INDIANA CONTINUING LEGAL EDUCATION FORUM (ICLEF)

CHARITABLE PLANNING

IN CONNECTION WITH

ESTATE AND BUSINESS SUCCESSION PLANNING

PRESENTER

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I. Charitable Planning Fundamentals

A. Don't Forget to Ask the Charitable Question: Mixing charitable planning with estate and business succession planning often presents the perfect opportunity for the business owner to establish his or her philanthropic legacy and at the same time avoid substantial tax liability through the use of one or more charitable gift planning techniques (often referred to as "vehicles" or "tools") available through the Internal Revenue Code ("Code") and Treasury Regulations ("Treas. Regs"). When closely held business owners initiate the business succession discussion with their advisors, their focus likely is on how to receive the greatest financial benefit, how to most effectively transfer the business to children, loyal employees, etc., and NOT on philanthropy. Nonetheless, chances are high that your business owner clients are charitable, either individually or through their companies. Just as most business owners are not aware of all of their succession options, neither are they aware of the benefits of charitable planning in connection with their estate and business transition planning. Those benefits can include income, capital gains and transfer tax reduction and/or avoidance, preservation of wealth, generation of reliable income for retirement or other purposes, diversification of assets, protection from creditors and the establishment of a sizeable charitable trust, foundation, donor advised fund or straight out gift to charity, much of which would otherwise have been paid to the federal government in taxes. This opportunity to help your client create an individual or family legacy, including a "new identity" beyond the company, can be very important for the retiring business owner. Accordingly, charitable planning should be a topic that every advisor introduces in the business transition discussion.

B. Necessity of Learning Client Objectives. Assuming charitable intent and that the business and estate succession planning will include a charitable component, determining the appropriate charitable vehicle will depend on the client's goals. Does the client need income following the business transition, and if so, how soon? Will the business be passed on to the next generation or to key employees? Will the client have a taxable estate absent comprehensive estate, financial and charitable planning? Is the client interested in engaging in strategic philanthropy immediately upon retirement/ business succession, or is the client more interested in knowing his or her legacy is "in place" and will spring forth on death for future generations of family to direct?

C. The Most Common Charitable Planning Vehicles for Business Interests.

There is no such thing as "one size fits all" when it comes to potential charitable planning options to consider in connection with a business succession plan. Whether a business owner can successfully contribute some of his or her business interests to charity depends on the nature of the business asset to be contributed, the objectives of the business owner (both charitable and non-charitable), and whether the available charitable options can meet the those objectives. Due to the complex interplay between charitable gifts of business interests, the federal tax code and the relative lack of sophistication of traditional public charities, the choice of charitable planning options available to business owners often jumps immediately beyond an outright gift to an operating public charity, to one or more "charitable vehicles or tools." The charitable vehicles most often of interest to business owners include:

- Charitable Remainder Trusts,
- Charitable Lead Trusts,
- Private Foundations, and
- Donor Advised Funds.

Each of these charitable vehicles offers unique opportunities for charitably minded clients to benefit their favorite charities or causes THROUGH the vehicle to support either specific charities named in the charitable trust documents, in the case of CRTs and CLTs, or to allow the client or people named by the client to support a variety of charities through grantmaking charitable vehicles or entities, such as a donor advised fund or a private foundation. They each offer varying benefits at varying times, such as income production, income tax charitable deductions, capital gains and transfer tax reductions, deferral or avoidance, strategies to reposition assets for either growth or income, strategies to protect assets, etc., and each are governed by varying stringent regulatory requirements. It is important to note that there often are times that a simple outright gift of an asset or cash to charity might do a great job of meeting the client's objectives.

The following is an *introductory* discussion of these four charitable planning vehicles along with a summary of applicable considerations and rules and a few examples of how they may benefit the charitably inclined business owner. Use of each of these vehicles can be extremely complex and subject to many detailed regulations, including all or some of the “private foundation rules,” even when a private foundation is not involved. Detailed explanation of all applicable rules and regulations is beyond the scope of this presentation, which is intended to introduce the business succession planner to the available charitable tools that might be available to help accomplish the goals of business owner clients in various situations. Following the discussion of the primary charitable vehicles used in connection with business succession and estate planning, the last part of this presentation highlights some general considerations potentially applicable to the use of each of these charitable vehicles, including basic rules around income tax charitable deductions, AGI percentage limitations and carry forwards, estate and gift tax exclusion, potential problems associated with unrelated business taxable income, IRS rulings and case law surrounding the issue of “pre-arranged sale” and anticipatory assignment of income, and the necessity for qualified appraisals for charitable contributions of “unmarketable assets,” including closely held business interests

D. The Relative “Popularity” of Giving Vehicles and Charitable Giving (Interesting Giving Factoids): Per Giving USA’s most recent annual report on charitable giving, *Giving USA 2015*, *The Annual Report on Philanthropy for the Year 2014*, IU Lilly Family School of Philanthropy (“*Giving USA 2015*”)**, e**stimated giving by individuals was up 5.7 % in 2014 over 2013, for total of $358.51 billion. This total eclipsed for the first time the previous high water mark of pre Great Recession giving in 2007 of $355.17 billion. The following information on numbers and asset levels of CRTs, CLTs, private foundations and donor advised funds is consolidated from the most recent IRS Statistics of Income data, *Giving USA 2015* (pp166-167) and the 2014 National Philanthropic Trust DAF Report, http://www.nptrust.org/daf-report/recent-growth.html:

(2012 #s)	CRAT	CLT	CRUT
Total #	14,616	6,498	91,250
Net Assets	$6.4 billion	$23.7 billion	$85.2 billion

(2014 #s)	PRIVATE FOUNDATION	DONOR ADVISED FUND
Total #	90,562 (decline of 2,195 from 2013)	217,367
Total Assets	$737 billion	$53.74 billion

The IRS SOI data released August 26, 2015, on individual income tax returns for calendar 2013 contains some interesting information potentially involving gifts of business interests: Taxpayers with adjusted gross incomes of $10 million or more claimed charitable deductions aggregating $27.8 billion, or about $2.27 million per return. Noncash contributions comprised nearly half of the claimed charitable deductions on those returns. https://charitableplanning.com/commentary/comments/2155997.

According to *2015 Giving USA*, thirteen individuals and estates made charitable gifts of $100 million or more in 2014, including a $556 million gift from co-founder of WhatsApp to a donor advised fund at the Silicon Valley Community Foundation and a $1.5 billion gift from Melinda and Bill Gates to the Bill & Melinda Gates Foundation. Sean Parker, 35 year old founder of Napster and former Facebook president, gave $550 million split between the Sean Parker Foundation and his donor advised fund at the Silicon Valley Community Foundation. (p. 74).

II. Charitable Remainder Trusts

A. Overview. Charitable Remainder Trusts ("CRTs") are tax exempt, "split-interest" trusts under Code Section 664(c), which offer the opportunity for a donor to make an irrevocable gift of assets, such as appreciated, closely held C corporation stock, into the trust and receive an income stream over the course of his or her lifetime (or the life of another or a specified term of years) as well as a current year income tax charitable deduction for the fair market value of the contributed assets, while at the same time avoiding capital gains tax associated with the contributed assets, making a substantial future gift to charity and removing those assets from the donor's estate. The named "income beneficiary(ies)", who are typically the donor, donor's spouse, and/or heirs, receive annual income of either a fixed dollar amount (for a CRAT) or a percentage of the annual trust asset value (for a CRUT). The named "charitable remainder beneficiary (ies)", which often include donor advised funds or private foundations, receive the charitable remainder when the trust terminates.

B. Historic Popularity. Throughout the Nineties and continuing up until the Great Recession, the CRT was a popular charitable tool used to balance the philanthropic and financial objectives of clients with appreciated assets. It is widely predicted to regain its popularity due to the increase in both appreciated assets in recent years and in capital gains tax rates following the American Taxpayer Relief Act of 2012 (ATRA). The financial objectives when employing a CRT traditionally have included (1) selling appreciated assets in the tax exempt environment of a CRT, (2) allowing the reinvestment of the full market value of those assets (not reduced by capital gains tax otherwise due upon the sale) to produce income, and (3) saving income tax due to the available income tax charitable deduction, which can be substantial, and (4) removing the donated assets from the donor's estate. The philanthropic objectives have included (1) committing currently to a charitable gift that the charity will receive at the end of the CRT term (which the donor may have planned to make a death anyway) and (2) providing a greater amount to charity than otherwise would have been possible for the donor's legacy-- to either favorite charity or for the donor or the donor's family to have a flexible pool from which to make future charitable grants if the remainder beneficiary is a donor advised fund (or less likely through a CRT or a private foundation). More recently, as a result of ATRA, with estate tax charitable deductions practically nonexistent for all but less than one quarter of one percent of the population (estate tax exemption in 2015 is inflation adjusted to $5,430,000 for individuals and $10,860,000 per couple), and with the resurgence of high capital gains tax rates, a planning tip for clients/ donors with estate plans involving the establishment of a testamentary CRT might be for them to consider accelerating the establishment of the CRT during the client/ donor's lifetime in order to obtain income tax benefits and capital gains tax benefits in circumstances where an estate tax charitable deduction no longer would benefit the donor's estate (because the estate would not be taxable in any event).

C. Impact of Low "AFR" / "Section 7520" Rates. The primary factor weighing against "CRT resurgence," as has been widely predicted, is the continuing relatively low "Section 7520 Interest Rates." The charitable income tax deduction available to the donor of a CRT is based on the present value of the remainder interest calculated in accordance with actuarial tables published in IRS Publication 1457, which in turn are based on an interest rate equal to 120 percent of the midterm applicable federal rate for the month of valuation (or either of the two previous months), pursuant to Code Section 7520. Whereas low Section 7520 rates function to increase the charitable deduction for CLTs (charitable lead trusts) because the lower rate *reduces* the calculated value of the remainder non-charitable interest, they lower the charitable deduction for CRTs, because the lower the rate *increases* the calculated value of the payments to individual income beneficiaries (and thereby decreases the value of the remainder interest). The Section 7520 for September is 2.2. Rev. Rul. 2015-19. In her August 27, 2015 PG CALC webinar, nationally known charitable gift planning lawyer, Kathryn Miree noted the huge swing in the charitable income tax deduction that would be allowed for the donor of a $1 million, one life age 65, 5% payout CRAT and CRUT, using a Section 7520 Rate of 1.4% *versus* a higher Section 7520 Rate of 5.8%:

CRAT	Charitable Income Tax Deduction with 1.4% CFMR = $235,224
	Charitable Income Tax Deduction with 5.8% CFMR = $495,747
CRUT	Charitable Income Tax Deduction with 1.4% CFMR = $447, 400

Charitable Income Tax Deduction with 5.8% CFMR = $468,210

D. CRT Basics. Section 664 provides for two types of CRTs, the Charitable Remainder Annuity Trust ("CRAT"), and the Charitable Remainder Unitrust ("CRUT"). In order to qualify as either type of CRT, the trust must:

- **Be an Irrevocable Trust** (a separate legal entity) created by the donor and valid under federal and state law to which the donor contributes property (it is important to note in this seminar that the CRT donor can be other than a natural person, e.g., a partnership or corporation);
- **With a 5 % Minimum Payout** at least annually to one or more named beneficiaries, at least one of which is not a charity. The annual distribution is measured as a percentage of the initial trust value (for an annuity trust) or of the annual market value of the trust property (for a unitrust), which cannot be less than 5% or greater than 50% of the trusts' assets at the time measured (NOTE there are self adjustment rules, Reg. Sec. 1.664-2 and 3, which require the trust instrument to provide for the correction of errors in the valuation of the net fair market value of the trust assets—making CRTs generally a good fit for gifts of closely held business interests and other hard to value assets); ***Which continues for a period of time** that can be measured by a life (or lives), a specific number of years (not more than 20), or a combination of the two;
- **Which must have an anticipated charitable remainder value of at least 10%** of the initial net fair market value of the property when placed into the trust (or at the time of addition if permitted);
- **Which must name a qualified charitable organization** as the remainder beneficiary to receive all property in the trust upon termination (can be public charity or private foundation, but selection determines AGI percentage limit for current charitable income tax deduction as well as basis—fair market value or donor's adjusted tax basis. NOTE: In order to qualify for the income tax charitable deduction limits for contributions to public charities (50/30% of AGI) versus contributions to private foundations (20% for non-publically traded stock), the trust agreement must eliminate the possibility that the donor could change the remainder beneficiary to a private foundation.
- **Which can be created during life or at death** in a will or trust.

See, Kathryn Miree, *Professional Advisors Guide to Planned Giving*, supra, Sections 11.02 (B), pp 11-8 through 11-53) for a detailed analysis of each of these required elements, *See also*, Rev. Proc 2003-54 through 60 and 2005-52 through 59 for IRS Model Forms. NOTE: The requirements of Code Section

664 are narrowly construed. Generally if a CRAT or CRUT fails to comply with the detailed requirements of a CRT in every respect from inception, it will cease to qualify as a CRT and become a taxable entity under Section 661 (unless it is treated as a grantor trust under Sections 671- 678).

1. The five basic types of CRTs: charitable remainder annuity trusts ("CRATs"); charitable remainder unitrusts ("CRUTs"); net income charitable remainder trusts ("NICRUTs"); net income with makeup charitable remainder unitrusts ("NIMCRUTs') and "flip trusts." Each CRT type has its own set of applicable rules and regulations which affect its respective suitability to accept particular assets and/or accomplish particular goals. A brief summary of relevant considerations as to suitability in particular circumstances include:

(a) CRAT—a CRAT (charitable remainder annuity trust) provides a fixed income amount to its income beneficiaries each year. The fixed payment can be expressed as a stated dollar amount or as a stated percentage of the initial funding value of the trust. There can be no further adjustments made to the income amount to reflect the changing value of the trust assets from year to year. Additionally, a CRAT may only be funded once—no additional contributions may be made at any time. When the trust earns more than the required annuity payment, the excess income is added to principal; when the trust earns less, the trustee must invade the principal to make the required payment. While CRATS are appropriate for donors who do not want to worry about variable payments, CRATS generally are not a good fit for gifts of closely held business interests due to the immediate payment obligation and the fact that additional contributions to CRATS are not legally permitted. (As reported in section __ below, in 2012, the most recent year for which IRS statistics are available, there were over six times as many CRUTs as CRATs.)

(b) CRUT—a CRUT (charitable remainder unitrust, also referred to as a standard CRUT, SCRUT or Type I Unitrust) pays a fixed percentage of the value of the trust principal, which must be revalued no less frequently than annually. The unitrust provides a hedge against inflation, with the amount of annual payment tied to the market value of the trust's assets. Income as well as principal may be used to make the annual payments. The major difference between a CRAT and a CRUT is that the annuity payment from a CRAT is a fixed amount, whereas the unitrust payment from a CRUT will fluctuate from year to year with the value of the trust. Additionally, additional contributions can be made to CRUTs, assuming the trust instrument allows them. The unitrust payment is then adjusted for the additional contribution. Reg. Sec. 1.664-3(b). A basic CRUT should not be used for a contribution of business interests unless the contributed assets can be sold before the first payment is due.

(c) NICRUT and (d) NIMCRUT—NICRUTS (net income charitable remainder unitrusts) and NIMCRUTS (net income with make-up charitable remainder unitrusts) are similar in that they are CRUTs that pay the unitrust fixed percentage of the annually revalued principal, but payments are limited to trust income, not principal. With a NIMCRUT, if any year's income is insufficient to fund the unitrust amount, in any future year in which income exceeds the unitrust amount, the excess is paid out to the extent necessary to "make up" for any prior year shortfalls. These types of trusts are often a good match for holding business interests such as closely held stock. Because there is a "net income" limitation, there will not be a need to distribute fractional interests in the property to satisfy the unitrust payments. This will avoid "phantom gain" that would be incurred by the beneficiary if they were to receive property in satisfaction of the payments.

(e) FLIP CRUT—a FLIP CRUT begins as a NICRUT or NIMCRUT that "flips" to a CRUT (standard CRUT) upon the occurrence of a triggering date or event. For gifts of closely held business interests, it offers a nice blend of a NICRUT or NIMCRUT and a regular CRUT. The triggering event must be (1) stated in the trust instrument, and (2) arise on a specific date or by a single event the occurrence of which is not discretionary with, or within the control of, the trustee or any other person. Reg. Sec. 1.664-3(a)(1)(c). The sale of an unmarketable asset is a permissible triggering event, whereas the sale of publicly traded stock is not, because the decision is within the discretion of the trustee. For FLIP NIMCRUTs, the trust will have until December 31 of the year of the "flip" event to make up any shortfalls in distributions from prior years. After that date, the make up account disappears and as of January I of the year following the "flip" event, the trust will operate as a CRUT with no make up provisions.

NOTE: With respect to all non-income producing assets placed in a CRT, even with NICRUTs and NIMCRUTs, when the trustee makes no payment to income beneficiaries until income is received in the trust, there likely will be expenses associated with the assets while they are in the CRT (e.g., for real estate) as well as trustee fees. Therefore, it may be necessary for the donor to make additional gifts to the CRT, which is one of the reasons a CRAT, to which no additional contributions may be made, is not a good fit for CRTs that will hold illiquid assets.

2. Taxation of Amounts Received by Non-charitable Income Beneficiaries—the 4 Tier Tax System.

It is important to note that the income beneficiaries of a CRT annuity or unitrust are subject to income tax on the distributions made to them from the CRT under a 4-tier income tax reporting rule, characterized as "WIFO," or worst in first out. *See*, Code Sec 664 Reg. Sec. 1.664-1(d). Distributions from a CRT are deemed to consist of:

- First, the "ordinary income tier"--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 distributed;
- Second, the "capital gain tier"--capital gain income to the extent of the trust's capital gain income from the current year, and undistributed capital gains from earlier years. Undistributed capital gains are determined on a cumulative net basis pursuant to the rules set out in the regulations.
- Third, the "other income/ tax-free income tier"—other income to the extent of the trust's "other income" for the current year and undistributed "other income" for prior years. "Other income" includes income that is excluded from gross income, such as life insurance, gifts and inheritances, and tax-exempt bond income.
- Fourth, when the current and undistributed income of the first three tiers is deemed to have been exhausted, remaining distributions are considered to have been made from trust corpus, meaning the nest fair market value of the trust assets less the total undistributed income, but not losses, in each of the first three tiers.

These rules indicate the necessity for sophisticated trust investment and accounting in order to minimize income at the ordinary rate in favor of capital gain or tax-free income. Due to the WIFO rules, it is not possible to use a CRT to sell a capital asset, invest the trust assets in tax-exempt securities, and pay out tax-exempt income. If a CRT produces nothing but tax-exempt income after selling a capital asset, the income distributed to the beneficiary will be capital gain—second tier income. However, at least that gain is deferred/ spread over the life of the trust as opposed to the lump sum capital gain that would be due upon an outright sale of the business interest or funding asset.

3. Charitable Tax Deductions (in addition to capital gains tax deferral):

(a) Income Tax Charitable Deduction. CRTs may be created both inter vivos and through testamentary/ estate plans. In addition to avoiding or deferring recognition of capital gains tax on appreciated property used to fund a CRT**, t**he donor of an inter vivos CRT receives an immediate income tax charitable deduction equal to the present value of the charitable remainder interest, as determined in accordance with the Section 7520 Rate. NOTE: The character of the CRT funding asset (cash, publically traded stock, or “unmarketable” closely held business interest), as well as the type of charitable remainder entity (public charity or private foundation) will determine the applicable limitation of the donor’s income tax deduction. Additionally, unmarketable assets must be appraised by a qualified appraiser if the value is more than $10,000. (*See* Section V.C., *infra*, re appraisal rules.) If the donor’s income tax deduction cannot be used fully in the year of the donation, the donor may carry the deduction forward for five years. Code Section 170 (d)(1)(A).

NOTE: Even if a portion of the income interest is paid to a charity, the income tax charitable deduction is limited to the value of the remainder interest. Treas. Regs. 1.664-2(d) and 1.664-3(d). On the other hand, the estate and gift tax charitable deductions may include both the value of the remainder interest as well as the present value at death of the charity’s share of any annuity or unitrust payments.

(b) Estate Tax Charitable Deduction. When the donor retains an interest in the trust as an income beneficiary, the full amount of the value of the trust is included in the donor’s estate. However, the entire amount qualifies for an estate tax charitable deduction because the balance of the trust property passes to the charitable remainder. An estate tax marital deduction is available when the surviving spouse is the sole non charitable beneficiary of an inter vivos CRT. Code Section 2656. If the donor names an individual other than the donor or the donor’s spouse as the income beneficiary, the value of the trust will not be included in the donor’s estate. The donor of a testamentary CRT is entitled to an estate tax charitable deduction equal to the present value of the remainder interest. Code Section 2055(a).

(c) Gift Tax Charitable Deduction. Gift tax returns must be filed for all gifts of future interests, whether or not they exceed the annual gift tax exclusion amount (currently $14,000) if the donor is not the sole recipient of the income interest. IRS Form 709. When the donor names someone other than the donor or the donor’s spouse as the beneficiary of the annual distribution from an inter vivos CRT, the present value of the annuity or unitrust interest is a taxable gift. Where the trustee is required to make annual payments, the donor’s annual exclusion may be used to reduce the amount of the taxable gift. Any value attributable to the excess of the income interest over the annual exclusion is a taxable gift which reduces the donor’s applicable federal lifetime gift exclusion amount.

4. Problems with UBIT and Private Foundation Rules in the context of CRTs.

(a) UBIT. Although qualified CRTs are tax exempt entities, Code Section 664(c) provides that if a CRT has any UBTI (Unrelated Business Taxable Income) in a taxable year, the CRT will owe 100% tax on that income. (Prior to 2006, CRTs could lose their tax exempt status and be subject to excise tax if they incurred any UBTI.) UBIT (Unrelated Business Income Tax) is imposed on the unrelated business taxable income of most tax-exempt organizations (but generally at regular tax rates—not 100%). In addition to the more typical imposition of UBIT on income from a trade or business activity which is not substantially related to the organization's exempt purpose and is regularly carried on by the organization, UBIT is imposed on the following situations that could be encountered by CRTs (as well as other charitable vehicles) absent careful planning, knowledge of the applicable rules and a knowledgeable investment manager:

(i) Debt financed income-- In general, when a CRT owns debt financed assets (such as mortgaged real estate), that may create UBTI, which will cause the trust to pay 100% tax on its income and gain. (And if the donor is mortgagor and trust makes mortgage payments, the trust will fail entirely.)

(ii) Partnership income-- A CRT must include in its UBTI calculation the net trade or business income passed through by a partnership of which it is a partner (whether or not distributed). Code Section 512(c).

(iii) S corporation stock—Because a CRT is not a pass through entity, it is not an appropriate shareholder of S corporation stock. Any income from Subchapter S stock, or any gain on the sale of the stock is taxed at 100%. (There are several possible techniques for getting around this limitation, including an asset transfer by the S corp itself as settlor or a conversion to C corporation stock well in advance of a charitable contribution to a CRT.)

(b) Application of Private Foundation Rules to CRTs. Over time, all of the charitable techniques discussed in this presentation have become subject to some or all of the "private foundation rules" more fully described in Section IV. B. 2 herein

The self-dealing rules, Code Section 4941, are most likely to cause problems for donations of closely held family business interests to a CRT or CLT. These rules prohibit a number of transactions, directly or indirectly, between "disqualified persons" and their trusts and private foundations. Unlike the rules applicable to public charities (and therefore donor advised funds) in Code Section 4958, there is no exception for transactions at arms' length or fair market value. Prohibited transactions include sales or exchanges, loans to or from the entity and renting or leasing property. An exception to the "no sales or exchanges" rule allows trusts and foundations to participate in a corporate reorganization, recapitalization, or redemption as long as all the shareholders are offered the same deal. Code Section 4941(d)(2)(F).

If a charity shares in the *income* interest of a CRT (as well as the remainder interest), *excess business holdings* and *jeopardy investment rules* may also apply. Finally, CRTs are prohibited from making certain *taxable expenditures*, such a lobbying expenses or contributions to political campaigns.

E. Advantages of CRTs. CRTs can offer myriad benefits to the donor. The most significant benefit most often is that the donor can dispose of appreciated property for reinvestment without incurring substantial tax. Due to the lack of tax on the sale of the assets within a CRT and avoidance of lump sum capital gains tax bill, a donor may have a greater opportunity to diversify holdings and ensure a more substantial stream of income to the income beneficiary of the CRT. Further, assets transferred to the CRT are effectively removed from the donor's estate in most cases. (Included, but estate tax charitable deduction.) CRTs are most attractive and most widely used during periods of improved market conditions (contributing to increasing asset values) combined with higher capital gains tax rates--similar what most business owners and investors are experiencing currently. CRTs can be structured in myriad ways to meet your clients' particular objectives.

Consider a CRT in connection with business succession planning:

- If your client is interested in providing a current or future stream of income for retirement, long-term care, grandchildren's college or other needs.
- If your client has highly appreciated, long term capital gain assets, including closely held stock, business assets and real estate that he or she would like to sell while at the same time providing for charity.
- If your client seeks to avoid the capital gains tax that would be triggered by an outright sale of these assets.
- If your client has concerns about estate taxation and would like to reduce his or her taxable estate.
- If your client would like to either make a significant future gift to a particular charity or would like to establish a private foundation or donor advised fund through which to make future charitable grants.
- If your client owns an S corporation that could be the settlor and contribute the assets of the corporation.

NOTE: When business assets will be used to fund a CRT, an annuity trust usually is NOT appropriate due to the immediate payment obligation and the fact that additional contributions to CRATS are not legally permitted.

F. Examples of Donations of Business Interests to a CRUT.

1. **Combining a gift of a portion of a business owner's closely held C corporation stock to FLIP NIMCRUT in connection with sale of the company.** Business owner anticipates sale of closely held C corporation in the next few years. Owner hates paying taxes, is anxious about post sale income and likes the idea of making an irrevocable gift to his church capital campaign. The capital gain on the shares gifted to the NIMCRUT will not be taxed and the charitable deduction for the shares gifted will help reduce the business owner's capital gains tax owed on the rest of the business sold outside the trust. Using another example from Kathryn Miree, the following steps illustrate combining a NIMCRUT gift of $500,000 market value of closely held shares of a company worth $5 million market value, with a subsequent sale of the of the company. Donor's basis in company is $1million, for a cost/tax basis in donated shares of $100,000:

STEP ONE	*STEP TWO*	*STEP THREE*
Gift to FLIP NIMCRUT	Sale of remaining shares	purchaser buys
$500,000 FMV stock	$4.5 million	$500,000 stock from CRUT
$100,000 tax basis	$900,000 tax basis	(in connection with purchase of
$178,725 charitable deduction	$3.6 million cap gain	remaining shares)
$25,000 income year 1	$540,000 tax at 15% owed	

Additional assumptions include current CFMR of 2.2%, 5%. 2- life NIMCRUT, with 68 year old business owner and 65 year old spouse. See, Miree, *10 Practical Planned Giving Ideas for the Current Environment*, 1/27/2015 (PG CALC), p.27.

2. Donating closely held stock to a 2 year CRT, which will sell the stock and pay out remainder to favorite charity. This is a variation of a recent a hypothetical illustrated by Renaissance Administration, LLC in the June 2, 2015 edition of Charitable Planning.com., https://www.charitableplanning.com/commentary/comments/1759849. Successful entrepreneur wants to devote half of his $3 million closely held business (for which client/ donor's basis is zero) to charity, and wants $1 million of that amount to go to his favorite operating charity. The charity decides it cannot accept a gift of unmarketable securities (even though several competitor businesses are willing to buy client/ donor's company). Upon advice of financial advisor and with assistance of legal and tax counsel, alternative method is utilized to accomplish client/ donor's objective: client/ donor contributes half his stock in the business to a 2-year net income charitable remainder unitrust naming a donor advised fund as remainder beneficiary. The burden of selling client's $1.5 million closely held stock has shifted from favorite charity to NICRUT—trustee has two years to negotiate sale of the stock (client/ donor's business). Due to present value calculations on such a short trust term, client/ donor receives $1.358 million charitable income tax deduction, which is 90% of the value of the contributed stock. He avoids $289,000 in immediate capital gains tax he would have paid had he sold the stock and made a cash gift of the proceeds. $1.5 million is removed from client/ donor's estate, also reducing his potential estate tax burden. And in addition to the tax savings, after two years, client/ donor uses the donor advised fund to not only accomplish goal of making a million dollar gift to favorite charity, but has a source of charitable funds (calculated to be $358, 000 following $1 million grant to favorite charity and likely is more) to support other charitable interests. (Assumptions include CRT payout rate of 5%; CMFR of 3.2%, combined federal and state capital gain tax rate of 19.25%.)

3. Charitable Gift in Connection with Passing Family Business to Next Generation. A charitable stock bailout would work very well with a gift of C corporation closely held stock to an inter vivos CRT followed by a corporate redemption of those shares. In situations in which the corporation has sufficient cash on hand or the ability to borrow from the bank (not the CRT) and children currently are minority shareholders, parents can gift shares of the company to CRT and corporation can buy back those shares. Following the exceptions to the private foundation rules for corporate redemption when all securities of the same class as that held by a charitable entity are subject to the same terms (Code Section 4941(d)(d)(F)), including that the charitable entity shall receive no less than fair market value for its stock, the corporation could redeem the shares in the CRT for cash and retire them. Control of the corporation could then pass to the children. This is sometimes called a charitable bailout, because both the charitable gift and subsequent redemption would be completely income tax tree and the corporation is able to "bail out" its accumulated cash.

4. Gift of" Qualified Replacement Property" to a CRT.

For a business owner who has sold stock to an ESOP and deferred recognition of capital gain through the purchase of qualified replacement property, a gift of some or all of the QRP to a CRT affords a method of further diversifying in a tax free trust, without having to sell the QRP and recognize the deferred capital gain. By transferring the qualified replacement property to a NIMCRUT, the owner receives an income tax charitable deduction for the present value of the charitable remainder, avoids the gain from the sale to the ESOP (except in the form of annual income tax consequences of income payments from the CRT), and is able to diversify the replacement property for better growth, benefitting both the owner and the charitable beneficiary.

Often, the reason a CRT is not implemented by the client is because it seems too complicated. The following is a link to a power point prepared by Russell James, J.D., Ph. D., CFP, for the express purpose of simplifying the explanation. I should have probably have just used it in this presentation!
http://www.slideshare.net/generosity/charitable-remainder-trusts-6093597

III. Charitable Lead Trusts

A. Overview

The charitable lead trust (CLT), another form of split-interest trust, conceptually is the opposite or mirror image of the CRT. The charity receives the annuity or unitrust income payments and the grantor, his or her heirs, or another trust or entity, receives the remainder value. A CLT constitutes a gift of a guaranteed income interest to charity. The tax consequences to the donor differ depending on whether the donor creates a grantor or non-grantor lead trust (described in detail below). Unlike a CRT, a CLT is not tax-exempt. Trust income is taxed like the income of any other complex trust. The basic requirements for all CLTs include:

- The transfer of a guaranteed income interest to charity by the grantor, which normally is structured as an irrevocable trust. A trust is required for income tax purposes, but not for gift and estate tax purposes. Treas. Reg. Sections 1.170A-6(c)(2)(i), (ii) (C), 20.2055-2(e)(2)(vi). The governing instruments must be irrevocable and the interest must be guaranteed. (For discussion purposes, this paper will use the term trust.)
- That provides for a guaranteed, specified distribution at least annually to one or more charitable beneficiaries. The distribution is measured as either a sum certain (annuity trust—CLAT) or a fixed percentage of the net fair market value of the trust assets valued annually (unitrust—CLUT). Treas. Reg. Section 1.170A-6(c)(2). (There is no minimum payout requirement as there is with the 5% minimum payout required for CRTs.)

- That continues for a term measured by an ascertainable life or lives (in being), a specified number of years, or a combination (most CLTs are structured for a term of years). *Id.* (There is no term of years limitation for CLTs as there is with CRTs.)
- That distributes the trust property at the end of the term to the grantor or individuals or entities named by the grantor. When the assets are distributed back to the grantor, the trust is known as a grantor lead trust. Code Sections 170(f)(2)(B), 671. When assets are distributed back to individuals other than the grantor, the trust is called a non-grantor lead trust.

B. The Two Types of Lead Interests, CLAT and CLUT. A CLT can pay either an annuity amount or a unitrust amount to charity during its term.

1. Charitable Lead Unitrust—CLUT. The charitable lead unitrust (CLUT) pays a charity a unitrust amount that is a fixed percentage of the fair market value of the trust as determined annually. Similar to a CRUT, additional contributions generally may be added to a CLUT, but unlike a CRUT, there may be no provision for net income payments- the governing instrument cannot provide for an income payment of the lesser of the stated unitrust distribution or actual income.

2. Charitable Lead Annuity Trust—CLAT. The charitable lead annuity trust (CLAT), provides an annuity for charity. It is typically a fixed dollar amount each year, expressed as a dollar amount or as a fraction or percentage of the trust's initial value. The annuity amount may increase over the term of the trust provided the trust instrument provides clear instruction. The CLAT can provide annuity payments of, e.g., 2% for the first several years, increasing to 5%, etc., so long as the value of the annuity interest is ascertainable at the inception of the CLAT. PLR 912009. In periods such as we are currently experiencing with low AFRs, CLATs offer the ability to "zero out" the charitable gift so that whatever value of property is received into the CLAT an equal value can be received in the form of a charitable deduction through gift and estate tax deductions.

C. Grantor Versus Non-Grantor Charitable Lead Trusts. The tax consequences of a CLT depend upon whether it is structured as a grantor trust or a non-grantor trust.

1. Grantor Lead Trusts. The two primary characteristics of a grantor CLT (CLAT OR CLUT) are (1) at the end of the trust term, the trust assets revert back to the grantor (or grantor's spouse), and (2) the grantor lead trust offers the grantor an immediate charitable income tax deduction for the present value of the annuity or unitrust amounts to be paid to charity over the life of the CLT. Therefore, the use of a grantor CLT generally is geared toward income tax planning rather than gift and estate tax planning. The grantor CLT is not permitted to claim a charitable deduction under Code Section 642(c) for its distributions to charity. Rather, the grantor/ settlor must report all of the net income realized by the CLT each year on his or her personal income tax return. Code Section 170(f)(2)(B). When a client experiences a large gain from the sale of a major asset, a portion of the proceeds could be used to fund a grantor CLT in the same year as the sale in order to create a large charitable income tax deduction to offset the tax bill. In addition to being willing to be taxed on the income of the grantor CLT, the donor must also be willing to give up the tax flow on the donated asset for the term of the trust—potentially timed to terminate at retirement.

Additional considerations for a Grantor CLT include:

- Although there is no limit regarding the term of the trust, if the donor dies during the term of the CLT, all or part of the income tax charitable deduction is subject to recapture.
- Note that the income tax charitable deduction is limited to 30% of AGI (even for gifts of cash) because the gift is "for the use of" rather than "to" the charitable lead interest recipient. Furthermore, the 20% limitation applies for trusts funded with long term capital gain property if the charitable recipient is not a public charity.

2. Non-grantor Lead Trusts. When a donor designates a beneficiary other than himself or his spouse to receive the remainder interest of a CLT (or when there is a less than 5% probability that the property will revert to the donor or spouse), the trust is characterized as a non-grantor lead trust. The donor does not receive a charitable income tax deduction for establishing a non-grantor charitable lead trust. The Tax Reform Act of 1969 provided that an income tax deduction is now allowed only for a charitable gift of trust income for a term when the income interest is expressed as an annuity or unitrust interest AND the trust is treated as a grantor trust. Code Section 179(f)(2)(B). However, the non-grantor CLT can offer substantial gift or estate tax savings. Non-grantor lead trusts primarily are used to transfer large amounts of property to future heirs at a reduced transfer tax value by combining the transfer with a gift to charity. Although the grantor may serve as trustee of a non-grantor trust, the grantor may not retain the power to select charitable beneficiaries each year or the trust corpus will be included in the grantor's estate. (However, to preserve flexibility in connection with the selection of ultimate charitable recipients of the annual charitable lead interest, the trust instrument can name a donor advised fund at a community foundation or other donor advised fund sponsoring organization which are Code Section 501(c(3) public charities. Advisory privileges in the grantor as advisor of a donor advised fund are not deemed to be the power to select, as all recommendations of donor advised fund advisors are subject to approval of the sponsoring organization.)

(a) Deduction for charitable lead distributions. Although no income tax charitable deduction is available to the grantor upon transfer of the assets to a non-grantor trust, the trust is treated under federal tax law as a separate taxpayer entitled to a Code Section 642(c) income tax charitable deduction for the amount that it pays to charity from the gross income of the trust each year. The trust's charitable deduction is not limited to a percentage of AGI, unless it has UBTI, but a trust cannot carry forward excess charitable deduction amounts to future years. In essence, the donor to a non-grantor CLT receives an unlimited income tax deduction on the annual trust income that is paid to charity. Although the charitable lead interest may be satisfied by in kind distributions at date of distribution values, the trust would get no Section 642(c) deduction for such distributions as they are not made from gross income. Unlike the 4 tier system applicable to CRTs, the income distribution from CLTs to the charitable income recipient is treated as coming ratably from each type of trust income. (Whereas application of the 4 tier system would attribute the highest cost income to the charity--which does not care--and leave the lowest rate income in the trust.)

(b) Discounted remainder interest. The primary tax savings offered by a non-grantor CLT is the reduction of estate or gift tax due to the discounted value of the remainder interest. The value of the remainder interest is computed when the trust is funded, using the IRS tables and the Section 7520 rate. The present value of the charitable lead interest is deductible for gift or estate tax purposes, and the value of the remainder (going to family members generally) is subject to estate and gift tax. When the AFR/ Section 7520 rate is low it is relatively easy to reduce the gift to the non-charitable beneficiary to close to zero so that the gift tax charitable deduction fully or almost fully offsets the value of the gift to the CLAT on funding. Thus, for a testamentary CLAT, there is no inclusion in the gross estate, and for an inter vivos CLAT there is no taxable gift. For example, if H&W establish a 25 year CLAT today with $1 million and a 5.1% annual payment to a donor advised fund at their community foundation, the donor advised fund will receive $51,000 annually. If the CLAT grows at 6% per year, their children, the remainder beneficiaries, will receive $1,493, 000 in 25 years. However, assuming a Section 7520 rate of 2%, the present value calculation of the annuity payment is $995,000, leaving only $5,000 as the remainder gift value.

If the grandchildren are named as the remainder beneficiaries, the generation skipping transfer tax will apply. The use of a CLUT is a better match to allow the grantor to leverage his GST exemption.

(c) Carryover Basis/ Cost Basis Planning. In the case of highly appreciated property being contributed in an inter vivos, non-grantor trust, the trust's cost basis is the same as it was in the donor's hands under the carryover cost basis rules. Assuming no significant changes in asset make up over the trust term, the trust will distribute highly appreciated property to the children and/or grandchildren when the trust ends. In this case the grantor has achieved gift and estate tax planning avoidance, but only deferred the income tax liabilities inherent within the highly appreciated property. A testamentary non-grantor CLT produces significantly different results due to the "step up' in cost basis rules. Although the assets of a testamentary trust may appreciate over the trust term so that there is some appreciation in the assets when received by the family, the untaxed appreciation that occurred while in the grantor's hands is eliminated, since those assets were part of the grantor's estate and received a stepped up basis before going into the CRT.

3. The "Super CLT" or "Intentionally Defective CLT." A third type of CLT is sometimes created to take advantage of tax rules, regulations and IRS rulings that allow a CLT to be created that for income tax purposes is treated as a grantor trust, while at the same time being treated as a non-grantor trust for transfer tax purposes. The result is that the donor now has a hybrid CLT that provides income and gift tax benefits, each calculated as the present value of the charitable income interest created by the trust. The assets of the trust are both frozen and discounted for gift and estate tax purposes. See, PLR 9224029, PLR199922007, PLR200010036, and PLR 200011012. However, since the grantor trust income tax treatment is allowed to the grantor, for annual income tax purposes, the trust does not exist and therefore phantom tax issues apply fully to super CLTs.

D. Application of Private Foundation Rules—All qualified CLTs are subject to the private foundation rules prohibiting jeopardizing investments, excess business holdings, self-dealing and taxable expenditures. However, if the value of the charitable lead interest is 60% or less of the grantor's contribution to the trust, the excess business holdings and jeopardizing investment rules will not apply so long as the governing trust document explicitly provides that these rules will not be violated (unless state law already provides these restrictions).

E. Examples of Donating Business Interests to a CLT.

1. In Connection with a Liquidity Event. If your client/donor arrives just after a significant liquidity event, or if your client's business interests cannot be donated in part to charity in connection iwht the business sale, a transfer of some portion of the proceeds to a CLT following the sale will provide a means of "income averaging" of the otherwise huge tax bill in the year of sale. This allows for a generous deduction in the year of sale, investment of that tax savings in the grantor-CLT, while ensuring a return of the donated assets ultimately to the donor as well as providing a generous gift to charity. (See section IV. A. herein for the strategic advantages of naming a donor advised fund as the charitable lead beneficiary.)

2. Testamentary CLT to Solve Estate Liquidity. For a business owner concerned that the business will have to be sold at death to pay estate taxes, creation of a testamentary CLT to be funded with stock in the business could be used to reduce estate tax. The estate would receive a charitable deduction for the value of the charity's lead interest, thereby reducing the estate tax payable to a more manageable level and possibly avoiding the need for a forced sale.

IV. Grantmaking Entities: Private Foundations, Donor Advised Funds and Supporting Organizations

When considering the best method for donating privately held business assets directly to charity (without reserving an income interest as in the case of a CRT or a remainder interest as in the case of a CLT), the most frequently used options are either a private foundation or a donor advised fund. These are the "go-to" options especially when the business owner is interested in creating an ongoing charitable concern to serve as a personal or family legacy and the source of all or the majority of the donor's future charitable giving. Moreover, they most often provide a better option than a direct gift to one or more specific operating charities, which often are not well equipped to accept a "complex gift" of business interests and would rather the donor sell the asset and contribute the cash. A better all-around result often is obtained by a gift of the business interest to a private foundation or donor advised fund, followed by a grant from the private foundation or donor advised fund to the particular charity of interest. One asset or business interest can be used to benefit myriad charities. Thus, these charitable vehicles often are referred to as conduit entities and serve as conduits between families and operating, mission focused public charities. In certain instances, the use of a supporting organization also may be warranted, so supporting organizations are briefly described as well.

Both types of vehicles (as well as supporting organizations) allow the donor to "accelerate" a charitable income tax deduction, by making the deduction available when the donor transfers property to the entity, rather than when the vehicle—private foundation, donor advised fund or supporting organization—ultimately makes a charitable distribution. Donors obtain sufficient time to strategically fund causes they care about, assets contributed to the vehicles can be invested and grow to fund future charitable grants and donors can involve family members in determining the family legacy and implementing agreed upon philanthropic objectives. A private foundation or donor advised fund can last for as long as the donor desires, including multiple generations.

Donors or their advisors frequently find that two or more charitable vehicles might work well together to accomplish the client's objectives, so that a donor advised fund or private foundation might be the recipient of the remainder interest of a CRT or the lead charitable interest of a CLT, or a private foundation might use part of its mandatory distribution requirement to establish or add to a donor advised fund, etc.

A. Donor Advised Funds

1. Overview. Although there is rarely an "EASY BUTTON" in connection with charitable gifts of business interests, the donation of closely held business interests to a donor advised fund is perhaps the most straight- forward, least costly option. There is no need to file a Form 1023 and annual reports with the IRS (as there is for private foundations and supporting organizations) or establish separate charitable trusts and calculate the present value of the charitable interests (as with CRTs and CLTs). However, as with charitable gifts to private foundations and supporting organizations, a gift to a donor advised fund is a gift of the donor's entire interest in the assets donated. There is no provision for income back to the donor or another, or property reversion to the donor or heirs. "Only" a charitable fund from which the donor and his or her family and heirs can make charitable grants.

2. The Basics. Generally, donor advised funds allow individuals, families, corporations and other entities to establish a separate charitable account at a host charity, the "sponsoring organization," with irrevocable gifts of cash, stock or other assets, including unmarketable assets at many sponsoring organizations, and take a charitable income tax deduction in the year the account is established (and each year in which additional contributions are made to the fund). A fund agreement or other instrument of transfer is executed. The donor, the donor's family, or other donor advisor or advisory committee appointed by the donor can then recommend to the sponsoring charity qualified charitable recipients to receive grants from the donor advised fund, either right away, over any number of months or years, or forever. Some donor advised funds will be fully expended during the donor's life time, whereas others are set up as permanent endowment-type funds. Successor advisors such as children and grandchildren may be identified, depending on the policies of the various sponsoring organizations. Subject to sponsoring organization policy, donors may or may not retain the right to advise the sponsoring organization on investment matters, including requesting that the sponsoring organization hire the donor's investment manager to invest the assets of the fund. The sponsoring organization must review all grant recommendations to ensure that proposed grants are for a qualified charity or charitable purpose, and generally heeds the recommendations from the donor-- but is not compelled to do so, as it is the legal owner of the assets in the fund.

Like the other charitable vehicles discussed herein, donor advised funds can be created during the donor's lifetime or through his or her estate plans. Whereas the general rule of thumb for creating a new private foundation is that one should be able to devote at least several million dollars or more to justify the legal time and expense, a donor advised fund can be established for $25,000 at many community foundations and for as little as $5,000 at most of the commercial donor advised funds. Lest one jump to the conclusion that a private foundation is more appropriate for assets of *more than* several million dollars, myriad donor advised funds have been established with far more than that, including several at Central Indiana Community Foundation, as well as several well- publicized donor advised funds at community foundations around the country, including the Zuckerberg Foundation, a fund of the Silicon Valley Community Foundation. (See, http://www.insidephilanthropy.com/home/2014/7/25/mark-zuckerbergs-25-billion-foundation.html , in which the author joked that the title of the article referring to "The Zuckerberg Foundation" was misleading since Mark Zuckerberg and his wife, Priscila Chan, did not actually create a private foundation but rather gifted 36 million shares of Facebook over two years to a donor advised fund and a supporting organization at Silicon Valley Community Foundation.)

3. Pension Protection Act. The Pension Protection Act of 2006 ("PPA") enacted certain rules around donor advised funds to ensure against abuses and as a practical matter served to further "legitimizing" donor-advised funds, by establishing a statutory definition and requiring a Department of Treasury study, which shed very favorable light on donor advised funds. According to the Council on Foundations, the number of donor advised funds increased by 15 % in 2007 alone, the year following enactment of the PPA.

(a) PPA Definition of Donor Advised Fund: The PPA added Code Section 4966 (d) (2), which provides a three-pronged definition of donor advised fund:

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

The Joint Committee Report, which serves as the legislative history of the PPA, expands upon each of these prongs:

Separately identified by reference to contributions of a donor or donors. This prong requires that the sponsoring organization reference the contributions of a donor or donors to the particular fund or account on its books and records by, e.g., naming the fund after the donor or by attributing contributions to a specific donor or donors. Accordingly, a fund of broad, general interest donors generally will not be considered to be a donor-advised fund, even if it has an advisor or advisors, provided the contributions of specific donors are not tracked for attribution purposes.

Owned or Controlled by a Sponsoring Organization. A "sponsoring organization" is defined under Section 4966(d)(1)as a Section 170(c)(1) organization that is not a governmental organization or a private foundation and maintains one or more donor advised funds, public charity, other than a supporting organization, that maintains one or more donor-advised funds.

A Donor or any Person Appointed by the Donor has Advisory Privileges. The PPA does not define "advisory privileges," other than to refer to advisory privileges as to distributions or investments. The Joint Committee Report notes that the presence of advisory privileges may be evidenced by a written agreement or through conduct of the donor or donor advisor and the sponsoring organization. The Joint Committee Report also distinguishes between advisory privileges and legal rights or obligations.
that a private foundation is more appropriate for assets of *more* than $10 million, myriad donor advised funds are established with far more than that, including several that have been funded with more than $10 million at Central Indiana Community Foundation. Practical considerations in selecting one charitable

vehicle over the other, as well as selecting a particular donor advised sponsoring organization are considered in section IV.A.5. below.

(b) Applicability of Private Foundation Rules to DAFs.

(i) Prohibited Benefits. Code Section 4966, regarding "prohibited benefits," prohibits distributions from a donor advised fund to an individual, as well as distributions to any organization that is not for a charitable purpose. Other distributions, e.g., to a private foundation or certain types of supporting organizations, require the sponsoring organization to exercise expenditure responsibility. This rule required modification of the composition and selection of scholarship funds, which community foundations now offer as a separate type of fund. The community foundation/ sponsoring organization must appoint all members of the selection committee and the donor and members of the donors' families may not constitute a majority, nor control the committee. Scholarship awards must be awarded on an objective and nondiscriminatory basis using procedures approved by the community foundation in advance. (Unlike for private foundation scholarship programs, no advance IRS approval of a particular program or fund is required.)

NOTE: Distributions which may be made by donor advised funds include grants to any organization described in Code Section 170(b)(1)(A), other than a disqualified supporting organization. Churches, educational organizations, hospitals and medical organizations, publically supported organizations, governmental units and private operating foundations may receive grants with no expenditure responsibility. Also, a donor advised fund may make a grant to the sponsoring organization of the fund, as well as other donor advised funds (of that or another sponsoring organization). Distributions to non-publically supported charitable organizations, including non-operating private foundations, may only be made with "expenditure responsibility," which includes a pre-grant inquiry, a grant agreement relating to the specific purpose of the grant and detailed follow up reporting.

(ii) Excise Tax on More Than Incidental Benefits and Excess Benefits. Code Section 4967 imposes a penalty tax on a donor advisor who recommends a grant from a donor advised fund which results in more than an incidental benefit being received from the grantee by a disqualified person. The definition of "disqualified person" applicable to donor advised funds includes any donor, donor advisor, or member of the family of a donor or donor advisor or a 35% controlled entity of which a donor or donor advisor owns more than 35% of the combined voting power, profits, interests, or beneficial interest. Code Sections 4976(d), 4958(f)(7), and 4958(f)(4). For donor advised fund disqualified person purposes, family members include a spouse, ancestors, lineal descendants (down to great-grandchildren), and siblings (whether whole or half), as well as their spouses. Code Section 4943. In addition to prohibited benefits from grantees back to donor advisors and other disqualified persons, the PPA also introduced the "excess benefits transactions" rule to donor advised funds. An excess benefit transaction for donor advised fund purposes is one in which a disqualified person receives an economic benefit, directly or indirectly, *that exceeds the value of the services* provided to the charity. This is more liberal than the flat out prohibition applicable to private foundations.

(iii) Excess Business Holdings Rules: The PPA also extended the private foundation excess business holdings rules to donor advised funds. In general, if a donor advised fund receives a gift or bequest of an interest in a business enterprise, it has 5 years to divest itself of any *excess holdings*, with a possibility of an additional 5 years under limited circumstances if approved by the Secretary of the Treasury. The holdings of a donor advised fund in a business enterprise, aggregated with the holdings of disqualified persons with respect to the fund, will be subject to penalties on the excess holdings if the aggregate holdings exceed: (1) 20 percent of the voting stock in a business enterprise in corporate form (35 percent if persons who are not disqualified persons have effective control of the business); (2) 20 percent of the profit interest in a partnership; or (3) 20 percent of the beneficial interest of a trust or estate. Code Section 4943. A *de minimus* exception applies when a donor advised fund, together with its disqualified persons (as defined in Code Section 4943), owns not more than 2 percent of the voting stock of a business enterprise. Code Section 4943 (c)(2)(C). "Business enterprise" is defined as the active conduct of a trade or business and does not include a business that derives at least 95percent of its income from passive sources such as dividends, interest, royalties and capital gains. Interests in family limited partnerships generally will come under this exclusion.

NOTE: The DAF excess business holdings rule does not apply to assets held by the sponsoring organization, as long as they are not held by the DAF. Therefore, it may be possible for the sponsoring charity to keep a contributed business asset as part of its overall investment portfolio. Additionally, the private foundation rules made applicable to donor advised funds were not made applicable to any other fund type at a community foundation that are not donor-advised, including e.g., designated funds, scholarship funds and field of interest funds.

(iv) Private Foundation Rules NOT Applicable to Donor Advised Funds.

- 2 % excise tax on investment income. (Code Section 4940)
- 5% annual distribution requirement. (Code Section 4942)

- Jeopardizing investment rules. (Code Section 4944)

(c) Department of Treasury Report. Section 1226(a) of the PPA mandated that the Department of Treasury conduct a study on the organization and operation of both supporting and donor advised funds. PPA Section 1226(b) mandated that the Secretary of the Treasury submit a report on the supporting organization and donor advised study to Congress. That report was submitted to Congress on December 5, 2011. *Report to Congress on Supporting Organizations and Donor Advised Funds,* Department of Treasury (Dec., 2011) ("Treasury Report"). As respects DAFs, Treasury was directed by the PPA to specifically consider:

> 1. Whether the existing deduction rules for contributions to donor advised funds are appropriate (Treasury answer: yes);
> 2. Whether donor advised funds should be subject to a distribution requirement like private foundations (Treasury answer: no); and
> 3. Whether an advisory role in the investment or distribution of donated funds is consistent with a completed gift and consequent qualification for a deduction from income, gift and estate tax purposes (Treasury answer: yes)

No new legislative changes or reforms for donor advised funds were recommended by the Department of Treasury in the 109-page Report. Among other findings, the Treasury found:

- The fact that donor advised funds have high approval rates for donor recommendations is not in itself indicative of donors' exerting excessive control over their donated assets. Approval is not automatic.
- The PPA appears to have provided a legal structure to address abusive practices and accommodate innovations in the sector without creating undue additional burden or new opportunities for abuse.
- The issue of the lag between contribution and final use of assets is no different at donor advised fund sponsoring organizations than it is for other public charities that may operate charitable funds or maintain endowments. "Thus, it is appropriate that the contribution deduction rules for donors to donor advised funds are the same as those applicable to donations to other public charities." Treasury Report at 7.
- It would be premature to recommend a distribution requirement for donor advised funds at this point. As more years of data become available, analysis of trends with respect to donor advised fund distributions will be possible.

- As is the case with gifts to other charities, if all existing tax and other legal requirements are met, donations to a donor advised fund may be completed gifts and become the property of the donee organization. Although donee organizations may feel an obligation to use donated funds in a manner preferred by the donor, especially when subsequent contributions may be desired, "there is nothing unique about donor advised funds... in this regard and, in fact, they have no legal obligation to follow the preference of the donor." *Id.* at 9.

4. Advantages and Disadvantages of Donor Advised Funds.

Advantages of donor advised funds over private foundations and other charitable giving vehicles include:

- **Simplicity**. Donor advised funds have no start-up costs. The sponsoring organization already exists, so setting up a fund is easy, whereas establishing a new private foundation, supporting organization or charitable trust is both time consuming and expensive.
- **Elimination of Administrative Hassles**. Donor advised funds are not required to file IRS Form 990s. The sponsoring organization handles all record keeping and ensures compliance with regulatory requirements.
- **Flexibility**. The donor may support multiple charitable organizations with one fund--and one asset, if desired. Many sponsoring organizations accept unmarketable or hard to value assets, usually on a case by case basis.
- **Experience and Service**. Depending on the sponsoring organization, the donor obtains the services, knowledge and expertise of a professional grants and philanthropic services staff for a comparatively low fee (usually one to two percent of the fund balance) With community foundation sponsoring organizations, the research and knowledge of the community foundation is shared with donor advised fund donors, and the foundation can assist with identifying and fulfilling the donor's personal charitable goals, researching specific charities, facilitating site visits, etc.
- **Available Ongoing Philanthropic Planning**. Most community foundation sponsoring organizations, including CICF, offer strategic charitable planning and family philanthropy facilitation.
- **Minimal Expense/Required Investment**. The minimum amount required to start a donor advised fund is much less than the minimum amount recommended to establish other charitable vehicles such as a private foundation, supporting organization or charitable trust
- **Ability to "Take a Test Drive**." Most sponsoring organizations offer pass through donor advised funds (whereas the more traditional endowment type funds are available less frequently). Thus, a donor could open a donor advised pass through fund for the

minimum required amount with the assurance that the donor could recommend grants from the fund out to charities of the donor's choice and spend out the entire amount of the fund. For donors concerned about whether the ability to serve as fund advisors to their fund provides them sufficient input over the distribution of their charitable capital, the pass-through alternative could provide a great introduction to charitable giving through donor advised funds. It also could be a great introduction and learning experience prior to the establishment of a private foundation.

- **Immediate Tax Deductibility**. Donor advised funds are especially attractive for donors with sudden and/or one time increases in income. The amount donated to establish a donor advised fund is tax deductible for the year the transfer to the fund is received from the donor, even though the donor may need additional time to recommend or advise grants to be made from the fund. The availability of an immediate income tax deduction without first having to determine all of the charitable recipients can prove very helpful to donors.
- **Greater Tax Deductibility**. Gifts to donor advised funds constitute gifts to public charities and are deductible up to 50% or 30% of adjusted gross income (for cash and appreciated assets, respectively), as opposed to the 30% or 20% limit for gifts to private foundations. Donors also can deduct the full fair market value of appreciated long-term capital gain property contributed to a donor advised fund—whereas the deduction for inter vivos gifts of long-term, nonmarketable assets to private foundations generally is limited to cost basis.
- **Anonymity if Desirable**. Donors have the opportunity to give anonymously, which is nearly impossible with private foundation reporting requirements. The entire fund can be anonymous or certain grants made from the fund can be anonymous.
- **Recognition if Desirable**. The donor can choose to name the donor advised fund after the donor or the donor’s family and call it a family foundation with associated name recognition and prestige. The donor also could establish a fund as a memorial to honor a loved one.
- **No Excise Tax on Earnings**. The 2% excise tax applicable to private foundations does not apply to earnings from donor advised fund assets, which can grow tax free in the fund and can be devoted to charitable causes of the donor’s choosing, rather than the government’s (through the investment earnings excise tax applicable to private foundations.)
- **No Required Payout.** Donors can choose to not grant every year and have the opportunity to grow their fund over time if desirable.

- **Centralized and Streamlined Charitable Giving**. Donors can make a single charitable contribution, take the tax deduction for that one gift, and make distributions from the fund at a later time to myriad charities without the need on the part of the donor to keep track of multiple charitable substantiation letters and tax years.
- **Protection from Solicitation**. The sponsoring organization receives all mail on behalf of the fund. Donors' addresses and other contact information remains protected. Depending on the sponsoring organizations policies, donors can refer all requests for funding to the sponsoring organization and thus avoid having to respond affirmatively or negatively themselves to specific requests.
- **Corporate Foundation Ease.** For corporations considering private foundations, donor advised funds offer 'turn-key" operation with no or minimal additional staff time required. All investment, compliance, administration, check distribution, etc., can be handled by the sponsoring organization in the name of the corporation, e.g., the ABC Corporation Foundation, thus freeing up staff to focus on the business of the corporation.

Disadvantages of donor advised funds include

- **Lack of Control with Grantmaking and Investments**. The sponsoring organization is by law the legal owner of the assets of the fund and is required to review grant recommendations to ensure that the proposed grants are for qualified charitable purposes. . It also has responsibility as to investment of the fund. The extent of flexibility as to grant recommendation process as well as investment of fund assets depends on the practices and procedures of the sponsoring organization.
- **No Ability to Hire Staff or Pay Travel Expenses**. All distributions from donor advised fund must be paid to charity for charitable purposes. A donor advised fund cannot even reimburse fund advisors for their travel or expenses incurred in connection with advising the fund. The sponsoring organization, however, generally is responsible for all administrative expenses of the fund such that the fund advisor should not need to incur expenditures in connection with the fund.
- **Not an Income Generating Vehicle**. Although grantmaking entities, including donor advised funds, private foundations and supporting organizations do not generate income back to the donor or others, they allow donors to "prefund" charitable giving in future years, which could serve to free up the donor's usual charitable giving budget allowing it to be used for other purposes.

5. Choosing a Donor Advised Fund Sponsoring Organization: Some issues to consider in determining whether a donor advised fund at a particular sponsoring organization will suit a donor's current and future needs include:

- What assets may be contributed to the fund? (More than cash and publically traded securities? Real estate? Business interests? Tangible personal property?)
- Are there geographical or interest area limitations on grantmaking? (CICF and affiliated community foundations do not impose geographical restrictions—grants from donor advised funds may be made to any U.S. 501(c)(3) public charity.)
- Services beyond the basics? (Will the sponsoring organization host advisory committee meetings, perform research on interest areas or specific charitable organizations, assist with mission or purpose statement development, goal setting and impact assessment?)
- Online access?
- Investment choices? (By law, the sponsoring organization has ultimate authority and control over the investment of donor advised fund assets and must establish investment policies concerning the fund. But can the donor recommend a certain investment manager be hired by the sponsoring organization for his or her fund? Commercial sponsors generally limit investments to their mutual fund offerings. CICF allows a donor to recommend an outside investment manager for any of its donor funds. Minimum fund balance to establish a fund generally is $25,000.
- Investment performance—even if outside investment manager selection recommendations are allowed, it might make more sense to let the sponsoring organization invest the assets of the fund.
- What is the sponsoring organization's policy regarding successor advisors and multi-generational involvement in the fund?
- What is the financial picture and reputation of the sponsoring organization? Are there references who can be contacted regarding their experience with the organization? What is the amount of unrestricted assets versus liabilities of the organization? What is its history?
- What are the fund minimums? Will an "acorn fund" be allowed?
- What are the fees, and what will the fees cover? E.g., consider the difference between funds that come with a local philanthropic advisor and family philanthropy education and involvement versus a 1-800 number.

6. Examples of Donations of Business Interests to DAFs.

(a) Donation of Closely Held Stock to DAF. In her November 25, 2013 Forbes article entitled, "*Generous Tax Tricks*," author Ashlea Ebeling reported on a wealthy couple who chose a donor advised fund over a private foundation primarily at first due to the hassle factor they attributed to private foundations. Ebeling reported, however, that the couple soon "tapped into two other advantages of DAFs that explain why some very rich people who in years past would have set up foundations are now using DAFs or 'supporting organizations' instead." The couple donated $2.5 million worth of shares of CitiStorage, a private- document-archive business the couple founded. The first advantage is the fair market value charitable income tax deduction for gifts of private stock to a public charity (without ever paying taxes on the appreciation) versus cost basis limit for gifts of private stock to private foundations. The "second tax goody," as characterized by Ebeling, is the deduction limit for private foundations of only 20% of adjusted gross income for gifts of publically traded stock versus the 30% limit for gifts of appreciated property (including private stock, real estate and other appreciated assets that cannot be donated with fair value deduction to private foundations) to public charities, DAFs and supporting organizations. Ebeling also noted that cash donations to private foundations offset only 30% of the donor's income, compared with 50% for cash contributions to a public charity, DAF or supporting organizations—all with the 5 year carry forward. She quoted the business owner/ donor to the DAF as saying the couple has a "pretty good" carry forward and that he might donate interests to his DAF from another recent venture, a chain of Japanese fast-food restaurants. http://www.forbes.com/sites/ashleaebeling/2013/11/25/charity-choice-when-donor-advised-funds-trump-private-foundations.

(b) Donation of Pre-IPO Shares to DAF. Employees of emerging companies who hold shares of their companies' common stock, or the companies' themselves may elect to donate pre-IPO shares to a donor advised fund, generally to a larger community foundation or a commercial sponsoring organization that accepts such gifts. The agreements governing transfer of shares, lock-up periods, etc. will need to be consulted and a qualified appraisal of the donated shares will need to be obtained that will require detailed information about the company. The DAF sponsoring organization will sell pre-IPO stock as soon as feasible unless the shares are restricted by a lock-up agreement. The proceeds from the stock sale are then added to the donor advised fund, which can carry the name of the corporation with a fund name such as the ABC Corporation Foundation. *See,* ,http://www.siliconvalleycf.org/enewsletter2Articles/community_2008b_8.html.

(c) CICF DAFs and other Funds. CICF and other community foundations commonly accept gifts of business interests into not only DAFs—but also scholarship, designated and field of interests funds, as well as unrestricted community funds. CICF has published many donor stories involving gifts of business interests. www.cicf.org. One involved the gift of a 20% interest in a horseracing facility to establish a pass through donor advised fund. Another involved a gift pf partnership interests that were converting into shares of a real estate investment trust and then liquidated. Yet another involves a corporate donor advised fund to which the corporation donates a percentage of its quarterly earnings. CICF holds many donor advised funds originally funded with shares of closely held businesses that were subsequently redeemed by either a purchaser of the corporation or the corporation itself.

B. Private Foundations.

1. The Basics. Under Code Section 509, a private foundation is a tax-exempt charitable organization described in Code Section 501(c)(3) that is NOT a public charity. In addition to less generous deductions for contributions from their supporters, private foundations are subject to greater regulation than other tax exempt organizations, including being subject to all of the "private foundation rules," the tax exempt entity for which the rules originally were prescribed. According to private foundation experts Bruce Hopkins and Jody Blazek, even after the Pension Protection Act provisions making certain private foundation rules applicable to donor advised funds and supporting organizations, "there is no category of tax-exempt organization that is subject to anything like the compliance burdens" applicable to private foundations. Hopkins and Blazek, *Private Foundations Tax Law and Compliance*, 4th ed. (Wiley, 2014). Quoting the U.S. Tax Court, Hopkins and Blazek assert that "it must be conceded that 'classification as a private foundation is burdensome.'" *Id*. at 9.

It often is noted that private foundations are not really private at all. They must apply for recognition of tax-exempt status (using IRS Form 1023) and must file annual information returns with the IRS, the 990PF, which discloses asset values, donations made, complete with the name of the donor, distributions made by amount and grantee, board members and their addresses, etc. Nonetheless, private foundations are often a would-be philanthropist's first thought based on the historic significance of many private foundations that carry the name of some of the most successful American entrepreneurs, families and businesses, e.g., Rockefeller Foundation, Lilly Endowment, Carnegie Foundation, Ford Foundation, Robert Wood Johnson Foundation. For many families and corporations, private foundations are an ideal charitable vehicle. As noted under the list of private foundation advantages herein, two important advantages include the ability for family members to be paid reasonable compensation, both in the form of director fees as well as receiving a salary for services rendered in the capacity of a staff member of the foundation, as well as the ability for private foundation board members to be reimbursed for travel and other expenses associated with meeting or other responsibilities. The primary advantage most often stated as the reason for choosing a private foundation over other forms of grantmaking charitable vehicles is the degree of control and discretion as to the selection of charitable grantees.

2. Private Foundation Rules. The federal tax rules pertaining to private foundations often are referred to as if they are laws governing the conduct of the entities to which they apply. However, since the rules are part of the tax code, they are cast a tax provisions, so that engaging in a particular act will trigger a tax, if the private foundations rules apply. The taxes are excise taxes and are structured as a tripartite level of taxation: Initial (first tier) taxes, additional (second-tier) taxes, and the involuntary termination (third tier or confiscatory) taxes. Because of the nature of this tax structure, a person/ organization subject to tax does not merely pay elect to pay it and continue with the transaction. Many of the private foundation rules applicable to other charitable vehicles already have been described at least briefly in other sections. However, since they all apply to private foundations, they are listed below. They apply generally to "disqualified persons", as defined in Code Section 4946, who generally are the equivalent of "insiders," including substantial contributors, foundation managers, trustees, directors, officers, etc., an owner of more than 20% of a business that is a substantial contributor, a member of the family of any of the above, and a 35% controlled entity.

(a) Self-Dealing Rules. The self-dealing rules, set forth in Code Section 4941 essentially prohibit financial transactions between and private foundation and a "disqualified person." (The term "disqualified person" is defined in Code Section 4946.) Self-dealing transactions include (1)sales, exchanges or leases of property between a private foundation and a disqualifies person (whether or not the transaction is a "good deal" for the foundation); (2) lending of money or extension of credit between a private foundation and disqualifies person; (3) furnishing of goods, services, or facilities between a fprivate foundation and a disqualifies person; (4) payment of compensation or payment or reimbursement of expenses, but a private foundation to a disqualified person and (5) payment be a private foundation to a governmental official. Important exceptions to these rules include, (1) payment of compensation by a private foundation to a disqualified person for certain personal services, when the compensation is reasonable and in furtherance of the foundation's exempt purposes, and (2) certain lending without interest and (3) certain transactions occurring during the administration of a decedent's estate.

(b) Mandatory Payout Rules. Pursuant to the private foundation mandatory payout rules, *see* Code Section 4942, a private foundation is generally required to pay out for charitable purposes an amount equal to 5% of its non-charitable assets. Set aside is permitted and administrative expenses are included in the 5% calculation.

(c) Excess Business Holdings Rules. The excess business holdings rules set out in Code Section 4943 are designed to prevent the control of a for-profit business by a private foundation, either alone or in connection with disqualified persons. A private foundation (as well as a donor advised fund and in certain cases a CLT) is prohibited (by the application if the excise taxes) from having more than a 20% interest in a business, or 35% where the control of the business is not in a disqualified person. As with donor advised funds, a private foundation that receives an excess business interest as a contribution has five years to dispose of it. This is often accomplished through redemption at market value offered to all shareholders under Code Section 4941(d)(2)(F).

A de minimis exception allows a private foundation (and donor advised fund) to own two percent of any business regardless of the holdings of disqualified persons with respect to the foundation or fund. Code Section 4943(c)(2(C).

(d) Jeopardizing Investment Rules. The jeopardizing investment rules under Code Section 4944, are the tax code equivalent of the prudent investor rules, requiring foundation managers to safeguard the foundation assets.

(e) Taxable Expenditures. Taxable expenditures prohibited to private foundations include expenditures for lobbying and grants to individuals for scholarships, travel or study, unless they have been pre-approved by the IRS. *See* Code Section 4945.

(f) Tax on Investment Income. Generally, pursuant to Code Section4940, a private foundation is required to pay an excise tax of 2% on its net investment income.

3. Reduced Charitable Deductions Applicable to Private Foundation. The percentage limitations on the deductibility, for federal income tax purposes, of gifts by individuals to private foundations are more limited than is the case with respect to gifts to public charities. For charitable gifts to private foundations, the limit is (1) 30% of adjusted gross income for gifts of cash—compared to 50% for charitable gifts of cash to public charities, and (2) 20% of adjusted gross income for property, including gifts of business interests—compared to 30% for such gifts to public charities. Gifts of appreciated long term property generally give rise to a charitable deduction based upon the fair market value of the property, whereas this type of gift to a private foundation is deductible only to the extent of the donor's basis in the property, with the exception of publically traded securities.

Unlike the federal income tax charitable deduction rules of gifts to private foundations, there is no limitation with respect to estate tax deductibility as to the amount that can pass to a private foundation (or other charitable organization) from a decedent's estate with a full deduction for the value of the assets. Code Section 2055(a).

4. Private Operating Foundations. Most private foundations make grants to other charitable organizations. Some private foundations, however, carry out their own charitable activities and programs and are referred to as private operating foundations. Private operating foundations are beyond the scope of this presentation.

5. Advantages and Disadvantages of Private Foundations.

Advantages of private foundations include

- Facilitation of family philanthropy and legacy of founder
- Donor control over governance and grants
- Ability to pay reasonable compensation
- Reimbursement of travel and other expenses for board
- Estate tax reduction; more limited deductibility of inter vivos gifts

Disadvantages of private foundations include

- Initial time commitment and set up expenses
- Excise tax on net income
- Extensive regulatory and administrative requirements (think twice if no staff)
- Annual reporting requirements
- Lower deductibility
- Less favorable treatment of gifts of business interests and other appreciated capital gain assets
- Lack of privacy
- Annual distribution requirement (if initial growth in assets is desired)

C. Using Donor Advised Funds with Private Foundations:

Many times the most appropriate vehicle to meet a client's charitable objectives is not an either/or, but a both/and. There are many situations in which private foundations could benefit from the establishment of a companion donor advised fund to more effectively accomplish the donor's objectives. Examples of utilizing both vehicles for more effective giving include:

- **Meeting the Required Five Percent Distribution Requirement.** Donor advised funds offer private foundations greater flexibility in grant payout management. Through a grant from a private foundation to a donor advised fund, the private foundation can obtain additional time to meet its annual five percent payout requirement. Time might simply have gotten away from the private foundation board or family, they may be waiting on a potential grantee to obtain requisite charitable status or accomplish certain objectives or conditions precedent to intended funding, or they may want to open a donor advised fund in order to strategically accumulate rather than pay out charitable assets for a certain period of time.
- **Making Anonymous Grants.** All of the information included in a private foundation's IRS Form 990-PF is readily available online, including asset base, the names and contact information of the officers and directors, and grants paid by grantee organization and amount. Donor advised funds, on the other hand, can keep donor names and grants completely confidential. Thus, a private foundation could establish a donor advised fund to make potentially controversial grants or to expand its interest area without opening up the foundation to additional stacks of grant requests from other nonprofits serving the new interest area.
- **Utilizing Donor Advised Funds as Recipients of Charitable Lead Trusts.** From an estate planning perspective, private foundations often do not work well as the charitable recipient of income from charitable lead trusts. CLTs that make payments to a private foundation in which the creator of the trust has an influential role present risks of estate inclusion under Code Section 2036. A similar, but much simpler approach for grantors of charitable lead trusts would be to establish a donor advised fund to be the recipient of the charitable lead interest.
- **Obtaining Enhanced Tax Benefits.** As public charities, sponsoring organizations' more favorable income tax deduction limitations often are more attractive than those afforded to donors of charitable gifts to private foundations. A donor may wish to ensure more charitable assets are available from a particular asset by donating it to a donor advised fund sponsoring organization, even though the donor also has a private foundation, due to income tax deductibility factors.

- **Disclaiming to a donor advised fund rather than a private foundation.** A problem arises if a parent names a child as a beneficiary of an estate and through the child's disclaimer the property passes to a private foundation where the child is a director. The child's participation in the private foundation's selection of charitable grant recipients could prevent the disclaimer from being a "qualified disclaimer," because the child's involvement in selecting the recipients to receive grants from the disclaimed property could violate the requirement for a qualified disclaimer that the property pass "without any direction on the part of the person making the disclaimer". Code Section 2581; Treas. Reg. Sec.25.2518-2(d)(1) and (2); 25.2518-2(e)(1)(I).

  Although one solution for the private foundation would be for it to amend its bylaws so as to prohibit the child and child's spouse from participating in the selection of grant recipients from the disclaimed property, with the disclaimed assets being isolated from other foundation assets in a separate account, this is a cumbersome and clumsy solution that interferes with the parent's intention to involve the child in the work of the foundation. (PLRs approving/upholding disclaimer with similar facts: 200802010 (Sept. 12, 2007), 200744005 (June 28, 2007), 200649123 (Aug. 23 2006), 200616026 (Dec. 22, 2005), 2004420007 (Jan. 23, 2004), 9317039 (Feb. 2 1993) and 9141017 (July 10, 1991)).

  A better solution might be to have a child disclaim property to a donor advised fund at a community foundation. The IRS concluded that the advisory nature of a child's or grandchild's grant recommendations did not pose a problem. PLRs 200518012 (Dec. 17, 2004 (disclaimers by grandchildren) and 9532027 (May 12, 1995)(disclaimers by children). (This recommendation is from the presentation materials prepared by Christopher Hoyt, *"Charitable Giving Implications of the 2012-2013 Income and Estate Tax Environment and Gifts and Bequests of Retirement Assets,"* Council on Foundations Advanced Legal Seminar, Sept. 9, 2012 ("Hoyt Presentation")).

D. Supporting Organizations

1. Overview. Creating a supporting organization to a community foundation may be an attractive alternative to the establishment of a donor fund with the community foundation for some donors. Many community foundations will work with donors interested in this option, sometimes referred to as a supporting foundation. Pursuant to Code Section 509 (a)(3), a supporting organization is a Code Section

501(c) (3) organization that qualifies as a public charity (as distinguished from a private foundation) due to its close relationship to one or more 501 (c) (3) public charities. Supporting organizations derive their 'public' status from their nexus to their supported charities rather than meeting the public support test on their own. A supporting organization to a community foundation would give the entity much greater grantmaking discretion than would a supporting organization, e.g., to a hospital. To qualify as a supporting organization under Code Section 509 (a) (3), an organization must satisfy three requirements:

- the organization must be organized and at all times thereafter operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified publicly supported organizations;
- the organization must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations; and
- the organization must not be controlled, directly or indirectly by one or more disqualified persons (as defined in Code Section 4946) other than foundation managers and other than one or more publicly supported organizations. Supporting organizations fall into three categories, Type I, Type II or Type III, depending on the degree of supervision and control of the supporting organization by the public charity being supported. Type I supporting organizations are the most common, whereas Type III offer the most donor control (and consequently are being scrutinized more closely by the IRS.)

Establishment of a supporting organization with a community foundation may be appropriate for donors who want to create a legal entity with almost as much control as a private foundation, but maintain the tax benefits and more lax regulatory requirements of a public charity. They may be especially attractive to owners of privately held companies or other donors who want to establish a foundation with illiquid assets, as the private foundation excess business holdings rules do not apply. Community foundations generally require a much higher minimum, often $2 to 5 million to establish a supporting organization, and generally limit their availability to Type I supporting organizations.

2. Supporting Organization Advantages over Private Foundations:

- SOs pay no 2 percent excise tax on investment income.
- SOs offer the charitable contribution deductions and deductions limits available for charitable gifts to public charities.
- SOs are not subject to excess business holdings rules.

V. General Charitable Gift Planning Considerations with Gifts of Business Interests

A. Tax Savings and Avoidance. While there must always be charitable intent in connection with any charitable gift, given a choice of paying taxes or benefiting charity, donors historically choose charity. And it is easier for people to think charitably in the face of increasing taxes. That's basically where we are following the enactment of the American Taxpayer Relief Act on January 1, 2013. The highest income tax bracket was increased to 39.6% and the effective federal rate on realized capital gains, when combined with the Medicare surcharge, is 23.8%. At the same time that ATRA significantly increased income and capital gains taxes, it also significantly increased the estate and gift tax exclusion amounts so that only one fourth of one percent of the U.S. population will incur estate or gift tax at the currently effective rates.

1. Income Tax Charitable Deduction. The income tax charitable deduction rules are set out in Code Section 170 and the regulations thereto. An income tax charitable deduction is allowed for lifetime, voluntary, irrevocable contributions of cash or property to or for the benefit of a qualified charity. Code Section 170 (a); *U.S. v. American Bar Endowment*, 477 U.S. 105 (1986). Qualified charitable organizations are described in Code Section 170 (c) and IRS Publication 78. The gift must be an outright gift of an asset and all rights thereto, or a partial interest gift that fits one of the narrow exceptions for transfers of less than a full interest, including charitable remainder trusts and charitable lead trusts. Generally, the value of the income tax charitable deduction is equal to the taxpayer's marginal tax rate. In the 39.6% new top bracket, a taxpayer will reduce his or her tax liability by 39.6 cents for every one dollar of charitable contribution, for a net cost of 60.4 cents per dollar contributed.

(a) AGI Limitations. An individual tax payer is permitted to claim an income tax charitable contribution deduction to the extent of the applicable allowable percentage of the donor's adjust gross income (AGI). Contributions to public charities are deductible up to 50% of the donor's AGI for gifts of cash and 30% of AGI for contributions of long-term capital gain property. Code Sections 170(b)(1)(A) and 170(b)(1)(c). Contributions to private foundations are deductible up to 30% of AGI for cash and 20% of AGI for long term capital gain property. Code Sections 170(b)(1)(B) and 170(b)(1)(D).

(b) Pease Limitation—a new/ renewed factor in analyzing tax savings from charitable gifts. The modified Pease limitations added by ATRA require that after applying the 50%/ 30%/20% limitations (whichever is applicable) on charitable deductions, higher income tax payers further reduce itemized deductions *by the lesser of* 3% of the amount by which their AGI in 2015 exceeds $258,250 for single taxpayers and $309,900 for married, or 80% of the tax payer's itemized deductions.

(c) Fair Market Value vs. Adjusted Tax Basis. Although contributions of appreciated, long term capital gain property are valued a fair market value for purposes of determining the deductible amount for gifts to public charities, charitable gifts of long term capital gain property (other than publically traded securities) to private foundations are deductible only at the donors' adjusted tax basis. Code Section 170(e).

(d) Carry Forward. Any unused charitable deduction may be carried forward for an additional five years. Code Section 170(d); Treas. Reg. Section 1.170A-8(c)(2).

2. Capital Gains Tax Avoidance. Post ATRA, gifts of appreciated long term capital gain property are more due to increased capital gains tax As mentioned above, the "tax benefit" of avoiding capital gains for charitable gifts of any long term capital gain business asset other than publically traded stock is much greater with a gift of that asset to a public charity than it is for a gift to a private foundation. One of the greatest advantages of making a charitable gift of appreciated property is the dual tax benefit of the tax payer (1) receiving an income tax charitable deduction for the value of the gift and (2) avoiding the tax on the capital gains in the contributed property that would be incurred if the property was sold.

3. Estate Tax Avoidance. ATRA set the federal estate and gift tax exemption at $5 million, adjusted for inflation, so that the 2015 exemption is currently $5,430,000 million. In addition, ATRA made permanent the right of a surviving spouse to use any portion of his or her deceased spouse's unused exemption, effectively allowing a married couple to give away to non-charitable beneficiaries as much as $10,860,000 and not incur any federal estate taxes. Through increasing the amount excluded from tax at death, ATRA created additional incentive for lifetime gifts. For taxpayers who have established business succession plans with a charitable component to be implemented through their estate plans, those plans should be evaluated to determine if acceleration of any charitable gifts might provide the tax payer greater tax savings, specifically if the tax payer's estate will not be subject to estate tax..

B. Avoiding Imputation of Gain to Donor—Assignment of Income and Step Transaction Doctrines. In *Palmer V. Commissioner*, 62 T.C. 684 (1974), the court held that the gain on the sale of stock of a closely held company by a charitable foundation would not be imputed back to the donor upon the corporate redemption of that stock from the charitable donee. The IRS had argued that since the donor controlled both the company and the charitable foundation and donated appreciated stock in the company to the foundation, the gift followed by redemption was pursuant to a "single step" or plan. The court found that the there was an actual, valid gift and that the gift of stock was not a gift of the proceeds of redemption. There is a long line of cases in this area, but suffice it to say that in the most recent case, the Tax Court required the IRS to accept the holding of its own ruling, Rev. Rul. 78-197, that capital gain will only be imputed back to the donor in a corporate redemption if at the time of the gift, the charity was legally bound, or could be compelled to sell the shares. The IRS will treat the proceeds of a stock redemption under facts similar to those in *Palmer* as income to the donor (assignment of income doctrine) ONLY if the done is legally bound to surrender the shares for redemption.

The imputation/ assignment of income issue should be considered whenever negotiations on the sale of a business have commenced prior to a contemplated charitable gift of all or a portion of that business. Negotiations should stop while the charitable transfer is completed (assuming the business sale negotiations were halted before the holder of the business interest could be compelled to surrender that interest to the purchaser). The charity should then take all steps necessary to exercise the rights and duties of ownership, including taking part in the business sale negotiations when appropriate.

C. Valuation Requirements. Except when the valuation of a charitable gift is straight-forward as with gifts of cash or publically traded securities, an appraisal is required in connection with claiming a charitable income tax deduction for making that gift. Code Section 170(f)(11)(A)(i). Additional "qualified appraisal rules" apply for charitable gifts over $5,000. Code Section 170(f)(11)(C). With respect to those gifts, the donor must (1) obtain a qualified appraisal and (2) attach a summary (Form 8283) to his or her return. For non-publically traded securities the threshold for a qualified appraisal is $10,000. Treas. Reg. Section 1.170A-13(c)(2)(ii)(A). For contributed property with an appraised value of more than $500,000, the qualified appraisal itself must be attached to the donor's income tax return. The penalty for noncompliance with the qualified appraisal rules is the complete disallowance of the charitable deduction. (*See*, http://www.pgdc.com/pgdc/appraisals-performed-donor-not-qualified-appraisals-deduction-denied,for discussion of the harsh result in *Mohamed v. Commissioner*, T.C. Memo 2012-152, in which the taxpayer

couple transferred what the tax court apparently recognized as five properties worth millions of dollars to a CRT. The charitable income tax deduction for the present value of the charitable gift was completely denied because the taxpayer failed to comply substantially with the qualified appraisal rules.)
IRS Publication 561, *Determining the Value of Donated Property*, www.irs.gov/pub/irs.pdf/p526.pdf, contains helpful information regarding the appraisal requirements for charitable gifts of business interests. Because it is the taxpayer who needs the qualified appraisal for income tax purposes, the taxpayer should pay for the appraisal.

Note the inherent tension between valuation discounts for lack of control, lack of marketability, etc., for transfer and estate tax purposes with business succession planning and obtaining a higher valuation/ appraisals for income tax purposes in connection with charitable gifts. With some justification, the IRS has claimed that the same valuation discounts claimed by donors of non-charitable gifts also apply to charitable gifts.

D. Use of "Charitable Lids" when transferring closely held business interests to heirs and charity. The term "charitable lid" is the term that has been given to the use of a defined value formula clause used by owners of closely held business interests to transfer those interests to their heirs and to charity without the risk of incurring additional gift or estate tax liability in the event of a determination of increased valuation.

1. The Case Law: Three recent cases have upheld the use of defined value formula clauses/ "charitable lids" to reduce or eliminate estate or gift tax liability that might be imposed as a result of IRS audits changing the valuation of the transferred assets from the value that originally was reported on the estate or gift tax returns:
Estate of Petter V. Commissioner, 653 F.3rd 1012 (9th Cir. 2011) affirming T.C. Memo. 2009-280 (Dec. 7, 2009) (gift tax);
Estate of Christiansen v. Commissioner, 586 F. 3rd 1061 (8th Cir. 2009), affirming 130 T.C. 1 (2008) (estate tax); and
Hendrix v. Commissioner, T.C. Memo. 2011-133 (June 15, 2011) (gift tax).

In each case, the clauses allocated the entire increased valuation amounts to charity so that the increased charitable tax deduction eliminated any increased estate or gift tax liability as a result of an increased valuation. The formula allocation clauses utilized in these cases differed from "savings clauses" that have been found to be void in previous cases (e.g., *Commissioner v. Procter,* 142 F. 2nd 824 (4th Cir. 1944)). The savings clause approach required the recipient to return to the donor whatever portion of the gifted property was subsequently valued higher than the original valuation. Whereas the savings clauses operated to change the amount of the completed gift, the formula allocation clauses only change the allocation among the various recipients.

Consider an estate plan in which an individual states in his or her will and trust instruments: "Give to my family the federal estate tax threshold in the year that I die, e.g., $1 million or $5 million...or $10 million..., and give the rest to charity." The intent is to avoid estate tax, and although this is not difficult when the estate or trust consists of liquid assets with undisputable valuations, a potential problem arises there if there are illiquid assets with a wide potential range of values e.g., closely held business interests. A defined value clause can be very helpful when challenges to valuation discounts are likely.

Way back in January, 2012, in his article in Trusts & Estates article entitled *The Perfect Storm*, Charles Redd urged that "now's the optimum time to provide charitably inclined clients holding difficult-to-value property with the opportunity to make gifts and sales of such property--allocating a stated dollar amount in value of the property to or in trust for their descendants, and allocating the remainder to charity." Redd counsels that before too long the IRS is likely to promulgate a regulation to eviscerate this excellent technique --which it was expressly invited to do by 9th Circuit Court of Appeals in *Petter*, *supra,* in response to the IRS complaining that defined value formula clauses remove any financial incentive for the IRS to audit an estate or gift tax return. No such IRS action has been taken to date. In fact, the case law underscores public policy supporting gifts to charity.

2. Drafting language: In *Petter*, the niece of the founder of United Parcel Service ("UPS") put UPS stock in a limited partnership and, among other complex gift and estate plans, made inter vivos gifts of the partnership units through two long-term intentionally defective grantor trusts to her two adult children and two donor advised funds at the children's respective community foundations, the Seattle Foundation and the Kitsap Community Foundation. The relevant sections from the *Petter* gift documents, as set forth in the 9th Circuit's opinion, provide:

> 1.1 Subject to the terms and conditions of this Agreement, Transferor:
>
> 1.1.1. assigns to the Trust as a gift the number of Units described in Recital C above that equals one-half the <maximum> dollar amount that can pass free of federal gift tax by reason of Transferor's applicable exclusion amount allowed by Code Section 2010(c). Transferor currently understands her

unused applicable exclusion amount to be $907,820, so that the amount of the gift should be $453,910; and

1.1.2. assigns to The Seattle Foundation as a gift <to the A. Y. Petter Family Advised Fund of The Seattle Foundation > the difference between the total number of Units described in Recital C above and the number of Units assigned to the Trust in Section 1.1.1.

1.2 The Trust agrees that, if the value of the Units it initially receives is finally determined for federal gift tax purposes to exceed the amount described in Section 1.1.1, Trustee will, on behalf of the Trust and as a condition of the gift to it, transfer the excess Units to The Seattle Foundation as soon as practicable.

1.3 The Seattle Foundation agrees that, if the value of the Units the Trust initially received is finally determined for federal gift tax purposes to be less that the amount described in Section 1.1.1, the Seattle Foundation will, as a condition of the gift to it, transfer the excess Units to the Trust as soon as practicable.

The fair value of the membership units as of the transfer date in 2002 was determined by a qualified appraiser to be $536.20 per unit. Following IRS audit in 2005 of the 2002 gift tax return, the parties settled the valuation issue stipulating to a $744.74 value per unit at the time of transfer. As a result of the stipulated value and the reallocation clauses of the transfer agreements, the community foundation donor advised funds received additional units. The tax court allowed the taxpayer (Mrs. Petter) to amend her 2002 gift tax return to take an additional charitable deduction based on the value of the additional LLC units the community foundation donor advised funds received.

3. Practical tips for selecting and planning for a charitable recipient. As a result of the reallocation approved in *Petter*, the Seattle Foundation received over $3.3 million worth of *additional* partnership units into the donor advised fund advised by the daughter of Mrs. Petter. This amount is likely more than many charitable organizations would be able to handle and more than most donors would intend to give to any single charity. As previously discussed, donor advised funds and private foundations allow for future grants to more than just one charity. Whereas donor advised funds were used as the charitable recipients in *Petter* and *Hendrix.* (*see also*, *McCord v. Commissioner,* 461 F. 3rd 614 (5th Cir. 2006), also using a donor advised fund), a private foundation was used as the charitable recipient in *Christiansen, supra.*

With both private foundations and donor advised funds, it is important to "plan an exit strategy" for the business interest donated to the charity due to the excess business holdings rules discussed above. Private foundations are subject to harsher self-dealing tax if the property is sold to a disqualified person, which is often a desired part of the plan. A private foundation's sale of an asset to a donor or to a related family member will likely trigger the tax. Section 4941 (d)(2)(F). Donor advised funds, on the other hand, are only subject to the usual rule that property must be sold for a reasonable price. There is no self-dealing penalty for a sale transaction with a donor advised fund. Nor would there be problems with a potential failure to meet the private foundation 5 percent distribution requirement that could be imposed retroactively to the date of gift (which was several years earlier in *Petter*).

E. Issues with respect to Business Form. As previously discussed in relation to S corporations and UBIT problems, not all forms of business interests are appropriate for charitable gifting, for the donor, the charitable vehicle or both. It may be that with proper planning and available time, the form of business interest could be modified to provide for "better tax deductibility" for the gift or less risk for the charitable entity. For example, with any partnership donation, debt inside the partnership is considered to be sale proceeds, giving rise to a "bargain sale." The charitable income tax deduction is measured by the difference between the partner's share of the value of the partnership's property less the sales proceeds. If the ratio of debt to value is relatively high, it is possible for the taxable gain to exceed the donation deduction—which likely would not be acceptable to the donor. Moreover, self-dealing rules are implicated in the case of bargain sale transactions in most cases. Also in the case of a donation of a partnership interests, the charitable entity generally will not accept a gift of a general partnership interest due to potential liability for actions of the partnership. Even in the case of limited partnership interests and LLC units, the partnership or operating agreement could require partners or members to make additional capital contributions or other payment. Thus, a charitable donee may require an agreement with the donor to cover costs of items such as capital assessments or phantom income, or the contemplated gift may prove unworkable.

Effect of Code Section 337. Corporations making large charitable contributions of corporate assets must be careful not to violate Treasury Regulation Section 1.337(d)(4), which continue the repeal of the "General Utilities Doctrine." Under the regulations, a taxable corporation is required to recognize gain or loss upon the transfer of "all or substantially all of its assets to one or more tax-exempt entities."