Special Session III-D

Creative Use of Planned Giving Techniques in an Uncertain Tax Environment

Charitable Giving Series

Michele A.W. McKinnon
McGuireWoods LLP
Richmond, Virginia

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CREATIVE USE OF PLANNED GIVING TECHNIQUES IN AN UNCERTAIN TAX ENVIRONMENT

Michele A. W. McKinnon
McGuireWoods LLP
Richmond, Virginia

I. METHODS OF GIVING AND TAX CONSEQUENCES.

A. Basic Methods of Charitable Giving.

1. Outright gifts and bequests can involve either:

   a. The donor's entire interest in the property; or

   b. A partial interest, either an undivided (fractional) share or life estate/remainder.

2. Retained interest gifts include:

   a. Charitable remainder annuity trusts;

   b. Charitable remainder unitrusts;

   c. Charitable lead trusts;

   d. Pooled income funds;

   e. Gift annuities;

   f. Gifts of remainder interests in personal residences or farms; and

   g. Qualified conservation contributions.

B. Overview of the Tax Rules.

1. **Applicable Internal Revenue Code Sections.**

   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 2055 – Estate tax charitable deduction rules.

   e. Section 2522 – Gift tax charitable deduction rules.

   f. Section 4940 through 4947 – Private foundation excise tax rules that apply to private foundations and in some cases to supporting organizations and donor advised funds.

2. **Income Tax Charitable Deduction for Individuals.**

   a. <u>Donor Must Itemize Deductions</u>. A donor who itemizes deductions is entitled to an income tax charitable deduction for contributions to qualified charitable organizations. I.R.C. § 170(a).

b. <u>Overall Limitation on Itemized Deductions</u>. Certain taxpayers with income above a certain amount ($166,800 (or $83,400 for a separate return filed by a married individual) in 2010) must reduce their itemized deductions by the lesser of 3% of the excess of their adjusted gross income over this certain amount or 80% of the amount of itemized deductions otherwise allowable for the tax year. I.R.C. § 68(a).

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

d. <u>50% Limitation</u>. For a gift of cash or unappreciated property to a "50%-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% ceiling"). I.R.C. § 170(b)(1)(A).

e. <u>30% Limitation</u>. 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.

f. <u>Limitations for Gifts of Capital Gain Property</u>. For gifts to a 50%-type organization of long-term capital gain property that has appreciated, the donor may deduct the full fair market value of the gift only up to 30% of the donor's contribution base. I.R.C. § 170(b)(1)(C). For gifts of such property to a private foundation, the deduction is limited to 20% of the donor's contribution base. I.R.C. § 170(b)(1)(D).

g. <u>Five-Year Carryover</u>. A five-year carryover generally applies to any portion of a charitable deduction that cannot be deducted because of the percentage limitations. I.R.C. § 170(b)(1)(D).

h. <u>Special Rules for Gifts to Private Foundations</u>.

(1) 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. I.R.C. § 170(e)(1)(B)(ii).

(2) 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. I.R.C. § 170(e)(5).

i. <u>Contributions of Related Use Tangible Personal Property</u>.

(1) 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. If the property is not related, the donee's deduction is limited to the property's basis (or fair market value if less).

(2) The 2006 Act treats as unrelated use tangible personal property that is sold, exchanged, or otherwise disposed of by the donee before the last day of the taxable year in which the donor made the contribution and with respect to which the donee has not in a written statement signed by an officer of the donee under the penalties of perjury either (a) certified that the use of the property was related to the donee's exempt purpose or function and described how the

property was used and how such use furthered such purpose or function of the donee or (b) stated the intended use of the property by the donee at the time of contribution and certified that such use has become impossible or infeasible to implement.

(3) 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 2006 Act requires the recapture of the charitable deduction in an amount equal to the difference between the amount claimed as a deduction and the property's basis. The donor must include this amount in ordinary income in the year in which the disposition occurs.

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

(5) The 2006 Act also imposes a $10,000 penalty (in addition to any criminal penalties) on any person who identifies property as exempt use property knowing that the property is not intended for such a use.

j. <u>Limitations for Gifts of Ordinary Income Property</u>. 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. I.R.C. § 170(e).

(1) Included in this category are: inventory, crops, dealer property and works created by the donor. In the case of a painting donated by the artist, for example, the deduction is limited to the artist's cost of materials.

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

(3) 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).

(4) Capital Gain/Ordinary Income Property, e.g., personal property with section 1245 recapture potential. Both the capital gain and the ordinary income rules apply. 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).

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 no limitations on the amount of the deduction for qualifying contributions and the classification of the charity as a public charity or private foundation is not relevant. I.R.C. §§ 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 Internal Revenue Code section 2518. In addition, Internal Revenue Code 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.

C. **Partial Interest Gifts.**

1. Generally, no charitable income tax deduction is allowable for a gift of a partial interest in property (that is, a gift of less than the donor's entire interest in the property).

2. Special exceptions are made for the following (which are deductible):

a. A partial interest if it represents the donor's entire interest in the property (for example, a gift of a life estate if all the donor owns is a life estate). The application of this rule is not clear in situations where the donor has recently disposed of another interest in the property.

b. An undivided portion of the donor's entire interest in the property (for example, a gift of a 25% interest as a tenant in common in a parcel of real estate).

c. Property transferred to a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund.

d. A contribution of a remainder interest in a personal residence or farm (whether or not occupied by the donor).

e. A qualified conservation contribution (for example, a conservation easement to preserve a marsh for wildlife).

D. **Bargain Sales.**

1. A deduction is allowed for the difference between the fair market value and the sales price.

2. Basis must be allocated between the gift portion and the sales portion.

3. A gift of mortgaged property is treated as a bargain sale.

4. A transfer of property in exchange for a gift annuity is treated as a bargain sale.

E. **Bequests and Other Testamentary Transfers.**

1. Generally, no income tax deduction is available to the decedent or the decedent's estate for a bequest to charity. Special rules apply to allow an income tax deduction to an estate for amounts payable to charity out of the gross income of the estate. *See* §642(c).

2. A full fair market value charitable deduction is available to the estate for estate tax purposes.

F. **Charitable Remainder Trusts.**

1. Description: The donor transfers assets to a trustee and provides for income payments of at least 5% but not more than 50% of the initial value of the trust assets in the case of an annuity trust, or at least 5% but not more than 50% of the value of the trust assets as valued annually in the case of

a unitrust, to one or more beneficiaries for a term of twenty years or less or for the lives of the beneficiaries. The remainder interest passes to a charitable organization at the termination of the income interest. In the case of an annuity trust, the donor may not make additional contributions to the trust.

2. Income Tax Consequences: If the trust is funded with appreciated property, the deduction is generally limited to the 30% ceiling. If the trust is funded with appreciated property, the donor avoids tax on the capital gain.

3. Estate and Gift Tax Consequences: If the donor retained a life interest, the trust is included in the donor's gross estate, but there is an offsetting charitable deduction (unless there is a secondary beneficiary, in which event only the charitable remainder is deductible). If the donor did not retain a life interest, the assets contributed to the trust may be removed from the donor's estate depending upon what other permissible rights the donor may have retained. Generally, there are no gift tax consequences in establishing the trust where the donor retains the right to revoke the rights of other beneficiaries.

G. **Pooled Income Funds.**

1. Description: Donors irrevocably transfer assets to the trustee of a pooled income fund maintained by a charitable organization reserving the right to income for themselves or other beneficiaries for life. At the death of the donor or other beneficiary, the charitable organization receives the remainder interest in the assets contributed by the donor.

2. Income Tax Consequences: The donor is entitled to an income tax deduction equal to the actuarial value of the charitable organization's remainder interest. Income of the pooled income fund is paid to the donor or other beneficiary for life based on the fund's annual rate of return and will be taxed to the donor. (Unlike remainder trusts, pooled income funds may not invest in tax-exempt securities.)

3. Estate and Gift Tax Consequences: The results are basically the same as with charitable remainder trusts. The donor's estate is entitled to an estate tax charitable deduction if the interest in the pooled income fund is includible in the donor's estate.

H. **Charitable Gift Annuities.**

1. Description: The donor transfers assets to a qualified charitable organization in return for the charitable organization's agreement to pay the donor or other beneficiary an annual annuity for life. The starting date for the annuity payments can be deferred to increase the charitable deduction.

2. Income Tax Consequences: The transfer is treated as a "bargain sale" (part gift, part sale) for income tax purposes if funded with appreciated property instead of cash. The donor is entitled to an income tax deduction equal to the difference between the fair market value of the property transferred and the value of the annuity contract. Capital gains, if any, attributable to the sale portion of the gift are reported over the donor's lifetime and a portion of the income received by the donor may be tax exempt.

3. Estate and Gift Tax Consequences: A gift tax charitable deduction is allowed for the difference between the fair market value and the sales price. Contributed property is removed from the donor's estate for estate tax purposes.

I. **Remainder Interests in Personal Residences and Farms.**

1. Description: The donor gives a personal residence or farm, including a vacation home, to a charity and retains the right for the donor (or the donor's spouse or other beneficiary) to reside in the property for life. The charitable organization does not gain possession and full ownership of the farm or residence until termination of the retained life estate or estates.

2. Income Tax Consequences: The donor is entitled to an income tax deduction equal to the present value of the charitable organization's remainder interest, taking into account depreciation and depletion.

3. Estate and Gift Tax Consequences: A charitable deduction is available for the remainder value, and depreciation and depletion need not be considered.

J. **Charitable Lead Trusts.**

1. Description: The donor transfers assets to a trustee directing payment of a certain amount to one or more charitable organizations for a term of years reserving the remainder interest for the donor's children, grandchildren, or other individuals.

2. Income Tax Consequences: The donor is not entitled to an income tax deduction unless structured as a grantor trust making the donor taxable on the income of the trust in future years.

3. Estate and Gift Tax Consequences: If the trust is created during the donor's lifetime, the donor is entitled to a gift tax charitable deduction equal to the actuarial value of the income interest payable to the charitable organization. If the trust is created at the donor's death, the donor's estate is entitled to an estate tax charitable deduction equal to the actuarial value of the income interest payable to the charitable organization.

II. WHEN IS THE GIFT COMPLETE?

A. **General Rules.**

1. A gift is complete when the gift has been unconditionally delivered to the donee and the donor's dominion and control over the property has ceased.

2. Delivery to a third person (for example, the donor's lawyer) who is an agent of the donor (as opposed to the donee) is not sufficient.

B. **Cash.**

1. A charitable contribution of cash by check is effective when the check is unconditionally mailed or delivered, provided the check clears the donor's bank in due course (even if this occurs in the subsequent year).

2. A contribution that is charged to a bank credit card is deductible in the year the charge is made.

3. Delivery of the donor's own promissory note is not deemed payment, and no deduction is available to the donor until the note is actually paid.

C. **Stocks and Bonds.**

1. The gift is complete upon delivery of the endorsed certificate or bond to the charity or its agent.

2. If delivery is by mailing and charity receives the gift in the ordinary course of the mail, the gift is complete and effective on the date of the mailing.

3. Delivery to the issuing corporation, its transfer agent, or the donor's broker is not sufficient -- they are agents of the donor.

4. A transfer of securities registered in street name at a brokerage firm is complete when transferred on the books of the brokerage firm.

D. **Real Estate.**

1. A gift of real estate is complete upon the execution and delivery of the deed to the donee charity.

2. Recordation of the deed is not required for the gift to be effective but can be the best evidence.

E. **Other Personal Property.**

1. For most items of tangible personal property (for example, a painting) the easiest way to complete the gift is to deliver the item to the charity in exchange for a receipt.

2. Intangible personal property (for example, a royalty) requires delivery of some form of deed of gift or other assignment document.

3. If the asset's governing instrument (for example, a life insurance policy or partnership agreement) provides that a transfer is not effective until the transfer is recorded with or approved by the home office or general partner, the better view is that the transfer is effective as between the donor and the donee upon delivery.

F. **Gifts in Trust.**

1. The date of transfer of the property to the trust (not the date of execution of the trust) is generally the date of the gift for tax purposes.

2. In the case of certain intangibles, the execution of the trust may, depending upon the precise language used, be sufficient to make the gift effective at that time.

3. A declaration of trust (as opposed to a trust agreement with a second party as trustee) may be considered at year-end as an expeditious way of completing a gift.

III. CHARITABLE GIFT ANNUITIES.

A. **Overview.**

1. **Description.** The donor transfers assets to a qualified charitable organization in return for the charitable organization's agreement to pay the donor or other beneficiary an annual annuity for life. The starting date for the annuity payments can be deferred to increase the charitable deduction.

2. **Income Tax Consequences.** The transfer is treated as a "bargain sale" (part gift, part sale) for income tax purposes if funded with appreciated property instead of cash. The donor is entitled to an income tax deduction equal to the difference between the fair market value of the property transferred and the value of the annuity contract. Capital gains, if any, attributable to the sale portion of the gift are reported over the donor's lifetime and a portion of the income received by the donor may be tax exempt.

3. **Estate and Gift Tax Consequences.** A gift tax charitable deduction is allowed for the difference between the fair market value and the sales price. Contributed property is removed from the donor's estate for estate tax purposes.

B. **Advantages and Disadvantages of Charitable Gift Annuities.**

1. **Simplicity.** Probably the most attractive feature of the charitable gift annuity is its simplicity. From the donor's perspective, it is easy to understand; the donor gives away the property in return for the charitable organization's agreement to pay an agreed annuity amount. The documentation is also simple. Rather than a complicated trust agreement, only a one-or two-page gift annuity agreement is required.

2. **Valuation Issues.** The annuity amount that the charity agrees to pay is usually based on a percentage of the value of the property given to the charity. In the case of property that is difficult to value, such as real estate, closely held stock, or tangible personal property, this can create future problems for the charitable organization if it ultimately sells the property below the appraised value as of the date of the gift. Once the charitable organization agrees to pay an annuity, the tax laws prohibit adjustment of the payments to reflect the sale at the lower price. Accordingly, charitable organizations should be advised to exercise caution when dealing with gifts of difficult-to-value assets in return for a charitable gift annuity.

3. **Flexibility.** Gift annuities frequently provide more flexibility than charitable remainder trusts for a number of reasons. There are two areas, however, where the charitable gift annuity is less flexible than other charitable giving techniques. Unlike a charitable remainder trust, a charitable gift annuity cannot be for a term of years. A charitable organization should not issue a gift annuity for more than two lives because it may run afoul of the debt-financed property rules.

4. **Effect of High or Low Section 7520 Rate.**

   a. The fluctuation in Section 7520 rates in recent years has had a definite effect on the donor's charitable deduction in the case of a gift annuity. The rates have ranged from a high of 11.6% in 1989 to a low of 1.0% in 2012 and 2013. High section 7520 rates produce a greater charitable deduction. However, a low section 7520 rate does produce one significant beneficial effect. A lower section 7520 rate increases the amount of each annuity payment that is excluded from gross income under the general rules for taxation of annuities.

   b. **Example.** If a donor who is age 65 gives property in return for a 4.7% annuity with a 7.0% section 7520 rate, the donor’s charitable deduction is 55.7% and the exclusion ratio for the annuity payments is 47.08%. If the section 7520 rate is 1.0%, however, the donor’s deduction decreases to 25.1%, while the exclusion ratio increases to 79.71%.

5. **Private Foundation Prohibitions.** One of the most significant benefits, and one that produces a significant amount of flexibility, is the avoidance of the private foundation rules that apply to charitable remainder trusts.

6. **Deferral of Annuity Payments.**

   a. With a charitable gift annuity, annuity payments can be deferred until some date in the future. While this can be accomplished with a net income or flip charitable remainder unitrust, it requires the trustee to invest in nonincome-producing assets and the donor's deduction will not reflect this deferral.

   b. Because of the deferral, the amount of the annuity to be paid in the future is usually much higher under the Committee on Gift Annuities' recommended rates due to the accumulation of value on a tax-deferred basis.

   c. The donor's income tax deduction may be larger with a deferred gift annuity.

7. **Ratable Recognition of Capital Gains.** Because the gift annuity is treated as a bargain sale, the donor will recognize gain when appreciated property is transferred to the charitable organization. But, if certain conditions are met, this gain will be recognized ratably over the donor’s life expectancy. First, the annuity must not be assignable to any person other than the charity. Second, the donor must be an annuitant. If the donor dies before all gain is reported, the remaining capital gain is not reportable (unless there is a successor annuitant). All gain is immediately reportable if the annuity is for the life of another.

C. **Creative Uses of Charitable Gift Annuities.**

1. **Property Not Suitable for a Charitable Remainder Trust.** In many cases, a charitable remainder trust will not work to accomplish the donor's goals. For example, gifts of tangible personal property, such as artwork, to a charitable remainder trust do not produce any income tax deduction for the donor. But in many instances, the donor may not be willing to fully part with the value of the artwork that the donor would like to give to his favorite local museum. The museum also may not be willing to enter into a bargain sale arrangement because it would require an immediate significant expenditure of capital. This is the perfect situation for the donor and the museum to consider a gift annuity to accomplish the goals of all the parties. Similarly, a charitable organization, such as a school, may want property owned by the donor adjacent to the school's property. Again, if the donor does not want to part with the full value of the property or is concerned about future financial security, a gift annuity may work to meet the goals of both the donor and the school. Mortgaged property can create a host of problems when contributed to a charitable remainder trust due to the self-dealing rules and the unrelated business income tax. In appropriate circumstances, a gift annuity may avoid these problems. The self-dealing problem can never arise if a public charity is involved. In certain circumstances, the unrelated business income rules can be avoided as well. Basically, if a charitable organization accepts mortgaged property for a gift annuity, it will have debt-financed income unless the mortgage was placed on the property more than five years before the inter vivos transfer, and the donor owned the property more than five years before the transfer. In this case, the mortgage is not considered acquisition indebtedness for a 10-year period following the transfer. Of course, the donor's charitable gift is valued by deducting the amount of the encumbrance. Any capital gain attributable to the donor as a result of the transfer of the mortgage probably cannot be reported ratably.

2. **Planning for Retirement.** Many donors are concerned about their financial security when they are older, but want immediate income tax deductions. Because of the unavailability of the IRA deduction for many individuals and the limits on the amount that can be placed in a qualified retirement plan under current tax laws, a deferred gift annuity may be useful to enable the donor to ensure future financial security during the donor's retirement years, while obtaining a current income tax deduction in years when the donor's taxable income is likely to be higher. The benefits of the gift annuity are even greater in this scenario because the deferral may generate a larger income for the donor, and the charitable organization is likely to be willing to pay a larger annuity when payments commence.

3. **Planning for the Elderly or Incapacitated.** An immediate or deferred gift annuity can be used to provide for an individual, such as a relative or family employee, whom the donor wishes to provide for during the person's life, when the donor also wants to make a gift to a particular charitable organization. Of course, this technique is probably best suited for cash gifts because the donor will not be able to recognize any capital gain ratably if the donor is not an annuitant. The gift tax consequences of the arrangement will also need to be examined when advising the donor.

4. **Combined with Gift of Remainder Interest in Personal Residence or Farm.** It may be possible to combine two gift techniques. The donor can give the charitable organization a remainder interest in a personal residence in return for an annuity. As long as the value of the remainder exceeds the value of the lifetime annuity, the donor is entitled to an income tax charitable deduction. Note, though, that the charitable organization may not be willing to do this because payments commence immediately while the charitable organization will not receive any property until the donor's death.

5. **Testamentary Gift Annuities.** A testamentary gift annuity for the life of a family member, spouse, or family employee may be appropriate for certain donors. An estate tax deduction is allowed as long as the will or trust agreement properly defines the amount of the annuity to be paid. The Internal Revenue Service will disallow a deduction if the annuity cannot be ascertained. If the estate uses appreciated property to fund the bequest to charity, the estate will incur capital gains under the bargain sale rules. The gain will be fully recognized in the year of the transfer because the ratable recognition rule is unavailable.

IV. CHARITABLE REMAINDER TRUSTS.

A. Overview of Charitable Remainder Trusts.

1. Under Internal Revenue Code section 664, a charitable remainder trust is a trust that provides for the distribution of a specified payment at least annually to one or more persons, at least one of which must be a noncharitable beneficiary. The payment period must be for the life or lives of the individual beneficiaries (all of whom must be living at the time the trust is created) or for a term of years, not in excess of 20 years. Upon the termination of the noncharitable interest or interests, the remainder must either be held in a continuing trust for charitable purposes or paid to or for the use of one or more charitable organizations described in Internal Revenue Code section 170(c).

2. For a trust to be a qualified charitable remainder trust, the value of the remainder interest that passes to charity at the end of the term (i.e., the amount of the donor's charitable deduction) must be no less than 10% of the initial value of the assets contributed to the trust.

   a. The valuation of interests in a charitable remainder unitrust is not affected significantly by the section 7520 rates, but the 10% remainder requirement can still cause issues. With a 2.2% section 7520 rate, a unitrust cannot be established for the life of an individual under age 27. Also, in the case of the two-life unitrust, if both individual beneficiaries are the same age, a unitrust cannot be established unless the beneficiaries are at least 39 years old with a 2.2% section 7520 rate.

   b. Charitable remainder annuity trust valuations are impacted by the section 7520 rates. The current low interest rate environment requires the exercise of caution. With a 2.2% section 7520 rate, a husband and a wife who are the same age and are to receive the annuity amount must be older than 64 to establish a charitable remainder annuity trust that does not violate the 10% remainder requirement. A trust for a single individual beneficiary will violate the 10% remainder requirement if the section 7520 rate is 2.2% unless the individual beneficiary is 57 or more years old.

3. A qualified charitable remainder trust is generally exempt from federal income tax. The grantor is entitled to an income tax charitable deduction and a gift or estate tax charitable deduction based on the present value of the remainder interest ultimately passing to charity. If the noncharitable beneficiary is an individual other than the grantor, the creation of a charitable remainder trust may have gift tax consequences.

4. There are two basic types of charitable remainder trusts under Internal Revenue Code section 664, a charitable remainder annuity trust and a charitable remainder unitrust.

   a. A charitable remainder annuity trust is required to pay a sum certain annually to one or more beneficiaries, at least one of which is not a charity. The annuity amount must be equal to at least 5% (but not more than 50%) of the fair market value of the trust assets valued as of the date the assets are transferred to the trust.

   b. A charitable remainder unitrust is required to pay a fixed percentage of the net fair market value of the trust assets as revalued annually to one or more beneficiaries, at least one of which is not a charity. The unitrust amount must be equal to at least 5% (but not more than 50%) of the net fair market value of the trust assets valued annually.

   c. The amount paid by a unitrust fluctuates with the fair market value of the trust assets, whereas the annual payment from an annuity trust remains constant.

5. A unitrust may provide for the payment of the lesser of the fixed percentage or the net income of the trust. This type of unitrust is referred to as a "net income" unitrust. A net income unitrust may have what is called a "makeup" provision. A makeup provision provides that any amount by which the trust income falls short of the fixed percentage is to be paid out in a subsequent year to the extent the trust's income exceeds the fixed percentage in that subsequent year. A unitrust may

also provide for the trust to be a net income trust initially and later convert to a straight unitrust. These types of trusts are often referred to as "flip" unitrusts.

B. **Governing Instrument Requirements of Charitable Remainder Trusts.**

1. In 1989 and 1990 the Internal Revenue Service published a series of Revenue Procedures containing sample governing instruments for use in drafting charitable remainder trusts. The sample instruments published by the Internal Revenue Service for annuity trusts and unitrusts included forms for inter vivos and testamentary trusts and trusts for one or two lives (but not for a term of years).

2. The Internal Revenue Service issued new (and improved) sample governing instruments for charitable remainder annuity trusts on August 4, 2003 and for charitable remainder unitrusts on August 19, 2005. These Revenue Procedures provide that a trust will satisfy the requirements of a qualified remainder trust if the trust instrument creates a valid trust under local law, refers to the applicable Revenue Procedure, and is substantially similar to the sample instruments published in the Revenue Procedures.

3. These new sample trusts are set forth in a series of Revenue Procedures, as described below, that supersede the earlier 1989 and 1990 sample forms for charitable remainder trusts.

   a. Revenue Procedure 2003-53 – one life, inter vivos charitable remainder annuity trust.

   b. Revenue Procedure 2003-54 – term of years, inter vivos charitable remainder annuity trust.

   c. Revenue Procedure 2003-55 – two lives (consecutive), inter vivos charitable remainder annuity trust.

   d. Revenue Procedure 2003-56 – two lives (concurrent and consecutive), inter vivios charitable remainder annuity trust.

   e. Revenue Procedure 2003-57 – one life, testamentary charitable remainder annuity trust.

   f. Revenue Procedure 2003-58 – term of years, testamentary charitable remainder annuity trust.

   g. Revenue Procedure 2003-59 – two lives (consecutive), testamentary charitable remainder annuity trust.

   h. Revenue Procedure 2003-60 – two lives (concurrent and consecutive), testamentary charitable remainder annuity trust.

   i. Revenue Procedure 2005-52 – one life, inter vivos charitable remainder unitrust.

   j. Revenue Procedure 2005-53 – term of years, inter vivos charitable remainder unitrust.

   k. Revenue Procedure 2005-54 – two lives (consecutive), inter vivos charitable remainder unitrust.

   l. Revenue Procedure 2005-55 – two lives (concurrent and consecutive), inter vivos charitable remainder unitrust.

   m. Revenue Procedure 2005-56 – one life, testamentary charitable remainder unitrust.

   n. Revenue Procedure 2005-57 – term of years, testamentary charitable remainder unitrust.

o. Revenue Procedure 2005-58 – two lives (consecutive), testamentary charitable remainder unitrust

p. Revenue Procedure 2005-59 – two lives (concurrent and consecutive), testamentary charitable remainder unitrust.

4. If a donor wishes to obtain the benefits of the income tax charitable deduction for a contribution to a 50%-type organization, the governing instrument must require that the charitable organization qualify under Internal Revenue Code section 170(b)(1)(A). In Revenue Ruling 79-368, 1979-2 C.B. 109, the Internal Revenue Service limited the allowable charitable deduction to 20% of adjusted gross income because the remainder interest could have passed to a 30%-type organization even though the document named a 50%-type organization. On the other hand, the Internal Revenue Service allowed a deduction based on a gift to a 50%-type organization in Revenue Ruling 80-38, 1980-1 C.B. 56 for a charitable remainder trust that provided for the remainder interest to pass to a public university. The instrument provided that, if the university was not an organization under Internal Revenue Code section 170(c), the trustee was to select another section 170(c) beneficiary. Although the instrument did not also mention Internal Revenue Code section 170(b)(1)(A), the Internal Revenue Service held the possibility that the remainder would not pass to a 50%-type organization to be negligible. Unlike the Internal Revenue Service's 1989 and 1990 sample forms which only referred to Internal Revenue Code section 170(c), the 2003 and 2005 sample forms for charitable remainder trusts address this issue specifically.

5. The Internal Revenue Service requires a special provision for a charitable remainder trust that has a life interest following the grantor's life interest. In Revenue Ruling 82-128, 1982-2 C.B. 71, *mod*. Rev. Rul. 72-395, the Internal Revenue Service ruled that the mere possibility that a death tax could be apportioned against the inter vivos charitable remainder trust under state law disqualified the trust as a charitable remainder trust. Under the ruling, if the trust agreement has a provision stating that the interest of the second life beneficiary shall not take effect unless the beneficiary furnishes funds with which to pay any death taxes apportioned against the trust on the donor's death for which the trust may be liable, the trust will qualify as a charitable remainder trust. The donor must require that the successor life beneficiary pay any death taxes imposed on the trust out of the life beneficiary's own assets as a condition of receiving distributions from the charitable remainder trust. If the successor life beneficiary fails to do so, the charity's interest takes effect immediately.

6. One of the important optional provisions is the reservation by the donor of the right to revoke or terminate the interest of any noncharitable beneficiary. This power may be exercisable only by will. Reg. §§ 1.664-2(a)(4), 1.664-3(a)(4). If the donor reserves this power, the secondary life interest is revocable and there is no gift at the time of the creation of the trust. By making the life interest revocable, the value of the trust would be included in the donor's estate but partially offset by the charitable deduction for the actuarial value of the charitable remainder interest determined as of the donor's date of death. If the donor is not one of the income beneficiaries, the reservation of a power to revoke may not accomplish the desired tax goals in certain circumstances. Particular care should be taken in these circumstances.

7. The Internal Revenue Service's sample forms generally do not contain provisions regarding the trustee's powers, right to resign, etc. As a general rule, it is advisable to include these types of provisions in the trust agreement.

C. **Noncharitable Beneficiaries of Charitable Remainder Trusts.**

1. If the noncharitable interest is for a life or lives (rather than a term of years) the annuity amount or the unitrust amount must be paid to one or more named persons, all of whom must be living when the trust is created. Payments may be made for the use of an individual thus allowing distributions to a guardian of an incompetent beneficiary. Revenue Ruling 76-270 allowed the payment from a charitable remainder trust to an educational trust for the benefit of three minor beneficiaries.

2. In Revenue Ruling 76-270, the income beneficiary of a charitable remainder trust was a trust established for the benefit of a permanently incompetent beneficiary. The trustee of the recipient trust had discretion to use all of the trust assets for the incompetent beneficiary and upon the death of the beneficiary, the trust assets were to be paid to the incompetent's estate. The Internal Revenue Service ruled that this trust was a qualified charitable remainder trust.

3. In Revenue Ruling 2002-20, the Internal Revenue Service ruled that a charitable remainder unitrust may pay the unitrust amounts to a second trust for the life of an individual who is financially disabled as defined in Internal Revenue Code section 6511(b)(2)(A) if the use of the unitrust amounts by the second trust is consistent with the manner in which the individual's own assets would be used, and upon the individual's death, the second trust 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.

D. **Contributions to Charitable Remainder Trusts.**

1. The rules governing charitable remainder trusts contain no express limitation on the types of property that may be contributed to a charitable remainder trust. Because charitable remainder trusts are tax-exempt entities, frequently charitable remainder trusts are funded with appreciated property.

2. If the grantor wishes to retain the option to make additional contributions to a charitable remainder trust, the grantor must use a charitable remainder unitrust. No additional contributions may be made to a charitable remainder annuity trust after the initial funding. The governing instrument of a charitable remainder unitrust must prohibit additional contributions or provide special rules for determining unitrust payments in the case of additional contributions.

3. A testamentary charitable remainder trust can be used as the beneficiary of retirement plan accounts possibly maximizing family wealth. By having the distribution made to a tax-exempt charitable remainder trust, it is possible to defer paying the income tax and the estate will receive an estate tax charitable deduction. The income taxes will be deferred over the life of the income beneficiary.

E. **Trustees of Charitable Remainder Trusts.**

1. A grantor may serve as trustee of a charitable remainder trust. If a grantor does serve as trustee, the grantor must not retain any power that would cause the trust to be subject to the grantor trust rules under Internal Revenue Code sections 671 through 679. (For example, the grantor may not have the power as trustee to alter the beneficial enjoyment of the income distributions.)

2. The charity that is the charitable remainder beneficiary may also serve as trustee of a charitable remainder trust assuming the charity is permitted to serve under applicable state law.

3. If the grantor serves as trustee, payment of commissions to the grantor should not constitute self-dealing, if the payments are reasonable and based on the amount ordinarily paid to trustees under state law.

4. Previously, practitioners took the position that the grantor should never be permitted to serve as trustee of a charitable remainder trust that contains assets that are difficult to value, such as real estate or closely held stock. It is questionable in these circumstances whether the charity should serve as trustee as well. Self-dealing concerns in these situations were resolved in final regulations issued in December 1998 as discussed in more detail below.

F. **Income Taxation of a Charitable Remainder Trust.**

1. Charitable remainder trusts are exempt from federal income tax under Internal Revenue Code section 664. Under prior law, if the trust had any unrelated business taxable income, all the trust income was subject to federal income tax. *See Leila G. Newhall Unitrust v. Commissioner*, 104

T.C. 236 (1995). Under current law, the unrelated business taxable income is subject to a 100% excise tax, but the other income of the trust remains tax-exempt at the trust-level.

2. Because of the tax-exempt status of the charitable remainder trust, donors will frequently give appreciated property to the trust. The trust can sell the property free of capital gains tax, and the trustee can invest the full proceeds for the benefit of the donor. This is one of the major attractions of a charitable remainder trust.

G. **Estate Tax Considerations.**

1. If the charitable remainder trust is includable in the donor's estate, the donor's estate receives an estate tax charitable deduction for the fair market value of the charitable remainder interest valued as of the date of the donor's death or the alternate valuation date. If the donor is the sole life beneficiary, the entire trust is included in the donor's gross estate for estate tax purposes. The entire value of the trust then qualifies for the charitable deduction.

2. If the noncharitable beneficiary is an individual other than the donor, the trust assets are not included in the donor's gross estate (unless the donor retained the power to revoke the noncharitable interest). There would be a taxable gift on the creation of the trust and the adjusted taxable gift will be includable in determining the donor's estate taxes.

H. **Payments to Noncharitable Beneficiaries.**

1. A charitable remainder annuity trust must pay at least annually a sum certain to one or more noncharitable beneficiaries. The payment must be for the life of the noncharitable beneficiary or for a term of years not to exceed 20 years. The sum certain may be stated as an absolute dollar amount or as a fraction or percentage of initial net fair market value of the property placed in the trust. Subject to certain exceptions, the stated annuity amount may not be less than 5% nor more than 50% of the initial net fair market value of the trust property. There are special rules where the sum certain is expressed as a fraction or percentage and the initial fair market value of the trust property is valued incorrectly.

2. A charitable remainder unitrust must pay at least annually a fixed percentage of the net fair market value of the trust assets, as revalued each year, to noncharitable beneficiaries. The payments must be for the life of the noncharitable beneficiaries or for a term of years not to exceed 20 years. Subject to certain exceptions, the fixed unitrust percentage for a charitable remainder unitrust may not be less than 5% nor more than 50% of the initial fair market value of the trust property. Similar to the charitable remainder annuity trust, there are special rules when the net fair market value of the unitrust assets is determined incorrectly.

3. The primary difference between a charitable remainder unitrust and annuity trust is that the amount of the annuity payment is fixed at the time the charitable remainder annuity trust is created, while the amount of the unitrust payment will fluctuate from year to year, depending upon the value of the trust principal. A unitrust will result in increasingly greater payments to the income beneficiaries if the trust assets appreciate. Because the amount of the annuity payment is fixed at the time the charitable remainder annuity trust is created, the amount the noncharitable beneficiaries receive will not vary and may be preferable for noncharitable beneficiaries who do not want investment or market risk.

4. There are four types of unitrusts: a standard unitrust, a net income only unitrust, a net income unitrust with a makeup provision, and a "flip" unitrust.

   a. A standard unitrust pays the recipient a fixed percentage of the net fair market value of the trust assets as revalued annually.

   b. A net income unitrust pays the noncharitable beneficiary the lesser of the trust's net income or the stated percentage.

c. The net income unitrust with a makeup provision pays the noncharitable beneficiary the lesser of the trust's net income or the stated percentage and, if the income in any year exceeds the unitrust amount for the year, the excess is paid out to the extent necessary to make up for any shortfalls in prior years.

d. "Flip" unitrusts are discussed in more detail below.

5. The minimum amount rule will not be violated where the governing instrument of the annuity trust or unitrust provides for a reduction of the stated amount or fixed percentage upon the death of a noncharitable beneficiary or upon the expiration of the term of years provided that a distribution of principal is made to a charitable organization at the same time. The total amount payable by the annuity trust after a distribution to the charity may not be less than the dollar amount that bears the same ratio to the total annuity amount before the reduction as the net fair market value of the trust assets immediately after the distribution bears to the net fair market value of the trust immediately before the distribution and for a unitrust the total percentage of the trust assets payable must be at least 5%.

6. The governing instrument of an annuity trust or unitrust must provide that in the case of a short taxable year other than the final year, the annuity or unitrust amount otherwise payable is prorated for the actual number of days in the short taxable year.

I. Period of Payment to Noncharitable Beneficiary.

1. The governing instrument of a qualified charitable remainder trust must require payment of the annuity or unitrust amount for a period that begins with the first year of the charitable remainder trust and continues for the life or lives of a named individual or individuals living at the creation of the trust or for a term of years not to exceed 20 years. Only an individual or section 170(c) organization may receive the annuity or unitrust amounts for the life of an individual. If payments are made to a noncharitable entity such as a partnership, corporation, or trust, the period of payment must be measured by a term of years not to exceed 20 years.

2. If an individual receives an amount for life, it must be payable solely for the life of that individual. An interest based on the life of another individual is not permissible.

3. Where payments are to be made for a term of years, it is permissible for payments to be made to the beneficiary's estate for the duration of the term. The Internal Revenue Service ruled in Revenue Ruling 74-39 that the following payment provision was acceptable: a payment to an individual for a term of 20 years and if the individual died before the expiration of the 20-year term, payments were made to a second individual for the balance of the period and if this individual also died, payments were made to that individual's heirs-at-law for the remainder of the 20-year period. The Internal Revenue Service ruled this was a permissible payment provision because the trust term cannot last longer than 20 years.

4. It is permissible to tack a period measured by the life of an individual onto a period measured by a term of years if the individual is living on the date of the creation of the trust. It is not permissible to tack a period measured by a term of years onto a period measured by the life of an individual. (The durational limit must be either a term of years not to exceed 20 years or the life of the individual beneficiary.)

5. Internal Revenue Code section 664(f) allows noncharitable annuity or unitrust payments to end upon the occurrence of a qualified contingency that will accelerate the charitable remainder interest. A qualified contingency must not extend the duration of the otherwise allowable term.

J. The Net Income Charitable Remainder Unitrust.

1. A unitrust with a net income only option limits the amount paid out to the noncharitable beneficiary to the income earned by the trust if less than the unitrust amount. The limitation does not affect the donor's charitable contribution deduction.

2. If the unitrust has the net income only option, it may be advantageous to include a makeup provision. With a makeup provision, any deficits between the calculated unitrust amount and the actual income available for payments in a year are made up in future years where the trust income exceeds the unitrust percentage. Normally, there is no reason not to include a makeup provision in a net income unitrust.

3. The recently issued final regulations, discussed below, authorize the use of "flip" unitrusts in certain circumstances and if certain requirements are met.

K. **Taxation of Payments to the Noncharitable Beneficiary.**

1. Internal Revenue Code section 664(b) sets forth the rules for determining the taxability of distributions from a charitable remainder trust to the noncharitable beneficiary. Payments to the noncharitable beneficiary are deemed to be made first from ordinary income, second from capital gains, third from other income (which is usually tax-exempt income), and last from trust principal.

2. Although there is more complexity than described here due to different tax rates for different types of income within each category, distributions to noncharitable beneficiaries consist first of ordinary income to the extent of the trust's ordinary income for the taxable year of the distribution and the trust's ordinary income for prior years not deemed to have been previously distributed. After all current year and prior year's undistributed ordinary income has been exhausted, the distribution to noncharitable beneficiaries is deemed to be composed of capital gain income to the extent of the trust's capital gain income for the year and undistributed capital gain income from earlier years. In determining the amount of capital gain distributed, long-term gains are netted against long-term losses, and short-term gains are netted against short-term losses. The short-term capital gains are deemed distributed before long-term capital gains. If capital losses exceed capital gains, excess losses are carried forward to succeeding taxable years. Losses are never carried back.

3. After capital gain income is exhausted, distributions to a noncharitable beneficiary are deemed to come from other income. Other income includes income that is excluded from gross income, which is usually tax-exempt income.

4. After the three categories of ordinary income, capital gains, and other income have been exhausted, remaining distributions to noncharitable beneficiaries are considered to have been made from trust principal.

5. The payment to a noncharitable beneficiary is deemed to have occurred on the last day of the trust's taxable year in which the amount is required to be distributed, even if the annuity or unitrust amount is not actually distributed until after the close of the trust's taxable year. Reg. § 1.664-1(d)(4)(i). The 1998 final regulations under Internal Revenue Code section 664 address the timing of payments of the unitrust or annuity amounts as discussed later and may require that distributions be made before the end of the taxable year in certain circumstances.

6. Charitable remainder trusts are required to use a calendar year tax year.

L. **Miscellaneous.**

1. The governing instrument must contain a provision addressing the incorrect valuation of the net fair market value of trust assets. If the trustee incorrectly determines the net fair market value of the trust assets and the payment is expressed as a fraction or a percentage of the net fair market of the trust property, the incorrect valuation will affect the amount payable to the noncharitable beneficiary. When this occurs, the trustee must pay to the beneficiary in the case of an undervaluation, or the beneficiary must pay the trustee in the case of an overvaluation, an amount equal to the difference between the amount the trustee paid the beneficiary and the correct payment amount. The payments or repayments must be made within a reasonable period after the final determination of the value of the trust assets.

2. A trust is not a charitable remainder trust if any person has the power to alter the amount to be paid to any named person other than an organization described in Internal Revenue Code section 170(c) if such power would cause any person to be treated as the owner of a trust if the grantor trust rules were applicable to the trust. For example, the governing instrument may not grant the trustee the power to allocate the fixed percentage among members of the class unless this power falls within one of the exceptions to Internal Revenue Code section 674(a).

3. The trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in Internal Revenue Code section 170(c). The grantor may retain the power exercisable by will to revoke or terminate the interest of any recipient other than an organization described in Internal Revenue Code section 170(c).

V. 1998 FINAL REGULATIONS AFFECTING CHARITABLE REMAINDER TRUSTS.

A. Generally.

1. The Internal Revenue Service issued final regulations amending the regulations under Internal Revenue Code section 664 on December 20, 1998.

2. The final regulations addressed a number of matters of concern to the Internal Revenue Service involving perceived abuses of the charitable remainder trust rules. The regulations also clarify certain matters that had previously been addressed in private letter rulings, including the use of "flip" unitrusts.

3. These regulations contained the most comprehensive and encompassing changes to the charitable remainder trust rules since the enactment of Internal Revenue Code section 664 in 1969 and the issuance of the regulations under Internal Revenue Code section 664 in 1972.

4. The most significant provisions of these regulations are:

   a. Rules for when a net income unitrust can convert to a straight unitrust (the so-called "flip" unitrust).

   b. Rules regarding the allocation of capital gain to income in a net income unitrust.

   c. New rules on the timing of unitrust and annuity amount payments.

   d. A procedure for valuing unmarketable assets when the donor or a related party serves as trustee of a unitrust.

B. "Flip" Charitable Remainder Unitrusts.

1. The regulations allow the creation of a net income charitable remainder unitrust (whether with or without a makeup provision) that converts to a straight percentage charitable remainder unitrust upon the occurrence of a specified event. Under these rules, a net income charitable remainder unitrust may convert to a straight percentage unitrust (using the same percentage) if the governing instrument of the charitable remainder unitrust meets the following requirements:

   a. The change from a net income unitrust to a straight unitrust must be triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustee or any other person (referred to as the "triggering event").

   b. The change from a net income unitrust to a straight unitrust must occur at the beginning of the taxable year of the unitrust that immediately follows the taxable year during which the triggering event occurs. Under this rule, if the triggering event occurs on July 1, 2016, the conversion of the unitrust to a straight unitrust must occur on January 1, 2017.

c. Following the conversion in the case of a net income unitrust with a makeup provision, the unitrust's governing instrument must provide that any makeup amount not paid as of the conversion date is forfeited.

2. These new flip unitrust rules are extremely broad and significantly enhance the planning opportunities available when establishing a charitable remainder unitrust for a donor.

C. **Planning with "Flip" Charitable Remainder Unitrusts under the Final Regulations.**

1. In the past, the use of a charitable remainder trust as a charitable gift technique had become fairly routine without much consideration given to planning opportunities presented beyond the immediate income tax benefits. Typically, the only decisions required were whether to use a charitable remainder annuity trust or a charitable remainder unitrust, the amount of the payout to the noncharitable beneficiary, and the timing of the payments to the noncharitable beneficiary. If a charitable remainder unitrust was selected, it was necessary to decide whether the unitrust should provide for payment of a straight percentage or the lesser of the net income or the set percentage. If a net income charitable remainder unitrust was selected, it was also necessary to decide whether to include a makeup provision. Because the options were somewhat limited, establishment of the charitable remainder trust and preparation of the trust agreement were fairly straightforward, and reliance on forms was the norm.

2. With the advent of the flip unitrust, traditional approaches to the establishment of a charitable remainder trust no longer work. Planned giving officers, lawyers, and other advisors to individuals desiring to establish charitable remainder trusts must now explore more fully the estate planning objectives and goals of the donor. Depending upon these objectives and goals, more attention must also be given to the drafting of the actual terms of the charitable remainder trust agreement. But, the charitable remainder unitrust is now a much more flexible estate planning tool. While there are certain obvious uses for a flip unitrust, there are also a myriad of circumstances for using flip unitrusts to accomplish the unique objectives and goals of the donor that are not so obvious.

3. The wide range of planning opportunities associated with a flip unitrust arises from the broad definition of a "triggering event" under the final regulations. It is the triggering event that causes the flip unitrust to convert from a net income charitable remainder unitrust (whether with or without a makeup provision) to a straight charitable remainder unitrust. The actual conversion to a straight charitable remainder unitrust will occur on January 1 of the first taxable year after the year in which the triggering event occurs.

   a. The final regulations offer a number of examples of permissible triggering events. A specific date is a permissible triggering event.

   b. A single event whose occurrence is not discretionary with, or within the control of, the trustee or any other person is a permissible triggering event.

   c. The sale of an unmarketable asset or the marriage, divorce, death, or birth of a child with respect to any individual are permissible triggering events. Unmarketable assets include real estate, closely held stock, or unregistered securities for which there is no available exemption permitting public sale under the rules of the Securities and Exchange Commission.

   d. The regulations also set forth a number of examples that illustrate the breadth of the definition of a permissible triggering event. Permissible triggering events under these examples include the sale of a personal residence, the attainment of a certain age by the noncharitable beneficiary of the flip unitrust, the marriage or divorce of the noncharitable beneficiary, the birth of the first child of the noncharitable beneficiary, and the death of the noncharitable beneficiary's father.

D. **Use of Flip Unitrust for Unmarketable Assets.**

1. The most obvious use of a flip unitrust is in connection with a gift of an illiquid or unmarketable asset, such as real estate or closely held stock. In the past, charitable remainder trusts funded with these types of assets were typically structured as net income (either with or without a makeup provision) charitable remainder unitrusts. This approach was necessary to enable the charitable remainder unitrust to satisfy the payout requirements to the noncharitable beneficiary during the time before the unmarketable asset was sold. Under recent market conditions, however, the sale of the unmarketable asset did not usually result in payment of the full straight percentage to the noncharitable beneficiary following the sale without an investment approach that favored the generation of income. This type of investment approach often conflicted with the long-term objective of growth, which would have resulted not only in benefits to the charitable remainderman, but also to the noncharitable beneficiary in the form of higher payouts over time.

2. Use of a flip unitrust when dealing with an unmarketable asset, with the triggering event defined as the sale of the unmarketable asset, will avoid problems associated with a net income unitrust and allow the assets of the unitrust to be invested for total return following the sale of the unmarketable asset. The flip unitrust enables the initial problems associated with funding a charitable remainder trust with unmarketable assets to be handled during the period before the unmarketable asset is sold, but has solved the long-term problem associated in the past with net income charitable remainder unitrusts and an investment strategy designed to produce income. Now, if a flip unitrust is used, the trust assets can be invested for growth or total return following the sale of the unmarketable asset to the ultimate benefit of not only the charitable remainderman, but also the noncharitable beneficiary of the charitable remainder unitrust.

3. If the flip unitrust is structured initially as a net income with a makeup provision and post-contribution appreciation is allocated to income under the terms of the trust agreement, it may also be possible to ensure that the noncharitable beneficiary receives some of the unitrust amount accrued while the unitrust owned the unmarketable asset before this amount is forfeited following the conversion to a straight unitrust on January 1 of the year following the year in which the triggering event occurs.

4. <u>Example</u>. Donor establishes a flip unitrust and funds the unitrust with unimproved real estate on January 1, 2015. The flip unitrust provides that the Donor is to receive the lesser of the net income of the unitrust or 6% of the value of the trust's assets as valued each year until the year following the year in which the real estate contributed to the unitrust is sold. The flip unitrust also provides that post-contribution appreciation is to be included in income or purposes of determining the payments to the Donor before the conversion of the unitrust to a straight unitrust. At the time the flip unitrust is funded the real estate is valued at $100,000. The real estate is sold on December 30, 2017 for $150,000. The accrued unitrust amount through 2017 is $18,000. Because post-contribution appreciation is allocated to income, the trustee has $50,000 of income in 2017, which amount can be used to pay the Donor the accrued unitrust amount of $18,000. Beginning on January 1, 2018, the unitrust will pay the Donor 6% of the fair market value of the trust assets as revalued each year.

5. Because of the unique benefits of the flip unitrust when dealing with unmarketable assets, it is likely that the flip unitrust will supplant the net income charitable remainder unitrust and become more widely used. Of course, there may still be situations where the donor may prefer a net income charitable remainder unitrust instead of a flip unitrust, particularly if income is defined to include post-contribution appreciation as now permitted under the final regulations. For these reasons, it will be necessary for the donor's advisors to review the possible choices with the donor in greater detail to insure that the form of charitable remainder unitrust chosen meets the donor's objectives and goals.

E. **Use of Flip Unitrusts for Retirement Planning.**

1. Another significant planning opportunity associated with the flip unitrust is in connection with planning for the donor's retirement. In the past, net income charitable remainder unitrusts have

been promoted as an effective technique for retirement planning in conjunction with a charitable gift. Under this technique, the donor would contribute assets to a net income charitable remainder unitrust during a year when the donor's income was high, thereby obtaining an immediate income tax charitable deduction to reduce the donor's income taxes. Then, through a choice of an investment strategy designed to minimize income and maximize growth while the donor was still earning significant income, the income received from the net income charitable remainder unitrust during the employment years was limited. Upon the donor's retirement, the investment strategy of the charitable remainder unitrust would be changed so as to favor income in the years following retirement. While this technique could work in certain circumstances, its success depended in part upon market conditions, which are not always predictable. There have also been concerns in the past that the manipulation of the investments to favor the donor's income needs could be considered self-dealing under Internal Revenue Code section 4941.

2. The flip unitrust is an excellent alternative to the net income unitrust in connection with retirement planning for the donor. The triggering event in the flip unitrust would be either a set date or the date upon which the donor attains a certain age, such as age 65. Before that time, the unitrust would be invested for growth or total return and the donor would receive the actual income earned by the charitable remainder unitrust under the net income limitation. Upon the conversion of the flip unitrust to a straight charitable remainder unitrust, the donor will begin receiving a straight percentage of the value of the trust assets as revalued each year. Thus, the donor's retirement objectives have been met without having to alter the unitrust's investment strategy to achieve these goals. The investment of the trust assets for total return throughout the donor's lifetime should also have the added advantage of generating a higher unitrust amount in later years assuming the assets increase in value during the term of the unitrust.

3. The use of a flip unitrust for retirement planning again illustrates the need for the donor's advisors to explore the donor's objectives when establishing the unitrust. In the case of a donor who is still working, the advisors should point out the potential benefits associated with the use of a flip unitrust tied to the donor's anticipated retirement date. (Note that the triggering event should not be defined as the donor's retirement as this could be deemed to be an event that is discretionary with the donor. Instead, the triggering event should be defined as a specific date or the date upon which the donor attains a certain age.)

F. **Use of Flip Unitrust to Meet Estate Planning and Income Objectives.** Because of the broad range of possible triggering events, there is a greater need to explore the donor's particular objectives when establishing a charitable remainder unitrust, even if the trust is funded with marketable assets or the donor is not concerned about retirement. There are any number of circumstances where the flip unitrust may be advisable or prudent for the donor. Planning with the flip unitrust will require a great deal of attention to the specific circumstances of the donor and greater creativity when structuring a charitable remainder unitrust to meet the objectives and goals dictated by the donor's unique circumstances. Examples of the types of situations where a flip unitrust may be useful or advisable include:

1. <u>Planning for Surviving Spouse</u>. Many donors are not concerned about their income needs while they are living, but instead worry that their spouses may need greater income following their deaths. In these circumstances, the donor should consider a flip unitrust, with the surviving spouse as a noncharitable beneficiary and the triggering event defined as the donor's death.

2. <u>Planning for a Child</u>. Many donors worry that their children may not have the necessary financial resources in the event of certain occurrences during their children's lives, such as divorce or birth of a child. In these circumstances, the donor may consider a flip unitrust, with the child as a noncharitable beneficiary and the triggering event defined as the child's divorce or the birth of the child's first child. Other possibilities would include defining the triggering event as the death of the donor or the death of the child's spouse to ensure that the child is adequately provided for following the donor's death or the death of the child's spouse.

3. <u>Planning for Education</u>. Many donors have provided funds for grandchildren's education under favorable gift tax provisions. Often, there are younger grandchildren who are not yet of school age. If the donor is concerned that he may not be living when the grandchild reaches school age,

the donor may consider a flip unitrust for a term of years with the triggering event defined as the date the grandchild reaches a certain age. Particular care should be taken to examine the transfer tax ramifications upon the creation of the trust.

4. Planning for Uncertainty. Many donors do not have a current need for income but worry about a possible need for income in the future. In these circumstances, a flip unitrust may be advisable with a triggering event tied to an event such as involuntary termination of employment or total disability. The examples under the final regulations also make it clear that it is permissible to use a triggering event tied to the sale of an unmarketable asset even when other assets of the unitrust consist of marketable assets. Because it may not be possible to plan for an unknown event, some flexibility could be created by funding a flip unitrust with marketable assets and one unmarketable asset, such as real estate or a share of closely held stock and defining the triggering event as the sale of the unmarketable asset. If the donor had a need for greater income in the future, the trustee could then sell the unmarketable asset to trigger a conversion of the unitrust from a net income charitable remainder unitrust to a straight charitable remainder unitrust.

G. **Allocation of Capital Gain to Income.**

1. Many trusts now providing for a makeup provision allocate capital gains to income which is permitted if so provided in the governing instrument under most state's principal and income acts.

2. The Internal Revenue Service had expressed concern that abuses could occur if the precontribution gain is allocable to income.

3. The regulations provide that the proceeds from the sale of a net income unitrust's assets, at least to the extent of the fair market value of the asset when contributed to the trust, must be allocated to principal.

4. The preamble to the 1998 regulations further provides that the makeup amount does not have to be treated as a liability to the extent of post-contribution appreciation in the assets for purposes of valuing the unitrust and determining the annual unitrust amount (contrary to the position of the Internal Revenue Service in earlier letter rulings).

H. **Timing of Payment of Unitrust and Annuity Amount.**

1. Previously under the regulations, a trustee was permitted to pay the annuity or unitrust amount within a reasonable period of time following the close of the trust's taxable year.

2. This was previously deemed to be by the due date of the trust's tax returns. This provision was originally intended as an administrative convenience for trustees of net income unitrusts.

3. To remedy concerns about accelerated charitable remainder trusts as described in Notice 94-78, the final regulations make certain changes to the rules regarding the timing of the payment of the annuity amount or the unitrust amount.

4. For charitable remainder annuity trusts and straight charitable remainder unitrusts, the annuity or unitrust amount may be paid within a reasonable time after the close of the taxable year in which it is due if:

   a. The character of the annuity or unitrust amount in the recipient's hands is income under Internal Revenue Code section 664(b); or

   b. The trust distributes property (other than cash) that it owned as of the close of the taxable year in satisfaction of the annuity or unitrust amount and the trustee elects on Form 5227 to treat any income generated by the distribution as occurring on the last day of the taxable year for which the annuity or unitrust amount is due.

5. For charitable remainder annuity trusts and straight charitable remainder unitrusts that were created before December 10, 1998, the annuity or unitrust amount may be paid within a reasonable time after the close of the taxable year for which it is due if the percentage used to calculate the annuity or unitrust amount is 15% or less.

6. Other charitable remainder trusts will be required to distribute the annuity or unitrust amount by the end of the year for which it is payable. The trusts covered by this rule include:

   a. Any trust for which some portion of the unitrust or annuity trust amount will be characterized as corpus under the four-tier tax system applicable to distributions from charitable remainder trusts.

   b. Any annuity trusts or straight unitrusts created before December 10, 1998 with a payout rate greater than 15%.

7. Net income unitrusts continue to operate under the prior rule and have a reasonable period of time after the end of the taxable year to pay the unitrust amount.

I. Valuation of Unmarketable Assets.

1. The legislative history to Internal Revenue Code section 664 has often been referred to for the proposition that a donor could not serve as trustee of a charitable remainder trust unless an independent trustee appraised the trust assets.

2. To clarify this issue, the regulations now provide that, if a charitable remainder trust holds unmarketable assets and the trustee is the grantor of the charitable remainder trust, a noncharitable beneficiary, or a related or subordinate party to the grantor or noncharitable beneficiary within the meaning of Internal Revenue Code section 672(c), the trustee may use a qualified appraisal from a qualified appraiser (within the meaning of Regulation section 1.170A-13(c)(3) and (5)) to value the unmarketable assets if there is not an independent trustee.

3. This change permits the grantor, a noncharitable beneficiary, or a related or subordinate party to serve as sole trustee of a charitable remainder trust funded with unmarketable assets.

VI. PLANNING OPPORTUNITIES WITH CHARITABLE REMAINDER TRUSTS.

A. Income Tax Planning.

1. Avoidance of capital gain on appreciated assets.

2. Income tax deduction without loss of income stream.

3. Early termination.

B. Unique Assets or Circumstances.

1. Retirement assets and testamentary charitable remainder trusts.

2. Deferral of philanthropic planning.

3. Short-term trust to control sale of assets.

VII. OVERVIEW OF CHARITABLE LEAD TRUSTS.

A. Executive Summary.

1. A charitable lead trust (“CLT”) is the reverse of a CRT.

2. Income is paid to charity for a specified term (for example, a number of years or an individual's lifetime); upon expiration of the term, assets pass to descendants or other designated noncharitable beneficiaries outright or in further trust.

3. Income payments to charity may be a fixed dollar amount (a charitable lead annuity trust or CLAT) or a fixed percentage of trust assets revalued each year (a charitable lead unitrust or CLUT).

4. The trust may be established during the donor's lifetime or at the donor's death.

5. Tax advantages of trust established during the donor's lifetime:

   a. Reduces cost of transferring assets to noncharitable beneficiaries while offering opportunity to transfer growth tax free;

   b. Removes appreciating asset and income from donor's taxable estate; and

   c. Avoids percentage limitations on charitable deductions.

6. Tax advantages of trust established at the donor's death:

   a. Estate receives deduction for value of income payable to charity; and

   b. Trust assets pass to descendants or other noncharitable beneficiaries with a stepped-up basis.

7. Nontax advantages:

   a. Accomplishes donor's charitable objectives while keeping capital in the family without the need for "wealth replacement" techniques; and

   b. Charity receives income currently.

8. Disadvantages:

   a. Portion of donor's income and wealth shifted to charity rather than family members;

   b. Donor foregoes current income from trust assets;

   c. Gift of remainder interest to noncharitable beneficiaries does not qualify for annual gift tax exclusion and generally requires donor to use portion of unified credit or pay gift tax; and

   d. Noncharitable beneficiaries must wait until expiration of trust term to receive assets.

9. Best candidates to establish charitable lead trust: donors with genuine charitable interests, sufficient other assets to provide for personal cash needs, and ability to defer receipt of assets by noncharitable beneficiaries.

10. Best assets with which to fund charitable lead trust:

   a. Common stocks and other assets likely to appreciate over the trust term,

   b. Assets producing sufficient income to satisfy annual charitable payments,

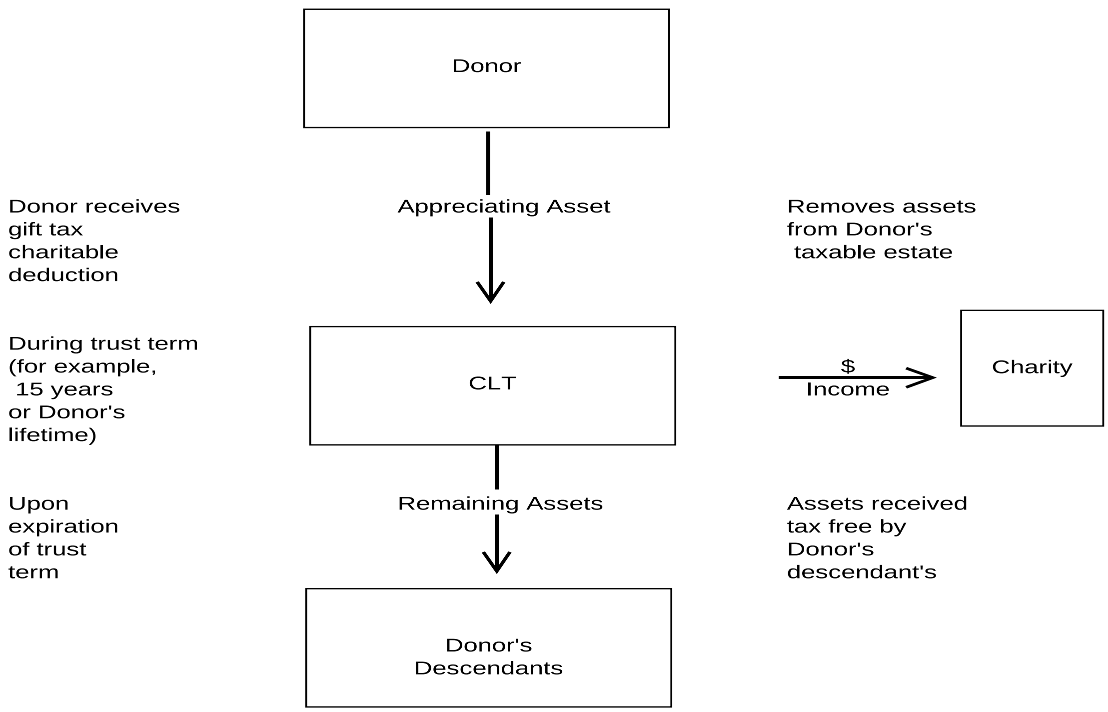
   c. Mixture of cash and high yielding securities with nonincome producing property; or

d. Assets such as limited partnership interests that have a good cash flow but can be discounted for transfer tax purposes.

B. **General Overview.**

1. A CLT is a split-interest trust under which the income (or "lead" interest) is payable to one or more charitable beneficiaries for the term of the trust, and upon expiration of that term, the trust corpus (the "remainder" interest) is payable to one or more noncharitable beneficiaries or reverts to the creator of the trust (the "donor").

2. The following diagram shows the basic structure and operation of a CLT created during a donor's lifetime.



3. The IRS issued Rev. Proc. 2007-45 and 2007-46, which set forth sample forms for inter vivos and testamentary CLATs, and Rev. Proc. 2008-45 and 2008-46, which set forth sample forms for CLUTs.

a. The suggested language is similar in many respects to that previously provided by the IRS for CRTs and to the form language used by most practitioners.

b. Sample forms are provided for both grantor and nongrantor CLTs and for a lead period measured by one or more lives as well as a term of years.

4. CLTs are very flexible.

a. The CLT may allow the trustee discretion in determining the charities to receive the unitrust or annuity payments, or the CLT may name one or more specified charities.

b. Unlike a CRT, there is no minimum payout for a CLT and it can be for any term of years and is not limited to 20 years like a CRT.

c. But, like a CRT, no additional contributions may be made to a CLAT and may only be made to a CLUT if authorized by the trust instrument.

C. **Tax Overview.**

1. Upon creation of a qualifying CLT, the donor receives a gift tax deduction (if the trust is created during the donor's life) or an estate tax deduction (if the trust is created at the donor's death) equal to the present value of the income payable to charity over the term of the trust. Under certain circumstances, the donor may also receive an income tax deduction. The donor is subject to gift or estate tax on the present value of the remainder interest that will pass to noncharitable beneficiaries at the end of the trust term. Because the values of the income and remainder interests are calculated using an assumed rate of return at the time the trust is funded, a CLT enables the donor to realize significant tax savings if the actual investment return on the trust assets during the trust term exceeds the assumed rate, in which case the excess value passes to the noncharitable beneficiaries free from transfer tax.

2. Charitable lead trusts may be divided into two categories:

a. Trusts transfers to which qualify for charitable tax deductions ("qualifying" CLTs), and

b. Trusts transfers to which do not qualify for charitable deductions ("nonqualifying" CLTs).

VIII. QUALIFYING CHARITABLE LEAD TRUSTS.

A. For a donor to receive a charitable tax deduction, the trust must satisfy certain requirements.

1. Pursuant to the trust instrument, income must be payable to one or more qualified charitable organizations in the form of either a "guaranteed annuity" or a "unitrust" interest.

a. A guaranteed annuity interest is a right to receive a fixed sum at least annually for a term of years or the life or lives an individual or individuals. The sum may be stated as a dollar amount or as a formula for determining a dollar amount (for example, a percentage of the net fair market value of the property transferred to the trust valued as of the date of transfer). The payment amount is determined at the creation of the trust and does not fluctuate with the value of the trust assets or income. A CLT providing for a guaranteed annuity interest is referred to as a "charitable lead annuity trust" or "CLAT."

b. A "unitrust" interest is a right to receive, at least annually, payment of a fixed percentage of the net fair market value of the assets of the trust, re-determined annually, for a term of years or the life or lives of an individual or individuals. Unlike the guaranteed annuity payment, the amount of the annual unitrust payment fluctuates according to the net fair market value of the trust assets each year. The annual payout percentage, however, must be determinable upon formation of the trust and may not vary over the term of the trust. A charitable lead trust providing for a unitrust interest is referred to as a "charitable lead unitrust" or "CLUT."

c. There is no minimum or maximum annuity or unitrust payment amount and no limitation on the number of years over which the charitable lead interest may be payable (terms of years and lifetimes may be mixed and matched without the restrictions that apply to charitable remainder trusts), subject to any applicable rule against perpetuities.

d. Under both payment methods, the trustee is required to pay out the specified amount of charity each year, even if the trust's income in a given year falls below the amount of the required payment. In such cases, the trustee must invade corpus or borrow to make up the shortfall. Income in excess of the guaranteed annuity or unitrust payment may be accumulated in the trust or distributed currently to the charitable beneficiary.

2. To receive an income, estate, or gift tax deduction, each charitable beneficiary must be described as a qualified charitable organization under IRC § 170, 2055, or 2522, respectively. For gift and estate tax purposes, the organization may be a public charity or a private foundation, including a private foundation affiliated with the donor.

   a. A donor may name one or more qualified charities to receive set portions of the income throughout the trust term or authorize the trustee to select charitable beneficiaries and allocate the income payment annually.

   b. The failure to designate specific charitable recipients of a CLT interest does not disqualify the interest for a charitable deduction where the trustee has the power to select the recipients. Rev. Rul. 78-101, 1978-1 C.B. 301.

   c. The donor must not have the power during the lead term to select the charitable beneficiary to avoid estate tax inclusion under IRC § 2036.

   d. Estate tax inclusion issues can also arise if the charitable beneficiary is an organization for which the donor serves as a director or officer. The donor's ability to participate as an officer and director of a foundation in the selection of charitable recipients of grants from the foundation, which was funded from a CLT created by the donor, is an IRC § 2036 retained power to control the enjoyment of the trust property resulting in inclusion of the CLT in the donor's estate. *Rifkind v. U.S.*, 84-2 U.S.T.C. ¶ 13,577 (Cl. Ct. 1984). Ltr. Rul. 9331015 offers suggested provisions for avoidance of estate inclusion under IRC § 2036.

3. Qualifying CLTs are generally subject to the same restrictions and excise taxes as private foundations. A CLT will not be subject to the private foundation restrictions on excess business holdings or jeopardy investments, however, if the present value of the charitable lead interest or interests does not exceed 60% of the net value of the trust assets on the valuation date.

4. Upon the transfer of assets to a qualifying CLT, the donor receives a deduction equal to the present value of the income interest payable to charity, as determined pursuant to IRC § 7520, thereby reducing the portion of the assets subject to tax. Under IRC § 7520, the value of the charitable interest is calculated using prescribed actuarial tables and an assumed interest rate equal to 120% of the federal midterm rate for the month in which the valuation date occurs, or at the donor's election, either of the two months preceding the transfer. The longer the charitable term and the higher the payout rate, the greater the value of the charitable interest and the lower the value of the taxable gift.

5. The following tables show the percentage of the initial funding of a CLAT or CLUT that would be treated as a deductible gift to charity and the percentage that would be treated as a taxable gift based on different payout rates and trust terms. (All calculations assume IRC § 7520 rate of 2.2% and quarterly payments.)

CHARITABLE LEAD TRUSTS FOR TERM OF YEARS

		Unitrust		Annuity Trust	
Term of Years	Payout Rate	Charitable Lead	Taxable Remainder	Charitable Lead	Taxable Remainder
5	3%	13.95%	86.05%	14.17%	85.83%
	5%	22.35%	77.65%	23.62%	76.38%
	7%	30.08%	69.92%	33.07%	66.93%
10	3%	25.95%	74.05%	26.89%	73.11%
	5%	39.70%	60.30%	44.81%	55.19%
	7%	51.11%	48.89%	62.74%	37.26%
15	3%	36.28%	63.72%	38.29%	61.71%
	5%	53.17%	46.83%	63.81%	36.19%
	7%	65.81%	34.19%	89.34%	10.66%
20	3%	45.16%	54.84%	48.52%	51.48%
	5%	63.64%	36.36%	80.86%	19.14%
	7%	76.09%	23.91%	100.00%	0.00%

CHARITABLE LEAD TRUSTS FOR LIFE OF INDIVIDUAL

		Unitrust		**Annuity Trust**	
Term for <u>Ages</u>	Payout <u>Rate</u>	Charitable <u>Lead</u>	Taxable <u>Remainder</u>	Charitable <u>Lead</u>	Taxable <u>Remainder</u>
55	3%	51.12%	48.88%	56.50%	43.50%
	5%	68.11%	31.89%	84.24%	15.76%
	7%	78.28%	21.72%	91.63%	8.37%
65	3%	39.28%	60.72%	42.36%	57.64%
	5%	55.10%	44.90%	68.67%	31.33%
	7%	65.96%	34.04%	81.87%	18.13%
75	3%	26.99%	73.01%	28.43%	71.57%
	5%	39.86%	60.14%	47.31%	52.69%
	7%	49.84%	50.16%	62.91%	37.09%

CHARITABLE LEAD TRUSTS FOR TERM OF JOINT LIVES OF INDIVIDUALS

		Unitrust		**Annuity Trust**	
Term for <u>Ages</u>	Payout <u>Rate</u>	Charitable <u>Lead</u>	Taxable <u>Remainder</u>	Charitable <u>Lead</u>	Taxable <u>Remainder</u>
55/55	3%	60.16%	39.84%	67.35%	32.65%
	5%	77.96%	22.04%	95.69%	4.31%
	7%	87.55%	12.45%	98.89%	1.11%
65/65	3%	48.38%	51.62%	52.74%	47.26%
	5%	66.23%	33.77%	84.23%	15.77%
	7%	77.58%	22.42%	94.93%	5.07%
75/75	3%	35.06%	64.94%	37.24%	62.76%
	5%	50.79%	49.21%	61.91%	38.09%
	7%	62.38%	37.62%	80.41%	19.59%

6. For a CLAT, the lower the IRC § 7520 rate at the time the trust is created, the greater the charitable deduction.

7. Changes in the IRC § 7520 rate have little impact upon the valuation of charitable unitrust interests, although if the unitrust payout rate is lower than the IRC § 7520 rate, the unitrust will produce a larger charitable deduction than the annuity trust because the excess of the assumed return over the payout rate is deemed to cause an increase in the trust assets from which the unitrust payout will be calculated.

B. **Income Tax Deduction for Qualified Grantor CLT.** To receive an income tax charitable deduction upon formation of a qualified CLT, the donor must be treated as the owner of the property transferred to the trust for income tax purposes under the "grantor trust" rules of IRC §§ 671 through 679. The donor's income tax deduction is limited to 30% of the donor's contribution base (20% if the trust is funded with appreciated property or the charitable beneficiary is a private foundation). As owner of the trust property, however, the donor continues to be taxed on the income earned during the term of the trust without the benefit of further income tax deductions for the amounts paid to charity. Thus, while the donor receives an upfront income tax deduction equal to the actuarial value of the charitable income interest, this deduction is "recaptured" over time as the donor is taxed annually on the trust income. If the donor dies or ceases to be treated as the owner of the CLT before the full recapture of the previously allowed charitable deduction, the remaining uncaptured portion is accelerated and taxed to the donor or the donor's estate. Consequently, a charitable lead grantor trust effectively defers rather than eliminates income tax, which may prove advantageous to individuals who expect to be in lower income tax brackets in future years.

C. **Income Tax Treatment of Qualified Nongrantor CLT.**

1. A donor is not entitled to an income tax deduction upon formation of a qualifying nongrantor CLT.

2. For income tax purposes, a nongrantor CLT is treated as a separate entity and taxed as a complex trust. It is required to file a federal Form 1041 and Form 5227 as well as any applicable state income tax returns.

3. Although the trust itself is not exempt from income tax, it will receive a deduction under IRC § 642(c) for amounts of gross income paid to charitable organizations pursuant to the terms of its governing instrument.

4. In contrast to the income tax deduction rules applicable to individuals, a qualifying nongrantor CLT is not subject to percentage limitations on income tax charitable deductions, and there is no requirement that the recipient beneficiary be a domestic organization. Income in excess of that distributed to charity and any undistributed capital gains are taxed to the trust. The noncharitable remainder beneficiaries are not taxed on the trust income during the term of the trust.

5. If the CLT has unrelated business taxable income, the IRC § 642(c) deduction is effectively limited by IRC § 681(a) to the percentage ceilings under IRC § 170(b), that is, a maximum of 50%.

6. If the annuity or unitrust payment is made after the close of the year (and before the last day of the following year), the trustee may elect to treat the payment as made during the prior year. There is no carryforward available for any unused charitable deduction.

D. **Estate and Gift Tax Deductions.** Upon formation of a qualifying CLT during the donor's lifetime (an "inter vivos" CLT), the donor receives a gift tax deduction equal to the present value of the charitable income interest and, if the trust assets are to pass to beneficiaries other than the donor, is subject to gift tax on the present value of the remainder interest. If the donor creates a CLT at the donor's death (a "testamentary" CLT), the donor's estate will be entitled to an estate tax deduction equal to the present value of the charitable income interest. Whether inter vivos or testamentary, when the CLT terminates and the remaining trust assets pass to the noncharitable beneficiaries, no further tax is imposed.

E. **Transfer Tax Savings.**

1. A qualified CLT enables a donor to achieve meaningful tax savings. First, because the present value of the remainder interest factors in the delay in the noncharitable beneficiaries' receipt of and control over the trust assets, these assets are valued at a discount, resulting in lower gift or estate tax liability for the donor. Although the value of the charitable interest is limited to the value of the property transferred to the trust, it is possible for the donor to create a CLT with a charitable interest equal (or nearly equal) to the value of the property transferred to the trust. In such a case, the remainder interest passing to the noncharitable beneficiaries would be equal to zero or of nominal value, and the donor would incur no (or nominal) gift or estate tax.

2. The following table shows payout rates and trust terms that "zero out" the remainder value for transfer tax purposes. (Assumes IRC § 7520 rate of 2.0% and quarterly payments).

CHARITABLE LEAD ANNUITY TRUST FOR TERM OF YEARS
Payout Rates to Zero Out or Produce Nominal (Unitrust) Remainder Value

Term of Years	Annuity Payout Rate
10	11.133%
15	7.783%
20	6.116%
25	5.123%
30	4.465%

3. Second, using the guaranteed annuity format, if the trustee's investment of the transferred assets yields a higher return than the IRC § 7520 rate during the trust term, any excess return passes to the noncharitable beneficiaries free from transfer tax. Consider a donor who wishes to contribute $100,000 annually to her favorite charities for 20 years. She transfers $1,588,058 to the trust and directs annual charitable payments of $100,000 (or 6.297% of the value of the initial assets contributed to the trust). At the end of the 20-year term, the trust assets are to be distributed to her daughter. Assuming the section 7520 rate is 2.4%, Donor is entitled to a gift tax charitable deduction equal to the amount transferred to the trust, and there is no gift to the daughter for gift tax purposes. During the 20-year trust term, the trust assets earn an annual return of 6%. At the end of the charitable term, the trustee will distribute remaining assets, worth $1,331,790, to Donor's daughter, free of transfer tax. if the trust earns an annual return of 7%, the distribution to Donor's daughter will be $1,938,121.

4. Because the income payments to charity under the unitrust format are keyed to the annual value of the trust property, appreciation or income above the assumed interest rate during the trust term inures to the benefit of charity as well as the noncharitable remainder beneficiaries (as charity receives increased unitrust payments), and the predicted balance between the value of charity's interest and the noncharitable beneficiaries' interest will be maintained throughout the term of the trust. Consequently, although a charitable lead unitrust does offer a tax-advantaged method of transferring assets to charity and noncharitable beneficiaries, it does not offer the same opportunity as a charitable lead annuity trust to maximize tax-free transfer of appreciation and excess income to noncharitable beneficiaries.

F. **Commutation.**

1. A CLT's trust instrument may not authorize the commutation of the charitable interest by making advance payments of the annuity or unitrust amount.

2. A CLAT may not be commuted based upon the actuarial value of the lead interest. Rev. Rul. 88-27, 1988-1 C.B. 331. The Internal Revenue Service has permitted commutation of a CLAT when the annuity payments are prepaid in full with no discount. Ltr. Rul. 200225045; Ltr. Rul. 199952093.

G. **Sale of Remainder Interest in a CLAT.**

1. There is an alternative way to leverage use of the GST exemption with a CLAT, if the CLAT is created in conjunction with a separate generation-skipping trust. The IRS, however, has not ruled favorably on this technique. *See* Ltr. Rul. 200107015.

2. **Example.** In 2009, Client funds a 15-year CLAT with $2,000,000 of property and pays an annuity of $200,000 per year to specified charities. The CLAT provides that at the end of the term, the CLAT property will be distributed in equal shares to Client's three children, and any deceased child's share is payable to the child's estate. Client's husband predeceased Client and a $1,000,000 GST trust was created at his death. Shortly after the CLAT is created, the trustees of the GST trust purchase the remainder interest in the CLAT from the children for $275,000. At the end of 15 years, the GST trust receives $2,000,000 or more of assets, which should be fully GST exempt because they were acquired for full and adequate consideration.

3. The remainder interest in a CLAT is valued for purposes of the sale in the same manner as it is valued for purposes of determining the initial gift when the trust is created. The value of the remainder interest equals the value of the property less the value of the retained annuity, which is a qualified interest under IRC § 2702.

4. The sale of a remainder interest in a CLAT may have income tax consequences to the selling remaindermen. The CLAT will have a uniform basis in the transferred property equal to the basis in the hands of the grantor (adjusted for gift tax paid, if any). The remaindermen are treated as having a proportionate share of that basis for the purpose of determining gain if the remainder interest is sold.

5. **Example.** The $2,000,000 of assets transferred to the CLAT have an aggregate basis of $1,000,000. The remainder interest represents about 14% of the value in the trust ($275,000/$2,000,000) so the remaindermen have about 14% of the basis, or $140,000. If the children sell the remainder interest in the CLAT to a GST trust, they would recognize gain of about $135,000 ($275,000-$140,000). If the CLAT is funded with cash, and the remainder interest is sold shortly after the trust is funded, the remaindermen should recognize little or no gain.

6. The GST trust that acquired the remainder interest takes a basis in it equal to what it paid. For instance, the GST trust in the example above will have a basis in the remainder interest of $275,000. When the CLAT terminates, the GST trust probably should take a basis in the assets it receives equal to its basis in the remainder interest. It thereafter would recognize gain (or loss) as assets are sold. If the distribution upon termination of the CLAT is in the form of cash, the IRS would probably conclude that the GST trust would recognize gain immediately to the extent the cash exceeded its basis.

H. **GST Considerations**. Although the formation of a CLT is not subject to immediate generation-skipping transfer (GST) tax, if the remaining assets pass to "skip persons" (for example, the donor's grandchildren) at the end of the trust term, the expiration of the term will be a taxable termination resulting in GST tax.

1. For a CLUT, all or a portion of the donor's GST exemption can be precisely allocated when the trust is created, with an opportunity for leverage because the amount of the allocation necessary to produce a zero inclusion ratio is the discounted present value of the remainder interest rather than the value of the assets ultimately passing to the remainder beneficiaries.

2. For a CLAT, however, GST exemption cannot be precisely allocated upon creation of the trust because calculation of the future GST tax (and therefore, the appropriate allocation of the donor's

GST exemption) is based in part upon the value of the trust assets actually passing to the noncharitable beneficiaries at the end of the trust term. Because it is generally impossible to predict this value, it is advisable to delay allocating GST exemption until the end of the lead interest to avoid allocating too much or too little GST exemption.

I. CLAT with Increasing Payout.

1. The IRS forms for CLATs provide that 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." Rev. Proc. 2007-45, 2007-9 I.R.B. 89, Sec. 5.02(2).

2. One alternative is to vary the payout rate by steadily increasing it over the term. This method of payment still qualifies as a guaranteed annuity, because the amount received by the charity may be calculated as of the date of the initial transfer. This method allows the trust's growth to be sheltered from depletion during the early years of the trust. For example, assume $50 million is contributed to a CLAT with a term of 20 years, the IRC § 7520 rate is 2.0%, and the payout rate starts at $363,000 and increases by 20% each year. With a 4% growth rate, the charity receives a total of $67,768,380 (compared to $61,160,000 with a straight percentage payout of 6.116% to zero out the remainder), while the remainder interest is $27,548,095 (compared to $18,494,793 with a straight percentage payout). The IRS approved a CLAT with an ascending annual annuity payment in Ltr. Rul. 201216045.

3. Another alternative is to provide a low, steady payout rate until the last year of the term when the charity receives a balloon payment (commonly referred to as a shark-fin CLAT). There has been no definitive guidance issued by the IRS regarding the ability to back load a CLT.

IX. PLANNING WITH CHARITABLE LEAD TRUSTS.

A. Planning Considerations.

1. <u>Annuity or Unitrust</u>. When the donor wishes to maximize the amount of assets ultimately passing to the noncharitable beneficiaries tax free, or anticipates an inflationary climate over the term of the trust, the guaranteed annuity format will generally be preferable to a unitrust format. The guaranteed annuity format may also be simpler from an administrative standpoint, as the annual valuation required by a unitrust may prove costly or burdensome, particularly if trust assets are difficult to value. When the donor wishes for the charitable beneficiaries to share any appreciation in the trust assets, anticipates a decrease in the value of the trust corpus or a general economic downturn, or wishes to obtain a greater degree of GST certainty and protection, the unitrust format may be preferable. Another advantage to the unitrust format is the donor's ability to make additional contributions to the trust and receive gift tax charitable deductions for these contributions.

2. <u>Inter Vivos or Testamentary</u>. The advantages of an inter vivos CLT are the immediate removal of an appreciating asset and its income from the donor's estate on a leveraged basis, and the maximization of growth passing to noncharitable beneficiaries tax free. The principal advantage of a testamentary CLT is the unlimited estate tax charitable deduction. If noncharitable beneficiaries do not have an immediate need for the assets, a CLT may be established with a sufficiently lengthy term so that the present value of the charitable interest is equal to the full value of the trust assets, thereby eliminating the estate tax payable on the assets used to fund the trust. Because the assets are included in the donor's estate, the noncharitable beneficiaries receive the assets with a stepped-up basis equal to their value on the date of the donor's death.

3. <u>Selection of Charitable Beneficiary(ies)</u>.

    a. The grantor of a CLT should avoid retaining the right to designate the charitable beneficiaries of the CLT to avoid inclusion of the trust assets in the grantor's estate and loss of the transfer tax benefits of the CLT.

b. The grantor may give the trustee, or an advisory committee designated in the trust instrument, the power to select charitable beneficiaries for the annual distributions or to select among certain designated charitable beneficiaries. The power to select should be limited to organizations described in IRC § 170(c).

c. Both private foundations and public charities can be beneficiaries of the CLT.

4. Selection of Trustee. Although the donor of a nongrantor CLT relinquishes ownership of the trust assets during the trust term, at the end of the term the assets pass to the donor's designated beneficiaries or revert to the donor. Selecting a trustee to carry out the donor's intent and ensure proper management of the assets during the interim is therefore essential. The donor generally may serve as trustee of a nongrantor CLT if the donor possesses only routine administrative powers. However, if the donor retains the power to select or change the charitable beneficiaries (or clearly controls a trustee with that power), the trust assets will be included in the donor's taxable estate at the donor's death. Further, if payments from a CLT are made to a charity of which the donor is an officer or director, and the donor may participate in selecting recipients of grants funded with such income, the trust assets may be included in the donor's taxable estate. To avoid this result, measures must be taken to insulate the donor from any decisions relating to the recipient charity's use of income received from the CLT. One or more members of the donor's family (other than the donor's spouse) generally may serve as trustee without adverse tax consequences and receive reasonable compensation for their services. If the remainder interest passes to the donor's family, it may be advisable to appoint a disinterested corporate or unrelated co-trustee to serve with the family member.

5. Comparison with Outright Gift or Bequest to Charity. By structuring a charitable gift as a series of payments from a charitable lead annuity trust rather than an outright gift, a donor will have the added ability to transfer assets to non-charitable beneficiaries free of tax as long as the investment return on the trust assets outperforms the IRC § 7520 rate.

6. Comparison with Accumulation Trusts. A taxable gift to a sprinkling trust that accumulates its after-tax income for a specified period will generally result in a greater amount of wealth remaining in the family than if a CLT were created for the same period. (This is so even when a GST tax is imposed upon termination of the trust.) The advantage of a CLT is the minimization of transfer tax costs at the outset while accomplishing the donor's charitable objectives.

7. Application of Private Foundation Excise Taxes.

a. A CLT is treated as private foundation for federal tax purposes and is generally subject to the self-dealing rules of IRC § 4941, the excess business holding rules of IRC § 4943, the jeopardy investment rules of IRC § 4944, and the taxable expenditure rules of IRC § 4945 with certain modifications and exceptions.

b. A CLT is exempt from the excess business holding rules of IRC § 4943 and the jeopardy investment provisions of IRC § 4944 if the charitable portion of the CLT does not exceed 60% of the CLT's fair market value. Therefore, a properly structured CLT can be funded with closely held business assets, as a method for eventually passing those assets to descendants at a reduced transfer tax cost. But doing so requires a large taxable transfer (40% or more of the value transferred).

8. Elimination of Use of "Ghoul" Trusts (or Permissible Measuring Lives.

a. Final regulations issued on January 5, 2001 eliminated the ability to use an aggressive type of CLT commonly referred to as a "ghoul" trust. In this type of CLT, taxpayers selected as a measuring life an individual who was seriously ill but not "terminally ill" within the meaning of the regulations under IRC § 7520. Because the individual was not terminally ill, the charitable lead interest was valued based upon the actuarial tables. When the seriously ill person does not survive to his normal life expectancy, the amount the charity receives will be less than the amount upon which the gift or estate tax charitable deduction was based.

b. Generally, under the final regulations, only the donor, the donor's spouse, a lineal ancestor of all of the remainder beneficiaries, or a spouse of such lineal ancestor may be used as a measuring life of a CLT established for the life or lives of an individual or individuals.

B. **Examples of Use.**

1. Leverage of Exclusion Amount. Facts: Estate owner wishes to make the most effective use of his exclusion amount at death and does not mind making his children wait to receive their inheritances. Solution: Create a testamentary CLUT for a term of years and let the children designate the charitable recipients.

2. Leverage of GST Exemption. Facts: In addition to making the most effective use of his unified credit, the estate owner wishes to maximize the advantages of his GST exemption. Solution: Create a testamentary CLUT for a term of years with the grandchildren as remaindermen.

3. Reduction of Estate Taxes. Facts: Estate owner wishes to reduce estate taxes and is willing to defer his children's receipt of their inheritances for an extended period. Solution: Create a testamentary CLUT for a term of years commencing at the death of the estate owner, or at the surviving spouse's death in the case of a marital trust.

4. Source for Funding Donor Advised Fund. Facts: Individual wishes to support a community foundation by creating a donor advised fund for his family. Solution: Create an inter vivos or testamentary CLAT or CLUT providing the community foundation with income payments that in the aggregate will create an appropriately funded donor advised fund.

5. Substitute for Private Foundation. Facts: Husband and wife like the idea of a private foundation as a vehicle for lifetime charitable giving but do not want the capital to be lost by the family. Solution: Create an inter vivos CLAT or CLUT with one spouse as grantor and the other as trustee. The trustee spouse makes the lead payments to the family's favorite charities periodically during the year just as could be done through a private foundation.

6. Source for Funding Private Foundation. Facts: Family has existing private foundation, and parents desire to enhance its endowment without depriving the children of their ultimate inheritances. Solution: Create an inter vivos CLAT or CLUT for a relatively short term with the family foundation as the charitable recipient.

7. Funding Family Charitable Giving. Facts: Parents and children annually give substantial amounts to various charitable organizations and intend to continue this pattern, and parents wish to make taxable gifts to shift growth from their gross estates but do not want to sacrifice their cash flow and existing standard of living. Solution: Create a long-term inter vivos CLUT with parents' income-producing assets and children as trustees.

8. Widow's Gift of Marital Trust Assets. Facts: Widow with independent wealth and ability to make a lifetime withdrawal or appointment of the marital trust created by her husband desires to use his assets to establish an endowment in his name and memory at his university while removing growth in the assets from her gross estate. Solution: Create an inter vivos CLAT or CLUT with a payout rate and term to give the university the necessary endowment amount.

9. Rate Arbitrage or Reduction of Large Unusual Gain. Facts: Taxpayer anticipates being in a lower bracket in future years and desires to use charitable planning to reduce his taxes without depriving his family of the underlying assets. Solution: Create an inter vivos CLAT or CLUT, with a payout rate and term suitable to the grantor, and structured as a grantor trust.

10. Tax-Exempt Bonds. Facts: Owner of tax-exempt bonds wishes to use these bonds to obtain a current income tax deduction. Solution: Create an inter vivos CLAT or CLUT structured as a grantor trust that will provide the grantor with a current income tax deduction equal to the annuity or unitrust value and without having taxable income to report in future years.

11. Leverage for Spouse's Poor Health. Facts: Husband and wife wish to create charitable lead trust as part of their gift program. Wife is younger than husband and is in poor health but can be expected to live for more than one year. Solution: Create a CLAT or CLUT to continue for the wife's life. A larger charitable deduction will be available than if based on husband's life, and the remainder will likely become possessory at a much earlier time.

12. Cascading Lead Trusts. Facts: An investor with many entrepreneurial investments, and who is otherwise willing to have the investments go to charity, wishes to use zeroed-out GRAT techniques to produce a benefit without transfer tax for his children if one or more of the investments have outstanding growth. Solution: Create a series of CLATs having staggered or "cascading" termination dates.

X. REAL ESTATE GIFTS.

A. Outright Transfers.

1. Long-term real estate -- full fair market value deduction subject to the 30% ceiling. An election is available to use the 50% ceiling, but the deduction is limited to basis.

2. Short-term real estate -- deduction limited to basis subject to the 50% ceiling.

3. A gift of real estate is complete upon the execution and delivery of the deed to the donee charity. Recordation of the deed is not required for the gift to be effective but can be the best evidence.

B. Gift of an Undivided Interest.

1. A charitable deduction is allowed for a gift of an undivided portion of a donor's entire interest in property. The gift must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in the property and it must extend over the entire term of the donor's interest. Examples of gifts of an undivided interest include:

   a. A fractional or percentile interest in a life estate in real property in which the donor owns no other interest.

   b. A fractional or percentile share of a remainder interest in a trust in which the donor holds no other interest.

   c. 50 acres of a donor's 100-acre farm.

   d. An open space easement in gross in perpetuity.

   e. Property where the charitable donee is given the right, as tenant in common with the donor, to possession, dominion and control of the property for a portion of each year appropriate to the donee's interest in the property.

2. A donor can give a charity both a remainder interest and an undivided interest in the same personal residence or farm, for example, by deeding his personal residence to charity reserving the right for life to use the property during part of the year as a vacation home. The donor will be entitled to a charitable deduction both for the value of the remainder interest and for the undivided portion of his life interest so donated.

3. An undivided interest is also a good means of obtaining an immediate charitable deduction for a gift of a partial interest in tangible personal property. Thus, an art collector can contribute a fractional interest in his collection to a museum, retaining possession of the collection for a portion of each year equal to the fraction of ownership retained.

C. **Bargain Sales.**

1. A bargain sale is a sale of property to a charity at less than fair market value. The excess of fair market value over the sale price represents a charitable contribution.

2. The taxpayer must allocate his cost basis in the property between the portion of the property that is "sold" and the portion that is "donated" according to the relative fair market value of each. If the property has appreciated in value since the taxpayer acquired it, he will realize capital gain on the appreciation allocable to the portion that is "sold." As a result, the taxpayer may owe capital gains tax from the bargain sale, even though the sale price is equal to or less than his cost basis in the property.

3. **Example.** An individual owns 100 shares of appreciated stock with a basis of $4,000 and a fair market value of $10,000. The individual has held the stock for more than one year. Wishing to make a $6,000 donation to his favorite qualified charity, he sells that stock to the charity for $4,000. The amount of the individual's basis allocable to the "sale" portion of the bargain sale is $1,600 ($4,000 divided by $10,000, times $4,000). As a result, the individual will recognize long-term capital gain of $2,400 ($4,000 minus $1,600), and will be entitled to a charitable deduction of $6,000.

D. **Gift of Remainder Interest in Personal Residence or Farm.**

1. A charitable deduction is allowed for income, estate, and gift tax purposes for a charitable gift of a donor's personal residence or farm, even though the donor retains an estate in the property for life or for a term of years. The donor may either retain a life estate or give one to others, and the life estate may include one or more lives.

2. In valuing the allowable income tax charitable deduction for the remainder interest, one must factor in depreciation (computed on a straight-line method) and depletion of the donated real estate. The resulting value is then further discounted under the Treasury Department tables.

3. For gift and estate tax purposes, depreciation or depletion need not be taken into account. The terms "personal residence" and "farm" do not include household furnishings or other tangible personal property, and no deduction is allowed for a gift of a remainder interest in such items.

4. **Gift Taxation.**

   a. A gift of a remainder interest to charity with a life estate reserved for a beneficiary other than the transferor results in a gift to the life beneficiary equal to the value of his or her life interest, determined under Treasury Department valuation tables. The life interest is a present interest and qualifies for the gift tax annual exclusion. If life tenant is the transferor's spouse, the entire value of the property will qualify for the QTIP marital deduction election. At the spouse's death, her estate will receive a charitable deduction for the full value of the property.

   b. A gift of a remainder interest to charity where the transferor reserves a life estate for himself and then for the life of another results in a future interest gift to the successor beneficiary of his or her life interest. The gift will not qualify for the gift tax annual exclusion, as it is not a present interest. However, the transferor can avoid making a gift to the successor beneficiary if the transferor reserves the right to revoke the successor's interest, without affecting the charitable gift. If the transferor exercises that right, the transferor should then receive an additional income tax charitable deduction for the then-current value of the successor's survivorship interest. If the successor beneficiary is the transferor's spouse, it appears that her interest will not qualify for the gift tax marital deduction, since her interest is contingent and begins in the future.

5. **Estate Taxation.**

a. In the case of a gift of a remainder interest to charity with a life estate reserved for the transferor's life, the full fair market value of the property is included in the transferor's estate at death. However, the estate will receive an offsetting estate tax charitable deduction.

b. When the transferor makes a lifetime gift of a remainder interest to charity with a life estate reserved for a beneficiary other than the transferor, he has transferred the entire property for gift tax purposes and no part of it is included in the transferor's estate at his death. For a lifetime gift of a remainder interest to charity where the transferor reserves a life estate for himself and then for the life of another, the entire property again is included in the transferor's estate at death.

c. If the successor life tenant survives the transferor, the value of the charitable remainder is nevertheless deductible in the transferor's estate; only the surviving life tenant's interest is subject to tax.

d. If the surviving life tenant is the transferor's spouse, the full value of the property should qualify for the QTIP marital deduction election in the transferor's estate. At the surviving spouse's death, her estate will then receive a charitable deduction for the property.

6. The IRS has ruled that gifts of remainder interests in a personal residence or farm must be in the property itself; they cannot be in the proceeds from the sale of the property. Thus, where a testator's will directs that the property be sold at the life tenant's death and that charity receive all or a part of the proceeds, no deduction is allowed. Rev. Rul. 77-169, 1977-1 C.B. 286; Rev. Rul. 76-543, 1976-2 C.B. 287. The Tax Court has reached the opposite result, however, in a situation in which the charity had the power under applicable state law to require distribution of the residence in kind instead of taking the sale proceeds. *Blackford v. Comm'r*, 77 T.C. 1246 (1981). The IRS has acquiesced in the result of this case. Rev. Rul. 83-158, 1983-2 C.B. 159.

E. **Flip Charitable Remainder Unitrusts (See discussion above).**

XI. RETIREMENT BENEFITS.

A. Retirement benefits are potentially subject to both estate and income tax upon the death of the participant. The designated beneficiary of the benefits will be subject to income tax on distributions from the retirement account after the death of the participant. The benefits also are subject to estate tax unless they are paid to a surviving spouse. In that case, they will be subject to tax at the spouse's subsequent death.

1. Because of this excessive tax burden, retirement benefits are viewed as good assets to leave to charity. Even if an individual is not charitably inclined, having a charitable remainder trust as the beneficiary of retirement benefits can minimize the tax cost and ultimately leave the family in a better financial position. The estate will be entitled to a charitable deduction for the value of the interest that will pass to charity. The trust will be tax-exempt, so it will not owe income tax upon receipt of the benefits. (Note, however, that any excise tax on excess accumulations will still be due.)

2. The payment of retirement benefits to a charitable remainder trust often makes the most sense when the participant in the plan is widowed or not married, so the beneficiary otherwise would bear the full brunt of the income tax and estate tax. If the beneficiary is a child or other family member in a lower generation and he or she lives to his or her normal life expectancy, it is likely that the increased amount that can be paid annually to the beneficiary from the charitable

remainder trust as a result of the tax savings will offset the "loss" of the property to charity at the beneficiary's death.

B. **Designating a Charitable Entity as Beneficiary.**

1. If a charity is the designated beneficiary of a qualified plan or IRA, it can collect the proceeds upon the participant's death without incurring income tax, by virtue of the charity's tax-exempt status. From an income tax standpoint, the benefit to the decedent's estate and beneficiaries is similar to the benefit obtained from donating appreciated marketable securities to a charity—the charitable gift is satisfied in part with unrealized taxable income, so the federal government in effect pays for part of the contribution.

2. **Example.** Client has an estate consisting of a $500,000 life insurance policy and $500,000 in a qualified plan. He wants to leave half of his estate to his spouse and half to charity. Assume he designates his wife as beneficiary of the qualified plan, and she takes a distribution of the entire amount. Using a 40% income tax rate, she has $300,000 left after taxes. Assume instead that he designates the charity as beneficiary of plan, and leaves the life insurance to his wife. The charity receives the plan benefits and pays no income tax. His wife receives $500,000 in insurance proceeds.

3. In addition, the decedent's estate will receive an estate tax charitable deduction for the value of the proceeds given to charity.

4. A charitable gift of qualified plan or IRA proceeds should not be accomplished by using the account proceeds to satisfy a pecuniary bequest to charity in the will or revocable trust. As is the case with other kinds of income in respect of decedent, use of a qualified plan or IRA to fund a pecuniary bequest will cause immediate recognition of income.

   a. Instead, the charity should be named as the designated beneficiary or one of the designated beneficiaries of the plan or IRA.

   b. The practitioner should make sure the client is aware that the plan or IRA designated to pass to charity could be depleted if the client lives past the RBD and must withdraw funds. If the client wants to be sure that the charity receives at least a specified amount, then a contingent make-up gift can be added to the client's estate plan.

   c. **Example.** Client has an IRA worth $100,000, which he wants to leave to his alma mater. He wants to make sure that the college receives at least $75,000, to fulfill a capital campaign pledge he made. Client designates the college as beneficiary of the IRA, and adds a bequest to his will that leaves to the college the sum of $75,000, reduced (but not below zero) by the value at his death of any IRA on which the college is the designated beneficiary.

   d. The client also may be concerned that the charity will receive too much if the qualified plan or IRA grows in value. In this case, the client could create a separate IRA account with the amount of property he wants the charity to receive. Each year, if the separate account has excess funds, he can direct an account-to-account transfer of those funds to his other IRA account.

   e. **Example.** Client has a $1,000,000 IRA and wants to use $250,000 of it for a testamentary gift to a local hospital. He creates a new IRA account with $250,000. At the end of each year, if the account exceeds $250,000, he directs that the excess be transferred back to his original IRA account.

   f. A client doing this should be sure to have a power of attorney in place which would direct his agent to make these transfers if the client becomes disabled.

   g. One of the entities that can be designated as beneficiary of a qualified plan or IRA is a charitable remainder trust (CRT). An individual could designate a CRT as beneficiary in order to permit a spouse or other relative to receive benefits from the retirement account while still benefiting charity.

(1) The CRT itself is a tax-exempt entity. It will not pay income tax upon collecting the qualified plan or IRA benefits. IRC § 664. The annuity or unitrust distributions to the CRT beneficiary will carry out the taxable income represented by the benefits, but possibly on a more favorable basis than if the benefits were payable directly to the beneficiary.

(2) The individual's estate also will receive an estate tax deduction for the charitable portion of the CRT.

h. If the client is considering a CRT for a spouse, he also should consider the alternative of designating a QTIP trust as beneficiary, with the remainder interest of the trust passing to charity. There are several differences between the two options:

(1) The QTIP trust provides the opportunity to make additional funds available to the spouse, through principal distributions. The annual distribution is not a fixed amount, as it is in a CRT.

(2) On the other hand, greater distributions from a marital trust will mean that more income tax will be incurred as benefits are distributed.

i. In most cases, it is not possible to avoid income tax on lifetime distributions from a qualified plan or IRA by "donating" the plan to a charity. The donation would be treated as a distribution taxable to the participant, followed by a charitable gift. However, clients who are considering making substantial withdrawals from a plan or IRA (for example, to keep the account below the level at which the excise tax could start to apply) should consider creating a CRT in the year of the withdrawal to provide a charitable deduction that will help offset the additional taxable income.

j. The IRA charitable rollover provisions provide an exclusion from gross income for certain otherwise taxable IRA distributions from a traditional or Roth IRA in the case of qualified charitable distributions. Qualified charitable distributions are any distributions up to $100,000 per year from an IRA made directly by the IRA trustee to a qualified charitable organization if the IRA owner has attained age 70½. The exclusion is not available for a distribution to fund a charitable remainder trust, pooled income fund, or charitable gift annuity. A qualified charitable organization is one described in section 170(b)(1)(A) other than a supporting organization or a donor-advised fund. Contributions to private foundations do not qualify for the exclusion. The IRA owner is not entitled to an income tax charitable deduction under section 170 for any amount excluded from gross income under this provision.

XII. 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 Internal Revenue Code 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 Internal Revenue Code 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 Internal Revenue Code imposes an excise tax of 2% on the net investment income of a tax-exempt private foundation in each tax year. I.R.C. § 4940(a). The 2% excise tax may be reduced to 1% for certain tax years in which the foundation's payout rate is increased. I.R.C. § 4940(e).

C. **Self-Dealing.**

1. Internal Revenue Code 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 Internal Revenue Code 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 between a private foundation and 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. I.R.C. § 4941(d)(1).

4. **Direct v. Indirect Self-Dealing.** Internal Revenue Code 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. <u>Certain Loans</u>. 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. I.R.C. § 4941(d)(2)(B).

   b. <u>Certain Leases</u>. 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.

      (1) 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. I.R.C. § 4941(d)(2)(C).

      (2) 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. I.R.C. § 4941(d)(2)(D).

   d. <u>Reasonable Compensation for Personal Services</u>. 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. I.R.C. § 4941(d)(2)(E).

(1) Whether compensation is reasonable is determined in accordance with the standards for reasonableness under Internal Revenue Code 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).

(2) 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. I.R.C. § 4941(d)(2)(F).

f. Preexisting Business Relationships. The regulations under Internal Revenue Code section 4941 provide an exception to the definition of indirect self-dealing for certain preexisting business relationships that meet the following three-part test:

(1) The transaction results from a business relationship that was established before such transaction constituted an act of self-dealing;

(2) 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

(3) 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:

(1) 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);

(2) Such transaction is approved by the probate court having jurisdiction over the estate (or revocable trust);

(3) The transaction occurs before the estate is terminated for federal income tax purposes;

(4) The estate (or revocable trust) receives an amount that equals or exceeds the fair market value of the foundation's interest or expectancy; and

(5) 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. 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. Internal Revenue Code 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. I.R.C. § 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. I.R.C. § 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. I.R.C. § 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 Internal Revenue Code 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 underdistribution. I.R.C. § 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. I.R.C. § 4942(b).

2. To avoid an excise tax, a private foundation must distribute at least 5% of the average fair market value of its noncharitable assets (cash, securities, other investment assets, etc.) each year. I.R.C. § 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. I.R.C. § 4942(a).

c. A foundation may carry forward any excess qualifying distributions for five additional years. I.R.C. § 4942(i).

3. The distributions that count towards this minimum distribution requirement are referred to as "qualifying distributions." Qualifying distributions are defined under Internal Revenue Code 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 or controlled organizations do not count as qualifying distributions. Under changes made by the 2006 Act, 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. I.R.C. § 4942(g)(1)(A), (4).

E. **Excess Business Holdings.**

1. Internal Revenue Code 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. I.R.C. § 4943(b).

2. While the term "business enterprise" is not expressly defined, it does not include:

a. A functionally related business.

b. A trade or business at least 95% of the gross income of which is derived from passive sources. I.R.C. § 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. I.R.C. § 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. I.R.C. § 4943(c)(3)(B). In all other cases, reference is made to the beneficial interests owned by the foundation and disqualified persons. I.R.C. § 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." I.R.C. § 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. I.R.C. § 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 Internal Revenue Code 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 Internal Revenue Service.

9. In certain circumstances the permitted holdings is 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 Internal Revenue Service that "effective control" of the corporation is in one or more persons who are not disqualified persons with respect of the foundation. I.R.C. § 4943(c)(2)(B).

F. **Jeopardy Investments**. The jeopardy investment rules of Internal Revenue Code 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. I.R.C. § 4944(a)(1). Any foundation manager who participated in making the investment knowing that it jeopardized 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. I.R.C. § 4944(a)(2).

G. **Taxable Expenditures.**

1. Internal Revenue Code 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 Internal Revenue Service.

    d. Grants to an organization other than one that is a public charity described in Internal Revenue Code 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 Internal Revenue Code section 4940(d)(2)).

    e. Expenditures for any purpose other than a charitable, religious, scientific, literary, or educational purpose. I.R.C. § 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. I.R.C. § 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. I.R.C. § 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. I.R.C. § 4945(h).

   a. Expenditure responsibility requires the foundation to:

      (1) Assure that the grant is spent only for the purpose for which it is made;

      (2) Obtain full and complete reports on how the funds are spent; and

      (3) Make full and detailed reports on the expenditures to the Internal Revenue Service. I.R.C. § 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 noncharitable 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 Internal Revenue Code section 170(c)(2)(B) to political subdivisions and certain other organizations that do not hold determination letters under Internal Revenue Code sections 501(c)(3) and 509(a)(1), (2), or (3). Treas. Reg. § 53.4945-5(a)(4).

H. **Private Foundations May Be Looking Better.**

1. **2006 Act Changes the Balance.** Private foundations formerly had more restrictive operating rules and limitations on donors' deductions than any other category of charity. The 2006 Act changes this balance, and some donors may find that private foundation status is preferable to continued existence as a supporting organization, while others may find that a donor advised fund brings restrictions they would rather avoid.

2. **Most Changes Did Not Affect Family Foundations.**

   a. <u>Doubled Penalties</u>. This shouldn't be a problem, since the goal always is to avoid the penalties in the first place.

   b. <u>Watch Out for Grants to Supporting Organizations</u>. Under the pre-2006 Act system, grants to public charities were always qualifying distributions for purposes of the minimum distribution requirement of Internal Revenue Code section 4942. Now, however, foundations must make further inquiries in the case of one category of public charity -- supporting organizations. It will first be necessary for a foundation to determine whether a prospective supporting organization grantee is a Type I, Type II, or Type III supporting organization. From there, the rules get somewhat complicated.

   c. <u>Type I, II, and Functionally Integrated Type III Supporting Organizations</u>. Private foundations may make distributions to Type I, Type II, or functionally integrated Type III supporting organizations; these distributions count as part of the foundation's qualifying distribution amount for the year. However, if a disqualified person to the foundation controls the Type I, Type II, or functionally integrated Type III supporting organization, or if that disqualified person controls a supported organization of that supporting organization, the foundation must exercise expenditure responsibility.

d. Type III Nonfunctionally Integrated Supporting Organizations. Private foundations may also make distributions to Type III supporting organizations that are not functionally integrated so long as they exercise expenditure responsibility. However, these distributions are not considered qualifying distributions for the purposes of the foundation's annual required distribution amount and are considered a taxable expenditure if the foundation does not exercise expenditure responsibility.

XIII. 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.[1] Private operating foundations continue to be subject to the excise tax provisions applicable to private foundations.

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 Internal Revenue Code 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.

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[1] "Conduit" or "pass-through" private foundations also receive favorable income tax charitable deduction treatment under Internal Revenue Code 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).

XIV. SUBSTANTIATION OF CHARITABLE GIFTS

A. General Substantiation Rules.

1. **Contributions under $250.** Under changes made by the Pension Protection Act of 2006, a taxpayer may not claim a deduction for any cash or other monetary gift regardless of amount unless the taxpayer maintains as a record of the contribution a bank record (such as a cancelled check or credit card record) or other written communication from the donee showing the name of the donee, the date of the contribution, and the amount of the contribution.

2. **Contributions of $250 or More.**

   a. No income tax charitable deduction is available for a separate contribution of $250 or more unless the taxpayer has a contemporaneous written receipt or other acknowledgement from the charity of the contribution.

      (1) To be contemporaneous, the taxpayer must have the receipt before the earlier of the date on which the taxpayer files a return for the year in which the contribution was made and the due date (including extensions) for filing such return.

      (2) The acknowledgement must include the amount of cash and a description of any property contributed by the donor.

      (3) The acknowledgement must contain a statement either that no goods or services were provided in return for the contribution or a good faith estimate of the value of any goods or services that were provided in return for the contribution. If such goods or services consisted solely of intangible religious benefits, the acknowledgement must include a statement to that effect.

      (4) Taxpayers may not rely on a canceled check as substantiation for a gift of $250 or more.

3. **Contributions over $500.** To claim an income tax deduction for a contribution of property (other than cash) valued at more than $500, the donor must obtain a written acknowledgement from the donee organization setting forth the name of the donee, the date and location of the contribution, and a description of the property in reasonably sufficient detail. The donor must also complete and file Section A of Form 8283 as part of the donor's federal income tax return for the year in which the deduction is claimed.

4. **Contributions over $5,000.** If the contributed property (other than cash or publicly traded securities) has a value in excess of $5,000 (or $10,000 in the case of nonpublicly traded stock), the donor must obtain a qualified appraisal of the property from a qualified appraiser. In addition, the donor must complete the appraisal summary on Form 8283.

   a. In the case of artwork with an aggregate value of $20,000 or more, a complete copy of the signed appraisal must be submitted with Form 8283 and an 8 x 10 inch color photograph of the artwork must be provided upon request.

   b. If the contribution is of a façade easement, the taxpayer must include with the taxpayer's return for the year of the contribution a copy of the qualified appraisal of the façade easement, photographs of the entire exterior of the building, and a description of all restrictions on the development of the building. In addition, the taxpayer is required to pay a $500 filing fee in the year of the contribution if the deduction is $10,000 or more, which is to be used for the enforcement of the new deduction rules for gifts of façade easements imposed under the Pension Protection Act of 2006.

c. In the case of a contribution of property for which a deduction of more than $500,000 is claimed, the qualified appraisal must be attached to the return for the year of the contribution.

5. **Exceptions from Written Acknowledgement Requirements.** Recognizing that the grantor of a charitable lead trust or a charitable remainder trust is not required to designate a specific charitable organization as the charitable beneficiary at the time the grantor transfers property to the trust, the Internal Revenue Service has exempted transfers of property to such trusts from the written acknowledgement requirements. Transfers to pooled income funds or in return for a gift annuity are not exempted from these requirements.

6. **Contributions to Donor-Advised Funds.** In the case of a contribution to a donor-advised fund, the written acknowledgement must include a statement from the sponsoring organization that such organization has "exclusive legal control over the assets contributed."

7. **Substantiation Requirements for Unreimbursed Out-of-Pocket Expenses.**

a. In order to claim a deduction for unreimbursed out-of pocket expenses incident to the rendition of services for a charitable organization, the donor must have "adequate records" to substantiate the amount of the expenditures and a statement from the donee containing certain required information.

b. The required "adequate records" would generally be reliable written records made by the donor. Factors indicating reliability include the contemporaneous nature of the writing evidencing the contribution and the regularity of the donor's recordkeeping procedures.

c. The statement from the donee organization must contain a description of the services provided by the taxpayer, a statement of whether or not the donee organization provided any goods or services in consideration, in whole or in part, for the unreimbursed expenditures, and a description and good faith estimate of the value of any goods or services that were provided in return for the contribution.

B. **Qualified Appraisals.**

1. **New Statutory Definitions Added by Pension Protection Act of 2006.**

a. The Pension Protection Act added provisions to Internal Revenue Code section 170 defining a qualified appraiser and a qualified appraisal. These terms had previously been defined by regulation but not in the Internal Revenue Code.

b. If the contributed property (other than cash or publicly traded securities) has a value in excess of $5,000 (or $10,000 in the case of nonpublicly traded stock), the donor must obtain a qualified appraisal of the property from a qualified appraiser in order to claim a charitable deduction for a gift of the property. While the qualified appraisal requirement had been a regulatory requirement before the enactment of the Pension Protection of 2006, it is now a statutory requirement and may be one reason why the IRS has been aggressively attacking the appraisals obtained by taxpayers as highlighted by recent court decisions. IRC § 170(f)(11)(C).

c. A "qualified appraisal" is an appraisal prepared by a qualified appraiser following accepted appraisal standards and any applicable Treasury regulations or other guidance.

d. A qualified appraiser is an individual who:

(1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements to be established by the Internal Revenue Service in regulations;

(2) regularly performs appraisals for compensation;

(3) can demonstrate verifiable education and experience in valuing the type of property for which the appraisal is being performed;

(4) has not been prohibited from practicing before the Internal Revenue Service by the Treasury at any time during the three years before the appraisal; and

(5) is not excluded from being a qualified appraiser under any applicable Treasury regulations.

2. **Qualified Appraisal.**

a. A “qualified appraisal” means an appraisal which is conducted by a “qualified appraiser” in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary. The Internal Revenue Service has stated in Notice 2006-96 that an appraisal that is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice as developed by the Appraisal Standards Board of the Appraisal Foundation will be considered to be in accordance with these standards.

b. To be a qualified appraisal, the appraisal must meet the following requirements under the current regulations:

(1) The appraisal must be made not earlier than 60 days prior to the date of contribution of the appraised property nor later than the due date of the return (including extensions) on which a deduction is first claimed;

(2) The appraisal must be prepared, signed, and dated by a qualified appraiser;

(3) The appraisal must not include any fee which is based on the appraised value of the property;

(4) The appraisal must be received by the donor before the due date (including extensions) of the return on which a deduction is claimed; and

(5) The appraisal must include the following:

(a) A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was contributed, including for tangible property, the physical condition of the property;

(b) The date or expected date of contribution;

(c) The terms of any agreement made by the donor or donee that restricts the use, sale, or other disposition of the property, including earmarks for a particular use;

(d) The name, address, and the identifying number of the qualified appraiser;

(e) The qualifications of the qualified appraiser who signs the appraisal, including background, experience, education, and membership in professional appraisal associations;

(f) A statement that the appraisal was prepared for income tax purposes;

(g) The date on which the property was appraised;

(h) The appraised fair market value of the property on the date (or expected date) of contribution;

(i) The method of valuation to determine the fair market value, such as the income approach, the market-data approach, or the replacement-cost-less-depreciation approach; and

(j) The specific basis for the valuation, such as specific comparable sales transactions.

3. **Qualified Appraiser.**

a. Internal Revenue Code section 170(f)(11)(E)(ii) states that a "qualified appraiser" means an individual who has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements as set forth in regulations, who regularly performs appraisals for compensation, and who meets such other requirements as the Secretary may prescribe in regulations.

b. Also, the individual performing the appraisal must demonstrate verifiable education and experience in valuing the type of property subject to appraisal and must not have been prohibited from practicing before the Internal Revenue Service by the Secretary under section 330(c) of Title 31, United States Code, at any time during the three years before the date of appraisal.

c. Internal Revenue Notice 2006-96 states that an appraisal designation which is awarded on the basis of demonstrated competency in valuing the type of property for which the appraisal is performed will satisfy these requirements.

d. The "qualified appraiser" must include on the appraisal summary a declaration containing the following:

(1) The individual either holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;

(2) Because of the appraiser's qualifications as described in the appraisal, the appraiser is qualified to make appraisals of the type of property being valued;

(3) The appraiser is not any of the disqualified persons listed in Treas. Reg. §1.170A-13(c)(5)(iv), such as the donor or taxpayer claiming a deduction, a party to the transaction in which the donor acquired the property, the donee of the property, any person employed by the foregoing persons, any person related to the foregoing persons, or an appraiser regularly used by one of the foregoing persons who does not perform a majority of appraisals for other persons;

(4) The appraiser understands that an intentionally false or fraudulent overstatement of the value of the property described in the qualified appraisal or appraisal summary may subject the appraiser to a civil penalty under section 6701 for aiding and abetting an understatement of tax liability, and the appraiser may have appraisals disregarded pursuant to 31 U.S.C. 330(c); and

(5) The appraiser understands that a substantial or gross valuation misstatement, resulting from an appraisal of the value of property that the appraiser knows or reasonably should have known would be used in connection with a return or

claim for refund, may subject the appraiser to a civil penalty under Internal Revenue Code §6695A.

C. **Substantial and Gross Overstatements of Property Valuations.**

1. The Pension Protection Act of 2006 lowered the thresholds for imposition of the accuracy-related penalty for taxpayer claiming a deduction for a contribution of property for which a qualified appraisal is required and eliminated the reasonable cause exception for gross misstatements of value.

    a. A substantial valuation misstatement occurs when the claimed value of property is 150% (rather than 200%) or more of the amount determined to be the correct value.

    b. A gross valuation misstatement occurs when the claimed value is 200% (rather than 400%) or more of the amount determined to be the correct value.

    c. For estate and gift tax purposes, a substantial valuation misstatement exists when the claimed value is 65% or less of the correct value and a gross valuation misstatement exists when the claimed value is 40% or less of the correct value.

2. The Pension Protection Act also established a civil penalty that will be imposed on any person who prepares an appraisal that is to be used to support a tax position if the appraisal results in a substantial or gross valuation misstatement. The penalty is equal to the greater of $1,000 or 10% of the understatement of tax resulting from the misstatement, up to a maximum of 125% of the gross income derived from the appraisal unless the appraiser can establish that the value established in the appraisal was more likely than not the proper value.

D. **Recent Case Law on Substantiation of Charitable Deductions.**

1. ***WT Art P'ship LP v. Commissioner*****, No. 19604-16, petition filed (T.C. 9/6/2016).** A New York partnership is disputing the rejection of $49.5 million worth of deductions for artwork it donated to the Metropolitan Museum of Art and arguing that the IRS incorrectly found that the appraisal the company used to value the artwork claimed as charitable did not qualify under section 170.

2. ***Bosque Canyon Ranch, LP v. Commissioner*****, No. 16-60068, brief filed (5th Cir. 9/16/2016).** In its reply brief the IRS says two Texas ranches that are appealing the denial of $16 million in charitable contribution deductions engaged in disguised sales with their limited partners and failed to donate easements that met the perpetuity requirements under section 170 because the boundaries could be modified by agreement. The IRS said that the penalties assessed against Bosque Canyon remain applicable because the easements were grossly overvalued.

3. ***Cave Buttes, LLC v. Commissioner*****, 147 T.C. No. 10 (9/20/2016).** The owner of property donated to a local government agency ended up with a larger charitable deduction than it had originally claimed, which the IRS had disallowed, following an audit of its bargain sale of 11 acres of prime Phoenix real estate to the local Flood Control District. The court accepted the taxpayer's appraisal value and found that appraisal substantially complied with the qualified appraisal rules and the failure of one of the appraisers to sign Form 8283 was not fatal.

4. ***PBBM-Rose Hill, Ltd. v. Commissioner*****, Bench Op. (T.C. 10/7/2016).** The Tax Court sustained the IRS's disallowance of a $15,160,000 deduction that a partnership claimed with regard to the donation of a conservation easement encumbering a golf course. The court determined that the easement had a value of only $100,000, that the partnership failed to satisfy certain requirements in section 170(h) and that and the partnership was subject to a 40% gross valuation misstatement penalty. The IRS argued that PBBM fail to obtain a qualified appraisal because the appraisal it submitted with its tax return was missing some of the required information. The Tax Court summarily disagreed, noting that it found that the appraisal contained all of the required information.

5. ***Palmer Ranch Holdings Ltd. v. Commissioner*, T.C. Memo 2016-190 (T.C. 10/13/16).** The donor of a conservation easement will be able to disregard the declining real estate market in 2006 to value 82 acres of land donated that tax year at $25.2 million. The Tax Court ruled that Palmer Ranch Holdings Ltd., which donated the acreage to Sarasota County, Fla., could use their method of valuation, based on an appraisal using applicable zoning. The case, on remand from the U.S. Court of Appeals from the Eleventh Circuit, strictly dealt with the issue of finding an alternative basis to support adjustments based on yearly market decline.

6. ***McGrady v. Commissioner*, T.C. Memo. 2016-233 (12/22/2016).** The court found that the taxpayers who donated two properties to their township in Pennsylvania overvalued the donated land by $1 million but would not face penalties because they had made a good faith investigation into the values of the property. The IRS argued that there was no donative intent and that the taxpayers were motivated by a desire to protect their privacy and to prevent suburban development from spoiling the attractive views from their residence, but the court disagreed with the IRS on this point.

7. ***15 West 17th St. LLC v. Commissioner*, 147 T.C. No. 19 (12/22/2016).** A charitable deduction under section 170 was disallowed for failure to obtain a contemporaneous written acknowledgment (CWA) from the donee organization that adequately described the gift. Although section 170 includes language that a donee organization can submit a tax return detailing the contribution that will take the place of the CWA if done in accordance with Treasury Department regulations, this only becomes operative once Treasury publishes regulations. After the taxpayer had filed its Tax Court petition, the donee organization submitted an amended return describing the gift. The court said that the requirement that a CWA be obtained for charitable contributions of $250 or more is a strict one and that the ability of donee organizations to file descriptions of the gifts in place of CWAs is not self-executing in the absence of regulations.

8. ***Coal Prop. Holdings LLC v. Commissioner*, No. 27778-16, petition filed (T.C., 12/28/16).** The IRS rejected $155 million in deductions for property rights the company donated to a land conservation organization. The IRS said that the taxpayer had negligently overvalued the donated rights and assessed overvaluation penalties.

9. ***Izen v. Commissioner*, 148 T.C. No. 5 (3/1/2017).** A purported agreement for the charitable donation of a historical 40-year old airplane did not meet the strict requirements of a contemporaneous written acknowledgment of a vehicle donation needed to substantiate the claimed deduction. The donation agreement had many deficiencies, including the lack of a name or signature of the donor claiming the deduction. It also lacked his taxpayer identification number and a certification of the charity's intended use of the plane.

10. ***Atkinson v. Commissioner*, No. 16-02083, brief filed (4th Cir., 6/5/2017).** In its brief, the IRS argues that the grant of two conservation easements bordering golf courses on the North Carolina coast were not made exclusively for conservation purposes, thereby making the donations ineligible for a charitable contribution deductions. The Tax Court agreed with the IRS in the 2015 decision which is now being appealed by the taxpayers who are arguing that the Tax Court erred in distinguishing between rare and endangered or threatened species and by requiring an unidentified minimum amount of qualifying habitat, failing to apply the regulatory standard regarding ecological viability, and finding that the use of chemicals was inconsistent with the conservation purpose of the donations.

11. ***Ten Twenty Six Investors v. Commissioner*, T.C. Memo. 2017-115 (6/15/2017).** A tardy deed recording of a conservation easement by a historical preservation organization deprived the donor property owner of an $11.4 million income tax charitable deduction for a conservation easement. The easement deed protecting the facade of the building was not recorded by the charity until two years after the date of the donation, and under applicable NY law, the restriction was not created until the deed was recorded. Because a conservation restriction protecting the property must be granted in perpetuity for the owner to claim a tax deduction for the reduction in value of the property, the requirements of the IRC were not met.

12. ***RP Golf, LLC v. Commissioner*, 119 AFTR 2d 2017-2338 (8th Cir., 6/26/2017).** The Eighth Circuit upheld the 2016 decision of the Tax Court holding that a golf course developer cannot claim a $16.4 million income tax charitable deduction for a conservation easement it granted to a Missouri not-for-profit corporation. The taxpayer did not meet the requirements to claim the deduction because the banks that supplied the loans to build the company's two golf courses had not subordinated their mortgages before the easement was conveyed. The taxpayer had argued it met the "protected in perpetuity" requirement under section 170 even if the subordination occurred after the conveyance. The court said that in order to take the deduction, the banks must have subordinated their mortgages before the conveyance, and the Eighth Circuit sided with the Tax Court that the taxpayer failed to prove the existence of oral subordination agreements.

13. ***Martinez v. Commissioner*, T.C. Summary Opinion 2017-42 (6/26/2017).** The taxpayer attempted to claim a charitable deduction for unreimbursed volunteer expenses, some of which were in excess of $250, based on a letter from the charity stating that he was a volunteer and was not reimbursed for expenses. The Tax Court denied the deduction based on the letter not being contemporaneous.

14. ***Fakiris v. Commissioner*, T.C. Memo. 2017-126 (6/28/2017).** The taxpayer was not entitled to a $5 million income tax charitable deduction for the donation of a dilapidated Staten Island theater to a charitable organization where the donor retained sufficient dominion and control over the theater after selling the building to the WEMGO Charitable Trust Inc. for $470,000. The sales contract (but not the deed) prohibited the charity from selling the theater to any purchaser other than a named 501(c)(3) dance ensemble for five years. Further, the taxpayer was found liable for a 40% gross valuation misstatement penalty because the taxpayer was not entitled to the entire deduction making the value of the property purportedly contributed zero. The court didn't reach the issue of the validity of the claimed $5 million valuation of the property for which the taxpayer paid $700,000.

15. ***RERI Holdings I, LLC v. Commissioner*, 149 T.C. No. 1 (7/3/2017).** The investors in the taxpayer could not claim a section 170 charitable income tax deduction for a partial interest in property donated to the University of Michigan because the taxpayer failed to report its actual investment in the property. RERI Holdings had left blank on the substantiation form the amount its adjusted basis in the donated property. The court disallowed the entire deduction because the omitted information would have alerted the IRS to a potential overvaluation.

16. ***Ohde v. Commissioner*, T.C. Memo. 2017-137 (7/10/2017).** The taxpayers failed to properly substantiate the $145,000 section 170 income tax charitable deduction claimed for more than 20,000 items they donated to Goodwill. The taxpayers had a TurboTax spreadsheet that detailed the items donated to Goodwill, but the spreadsheet did not show a dollar value for any individual item. The court said there is no credible evidence in the record to establish the fair market value of any of the 20,000 individual items. Further, there was no qualified appraisal for items valued in excess of $5,000.

17. ***Partita Partners LLC v. U.S.*, 120 AFTR 2d 2017-5147 (S.D.N.Y. 7/10/2017); 118 AFTR 2d 2016-6243 (S.D.N.Y. 10//25/2016).** The owner of a historic New York building could not take a $4.19 million deduction for granting a facade preservation easement because the easement did not cover the entire exterior, as section 170 by its plain language requires that such an easement apply to the entire exterior of the building. The court also held that the 40% valuation misstatement penalty could apply to an underpayment when the claimed charitable deduction was disallowed on other grounds.

18. ***Green v. U.S.*, No. 16-06371, brief filed (10th Cir., 7/24/2017); 117 AFTR 2d 2016-700, jury verdict (W.D. Okla., 2/10/2016).** The taxpayer argued that the District Court was correct in holding that the trust which indirectly owned a majority of Hobby Lobby stores could deduct for income tax purposes the appreciated $28.5 million fair market value of real property it purchased with gross income and later donated to the National Christian Foundation notwithstanding that section 642(c) only allows for deductions of donations made from a trust's gross income. The question before the District Court was whether the trust's charitable deduction is limited to the

$10.4 million basis (cost) of a non-cash contribution which had been originally acquired with its gross income. In its brief in March 2017, the government argued that the statute was clear and unambiguous. The District Court opinion noted that section 642(c)(1) does not specify a different standard of valuation from section 170.

19. ***Rutkoske v. Commissioner*, 149 T.C. No. 6 (8/7/2017).** The taxpayers were not "qualified farmers" under section 2032A and could not deduct the full value of a qualified conservation contribution under section 170 but were limited to 50% of their charitable contribution base. In a bargain sale transaction, the taxpayers sold a conservation easement to a land conservancy and later on the same day sold their interest in the property to a third person. Although the taxpayers were in the business of farming, the proceeds from the sales did not constitute farming income. The court noted that the taxpayers used most of the sales proceeds in their continuing farming operations; but being a farmer does not make one a "qualified farmer."

20. ***BC Ranch II, LP v. Commissioner*, 120 AFTR 2d 2017-5469 (5th Cir., 8/11/2017).** The Fifth Circuit has remanded the entire Tax Court decision that had disallowed an income tax charitable deduction for the contribution of a conservation easement. The IRS relied on the *Belk* case where the boundaries could be moved and thus did not satisfy the perpetuity requirement. Here, the homesite boundary adjustment provision in the conservation easement did not violate the perpetuity requirement of section 170. In *Belk* the issue was that what is protected in perpetuity is not known if the location of the property is not known. In BC Ranch II, L.P., the issue is about moving boundaries that are already defined.

21. ***310 Retail, LLC v. Commissioner*, T.C. Memo. 2017-164 (8/24/2017).** The taxpayer's deed of a façade easement to the Landmarks Preservation Council of Illinois (LPCI) granting a conservation right in the Metropolitan Tower building in Chicago satisfied the "contemporaneous written acknowledgment" requirement of section 170 even though the taxpayer did not receive a timely letter from LPCI acknowledging receipt and that no goods or services were received in exchange. However, the deed of easement stipulated that the easement was gifted in exchange for nothing.

22. ***Gardner v. Commissioner*, T.C. Memo. 2017-165 (8/24/2017).** An avid hunter's collection of stuffed animals and various pelts, horns, hooves, and other parts was worth "at most" the $163,045 determined by the IRS using comparable sales and not the $1.43 million replacement cost claimed by the taxpayer when he donated them to an ecological foundation.

23. ***Big River Development, L.P. v. Commissioner*, T.C. Memo. 2017-166 (8/28/2017).** Although no "contemporaneous written acknowledgment" of the conservation deed of easement was received, the deed of easement as in 310 Retail, LLC did constitute a contemporaneous written acknowledgment because it included an affirmative indication that the donee organization had supplied no goods or services to the taxpayer in exchange for the gift. The deed said it contained the entire agreement of the parties and thus negated the receipt of any goods or services. The court dismissed the fact that the deed contained boilerplate language reciting $10 and other good and valuable consideration. The court also dismissed the fact that the taxpayer paid a one-time donation fee of $93,500 to endow periodic easement monitoring and related costs and support a preservation easement defense fund. Commenting on whether such monitoring constitutes a service, the court said by inspecting the building to ensure compliance the charity would be discharging its own enforcement responsibilities, and it would be an odd form of service because it could generate no upside for the taxpayer but only downside. In any event, section 170(f)(8) does not prohibit a charity from providing services to a donor – rather, it requires the charity to provide the donor with a "description and good faith estimate of the value" of any services supplied in exchange for the gift.

EXHIBIT A

SAMPLE RECEIPT

[CHARITY LETTERHEAD
OR
NAME AND ADDRESS OF CHARITY]

[Date]

[Name and address of donor]

Dear [Name of donor]:

In compliance with the substantiation requirements of the Internal Revenue Code, this is to acknowledge [Name of Charity]'s receipt from you during calendar year [Year of gift] of the following: [Amount of cash or description of securities, including number of shares]. [Name of Charity] did not provide any goods or services in consideration, in whole or in part, for your contribution.

Sincerely,
[Name of Charity]

[Name of Officer], [Title]