide an exception to the definition of indirect self-dealing for certain preexisting business relationships that meet the following three-part test:

i. The transaction results from a business relationship that was established before such transaction constituted an act of self-dealing;

ii. The transaction was at least as favorable to the organization controlled by the foundation as an arm's-length transaction with an unrelated person; and

iii. Either (a) the organization controlled by the foundation could have engaged in the transaction with someone other than a disqualified person only at severe economic hardship to the organization, or (b) because of the unique nature of the product or service being provided by the organization controlled by the foundation, the disqualified person could not have engaged in the transaction with anyone else, or could have done so only by incurring severe economic hardship. Treas. Reg. § 53.4941(b)-1(b)(1).

g. Estate Administration Exception

There is a regulatory exception for certain transactions that occur during the administration of an estate (or revocable trust). This exception specifically provides that an act of indirect self-dealing does not include a transaction with respect to a foundation's interest or expectancy in property held by an estate (or revocable trust), regardless of where title to the property vests under state law, if:

i. The administrator of the estate (or trustee of the revocable trust) has the power of sale with respect to the property or the power to reallocate the property to another beneficiary or is required to sell the property under the terms of any option subject to which the property was acquired by the estate (or revocable trust);

ii. Such transaction is approved by the probate court having jurisdiction over the estate (or revocable trust);

iii. The transaction occurs before the estate is terminated for federal income tax purposes;

iv. The estate (or revocable trust) receives an amount that equals or exceeds the fair market value of the foundation's interest or expectancy; and

v. Either, the foundation receives an asset at least as liquid as the one it gave up, the transaction results in the foundation receiving an asset related to its exempt purpose, or the transaction is required under the terms of an option binding on the estate (or revocable trust). Treas. Reg. § 53.4941(d)-1(b)(3).

h. Corporate Redemption Exception

A corporation that is a disqualified person can redeem stock held by the foundation without engaging in an act of self-dealing if certain requirements are met. The exception is available if all securities of the same class as that held by the foundation are subject to the same terms and those terms provide that the foundation shall receive no less than fair market value for its stock.

6. Self-Dealing Penalty

The penalty imposed on an act of self-dealing is a two-tier excise tax that can be imposed on a foundation manager as well as the disqualified person. There is no self-dealing tax imposed on the private foundation. An additional and confiscatory tax is imposed if the act of self-dealing is not corrected within the statutorily defined correction period.

a. IRC Section 4941(a) imposes an initial tax pursuant to which any disqualified person who participates in an act of self-dealing must pay a tax of 10% of the amount involved with respect to the act of self-dealing. In addition, any foundation manager who participated in an act of self-dealing is liable for a tax of 5% of the amount involved (up to $20,000 per act for all managers) unless such participation was not willful and was due to reasonable cause. IRC § 4941(a), (c)(2).

b. In addition to paying the initial tax, the disqualified person must correct the self-dealing by undoing the transaction and restoring the foundation to the position it would have been in had there been no self-dealing. IRC § 4941(e)(3).

c. If the act of self-dealing is not corrected, an additional tax of 200% of the amount involved is imposed on the disqualified person, and an additional tax of 50% of the amount involved is imposed on foundation managers who refused to agree to part or all of the correction with an aggregate cap of $20,000. IRC § 4941(b), (c)(2).

d. For purposes of these rules, if the self-dealing transaction results from a payment of excessive compensation, the tax applies only to the amount of such excess and not to the entire payment.

D. Minimum Distribution Requirements

1. A private foundation must make minimum distributions of income annually for its exempt purposes to avoid an excise tax on undistributed income under IRC Section 4942.

a. If the foundation fails to meet the minimum distribution requirements, it is subject to an excise tax equal to 30% of the amount of the under-distribution. IRC § 4942(a).

b. If the foundation does not make the required distributions after a certain correction period, an additional excise tax is imposed equal to 100% of the amount remaining undistributed at the close of the correction period. IRC § 4942(b).

2. To avoid an excise tax, a private foundation must distribute at least 5% of the average fair market value of its non-charitable assets (cash, securities, other investment assets, etc.) each year. IRC § 4942(d), (e).

a. The minimum distributable amount is calculated each year on the foundation's annual Form 990-PF.

b. The foundation essentially has two years in which to make the required minimum distribution: the year for which the minimum distribution amount is calculated and the subsequent tax year. IRC § 4942(a).

c. A foundation may carry forward any excess qualifying distributions for five additional years. IRC § 4942(i).

3. The distributions that count towards this minimum distribution requirement are referred to as "qualifying distributions." Qualifying distributions are defined under IRC Section 4942(g)(1) as:

a. Any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more exempt purposes.

b. Any amount paid to acquire an asset used (or held for use) directly in carrying out one or more exempt purposes.

4. Distributions to other private foundations (non-operating) or controlled organizations do not count as qualifying distributions. Distributions are not qualifying distributions if made to a non-functionally integrated Type III supporting organization or a Type I or Type II supporting organization if a disqualified person with respect to the private foundation directly or indirectly controls the supporting organization or a supported organization of the supporting organization. IRC § 4942(g)(1)(A), (4).

E. Excess Business Holdings

1. IRC Section 4943(a)(1) imposes a 10% excise tax on the excess business holdings of any private foundation in a business enterprise during any tax year. The tax is imposed upon the value of the excess business holdings. There is an additional tax of 200% if the foundation does not dispose of the excess business holdings within the statutorily prescribed correction period after the imposition of the initial 10% tax. IRC § 4943(b).

2. While the term "business enterprise" is not expressly defined, it does not include:

a. A functionally related business; or

b. A trade or business at least 95% of the gross income of which is derived from passive sources. IRC § 4943(d)(3).

3. The permitted holdings of a private foundation in an incorporated business are 20% of the voting stock of such business enterprise, reduced by the percentage of voting stock owned by all disqualified persons. IRC § 4943(c)(2)(A). In the case of a partnership or joint venture, reference is made to the profits interest held by the foundation rather than voting stock. IRC § 4943(c)(3)(B). In all other cases, reference is made to the beneficial interests owned by the foundation and disqualified persons. IRC § 4943(c)(3)(C).

4. "Excess business holdings" are the amount of stock or other interests that the private foundation would have to dispose of to a person other than a disqualified person in order for the foundation's holdings in the business enterprise to be "permitted holdings." IRC § 4943(c)(1).

5. Under a de minimis rule, a foundation will not be treated as having an excess business holding if it does not own more than 2% of the voting stock and not more than 2% in value of all of the outstanding shares of all classes of stock in a business enterprise. IRC § 4943(c)(2)(C).

6. Permitted holdings in a corporation also include any share of nonvoting stock in the business enterprise if disqualified persons hold, actually or constructively, no more than 20% of the voting stock of the corporation. Treas. Reg. § 53.4943-3(b)(2)(i).

7. The percentage of voting stock held by any person in a corporation is normally determined by reference to the power of stock to vote for the election of directors. Treasury stock and stock that is authorized but not issued is ignored as are higher voting requirements for extraordinary corporate actions. Treas. Reg. § 53.4943-3(b)(1)(ii). Equity interests do not include evidences of indebtedness (including convertible indebtedness) and warrants or other options or rights to acquire stock. Treas. Reg. § 53.4943(b)(1)(i).

8. Special holding periods apply if the private foundation receives holdings in a business enterprise by gift or bequest. Under Section 4943(c)(6), if a private foundation acquires holdings in a business enterprise other than by purchase by the private foundation or disqualified persons with respect to the foundation and the acquisition causes the foundation to have an excess business holding, the foundation has five years to dispose of sufficient holdings to eliminate the excess business holdings. During this five-year period, the excess business holdings are deemed to be held by a disqualified person instead of the private foundation. The five-year grace period can be extended for an additional five years at the discretion of the IRS.

9. In certain circumstances the permitted holdings are increased from 20% to 35%. This increase is available if (a) the foundation and all disqualified persons together do not own more than 35% of the voting stock of an incorporated business enterprise, and (b) the foundation establishes to the satisfaction of the IRS that "effective control" of the corporation is in one or more persons who are not disqualified persons with respect of the foundation. IRC § 4943(c)(2)(B).

10. Effective February 9, 2018, a new exception has been created for certain holdings of a private foundation in a business enterprise that is an "independently operated philanthropic business." IRC Section 4943(g). In order to qualify, the business enterprise must be 100% owned by the private foundation at all times during the year, the ownership interests must have been acquired by means other than purchase, the business enterprise must donate all of its operating income to charity, and the business enterprise must be independently operated. IRC Section 4943(g)(1)-(4).

F. Jeopardy Investments

The jeopardy investment rules of IRC Section 4944 impose an excise tax if a private foundation invests its assets in manner that jeopardizes the accomplishment of the foundation's exempt purposes. The foundation is subject to a tax of 10% of the amount invested. IRC § 4944(a)(1). Any foundation manager who participated in making the investment knowing that it was jeopardizing the foundation's exempt purposes is subject to an excise tax equal to 10% of the amount invested unless such participation was not willful and was due to reasonable cause. IRC § 4944(a)(2).

G. Taxable Expenditures

1. Section 4945 prohibits private foundations from making "taxable expenditures." Taxable expenditures are defined as:

   a. Expenditures to carry on propaganda or otherwise to attempt to influence legislation;

   b. Expenditures to influence the outcome of any specific public election or to carry on, directly or indirectly, any voter registration drive;

   c. Grants to an individual for travel, study, or other similar purposes unless the grant is awarded on an objective and nondiscriminatory basis and is approved in advance by the IRS;

   d. Grants to an organization other than one that is a public charity described in IRC Section 509(a)(1), (2), or (3) (other than a non-functionally integrated Type III supporting organization) or an exempt operating foundation (as defined in IRC Section 4940(d)(2)); and

   e. Expenditures for any purpose other than a charitable, religious, scientific, literary, or educational purpose. IRC § 4945(d).

2. Any taxable expenditure made by a private foundation is subject to a 20% initial excise tax, and foundation managers who agreed to the making of the taxable expenditure knowing that it was a taxable expenditure are subject to an initial tax of 5% (capped at $10,000 in the aggregate) unless such agreement is not willful and is due to reasonable cause. IRC § 4945(a)(1), (2), (c)(2). If the taxable expenditure is not corrected, an additional 100% tax is imposed on the foundation and a 50% tax (capped at $20,000) is imposed on foundation managers who refused to agree to the correction. IRC § 4945(b)(1), (2), (c)(2).

3. Certain taxable expenditures are permitted, such as grants to another private foundation, if the private foundation exercises "expenditure responsibility" with respect to the grant. IRC § 4945(h).

   a. Expenditure responsibility requires the foundation to:

      i. Assure that the grant is spent only for the purpose for which it is made;

      ii. Obtain full and complete reports on how the funds are spent; and

      iii. Make full and detailed reports on the expenditures to the IRS. IRC § 4945(h)(1).

   b. The foundation should also conduct a pre-grant inquiry to determine the identity, past history, and experience, management, and activities of the grantee organization. Treas. Reg. § 53.4945-5(b)(2)(i).

   c. The foundation must also require the pre-payment submission of a written commitment signed by an appropriate officer or director of the grantee organization, which agreement must clearly specify the purposes of the grant as well as reporting and accounting requirements necessary from the grantee and should stipulate that the grant may not be used for any non-charitable purpose. Treas. Reg. § 53.4945-5(b)(3).

d. The private foundation can make grants that are earmarked for one or more charitable purposes under IRC Section 170(c)(2)(B) to political subdivisions and certain other organizations that do not hold determination letters under IRC Sections 501(c)(3) and 509(a)(1), (2), or (3). Treas. Reg. § 53.4945-5(a)(4).

IX. PRIVATE OPERATING FOUNDATIONS

A. Generally

A private operating foundation operates its own charitable programs rather than making grants to public charities. For income tax charitable deduction purposes, a private operating foundation is treated the same as a public charity, meaning that the limitations normally applicable to contributions to private foundations do not apply. Private operating foundations continue to be subject to the excise tax provisions applicable to private foundations.

"Conduit" or "pass-through" private foundations also receive favorable income tax charitable deduction treatment under IRC Section 170(b)(1)(F). While these foundations are beyond the scope of this outline, a conduit private foundation is essentially a private foundation that distributes an amount equal to 100% of all contributions it receives in such year not later than the 15th day of the third month after the close of the taxable year in which such contributions are received. Treas. Reg. § 1.170A-9(h)(1)(i).

B. Tests Applicable In Lieu Of Minimum Distribution Requirements

Because private operating foundations actually conduct charitable activities, they are not required to meet the minimum distribution requirements imposed on private foundations under IRC Section 4942. Instead, to maintain classification as a private operating foundation, the foundation must meet an income test and either an assets test, endowment test, or a support test.

1. Income Test

A private operating foundation must use substantially all (at least 85%) of its adjusted net income or its minimum distribution amount (ordinarily 5%), whichever is less, directly for the active conduct of its exempt charitable activities. Grants to other organizations do not count as direct expenditures.

2. Assets Test

The assets test requires that substantially more than one-half (at least 65%) of the private operating foundation's assets are actually used for the active conduct of its exempt charitable activities or functionally related businesses. Stock in a corporation that the foundation controls and of which substantially all of the assets are devoted to charitable purposes will also qualify under the assets test.

3. Endowment Test

A private operating foundation must normally expend at least two-thirds of its minimum distribution amount directly for the active conduct of exempt charitable activities to meet this test.

4. Support Test.

This test requires:

a. Substantially all of a private operating foundation's support must be normally received from the general public and at least five exempt organizations that are not disqualified persons with respect to each other or the private operating foundation.

b. Not more than 25% of a private operating foundation's support may be normally received from any one of the five exempt organizations.

c. Not more than half of a private operating foundation's support may be normally received from gross investment income.

X. FACTORS FOR CONSIDERATION IN CHOICE OF CHARITABLE DONEE

A. Availability of investment management

B. Donor's relationship (or lack thereof) with one or more public charities

C. Amount of assets to be contributed to charitable donee

D. Donor's willingness to relinquish control over management, investments, or grant making

E. Nature of assets to be contributed to charitable donee

F. Potential application of excess business holdings rules to assets to be contributed

G. Limitations on income tax charitable deduction associated with gifts of certain types of property to private foundation

H. Donor's current need for an income tax charitable deduction without certainty of ultimate charitable donee

I. Donor's desire to have family involvement on board and length of time of involvement

J. Donor's desire to use the charitable donee as a training vehicle to promote good stewardship and investment management among younger generations of the family

K. Donor's desire to use the charitable donee as a vehicle for coordinated family philanthropy

L. Donor's desire for charitable donee to employ family members

M. Donor's desire for future generations to have a vehicle to continue the family's philanthropic tradition

N. Donor's expectation that funds may be raised from third parties (i.e., the general public)

O. Donor's desire for anonymity or privacy (in connection with funding or in connection with grants awarded)

P. Tax on investment income

Q. Minimum distribution requirements

R. Donor's expectations that charitable donee will carry on a direct charitable activity, such as operation of an art museum

S. Donor's desire to defer funding until death

T. Donor’s desire to use planned giving vehicles, such as charitable remainder trusts or charitable lead trusts to fund the charitable donee

U. Donor’s willingness to bear cost and burden of administration, tax filings, and management of charitable organization

V. Nature and location of anticipated grantees of charitable donee

W. Donor’s desire for charitable donee to make scholarship grants to individuals

X. Donor’s desire for grant-making support and advice

XI. CHARACTERISTICS OF CHARITABLE DONEES

	PRIVATE FOUNDATION	PRIVATE OPERATING FOUNDATION	TYPE I OR II SUPPORTING ORGANIZATION	TYPE III SUPPORTING ORGANIZATION	DONOR ADVISED FUND
Source of Funding	Usually single family or corporation	Usually single family or corporation	Varies	Varies	Usually single family or corporation
Donor Able to Control	Yes	Yes	No, but board participation allowed	No, but board participation allowed	Advisory rights only
Income Tax Deduction	Yes, but limitations apply	Yes	Yes, unless supported organization controlled by donor	Yes, unless supported organization controlled by donor	Yes, if sponsoring organization is qualifying charity
Transfer Tax Deduction	Yes	Yes	Yes	Yes	Yes
Tax on Investment Income	Yes	No	No	No	No
Minimum Distribution Requirement	Yes (5%)	No	No	Expected to have 5% distribution requirement if non-functionally integrated upon issuance of final regulations	No
Jeopardy Investment Rules Apply	Yes	Yes	No	No	No
Tax on Impermissible Distributions	Yes, for taxable expenditures	Yes, for taxable expenditures	No	No	Yes, on taxable distributions and prohibited benefits
Excess Business Holdings Rules Apply	Yes	Yes	No, unless supported organization controlled by supporting organization's donors	Yes	Yes
Excess Benefit Transaction Rules Apply	No	No	Yes	Yes	Yes, with special rules applicable to donor, donor advisor, and investment advisor
Self-Dealing Rules Apply	Yes	Yes	No	No	No
Able to Support Unlimited Qualifying Charities	Yes	Not generally applicable	No	No	Yes, but subject to control by sponsoring organization

	PRIVATE FOUNDATION	PRIVATE OPERATING FOUNDATION	TYPE I OR II SUPPORTING ORGANIZATION	TYPE III SUPPORTING ORGANIZATION	DONOR ADVISED FUND
Able to Provide Scholarships	Yes	Maybe	Yes	Yes	Only with close attention to statutory rules
Able to Involve Family Members in Management	Yes	Yes	Yes	Yes	Maybe
Able to Employ Family Members	Yes, with caution	Yes, with caution	No	No	No
Able to Involve Future Generations	Yes	Yes	Maybe	Maybe	Advisory privileges usually available for multiple generations
Annual Tax Filing Required	Yes	Yes	Yes	Yes	No
Exemption Application Required	Yes	Yes	Yes	Yes	No

XII. PLANNING CHART

TYPE OF GIFT	DONOR BENEFITS	FAMILY BENEFITS	CHARITY BENEFITS	PREFERRED TYPE OF CHARITY
Outright Gift of Undiscounted Assets	Full income tax deduction. No payments to donor.	None	Charity receives income and appreciation on the contributed assets from the date of gift.	For cash and marketable securities, differences are minimal. For closely held and real estate assets, private foundation gifts are less desirable.
Outright Gift of Discounted Assets followed by family purchase or redemption	Full income tax deduction. No payments to donor. Note that the restrictions on the gift could create a future interest thus eliminating the income tax deduction	Potential value received by the family through the purchase or redemption of assets that are discounted from pro rata value.	Charity receives income and appreciation on the contributed assets from the date of gift. However, enjoyment may be postponed if the assets are illiquid.	Donor advised fund or some supporting organizations are most desirable. Public charity is a good donee but may lack experience to handle the gift efficiently. Private foundation is undesirable because of self-dealing rules.
Defined value / charitable allocation clause transfer	Full income tax deduction. No payments to donor.	Potential for discounted assets to pass to the family transferring additional value.	Charity receives income and appreciation on the contributed assets from the date of gift. However, enjoyment may be postponed if the assets are illiquid.	Donor advised fund or some supporting organizations are most desirable. Public charity is a good donee but may lack experience to handle the gift efficiently. Private foundation is undesirable because of self-dealing rules.
Bequest	No income tax deduction. No payments to donor.	None	Assets available at an undetermined future date.	No substantial differences. Bequests to a private foundation may be “bought out” by the family using the Probate Exception.
Disclaimer to a Charitable Fund	No income tax deduction. No payments to donor.	Potential for discounted assets to pass to the family transferring additional value.	Assets available at an undetermined future date.	Donor advised fund or some supporting organizations are most desirable. Public charity is a good transferee but may lack experience to handle the gift efficiently. Private foundation is undesirable because of self-dealing rules regardless of the probate exception.

TYPE OF GIFT	DONOR BENEFITS	FAMILY BENEFITS	CHARITY BENEFITS	PREFERRED TYPE OF CHARITY
Gift Annuity	Partial income tax deduction. Annuity payments to donor.	None	Assets available immediately, subject to an obligation to make annuity payments.	Public charity is almost always the best choice.
Charitable Remainder Trust	Partial income tax deduction. Annuity or unitrust payments to donor.	None	Assets available in the future, date may or may be fixed. Asset may be monetized through a fair market value sale.	The income tax deduction for gifts to private foundations is limited and monetizing the interest of a private foundation may be difficult.
Remainder interest in house or farm	Partial income tax deduction. Donor may use the house or farm for life.	If remainder interest is purchased by the family, potential for value to transfer depending on the appreciation rate of the asset and the length of the donor's life.	Assets available in the future at a date that is not fixed. Asset may be monetized through a fair market value sale.	Private foundations are undesirable recipients.
Charitable Lead Trust - - Constant Annuity	Typically, no income tax deduction but income is removed from the donor's taxable income base. No payments to donor.	Assets available in the future, date may or may not be fixed.	Annuity or unitrust payments to charity.	Any charitable donee. Private foundations do not have to include the assets of the lead trust when calculating the annual 5% distribution.
Charitable Lead Trust - - Increasing Annuity or Shark-Fin CLAT	Typically, no income tax deduction but income is removed from the donor's taxable income base. No payments to donor.	Assets available in the future, date likely to be fixed at the end of a specified term.	Annuity payment to charity largely deferred until the end, or close to the end, of the trust term. Minimal payments until then.	Private foundations less desirable because the charitable donee must be free to challenge the investment of trust assets during the term, and to ensure that all trustee actions are independent.

XIII. CHALLENGES AND RESPONSES

A. Economic and Legal Uncertainty

1. Stricter Rules Which Limit the "Value" of Contributions – Now and in the Future

2. Tighter Controls on the Operation of Charitable Donees

3. Court Modification of Donor Intent

B. Specific Responses

1. Satisfying Pledges

2. Tapping IRAs

3. Cautious Fractional Gifts - Making Gifts of Art and Other Tangible Property

4. Avoiding the IRS Hit List

a. Gifts involving Life Insurance

b. Tax Shelters Transactions

c. Abuse of Charitable Organizations and Deductions

5. Eliminating the Costs, Legal Restrictions and Management Challenges Associated with New Separate Entities – Carefully Restricted, Goal Oriented Funds

6. Taking Advantage of Lower Interest Rates and Depressed Asset Values – Charitable Lead Trusts

7. Low Hassle Donor Centered Philanthropy – Donor Advised Funds (DAFs)

a. Gifts of Closely held Assets – The Non-DAF DAF

b. Scholarships – Special DAFs

c. Avoiding Penalty Taxes – The "Bullet-Proof" DAF

d. Supporting Private Foundations – The "Fully Staffed" DAF

8. Less Hassle Donor Centered Philanthropy – Supporting Organizations

a. Risks for Existing Supporting Organizations – Making Old New Again

b. Exit Strategies for Supporting Organizations on "life support"– The Donor's Seat at the Table – Type I Supporting Organizations

c. “Perpetual”? Donor Restrictions – Do Type III Supporting Organizations Still Work?

d. Avoiding Penalty Taxes – The “Bullet Proof” Supporting Organization

9. Donor “Controlled” Philanthropy – Private Foundations

a. Good Hygiene leads to Good Results – The Well Mannered Private Foundation

b. Support for Supporting Organizations – Funding Strategies to Avoid Catastrophic Outcomes

XIV. CHARITABLE GIVING ILLUSTRATED

A. Deferring Capital Gains

Mr. Shareholder has decided to make a sizeable charitable gift this year. He also holds a number of shares of stock in Conglomerate, Inc., which his financial consultant has urged him to sell. Mr. Shareholder is reluctant to sell his stock because it has appreciated substantially and he does not want to pay a tax on the sale. Can Mr. Shareholder avoid the tax?

B. Improving Rate of Return – Keeping It Within the Family

Mr. Miser inherited a portfolio of blue chip stocks from his grandparents decades ago. Although the stocks have appreciated in value considerably, the return is still modest. Can Mr. Miser do better by doing good? Can he preserve the capital for his children?

C. Deferring the Income Tax

Mrs. Leisure, a widow, is retired, and her largest asset is the balance in her IRA. She wants to provide for her children and support her local community foundation. What is our best advice?

D. Retirement Planning

Mr. Parent is 40 with two children who will be college age when Mr. Parent is ready to retire (age 60). Although he has a retirement plan, Mr. Parent would like to increase his potential retirement income. Can he bank funds for retirement, largely tax-free, while winning a warm spot in the hearts of the administration at “Dear Old State?”

Dr. Jones would like to “help” his retired nurse by making the income from a $100,000 trust available for her life. He recognizes that such an amount may be too small to warrant a professional fiduciary. He is not prepared to manage the fund. If possible he would like to help his medical school. Any ideas?

E. College Bound

Mr. and Mrs. Miller earn a combined annual income of $120,000 and have an investment portfolio containing primarily highly appreciated securities. In several months, their daughter, Jennifer, will be entering college at Mrs. Miller’s alma mater. Mrs. Miller has wanted to make a contribution to the building fund of the college but is concerned about having adequate funds to cover Jennifer’s education. In addition, the Millers will need to liquidate some of their securities to pay college tuition, and they are concerned about the income tax consequences.

F. Current Benefits from Gifts at Death

Mr. and Mrs. Greenjeans own a farm. They have no children and would like, when they die, for their farm to pass to their local state university to be used by its School of Agriculture. What to do?

G. Gifts of What is Not Used

Mr. Bather has a magnificent vacation home at the beach. He only uses the home for two months every summer. His favorite charity has used the home from time to time to hold conferences. A permanent arrangement may result in a current benefit!

H. Passing a Business to the Next Generation

Mr. and Mrs. Murphy hold a controlling interest in a family company and hope that one day their son, Joe, will hold a substantial interest in the company. The company has not been paying dividends and has a large amount of accumulated earnings. Due to inflation, the Murphys are concerned that the estate taxes due to their interest in the company will be large. They also have avoided making large lifetime gifts to Joe due to the gift tax. The Murphy's interest in the company is their primary asset. The Murphys make regular charitable contributions.

I. Reducing Transfer Taxes

Mr. and Mrs. Smith, who have primarily liquid assets with a value of approximately $40 million, want to leave their assets to their children and grandchildren while avoiding as much estate tax as possible. In addition, the Smiths would like to establish a family foundation to support the arts and to bear their names after their deaths. The Smith children and grandchildren are independently wealthy.

XV. ADVISORS AND THE PHILANTHROPIC QUESTION (by Joseph C. Imberman) Reprinted from the August 2004 issue of Planned Giving Today.

When it comes to broaching charitable giving with their clients, there are three types of professional advisors. *Doing Well by Doing Good. Improving Client Service, Increasing Philanthropic Capital: The Legal and Financial Advisor's Role*, THE PHILANTHROPIC INITIATIVE 8 (2000).

Initiators, who always raise the issue of philanthropy with their clients, value the difference charitable giving makes and are personally involved in charities.

Facilitators, who know philanthropic counsel is important, but believe they lack the skills to undertake it.

Followers, who wait for the client to raise philanthropic issues, or who focus charitable giving on tax planning, rather than on personal values and interests.

Current research supports the critical role advisors have in their clients' philanthropic decisions. But most fall into the facilitator and follower categories. With the right questions and resources, advisors can become initiators, engaging clients in mutually beneficial, values-based estate planning.

<u>Advisors and Philanthropy</u>.

With the generational transfer of wealth over the next fifty years estimated at $40 to $130 trillion dollars, this is an ideal time for advisors to direct client thinking. The estate planner working on a will, the financial advisor sorting through investment strategies and the family business advisor helping a family prepare for succession all have compelling reasons to raise the subject of philanthropy with their clients. Stephen P. Johnson, *Advancing Philanthropy: Tapping the Potential of Legal and Financial Advisors*, TRUSTS AND ESTATES 2 (Summer Supp.) (2000).

Clients want their advisors to discuss philanthropy. According to a study by The Philanthropic Initiative — a Boston-based nonprofit consulting firm that helps donors increase the impact of their philanthropy — many donors actively seek stimulation or cultivation of their philanthropic interests and opportunities to explore, develop and/or refine a sense of mission that will motivate and guide their giving.

Yet donors indicate that it is they, rather than the advisor, who typically raise the philanthropic topic. In a study conducted for The Chronicle for Philanthropy, donors noted that many advisors do not have a solid technical grasp of planned giving vehicles, nor access to resources or other professionals that could facilitate informed estate-planning decisions. Holly Hall, *Rich Donors Cite Displeasure with Financial Advisors*, The Chronicle of Philanthropy (1997).

<u>Why Advisors Hold Back</u>.

What stops advisors from being initiators? The most common reasons are:

A lack of understanding of planned gift vehicles;

Unfamiliarity and discomfort with the philanthropic discussion;

Fear of losing business through referrals to third-party professionals;

A focus on the tax savings associated with charitable giving.

Advisors indicate there is ample room for improvement in their philanthropy-related practice, but they also need guidance and resources to make those professional advancements.

See Johnson, at pages 4–5; See also Giving New Hampshire, *Tips from the Field*

<u>Becoming the Initiator</u>.

There are at least six practical strategies to help clients address philanthropic planning:

1. Ask The Question.

   Ginny Esposito, president of the National Center for Family Philanthropy, encourages advisors to ask: “What do you want to do for people, causes and institutions that have been important to you in your lifetime?”

   Esposito suggests raising it as part of routine estate- or wealth-planning sessions. *Tips from the Field*, GIVING NEW HAMPSHIRE. .Follow-up questions emerge from the conversation that lead advisors and clients to select appropriate philanthropic vehicles and strategies.

2. Become Informed.

Contact local charities' planned giving departments that offer staff and literature laying out the basics of giving vehicles. Advisors sitting on organizations' professional advisory committees can collegially teach peers about charitable giving. Some charitable agencies sponsor seminars that fulfill advisors' professional development requirements and feature informative charitable giving sessions.

For example, for more than fifty years, the Jewish federation system has worked with advisors to offer valuable charitable giving resources. Many of the 156 federations nationwide establish professional advisory committees, sponsor seminars and publish informational tools that ground advisors in philanthropic issues and practices. Advisors frequently call on federation expertise to sift through complex philanthropic issues. Federations and their donors significantly utilize community advisor expertise. Many of these professionals have served as federation and foundation presidents and officers.

Join advisor networks for an easy and practical way to become informed. The Council on Foundation's Philanthropic Advisors Network (PAN) is an example of such an entity. Or, become a Chartered Philanthropic Advisor through American College's Wallace Chair in Philanthropy, a program that builds advisor effectiveness when helping clients and prospective donors reach both financial and philanthropic goals.

Gather information on best practices through organizations and associations, such as New Ventures in Philanthropy, the Planned Giving Design Center, the National Association of Philanthropic Planners, The Legacy Companies, and The Philanthropy Initiative. These agencies have dedicated a portion of their services to improving advisor/client interaction with regard to philanthropy.

3. Make Fearless Referrals.

Advisors might consider referring a client to a colleague with philanthropic advising experience. Planned giving professionals at charitable organizations can also be a source of one-on-one counsel. Though advisors believe they will lose business through referrals, clients appreciate their professionals' willingness to seek the information they want and need.

4. Explore Personal Charitable Interests and Goals.

It is likely many advisors are charitably and civic-minded. In the same way that they make philanthropic decisions for themselves, they can guide others. Advisors may first want to inventory their personal motivations, interests and values as a way to bring perspective to client discussions about giving.

5. Be an Active Listener.

Listen for philanthropic cues when meeting with a client on estate planning. Is the client a major donor to community institutions, such as a hospital or university? Does the client sit on nonprofit boards? Such involvement can spearhead a conversation about charitable estate planning.

6. Know The Difference.

Discussing a client's charitable mission revolves around values-based planning, not financial planning. Philanthropic advising helps clients "to make wise decisions about where money should be given, building on the values and culture of the donor, and selecting the recipient organizations and types of gifts that best reflect those values and culture. Richard A. Marker, *Expanding Professional Services to Clients through an Understanding Philanthropic Advising*.

Benefits of Philanthropic Advising.

The initiator creates benefits for all involved. The advisor has enhanced an essential skills base by building philanthropy into his or her overall estate-planning offerings. The client gives greater thought to helping others, while benefiting from the financial perks philanthropic planning allows. Charities gain donors and gifts that promote their effectiveness, impact and longevity.

And don't forget — all this charitable and civic activity just makes the world better.

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