Charitable Giving in the New Estate Planning Environment

T urney P. Berry
Louisville, Kentucky

Martin Hall
Boston, Massachusetts

Stephanie B. Casteel
Atlanta, Georgia

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Appendix – Planning Chart

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CHARITABLE PLANNING WITH CLOSELY-HELD BUSINESSES

Charitable gifts involving some kind of closely held business entity are becoming an increasingly important element of an overall estate plan. They can be an effective tool to maximize the benefits of valuation discounts, reduce income and estate taxes, and generally promote your client’s estate planning and philanthropic goals. But it is important to understand the unique tax and other implications of the gift from the perspectives of the donor, the donee, and the closely-held business entity. It is equally important to plan for the ultimate disposition of the business interest—will the charity hold the interest long-term, or should the plan include an appropriate “exit strategy”? The purpose of this outline is to provide something of a primer on the basic issues, and some “food for thought” on some interesting planning ideas.

I. CHARITABLE GIFTS GENERALLY

A. Charitable Deduction Overview.

1. Income Tax - § 170.

   (a) Gifts of cash or unappreciated property. If “to” public charities (not private foundations) (“50% Organizations”) are deductible up to 50% of the donor’s contribution base (essentially adjusted gross income). § 170(b)(1)(A).

   (b) Gifts of cash or ordinary income property. If to private foundations (not publicly supported) other than “operating foundations” (“30% Organizations”) and gifts “for the use of” 50% Organizations are deductible to 30% of the donor’s contribution base. § 170(b)(1)(A) & (B).

   (c) Gifts of Capital Gain Property. A deduction for a gift of such property (closely-held stock, real estate, etc.) to a 50% Organization is limited to 30% of the donor’s contribution base. § 170(b)(1)(C). A deduction for contributions of capital gain property to a private foundation is limited to 20% of the donor’s contribution base. § 170(b)(1)(D).

   (d) Definition of Capital Gain Property. Capital gain property is any capital asset the sale of which at its fair market value at the time of contribution would have resulted in gain that would have been long-term capital gain. § 170(b)(1)(c)(iv). In turn, long-term capital gain is defined as property held more than one year. § 1221.

   (e) Election Out. In the case of a gift to a 50% Organization, a donor can elect to use the 50% limitation, instead of the 30% limitation, if the donor reduces the value of the gift by the amount of gain which would have been long-term capital gain had the contributed
property been sold (40% of gain prior to 1987). § 170(b)(1)(C) and § 170(e)(1)(B).

EXAMPLE: Gift of $500,000 is in appreciated property (basis $300,000) by a donor with a contribution base of $200,000. Donor can deduct the full $500,000 at the rate of $60,000 in the year of the gift and $440,000 over the next 5 years (subject to the 30% limit), or deduct only $300,000, but deduct $100,000 in the year of the gift, and the other $200,000 over the next 5 (subject to the 50% limit).

Generally, depreciated property should be sold rather than given to charity because this gives rise to a section 165 loss deduction. See Commissioner v. Withers, 69 T.C. 900 (1977).

(f) Special Rules for Private Foundations. Generally the contribution deduction is further limited to the donor’s basis. § 170(e)(1)(B)(ii); Treas. Regs. § 1.170A-4(a)(2) and (3). However, an exception has applied for gifts of “qualified appreciated stock,” stock for which market quotations are readily available on an established securities market. The value of such gifts for purposes of a charitable contribution deduction has been the full fair market value of the stock, not just the donor’s basis in the stock. § 170(e)(5). Following several temporary extensions, the Taxpayer Relief Act of 1998 made this rule permanent.

(g) Limitations for Gifts of Ordinary Income Property. The amount of the charitable deduction for gifts of property, the sale or exchange of which would produce a gain, other than a long-term capital gain, is reduced by the amount of the non-long-term gain. § 170(e). Included in this category are: inventory, crops, dealer property and works created by the donor. In the case of a painting donated by the artist, for example, the deduction is limited to the artist’s cost of materials. Note: This applies to property that would yield a short-term capital gain, as well as to property that would yield ordinary income. Normally, this means that if the asset is not a long-term capital asset, a charitable deduction is limited to basis (fair market value, less potential non-long-term capital gain).

(h) Capital Gain/Ordinary Income Property. E.g., personal property with section 1245 recapture potential. Both the capital gain and the ordinary income rules apply. This is the one situation in which the deduction may be more than basis, since it would be basis plus the potential capital gain, but without the potential recapture income. See Treas. Regs. § 1.170 A-4(d) (ex. 2).
(i) **Bona Fide Business.** In Quinton U. Ford, T. C. Memo 1983-556, a partnership owned an underwater craft, the Aegir, the contribution of which to charity would have created no income tax deduction because it was fully depreciated ordinary income property. The partnership created a corporation (with one share of stock, owned by the partnership), transferred the Aegir to the corporation and, the same day, gave the share of stock to charity. The court found there was no business purpose for the corporation but rather it was a sham and conduit for tax avoidance purposes.

(j) **Five Year Carryover for Contributions which Exceed Contribution Base.** For contributions to which the 50%/30% limitation applies. §§ 170(d)(1)(A), 170(b)(1)(C)(ii). For contributions to which the 30%/20% limitation applies. §§ 170(b)(1)(B), 170(b)(1)(D)(ii).

2. **Income Tax (For Estates and Trusts) - § 642(c).**

   Deduction for amounts of gross income paid or set aside for charitable purposes.

3. **Estate Tax - § 2055.**

   Section 2055 permits an unlimited deduction from a decedent’s gross estate for bequests and other transfers to qualifying recipients for public, charitable, religious, and other similar purposes. Although the basic concept has been altered by a number of statutory refinements and limitations, the original underlying policy of encouraging charitable giving remains unchanged. The charitable deduction is reduced by the amount of any death taxes that are, either by the terms of the will or by local law, assessed against an otherwise deductible bequest or other transfer. The amount of the deduction may not be more than the value of the transferred property that is required to be included in the gross estate. Consequently, to be deductible, property that comprised a lifetime charitable contribution must be included in the gross estate. Similarly, the testamentary exercise of a special power of appointment in favor of a charity is not deductible. No deduction is allowed for a transfer to or for the use of an organization or trust described in sections 508(d) or 4948(c)(4), subject to the conditions specified in those sections. Where an interest in property is split between a charitable and a noncharitable recipient, special rules must be followed, or the deduction will not be allowed. A remainder interest must be in the form of a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. An income interest must be in the form of a guaranteed annuity or must be a fixed percentage of the fair market value of the property, determined yearly. These requirements do not apply to a remainder interest in a personal residence or farm or to an undivided portion of a decedent’s entire interest.
4. **Gift Tax - § 2522.**

Section 2522 allows an **unlimited** gift tax deduction for lifetime transfers to qualifying recipients for public, charitable, religious, and other similar purposes. In effect, the deduction operates as an exclusion. With minor exceptions, the definition of eligible recipients and qualifying transfers are identical to those applicable for federal estate tax purposes. For gifts made after August 5, 1997 a donor need not file a gift tax return if the entire value of the donated property qualifies for a gift tax deduction. § 2522(d).

5. **Generation Skipping Transfer Tax - § 2642(a).**

Section 2642(a) provides that in determining the Inclusion Ratio, the denominator of the fraction is reduced by “any charitable deduction allowed under section 2055 or 2522 with respect to such property.” In essence, this reads charitable gifts out of the equation for calculating the tax.

**B. Valuation and Substantiation.**

1. **General Valuation Considerations.**

Noncash gifts are valued at “fair market value”, raising familiar problems of determination of value. Aggressive or fraudulent valuations of charitable contributions have been a problem since enactment of the first charitable deduction in 1917. Traditionally most of the reported decisions involved charitable gifts of artwork. As noted by the judge in a 1984 Tax Court overvaluation case (not involving a charitable contribution), “after examining some of the paintings, we feel obliged to note that we refer to them as artwork merely for convenience.” [*J.S.M. Enterprises v. Commissioner*, 48 T.C.M. 138 (1984)]. Recent audit data, however, confirms that the valuation of charitable gifts of business interests is the subject of increasing IRS scrutiny. As in most valuation disputes, the donor has the **burden of proof** in a charitable deduction case. [*Welch v. Halvering*, 290 U.S. 111 (1933); *Lamphere*, 70 T.C. 391 (1978). See also *Holtzman*, 40 T.C.M. 350 (1980)].

2. **Actuarial Factors.**

In general, actuarial factors used in determining the present value of an annuity, an interest for life, or a remainder or reversionary interest are, for federal estate, gift, and certain income tax purposes, based on two components: (i) the life expectancy of a designated individual or individuals (the “mortality component”); and (ii) the assumed rate of return (the “interest rate component”).

Under section 7520, the value of an annuity, interest for life or for a term of years, or remainder or reversionary interest for valuation dates occurring on or after May 1, 1989, is determined under tables that are prescribed by the Secretary of the Treasury. Treas. Regs. § 1.7520, § 20.7520, § 25.7520. See IRS Publication 1457,
Actuarial Values, Alpha Volume and IRS Publication 1458, Actuarial Values, Beta Volume. With respect to the interest rate component, the valuation tables under this section are based on the interest rate that the Service announces monthly in a news release and publishes in the Internal Revenue Bulletin. This rate is 120 percent of the applicable federal midterm rate compounded annually (rounded to the nearest two-tenths of one percent) in effect under section 1274(d)(1) for the month in which the valuation date falls.

If an income, estate, or gift tax charitable contribution is allowed for any part of the property transferred, the taxpayer may use the federal midterm rate for the month of the transfer or for either of the two months preceding the month in which the valuation date falls. In the case of transfers of more than one interest in the same property, each interest must be valued on a basis consistent with the valuation of all other such interests. For example, if a taxpayer transfers property to a charitable remainder trust in October the taxpayer may use an interest rate based upon the federal midterm rate for August, September or October however, the taxpayer must use the same rate for both the non-charitable lead interest and the charitable remainder interest.

Regulations provide the 7520 tables apply to “ordinary” beneficial interests. A “restricted” beneficial interest is an interest that is subject to one or more additional conditions, powers or restrictions. The governing instrument may impose these limitations or they may exist based on surrounding circumstances. Restricted beneficial interests are valued based on all relevant facts and circumstances, rather than the standard actuarial tables, even though the tables may be one useful fact in valuing such interests. Treas. Regs. §§ 1.7520-3(b)(1)(ii) and (iii), 20.7520-3(b)(1)(ii) and (iii), 25.7520-3(b)(1)(ii) and (iii).

The standard tables are not available if the individual who is a measuring life is terminally ill at the time of the transaction. An individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within one year. An individual who survives for eighteen months after a transfer is presumed not to have been terminally ill at the time of the transfer, “unless the contrary is established by clear and convincing evidence.” Treas. Regs. §§ 1.7520-3(b)(3), 20.7520-3(b)(3), 25.7520-3(b)(3).

An income interest cannot be valued under the standard actuarial tables if the assets upon which the interest is based do not produce a reasonable amount of income and the beneficiary cannot compel the trustee to make them productive. Treas. Regs. § 20.7520-3(b)(2)(v) (Examples 2 and 3).
3. **Appraisals And Expert Witnesses.**

Rev. Proc. 66-49, 1966-2 C.B. 1257 (modified by Rev. Proc. 96-15, infra) sets forth minimal information that should be included, for income tax purposes, in a competent appraisal report:

A summary of the appraiser’s qualifications.

A statement of the value and the appraiser’s definition of the value he has obtained.

The bases on which the appraisal has been made, including any restrictions, understandings, or covenants limiting the use or disposition of the property.

The date as of which the property was valued.

The signature of the appraiser and the date the appraisal was made.

See also Treas. Reg. § 20.2031-6(a) (IRS not required to accept expert appraisals); IRS Pub. No. 561 (Rev. Dec. 88) (IRS may reject valuation of taxpayer’s appraiser); Taxpayer’s appraisal upheld where appraiser is qualified as to property appraised and is familiar with characteristics of the property; *Estate of Roberts v. Commissioner*, 28 T.C.M. 40, 47 (1969) (opinion of taxpayer’s appraiser upheld where appraiser highly qualified as to nature of paintings and object d’art in question); *Isbell v. Commissioner*, 44 T.C.M. 1143 (1982) (opinion of taxpayer’s appraiser discounted where appraiser not expert in appraising property in question (Han dynasty ceramic jar) and whose description of property not supported by facts); *Weil v. Commissioner*, 26 T.C.M 388 (1967) (expert called by taxpayer knew little about painting or painter in question and, therefore, his testimony was discounted); *Posner v. Commissioner*, 35 T.C. Memo. 943 (1976) (IRS Art Advisory Panel valuation relied on where large discrepancy in appraisers’ valuations.); *Furstenberg v. United States*, 595 F.2d 603 (Cl. Ct. 1979) (credibility of art appraisers discussed, particularly one associated with IRS Art Advisory Panel).

4. **“Qualified Appraisals” Requirements For Gifts Over $5,000.**

Donor must obtain a qualified appraisal and attach a summary (Form 8283) to his or her return if the claimed value of donated property (other than cash or publicly-traded securities) is over $5,000. For closely-held stock, the threshold is $10,000. To be a qualified appraisal: (1) the appraisal must be made not earlier than 60 days before the date of the contribution; (2) the appraisal document must be prepaid, signed, and dated by a “qualified appraiser”; and (3) generally, the fee for the appraisal must not be based upon a percentage of the appraised value. Treas. Regs. § 1.170A-13(c). These rules apply to individuals, partnerships and corporations. Moreover, in the case of appraised contributions with a value of
more than $500,000, the qualified appraisal itself must now be attached to the taxpayer’s return. American Jobs Creation Act of 2004, § 883. Note: A couple who contributed non-publicly traded stock and who failed to obtain a qualified appraisal were limited to a charitable contribution deduction equal to their basis in the stock. The taxpayers’ ability to prove the fair market value of the stock was not substantial compliance with the substantiation requirements. Hewitt v. Comm. 109 T.C. No. 12 (1997). The Pension Protection Act of 2006 tightened the definition of a qualified appraiser (Section 170(f)(11)(E) and created a civil penalty (Section 6695A) for any person who prepares an appraisal that results in a substantial or gross valuation misstatement in value. The penalty is equal to the greater of $1,000 or 10 percent of the understatement of tax resulting from such a misstatement up to a maximum of 125 percent. The penalty will not apply if the appraiser establishes that it was “more likely than not” that the appraisal was correct.

5. Overvaluation Penalty A Trap For Donor And Preparer Alike.

A twenty percent income tax penalty can be imposed if an individual has an underpayment of income tax attributable to a substantial valuation misstatement (where the value of any property or its adjusted basis claimed on a return is 200 percent or more of the amount determined to be correct). § 6662(e). The penalty increases from 20 percent to 40 percent in the case of gross valuation misstatements. A gross valuation misstatement is reporting the value of any property or its adjusted basis at 400 percent or more of the correct amount. § 6662(h). No penalty is imposed with respect to an underpayment if it is shown there was reasonable cause and the taxpayer acted in good faith. § 6664(c). Fair market value is generally defined as the price at which the property would change hands between a willing seller and a willing buyer, the buyer being under no compulsion to buy and having reasonable knowledge of the relevant facts. The Pension Protection Act of 2006 amended Section 6662 by lowering the thresholds for returns filed after the date of enactment. The threshold for a substantial misstatement was lowered from 200 percent to 150 percent and the threshold for a gross misstatement was lowered from 400 percent to 200 percent or more. The reasonable cause exception now applies only to substantial misstatements.


A taxpayer is not allowed a deduction for any charitable contribution of $250 or more unless the taxpayer substantiates the contribution with a “contemporaneous written acknowledgement” of the contribution by the donee organization. Acknowledgement may be provided for each contribution of $250 or more or may be provided on a periodic basis (i.e., quarterly or annually). Such acknowledgement must include the amount of cash and a description (but not value) of any property (other than cash) contributed. If the donee provides any goods or services in consideration for such contribution, such fact also must be acknowledged along with a description and a good faith estimate of the value of
such goods or services. If such goods or services consisted solely of “intangible religious benefits” (a benefit exclusively for religious purposes generally not sold in a commercial transaction outside the donative context) that also must be acknowledged. The acknowledgement is considered contemporaneous if it is received on or before the date the applicable tax return is filed or the due date for such return (including extensions). § 170 (f)(8). A single payroll deduction over $250 can be substantiated by combining the donor’s pay stub or Form W-2 and a pledge card that otherwise meets the statutory notice requirements under § 170 (f)(8). Treas. Regs. § 1.170A-13(f)(11).

This rule applies to gifts to private foundations, even to trust-form private foundations of which the donor is the sole trustee. Compliance with the rule in this case would thus literally require the donor as trustee to give a receipt to himself or herself.

In the case of charitable gifts by S Corporations or partnerships, the entity is treated as the taxpayer for substantiation purposes, so the shareholder or partner is not required to obtain any additional substantiation for his or her share of the contribution. Treas. Reg. § 1.170A-13(f)(15).

The receipt requirement does not apply to gifts to charitable remainder trusts, but it does apply to transfer to pooled income funds. Treas. Reg. § 1.170A-13(f)(13).

The penalty for noncompliance with the qualified appraisal rules is the complete disallowance of a charitable deduction. Some taxpayers have successfully argued substantial compliance (see, e.g., Bond v. Commissioner, 100 T.C. 32 (1983)), but most of the reported decisions have required strict compliance. See, e.g., Hewitt v. Commissioner, 109 T.C. 258 (1997), aff’d 166 F.3d 332 (4th Cir. 1998); D’Arcangelo v. Commissioner, T.C. Memo. 1994-572 (1994).

7. Charity Must Report Disposition Within Three Years.

If property to which the qualified appraisal rules applies (essentially property other than cash or marketable securities) is sold or otherwise disposed of by the donee charity within three years, the disposition (and the proceeds, if any) must be reported to the IRS and the donee via Form 8282. See § 6050L.

C. Private Foundation Rules and Requirements.

1. Introduction.

A family foundation is a common element in a complete estate plan for wealthier clients. Foundations are used to enable someone who wants to support charitable activities to do so with greater facility and flexibility, and sometimes even to give somewhat more to charity. In addition, a private foundation can be a useful vehicle for creating a permanent ongoing charitable endowment. Before the Tax
Reform Act of 1969, foundations were used widely because they were viewed as offering broad tax planning possibilities.

Donors could secure a current income tax deduction without much personal inconvenience;
Deductions were available for contributions of closely-held stock;
The same stock could then be redeemed by the company;
Money could be borrowed by the donor from the foundation without adequate security; and
Foundations were not required to make ongoing distributions to charity.

In response to perceived abuses, Congress imposed new restrictions and limitations on the formation and operation of the family foundation. Since then, advisers have viewed the creation of such foundations as involving a trade-off.

Pros. Independence and flexibility; control; and separate identity within the community.

Cons. Penalty taxes; compliance complexities; procedural requirements; and less favorable income tax treatment.

2. **Tax Characteristics Of A Private Foundation.**

The Tax Reform Act of 1969 substantially changed the tax laws governing charitable contributions and charitable organizations in general, and private foundations in particular. As a result, since 1969 private foundations have been subjected to a variety of strict rules.

(a) **Description:**

A private foundation is a tax-exempt charitable organization described in section 501(c)(3), which is not:

A so-called 50% organization (church, school, et. seq.), § 509(a) (1);
Publicly-supported organizations which meet the objective tests as to their support sources and which have limited endowment income, § 509(a)(2);
Supporting or “satellite” organizations that exist solely to support an organization that is not a private foundation, § 509(a)(3); and
Underwriters laboratories and certain public safety testing organizations, § 509(a)(4).
(b) **The Donor’s Income Tax Deduction.**

(i) Gifts of cash or ordinary income property. Generally a taxpayer can deduct currently amounts not to exceed 50% of the donor’s contribution base (essentially adjusted gross income). § 170(b)(1)(A). However, with respect to such gifts to private foundations the limitation is 30%. § 170(b)(1)(C).

(ii) Gifts of capital gain property. Capital gain property is any capital asset the sale of which at its fair market value at the time of contribution would have resulted in gain which would have been long-term capital gain. § 170(b)(1)(C)(iv). In turn, long term capital gain is defined as property held more than one year. § 1222. Generally a gift of such property (closely-held stock, real estate, etc.) to a public charity is limited to 30% of the donor’s contribution base. However, a deduction for contributions of capital gain property to a private foundation is limited to 20% of the donor’s contribution base. § 170(b)(1)(D).

Generally the contribution deduction is further limited to the donor’s basis. § 170(e)(1)(B)(ii); Treas. Regs. § 1.170A-4(a)(2) and (3). However, an exception has applied for gifts of “qualified appreciated stock,” stock for which market quotations are readily available on an established securities market. The value of such gifts for purposes of a charitable contribution deduction has been the full fair market value of the stock, not just the donor’s basis in the stock. § 170(e)(5)(D). Following several temporary extensions, this rule was permanently extended by the Taxpayer Relief Act of 1998.

(iii) Limitations for Gifts of Ordinary Income Property. The amount of the charitable deduction for gifts of property, the sale or exchange of which would produce a gain, other than a long-term capital gain, is reduced by the amount of the non-long-term gain. § 170(e). Included in this category are: inventory, crops, dealer property and works created by the donor.

(iv) Hierarchy for Determining What Type of Gift Can Be Deducted When. The following hierarchy is imposed when determining the application of the various contribution base limitations.
Cash type gifts to public charities.
Cash type gifts to private foundations.
Gifts of 30% capital gain property.
Gifts of 20% capital gain property.

(v) Five Year Carryover for Contributions which Exceed Contribution Base. § 170(d)(1).

(c) Reporting Requirements.

A private foundation must file an extensive annual information return (Form 990-PF) with the Service. In addition, the annual return must be filed with the appropriate state officials and made available to the general public at the foundation’s principal office. The foundation’s exemption application (Form 1023) must also be made available to those who request it.

(d) Penalty Taxes.

In addition to less generous deductions for their supporters, private foundations are subject to a series of (Chapter 42) excise taxes in various situations. Except for the section 4940 tax on net investment income, each of the Chapter 42 penalty excise taxes provides for a two-level tax structure. An initial tax is imposed at a relatively low level, followed by a more severe second-level tax which applies if the foundation fails to “correct” the violation which gives rise to the initial liability. In addition, section 6684 imposes a penalty equal to the applicable tax if the person liable has previously been liable for a Chapter 42 tax, or if the transgression is both willful and flagrant; the effect is to double the applicable penalty in such cases.

(i) Tax on acts of self-dealing (dealings between the foundation and its substantial contributors, foundation officials and related persons “disqualified persons”). § 4941.

The prohibition on self-dealing, often can create unexpected difficulties. The prohibition is absolute and, presently, the IRS is without equitable authority to excuse harmless violations. Examples of prohibited transactions are selling or leasing of property or making of loans between the foundation and a disqualified person.
Initially the tax is 5% on a foundation manager and 10% on the self-dealer, but if not corrected within the taxable period the tax on the disqualified person increases to 200% of the amount of the self-dealing transaction.

(ii) Tax on failure to make a minimum distribution equal to 5% of investment assets. § 4942. The tax is 30% of the amount of income undistributed at the beginning of the next year and, if the distribution deficiency is not corrected within the taxable period, the penalty increases to 100%. A foundation can treat amounts set aside for a specified charitable project as having been distributed, even though payment is not made until a later year. Advance IRS approval of the project is required. § 4942(g)(2)(B). Typically used for construction projects and comparable undertakings of a magnitude requiring the accumulation of funds. Allows donor/manager to undertake larger projects than he/she could have otherwise.

(iii) Tax on excess business holdings. § 4943. The prohibition on excess business holdings is designed to restrict foundation involvement in the ownership and operation of businesses. While this prohibition may be simple in concept, section 4943 is an intricate and complex statute. Generally, holdings are excess if disqualified persons own 20% or more of the voting stock of incorporated business and the private foundation owns at least 2%. 2-tier tax of 10%/200%.

(iv) Tax on investments which jeopardize the foundation’s exempt purpose. § 4944. 10%/50% taxes on foundation and foundation manager.

(v) Tax on expenditures for noncharitable purposes. § 4945. (Expenditures for lobbying and propagandizing, influencing elections or conducting voter education, making grants to certain individuals unless approved by the IRS in advance, grants to organizations other than public charities unless the foundation monitors grantee’s use and making grants for noncharitable purposes). 20%/100% on the foundation and 5%/50% on foundation manager.

(vi) Tax on termination of the foundation. § 507. The tax equals the aggregate benefits of the foundation’s exempt status or the net value of its assets. § 507(c). The tax is avoided in several ways. If the foundation continues in
existence, it may transform itself into a public charity and operate as such for at least five years. Alternatively, the foundation can terminate and transfer all of its net assets to any charity which has been a public charity for at least five years. In addition, mergers or comparable combinations between private foundations are permitted, and the regulations provide for the carryover of various private foundation characteristics in the context of such transactions.

(vii) Tax on investment income set at 2%. § 4940. Can be reduced to 1%, but not if the foundation was liable for tax for failure to distribute income under section 4942 during base period. The definition of “investment income” was expanded in 2006 to include: (i) income from sources “similar to” dividends, rent, interest, royalty; and (ii) net capital gain from any property which produces “gross income” (broader than term “gross investment income” currently in IRC Section 4940). There are limits on the use of loss carrybacks and loss carryovers, and there is no tax on capital gain from an IRC Section 1031 like-kind exchange of “exempt use” property which has been used for exempt purposes for at least one year.

3. **Foundation as Beneficiary of a Charitable Lead Trust.**

A family that has sufficient wealth to create a family foundation may well consider using one or more charitable lead trusts to minimize transfer taxes on large transfers to younger generations. By directing the ongoing charitable distributions to a family foundation, the tax-saving characteristics of the lead trust are obtained, and the amounts distributed are paid to the foundation, where family members are able to influence, if not control, their ultimate application.

(a) **Minimum Distribution Requirement.**

The regulations under section 53.4942(a)-2(c)(2)(iii), take the position that a private foundation that is the beneficiary of a charitable lead trust must take into account as part of the foundation’s minimum distribution, the lesser of (a) the income distributions from the lead trust or (b) five percent of the trust assets. However, this regulation was held invalid in Ann Jackson Family Foundation v. Comr., 15 F.3d 917 (9th Cir. 1994), aff’g 97 T.C. 534 (1991) (reviewed) where a private foundation disregarded taking into account the assets of the trust or the annuity distributions received from the trust in determining its minimum investment return.
(b) Estate Tax Treatment of Foundation in Creator’s Estate.

Charitable lead trusts that make payments to a foundation in which the creator of the trust has an influential role can be problematic. In Rev. Rul. 72-552, 1972-2 C.B. 525, the IRS held that the value of property transferred to a foundation was included in the donor’s estate under section 2036 because the donor/decedent, in his capacity as a member, director and president of the foundation, had the power to direct the disposition of its funds for charitable purposes. Similarly, in PRIVATE LETTER RULING 7929002 this same rule was applied to a decedent who held multiple fiduciary positions in an organization to which the income from a trust he had created was paid. In Rifkind v. U.S., 5 Cl. Ct. 362 (1984), a foundation was the sole beneficiary of a lead trust and its settlor in his role as an officer, member and director of the foundation, was able to designate (or at least participate in designating) the recipients of foundation grants. The court found section 2036(a)(2) applicable, so the lead trust was taxable in his estate. But see PRIVATE LETTER RULING 200138018 for an illustration of a proper segregation of a grantor of a CLT from his private foundation, which was the charitable beneficiary of the grantor’s lead trust, such that the trust was not taxable in the grantor’s estate.

4. Foundation as Beneficiary of a Charitable Remainder Trust.

If the trust instrument requires that the remainder beneficiary be an organization described in section 170(b)(1)(A), a private foundation cannot receive the remainder interest. On the other hand, unless the instrument so provides the settlor’s income tax charitable deduction for the transfer to the trust will be subject to the lower percentage limitations applicable to contributions to private foundations. For purposes of the beneficiary/foundation’s minimum distribution requirement, the foundation’s future interest in the charitable remainder trust will not be taken into account until all intervening interests in the trust have expired. See Treas. Regs. §53.4942(a)-2(c)(2)(i). If a donor does not wish to create a “stand by” foundation to receive what will eventually be distributed from a charitable remainder trust, it is possible to provide in the terms of the charitable remainder trust itself that the trust will continue after the death of the non-charitable beneficiaries as a grant-making entity.

5. Probate Exception to Self-Dealing.

Many transactions that would not be allowed between a private foundation and a disqualified person may be allowed under limited circumstances known as the probate exception. Section 53.4941(d)-1(b)(3) of the regulations provides that the term, “indirect self-dealing” shall not include a transaction with respect to a
private foundation’s interest or expectancy in property (whether or not encumbered) held by an estate (or revocable trust, including a trust which has become irrevocable on a grantor’s death), regardless of when title to the property vests under local law, if:

The administrator or executor of an estate or trustee of a revocable trust either:

(a) Possesses a power of sale with respect to the property,

(b) Has the power to reallocate the property to another beneficiary, or

(c) Is required to sell the property under the terms of any option subject to which the property was acquired by the estate (or revocable trust).

Such transaction is approved by the probate court having jurisdiction over the estate (or by another court having jurisdiction over the estate (or trust) or over the private foundation);

Such transaction occurs before the estate is considered terminated for federal income tax purposes pursuant to paragraph (a) of section 1.641(b)-3 of the regulations (or in the case of a revocable trust, before it is considered subject to section 4947 of the Code);

The estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation’s interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate (or trust); and

The transaction either:

(a) Results in the foundation receiving an interest or expectancy at least 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 estate (or trust).

6. Corporate Adjustment Exception to Self-Dealing.

Section 4941(d)(2)(F) exempts from self-dealing transactions between a private foundation and a corporate disqualified person any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization if the foundation receives fair market value in the transaction and all classes of stock held before the transaction are subject to the same terms.
The IRS ruling position is that the exception applies even where it is anticipated and all but certain that only the foundation will be redeemed. See, e.g. Private Letter Rulings 9108030, 9108036, 9101021, 9338046., 200720021,200521028.

The terms of the redemption must be identical. For instance, where other shareholders receive cash and the foundation receives debentures, the exception likely will not apply.

7. **Exit Strategies to Terminate a Private Foundation.**

A family that no longer wishes to operate its own separate foundation has several choices.

Pay the termination fee under § 507. Since this normally means disgorging all of the foundation’s net assets to the government, this alternative is seldom voluntarily chosen.

Pay over all the foundation’s net assets to one or more public charities in accordance with § 507(b)(1). A range of terms and conditions may be placed on such transfers to allow the family to have continuing recognition or involvement.

Convert the foundation into a form of public charity (including a supporting organization) and operate in that form for a continuous 60-month period.

Merge with another foundation in accordance with § 507(b)(2) and the regulations thereunder.

D. **Alternatives to the Private Foundation.**

1. **Donor Involved (Advised or Philanthropic) Funds.**

These are funds created by public charities (50% Organizations) as to which advice or recommendations concerning distributions are made by the former trustees of a transferor private foundation or by a donor contributing to the fund. The fund must be operated as a “component fund” of the public charity. If not, the fund could be treated as a private foundation and the donor’s deduction would be limited accordingly. Although the donor and/or others he or she designates may make recommendations as to distributions, the public charity must have ultimate control over decisions concerning distributions. Historically donors and charities looked to the regulations for guidance in determining whether an advised fund was a “component part.” Treas. Regs. §§ 1.170A-9(e)(11), 1.507-2(a)(8)(iv)(A)(2) and (3).

The Pension Protection Act of 2006 included a number of provisions which significantly impacts the formation and operations of donor advised funds. For the first time there is a statutory definition of what is a donor
advised fund (and what is not) (§4966). The definition is important because the Act also imposes new excise taxes on the funds so defined (§§4966 and 4967), expanded the application of intermediate sanctions with respect to such funds and applied the excess business holding rulings for private foundations to such funds as well.

(a) **New Legislative Definition of Donor-Advised Fund (DAF).** A “donor advised fund” now is defined as any fund or account:

Which is owned and controlled by a “sponsoring organization”, which generally includes most public charities;

Which is separately identified by reference to contributions of a donor or donors; and

With respect to which a donor or person appointed by the donor (“donor advisor”) has advisory rights with respect to investments or distributions.

However, such funds do not include any fund which:

Makes distributions to only one identified organization or governmental entity; or

Makes grants to individuals for travel, study or similar purposes if the fund is advised by a committee, all the members of which are appointed by the sponsoring organization, if such committee is not controlled by a donor or donor advisor and grants are awarded using an objective and nondiscriminatory process approved in advance by the sponsor’s governing body that meets the requirements for similar grants by private foundations; or

Is exempted by the Secretary of the Treasury, provided that the fund is either advised by a committee not controlled by a donor or donor advisor or is a fund benefiting a single charitable purpose.

(b) **Taxable Distributions.** Distributions from DAFs to individuals and to any entity if the payment is not for charitable purposes will result in the imposition of penalty taxes on the persons who recommended and approved such distributions. As discussed below, distributions to “disqualified supporting organizations” also will be subject to penalty taxes, unless expenditure responsibility is exercised.
(c) **Permitted Distributions.** A DAF may make distributions to the following:

Any charitable organization described in Code Section 170(b)(1)(A) (other than a “disqualified supporting organization”, discussed below). These include organizations classified as churches, educational organizations, hospitals and medical organizations, publicly supported organizations, governmental units, and private operating foundations;

The sponsoring organization of the DAF; and

Other DAFs.

(d) **Distributions Requiring Expenditure Responsibility.** A DAF distribution may be made to the following only if expenditure responsibility is exercised (this requires a pre-grant inquiry, a detailed grant agreement, obtaining reports from the grantee and taking action to recover any diverted grant funds):

To a private nonoperating foundation;

To a “disqualified supporting organization”; or

To an organization not described in IRC Section 170(b)(1)(A).

“Disqualified supporting organizations” include:

Type III supporting organizations that are not “functionally integrated”; and

Type I and Type II supporting organizations and “functionally integrated” Type III supporting organizations if

a donor, donor advisor or related party controls a supported organization of such supporting organization; or

the Secretary of the Treasury determines by regulation that a distribution to such a supporting organization is “inappropriate”.

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(e) **Prohibited Benefits.** Penalties are imposed on a donor-advised fund if, based on the advice of a donor, donor advisor or related party, a distribution is made from a donor-advised fund and a donor, donor advisor or related party receives a “more than incidental benefit” as a result of such distribution. The penalty is 125% of the amount of the benefit and can be imposed on the person who recommended the distribution or the person who received the benefit. In addition, fund managers who approve such distributions are subject to a penalty tax of 10% ($10,000 maximum) if they knew the distribution would result in the benefit.

(f) **Excess Benefit Transactions.** For transactions occurring after August 17, 2006, any “grant, loan, compensation, or other similar payment” from a donor-advised fund to a donor, donor advisor or related party is prohibited. If such a payment or loan is received from a donor-advised fund, a 25% penalty tax is imposed on the recipient based on the amount involved and any amount repaid as a result of correcting an excess benefit transaction must be repaid to the sponsoring organization but not held in any donor-advised fund.

(g) **Compensation of Investment Advisors.** For transactions occurring after August 17, 2006, a sponsoring organization is prohibited from paying excessive compensation to anyone providing investment advice with respect to DAFs.

(h) **Application of Excess Business Holdings Limitations.** The private foundation excess business holdings limitations now are applied to assets held by DAFs. These limitations generally limit the combined holdings of a DAF and donors, donor advisors and related parties to 20% of the voting stock of a corporation (or equivalent ownership of a partnership or other entity). Transition rules apply to existing holdings of donor-advised funds at August 17, 2006.

(i) **Charitable Deduction Requirements.** Certain charitable contribution rules now apply for contributions to DAFs.

Donors will be denied an income, gift or estate tax deduction for contributions to a DAF held by a Type III supporting organization which is not “functionally integrated”.

All DAF gift acknowledgments to donors must indicate to donors that the sponsoring organization has exclusive legal control over the assets contributed to a DAF. If such
acknowledgement is not provided, a donor could be denied a charitable deduction.

2. Supporting Organizations.

(a) Generally.

This category of public charity need not be, and is generally not, publicly supported. The supporting organization is indirectly responsive to the public by reason of its relationship to one or more public charities that it supports. Examples are religious organizations connected with churches, trusts organized and operated for the benefit of a school and controlled by, or operated in connection with, the school, university presses, or similar organizations. Under section 509(a)(3), three separate requirements or tests must all be satisfied. The supporting organization must:

- Be organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of, one or more specified public charities;
- Be operated, supervised, or controlled by, or in connection with, one or more public charities; and
- Not be controlled directly or indirectly by one or more disqualified persons.

The Pension Protection Act of 2006 included a number of provisions which significantly affects the organization and operation of supporting organizations. Some provisions apply to all supporting organizations. These include an expansion of the application of intermediate sanctions, the definition of a disqualified person and certain disclaimer requirements. In addition so-called type III supporting organizations that are not “functionally integrated” are now subject to a payout requirement, limitations on excess business holdings and additional organizational and operational requirements to qualify.

(b) Supporting Organizations v. Private Foundations. Potential advantages of a supporting organization over a private foundation.

- No 2% excise tax on the investment income of a supporting organization.

Contributions of any type of long-term appreciated property to a supporting organization, including closely held stock, are deductible to the extent of 30% of the donor’s “contribution base.”
Contributions of cash to a supporting organization are deductible to the extent of 50% of the donor’s contribution base.

Transactions between the supporting organization and the donor or related parties (including entities controlled by the donor) are permissible, provided that transactions are at arm’s length and are reasonable. (For example, stock owned by a supporting organization may be redeemed by a corporation controlled by the donor, a supporting organization may purchase stock from the donor’s estate and may sell stock to members of the donor’s family.)

The costs of operating a supporting organization may be reduced when one or more public charities assume administrative responsibility for its operation.

Restrictions on a supporting organization’s investment activities are less stringent than those applicable to a private foundation.

Participation of the representatives of the supported public charities on the board of a supporting organization helps to assure continuity and operation in a consistent manner and helps to provide guidance to younger generation members of the donor’s family who become members of the board.

II. CONTRIBUTION OF C CORPORATION STOCK AND THE CHARITABLE BAILOUT.

A. Generally.

A charitable gift of C Corporation stock followed by a redemption by the corporation can be a great way to accommodate the donor’s charitable objectives, ultimately fund the gift with cash, and permit the tax-free distribution of excess cash accumulated in the corporation. This plan is sometimes referred to as a “charitable bailout” because both the charitable gift and the subsequent redemption would be completely income tax free, and the corporation would be able to “bail out” its accumulated cash.

B. Redemption for a Note.

If the charitable donee is a private foundation or charitable remainder trust, normally the redemption would constitute impermissible self-dealing, but the “corporate adjustment” exception permits redemptions as discussed earlier.

May the redemption occur for a note? Loans by a foundation to a corporate disqualified person are an impermissible act of self-dealing. Is a redemption for an installment note a loan? In Private Letter Ruling 9347035 the IRS determined
that the answer was no. In the ruling the owner of approximately 82% of a closely-held manufacturing corporation intended to give 16.5% of the stock to a charitable trust subject to the self-dealing rules. The corporation planned to offer to redeem shares for 10% of the redemption price paid in cash and 90% paid in a note bearing interest at 8% and fully amortized over 10 years. With respect to the note the ruling states:

Furthermore, the proposed transaction provides for an installment payment arrangement for the redemption of shares with part of the purchase price being paid in cash at the time of the redemption and the balance, pursuant to the terms of the transaction, being payable quarterly thereafter for the remaining ten year installment payment term. Thus, the retention by B of the redemption notes evidencing A’s obligation to pay the balance of the redemption price is a part of the redemption transaction and is not self-dealing under section 4941(d)(2)(F) of the Code.

Subsequently, the IRS revoked the ruling. Private Letter Ruling 9731034 states:

In your letter dated June 24, 1992, you were concerned with the tax consequences of a redemption of shares of common stock from B following the donation of such shares to B by C. Redemption was to be accomplished through extensions of credit by A, a disqualified person with respect to B.

On August 31, 1993, we issued a favorable ruling to B (PLR 9347035) on this request. Subsequent to the issuance of the ruling it was discovered that the ruling was contrary to Example 2 of section 53.4941(d)-3(d)(2) of the Foundation and Similar Excise Taxes Regulations. When B was informed of our intent to revoke the ruling, B indicated that the transaction was never entered into and asked that the ruling request be withdrawn. On October 27, 1994, we acknowledged the withdrawal of B’s ruling request.

This letter formally revokes PLR 9347035.

The example 2 referred to states:

Private foundation Y, which is on a calendar year basis, acquires 60 percent of the class A preferred stock of corporation N by will on January 10, 1970. N, which is also on a calendar year basis, is a disqualified person with respect to Y. In 1971, N offers to redeem all of the class A preferred stock for a consideration equal to 100 percent of the fair amount of such stock by the issuance of debentures. The offer expires January 2, 1972. Both Y and all other holders of the class A preferred stock accept the offer and enter into the transaction on January 2, 1972, at which time it is determined that the fair market value of the debentures is no less than the fair market value of the preferred stock. The transaction
on January 2, 1972, shall not be treated as an act of self-dealing for 1972. However, because under §53.4941(e)-1(e)(1)(i) an act of self-dealing occurs on the first day of each taxable year or portion of a taxable year that an extension of credit from a foundation to a disqualified person goes uncorrected, if such debentures are held by Y after December 31, 1972, except as provided in §53.4941 (d)-4 (c)(4), such extension of credit shall not be excepted from the definition of an act of self-dealing by reason of the January 2, 1972, transaction. See §53.4941(d)-4(c)(4) for rules indicating that under certain circumstances such debentures could be held by Y until December 31, 1979.

If the redemption for a note occurs as part of the probate exception to self-dealing (see discussion above), self-dealing may be avoided. See, e.g., Private Letter Ruling 9312024, and also 9042030, 9108024, 9112012, 9350038.

Even if the probate exception is available an uncertain issue is whether payments on the note will be self-dealing. The answer should be no and certainly that result is within the spirit of the rulings.

What if the note already exists in the estate such that no probate exception is available? Self-dealing encompasses receipt by a foundation of notes made by disqualified persons through gift or bequest. See General Counsel Memoranda 37731 and 37037, and Private Letter Ruling 8521122. In Private Letter Ruling 200635017 notes were contributed to a limited liability company that were then purchased through a transaction approved through the probate exception. The facts giving rise to the favorable ruling were as follows:

B had three children: C, married to D, E, married to F, and G. C, E, D, and G are now deceased. D, F and G are each referred to as a “Taxpayer” and collectively as the “Taxpayers.”

C, F and G entered into a business transaction with family members (including trusts or other entities controlled by, or created for the benefit of, family members). Pursuant to these transactions, C, F and G acquired a promissory note as consideration, each referred to as a “Note.” Each Note provides for annual interest at the mid-term Applicable Federal Rate, with principal due at the end of the note term.

Taxpayer is the sole member. Each of these entities is referred to as a “Company” and collectively as the “Companies.” Each Taxpayer contributed his or her Note to his or her Company, in exchange for which the Taxpayer received all of the voting units (“Voting Units”) and nonvoting units (“Nonvoting Units”) of his or her respective Company. Pursuant to C’s and D’s estate plans, D’s estate currently owns the Voting and Nonvoting Units in C’s Company. In addition, F (through her revocable trust) currently owns the Voting and Nonvoting Units in F’s
Company, and G’s estate currently owns the Voting and Nonvoting Units in G’s Company. Each taxpayer entered into a limited liability company agreement (“Company Agreement”) to govern his or her respective Company.

Taxpayers state that each Company will be engaged solely in passive investment activities; will not engage in the operation of any business enterprise; and at least 95 percent of the gross income of each Company will be derived from passive investments that will include, for example, interest and dividends.

Each Taxpayer created a charitable trust to be funded at his or her death. Each of these trusts is referred to as a “CT” and collectively as the “CTs.” Each CT has a 20-year term commencing at the Taxpayer’s death, during which term the CT will annually pay a guaranteed annuity to one or more charitable organizations.

Each Taxpayer has also created a revocable trust, separate and distinct from the Taxpayer’s CT. Taxpayers state that each Taxpayer has provided in his or her revocable trust that at the Taxpayer’s death, the Nonvoting Units owned by the Taxpayer will be allocated to the CT created by that Taxpayer. As a Nonvoting Unit holder, the CT cannot be required by the Company or its members, under the Company Agreement, to make any capital contributions or take any other actions. Nor does the CT have a right to force any distributions from the Company. Rather, under the Company Agreement the CT only has a right to receive distributions (in proportion to its ownership interest) when the Company dissolves or otherwise chooses to make distributions. The Taxpayer’s Voting Units will be bequeathed to or in trust for the benefit of the Taxpayer’s descendants.

Pursuant to an agreement (the “Option Agreement”), each Taxpayer (and his or her revocable trust) granted his or her children and a business entity controlled by the Taxpayers and their families (collectively, the “Option Holders”) an option (the “Option”) to purchase one or more specific assets (including the Note and any of the Nonvoting Units) (collectively, the “Option Assets”) from the then current owner of the Option Assets, including the Company or the Taxpayer’s estate or revocable trust. The Option Assets will not include any of the Voting Units. The Option Agreement provides that the Option Holders may purchase some or all of the Option Assets for a purchase price equal to the fair market value of such Option Assets as determined for federal estate tax purposes in the Taxpayer’s estate at any time within nine months of the Taxpayer’s death (the “Option Term”). The Option Holders will be required to pay the purchase price for the Option Assets in cash, marketable securities, or a combination of both.
With respect to any Option Assets to be purchased from the Taxpayer’s estate or revocable trust, before the expiration of the Option Term, Taxpayers state that their estates or revocable trusts will petition a court of competent jurisdiction for approval of both the Option Holders’ exercise of their options, as well as the tendering and receipt of consideration pursuant to each Option Agreement. Taxpayers state that the exercise of the Options by the Option Holders, the sale and purchase of Option Assets, and the tendering and receipt of consideration related thereto, will occur before the end of the period reasonably required by the executors or trustees to perform the ordinary duties of administration necessary for the settlement of the Taxpayers’ estates and before the Taxpayers’ revocable trusts are treated as trusts under section 4947 of the Code. Taxpayers state that the purchase of the Option Assets owned by the Taxpayers’ estates or revocable trusts pursuant to each Option Agreement will be contingent upon receipt of approval from a court of competent jurisdiction.

III. CHARITABLE GIFTS OF PARTNERSHIP (OR LLC) INTERESTS.

A. Donor Issues.

1. Phantom Income.

Charitable gifts of interests in partnerships or limited liability companies can sometimes result in surprising and unfavorable tax consequences to the donor. The gift may result in the realization of ordinary income by the donor if the partnership has unrealized receivables or appreciated inventory, or if there is any investment tax credit subject to recapture. See generally IRC §§ 47 to 50 and 751(a). The gift could also accelerate any unrecognized installment gain in the partnership. See Rev. Rul. 60-352, 1960-2 C.B. 208.

2. Bargain Sale Rules.

The so-called “bargain sale rules” apply to gifts of interests in partnerships with outstanding indebtedness, even if the indebtedness is nonrecourse and unsecured. The partner is treated as having received payment for his or her entire share of partnership liabilities. See IRC § 752; Treas. Reg. § 1.752-1(d). See also Rev. Rul. 75-194, 1975-1 C.B. 80. This can result in “phantom” capital gain income to the donor.

3. Valuation and Substantiation.

A charitable gift of an interest in a partnership or LLC is generally treated as a gift of a capital asset, so a gift to a public charity generally would qualify for a full fair market value deduction. The Service quite properly asserts, however, that all the same valuation discounts promoted by donors
of noncharitable gifts also apply to charitable gifts, so the appraised value of the interest transferred generally would be 10 to 50 percent less than the undiscounted value based on the value of the underlying assets. Gifts of such interests are subject to the “qualified appraisal” rules. If the charitable donee is given rights to liquidate the partnership or LLC immediately or after a short period of time, along with the broad ability to transfer the interests, the discount may be reduced significantly.

4. **Prearranged Sale Rules.**

Although most of the reported cases and rulings deal with prearranged sales or redemptions of stock, the same principals would apply to gifts of partnership or LLC interests.

B. **Donee Issues.**

1. **Unrelated Business Income.**

A tax-exempt organization, including a private foundation, pays tax on its unrelated business taxable income (“UBTI”). IRC §511. UBTI is income from activities that: (1) are regularly carried on, (2) rise to the level of a trade or business, and (3) are substantially unrelated to the organization’s exempt purposes. IRC §§512, 513. UBTI does not include passive income such as dividends, interest, most rents from real property and gains from the sale of property (other than dealer property). IRC §512(b). If a tax-exempt organization is a partner in a partnership that regularly carries on a trade or business that is unrelated to the exempt purpose of the organization, such organization shall, in computing its UBTI, include its share of partnership gross income from the unrelated trade or business and its share of partnership deductions directly connected with such gross income, subject to the exceptions for passive income. IRC §512(c).

Unlike the case with shares of S corporations held by tax-exempt organizations, a tax-exempt partner’s share of partnership income and gain is not necessarily treated as unrelated business income. Instead, there is something of a “look through” rule. The charitable organization must include in its unrelated business income only its share of the partnership’s income attributable to unrelated trade or business activities carried on by the partnership. IRC § 512(c). In other words, for purposes of this rule, the partner is treated as engaged in the same activities of the partnership. The tax-exempt partner’s share of the partnership’s dividends, interest, rents, royalties, and other “passive” income retains its tax-free character.

The exclusion of rent from UBTI does not apply if the determination of rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed
percentage or percentages of receipts or sales). §512(b)(3)(B)(ii). In other words, rent is not passive income if it represents a portion of the tenant’s net income or profit. Some commercial leases (including many shopping center leases) provide for both a fixed minimum rent and an additional percentage of (i) gross receipts or sales from tenants minus (ii) agreed upon exclusions such as real estate taxes, property insurance, and common area maintenance paid by such tenants. To avoid UBTI for tax-exempt organizations owning rental property with such leases (or owning partnership interests where the partnership owns such rental property), care should be taken to craft a rental formula that avoids rent becoming an interest in the profits of the tenant. For example, if percentage rent contains exclusions from gross receipts, such exclusions should be tied to expenses of the property and not to other activities of the tenant’s business.

2. Debt-Financed Income.

The exclusion from UBTI for income from passive activities is limited when the property giving rise to the income is financed by “acquisition indebtedness,” that is, indebtedness incurred to purchase or improve the property (or indebtedness incurred before or after a purchase or improvement that would not have occurred but for such purchase or improvement). IRC §§514(a), 514(c)(1). Where property is acquired (including by gift or bequest) subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien is considered acquisition indebtedness even though the organization does not assume or agree to pay such indebtedness. IRC §514(c)(2)(A).

When there is acquisition indebtedness, a portion of the gross income (including capital gain) generated by the property is UBTI. Such portion is the ratio of the average acquisition indebtedness over the average adjusted basis in the property during the year. However, the acquisition indebtedness rule does not apply to the extent that the use by the organization of the mortgaged property is substantially related to its exempt purposes. IRC §514(b)(1)(A).

Where mortgaged property (including a partnership interest in a partnership that owns mortgaged property) is acquired by the organization as a result of a bequest or devise from a deceased donor, the indebtedness is not treated as acquisition indebtedness during the 10-year period following the date of acquisition. Where mortgaged property (including a partnership interest in a partnership that owns mortgaged property) is acquired by the organization as a result of a gift from a living donor, the indebtedness is not treated as acquisition indebtedness during the 10-year period following the date of acquisition if: (i) the mortgage was placed on the property more than five years before the date of the gift and (ii) the
3. **Payments of Income Tax.**

The charitable partner may be subject to income tax on its share of partnership unrelated business income, without regard to actual distributions from the partnership. It is thus important that the partnership agreement or LLC operating agreement require the entity to make distributions in an amount at least sufficient to pay any unrelated business income tax.

4. **Capital Assessments.**

Although limited partners and members of LLCs generally are liable for partnership debts and expenses only to the extent of their investment, the terms of the partnership agreement or operating agreement can require partners or members to make additional capital contributions or other payment. The charitable donee should carefully consider these and other cash flow issues before accepting a gift. In some instances donors have obligated themselves to make the capital calls on behalf of the charitable donee, but there is some question as to whether such contributions are deductible and to what extent. Perhaps, the payment made pursuant to the original gift agreement is merely carrying out the donor’s contractual obligation. On the other hand it may be likened to a charitable pledge, not deductible when made, but only when carried out.

5. **Environmental Liabilities.**

The interest of a limited partner or a member of an LLC is personal property, even if the entity owns real property. The partner or member should thus not constitute an “owner” within the meaning of federal and state environmental laws, but in some cases the partner or member could be deemed an “operator” of property. A prudent charitable organization will undertake at least limited environmental due diligence before accepting an interest in any entity operating real property.

6. **Donor Indemnities.**

With respect to any of these potential liabilities, a charitable donee may wish to consider requesting an indemnity from its donor.
C. Private Foundation Issues.

Generally.

There is a substantial tax on a private foundation that conducts an act of self-dealing with a disqualified person. IRC §4941(a)(1). The term self-dealing includes a sale or exchange of property between a private foundation and a disqualified person, IRC §4941(d)(1)(A), and includes the sale of assets by a disqualified person to a private foundation in a bargain sale. Treas. Reg. §53.4941(d)-2(a).

A disqualified person includes (i) a substantial contributor to the foundation (the creator of the foundation formed as a charitable trust, and any contributor to the foundation whose contributions are in the aggregate more than $5,000 and more than 2 percent of the foundation’s total contributions), IRC §§4946(a)(1)(A) and 507(d)(2); (ii) certain owners of entities that are substantial contributors, IRC §4946(a)(1)(C); (iii) a foundation manager (an officer, director, or trustee of the foundation or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation, and with respect to any act (or failure to act), the employees of the foundation having authority or responsibility with respect to such act (or failure to act), IRC §§4946(a)(1)(B) and (b); (iv) certain family members of substantial contributors, owners of substantial contributors, and foundation managers, IRC §§4946(a)(1)(D) and (d); and (v) certain entities that are owned by substantial contributors, owners of substantial contributors, foundation managers, and such family members, IRC §§4946(a)(1)(E), (F) and (G).

When a gift is made by a disqualified person to a private foundation of debt-encumbered property, or of a partnership interest in a partnership that owns debt-encumbered property, are the rules that govern whether there has been a “sale or exchange” for income tax purposes the same as the rules that govern whether there has been a “sale or exchange” for self-dealing purposes?

There is ample authority for the proposition that for purposes of computing gain from the disposition of property, the amount realized includes the amount of liabilities from which the transferor is discharged. Treas. Reg. §1.1001-2(a)(1). If the disposition is of property that secures a liability, the transferor is considered to be discharged from the liability even if the transferee takes the property subject to the liability and does not assume the liability. Treas. Reg. §1.1001-2(a)(4)(i). A disposition of property includes a gift of the property, Treas. Reg. §1.1001-2(a)(4)(iii), and the amount realized is the amount of the loan encumbering the property. Treas. Reg. §1.1001-2(c) Example (6). Similarly, a gift of debt-encumbered property to a charity is a bargain sale, and the amount realized
by the donor includes the liability even if the transferee does not agree to assume or pay it. Treas. Reg. §1.1011-2(a)(3). If the disposition is of a partnership interest, the liabilities from which the transferor is considered to be discharged include the transferor’s share of the partnership’s liabilities. IRC §752(d); Treas. Reg. §1.1001-2(a)(4)(v). And so it is with a gift to charity of a partnership interest where the partnership owns the encumbered property -- the amount of liabilities from which the charitable donor is discharged equals the donor’s share of the partnership’s liabilities. Rev. Rul. 75-194. The discharge of the liability can presumably be negated where the donor assumes primary responsibility for the liability.

1. Debt.

A special rule in IRC §4941(d)(2)(A) provides that for purposes of defining self-dealing, a sale or exchange includes the transfer of real or personal property by a disqualified person to a private foundation if the property is subject to a mortgage or similar lien which the foundation assumes, or if the property is subject to a mortgage or similar lien which a disqualified person placed on the property within 10 years of the date of the transfer. This special rule describes alternative necessary conditions for self-dealing to result from a gift of debt-encumbered property by a disqualified person to a private foundation, and where neither of the alternative necessary conditions is present, a gift or bequest of debt-encumbered property by a disqualified person to a private foundation will not result in self-dealing. See Private Letter Ruling 9241064 (no self-dealing because the mortgage on the property was placed more than 10 years before the gift to a charitable lead annuity trust, and because the lead trust did not assume the mortgage).

The first alternative necessary condition is that self-dealing will arise if the foundation assumes the liability. Note, as cited in paragraph 1 above, that for income tax purposes a gain will result even if the transferee merely takes the property subject to the liability and does not assume the liability. But for purposes of self-dealing under the conditions described in this paragraph, there is no self-dealing if the transferee takes property subject to the liability without assuming it—since if mere acceptance of debt encumbered property caused self-dealing there would be no point to the second alternative condition which causes self-dealing (debt placed on the property by a disqualified person within ten years of the date of transfer). Rev. Rul. 78-395. Debt assumption by a donee foundation seems unlikely, especially where the gift is of a partnership interest and the debt is inside the partnership.

The second alternative necessary condition is that self-dealing will arise if the debt was placed on the property by a disqualified person within 10 years of the date of the transfer. If a partner or the partnership placed the
debt on the property within 10 years but neither is a disqualified person, then the contribution of the partnership interest does not result in self-dealing. Private Letter Ruling 8932042.

Assuming that, within ten years of the charitable gift to the foundation, debt was placed on partnership property by either the partnership or a partner—we need to determine whether the partnership or the partner is a disqualified person with respect to the foundation. There appears to be no requirement that the partner or the partnership have been a disqualified person at the time that he, she or it placed the debt on the property—only that such partner or partnership is a disqualified person at the time that the property is contributed to the foundation. See Gershman Family Foundation, 83 TC 217 (1984), where the foundation was created after the lien was placed on the gifted property.

(a) If a partner is a substantial contributor to the foundation (or if certain family members or related entities are substantial contributors), or if a partner is a foundation manager, then the partner is a disqualified person. The partnership itself is a disqualified person if disqualified persons own more than 35% of the profits interest in the partnership. IRC §4946(a)(1)(F).

(b) However, the “one bite rule” provides that self-dealing does not include a transaction between a private foundation and a disqualified person where the disqualified person status arises only as a result of the transaction. Treas. Reg. §53.4941(d)-1(a). So if the gift to a foundation by a donor (not otherwise a disqualified person) is of debt-encumbered property or of a partnership interest that owns debt-encumbered property (in either case where the debt was placed on the property by a disqualified person within ten years of the gift), no self-dealing occurs on account of such gift. Accordingly, one solution would be to use a “fresh foundation” each time a gift of such property is contemplated (note that the donor should not be a foundation manager prior to the gift). Consider giving multiple foundations a different charitable purpose as a way of avoiding the IRS treating all such foundations as one foundation.

2. Estates.

Interesting planning issues arise if partnership interests will pass to the private foundation at the partner’s death (where debt was placed on partnership property by a disqualified person within ten years of the bequest). Is the estate of the partner a disqualified person? Not necessarily:
An estate has a separate identity from its deceased, so even if the deceased is a disqualified person with respect to the foundation, his estate is not automatically so. GCM 39445. An estate is not a disqualified person merely because its executor is a disqualified person. *Id.*

An estate will become a disqualified person if it is a substantial contributor to the foundation, but the one bite rule will apply at the time of the estate’s initial funding of the foundation. Thereafter, the estate will be a disqualified person, but by then the estate may well terminate and will not have any further dealings with the foundation.

The estate will be a disqualified person if more than 35% of its beneficial interest is held by disqualified persons. IRC §4946(a)(1)(G). So if the decedent is a substantial contributor to the foundation during his lifetime, then he and certain family members are disqualified persons, and if more than 35% of the estate passes to such family, then the estate is also a disqualified person and thus there would be self-dealing when the estate distributes the partnership interest to the foundation.

If the deceased partner leaves 35% or less of his estate to his family, then the estate will not be a disqualified person. The analysis of this issue should be done conservatively, without relying on delayed funding of the foundation until after family bequests are paid, and without relying on the existence of funded intervivos revocable trusts to shelter assets passing to family.

If the foundation benefiting from the estate is a “fresh foundation”, then the deceased will not be a substantial contributor to the foundation and he and his family will not be disqualified persons, and thus the family may have more than a 35% beneficial interest in the estate without the estate becoming a disqualified person.

However, even with a fresh foundation, if the family were foundation managers then they would be disqualified persons and could not have a 35% beneficial interest in the estate. So independent trustees of the foundation would be required prior to the funding of the bequest.

3. **Co-Ownership.**

If a private foundation and a disqualified person each own interests in the same partnership, what other self-dealing issues are of concern?

Is a redemption of the foundation’s interest a sale or exchange with the partnership or its partners? In Private Letter Ruling 200724023 the liquidation of a private foundation’s limited partnership interest in a real estate limited partnership was not an act of self-dealing.
If the partnership makes a capital call and either the foundation or the disqualified person fails to make the required capital contribution, resulting (in accordance with the terms of the partnership agreement) in a shift of beneficial interests from those partners who fail to make the contribution to those partners who make it—is this a sale or exchange that constitutes self-dealing?

Are the foundation’s and the disqualified person’s interests being pooled so that the disqualified person meets minimum investment requirements? Does any such pooling result in lower fees for the disqualified person? And does the disqualified person’s investment return vary on account of the foundation’s participation? Self-dealing occurs, even without a sale or exchange, if a disqualified person uses or benefits from the income or assets of a private foundation. IRC §4941(d)(1)(E). In PRIVATE LETTER RULING 9844031, the IRS ruled that there was no self-dealing where both a private foundation and an investment fund invested in the same private equity and real estate partnerships and where the investment fund both had investors who were disqualified persons and was managed by a disqualified person. Key factors in the IRS determination were (i) the fund did not rely on the foundation’s investment to meet minimum investment requirements; (ii) the fund did not use the foundation’s investment to qualify for lower investment fees; (iii) the disqualified person’s investment return (both as an investor in the fund and as a manager of the fund) did not vary on account of the foundation’s participation; (iv) the foundation’s participation as an investor in the partnership was not exploited by the fund in its marketing, including its private placement memoranda to its investors; and (v) the partnerships’ management was independent of the fund and of any disqualified persons.

IV. SPECIAL RULES APPLICABLE TO GIFTS OF S CORPORATION STOCK.

A. Before 1998.

A gift of stock in an S Corporation to a charitable organization “blew” the S election. A charitable organization could not be a qualified S shareholder.

Gifts of appreciated stock destroyed the S election even if an immediate redemption or other sale was contemplated.

Nor could a charitable remainder annuity or unitrust or a pooled income fund hold stock in an S corporation. Similarly, stock in an S corporation could not be exchanged for a charitable gift annuity without destroying the S election.

Charitable Lead Trusts could not hold stock in an S corporation with the exception of certain front-end deduction lead trusts.
Because so much wealth was held in S corporations, this created a problem both for donors and for charities. The problem became more acute after 1986 when tax law changes, including the repeal of the *General Utilities* doctrine and changes in corporate and individual rates, made use of S corporations relatively even more attractive.

**B. Rules Broadened In 1996.**

The Small Business Job Protection Act of 1996 permits charitable organizations to be S shareholders from and after January 1, 1998. I.R.C. § 1361(b)(1(B) and (c)(6).

The *good news* is that a donor may give or sell S corporation stock:

- To charitable organizations, particularly gifts of appreciated stock.
- To charitable lead trusts that make an Electing Small Business Trust (“ESBT” election under I.R.C. § 1361(e).
- To provide consideration for a charitable gift annuity.

The *bad news* is that:

Gifts to charitable remainder trusts and pooled income funds are still not permitted. Such trusts cannot be a (i) grantor trust, (ii) Qualified Subchapter S Trust (“QSST”), or (iii) an ESBT. Consideration should be given to the purchase of a charitable gift annuity as a substitute device.

The donor’s deduction will be reduced from the appraised value of the stock by ordinary income items internal to the S corporation such as:

- Unrealized receivables.
- Appreciated inventory. It is not clear whether the rule covers all appreciation (I.R.C. § 751(a)), or merely “substantially appreciated” inventory (I.R.C. § 751(b)), inventory with a market value more than 120% greater than its basis.
- Depreciation recapture under I.R.C. §§ 1245 or 1250.
- A long list of particular assets which produce ordinary income rather than long term capital gain upon sale. See I.R.C. § 751(c).

The rules pertaining to partnership sales and distributions are made applicable to gifts of S Corporation stock by the last sentence of I.R.C. § 170(e)(1). It applies only to income tax deductions and not to transfer tax deductions.
C. **Taxation of S Corporation Stock Owned By A Charity.**

All of the charity’s earnings with respect to its S Corporation stock will be unrelated business taxable income (“UBI”) subject to UBIT. I.R.C. § 512(e).

1. **Unrelated Business Income.**

UBIT is payable without regard to whether the corporation has made any cash or other distributions which might enable the charity to pay the UBIT. Consideration should be given by the charity to requiring as a condition of acceptance of the gift of either a distribution agreement whereby the corporation agrees to make distributions sufficient to enable the charity at least to pay the UBIT; and/or an indemnity agreement by the donor to cover any cash flow shortfalls caused by the UBIT. UBIT is payable with respect to sources of income which would not otherwise be UBI if the company were a partnership or LLC, such as:

- Dividends on C Corp. stock owned by the S Corp.
- Interest paid to the S Corp.
- Rental income (even if not debt financed).
- Capital gains realized on the sale of S corp. assets.

2. **Sale or Redemption of the S Corporation Stock.**

Capital gain on the sale or redemption of the S Corp. stock itself is also taxed as UBI. I.R.C. § 512(e)(1)(B)(ii). This result differs from the treatment of virtually any other asset held by the charity. An exception exists where all of the stock is sold in a transaction (such as to a public company) which terminates the S election. In such case, the election is deemed terminated on the day before the sale. Because there is no gain on the sale of C corp. stock, no UBI results. In other cases where the buyer intends to give up the S election it may be advisable to terminate it voluntarily before the sale. This will also avoid the UBI to the charity, and may also avoid Section 751 treatment to the charity and other shareholders. In cases where it is anticipated that a sale to a public company (or other event which will terminate the S election) is fairly certain to occur shortly after the charitable gift, it may make sense to voluntarily terminate the S election before the charitable gift. In such case: (a) The donor will avoid reduction of his deduction by Section 751 items; and (b) The charity will not pay UBIT on the subsequent sale of the stock. Would the assignment of income issues discussed later in this outline apply?
D. Use of Supporting Organizations to Hold S Corporation Stock.

1. Generally.

Because charitable organizations holding S corporation stock are subject to unrelated business income tax on the organization’s share of corporate income and any gains realized on sale, the conventional analysis has been to consider the “best” way to minimize any income taxes. Frequently this analysis involves little more than the consideration of whether it would be better to organize the charity in trust or corporate form. Charitable corporations and charitable trusts have been subject to income tax at roughly the same top bracket, but since enactment of the American Taxpayer Relief Act of 2012 (“ATRA”), trusts are now subject to a tax rate of 39.6% on undistributed ordinary income exceeding $11,950. In addition, for tax years beginning after December 31, 2012, charitable trusts are subject to an additional 3.8% tax on certain passive investment income, under new I.R.C. § 1411. Charitable trusts, on the other hand, are entitled to the same maximum rate of 20% on capital gain income as individual taxpayers, whereas corporations must pay income tax on capital gain at the usual rates. For these reasons, the conventional wisdom is that a charitable trust is preferable only if it is expected that the stock will be sold relatively soon. Otherwise, so the conventional wisdom goes, it is usually better to use a corporation.

2. Charitable Corporations.

A corporate-form supporting organization could be formed to acquire, hold, and sell S corporation stock. In addition to potential limited liability benefits, the income tax charitable deduction available to tax-exempt corporations receiving unrelated business income can effectively reduce the overall rate of income tax. Under IRC section 512(b)(10), a tax-exempt organization receiving unrelated business income is entitled to a deduction for charitable contributions of up to 10 percent of its unrelated business taxable income. The regulations under this section provide in part as follows:

The contribution, whether made by a trust or other exempt organization, must be paid to another organization to be allowable. For example, a university described in section 501(c)(3) which is exempt from tax and which operates an unrelated business, shall be allowed a deduction, not in excess of 5 percent [now 10 percent] of its unrelated business taxable income, for gifts or contributions to another university described in section 501(c)(3) for educational work but shall not be allowed any deduction for amounts expended in administering its own educational program. Treas. Reg. § 1.512(b)-1(g)(3).

It is thus possible to reduce the overall unrelated business income tax by having the supporting organization make “upstream” grants to the “parent,” effectively reducing the overall tax rate by about 10 percent.
3. **Charitable Trusts.**

The income tax charitable deduction available to charitable trusts receiving unrelated business income is much different than the rule for charitable corporations. IRC section 512(b)(11) provides as follows:

In the case of any trust described in section 511(b), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), and for such purpose a distribution made by the trust to a beneficiary described in section 170 shall be considered as a gift or contribution. The deduction allowed by this paragraph shall be allowed with the limitations prescribed in section 170(b)(1)(A) and (B) determined with reference to the unrelated business taxable income computed without the benefit of this paragraph (in lieu of with reference to adjusted gross income).

Under this section, tax-exempt charitable trusts receiving unrelated business income are entitled to the same income tax charitable deduction afforded individual taxpayers, which in the case of cash gifts to public charities is 50 percent of adjusted gross income. A trust-form supporting organization making “upstream” grants to its charitable “parent” can thus reduce the effective overall tax rate by up to 50 percent

V. **CHARITABLE LEAD TRUSTS.**

A. **Charitable Lead Trust May Be An Electing Small Business Trust.**

1. **Potential Current Beneficiary.** The only Potential Current Beneficiary (“PCB”) is a charity. This is permitted under I.R.C. §1361(e)(1)(A)(i)(III).

2. **Not Disqualified.** CLT is not a tax exempt trust or a QSST which are disqualified under I.R.C. § 1361(e)(1)(B),

B. **No Charitable Deduction.**

The CLT will not be allowed any deduction for its payments of the charitable annuity or unitrust amount except with regard to income from non S Corp. assets of the trust. I.R.C. § 641(d)(2)(C). I.R.C. § 1366(a)(1)(A) does not apply. It merely passes through to the ESBT the deductions which would have been allowable to the S Corp. were it a true taxpayer. See Reg. § 1.641(c)-1(d). This includes the charitable deduction but only for amounts paid to charity by the S Corp. It does not create a deduction for amounts paid to charity by the Trust itself. The ESBT can reduce the tax it owes as a result of the amount paid to charity by the S Corp., but it gets no tax benefit from payment of the charitable annuity or unitrust amount. This conclusion is both confirmed and restricted by the regulations. First, the donation by the S Corporation must have been made
from gross income. This imposes on the S Corporation a requirement normally applicable only to trusts, and one to which it may not wish to adhere because it does not have any meaning to its individual shareholders. Consider the effect of a donation by the corporation of land held by it. The land is usually not part of gross income, so the deduction allowed to individual shareholders will not be allowed to the ESBT. Reg. § 1.641(c)-1(d)(2)(ii). The donation is treated as made pursuant to the governing instrument of the ESBT. To the extent the S Corporation made the deduction from gross income, it may still be limited by the UBI rules of I.R.C. § 681. These rules are likely to apply to most operating businesses operated as S Corporations except perhaps certain real estate rental businesses.

C. **Effect.**

This result sounds terrible, but it is conceptually no worse than the situation for a CLT holding stock in a C Corp. It is true that the CLT pays tax on its share of the corporation’s total income whether or not it is distributed, pay the full tax and then make the required charitable distribution. But compare the two situations, C and S, assuming for simplicity that the top individual and corporate rates are both 40%.

1. **The C Corporation situation.**
   
   (a) $1 million CLT
   
   (b) $70,000 annuity.
   
   (c) Corporation earns $200,000.
   
   (d) Corporation pays tax of $80,000.
   
   (e) Corporation distributes $70,000 to CLT.
   
   (f) CLT distributes $70,000 to charitable beneficiary.
   
   (g) CLT deducts $70,000 per I.R.C. § 642(c).
   
   (h) CLT’s taxable income and tax are both $0.

2. **The S Corporation situation.**
   
   (a) $1 million CLT
   
   (b) $70,000 annuity.
   
   (c) Corporation earns $200,000.
   
   (d) Corporation pays no tax.
(e) Corporation distributes $150,000 to CLT - total of amounts in 2.d and e above.

(f) CLT pays tax of $80,000 (40% of $200,000).

(g) CLT distributes its remaining cash flow of $70,000 to charity.

3. **Comparison.** Both results are substantively the same. If the S Corp. distributed less of its earnings, a cash flow crunch would result, but the same is true for the C Corp. situation too. In only one respect is the ESBT/CLT situation clearly worse than for the situation for a C corp. CLT. This occurs where there are sales or deemed sales of the ESBT stock. A deemed sale might occur if some of the stock were distributed to the charity as part of an annuity or unitrust amount distribution. If C Corp stock were sold and distributed (or simply distributed to the charity), the CLT would recognize capital gains, but would usually get an offsetting charitable deduction. In the ESBT situation the gain is recognized but there is no offsetting deduction.

VI. **CHARITABLE GIFTS BY THE BUSINESS ENTITY.**

A. **Generally.**

Although most of us tend to focus on charitable gifts of interests in closely-held businesses, sometimes it makes sense to consider a charitable contribution by the business entity.

B. **C Corporations.**

Unlike the case with individual taxpayers, who generally may deduct charitable contributions up to 30 or 50 percent of adjusted gross income, contributions by C corporations are deductible up to only 10 percent of the corporation’s taxable income, computed without regard to certain special deductions for corporations (under IRC §§ 241, 243-247, and 249), any net operating loss carrybacks (under § 172), and any capital loss carryback (under § 1212(a)(1)). IRC § 170(b)(2).

C. **S Corporations.**

Prior to the Subchapter S Revision Act of 1982, S corporations were entitled to the same 10 percent charitable deduction allowable to C corporations. See former IRC § 170(b)(2) and 1373(d). It was thus possible for an S corporation shareholder who had already made contributions up to his or her personal limit to make additional contributions up to the corporation’s 10 percent limit. After 1982, charitable contributions by S corporations are deductible proportionately by the shareholders. IRC § 1366(a)(1) (which refers to the partnership rules of Section 702(a)(4)). The amount deductible (fair market value or basis) is determined at the entity level based on the type of property donated and the status
of the donee, and any percentage or other limitations are then determined at the shareholder level based on the shareholder’s overall income.

Any charitable contribution made by the S corporation will reduce each shareholder’s basis in her shares. IRC § 1367(a)(2)(B). The issue is by how much. Prior to 2006, a shareholder was required to reduce her basis by her allocable share of the fair market value of the property donated by the S corporation. That was not necessarily a drawback if the contribution was made in cash or with property with a high cost basis. The transaction would essentially be a wash; the pro rata share of the property being contributed would be part of the shareholder’s basis in her stock; when the contribution was made the charitable deduction would reduce the shareholder’s basis by an identical amount. However, if a contribution was made with appreciated property, reducing the basis of the shareholder’s stock by the value of the property would in effect transfer the unrealized appreciation in the contributed property to the shareholder’s stock, where it would be later taxed if the stock were sold.

Beginning with contributions made in tax years after December 31, 2005, and now extended by ATRA to cover contributions made through December 31, 2013, the amount of a shareholder’s basis reduction in the stock of an S corporation attributable to a charitable contribution made by the corporation is instead equal to the shareholder’s pro rata share of the adjusted basis of the contributed property. IRC § 1367(a)(2).

In addition, ATRA extends a second relief provision that originated in the Tax Technical Corrections Act of 2007, Pub. L. 110-172, and was designed also to put charitable gifts made through S corporations on a footing similar to those made through partnerships. Under the regular rules of Code section 1366(d), the amount of losses and deductions that an S corporation shareholder may take into account in any taxable year is limited to her adjusted cost basis in her S corporation stock. The extended relief provision states that this basis limitation does not apply to a charitable contribution of appreciated property to the extent that the shareholder’s pro rata share of the contribution exceeds the shareholder’s pro rata share of the adjusted basis of the property contributed. In other words, the basis limitation does not apply to the amount of deductible appreciation in the contributed property. IRC § 1366(d)(4).

These relatively convoluted provisions may be explained more clearly by the following example:

Jane is the sole shareholder of an S corporation. The S corporation makes a charitable gift of a capital asset held for more than one year to a public charity. The gift has a fair market value of $500,000. The corporation’s basis in the property is $200,000. Had the corporation sold the property no part of the gain would have been treated as ordinary income. Jane’s basis in her stock is $300,000. Jane is treated as having made
a $500,000 charitable contribution, and reduces her basis in her S corporation stock by $200,000 to $100,000.

For purposes of applying the limitation under Code section 1366(d) to the contribution, the limitation does not now apply to the appreciation element of the gift ($300,000). Since Jane’s basis in her stock, $300,000, exceeds the adjusted basis of the corporation in the contributed property ($200,000), the 1366(d) limitation does not apply at all to Jane’s contribution and can be ignored.

If, under prior law, an S corporation made a contribution in excess of the shareholder’s basis, the excess amount was not necessarily lost; it was, in effect, credited against the shareholder’s basis and could be carried forward and deducted in future years whenever the basis in the stock was increased, through a contribution to capital and/or a retention of earnings by the S corporation. (Rev. Rul. 2008-16, 2008-11 I.R.B. 585, illustrates that, under current law, a shareholder may be limited from fully deducting property donated to charity by an S corporation if the taxpayer is also allocated other deductions or losses of the S corporation. A shareholder remains unable to reduce her basis below zero on account of deductions or losses other than the built-in-gain of contributed property.) Under IRC § 1366(d)(2), the carryforward of previously prohibited deductions is “indefinite.” While this may seem to be an interesting planning tool to make a large contribution that can be carried forward indefinitely by the individual shareholder, on closer analysis it may not be particularly beneficial. Under the former provisions set to return in 2014, the unrealized appreciation in the S corporation asset would actually be transferred to the shareholder’s stock. Moreover, if the S corporation stock is sold before the deduction is fully recovered, the deduction is lost forever.

Two other difficulties arising with charitable gifts involving S corporations are worth noting. First, if there is more than one shareholder of the S corporation, not all of the shareholders may want to make a charitable contribution; that simple fact may prohibit the contribution of S corporation assets to charity. Second, if the S corporation plans to give all or substantially all of its assets to charity, the gift triggers Code section 337(d). As a consequence, the corporation would be required to recognize gain or loss on the transfer, the corporation’s deduction would be subject to the 10 percent limitation applicable generally to gifts made by corporations to charity, and no charitable contribution deduction would be passed through to the shareholders. Treas. Reg. § 1.337(d)-4. Accordingly, the application of section 337(d) effectively prohibits the gift of all or substantially all of an S corporation’s assets to charity.

D. **Partnerships and LLCs.**

As in the case of gifts by S corporations, gifts by partnerships or LLCs are deductible proportionately by the partners or members. IRC § 702(a)(4). Rev.
Rul. 96-11, 1996-1 C.B. 140, holds that when a partnership makes a charitable contribution of property, the basis of each partner’s interest in the partnership should be decreased, but not below zero, by the partner’s share of the partnership’s basis in the property contributed. Similarly, a partner’s charitable deduction for the contribution of appreciated property by the partnership does not seem to be limited to her share of the partnership’s basis in the assets. See Private Letter Ruling 8405084. Thus, contributions of appreciated property by partnerships preserve the tax benefit of receiving a deduction at fair market value for the contribution of appreciated property; the unrealized appreciation is not transferred to the partner’s interest in the partnership. See also Private Letter Ruling 200208019, in which the IRS considered whether the members of a partnership were entitled to a charitable deduction on account of the partnership’s grant of a conservation easement to a charitable organization. The IRS concluded that each partner was entitled to a charitable deduction equal to each partner’s distributive share of the gift.

Rev. Rul. 2004-05, 2004-3 IRB 295, provides that a trust which is a partner will benefit from a charitable contribution made by the partnership even if the trust itself has no charitable beneficiaries. The Ruling does not state how the trust came to be a partner. May a trust with no charitable beneficiaries become a partner in a partnership which allows charitable contributions without the consent of the trust partner?

E. Effect of Section 337.

Corporations making large charitable contributions must be careful not to violate the “new” regulations under IRC section 337, which continue the repeal of the “General Utilities Doctrine.” The new regulations (Treas. Reg. § 1.337(d)-4) were generally effective as to transfers of assets occurring after January 28, 1999. Under these regulations, a taxable corporation is required to recognize gain or loss upon the transfer of “all or substantially all of its assets to one or more tax-exempt entities.” Treas. Reg. § 1.337(d)-4(a)(1). With certain exceptions, the rule also applies to “a taxable corporation’s change in status to a tax-exempt entity.” Treas. Reg. § 1.337(d)-4(a)(2). It specifically applies to transfers both to charitable remainder trusts. Treas. Reg. § 1.337(d)-4(c)(2). The determination of whether a corporation has transferred “substantially all” its assets is based on all the facts and circumstances under the general rules of IRC section 368(a)(1)(C). The Courts generally have considered a variety of factors in determining whether a corporation has transferred substantially all its assets, such as the percentage of assets transferred, the types of assets retained, the purpose for the retention of assets, and the liabilities of the corporation prior to the transfer.

F. Contributions to Charitable Remainder Trusts.

This can be a particularly effective strategy for gifts of highly appreciated, under productive assets, whether outright to a charitable organization or to a term of
years charitable remainder trust for the benefit of the business entity. Based on the very broad definition of “person” contained in IRC section 7701(a)(1), the Service has ruled that charitable remainder trust of this nature may be established by C corporations (PRIVATE LETTER RULING 9205031), S corporations (PRIVATE LETTER RULING 9340043), or partnerships (PRIVATE LETTER RULING 9419021). With an S corporation gift, the charitable deduction would flow through to the shareholders as with any other charitable contribution by an S corporation. This can enable sale by a charitable remainder trust of contributed appreciated assets with no capital gains cost. An illustrative ruling is Private Letter Ruling 200644013. In that Ruling, an S corporation proposed to contribute real property to a charitable remainder trust. The trust was established for a period of 20 years and the company would be the unitrust beneficiary. According to the Ruling, the company would not have built in gain recognition under section 1374 on either the contribution or the trust disposition of the real estate would not have recognized built in gain on unitrust amounts received to the extent the unitrust amounts did not exceed trust income and would not recognize built in gain under section 1374 on unitrust amounts received by it after the recognition.

G. Contribution of Intellectual Property To Private Foundation.

In Private Letter Ruling 200715015, a corporation formed a limited partnership and contributed to it exclusive ownership of certain trademarks and other intellectual property; the other partner was the owner of the corporation who contributed cash. The partnership granted the corporation a license to use that property in exchange for a royalty based on the corporation’s net sales. The corporation then contributed the limited partnership units to a private foundation (created and managed by the owner). Because the limited partnership receives 95% or more of its gross income from passive sources (here, royalties), the units are not an excess business holding. Further, the foundation has no unrelated business income because royalties are exempt.

VII. CHARITABLE LEAD TRUST.


1. Generally.

   Conceptually, a CLT is the reverse of a Charitable Remainder Trust (“CRT”). With a CLT, a fixed or variable annuity is paid to charity for a determinable period which may be measured by a term of years or by reference to the life of one or more individuals; the remainder passes outright or in trust to one or more non-charitable beneficiaries. The charity should qualify under the applicable sections of the Code, sections 170, 2055 and 2522, which govern the type of deduction associated with the creation of the charitable lead trust. The remainder beneficiary can be one or more individuals, partnerships, corporations, estates or trusts.
CLTs have been one of the more valuable planning structures available for wealthier individuals who wish to give to charity but also want to provide for the continued affluence of designated family members. Two separate gifts are made when the CLT is created: a gift of a current interest to one or more charitable beneficiaries; and a gift of the remainder interest to one or more non-charitable beneficiaries. The donor is liable for gift tax on the present value of the non-charitable remainder interest.

The principal tax advantage to a CLT lies in the transfer tax deduction for the present value of the charitable interest. The CLT has been used most appropriately in situations where the donor and his or her family have no immediate need for all of the income that they currently enjoy and are willing to forego some current benefit in exchange for the prospect of long-term capital appreciation. The trust property and any appreciation on that property are removed from the donor’s estate, unless the donor retains any powers that could lead to its inclusion in his or her estate under sections 2036 or 2038 of the Code. The donor must designate the charitable beneficiary when the trust is created (or provide a method for designating the charity that is beyond his or her legal control). Unless great care is taken with the wording and structure of the charitable benefit, a donor should not designate a private foundation of which he or she is a trustee as the charitable beneficiary of a CLT created by that donor.

2. **Term.**

The term of the lead interest can be measured: in a variety of ways: (i) in years; (ii) by the life or lives of individuals living when the CLT is created; (iii) a measuring life plus a term of years; or even (iv) by the shorter of a term of years or a measuring life plus a term of years. Treas. Regs. §§ 1.170A-6(c)(2); 20.2055-2(e)(2); 25.2522(c)-3(c)(2) and Rev. Rul. 85-49, 1985-1 C.B. 330. See Private Letter Ruling 1997-21006. The core requirement is that the term is ascertainable when the CLT is created.

3. **Income Tax Status.**

There are two basic varieties of qualified CLTs: those created inter-vivos or at death that are treated as separate taxpayers, (often referred to as Qualified Non-Grantor CLTs) and those created inter vivos where the grantor is treated as the owner of the CLT’s income for income tax purposes (often referred to as Qualified Grantor CLTs). Another variation is a Non-Qualified Non-Grantor CLT created during life.

4. **Qualified CLTs.**

A Qualified CLT is a trust that meets the various statutory definitions that qualify a donor’s transfer to the CLT for one or more tax deductions.
To be Qualified, the CLT must pay the charitable lead interest in the form of a fixed annuity or unitrust amount. The CLT need not specify a particular charitable recipient; this designation can be left to the trustees and can be changed by the trustees from year to year.

5. **Charitable Lead Annuity Trust.**

A charitable lead annuity trust is an irrevocable trust under which a sum certain is to be distributed periodically to one or more charitable beneficiaries not less often than annually for a term of years or during the life or lives of one or more individuals who are living when the trust is created. The principal of the trust must be used to satisfy the annuity if trust income is insufficient. So long as the annuity payments are determinable when the CLT is created, provision can be made to vary them. Treas. Regs. §§ 1.170A-6(c)(2)(i); 20.2055-2(e)(2)(vi) and 25.2522(c)-3(c)(2)(vi).

Unlike the rules governing charitable remainder annuity trusts there is no explicit prohibition against making additional contributions to a charitable lead annuity trust. But see Private Letter Ruling 1993-04020. However, such contributions do not generate additional estate or gift tax deductions because the amount of the annual guaranteed annuity payment must be determinable at the inception of the trust. Treas. Regs. §§ 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi)(a) and 25.2522(c)-3(c)(2)(vi)(a). Furthermore, it is unclear how the annuity amount would be adjusted to take such additions into account. Accordingly, most planners have assumed that such additions must be prohibited and that separate trusts must be created to hold such assets.

6. **Charitable Lead Unitrust.**

A charitable lead unitrust is an irrevocable trust under which a fixed percentage of the net fair market value of its assets (valued annually) is to be distributed not less often than annually to one or more charitable beneficiaries for a term of years or during the life or lives of one or more individuals who are living when the trust is created. Corpus must be used to satisfy the unitrust amount if income is insufficient. Unlike charitable remainder unitrusts, a net income limitation is not available. Rev. Rul. 77-300, 1977-2 C.B. 352; Private Letter Ruling 7918102. Further, the trust instrument may not provide for the percentage to vary over the term of the CLT. Treas. Regs. §§ 1.170A-6(c)(2)(ii)(A), 20.2055-2(e)(2)(vii)(a) and 25.2522(c)-3(c)(2)(vii)(a).
In computing fair market value of the trust, all assets and liabilities are taken into consideration without regard to whether particular items also are taken into account in determining trust income. The same valuation date and method should be used each year. If these details are not specified in the trust, the trustee must select the date and method on the first income tax return that the trust is required to file. Treas. Regs. §§ 1.170A-6(c)(2)(ii); 20.2055-2(e)(2)(vii) and 25.2522(c)-3(c)(2)(vii).

There is no specific prohibition against additional contributions being made to charitable lead unitrusts. The IRS has ruled that a provision that allows additional contributions to be made would not disqualify the trust: in fact a gift tax deduction may be allowable for such contributions. See Private Letter Ruling 8052068 and 8043077.

7. Additional Considerations.

There is no minimum or maximum payout requirement and no limitation on the number of years that the annuity can be paid to charity. I.R.C. § 170(f)(2)(B); Treas. Regs. § 1.170A-6(c)(2)(i)(A). The trust remainder is distributed to or held for the benefit of the donor’s non-charitable beneficiaries. A clause that “saves” the trust from violating any applicable rule against perpetuities will not disqualify the trust, even if the trust’s term is shortened as a result. Private Letter Rulings 8104213 and 9721006. However, a charitable lead interest will not qualify as a guaranteed annuity interest if the trustee has the discretion to commute and prepay the charitable interest prior to the expiration of the specified annuity term. Crown Income Charitable Fund v. Comm’r., 98 T.C. 327 (1992) aff’d, 8 F.3d 571 (7th Cir. 1993) pro; see also Rev. Rul. 88-27, 1988-1 C.B. 331 and Private Letter Ruling 9734057. In general, no amounts may be paid for private purposes from the charitable lead annuity trust until the expiration of the charitable annuity term. Treas. Regs. §§ 1.170A-6(c)(2)(i)(E) and 1.170-A-6(c)(2)(ii)(D). However, in light of the Tax Court’s decision in Boeshore Est. v. Comm’r., 78 T.C. 523 (1982), the IRS issued final regulations that acknowledge a non-charitable interest in the form of qualifying annuity or unitrust interest can precede a charitable lead interest. T.D. 9068 (7/3/03).

8. Reformation.

The transfer of a partial interest to a charity generally will not qualify for a deduction (unless the trust interest is a qualified annuity or unitrust interest) even if the non-charitable trust interests are clearly separable. Rev. Rul. 77-97, 1977-1 C.B. 285. The Tax Reform Act of 1984 included permanent “reformation” rules which permit the amendment of certain charitable trusts which otherwise would not qualify for a charitable contribution deduction. I.R.C. §§ 170(f)(7), 2055(e)(3) and 2522(c)(4).
To be eligible for this relief the nonqualifying interest must be “reformable” as defined in the statute. As a matter of practice a provision often is included in CLTs which authorizes the trustee to amend the trust to assure it is and remains a qualified CLT.

B. **Tax Consequences To The Donor.**

1. **Lifetime Transfers.**

   For income tax purposes, generally no immediate deductions are available and the CLT is treated as a taxpayer separate and apart from the donor. I.R.C. § 170(f)(2)(B); Treas. Regs. § 1.170A-6(c). A current income tax deduction is allowable only if the donor is treated as the owner of the property. If the trust is a Qualified Grantor CLT, all items of income, deduction and credit of the CLT are attributed to the grantor. I.R.C. §§ 671-678.

   For gift tax purposes, a deduction is allowable based on the present value of the charitable interest. I.R.C. § 2522(c)(2)(B). The remainder interest does not qualify for a gift tax per donee exclusion. For the gift tax to apply the gift must be complete. If the donor retains the power, directly or indirectly, to affect the charitable recipient the gift is incomplete. Treas. Regs. § 25.2511-2(b) and (c). It appears the donor may be an officer or director of a charitable recipient. Private Letter Ruling 8130033. However, the governing documents of the charity should include provisions that prevent the donor from having control over the property received from the CLT he or she created. See Private Letter Rulings 200138018; 200108032, 200030014. Payment to a donor advised fund operated by the charitable recipient are discussed in Private Letter Rulings 200010036 and 200009048.

2. **Testamentary Transfers.**

   An estate tax charitable contribution is allowable for the value of the charitable interest. I.R.C. § 2055(e)(2)(B). If a grantor retains a reversionary interest in a lifetime CLT which exceeds 5% of the corpus and dies during the term of the trust, a portion of the value of the CLT will be included in the grantor’s estate. I.R.C. § 2037.

3. **Valuing the Charitable Interest.**

   The present value of an annuity is determined by multiplying the amount of the annuity by factors which are dependent on the applicable rate under section 7520. See IRS Pub. 1457. The present value of a unitrust interest is determined by subtracting the present value of the remainder interest.
from the value of the property contributed to the CLT. Treas. Regs. §§ 1.170A-6(c)(3); 20.2055-2(f)(2) and 25.2522(c)-3(d)(2).


Congress rewrote the GST rules in the Tax Reform Act of 1986. See I.R.C. §§ 2601, et. seq. Subject to a complicated set of exceptions and exemptions, GSTs are taxed at the top marginal estate tax rate in effect at the time of the transfer. See I.R.C. §§ 2601, 2602 and 2641.

A GST generally occurs when property is transferred to or for the benefit of a “skip person” or when an intervening interest in property terminates in favor of a skip person. A “skip person” is a person who is more than one generation younger than the transferor of the property (e.g., grandchildren or more remote lineal descendants) or a trust for the benefit of such person(s). I.R.C. §§ 2613(a), 2651. A “non-skip person” is any person who is not a skip person. I.R.C. § 2613(b).

A CLT and its charitable beneficiaries are non-skip persons. I.R.C. § 2651(f)(3). Therefore, neither the creation of a CLT nor distributions to its charitable beneficiaries will result in any GST tax consequences.

However, upon termination of the charitable interests in a CLT, a GST tax might be imposed if the remainder beneficiaries are “skip persons” in relation to the donor of the CLT. For example, if the donor of a CLT creates a remainder interest in favor of his grandchildren, a GST tax might be imposed upon the termination of the charitable lead interest. Although a GST exemption may be available to shield part or all of the remainder interest from GST tax, every donor must consider the potential impact of the GST tax (for example, a skip person may succeed to the trust remainder if a primary non-skip remainderman dies before the charitable interest expires).

In general, GST tax is paid from the remainder interest. I.R.C. § 2603(a)(2).

All individuals are granted a GST exemption, which may be allocated to lifetime and/or testamentary transfers to shield all or part of such transfers from GST tax. I.R.C. § 2631. Allocation of the donor’s GST exemption to a charitable lead unitrust that will result in GSTs (where the remainder passes to grandchildren) is relatively simple: to avoid future GST tax, the donor may allocate (on a timely filed gift or estate tax return) that portion of his or her GST exemption which is equal to the value of his or her taxable transfer(s) to skip persons, using the valuation factors provided by the IRS in effect as of the date the unitrust is created. I.R.C. § 2642(b).
The effect of allocating a portion of the donor’s GST exemption upon creation of a charitable lead annuity trust cannot be determined until termination of the charitable lead interest using an “adjusted GST exemption” formula. I.R.C. § 2642(e). The formula “adjusts” the donor’s initially allocated GST exemption to a projected future value as of the date the charitable lead interest actually expires, using the discount rate applied under the valuation methods provided by the IRS in effect at the time the trust was created. The amount of GST exemption a donor should allocate to a charitable lead annuity trust is based upon (i) the term and payout rate of the charitable lead interest, (ii) the projected rate of return on trust property (i.e., the donor’s best estimate of the future value of the trust when the charitable lead interest expires), and (iii) the discount rate provided by the IRS in effect when the trust is created. Private Letter Ruling 200107015, dealing with an assignment of an interest in a charitable lead annuity trust, illustrates the difficulties and risks of using a CLAT to benefit grandchildren.

C. Taxation Of Trust And Its Beneficiaries.

1. The Charitable Lead Trust.

The trust is taxed as a complex trust. I.R.C. § 661. Any trust income in excess of the income tax deduction allowable with respect to the charitable payout is taxed to the trust. The trust receives an unlimited charitable income tax deduction for items of gross income that, pursuant to the terms of the governing instrument, are paid during the taxable year to a qualified charity. I.R.C. § 642(c)(1). The deduction is not limited by percentage limitations applicable to individuals. However, the CLT’s charitable deduction is reduced by any unrelated business income realized by the CLT during the year to the extent the UBI exceeds the percentage limitations attributable to individuals under section 170(b)(1)(A). I.R.C. §§ 681 and 512(b)(11). The deduction is limited to the extent capital gains or tax-exempt income is deemed distributed. For this reason, practitioners historically have provided, in their governing instruments, for a hierarchy of sources of payments to maximize the income tax benefits of the charitable payouts, for example, by providing for distributions first from ordinary income (including short-term capital gains), next from capital gains, then unrelated business income, then tax-exempt income, with principal last. Rev. Rul. 71-285, 1971-2 C.B. 2487. The IRS has consistently interpreted the controlling regulations to require pro rata allocations in the absence of economic substance (see, for example, GCM 39161 and Private Letter Ruling 199908002), and effective April 16, 2012, the IRS amended the section 642(c) regulations to state that a provision in a trust specifically indicating the source out of which amounts of income are to be paid, permanently set aside, or used for a 642(c) purpose must have an economic effect independent of the income tax consequences to
be respected for federal tax purposes. Treas. Reg. §1.642(c)-3(b)(2); T.D. 9582, 77 Fed. Reg. 22482 (4/16/12). Note that the preamble to the regulations state that such an ordering provision can never have an independent economic effect.

The CLT is subject to estimated tax payments. I.R.C. § 6654(1).

In general, the taxable year of a trust is the calendar year. I.R.C. § 644. There is an exception for wholly charitable trusts exempt from taxation under section 501(a). I.R.C. § 644(b). However, CLTs are not described in section 501(a) and thus report on a calendar year basis.

The income of a CLT is reported on Forms 1041, 1041-A and 5227 and a Schedule K-1 is provided to the charitable beneficiary. The returns are filed on or before April 15th of the year following the year with respect to which the returns are filed.

In order to avoid forced sales or adverse tax consequences to the trust, plans should be made for the trust to realize a sufficient level of cash flow to satisfy the regular payment of the annuity or unitrust interest. If there is insufficient cash to satisfy a given annuity or unitrust interest the sale or distribution of appreciated property will result in the CLT realizing capital gain. Borrowing may be a more favorable short-term alternative. However, borrowing is not a long-term solution economically and the trustee must be careful to avoid creating unrelated business income. Treas. Regs. § 1.514(c)-1(a)(1)(iii).

2. The Charitable Beneficiary.

The tax characterization of what the charitable beneficiary receives can be determined by the terms of the CLT. In the absence of direction in the governing instrument, the Code allocates Distributable Net Income ratably. To the extent possible, a draftsperson will want to allocate items taxed at higher rates to the charitable beneficiaries. Similarly, a draftsperson should consider allocating expenses to income. But see Rev. Rul. 74-19, 1974-1 C.B. 155.

3. Income Taxation of the Non-charitable Beneficiary.

The non-charitable remainder beneficiary generally is not taxed during the ongoing term of the CLT.

D. Private Foundation Rules.

The CLT is considered to be a private foundation for purposes of certain restrictions placed on such organizations. I.R.C. §§ 508(d)(2) and 4947(a)(2). Thus, the trust can be subject to the taxes on self-dealings (§ 4941), excess

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business holdings (§ 4943), investments jeopardizing charitable purposes (§ 4944), and taxable expenditures (§ 4945). The private foundation limitations may apply automatically to the trust under state law but, if not, the limitations must be spelled out in the governing trust instrument. See Rev. Rul. 75-38, 1975-1 C.B. 161 and Treas. Regs. § 508-3(d).

1. **The Penalty Taxes.**

   An initial tax is imposed at a relatively low level, followed by a more severe second-level tax which applies if the CLT fails to “correct” the violation which gives rise to the initial liability. In addition, section 6684 imposes a penalty equal to the applicable tax if the person liable has previously been liable for a Chapter 42 tax, or if the transgression is both willful and flagrant; the effect is to double the applicable penalty in such cases.


   The prohibition on self-dealing, often can create unexpected difficulties. The prohibition is absolute and, presently, the IRS is without equitable authority to excuse harmless violations. Examples of prohibited transactions are selling or leasing of property or making of loans between the foundation and a disqualified person. The IRS has issued several letter rulings denoting relationships which will not violate this prohibition. See Private Letter Rulings 9425004; 9402026 and 8743085. The IRS also has noted instances when a relationship will constitute self-dealing. See Private Letter Ruling 9438045.

3. **Tax on excess business holdings.** I.R.C. § 4943.

   The prohibition on excess business holdings is designed to restrict involvement in the ownership and operation of businesses. While this prohibition may be simple in concept, section 4943 is an intricate and complex statute. Generally, holdings are excessive if disqualified persons own 20 percent (35 percent where a third party has effective control) or more of the voting stock of incorporated business and the CLT owns more than 2 percent. The CLT has five years within which to dispose of excess holdings, absent an extension of up to five additional years which can be granted for good cause shown. I.R.C. § 4943(c)(7). Nevertheless, caution is advised when funding a CLT with interests in a closely-held business.
4. **Tax on investments which jeopardize the foundation’s exempt purpose.**

I.R.C. § 4944.

No investment is per se a jeopardy investment; however, by regulation, several categories of investments are suggested for careful examination. Treas. Regs. § 53.4944-1(a)(2).

5. **Taxable Expenditures.** I.R.C. § 4945.

The provision prohibits expenditures for: (i) lobbying and propagandizing; (ii) influencing elections or conducting voter education; and (iii) making grants to certain individuals (unless approved by the IRS in advance). This provision also discourages grants to organizations other than public charities unless the trustees of the CLT monitor grantees’ use of distributions and making grants for non-charitable purposes.

6. **The 60% Exception.**

While the taxes on acts of self-dealing and taxable expenditures will apply in all events, the taxes on excess business holdings and jeopardizing investments do not apply if, at inception, the value of the charitable “income interest” is 60% or less of the initial value of the entire trust property. I.R.C. 4947(b)(3). The regulations define “income interest” to include a guaranteed annuity or a unitrust amount.

The IRS has ruled that the less than 60% exception is not applicable unless all of the trust’s income, even if it exceeds the annuity or unitrust amount, is made payable to charity. Private Letter Ruling 8241098. But Rev. Rul. 88-82, 1988-2 C.B. 336, has since clarified that if (i) trust income in excess of the guaranteed annuity payment to charity is added to trust corpus for distribution to noncharitable remaindermen upon expiration of the guaranteed annuity period, and (ii) all of that excess income, along with any other property held by the trust, may be applied, if necessary, to pay the guaranteed annuity during the annuity’s term and is not available for any private purpose during that term, then the 60% exception applies. Under the private letter ruling, the excess income could have been used for private purposes currently and so was not devoted solely to charitable purposes.

Moreover, in cases where the present value of all charitable income interests (without regard to whether any deduction is allowed) exceeds 60% of the aggregate value of the net assets of the annuity lead trust computed on the date of valuation, the governing instrument of the trust must prohibit not only the acquisition but also the retention of property the acquisition of which would give rise to a tax under section 4944. Treas.
E. **Grantor CLTS.**

**The Qualified Grantor CLT.**

If the grantor would benefit from a current income tax charitable contribution deduction, a CLT can be created that is taxed as owned by the grantor under the grantor trust rules (“Qualified Grantor CLT”).

There are several ways to cause a trust to be treated as a grantor trust but most of the rules lead to results antithetical to the requirements for a qualified CLT annuity or unitrust interest.

Section 673 taxes the grantor on trust income if the grantor has a reversionary interest with value greater than 5 percent of the value of the trust assets at the time assets are transferred to the trust. The same result obtains if the reversion is held by grantor’s spouse. I.R.C. § 672(e). Commentators generally conclude retaining a reversion is the preferred way to secure grantor trust treatment for a CLT.

Section 674 generally provides that if the grantor or a non-adverse trustee has the power to alter the beneficial enjoyment of the income or remainder interest in a trust, the grantor is taxed on the trust income. However, the retention of these powers could foil the requirement that the CLT’s guaranteed annuity or unitrust interest must be irrevocable.

Section 675 provides that a grantor will be treated as the owner of a trust if the grantor, individually or as trustee, retains certain administrative powers. The enumerated powers could violate certain private foundation rules, disqualify the charitable interest or result in an incomplete gift of the remainder interest. However, retaining a power to substitute assets may create some planning opportunities for a CLT. The IRS form provisions illustrate grantor lead trusts using the section 675(4)(C) power held in a non-fiduciary capacity to substitute assets of equivalent value.

Section 676 provides that if the grantor, either alone or in conjunction with a non-adverse party, retains the power to revoke all or a portion of the trust, the income of the trust will be taxed to the grantor. Retention of such a power should disqualify a CLT ab initio.

Section 677 provides that if the income of the trust, without the approval of any adverse party, can be distributed to the grantor or the grantor’s spouse, or accumulated for either of them, the income of the trust will be taxable to the grantor. However, diverting funds would fail the requirement for a guaranteed annuity or unitrust payout. The section also
addresses using trust income to purchase life insurance on the life of the grantor or the grantor’s spouse. While this creates some theoretical possibilities, it is not practical.

Section 679 applies the grantor trust rules when a U.S. person transfers property to a so-called foreign trust. The rule is independent of the other rules set forth above. A foreign trust is created when the trust provides that no U.S. court is able to exercise primary supervision over the trust and no U.S. person has authority to control substantially all of the decisions of the trust. I.R.C. § 7701(a)(30)(E) and (31)(B).

An income tax deduction is available for the present value of the qualified annuity or unitrust interest dedicated to charity. The deduction is equal to the present value of all distribution payable to charity. I.R.C. § 170(f)(2)(B).

The gift is considered “for the use of” the charity, so the 30 percent or 20 percent limits apply. I.R.C. § 170(b)(1)(B)(i).

For each year thereafter the grantor will be taxed on all items of income attributable to the trust. Accordingly, the key tax consideration is a comparison of the value of the current deduction versus the deferral of the tax liability during the term of the trust.

In theory, the trust could be invested in nontaxable assets so that, while the grantor would be subsequently taxed as the owner of the trust (the income of which he/she would not receive), there would be no net taxable income.

If the trust ceases to be a grantor trust due to the grantor’s death or otherwise, the income tax deduction is recaptured (that is, included in the gross income of the grantor) to the extent that the upfront deduction is greater than the amount of trust income that has been attributed to the grantor under the grantor trust rules. I.R.C. § 170(f)(2)(B). In other words, the recapture is based on the trust income rather than the benefit passing to charity. Although charity may receive an amount equivalent to the charitable income tax deduction taken by the grantor, the grantor loses the income tax deduction to the extent that the trust does not produce taxable income. But note that Treas. Reg. § 1.170A-6(c)(4) provides a different recapture rule. Under the regulations, the grantor is treated as having received income equal to the amount of any deduction that was previously allowed less the discounted value of all amounts that were required to be, and actually were, paid to charitable beneficiaries.

The income of the CLT is taxed to the grantor. I.R.C. §§ 671-679.

For transfer tax purposes (estate and gift taxes), a charitable deduction is allowable where a charitable designation is made after the income is earned.
1. **The Non-Qualified Non-Grantor CLT.**

Instead of defining the charitable interest as a qualifying annuity or unitrust interest a CLT can provide that charity will receive “all net income”. Since the charitable interest is not qualified, the grantor is not entitled to an income or gift tax charitable contribution deduction. However, the trust’s income is not taxed to the grantor and the trust qualifies for an unlimited income tax deduction for the full amount passing to charity. I.R.C. § 642(c). In essence, the grantor gets the benefit of an unlimited charitable deduction. In addition, the CLT will not be subject to the private foundation rules. I.R.C. § 4947(a)(2)(A).

F. **Operating a CLT as the Family’s Charitable Pocketbook.**

1. **Generally.**

A grantor can authorize the trustee of a CLT to sprinkle the lead interest among qualifying charitable beneficiaries. However, if the power is held by the grantor or the grantor’s spouse the grantor may be treated as the owner for income tax purposes. I.R.C. § 674(a). Moreover, if the grantor retains the power the value of the CLT will be included in the grantor’s estate for estate tax purposes. I.R.C. §§ 2036(a)(2) and 2038(a)(1).

2. **Illustration.**

This technique is illustrated in Private Letter Ruling 200240027. Donors, a husband and wife, created three irrevocable charitable lead unitrusts (“Trusts”). At the end of the charitable terms, the Trusts are to continue for the benefit of each of their three children. They appointed one of their children as the initial trustee of each Trust. The Trust documents provided:

The trustee shall pay (in cash, in kind, or partly in each) to such organization or organizations selected by the trustee that is/are described in each of sections 170(b)(1)(A), 170(c), 2055(a), and 2522(a), to be used in furtherance of each organization’s religious and charitable purposes, in such proportions as are determined by the trustee, in each taxable year during the trust term, an amount equal to six percent of the net fair market value of the trust assets (valued as of the first day of each taxable year of the trust) (the unitrust amount). The unitrust amount shall be paid on an annual basis on the 31st day of December of each year during the trust term, first from ordinary income (excluding unrelated business income), then from short-term capital gain, then from long-term capital gain, then from unrelated business income, then from tax-exempt income, and, to the extent that the foregoing items for the taxable year are not sufficient, from principal. Any income of the
trust for a taxable year that exceeds the unitrust amount shall be added to principal. Notwithstanding any existing or hereafter enacted state law, no amount may be paid during the trust term to or for the use of any person other than an organization described in section 170(b)(1)(A), section 170(c), section 2055(a) and section 2522(a). However, an amount shall not be deemed to be so paid if the amount is paid for full consideration, such as reasonable trustee fees. (emphasis added).

The Trust documents also included prohibitions against the types of activities and powers that traditionally would cause the Trusts to be treated as grantor trusts. The Trust documents alone provided that should the donors’ child ever cease to serve as trustee the child is authorized to designate successor trustees. Should there ever be a vacancy not filled under the child’s authority, two specific individuals were named to serve as successor trustees, one after the other, with the same power to designate successors. In the event there still is a vacancy the Trust documents provide: “the successor trustee is to be such individual or entity designated in writing by a majority of the then living adult beneficiaries of the trust who are eligible to receive any current income therefrom and who are not incompetent, so long as such individual or entity that is to become the successor trustee is not a related or subordinate party (as defined in section 672(c)) of either of the Grantors or any adult beneficiary.”

The IRS ruled that on the face of the documents sections 673, 674, 676, and 677 would not apply. It was noted, however, that whether the donors would be treated as grantors under section 675 is a question of fact, the determination of which would be deferred until the income tax returns of the parties involved had been examined.

Since qualified charitable organizations were given the irrevocable right to receive annually an amount equal to a stated percent of the net fair market value of the assets in the Trusts determined annually (the unitrust amount), the IRS concluded that the unitrust amounts payable under the Trusts are qualified unitrust interests. Accordingly, the donors were allowed a gift tax charitable deduction under section 2522(a) for the present value of the unitrust amounts in the Trusts.

The IRS noted: (i) the trusts were irrevocable; (ii) the donors had retained no interest or reversion in the Trusts; (iii) the donors had no right to alter, amend, or revoke the Trusts, or to receive an annuity or other payment from the Trusts during their lives; and (v) the donors held no general power of appointment over the property in the Trusts. Accordingly, assuming there was no understanding, express or implied between the donors and the trustee regarding the disposition of the amounts received by
the Trusts, we concluded that no portion of the assets of Trusts will be included in either Grantor’s gross estate for federal estate tax purposes.

There was one negative ruling. Citing regulation section 1.642(c)-3(b)(2) the IRS noted the ordering provision had no economic effect on the distributions independent of tax consequences. Instead, income distributed to the charitable organizations will consist of the same proportion of each class of the items of income of the Trusts as the total of each class bears to the total of all classes.

G. Funding the Family Foundation with a Charitable Lead Trust.

1. Generally.

A family that has sufficient wealth to create a family foundation may well consider using one or more charitable lead trusts to minimize transfer taxes on large transfers to younger generations. By directing the ongoing charitable distributions to a family foundation, the tax-saving characteristics of the lead trust are obtained, and the amounts distributed are paid to the foundation, where family members are able to influence, if not control, their ultimate application.


Treasury regulation section 53.4942(a)-2(c)(2)(iii) takes the position that a private foundation that is the beneficiary of a charitable lead trust must take into account as part of the foundation’s minimum distribution, the lesser of (a) the income distributions from the lead trust or (b) five percent of the trust assets. However, this regulation was held invalid in Ann Jackson Family Foundation v. Comm’r., 15 F.3d 917 (9th Cir. 1994), aff’g 97 T.C. 534 (1991) (reviewed), where a private foundation disregarded taking into account the assets of the trust or the annuity distributions received from the trust in determining its minimum investment return. In response, the IRS intends to issue proposed regulations modifying the regulations under section 4942. Until further guidance, income distributions received by a private foundation from a non-grantor charitable lead trust will not be included in determining a private foundation’s distributable amount for the year the amount is received. Notice 2004-36, C.B. 2004-19 at 889. See also Notice 2004-35, C.B. 2004-19 at 889.


CLTs that make payments to a foundation in which the creator of the trust has an influential role can be problematic. In Rev. Rul. 72-552, 1972-2 C.B. 525, the IRS held that the value of property transferred to a
foundation was included in the donor’s estate under section 2036 because the donor/decedent, in his capacity as a member, director and president of the foundation, had the power to direct the disposition of its funds for charitable purposes. Similarly, in Private Letter Ruling 7929002 this same rule was applied to a decedent who held multiple fiduciary positions in an organization to which the income from a trust he had created was paid. In Rifkind v. U.S., 5 Cl. Ct. 362 (1984), a foundation was the sole beneficiary of a lead trust and its settlor in his role as an officer, member and director of the foundation, was able to designate (or at least participate in designating) the recipients of foundation grants. The court found section 2036(a)(2) applicable, and included the CLT in his taxable estate.

4. Illustration.

This technique is illustrated by Private Letter Ruling 200138018:

A donor created a charitable lead annuity trust and funded the trust with publicly-traded stock. The trust is designed to pay an amount equal to 8 percent of the fair market value of the initial value of the trust property to the donor’s private foundation each year for ten years. At the end of the term the balance of the CLT will be paid to or for the benefit of lineal descendants of the donor. The CLT provides that neither the donor nor her husband can serve as a trustee of the CLT. Further, any trustee may appoint an individual, individuals, or a bank or trust company as co-trustee or successor trustee. If ever there is a vacancy and no successor is so appointed then a majority in interest of the remainder persons (or their guardians) are to appoint a successor trustee.

The Bylaws of the donor’s foundation provide: (i) the number of directors may not be less than 3 nor more than 15; (ii) the donor will be a director for life; (iii) every other director will serve for a term of one year and until his or her successor is duly elected and qualifies; (iv) any vacancy in the Board of Directors may be filled by a majority vote of the remaining directors or by the sole remaining director, however, the donor may not cast a vote for or appoint an individual as a director that is either related or subordinate to her within the meaning of section 672(c); (v) any time the foundation is a beneficiary of a charitable lead trust, a charitable remainder trust or other similar trust, and the charitable trust was established by a director, officer or substantial contributor to foundation, the director, officer or substantial contributor establishing the charitable trust is prohibited from acting on matters concerning funds coming to foundation from the charitable trust; (vi) a director, officer, or substantial contributor who establishes a charitable trust for the benefit of foundation may not
be counted when establishing a quorum to vote on matters relating to those funds. The director, officer, or substantial contributor will be prohibited from voting on any matters relating to the funds received or anticipated to be received from the charitable trust, including voting on any disbursements or grants of such funds; and (vii) any funds received from a charitable trust are to be segregated into a separate account in the Foundation’s books in such a manner as to allow tracing of the funds into and out of that account. The separate account will be administered and distributed by a separate fund committee and donor may not possess any power over this account or this separate fund committee.

The IRS noted the donor had not retained a power over the property transferred to CLT, and she had not retained an interest, reversion, or right to alter, amend or revoke CLT. Moreover, although she will remain one of the directors of foundation, she is not permitted to vote on matters relating to disbursements or grants of funds received from CLT. Since the annuity payable under the CLT is a qualifying annuity for purposes of section 2522(c), the donor’s transfer to the CLT is a completed gift for federal gift tax purposes and is entitled to a gift tax deduction under section 2522, based on the present value of the guaranteed annuity payable to charity.

Noting the donor could not serve as a trustee of the CLT or any successor trust, and could not participate in any vote of the foundation Board of Directors or officers concerning the annuity funds received from the CLT, the IRS found the donor had retained no interest or reversion in trust and no right to alter, amend, or revoke CLT. Accordingly, no portion of the CLT will be included in Taxpayer’s gross estate.

H. Funding A CLT With A Promissory Note Is Not Self-Dealing.

In Private Letter Ruling 200124029 the personal representative of an estate sought rulings with respect to the eventual funding of a series of charitable lead annuity trusts. A significant portion of the decedent’s estate was comprised of interests in real estate and various real estate partnerships and corporations (“Real Estate”). Under the terms of the decedent’s Will all of his assets passed to a QTIP marital trust with income payable to his surviving wife. The personal representatives split the marital trust into three trusts, each with identical terms. Upon the death of the wife, the marital trusts will be split among trusts for the benefit of the decedent’s descendants and several CLTs. Each CLT will have a 21 year term and is designed to bear the smallest annuity rate that will result in a full estate tax charitable contribution deduction.

The personal representatives proposed to sell the Real Estate to a newly formed limited liability company (“LLC”) which will be owned, partially or wholly, by or for the benefit of any or all of the decedent’s children and their issue (“Related
Family Members”), in exchange for a secured, interest-bearing promissory note (“Note”). The Note (i) will bear interest at the applicable federal rate in effect for the month in which the sale occurs; (ii) will have a term of not greater than thirty years; and (iii) will be secured by the real estate interests. The fair market value of the Note will be equal to the fair market value of the property as established by a qualified appraisal.

After the transaction, the Note will be included among the assets used to fund the marital trusts for the benefit of decedent’s wife. Upon her death, the Note will be included among the assets used to fund the CLTs. As a result, the Related Family Members will be indebted to the CLTs under the terms of the Note. The State Court must approve the proposed transaction and the Attorney General of State will represent the interests of the charitable beneficiaries in that proceeding.

The expected effect of the terms and conditions is that the charitable beneficiaries will be in a position which is at least as favorable as their current position and is likely to be more favorable. By entering into the transaction, it was expected the CLTs will be protected from fluctuations in the real estate market that may occur prior to the death of the decedent’s wife. The Note will serve to fix the value of the CLTs’ assets at the current value of the Real Estate, thus protecting the CLTs from a downturn in the real estate market, and will fix the return of the CLTs through a fixed rate of interest, thus protecting the CLTs from fluctuations in the returns realized by the Real Estate itself. Also, as a result of the proposed transaction, the cash flow of the CLTs will be improved and stabilized so that the CLTs will be better able to satisfy their annuity obligations. Without the sale, the CLTs would receive the Real Estate interests and would be required to engage in the real estate business. With the proposed transaction, the CLTs and thus the charitable beneficiaries will be less concerned about fluctuations in the real estate market and in interest rates since the CLTs’ income will be fixed in accordance with the terms of the Note.

Possibly most important, without the proposed transaction, the CLTs only would have access to the Real Estate in order to satisfy annuity payments to the charitable beneficiaries. With the proposed transaction, the CLTs will have access to (i) the Note, (ii) the real estate interests themselves, and (iii) the capital of the family LLC.

Based on the information and representations submitted, the IRS ruled:

The sale of the property by the estate to the Related Family Members is not an act of self-dealing within the meaning of section 4941 of the Code, and will not give rise to tax under that section to the Estate, to the marital trusts, to the Related Family Members, or to the CLTs.
The eventual receipt and holding of the Note by the CLTs, and the subsequent payment of principal and interest on the Notes by disqualified persons will not constitute acts of self-dealing under section 4941(d) of the Code, and will not give rise to tax liability under section 4941 to the Estate, to the martial trusts, to the Related Family Members, or to the CLTs.

Notwithstanding that the interests that will be sold to the LLC, a disqualified person, will be pledged as collateral for the Note to the CLTs, the continued operation of the real estate business by the managers of the LLC or any other Related Family Members, including, but not limited to, the leveraging and selling of secured assets, and the acquisition of new assets, will not constitute acts of self-dealing under section 4941(d) of the Code because the proposed transaction has met the requirements of section 53.4941(d)-1(b)(3) of the regulations, so long as the value of the collateral remains as required by the terms of the Note, and will not give rise to tax liability under section 4941 of the Code to the Estate, to the marital trusts, to the Related Family Members, or to the CLTs.

I. **CLT’s Investment In A Limited Partnership Was Not Self-Dealing.**

Private Letter Ruling 200018062 involved the transfer of real estate and interests in a limited partnership to a nine year testamentary charitable lead unitrust created upon the death of the grantor’s surviving spouse. The other limited partners of the limited partnership are a number of individuals and trusts, an estate and another limited partnership. The individuals are all related to the grantor of the CLT by blood or marriage. All of the trusts are for the benefit of those individuals. The partnership has a corporate general partner. Real estate transferred to the CLT will be sold and the proceeds reinvested in additional interests in the partnership. However, the CLT will always own less than 20 percent of the value of the total partnership interests. The partnership’s other investment assets provide dividends, interest and realized and unrealized gains from its investment activities. The partnership charges its limited partners a fee for its investment services, including compensation to an unrelated professional investment manager and reimbursements to the corporate general partner. Another corporation provides accounting, tax and clerical services on a cost-sharing basis to members of the family and various family entities, including the CLT and the partnership. The CLT and the partnership pay a fee for these services. The service corporation subleases office space to the partnership. The partnership, both corporations and many of the limited partners are disqualified persons with respect to the CLT.

Here, the IRS ruled:

The CLT’s retention of an interest and investment in the partnership are not direct or indirect acts of self-dealing, as defined in section 4941(d)(1).
Payments by the CLT to the service corporation for general accounting, tax and clerical services and to the partnership (i) for investment management and advisory services, (ii) for the reimbursement of the corporate general partner for costs and expenses paid as the general partner, and (iii) for the payment to the service corporation for general accounting, tax and clerical services do not constitute direct or indirect acts of self-dealing by the CLT, as defined in section 4941(d)(1), or taxable expenditures, as defined in section 4945(d)(5).

A sublease of office space by the partnership from the service corporations does not constitute an indirect act of self-dealing by the CLT, as defined in section 4941(d)(1).

The CLT’s limited partnership interest in the partnership does not constitute excess business holdings, as defined in section 4943(c).

J. **A Delay In Funding A CLT Caused By Protracted Estate Litigation Is Not Self-Dealing.**

In Private Letter Ruling 200232033 the IRS was asked to rule on a complicated set of facts relating to the delayed funding of two charitable lead unitrusts (“CLTs”). After a set term the CLTs were to terminate and the remainder of one CLT was to be divided into trusts for the decedent’s children, and the remainder of the other CLT was to be paid outright to the decedent’s children. Due to protracted litigation, the CLTs had not been funded and the decedent’s estate lacked sufficient liquid assets to do so. Given the delay in funding, the CLTs owe substantial amounts to the charitable beneficiary. The estate sought to fund the CLTs with tenancy-in-common interests in alternate estate property that was income producing. The transferred property also would include certain related party promissory notes that would be transferred to the charity to make up the CLTs’ arrearages. The estate petitioned a local court for approval of the proposed funding and related transactions.

Based on the information submitted and the representations made the IRS ruled that all of the following elements of the proposed transaction met the estate administration exception described in section 53.4941(d)-1(b)(3) of the regulations and therefore were not acts of self-dealing:

- The distributions of related notes to the charitable beneficiary in satisfaction of the accrued obligations of the two CLTs;
- The transfer of liabilities to the charitable beneficiary together with assets earmarked to pay such liabilities, via the residue of the decedent’s estate;
- The reallocation of assets subsequent to partial funding of the CLTs;
The assumption of liability by one of the CLTs under an environmental indemnification;

The receipt by the other CLT of property subject to a lien created within 10 years prior to the transfer;

The assumption of liability by the charitable beneficiary under a limited liability company operating agreement;

The assumption of debt and partial surrender by the children of the decedent of their rights to distributions of assets in exchange for net relief from liability to the estate; and

The sale of stock by the decedent’s estate to the children of the decedent in exchange for the assumption of debt owed by the estate.

K. Modification Of A Successful CLT Can Be Permissible.

1. Early Termination.

Private Letter Ruling 199952093 involved a twenty year inter-vivos charitable lead annuity trust. The sole charitable beneficiary was the grantor’s family private foundation. Originally the CLT was funded with shares of stock in a closely-held, non-public bank holding company which was controlled by the grantor’s family. The CLT was designed to pay the private foundation a qualified annuity equal to 5 percent of the fair market value of the stock contributed to the CLT. At the end of the charitable term the remainder is to be distributed to the grantor’s four children who also are all of the trustees of the CLT and all of the foundation managers of private foundation.

The bank holding company merged into a public corporation whose common stock is traded on the New York Stock Exchange. The CLT received a number of shares of stock in the new company with a value substantially in excess of the value of the stock originally contributed to the CLT. Also, the dividend the CLT will receive from the new company is well in excess of the amount necessary to pay the annuity to the family foundation.

Since the CLT now had assets that were readily convertible to cash, the CLT’s charitable interest could be satisfied much earlier than originally anticipated by the grantor. Accordingly, the grantor, the trustees of the CLT, the foundation managers of the family foundation, and the four remaindermen all wanted to pay the CLT, in one lump sum, the remaining amount due to the CLT, without discount.
The parties filed a petition in state court seeking authorization to pre-pay the CLT and then to terminate the trust by distribution of the remainder interests. Their petition named the state Attorney General as a party to the suit to protect the interests of the charity.

Under these facts the IRS ruled:

The Trustees’ prepayment of the entire remaining charitable interest without discount to the family foundation as the sole charitable beneficiary of CLT would not constitute the termination of a private foundation under section 507 of the Code.

The Trustees’ prepayment of the entire remaining charitable interest without discount to the family foundation as the sole charitable beneficiary of the CLT would not be an act of self-dealing under section 4941 of the Code since the family foundation was not a disqualified person.

The Trustees’ prepayment of the entire remaining charitable interest without discount to the family foundation would not be a taxable expenditure under section 4945 of the Code but the IRS cautioned that this is not to say that the income payment to the charitable beneficiary of a charitable lead trust will never constitute a taxable expenditure. Here, however, the payment was to be made for the appropriate charitable purpose established by the trust document so there would be no taxable expenditure and it was understood that neither the CLT, the grantor, the trustees, nor any “disqualified person” within the meaning of section 4946 of the Code would receive any benefit from the prepayment to the family foundation other than the rights of remaindermen provided in the trust document. The Service ruled favorably on similar facts in Private Letter Ruling 200225045.

2. Term Extension Coupled with Early Distributed to Private Beneficiary.

Private Letter Ruling 200226045 involved another successful plan. The trustees of a charitable lead annuity trust proposed to modify the CLT so the trust’s charitable beneficiary, a private foundation, and the remainder beneficiary, a non-exempt limited partnership, would receive different distributions than under the original agreement. The CLT had an initial term of 15 years of which 11 years remained. Due to appreciation in the value of the CLT’s assets, the current value of the assets greatly exceed the amount needed to fund the remaining annuity obligation to the charitable beneficiary.
The trustees executed an amended and restated agreement which provides that the CLT was to distribute the CLT’s assets in excess of 110 percent of the remaining undiscounted annuity obligations to the limited partnership. The remaining undiscounted annuity obligation would be paid in annual annuity installments over a new fifteen year term, based on the annuity factor determined in accordance with the applicable regulations and the section 7520 rate applicable to the date of the amendment, so the remainder interest will be as close to zero as possible.

The purpose of the change was to move excess assets from the restrictions the Code imposes on private foundations so that the assets can achieve greater economic good by producing a greater return on investment while at the same time providing more funds to the charity than originally provided.

The amendment required the CLT to obtain a ruling from the Internal Revenue Service that the distribution to the remainderman of trust of the excess assets would not violate any of the Code’s restrictions on private foundations in sections 1941 through 4945, inclusive. In addition, all parties planned to petition the state court to approve the amendments to the CLT and the parties planned to make the state Attorney General a party to the proceedings to protect the interests of the charity.

Under this set of facts the IRS ruled that the CLT’s distribution of excess assets to the limited partnership and the payment of the remaining undiscounted annuity obligation to the charity at a new annuity amount based on the current section 7520 rate for a new 15 year period would:

- Not constitute a termination of a private foundation under section 507 because section 53.4947-1(e)1 of the regulations specifically provides that the provisions of section 507(a) do not apply to a trust described in section 4947(a)(2) by reason of any payment that is directed by the terms of the governing instrument of the trust and is not discretionary with the trustee. The trust agreement directed the terms of the payments to the charity and was not discretionary with the trustees.

- Not be self-dealing under section 4941 because the CLT, treated as a private foundation described in section 501(c)(3) of the Code, was not a disqualified person with respect to the charity. Thus, the CLT’s payment of the remaining undiscounted annuity obligation to the charity would not be an act of self-dealing. There would be no sale or exchange of property, the charity was merely agreeing to receive more money.
Not subject the CLT to tax on the undistributed income of a private foundation under section 4942 because the CLT already was subject to a payout requirement. Although the CLT’s payout requirement would change, the change was required by the amended agreement that was to be approved by court order and the state Attorney General.

Not subject the CLT to tax on excess business holdings under section 4943 because the payments to the limited partnership and the charity would not result in the CLT acquiring interests in business.

Not be an investment which jeopardizes charitable purposes under section 4944 because the payment of the remaining annuities would be made to accomplish charitable purposes. Moreover, the transaction would be based on the amended trust agreement approved by a court order and in a court action in which the state Attorney General is joined to protect the interest of the charity. The charity would be protected from decline in the value of the CLT’s assets by the fact that the undiscounted amount of the remaining annuities to the charity plus 10 percent would remain in the CLT. There was no investment, the CLT is merely paying its obligations.

Not be a taxable expenditure under section 4945 since the CLT’s expenditure to the charity as required under the CLT’s trust instrument was in furtherance of a section 170(c)(2)(B) purpose in fulfillment of its charitable lead annuity requirement in its governing instrument.

L. Back-Loaded Charitable Lead Annuity Trusts, a/k/a Shark-Fin CLATs.

The Treasury Regulations allow an annuity amount that is initially stated as a fixed dollar or fixed percentage amount to increase during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded. The regulations also state that the annuity amount “may be changed by a specified amount” at the expiration of a term of years or at the death of an individual. Treas. Reg. §§ 1.170A-6(c)(2)(i)(A); 20.2055-2(e)(vi)(a); 25.2522(c)-3(c)(2)(vi)(a).

A traditionally structured CLAT may fail if the growth rate of the assets does not exceed the section 7520 rate; even if the growth rate does exceed the section 7520 rate, the CLAT may fail because of the “path of the returns.” Back-loading the payment to charity is intended to hedge against market volatility, thereby allowing for a significant buildup of funds ultimately passing to family members on the termination of the trust.

To illustrate, assume a section 7520 rate of 3.2%. A trust funded with $1,000,000 that paid $1000 per year for 19 years to charity, followed by a payment at the end of the 20th year of $1,852,000 would zero-out. If the CLAT assets have a total return annually of 5.45% the original $1,000,000 will remain at the end of the 20 year period. If the rate of return were 7% then almost $2,000,000 would remain.

Longer periods will yield more spectacular results. For example, a 50 year trust funded with $1,000,000 might need to pay $4,800,000 in the 50th year, in addition to minimal payments in each of the first 49 years. Such a trust that grew at 5.45% could have $9,000,000 remaining after all payments were made. In general, the consequences of such long terms may be unpredictable. Suppose a charity with the right to receive $1000 per year for 49 years and $4,800,000 in year 50 were approached by a buyer acting independently of the original donor, to conduct an arms-length negotiation and potential transaction. If such a charity were conservative and anticipated earning only 5% a year, on average, over the 50 year term, such a charity might consider selling its annuity interest for $420,000 plus a reasonable profit. Might the remainder beneficiaries of such a trust be interested in purchasing the annuity interest for something in the range of $420,000 - $450,000?

The shark fin CLAT can result in more wealth transfer than other forms of non-charitable techniques, including both GRATs and installments sales to defective grantor trusts, but only if the CLAT is structured as a grantor trust. In this case, it is possible to double the value left for the remaindermen with a greater than 98% probability of success. This is due to the limitations of the charitable income tax deduction under section 642(c) of the Code.

If the CLAT is a non-grantor CLAT, assuming the assets are invested in globally diversified equities, the most efficient wealth transfer results with a variable CLAT that provides for 150% back-loaded annuities. See P. Lee et al., Innovative CLAT Structures: Providing Economic Efficiencies to a Wealth Transfer Workhorse, 37 ACTEC L. J., Summer 2011, at 93.

Assets that traditionally have not been good candidates for CLATs, such as those with a lack of liquidity or those with a very low value at the time of contribution (private equity investments or interests in FLPs holding commercial real property), could be used in a shark fin CLAT structure. A back-loaded CLAT can provide significant cushion so that the charitable payments are matched to when liquidity and higher value are expected to occur.
The IRS has not specifically ruled on Shark-Fin CLATs, but in Private Letter Ruling 201216045, the IRS ruled that a testamentary CLAT could make variable, ascending (by 20% per year) annuity payments to the CLAT’s charitable income beneficiary over its 10-year term without violating any of the requirements applicable to CLATs under the income, estate, or excise tax provisions of the Internal Revenue Code.

VIII. ASSIGNMENT OF INCOME ISSUES AND THE PRE-ARRANGED REDEMPTION.

A. Generally.

Considerable care should be taken to avoid any “prearranged redemptions” resulting in taxation to the donor of any capital gain realized on the redemption. In Palmer v. Commissioner (62 T.C. 684 (1974), aff’d on other grounds, 523 F.2d 1308 (8th Cir. 1975), acq, 1978-1 C.B. 2), the Tax Court held that a taxpayer’s gift of stock in a closely-held corporation to a private foundation, followed by a redemption, would not be characterized as a sale or redemption between the taxpayer and the corporation followed by a gift of the redemption proceeds to the foundation, because the foundation was not legally obligated to redeem the stock at the time it received the shares. In Revenue Ruling 78-197 (1978-1 C.B. 83), the Service announced that it would treat the proceeds of a stock redemption under facts similar to those in the Palmer case as income to the donor only if the donee is legally bound or can be compelled by the corporation to surrender the shares for redemption.

B. Illustration.

In Private Letter Ruling 200230004, husband and wife proposed to transfer 495 of 500 shares of a C corporation to a charitable remainder unitrust and asked whether the redemption would be treated as an assignment of income. The ruling first describes Palmer and Revenue Ruling 78-197 and then states:

In the present case, at the time X shares are transferred to Trust, X will be under no legal obligation to redeem the contributed stock. There is no agreement among the parties under which X would be obligated to redeem, or Trust would be obligated to surrender for redemption, the stock. Trust is not legally obligated to accept any offer of redemption made by X. Accordingly, any redemption by X of the stock contributed by Grantors to Trust will be respected.

Based on the representations submitted and information described above, we conclude that a purchase by X of the
stock transferred by Grantors to Trust will be treated as a redemption of the stock from Trust, and will not be treated as a redemption of stock from Grantors or a distribution by X to Grantors. Therefore, the sale or redemption by Trust of its X stock will not result in the capital gain in such sale or the redemption price being attributed for tax purposes to Grantors.

Among the representations made were:

In addition, A, as president and sole shareholder of X and grantor and co-trustee of Trust, represents the following:

(1) I, A, grantor and co-trustee of Trust, hereby represent that neither I nor any family member of me will acquire, offer to acquire, or become obligated to acquire shares of X stock from Trust earlier than at least one year after the date of any transfer of shares of X stock to Trust.

(2) I, A, President and sole shareholder of X, hereby represent that X will not redeem, offer to redeem, or become obligated to redeem shares of X stock from Trust earlier than at least one year after the date of any transfer of shares of X stock to Trust, directly or indirectly, by the grantor of Trust or a family member of the grantor.

(3) I, A, President and sole shareholder of X, and grantor and co-trustee of Trust, hereby represent that neither X nor I am aware of any plan or intention of Trust to transfer any corporate stock, or to have any person acquire any corporate stock from Trust.

The application of Revenue Ruling 78-197 also arose in Gerald A. Rauenhorst, et al. v. Commissioner, 119 T.C. No. 9 (2002). Arbeit (a partnership) owned warrants enabling it to purchase NMG stock. On September 28, 1993, WCP (a corporation) offered to purchase all NMG stock. On November 9, 1993 the partnership assigned some warrants to four charities. On November 19 Arbeit sold its remaining warrant to WCP, and the charities sold their warrants to WCP. On November 22, 1993, WCP and NMG agreed on a sale of all the NMG stock. The government argued that the bright-line rule of Rev. Rul. 78-197 was not controlling. The Opinion states:

Respondent argues that petitioners are not entitled to judgment as a matter of law and that genuine issues of material fact remain for trial. Respondent argues that the question whether the donees were bound or could be legally
compelled to surrender their NMG warrants is not “the critical issue” to be resolved and, accordingly, neither Carrington v. Commissioner, supra, nor Rev. Rul. 78-197, supra, controls this case. It is respondent’s position that “the critical issue” in this case is “a factual one”: whether petitioners’ rights to receive the proceeds of the stock transaction involving WCP “ripened to a practical certainty” at the time of the assignments. Respondent relies on Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999), Jones v. United States, supra, Kinsey v. Commissioner, 477 F.2d 1058 (2d Cir. 1973), affg. 58 T.C. 259 (1972), Hudspeth v. United States, 471 F.2d 275 (8th Cir. 1972), and Estate of Applestein v. Commissioner, supra.

Respondent purports to distinguish both Carrington and Rev. Rul. 78-197, supra, on the facts of the case and the ruling. To that end, he contends that Carrington and Rev. Rul. 78-197, supra, are not inconsistent with the cases he relies upon above. Respondent claims that in this case, and the cases upon which he relies, there was a pending “global” transaction for the purchase and sale of all the stock of a corporation at the time of the gift or transfer at issue. He then surmises that because Carrington and Rev. Rul. 78-197, supra, did not involve a pending “global” transaction, the legal principles of those authorities do not apply. Instead, he argues that we must apply the principles of the cases he relies upon, and, accordingly, we must conduct a detailed factual inquiry for purposes of determining whether the sale of the stock warrants had ripened to a practical certainty at the time of the assignments.

We cannot agree that respondent has effectively distinguished Carrington and Rev. Rul. 78-197, supra, on their facts. First, neither this Court nor the Courts of Appeals have adopted respondent’s theory of a pending “global” transaction as a means of distinguishing cases such as Carrington and Palmer v. Commissioner, 62 T.C. 684 (1974). Indeed, the case law in this area applies essentially the same anticipatory assignment of income principles to cases of a “global” nature as those applicable to cases of a “nonglobal” nature. See, e.g., Greene v. United States, supra at 581. We can only interpret respondent’s use of the phrase “pending global transaction” as simply a restatement of the principles contained in the cases upon which he
relies. Thus, we cannot agree that respondent’s reliance on a pending global transaction distinguishes either *Carrington*, Rev. Rul. 78-197, supra, or other cases upon which petitioners rely. With that being said and leaving *Carrington* and those other cases aside at this point, the bright-line test of Rev. Rul. 78-197, supra, which focuses solely on the donee’s control over the contributed property, stands in stark contrast to the legal test and the cases upon which respondent relies and which consider the donee’s control to be only a factor.

The Court took a dim view of the government’s urging that Rev. Rul. 78-197 be ignored:

While this Court may not be bound by the Commissioner’s revenue rulings, and in the appropriate case we could disregard a ruling or rulings as inconsistent with our interpretation of the law, see *Stark v. Commissioner*, 86 T.C. 243, 251 (1986), in this case it is respondent who argues against the principles stated in his ruling and in favor of our previous pronouncements on this issue. The Commissioner’s revenue ruling has been in existence for nearly 25 years, and it has not been revoked or modified. No doubt taxpayers have referred to that ruling in planning their charitable contributions, and, indeed, petitioners submit that they relied upon that ruling in planning the charitable contributions at issue. Under the circumstances of this case, we treat the Commissioner’s position in Rev. Rul. 78-197, 1978-1 C.B. 83, as a concession. Accordingly, our decision is limited to the question whether the charitable donees were legally obligated or could be compelled to sell the stock warrants at the time of the assignments.

On the facts, the court found for the taxpayer:

Petitioners argue that as of November 12, 1993, the date the warrants were transferred on the books of NMG, the donees had not entered into any agreement to sell the warrants and could not be compelled by any legal means to transfer the warrants. Accordingly, they contend that, as a matter of law, there was not an assignment of income. Petitioners submitted affidavits from representatives of the donees in support of their motion for partial summary judgment. Each
of those affidavits outlines the events which preceded the assignments, each states that the stock warrants were received on November 12, 1993, and each also states that, as of that date, the donees had not entered into agreements to sell the stock warrants.

* * *

Respondent alleges no facts or evidence to substantiate his position, and he has submitted no affidavits in response to the affidavits that petitioners submitted. Instead, he points out that the record lacks information regarding any discussions, deliberations, or negotiations which may have taken place between the donees and the other parties. Respondent has had ample opportunity to investigate the facts surrounding these transactions, and it is clear that respondent could have requested additional information from the individuals involved. See Rule 121(e). He has requested neither additional discovery nor a continuance for purposes of additional discovery. He has not demonstrated to our satisfaction that the only available method for opposing the statements in the affidavits is through cross-examination at trial. Further, it is insufficient for the opposing party to argue in the abstract that the legal theory involved in the case encompasses factual questions. Hibernia Natl. Bank v. Carner, 997 F.2d 94, 98 (5th Cir. 1993); Daniels v. Commissioner, supra. Since petitioners have offered affidavits directly supporting their position on a material issue of fact, and since respondent has failed to counter those affidavits with anything other than unsupported allegations, respondent cannot avoid summary judgment on this issue. See Greene v. United States, 806 F. Supp. 1165, 1171 (S.D.N.Y. 1992), affd. 13 F.3d 577 (2d Cir. 1994). Thus, we find that there is no genuine issue of material fact regarding whether the donees entered into a legally binding agreement to sell their stock warrants before, or at the time of, the assignments by petitioners.

Footnote 14 states:

The record indicates that no agreement was entered into by the donees before Nov. 19, 1993, the date they signed the warrant purchase and sale agreement. On Nov. 16, 1993, NMG’s legal counsel sent letters to each of the donees enclosing a warrant purchase and sale agreement. Those letters state that pursuant to the warrant purchase and sale
agreement, the donees would agree to sell their reissued warrants to WCP and “to abstain from either exercising its Warrant or selling or otherwise transferring it to any other party through Dec. 31, 1993.” Certainly, the formality of having the donees enter into the warrant purchase and sale agreements suggests that they had not entered into any binding agreements before Nov. 19, 1993.

Subsequent to the decision, the government reiterated its intention, generally, to follow its own rulings in litigation.

In PRIVATE LETTER RULING 200321010 a retired officer of a corporation intended to give shares of the corporation to a CRUT. The corporation had the right to purchase the stock if it so desired, and the agreement also bound the trust:

X proposes to establish a CRUT (as defined in § 664 of the Internal Revenue Code). Upon establishment of the CRUT, X will notify Company of X’s intent to transfer a portion of X’s Company stock purchased under the Plan to the CRUT, thereby triggering Company’s option to purchase the stock for the formula price set forth in the stock restriction agreements applicable to such stock. Taxpayer represents that Company will likely decline to purchase the stock for the formula price set forth in the stock restriction agreements and thus X will be free to transfer the stock to the CRUT. The stock transferred to the CRUT will continue to be subject to the terms of the stock restriction agreements under the Plan in accordance with the terms of the stock restriction agreements. Therefore, if the trustee of the CRUT wishes to sell or otherwise dispose of the stock, Company will have a right to purchase the stock for the formula price set forth in the stock restriction agreements. The trustee will notify Company that the CRUT wishes to sell Company stock prior to any proposed sale or disposition. X represents that Company has always exercised its option under the stock restriction agreements in the past for the formula price set forth therein.

The ruling described the “bright-line” test of Palmer, citing Rauenhorst, and concludes:

Consequently, the test for purposes of this ruling request, is whether the CRUT will be legally bound or can be compelled by Company to surrender the stock for redemption at the time of the donation. Here, X proposes to
transfer the Company stock to the CRUT. Under the restrictions contained in each year’s stock restriction agreement, the CRUT must first offer the stock to Company at a set formula price should the CRUT propose to dispose of the shares. This provision amounts to a right of first refusal. However, it does not mean that the CRUT is legally bound or can be compelled by Company to surrender the stock to Company at the time of the donation. The information submitted contains no indication that the CRUT will be legally bound, or could be compelled by Company, to redeem or sell the gifted stock. That all or a portion of the gifted stock was subject to restrictions upon transfer to a third party by X, and thus by the CRUT following the transfer, does not give Company the ability to compel its redemption or sale from the CRUT. The CRUT is free to retain title to and ownership of the stock indefinitely.

Because the CRUT is not legally bound and cannot be compelled by Company to redeem or sell the stock, we conclude that the transfer of the Company stock by X to the CRUT, followed by any subsequent redemption of the stock by Company, will not be recharacterized for federal income tax purposes as a redemption of the stock by Company from X followed by a contribution of the redemption proceeds to the CRUT. See Palmer v. Commissioner, supra, and Rev. Rul. 78-197, supra. The same principles apply if the stock is sold by the CRUT rather than redeemed by Company. Thus, provided there is no prearranged sale contract whereby the CRUT is legally bound to sell the stock upon the contribution, we conclude that any subsequent sale will not be recharacterized for federal income tax purposes as a sale of the stock by X, followed by a contribution of the sale proceeds to the CRUT. Accordingly, any redemption proceeds or sales proceeds received by the CRUT for the stock will not be treated as taxable income received by X.

See also 200821024.

IX. DISCLAIMER TO A CHARITABLE FUND.

A. Tax Benefits.

The deduction is allowed for an amount that becomes or is added to a charitable bequest or transfer as a result of a “qualified disclaimer” under section 2518.
Where the disclaimer is described by a formula significant tax savings may be achieved as well as a form of audit insulation. This issue arose in Estate of Helen Christiansen v. Commissioner, 130 T. C. No. 1 (2008) (reviewed), aff’d, 586 F.3d 1061 (8th Cir. 1061).

Helen Christiansen died leaving everything to her only child, Christine Hamilton. Any amounts Christine Hamilton disclaimed would go 75% to a charitable lead annuity trust and 25% to a private foundation. Ms. Hamilton disclaimed a fraction of the estate the numerator of which was the fair market value of the estate, before payment of debts, expenses, and taxes, less $6,350,000, and the denominator of which was the fair market value of the estate, before payment of debts, expenses, and taxes. Fair market value was defined using the willing buyer, willing seller formula and referencing the value as finally determined for Federal estate tax purposes. The estate included some cash and real estate but also 99% interests in two limited partnerships. The estate tax return reported a total value of $6,512,223.20; in the litigation the parties agreed that the value of the estate was $9,578,895.93.

The government argued that the disclaimer to the Foundation should generate an estate tax charitable deduction only for the amount originally set forth on the estate tax return, not the amount agreed to after audit. The Court disagreed. The government first argued that the increase amount passed as a result of a contingency - - the IRS audit increasing the value of the estate - - but the Court noted that merely because “the estate and the IRS bickered about the value of the property being transferred doesn’t mean the transfer itself was contingent in the sense of dependent for its occurrence on a future event.”

The government also argued public policy, Procter like, grounds for disallowing an increased charitable deduction. The majority opinion in the Tax Court rejected that contention holding:

This case is not Procter. The contested phrase would not undo a transfer, but only reallocate the value of the property transferred among Hamilton, the Trust, and the Foundation. If the fair market value of the estate assets is increased for tax purposes, then property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn’t in any way upset the finality of our decision in this case.

We do recognize that the incentive to the IRS to audit returns affected by such disclaimer language will marginally decrease if we allow the increased deduction for property passing to the Foundation. Lurking behind the Commissioner’s argument is the intimation that this will increase the probability that people in Hamilton’s situation
will lowball the value of an estate to cheat charities. There’s no doubt that this is possible. But IRS estate-tax audits are far from the only policing mechanism in place. Executors and administrators of estates are fiduciaries, and owe a duty to settle and distribute an estate according to the terms of the will or law of intestacy. See, e.g., S.D. Codified Laws sec. 29A-3-703(a) (2004). Directors of foundations—remember that Hamilton is one of the directors of the Foundation that her mother created—are also fiduciaries. See S.D. Codified Laws sec. 55-9-8 (2004). In South Dakota, as in most states, the state attorney general has authority to enforce these fiduciary duties using the common law doctrine of parens patriae. Her fellow directors or beneficiaries of the Foundation or Trust can presumably enforce their observance through tort law as well. And even the Commissioner himself has the power to go after fiduciaries who misappropriate charitable assets. The IRS, as the agency charged with ruling on requests for charitable exemptions, can discipline abuse by threatening to rescind an exemption. The famed case of Hawaii’s Bishop Estate shows how effectively the IRS can use the threat of the loss of exempt status to curb breaches of fiduciary duty. See Brody, “A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?”, 21 U. Haw. L. Rev. 537 (1999). The IRS also has the power to impose intermediate sanctions for breach of fiduciary duty or self-dealing. See sec. 4958.

The Eighth Circuit had no difficulty upholding the Tax Court. The government made two arguments described by the Court as follows:

First, the Commissioner argues that because the overall value of the estate was not finally determined at the time of Christine’s death, but only after the Commissioner’s partially successful challenge, the transfer to the foundation was, ultimately, “dependent upon the performance of some act or the happening of a precedent event” in violation of Treasury Regulation § 20.2055-2(b)(1). The Commissioner identifies as the purported “precedent event” or contingency the challenge mounted against the estate’s initial return and the ultimate process of settling the estate’s value.

As a second argument, the Commissioner asserts policy concerns related to the incentives and disincentives that exist regarding the decision to conduct audits in any given case. In particular, the Commissioner argues that we should
disallow fractional disclaimers that have a practical effect of disclaiming all amounts above a fixed-dollar amount. According to the Commissioner, such disclaimers fail to preserve a financial incentive for the Commissioner to audit an estate’s return. With such a disclaimer, any post-challenge adjustment to the value of an estate could consist entirely of an increased charitable donation. Because this scenario would provide no possibility of enhanced tax receipts as an incentive for the Commissioner to audit the return and ensure accurate valuation of the estate, the Commissioner argues such disclaimers should be categorically disqualified as against public policy.

The Court rejected the first argument as follows:

Regarding the first argument, we are unable to accept the Commissioner’s interpretation of Treasury Regulation § 20.2055-2(b)(1). The regulation is clear and unambiguous and it does not speak in terms of the existence or finality of an accounting valuation at the date of death or disclaimer. Rather, it speaks in terms of the existence of a transfer at the date of death. See Treas. Reg. § 20.2055-2(b)(1) (“If, as of the date of a decedent’s death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible.”); see also 26 U.S.C. § 2518(a) (providing that a qualifying disclaimer relates back to the time of death by allowing disclaimed amounts to pass as though the initial transfer had never occurred); S.D. Codified Laws § 29A-2-801 (b) (same). Here, all that remained uncertain following the disclaimer was the valuation of the estate, and therefore, the value of the charitable donation. The foundation’s right to receive twenty-five percent of those amounts in excess of $6.35 million was certain.

In pressing his current argument, the Commissioner fails to distinguish between events that occur post-death that change the actual value of an asset or estate and events that occur post-death that are merely part of the legal or accounting process of determining value at the time of death. The Commissioner cites several cases in which courts disallowed deductions because future contingent events might have defeated a transfer or a charitable
contribution. See Comm’r v. Sternberger’s Estate, 348 U.S. 187, 199 (1955) (deduction disallowed where bequest to charity was dependent upon testator’s daughter dying without descendants); Henslee v. Union Planters, 335 U.S. 595, 600 (1949) (deduction disallowed where a bequest to charity was the remainder of trust and where the trust’s primary beneficiary had the right to invade the trust corpus, therefore making not only the value of the bequest contingent, but making the existence of the charitable bequest non-ascertainable); Bookwalter v. Lamar, 323 F.2d 664, 669-70 (8th Cir. 1963) (marital deduction disallowed where surviving spouse’s continued survival was a condition upon disposition of the estate, thus creating “a ‘terminable interest’ within the meaning of § 2056 of the 1954 [Internal Revenue] Code.”). In each cited case, however, the actual contingencies under scrutiny were outside the legal or accounting process of determining a date-of-death value for the estate or an asset. None of these cases stand for the proposition that deductions are to be disallowed if valuations involve lengthy or disputed appraisal efforts or if the Commissioner’s actions in challenging a return result in determination of an adjusted value.

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It seems clear, then, that references to value “as finally determined for estate tax purposes” are not references that are dependent upon post-death contingencies that might disqualify a disclaimer. Because the only uncertainty in the present case was the calculation of value to be placed on a right to receive twenty-five percent of the estate in excess of $6.35 million, and because no post-death events outside the context of the valuation process are alleged as post-death contingencies, the disclaimer was a “qualified disclaimer.” 26 U.S.C. § 2518(a). We find no support for the Commissioner’s assertion that his challenge to the estate’s return and the ultimate valuation process and settlement are the type of post-death events that may disqualify a partial disclaimer.

More interesting was the Circuit Court’s wholesale rejection of the argument that this sort of disclaimer planning interfered with the ability to audit estates:

For several reasons, we disagree with the Commissioner’s argument that we must interpret the statute and regulations
in an effort to maximize the incentive to audit. First, we note that the Commissioner’s role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner’s role is to enforce the tax laws. [citations omitted]

Second, we find no evidence of a clear Congressional intent suggesting a policy to maximize incentives for the Commissioner to challenge or audit returns. The relevant policy in the present context is clear, and it is a policy more general in nature than that articulated by the Commissioner: Congress sought to encourage charitable donations by allowing deductions for such donations. See 26 U.S.C. § 2055(a)(2); Sternberger’s Estate, 348 U.S. at 190 n.3 (“The purpose of the deduction is to encourage gifts to the named uses.”). Allowing fixed-dollar-amount partial disclaimers supports this broad policy.

Third, and importantly, even if we were to find a general congressional intent regarding a need to maximize the incentive-to-audit, no corresponding rule of construction would be necessary in the present context to promote accurate reporting of estate values. The Commissioner premises his policy argument on the assumption that executors and administrators will purposefully undervalue assets in order to take advantage of his marginally decreased incentive to audit. In the present context, however, there are countless other mechanisms in place to ensure that fiduciaries such as executors and administrators accurately report estate values. State laws impose personal liability on fiduciaries, and state and federal laws impose financial liability or, in some circumstances criminal sanctions, upon false statements, fraud, and knowing misrepresentations. See, e.g., S.D. Codified Laws § 29A-3-703(a) (“A personal representative is a fiduciary. . . .”); id. § 55-9-5 (providing that the attorney general is the representative of beneficiaries of charitable foundations and has a duty to enforce their rights in court actions); 18 U.S.C. 1001 et seq. (criminalizing various acts of fraud and knowing misrepresentations); Ward v. Lange, 553 N.W.2d 246, 250 (S.D. 1996) (“[T]he fiduciary has a ‘duty to act primarily for the benefit’ of the other.”) (quoting High Plains Genetics Research, Inc. v. J K Mill-Iron Ranch, 535 N.W.2d 839, 842 (S.D. 1995)).
In addition, with a fixed-dollar-amount partial disclaimer, the contingent beneficiaries taking the disclaimed property have an interest in ensuring that the executor or administrator does not under-report the estate’s value. Such beneficiaries, therefore, have an interest in serving a watchdog function. Further, in this case Hamilton was not only the primary beneficiary who made the contested partial disclaimer, she was the executor of the estate and a board member for the foundation. Because she owed a fiduciary obligation to both the estate and the foundation, any self-dealing in this instance would be a clear violation of her general state-law fiduciary obligation to put the interests of the foundation above her own interests and possibly a violation of state and federal statutory prohibitions on certain forms of self dealing. See Ward, 553 N.W.2d at 250; S.D. Codified Laws § 55-9-8 (“The trustee of a trust described in § 55-9-7 shall not engage in any act of self-dealing which would give rise to any liability for the tax imposed by section 4941 (a) of the Internal Revenue Code.”); id. § 55-9-7 (defining trusts to include private foundations). In general, and on the specific facts of the present case, then, there are sufficient mechanisms in place to promote and police the accurate reporting of estate values beyond just the threat of audit by the Commissioner, thereby undercutting the Commissioner’s policy-based argument.

B. Non-Tax Benefits.

The idea of creating a charitable fund over which descendants have control has long been used in planning for the wealthiest families. However, recently the idea has been refined to become more useful for families of more moderate wealth.

The issue confronting the parent and the descendant is whether the descendant would be better off with a charitable fund, unreduced by estate or gift taxes, or with a personal fund from which estate or gift taxes have been paid. For simplicity, assume a combined 50% Federal and state bracket for both estate and generation-skipping tax. A parent must begin with $200,000 in order to set aside $100,000 for a child’s use. Is the child better off with a charitable fund of $200,000 or a personal fund of $100,000? Similarly, in order to generate $100,000 in a personal trust for a grandchild, a grandparent must begin with about $300,000 in order to pay estate tax of about $150,000 and generation skipping tax of about $50,000 (on a tax exclusive basis). Would the grandchild be better off with a charitable fund of $300,000 or a personal fund of $100,000?
The answer to these questions will depend in large part, of course, on the economic circumstances of the family. If the child or grandchild will inherit only the assets in question, then a personal fund will almost certainly be more desirable, but if the assets in question are only a small part of the total inheritance, then a charitable fund becomes more attractive. The position of the child or grandchild in the community, the family situation of the child or grandchild, and perhaps the economic circumstances of the spouse of the child or grandchild are other factors to be considered.

A major impediment to creation of such charitable funds is the concern on the part of parents (and grandparents) that descendants be treated fairly. Where one descendant, or group of descendants, might like a charitable fund but another would not, a charitable fund is often not created. This “lowest common denominator” estate planning can be combated through a charitable fund created by disclaimer.

Suppose parent or grandparent provides for a sum to be set aside for the child or grandchild which will bear its own estate and generation skipping taxes (if any). If the child or grandchild disclaims the sum, the sum would pass into a charitable fund to be named for the child or grandchild the income from which can be “used” on an annual basis for charitable giving. The child or grandchild has a choice: accept the sum as a bequest or disclaim it into a charitable fund (or disclaim only part). If the child or grandchild disclaims, then the amount disclaimed passes into the charitable fund free of estate or generation skipping tax. If the child or grandchild accepts the bequest then all applicable estate and generation skipping taxes are paid from the bequest.

Each child or grandchild may make his or her own decision and each decision affects the child or grandchild alone. A disclaimer is a formal legal document that must be executed within nine months after the death of the parent or grandparent, and prior to executing the disclaimer the child or grandchild must not have received any benefits from the amount disclaimed. For this reason, establishing a specific sum as to which the disclaimer may apply is often a good idea—the child or grandchild may receive income from the general assets of the estate during the initial nine month period without jeopardizing the disclaimer.

The charitable fund may be created either in a private foundation or as a donor advised fund in a community foundation. The latter mechanism is more flexible because of a special rule having to do with disclaimers, namely that the disclaiming party may not direct the ultimate disposition of the disclaimed funds. Where the disclaimed assets pass to a private foundation, the child or grandchild who has disclaimed must ensure that he or she does not control the distribution of the assets or the income from them. The IRS has discussed the limited role the disclaiming party may play in Private Letter Rulings 200616026, 9320008 and 9008011.
On the other hand, where the charitable fund is created as a donor advised fund in a community foundation, the problems are greatly minimized. Because the community foundation, through its board of directors, has ultimate authority over the distribution of the assets and the income, the disclaiming party does not have control. The IRS has required that the disclaiming party not vote as a member of the board of the community foundation on any distribution from the charitable fund created with the disclaimed assets. In Private Letter Ruling 200518012, several beneficiaries under a decedent’s revocable trust proposed to disclaim interests which would, as a result, pass under the terms of the trust into a donor advised fund maintained by a public charity not subject to the control or influence of the disclaiming beneficiary. The IRS ruled the disposition would qualify for an estate tax charitable deduction. See also Private Letter Ruling 9532027 to the same effect.

X. **THE CHARITABLE PARTNERSHIP.**

A. **Purpose and Effect.**

The purpose of a charitable partnership is to (1) enable a donor to make a larger charitable gift than the donor would feel comfortable making otherwise; (2) enable a donor to make a charitable gift when the donor is making substantial gifts to the donor’s descendants; and (3) enable the donor to sell appreciated assets without incurring gain. In the discussion below a transaction with the donor’s children is generally assumed. However, the transaction may also be undertaken with grandchildren or other descendants, or with trusts for the benefit of descendants.

B. **Mechanics of the Basic Transaction.**

The donor creates a limited partnership. The other initial partner may be the donor’s spouse or children. Generally forming a limited partnership between a donor and spouse is better than involving children because it reduces the opportunity for the IRS to claim that the donor made a gift upon the formation of the partnership. The partnership may have 10,000 units of which 100 would be general partnership units and 9900 would be limited partnership units. Thus, 99% of the “equity” in the partnership is represented by the limited partnership units while 1% of the partnership controls it.

The partnership would be funded with whatever assets the donor desires. Ideally appreciated assets would be used and care must be taken to avoid the investment company rules (as with all family partnerships). The effects on valuation of funding options should be considered as well. For example, if land is used, more different parcels usually create lower values, e.g. a partnership that contains some undeveloped land and rental properties of various types may be discounted more than a partnership that owns only one kind of real estate.
The donor would contribute the 9900 limited partnership units to a charity. A
community foundation is often a good choice because through the foundation the
donor is able to benefit multiple charitable beneficiaries. Private foundations are
not a good choice because of the self-dealing limitations nor are public charities
that are controlled or substantially influenced by the donor.

Section 170 allows the donor to receive and income tax deduction for the
contribution of limited partnership units so long as the contribution is not viewed
as being of a partial interest. That is, in order for an income tax deduction to be
available the partnership must be respected so that the charity is viewed as
receiving partnership units rather than a partial interest in the assets of the
partnership. For that reason, the charity should receive the full benefits of the
units it receives including income distributions and the partnership formalities
should be followed completely. In general, the same considerations as a donor
would follow to minimize or avoid the application of section 2036(a)(1) in the
family limited partnership context are applicable here. The amount of the donor’s
income tax deduction depends on the fair market value of the units which must be
determined by appraisal (Treas. Reg. §1.170A-13).

Most charities do not desire to retain limited partnership interests and thus will
want to sell the units. Experience suggests that the most likely purchasers will be
one or more members of the donor’s family. That may be the children,
grandchildren, or trusts for their benefit. The charity should be willing to sell the
units for their fair market value which is appraised value. The net effect is that
the charity receives appraised value and the children, or other purchasers of the
units, receive the value of the partnership above the appraised value.

C.  Economics of the Basic Transaction.

1.  With Children.

Is the transaction beneficial to the family and to the charity? Stated differently, is
it a good deal? To illustrate, let us begin with a donor with $1,000,000 in cash.
The donor, who has used her gift tax exemption, intends to give $700,000 of that
to charity and $300,000 to her children. Of the $300,000 for the donor’s children,
gift tax of about $86,000 will be owed netting to the children about $214,000.

The $700,000 given to charity will remove $700,000 from the donor’s estate but
will save the donor about $280,000 in income tax (assuming a combined 40%
federal and state rate). If the donor took that $280,000 and paid gift tax of
$80,000 (assuming a 40% tax rate) the donor’s children would receive about
$200,000.

So, the donor’s children would receive $214,000 plus $200,000 for about
$414,000 in this transaction. Charity would have $700,000.
The same transaction with the partnership would have the following results. First, assume that the partnership is funded with $1,000,000 and that the 9900 limited partnership units are valued at $700,000 (approximately a 30% discount). The donor receives a $700,000 income tax deduction upon making the gift to charity which is same as above. If the donor takes the income tax savings and gives them to the children they will net $200,000.

If the children purchase the partnership units from the charity for $700,000 the units would have $990,000 of underlying value. If (when) the donor transfers the 100 general partnership units to the children that value may be unlocked. If it is unlocked, the children will have paid $700,000 for something worth $990,000.

The total benefit to the children is, therefore, $200,000 from the charitable deduction and $290,000 from the unlocking of partnership value for a total of $490,000. The children are ahead by $76,000. Of course, we must still worry about the children’s basis (see section [4]).

2. **With Grandchildren or Trusts for Descendants.**

The transaction becomes more favorable when assets are moved down more than one generation. To illustrate, a donor with $300,000 of cash will pay $86,000 in gift tax and $61,000 in generation skipping tax (at the 40% rate, tax exclusive because a direct skip), leaving the children with $153,000. Similarly, the donor who makes a charitable gift of $700,000 and receives an income tax deduction of $280,000 may give only $143,000 to the grandchildren after payment of gift and generation skipping tax. Thus the grandchildren would receive $153,000 + $143,000, which is $296,000.

Recall that the yield of the charitable partnership transaction does not vary regardless of the purchaser of the limited units; if grandchildren or a trust for descendants is the purchaser, the benefit remains at $217,500 net of capital gains tax. The value of income tax deduction to the grandchildren remains $143,000. So the grandchildren receive if the partnership is used a total of $360,500. The increase to the grandchildren from using the partnership is $360,500 - $296,000, which is $64,500. If the donor must sell assets to pay gift tax and generation skipping tax the benefits are likewise substantially increased.

3. **Level of the Discount.**

The examples above have assumed a discount of 30%. Many appraisers are comfortable with that level, even for marketable securities, especially if the partnership contains shares of only one or two companies. Discounts for real estate often range higher.
4. **Enhancement of the Transaction.**

If appreciated assets are used to fund the partnership, the transaction may be enhanced. If the assets are sold while the charity owns the limited units the gain realized by the partnership would be reported to the charity and thus escape income tax. A partner who contributes assets to a partnership must recognize gain from the sale of the assets within two years; however, that rule causes the owner of the limited units to be taxed, in effect, rather than the donor/contributor. Presumably the IRS could attempt to recharacterize the transaction; any such attempt would appear to be minimized, if not eliminated, by having the donor give or sell the general units to the children prior to the time the assets are sold.

In almost every situation the assets inside the partnership should be sold while the charity is the substantial partner. Otherwise, the donee’s lack of basis tends to reduce the overall tax benefits.

5. **Role of the Charity.**

The charity’s role is that of an independent charity looking out for its own best interest. To that end, it will require an appraisal, at a minimum, before selling the limited partnership units. The appraisal may be the same as the donor’s appraisal, although the better practice would be to have an independent review. In addition, the charity may have other procedures it follows, such as review of acceptance and disposition of partnership units by special committees; requirements that it be indemnified against liability and unrelated business income tax before it accepts the units; and “shopping” the units to potentially interested purchasers (e.g. “advertising” the availability of units to the financial community through private communications, notification to the charity’s board, etc.).

Charities are required to disclose the disposition of contributed nonmarketable assets sold within three years of receipt by filing a Form 8282 (Donee Information Return) within 125 days after the disposition. In many instances charities have as policy the retention of nonmarketable assets during the three year period. If the partnership units are to be retained, then another appraisal will be required at the time of the sale and should be procured by the charity.

An independent charity is best to ensure that the IRS does not conclude that the sale of the units was conducted in other than an arms-length manner. Although private foundations should not be used for this purpose – because of concerns about self-dealing arising not only from the sale of the units but also from the acquisition and retention of the units – supporting organizations may be. Special care should be taken to ensure that all decisions about the retention and sale of the units are made by persons other than the donor or the donor’s family.
6. **Poor Children.**

A common concern about the charitable partnership is that the children do not have sufficient assets to purchase the limited partnership units. Generally it is a concern raised by the charity. Experience suggests that it is not a concern in most family situations. The reason would appear to be that most persons who are ready to contribute significant amounts to charity have already given significant amounts to their descendants or at least in trust for their descendants. However, if that is not the case, or if the costs of generating the funds is prohibitive – e.g. the basis of the purchaser in the assets to be sold to raise cash to purchase the units is zero or very low – then a variation may be used.

The partnership may sell the assets it owns and generate cash. With that cash it may redeem partnership units from the charity, at the appropriately discounted value, thereby, indirectly, increasing the value of the remaining units. To illustrate, suppose donor creates a partnership with 100 general partnership units and 9900 limited partnership units and gives the 100 general partnership units to a trust for the benefit of the donor’s descendants (value is 1% of the amount in the partnership; a $1,000,000 partnership produces a $10,000 gift). The trustee, as general partner, orders all of the assets of the partnership to be sold and then negotiates a redemption of the charity’s units at appraised value. If the charity’s 9900 limited units are redeemed for $700,000 the partnership has only 100 general partnership units remaining and owns $300,000 in assets. As before, gain will be triggered if the partnership is liquidated. In many instances it may be desirable to retain the form of a general partnership interest in which case a few limited units may be given to the trust or to the donor’s descendants.

Transactions structured in this manner have been advocated across the country by a number of different entities and planners. In certain versions the redemption occurs at deeply discounted values, supported, in some instances, by giving the charity the rights to put the units to the partnership for specified amounts. To illustrate, the partnership might provide for a 50 year term during the first year of which the charity would have the right to put the units for 2% of the partnership’s book value, during the second year for 4%, and so forth. Planners will need to evaluate such arrangements carefully.

**XI. REMAINDER INTEREST IN PERSONAL RESIDENCE OR FARM.**

In many cases the donor’s personal residence will be the only real estate that she owns. As long as the donor wishes to continue to occupy the residence, an outright gift is not possible. Even if the residence is about to be sold, an outright gift may not be prompted by tax planning considerations because, in many cases, the donor can avoid the taxation of any gain. The Taxpayer Relief Act of 1997 provides for the exclusion of gain realized on the sale of a principal residence after May 6, 1997 of up to $250,000 ($500,000 for
married taxpayers filing a joint return). \(^1\) Under prior law, a homeowner could defer the recognition of gain on sale by rolling over the proceeds of sale into a new principal residence. \(^2\) In addition, homeowners aged 55 or older were entitled to a one-time exclusion of up to $125,000 of gain realized on the sale of a principal residence.

The partial-interest rules, however, contain a special exception that makes gifts of personal residences attractive. Under this exception, the donor can give a personal residence (or a farm) to charity and retain the right to live in the residence for the rest of her lifetime. The donor receives an income tax deduction for the present value of the remainder interest. \(^3\)

### A. What Is a Personal Residence?

The property must be used by the donor as a residence but need not be the donor’s principal residence; a vacation home may be a personal residence. \(^4\) A personal residence includes all the land used in connection with the residence (77+ acres in one instance). \(^5\)

A personal residence includes stock in a cooperative housing corporation or a condominium, provided the donor uses the property as her residence. \(^6\) A yacht, houseboat, or house trailer may be a personal residence provided it contains facilities for cooking, sleeping and sanitation and the donor actually uses it as a residence. \(^7\)

The value of the remainder interest in any furnishings contributed is not deductible because these items do not constitute real property.

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\(^1\) I.R.C. § 121.

\(^2\) Under former I.R.C. § 121 (repealed effective for sales and exchanges after May 6, 1997), a taxpayer could postpone recognizing the gain on the sale of a principal residence by investing the proceeds of sale in a new principal residence within two years of the date on which the old residence was sold. The basis of the new residence was adjusted by reducing it by the amount of the unrecognized gain. Thus the gain was not avoided, but was deferred until such time as the taxpayer sold the residence without reinvesting the proceeds in a new residence.

\(^3\) I.R.C. §§ 170(f)(3)(B)(i), 2055(e)(2) and 2522(c)(2). See e.g., PLRs 8711038, 9538040.

\(^4\) Treas. Reg. § 1.170A-7(b)(3); Rev. Rul. 75-420, 1975-2 C.B. 78.

\(^5\) See, e.g., PLR 8202137 (donation of remainder interest in 77.33 acres of a 173.78-acre property held to be deductible).

\(^6\) Treas. Reg. § 1.170A-7(b)(3).

\(^7\) See PLR 8015017 (yacht qualified as principal residence for purposes of IRC § 1034); Treas. Reg. § 1.1034-1(c)(3)(i) (houseboat or house trailer qualifies as principal residence for purposes of IRC § 1034).
B. **What Is a Farm?**

A farm is land and buildings used by the donor or the donor’s tenant for the production of crops, fruits, agricultural products or sustenance of livestock; it includes the farmhouse and other improvements such as barns, sheds and corrals.\(^8\)

A farm may include acreage with or without the farmhouse. Thus, in the case of a farm, a donor may convey a remainder interest in separate parcels at different times, e.g., a gift of remainder interests in Parcel A consisting of 10 acres of the farm in 1996, Parcel B consisting of 25 acres of the farm in 1997, and Parcel C consisting of five acres of the farm and the farmhouse in 1998.\(^9\)

C. **Term of Reserved Interest.**

The gift must be an irrevocable remainder interest (not in trust) that follows a life estate in the donor and/or another, or which follows an interest for a term of years.\(^10\)

D. **Gift of a Remainder Interest in the Proceeds of Sale.**

The IRS originally took the position that the gift of a remainder interest must be an interest in the property itself; it may not consist of the right to the proceeds of sale of the property.\(^11\) The Tax Court, however, has held that a remainder interest in the proceeds from the sale of a residence will qualify for the charitable deduction, and the Service has conceded that, if local law gives a charity the option of taking the property itself despite the terms of the gift, the gift of a remainder interest in the proceeds will be treated as a deductible gift of the residence.\(^12\)

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\(^8\) Treas. Reg. § 1.170A-7(b)(4).


\(^11\) See Rev. Rul. 77-169, 1977-1 C.B. 286 (estate tax deduction disallowed for gift of remainder interest in personal residence where will directed that, on death of life tenant, the residence was to be sold and the proceeds paid to charity); Rev. Rul. 76-543, 1976-2 C.B. 287 (deduction denied where charity received only a portion of sale proceeds).

\(^12\) See *Estate of Blackford v. Comm’r*, 77 T.C. 1246 (1981), acq. in result 1983-2 C.B. 1; Rev. Rul. 83-158, 1983-2 C.B. 159; PLR 8141037. See also Rev. Rul. 84-97, 1984-2 C.B. 196, in which a gift of a remainder interest in a farm was determined to qualify for an estate tax charitable deduction even though the applicable state mortmain statute required the charitable recipient to dispose of the farm within 10 years of acquisition.
E. **Gift of a Portion of the Remainder Interest.**

Similarly, the IRS used to argue that on the expiration of the life estate(s), the charity or charities must receive the entire residence outright and that a deduction was not available for a gift of a fractional interest in the remainder.\(^{13}\) This position was clearly at odds with the principle that a gift of an undivided fractional interest is deductible; in 1987 the Service reversed its position and held that a gift of a 10 percent remainder interest was a deductible interest even though 90 percent of the interest passed to an individual, since the gift was of an undivided fractional interest.\(^{14}\) The ruling suggests that the value of the remainder interest must be reduced to reflect an appropriate valuation discount for the co-tenancy arrangement.\(^{15}\)

F. **Gift of the Remainder Interest Coupled with a Gift of a Partial Present Interest.**

A donor may make a deductible gift of the entire remainder interest, plus a fractional interest in the retained life estate, by giving a charity the right to use the property for a proportional period of each year.\(^{16}\)

G. **Restrictions on Disposition.**

The gift of the remainder interest may not be subject to restrictions as to its disposition\(^{17}\) unless the restrictions are so insubstantial in nature as to have no

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\(^{13}\) See Rev. Rul. 76-544, 1976-2 C.B. 288 (deduction disallowed where, upon termination of life estate, property vested in charity and individual as equal tenants in common). See also PLR 8341009.


\(^{15}\) In PLR 93366002, the IRS ruled, in connection with the valuation of a one-half interest in real property for estate tax purposes, that a discount to reflect dual ownership is generally limited to the estimated cost of a partition of the property.

\(^{16}\) In Rev. Rul. 75-420, 1975-2 C.B. 78, the donor conveyed vacation property (including a house, tennis court, swimming pool, gym, barn and caretaker's cottage) to a neighboring university, reserving the right to use the property from August 1 to September 15 of each year and to store his personal property year round in the home. The university could make no changes to the property without the donor's consent and could not sell its interest in the property until the later of 10 years from the date of the gift or the donor's death. The donor was held to be entitled to deduct the value of the interest contributed; the retained year-round rights were held not to be substantial and the contribution qualified as a deductible gift of an undivided interest and a deductible gift of a remainder interest in the residence.

\(^{17}\) See *Darling v. Comm'r*, 43 T.C. 520 (1965) (in addition to reserving life estate, donors reserved right to determine when and whether the property should be sold as well as terms of (continued…)}
effect on the value of the contributed property. For example, the IRS has taken the position that the deduction will be lost if the life tenant can compel a charity to join in a sale of the property and divide the proceeds. The rationale for this position is highly questionable, for in such a case the charity would presumably receive value equivalent to the value of the donor’s charitable deduction, and it is hard to see what purpose is gained by forcing the life tenant to continue the life estate. The position of the IRS seems to be based on the premise that the donor’s reserved right to force the sale of the property makes it impossible to value the remainder interest, a premise that does not make much sense. Thus, as long as the donor cannot compel a charity to do so, it should be permissible for the life tenant and the charity, as an independent matter, after the gift has been made, to agree to sell jointly and to divide the proceeds in proportion to the value of their respective interests.

H. **Bargain Sale of Remainder Interest.**

The donor may sell the remainder interest to a charity for less than its value, in which case the bargain-sale rules will apply, and the donor will be entitled to a deduction for the difference between the value of the remainder and the amount paid by the charity. The payment for the remainder may take the form of a gift annuity.

I. **Valuation.**

The calculation of the deduction for the gift of the remainder interest begins with the fair market value of the property at the time the remainder interest is given. If the deduction claimed exceeds $5,000, then, as discussed above in Chapter 4, the donor must obtain a qualified appraisal to substantiate the income tax deduction.

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19 See Rev. Rul. 77-305, 1977-2 C.B. 72 (no deduction allowable for gift of remainder interest in residence where donors required charity to join in sale and receive cash for its interest if donors decided to sell residence). Cf. PLR 9436039 (transfer of a remainder interest was a valid gift despite various restrictions on the disposition of the residence, because the acts which could cause the gift to be revoked were not dependent on any act of the donors).
20 See PLR 8134106. If the life tenant wishes to avoid the realization of gain on the sale of the life interest, it appears that this could be accomplished by conveying the life interest in the property to an income-only unitrust which can then sell the life interest without paying a tax on the gain.
21 See PLRs 8120089, 8305060 and 8806042.
The $5,000 threshold is based on the value of the remainder interest rather than the value of the property itself.\textsuperscript{22}

Once the fair market value of the property has been established by an appraisal, the present value of the remainder interest is calculated by discounting the fair market value to reflect the term of the life estate at the interest rate in effect when the gift is made. Section 7520 of the Internal Revenue Code requires that, for purposes of valuing all forms of remainder interests, the Treasury Department must issue monthly tables using a rate that represents 120 percent of the “applicable mid-term federal rate” under IRC § 1274(d)(1). That rate is based on the interest rates paid on medium term (three to nine years) government securities. The donor may choose the discount rate in effect for the month in which the gift is made or for either of the two preceding months.

The low interest rate environment of recent years has had a dramatic impact at times on donors making a charitable gift. While a donor giving to a charitable remainder unitrust or charitable lead unitrust, the value of which moves up and down with the value of the underlying trust assets, will experience little or no impact on the deduction for a charitable gift due to changes in the federal rate, certain other charitable gifts have been dramatically affected. In particular, the deduction generated by the value of a gift of a remainder interest in a personal residence is substantially enhanced as the Section 7520 rate drops. A simple example will illustrate. Assume a donor, age 65, owns a personal residence worth $500,000 (the “net depreciable” portion of which is $333,333). The donor gives a remainder interest in the residence to charity, retaining use of the property for her remaining lifetime. If the Section 7520 rate is 8.2 percent (March, 2000) the charitable deduction for this gift is $141,823; if instead the Section 7520 rate is 3 percent (January, 2010), the deduction is $258,988, or almost 83 percent more than at the higher interest rate.

When valuing a remainder interest in depreciable real estate for income tax purposes, the remainder interest also must be discounted to reflect straight-line depreciation.\textsuperscript{23} The computation with respect to the depreciable portion uses a special method. Depreciation need not be taken into account for gift or estate tax purposes.\textsuperscript{24}

\textsuperscript{22} Treas. Reg. § 1.170A-13(c) states: "The amount claimed or reported . . . for an item of property is the aggregate amount claimed or reported as a deduction . . . for such items of property and all similar items of property . . . by the same donor for the same taxable year . . . ."

\textsuperscript{23} I.R.C. § 170(f)(4).

\textsuperscript{24} See Rev. Rul. 76-473, 1976-2 C.B. 306 (gift tax deduction for gift of remainder interest in personal residence is calculated without taking depreciation into account; hence, gift tax deduction will be higher than the income tax deduction).
J. Avoiding Unnecessary Gift Tax.

If, in addition to reserving a personal life estate, the donor wishes to permit another person to use the property after the donor’s death for the surviving person’s lifetime, the gift of the successor life estate represents a gift of a future interest that does not qualify for the $14,000 annual gift tax exclusion. Moreover, if the successor life estate is given to the donor’s spouse, it does not qualify for the marital deduction because it is not a present interest. The donor can avoid making a taxable gift of a future interest by reserving the right (to be exercised in the donor’s will) to revoke the successor life estate. For gift tax purposes, this renders the gift of the successor life estate incomplete until the donor’s death, at which time it will be taxable as a part of the donor’s estate.

K. Impact of Mortgages.

A gift of property subject to a mortgage is treated as though the property were sold to charity for the amount of the outstanding mortgage. While the donor ought to be able to avoid the bargain-sale rules by agreeing to hold the charity harmless, the value of the property will be reduced by the amount of the mortgage for purposes of computing the deduction. Although most residences are subject to a mortgage, there is a curious dearth of authority dealing with a gift of a remainder interest in a mortgaged residence. Thus the law is, at best, unclear. There are at least three potential analyses:

1. Ignore the Life Estate.

If a donor gives a charity a remainder interest in a residence that is subject to a mortgage, the transaction might be taxed as though the donor had sold the property to the charity for the full amount of the indebtedness and the deduction might be reduced by that amount, ignoring the fact that the donor had reserved a life estate. It seems that this result would be in conflict with the economic reality of the transaction. The donor will continue to live in the residence and will make the mortgage payments during the balance of her lifetime. The gift of the remainder interest does not relieve the donor of any liability for the mortgage payments that fall due during the donor’s life expectancy.

I.R.C. § 2503(b).

I.R.C. § 2523(f); the spouse does not receive the interest "for life" because it does not take effect until the donor’s death.

This may be due to the fact that donors of remainder interests have reached a stage in life where they have paid off the mortgage; but it may also reflect the fact that the issue is very complicated.
2. **Apportion the Mortgage Between the Life Estate and the Remainder.**

An alternative approach might be to apportion the mortgage between the life estate and the remainder on the basis of the fair market value of each. In this approach the donor would be deemed to have sold the property to charity for an amount equal to that portion of the mortgage equivalent to the ratio of the value of the remainder interest to the fair market value of the property. While this approach is more rational, it assumes, in effect, that the mortgage is a permanent liability and does not reflect the fact that the mortgage may, in fact, be paid off by the time the remainder interest passes to the charity.

3. **Take the Life Estate Fully into Account.**

It would seem that the most rational solution is to compare the length of the retained life estate with the remaining period of the mortgage. If the life estate is longer than the mortgage payment period so that the mortgage should be paid off in full before the remainder interest falls in, the transaction ought not to be treated as a bargain sale. As long as the donor agrees to hold the charity harmless against any liability on the mortgage, the donor ought to be entitled to a full deduction for the value of the remainder interest. In this situation, the obligation to make the mortgage payments is, in effect, similar to the donor's obligation to maintain the property during the life term.

If, on the other hand, the mortgage period extends beyond the donor's life expectancy, the gift of the remainder interest is technically subject to a liability, for if the donor dies “on schedule” the remainder interest passing to the charity will be subject to an unpaid liability. In this situation, the donor ought to be able to avoid the impact of the bargain-sale rules by agreeing to hold the charity harmless with respect to any liability arising under the mortgage. However, since the remainder interest is potentially subject to the liability for the principal portion of the mortgage payments that will fall due after the death of the donor, the donor's deduction probably ought to be reduced by the amount of that liability. As in the case of an outright gift, the donor's agreement to hold the charity harmless against the liability is, in effect, a non-deductible pledge.

L. **Other Factors: Repairs, Insurance, Taxes, Improvements.**

Other factors to consider when making a gift of a remainder interest in real estate include arrangements for maintenance, insurance, repairs and improvements. Under state laws the life tenant is responsible for maintaining the property and for paying all current operating costs (utilities, taxes, etc.). To protect the value of the property, it is advisable for the donor to agree to keep the property insured with a policy that identifies the remainder interest of the charity. The tax clause in the donor's will should be reviewed and, if necessary, revised to ensure that the property is not subjected to death taxes.
If the donor makes a capital improvement (as opposed to a repair) that increases the value of the property, the donor should be entitled to a further deduction based on the increased value of the property (which will not necessarily be measured by the cost of the improvement). The increase in value should be determined by an appraisal that compares the value of the property before and after the improvement. If the increase in value is greater than the cost of the improvement, the amount of the deduction should arguably be limited to cost on the theory that the donor has not “held” the improvements for the requisite long-term holding period. However, since the improvements become a part of the basic property, which if sold, would not produce any short-term capital gain, there should be a strong case for the proposition that the reduction rule of Section 170(e)(1) ought not to apply. Once the appropriate value of the improvement has been determined, the deductible portion is determined by applying the appropriate remainder and depreciation factors for the donor's age at the time the improvement is made.

M. **Form of the Gift.**

A simple deed of the property to charity reserving a life estate in the donor is sufficient; it is normally good practice to cover the responsibilities for taxes, repairs and expenses in a separate-letter agreement. Since local practices for recording and perfecting title to property vary widely, a donor should consult local counsel who is knowledgeable about the local conveyance requirements.

XII. **CHARITABLE GIFT ANNUITIES.**

A. **Introduction.**

A charitable gift annuity (“CGA”) is a vehicle that enables a taxpayer to make a gift with appreciated assets that qualifies in part for the charitable contribution deduction, retain an interest in the assets transferred, avoid immediately generating a taxable capital gain (and therefore adjusted gross income (“AGI”) and net investment income (“NII”)), and stretch out the taxation of the gain and NII over an extended period. As a consequence, it can be used to avoid, minimize or defer the 3.8% Medicare tax on NII under new IRC § 1411, enacted by Section 1402(a)(1) of the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, (the “section 1411 tax”), while enabling the taxpayer to reduce taxable income due to the permitted income tax deduction for the charitable component of the gift.

Although it functions in much the same fashion as a charitable remainder trust or pooled income fund, a CGA is not technically a deferred gift, or a gift that represents an exception to the partial interest rule. Instead, it is a type of bargain sale transaction in which the taxpayer transfers cash or other assets to a charitable organization in return for

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28 In PLR 9329017, in connection with the gift of a remainder interest in real property, the Service held that the remainder interest in any improvements made to the real estate by the donor would be charitable contributions, but did not state how to value such contributions.
the charity’s promise, backed by its general assets, to make annuity payments to one or more individuals for their lifetimes.\textsuperscript{29} Most charities determine the annuity amount based on rates published by the American Council on Gift Annuities. These rates in turn are based on the number and age of the annuitants and certain expectations with respect to expenses and the rate of return earned by the institution’s assets (or dedicated charitable gift annuity reserve fund) and are designed to produce an average residuum or gift to the organization at the expiration of the agreement of approximately 50 percent of the amount originally donated (based on present values as of the time of the gift). As a consequence, the rates are lower than, and are not in competition with, commercially offered annuity rates.

From a donor’s standpoint, gift annuities are desirable for their simplicity and security. A gift annuity contract is a short document; there is no complex trust instrument underpinning the arrangement. Furthermore, the gift annuity is a direct obligation of the charity and is paid from the charity's general funds; the payments are not generated by and dependent upon the limited assets of a trust. From the charity's perspective, a gift annuity is attractive because it can be established at minimal cost, which permits the charity to offer it to a wider group of donors. Furthermore, assets contributed by a donor for a gift annuity can be used by the charity immediately – the charity does not have to wait for the annuitant to die before it can access the funds.\textsuperscript{30}

Because a gift annuity is a bargain sale, it may offer donors more flexibility than that available with a charitable remainder trust or pooled income fund. For example, a gift annuity is often the preferred method for “retaining” an income interest where the donor is seeking a deduction based on fair market value for a gift of tangible personal property that the charity will use in carrying out its exempt function. Because no income interest is reserved, the special rule governing a retained interest in tangible personal property is not applicable.\textsuperscript{31} Similarly, gift annuities are not subject to the prohibition on unrelated business taxable income (“UBTI”) that applies to charitable remainder trusts; as such, gift annuities may be funded with assets that are inappropriate for charitable remainder trusts, such as limited-partnership interests or S corporation stock.

Finally, a gift annuity also may be preferable if the donor wants to “retain” an interest in closely held stock that will be redeemed by the issuer or, for lack of another potential purchaser, by the donor. Because no trust is involved, the self-dealing and other private

\textsuperscript{29} Unless CGAs meet certain requirements, the obligation of the charity to pay the annuity is considered acquisition indebtedness and will give rise to UBTI that is taxable to the charity. IRC § 514(c)(5). In addition, CGAs must meet these same requirements if their issuance is not to constitute the business of providing commercial type insurance, which can cause an organization to lose its tax exemption. IRC § 501(m). CGAs are also subject to state regulation.

\textsuperscript{30} In some states, insurance regulations may require the charity to hold a portion of the funds as a reserve fund.

\textsuperscript{31} I.R.C. § 170(a)(3).
foundation rules do not apply to the gift annuity, permitting added flexibility in the sale or redemption of the stock.

B. Income Tax Consequences.

The taxation of the annuity payments made back to the taxpayer or other individual annuitant is determined under the principles of IRC § 72. A portion of each annuity payment during the annuitant’s life expectancy is excluded from gross income as a tax-free return of principal; the balance in the case of a cash funded annuity is ordinary income. Contrast this with the worst-in, first-out tiering system applicable to the taxation of annuity and unitrust distributions from a charitable remainder trust under IRC § 664(b). To determine the excluded amount in the case of a one-life annuity, the amount of the annual payment is multiplied by an exclusion ratio, the numerator of which is the investment in the contract (that is, the non-charitable component of the gross transfer to the charity) and the denominator of which is the expected return (that is, the annual payment multiplied by the annuitant’s life expectancy and adjusted for timing and frequency of payment). The portion of each annuity payment excludable from gross income cannot exceed the unrecovered investment in the contract. This means that, once the annuitant’s life expectancy is reached (and the investment in the contract has been fully recovered), the entire amount of the annuity becomes includable in gross income.

If the taxpayer transfers appreciated property rather than cash in exchange for a CGA, the bargain sale rules under Treas. Reg. § 1.1011-2(a)(4) also apply. Ordinarily the taxpayer will realize capital gain income, taxable to the taxpayer (regardless of the identity of the actual annuitant) at the time of the transfer as either long-term or short-term capital gain, depending on the nature of the property transferred and the taxpayer’s holding period of

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32 I.R.C. §§ 4941, 4945 and 4947(a)(2).
33 Treas. Reg. §§ 1.72-4 and 1.72-5(a).
34 IRC § 72(b)(2). It should be noted there is a silver lining to the current low section 7520 interest rate cloud. While low interest rates reduce the taxpayer’s immediate income tax deduction when funding a CGA (all other things being equal), they correspondingly boost the taxpayer’s investment in the contract. As a result, a larger amount of each annuity payment is treated as tax-free return of principal and a smaller amount is taxed as ordinary income.
35 If the annuitant dies prior to the expiration of her life expectancy and has unrecovered investment in her one-life annuity contract, the annuitant is, however, entitled to deduct the amount of the unrecovered investment on her final income tax return. IRC § 72(b)(3). This deduction is not a charitable gift and is not subject to the percentage and other limitations on charitable gifts imposed by IRC § 170. The net effect of this rule is to ensure that the entire investment in the contract (but no more) will be recovered tax-free regardless of how long the annuitant lives.
the property transferred. However, if the taxpayer is the only annuitant or is the first of two named annuitants and the CGA is non-assignable, the gain is reportable ratably over the taxpayer’s life expectancy. This means that a portion of each annuity payment otherwise excludable as a return of principal is taxable as capital gain; said another way, each annuity payment now has three elements – tax-free return of principal, capital gain income and ordinary income.

The donor of a gift annuity is entitled to an income tax charitable deduction equal to the difference between the value of the property contributed to the charity and the present value of the annuity. The valuation of an annuity is dependent on the following factors: the life expectancy of the annuitant or annuitants; the frequency (monthly, quarterly, semi-annually or annually) and timing (beginning or end of installment period) of the annuity payments; and the interest rate used to discount the value of the annuity payments to be received in the future. Prior to May 1, 1989, the tables used by the IRS to make such valuations used actuarial tables that were somewhat out of date and assumed a fixed discount rate of 10 percent. The Technical and Miscellaneous Revenue Act of 1988 added a new Section 7520 to the Internal Revenue Code that sets the interest rate (rounded to the nearest fifth of a percentage point) at 120 percent of the “federal mid-term

36 Accordingly, if the taxpayer transfers long-term capital gain property in return for an annuity to be paid to the taxpayer’s daughter, the taxpayer must pay a tax on the capital gain as determined under the bargain-sale rules in the year in which the initial transfer is made. The taxable gain equals the investment in the contract reduced by that portion of the taxpayer’s cost basis in the assets transferred that is allocable to the investment in the contract.

37 An annuity is considered to be non-assignable even though the taxpayer retains the right to revoke a successor annuitant’s interest and even though the taxpayer may release her right to future annuity payments in favor of the donee charity. Treas. Reg. §1.1011-2(a)(4)(ii). If the taxpayer dies before the expiration of her life expectancy, and there is no successor annuitant, the remaining gain is neither taxed on the taxpayer’s final income tax return nor taxed as income in respect of a decedent to the taxpayer’s estate.

38 IRC § 1011(b); Treas. Reg. § 1.1011-2(a)(4).


40 Before 1984, the value of the annuity was determined using special IRS tables that valued the annuity in terms of what the donor would have to pay for a comparable annuity in the marketplace. This approach produced a significantly lower charitable deduction than did the tables used for charitable remainder trusts and pooled income funds, because those tables valued the donor’s benefit in terms of the present value of the annuity payments to be received by the donor. Rev. Rul. 72-438, 1972-2 C.B. 38. Since 1984, however, gift annuities have been valued on the same basis as charitable remainder annuity trusts and thus are now on a par with those trusts, at least so far as the income tax deduction is concerned. Rev. Rul. 84-162, 1984-2 C.B. 200.

rate," which changes monthly; that section also directed the Internal Revenue Service to establish new mortality tables to take account of the most recent mortality experience available and to revise those mortality tables at least once every 10 years.\textsuperscript{43}

The Section 7520 discount rate has, since its introduction, ranged from a high of 11.6 percent to a low of 1.0 percent, and the monthly swings sometimes have been quite significant. Annuity valuations are particularly sensitive to changes in the interest rate; the higher the interest rate, the lower the value of the annuity and, in the context of a gift annuity, the higher the deduction.\textsuperscript{44} For example, at a 7.8 percent discount rate, the value of a $780 annuity (paid in quarterly installments of $195) for a donor age 70 is $6,041 but at a 3.4 percent discount rate, the value of a 7.8 percent annuity paid quarterly is $8,164. If the donor funded the annuity with a gift of $10,000, the deductible gift portion is $3,959 at a 7.8 percent rate, and $1,836 at a 3.4 percent rate.

In order to cushion the impact of the monthly changes to the discount rates on charitable transfers, the Internal Revenue Code provides a special rule that permits a donor who makes a transfer of property with respect to which a charitable income, estate, or gift tax deduction is allowable in whole or in part to elect to use the applicable rate for the month in which the transfer is made, or either of the two months preceding the month of the transfer.\textsuperscript{45} Since the applicable rate for any particular month is normally published on or about the 20th day of the preceding month, a donor making a gift near the end of any month can, in effect, select among four potential rates simply by deferring the gift until the following month. However, for a gift being made in December, the donor is, from a practical standpoint, limited to a choice of three rates, since deferral of the gift until the following month will defer the deduction for a year.

New mortality tables effective for gifts after May 1, 2009 were issued in May 2009.\textsuperscript{46} The generally longer life expectancies in the current tables have had the effect of increasing the value of the annuity and thus decreasing the deductible value of the gift.\textsuperscript{47}

\textsuperscript{42} That rate is defined by I.R.C. § 1274(d)(1) as the average market yield on obligations of the United States that have a maturity over three years and less than nine years. The rate is set monthly.

\textsuperscript{43} I.R.C. § 7520(c)(3). Life expectancies are set forth in actuarial tables published by the IRS (Publication 1457, Table S).

\textsuperscript{44} The reason for this is that the valuation of an annuity involves discounting a series of future cash flows. The higher the discount rate, the lower will be the present value of each of the future cash flows; the lower the value of the annuity, the higher the value of the deduction.

\textsuperscript{45} I.R.C. § 7520(a).

\textsuperscript{46} Treas. Reg. §§1.7520-1, 20.7520-1 are applicable to valuation of annuities, unitrust interests, life interests and other remainder interests prior to May 1, 2009. Treas. Reg. §§ 1.7520-1T, 20.7520-1T are applicable on or after May 1, 2009. For gifts made after April 30, 2009 and before July 1, 2009, the donor was able to choose the more favorable mortality rate.

\textsuperscript{47} While there was a general increase in life expectancies in the new tables, life expectancy for individuals age 102 and older actually decreased. The result of this decrease is that donors (continued…)}
For example, at a 5 percent discount rate, a $590 annuity for a 70-year-old person had a value of $5,390 under the pre-2009 tables; under the current tables, that same annuity has a value of $5,498. If the annuity was funded with a gift of $10,000, the deductible value under the old tables was $4,610, and under the new tables is $4,502.

For purposes of the section 1411 tax, the ordinary income and any capital gain component of the annuity are treated as NII; the tax-free return of principal is not. However, the NII components are spread out over the taxpayer’s life expectancy, not bunched into one taxable year. Thus, depending on the taxpayer annuitant’s overall level of AGI and NII over the remainder of her life, a CGA purchased with appreciated property could eliminate or reduce the section 1411 tax, or at the very least defer the tax, which would otherwise have been paid had the taxpayer sold the property herself.

C. Gift Tax Consequences.

If annuity payments are to be made to anyone other than the donor, and if the donor has no power to revoke such payments, the creation of the annuity is a taxable gift from the donor to the annuitant, and a gift tax will be imposed on the value of the annuity.

Assuming the annuity payments begin immediately (or at least within the year of the transfer), the interest of the primary annuitant is a “present interest” that qualifies for the gift tax annual exclusion ($14,000 in 2013).48 If the donor is married and the spouse consents,49 the spouse’s annual exclusion may be used to enable the donor to give a total of $28,000 per year (as of 2013) to each individual beneficiary.50 The interest of the secondary annuitant (i.e., the annuitant who will receive annuity payments on the death of the primary annuitant), if any, is a future interest that does not qualify for the $14,000 exclusion. If the donor is the primary annuitant, a present gift of a future interest to the secondary annuitant can be avoided by having the donor reserve the right to revoke the interest of the secondary annuitant; if the donor dies without having revoked the annuity, the transfer to the secondary annuitant becomes effective on the death of the donor, at which time, as discussed below, the transfer will be taxable as a part of the donor’s estate.

If the annuity is a deferred annuity (i.e., payments commence at a date more than one year from the date of gift), the annuity interest is a future interest that, if given to another

(…continued)

who are age 84 or older now receive a larger deduction for establishing a gift annuity than they would have under the old mortality tables.


49 The spouse would consent on the gift tax return (Form 709) filed for the year the gift was made.

50 I.R.C. § 2513.
person, will not qualify for the present-interest gift tax exclusion. Again, however, the donor can avoid a present gift by reserving the right to revoke the annuity until the earlier of (i) the annuity starting date or (ii) the donor’s death. This approach will defer the taxable transfer until that date, at which time the annuity will have a significantly greater value to be taxed. It may, therefore, be advantageous not to reserve the power to revoke in order to obtain the advantage of the significant discount given to the future interest. If the annuity interest is given to the donor’s spouse, and if the spouse is the only annuitant, the annuity will qualify for the marital deduction. If there are other annuitants, however, whose interests precede or follow the spouse’s interest, the marital deduction may not be available for the spouse’s interest.\footnote{See I.R.C. § 2523(f)(6). This section was added to the Code in 1988, and it automatically treats a spouse’s interest in a joint and survivor annuity as a QTIP interest unless the donor elects out of such treatment. The Revenue Reconciliation Act of 1990 included a provision extending the marital deduction for gifts of joint and survivor annuities to alien spouses. See I.R.C. § 2523(i). At the donor spouse’s death, the qualified domestic trust (“QDOT”) requirements of (continued…)}

If the annuity interest is given to the donor’s spouse, and if the spouse is the only annuitant, the annuity will qualify for the marital deduction. If there are other annuitants, however, whose interests precede or follow the spouse’s interest, the marital deduction may not be available for the spouse’s interest.\footnote{Treas. Reg. § 25.2523(b)-1(c) states that an annuity providing payments to the donor for life and then to the donor’s spouse, if the spouse survives the donor, is a terminable interest not qualifying for the marital deduction since the spouse may not survive the donor. However, if the spouse is the only annuitant (so that the spouse’s interest is vested at the date of the gift and no annuitant has an interest following the interest of the spouse) the annuity is not a "terminable interest" and qualifies for the marital deduction. See Rev. Rul. 79-420, 1979-2 C.B. 335; Rev. Rul. 77-404, 1977-2 C.B. 333. The theory here is that the interest transferred is the annuity itself rather than an interest in the property. However, if there is an annuity interest which follows that of the spouse, the spouse’s annuity interest will be treated as a terminable interest that fails to qualify for the marital deduction. \textit{Estate of Rubin v. Comm’r}, 57 T.C. 817 (1972), \textit{aff’d}, 478 F.2d 1399 (3d Cir. 1973); \textit{Sutton v. Comm’r}, 32 T.C.M. 982, \textit{aff’d}, 535 F.2d 254 (4th Cir. 1974). Similarly, if a transfer were to an annuity trust, the annuity interest in the trust would be treated as a terminable interest on the theory that the interest transferred is the property contributed to the trust, with respect to which the annuity is a terminable interest. See \textit{Estate of Leach v. Comm’r}, 82 T.C. 952 (1984). However, an automatic marital deduction for both estate and gift tax purposes is available for the spouse’s interest in a charitable remainder annuity trust, provided the donor and the spouse are the only non-charitable beneficiaries of the trust. I.R.C. §§ 2056(b)(8) and 2523(g).} The traditional joint and survivor annuity
provides for payments to be made jointly to the husband and wife during their lifetimes and then all to the survivor. The donor spouse must file a gift tax return acknowledging the transfer. It is unclear whether an annuity that provides payments to the donor as primary annuitant and to the spouse as secondary annuitant will also qualify as a joint and survivor annuity. If the annuity is so structured, however, any problem with the marital deduction can be avoided by having the donor reserve the right to revoke the interest of the spouse. In this case, the annuity for the spouse will not vest until the death of the donor, at which point it will qualify for the estate tax marital deduction. Again, the donor spouse must file a gift tax return acknowledging the transfer.

Another instance in which the annuity should be drawn as a joint and survivor annuity is when spouses plan to establish a gift annuity with joint property. The gift will qualify for the gift tax marital deduction as discussed above. As an alternative, in order to avoid any question regarding the marital deduction, each spouse in such a case also may reserve the right to revoke the survivorship interest of the other to the extent of the interest of the contributing spouse in the joint property.

D. Estate Tax Consequences.

If the donor is the sole annuitant, the annuity is extinguished at the donor’s death, and there is nothing to include in the donor’s gross estate for estate tax purposes. However, the value of any successor annuity interest that follows that of the donor’s will be included in the donor’s gross estate, as will any annuity interest that the donor has

I.R.C. § 2056A must be met in order for the estate of the donor spouse to receive an estate tax marital deduction for the value of the donee spouse’s annuity interest. I.R.C. § 2056(d).

The scope of I.R.C. § 2523(f)(6) has not been elaborated in regulations or rulings, and the gift tax regulations do not define a joint and survivor annuity. Although an annuity paying the donor as primary annuitant and the spouse as secondary annuitant is the economic equivalent of the traditional joint and survivor annuity, it is unclear whether altering the structure of the payments is a change material enough to warrant different treatment. The definition of a joint and survivor annuity in I.R.C. § 417(b) (the only Internal Revenue Code section that defines the term) seems to support an argument that such an annuity is a joint and survivor annuity. That Internal Revenue Code section provides that a joint and survivor annuity is an annuity "(1) for the life of the participant with a survivor annuity for the life of the spouse which is not less than 50 percent of (and is not greater than 100 percent of) the amount of the annuity which is payable during the joint lives of the participant and the spouse, and (2) which is the actuarial equivalent of a single annuity for the life of the participant," or "any annuity in a form having the effect of an annuity described in the preceding sentence" (emphasis added). See also Treas. Reg. § 1.401(a)-11(b)(2).

Treas. Reg. § 20.2056(b)-1(g).

I.R.C. § 2039.
reserved the right to revoke. If the surviving spouse is the annuitant, the interest of the spouse will qualify for the estate tax marital deduction as long as the spouse is the only annuitant.

In the case of a two-life annuity where the donor is the initial annuitant and retained a revocation right, the value of the survivor’s annuity will be includable in the donor’s estate. Any estate tax attributable to the annuity will be allowed as an income tax deduction to the successor annuitant (amortized over the annuitant’s life expectancy).

In the case of a two-life annuity funded with joint property, one half of the value of the survivor’s annuity will be includable in the predeceasing donor’s estate.

A gift annuity also may be established by a donor upon her death under the terms of her estate planning documents. In this event, the donor’s estate will be entitled to an estate tax charitable deduction for the difference between the amount transferred to the charity and the value of the annuity to be paid back to the individual annuitant, determined in the same manner as the income and gift tax deductions for lifetime gift annuities. The deduction will only be available, however, if the amount of the annuity is ascertainable, which requires that the annuity starting date be stated clearly together with the amount of the annuity or the method of calculating the annuity. Reference to the ACGA rate in effect at the time of the donor’s death for an annuitant of the same age as the specified beneficiary should adequately satisfy the certainty requirement. If the sole annuitant of

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57 I.R.C. § 2038.
58 In this case, any amount includable in the donor’s estate that is attributable to the charitable gift annuity will qualify for the estate tax marital deduction as QTIP property. A QTIP election is deemed made unless the donor’s executor elects out. I.R.C. § 2056(b)(7)(C). Where the surviving spouse is not a U.S. citizen, the qualified domestic trust requirements of I.R.C. § 2056A must be met in order for the transfer to be eligible for the estate tax marital deduction. I.R.C. § 2056(d). Here, there are two alternative arrangements available to qualify the annuity for the marital deduction. Treas. Reg. § 20.2056A-4(c). Under the first, the surviving spouse must inter alia agree to pay the deferred estate tax due on the corpus portion of each annuity payment as it is received. Treas. Reg. § 20.2056A-4(c)(2). Under the second, the surviving spouse must inter alia agree to transfer the corpus portion of each annuity payment to a QDOT that is established prior to the date that the estate tax return is filed. Treas. Reg. § 20.2056A-4(c)(3).
59 I.R.C. §§ 2038, 2039. If the donor did not retain a revocation right, the value of the survivor’s annuity will still be includable in the donor’s estate, but under I.R.C. § 2039 only.
60 I.R.C. §§ 691(c) and (d). Note that even if the donor revokes the survivor annuity effective as of the donor’s death, the value of the annuity will be includable in the donor’s estate under I.R.C. § 2038, albeit that the donor’s estate should be entitled to an offsetting estate tax charitable deduction.
61 I.R.C. § 2039. If the surviving joint annuitant is the deceased’s spouse, a QTIP election will be deemed to have been made with respect to the value of the interest that is includable in the estate (unless the survivor is not a U.S. citizen, in which case the QDOT rules must be followed).
the testamentary annuity is the decedent’s surviving spouse, the spouse is a U.S. citizen, and the annuity is not deferred, the spouse’s interest automatically will qualify as QTIP property for purposes of the estate tax marital deduction.

E. Generation-Skipping Transfer Tax Consequences.

Generation-skipping transfer (“GST”) tax is only a concern if a skip person – a natural person assigned to a generation that is two or more generations below that of the donor – is named as an annuitant.\(^{62}\) The term includes a donor’s grandchild, unless at the time of the transfer the grandchild’s parent who is a child of the donor is deceased.\(^{63}\) For purposes of the GST tax, an annuity is treated as if it were a trust; accordingly, trust rules determine the incidence of the tax and the method of allocating the GST tax exemption.\(^{64}\)

If the only annuitant is a skip person, the donor’s transfer is a direct skip for GST tax purposes.\(^{65}\) The donor will be liable for any GST tax liability.\(^{66}\) If the donor has an available GST tax exemption, the GST tax can be avoided by allocating the exemption solely to the value of the annuity given to the skip person. The charitable component of the entire transfer will be subtracted out in determining the gift annuity’s inclusion ratio.\(^{67}\)

If a two-life annuity is created and the second annuitant only is a skip person, there is no direct skip at the time of the donor’s transfer. However, the death of the first annuitant will be considered a taxable termination for GST tax purposes.\(^{68}\) In this event, the Internal Revenue Code appears to make the charity, in its functionally equivalent role as trustee, liable to pay any GST tax liability.\(^{69}\) If the first annuitant is not the donor or the donor’s spouse, such liability can be avoided if the donor allocates GST exemption at the time the annuity arrangement is established, albeit that the allocation would have to correspond to the entire value of the two-life annuity (including the initial annuity to the non-skip person) to avoid the tax entirely. For this reason, a donor may prefer to establish two different annuities: an immediate one for the non-skip person and a deferred contract for the skip person. The donor would then need only to allocate GST tax exemption to the second arrangement to avoid the GST tax.

In the case of a two-life annuity, if the first annuitant is the donor (and in some cases the donor’s spouse) GST tax exemption cannot be allocated during the “estate tax inclusion period,” namely, the period during which the donor is receiving annuity payments.\(^{70}\)

\(^{62}\) I.R.C. § 2613(a).
\(^{63}\) I.R.C. § 2651(e).
\(^{64}\) I.R.C. § 2652(b)(3).
\(^{65}\) I.R.C. § 2612(c).
\(^{66}\) I.R.C. § 2603(a)(3).
\(^{67}\) I.R.C. § 2642(a).
\(^{68}\) I.R.C. § 2612(a).
\(^{69}\) I.R.C. §§ 2603(a)(2), 2652(b)(2).
\(^{70}\) I.R.C. § 2642(f).
F. Deferred Gift Annuities.


Most annuities are set up to begin payments within a few months after the initial transfer is made. It is possible, however, and in some cases quite desirable, to defer the payments until a later date. This will significantly increase the charitable deduction (because the present value of the deferred annuity is much less than the present value of an annuity that begins immediately) and enables the annuity to function as a retirement vehicle. In some cases, a deferred gift annuity may function as a substitute for an Individual Retirement Account, the deduction for which was sharply curtailed for high-income taxpayers by the Tax Reform Act of 1986.\footnote{I.R.C. § 219(g).}

Unlike the IRA deduction, the deduction for a gift annuity is not limited to $5,000 per year.\footnote{I.R.C. § 219(b)(5)(A).} Therefore, a donor may set aside considerably more in a gift annuity program than he could in an IRA.

In the case of a deferred annuity, relatively high discount rates work in favor of the donor, for high discount rates have the effect of depressing the present value of the deferred annuity and thus increasing the charitable deduction.

The American Council on Gift Annuities has a recommended method for calculating the payments a charity should offer under a deferred gift annuity.\footnote{For all states except New York and New Jersey that are specifically regulated for this purpose. See www.acga.com.} Effective July 1, 2011, this requires compounding the amount transferred annually from the date of transfer until the annuity starting date at a rate of 4 percent and then multiplying that amount by the immediate gift annuity rate currently in effect for a person who is the same age as the annuitant will be when annuity payments actually begin.

The deferred annuity payments will be taxed to the annuitant in a like manner to that applicable to annuities that are immediately payable. For example, if a deferred annuity is funded with appreciated assets, and if the donor is the sole annuitant, the capital gain will not be reportable until the annuity payments begin.

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\footnote{I.R.C. § 219(g).} \footnote{I.R.C. § 219(b)(5)(A).} For individuals ages 49 and below, the deductible amount was $5,000 in 2008 and subsequent years, $4,000 for 2005 through 2007, and $3,000 for 2002 through 2004. The deductible amount is also subject to income limits to prevent higher income taxpayers from utilizing the IRA; however, a deferred gift annuity is not subject to any income limitation.\footnote{For all states except New York and New Jersey that are specifically regulated for this purpose. See www.acga.com.}
and will then be reported ratably by the donor over his life expectancy as determined at the annuity starting date.

Other tax consequences largely should be the same. Note, however, that a deferred gift annuity will likely be considered a future interest for purposes of the gift tax annual exclusion, meaning that the entire present value of a third party annuitant’s interest in the deferred annuity contract will be a taxable gift.  

Of course, an “income only” or “net income” charitable remainder unitrust also may function as a retirement vehicle by having the trustee invest for growth until retirement of the beneficiary and then switch to income-producing investments. While the unitrust may provide better growth potential than the deferred gift annuity (which is a fixed amount), the deduction for the remainder interest in an income-only charitable remainder unitrust does not reflect the deferral period. The donor’s income tax charitable deduction on funding the trust is the same as if the full unitrust amount were actually paid to the donor from the outset.  

Thus the deduction for a deferred gift annuity will be much higher than that for an income-only charitable remainder unitrust. Furthermore, it generally is not efficient to establish a unitrust for small amounts, and the minimum payout requirements imposed on charitable remainder trusts make them much less flexible planning vehicles than gift annuities.

2. Flexible.

Some practitioners have suggested an enhancement to the deferred gift annuity that would increase its attractiveness as a form of retirement savings coupled with a charitable gift, namely, allowing the donor to retain the right to elect the starting date of the payments from a specified range of dates under the annuity contract.  

Such an election would, presumably, not violate the requirements of IRC § 514(c)(5), since the annuity still would be payable over the lives of either one or two individuals in being at the time of the gift. It is important, however, that the annuity payments be fixed in the annuity contract for any payment starting date that the annuitant might elect. In exchange for this added flexibility, however, the donor would have to accept the lowest possible charitable contribution deduction based on the earliest commencement ages and corresponding annuity amounts. In other words, the donor would have to agree to a minimum possible

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74 But see Treas. Reg. § 25.2503-3 (The term "future interest" has no reference to such contractual rights as exist in a bond, note, or in a policy of life insurance, the obligations of which are to be discharged by payments in the future).

75 I.R.C. § 664(e).

commencement age and a maximum annuity payout and accept whatever the charitable deduction would be under those circumstances.

With a standard deferred gift annuity, the donor could elect a later starting date and a greater charitable deduction. With the flexible gift annuity, the donor could receive a greater annuity payment (for the same contribution) if the donor chose to delay commencement of the payments under the contract, but could not increase his or her charitable contribution deduction. Certain planned giving software allows a donor to choose an optimal start date in an effort to maximize the donor’s charitable deduction. For instance, if a donor wants a 10-year election range but realistically the donor does not anticipate that she will elect to begin annuity payments prior to the fifth anniversary of the contract, the software will assume that the election will occur in year 5. In order for the donor to receive a charitable deduction reflecting a year 5 election, the annuity payments corresponding to a year 1 election date will be reduced to the point where they produce the charitable deduction corresponding to a year 5 start date. If a donor selected this option but later chose to elect annuity payments beginning in year 1, the donor would be entitled only to the more limited annuity payments. The IRS has approved the flexible deferred annuity with an optional starting date and a different annuity amount depending on the length of the period of actual deferral in private letter rulings (which do not bind the IRS with regard to taxpayers other than those who requested the rulings). That ruling does not address the potentially troublesome issue of whether an annuitant who chooses not to begin receiving payments at the earliest possible date would nonetheless have constructive receipt of the annuity payments (and therefore would need to pay tax on those payments) at that time. In 2007, the IRS addressed this issue in a private letter ruling and concluded that, so long as payments are made in accordance with IRC § 72 and its related regulations, no income tax consequences would flow to the annuitant until payments were actually received.

For a somewhat analogous situation, see PLR 9017071, where a deferred gift annuity issued to spouses for their joint lives provided that if one spouse died prior to the payment starting date specified in the annuity contract, the surviving spouse could elect to receive reduced annuity payments commencing prior to the specified starting date. The IRS ruled that the option to receive reduced annuity payments prior to the scheduled commencement date of the payments did not invalidate the charitable contribution deduction.

PLR 200449033 (donor may elect a starting date for any year in a specified eight-year period); PLR 9743054. In such events, the donor’s income tax charitable deduction will be based on the largest possible present value annuity that the donor could choose (which presumably will be the annuity available on the earliest election date for starting payments). The flexibility inherent in such an approach may be particularly attractive to a young donor who is uncertain when she will have future income needs.

PLR 200742010.
G. Gift Tax Issues.

IRC § 2503 provides an annual exclusion from the gift tax for a gift made to any person by the donor during the calendar year. The 2013 inflation adjusted annual exclusion amount is $14,000. The annual exclusion does not, however, apply to gifts of “future interests” in property. The right to receive annuity payments that begin immediately is not a future interest; therefore a gift of an immediate annuity is eligible for an exclusion as a present interest from the gift tax under IRC § 2503, notwithstanding the fact that some of the payments will be made in the future.

In the case of a deferred gift annuity, the situation is not as clear because payments on a deferred annuity do not begin immediately. Treas. Reg. § 25.2503-3 states that the term “future interest” has “no reference to such contractual rights as exist in a bond, note . . . or in a policy of life insurance, the obligations of which are to be discharged by payments in the future.” Since the right to receive an annuity payment is similar to the interest created in an insurance policy, some commentators have concluded that this regulation exempts a deferred gift annuity from being considered a future interest. Although one can make a colorable argument that, as long as there is no intervening interest, the deferred payments do not constitute a future interest, the regulation does not specifically discuss deferred annuities, and other commentators assume that a deferred annuity is a future interest. The authors believe that it is more likely than not that a court would view a deferred annuity as a future interest notwithstanding the obscure language of the regulation. Thus, if a donor wishes to treat a deferred annuity as a present interest, consideration should be given to a request for a ruling from the IRS on the issue.

H. Variable Payment or Stepped Annuities.

In a private letter ruling, the IRS has recognized that a gift annuity may provide for payment of an amount that escalates each year. In that ruling, the amount increased by 5 percent in each succeeding year. Thus, the annuitant could receive growing (or decreasing) annual payments rather than a fixed annual payment for life under the more typical annuity arrangement. Although private letter rulings cannot be used as precedent, the approach of the ruling is clearly correct. The valuation process for an annuity involves a rather straightforward discounting of a stream of future payments, and as long as the amount and timing of each payment is known in advance, it can be discounted and there is, therefore, no reason why all of the payments have to be in the same amount. The charitable deduction is calculated by valuing each “step” in the payment schedule, adding these amounts together and subtracting this figure from the amount of the gift.

81 See PLR 8322068. In contrast, I.R.C. § 664 does not permit a stepped-annuity arrangement in a charitable remainder annuity trust.
For instance, assume a donor, age 65, contributed $10,000 in July, 2009 to fund a stepped gift annuity. Under the contract, the charity agrees to pay the donor a 5.3 percent annuity during years one through five, and a 6.3 percent annuity for the remainder of the donor's life. The value of a 5.3 percent annuity is $6,687. The value of a 1.0 percent five-year deferred annuity is $812 for a total of $7,499. The donor's charitable deduction for this gift was therefore $2,501. Note, however, that a gift annuity cannot be dependent on the income of the property contributed without running afoul of the unrelated business income rules. The payment schedule must be determined at the outset.

The stepped annuity can be a favorable arrangement for a donor who wants the security of a fixed payment and would like to receive a growing income stream. For a donor who can tolerate market risk, however, a charitable remainder unitrust may be more appealing, as there is no constraint on potential payment growth.

I. Other Applications of Gift Annuities.

Traditionally, gift annuities have been viewed as an option for smaller planned gifts, with most such arrangements funded with less than $50,000, an amount well below that needed to justify a charitable remainder trust. Charitable remainder trusts typically are the first choice vehicle for larger gifts, although the myriad rules applicable to charitable remainder trusts often thwart charitable planning with certain types of assets. In these situations, regardless of the amount involved, a gift annuity may be a viable alternative.

1. Tangible Personal Property.

There is no prohibition on funding a charitable remainder trust with tangible personal property, such as artwork. Two special rules limit, however, the availability of a charitable income tax deduction to the donor on account of funding the trust with such property. These rules do not necessarily apply where the gift is used to establish a gift annuity.

First, if a donor funds a charitable remainder trust with tangible personal property, and if the donor or relatives of the donor are the individual beneficiaries of the charitable remainder trust, no charitable income tax deduction is available to the donor so long as the charitable remainder trust owns the tangible personal property and the donor or the donor's relatives have an interest in the tangible personal property through the charitable remainder trust. Once the charitable remainder trust sells the tangible personal property, however, a deduction should be available. This “future interest” rule does not apply in the case of a gift annuity, since the charity owns the tangible personal property immediately and

82 I.R.C. § 514(c)(5).
83 I.R.C. §170(a)(3).
84 See PLR 9452026.
outright. The annuitant has no retained interest in the tangible personal property itself.

Second, the income tax charitable deduction for gifts of tangible personal property is calculated with reference to the donor's cost basis in the property as opposed to the property's fair market value (assuming that cost basis is lower) unless the charity intends to use the property for its exempt purposes. In the context of a charitable remainder trust, where it is contemplated that the tangible personal property will be sold in order to provide funds for the purchase of investments to pay the annuity or unitrust interest, the donor's gift will not be for a related use. The donor's deduction will, therefore, be determined with reference to that portion of the donor's cost basis that is allocable to the charitable remainder. In contrast, the related use rule will not automatically stymie a donor's deduction when tangible personal property is used to fund a gift annuity. For example, if the donor transfers artwork to a museum in return for a gift annuity, and the museum intends to display the artwork and not sell it, the donor's charitable income tax deduction can be determined with reference to the artwork's fair market value. Of course, if the museum intends to sell the artwork, the donor's cost basis determines the size of the donor's deduction, just as in the charitable remainder trust context.

2. Residential Real Estate.

Residential real estate can be used as a funding asset for a charitable remainder trust. The type of charitable remainder trust that would most commonly be used in this instance would be a FLIPCRUT. However, residential real estate charitable remainder trusts present a number of issues.

The philosophy behind the charitable remainder trust arrangement presupposes that the real estate will be sold and not retained. Indeed, a donor must vacate residential real estate before it is contributed to a charitable remainder trust. The continued use of the property after the transfer by the donor or members of the donor's family constitutes an impermissible act of self-dealing. Self-dealing cannot be avoided by the donor entering into a lease with the charitable remainder trust. In contrast, a donor can contribute residential real estate to a charity in return for a gift annuity and then lease the property back from the charity if the donor desires to live there in the short-term.

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86 A charitable remainder annuity trust or a straight charitable remainder unitrust would only be appropriate if the donor also transferred sufficient marketable securities or cash to the trust to enable the trust to pay the real estate carrying costs and to meet any annuity or unitrust payouts due the individual beneficiary prior to the sale of the real estate.
If the donor wants instead to continue residing in the real estate for an indefinite period, perhaps until the donor's death, and also wants to use the real estate to fund a charitable gift, obtain an immediate income tax deduction and provide a source of supplemental income back to donor, the donor could propose to a charity an arrangement that combines two planned giving techniques: (i) a gift of a remainder interest in residential real estate (a special exception to the partial interest rule under IRC §§ 170(f)(3), 2055(e)(2) and 2522(c)(2)); and (ii) a gift annuity. In short, the donor would give the charity a remainder interest in the real estate, retaining a life estate, and request in return a gift annuity based on the value of the remainder interest gift. If the real estate donated is the donor's principal residence, the capital gain component of the donor's annuity payments may be eliminated (or substantially reduced) if the special exclusion under IRC § 121 is available (thereby effectively equating the taxation of the annuity payments to an all cash funded gift annuity). That exclusion — $250,000 for a single taxpayer, $500,000 for a married couple — can be used in its entirety to offset gain on the sale of a partial interest; there is no requirement that it be prorated between the “sold” remainder component and the retained life estate.\(^8\) The only issue surrounding the availability of the IRC § 121 exclusion is the impact of the installment reporting rule for gain recognized in a gift annuity transaction when the donor is the annuitant or the first of two annuitants. In Private Letter Ruling 8615025, interpreting the predecessor IRC § 121 exclusion, this issue was not considered. Instead, it appears that the exclusion was applied in such a way to wash out the gain up front as if it were all recognized in the year of sale. Any gain in excess of the exclusion can then presumably be reported ratably over the donor's life expectancy.

If residential real estate is subject to a mortgage, it should not be used to fund a charitable remainder trust. In contrast, mortgaged real estate may be transferred in exchange for a gift annuity, albeit that there may be UBTI issues if the charity assumes the mortgage, rather than taking the property subject to the mortgage.

It is not clear if a donor can transfer a fractional interest in property to a charitable remainder trust and continue to hold the retained portion. The mere existence of a joint or co-ownership arrangement could be treated as impermissible self-dealing under IRC § 4941. Subsequent joint activity, such as the sale of the property, is more obviously problematic. This issue was considered in Private Letter Ruling 9114025, in which the Internal Revenue Service approved an arrangement by which the donor first transferred real estate to a partnership and then contributed an interest in the partnership to a charitable remainder trust, retaining the rest of the partnership interest for himself, as a means of circumventing IRC § 4941 concerns. Self-dealing is, of course, not an issue in the context of gift annuities. Therefore, a donor who wishes to enter into a planned gift with a partial interest in

\(^8\) I.R.C. §121(d)(8); Treas. Reg. §1.121-4(e)(2); FSA 200149007; Rev. Rul. 84-43, 1984-1 C.B. 27 (interpreting predecessor rule).
real estate, which the donor hopes subsequently to sell, may prefer the simplicity of a gift annuity, followed by a joint sale of the property with the charity, as opposed to the complexity of first establishing a partnership, contributing a partnership interest to the charitable remainder trust and then selling the real estate through the partnership, which presumably would then be dissolved.

3. **S Corporation Stock.**

IRC § 1361(c)(6) permitted IRC § 501(c)(3) organizations and certain qualified retirement plans to be eligible S corporation shareholders effective for tax years beginning after December 31, 1997. As an eligible S corporation shareholder, a charity can accept a gift of S corporation stock in return for a gift annuity. For the donor, however, a special rule in IRC § 170(e)(1) (applying to the calculation of the donor's up-front income tax deduction, not to the characterization of the annuity payments or any gift tax deduction) requires that the deduction be adjusted to reflect assets that would produce ordinary income on a sale. These items would include unrealized receivables, substantially appreciated inventory and depreciation recapture. The effect of this provision is obviously dependent on the scope of such items within the business and may or may not be significant.

Moreover, under IRC § 512(e), every penny of income attributable to S corporation stock held by a charity is treated as unrelated business taxable income, including passive activity income such as interest and dividends. Also significant is that the gain on the sale of S corporation stock by the charity is treated as unrelated business taxable income.\(^{89}\) Because of this rule, a charity may be reluctant to take S corporation stock in return for a gift annuity, or if it does, it may offer an annuity in an amount substantially less than would be offered if the gift were funded otherwise.

4. **Retirement Plan Benefits.**

Under current law, qualified retirement plans and individual retirement accounts cannot be transferred to a charity or to a charitable remainder trust.\(^{90}\) If a donor

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\(^{89}\) In contrast, if a charity owns an interest in a partnership or limited liability company, the charity only pays unrelated business income tax on its share of income attributable to unrelated commercial activities; no tax is paid on its share of income from passive investments and no tax is due when the charity sells its interest in the partnership or LLC.

\(^{90}\) I.R.C. § 401(a)(13). The Pension Protection Act permitted qualified charitable distributions directly from IRAs during 2006 and 2007, and that provision has been extended; currently it is set to expire on December 31, 2013. In brief, the law provides an exclusion from income for otherwise taxable IRA distributions of up to $100,000 per year for transfers made directly and outright to a public charity (other than donor advised funds and supporting organizations). Numerous other restrictions are imposed, including the requirement that the (continued…)
wants to use a retirement plan to fund a charitable gift of any type, the donor must first withdraw assets from the plan or IRA. This withdrawal is treated as taxable income to the donor. The donor can then donate the withdrawn funds. The taxable income generated by the withdrawal may be offset by the charitable income tax deduction. Obviously, any such offset is only partial if the charitable gift is to a charitable remainder trust or in return for a gift annuity, since the donor's deduction does not equal the gross amount transferred to the charitable remainder trust or to the charity. Moreover, the offset may be partial only in the current year because the donor runs up against the percentage limitations that apply to the deductibility of all charitable gifts. Retirement plan benefits can, however, be used to fund charitable gifts at death, including testamentary charitable remainder trusts and gift annuities.

A private letter ruling suggests that if a gift annuity is funded at death through a retirement plan distribution, the plan participant's estate may be entitled to claim an estate tax charitable deduction equal to the value of the plan distribution, reduced by the present value of the annuity. The plan distribution is still treated as income in respect of a decedent, but it will be income to the charity and not to the donor's estate. In the hands of the charity, the income is not considered unrelated business taxable income and is accordingly not taxed. What is still unclear, however, is how the annuity payments will be taxed to the beneficiary. In the private letter ruling, the IRS did not rule on the characterization issue or whether the plan proceeds transferred to the charity (reduced by the charitable gift component (could be considered the annuitant's “investment in the contract.”) If not so considered (which presumably is the case, unless the plan had been funded by the donor with after-tax dollars), the entire annuity stream will be taxed to the annuitant as ordinary income. The ruling also did not consider whether the annuitant was entitled to claim the IRC § 691(c) income tax deduction for any estate taxes attributable to the annuitant's portion of the plan distribution.

J. **Reinsurance.**

The cash or property transferred by the donor to fund a gift annuity is not held in trust; it becomes part of the general assets of the charity, which (in many states) need not maintain a reserve or otherwise dedicate specific assets to provide for the payment of the annuity obligation. The annuity obligation is an unsecured obligation supported by all the assets of the charity. In the case of a major college with a significant endowment, that security is quite impressive, but, in the case of a small charity, a donor may feel...
considerably more comfortable if the charity reinsures its obligation by purchasing a commercial annuity contract from which the payments will be made.

In 1962, the IRS ruled that the deduction for a gift annuity will not be affected by the fact that the gift annuity contract is reinsured or co-insured with a commercial insurance company unless the agreement provides that all or a designated portion of the annuity obligation must be reinsured by a designated commercial insurer. That ruling also holds that if the agreement requires the contract to be reinsured by a specific commercial insurer, the deduction for the gift element is the difference between the amount transferred and the premium charged by the commercial insurer for the reinsurance annuity; in other words, the deduction is equal to the amount the charity gets to keep after meeting the reinsurance obligation (assuming that it is 100 percent reinsured). That is a rational approach, for it focuses on the value received by the charity to measure the donor's deduction.

It is not clear, however, whether and to what extent the approach of the 1962 ruling has any continued validity, since it was issued under a different system for valuing annuities. Prior to 1984, the value of a gift annuity was determined by reference to tables published by the IRS that were supposed to reflect the rates charged by commercial insurers. Under that system, the donor's deduction was based, at least in theory, on what it would cost the donor to buy an annuity equivalent to the annuity received from the charity. Accordingly, if the donor selected a particular commercial insurer, it was reasonable to use the premium rates of that insurer to value the annuity. However, annuities are now valued by looking at the payments to be received by the donor rather than the real or hypothetical cost of purchasing an equivalent annuity; it is arguably irrelevant whether or not the donor specifies a reinsurer.

It seems reasonably clear that as long as the charity remains free to determine whether or not to reinsure, the current valuation tables will be used, but it is arguable that the donor’s deduction should be measured by the net value received by the charity rather than by the benefit to be received by the donor if the donor requires the charity to reinsure (even if no particular reinsurer is designated). Until the issue is clarified, donors who require that

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93 The IRS has applied this approach in recent private letter rulings, which indicated that annuities sold by a charity qualify as charitable gift annuities, where the charity expects to fund the annuity payments to the donor by purchasing a commercial annuity (whose timing and amounts are substantially the same as the gift annuity’s). The IRS has ruled that the difference in the premium received from the donor and the premium charged by the commercial insurer would not constitute income from an unrelated trade or business. PLRs 200852037 (12/26/08) and 200847014 (11/21/08).
95 This would effectively reinstate the valuation system that was abandoned in 1984 for any gift annuity in which the donor requires the charity to reinsure. Some support for this approach can be found in GCM 39302, issued November 2, 1984, in conjunction with the issuance of Rev.
the annuity be reinsured run the risk that the reinsurance requirement will affect the value of the deduction.

XIII. Charitable Planning and the New 3.8 Percent Medicare Tax on Net Investment Income.

A. Overview of the New 3.8 Percent Medicare Tax on Net Investment Income.

Effective for tax years beginning after December 31, 2012, new Code section 1411 subjects individuals, estates and trusts to a 3.8% Medicare tax on net investment income (“NII”). It is important to note that this is a separate tax, albeit an income tax, with separate rules determining how it is triggered. It does not operate as a surcharge on regular income tax rates, a fact that does not seem to be widely appreciated.

In the case of an individual, the tax is imposed each year on an amount equal to the lesser of (1) the individual’s NII for the tax year and (2) the excess, if any, of (a) the individual’s Modified AGI for such year over (b) the Threshold Amount. In the case of a trust or estate, the tax is imposed each year on an amount equal to the lesser of (1) the trust’s or estate’s undistributed NII for the tax year and (2) the excess, if any, of (a) the trust’s or estate’s AGI for the year over (b) the dollar amount at which the highest tax bracket under Code section 1(e) begins for the year. Three definitions are key to understanding the tax.

NII means the excess of (1) the sum of (a) interest, dividends, annuities, royalties, and rents (unless derived in the ordinary course of an active trade or business other than a trade or business of trading in financial instruments or commodities), (b) gross income derived from a passive activity or a trade or business of trading in financial instruments or commodities, and (c) net gain attributable to the disposition of property derived from a passive activity or a trade or business of trading in financial instruments or commodities, over (2) deductions that are properly allocable to such income or net gain. NII does not include (a) distributions from qualified retirement plans, including IRAs, (b) income from an active trade or business (unless the income is derived from trading financial instruments or commodities or from the investment of its working capital) and (c) tax-exempt income (such as life insurance proceeds excluded from gross income under Code section 101(a) or interest paid on State or local bonds excluded from gross income under Code section 101(a) or interest paid on State or local bonds excluded from gross income under Code section 101(a) or interest paid on State or local bonds excluded from gross income under Code section 101(a) or interest paid on State or local bonds excluded from gross income under Code section 101(a) or interest paid on State or local bonds excluded from gross income under Code section 101(a) or interest paid on State or local bonds excluded from gross income under Code section 101(a) or interest paid on State or local bonds excluded from gross income under.

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Rul. 84-162. That Memorandum states that the estate and gift tax valuation tables may be substituted as a valuation method for gift annuities because those tables “currently” produce a result comparable to that produced by the use of commercial insurance tables. The substitution should be treated, according to the Memorandum, as temporary, in other words, effective so long as that similarity remains.


97 IRC § 1411(c).
Code section 103(a). Such items are generally referred to as “excluded income” for purposes of Code section 1411.98

Modified AGI means the individual taxpayer’s AGI increased by the excess of (1) the amount excluded from gross income under Code section 911(a)(1) over (2) any deductions (taken into account in determining AGI) or exclusions disallowed under Code section 911(d)(6) with respect to any amount of income excluded from gross income under Code section 911(a)(1).99 As a consequence, an individual taxpayer’s Modified AGI only differs from AGI if the taxpayer has a tax home in a foreign country and uses the foreign earned income credit. For estates and trusts, the threshold is stated in terms of AGI only.100

For individuals, the Threshold Amount depends on their filing status. The Threshold Amount is $250,000 in the case of married taxpayers filing jointly, $125,000 in the case of married taxpayers filing a separate return, and $200,000 for single and head of household filers.101 Given the stated levels of the Threshold Amount, there is a marriage penalty implicit in the structure of the section 1411 tax. In addition, the Threshold Amount for individuals is not indexed for inflation.

For trusts and estates, the threshold for imposition of the tax is the dollar amount at which the highest tax bracket takes effect.102 In 2013, that amount is only $11,950. As a minor consolation, it is indexed for inflation because of its tie in to the tax brackets.

B. The Effect of Charitable Planning on an Individual’s Liability under Code Section 1411.

NII is not determined with reference to an individual taxpayer’s taxable income. It is determined with reference to either the total amount of the individual’s NII, reduced only by deductions properly allocable to NII, or the amount by which the individual’s Modified AGI exceeds the applicable Threshold Amount. Since the charitable deduction is an itemized deduction applied after the determination of AGI, and since a charitable gift will not generate a deduction properly allocable to NII,103 charitable gifts and the contribution deduction generated thereby have no effect on the section 1411 tax of an individual.

98 Prop. Reg. § 1.1411-3(e)(5).
99 IRC § 1411(e).
100 IRC § 1411(a)(2)(B). An estate’s or trust’s AGI is determined in large measure in the same way as an individual’s AGI, except that it is reduced by (1) expenses paid or incurred in connection with administering the estate or trust that would not have been incurred if the property was not held in the estate or trust, (2) the deduction for personal exemptions under Code section 642(b), and (3) the distribution deductions permitted to the estate or trust under Code sections 651 or 661. IRC § 67(e).
101 IRC § 1411(b).
102 IRC § 1411(a)(2).
103 Prop. Reg. § 1.1411-4(f).
Jane is a single filer. In 2013, she has NII in the form of capital gain income of $200,000, excluded income in the form of salary of $200,000, and total AGI of $400,000. Jane makes charitable gifts of cash to public charities of $150,000 (all deductible in 2013 within the 50 percent contribution base limit), and has other itemized deductions of $54,500. Her itemized deductions are limited to $200,000 because of the Pease limitation. She loses the benefit of her personal exemption because of the phase-out. Although Jane’s taxable income is $200,000, her AGI is $400,000. As a consequence, she exceeds the threshold for the imposition of the section 1411 tax by $200,000, the full amount of her NII. Consequently, all of her NII is subject to the section 1411 tax, increasing her overall tax liability by $7,600.

That is not to say, however, that charitable planning strategies cannot be used to avoid, defer or mitigate the section 1411 tax.

1. **Outright Gifts.**

   If a taxpayer donates property that yields NII or would produce NII if sold to a charity, the NII is shifted to the charitable organization and is thereby exempted from the section 1411 tax. This is because Section 501(c)(3) organizations, even if organized as trusts, are not subject to the tax.\(^{104}\) This result follows, whether the gift is made outright to a public charity, to a donor advised fund sponsored by a public charity, or to a private foundation.

2. **Funding a CRT.**

   A CRT is one of the two types of split interest trust that are excluded from the application of the partial interest rule. This rule generally prohibits a taxpayer from claiming an income, gift and/or estate tax deduction for a contribution to a charitable organization of less than her entire interest in property.\(^ {105}\)

\(^{104}\) Prop. Reg. § 1.1411-3(b)(2).

A CRT is an irrevocable trust that creates two distinct property interests. The first is the lead or income interest that is paid either to the donor or other designated noncharitable beneficiaries for life or for a fixed term of up to 20 years. The lead interest can take one of two forms: an annuity interest; or a unitrust interest. If the latter, the CRT may also be structured to pay out the lesser of the unitrust interest or the net income earned by the trust. The second interest is the remainder interest, which consists of the assets remaining in the trust after the lead interest has terminated. The remainder interest must be paid to one or more qualified charitable organizations. Eligible charities include public charities, a donor advised fund sponsored by a public charity, or the taxpayer’s own private foundation. While the donor may fix the identity of the remainder beneficiary organizations, the donor may also retain the right to later designate or change the remainder beneficiaries by either a provision in her will or a written instrument filed with the trustee during her lifetime. The selection of charitable beneficiaries may also be left to the trustee, to the income beneficiary of the CRT or to a third party.

A CRT also has two distinct tax characteristics. First, the donor is entitled to a deduction for income, gift and/or estate tax purposes for the present value of the remainder interest given to charity. Secondly, the CRT itself is an entity exempt from federal income taxes imposed by Subtitle A of the Code. Accordingly, the CRT itself does not pay federal income taxes on income received from trust assets and gains realized on the sale or disposition of trust assets. This exemption is carried over to the tax under section 1411.

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106 IRC § 664.
107 Further variants on this theme permit a charitable remainder unitrust (“CRUT”) to be structured to pay out net income earned in any year in excess of the unitrust amount to the extent that in prior years the net income was less than the unitrust amount (a so-called “net income with make-up CRUT”), and permit a CRUT to make a one-time “flip” from one of the net income variants to a straight unitrust payout. IRC § 664(d)(3) and Treas. Reg. § 1.664-3(a)(1)(i)(c).
108 The ability of the taxpayer to claim a deduction for the value of the charitable remainder interest will be impacted if the remainder interest is directed to be paid or may be paid to a private foundation.
111 IRC § 664(c) and Treas. Reg. § 1.664-1(a)(1)(i). For tax years beginning after December 31, 2006, a CRT that earns UBTI retains its tax exempt status, but is subject to a 100 percent excise tax on the UBTI itself. IRC § 664(c)(2). Under prior law, a CRT lost its tax exempt status in any year that it earned UBTI, with the result that all income earned and gains realized were subject to tax as if the trust were a regular complex trust.
112 Prop. Reg. § 1.1411-3(b)(3).
Consequently, if a taxpayer transfers highly appreciated assets to a CRT, and those assets are subsequently sold in the CRT, there is no immediate imposition of any regular income tax or section 1411 tax on the capital gain/NII. The full amount of the sale proceeds can be reinvested in the trust. In addition, the taxpayer has not generated any personal AGI or NII in connection with the sale.

While the CRT itself is exempt from income tax, the annuity or unitrust distributions made to individual beneficiaries are subject to regular income tax in their hands. The scheme for taxing these distributions is unique to CRTs. It embodies a special four-tier system that captures the historic income earned and gains realized within the trust, and treats that historic income and gains as distributed, for the most part, on a “worst-in, first-out” approach. Accordingly, a distribution is first taxed as ordinary income to the individual beneficiary to the extent of the trust’s current and past undistributed ordinary income. To the extent that the amount distributed to the individual beneficiary exceeds current and past undistributed ordinary income, the distribution next consists of current year and prior years’ accumulated capital gain. If the amount distributed to the beneficiary exceeds both distributable ordinary income and capital gain income for current and prior years, the distribution is next treated as other income (to the extent that there is such other income for both the current and prior years). This other income includes federally tax-exempt interest income. Finally, to the extent that the distribution exceeds tiers one, two and three, it is deemed to consist of a tax-free distribution of principal.

Within the first two tiers, the regulations require that the income be broken down into different classes. The classes are determined with reference to the highest income tax rate that applies in the year of distribution (as opposed to the year of realization) to the particular class of income. Accordingly, within the ordinary income tier, interest and rents (potentially subject to a maximum income tax rate of 39.6 percent) are treated as one class, while qualifying dividends (subject to a maximum rate of 20 percent) are treated as another. Similarly, within the capital gains tier, short-term capital gains, 28 percent long-term capital gains attributable to collectibles, 25 percent long-term capital gains attributed to depreciation recapture from real estate, and 20 percent long-term capital gains from other assets held for investment purposes each constitute a separate class. The regulations then provide that within the first two tiers the highest-tax rate class of income is deemed to be distributed first.

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113 IRC § 664.
114 Treas. Reg. § 1.664-1(d).
116 The system now contains one significant exception to the basic worst-in, first-out rule. Although qualifying dividends (subject to a 20 percent maximum tax rate) are not treated as distributed until all other classes of tier one ordinary income are exhausted, they are nevertheless treated as distributed before short-term capital gains, long-term capital gains on collectibles, and (continued…)}
One question obviously raised by this unique system is how it should be integrated with Code section 1411 to determine the extent to which annuity or unitrust distributions are treated as NII in the hands of the individual beneficiary. Proposed regulations provide that the NII of the beneficiary attributable to the beneficiary’s annuity or unitrust distribution shall include an amount equal to the lesser of (1) the total amount of distributions for the year and (2) the current and accumulated NII of the CRT. If there are multiple beneficiaries, NII is apportioned among the beneficiaries based on their respective shares of the total annuity or unitrust amount paid by the trust for that year.

For purposes of this rule, the proposed regulations go on to provide that accumulated NII is the total amount of NII received by the CRT for all taxable years beginning after December 31, 2012, reduced by the total amount of NII distributed for all prior years of the trust that begin after December 31, 2012. Accordingly, historic income earned or realized prior to January 1, 2013 that is captured in the tiers and that would otherwise meet the definition of NII is not subject to tax under Code section 1411, no matter when it is considered distributed to the individual beneficiaries under the tiering system.

The interesting feature of the proposed regulations is that they deem current and accumulated NII to be distributed for purposes of the section 1411 tax before income and gains that is not NII, irrespective of the four-tier ordering rule that otherwise applies to determine the income tax character of the annuity or unitrust payments in the hands of the individual beneficiary. While in many situations this may not matter (since the result will be the same under the approach of the proposed regulations and an approach that followed the tiering system), in others it produces an anomalous and unfair result. This has been highlighted in comments on the proposed regulations filed by several organizations, including the ABA Section of Taxation and the AICPA. The ABA comments provide the following example:

unrecaptured gain on the sale of real property, even though all three of these classes of income are subject to potentially higher maximum tax rates. This is because the latter items fall into tier two.

117 Prop. Reg. § 1.1441-3(c)(2)(i).
118 Prop. Reg. § 1.1441-3(c)(2)(iii).
In 2012, a CRT is funded with a distribution from a non-Roth IRA valued at $1 million through a beneficiary designation. Under Regulation section 1.664-1(d)(1)(a)(1), the $1 million distribution is characterized as ordinary income (“tier one”). The $1 million is reinvested and generates the following income in tax year 2013: $30,000 of interest income (“tier one” income) and $20,000 of long-term capital gains (“tier two” income). At the end of 2013, the CRT has $1,030,000 of tier one amounts and $20,000 of tier two amounts. Further, current and accumulated NII of the trust under Proposed Regulation section 1.1411-3(c)(2) would be $50,000. Assume that during tax year 2013, $70,000 of distributions are made to a noncharitable beneficiary. Under Code section 664(b), the noncharitable beneficiary would categorize the entire $70,000 distribution as tier one ordinary income ($30,000 of interest income and $40,000 of retirement plan income). However, under Proposed Regulation section 1.1411-3(c)(2)(i), $50,000 of the distribution would be treated as NII. The $50,000 would include the $20,000 tier-two long-term capital gain, even though the $20,000 long-term capital gain was not deemed to have been distributed under Code section 664.

An equally interesting feature of the proposed regulations is that they acknowledge in the Preamble that the Treasury Department and the IRS considered an alternative method in which NII would be determined class-by-class within each of the four tiers under Code section 664. This was rejected because of record-keeping and compliance burdens on trustees that were perceived to outweigh the benefits. The weight of the comments filed to date would suggest that this calculation may be revisited, and the approach in the proposed regulations revised to comply with the tiering system.

This technical dispute over the methodology for taxing distributions as NII should not mask the fact that CRTs are very useful planning vehicles with respect to the section 1411 tax. By using a CRT, NII is captured within a tax-exempt environment, particularly NII that is attributable to the sale of highly appreciated assets that are used to fund the CRT. Then, while distributions will carry out NII, the effect is to spread out the receipt of NII by the individual beneficiary over a substantial period. Depending on the level of the individual beneficiary’s AGI, this will serve to avoid, reduce or defer the incidence of section 1411 tax.

Jane has a salary in 2013 of $150,000 and no other income. She has no above the line deductions. Her AGI is, accordingly, $150,000. Jane has capital gain property worth $1 million which, if it were sold, would produce $350,000 of long-term capital gain income. If Jane sells the property, she would have AGI of

$500,000 and taxable NII of $300,000 (the lesser of her NII of $350,000, and the excess of her AGI ($500,000) over her threshold amount ($200,000).

If, instead, Jane were to fund a CRT with the property and the CRT trustee were then to sell it, the gain would not be taxable in the CRT and the CRT would pay no NII. In addition, the transaction would produce no immediate AGI or NII to Jane. If in 2013 the annuity distribution to Jane was $50,000, and if the trust was invested in a way that produced no current yield and there were no other realization events, the annuity distribution would be treated under the tiering rules as carrying out $50,000 of long-term capital gain income attributable to the initial sale and $50,000 of NII. Jane would now have AGI and NII for 2013 equal to $200,000 and $50,000 respectively. Jane would owe no section 1411 tax, since her AGI does not exceed her Threshold Amount as a single filer.

3. **Funding a Pooled Income Fund Gift.**

The final charitable method of planning for avoiding the bunching of NII in any one year and smoothing out the receipt of an income return involves a gift to a pooled income fund ("PIF"). A PIF is a collective investment vehicle created and maintained by a public charitable organization (with certain exceptions to the definition under Code section 170(b)(1)(a)), to which numerous taxpayers contribute, retaining income interests for themselves or their designated individual beneficiaries and providing a remainder interest to the charity maintaining the fund. No gain or loss is recognized to the taxpayer as a result of the transfer of property to a PIF, and the taxpayer is entitled to claim a federal income tax charitable contribution deduction for the value of the remainder interest.

In contrast to the CRT, a PIF is not exempt from federal income tax. Instead, it is taxed under the general rules applicable to trusts under Code section 641,
although it is exempted from the application of the grantor trust rules. As a practical matter, however, PIFs face minimal or no federal income tax liability. The PIF receives a distribution deduction for the amounts paid out to income beneficiaries under Code section 661; and, as a qualification requirement, the governing instrument of the PIF must require that all fiduciary accounting income be paid to the fund’s income beneficiaries. In addition, a PIF generally also receives a charitable deduction for any amount of net long-term capital gain that, pursuant to the terms of the governing instrument, is permanently set aside for the charitable remainder beneficiary under Code section 642(c)(3). Consequently, the primary instance in which a PIF pays income tax is when it realizes net short-term capital gain that is not required to be distributed to the income beneficiaries pursuant to the terms of the governing instrument and applicable state law.

While the NII rules for trusts generally follow those for the regular income tax, it has been pointed out that the Proposed Regulations do not make it clear that the charitable set aside deduction allowed in calculating the fund’s taxable income is allowed in full when calculating the fund’s NII tax. The anomaly appears to arise when the PIF earns NII and excluded income, albeit that this should be a fairly rare circumstance.

Net short term capital gain will be NII for purposes of Code section 1411. As a result, if a PIF realizes net short-term capital gains, a PIF may also face liability under Code section 1411 at the very low threshold applicable generally to trusts. This result places a further premium on the maintaining organization to ensure that it does not accept gifts of appreciated assets that have been held by the taxpayer for less than a year and that would produce short-term capital gain income when sold in the PIF, and that it manages the turnover of the PIF investment portfolio in a manner that minimizes short-term capital gain income realized in the portfolio.

For the PIF income beneficiary, the taxation of her distributions is determined with reference to normal trust rules. As a result, the distributions retain their character as earned in the trust and may represent qualified dividends, taxable

(…continued)

are confined mostly to cash and marketable securities; and (5) a CRT does not have to be maintained or trusteeed by the remainder charitable beneficiary, which in turn does not have to be specifically identified in the trust document, meaning that there is considerable flexibility in the structure and management of a CRT and the identity of the eventual recipient of the remainder interest, whereas the PIF must be organized and managed by a public charitable organization and the remainder interest must be paid to that maintaining organization.

124 Treas. Reg. § 1.642(c)-(5)(a)(2).
125 ABA Section of Taxation, “Comments Concerning Proposed Treasury Regulations Under Section 1411,” April 5, 2013, supra note 149.
interest or other taxable ordinary income. The distributions will also be subject to the section 1411 tax to the extent that the amounts treated as distributed constitute NII. However, as with CRTs and CGAs, there is no bunching of the receipt of income and instead a general smoothing of its receipt over an extended period to the individual beneficiary, thereby minimizing and deferring, and possibly avoiding, the section 1411 tax.

4. Funding a CLT.

A CLT is basically the opposite of a CRT. It is an irrevocable trust that provides a current or lead interest to charity, in the form of annuity or unitrust distributions, for a term of years or the lives of certain individuals. At the end of the lead term, the remainder passes to non-charitable beneficiaries, typically members of the donor’s family. As mentioned above, when structured in conformity with the requirements of the Code, a CLT can be a powerful wealth transfer vehicle, since the taxable gift associated with the funding of the trust is reduced by the value of the charitable lead interest. In the case of an annuity trust (but not a unitrust), it is possible to structure the lead interest so that it has a value equal to the entire funding contribution. As a result, any remainder passing to family members passes entirely outside the gift and estate tax system.

Where CLTs and CRTs diverge the most is in their income tax consequences. A CLT is a taxable trust; a CRT is a tax-exempt trust. The value of the lead interest in a CLT produces an immediate charitable income tax deduction to the donor only in very limited circumstances; the value of the remainder interest in a CRT almost always produces such a deduction to the donor. The taxation of a CLT and the income tax impact that its funding has on the donor depend on whether the CLT is treated as a grantor or non-grantor trust for income tax purposes.

If structured as a grantor trust under Code sections 671 through 679, two income tax results follow: (1) the donor is entitled to an upfront charitable contribution income tax deduction for the value of the charitable lead interest;\textsuperscript{126} and (2) the donor remains taxable on all the income earned and capital gains realized during the lead term of the trust, without a further charitable contribution income tax deduction for the annual payments that are made to charity.\textsuperscript{127}

\textsuperscript{126} IRC § 170(f)(2)(B).
\textsuperscript{127} In addition, if a lead payment is satisfied by the in-kind distribution of appreciated property, the IRS takes the position that capital gain is triggered and is taxable to the donor, notwithstanding the fact that if the donor had owned the same appreciated property and had given that property to charity, no capital gain would be realized and the donor would be entitled to an income tax deduction. PLR 200920031.
For purposes of NII tax, the grantor CLT itself is not subject to Code section 1411. Instead, and consistent with the grantor trust rules, all items of NII earned and realized by the CLT are taxable to the donor, again without any offset for the fact that those items may be paid to charity as part of the annuity or unitrust distribution. As a result, while a grantor CLT can be a useful planning device for regular income tax purposes, it is not a planning vehicle for mitigating potential section 1411 liability for the taxpayer.

If structured as a non-grantor trust, the income tax and section 1411 tax results are quite different. For regular income tax purposes, while the taxpayer receives no upfront income tax deduction for the value of the lead interest, the taxpayer has no continuing income tax linkage to the trust. The CLT is treated as a regular complex trust, taxable as a separate taxpayer under the regular provisions of Subchapter J of the Code. Each year, the trust is taxed on its ordinary income and capital gains, but is entitled to an income tax deduction under Code section 642(c)(1) for the full amount of the annuity or unitrust amounts distributed to charity. Consequently, it is only taxable on undistributed income and gains in excess of the amount required to pay the lead interest.

If a non-grantor CLT could be structured with distribution provisions comparable to the worst-in, first-out principles of Code section 664, the taxation of undistributed income and gains could be optimized. However, income ordering provisions are generally not effective to push out to the charity income that would be taxed at higher rates, and to retain income that would be taxed more favorably in the trust. Recently finalized regulations provide that, unless an ordering provision has separate economic effect beyond its tax impact, it will be ignored and distributions from a non-grantor CLT to charity will consist of the same proportion of each class of the items of income and gains earned and realized in the trust as the total of each bears to the total of all classes. Since the amount paid to charity is set and cannot depend on the type of income used to satisfy it, it is difficult to envisage circumstances in which an ordering provision in a CLT would be effective.

128 Prop. Reg. § 1.1411-3(b)(5).
129 IRC §170(f)(2)(B) and Treas. Reg. §1.170A-6(c).
130 Any unused deduction cannot be carried forward, however.
131 If a non-grantor CLT earns any UBTI, however, it cannot use the Code section 642(c) deduction against the UBTI. Instead, in such circumstances, it is permitted a partial deduction, subject to the percentage limitation applicable to individuals, against the UBTI paid to charity. IRC §§ 512(b)(11) and 681(a); Treas. Reg. § 1.681(a)-2(a).
132 Treas. Reg. §§ 1.642(c)(3) and 1.643(a)-5.
Although not specifically addressed in Code section 1411 or the proposed regulations, a non-grantor CLT is subject to the section 1411 tax in the same way as any other complex trust. However, the CLT can effectively claim a charitable deduction against its NII liability since, in computing its undistributed NII under the first limb of the measure of income subject to the tax, it is permitted to reduce its NII by that portion of its NII that is allocated to amounts allowable as a charitable deduction under Code section 642(c). As a result, it can shift NII into the hands of the charitable beneficiary, where it will not be taxed as such. If the CLT has both NII and excluded income, the offset will not be complete because the charitable distribution must be allocated between the NII and excluded income; if the charitable deduction for the lead distribution is less than the total of the NII and excluded income, a portion of the retained income will be NII and potentially taxable to the trust as such.

The overall effect of these rules is that a non-grantor CLT can provide a useful income tax benefit in conjunction with its role as a wealth planning vehicle, notwithstanding the lack of upfront income tax deduction available to the taxpayer. For example, assume that a taxpayer has made or is making regular gifts that exceed her applicable AGI deduction limits and she wants to begin a new charitable giving program. She is also interested in the potential for passing wealth free of gift and estate tax to her family. Outright gifts would provide no income tax benefit and no family wealth transfer. A grantor lead trust would meet her estate planning goals, but the upfront income tax deduction would be wasted and the taxpayer would retain income tax liability for activity within the trust, diminishing her overall asset level and what might otherwise be available to pass to her family at her death. On the other hand, a non-grantor lead trust would effectively allow the taxpayer to create deductible gifts for regular income tax purposes, albeit at the trust level, but resulting in tax savings and more assets retained for eventual distribution to her family. The trust also avoids the section 1411 tax that the taxpayer would have paid on the yield from the assets that are used to fund the CLT.

Much has been made in the last several years about the possibility of back-loading annuity streams from CLATs. Structuring the trust so that the annuity payments increase during the term can help manage investment risks, including the path of return problem, by allowing the trustee to adjust the mix of investments over the lifespan of the trust and by reducing the outflow of trust assets in the early years of the trust’s administration. While escalating structures can be helpful, detailed financial modeling demonstrates that too extreme an escalation, including a balloon-like schedule, may not be that advantageous. This result is attributable to the effect of income taxes payable on the return earned by the trust assets in the early years due to the mismatch between income and gains earned and the low

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133 Prop. Reg. § 1.1411-3(e)(4).
134 Id.
level of annuity payment and correspondingly low section 642(c) deduction. With higher
tax rates and the section 1411 tax now in place, the efficient use of the
deduction is an ever more important component of successfully structuring and
administering a non-grantor CLAT. Consequently, steep back-loading may not be
appropriate in a nongrantor trust setting, except in those circumstances where the
funding assets are likely to be retained in the trust and those assets have yield
features that minimize income tax inefficiencies.\footnote{See Lee, Berry and Hall, at pp.104-107, supra note 108.}

C. \textbf{The Effect of Charitable Distributions on a Trust’s Liability under Code Section 1411.}

As mentioned above, in the case of a trust, the section 1411 tax is determined with
reference to NII equal to the lesser of (1) the trust’s undistributed NII and (2) the excess
of the trust’s AGI over the inflation adjusted threshold at which the highest tax bracket
begins (currently $11,950). This measure is similar to that applicable to individuals but
there are significant digressions from the results applicable to individuals. These
differences result from the application of the distribution deduction for amounts
distributed from the trust to individual beneficiaries and the charitable deduction for
amounts distributed from the trust to charitable beneficiaries.

Turning first to individual distributions, a trust’s AGI for regular income tax purposes is
reduced by amounts distributed to individual beneficiaries that constitute distributable net
income (“DNI”) and are deductible under Code sections 651 or 661.\footnote{IRC § 67(e).} A comparable
rule applies with respect to the tax under Code section 1411; in calculating undistributed
NII, gross NII is reduced by distributions of NII made to individual beneficiaries, with the
reduction limited to the amount of NII that is deductible under either Code sections 651
or 661.\footnote{Prop. Reg. § 1.1411-3(e)(2) and (e) (3). If the deduction permitted the trust under Code
sections 651 or 661 consists of both NII and excluded income, the distribution must be allocated
between NII and excluded income in a manner similar to the determination of the Code section
661 deduction when there are both items includable and not includable in the gross income of the
trust. See Treas. Reg. § 1.661(c)-1.} The respective amounts of DNI and NII deductible by the trust are then treated
as taxable income and NII in the hands of the individual beneficiaries. Accordingly, the
distribution shifts the tax liabilities away from the trust to the individual beneficiaries.
This may reduce regular income tax liability if the beneficiaries are in lower income tax
brackets than the trust and may eliminate the section 1411 liability because of the higher
threshold for that tax applicable to individuals.

A trust has gross income consisting of taxable interest income of $50,000, all of
which is NII. It has no expenses. The trust distributes $30,000 to an individual
beneficiary, and receives a section 661 distribution deduction of $30,000. The
trust’s AGI (determined after the distribution deduction) is $20,000 and its

\footnote{See Lee, Berry and Hall, at pp.104-107, supra note 108.}
undistributed NII is $20,000. The trust is subject to the section 1411 tax on $8,050 (the lesser of (1) $20,000 and (2) $20,000 reduced by $11,950. The beneficiary has $30,000 of taxable interest income and NII.

When there are multiple beneficiaries of the trust to whom distributions are made, both DNI and NII are allocated among those beneficiaries under the tiering system set forth in Code section 662.138 Under that section, DNI is allocated first to those entitled to current distributions of fiduciary accounting income (a first-tier distribution), with the distribution treated as consisting of the same proportion of each class of the items of income that enter into the computation of DNI as the total of each class of items bears to total DNI (unless the governing instrument or local law requires a special allocation of a class of DNI income to a particular beneficiary and that allocation has economic effect).139 Any remaining DNI is then allocated to beneficiaries to whom distributions are properly paid or credited or required to be paid otherwise from fiduciary accounting income (a second-tier distribution), also on a pro rata basis.140

The distribution deduction rules may not be effective, however, to shift liability with respect to realized capital gains. Except in limited circumstances, capital gain income is not included in DNI.141 If it is not part of DNI, it is not deductible under Code sections 651 or 661. Consequently, it is subject to regular tax at the trust level. The same is true for purposes of calculating the section 1411 tax – namely, only NII that is included in DNI and deductible under Code sections 651 or 661 can be taken into account in determining the trust’s undistributed NII, with the result that NII in the form of capital gain income ordinarily remains taxable at the trust level under section 1411.

With respect to charitable distributions, deductibility for regular income tax purposes is determined under Code section 642(c). As outlined previously, this section provides the trust with an income tax charitable contribution deduction for any amount that pursuant to the terms of the governing instrument is paid or permanently set aside during the tax year from gross income, including gross income accumulated from prior years, for a purpose specified in Code section 170(c). It is not necessary for the trust to direct the charitable

139 Treas. Reg. §§ 1.662(a)-2. A detailed example of how these rules work for purposes of the section 1411 tax is set forth in Prop. Reg. § 1.1411-3(f), Example 1 (Calculation of undistributed net investment income (with no deduction under section 642(c))). However, it seems that the example may need further revision, in that it does not appear to calculate correctly fiduciary accounting income and DNI, and as a consequence misstates the amount of distributions made that should be considered NII in the hands of individual beneficiaries and the amount of NII that remains taxable to the trust. See Blattmachr, Gans & Zeydel, “Imposition of the 3.8% Medicare Tax on Estates and Trusts,” 40 Est. Pl. 3 (April 2013); see also Fox, “Charitable Planning to Avoid New 3.8% Tax on Investment Income”, 40 Est. Pl. 3 (August 2013), for a general discussion of the new tax and the impact of charitable giving techniques.
140 Treas. Reg. § 1.662(a)-3.
141 Treas. Reg. § 1.643(a)-3(b).
contribution; it is enough that the trust authorizes the payment to charity by, for example, including charitable organizations as permissible discretionary beneficiaries.\textsuperscript{142}

For purposes of Code section 1411, a trust is allowed a deduction in computing its undistributed NII for those amounts of its NII that are allocated to amounts allowable as deductions under Code section 642(c).\textsuperscript{143} Consequently, a section 642(c) deduction will shift not only regular taxable income but also NII from a trust to the charitable beneficiary, where it will not be subject to the regular income tax and the section 1411 tax.

As a result, it may be advantageous, at least from an income tax perspective, to cause a charitable gift to be funded from a trust as opposed to being made directly by an individual. Paying the gift from a trust shifts both regular and NII tax liability to the charity and thereby avoids both taxes. Paying the gift individually may reduce regular income tax liability, subject to the individual’s contribution base limitations, but will not otherwise change the individual’s liability under Code section 1411. This, of course, assumes that the trust authorizes the trustee to make charitable distributions and that using the trust income to make charitable gifts does not thwart other non-tax objectives, including the accumulation of assets outside the estate and generation-skipping transfer tax systems and the protection of trust assets from creditors’ claims.

As a drafting consideration, however, it may prompt estate planners to suggest that charities be included in the class of potential discretionary beneficiaries of income and principal from a spray trust, even in those circumstances where the client does not herself have strong charitable inclinations. In addition, in circumstances where trustees and beneficiaries alike are considering the possibility of decanting a trust, the addition of charitable beneficiaries for income tax planning purposes might be a consideration in the preparation of the new trust.

Before concluding this discussion, it is important to review how the distribution deduction and charitable deduction work together in situations where a trust permits both individual and charitable distributions to be made by the trustees, and where both types of distribution are in fact made. The starting point is the special rule in Code section 662(b) for characterizing income distributed to individual beneficiaries when a charitable contribution is made from the trust. Under that rule, the charitable contribution deduction is allocated proportionately among the classes of income entering into the computation of trust income before individual distributions are characterized. Consequently, the charitable distribution is treated as paid off the top, reducing DNI and the amount of taxable income in the various classes that individuals must report. However, in the case of individual beneficiaries to whom income is required to be distributed currently, the character of their distributions is determined by disregarding the charitable contribution deduction “to the extent that it [the deduction] exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed

\textsuperscript{142} Old Colony Trust Company v. United States, 301 U.S. 379 (1937).

\textsuperscript{143} Prop. Reg. § 1.1411-3(e)(4).
As a result, the section 642(c) deduction does not affect the DNI computation and characterization for purposes of determining the items of income distributed under a mandatory provision to an individual beneficiary.

A trust provides that income, including accumulated income, may be distributed to A, an individual, and/or XYZ Charity. In the current tax year, the trust has $40,000 of taxable interest and $10,000 of tax exempt interest, and DNI of $50,000. The trustee distributes $50,000 to XYZ Charity and $10,000 to A. In determining the amount that A is required to take into income, the entire charitable contribution deduction is taken into account. Since the deduction equals DNI, A has no amount that is included in her gross income.

Assume the same facts, except that the trust is also required to make an income distribution to B of $30,000. For purposes of determining the character of the distribution to B, DNI is $30,000. The charitable contribution deduction only reduces DNI by $20,000, the difference between the total income of the trust ($50,000) and the amount required to be distributed ($30,000). The charitable contribution is allocated proportionately to the income items ($16,000 to taxable interest and $4,000 to tax-exempt interest). B’s distribution is then characterized as $24,000 of taxable interest and $6,000 of tax-exempt interest. B receives no income tax benefit as a result of the charitable distribution. In determining the amount that is included in the gross income of A, however, the entire charitable contribution can still be taken into account, with the result that for A’s purposes there is no DNI and therefore no amount that A has to take into income.

Comparable rules apply for determining NII in the hands of individual beneficiaries. In the examples above, A would have no NII as a result of the trust distribution; B would have $24,000 of NII, since the tax-exempt interest portion of her distribution would constitute excluded income.

XIV. Conclusion.

Charitable planning remains an important element of effective tax planning. With current gift and estate tax exemption levels, advisers will need to give more thought to the appropriateness of charitable bequests and encourage the use of lifetime giving strategies. Those same strategies can be helpful in reducing income tax liability and managing the new income tax on investment income. It goes without saying, however, that as in the past charitable planning and the use of charitable giving vehicles should only be employed where it is consistent with the philanthropic objectives of the taxpayer.

144 Treas. Reg. § 1.662(b)-2.
145 Prop. Reg. § 1.1411-3(e)(4).