FLORIDA FELLOWS INSTITUTE

CHARITABLE PLANNING

-by-

Louis Nostro
Nostro Jones, P.A.
Miami, Florida

I. Introduction.

A. This presentation will describe a number of charitable planning strategies which may be of interest to your clients.

B. Despite our best efforts, we often do not take the initiative to present charitable planning options during estate planning conferences with clients. It is extremely difficult to explain the myriad of estate, gift and generation-skipping tax rules and introduce a variety of estate planning options in the short duration of the typical estate planning conference.

1. FLPs, GRATs ILITs, QTIPs IDGTs and other acronyms must be explained in a straight-forward manner.

2. While presenting these options, we are listening closely to discern our client's goals and desires.

3. Charitable planning techniques receive short shrift during most conference – and many times are never mentioned at all!

C. With the primary goal of reducing, deferring and/or eliminating estate taxes in mind, little focus is given to the vast sums of money left to the beneficiaries.

1. Many clients abhor the idea of their children getting "too much, too soon" (if at all).

2. Often these clients wish to instill in their children and grandchildren.

(a) work ethic

(b) community involvement

(c) philanthropic desires.

D. There is a strong interest for some combination of the strategic use of philanthropic planning through.

1. Reduction of estate taxes;

2. Increase of funds for charitable purposes; and

3. Income tax reduction

In particular, the concept of “matching” contributions for charity coming in part from the Internal Revenue Service and the beneficiary is appealing to some clients. Matching contributions can range from dollar-for-dollar to more than three dollars in tax reduction for one dollar from the beneficiary.

E. This paper will present a number of charitable planning options – such as testamentary charitable lead trusts - which can provide “matching” funding of philanthropic causes.

F. We will describe the steps to be taken in forming and operating a private foundation.

G. In closing, this paper will summarize the qualified conservation interest and qualified appraisal rules.

II. Estate Tax Exemption and Income/Gift Estate Tax Rates

A. The exemption equivalent (i.e., the amount shielded from estate tax by the unified credit) has increased dramatically in recent years and has been adjusted annually for inflation since 2012:

Year	Exemption Equivalent	Rate	Annual Exclusion
2009	$3,500,000	45%	$13,000
2010	None	35%	$13,000
2011	$5,000,000	35%	$13,000
2012	$5,120,000	35%	$13,000
2013	$5,250,000	40%	$14,000
2014	$5,340,000	40%	$14,000
2015	$5,430,000	40%	$14,000
2016	$5,450,000	40%	$14,000
2017	$5,490,000	40%	$14,000
2018	$5,600,000	40%	$15,000

1. Note that from 2002 through 2010 the gift tax exemption remained frozen at $1,000,000.

2. The “portability” provisions, added to IRC Section 2010(c) by the 2010 Act and made permanent by the 2012 Act, allow a surviving spouse to make use of a deceased spouse’s unused exemption equivalent.

   (a) Portability is elective and requires the filing of a timely estate tax return.

   (b) Portability is available only for surviving spouses of decedents dying after 2010.

3. **Federal Income Tax Rates**. A comparison of federal income tax rates between 2012 and 2017:

Income Taxes	2012	2017
Income tax rates	Maximum rate of 35% (10%, 15%, 25%, 28%, 33% and 35% income tax brackets)	Maximum rate of 39.6% (or 43.4% with health care surtax) (10%, 15%, 25%, 28%, 33%, 35% and 39.6% income tax brackets)
Dividends	15% (0% for taxpayers under 25% bracket)	Ordinary income treatment (taxed at rates listed above)
Qualified Dividends	15% (0% for taxpayers under 25% bracket)	20% for taxpayers in 39.6% bracket 15% for taxpayers in 25%, 28%, 33% and 35% brackets 0% for taxpayers under 25% bracket
Long-term capital gains	15% (0% for taxpayers under 25% bracket)	0% for taxpayers under 25% bracket 15% if in 25%, 28%, 33% and 35% brackets 20% if in 39.6% bracket (or 23.8% with health care surtax)
Health care surtax	Not Applicable	3.8% on lesser of (i) net investment income; or (ii) excess of modified adjusted gross income over the “threshold amount” ($250,000 for married couple; $200,000 for individual taxpayers)

III. Charitable Tax Law Developments

A. **Popular Charitable Planning Techniques.** There have been a number of changes in the law affecting charitable planning which have a direct impact on the use of the following popular charitable planning techniques:

1. Use of inter vivos charitable remainder trusts to receive gifts of appreciated property and avoid (or defer) capital gain tax on diversification.

2. Use of inter vivos charitable lead trusts to obtain substantial estate tax savings on transfer of property:

   (a) Extremely low applicable federal rate provides a tremendous planning opportunity.

3. Can use an escalating or "shark fin" charitable lead trust to defer payments to charity and maximize amount passing to family. Private Letter Ruling 201216045 validated escalating charitable lead trusts.

4. Gift of qualified appreciated stock to a private foundation controlled by the donor and the donor's family.

5. Gift of a remainder interest in a residence or farm to charity.

6. Use of donor-advised funds to avoid the contribution limitations, excise tax liability and administrative burdens associated with a private foundation.

7. Direct charitable gifts from IRAs (not yet extended for 2015).

B. **Tax Law Changes Impacting Charitable Giving.** The following tax law changes have had a direct impact on charitable planning over the last ten years:

1. Reduction of estate tax rate to 40% in 2013.

2. Increase of estate, gift and GST tax exemptions to $5,430,000.

3. Increase of capital gain tax rate over the last decade from 15 to 20% or 23.8%. ***Internal Revenue Code ("IRC") Section 1(h)***

4. Reinstatement of the 3% floor on itemized deductions and personal exemptions. ***IRC Section 68(f)***

5. Requirement that a charitable remainder trust must pay out its annuity or unitrust amount by December 31 (the end of its taxable year).

6. The actuarial value of the remainder interest of a charitable remainder trust must be at least 10% of the fair market value of the donated property. ***IRC Section 664(4).*** (Recent proposals have been introduced to lessen the impact of this rule.)

7. A charitable remainder unitrust cannot have a payout greater than 50% of its initial fair market value. ***IRC Section 664(d).***

8. Use of a charitable organization or a charitable lead trust to own Subchapter S corporation stock as an "Electing Small Business Trust." ***IRC Sections 1361(b)(1)(B) and 1361(c)(2) and (6).***

9. Use of a qualified appraiser to value unmarketable assets owned by a charitable remainder trust in lieu of an independent trustee.

10. Regulations governing, and clarification of, the operation of the tier income tax rules of a charitable remainder trust.

11. Creation of safe harbor for use of mortality tables in connection with gifts to split interest trusts valued under the Section 7520 applicable federal rates. ***Treasury Regulation Section 1.7520-3(b)(3).***

12. Qualified appreciated stock exception for gifts to private foundations. ***IRC Section 170(e)(5).***

13. Approval of the use of a "flip" unitrust funded with unproductive property. ***Proposed Treasury Regulation Section 1.664-3(c).***

C. The effect of many of these changes on popular charitable planning techniques will be addressed in the balance of this outline.

IV. Tax Savings Available Through Charitable Giving

A. **Income Tax Deduction**. A taxpayer is entitled to an income tax deduction for the amount of a gift to a charitable organization.

1. Maximum income tax rate of 39.6% (43.4% maximum rate when subject to 3.8% health care surtax) for married taxpayers filing jointly with taxable income in excess of $464,850 in 2015. ***IRC Section 1(i).***

2. Social Security and FICA taxes can raise maximum effective marginal income tax rate higher.

   (a) Social Security wage base of $118,500 in 2015.

   (b) OASDI taxes of 12.4% on self-employed persons in 2015.

3. State income taxes imposed on residents of certain states (not Florida) can raise the effective maximum tax rate even higher.

B. **Estate Tax Deduction.**

1. Maximum estate tax rate of 40%.

2. Various estate tax proposals may be introduced this year but have little chance of passage.

C. **Income Tax Savings.**

1. Use to avoid income tax on Individual Retirement Accounts and qualified retirement plan benefits.

2. Can also avoid income tax and achieve diversification on inter vivos gifts of appreciated property.

V. Types of Charitable Organizations.

A. **Public Charity**. Public charities include churches, schools, hospitals and other tax-exempt organizations organized and operated under United States law for religious, charitable, scientific, literary or educational purposes. ***IRC Section 170(c)(2)***.

B. **Private Foundation.** A grant-making charitable organization which does not qualify as a public charity because it is primarily funded and controlled by a single donor or family (discussed in Section XVI below). ***IRC Section 509(a).***

C. **Private Operating Foundation**. A private operating foundation is a private foundation that devotes directly to the active conduct of its charitable purposes:

1. More than 50% of its assets; and

2. Substantially all (defined as 85% or more) of its income. ***IRC Section 4942(j)***.

D. **Community Foundation**. A community foundation is a grant-making organization classified as a public charity which receives more than one-third of its support from the general public. ***Treasury Regulation Section 1.170A-9(e)(10).***

E. **Donor-Advised Funds.** Many public charities and community foundations have established donor-advised funds in recent years. A donor may make non-binding charitable grant recommendations in connection with gifts to a donor-advised fund.

1. **Advantages Compared to a Private Foundation**. A donor-advised fund has the following advantages over a private foundation:

(a) Gifts are deductible up to 50% of AGI.

(b) Avoid private foundation excise tax on net investment income (generally 2%)

(c) Can deduct full fair market value of appreciated property.

(d) No investment and administrative burden.

2. **Disadvantage Compared to a Private Foundation**. A private foundation has the following advantages over a donor-advised fund:

(a) A donor has more control with a private foundation.

(b) Many donor-advised funds have geographical or purpose limitations.

(c) Grant recommendations to a donor-advised fund are non-binding.

VI. Contribution Limits.

A. **Contribution Base Limitation**. The charitable income tax deduction is limited to a percentage of the "contribution base" of the donor in the year of the gift. In general, "contribution base" is defined as adjusted gross income computed without net operating loss carry back. ***IRC Section 170(b)(1)(F).*** The contribution base percentage threshold for gifts of cash and ordinary income property varies depending on the type of charitable recipient:

1. **50% Limitation - Gifts to Public Charity.** ***IRC Section 170(b)(1)(A).***

2. **30% Limitation - Gifts to Private Foundation.** ***Section IRC 170(b)(1)(B).***

B. **Limitation on Gift of Capital Gain Property.**

1. **30% Limitation - Gifts to Public Charity.** ***Section IRC 170(b)(1)(C).***

(a) Must be held for more than one year.

(b) Deduct at cost basis, rather than fair market value, if held less than one year (subject to 50% AGI).

2. **20% AGI Limitation - Gifts to Private Foundation.** ***IRC Section 170(b)(1)(D).***

(a) Cost basis, rather than fair market value, of donated property used in determining amount of income tax deduction.

(b) **Qualified Appreciated Stock Exception.**

(i) Can use fair market value of "qualified appreciated stock" donated to a private foundation.

(ii) **"Qualified appreciated stock"** is defined as stock of a corporation for which market quotations are readily available on an established securities market. The gift cannot exceed 10% of the stock of the corporation. ***IRC Section 170(e)(5).***

(iii) **Rule 144 Stock.** Stock subject to Rule 144 does not constitute "qualified appreciated stock." ***Private Letter Ruling 1999247018.***

C. **Charitable Contribution Carry Forward Provisions.** Excess contributions may be "carried forward" for five additional taxable years. However, the carry forward provision is limited to one year following the death of the donor.

D. **3% Floor on Itemized Deductions.** There was a reinstatement in 2013 of the floor set on itemized deductions for married taxpayers in excess of adjusted gross income of $300,000, indexed for inflation. The income threshold is $309,900 for married taxpayers filing jointly in 2015. ***IRC Section 68(b)***

1. The floor imposed on itemized deductions is the lesser of:

   (a) 3% of adjusted gross income; or

   (b) 80% of the allowable deductions. ***IRC Section 68(a)***.

2. The floor does not affect charitable contribution deductions for taxpayers who otherwise have itemized deductions in excess of the 3% floor (and personal exemptions).

3. The floor on itemized deductions were previously phased out over a five year period beginning in 2006 and reinstated in 2013 and thereafter:

   (a) The floor was reduced by one-third in 2006 and 2007 (resulting in a "2% floor");

   (b) The floor was reduced further by two-thirds in 2008 and 2009 (resulting in a "1% floor"); and

   (c) The floor was eliminated in 2010-2012. ***IRC Section 68(f).***

   (d) The 3% floor on itemized deductions returned in 2013, with the income threshold indexed for inflation ($309,900 for married taxpayers filing jointly in 2015).

E. **IRA Charitable Rollover.** If extended again in 2015, taxpayers may use an IRA charitable rollover to exclude up to $100,000 per year of "qualified charitable distributions" from gross income (with no charitable deduction under Section 170 for the excluded amount). ***IRC Section 408(d)(8).***

1. **Qualified Distribution**. A qualified charitable distribution is a distribution from an individual retirement plan made directly to an eligible charitable organization on or after the date the individual taxpayer reaches age 70½. The charitable rollover is available only to the extent the distribution would otherwise be includible in gross income, and only if a contribution of the

distributed amount would otherwise be fully deductible (without regard to the IRC Section 170(b) percentage limitations).

2. **Limited to IRA**. The charitable rollover applies only to distributions from an individual retirement account (or individual retirement annuity), which may include amounts rolled over from an IRC Section 401(k) or 403(b) plan. The charitable rollover does not apply to a "simplified employee pension" (IRC Section 408(k)) or a "simple retirement account" (IRC Section 408(p)).

3. **Distributee Requirements**. The distributee must be an eligible charitable organization, which includes public charities and governmental entities (but not supporting organizations, donor-advised funds, most private foundations, or split-interest charitable trusts).

4. **Excluded Amount and MRD**. The excluded amount counts toward the required minimum distribution to the same extent as if distributed to the taxpayer. (Note that the required minimum distributions must begin by April 1 after the taxpayer reaches age 70½.)

5. **General Non-Applicable for Roth IRA**. Because the distribution must otherwise be includible in gross income, the charitable rollover generally does not apply to a Roth IRA (unless made during the 5-year taxable window after the initial contribution) or to the nontaxable portion of a traditional IRA. Nevertheless, a favorable ordering rule treats the distribution as coming first from the taxable portion of the plan.

6. **Quid Pro Quo Disallowed**. The fully deductible requirement is met only if there is no quid pro quo. In addition, IRC Section 170(f)(8) requires the taxpayer to obtain a contemporary written acknowledgment from the charitable organization confirming that it provided no goods or services as consideration for any part of the distribution. A charitable rollover cannot be used to fund a pooled income fund or a charitable gift annuity, even if the recipient is a public charity, because a contribution to such a recipient would not be fully deductible.

F. **IRA Charitable Rollover Practice and Planning**. If an IRA owner takes a required minimum distribution and immediately contributes the distributed amount to charity, the distribution is generally taxable as ordinary income, but the inclusion is offset by a charitable deduction, subject to the percentage limitations of IRC Section 170(b). A charitable rollover achieves a similar result, but it avoids the percentage limitations of IRC Section 170(b) on contributions of up to $100,000 per year. In effect, a qualified charitable distribution shelters up to $100,000 from tax in addition to any other charitable contributions that are subject to the percentage limitations. This advantage is especially important for taxpayers who have relatively low adjusted gross income or large charitable contributions.

1. **Gift of Appreciated Stock the Preferred Contribution**. Normally a gift of appreciated stock is more advantageous than a charitable contribution of an equivalent taxable IRA distribution. The in-kind gift avoids incurring a capital gain tax while generating a deduction for the full value of the contributed stock.

2. **Example**. TP intends to make a $100,000 charitable contribution, which may be funded either with zero-basis stock worth $100,000 or with cash from an IRA. Assume that the applicable tax rate is 20% for capital gains and 40% for ordinary income.

   (a) TP donates the stock directly to charity, incurring no tax and generating a $100,000 deduction (equivalent to $40,000 tax reduction). (The in-kind donation avoids the $20,000 capital gains tax that would be imposed on a sale of the stock.)

   (b) TP makes a qualified charitable distribution of $100,000 from the IRA, incurring no tax and generating no deduction. (The charitable rollover avoids the $100,000 of ordinary income and the offsetting $100,000 charitable deduction that TP would report on a withdrawal followed by a gift to charity.)

   Assuming that TP has no other charitable contributions or carryforwards subject to the IRC Section 170(b) percentage limitations, the donation of appreciated stock (subject to the 30% limitation for long-term capital gain property) is fully deductible only if TP has AGI of at least $333,333. Similarly, a $100,000 cash donation (subject to a 50% limitation) is fully deductible only if TP has AGI of at least $200,000. However, if TP has very low AGI (or has other charitable contributions or carryforwards that count against the IRC Section 170(b) percentage limitations), the charitable rollover may provide a larger immediate tax benefit.

3. **Collateral Benefits**. Excluding a qualified charitable distribution from gross income also has collateral benefits. A reduction in gross income, and hence in adjusted gross income, mitigates the adverse effects of the 2% floor for miscellaneous itemized deductions (***IRC Section 67***), the 3% phase-out for itemized deductions (***IRC Section 68***), the tax on social security benefits (***IRC Section 86***), and the AMT exemption phase-out. **(*IRC Section 55(d)*)**

4. **Extension Uncertain**. The charitable rollover provision was first enacted in 2006 on a temporary basis and has repeatedly been extended.

   (a) It was not extended in 2014 until Friday, December 19, 2014.

   (b) It has now been extended in 2017.

VII. Types of Charitable Gifts.

A. **Outright Gifts.**

B. **Charitable Remainder Trusts** (discussed in Section VIII below).

1. **Charitable Remainder Annuity Trust.**

2. **Charitable Remainder Unitrust.**

C. **Charitable Lead Trusts** (discussed in Section XIII below).

1. **Charitable Lead Annuity Trust.**

2. **Charitable Lead Unitrust.**

D. **Charitable Gift Annuity.** A charitable gift is a private arrangement between a donor and a charitable organization under which the donor will receive a fixed annuity. The charitable annuity is treated like a bargain sale under Section 1011(b).

1. A charitable gift annuity is a contract (not a trust) under which a charitable organization, in return for transfer of cash, marketable securities or other assets from the donor, agrees to pay a fixed amount of money to one or two individuals, for their lifetime.

2. The contributed property (the gift) is given irrevocably and becomes a part of the assets of the charitable organization, the annuity payments are considered a general obligation of the charitable organization (The annuity is backed by the charity's entire assets, not just the property the donor contributed).

3. Annuity payments will continue for the life/lives of the annuitant(s), no matter what the investment of the gift annuity fund.

4. The annuity payments are fixed and unchanged for the term of the contract.

5. Will produce a charitable income tax deduction and, if appreciated property is gifted, taxable gain to the donor. A portion of the payments are considered to be a partial tax-free return of the donor's gift, which are spread in equal payments over the life expectancy of the annuitant(s).

6. Regulated by a number of states (including Florida).

7. Generally will require at least a 50% payout (measured by the actuarial value of the remainder interest) to the charity.

8. The present value of a gift annuity's payments must be less than 90% of the value of the property contributed in order for the arrangement to qualify as a charitable gift annuity. As a practical matter, this means the charitable deduction must be more than 10% of the value of the property contributed.

9. The American Council on Gift Annuities ("ACGA") recommended a decrease in payout rates effective January 1, 2012 (the rates remain unchanged as of the ACGA Board of Director's most recent semi-annual meeting on November 3, 2014).

   (a) Most annuity rates decreased by 0.4% to 0.8%, depending on the age of the annuitant (age 50 and above).

   (b) Charitable deductions have increased accordingly.

10. Advantages of a Charitable Gift Annuity

   (a) Simplicity – a one page contract is sufficient.

   (b) No tax return, trust or trustee.

11. Disadvantages of a Charitable Gift Annuity

   (a) Must be a 50% or more residual interest to the charity.

   (b) May constitute a security in certain states.

12. Current ACGA Single Life and Joint-Life Rate Table:

Single Life Table/Joint-Life Table

Age	**Rate**	**Age**	**Rate**
65	4.7%	65/65	4.2%
70	5.1%	70/70	4.6%
75	5.8%	75/75	5.0%
80	6.8%	80/80	5.7%
85	7.8%	85/85	6.7%

E. **Pooled Income Funds.** Maintained by a public charity to receive gifts of cash and marketable securities from a number of donors to be held in a single pool, with separate accounting for each donor.

VIII. Charitable Remainder Trusts.

A. Types of Charitable Remainder Trusts.

1. Charitable Remainder Annuity Trust.

2. Charitable Remainder Unitrust.

B. **Requirements for Tax Deduction.** In order to obtain an estate, income or gift tax deduction for a donor's transfer of a partial interest in property to charity, where the donor or other non-charitable beneficiary has also retained an interest in the property, the charitable interest must be either in the form of a guaranteed annuity, a fixed percentage (redetermined annually) of the annual trust property or a form of net income unitrust.

1. **Guaranteed Annuity Interest.**

(a) **Fixed Dollar Amount.** A charitable remainder annuity trust may state a fixed dollar amount as the guaranteed annuity payment. The guaranteed annuity payment must be payable at least annually for a fixed term of years (not to exceed 20 years) or until the death an individual or the survivor of a group of individuals.

(b) **Formula Approach.** A charitable remainder annuity trust may include a formula for computing the guaranteed annuity payment so long as the annuity amount is ascertainable at the time of the funding of the trust.

2. **Unitrust Interest.** A charitable remainder unitrust must state a fixed percentage of the annual net fair market value of all trust assets as the unitrust interest. The unitrust payment must be payable at least annually for a fixed term of years (not to exceed 20 years) or until the death of an individual or the survivor of a group of individuals.

3. **Minimum Payout Rate.** The minimum annuity or unitrust payout must be at least 5%.

4. **Maximum Unitrust Rate.** The unitrust rate of a charitable remainder unitrust cannot exceed 50%. This was designed to reduce the use of charitable remainder trust as an income tax avoidance mechanism.

5. **Computation of Value of Remainder Interest.** The actuarial value of the remainder interest projected to pass to a charitable organization following the expiration of the income interest is computed based on the following factors:

(a) Rate of return payable to the income beneficiary.

(b) “Applicable federal rate” in effect at the time of the gift.

(c) Life expectancy of income beneficiary based on mortality tables.

6. **Applicable Federal Rates.**

(a) The September 2017 applicable federal rate was only 2.4%.

(b) The chart listed below shows the fluctuation of the applicable federal rates in the month of September over the last twelve years:

Month	Section 7520 Rate
September 2017	2.4%
September 2016	1.4%
September 2015	2.2%
September 2014	2.2%
September 2013	2.0%
September 2012	1.0%
September 2011	2.0%
September 2010	2.4%
September 2009	3.4%
September 2008	4.0%
September 2007	5.8%
September 2006	6.0%
September 2005	5.8%

C. **Types of Charitable Remainder Unitrusts.**

1. **Fixed Percentage Unitrust.** The unitrust pays a fixed percentage of trust assets, revalued on an annual basis, to the lead beneficiary. ***IRC Section 664(d)(2)***

2. **Net Income Unitrust.** The unitrust pays the lesser of: (1) the net income of the unitrust for the year; or (2) a fixed percentage of trust assets, revalued annually. ***IRC Section 664(d)(2) and (3).***

3. **Net Income Make-Up Unitrust.** The net income unitrust payment increases to "make up" for prior deficient payments to the lead beneficiary as the net income of the trust is earned. ***IRC Section 664(d)(2) and (3).***

   (a) Capital gain may be allocated to trust income under the trust agreement.

   (b) Pre-contribution gain cannot be allocated to income.

4. **Flip Unitrust.** A net income unitrust or a net income make-up unitrust may "flip" to a standard unitrust under the following circumstances:

   (a) 90% or more of the initial fair market value of the unitrust assets consist of unmarketable securities;

   (b) The income exception is used until 50% or less of the unitrust assets consist of marketable securities;

   (c) The trust is thereafter administered as a fixed percentage unitrust; and

   (d) The make-up income amount is forfeited. Proposed Treasury Regulation Section 1.664-3(c).

D. **Flexibility.** A great deal of flexibility may be retained in creating a charitable remainder annuity trust or unitrust.

1. **Qualified Contingencies.** Section 664(f) provides that annuity and unitrust payments may terminate on the occurrence of a "qualified contingency" such as:

   (a) Divorce;

   (b) Remarriage; or

   (c) Other event which does not reduce the value of the remainder interest passing to charity. ***IRC Section 664(f).***

2. **Right to Change Charitable Beneficiary.** The donor may retain the right to change the charitable beneficiary at any time before distribution. The charitable income tax deduction may be affected if a private foundation is substituted for a public charity. ***Private Letter Ruling 199750061.***

3. **Trustee.** The grantor may serve as trustee.

E. **Revenue Ruling 77-374.** A charitable remainder annuity trust does not qualify for a charitable deduction if there is more than a 5% probability that the income beneficiary will survive the exhaustion of the charitable remainder annuity trust assets. ***Revenue Ruling 77-374***.

F. **IRC Section 664(d)(4).** Internal Revenue Code Section 664(d)(4) requires that the actuarial value of the charitable remainder interest must be at least 10% of the fair market value of the donated property to qualify as a charitable remainder trust.

1. The actuarial value of the charitable remainder is equal to the income tax charitable deduction generated by the gift.

2. The 10% requirement is to discourage the use of charitable remainder trusts solely for income tax avoidance.

3. The application of Section 664(d)(4) can result in an unexpected failure to qualify as a charitable remainder annuity trust.

(a) **CRAT EXAMPLE:** Tom Taxpayer (age 60) gifts publicly traded stock worth $1,000,000 to a charitable remainder annuity trust, retaining the minimum $50,000 annuity for his life. Assuming an applicable federal rate of 1%, the actuarial value of the charitable remainder interest is $55,000. Since actuarial value of the charitable remainder is less than 10% of the fair market value of the $1,000,000 gift, the trust violates Section 664(d)(4) of the IRC and does not qualify as a charitable remainder annuity trust.

(b) **CRUT EXAMPLE:** Terry Taxpayer (age 60) gifts publicly traded stock worth $1,000,000 to a charitable remainder unitrust, retaining a 5% annual unitrust interest (initially $80,000 in year one) for her life. Assuming an applicable federal rate of 1%, the actuarial value of the charitable remainder interest is $378,000. Since actuarial value of the charitable remainder is 10% of the fair market value of the $1,000,000 gift, the trust does not violate Section 664(d)(4) of the IRC and qualifies as a charitable remainder annuity trust.

G. **Proposal**. Congress has been advised to soften the effect of Section 664(d)(4).

H. **Charitable Gift of Property Subject to an Option.** The fair market value and timing of a charitable income tax deduction for property subject to an option gifted to charity is the value at the expiration of the option. ***Private Letter Ruling 199982001.***

I. **Early Termination.** The early termination of a charitable remainder trust through the purchase of the donor's interest at its actuarial value results in capital gain tax. ***Private Letter Ruling 200403051.***

J. **Private Letter Ruling 201133004.** The Service ruled that the judicial reformation of a net income charitable remainder unitrust with makeup provisions into a standard charitable remainder unitrust does not violate IRC section 664.

1. The scrivener of the CRUT acknowledged that a standard fixed percentage CRUT was intended.

2. The CRUT was administered in its early years as a standard fixed payout CRUT.

3. The trustees and all beneficiaries (income and remainder) consented to the reformation action.

IX. Income Taxation of Charitable Remainder Trusts

A. **Tax Exempt.** A charitable remainder trust is exempt from income tax unless there is unrelated business taxable income. ***IRC Section 664(c).*** Otherwise charitable remainder unitrust income is passed through to the income beneficiary.

B. **Unrelated Business Taxable Income.**

1. **Newhall Case**. The 9th Circuit affirmed a Tax Court decision disqualifying a charitable remainder unitrust which realized unrelated business taxable income on the liquidation of publicly traded stock. ***Lelia G. Newhall Uniturst v. Commissioner, 104 T.C. 236 (1995), aff'd., 105 F.3d 482 (9th Cir. 1997)***.

C. **Tier System**. Income is taxed to the income beneficiary under the "WIFO" tier system ("worst in/first out"). Tier system allows for significant deferral of income tax.

1. The tier system works as follows:

   (a) Ordinary income, from current year earnings or prior accumulations.

   (b) Capital gain income, from current year earnings or prior accumulations.

   (c) Tax-exempt income.

   (d) Return of principal.

2. Proposed regulations create additional ordering rules with "sub-tiers" within each tier:

   (a) Taxed at rate in effect when the distribution comes out of the charitable remainder trust, not at the rate in effect when the income was earned.

   (b) The 15% qualified dividend rate can be utilized under the proposed regulation.

D. **Calendar Year Reporting.** Charitable remainder trusts must use a calendar year for tax reporting purposes. ***IRC Section 645***.

X. Use of Charitable Remainder Trust as Beneficiary of Individual Retirement Account and Other Qualified Retirement Plan Benefits.

A. **Severe Income/Estate Tax Burden.** Without proper planning, the combined income and estate tax payable on IRA and qualified retirement plan benefits can exceed 65%. The tax effect is computed as follows: (1) First: compute federal and state estate tax; (2) Second, compute state income tax (if any); and (3) Third, compute federal income tax. The federal estate tax attributable to the IRA or retirement plan benefit is deductible for federal income tax purposes. ***IRC Section 691(c)***.

B. **Avoid Income Tax/Reduce Estate Tax**. The tax burden can be reduced by naming a charitable remainder trust as the beneficiary of an IRA or qualified retirement plan benefit.

1. No income tax payable on the distribution of the IRA or qualified retirement plan benefit to the charitable remainder trust.

2. Estate tax deductions for value of the charitable remainder interest.

3. Income and estate tax savings are invested in the charitable remainder trust and generate a larger return for the beneficiaries than they would otherwise receive.

C. **Roth IRAs**. Do not name charitable beneficiaries of Roth IRAs. The Roth IRA grows and is distributed income tax-free to individual beneficiaries.

XI. Section 501(c)(3) Charitable Organizations and Certain Charitable Trusts as Shareholders of Subchapter S Corporation Stock.

A. **Small Business Job Protection Act of 1996.** Section 501(c)(3) charitable organizations and certain trusts qualifying as "Electing Small Business Trusts" ("ESBTs") are qualified Subchapter S corporation shareholders.

1. **Section 501(c)(3) Organizations.** Sections 1361(b)(1)(B) and 1361(c)(6) allow Section 501(c)(3) charitable organizations to become shareholders of Subchapter S corporations.

(a) **Special Rules.** Section 512(e), however, provides special rules applicable to Subchapter S corporations.

(i) **Unrelated Business Taxable Income ("UBTI").** Section 512(e)(1) provides that: (i) all items of income, loss, or deduction taken into account under Section 1366(a); and (ii) any gain or loss on the disposition of the Subchapter S corporation stock, shall be taken into account in computing the UBTI of such organization.

(ii) **Basis Reduction.** Section 512(e)(2) provides that, except as otherwise provided in the Regulations, the basis of any Subchapter S corporation stock acquired by purchase shall be reduced by the amount of any dividends received by the organization.

2. **ESBTs.** Sections 1361(b)(1)(B) and 1361(c)(2) allow certain trusts qualifying as ESBTs to become shareholders of Subchapter S corporations.

(a) **Trusts Qualifying as ESBTs.** Trusts which qualify as ESBTs are defined under Section 1361(e)(1)(A). Trusts which qualify as ESBTs must not: (i) have a beneficiary other than an individual, an estate, or an organization described in Section 170(c)(2) through (5); (ii) have an interest which was acquired by purchase; and (iii) be exempt from taxation under Subtitle A (other than Section 501(a)) of the Internal Revenue Code.

(b) **Charitable Lead Trusts.** Charitable lead trusts qualify as ESBTs since they are not trusts exempt from taxation under Subtitle A of the Internal Revenue Code.

(c) **Charitable Remainder Trusts Do Not Qualify as ESBTs.** Section 1361(e)(1)(B) provides that charitable remainder trusts do not qualify as ESBTs since they are exempt from taxation under Subtitle A (other than Section 501(a)) of the Internal Revenue Code.

XII. The Interest Element in Charitable Planning

A. **Background**.

1. **Concept**. The concept of making interest free or below-market interest rate loans as a device to shift income and wealth while retaining control has been around for many years and was approved by the Tax Court in ***Crown v. Commissioner,*** ***67 TC 1060 (1977); non-acq. 1978-1 CB 2; aff'd, 585 F2d 234, (7th Cir. 1978)***

2. **Taxable Gift**. In 1984 the U.S. Supreme Court held that the failure to charge a market rate of interest for the use of money was a taxable gift by the lender to the borrower. ***Dickman v. Commisioner,*** ***460 U.S. 330 (1984)***

3. **"Gift Loans."** Congress expanded upon the Dickman decision by adopting IRC Sections 7872 and 1274, applicable for both gift and income tax purposes, so as to impute interest at a market rate, creating income to the lender, a deduction to the borrower, and a gift by the lender to the borrower on "gift loans," i.e., below market loans to a family member.

(a) The rules require a market interest rate based upon the applicable federal rate ("AFR").

(b) The rules can also be imposed in loan transactions between an employer and employee.

(c) **Exceptions to Section 7872 application**.

(i) Loans between natural persons of no more than $10,000 are generally ignored.

(ii) Loans of up to $100,000 between natural persons (determined on a "marital unit" concept) that are not designed to shift taxable income are either exempted from the rule if the borrower (and spouse) during the taxable year has net investment income of no more than $1,000.

(iii) Sales of property under which interest may be imputed under Section 483 are outside of Section 7872; however, the Dickman rationale would still apply to the gift tax exposure. (c.f., ***Ballard v. Commissioner*, 854 F2d 185 (7th Cir. 1988)** where the court permitted a below-market, safe-harbor rate under Section 483 to determine the gift tax value; ***Estate of Krabbenhoft v. Commissioner*, 939 F2d 529 (8th Cir. 1991)** where the court held that the safe harbor rates under Section 483 were irrelevant for gift tax purposes.)

B. **The Applicable Federal Rate – 26 US Code Section 1274(d).**

3. **AFRs Determined Monthly**. During each calendar month the IRS determines the federal short-term rate (applicable to debt instruments with a term not over 3 years) "based on the average market yield . . . on outstanding marketable obligations of the United States with remaining periods to maturity of 3 years or less." ***IRC Section 1274(d)(1)(c)(i).*** The federal mid-term (over 3 years but not more than 9 years) and long-term (over 9 years) rates are determined under the same principles.

4. **Minimum Market Interest Rate**. The AFR determined under Section 1274(d) is used to establish the minimum market interest rate for debt instruments.

E. **The Section 7520 Rate**.

1. **Rate Determined Monthly**. The IRS publishes interest rate assumptions monthly since 1989 when Section 7520 was enacted. The Section 7520 interest rate is used to value:

(a) Any annuity;

(b) Any interest for life or for a term of years; and

(c) Any remainder or reversionary interest.

2. **Definition**. The "7520 Rate" is defined as "an interest rate (rounded to the nearest 2/10ths of 1%) equal to 120 percent of the federal mid-term rate in effect under Section 1274(d)(1) for the month in which the valuation date falls." ***IRC Section 7520(a)(2)***

   (a) The Treasury Regulations provide that the 7520 Rate is to be based on 120% of the federal mid-term rate using <u>annual</u> compounding. ***Treas. Reg. Section 20.7520-1(b)(1)(i)***

   (b) The rates published in the monthly IRB are based upon semi-annual compounding with the rates for the other compounding periods derived to produce an equivalent yield.

   (c) **Example**: If 120% of the federal mid-term rate is 1.68%, the 7520 Rate is rounded to 1.6%; 1.71 is rounded to 1.8%.

3. **Election of Rate**. If an income, estate, or gift tax <u>charitable</u> deduction is allowable for any part of the property being transferred, you may elect to use the 7520 Rate determined for the month in which the valuation date falls or either of the <u>preceding</u> 2 months.

4. **Timing of Rate**. The 7520 Rate is published monthly in the Internal Revenue Bulletin and is usually available, <u>in advance</u>, during the third week of the month preceding the applicable month. Consequently, for planning purposes, we can have up to four available rates to use by timing our transactions to occur immediately before or immediately after the first of a month

5. **All-Time Low Rates**. Since 2008, the 7520 Rate has been at historic lows with a high of 4.2% in August 2008 and a low of 1% as recently as January 2013. The 7520 Rate increased from 1.4% in September 2016 to 2.4% in September 2017.

XIII. Charitable Lead Trusts.

A. **Definition**. A Charitable Lead Trust ("CLT") is a split-interest trust which pays either a fixed annuity or a percentage income amount to a charitable beneficiary for a fixed number of years or for the life of the donor (the "lead interest") and then distributes the remaining trust property to the donor or other non-charitable beneficiaries (the "remainder interest"). There are two types of charitable lead trusts distinguished by estate tax deduction purposes:

1. **Qualified Charitable Lead Trust**. Transfers to a qualified charitable lead trust are deductible for estate or gift tax purposes. A qualified charitable lead trust may be created during a donor's life ("inter vivos") or by will ("testamentary"). The amount of the estate or gift tax deduction is limited to the actuarial value, at the time of the transfer to the trust, of the charitable

interest. As is the case with charitable remainder trusts, there are two types of qualified charitable lead trusts: a charitable lead annuity trust and a charitable lead unitrust.

(a) **Two Forms: CLAT vs CLUT**. A Charitable Lead Trust takes two basic forms: (1) a Charitable Lead Annuity Trust ("CLAT"); or (2) a Charitable Lead Unitrust ("CLUT"). From a planning perspective, these trusts can be established during lifetime or at death. If established during lifetime, they can be structured as either a grantor or a non-grantor CLT under which there will be differing income tax and charitable deduction consequences.

(i) **Charitable Lead Annuity Trust**. A charitable lead annuity trust is a charitable lead trust in which the "lead" charitable interest is a guaranteed annuity interest, which pays a fixed dollar amount each year to one or more charitable lead beneficiaries, which sum may be stated as a percentage or fraction or formula for determining the fixed dollar amount determinable at the inception of the trust. There is no minimum payout required as in the case of a CRT. In addition, the actual amounts of the payments each year can vary so long as they are determinable at inception. ***Treas. Reg. Section 20.2055-2(e)(2)(vi) and PLR 9112009***.

(A) **Guaranteed Annuity Interest**. The requirement of a "guaranteed annuity interest" will be satisfied as long as the payments are "determinable" at the inception of the CLT (for example, see, ***PLR 201216045***)

(B) **Growth of Corpus Benefits Remainder Beneficiaries**. It should be evident that in the case of a CLAT, the charitable interest does not benefit from any growth in the trust assets which growth all inures solely to the benefit of the remainder beneficiaries at the end of the trust term.

(ii) **Charitable Lead Unitrust**. A charitable lead unitrust is a charitable lead trust in which the "lead" charitable interest is an amount calculated as a fixed income percentage of the value of the trust property, re-determined annually, of all the trust property to one or more charitable lead beneficiaries. The methodology of annual valuation need not be limited to determining fair market value on January 1 but it must be the same manner of determination each year. For example, you could specify that the fair market value be an average of the quarterly fair market values.

(A) **7520 Rate Does Not Affect Value of Split Interests**. In the case of a CLUT, the 7520 Rate does not significantly affect the valuation of the split interests. In fact, it has no effect when the unitrust amount is payable annually with a payment date the same as the annual valuation date.

(B) **Appreciation/Depreciation Shared Between Split Interests**. The CLUT shares any appreciation (or depreciation) between the charitable and non-charitable interests.

(b) **Income Tax Consequences & Limitation on Deductions**. A grantor-CLT will produce an income tax charitable deduction in the year it is initially funded; however, as a grantor trust for tax purposes, the grantor must report the trust income annually during each year of its term. Furthermore, the percentage deduction limitation for transfers to the CLT will be considered a gift “for the use” of the charity rather than “to” the charity, resulting in the lower income tax percentage limitations of 30% (or even 20% if the trust is funded with long term capital gain property and the beneficiary is not a public charity). This technique is generally considered when the taxpayer has an unusually large income in a year where the charitable deduction will produce a significant deduction and result in a shift of the deferred tax liability over the remaining term of the trust.

2. **Nonqualified Charitable Lead Trust.** Transfers to a nonqualified charitable lead trust are not deductible for estate or gift tax purposes.

(a) A nonqualified charitable lead trust may also be created during a donor's life (“inter vivos”) or by will (“testamentary”).

(b) This outline will address qualified charitable lead trusts.

3. **Intentionally Defective Grantor Charitable Lead Trusts.** Used to obtain the charitable income tax deduction and to transfer assets free of estate and gift tax to beneficiaries.

4. **Model Forms.** The IRS issued model charitable lead annuity trust forms in 2007:

(a) **Lifetime CLATS**. Inter Vivos CLAT forms. ***Revenue Procedure 2007-45***.

(b) **CLATs Under Wills**. Testamentary CLAT forms ***Revenue Procedure 2007-46***.

B. **Requirements for Gift Tax Deduction.** In order to obtain an estate, income or gift tax deduction for a donor's transfer of a partial interest in property to a charitable lead trust, the charitable interest must be in the form of a guaranteed annuity or is a fixed percentage of the annual trust property.

1. **Charitable Beneficiary.** The charitable beneficiary of a charitable lead trust must be a charitable organization to which contributions are deductible under Sections 2055 or 2522.

(a) **Trust Document**. The trust document must either directly specify, or grant the trustee authority to select, the charitable organization to which the trust annuity or unitrust amount is paid. In order to secure a charitable deduction for the value of the charitable lead interest, it is necessary for the trust document to contain specific provisions applicable to private foundations. (***IRC Sections 508(d)(2) and (e); Treas. Reg. Section 1.508-2(b)(1)(vi)(a)***). These provisions deal with prohibitions against self-dealing, retention of excess business holdings, jeopardy investments and taxable expenditures. These will be discussed later in the outline.

(i) **Specific Charity**. The trust document may specify the charitable organization to which the trust annuity or unitrust amount is paid. In this instance, the trust document must also specify the method by which an alternate charitable organization is selected. In order to avoid inclusion in the donor's gross estate, the donor should not have the ability to direct how the payment amount is made to, or change, the charitable organization.

(ii) **Non-Specific Charity.** The trust document may also grant the trustee the authority to select the charitable organization to which the annuity or unitrust amount is paid. The trust document should direct that the trustee may only select amongst charitable organization to which payments would be deductible. Again, to avoid inclusion in the donor's gross estate, the donor should not have the ability to direct how the payment amount is made to, or change, the charitable organization.

2. **Guaranteed Annuity Interest.**

(a) **Fixed Dollar Amount.** A charitable lead annuity trust may state a fixed dollar amount as the guaranteed annuity payment. Under Treasury Regulations Sections 20.2055-2(e)(2(vi) and 25.2522(c)-3(c)(2)(vi), the guaranteed annuity payment must be payable at least annually for a fixed term of years or until the death an individual or survivor of a group of individuals.

(b) **Formula Approach.** A charitable lead annuity trust may include a formula for computing the guaranteed annuity payment so long as the annuity amount is ascertainable at the time of the funding of the trust.

3. **Unitrust Interest.** A charitable lead unitrust must state a fixed percentage of the annual net fair market value of all trust property as the unitrust interest. Under Treasury Regulations Sections 20.2055-2(e)(2)(vii) and 25.2522(c)-3(c)(2)(vii), the unitrust payment must be payable at least annually for a fixed term of years or until the death an individual or survivor of a group of individuals.

4. **Annuity or Unitrust Payments in Excess of Stated Amount.** Under Treasury Regulations Sections 20.2055-2(e)(2)(vi)(d) and (vii)(d) and 25.2522(c)-3(c)(2)(vi)(d) and (vii)(d), a qualified charitable lead trust may provide that trust income in excess of the annuity or unitrust amount be payable to the charitable organization; however, no estate or gift tax deduction will be allowed for the value of the charity's right to receive such excess amount.

5. **Payment Prior to End of Charitable Period.** Treasury Regulation Sections 20.2055-2(e)(2)(vi)(f) and (vii)(e) and 25.2522(c)-3(c)(2)(vi)(f) and (vii)(e) state that no payment may be made to a non-charitable beneficiary prior to the end of the charitable period unless such payment is made from assets specifically available for non-charitable purposes. ***Crown Income Charitable Fund v. Commissioner, 98 T.C. 327 (1992).***

C. **Escalating Payments.** A charitable lead trust may provide for escalating payments to charity:

1. **Private Letter Ruling 201216045.** The Service issued a ruling allowing 20% annual increases of the annuity amount over a 10 year period.

2. **Balloon CLAT.** Based on this private letter ruling and other authority, it is expected that a “balloon” or “shark fin” charitable lead trust would be allowed by the Service.

D. **Permissible Term.** A charitable lead trust may have a term defined as either:

1. **Term of Years.** A fixed term may be used (without the 20-year restriction imposed on charitable remainder trust).

2. **Measuring Life.** The charitable lead trust may also be measured by the life of the donor.

   (a) **More than one life can be used**.

   (b) **Cannot base solely on another unrelated person's life ("per autre vie")**.

   (c) **Limitation on Class of Individuals Designated as Measuring Lives**. Unlike the CRAT or CRUT, there is no requirement that the individual whose life measures the term of a charitable lead annuity or unitrust be a beneficiary of the trust. Until a few years ago, there was no requirement that the individual have any relationship to the trust, the donor, or the trust beneficiaries. However, the IRS has issued Treasury Regulations which now limit the class of individuals who can be designated as a measuring life.

      (i) **"Ghoul Trusts"**. According to the IRS, the previous lack of guidance regarding the term of a charitable lead trust's charitable interest has resulted in the use of the so-called "ghoul trust." A ghoul trust is a charitable lead trust whose charitable term is measured by the life of an individual unrelated to the settlor. The individual serving as a measuring life is seriously ill, but not "terminally ill" as defined in the Section 7520 Regulations. As a result, the charitable interest is valued based on the actuarial tables. If the seriously ill individual dies prematurely (as is expected), the amount the charity actually receives will be significantly less than the amount on which the gift or estate tax charitable deduction was based

      (ii) **"Ghoul Trusts" Disallowed Post-April 4, 2000**. In order to curb these abusive transactions, the IRS has issued Treasury Regulations governing transfers to inter vivos charitable lead trusts made on or after April 4, 2000, or to transfers made under wills or revocable trusts when the decedent dies on or after that date. Based on these rules, donors are prohibited from using an unrelated individual's (who is seriously ill, but not terminally ill) measuring life as the term of the charitable lead trust to artificially inflate the charitable deductions.

E. **Federal Estate and Gift Tax Savings.** There is an estate or gift tax deduction for the actuarial value of the "lead" interest payable to a charitable organization.

1. **Charitable Lead Annuity Trust.**

(a) **Estate or Gift Tax Deduction**. The donor of a charitable lead annuity trust will receive an estate or gift tax deduction for the actuarial value of the annuity payable to the charity computed under Sections 7520 and 2055(a).

(i) During its term of operation, the CLT is not a tax exempt entity and will be taxed in accordance with the provisions of Subchapter J of the IRC.

(ii) Like a CLT established during lifetime as a non-grantor trust, a testamentary CLT will be entitled to an unlimited income tax deduction for the amount of the annuity payment paid each year during the term of the trust to the charitable beneficiaries. ***IRC Section 642(c)(1)***

(b) **Estate or Gift Tax Payable.** The donor will, however, be subject to estate or gift tax for the actuarial value of the non-charitable remainder interest determined at the creation of the annuity trust.

(c) **Tax Savings.**

(i) **Discounted Value**. The benefit to the donor is that the estate or gift tax payable on the transfer of the non-charitable remainder discounted to reflect the present value of the charitable "lead" annuity stream computed using the rates under IRC Section 7520 (re-determined monthly by the Service).

(A) **Month of Creation.** The donor may choose to discount the "lead" annuity stream using the Section 7520 rate effective for the month the trust is funded.

(B) **Two Preceding Months.** The donor may instead choose to value the "lead" annuity stream using the Section 7520 rate for either of the two months preceding the month in which the trust was funded. ***IRC Section 7520(a).***

(ii) **Future Appreciation**. The major tax advantage of a charitable lead annuity trust is that the donor will escape estate or gift tax on the future appreciation of the trust assets in excess of the Section 7520 rate. If the trustee can earn a higher rate of return on the trust assets than the trustee is required to pay to the charitable beneficiary under the predetermined annuity amount, substantial estate or gift tax savings will be recognized.

(A) Normally, the “price” to be paid for this benefit is a deprivation in the ability to enjoy the assets of the CLT until the end of the term of the trust.

(B) The specialized CLTs presented later in the outline combine several different planning techniques into an integrated plan that enhances the benefits to the remainder beneficiaries both during and at the end of the term, provides further estate planning benefits for multiple generations and permits the family to begin enjoying the use and benefits of the decedent’s estate set aside in a CLT during the term of the CLT

(iii) **Low Section 7520 Rates**. The current low applicable federal and Section 7520 rates make charitable lead trust an unusually beneficial estate planning technique. The lower the Section 7520 Rate, the higher the value of the charitable lead interest and, coincidentally, the estate tax charitable deduction.

(d) **Example Showcasing Effect of Length of CLAT Term**.

Assume Jack dies in January 2017. Jack’s will creates a $1,000,000 CLAT with the annual annuity payments set as a formula designed to “zero-out” the remainder interest so that 100% of the CLAT will produce a charitable deduction. If the Section 7520 Rate is 2%, then the annual annuity payment necessary to zero-out the CLAT will be the following amounts depending upon the trust term:

Trust Term	Annual Annuity
5	$212,160
10	**$111,330**
15	$ 77,830
20	$ 61,160

This example assumes a 2% growth rate over its charitable term. To the extent that actual total trust return exceeds 2%, the remainder beneficiaries will reap benefits at the end of the charitable term. Conversely, if the trustee is unable to outperform the Section 7520 Rate there will be little, if anything, remaining for the remainder beneficiaries. In order for the remainder beneficiaries to receive an amount equal to the original principal, the trust would need to generate slightly better than a 6% per annum growth rate over a 20 year trust term. The testamentary techniques described below are not concerned with the CLT returns as it will be holding a promissory note that will be amortized over the term of the CLT so at termination there will be virtually no risk to the remainder beneficiaries.

(e) **Example of 7520 Rate in Determining Annuity Payment.**

Assume the same facts as in the prior example except that Jack sets the trust charitable lead interest at 10 years. Now, based upon varying Section 7520 Rates the annuity payment necessary to zero-out will be as follows:

Section 7520 Rate	Required Annuity
1.8%	$110,170
2.0%	**$111,330**
2.6%	$114,860
3.0%	$117,240
4.0%	$123,300
5.0%	$129,510

2. **Charitable Lead Unitrust.**

(a) **Estate or Gift Tax Deduction.** The donor of a charitable lead unitrust will receive an estate or gift tax deduction for the actuarial value of the charitable "lead" unitrust interest.

(b) **Estate or Gift Tax Payable.** The donor will, however, be subject to estate or gift tax for the actuarial value of the non-charitable remainder interest determined at the creation of the unitrust.

(c) **Tax Savings.**

(i) **Discounted Value.** Although the donor of a charitable lead unitrust will receive a tax deduction for the actuarial present value of the "lead" annuity interest, the donor will not enjoy the benefit of the assumed Section 7520 rate.

(ii) **Future Appreciation**. The donor of a charitable lead unitrust will also not receive the full benefit estate or gift tax savings available through future appreciation of the trust assets since the unitrust percentage payable to the charitable beneficiary fluctuates annually with the fair market value of the trust assets and the income earned by the trust.

F. **GST Considerations**. A CLT will not be subject to the generation-skipping transfer tax ("GST") at its formation. However, if at the end of the charitable lead interest there is no non-skip person with an interest in the trust, it will be subject to GST as a taxable termination.

1. **Charitable Lead Annuity Trust**. In the case of a CLAT, it is virtually impossible to allocate GST exemption to the trust at inception with any degree of certainty necessary to produce an inclusion ratio of zero at the end of the CLAT term. This is so because the formula to determine the applicable fraction is based upon the value of the trust property immediately after the termination of the charitable lead interest. Thus, for all intents and purposes, GST exemption cannot be allocated to a CLAT.

2. **Charitable Lead Unitrust**. On the other hand, in the case of a CLUT, the applicable fraction is determined under the usual GST rules and can be applied at creation. ***IRC Section 2642(a)(2)***

   (a) However, it is impossible to zero-out a CLUT actuarially.

   (b) Although generation-skipping tax exemption may be allocated to a charitable lead unitrust, the tax advantage may be limited since the unitrust is measured as a percentage of trust principal.

G. **Income Tax Savings.** Although no income tax deduction is allowed for a gift of property to a non-grantor charitable lead trust designed for estate and gift tax savings, the donor is not taxed on the income earned by the trust during the charitable "lead" term.

1. **New Regulation.** Treasury Regulation Sections 1.642(c)-3 and 1.643(a)-5 provide new charitable lead trust ordering rules for income tax purposes.

2. **Final Regulations.** Issued April 16, 2012.

H. **Applicable Federal Rate.** A charitable lead trust may use the applicable federal rate in effect for the month of funding or one of the two prior months.

1. **March 2015 AFR.** The March 2015 applicable federal rate is only 1.8%.

2. **April 2015 AFR.** The April 2015 applicable federal rate is 2.0%.

3. **May 31, 2015 Deadline.** Charitable lead trusts funded by May 31 may use the March 1.8% rate.

I. **Terminally Ill Clients**. A charitable lead trust may produce substantial estate and generation-skipping tax savings (in the case of a charitable lead unitrust) for terminally ill clients. The actuarial tables cannot be used if the individual whose life is measured:

1. **Incurable Illness.** Is known to have an incurable illness or other deteriorating physical condition; and

2. **50% Probability.** There is at least a 50% probability that such individual will die within one year.

J. **18 Month Safe Harbor.** If the individual whose life is measured survives for at least 18 months, there is a presumption that such individual was not terminally ill.

1. **IRS Rebuttal.** The Service may rebut such presumption by "clear and convincing evidence."

2. **Old Age.** General infirmities of old age not considered a terminal illness.

K. **Private Foundation Restriction**. Although a private foundation may be named as the charitable beneficiary of a charitable lead trust, the donor may not serve as a trustee, director or officer of the foundation and control the disposition of funds received from the charitable trust. ***Rifkind v. United States*, 5 Ct. Cl. 362 (1984).**

1. **Donor May Remain on Board with Limitations**. Can remain on the Foundation board as long as the funds received from the donor's charitable lead trust are segregated from the foundation's other assets and the donor has no involvement in the management and disbursement of such funds. ***Private Letter Ruling 200138018.*** See also ***Private Letter Ruling 200240027***.

2. **Other Private Foundation Operating Rules.**

(a) **CLT Treated as a Private Foundation**. A CLT is treated as a private foundation. The excise tax provisions under IRC Sections 4941 to 4945 are applicable to the CLT.

(i) Typically, the trust document needs to contain specific prohibitions against their violation as required under IRC Sections 4947(a) and (c) and 508(e).

(ii) Additionally, the excess business holdings and jeopardizing investments provisions of IRC Sections 4943 and 4943 could come into play.

(iii) These rules are quite complex and draconian; however, as we will see, there are exceptions that can be utilized to thread through them and reach a positive result.

(iv) One additional complicating factor is that clients generally prefer to have their family private foundation be the recipient of the charitable lead payment. This can add an additional layer of complexity when dealing with issues such as “self-dealing” and “disqualified persons.”

(b) **“Self-Dealing” Analysis**. Therefore, we must analyze whether the transactions we will review involve an act of “self-dealing” between a “disqualified person” and the CLAT. Self-dealing includes a sale or exchange between the CLT and a disqualified person as well as any direct or indirect furnishing of goods, services, or facilities between a private foundation and a “disqualified person.” The following are also prohibited transactions under the self-dealing rules:

(i) Purchase or sale of assets between the foundation and disqualified persons;

(ii) Leasing property by the foundation from a disqualified person or an entity controlled by a disqualified person; and

(iii) Compensation to a disqualified person unless the services provided are reasonable and necessary and the amounts paid are reasonable.

(iv) In addition, IRC Section 4941(d)(1)(B) provides that the lending of money or other extensions of credit between a disqualified person and a private foundation are acts of self-dealing.

(c) **“Administrative Exception” to Self-Dealing Rules**. There is a very important “administration exception” to the self-dealing rules.

The Regulations to Section 4941 provide that certain transactions <u>not</u> be considered “indirect self-dealing.” ***Treas. Reg. Section 53.4941(d)-1)***. Included in the exceptions under the Regulation are transactions during the administration of an estate or revocable trust,” if:

(i) The . . . trustee of a revocable trust [which includes a trust that has become irrevocable because of the grantor’s death] **<u>either</u>**:

(A) possesses a power of sale with respect to the property;

(B) has the power to reallocate the property to another beneficiary**; <u>or</u>**

(C) is required to sell the property under the terms of any option.

(ii) Such transaction is approved by a court having jurisdiction over the trust;

(iii) Such transaction occurs before a trust is considered subject to IRC Section 4947 . . .; **and**

(iv) The trust receives an amount which equals or exceeds the fair market value of the trust's interest **and**

(A) results in the trust receiving an asset as liquid as the one it gave up;

(B) results in the foundation receiving an asset related to the active carrying out of its exempt purposes; **or**

(C) is required under the terms of any option which is binding on the trust. ***Treas. Reg. Section 53.4941(d)-1(b)(3)***.

(f) **Safe-Harbor**. This only technically provides a safe harbor for IRC Section 4941. There is some argument that the Service could try and invoke the "step transaction doctrine" to treat the transaction as a "direct sale or exchange" within Section 4941.

(i) However, the lack of discussion of these applications in the Regulations and in PLRs would seem to suggest that the safe harbor of IRC Section 4941 would be conclusive.

(ii) Furthermore, the step transaction doctrine is predicated upon the taxpayer engaging in a series of transactions merely to avoid tax consequences.

(iii) The "steps" in this transaction are not merely to avoid tax consequences; the need to distribute from the estate or a revocable trust (now irrevocable) would have independent significance.

(iv) Furthermore, since IRC Section 4941 specifically recognizes the vitality of this kind of transaction, it appears unlikely the Service could undermine the Regulations by merely couching its argument in another framework.

(g) **Possible Re-Characterization of Transaction Unlikely**. Likewise, it appears unlikely that the Service could re-characterize this transaction under IRC Section 482 which allows the Service to reallocate income, deductions, etc., among entities controlled directly or indirectly by the same interests. It is not clear whether IRC Section 482 would even have application in a IRC Section 4941 setting. In any event, reallocation is not appropriate in this transaction because it is the "nature" of the transaction that is at stake and not the amounts of the payments, income, etc.

(h) **"Prohibited Transactions" Inquiry**. Our inquiry is not complete upon the conclusion that we have no self-dealing sale or exchange for IRC Section 4941 purposes because two of the CLT examples we will be examining will be funded with a promissory note payable by a related entity when the estate implements the terms of the trust after its reasonable period of administration. Even assuming the sale or exchange component of the "prohibited transactions" can be avoided under Treas. Reg. Section 53.494(d)-1, would the continuing obligation to pay on the promissory note now held by the CLT be considered a prohibited transaction because of the debtor/creditor relationship created by the acquisition of the note by the CLT?

(i) **PLR 201448023 and Administrative Exception Analysis**. Again, IRC Section 4941(d)(1)(B) would include an extension of credit between a private foundation (the CLT) and a disqualified person; however, Treas. Reg. Section 53.4941(d)-2(c)(1) excludes notes received pursuant to a Treas. Reg. Section 53.4941(d)-1(b)(3) transaction. (See, e.g., ***PLR 8006029*** and ***PLR 200124029***). If the transaction otherwise qualifies under Treas. Reg. Section 53.4941(d)-1(b)(3), it should escape self-dealing under either the sale or exchange component or the creditor component. An interesting Private Letter Ruling issued last year contains an excellent analysis of the threading of exemptions under the administration exception. ***PLR 201448023***.

(j) **AFR vs Market Interest Rate**. Finally, we have to address the use of an interest rate on the promissory note at or close to the AFR rather than a market rate of interest. In 2012, the Service announced that it would no longer issue letter rulings pertaining to the IRC Section 4941 exception for transactions during the administration of an estate or trust where a note is issued in a sale of property. There are at least three PLRs issued where the Service favorably ruled on purchase transactions under the administration exception that involved notes with interest rates pegged to the AFR. ***PLR 200124029; PLR 20126019;*** and ***PLR 201129049*** This issue appears to be aimed directly at the administration exception, discussed above, requiring the note that is received back for the property interest be "…an amount which equals or exceeds the fair market value of the … (transferred) interest." One needs to be cautious in structuring these transactions using notes tied to the AFR when there remains such a large disparity between the AFR and "true market" interest rates.

Example: For example, if we structure a 20 year CLAT funded with a $1,000,000 promissory note when the AFR is 2%, the annual payment to zero out the CLAT at termination is $61,160. If the promissory note carries a 2.40% interest rate (the long term AFR for September 2017), it will generate an annual payment of $63,543 that will fully amortize the note over the 20 year term.

This would produce enough cash flow annually for the CLAT to make its annual annuity payment and pay the nominal expenses of it operations. However, the transaction could be at risk if the Service starts to take any of the positions discussed above to view such a low interest rate on the promissory note as voiding the administration exception that is the backbone of these transactions.

L. **IRC Section 508(a) Rules.** Charitable lead trusts are subject to the IRC Section 4943 excess business holding and IRC Section 4944 jeopardy investment rules if the present value of the charitable interest exceeds 60% of trust assets.

XVI. Private Foundation.

A. **Definition.** A private foundation is a charitable grant-making organization which may be established, administered and controlled by a single donor or one or more individuals selected by the donor. The payment of grants and administration expenses are made from endowment principal and income, not from a fundraising program.

B. **Growth of Private Foundations.** The National Center for Charitable Statistics has reported that the number of private foundations increased by more than 200% to approximately 120,000 from 1990 to 2010.

C. **Advantages and Disadvantages of Establishing a Private Foundation**.

1. **Advantages.** A private foundation provides great control by allowing the donor to invest funds and select charitable recipients.

2. **Disadvantages.** A private foundation is subject to certain operating and reporting rules such as the requirement to file an annual tax return (Form 990-PF, Return of Private Foundation) and pay an annual excise tax on the net investment income of the foundation. The limitations on the deductibility for income tax purposes of contributions to a private

foundation are stricter than the limitations imposed on similar contributions to a public charity.

D. **Choice of Entity.** A private foundation may be established either in corporate or trust form. Most Florida estate planning practitioners choose corporate form.

1. **Not For Profit Corporation.** Florida not for profit corporation law protects the foundation's directors and officers from liability under the business judgment rule.

(a) **Civil Liability Immunity.** Florida Statute Section 617.0834 grants immunity from civil liability to directors and officers of Florida not for profit corporations organized under Section 501(c)(3) for monetary damages resulting from any statement, vote, decision or failure to act regarding policy or organizational management unless:

(i) **Breach of Duties.** The director or officer breached or failed to perform his or her duties as a director or officer; and

(ii) **Magnitude Of Breach.** The director's or officer's breach of, or failure to perform, those duties constitutes either:

(A) **Criminal Violation.** A violation of the criminal law, unless the director or officer had reasonable cause to believe such conduct was lawful or had no reasonable cause to believe such conduct was unlawful;

(B) **Self-Dealing.** A transaction from which the director or officer directly or indirectly derived an improper personal benefit; or

(C) **Recklessness or Bad Faith.** Recklessness or an act or omission which was committed in bad faith or with malicious purposes or in a manner exhibiting wanton and willful disregard of human rights, safety or property.

(b) **Conflict of Interest.** Florida Statute Section 617.0832 provides that no contract or other transaction between a corporation and one or more of its directors or affiliates shall be either void or voidable because of such relationship or interest, either because such director is present at the meeting of a Board of Directors which authorizes, approves or ratifies such contract or transaction, or if the director's vote is counted for such purpose, if one of the following three safe harbor provisions is satisfied:

(i) The relationship or interest is disclosed or known to the Board of Directors which authorizes the contract or transaction by a vote sufficient for the purpose without counting the votes of such interested directors;

(ii) The fact of such relationship or interest is disclosed or known to the members entitled to vote and they authorize, approve or ratify such contract or transaction by vote or written consent; or

(iii) The contract or transaction is fair and reasonable as to the corporation at the time it is authorized by the Board of Directors or the members.

(c) **Indemnification.** A Florida not for profit corporation has the power to indemnify any present or former director, officer, employee, or agent of the corporation against liability and for litigation expenses if such person acted in good faith and in a manner he or she reasonably believed to be in, or not opposed to, the best interests of the corporation and, with respect to any criminal action or proceeding, had no reasonable cause to believe his or her conduct was unlawful.

2. **Trust**. Florida trust law provides a private foundation with less formal operating rules than a corporation. As compared to Florida not for profit corporation law, Florida trust law does not require articles of incorporation, bylaws, regular meetings, minutes, annual filings and other related reporting requirements. A disadvantage of choosing the trust form, however, is that the directors and officers of the foundation are not provided with the same degree of liability protection that directors and officers are provided under the corporate form.

E. **Application for Federal Income Tax Exemption (Form 1023)**. A private foundation must file an Application for Recognition of Exemption (Form 1023) with the Internal Revenue Service to obtain a Federal income tax exemption as a Section 501(c)(3) charitable organization. After the Internal Revenue Service approves Form 1023, a determination letter is issued by the Service to evidence that the foundation is exempt from federal income tax retroactive to the date of incorporation.

F. **Excise and Penalty Taxes.**

1. **2% Excise Tax**. Although a private foundation is exempt from income tax, a private foundation is generally subject to an annual excise tax of 2% of its "net investment income." ***IRC Section 4940(a).***

(a) **Net Investment Income.** Net investment income is defined as all ordinary income (interest, dividends, etc.) and net capital long-term gains (capital gains offset only by capital losses), less expenses incurred for the production or collection of income or for the management and maintenance of investment property. ***IRC Section 4940(c).***

(b) **Reduction of Excise Tax to 1%.** The 2% excise tax of a private foundation can be reduced to 1% of its net investment income if the actual charitable distributions from the foundation (computed on a five-year average) are increased by an equivalent amount. The 1% rate is not available to foundations held liable at any time during the five year period for failure to satisfy the minimum distribution rule. ***IRC Section 4940(e)***. Legislation has been considered to adopt a 1% excise tax on net investment income.

(c) **Estimated Tax Payments.** A private foundation must estimate tax payments of the annual 2% excise tax. ***IRC Section 6655.***

(d) **Retirement Accounts**. Payment of retirement account benefits to a private foundation does not constitute "net investment income" for excise tax purposes. ***Private Letter Ruling 199838028***.

2. **Penalty Taxes.**

(a) **Failure to Satisfy Operating Rules.** A private foundation may be subject to a penalty tax for the failure to satisfy any of the following operating rules:

(i) The failure to distribute a prescribe minimum amount of income (commonly referred to as the "minimum distribution rule");

(ii) Self-dealing (prohibited transactions with disqualified persons – selling or leasing foundation property; using foundation's offices; loaning or borrowing money; furnishing good and services to a foundation);

(iii) Lobbying, electioneering and private grants;

(iv) Hazardous investments; and

(v) Excess business holdings.

(b) **Assessment by Internal Revenue Service.** Penalty taxes are generally automatically assessed by the Internal Revenue Service when a private foundation violates one of the five prescribed operating rules. The Internal Revenue Service has discretionary authority not to assess or, if assessed, to abate, credit or refund such taxes (other than the tax on self-dealing) if the violation is due to reasonable cause and not willful neglect and is corrected within a limited period of time.

G. **Operational Rules.**

1. **Minimum Distribution Rule**. A private foundation must make distributions to charitable organizations on an annual basis of at least 5% of the fair market value of the foundation's assets ("5% Test"). ***IRC Section 4942(e).***

(a) **Monthly Valuation of Assets**. The assets of a private foundation are valued monthly for purposes of computing the distributable amount.

(b) **Exclusion of Certain Assets.** Certain foundation assets are excluded in computing the distributable amount:

(i) Cash reserves equal to 1 1/2% of the foundation assets; and

(ii) Assets used in carrying out the charitable activities of the foundation (such as computer equipment, furniture, etc.).

(c) **Allocation of Foundation Expenses.** Expenses of a private foundation are allocable either to its "charitable function" or "investment function." Expenses allocable to its charitable function reduce the distributable amount payable to charitable organizations on a "dollar for dollar" basis.

(i) If a private foundation owning assets valued at $10,000,000 incurs expenses of $100,000 which are allocated equally between the "charitable function" and the "investment function", the distributable amount is effectively reduced from 5% to 4½%.

(ii) There is very little guidance as to the proper allocation of foundation expenses between the "charitable function" and "investment function."

(d) **Certain Distributions Which Satisfy 5% Test.** The following expenditures of a private foundation constitute a qualifying distribution under the 5% Test:

(i) Distributions to public charities;

(ii) Direct expenditures, including administration expenses, for charitable purposes (for example student loans or approved grants);

(iii) Expenditures for property to be used for charitable purposes (for example, buying books or art for an education program); and

(iv) Distributions to private operating foundations. ***IRC Section 4942(g).***

(e) **Exception to Distribution Requirement.** An exception to the minimum distribution requirement (known as a "set-aside") allows a foundation to delay distributions for up to five years if a particular charitable program would be better served by an accumulation of income provided that the set-aside amount will actually be paid for the specific project within five years. Advance approval from the Department of Treasury is required in order for a foundation, other than a newly created foundation, to take advantage of this exception. A new foundation may establish a set-aside under a special cash distribution test without advance approval from the Department of Treasury. ***IRC Section 4942(g)(2).***

(f) **Penalty Tax.** A foundation is subject to a penalty tax of 30% on any amount required to be distributed in respect to any taxable year which is not paid within twelve months of the end of the taxable year. Any amount still remaining undistributed after the expiration of a permitted correction period is subject to a 100% tax. Unlike the case with self-dealing (discussed below), no comparable penalty taxes are imposed on foundation managers under this rule. ***IRC Section 4942(a) and (b).***

2. **Self-Dealing.** A private foundation may not engage in certain types of prohibited conduct which constitute self-dealing with persons (called "disqualified persons") who have a special relationship with the foundation. ***IRC Section 4941.***

(a) **Disqualified Persons.** Disqualified persons include:

(i) "Substantial contributors", which include anyone who contributes more than $5,000 or 2% of total contributions to a private foundation;

(ii) "Foundation managers," which include officers, directors or trustees of the foundation (and anyone with similar powers or responsibilities);

(iii) Owner of more than 20% of any corporation partnership, trust or other enterprise which is a substantial contributor;

(iv) Members of the family (spouse, parent, child, grandchild or great-grandchild, or spouse of a child, grandchild or great-grandchild) of any substantial contributor, foundation manager or 20% owner;

(v) A corporation, partnership, trust or estate over 35% of whose voting power, profits, interest, or beneficial interest is owned by a substantial contributor, foundation manager, 20% owner or members of the family of any of them; and

(vi) Certain government officials. ***IRC Section 4946(a).***

(b) **Prohibited Conduct**. There are many transactions of an improper character which may be considered acts of self-dealing between a private foundation and a disqualified person, some of which include:

(i) Payment of excessive compensation;

(ii) The sale, exchange, transfer or lease of property;

(iii) Loan agreements;

(iv) The furnishing of any goods, services or facilities; and

(v) An agreement to pay a government official (other than an agreement to employ him after he leaves his government job, provided he leaves within ninety days). ***IRC Section 4941(d).***

(c) **Penalty Tax.** A penalty tax may be imposed for each act of self-dealing upon the disqualified person who participates in the self-dealing transaction, whether or not inadvertently, in the amount of 5% of the gross amount involved in the transaction. The penalty tax imposed on the foundation manager who knowingly participates is 2-1/2% (up to a maximum of $10,000). If the situation is not corrected within a specified period, an additional 200% tax is imposed on the disqualified person, and any foundation manager who refuses to agree to the correction is subjected to an additional 50% tax (again, to a maximum of $10,000). ***IRC Section 4941(a) - (c).***

3. **Lobbying; Electioneering; Private Grants**. A private foundation cannot make a disbursement deemed a taxable expenditure.

(a) **Taxable Expenditure**. A taxable expenditure includes, but is not limited to, the following four categories of disbursements:

(i) **Lobbying.** Attempting to influence legislation through lobbying or propaganda directed to the general public or by contact with legislators or their employees, except for technical advice; ***IRC Section 4945(e)***

(ii) **Electioneering.** Seeking to influence the outcome of any specific public election or, except within limits defined in detail in the IRC, supporting voter registration drives; ***IRC Section 4945(f)***

(iii) **Grants to Individuals.** Making grants to individuals for travel, study, etc., except grants awarded on an objective, nondiscriminatory basis pursuant to selection procedures approved in advance by the Treasury. Grantees must be selected on an objective basis from a class large enough to constitute a charitable class; ***IRC Section 4945(g)*** and

(iv) **Grants to Foundations.** Making grants to other private foundations, unless the granting foundation assumes the responsibility for seeing that the amounts granted are spent by the receiving foundation for charitable purposes — which includes obtaining reports from the receiving foundation and rendering reports to the Internal Revenue Service. ***IRC Section 4945(h)***

(b) **Penalty Tax**. A private foundation is subject to a severe penalty tax from the Internal Revenue Service for making a taxable expenditure.

4. **Hazardous Investments.** A private foundation cannot invest any of its assets in such a way as to jeopardize its exempt purposes. ***IRC Section 4944.***

(a) **Standard for Investments.** Although the law does not provide detailed standards for investments which jeopardize a private foundation's exempt purposes, regulations have indicated that investments in warrants, puts, calls, straddles, commodity futures, investments on margin and short sales are subject to scrutiny as investments which may jeopardize a foundation's exempt purposes.

(b) **Penalty Tax.** A private foundation is subject to a penalty tax from the Internal Revenue Service for jeopardizing its exempt purposes through investments.

5. **Excess Business Holdings.** A private foundation is limited in the type and amount of interest it may hold in a business enterprise. ***IRC Section 4943.***

(a) **Sole Proprietorship.** A private foundation is prohibited from owning a business as a sole proprietor.

(b) **Partnerships and Corporations**.

(i) **20% Limit.** A private foundation is considered to have excess business holdings if, together with all disqualified persons (directors, officers, trustees and contributors), it owns more than 20% of the voting stock of a corporation or more than a 20% interest in the profits of a partnership conducting a business not substantially related to the foundation's exempt purpose. ***IRC Section 4943(c)(2)***

(ii) **2% De Minimis Limit.** Regardless of any other factor, a private foundation is not considered to have excess business holdings if it does not own more than 2% of the voting stock and not more than 2% in value of all outstanding shares of all classes of stock in a corporation. ***IRC Section 4943(c)(3)***

(c) **Penalty Tax.** A private foundation is subject to penalty tax from the Internal Revenue Service if it has excess business holdings. ***IRC Section 4943(a) and (b)***

H. **Reporting Requirements**. A private foundation is required to satisfy a number of disclosure and public reporting requirements.

1. **Form 990-PF.** As noted earlier, a private foundation must file an annual Return of Private Foundation (Form 990-PF) with the Internal Revenue Service and the State of Florida. Form 990-PF contains detailed information regarding, among other things, the source of foundation's funds and the nature of its grants. Form 990-PF must also be available for public inspection.

2. **Public Notice.** A private foundation is required to publish an annual notice, including the address and telephone number of its principal office, in a local newspaper notifying the public that the report is available for inspection during regular business hours for six months after publication. The report may be held for inspection at the office of the attorney or accountant for the private foundation.

I. **Termination of Private Foundation.** A private foundation must be terminated in accordance with Federal tax law.

1. **Public Charity**. A private foundation may be terminated by distributing all of its assets to a public charity, provided the public charity has been in existence for a 60-month period.

2. **Recapture Tax**. If the private foundation is terminated without making such a transfer to a public charity, a tax is imposed upon the foundation which recaptures the aggregate tax benefits (with interest) realized during the prior exempt status of the foundation.

(a) **Aggregate Tax Benefits.** Such recapture tax include taxes saved by all substantial contributors through deduction of contributions for income, estate and gift tax purposes as well as all income taxes the foundation would have paid if it had not been exempt from income tax.

(b) **Limit on Recapture Tax.** The recapture tax may not exceed the value of the private foundation's net assets.

(c) **Divorce**. The transfer of a foundation's assets to two new private foundations on the divorce of a husband and wife who serve as officers and directors of the terminating foundation does not constitute self-dealing under Section 4941 or a taxable expenditure under Section 507. ***Private Letter Ruling 199826041.***

XVII. Conservation Easements

A. **Qualified Conservation Contributions**. IRC Section 170(f)(3)(A) generally denies a charitable deduction for a contribution of a partial interest in property (i.e., “an interest in property which consists of less than the taxpayer’s entire interest in such property”), but IRC Section 170(f)(3)(B)(iii) recognizes an exception for a “qualified conservation contribution.”

1. **Definition**. IRC Section 170(h)(1), originally enacted in 1980 and subsequently amended, defines a qualified conservation contribution as a contribution of a “qualified real property interest” to a “qualified organization” “exclusively for conservation purposes.”

(a) A qualified real property interest includes a conservation easement, i.e., “a restriction (granted in perpetuity) on the use which may be made of the real property.” ***IRC Section 170(h)(2)(C); Treas. Reg. Section 1.170A-14(b)(2)***.

(b) A qualified organization includes governmental units and public charities (as well as certain supporting organizations), but not private foundations. ***IRC Section 170(h)(3)***.

(c) Conservation purposes include: preserving land for outdoor recreation or public education; protecting a natural habitat of fish, wildlife, or plants; preserving open space for scenic enjoyment or pursuant to a clearly delineated governmental conservation policy, with a significant public benefit; and preserving a historically important land area or a certified historic structure. IRC Section 170(h)(4)(A). Additional restrictions on façade easements were added in 2006, including a requirement of a written agreement certifying the donee organization’s purpose of environmental protection, land conservation, open space preservation, or historic preservation and its ability and commitment to enforce the restriction. ***IRC Section 170(h)(4)(B); Treas. Reg. Section 1.170A-14(d)***.

2. **Perpetuity**. The provisions of IRC Section 170(h) are further elaborated in Treas. Reg. Section 1.170A-14. The regulations attempt to ensure that the conservation purposes of the original contribution are protected in perpetuity.

   (a) Any subsequent transfer of the easement must provide for continuation of the original conservation purposes and must be restricted to an eligible donee. ***Treas. Reg. Section 1.170A-14(c)(2)***.

   (b) If the underlying property is subject to a mortgage, the mortgage lender must subordinate its rights in the property to the donee organization's right to enforce the conservation purposes of the easement in perpetuity. ***Treas. Reg. Section 1.170A-14(g)(2)***.

   (c) The charitable deduction is not defeated by a possibility that some act or event may defeat the donee organization's interest, if the possibility is so remote as to be negligible. ***Treas. Reg. Section 1.170A-14(g)(3)***.

   (d) If the continued use of the property for conservation purposes becomes impossible or impractical due to an unexpected change in conditions, the conservation purpose is nevertheless treated as adequately protected if the restrictions are extinguished by a judicial proceeding and the donee organization's share of any proceeds of a subsequent sale are used in a manner consistent with the original conservation purposes. The donee organization must be entitled to a share of any sale proceeds at least equal to the value of the easement divided by the value of the whole property at the time of the original contribution. ***Treas. Reg. Section 1.170A-14(g)(6)***.

   (e) In the absence of comparable sales, the fair market value of a conservation easement is equal to the difference in the value of the property before and after the grant of the easement, adjusted for any offsetting benefit to the donor. No deduction is allowed if the easement causes no material reduction in the value of the property. ***Treas. Reg. Section 1.170A-14(h)(3)***.

3. **Income Tax Deduction**. The income tax charitable deduction for conservation easements is unusually generous. Unlike the normal 30% limitation and 5-year carryforward period for contributions of long-term capital gain property, a qualified conservation contribution is eligible for a 50% limitation (100% for certain farmers and ranchers) and a 15-year carryforward period. ***IRC Section 170(b)(1)(E)***.

   (a) The special provisions concerning the percentage limitation and carryforward period were first enacted in 2006 on a temporary basis and have repeatedly been extended; they are currently scheduled to expire at the end of 2015.

4. **Gift and Estate Tax Deduction**. A contribution of a perpetual easement to a charitable organization also qualifies for a gift or estate tax deduction, whether or not it is made exclusively for conservation purposes. IRC Sections 2522(d) (gift tax) and 2055(f) (estate tax). Furthermore, property subject to a qualified conservation easement (other for historic preservation) is potentially eligible for an estate tax exclusion of up to 40% of the value otherwise includible in the gross estate (net of the easement), up to a maximum of $500,000. ***IRC Section 2031(c)***.

B. **Reporting and Substantiation.** IRC Section 170(f)(11), enacted in 2004, imposes additional specific substantiation requirements which vary according to the value of the charitable contribution. For contributions of more than $500, the taxpayer must attach to the tax return a description of the contributed property. For contributions of property (other than cash or publicly traded securities) worth more than $5,000, the taxpayer must obtain a “qualified appraisal” made by a “qualified appraiser” and attach an appraisal summary. For contributions of such property worth more than $500,000, the taxpayer must attach the qualified appraisal itself. For this purpose, contributions of similar items of property made by the same donor in the same taxable year, whether or not to the same donee, are aggregated.

1. **Substantiation Regulations**. Regulations elaborating the substantiation requirements of IRC Section 170(f)(11) are found in Treas. Reg. Section 1.170A-13. A qualified appraisal must include, among other things, a description of the valuation method and the specific basis for the valuation. ***Treas. Reg. Section 1.170A-13(c)(3)(J)-(K)*** An individual is not a qualified appraiser if the donor “had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property.” ***Treas. Reg. Section 1.170A-13(c)(5)(ii)*** Subject to a limited exception, an appraisal fee must not be based on a percentage of the appraised value of the property. ***Treas. Reg. Section 1.170A-13(c)(6)***

   (a) In 2008 the Treasury issued proposed regulations relating to the 2006 amendments to IRC Section 170(f)(11).

   (b) Until those regulations become final, however, transitional guidance is found in Notice 2006-96, 2006-2 C.B. 902.

2. **Written Records**. IRC Section 170(f)(17), enacted in 2006, requires that the donor maintain a record of cash contributions in any amount, identifying the donee as well as the date and amount of the contribution. For contributions of $250 or more, the donor generally must obtain a contemporaneous written acknowledgment from the donee, identifying the cash or other property contributed as well as any goods or services provided

by the donee in return. ***Section 170(f)(8)***

C. **Penalties**. IRC Section 6662 imposes a 20% penalty for a "substantial valuation misstatement" and a 40% penalty for a "gross valuation misstatement."

1. **Substantial Valuation Misstatement**. A substantial valuation misstatement occurs if the value of property (e.g., a conservation easement) claimed on an income tax return exceeds the correct value by 150% or more, resulting in a tax underpayment of more than $5,000.

2. **Gross Valuation Misstatement**. A gross valuation misstatement occurs if the claimed value exceeds the correct value by 200% or more. ***IRC Section 6662(e), (h)***.

3. **Waiver of Penalty**. The IRC Section 6662 penalty normally does not apply to the extent the taxpayer shows "reasonable cause" and "good faith." ***IRC Section 6664(c)(1)***

(a) This exception is sharply limited, however, with respect to charitable deduction property.

(b) In the case of a substantial valuation overstatement, the penalty will be imposed unless (1) the taxpayer shows reasonable cause and good faith, (2) the claimed value was based on a "qualified appraisal" made by a "qualified appraiser," and (3) the taxpayer made a "good faith investigation" of the property's value.

(c) In the case of a gross valuation overstatement, the reasonable cause/good faith exception is unavailable. ***IRC Section 6664(c)(3)-(4)***.

4. **Appraiser Penalty**. IRC Section 6695A, enacted in 2006, imposes a penalty on any person who prepared an appraisal and knew (or should have known) that it would be used in connection with a tax return, if the claimed value of property based on the appraisal results in a substantial or gross valuation misstatement penalty under IRC Section 6662. The penalty does not apply if the preparer shows that "the appraisal was more likely than not the proper value."

D. **Recent Statutory Amendments**. Several statutory amendments affecting charitable contributions occurred in 2004 and 2006. In 2003 and 2004 the Washington Post published a series of articles exposing questionable transactions and practices involving conservation easements. In 2004 the Service issued Notice 2004-41 relating to improper charitable deductions of conservation easements. In 2005 the Joint Committee on Taxation issued a report recommending new restrictions on the deduction for contributions of conservation easements, and in the same year the Senate Finance Committee issued a report recommending numerous reforms based on an investigation of The Nature Conservancy.

1. The substantiation requirements of IRC Section 170(f)(11) were added in 2004.

2. The 2006 Act amended Section IRC 170(f)(11) to provide statutory definitions of qualified appraiser and qualified appraisal.

3. The 2006 Act tightened the requirements for façade easements under IRC Section 170(h)(4)(B)-(C) (scope of easement, terms of agreement, substantiation, restriction on eligible property); imposed a $500 filing fee under IRC Section 170(f)(13) for façade easements of more than $10,000; and imposed an offset under IRC Section 170(f)(14) for any IRC Section 47 rehabilitation credit.

4. The 2006 Act introduced special provisions in IRC Section 170(b)(1)(E) allowing an enhanced percentage limitation and carryforward period for qualified conservation contributions.

   (a) The percentage limitation and carryforward period for qualified conservation contributions are temporary provisions which have repeatedly been extended; they are currently scheduled to expire at the end of 2014. Proposals to make these provisions permanent are being considered in the House and are included in the President's 2016 budget proposals. The President's budget proposals would also deny a charitable deduction for contributions of conservation easements relating to property used as a golf course or "foregone upward development" rights over historic buildings.

5. The 2006 Act lowered the penalty threshold under IRC Section 6662 (relating to substantial and gross valuation misstatements) and eliminated the reasonable-cause/good-faith exception under IRC Section 6664(c)(2) for gross valuation misstatements with respect to charitable deduction property.

6. The 2006 Act introduced the IRC Section 6695A penalty on appraisers whose appraisals give rise to a substantial or gross valuation misstatement.

E. **Selected Recent Cases**. The Tax Court has issued numerous decisions involving claimed deductions for conservation easements. Recurring issues include qualifications and credibility of appraisers; compliance with technical requirements for qualified appraisals; recordkeeping and substantiation; valuation methodology; qualified conservation purposes; impact of restrictions on property value; and penalties. Most of the cases decided to date involve transactions that occurred before the effective dates of the statutory amendments enacted in 2004 and 2006.

1. **Scheidelman v. Commissioner**, T.C. Memo 2010-151 (Jul. 14, 2010), vacated, 682 F.3d 189 (2d Cir. 2012); on remand, T.C. Memo 2013-18 (Jan. 16, 2013), affirmed, 755 F.3d 148 (2d Cir. 2014); see also Rothman v. Commissioner, T.C. Memo 2012-163 (Jun. 11, 2012), vacated in part on

reconsideration, T.C. Memo 2012-218 (Jul. 31, 2012).

2. **Kaufman v. Commissioner**, 134 T.C. 182 (2010), and 136 T.C. 294 (2011), affirmed in part and vacated in part, 687 F.3d 21 (1st Cir. 2012); on remand, T.C. Memo 2014-52 (Mar. 31, 2014) (appeal pending).

3. **Whitehouse Hotel Limited Partnership v. Commissioner**, 131 T.C. 112 (2008), vacated, 615 F.3d 321 (5th Cir. 2010); on remand, 139 T.C. 304 (2012), affirmed in part and vacated in part, 755 F.3d 236 (5th Cir. 2014).

4. **Esgar Corp. v. Commissioner**, T.C. Memo 2012-35 (Feb. 6, 2012); affirmed, 744 F.3d 648 (10th Cir. 2014).

5. **Mitchell v. Commissioner**, 138 T.C. 324 (2012), vacated on reconsideration, T.C. Memo 2013-204 (Aug. 29, 2013); see also Carpenter v. Commissioner, T.C. Memo 2012-1 (Jan. 3, 2012).

6. **Chandler v. Commissioner**, 142 T.C. No. 16 (2014).

XVIII. Qualified Appraisals

A. **Basics**.

1. **Qualified Appraisal Requirement**. If deduction is being claimed for the donation of an item or a group of similar items valued at $5,000 or more, a qualified appraisal made by a qualified appraiser must be prepared (in addition to Section B of Form 8283 of a tax return).

(a) Appraisal must be kept in your records. Certain items require the appraisal to be attached to the tax return such as:

(i) Art valued at $20,000 or more (and said appraisal must meet IRS photo-documentation requirements and should follow the format recommended by the Art Advisory Panel).

(ii) Clothing or household items that are **not** in good used condition or better valued at $500 or more.

(iii) Items where the deduction is over $500,000.

(iv) Easements or other restrictions on the exterior of a building in a historic district.

(v) Personal property with a claimed deduction exceeding $250 must include a written communication from the qualified organization containing the name of the organization, the date of contribution and the amount of contribution and an acknowledgement stating whether the organization provided any goods or services in exchange for the gift (and if so, a good faith estimate of the value of those goods or services). The written communication from the qualified organization must be a "contemporary acknowledgment" under Section 170(f)(8).

(A) In ***Smith v. Commissioner, T.C. Memo 2014-203***, Donor Thad DeShawn Smith contributed $27,767 in personal property (multiple sofas, bedroom sets, televisions, mattresses, kitchen and dining room sets, clothing etc.) to a veteran's service organization. The Tax Court denied the deduction because the organization gave the taxpayer 3 blank receipts signed by its employees for the items and said receipts did not describe the contributed property, and the there was no evidence that taxpayer's spreadsheet of the items was prepared contemporaneously at the time of contribution or that the spreadsheet was submitted to the organization. The Tax Court further noted that because all the gifts were donations of $250 or more, similar items of property had to be aggregated to determine if substantiation was required. Taxpayer was also found to have failed to maintain reliable written records of the items valued at $500 or more and failed to attach an appraisal for the property valued in excess of $5,000.

(b) "Similar items" means property within the same generic category or class such as stamp collections, coins, lithographs, books, kitchen appliances, etc.

(c) Exceptions to qualified appraisal rule:

(i) Non-publicly traded stock valued at $10,000 or less.

(ii) Vehicles (cars, boats or airplanes) for which the deduction is limited to the gross proceeds from its sale.

(iii) Qualified intellectual property.

(iv) Certain publicly traded stocks.

(A) Listed on a stock exchange with daily published quotes.

(B) Regularly traded in a national or regional over-the-counter market for which published quotations are available.

(C) Shares or an open-end investments company for which quotations are regularly published on a daily basis in a newspaper of general circulation in the U.S.

(v) Inventory and other property donated by a corporation that are "qualified contributions" for the care of the ill, the needy, or infants within IRC Section 170(e)(3)(A).

(vi) Stock in trade, inventory, or other property held primarily for sale to customers in the ordinary course of a trade or business of the donor.

B. **Qualified Appraisals**.

1. **Basic Requirements**.

(a) Appraisal must be made, signed, and dated by a qualified appraiser.

(b) Appraisal must meet requirements of Treas. Reg. Section 1.170A-13(c)(3) and Notice 2006-96, 2006-46 I.R.B. 902.

2. Appraisal should include the following:

(a) A description of the property in sufficient detail, the physical condition of any tangible property, date or expected date of contribution, and the terms of any agreement between the donor and the done.

(b) The name, address, and taxpayer identification of the qualified appraiser.

(c) The qualifications of the appraiser.

(d) A statement that the appraisal was prepared for income tax purposes.

(e) The date or dates on which the property was valued.

(f) The appraised fair market value on the date of contribution.

(g) Method of valuation used to determine the fair market value.

(h) The specific basis for the valuation.

3. The appraisal must be made no earlier than **60 days** before the date of contribution of the appraised property. If the contribution of the property is finalized after the 60 day period, an updated appraisal must be prepared reflecting the revised date and value.

4. In **Alli v. Commissioner, T.C. Memo 2014-15**, taxpayer bought two apartment buildings in 1983 and allowed them to go into disrepair. In 2008, taxpayer donated 1 of the properties to a public charity which quickly sold the property for $60,000. On the taxpayer's return, the value of the property for the purposes of a deduction was listed as $499,000. Taxpayer obtained 2 appraisal reports for the properties. The 1999 appraisal determined that both properties combined had an annual gross income potential of $390,840. This appraisal was denied because it was not timely, had no expected date of contribution, failed to include a statement that the appraisal was made for income tax purposes, and did not include the fair market value of the properties. The second appraisal prepared in 2008 valued the two properties at $898,437 and $664,062, respectively. The 2008 appraisal was denied because it was found not to be an appraisal of the properties but an appraisal of the properties if they had been fully renovated and improved. Both appraisals were found not be prepared by qualified appraisers as they did not make the proper reporting declarations under Treas. Reg. Section 1.170A-13(c)(3). Taxpayer also omitted multiple categories of required information (donee information and appraiser information) and provided false information (misrepresented the condition of the property, falsified year of purchase and basis in property, etc.). The deduction was denied in full.

5. No part of the fee arrangement for the qualified appraiser can be based on a percentage of the appraised value of the property or of the allowed deduction on the property.

C. **Qualified Appraisers**.

1. The qualified appraiser must:

(a) Have earned an appraisal designation from a recognized professional appraiser organization or met certain minimum education and experience requirements.

(b) Regularly prepare appraisals for payment.

(c) Demonstrate a verifiable education and experience in valuing the type of property being appraised.

(d) Not have been prohibited from practicing before the IRS under IRC Section 330(c).

(e) Not be an excluded individual.

2. Individuals excluded from preparing a donor's qualified appraisal include:

(a) The donor or the taxpayer claiming the deduction.

(b) The donee.

(c) A party to the transaction in which the donor acquired the property being appraised unless the property is donated within 2 months of the date of acquisition and its appraised value is no more than the acquisition price.

(d) Any person employed by the donor, taxpayer, donee, or party to the transaction of the donor.

(e) Any person related under IRC Section 267(b) to any of the above persons or married to a person related under IRC Section 267(b).

(f) Any person who regularly appraises items for donor, taxpayer, donee or party to a transaction and does not perform a majority of his or her appraisals for other individuals.

D. **Penalties**.

1. A 20% penalty of the underpayment of tax is imposed if:

(a) The value or adjusted basis claimed on the return is 200% or more of the correct amount; and

(b) The underpayment of tax is $5,000 or more due to the overstatement of donated property's value.

2. A 40% penalty of the underpayment of tax is imposed if:

(a) The value or adjusted basis claimed on the return is 400% or more of the correct amount; and

(b) The underpayment of tax is $5,000 or more due to the overstatement of donated property's value.