Practical Charitable Giving Techniques 2019

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SECTION I.

INCOME AND ESTATE TAX CHARITABLE DEDUCTIONS

A. Income Tax: Itemize Charitable Deductions. A donor may take an income tax deduction for qualifying contributions to charitable organizations if they itemize their deductions. IRC § 170(a). Under the Tax Cuts and Jobs Act, for tax years 2018-2025 the standard deduction dollar amounts are increased to:

1. $24,000 for joint filers and surviving spouses (computed as 200% of the single filers' amount below)

2. $18,000 for heads of household

3. $12,000 for singles and marrieds filing separately.

It is expected that the increase in the standard deduction will reduce the number of taxpayers who itemize to 5%.

B. Gift Tax. Present-interest gifts under $15,000 per donee are not required to be reported on Form 709. Outright gifts of cash or property are generally not required to be reported assuming they qualify for the gift tax charitable deduction. However, if a client is otherwise required to file a gift tax return, all gifts to be charities must be included on the return. In general, split-interest gifts must always be reported on a Form 709.

C. Carry Forward. Any contributions in excess of the deduction limitation may be carried forward for the following five years. IRC § 170(d)(1); Treas Reg § 1.170A-10(a). Donors who give to both a public charity (a 50-percent type organization) and a private foundation (a 30-percent type organization) in a given year must calculate their deduction under the 50-percent limitation first. All amounts in excess of the deduction limitations may be carried over for the following five years. The carryforward is available even if the individual did not itemize deductions in the contribution year.

D. Income Rates. The Tax Cuts and Jobs Act modified the income tax rates and reduced the top bracket so that the top rate in 2019 for single taxpayers is $510,300 and married individuals making more than $612,350 for years 2018 through 2025.

E. Ceiling for Income Tax Deductions.

1. 50 Percent. Gifts of cash and unappreciated property are deductible up to 50% of the donor's contribution base for contributions to 509(a)(1), 509(a)(2), and 509(a)(3) Type I and Type II organizations, private operating foundations, and conduit foundations. IRC §170(b)(1)(A); Treas Reg §1.170A-8.

2. 30 Percent. Gifts of cash and unappreciated property are deductible up to 30% of the donor's contribution base for contributions to private foundations. Gifts "for the use of" a 50% organization are also deductible up to 30% of the donor's contribution base.

3. **The Tax Cuts and Jobs Act**. The Tax Cuts and Jobs Act increases the contribution base percentage limit for tax years 2018-2025 for deductions of cash contributions by individuals to 50% charities from 50% to 60% (the "60% limit"). IRC § 170(b)(1)(G). Increasing the charitable percentage limit for cash contributions to public charities is intended to encourage taxpayers to provide essential monetary support to front-line charities. Cash contributions that are taken into account under the 60% limit are not taken into account for purposes of applying the 50% limit. But the 30% and 50% limits are applied for a tax year by reducing the aggregate contribution limit allowed for that year by the aggregate cash contributions allowed under the 60% limit for the year.

> **Example**. Individual X has a contribution base of $100,000. She contributes $28,000 to a 50% charity and $5,000 artwork for the use of the 50% charity. X's limit for cash contributions is $60,000 ($100,000 × 60%). X's limit on contributions for the use of a charity is $30,000 ($100,000 × 30%), but this amount must be reduced by X's $28,000 cash contribution, to yield a contribution limit of $2,000. X may deduct $2,000 of the automobile's value in the current tax year but must carry the remaining $3,000 foreword to subsequent tax years.

F. Gifts After Death: Estate Tax Consequences. In general, gifts to a charity after death (through a bequest in a will or a transfer under a trust agreement) are deductible for estate tax purposes at full fair market value and are not subject to any of the deduction limitations discussed above. Unlike the complex rules that govern the income tax charitable deduction, there is no limit on the total estate tax charitable deduction, no requirement that the deduction for capital gain or other property be limited to basis, and no distinction made among types of charitable organizations or the use of certain charitable bequests. Most people are aware of the income tax advantages associated with charitable giving. However, the estate tax benefits of charitable giving can also be substantial and should be considered as part of an overall estate plan.

1. **General Rules**.

(a) **Tax Rates**. The Tax Cuts and Jobs Act increased the estate and gift and GST exclusion amounts to $11.4 million as adjusted for inflation in 2019 for years 2018-2025. IRC § 2010, 2505, 2631

(b) **Deduction**. Bequests to qualified charitable organizations are deductible in determining the net taxable estate of a decedent. The amount deductible is the fair market value of the property at the date of death. IRC § 2055(a); Treas Reg § 20.2055-1(a). For the most part, the estate tax rules track the income tax rules regarding which organizations qualify as charitable organizations for purposes of the estate tax charitable deductions.

PRACTICE TIP: If a married couple shares a strong charitable intent, consider an outright bequest to the surviving spouse of the amount of the intended charitable gift. The spouse

can then make the gift to charity and obtain an income tax benefit. The amount will not be taxable in the estate, as it will be protected by the marital deduction.

(c) Private Foundations Versus Public Charities. As stated above, unlike the income tax, there is no distinction made for estate tax purposes between a bequest to a private foundation and a public charity.

SECTION II.

CALCULATING THE INCOME TAX DEDUCTIONS FOR VARIOUS TYPES OF PROPERTY

A. Gifts of Capital Gain Property.

1. **50 Percent Organization**. Gifts of appreciated property held for more than one year are deductible at the fair market value if contributed to a 50% charitable organization. However, the deduction is limited to 30% of the donor's contribution base. IRC § 170(b)(1)(C)(i); Treas Reg § 1.170A 8(d)(1). IRC § 170(b)(1)(C)(ii). There is a "step-down" election where a donor may elect to increase the ceiling on the deduction to 50% of contribution base (with a five-year carryover for any excess). However, the donor must then reduce the amount of the deduction for all long-term property gifts made during the year by 100% of the appreciation (i.e., deduct the basis of the property rather than the full fair market value) and must similarly reduce the deduction for long-term property gifts being carried over from earlier years. IRC § 170(b)(1)(C)(iii) and (e)(1)(B); Treas Reg § 1.170A-8(d)(2). The "step-down" election cannot be revoked after the tax return's due date.

> **PRACTICE TIP:** If property has a fair market value lower than its basis, the donor should consider selling the property and contributing the proceeds, thereby taking advantage of the capital loss for income tax purposes.

2. **Private Foundation**. Gifts of appreciated property to a private foundation are deductible at the lesser of the property's basis and its fair market value. However, the deduction is limited to 20% of the donor's contribution base. IRC § 170(e)(1)(B)(ii).

3. **Qualifying Publicly Traded Securities**. Gifts to a private foundation of qualifying public traded securities may be deducted at full fair market value. IRC § 170(e)(5)(A). The securities must be the type for which market quotations are readily available on an established securities market. Mutual fund shares also count under this rule so long as market quotations for the fund are published daily in readily available newspapers. Treas Reg §1.170A-13(c)(7)(xi)(A)(2). The IRS has taken the position that stock subject to Rule 144 restrictions is not qualified appreciated stock. PLR 9247018

B. Ordinary Income and Short-Term Capital Gain. For gifts of property the sale or exchange of which produces a gain other than long-term capital gain, the deduction reduced by the amount of the non-long-term gain. Examples are inventory, crops, artwork or other works subject to copyright created by the donor, certain types of stock, and certain partnership property. Generally, this means that the charitable deduction is limited to basis. IRC § 170(e)(1)(A). Deductible up to 50% of the donor's contribution base. IRC § 170(b)(1)(A).

C. Tangible Personal Property. The reduction rules applicable to tangible personal property depend on whether the use of the property by the charity will be "related" to its exempt function. For example, a gift of a painting to a museum for display would be a related use, while a gift of the same painting to a hospital would be an unrelated use. Treas Reg § 1.170A-4.

1. **Related Gifts**. For gifts of tangible person property related to the charity's exempt function to a 50% organization, the deduction is for fair market value. IRC § 170(e)(1)(B)(i). However, the deduction is limited to 30% of the donor's contribution base. IRC § 170(b)(1)(D)(i) The "step-down" election described above is also available so that the donor may raise the ceiling on the deduction limitation from 30% to 50% of contribution base but would then be limited to deducting the cost basis of the property).

2. **Unrelated Gifts**. If gift is unrelated to donee's exempt function, deduction must be reduced by the amount of gain that would have been long-term capital gain had the property been sold at its fair market value (i.e., deduction limited to basis). IRC § 170(e)(1)(B). Deductible up to 50% of contribution base. IRC § 170(b)(1)(A).

3. **Household Items**. Clothing and household items (furniture, electronics, appliances) are subject to a special rule which prohibits any deduction unless the items are in "good used condition or better." IRC § 170(f)(16).

4. **Sale of Property**. There are additional rules that apply to property that was identified as related use property by the donee on Form 8283 and for which a deduction of more $5000 is claimed. There is a $10,000 penalty imposed on a person who identifies property as exempt use property knowing that the property is not intended for such use.

> **(a)** Any tangible personal property that is sold, exchanged, or otherwise disposed of by the charitable organization before the last day of the taxable year in which the property was donated and with respect to which the done has not in a written statement signed by an officer of the done under the penalties of perjury either (a) certified that the use of the property was related to the donee's exempt purpose of function and described how the property was used and how such use furthered such purpose of function of the done or (b) stated the intended use of the property by the done at the time of contribution and certified that such use has become impossible or infeasible to implement. IRC § 170(e)(7)
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> **(b)** If the property is disposed of after the close of the taxable year of the contribution (unless the done makes the certification described above) the donor must recapture 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. IRC § 170(e)(7)
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> **PRACTICE TIP:** Although income tax charitable deductions generally are not allowable for remainder interests in tangible personal property, a deduction is allowed for gifts of undivided interests – e.g., an undivided one-sixth interest in a painting given to museum, with the museum having possession two months each year.

5. **Bargain Sales**. A bargain sale is a sale of property where the sale price is less than the property's fair market value. If a bargain sale is made to a charity, the donor may receive a charitable deduction for the difference between the fair market value and sale price. IRC § 170(e)(2). However, the cost basis of the property must be allocated between the portion of property "sold" and the portion of the property "given" to charity on the basis of the fair

market value of each. Appreciation allocable to sale is subject to capital gains tax; appreciation allocable to the gift is not. IRC § 1011(b). An outright gift of mortgaged property is considered a bargain sale. Treas Reg §1.1011-2(a)(3).

6. Valuation of Charitable Contributions. The deduction for a gift of property generally is based on the property's fair market value. However, the deduction may be reduced because of the rules outlined above. Following is a list of property and the appropriate method for obtaining a fair market value figure for each type of property:

(a) Securities. Listed securities such as publicly traded stocks or bonds are valued at the mean between highest and lowest quoted selling prices on the valuation date (the date of delivery). Treas Reg § 20.2031-2(b) and 25.2512-2(b). If there is not a market for securities on a stock exchange or over the counter, the fair market value is the mean between the bona fide bid and asked prices on the date of delivery. Reg. §§ 20.2031-2(c) and 25.2512-2(c).

(b) Mutual Funds. Mutual fund shares are valued as of the redemption price on the date of delivery.

(c) Real Estate, Works of Art, and Other Property Not Traded on an Exchange or Over the Counter. Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Treas Reg § 1.170A-1 (c). In general, any donated property worth more than $5,000 must be appraised. The Treasury Regulations set out very strict appraisal requirements. A "qualified appraisal" must be obtained and a fully completed "appraisal summary" must be attached to Form 8283. Treas Reg § 1.170A-13(c)(1), et al.

(d) Vehicles. Concerns about abuse in vehicle donating programs run by charities have led to a special rule limiting the deduction for a car donation to the actual sale price of the car when it is sold by the charity.

(e) Partnership and LLC Interests. In addition to the qualified appraisal rules that may apply to the donation of this type of property, contributions of partnership and LLC interests require additional analysis - the explanation of which is beyond the scope of this article. In a nutshell, IRC § 170(e)(1)(A) requires that the contribution be reduced by the amount of ordinary income or short-term gain that would have been recognized if the interest were sold. If the partnership or LLC has debt, the contribution may invoke the bargain sale rules under IRC § 1011.

(f) S Corps. Contributions of S corporation shares have similar issues to those stated above with respect to contributions of partnership and LLC interests.

(g) Unreimbursed Volunteer Expenses. Certain expenses may be deductible when incurred in rendering services for charity. Rev Rul 55-4, 1955-1 CB 291. Ceiling is 50% of contribution base, with a five-year carryover.

(i) Travel Expenses. Volunteers whose duties keep them away from home overnight may deduct reasonable payments for meals and lodging as well as travel costs. However, deductions for unreimbursed charitable travel expenses will be disallowed if there is a significant element of personal pleasure, recreation, or vacation in the travel. IRC § 170(k).

(ii) Unreimbursed Automobile Expenses. Donors who use their automobiles in rendering gratuitous services to charitable organizations may deduct their gas, oil, tolls, and parking costs (but not insurance and depreciation); or they may deduct a standard cents-per-mile rate in computing the cost of operating the automobile while volunteering.

7. Substantiating Charitable Deductions. The charity's receipt must provide (1) the amount of cash and a description (but not the value) of any property contributed; (2) whether anything of value was given to the donor in exchange for the gift; and (3) if the donor did receive something from the charity, a description and good faith estimate of the value given. Gifts of cash under $250 are deductible only if the donor retains a bank record of the transaction, or if the charity issues a receipt stating the date and amount of the gift. Of course, regardless of whether a donor has a receipt, the IRS may challenge the deduction for other reasons (*e.g.*, the charity is not qualified, the value placed on the gift by the donor or the charity is inflated, the donor received a benefit).

(a) Contributions of $250 or More. Donors must have a receipt from a charity to claim a charitable deduction of $250 or more. A canceled check without a receipt is insufficient.

(b) Noncash Contributions over $500. A donor who contributes property over $500 must file a Form 8283 with his or her 1040. Form 8283 requires a description of the property, name and address of donee, date of contribution, and the value of the property. A gift for which an income tax charitable deduction of over $5,000 is claimed requires a qualified appraisal and an appraisal summary (other than for gifts of cash or other easily valued property such as publicly traded securities).

(c) Repeal of 80/20 Rule. The Tax Cuts and Jobs Act repealed the rule that allowed a charitable deduction for 80% of amounts paid to or for the benefit of an educational institution in exchange for which the taxpayer receives directly or indirectly the right to purchase tickets for seating at an athletic event in an athletic stadium of such education institutional.

SECTION III.

PLANNING IN THE CURRENT TAX AND ECONOMIC ENVIRONMENT

A. Favor Charitable Giving Techniques. Look for charitable giving techniques that:

1. Favor Low Interest Rates. The 7520 rate for September was 2.2% and for October is 1.8%. Vehicles such as charitable lead trusts and remainder gifts of residence and farm property and maybe charitable gift annuities.

2. Favor Single Significant Charitable Gift. The standard deduction is high, and as a result only 5% of taxpayers are expected to itemize deductions. We can look for opportunities to create a single charitable gift that creates the opportunity to itemize deduction and take full effect of the available charitable deduction. Charitable remainder trusts, donor-advised funds, and private foundations work well.

3. Favor Exclusion of Income. It may be worth more to donors to exclude income rather than itemize deductions. Charitable Gift annuities, certain charitable Flip trusts, charitable gifts from retirement accounts and impact investing work well.

4. Favor Win-Win Giving. Find ways to meet both charitable and noncharitable goals. Using Flip trusts to provide retirement or other goals. Charitable lead trusts do not provide a charitable deduction, but in the alternative, provide an opportunity to make a gift to children or other family members with no gift tax.

5. Favor lifetime benefits. The estate tax exclusion is high and many donors may not need an estate tax deduction. A donor can use a charitable remainder trust during life rather than waiting to make a testamentary gift.

6. Favor Meaningful Experiences. Consider the Seven Faces of Philanthropy and other tools to help identify how charities can work together with community members to achieve something together.

SECTION IV.

PHILANTHROPY: DEVELOPING COMMUNITY ENGAGEMENT

In his book *Man's Search for Meaning*, Viktor Frankl proposed that all humans are driven to achieve meaning. The big existential question for donors is what is meaningful to them. If we identify what is meaningful to the donor, we know what factors drive their impulse to give and how they will evaluate giving opportunities. How does the donor want to work to achieve something meaningful? How can we work together to achieve something?

Russ Alan Prince and Karen Maru File, through their research, segmented donors into seven classifiable types in their book *The Seven Faces of Philanthropy*.

A. Communitarian: Doing good makes sense for the benefit of the community. Local and community focus which can also help their business interests. Seek long-term relationship and substantial involvement in nonprofit decision-making. What to be understood as a community leader. Desire personal attention, empathy of their motivations and appropriate social recognition. This is the largest donor segment. 26.3% of contributors. Often business owners who serve on the board of directors. Believe that relationships and supporting local community are good for business. See giving as win-win.

B. Investor: Doing good is good business. 15.3% Interactions are principally business relationships. Donations are driven by business, tax, and estate considerations, expect nonprofits to be result oriented and acknowledging major donors. Mostly business owners. Tend to engage in farsighted planning for the long-term. Inclined to consider multi-generational. Want to know how the money will be used wisely.

C. Socialite: Doing good is fun. 10.8% Charity and fundraising activities are part of their personal, social identity. Nonprofit support is a social activity. Social network oriented. Desire social acknowledgment. They enjoy social functions and hosting. They want to be part of the nonprofit group and events. Enjoy giving to organizations others give to.

D. Altruist: Doing good feels right. 9%. Use philanthropy to seek personal development and growth. Strive for the highest morality. Giving is pure and free of self-serving motivations. Do not desire honors – sometimes give anonymously. Respond to emotional and moral imperative of the gift. Seek nonprofit aligned with theirs. Do not respond to ego reasons for giving.

E. Devout: Doing good is God's Will. 0.9% of donors. Primarily give to religious organizations. Mostly male.

F. Repayers: Doing good in return. 10.2% Feeling of obligation or gratitude; pay for previous receipt of charity. Do not seek recognition and prefer to focus on constituents; appreciative of sensitivity to their personal story. Were recipients first. Want others to benefit like they did.

G. **Dynasty**: Doing good is a family tradition. 8.3% Giving is a tradition and philanthropy is part of family socialization. Diverse giving portfolio. Desire nonprofits to perform excellently on their behalf without too active a role. Take time to evaluate charities.

H. **Tax Vehicle**: what do property do they want to give? What benefits do they want in return? Tax benefit, annuity, deferred gift, nonfinancial? Maximize benefits.

SECTION V.

RETIREMENT ASSETS

A donor must recognize income when assets are withdrawn from a retirement account. This fundamental rule still applies when retirement assets are withdrawn and given to charity during life. Donors who itemize can claim a charitable deduction for the amounts donated to charity, subject to the contribution base deductibility ceilings and carryover rules discussed above. Retirement assets are also subject to estate tax upon the death of the owner.

A. Charitable Distribution. In 2006, Congress created the "IRA Charitable Distribution" as a limited exception to the general rule. The exception provides that a donor who is age 70 1/2 or older can make a direct charitable contribution from an IRA of up to $100,000 per year to a qualified charity (in general – a "public charity," but not a supporting organization, donor-advised fund, or charitable remainder trust). A donor who qualifies for this exception can exclude the amount of the contribution from his or her taxable income. The charitable distribution was made permanent by Congress effective January 1, 2016.

1. IRAs Only. The IRA charitable rollover works only for traditional and Roth IRAs. Distribution from SIMPLE IRAs, SEPs, Keoghs, 403(b)s, 401(k)s, and profit-sharing plans do not qualify.

2. Details. Distributions must be direct from the IRA administrator to the charity, and the charity must issue a timely written acknowledgment to the donor stating that it has received the IRA distribution and that no goods or services were received in exchanged for the contribution. Any benefits received back (*e.g.*, a dinner at the charity gala) will disqualify the entire distribution.

3. Exclusion from Income. There is no charitable deduction for the charitable IRA rollover. But excluding the amount from income is a better result for many taxpayers. The distribution amount is included in the donor's Required Minimum Distribution for the year. There are special allocation rules (favorable to the taxpayer) that apply when making a gift from an IRA account that consists of both deductible and non-deductible contributions.

B. Designation of Charitable Remainder Trust as Beneficiary. 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. Because of this excessive tax burden, retirement benefits are good assets to leave to a charitable remainder trust. Naming a charitable remainder trust as the beneficiary of retirement benefits will provide the estate with 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. This technique is particularly useful if the beneficiary is young. In this case, the assets can continue to grow in a tax-free environment and be paid over a long life span (assuming the § 7520 rate supports the life span payment and complies with the 10% to charity and 5% exhaustion rules).

C. Designating a Charitable Entity as Beneficiary. Naming a charitable organization as the designated beneficiary will provide the estate with a charitable deduction. Further, 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; thus avoiding both the estate and income tax on the retirement assets. As with all estate planning with retirement benefits, the retirement plan account may be depleted or exhausted at the time of death. If the donor wants to ensure that the charity receives at least a certain amount, the attorney can provide under the terms of the will or trust for a supplemental payment if the retirement account has a value of less than the specified amount.

> **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.

SECTION VI.

CHARITABLE REMAINDER TRUSTS

While Charitable Remainder Trusts ("CRTs") can be complex, the deferral of capital gain and the charitable deduction for the portion of the contribution going to charity represent a significant trade-off. The IRS has published revenue procedures with sample instruments for inter vivos and testamentary charitable remainder annuity and unitrusts.

A. Mortality Tables. All of the actuarial calculations use the current mortality tables. Code § 7520 requires that the IRS update the mortality tables every 10 years and that was supposed to happen on May 1. The process has been delayed, but when the new tables are issued they will probably reflect longer life expectancies.

B. CRT Requirements.

1. A charitable remainder trust must provide for the distribution of a specified payment, at least annually, to one or more persons either for the life or lives of the individual beneficiaries or for a term of years, not exceeding 20. Treas Reg § 1.664-1(a). The payment must be equal to at least 5% but not more than 50% of the net fair market value of the assets on the date they are contributed to the trust. IRC § 664.

2. Upon the termination of the noncharitable interest, the remainder must either be held in a continuing trust for charitable purposes or be paid to or for the use of one or more organizations described in § 170(c). Donors can reserve the right to change the remainder charity to accommodate changes in charitable priorities, charitable organizations, and tax laws. The value of the charitable remainder interest cannot be less than 10% of the donation to the trust. The higher the noncharitable payout rate, the older the beneficiary will have to be to satisfy the 10% requirement.

3. In addition, charitable remainder annuity trusts must also pass the 5% probability of exhaustion test under Revenue Ruling 77-374. If the annuity payout rate is higher than the applicable § 7520 rate, there is some chance the trust will theoretically run out of money before the donor dies, and if that probability exceeds 5%, the trust will not be a qualified charitable remainder trust (CRT?).

4. A qualified charitable remainder trust is exempt from income tax, and the grantor is entitled to an income, gift, and/or estate tax charitable deduction based on the present value of the remainder interest ultimately passing to charity. In other words, the gift tax deduction is equal to the value of the property or cash contributed less the value of the retained annuity interest. IRC § 664(d)(1).

5. The method of distribution of the remainder interest will affect the ceiling imposed on the grantor's income tax charitable deduction under § 170 (but not the amount of the gift or estate tax deduction). If the charitable remainder is retained in trust for the benefit of a designated charitable remainder beneficiary, the deductibility for income tax purposes is limited to 30% of the grantor's "contribution base" in the year of the gift with a five-year carryover. If

the remainder interest will pass outright to a charity, either a 30% or a 50% limitation applies, depending upon the nature of the property placed in trust. A lower limitation applies where a private foundation (as opposed to a public charity) is named as the remainder beneficiary.

C. Influence of Low Interest Rates on CRTs. The low 7520 rate can limit the effective use of a CRT. To be a qualified charitable remainder trust, the value of the charitable remainder interest upon creation of the trust must be at least 10%. With a 2.2% § 7520 rate, a unitrust for spouses, using the minimum unitrust payment of 5% will violate the 10% rule unless the spouses are 39 or older. However, using the same 2.2% § 7520 rate, a 5% charitable remainder annuity trust for spouses will violate 5% probability of exhaustion test of Revenue Ruling 77-374 the unless both spouses are 73 or older. CRUTs are not subject to the exhaustion rule.

D. Some Factors Indicating the Use of Charitable Remainder Trust.

1. Avoidance of Capital Gain.

(a) In the current tax system, excluding gain from current income may be more valuable to individuals than a deduction of the same amount, given the various deduction limitations. A properly implemented CRT will provide both the gain exclusion and an income tax deduction.

(b) A donor can transfer appreciated stock to a charitable remainder trust as part of a diversification or rebalancing plan, where the stock can be sold in a tax-exempt environment. It is not generally necessary to create a new trust each time: additional securities can be contributed to existing CRUTs.

(c) If the business is to be sold, a donor can contribute stock to the CRT, then the corporation redeems the stock from the CRT and the departing owner has the income from the CRT for retirement. A grantor generally recognizes no gain on the transfer of appreciated property to an inter vivos charitable remainder trust. However, in funding such a trust, a grantor may face the principles articulated in ***Ferguson v. Commissioner***. If ***Ferguson*** applies, then, pursuant to the assignment of income doctrine, if the right to receive the income inherent in the transferred property has ripened for tax purposes, the grantor who earned or created the right must recognize any income that results from that right, even if the grantor transfers the right to a charitable remainder trust before actually receiving the income.

(d) Income Deduction. A current income tax deduction is available for the present value of the remainder interest. Donors who are planning a testamentary charitable bequest should consider a CRT instead. The property will still pass to the charity at the death of the donor, but the donor receives an income tax deduction as well as an estate tax deduction, while retaining a life income stream.

(e) Achieving other Goals. A NIMCRUT or Flip CRUT can defer income to the donor-beneficiary until the date the donor expects to retire, thus allowing tax-free accumulation without qualified-plan or IRA-contribution limits. Also, unlike qualified

plans and IRAs, a NIMCRUT or Flip CRUT allows the accumulated income to retain its character as qualified dividends and capital gains upon eventual distribution.

2. Choosing a Charitable Remainder Annuity Trust ("CRAT") or Charitable Remainder Unitrust ("CRUT")

(a) CRAT.

(i) Predictability. The income beneficiary knows exactly how much cash he or she will receive each year (unless the trust is depleted). Charitable Remainder Unitrust ("CRUT") payments will vary from year to year.

(ii) Simplicity for the Trustee. The trustee does not have to revalue or recalculate the annual or quarterly distribution.

(b) CRUT.

(i) Variable Payments. As the value of the trust grows, the unitrust payment will share in the growth, potentially providing the donor with some inflation protection. However, the payments will also decrease if the trust is depleted – which can occur in a 10% trust.

(ii) Variable Trust Provisions. Certain variations on a CRUT are suitable for donations of illiquid assets that may not be sold before the first payment is due.

(iii) Additional Contributions. Additional contributions can be made to a unitrust. If the donor might want to add assets later, a CRUT is probably a better alternative to creating additional CRATs.

E. Property Contributions to Charitable Remainder Trusts. Property contributed to a CRT could include cash, marketable securities, closely-held business interests, art and collectible to be sold before year-end. A CRT will be subject to an excise tax on any UBIT received.

F. Income Tax Rules. The remainder trust itself is exempt from income tax (except to the extent that the trust incurs unrelated business taxable income). IRC § 664(c). The income beneficiary is required to treat distributions from a remainder trust in accordance with the following schedule:

1. First, as ordinary income, to the extent that the trust has ordinary income for the current year and any undistributed ordinary income from prior years;

2. Second, as capital gain, to the extent that the trust has capital gain for the current year and any undistributed capital gain from prior years;

3. Third, as other income (*e.g.*, tax-exempt income), to the extent that the trust has other income for the current year and any undistributed other income from prior years;

4. Fourth, as a distribution from corpus. IRC § 664(b).

G. Gift Tax Rules. A remainder trust with the donor as the sole income beneficiary is not subject to gift tax. However, the donor must report the remainder gift to charity (regardless of size because it is a future interest) on a federal gift tax return. IRC § 6019. The donor then takes an offsetting gift tax charitable deduction. Where a donor creates a remainder trust benefiting another person, the donor has made two gifts: one to the beneficiary (the value of the life interest) and one to the charity (the value of the remainder interest). If the life interest is a present interest, it will qualify for annual exclusion. However, to the extent the value of the life interest exceeds the $15,000 per donee annual exclusion, or if the gift is a future interest, the gift will use up the donor's gift tax credit. If the donor has no gift tax credit left, gift tax will be due. IRC § 2503(a); Treas Reg §25.2503(b).

> **PRACTICE TIP:** A donor can avoid making a gift to a survivor beneficiary by providing in the inter vivos trust instrument the right (exercisable only by will) to revoke the survivor's life interest. Should the donor exercise that right, the trust will terminate on the donor's death, and the remaining amount in the trust will be paid to charity. The donor need not actually exercise the right in the will; merely retaining the right avoids the donor's making a completed gift to the survivor beneficiary. Rev Rul 79-243, 1979-2 CB 343; Treas Reg § 1.664-3(a)(4) and 25.2511-2(c). Despite the flexibility of this approach, for donors living in a state with a separate estate tax and no gift tax (such as Oregon or Washington), it will be better to make a completed gift and file a gift tax return at the time of funding.

H. Estate Tax Rules. In general, the value of trust assets remaining at the donor's death is includable in the gross estate of the donor if the donor is a lifetime income beneficiary of the trust. The estate may then deduct the value of the trust assets as charitable contribution, resulting in a wash. IRC § 2036 and 2055(e)(1)(B); Treas Reg § 1.664-4. Where the donor is not a lifetime beneficiary of a trust, the value of the trust assets will not be included in the donor's gross estate. IRC § 2035(d). If the donor created a two-life remainder trust that benefits another person after the donor's death, the entire value of the trust is included in the donor's estate. IRC § 2036. The estate will receive a charitable deduction for the full value of the trust if the other person predeceases the donor. Treas Reg § 20.2031-7. If the other person survives the donor, the value of that person's interest is subject to estate tax *unless* the person is a surviving spouse entitled to a marital deduction. IRS § 2032(b)(2); IRC § 2056(b)(8). Note that an estate tax marital deduction for spouse's life interest is allowable only if the spouse is the sole noncharitable beneficiary of the remainder trust. For example, a remainder trust created by a donor's will providing payments to spouse for life, and then to son for life, would not qualify for an estate tax marital deduction. (The charitable remainder interest would still qualify for the estate tax charitable deduction.)

I. Variations of CRT: NIMCRUT and Flip CRUT

(a) NIMCRUT (a "net income only" unitrust). Treas Reg § 1.664-3(a)(1)(i)(b)(1) and (2). One variation is a trust that allows the trustee to pay the lessor of the fixed percentage on the trust accounting income.

(b) Flip CRUT Requirements. There is a second variation often referred to as a “Flip Trust” which allows the unitrust to use the net income with make-up provisions payout method for an initial period, and then “flip” to the fixed percentage method for the remaining portion of the term. Reg. §1.664-3(a)(1)(i)(c). The “flip” must be triggered “on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other persons. With some exceptions, a trustee can have the discretionary power to allocate capital gains to income, as allowable under state law. The conversion date must be the beginning of the taxable year immediately following the year containing the date of the triggering event. Any remaining “make-up” amount is forfeited in the year after the conversion. This type of trust is often chosen when the CRUT is funded with an illiquid asset (e.g., land, closely held stock) but the donor would like a more consistent stream of income once the asset is sold.

The final regulations offer a number of examples of permissible triggering events that are not considered discretionary with or within the control of the Treas or any other person. Treas. Reg. § 1.664-323(a)(1)(i)(d).

(i) Marriage, divorce, death, birth.

(ii) A specific date is a permissible triggering event.

(iii) That is funded with an asset such as real property and provides that the change in distribution occurs the year after the property is sold.

(iv) A trust may state a combination of methods that satisfy the treasury rules.

1. Finding Win-Win Benefits with Flip Charitable Remainder Unitrusts. The Flip unitrust allows donors and their advisors to achieve the charitable goals of the client, and also provide a greater opportunity to achieve some nonphilanthropic goals.

(a) Use of Flip Unitrust for Unmarketable Assets.

(i) The most obvious use of a Flip unitrust is in connection with a gift of an illiquid or unmarketable asset, <u>such as real estate or closely held stock</u>. In the past, charitable remainder trusts funded with these types of assets were typically structured as net income (either with or without a make-up 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.

(ii) 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.

(iii) If the Flip unitrust is structured initially as a net income with a make-up 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.

Example. Donor establishes a Flip unitrust and funds the unitrust with unimproved real estate on January 1, 2019. 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, 2025 for $130,000. The accrued unitrust amount through 2025 is $36,000. Because post-contribution appreciation is allocated to income, the trustee has $30,000 of income in 2021, which amount can be used to pay the Donor the accrued unitrust amount of $36,000. Beginning the following year, the unitrust will distribute to the Donor a 6% unitrust payment. The $6,000 will be forfeited.

(b) Use of Flip Unitrusts for Retirement Planning. 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 § 4941.

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.

(c) Planning for Surviving Spouse. 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.

(d) Planning for Education. 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.

SECTION VII.

CHARITABLE LEAD TRUSTS

In reverse of charitable remainder trusts, a charitable lead trust ("CLT") pays the lead distributions to a charitable beneficiary for a specific period of time and the remainder interest reverts back to the donor or other family members. CLTs can be used as a lifetime giving vehicle or as a testamentary device. CLTs may be structured in a variety of different ways: grantor v. non-grantor; unitrust v. annuity trust; qualified v. non-qualified. The IRS has provided sample forms for CLTs and provided alternative provisions.

A. Grantor Trust. If a CLT is structured as a grantor trust, the grantor may take a charitable deduction for the present value of the charitable interest in the trust. In addition, all of the trust's income, gains and losses will be recognized on the donor's individual income tax return each year. Grantor lead trusts can only be created during lifetime. Benefits of grantor trusts include the fact that the donor is obligated to pay income tax on the trust's earnings during the charitable term may be a positive factor for those donors who are motivated to maximize the amount distributed to family at the termination of the lead trust. Payment of income tax by the donor allows the trust assets to grow tax free. In addition, the donor receives a single large deduction for charitable gifts being made over time.

B. Non-Grantor Trust. If a CLT is structured as a non-grantor lead trust, the donor receives no charitable deduction upon funding. The trust itself would be entitled to a charitable income tax deduction for distributions made to charity during the trust term. Non-grantor lead trusts are used primarily for their transfer tax benefits.

C. Unitrust v. Annuity Trust. The income interest in a CLT may be structured as a guaranteed annuity payment (charitable lead annuity trust or "CLAT"), or as a fixed percentage of the annual fair market value of trust property (charitable lead unitrust or "CLUT"). The requirements for the CLUT are strict. Unlike a charitable remainder trust, there is no "lesser of income or unitrust amount" available for a CLUT. Due to the complexities of the GST exemption allocation rules, only a CLUT should be used when there are skip persons as remainder beneficiaries.

D. Qualified v. Non-Qualified. An income, gift and estate tax deduction are allowed only for qualified CLTs. The CLT must provide for an annuity or unitrust payment, but not a hybrid.

E. Annuity Amount.

1. Generally. An annuity must be a specific amount payable at least annually for a term of years or for the life or lives of an individual or individuals. The amount of the payment must be determinable at the time the trust is established. In determining the annual amount to be paid to the charity, a CLAT may provide for any dollar or percentage amount. Neither the 5% minimum annual payout requirement nor the 5% exhaustion requirement for charitable remainder annuity trusts is applicable. It is permissible to provide for payment for the duration of one or more lives in being plus a term of years. The value of the annuity interest is determined by using the actuarial life expectancy and the IRC § 7520 rate as of the date of the

transfer. Donors may use the month of the transfer or either of the two previous months. Income in excess of the guaranteed annuity payment may be retained by the trust.

2. CLAT with Increasing Payout. 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) and PLR 201216045. This method allows the trust's growth to be sheltered from depletion during the early years of the trust.

> **Example**. Assume $1,000,000 is contributed to a CLAT with a term of 10 years, the IRC § 7520 rate is 1.8%, and the payout rate starts at 4.7% and increases by 20% each year. With a 6% growth rate, the remainder beneficiary receives $421,857 and the charitable beneficiary also receives $30,000 more over the 10-year term.

F. Unitrust Amount. A unitrust interest is defined as an irrevocable contractual right to receive payment, at least annually, of a fixed percentage of the net fair market value, determined annually, of the assets of a CLT. For purposes of determining the net fair market value of the property, all assets and liabilities of the trust are taken into account regardless of whether or not particular items are taken into account in determining the income from the property. The key requirement is that the duration of unitrust payments (but not the amount of such payments as with the guaranteed annuity interest) must be ascertainable at the outset, whether for a term or for a life. For purposes of determining the amount of each unitrust payment, the trust can use an annual valuation or a rolling valuation. In the case of a unitrust, the governing instrument cannot provide for the payout percentage to vary over the term of the trust. A variable percentage would violate the requirement that a fixed percentage must be determinable at the outset. There is no minimum or maximum unitrust payment. Additional contributions to charitable lead unitrusts are permitted. Unitrusts work best where assets can be easily valued and are expected to decline in value.

G. Private Foundation Rules. The private foundation rules regarding self-dealing, excess business holdings, jeopardy investments and taxable expenditures all apply to "qualified" lead trusts. A donor who wishes to fund a lead trust with assets that would otherwise violate the private foundation rules may create a non-qualified non-grantor lead trust. With a non-qualified non-grantor lead trust, the grantor avoids tax on the income (paid by the trust), and the trust receives a charitable deduction when income is distributed to charity. The entire gift to the trust will be subject to gift tax because the trust is not a qualified lead trust. However, if the grantor retains the power to designate the charitable lead interest there is no completed gift on funding. In addition, in the case where the present value of all charitable lead interests does not exceed 60% of the aggregate value of the net assets of the trust on the transfer date, the governing instrument of a CLAT is not required to prohibit acquisition and retention of excess business holdings and jeopardy investments.

H. Factors Indicating the Use of CLTs.

1. Low 7520 Rate. A CLAT produces a benefit when interest rates are low. Any growth in the trust in excess of the 7520 rate passes to the noncharitable remainder beneficiaries at termination of the CLAT free of gift or estate tax.

2. High Inflation. Annuities are preferred in inflationary climates. As the value of trust assets increases, the value of the remainder increases, providing a larger tax-free gift to the remainder beneficiaries.

3. Maximum Charitable Deduction/Zero Taxable Gift. With a "zeroed out" CLAT the remainder interest passing to the noncharitable beneficiaries would be equal to zero for gift tax purposes and the donor would make no taxable (or only a nominal) transfer. With lower § 7520 rates, the remainder interest can be reduced to zero with shorter terms and lower payouts than would be the case at higher § 7520 rates. With a zeroed out CLAT, if the trustee's investment of the transferred assets yields a higher return than the § 7520 rate during the trust term, the excess return passes to the children free from transfer tax.

> **Example**. Assuming a 1.8% § 7520 rate and annual payments made at the end of each year to charity a donor could zero out a CLAT by making 11.017% payments for only 10 years.

> **Example**. Using the facts above, donor wishes to contribute $1,000,000 to her CLT. The trust pays Charity $110,170 for 10 years. 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 10-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 $338,720 to Donor's daughter, free of transfer tax.

SECTION VIII.

POOLED INCOME FUNDS, CHARITABLE GIFT ANNUITIES, AND GIFT OF REMAINDER INTEREST IN PERSONAL RESIDENCE OR FARM

A. Pooled Income Funds. A pooled income fund is a fund that maintains property for the lifetime benefit of the donor or named beneficiaries and the remainder interest for a qualified charitable organization. The fund is a "group pool" of sorts – all donor assets are commingled. The funds must be administered by the ultimate remainder beneficiary – so usually only larger charitable institutions (*e.g.*, schools and hospitals) offer them. Pooled income funds are also available through community foundations. The advantage of a pooled income fund is that donors can transfer relatively small amounts to the fund and still reap the benefits of an income stream and a current income tax deduction. The income paid to the donor (or designated beneficiary) is based upon the annual rate of return of the fund and is taxed to the donor (or beneficiary) as ordinary income.

B. Charitable Gift Annuities.

1. In General. A donor creates a charitable gift annuity by irrevocably transferring money or property to a qualified organization in return for its promise to pay the donor (or another beneficiary) fixed and guaranteed payments for life. In essence, the transfer is part charitable gift and part purchase of an annuity. The amount of payment is fixed at the outset and never varies. As with a commercial annuity: (1) the older the annuitant at the annuity starting date, the larger the annual payments; (2) when there are two annuitants, the annual payments are smaller than if there is one annuitant; and (3) a portion of each annuity payment is excludable from gross income for the period of the annuitant's life expectancy. The excludable (tax-free) amount is established at the annuity starting date. The charitable contribution for the annuity is the difference between the amount of money (or the fair market value of long-term securities or real estate transferred) and the value of the annuity. Treas Reg § 1.170A-l(d).

2. Capital Gains. If the gift consists of appreciated property, the transfer is treated as a bargain sale (that is, part-gift, part-sale). Assuming the donor is the annuitant, any capital gains attributable to the sale portion of the gift are reported ratably over the donor's lifetime.

3. Credit Worthiness of Charity. Because a charitable gift annuity is a contract with a particular charity, the financial viability of the charity can present a risk to the donor. Any donor entering into a gift annuity arrangement with a charity should undertake appropriate due diligence before making the transfer to determine the financial stability and longevity of the charity.

4. Low Interest Rates Reduce Reportable Income. The current low § 7520 rates significantly reduce the available charitable deduction. However, for a donor interested in tax-free income and not concerned with the amount of the charitable deduction, the low § 7520 rates have a significant and advantageous impact on the exclusion ratio. The exclusion ratio is the amount of the annuity payments that will be excluded from income each year for federal income tax purposes. So, a non-itemizer who cares more about how much income is taxable than about

the charitable deduction will find the charitable gift annuity especially attractive now. Those donors should elect to use the lowest available 7520 rate.

> **Example**. A 65-year old donor gives property in return for a 4.7% annuity. With a 7.0% § 7520 rate, the donor's charitable deduction is 55.7% of the value of the property transferred, and the exclusion ratio for the annuity payments is 47.08%. If the § 7520 rate is 1.0%, however, the donor's deduction decreases to 25.1%, while the exclusion ratio increases to 79.71%.

5. Regulation. The self-dealing prohibition and other private foundation rules do not apply to Charitable Gift Annuities ("CGA"). Gift annuities are subject to regulation by the Insurance Commission for the State of Oregon. The state imposes registration and reporting requirements upon charities that offer gift annuities.

C. Factors in Favor of a Gift Annuity.

1. Simplicity. Minimal cost is required to establish and administer. No "5% exhaustion test" applies (unlike the CRAT situation).

2. Elevated Payments. There is no risk of a trust running out of principal should the donor substantially outlive his or her life expectancy.

3. S Corporation Stock. A gift annuity can be funded with S corporation stock, assuming the charity is willing to accept the stock. S corporation stock cannot be transferred to a CRT without terminating the S election.

4. Income Tax. If the property transferred has significant basis, the CGA allows basis recovery over the beneficiary's expected lifetime. In a CRT, basis is only recovered once all current and accumulated income has been distributed.

Although the donor cannot change the charity once the gift annuity is established, many donor-advised funds will issue gift annuities, effectively allowing the donor or a successor fund advisor to choose the charitable beneficiary.

D. Creative Uses of Charitable Gift Annuities.

1. Property Not Suitable for a Charitable Remainder Trust. If a donor would like to give to tangible personal property that will not be sold, a charitable gift annuity may work. For example, donor would like to gift his artwork to a favorite local museum, but the museum is unwilling to enter into a bargain sale arrangement because it would require an immediate significant expenditure of capital. 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.

Additionally, a charitable gift annuity can work for contributions of property with debt. 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. 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. A charitable gift annuity allows the donor to contribute property now, obtain an income tax deduction but defer payments until the donor reaches retirement age. 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 Others. An immediate or deferred gift annuity can be used to provide for an individual, such as a relative or family employee. However, where the donor contributes property and is not the annuitant, the donor will have to recognize capital gains immediately. The gift tax consequences of the arrangement will also need to be examined when advising the donor.

E. Gift of Remainder Interest in Personal Residence or Farm.

1. In General. A donor can obtain income and estate tax benefits by making a charitable gift of a personal residence or farm even though the donor retains the right to life enjoyment. IRC §170(f)(3)(B)(i); IRC §~2522(c)(2) and 2055(e)(2). A life estate may be retained for one or more lives, or an estate may be retained for a term of years. However, this method of deferred giving will *only* work for a personal residence or farm. The definition of a personal residence includes a vacation home. The gift must be outright – it cannot be in trust. Rev Rul 76-357, 1976-2 CB 285.

2. Charitable Deduction. The donor may take an immediate charitable income tax deduction. For the income tax charitable deduction, depreciation and depletion must be taken into account to determine the value of the remainder interest. Those values are discounted at an interest rate that depends on the federal rate in effect at the time of the transfer. For gift and estate tax purposes, depreciation (or depletion) need not be taken into account in valuing the remainder. Because the retained use of the residence is equivalent to an income stream, the lower the interest rate, the less the retained residential interest is worth and greater the value of charitable remainder. Suppose a donor age 70 wishes to contribute the remainder interest in her residence to charity. Assume also that the house has a fair market value of $1,000,000, of which $800,000 represents the value of the house and $200,000 the value of the land plus salvage value. If the 7520 rate was 6%, the deduction would have been $386,194. Using the October 2019 interest rate of 1.8%, the deduction rises to $598,584 – a dramatic increase. So, if I were a planned giving officer, the gift of the remainder interest in a personal residence or farm would be a gift I would be marketing vigorously right now. The gift of a remainder interest in a personal residence or farm is attractive for several other reasons. From the charity's side: no trust to

administer, no annual tax returns to file. From the donor's side: a substantial income tax deduction without any change of life style and without having to part with liquid assets. And when the donor dies it will be the charity's responsibility to dispose of the residence, not the donor's family. Remember: § 7520 provides that if an income, estate, or gift tax charitable contribution is allowable for any part of the property transferred, the taxpayer may use the 7520 interest rate for the month of the transfer or may elect to use the rate for either of the two months preceding the month of the transfer. And since the 7520 rate is announced about the 15th or 20th of each month for the following month, the split-interest charitable donor really has rates from four months to choose from. If I like next month's rate better, I can just wait a few weeks to make my transfer.

3. Capital Gain. Capital gain is generally not taxable on a transfer of appreciated property to charity. However, gain is taxable to a donor who donates property subject to indebtedness, whether or not charity assumes the debt. IRC § 1011(b); Treas Reg § 1.1011-2(a)(3). If a donor bargain-sells a remainder interest in an appreciated personal residence or farm to charity, donor will have gain determined under IRC § 1011(b) and Treas Reg § 1.1011-2.

4. Gift of Remainder Interest with Life Estate Reserved for Beneficiary Other than Donor. A donor who donates a remainder in a personal residence or farm creating a life estate in him or herself and then in another (*e.g.*, a spouse or child) makes two gifts: one to the life beneficiary (the value of the life interest) and one to the charity (the value of its remainder interest). If the life tenant predeceases the donor, the entire amount will be included in the donor's estate subject to a full charitable deduction. If the life tenant survives the donor, the value of the life tenant's interest will be subject to estate tax. Of course, if the surviving life tenant is the donor's spouse, the interest may qualify for the marital deduction.

5. Gift Tax Issues. The remainder interest to charity is a future interest and therefore a donor must file a federal gift tax return and report the value of the remainder as a gift. The donor receives a full gift tax charitable deduction. If the donor gives a life estate to another person (non-spouse) with remainder to charity, he or she must report the value of both gifts. If the life estate is a present interest, there will be a $15,000 annual exclusion available. The charitable remainder is a future interest but receives a charitable deduction as an offset. A life estate to a spouse is QTIPable.

F. Qualified Conservation Contributions.

1. In General. A qualified conservation contribution (aka "conservation easements") is a gift of a qualified real property interest to a qualified organization exclusively for conservation purposes. IRC § 170(h). A qualified real property interest is: (1) the <u>entire</u> interest of the donor (other than a qualified mineral interest); (2) a remainder interest; or (3) a restriction, granted in perpetuity, on the use that may be made of the real property. A qualified organization is defined (essentially) as a public charity, governmental unit, and certain supporting organizations.

2. Conservation Purposes. A "conservation purpose" must be: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, plants, or similar ecosystem; (3) the

preservation of open space (including farmland and forest land) where that preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or under a clearly delineated federal, state, or local governmental conservation policy; or (4) the preservation of an historically important land area or a certified historic structure.

3. Deduction Limitations. In general, the regular income tax deduction limitation rules apply to contributions of conservation easements. Special legislation has raised the normal 30% contribution base limitation for the contribution of capital gain property to 50% for the contribution of a qualified conservation easement. IRC § 170(b)(1)(E)(i). There is also a 15-year carryover (in lieu of the usual 5-year carryover limitation). Finally, qualified farmers and ranchers have additional tax incentives for qualified contributions (e.g., deductions of up to 100% of contribution base). IRC § 170(b)(2)(B)(i).

SECTION IX.

PRIVATE FOUNDATIONS AND DONOR-ADVISED FUNDS

A. Private Foundations.

1. Purpose. Private foundations are often established by an individual donor to facilitate and manage the donor's (or the donor's family's) charitable contributions, while offering retained control and a permanent vehicle for charitable giving. A private foundation is usually structured as a charitable corporation or charitable trust. Family members often serve as foundation directors or trustees and actively participate in investment management and grant-making activities.

2. Restrictions on Income Tax Deductions. Private foundations also offer an immediate charitable deduction for a large gift, even while the donor is still determining how to use the charitable dollars. Deductions for contributions to private foundations are limited to 30% of a donor's contribution base. Deductions for gifts of long-term capital gain property are limited to 20% of a donor's contribution base. In general, contributions of capital gain property are limited to basis, with the exception of publicly traded securities, which are deductible at full fair market value.

3. Charitable Lead Trust Funding. A private foundation can be funded through a charitable lead trust eliminating the restrictions related to the income tax deductions for private foundations.

4. Charitable Activities. A private foundation can go beyond grant making to engage in mission and impact investing and program-related investments.

5. Definition Under the Tax Code. Private foundations are defined by exception. By definition, every § 501(c)(3) organization is a private foundation unless it fits into one of many specific exceptions that allow the organization to be treated as a non-private foundation (often referred to as a "public charity"). These exceptions include statutory charities such as schools, churches, hospitals, governmental units, and certain other organizations. It also includes organizations that demonstrate broad financial support from the general public.

6. Operational Restrictions. The Treasury Regulation imposes significant restrictions on the operations of a private foundation. These restrictions are aimed at curtailing the abuse of private foundations. Following is a list of the most significant restrictions:

> **(a) Self-Dealing**. Certain acts of self-dealing are subject to excise taxes. Self-dealing is a direct or indirect sale or exchange between a private foundation and a "disqualified person." Disqualified persons include substantial contributors to the foundation, foundation managers, persons related to a substantial contributor, and entities in which disqualified persons have a substantial interest. Self-dealing includes loans, furnishing goods and services, providing facilities, and payments of excess compensation. IRC § 4941.

(b) Excess Business Holdings. Excise taxes are imposed on "excess business holdings" of a private foundation. The prohibition states that the combined holdings of a private foundation and all disqualified persons are limited to 20% of the voting stock of any corporation not substantially related to the exempt purposes of the private foundation. The excise tax is 50% of the value of the "excess business holdings" followed by a tax of 200% of the value of the excess business holdings if the violation is not cured within a certain time. IRC §4943.

(c) Minimum Distribution Rules. A private foundation, in general, must distribute an annual amount equal to 5% or more of the value of its investment assets. There is a substantial excise tax on the failure to distribute the required amounts. IRC § 4942.

(d) Tax on Investment Income. The net investment income of a private foundation is subject to a flat two% excise tax. IRC § 4940.

(e) Jeopardy Investments. There is an excise tax on certain "jeopardy" investments deemed to jeopardize the charitable purpose of a private foundation. The Treasury Regulations do not list particular types of investments as jeopardy investments. However, the regulations list transactions that will be closely scrutinized such as trading on margins, trading in commodity futures, purchasing puts, calls, or straddles, purchasing warrants, and selling short. IRC § 4944.

(f) Taxable Expenditure Rules. There is an excise tax on "taxable expenditures" by a private foundation. Taxable expenditures include amounts paid: (1) to influence legislation or elections; (2) as a grant to an individual for travel or study (unless certain other requirements are met); (3) as a grant to any organization other than a public charity (in general); or (4) for any purpose other than a "charitable" purpose. IRC § 4945.

B. Community Foundations and Advised Funds.

1. Community Foundations. Community foundations are § 501(c)(3) organizations that qualify as "public charities" under the public support test. As public charities, community foundations are not subject to most of the operating restrictions or restrictions on contributions applicable to ordinary private foundations. Community foundations offer donors many significant advantages over a private foundation. In addition to fewer restrictions on donations, community foundations offer efficiencies through consolidated investment management and lower administrative costs. Although donors sacrifice some degree of control by using a community foundation instead of a private foundation, there are several ways that a donor can remain actively involved in the administration of donated funds.

2. How Community Foundations Operate. A community foundation is essentially a pool or group of grant-making funds. Most community foundations (such as The Oregon Community Foundation) offer a variety of options for giving. Donors can make unrestricted contributions giving the community foundation complete discretion as to how to expend the charitable donation. Community foundations also offer designated funds and field of interest

funds that benefit specific charities or causes. One of the most popular giving vehicles offered by a community foundation is the donor-advised fund.

3. Advised Funds. A donor-advised fund allows a donor to contribute assets to a fund that is managed by a sponsoring charity and receive an immediate income tax deduction for the contribution. The donor can then direct distributions to charities from the fund over time. With an advised fund, the donor (or a committee designated by the donor, such as the donor's family) advises the sponsoring charity on the actual charitable distributions to be made from the advised fund. The sponsoring charity will make its best effort to honor a donor's wishes for an advised fund. However, because the charity has legal control over all funds (a gift must be *complete* in order to qualify as a charitable contribution), the charity retains the right to make a final decision regarding distributions from an advised fund. The use of advised funds has spread to commercial brokerage firms who have established charities to house donor-advised funds created by customers (*e.g.*, Fidelity Charitable Gift Fund). Some sponsoring charities (*e.g.*, large schools and hospitals) offer donor-advised funds with the proviso that a certain percentage of fund distributions be made to the sponsoring charity.

Advised funds have evolved through IRS rulings and case law; there was never a statutory definition for an advised fund until the Pension Protection Act of 2006. A donor-advised fund is now defined as a fund that is:

(a) Separately identified with reference to the contribution of a donor or donors (e.g., the Serrurier Family Fund);

(b) Owned and controlled by a sponsoring organization (e.g., The Oregon Community Foundation);

(c) Operated such that the donor has the privilege of providing advice with respect to the fund's investments or distributions.

The Pension Protection Act added an excess benefits tax on advised funds similar to the private foundation self-dealing tax. The tax is automatically imposed on any grant, loan, compensation or other payment to the donor or other disqualified person (e.g., family member).

C. Supporting Organizations. Supporting organizations are charitable organizations described in § 509(a)(3) of the Code. A supporting organization is typically funded and can be operated much like a private foundation, but is treated for tax purposes as a public charity rather than a private foundation. Therefore, supporting organizations can be very attractive to donors looking for the maximum tax deduction for a contribution. A supporting organization receives special treatment under the tax code because, by definition, it must be structured to further the charitable goals of one or more public charities.

> **Example**. If a client has appreciated real estate with a fair market value of \$800,000 and a basis of \$200,000, she can deduct \$200,000 if she gives the property to her private foundation, or she could deduct \$800,000 if she gives it to a supporting organization. In addition, her deduction for a gift to her supporting organization

would be capped each year at 30% of her contribution base ("contribution base") whereas the deduction for a gift to her private foundation would be capped each year at 20% of her contribution base. (A cash gift would be 50% v. 30% contribution base cap.)

1. The Four-Part Test.

(a) Relationship Test. The supporting organization must be operated, supervised, or controlled, or operated in connection with, one or more specified public charities. This relationship test may be satisfied by one of three specific structures – also known as "the Types" – Type I; Type II; Type III.

(b) Organizational Test. The supporting organization must be organized exclusively for the benefit of, to perform the functions of, or carry out the purposes of one or more specified public charities. The supporting organization can be created as a nonprofit corporation or charitable trust. The organizational documents must meet all of the requirements under the treasury regulations under § 501(c)(3) and 509(a). There are additional requirements for the Type III supporting organization. A Type III must identify by name the charities it supports, and its organizational documents may authorize the substitution of a charity only if the substitution is conditioned on an event that is beyond the control of the supporting organization.

(c) Operational Test. The supporting organization must be operated exclusively for the benefit of, to perform the functions of, or carry out the purposes of specified public charities. Treas Regs § 1.509(a)-5(b)-(d). The supporting organization can meet the operational test by (1) paying income directly to the designated charity; (2) directly carrying on activities that benefit the designated charities; (3) making direct expenditures for the benefit of individual or charities served by the supported organization; or (4) fundraising to benefit the supported charities.

(d) Control Test. The supporting organization must not be controlled (directly or indirectly) by disqualified persons. Under the control test, "disqualified persons" may not, by themselves, have the power to require a supporting organization to perform acts that affect its operations. In the context of a supporting organization, the following are treated as "disqualified persons":

(i) Substantial contributors (contributors of $5,000 or 2% of the total gifts received by the supporting organization);

(ii) Persons with voting or beneficial interests that exceed 20% in an entity that is a substantial contributor;

(iii) Ancestors, children, grandchildren or great-grandchildren; and

(iv) Spouses of any of the above.

A supporting organization can flunk the control test if a disqualified person exercises indirect control – based on a facts and circumstances test. For example, if a disqualified person can manipulate the structure of the board of the supporting organization through other connections – the IRS can find indirect control.

2. Types of Supporting Organizations. As stated above, § 509(a)(3)(B) of the Code allows for the relationship test to be satisfied in one of three ways:

(a) Type I. "Operated, supervised or controlled by" one or more public charities. With this structure, a majority of directors (or trustees) are appointed by the supported organization. The relationship between the two entities is analogous to a corporate parent and its subsidiary. Treas Reg § 1.509(a)-4(g).

(b) Type II. "Supervised or controlled in connection with" one or more public charities. This structure requires common management between the supporting organization and the public charity it is supporting. The relationship is analogous to a "brother-sister" corporate relationship. Treas Reg § 1.509(a)-4(h).

(c) Type III. "Operated in connection with" one or more public charities. This form requires the least connection with the public charity. The supporting organization need not be formally tied to the supported organization. Instead, the supporting organization must be "responsive" to the charity, and must function such that it is an "integral part" of the charity. Treas Reg § 1.509(a)-4(i).[1]

3. Operation. Supporting organizations have all of the tax benefits associated with giving to a public charity yet provide a greater degree of control over investments and charitable distributions. In particular, supporting organizations avoid most of the administration requirements and regulations imposed the rules that govern private foundations. The catch is that a supporting organization must be structured with care, must support one or more public charities, and must be independent of the donor or donor's family.

(a) Designating Charities. A supporting organization must designate the public charities it will support. A donor can preserve flexibility by designating a community foundation as a public charity.

(b) Corporation or Trust. A supporting organization can be structured as a trust or corporation. Individual circumstances will dictate which model is best, but generally a corporation may provide greater continuity and predictability, and better liability protection. Trusts offer more opportunity for custom drafting, and if tax is a factor, will generally provide more favorable capital gain tax rates (but a higher tax on ordinary income).

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[1] There are specific "responsiveness" and "integral part" tests for the Type III supporting organization. See Treas Reg § 1.509(a)-4(i)(2)-(4). Donors are often attracted to the Type III supporting organization because it requires the least supervision by the supported charity or charities. However, the Type III is subject to much stricture scrutiny by the IRS.

(c) Compliance. Supporting organizations must file annual tax returns (Form 990), maintain compliance with state law (regular meetings, reporting requirements, etc.), manage its investments, and make distributions in support of its public charity or charities (although a private foundation, no minimum payout is required). In addition, the Pension Protection Act of 2006 assesses a penalty tax on supporting organizations that are similar to the self-dealing tax. The tax is imposed on any grant, loan, compensation payment or similar distribution to a substantial contributor (or the family of a substantial contributor) to the supporting organization. The law also imposes the private foundation excess business holdings prohibition on Type III supporting organizations.