Charitable Giving

Overview

Charitable giving is an important part of estate planning, particularly for clients with significant wealth. Charitable gifts are governed by complex income and transfer tax rules. This guide provides an overview of the tax rules governing charitable gifts, with particular emphasis on recent changes in the law.

On December 20, 2017, President Trump signed into law an Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, popularly referred to as the "2017 Tax Cuts and Jobs Act." This Act changed a number of rules affecting both tax incentives for charitable giving and taxation of tax-exempt organizations. Congress made further tax changes as part of the Bipartisan Budget Act of 2018, enacted on February 8, 2018. Some of the key new changes affecting charitable giving as discussed herein include:

- Increased flexibility regarding certain holdings of business interests by private foundations (¶1.03).
- Increased taxation of many charities and other tax-exempt organizations that have unrelated business taxable income or provide certain fringe benefits to employees (¶1.03).
- Increased taxation of executive compensation paid by non-

profit organizations (¶1.03).

- Increased adjusted gross income deduction limits from 50 percent to 60 percent for gifts of cash to public charities in certain circumstances (¶1.04).
- Elimination of charitable deduction for contributions to higher education institutions in exchange for athletic event ticket purchase rights (¶1.04).
- Increased standard deduction for taxpayers who do not itemize their deductions (as is required in order to take advantage of the income tax charitable deduction) (¶1.04).
- Suspension of "Pease" limitation on itemized deductions (¶1.04).

¶1.01 Introduction

Many individuals choose to make charitable giving an integral part of their estate plans. A variety of factors motivate individuals to give to charitable organizations, including the desire to benefit a particular cause or organization. In addition, there are significant income, gift, and estate tax benefits associated with charitable giving.

> **EXAMPLE 1-1.** Harry gives $1,000 to the American Red Cross. Generally, Harry can deduct the gift from his gross income before applying the income tax rates and paying income tax. If he is in a marginal 37 percent income tax bracket, his deduction saves him $370 in income taxes. If his gift and estate tax marginal bracket is 40 percent, then this gift also saves him $400 of gift or estate tax that would otherwise be due by the time of his death. At his death, Harry leaves the charity another $100,000, which his estate can deduct against the federal estate tax, saving $40,000. So Harry's total charitable gifts of $101,000 saved a total of $40,770 in taxes and cost him and his heirs only $60,230. The charitable gift would provide additional estate tax savings if Harry were domiciled in a state with a state estate tax. Despite the various tax benefits associated with charitable giving, donors should always have as a primary motive the desire to benefit the charity, because the charity receives the

money rather than the donor or the donor's family.

A small cash gift to a charitable organization does not usually give rise to any legal issues. However, clients frequently need an estate planner's advice in order to navigate the complex tax rules associated with larger gifts or gifts of property other than cash. In order to maximize the benefits of a charitable gift to both the donor and the charity, an estate planner's advice is often sought regarding (1) how much to give in a particular year, (2) if assets other than cash are being given, which assets to give, (3) when to make the gift, (4) whether to make the gift outright or in trust, and (5) which organizations to benefit. Accordingly, an estate planner should have a good working knowledge of the specific rules governing the income, gift, and estate tax deductions for charitable gifts. This will require the estate planner to understand:

- What constitutes a charitable donation;
- The distinctions between various types of public charities, private foundations, and donor-advised funds;
- The different rules applicable to charitable deductions for income, gift, and estate tax purposes;
- How to structure split-interest gifts, such as charitable lead trusts, charitable remainder trusts, and charitable gift annuities; and
- Ways to ensure that the donor's wishes are carried out by the charity.

¶1.02 Charitable Contributions and Charitable Organizations

What Constitutes a Charitable Contribution? In order to achieve the tax benefits associated with charitable giving, the donor must generally make a *charitable contribution* to a *charitable organization*. Generosity does not always qualify for tax benefits. For example, if a donor provides direct financial support to a needy family, that may be a generous act inspired by a charitable intent, but it will not qualify as a deductible charitable contribution unless the money is given to a qualifying charitable organization.

To be deductible for federal income tax purposes, a charitable contribution must be a donation of cash or property to a charitable organization that has been recognized as such by the Internal Revenue Service and that has been created and organized under the laws of the United

States, a state, or any political subdivision.[1] The contribution of services for charitable purposes is not deductible.

What Is a Charitable Organization? Charitable organizations are described in Section 501(c)(3) of the Internal Revenue Code and must have the following characteristics:

- The primary purpose of the organization, expressed both in organizational documents and in practice, is religious, charitable (such as social service organizations), educational, scientific, health-related, literary, the promotion of amateur sports competition, or the prevention of cruelty to children or animals;
- Private individuals may not be shareholders and may not benefit from the profits of the organization, and regulations provide that the prohibition against private benefit can include either economic or non-economic benefits, even if ostensibly reasonable;[2]
- The organization may not (except for an insubstantial amount) conduct any lobbying activities aimed at influencing legislation at local, state, or national levels;[3] and
- The organization may not participate in or intervene in any political campaign on behalf of (or in opposition to) any candidate for public office.[4]

> **EXAMPLE 1-2.** Rachel wanted to start an organization dedicated to protecting children from the dangers of smoking. She did not expect the organization to have much income and wasn't

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[1] IRC §170(c).

[2] Reg. §1.501(c)(3)-1(d).

[3] Lobbying limited to time and effort of less than 5 percent of an organization's activities has been found to be insubstantial. Seasongood v. Comm'r, 227 F.2d 907 (6th Cir. 1955). Public charities that prefer to be judged by an expenditure test may make an election to limit lobbying expenditures, with permissible limits set by statute via a sliding scale with an upper limit of 20 percent of the organization's total expenditures (not to exceed $1 million), and only a portion of such permitted amounts being spent on grassroots lobbying.

[4] See Rev. Rul. 2007-41 (describing various situations in which activities and communications by a 501(c)(3) organization are, and which are not, impermissible political activities).

too concerned about the organization paying income taxes. She was concerned, however, that the organization would not attract sufficient contributions unless donors could claim income tax deductions for those contributions. As a consequence, she decided that the organization should apply for tax-exempt status as an educational organization described in Section 501(c)(3). Although she had initially considered having the organization actively lobby for anti-smoking legislation and support anti-smoking candidates, Rachel decided (out of an abundance of caution, even though a limited amount of lobbying activities could have been permissible if structured appropriately) that charitable status was more important, and so she prohibited those activities in the organization's governing documents and limited the written purpose and actual activities of the organization to developing an anti-smoking curriculum to be used by elementary school teachers.

In order for donations to an organization to be tax deductible, the organization generally must be specifically recognized by the Internal Revenue Service as a charitable organization.[5] With a few exceptions, primarily pertaining to certain religious organizations,[6] each charitable organization that meets the requirements described in Section 501(c)(3)

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[5] This requirement, found in IRC §508, does not apply to organizations to which contributions are deductible under IRC §170(c) (defining "charitable contribution") that are not §501(c)(3) organizations. Such organizations include certain governmental and quasi-governmental organizations (IRC §170(c)(1) and §115), war veterans organizations (IRC §170(c)(3)), fraternal organizations (IRC §170(c)(4), deductible only for gifts for certain purposes), and non-profit cemetery companies (IRC §170(c)(5)). Although an organization in one of these categories may not (unless it has affirmatively requested confirmation of its tax status, as many do) have a determination letter or be listed in ~~Exempt Organizations Select Check~~Tax Exempt Organization Search (discussed below), contributions to the organization may nevertheless be eligible for an income tax charitable deduction. *See* IRS Publication 526, Charitable Contributions.

[6] IRC §508(c)(1)(A). This exception applies to churches, synagogues, temples and mosques, and also to certain entities under their control (referred to as "integrated auxiliaries"). Organizations under a "group exemption" may also be excused from these application procedures. Treas. Reg. § 1.508-1(a)(3)(c).

must also apply to the Internal Revenue Service for approval as a charitable organization.[7] The application is made on Form 1023, which requires the organization to disclose all of its planned activities, its affiliations, and commercial obligations with other organizations, and its current and projected financial statements.[8] Once approved, the organization will receive a *determination letter* from the Internal Revenue Service stating that the organization is eligible to receive tax deductible contributions. So long as the organization files its application within 27 months of its creation, approval of its status under Section 501(c)(3) will be retroactive to the date of its formation.[9] The determination letter is a charitable organization's best proof of its tax-exempt charitable status,[10] and many donors will ask for a copy before making a gift. Although many religious organizations are not required to apply for a determination letter in order to receive tax deductible donations, some do so in order to have a determination letter to show to donors.

An estate planner who is assisting a client with a charitable gift should always check an official source to confirm that the organization is eligible to receive tax deductible donations. This has the added advantage of enabling the estate planner to make sure that the gift uses the charity's official name. Donors and their advisors can find a list of all qualified charitable organizations by using ~~Exempt Organizations Select Check~~Tax Exempt Organization Search which is available online at the

[7] IRC §508(d)(2)(B) bars a charitable deduction for contributions to organizations that have not applied for approval as a charitable organization pursuant to IRC §508(a).

[8] Certain small organizations may be eligible to file the streamlined Form 1023-EZ.

[9] Reg. §1.508-1(a)(2) sets the original 15-month deadline; Reg. § 301.9100-2 provides for an automatic 12-month extension.

[10] Donors are generally permitted to rely on a copy of an organization's exemption letter. *See* Treas. Reg. 1.509(a)-7. However, once the IRS has issued public notice of a change in an organization's tax-exempt status (which it does by way of ~~Exempt Organizations Select Check~~Tax Exempt Organization Search, discussed below), a donor can no longer rely on a copy of the organization's exemption letter. Accordingly, donors should never rely on an exemption letter without checking ~~Exempt Organizations Select Check~~Tax Exempt Organization Search as well.

IRS website.[11] Donors and advisors can also check one of several private websites that have teamed up with the Internal Revenue Service to make this and other information available[12] – however, donors should be aware that the only online source on which they are officially entitled to rely is ~~Exempt Organizations Select Check~~Tax Exempt Organization Search.[13]

Finally, gifts to foreign charitable organizations, even to a publicly supported institution such as the British Museum, are not deductible for U.S. income tax purposes.[14] This limitation does not apply to the estate tax deduction, so gifts to foreign as well as U.S. charitable organizations may be deducted in computing the donor's federal estate tax liability.[15]

It should be noted that charitable organizations described in Section 501(c)(3) are just one of many types of tax-exempt organizations. Organizations such as civic leagues are tax-exempt under Section 501(c)(4); labor organizations under Section 501(c)(5); trade associations and chambers of commerce under Section 501(c)(6); and social clubs under Section 501(c)(7).[16] However, generally only gifts to charitable organizations that are exempt under Section 501(c)(3) qualify for

[11] ~~Also K~~Kknown as "Exempt Organizations Select Check", prior to May 2018," and ~~formerly~~ originally known as "Publication 78." Tax Exempt Organization Search also includes copies of determination letters for many organizations created after January 1, 2014.

[12] One example can be found at www.guidestar.org.

[13] *See* Rev. Proc. 2011-33.

[14] IRC §170(c)(2)(A). Under treaties with Canada, Mexico, and Israel, there are a few limited exceptions under which a gift to a foreign charitable organization might allow for a U.S. income tax deduction. See IRS Publication 526, Charitable Contributions.

[15] *See generally* IRC §2055.

[16] Tax-exempt organizations must still pay income tax on business activities that are unrelated to their exempt purposes. IRC §512. For example, a school, or an association of electrical engineers, or the League of Women Voters can apply to the IRS for tax-exempt status and, if granted, can invest its funds to earn interest, dividends, and capital gains, all of which will be tax-free to the organization. If any of these organizations decides to open a dry-cleaning shop, however, the proceeds from the shop will be subject to income tax (even if the organization uses the proceeds to further its exempt purposes). Also, some non-charitable organizations, such as social clubs, are exempt from tax on exempt function income (such as membership dues) but must pay income tax on investment income.

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the charitable deduction.[17]

¶1.03 THE DISTINCTION BETWEEN PUBLIC CHARITIES AND PRIVATE FOUNDATIONS

In General. Each tax-exempt charitable organization is further classified by the IRS as either a public charity or a private foundation, and donors making a charitable contribution must be educated on the distinction between the two, because the charitable deduction rules are different depending upon whether a gift is to a public charity or to a private foundation. As discussed below, donors to public charities can receive somewhat more generous deductions than can donors to private foundations. In addition, charities themselves are subject to different rules, restrictions and penalties depending on whether they are public charities or private foundations.

In general, public charities receive funds from a broad group of donors and have boards that are responsive to such donors, while private foundations are often funded and controlled by one person or family. For example, the United Way and the American Cancer Society are public charities because they receive substantial support from the general public. The Ford Foundation is a private foundation because it received its funding from a single family. Federal tax law draws a distinction between the two because Congress saw more opportunity for abuse and a greater need for regulatory oversight for private foundations. Congress also decided that the charitable deductions for donations to private foundations should be more limited than donations to public charities.

When a new charitable organization is created and files Form 1023 to apply for tax-exempt status, it must set forth its case for being classified as a public charity. If an organization fails to prove that it qualifies as a public charity, it will be classified as a private foundation.

Public Charities. Section 509(a) of the Code sets forth four alternative categories of public charities, and provides that if a charitable organization is not described in one of these categories, it is automatically considered a private foundation.

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[17] A charitable deduction may also be allowed for a gift to a charitable trust that is described in IRC §4947(a)(1).

- *Category 1.* An organization must either (i) be a religious organization, school, hospital, or a government branch or agency,[18] or (ii) show that it is sufficiently supported (see the public support tests below) by contributions from government units and/or the general public.[19]
- *Category 2.* This category also requires proof of sufficient support from government units and/or the general public, and includes not only contributions but also receipts for the provision of charitable services.[20]
- *Category 3.* The third category, known as supporting organizations,[21] includes organizations that are dedicated to the support of organizations described in the first two categories.
- *Category 4.* The fourth category is for organizations that test for public safety.[22]

Publicly Supported Organizations. As described above, two categories of public charities require that an organization prove that it receives significant support from government units and/or the general public. The tests are quite technical, and discerning the difference between the two is challenging. An organization can attempt to meet either test, but will generally find one or the other is the better fit, depending upon whether the organization's support consists primarily of contributions, or whether it also has significant receipts from the performance of charitable activities. The organization will also need to consider the investment income it receives, as that affects each of the two tests in different ways.

Significant Support from Contributions. Under the first category of public charities, an organization must show that it receives contributions from government units and/or the general public that, on average over its most recent five years of operation, make up at least one-third of its

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[18] IRC §§509(a)(1) and 170(b)(1)(A)(i)–(v).
[19] IRC §§509(a)(1) and 170(b)(1)(A)(vi).
[20] IRC §509(a)(2).
[21] IRC §509(a)(3).
[22] IRC §509(a)(4).

annual support.[23] For purposes of this public support test, the term "general public" is defined to include any individual or corporate donor except to the extent that donations from the donor (when aggregated with donations from related parties) exceed 2 percent of the organization's total support.[24] For organizations that cannot meet the "one-third support" test, there is an alternative "ten percent of support" test whereby the organization need only show that, on average over its most recent five years of operation, at least 10 percent of its support comes from government units and/or the general public, but must also show that certain facts and circumstances exist that prove the organization is in the nature of a publicly supported organization.[25] Organizations receiving significant support from contributions are not subject to an express limitation on investment income, but because such income counts as part of the total support in the denominator of the public support fraction but not in the numerator, it will have the effect of lowering the percentage of public support.

> **EXAMPLE 1-3.** An organization created to promote the history of women's achievements in America has plans to raise $1 million over the next five years. It has several key backers who intend to donate a large portion of the funds, and those backers want the organization to qualify as a public charity so that they can receive the most beneficial deductions (*see* ¶10.04 *infra*). To achieve public charity status, the organization must raise $333,333 from unrelated donors where no one donation is counted beyond $20,000 (2 percent of the total donations) (the goal could be reached by as few as 17 donors giving $20,000 each, or thousands of donors giving smaller amounts). The organization will work hard to meet the one-third public support test, not wanting to rely on the alternative 10 percent public support test (the organization is not optimistic that it could meet the required facts and circumstances that would compel the IRS to

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[23] IRC §§509(a)(1) and 170(b)(1)(A)(vi).

[24] Reg. §1.170A-9(e)(6).

[25] Reg. §1.170A-9(e)(3) (large number of donors; governing body representing broad interests of the public; services provided directly to the public; appeal for members designed to attract broad cross section of public; etc.).

conclude that it is “in the nature of a publicly supported organization”).

Significant Support from Receipts for Charitable Services. Under the second category of public charities, an organization must show that it receives a combination of contributions from government units and/or the general public and/or receipts (received from the general public or from government units) for the conduct of its exempt activity that, on average over its most recent five years of operation, make up at least one-third of its annual support. For purposes of this public support test, the term “general public” is defined differently: it includes any individual or corporate donor, except that if the combined donations and receipts from the donor (when aggregated with donations and receipts from related parties) exceed 2 percent of the organization's total support (making such donor a “substantial contributor”), then the donations and receipts from such donor will be entirely excluded.[26] In addition, when counting receipts from the conduct of its exempt activity (such as a museum's admission receipts or a social service organization's government reimbursements) as part of its one-third support fraction, receipts for services from any one person or any one government agency cannot be counted in any one year to the extent they exceed the greater of $5,000 or 1 percent of the organization's total support for that year.[27] Finally, an organization qualifying for this second category of public charity must not have investment income that exceeds one-third of its total support.

EXAMPLE 1-4. A mental health counseling center has $1 million of support during its most recent five years of operation, including receipts from patients for its delivery of counseling services, and hopes to preserve public charity status. Using the two alternative public support tests:

1. At least $333,333 must have come from government grants and/or contributions of no larger than $20,000 per donor (2 percent of total support) (aggregating gifts from the donor and his or her family members), or

[26] Reg. §1.509(a)-3; IRC §4958(c)(3)(C) (defining a “substantial contributor”).
[27] IRC §509(a)(2)(A)(ii); Reg. §1.509(a)-3.

2. At least $333,333 must have come from a combination of government grants and/or contributions and/or receipts for services not counting any contributions or receipts from one person (and related family) at all if such support exceeds $20,000 (2 percent of total support), and not counting any receipts for services from any person or government agency in excess of $10,000 (the greater of $5,000 or 1 percent of total support), all while no more than $333,333 of support comes from investment income.

Supporting Organizations. A supporting organization is a charitable organization dedicated to the support of one or more other public charities. A supporting organization enjoys public charity status without the need to satisfy a public support test, so some donors may prefer to establish and fund a supporting organization rather than a private foundation. The tax code and regulations governing supporting organizations are very complex and have been subject to several changes over the past several years, including changes enacted with the Pension Protection Act of 2006 and regulations issued on December 28, 2012 and December 21, 2015. The supporting organization's governing documents must either specify the name(s) of the supported organization(s) or describe a class of charitable organization(s) that will be supported.[28] The supporting organization must support the specified organization(s) by either providing it/them with substantial financial resources or by conducting charitable activities that it/they would otherwise undertake directly.[29] The supporting organization may not be controlled (directly or indirectly) by a substantial donor,[30] and in fact is often controlled by the supported public charity with the participation of the donor and his or her family.

EXAMPLE 1-5. A donor wants to endow a program run by a specific public charity, but would prefer to retain some control

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[28] The class must be drawn narrowly enough that the qualifying members of the class are "readily identifiable." *See* Reg. §1.509(a)-4(d)(2)(iii); Rev. Rul. 81-43; Polm Family Foundation, Inc. v. United States, 644 F.3d 406 (D.C.Cir. 2011) (class of organizations which support, promote and/or perform public health and/or Christian objectives not readily identifiable).

[29] IRC §509(a)(3); Reg. §1.509(a)-4.

[30] IRC §509(a)(3)(C).

over when and how the income from the fund is used, and would like to control the investment of the fund. A private foundation is not an acceptable solution because the donor intends to fund the endowment with appreciated property other than publicly traded stock, and wants a deduction for the full value of the property (*see* ¶10.04 *infra*). The donor forms a supporting organization, giving a majority of the seats on the board to nominees of the supported public charity and keeping a minority of the seats for his family. The supporting organization's governing documents limit the use of funds solely for the benefit of the supported public charity.

The Treasury Regulations[31] provide that a supporting organization must meet each of the following four requirements:

1. *The Control Test*. A combination of statutes and regulations describe three alternative requirements for the control of a supporting organization, one of which must be met:

- the supporting organization must be operated, supervised or controlled by the supported organization (commonly known as a “Type I supporting organization”) (the regulations provide that the requirement is satisfied if the supporting organization has a majority of its directors appointed by the supported organization); or
- the supporting organization must be supervised or controlled in connection with the supported organization (commonly known as a “Type II supporting organization”) (the regulations provide that the requirement is satisfied if the control or management of the supporting organization is vested in the same persons that control or manage the supported organization); or
- the supporting organization must be operated in connection with the supported organization (commonly known and now defined in the Code as a “Type III supporting organization”); the regulations pro-

[31] Reg. §1.509(a)-4.

vide that the requirement is satisfied by complying with a notification requirement[32] and meeting each of the following two further tests:

a. *Type III Responsiveness Test.* One of the following three relationships must result in the supported organization having a *significant voice* in the supporting organization's investment policies and the use of the supporting organization's income and assets: (i) the supported organization has the right to appoint or elect at least one officer, director or trustee of the supporting organization; or (ii) at least one officer, director or trustee of the supporting organization is in fact a member of the governing body of the supported organization; or (iii) the directors, officers or trustees of the supporting organization maintain a close and continuous relationship with the directors, officers or trustees of the supported organization.

b. *Type III Integral Part Test.* A supporting organization must show that it has significant involvement in the operations of the supported organization and that the supported organization is dependent upon the supporting organization for support. Regulations provide that this requirement can be met in one of two ways: either (i) the supporting organization must show that it provides a certain amount of support each year[33] to the supported organization and the amount of support is sufficient to ensure the attentiveness of the supported organization to the supporting organization's operations;[34] or (ii) the supporting organization

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[32] For each taxable year, a Type III supporting organization must provide certain information to its supported organization(s). Reg. §1.509(a)-4(i)(2) (requiring submission of a written notice following certain formalities and outlining support provided for the past year, a copy of the supporting organization's latest Form 990, and updated copies of its governing instruments if not previously provided).

[33] The required distribution amount is the greater of (i) 85 percent of the supporting organization's adjusted net income for the preceding taxable year, and (ii) 3.5 percent of the fair market value of its non-exempt-use assets in the preceding taxable year. Reg. §1.509(a)-4(i)(5)(ii); Reg. §1.509(a)-4(i)(6) (providing guidance on what distributions and expenses count towards this distribution requirement).

[34] At least one-third of the distributable amount must be distributed to one or more supported organizations that are attentive to the supporting organization

shows that substantially all of its activities consist of performing one or more important functions of the supported organization and that, but for its activities, the supported organization would have to conduct those activities itself.[35] Supporting organizations that satisfy the Integral Part Test in the latter way (by directly performing such functions of the supported organizations) are called "functionally integrated Type III supporting organizations."[36] Those that satisfy this test by providing financial support are called "non-functionally integrated Type III supporting organizations," and (unlike functionally integrated Type III supporting organizations) are subject to many of the rules and restrictions applicable to private foundations.[37]

2. *The Organizational Test.* The supporting organization's organi-

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and to which the supporting organization is responsive. A supported organization is "attentive" to the supporting organization if (i) the support provided amounts to at least 10 percent of the supported organization's total support (or, for a university, hospital, or church, of the total support of the particular department or school of the organization to which the distributions are made), (ii) the support is necessary to avoid the interruption of a particular substantial function or activity for which the funds are earmarked, or (iii) based on all of the facts and circumstances, there is evidence of actual attentiveness to the supporting organization's activities by the supported organization. Reg. §1.509(a)-4(i)(5)(iii).

[35] *See* Reg. §1.509(a)-4(i)(4)(ii) (defining "substantially all" and "directly further"). The aspects of the Integral Part Test (the "attentiveness" subtest and the "but for" subtest) have been litigated at the Tax Court by an organization seeking and failing to be found to be a supporting organization. *See* Lapham Foundation v. Comm'r, T.C. Memo 2002-293, where the court found that the supported organization would have conducted its own exempt activities whether or not the supporting organization helped out, and where, in any event, the support was too insignificant to guarantee the attention of the supported organization.

[36] IRC §4943(f).

[37] Distributions from private foundations to non-functionally integrated Type III supporting organizations are not qualifying distributions for purposes of satisfying a private foundation's required annual distributions under IRC §4942 and may be treated as taxable expenditures under IRC §4945. Such organizations are also subject to the excess business holdings rules for private foundations (IRC §4943), and are not eligible to receive direct charitable rollovers from IRAs.

zational documents (articles of organization and by-laws) cannot empower the supporting organization to conduct activities beyond the scope of its support for the supported organization, and cannot permit the supporting organization to support any other organization.

3. *The Operational Test.* All of the supporting organization's activities must be in support of, or for the benefit of, the supported organization (or, if the supported organization is not specified by name in the documents, the class of organizations that is so specified). In addition, the supporting organization may not financially benefit any organization other than the supported organization (or the class of organizations that is so specified).

4. *The "No Control by Disqualified Persons" Test.* The supporting organization cannot be controlled (directly or indirectly) by any substantial contributors or persons or organizations related to substantial contributors. In addition, Type I and Type III supporting organizations will lose their status as supporting organizations if they accept any gift or contribution from a person who controls (alone or in conjunction with related parties) the *supported* organization.[38]

Donor-Advised Funds. A donor-advised fund (DAF) is a charitable giving program sponsored by a public charity that gives a donor an ongoing role over the DAF even after the charitable contribution is complete.[39] Charitable community foundations (such as the Boston Foundation, the New York Community Trust, and the Silicon Valley Foundation) typically sponsor donor-advised funds, where they agree with a donor to hold and invest donated funds in separate accounts (bearing the donor's name, if the donor so wishes), with each donor advising the charity on how and when the funds in his or her separate account should be distributed among other charities.[40] Many financial service institutions also sponsor charitable organizations that host donor-advised funds.

Advantages of using a donor advised fund include:

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[38] IRC §509(f).
[39] IRC §4966(d)(2).
[40] Reg. §1.170A-9(e)(10)-(14).

- The ability to claim the donor's income tax charitable deduction in the year that the DAF is funded, even though the distributions to charities will be made over several years; this outcome is particularly attractive in years when the donor is otherwise facing large income tax obligations;
- Compared to a private foundation, a DAF is less expensive to create and maintain (a private foundation requires an initial application for tax-exempt status and annual federal and state filings);
- DAFs allow donors to give anonymously, whereas private foundation tax returns are readily available through services such as Guidestar and disclose not only the charitable organizations supported by the foundation but also the identity of, and amounts contributed by, each donor to the foundation.
- As a public charity, a DAF offers more favorable income tax deductions to donors than does a private foundation: first, gifts to a DAF of appreciated property (long-term gain) are deductible at fair market value, while gifts of such property to a private foundation generally provide a fair market value deduction only if the gift is of publicly-traded stock—otherwise the deduction is limited to the donor's basis in the gifted property; second, the limits on the amount of taxable income that may be offset by the charitable deduction in any one tax year are more generous for gifts to a DAF than for gifts to a private foundation;
- Community foundations and other DAF sponsors offer donors access to resources that can lead to satisfying and strategic philanthropy, including methods to facilitate family philanthropy.

In recent years, the IRS has tightened its oversight of DAFs. The rules impose penalties on both a DAF and its managers if a DAF distribution is made for non-charitable purposes.[41] In addition, a penalty is imposed where a DAF provides more than an incidental benefit to a donor of the DAF or to the grant advisors of a DAF.[42] The intermediate sanctions rules (described below) have been expanded to include DAFs, bringing more scrutiny to transactions between a DAF and its donors, its grant advisors, and even its investment advisors.[43] In addition, the ban against

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[41] IRC §4966(a).
[42] IRC §4967(a); IRS Notice 2017-73.
[43] IRC §4958(c)(2).

excess business holdings applies to DAFs as well as private foundations.[44]

Intermediate Sanctions. Public charities and donors to public charities should be aware of the so-called "intermediate sanctions," so dubbed because they are intended to curb the abuses that are not considered egregious enough to warrant a revocation of the organization's tax-exempt status. These provisions impose substantial penalties against any person "in a position to exercise substantial influence over the affairs of the organization" if such person engages in an "excess benefit transaction" with the organization.[45] Regulations indicate that being a substantial contributor (one who donates more than 2 percent of the organization's support in any one year) is a factor that tends to show substantial influence; and that such influence is held by a director or officer (and anyone else having similar powers and responsibilities) but only if such person is aware of the rule against excess benefit transactions and negligently fails to ascertain whether an excess benefit transaction exists in the face of facts sufficient for a reasonable person to conclude that there is in fact an excess benefit.[46] Excess benefit transactions include any compensation arrangement where the person with such influence receives from the organization compensation and any other economic benefits that exceed the fair market value of services provided to the organization; the term also includes any financial transaction where the person with such influence receives from the organization an economic benefit in excess of the fair market value of money or goods provided to the organization.[47]

Regulations also provide "safe harbor" protection to organizations

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[44] IRC§4943(e).

[45] IRC §4958.

[46] Reg. §53.4958-3(c), (e).

[47] IRC §4958(c); Reg. §53.4958-4. The term "excess benefit transaction" includes any grant, loan, compensation or similar payment from a supporting organization to a substantial contributor (or related person), or from a donor-advised fund to any donor or donor-designated advisor (or related person), regardless of whether the payment is reasonable and not in excess of the value of the services provided by such person; similarly, there is an automatic excess benefit transaction regarding any loan from a supporting organization to its other disqualified persons (anyone in a position to exercise substantial influence over the supporting organization). IRC §4958(c)(2)-(3).

(other than supporting organizations and donor-advised funds), providing that compensation and transactions will have a rebuttable presumption of reasonableness if (1) they are approved in advance by the organization's governing body (or authorized committee) composed of members not conflicted in the matter, (2) there is available to such decision makers some data of comparable compensation or fees incurred by unrelated organizations, and (3) the basis for the decision made is documented.[48]

Even if compensation is reasonable and is sufficiently supported, under new rules the organization may be subject to tax on that compensation if it is in excess of $1 million, or is in the nature of a severance payment and is more than three times the employee's base salary over the previous five years (an "excess parachute payment").[49] This excise tax is independent of and in addition to the intermediate sanctions rules.

Regulations provide that the IRS has discretion to impose intermediate sanction penalties, revoke an organization's tax-exempt status, or both, and that facts relevant to such determination include whether there have been repeated excess benefit transactions, the size and scope of such transactions, whether safeguards against future violations have been put into place, and whether there has been compliance with other applicable laws.[50]

Limitations on Global Funding. The U.S. Department of Treasury maintains a list of countries in which it is illegal to conduct business or even make charitable grants.[51] In addition, the Treasury Department has issued an advisory entitled "Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-based Charities,"[52] which contains suggestions that are much-criticized for being overbearing and effectively discouraging global philanthropy by anyone but the largest of grantmaking foundations. The Guidelines recommend that before funding a foreign organization, donors (including U.S.-based public charities) must collect basic information, conduct basic vetting of the grantee's

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[48] Reg. §53.4958-6.

[49] IRC § 4960, effective for taxable years beginning after December 31, 2017.

[50] Reg. §1.501(c)(3)-(1)(g).

[51] *See* www.treas.gov/offices/enforcement/ofac/sdn.

[52] *See* www.treasury.gov/press-center/press-releases/Documents/0929%20 finalrevised.pdf.

personnel, and review the grantee organization's financial operations, all as summarized below:

(i) Collect basic information about the grantee:

- organization's name in English and in its language of origin, any acronyms used in jurisdictions in which it operates, with addresses and local phone numbers;
- copies of the grantee's governing documents and information about its founders;
- a detailed report of the organization's purposes, projects and goals;
- names and addresses of the organizations to which the grantee organization provides (or proposes to provide) funds, services, or material support, to the extent reasonably discoverable;
- names and addresses of any subcontracting organizations used by the grantee organization;
- copies of any of the grantee organization's public filings and annual reports;
- financial data of the grantee organization, including sources of income.

(j) Conduct basic vetting of the grantee:

- research public information about the grantee to determine any connection to terrorism or terrorist financing;
- the grantee must not be on any OFAC prohibited parties lists; consider similar lists of other nations created pursuant to United Nations Security Council Resolution 1373;
- obtain names, nationality, citizenship, and place and date of birth of grantee organization's board members and key staff in every field office; check to be sure these names are not on the above lists;
- get certification from the grantee organization that it is in compliance with United States laws regarding OFAC prohibited parties lists; if the grantee is a foreign organization, the certification should state that the grantee does not deal

with any individuals, entities or groups on OFAC prohibited parties lists or who support terrorism.

Annual Reporting Requirements. Public charities (except for religious organizations) must annually file a federal tax return, which may be a Form 990, Form 990EZ, or Form 990-N, depending on the organization's gross receipts, and, in most states, must file some form of report with the Charities Division of the office of the Attorney General of the state in which the organization is based, and possibly of other states in which the organization is raising funds or performing activities. These returns contain information concerning the organization's activities and accomplishments, information on officers and directors and their compensation, and financial statements. These forms are open to public inspection, and donors considering a charitable contribution often review such reports as part of their investigation of an organization. In addition, if the charity has any "unrelated business taxable income" (e.g., income from regularly operating a commercial business, advertising revenue, income from certain debt-financed property, and the cost of certain fringe benefits provided to employees which, under the 2017 Tax Cuts and Jobs Act, are now treated as deemed unrelated business taxable income[53]), federal income tax must be paid with Form 990-T (and most states collect such tax as well).[54] Further, if the charity is a corporation, an annual report listing the current directors and officers must be filed with the Secretary of State's office for the state in which the organization is incorporated (and possibly for other states in which the organization is active). In general, a charitable organization should keep its records on hand for several years in order to comply with any requests for information by state or federal regulatory authorities.

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[53] *See* new IRC 512(a)(7), enacted as part of the 2017 Tax Cuts and Jobs Act, treating costs pertaining to certain transportation, parking and fitness benefits provided to employees as deemed unrelated business taxable income to the organization incurring those costs. This new rule will require many organizations that did not previously file the Form 990-T to begin filing that form to report this deemed "income" and pay the resulting tax.

[54] Under new IRC §512(a)(6), enacted as part of the 2017 Tax Cuts and Jobs Act, an organization can no longer use losses in one unrelated trade or business to offset unrelated income from a separate trade or business. This new rule will have the effect of increasing the unrelated business income tax exposure of many organizations.

Private Foundations

Overview. If a charitable organization cannot meet one of the tests for public charity status, it is automatically considered a private foundation.[55] Most private foundations are created by design to receive contributions from only one donor or one family or one corporation, and so their founders simply acknowledge private foundation status on Form 1023 and accept the consequences of private foundation status:

- Donors to private foundations follow different income tax deduction rules for their contributions;[56]
- Private foundations pay an excise tax on net investment income;
- Several penalty taxes apply to private foundations that fail to meet certain requirements; and
- Public disclosure rules are slightly different for private foundations.

Excise Tax on Net Investment Income. Although private foundations are exempt from federal income tax, they nevertheless pay tax under a special "excise tax"[57] intended to collect funds sufficient for the IRS to cover the costs of policing private foundations and enforcing the penalty tax system described below. The tax is 2 percent of the foundation's net investment income (including interest, dividends, rents, realized capital gains, less deductions for depreciation and expenses paid or incurred for the production of the income), but the rate can be reduced to 1 percent in certain circumstances where the foundation has distributed more than the minimum amount (described below) to other charitable organizations.

Minimum Distribution Requirement. Private foundations must annually distribute 5 percent of the net fair market value of the foundation's assets to accomplish one or more charitable purposes.[58] The computation of the 5 percent minimum distribution for a given fiscal year begins

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[55] IRC §§508(b), 509(a).
[56] *See* ¶1.04 *infra*.
[57] IRC §4940.
[58] IRC §4942.

after the close of the fiscal year when it is possible to value the foundation's assets using the average monthly value of marketable securities and average monthly cash balance and an annually updated appraisal of other assets (real estate may be re-valued every five years).[59] The value of the foundation's assets does not include cash on hand equal to 1.5 percent of the value of all foundation assets, in acknowledgement of the need to use cash for charitable distributions and miscellaneous operating expenses, nor the value of any assets used by the foundation in directly conducting its charitable purpose, such as kitchen equipment used by a foundation that operates a soup kitchen.[60] The 5 percent minimum distribution, once computed, is reduced by the amount of any excise tax on investment income. The resulting minimum distribution amount computed for a tax year must actually be distributed for charitable purposes by the end of the following tax year.[61] Distributions to public charities and private operating foundations will satisfy the distribution requirement, but distributions to other private foundations will not count toward satisfaction of the distribution requirement.[62] A private foundation's grant to a Type III supporting organization will count toward satisfaction of the distribution requirement only if the supporting organization is functionally integrated. Grants to Type I, Type II and Type III functionally integrated supporting organizations will not count toward satisfaction of the distribution requirement if a disqualified person with respect to the private foundation controls such supporting organization or if such a disqualified person controls any supported organization supported by such supporting organization.[63] A distribution to a foreign charity that is the equivalent of U.S.-based public charity or operating foundation will also satisfy the requirement if the equivalency is determined in good faith by the organization reasonably relying on a current opinion of a qualified tax practitioner (attorney, CPA or enrolled agent).[64] The dis-

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[59] IRC §4942(d), (e); Reg. §53.4942(a)-2(c).
[60] Reg. §53.4942(a)-2(c)(3).
[61] IRC §4942(d)(2).
[62] IRC §4942(g); Reg. §53.4942(a)-3.
[63] IRC §4942(g)(4).
[64] Reg. §53.4942(a)-3(a)(6); Reg. §53.4945-5(a)(5); Reg. §53.4945-6(c)(2)(ii); Rev. Proc. 2017-53. An organization is no longer permitted to rely on an affidavit of the foreign charity.

tribution requirement can also be satisfied by certain foundation expenses incurred to support charitable activity (salary or fees paid for administration of the foundation's charitable programs, travel and conference fees regarding a charitable strategy of the foundation, or legal fees associated with the foundation's grant making).[65] Shortfalls in the 5 percent minimum distribution must still be paid and will be subject to a 30 percent tax.[66]

> **EXAMPLE 1-6.** The Green family funds a private foundation with $1 million on October 15, 2018. They select the longest fiscal and tax year possible, ending on the following September 30, 2019. Before this first fiscal year is over, the foundation distributes $20,000 to charitable organizations. After the close of the fiscal year, the Greens value the foundation's assets for the fiscal year that has just ended, being sure to use the average monthly balances for cash (reduced as permitted) and marketable securities. The value is $1,060,000. The foundation also computes an excise tax of $1,000 on its net investment income for the year that has just ended. So with respect to the fiscal year that has just ended on September 30, 2019, the Greens must distribute (or spend on certain charitable expenses) at least $53,000 (5 percent of $1,060,000), less $1,000 of taxes due, which is $52,000; they have already distributed $20,000 of that amount, and the balance of $32,000 must be distributed to public charities or paid for charitable expenses before September 30, 2020.

Prohibitions on Self-Dealing. One of the most significant of the private foundation rules is the rule that prohibits self-dealing.[67] Self-dealing is described as virtually any transaction, direct or indirect, between a private foundation and a disqualified person. Disqualified persons generally include substantial contributors and the foundation's managers (directors, trustees, officers, key employees), and any person or entity related to such persons.[68] Prohibited transactions specifically listed include selling, leasing (except a rent-free lease to the foundation),

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65 IRC §4942(g)(4).
66 IRC §4942(a).
67 IRC §4941.
68 IRC §4946(a).

lending (except an interest-free loan to the foundation), furnishing of goods or services (except the donation of goods or services to the foundation), and payment of compensation by the foundation (except reasonable, "not excessive," compensation).[69] The rule against self-dealing generally provides no exceptions for a prohibited transaction, even if the transaction was fair or even favorable to the foundation.[70] The penalty assessed to a disqualified person who engages in self-dealing with a foundation is 10 percent of the amount involved in the self-dealing.[71] A foundation manager who participates in an act of self-dealing is subject to an excise tax of 5 percent of the amount involved in the self-dealing if the manager's participation was willful and without reasonable cause.[72] An additional tax of 200 percent of the amount involved in the self-dealing is imposed on the disqualified person, and 50 percent of such amount on the foundation manager, if the self-dealing is not corrected in a timely fashion.[73]

> **EXAMPLE 1-7.** Marge and Bob funded their foundation with cash and have invested in a diverse portfolio of securities. Their investment advisor suggests that the foundation's portfolio should have some real estate investments as a hedge against inflation. Their son Tim just bought a fully leased office building in a negotiated deal for $10 million, but would be willing to sell it to the foundation for only $5 million and take a charitable contribution deduction for the difference. However, any sale between Tim and the foundation, regardless of price, is prohibited self-dealing.

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[69] IRC §4941(d)(1), (2).

[70] *But see* Reg. §53.4941(d)-1(b) for a rule permitting an estate in administration to deal with disqualified persons prior to distributing estate assets to a foundation. Interestingly, the IRS ruled that the pro rata partition of undivided interests in real estate among a private foundation and disqualified persons is not self-dealing, Ltr. Rul. 200350022, and that an early termination of a charitable remainder trust, with the disqualified person receiving payment for the sale of his income interest to the charitable remainderman, is not self-dealing, Ltr. Rul. 200552015.

[71] IRC §4941(a)(1).

[72] IRC §4941(a)(2).

[73] IRC §4941(b).

Prohibition on Excess Business Holdings. A private foundation is generally not permitted to control, together with disqualified persons, more than 20 percent of certain active businesses,[74] which becomes an issue when an individual wishes to contribute a substantial interest in a family business to a private foundation and have that interest retained by the foundation. However, the foundation is given five years within which to dispose of gifts and bequests of business interests that would otherwise cause an excess business holding problem.[75]

Under a special exception to these rules enacted on February 9, 2018, a private foundation can hold certain business interests that under prior law would have been treated as excess business holdings as long as the following conditions exist:

- One hundred percent of the voting stock is held by the private foundation, all of which was acquired by gift or bequest, not purchase.
- All of the net profits of the business (other than a reasonable reserve) are distributed to the foundation no later than 120 days after the close of the taxable year; and
- The business is operated independently of the foundation.[76]

Limitations on High-Risk Investment of Foundation Assets. A private foundation must not invest its assets in such a manner that jeopardizes the carrying out of its exempt purpose.[77] An investment is considered to jeopardize the carrying out of exempt purposes if the foundation manager, in making the investment, has failed to exercise ordinary business care and prudence in providing for the long-term and short-term

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[74] IRC §4943.

[75] IRC §4943(c)(6). In addition, the IRS may extend this period for an additional five years. IRC §4943(c)(7).

[76] IRC §4943(g), enacted as part of the Bipartisan Budget Act of 2018. A business is treated as operated independently of the foundation where (1) no substantial contributor to the foundation (or family member) is a director, officer, manager, employee or contractor of the business, (2) at least a majority of the foundation's directors are persons who are not directors or officers of the business (or family members of a substantial contributor to the foundation), and (3) there is no loan outstanding from the business to a substantial contributor to the foundation (or any family member).

[77] IRC §4944.

financial needs of the foundation to carry out its exempt purposes, under the facts and circumstances then prevailing.[78] Without giving certain examples of imprudent investments, the regulations state that methods of investment which will be closely scrutinized include trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of derivative securities such as puts, calls, and straddles, the purchase of warrants, and selling short.[79]

A program-related investment that furthers a private foundation's exempt purpose is not a jeopardizing investment.[80] An investment is program-related if: (i) its primary purpose is to accomplish one or more religious, educational, or other charitable purposes; (ii) no significant purpose of the investment is the production of income or the appreciation of property; and (iii) no purpose of the investment is attempting to influence legislation or intervening in any political campaign.[81] On May 9, 2016, the IRS issued final regulations providing guidance on program-related investments.[82] The new regulations include several detailed examples and provide that an investment is made primarily to accomplish one or more exempt purposes if it significantly furthers the accomplishment of the foundation's exempt activities and would not have been made but for the relationship between the exempt activities and the investment. For example, a foundation committed to combat inner-city deterioration could invest in a company located in a distressed area that provides jobs and training to economically disadvantaged people.

Many foundations participate in investments that may not meet the definition of a program-related investment, but that nevertheless have a purpose (in addition to generation of returns) that is consistent with the foundation's charitable mission. These sorts of investments are often referred to as "mission-related" investments. While there are no regulations or other forms of guidance on which an organization may rely regarding when a mission-related investment may run afoul of the jeopardizing investment rules, the IRS has acknowledged that a private foundation may consider the relationship of a particular investment to the

[78] Reg. §53.4944-1(a)(2).
[79] Reg. §53.4944-1(a)(2).
[80] IRC §4944(c).
[81] Reg. §53.4944-3.
[82] Reg. § 53.4944-3

foundation's exempt purposes in determining whether the investment is prudent.[83]

Taxable Expenditures. A private foundation must avoid certain "taxable expenditures."[84] Taxable expenditures are amounts paid by a private foundation:

- For influencing legislation or public elections or for other noncharitable purposes;[85]
- As grants to individuals for travel or study unless they are awarded on an objective and nondiscriminatory basis in accordance with procedures approved in advance by the IRS;[86] or
- As grants to other private foundations, foreign charities or noncharitable organizations without exercising *expenditure responsibility*.[87]

"Expenditure responsibility" requires the foundation to exert all reasonable efforts and establish adequate procedures: (1) to see that the grant is spent solely for the purpose for which it was made; (2) to obtain full and complete reports from the grantee on how the funds are spent; and (3) to make full and detailed reports on the expenditures to the IRS.[88] To avoid the extra complications of exercising expenditure responsibility, many private foundations make grants only to public charities.

Also excused from the definition of taxable expenditure is a distribution to a foreign charity that is the equivalent of a U.S.-based public charity or operating foundation where the equivalency is determined in good faith by the organization reasonably relying on a current opinion of a qualified tax practitioner (attorney, CPA or enrolled agent).[89]

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[83] IRS Notice 2015-62.

[84] IRC §4945.

[85] IRC §4945(d).

[86] IRC §4945(g).

[87] IRC §4945(h).

[88] Reg. §53.4945-5. The expenditure responsibility procedures can be set forth in a grant agreement between the private foundation and the non-public charity grantee. Ltr. Rul. 200603031.

[89] Reg. §53.4945-5(a)(5); Reg. §53.4945-6(c)(2)(ii); Rev. Proc. 2017-53. An organization is no longer permitted to rely on an affidavit of the foreign charity. In addition, a distribution to a foreign organization treated as a partial or

Limitations on Global Funding. Private foundations are subject to the same scrutiny with respect to funding global organizations as are public charities (described above).

Annual Reporting Requirements. Private foundations are subject to the same reporting requirements as are public charities, except that they file IRS Form 990-PF, rather than Forms 990, 990-EZ or 990-N.

Private Operating Foundations

In General. Some private foundations directly conduct the charitable activity that constitutes their exempt purpose, either in addition to or in lieu of making grants to public charities. If a substantial portion of a foundation's income or assets is devoted to such direct conduct of charitable activity, the foundation can qualify as an "operating foundation"[90] and it will not be subject to the five percent minimum distribution rule.[91] In addition, donations to operating foundations will qualify the donor for the more attractive income tax deduction rules that normally apply only for gifts to public charities (described below).

To qualify as an operating foundation, an organization must satisfy the "income test" and any one of three other tests, known as the "asset test," the "endowment test," and the "support test."

Income Test. To satisfy the income test, a foundation must make *qualifying distributions* that are *directly for the active conduct* of its exempt purpose which are equal to *substantially all* of the lesser of (i) its *adjusted net income,* or (ii) its *minimum investment return*.[92]

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complete termination of a private foundation under the rules of IRC §507 and Reg. §1.507-3(c) (i.e., a distribution or series of related distributions amounting to 25 percent or more of the fair market value of the organization's assets) must be held in a separate fund by the grantee devoted exclusively to purposes described in IRC §170(c)(2)(B), and must comply with the expenditure responsibility rules regardless of whether an equivalency determination is made. *See* Reg. §53.4945(a)-6(c)(2)(ii) and Rev. Proc. 2017-53.

[90] IRC §4942(j)(3).

[91] IRC §4942(a)(1).

[92] Reg. §53.4942(b)-1.

- *Qualifying Distributions* are distributions and expenditures made to accomplish a charitable purpose;

- *Directly for the active conduct* of the foundation's own exempt purposes and programs means, generally, that the foundation administers and provides the charitable activity itself instead of funding others to do it. Examples of qualifying distributions directly for the active conduct of exempt purposes include:

  - Wages paid to staff, including program specialists, researchers, teachers, administrators, or other personnel who supervise, direct, and carry out the foundation's programs on a continuing basis;

  - The cost of acquiring and maintaining assets used in the foundation's programs, such as buildings, collections of specimens and art objects, research laboratories, books and other publications, computer programs and hardware, and other project supplies, such as food to feed the poor;

  - The cost of administering the foundation's programs, such as telephone and utilities bills, insurance premiums, and professional advisors' fees attributable to active (non-grantmaking) programs;

- *Adjusted Net Income* is gross income for the year, including investment income and other revenues from charitable and non-charitable activities but excluding long-term capital gains, reduced by ordinary and necessary expenses paid or incurred for the production or collection of gross income;

- *Minimum Investment Return* is roughly equal to 5 percent of the value of the foundation's assets (but *not* counting assets that are used directly for the active conduct of the foundation's exempt purpose);

- "*Substantially all*" of adjusted net income or minimum investment return means at least 85 percent of such amounts.

Asset, Endowment, and Support Tests. In addition to the income test, an operating foundation must meet one of three alternative tests: the asset test, the endowment test, or the support test.

- *Asset Test*: The asset test requires that substantially more than half of the foundation's assets be devoted directly to the active conduct of either (i) activities constituting the foundation's exempt purpose, or (ii) functionally related businesses.[93]

- *Endowment Test*: A foundation satisfies the endowment test when it makes qualifying distributions directly for the active conduct of its tax-exempt activities in an amount equal to at least two thirds of its minimum investment return. All definitions and requirements in the endowment test parallel those of the income test, so that an organization that satisfies the income test by expending at least 85 percent of its minimum investment return on the direct conduct of charitable activity will always satisfy the endowment test.[94]

- *Support Test*: The support test requires that (i) at least 85 percent of the foundation's *support* (when such support is computed not counting gross investment income) be from the *general public* and/or exempt organizations, (ii) not more than 25 percent of the foundation's *support* (again when such support is computed not counting gross investment income) be from any one exempt organization, and (iii) not more than 50 percent of all *support* be from gross investment income. The support test would appear to be applicable to an organization that fails to qualify as a public charity only because a substantial part of its public support includes gross receipts from admission to an exempt activity while it receives more than one third of its support from gross investment income.[95]

Pass-through Foundations. Donations to a private foundation that is a pass-through foundation can qualify for the more attractive in-

93 Reg. §53.4942(b)-2(a).
94 Reg. §53.4942(b)-2(b).
95 Reg. §53.4942(b)-2(c).

come tax deduction normally applicable only to gifts to public charities.[96] Pass-through foundations, which are still generally subject to the excise tax and penalty taxes applicable to private foundations, must pay out to public charities, within two and a half months of the close of a tax year, 100 percent of the contributions received during the year.[97]

Giving to Existing Charities or Creating Your Own Charity. An individual who intends to make a charitable gift has the opportunity to develop a philanthropic strategy. Sometimes the strategy simply calls for outright gifts to charitable organizations that can (or at least are attempting to) accomplish the donor's philanthropic wishes. Other times, however, the donor must first create the charity to meet the strategic goals. Common reasons for creating a charity are: no other charity is addressing the selected issue in the donor's preferred manner; part of the donor's vision of philanthropy is to conduct it as a family with thoughtful meetings and decision making by consensus, so a private foundation or one of its alternatives may be appropriate; the donor wants to give away and deduct more cash or property today than he or she is prepared to actually hand over at one time to charities—parking such gifts in a private foundation or donor-advised fund may be the answer; or the donor would part with the funds (say, to a charity's endowment fund), but wants to retain control over investment decisions. In each case, the donor must determine the degree of control desired after the gift is made. If control is important, the donor must then decide whether to abide by the rules governing private foundations, or whether an alternative public charity is warranted.

¶1.04 INCOME TAX DEDUCTION

Overview. Gifts of cash and other property to U.S.-based charitable organizations are generally deductible for income tax purposes, as itemized deductions.[98] However, as discussed below, the deduction is

96 IRC §170(b)(1)(E)(ii).
97 IRC §170(b)(1)(E)(ii).
98 IRC §63(d). Taxpayers who do not itemize deductions, but instead elect the standard deduction, do not receive any income tax benefit from making charitable contributions. Under the 2017 Tax Cuts and Jobs Act, the standard deduction has been temporarily increased (effective from 2018 through 2025), to

subject to numerous limitations depending on whether cash or appreciated property is donated, whether the charity receiving the gift is a public charity or private foundation, and the amount of the donor's adjusted gross income.

When speaking to a client regarding the planning of a charitable gift, an estate planner must gather the following information:

- What is the donor receiving in return for the gift?
- Is the donor giving cash, appreciated property, or depreciated property?
- Would a sale of any donated property be eligible for long-term capital gain treatment?
- What is the donor's adjusted gross income and marginal tax bracket?
- Is the charitable organization classified as a public charity or a private foundation, and if it is a new organization to be established, is it possible to design it to qualify as a public charity?

Qualification for Deduction

Receipt of Value in Return for Gift. It has long been the rule that a donor may not deduct a gift to charity to the extent that the donor receives value back from the charity.[99] Certainly (and this may come as news to many donors and even some charitable organizations) if a donor buys a painting at a charitable auction for half of the painting's fair market value, there is no charitable deduction to the donor because she received back more than she paid to the charity (and it is irrelevant that the charity may have received the painting as a donation for the auction). Similarly, if an individual pays $100 to attend a benefit performance for a charity and tickets to such a performance would sell for $25, then her charitable contribution is limited to $75. A perception of rampant neglect of this rule led to stricter regulations. For gifts as small as $75, charitable organizations must now inform a donor of the estimated value

$12,000 for single filers (or married filing separately), $18,000 for head of household, and $24,000 for married filing jointly (in each case, to be adjusted for inflation in future years). IRC §63(c)(2); Rev. Proc. 2018-18.

[99] Reg. §1.170A-1(h).

of any goods or services received in return for the gift.[100] Under a special rule enacted as part of the 2017 Tax Cuts and Jobs Act, contributions to higher education institutions in exchange for the right to purchase tickets for seating at athletic events are no longer deductible.[101]

Substantiation of Gift. In order to deduct any gift of $250 or more, taxpayers must have a receipt from the charitable organization acknowledging the donation (a canceled check is not sufficient), and the acknowledgment must describe and state the value of any goods or services received by the donor in return for the contribution.[102] There is an exception for goods or services having a value of less than 2 percent of the amount of the gift (capped at an amount that is indexed for inflation each year – for 2018, the limit is $108); in addition, certain token "low-cost" ($10.80 or less in 2018) gifts to donors may also generally be disregarded.[103] The acknowledgment must be received on or before the earlier of the date the donor files his tax returns for the calendar year of the donation or the due date for filing such return.[104]

Required Description and Appraisal of Gift. For contributions of property valued at more than $500, in order to substantiate the claim of an income tax deduction, the tax return must adequately describe the property.[105] For contributions of property valued at more than $5,000, the taxpayer must obtain a "qualified appraisal." A qualified appraisal is a formal written valuation by an appraiser who has earned an appraisal designation from a recognized professional organization or has otherwise met minimum education and experience requirements, who has qualifications to make an appraisal of the type of property being valued,

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[100] IRC §6115.

[101] IRC §170(l). Previously, a donor could deduct up to 80 percent of such amounts (effectively valuing the ticket purchase rights received in exchange for the contribution as worth 20 percent of the total contribution).

[102] IRC §170(f)(8). For all charitable donations, including gifts under $250, the taxpayer must have some form of substantiation—a cancelled check, a credit card statement, or a receipt from the charity. IRC §170(f)(13).

[103] Reg. §1.170A-13(f); Rev. Proc. 90-12; Rev. Proc. 2018-18, Sec. 3.30(2) (establishing *de minimis* low-cost articles, payment and benefit thresholds below which amounts need not reduce the charitable deduction).

[104] IRC §170(f)(8)(c).

[105] IRC §170(f)(11).

who holds herself out to the public as an appraiser and regularly performs appraisals for compensation, and who is not related to the donor or donee.[106]

Limitations Affecting Gifts of Appreciated Property. Donors to charity often like to contribute appreciated property (long-term gain) rather than cash, because the charity can sell the appreciated property and, being tax-exempt, it will not pay any income tax on realized gain.[107] This can often produce significant tax benefits.

EXAMPLE 1-8. A donor has $1,000 of cash and $1,000 of stock for which she paid $400. If the donor needs some funds for her own use, she could either:

- Donate the cash and keep the stock, which she sells:

Amount realized on sale	$1,000
Donor's basis in stock	(400)
Donor's gain on sale	$600
Donor's tax on gain (25.25% federal and state combined rate)	$151
Net proceeds	$ 849

- Keep the cash and donate the stock, which the charity sells:

Amount realized on sale	$1,000
Donee's basis in stock	(400)
Donee's gain on sale	$600

106 IRC §170(f)(11)(C)-(E).

107 Donors of appreciated property that will be subject to a sale in the hands of a charity must part with control early enough to avoid the assignment of income doctrine that will apply if the realization occurs only after the donor already has a fixed right to the gain. In Ferguson v. Comm'r, 174 F.3d 997 (9th Cir. 1999), the donor contributed stock to charity too late, after a tender offer had been announced by an acquiring corporation and after the acquiring corporation had acquired a majority of the target corporation's stock, thus removing any meaningful contingency prior to the tender of the remaining stock.

Donee's tax on gain (donee is tax-exempt)	0
Net proceeds	$1,000

NOTE: There are limitations on a donor's ability to fully deduct the value of appreciated property that apply with respect to gifts of short-term capital gain property and some gifts of long-term capital gain property.

Gifts of Short-Term Capital Gain Property. With respect to gifts of appreciated property that, if sold, would result in short-term capital gain (the donor has held the property for one year or less), only the donor's basis (generally, the amount paid by the donor) is deductible, not the portion of the property's value representing the gain.[108] There are exceptions for gifts of inventory and computer equipment used for certain purposes.[109]

EXAMPLE 1-9. Maura is a day-trader in stocks, and has a talent for buying and selling quickly to make a profit. She would like to donate one of her short-term holdings that she bought for $1,000 and that has gone up to $10,000, to avoid the ordinary income tax on short-term capital gain of $9,000 that she would pay if she were to sell the stock. Her income tax charitable deduction, however, will be limited to her $1,000 basis in the stock.

Gifts of Long-Term Capital Gain Property. With respect to gifts of appreciated property that, if sold, would result in long-term capital gain (the donor has held the property for more than one year), the full fair market value of the property may be deducted if the gift is to a public charity, donor-advised fund or private operating foundation.[110] However, if the gift is to a private non-operating foundation, the full fair market value of the property may be deducted only if the gift is of publicly

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[108] IRC §170(e)(1)(A).
[109] IRC §170(e)(3), (6).
[110] IRC §170(e)(1) by inference.

traded stock.[111] The income tax deduction for gifts to a private non-operating foundation of long-term capital gain property consisting of closely held stock, or of bonds, real estate, or partnership interests, is limited to the donor's basis in the property.[112]

> **EXAMPLE 1-10.** Steve bought a commercial building ten years ago for $200,000 and he is thinking of selling it now for $500,000, and wonders whether he should first give it to a charity and have the charity sell it, so that the $300,000 gain will not be taxed to him or to the charity (the charity is tax-exempt). Steve would like to maintain some control over the charity's investments and disbursements and is thinking of setting up a family foundation to receive the gift. While such a gift may avoid the capital gains tax on the sale, Steve's income tax deduction will likely be limited to his basis in the building of $200,000 because his new charity will be a private foundation. An alternative to a private foundation may permit Steve to deduct the building's full fair market value of $500,000, such as a gift to a supporting organization or a donor-advised fund.

Limitations on Gifts of Tangible Personal Property. One exception to the above rule that long-term capital gain property is fully deductible if given to a public charity arises with a gift of tangible personal property. The deduction for a gift of tangible personal property is limited to the donor's basis in the property even if the organization is a public charity unless the organization's use of the property is related to its tax-exempt purpose.[113] For gifts of tangible personal property to a private foundation, the same rules applicable to any gift of appreciated property

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[111] IRC §170(e)(1)(B), (e)(5).

[112] IRC §170(e)(1)(B)(ii).

[113] IRC §170(e)(1)(B)(i). The rules take aim at abuse in this area: if the public charity disposes of the related-use tangible personal property within the same year as the contribution, the deduction is limited to the donor's basis (IRC §170(e)(1)(B)(i)(II)); and if the disposition by the charity takes place within three years of the donation, the donor will have recapture of a portion of the deduction relating to gain in the property (IRC §170(e)(7)(A)). In both cases the result can be avoided if the charity certifies that the property's use was in fact related to the charity's exempt purposes. IRC §170(e)(7)(B).

apply: the deduction is limited to the donor's basis (even if the foundation were to use the property in accomplishing its charitable purpose).[114]

> **EXAMPLE 1-11.** Julia bought a painting for $200,000 that has appreciated to $1 million. She is thinking of donating it either to the American Red Cross (which will sell it) or to the Museum of Fine Arts (which will keep it for its permanent collection). Her income tax charitable deduction will be limited to her basis in the painting ($200,000) if she gives it to the Red Cross. Julia may deduct the painting's full fair market value of $1 million if she gives it to the Museum of Fine Arts.

Limitations on Deductions

General Limitations. Once the amount of the charitable deduction is established, additional limitations may affect whether the whole deduction may be taken in one tax year, or whether only part of the deduction may be taken for the year of the gift with the balance being carried forward to future tax years. Congress did not intend for taxpayers to completely wipe out their adjusted gross income through the charitable deduction, so it limited the charitable deduction to certain percentages of the donor's contribution base each year.[115] The donor's *contribution base* is the donor's adjusted gross income without regard to any net operating loss carry-back.[116] The annual limitation is either 20 percent, 30 percent, 50 percent, or 60 percent of the donor's contribution base, with the percentage depending upon what kind of property is being given and what kind of charity is receiving it.[117] Excess contributions generally may be carried forward for up to five tax years.[118]

Subparagraph G Gifts – Gifts of Cash to a Public Charity. Under a new temporary rule enacted as part of the 2017 Tax Cuts and Jobs Act, for tax years after 2017 and prior to 2026 an individual donor may deduct up to 60 percent of her contribution base for gifts of cash to a public

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[114] IRC §170(e)(1)(A).
[115] IRC §170(b).
[116] IRC §170(b)(1)(H).
[117] IRC §170(b)(1).
[118] IRC §§170(d), 170(b), and Reg. §1.170A-10.

charity.[119] To qualify for the 60 percent threshold, such gifts must be "to" the public charity, not "for the use of" the public charity.[120] We will refer to cash gifts qualifying for the 60 percent limitation as "subparagraph G" gifts (with reference to IRC §170(b)(1)(G)).

Subparagraph A Gifts[121] *– Gifts to a Public Charity (other than Subparagraph G gifts, and subject to Subparagraph C).* Traditionally, all gifts to (not "for the use of") a public charity are subparagraph A gifts, provided that deductibility of gifts of short-term capital gain property is limited to the donor's cost basis, and deductibility of subparagraph C gifts (gifts of long-term capital gain property) is limited as described below. Under the new law, deductibility of cash gifts to public charities is now provided for primarily under subparagraph G. Other gifts to public charities fall under subparagraph A. An individual donor may deduct up to 50 percent of her contribution base, reduced by the amount of any subparagraph G deduction allowed, for subparagraph A gifts.[122]

Subparagraph B Gifts[123] *– Gifts of Cash and Short-Term Capital Gain Property to a Private Foundation, or Gifts "For the Use of" Public*

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[119] IRC §170(b)(1)(G) (increasing annual limitation to 60 percent for certain gifts, enacted as part of the 2017 Tax Cuts and Jobs Act but expiring on December 31, 2025). In addition, Congress occasionally passes disaster relief bills which suspend these annual limitations entirely for qualifying cash gifts to support affected disaster areas. *See*, e.g., Section 20104 of the Bipartisan Budget Act of 2018 (suspending adjusted gross income limitations for cash gifts made during a certain time period for the purpose of relief efforts in the California wildfire disaster area).

[120] Reg. §1.170A-8(a)(2). Many gifts in trust, including gifts to charitable lead trusts, are treated as contributions "for the use of" the recipient charity rather than "to" the charity, and therefore are subject to the lower 30 percent limitation for subparagraph B gifts. However, gifts to public charities of remainder interests in charitable remainder trusts are generally treated as gifts "to" the charity and therefore may take advantage of the higher 50 percent limitation for subparagraph A gifts (but not the 60 percent limitation under subparagraph G, which is available only for cash gifts).

[121] IRC 170(b)(1)(A).

[122] IRC §170(b)(1)(G)(iii)(II).

[123] IRC §170(b)(1)(B).

Charities. For gifts of cash or short-term capital gain property to a private foundation, and for gifts that are "for the use of" rather than "to" a public charity, an individual donor may deduct up to the lesser of (i) 30 percent of her contribution base or (ii) the excess of 50 percent (not 60 percent) of the donor's contribution base for the year over the combined amount of subparagraph G gifts and subparagraph A gifts (remember, the deduction for short-term capital gain property is limited to the donor's basis).

Subparagraph C Gifts[124] *– Gifts of Long-Term Capital Gain Property to a Public Charity.* Subparagraph C of IRC §170(b)(1) operates as a limitation on deductibility of subparagraph A gifts involving long-term capital gain property. Except for gifts of qualified conservation easements, an individual donor may deduct up to 30 percent of her contribution base for gifts of long-term capital gain property to a public charity.[125] Donors of qualified conservation easements may deduct up to 50 percent or, in certain circumstances, up to 100 percent of their contribution base.

Subparagraph D Gifts[126] *– Gifts of Long-Term Capital Gain Property to a Private Foundation.* For gifts of long-term capital gain property to a private foundation, an individual donor may deduct up to the lesser of (i) 20 percent of her contribution base and (ii) the excess of 30 percent of the donor's contribution base for the year over the amount of subparagraph C gifts (remember, only basis in long-term capital gain property is deductible unless the gift is of publicly traded stock).

Charitable Planning and Income Tax Planning. Individuals should plan charitable gifts in conjunction with other income tax planning in order to ensure that the full benefit of an income tax deduction for the gift can be enjoyed.

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[124] IRC §170(b)(1)(C).

[125] In 2015, the limitation was permanently increased to 50 percent of the donor's contribution base for gifts of qualified conservation easements, and any such contribution in excess of this expanded limit can be carried forward for up to 15 years. IRC § 170(b)(1)(E); Protecting Americans from Tax Hikes Act of 2015 (Pub. L. No. 14-113).

[126] IRC §170(b)(1)(D).

The following chart summarizes the percentage limitation rules described above:

MAXIMUM PERCENTAGE OF CONTRIBUTION BASE AVAILABLE FOR CHARITABLE DEDUCTION

	Gifts to Public Charities	*Gifts to Private Foundations*
Cash and Short-term Capital Gain Property	60 percent[127]	30 percent
Long-term Capital Gain Property	30 percent	20 percent

> **EXAMPLE 1-12.** Don has always given to charities, but never in such large amounts as compared to his income that he needed to worry about percentage limitations. This year he became a real estate investor and will have depreciation deductions that substantially reduce his adjusted gross income. He is thinking of donating to a hospital a building that he has held for more than one year. The full fair market value of the building will be deductible because the hospital is a public charity, but the deduction this year is limited to 30 percent of his contribution base since it is long-term capital gain property. Don's contribution base is $100,000 and the building is worth $200,000. Only $30,000 can be deducted this year. The remaining $170,000 can be carried forward and deducted over the next five years (again, subject to the donor's 30 percent limitations in those years).

Multiple Gifts in One Year. If an individual makes multiple charitable gifts in one year it will be necessary to determine the order in which different limitations apply to the contributions. Deductions for gifts to

[127] Reverts to 50 percent as of January 1, 2026, when IRC §170(b)(1)(G) expires. Note that because the statutes regarding limitations on deductions for gifts to private foundations were not updated, the effect of the higher 60 percent limitation is lost in many cases (see below). Unlike cash gifts, gifts of short-term capital gain property to public charities are subject to the 50 percent limitation.

both public charities and private foundations generally cannot in the aggregate exceed 60 percent of the donor's contribution base, and in many cases will be effectively limited to an aggregate of 50 percent of the donor's contribution base.

Because this temporary increase in the threshold for gifts to public charities to 60 percent was accomplished by a statute (subparagraph G) that interacts with the pre-existing threshold rules of subparagraphs A through D in a variety of ways, the new law has introduced considerable confusion regarding how mixed gifts are treated. Here are two examples of how this would work under the new tax law:

Examples Involving Cash and Short-Term Capital Gain Property Gifts Only

Example 1-13a: Mary has adjusted gross income of $100,000, and contributes $30,000 cash to a public charity (a subparagraph G gift), $10,000 of high-basis short-term capital gain property to a public charity (a subparagraph A gift, but with a deduction limited to cost basis), and $10,000 cash to a private foundation (a subparagraph B gift).

- The $30,000 cash contribution to the public charity is deductible in full during the year of the gift under subparagraph G, as it is less than 60 percent of Mary's contribution base.
- The $10,000 contribution of short-term capital gain property to the public charity is deductible in full under subparagraph A, as it is equal to the difference between $50,000 (50 percent of Mary's contribution base, the maximum under subparagraph A) and the subparagraph G contribution of $40,000 (which, under the rules of subparagraph G, reduces the subparagraph A deductible amount).
- The $10,000 contribution to the private foundation is also deductible in full under subparagraph B, as that amount is within the permitted limits (the lesser of $30,000, or 30 percent of Mary's contribution base, and $10,000, the difference between the 50 percent aggregate limit under subparagraph B ($50,000) and the combined subparagraph G and subparagraph A deductible amounts ($40,000)).

- **In all, the entire $50,000 contributed is allowed as a deduction in the tax year of the contribution.**

<u>Example 1-13b</u>: Mary has adjusted gross income of $100,000, and contributes $35,000 cash to a public charity (a subparagraph G gift), $20,000 of short-term capital gain property to a public charity (a subparagraph A gift), and $10,000 cash to a private foundation (a subparagraph B gift).

- The $35,000 cash contribution to the public charity is deductible in full during the year of the gift under subparagraph G, as it is less than 60 percent of Mary's contribution base.
- The $20,000 contribution of short-term capital gain property to a public charity is only deductible in the year of the gift up to $15,000, as the subparagraph A maximum ($50,000, or 50 percent of Mary's contribution base) is reduced under the subparagraph G rules by the $35,000 subparagraph G deduction, leaving only $15,000 of subparagraph A deduction left to be used.
- The $10,000 contribution to the private foundation is not deductible *at all* in the year of the gift under subparagraph B, even though the public charity donation is $5,000 below the 60 percent threshold.
    - This is because the rule for mixed gifts to public charities and private foundations in subparagraph B limits deductibility of the private foundation gift to the lesser of $30,000 (30 percent of Mary's contribution base) and $0 (the difference between (i) Mary's combined subparagraph G and subparagraph A gifts and (ii) 50 percent, not 60 percent, of Mary's contribution base).
- **In all, only $50,000 of the $65,000 contributed is allowed as a deduction in the tax year of the contribution**.
    - The unused subparagraph A and subparagraph B contributions may be rolled over and used as subparagraph A and subparagraph B deductions, respectively, for up to five subsequent years.

After applying the limitations in the order described above, the gifts to public charities must be revisited to be sure that any gifts of long-term capital gain property (subparagraph C gifts) do not exceed 30 percent of the contribution base.[128] If such gifts of long-term capital gain property are less than the 30 percent limit, then gifts to private foundations must also be revisited to be sure that gifts of long-term capital gain property (up to the lessor of (i) 20 percent of the contribution base and (ii) the excess of 30 percent of the donor's contribution base for the year over the amount of allowed subparagraph C gifts) do not push total gifts of long-term capital gain property beyond that 30 percent limit.[129]

Examples Involving Mixed Gifts of Cash and Capital Gain Property

Example 1-14a: Mary has adjusted gross income of $100,000, and contributes $20,000 cash to a public charity (a subparagraph G gift), $20,000 of long-term capital gain property to a public charity (a subparagraph C gift), $5,000 cash to a private foundation (a subparagraph B gift), and $5,000 of long-term capital gain property in the form of publicly traded stock to a private foundation (a subparagraph D gift).

- The $20,000 in cash contributions to the public charity is deductible in full under subparagraph G, as it is well below $60,000 (60 percent of Mary's base contribution amount).
- The $20,000 of long-term capital gain property to the public charity is deductible in full under subparagraph A as modified by subparagraph C (providing limits on how much of the subparagraph A limitation may be used by long-term capital gain property), as the amount is less than both the 50 percent limitation of subparagraph A reduced by the subparagraph G gifts (or $30,000) and the 30 percent limitation on gifts of long-term capital gain assets to public charities under subparagraph C (also $30,000).
- The $10,000 in cash contributions to the private foundation is also deductible in full under subparagraph B, as that amount is within the permitted limits (the lesser of $30,000, or 30 percent of Mary's contribution base, and $10,000, the

128 IRC §170(b)(1)(C)(i).
129 IRC §170(b)(1)(D)(i).

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difference between the 50 percent aggregate limit in subparagraph B ($50,000) and the combined subparagraph A and subparagraph G gifts ($40,000)).

- The $5,000 capital gain contribution to the private foundation is deductible in full, as that amount is within the permitted limits (the lesser of $20,000, or 20 percent of Mary's contribution base, and $10,000, or the excess of 30 percent of the donor's contribution base ($30,000) over the amount of subparagraph C gifts ($20,000)).
- **In all, the entire $50,000 contributed is allowed as a deduction in the tax year of the contribution.**

<u>Example 1-14a</u>: Mary has adjusted gross income of $100,000, and contributes $20,000 cash to a public charity (a subparagraph G gift), $35,000 of long-term capital gain property to a public charity (a subparagraph C gift), $5,000 cash to a private foundation (a subparagraph B gift), and $5,000 of long-term capital gain property in the form of publicly traded stock to a private foundation (a subparagraph D gift).

- The $20,000 in cash contributions to the public charity is deductible in full under subparagraph G, as it is well below $60,000 (60 percent of Mary's base contribution amount).
- The $35,000 of long-term capital gain property is deductible only up to $30,000 in the year of the gift. Subparagraph A only allows up to $30,000 of additional deductibility for gifts to a public charity, as the 50 percent limitation of subparagraph A ($50,000) must be reduced by the amount of any subparagraph G deduction ($20,000). Separately, the subparagraph C limitation (30 percent of Mary's contribution base) would also limit this deduction to $30,000.
- The $5,000 cash contribution to the private foundation is not deductible at all in the year of the gift, as subparagraph B limits that deduction to the lesser of $30,000 (30 percent of Mary's contribution base) and $0 (the excess of 50 percent of Mary's contribution base, or $50,000, over the combined subparagraph G and subparagraph A gifts, or $55,000).
- Similarly, the $5,000 contribution of long-term capital gain property to the private foundation is not deductible in the

year of the gift, as subparagraph D limits that deduction to the lesser of $20,000 (20 percent of Mary's contribution base) and $0 (the excess of $30,000, or 30 percent of Mary's contribution base, over $30,000, the amount of allowed subparagraph C deductions).

- **In all, only $50,000 of the $65,000 contributed is allowed as a deduction in the tax year of the contribution.**
    - The unused contribution amounts may be rolled over and used as deductions for up to five subsequent years, subject to the same contribution limits for such gifts in those future years.

For planning purposes, as long as a donor is willing to forego the higher 60 percent threshold established by the new law for subparagraph G gifts (cash gifts to public charities), a donor can maximize tax benefits and control over the charitable gifts by giving as much appreciated property as can be deducted to a private foundation, and then giving as much appreciated property as can be deducted to public charities, and then giving as much cash as can be deducted to the private foundation, and, finally, giving as much cash as can be deducted to public charities. However, donors seeking to take advantage of the higher 60 percent threshold should emphasize gifts of cash to public charities (which may include donor-advised funds).

Gifts by Corporations. For gifts by corporations of cash and appreciated property to any type of tax-exempt charitable organization (i.e., both public charities and private foundations), the percentage limitation is 10 percent of taxable income (computed after several adjustments).[130] However, contributions to charities by corporate donors are often deductible as business expenses rather than as charitable contributions.

Overall Limitation on Itemized Deductions for Individuals ("Pease Limitation"). Prior to 2006, and again from 2013 through 2017, federal tax law set an additional limitation on the amount of charitable deduction that a donor can enjoy in one tax year. Individuals with adjusted gross income over a threshold amount were required to reduce their itemized deductions (including the charitable deduction) by the

[130] IRC §170(b)(2).

lesser of one-third of: (i) 3 percent of the amount by which their adjusted gross income exceeds the threshold amount; or (ii) 80 percent of the itemized deductions otherwise allowable).[131] The threshold amount is inflation-adjusted, and in 2017, it was $313,800 in the case of a joint return or surviving spouse's return ($261,500 if unmarried or married, filing separately).[132] Under the 2001 Tax Act, this limitation was phased out beginning in 2006, and completely repealed in 2010. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312) extended the phase-out of the limitation on itemized deductions through 2012. The limit on itemized deductions returned on January 1, 2013. However, under the 2017 Tax Cuts and Jobs Act, this limitation has been suspended until 2026.

Denial of Deduction for Gift of Partial Interests. Generally, a donor must give his or her entire interest in property (or a fraction of the entire interest) to a charity in order to qualify for a deduction.[133] For example, a donor owning a parcel of land may deduct a gift of the entire parcel to charity, and may also deduct a gift of a 20 percent undivided interest in the parcel.[134] But (subject to the exceptions described below), there is no deduction for a gift of a temporal interest in the property (charity gets the parcel only for the next five years, or only for the rest of the donor's lifetime) or for any other partial use of the property (charity can use the parcel for harvesting timber but otherwise the donor keeps the right to use or to sell the parcel).[135] Further, in an attempt to reduce abuse with gifts of fractional interests in tangible personal property (especially works of art that are likely to appreciate), rules provide

[131] IRC §68.

[132] Rev. Proc. 2015-35, 2015-26 I.R.B. 1142.

[133] IRC §170(f). Reg. §§1.170A-6 and 1.170A-7.

[134] IRC §170(f)(3)(B). In a Field Service Advice, Ltr. Rul. 200149007, the IRS Chief Counsel set forth a detailed analysis of the criteria for establishing a fraction of an entire interest in property, including: (1) the donee must receive a portion of every substantial right owned by the donor, (2) the gifted interest must run for the same term as the donor's interest, and (3) the donor must give the donee the right, as a tenant in common, to possession, dominion and control over the property for the time period commensurate with the fractional interest.

[135] Reg. §1.170A-7.

that no deduction is available for a contribution of an undivided fractional interest in tangible personal property unless immediately before the contribution all interests in the property are held either by the donor or by the donor and the donee-charity.[136] Therefore, a taxpayer will be permitted to deduct an initial contribution of an undivided fractional interest in an item of tangible personal property ("initial contribution"), and to deduct gifts of further undivided fractional interests in the same item in future years ("additional contributions"), but only so long as the charity still retains the interests it has received. The rules also provide that if a deduction is claimed for an initial contribution of an undivided fractional interest in tangible personal property and later a deduction is claimed for an additional contribution of an undivided fractional interest in such property, the donor may not value the item of property at the time of an additional contribution any higher than its value at the time of the initial contribution.[137] Therefore, the donor's aggregate deductions for a series of gifts of interests in the same item can no longer be greater than the deduction would have been if a gift of the entire item had been made initially. Finally, the rule provides for recapture of a charitable deduction claimed by the donor for all contributions of such interests if the donor has not completely donated all of his interests in the property to the charitable donee (or if the initial charitable donee is no longer in existence, to any other charitable donee) by the earlier of ten years after the initial contribution or the donor's death, and there is also recapture if during such period the charitable donee has not had substantial possession of the property and has not used such property in a manner related to its exempt purposes.[138]

> **EXAMPLE 1-15.** Rick donates the use of his ski condominium for one week to his daughter's school for its annual fundraising auction. The ski condominium is usually rented out at $500 for a week. Nonetheless, Rick receives no deduction for the gift because it is a gift of a partial interest.

There are several important exceptions to this prohibition of deductions for partial interests:

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[136] IRC §170(o)(1).
[137] IRC §170(o)(2).
[138] IRC §170(o)(3).

- *Charitable Remainder Trusts*. A donor may deduct the present value of the remainder interest in a charitable remainder trust, where the income is paid to noncharitable beneficiaries (such as the donor and her family members) for a term of years or for one or more lifetimes, at which time the remainder passes to charities. The income interest must be in the form of a fixed annuity or a unitrust interest (a fixed percentage of the value of the trust principal, revalued annually).[139]

- *Charitable Lead Trusts.* For a gift to a charitable lead trust where charities receive the income interest for some period of time, after which individuals receive the remainder interest, the donor could receive an income tax deduction for the present value of the income that is predicted to pass to charity. Alternatively, a charitable lead trust can be designed so that the donor receives no immediate deduction and instead the trust receives an annual deduction as the income is actually paid to charity.[140] The trust will qualify as a charitable lead trust only if the lead interest is in the form of a fixed annuity or a unitrust interest.[141]

- *Pooled Income Funds.* A donor may deduct the present value of the remainder interest in a gift to a pooled income fund sponsored by a charitable organization.[142]

- *Remainder in Personal Residence or Farm.* A donor may deduct the gift of a remainder interest in a personal residence or farm.[143]

- *Qualified Conservation Easement.* A donor may deduct the gift of a conservation easement limiting the use of property to certain qualified purposes.[144]

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139 IRC §170(f)(2)(A).
140 IRC §642(c).
141 IRC §170(f)(2)(B)..
142 IRC §170(f)(2)(A)..
143 IRC §170(f)(3)(B).
144 IRC §170(f)(3)(B) and §170(h).

¶1.05 GIFT AND ESTATE TAX DEDUCTIONS

Gifts and bequests to charitable organizations are fully deductible for gift and estate tax purposes regardless of whether the organization is a public charity or private foundation.[145] In addition, the amount of the deduction is equal to the full fair market value of the bequest or gift, regardless of whether the property has appreciated in value.[146] Thus the distinction under the federal income tax law between public charities and private foundations is not present with respect to estate and gift taxes. A donor may make unlimited lifetime or testamentary gifts to a private foundation free of estate and gift taxes. However, the rule against deductibility of a gift of a partial interest in property does apply in the gift and estate tax context, so that, generally, the gift or bequest of a remainder or term interest in trust will qualify for the gift or estate tax charitable deduction only if the trust is a charitable remainder annuity trust or unitrust, or a charitable lead annuity trust or unitrust, or a pooled income fund.[147]

Many donors are motivated to give to charity because each dollar will get to the charity free of estate tax, while the same dollar passing to family members will be greatly reduced by gift or estate tax. For a donor in a 46 percent estate tax bracket (state and federal combined), only 54 cents of every dollar gets to the children. All dollars left to charity at death will be available to accomplish the donor's charitable wishes.

Some donors gain further comfort with dollars passing to charity rather than to family by selecting as the charity a family foundation or one of its alternatives,[148] so that the family stays involved with the

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[145] IRC §§2055(a) and 2522(a). However, similar to the income tax rules, no gift tax deduction is available for a contribution of an undivided fractional interest in tangible personal property unless immediately before the contribution all interests in the property are held either by the donor or by the donor and the donee charity. IRC §2522(e).

[146] IRC §§2055(a) and 2522(a). Unlike the income tax rules, if a donor makes a lifetime charitable gift of a fractional interest in an item of tangible personal property, and subsequently makes a gift or bequest of the balance of the interest in the item to the same charity, the value of the additional contribution for purposes of the gift or estate tax charitable deduction is not limited to the value of such item at the time of the initial contribution.

[147] IRC §§2055(e), 2522(c).

[148] *See* §10.03 *supra.*

wealth and is empowered in that regard.

> **EXAMPLE 1-16.** Elena believes that she is leaving sufficient bequests to her children to help them be comfortable, even after considering the estate taxes that her estate must pay. She decides to leave the residue of her estate to a family foundation, which can be funded without any diminution for estate taxes. By naming her children as trustees of the foundation, Elena has provided them with the opportunity to make charitable grants to organizations that they support.

¶1.06 SPECIAL TYPES OF CHARITABLE GIFTS

Donors will often inquire of estate planners whether it is possible to donate property to charity but keep the income (rent, dividends, interest) generated by the property, and still qualify for tax deductions. Other donors want to restrict the use of real property for conservation or historic preservation purposes, but otherwise keep the ownership of the property, and again are interested in any available tax deductions. These special issues are discussed below.

Gifts of Income or Remainder Interests. Donors may wish to retain for themselves or their family members partial interests in gifts otherwise intended for charity. Some donors want to keep the use of property or the income from property for a term of years or for one or more lifetimes, but also want to ensure that the remainder interest will pass to charity. Other donors are pleased to commit the use of property or the income from property to a charity for a specific period of time, after which the use or the income will revert to family members. These *split-interest* gifts also provide opportunities for reducing or deferring capital gains tax and for passing property to children at reduced gift and estate taxes. The common split-interest gift vehicles include:

- A gift of a remainder interest in a personal residence or farm;
- A gift to a pooled income fund;
- A gift to a charitable remainder trust;
- A bargain sale to a charity with payment in the form of a charitable gift annuity; and
- A gift to a charitable lead trust.

Computation of Charitable Deduction for Split-Interest Gifts. In computing income, gift, and estate tax charitable deductions with respect to split-interest gifts, a deduction is allowed only for the present value of the amount that is expected to pass to charity.[149] In addition, the charitable deduction is only permitted if the income interest is for a fixed term of years or for the lifetime of one or more individuals.[150]

The present value computation is based on (1) the term of the interest (with IRS life expectancy tables used to determine the term of an interest for an individual's life[151]), and (2) discount rates established by the IRS.[152] The IRS publishes applicable rates each month (generally 120 percent of the average market yield on midterm U.S. Treasury obligations determined just prior to the applicable month), and the donor may use the rate that applies for the month in which the gift is made or for either of the preceding two months.[153] There is commercial software available that contains these factors and computes the present value of the charitable interest for various types of split-interest gifts.

Remainder Interest in Personal Residence or Farm. Income tax rules specifically permit a charitable deduction for the present value of a gift to charity of a remainder interest in a personal residence or in a farm, allowing homeowners and farmers to keep the use of their property for their lifetimes and enjoy an income tax deduction during life for the irrevocable transfer of the remainder interest to charity.[154] A special rule for gifts of a remainder interest in real property requires that, when computing the present value of the remainder, the depreciable portion of the gift (the value of the house alone less its salvage value following its estimated useful life) must be subject to a special factor that will decrease the value of the gift, while the nondepreciable portion of the gift (the

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[149] Reg. §§1.170A-6, 1.170A-7, 20.2055-2, 25.2522(a)-2.

[150] *Id.*

[151] On April 30, 2009, the IRS issued mortality Table 2000CM which affects charitable deduction computations for gift annuities, charitable remainder trusts, retained life estates and charitable lead trusts. Donors must use Table 2000CM to value any gift made on or after July 1, 2009. *See* IRS Publications 1457 (Remainder, Income and Annuity Examples) and 1458 (Unitrust Remainder and Life Estate Examples).

[152] IRC §7520.

[153] IRC §7520(a). There is an exception to this rule for pooled income funds.

[154] IRC §170(f)(3)(B)(i).

land and the salvage value of the residence following its estimated useful life) is not subject to such factor.[155]

> **EXAMPLE 1-17.** John lives in a large house that his grown children do not wish to inherit. He signs a deed in which he keeps a life interest in the house and conveys the remainder interest to his church. He receives an income tax deduction equal to the present value of the remainder interest, which takes into consideration John's actuarial life expectancy and an assumed interest rate that the IRS publishes on a monthly basis. Because the gift includes depreciable property, the value of the deduction also considers depreciation of the house (but not the land) prior to the time when the church will receive it. If John is 72 and the IRS published rate is 8 percent, the present value of the remainder of the nondepreciable portion (land plus salvage value of house) is 0.43666 times its current value. If the house has an estimated useful life of 40 years, the present value of the remainder of the depreciable portion (house less its salvage value) is only 0.33851 times its current value. And if the depreciable portion is two-thirds of the total value of the house and land, then John's income tax deduction is 37 percent of the current value of the house and land.

Pooled Income Funds. A charitable organization is authorized to sponsor its own pooled income fund to which many donors contribute, each donor retaining the income attributable to his or her contributed share of the fund principal.[156] A pooled income fund is in some respects similar to a mutual fund, except that capital gains are not distributed and the charity receives the principal after the deaths of the donor and/or any other named beneficiaries.

A pooled income fund is particularly valuable when a donor contributes appreciated capital gain assets because the fund can sell the assets tax free (although the fund is taxable, it receives a charitable deduction for long-term capital gains as they are permanently set aside for the use of the charity).[157] This enables the donor to enjoy income from the

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[155] Reg. §1.170A-12.
[156] IRC §642(c)(5).
[157] IRC §642(c)(3).

full value of the gift. The income can be paid to the donor or other individuals for one or more lifetimes, after which the charity can remove and keep the principal attributable to the contributed share. The donor's income, gift, and estate tax deduction is the present value of the remainder interest, computed using IRS actuarial tables and a discount rate equal to the fund's highest yearly rate of return during the three years preceding the gift.[158] Distributions from the fund are taxed as ordinary income to the recipient.[159]

Charitable Remainder Trusts

Requirements. A *charitable remainder trust* is defined by statute and regulations as a trust arrangement where a donor retains an interest for him or herself and/or other individuals that can be objectively valued, prior to a charitable organization receiving the remainder interest (which can also be objectively valued).[160] The rules governing charitable remainder trusts were enacted because Congress was concerned that some split-interest charitable arrangements could be manipulated through the choice of investments to produce less for charity than was predicted using the published discount rates.

> **EXAMPLE 1-18.** A donor contributed $100,000 to a trust, retaining an income interest for life and giving the remainder interest to charity. The trust property was invested solely in high-yield junk bonds. Based on the presumed interest rate, the donor would get a large charitable deduction. However, the income paid to the donor would be more than presumed by the published discount rate, while the principal of the trust that passed to the charity at the donor's death would not have enjoyed the capital appreciation presumed by the published discount rate.

To avoid this outcome, Congress now generally requires that split-interest gifts (other than a gift of a remainder interest in a personal residence or farm) state the income interest in the form of either a fixed dollar amount (an “annuity interest”) or a fixed percentage of the principal as

[158] IRC §642(c)(5) and Reg. §1.642(c)-6.
[159] IRC §652(a).
[160] IRC §664.

that principal is redetermined annually (a "unitrust interest").[161] Requiring that fixed sums be paid during the term of a split-interest trust ensures that the trust earns income and capital appreciation initially predicted, the amount allowed as a deduction will match (on a present value basis) the amount actually received by the charity.

The value of the deduction to the donor will correlate inversely to the interest retained by the donor.

> **EXAMPLE 1-19.** Jack would like to contribute some of his savings to the hospital that cared for his wife during her illness, but is not sure that he can afford to give up the income from the property. Jack is considering creating a charitable remainder trust, in which he will retain for his lifetime annual distributions equal to a percentage (Jack is considering distributions of 5 percent, 6 percent, and 7 percent) of the fair market value of the trust on the first day of each year. Upon Jack's death, any remaining trust property would be distributed to the hospital. If Jack is 70 and the published discount rate is 2.2 percent, and if he contributes $100,000 to the trust, then the present value of his retained income interest (paid to him in quarterly installments) and the present value of what is predicted to pass to the hospital (and therefore deductible) are as follows:

Jack's retained interest in the trust as it is revalued annually	*Present value of Jack's retained interest*	*Present value of remainder passing to charity (amount of deduction)*
5 percent	$47,700	$52,300
6 percent	$53,400	$46,600
7 percent	$58,300	$41,700

Note that the greater the percentage retained by Jack, the less that is predicted to pass to charity. If Jack were 80 years old rather than 70, the value of his retained life income interest would decrease and the value of the charitable remainder interest would increase.

[161] IRC §§170(f), 2055(e), 2522(c). The rules governing charitable remainder trusts are found in IRC §664 and the accompanying regulations.

Why Fund a Charitable Remainder Trust? Charitable Remainder Trusts (CRTs) are funded by donors who wish to retain for themselves (or give to family members or other individuals) the income from property for some duration of time, but who are also willing to transfer the remainder interest to charity. Donors to CRTs can claim an income tax deduction for the present value of the remainder interest in the year that the CRT is funded, even though the donor retains the right to receive payments from the trust. In addition, estate planners often recommend the use of a CRT when a donor owns appreciated property that, if sold, would give rise to a capital gains tax. If, instead, the donor gives the appreciated property to a CRT and the CRT sells it, there is no immediate capital gains tax. The taxable gain is suspended inside the CRT (which is exempt from income tax) and is taxed to the beneficiary over time as distributions are made.[162]

> **EXAMPLE 1-20.** Donna is nearing retirement and will need more income than her investment portfolio now produces. She would like to sell some of the growth stocks that have done well and which now represent too much of the portfolio, and diversify the investments to include more bonds and stocks that pay better dividends. If she sells the growth stocks, however, the capital gains tax will diminish the portfolio by 25.25 percent of the long-term gain in those stocks (assuming combined state and federal capital gains tax rate of 25.25 percent). Donna would receive the earnings on only the remaining 74.75 percent of the portfolio. Instead of selling the growth stock, Donna donates the growth stock to a CRT. The CRT sells the stock and, being tax-exempt, is able to keep 100 percent of the proceeds and diversify them into income-producing assets. The CRT pays Donna the enhanced income for her lifetime (in the form of a fixed annuity interest or a unitrust interest). On her death the remainder passes to Donna's favorite charities.

CRATs and CRUTs

CRATs Versus CRUTs. Donors to CRTs must decide if the income

[162] IRC §664(c). Distributions from the CRT to the beneficiary will be taxable to the beneficiary (and will reflect this capital gain).

interest they retain or give to family members will be in the form of an annuity interest (a fixed amount) under a charitable remainder annuity trust (CRAT) or a unitrust interest (a fixed percentage of the trust assets as the assets are revalued annually) under a charitable remainder unitrust (CRUT). There are various factors to consider in choosing between a CRAT and a CRUT. The primary advantage of a CRUT (and indeed the reason that it is chosen more often by donors) is that the distribution is more likely to keep pace with inflation since the amount of the annual distributions from the CRUT will rise and fall with the value of the assets in the trust. However, a donor might nonetheless choose to fund a CRAT if he wants to be assured of a fixed annuity regardless of the performance of the trust, or if he wants to avoid the expense of revaluing the trust property every year.

Rules Applicable to CRATs and CRUTs. In order for a trust to qualify as a CRAT or a CRUT, the noncharitable interest retained by the donor (or given by the donor to one or more individuals) must be paid annually for a term of years (not to exceed 20) or for one or more lifetimes (provided that the measuring lives are of beneficiaries receiving an income interest).[163] A CRAT must pay a minimum annuity of 5 percent (and may not exceed 50 percent) of the initial value of the trust property, and no further additions may be made after the initial funding of a CRAT.[164] A CRUT must pay a minimum distribution of 5 percent (and may not exceed 50 percent) of the value of the trust property determined each year, but there is no restriction on additional contributions.[165] With both a CRAT and a CRUT, the present value of the remainder interest passing to charity must be at least 10 percent of the value of the property contributed.[166] As a result of this rule, young donors wishing to retain a life interest in a CRAT or CRUT will have to keep the payments at a low level. The IRS has released sample forms for CRATs[167] and CRUTs[168] which, in most circumstances, ought to be carefully followed in order to be sure a trust will qualify as a charitable remainder trust.

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[163] IRC §664(d); Reg. §§1.664-2(a)(5) and 1.664-3(a)(5).
[164] IRC §664(d); Reg. §1.664-2.
[165] IRC §664(d); Reg. §1.664-3.
[166] IRC §§664(d)(1)(D) and 664(d)(2)(D).
[167] Rev. Procs. 2003-53 to 2003-60, 2003-31 I.R.B. 230–274.
[168] Rev. Procs. 2005-52 to 2005-59, 2005-34 I.R.B. 326–412.

EXAMPLE 1-21. A 30-year-old seeking to create a CRUT for her lifetime could keep a 5 percent unitrust interest; but increasing the retained interest to a 6 percent unitrust interest means that, on a present value basis, less than 10 percent of the gift is passing to charity, so the trust would not qualify as a CRUT. A couple who are both 30 could not create a CRUT for their joint lifetimes because a retention of the minimum 5 percent unitrust amount would leave less than 10 percent (on a present value basis) for charity.

Income Taxation of CRTs and Beneficiaries. A CRT is exempt from income tax. However, the beneficiaries of a CRT do pay tax on the income of the CRT under rules quite different from the usual rules applicable to beneficiaries of trusts. When the trust makes annual distributions to the individual beneficiaries, the distributions are taxed to the beneficiaries -

1. First, as ordinary income to the extent the trust earned ordinary income that year (or in a prior year if not fully carried out to the beneficiaries in any prior year); within this category, for different classes of ordinary income that are subject to varying tax rates, a class taxed at a higher rate (such as taxable interest) is deemed to pass out before a class taxed at a lower rate (such as taxable dividends);

2. Second, as capital gain to the extent the trust realized capital gain in that year (or in a prior year if not fully carried out to the beneficiaries in any prior year); within this category, for different classes of capital gain that are subject to varying tax rates, a class taxed at a higher rate (such as short-term capital gain) is deemed to pass out before a class taxed at a lower rate (such as long-term capital gain);

3. Third, as tax-exempt income to the extent the trust earned tax-exempt income that year (or in a prior year if not fully carried out to the beneficiaries in any prior year); and

4. Fourth, as tax-free return of principal.[169]

Notwithstanding the foregoing, if the CRT earns any unrelated business taxable income, the CRT must pay an excise tax equal to the amount of such unrelated business taxable income.[170]

> **EXAMPLE 1-22.** Sophia owns zero-basis stock held for more than one year, which she contributes at the beginning of 2018 to a CRUT that distributes a 5 percent unitrust payment to her for her lifetime. The CRUT trustee sells the stock for $1 million, and invests the proceeds in a diversified portfolio of bonds and stocks that, for year 2018, yield $15,000 in taxable interest and $8,000 in dividends. Of the total $50,000 distribution to Sophia in 2018, the first $15,000 is taxed to her as interest, the next $8,000 is taxed to her as dividends, and the remaining $27,000 is a portion of the suspended long-term capital gain and is taxed to her as such.

NICRUTs, NIMCRUTs, and FLIPCRUTs. The requirement to make annual distributions under a traditional CRT may be problematic in the situation where the donor transfers assets that, at the time of transfer, do not produce sufficient income to meet the annual payments. This commonly occurs when the donor transfers an interest in a closely held business or non-income-producing land.

There are a variety of permissible variations on the traditional CRUT that are used to address this problem. One variation is to set the income distribution to the noncharitable beneficiaries at the *lesser of:* (1) a fixed percentage of the principal; and (2) the net income earned by the trust (NICRUT). The problem with the NICRUT is that the noncharitable beneficiary will lose some of the income (for the period where the percentage amount is less than the actual income earned by the trust) to which she would otherwise be entitled. To address this problem, there is another permissible variation on a NICRUT that enables the trustee to *make up* to the noncharitable beneficiary the underpayment attributable to years in which the net income of the trust is in fact less than the stand-

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[169] IRC §664(b); Reg. §1.664-1(d)(1).

[170] IRC §664(c)(2).

ard unitrust amount, by distributing to her such underpayment in subsequent years when the net income may exceed the standard unitrust amount (NIMCRUT).[171] NICRUTs and NIMCRUTs are popular vehicles when the unitrust is unlikely to have sufficient income and principal liquidity to be able to make the required distributions to noncharitable beneficiaries. In such situations, most donors would prefer a NIMCRUT, which gives the donor at least a possibility of making up for early low income years during later high income years; however, more charitably inclined donors (or donors who don't want to track the make-up amounts) might choose a NICRUT and forego the make-up amounts. NIMCRUTS are also used by some estate planners (albeit in the face of IRS criticism) to hold partnership interests that intentionally distribute little or no income in years when the beneficiary is in a high income tax bracket but that distribute lots of income in later years when the beneficiary is in a lower bracket.

There is a way to give relief to donors who use a NICRUT or NIMCRUT because the asset contributed to the CRT is illiquid and pays little or no income, but who desire to receive the standard unitrust amount at such time as the CRT has the liquidity to pay it. Regulations permit the governing instrument of a NICRUT or a NIMCRUT to authorize a flip (hence named a FLIPCRUT) into a standard CRUT upon certain events or dates (e.g., upon the beneficiary attaining a certain age, and even upon the sale of certain "unmarketable assets"[172]). A FLIPCRUT can be useful because an individual can contribute illiquid, non-income-producing property to the CRT, and then receive the higher standard unitrust amount once the trust has sufficient liquidity.

> **EXAMPLE 1-23.** Marie and Marvin contribute their respective interests in a parcel of undeveloped real estate to separate 5 percent CRUTs, with hopes that the trustees will eventually sell the property and invest the proceeds to create an income stream. Due to market conditions, they do not expect any sale to occur in the near future and they are concerned that until such sale occurs, the trustees will be unable to make the required distributions. Marie makes her trust a NICRUT with an automatic flip into a standard CRUT in five years, so the trustee need not

[171] IRC §664(d)(3); Reg. §1.664-3(a)(1)(i)(b).
[172] Reg. §1.664-3(a)(1)(i)(c).

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make any distribution in the first five years if in fact there is no net income. Marvin makes his trust a NIMCRUT with the same flip provision, accomplishing the same thing, with the exception that he may get some extra distributions during the first five years if the property is sold and thereafter the net income actually exceeds the 5 percent unitrust amount. Their tax deductions are computed as if they retained straight 5 percent unitrusts, so there is no deduction for the extra funds that may go to charity on account of the lower distributions they may receive before the flip occurs. After the five years have passed, both trusts become standard CRTs paying out a 5 percent unitrust amount each year.

Bargain Sale to Charity with Payment in the Form of a Charitable Gift Annuity. Some donors want to receive (or want their beneficiaries to receive) a life annuity in return for a charitable gift, and do not care about establishing a charitable remainder trust to hold their gift and secure their income stream. Instead, they transfer cash or sell appreciated property directly to a charity, with the payment back in the form of a charitable gift annuity backed by the general credit of the charity. Charities benefit from these contracts with donors because the present value of the life annuity paid by the charity (computed using IRS actuarial and interest rate assumptions) is less than the fair market value of the cash or property received from the donor. In such a “bargain sale” of appreciated property, the donor's gain is computed by reducing the sales proceeds (the present value of the life annuity) by a *pro rata* portion of the donor's basis in the sold property. The donor's income tax deduction is the difference between the sold property's fair market value and the sales proceeds received in return (the present value of the annuity). The payments to the donor or other beneficiary are taxed a bit more favorably than payments from a CRT, because each payment is considered to carry out a proportionate amount of tax-free return of capital as well as taxable income.[173]

EXAMPLE 1-24. Millie would like to increase her income and support a major university. She is familiar with the benefits of a charitable remainder trust and is thinking of creating one and

[173] IRC §72.

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funding it with $200,000 of appreciated stock that pays no current dividend. Her plan is for the trustee to sell the stock without paying capital gains tax, reinvest the proceeds, and annually distribute $12,000 to her for her lifetime. At her death any remaining balance would pass to the university. The university suggests she not bother with a CRT and instead just sell the stock to the university in return for a charitable gift annuity—the university's promise to pay her $12,000 a year for her lifetime. Millie likes the thought of not needing a lawyer to draft a CRT and not needing an accountant to file annual tax returns for a CRT. If she is willing to become a general creditor of the university (which she may well be since this is a large, creditworthy institution) and give up the ability to oversee the investment of an identifiable trust portfolio, then she should consider the charitable gift annuity.

From the donor's point of view, charitable gift annuities are simpler than CRTs because there is no need for a trust instrument or a trustee. The sponsoring charity gets immediate use of the funds (with a CRT, the charity has to wait until the payments to individual beneficiaries have terminated), but the charity must be aware of any state regulations that might require it to keep sufficient reserves to pay the annuity.

Charitable Lead Trusts. A charitable lead trust (CLT) is the opposite of a CRT in that it makes annual income distributions to a charitable organization for a term of years or for one or more persons' lifetimes, after which the remainder of the trust passes to individuals (or trusts for individuals) such as the donor's children.[174] To achieve any income, gift, or estate tax deduction, the income interest must be in the form of either a fixed annuity (a charitable lead annuity trust or CLAT) or a fixed percentage of the trust assets as the assets are revalued annually (a charitable lead unitrust or CLUT).[175]

An important motivation for most donors to fund a CLT is that rapidly appreciating assets can be donated to a CLT and, after the termina-

[174] *See* IRC §§170(f)(2)(B), 2055(e)(2)(B), 2522(c)(2)(B), and the regulations accompanying each of these Code sections.

[175] Reg. §§1.170A-6(c), 20.2055-2(e)(2), 25.2522(c)-3(c)(2).

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tion of the charitable term, passed on to children or grandchildren at reduced gift or estate tax costs. Much of the value of the donated property generally is represented (on a present value basis) by the stream of annuity payments. The value of the remainder interest passing to children or grandchildren (or to trusts for their benefit) represents none or only a small part of the value of the property transferred to the trust, and, as a consequence, funding a CLAT gives rise to little or no gift tax. If the property in the CLAT appreciates at a rate greater than the prescribed discount rate, then the amount of assets passing to children at the end of the trust term will exceed the amount that was subject to gift tax.

A CLT can be structured in one of two ways for income tax purposes. If the donor is willing to design the CLT as a *grantor trust* (in which case all of the CLT's income would be taxed to the donor), then the donor can receive an income tax deduction up front for the present value of the amount predicted to pass to charity.[176] Each year the donor will report the trust income on her return, and she will not be entitled to any further income tax deduction for the amount paid each year to the charity. If the donor to a grantor trust dies during the term of the CLT (or the trust otherwise ceases to be a grantor trust as to the donor) there is a recapture of all or a part of the charitable income tax deduction that was allowed to the donor on funding the CLT.[177] As an alternative, the donor may create a *nongrantor trust* and forego an upfront income tax deduction. In that case the CLT will be subject to income tax on its income but the income generally will be offset by a charitable income tax deduction each year for the amount that it distributes to charity.[178] It

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[176] To the extent that a lesser amount is distributed to charity than the donor deducted, there will be recapture of the excess charitable income tax deduction. *See* IRC §170(f)(2)(B).

[177] IRC §170(f)(2)(B).

[178] IRC §642(c). The IRS has issued regulations that disregard income ordering provisions in a CLT designed to treat the most highly-taxed income as being distributed to charity first, before other types of income or principal, unless the ordering provision has economic effect independent of income tax consequences. Reg. §§ 1.642(c)-3 and 1.643(a)-5. The regulations give an example of a CLAT which provides that the annual annuity will be deemed to be paid first from ordinary income, second from short-term capital gain, third from 50 percent of the UBTI, fourth from long-term capital gain, fifth from the balance of UBTI, sixth from tax-exempt income, and last from principal,

should be noted that a CLT is not tax exempt and, unlike a CRT, is not a technique for capital gain deferral. The IRS has released sample forms for CLTs which, in most circumstances, ought to be carefully followed in order to ensure that a trust will qualify as a CLT.[179] The sample forms confirm that CLUTs can provide for varying percentage payouts from year to year, for example, increasing the percentage that must be paid to charity in later years after the CLUT has had time to appreciate. Similarly, the sample forms confirm that CLATs can provide for varying annuity amount payments from year to year. Estate planners may want to use the software programs now available to compare potential remainder amounts passing to the CLT remaindermen using straight annuity or unitrust payments versus unitrust or annuity payments that increase over the lead term.

EXAMPLE 1-25. Susan is charitably inclined, but is also interested in passing the future appreciation in her company stock (which may go public) to her children at reduced gift and estate tax costs. She establishes a CLAT with $1 million of stock, which will make distributions to her donor-advised fund at the local community foundation, with the remainder passing to trusts for her children. Assuming that the applicable IRS interest rate is 2.2 percent, the annual annuity that would be required to go to charity in order for the value of the remainder to be zero (and hence the gift tax to be zero), assuming the lead term lasts five, ten, or fifteen years, is calculated as follows:

Term of charity's interest in the CLAT	*Required annual annuity to charity in order to create a remainder with a zero value*
5	$213,400
10	$112,500
15	$79,000

and states that such provisions lack economic effect and would be disregarded.

179 Testamentary CLTs: Rev. Proc. 2007-46, 2007-29 I.R.B. 102 (6/22/07); Rev. Proc. 2008-46, 2008-30 I.R.B. 238 (7/30/08). Intervivos CLTs: Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (6/22/07); Rev. Proc. 2008-45, 2008-30 I.R.B. 224 (7/30/08).

Susan selects the five-year CLAT, and two years later she sells the company and the CLAT assets increase substantially. At the end of the five-year term, the donor-advised fund has received over $1 million from the CLAT, and the trusts for her children receive substantial funds remaining in the CLAT. There are no further gift and estate tax consequences, since the taxable gift was completed at the time the CLAT was funded.

Note that a special rule under the generation-skipping transfer tax[180] makes it difficult for Susan to make the trusts for her children fully exempt from that tax, even though the gift tax value was successfully established at zero. Under this rule, the generation-skipping tax exemption is allocated at the time of the gift and such allocation is then deemed to grow at the rate determined under IRC Section 7520 during the lead term. The trust's inclusion ratio is not finally determined until the end of the lead term, and if, at that time, the trust property has grown at a rate better than the IRC Section 7520 rate, then the trust's inclusion ratio will be greater than zero. Donors would not usually fund a CLT if they felt that the assets could not appreciate at a rate in excess of the IRC Section 7520 rate.

Conservation Easements. Another type of partial interest in property that qualifies for an income, gift, and estate tax charitable deduction is a *qualified conservation contribution.* A qualified conservation contribution must be in the form of an easement for real estate deeded to a qualified conservation organization (one whose purpose is land conservation or preservation) for one of the following purposes: (1) use of the land by the public for outdoor recreation or education; (2) to protect a natural ecosystem; (3) to preserve open space, farmland, or forest land for significant public benefit (including scenic enjoyment of the general public); or (4) to protect an historic landmark.[181] Generally, the amount of the deduction is equal to the difference between the fair market value of the property before the easement was placed on the property and its fair market value with the easement. As noted in ¶1.04 above, qualified conservation easement donations of long-term capital gain property can be deducted up to 50 percent of the donor's contribution base, or up to

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180 IRC §2642(e).
181 IRC §170(h).

100 percent of the donor's contribution base if the donor is a qualifying farmer or rancher, and the unused deduction may be carried forward for to up to 15 years.

¶1.07 FUNDING CHARITABLE GIFTS

Lifetime Gifts Versus Testamentary Gifts. One advantage of a lifetime gift to charity is that a lifetime gift provides the donor with a double tax benefit. The donor is entitled to claim an income tax deduction, and, in addition, the property is no longer in his estate and will not be subject to estate tax. Bequests to charity at the donor's death are not subject to estate tax, but neither the estate nor the beneficiaries are entitled to a deduction for income tax purposes. For this reason, some donors who have been planning to fund charities at death decide to accelerate their bequests through lifetime gifts, especially when they reach an age at which they are comfortable that their remaining wealth is sufficient for their support.

Alternatively, a client who does not want a charitable gift paid until his death can arrange for his surviving spouse to make such a gift after he dies and obtain an income tax deduction at that later date.

> **EXAMPLE 1-26.** A married couple is considering a charitable bequest to the husband's alma mater at the death of the husband. In order to build flexibility into the plan, the husband's will could provide for a bequest to the school in the event the husband is the second to die, but also provide that, if his wife survives him, the bequest goes instead to her (qualifying for the estate tax marital deduction) with the suggestion that she use the bequest to make a gift to the school, for which she will get an income tax deduction.

Use of Retirement Benefits to Fund Charitable Bequests. Using qualified retirement benefits or IRAs to fund a charitable bequest can be a very tax-efficient way to make a charitable gift.

Qualified retirement funds, such as Section 401(k) plans, and deductible IRAs[182] are subject to income tax at the time that funds are distributed because income tax has not yet been paid on the initial amounts

[182] The rules are different for Roth IRAs.

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funded or on the income earned since funding. In addition, such funds are included in their owners' estates, and thus are subject to estate taxes. The double taxation of retirement benefits is somewhat ameliorated because the estate tax attributable to the benefits is deductible against the income taxed to the beneficiary.[183] If such funds pass to a charity, the estate tax charitable deduction and the charity's income tax exempt status would eliminate the impact of both the federal estate tax and the federal income tax, but possibly not state income tax.

Owners of retirement benefits and IRAs may be interested in giving their beneficiaries the option of accepting a bequest of such assets (subject to taxes) or disclaiming such bequest, in which case such assets would pass free of such taxes to a charity such as a family-controlled private foundation. Care should be taken to ensure that the rules governing qualified disclaimers[184] are satisfied, including the rule that the person disclaiming cannot retain any right to control the disposition of the disclaimed assets.[185]

> **EXAMPLE 1-27.** Ian has an IRA worth $100,000. If he left it to his daughters in 2018, the total federal estate tax on the fund could be as high as $40,000. The beneficiaries may deduct the estate tax attributable to the IRA ($100,000 × 40% federal estate tax bracket = $40,000). Therefore, the $39,600 of income taxes on the IRA withdrawal (assuming the top federal rate of 39.6 percent) would be entirely offset by the deduction for federal estate taxes paid on the IRA. Note that IRA withdrawals are not subject to the 3.8% Medicare surtax. Ian decided that designating his daughters to inherit the IRA where they kept only $60,000 after federal taxes without factoring in any state income or estate taxes) was not an efficient use of his money, so he designated a family foundation as the beneficiary of the IRA. If the IRA still has $100,000 in it at the time of his death, Ian

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[183] IRC §691(c).

[184] *See* §14.06 *infra.*

[185] In Ltr. Rul. 200420007, the IRS ruled that a disclaimer is qualified where the disclaimed funds passed to a family foundation and the foundation undertook to reform its bylaws to provide that funds passing to it by disclaimer would be held in a segregated account over which only directors other than the disclaimant had control.

will be leaving his daughters in charge of a $100,000 foundation.

Taxpayers age 70 or older can do a "charitable rollover" and distribute up to $100,000 per year directly from a traditional IRA or Roth IRA to certain public charities.[186] The 70 age requirement applies to "the individual for whose benefit the plan is maintained," and refers to both the original owner of an IRA and to a beneficiary of an inherited IRA (provided that the beneficiary was 70 or older). The charitable distribution counts toward satisfaction of the owner/beneficiary's required minimum distribution under Section 401(a)(9). Specifically excluded from the class of permissible charities are supporting organizations and donor-advised funds. Charitable distributions excluded from the taxpayer's income are not deductible by the taxpayer and do not count when applying limitations on the taxpayer's charitable deduction. However, the *quid pro quo* receipt of value and substantiation rules of Section 170 do apply, reducing the exclusion to the extent that the IRA owner/beneficiary receives value in return for the contribution, and requiring that the owner/beneficiary obtain a tax receipt from the charity.

[186] IRC §408(d). The IRA charitable rollover was made permanent by the Protecting Americans from Tax Hikes Act of 2015 (Pub. L. No. 114-113).