Assessing and Planning for Clients' Charitable Goals

Hampton Roads Estate Planning Council
September 19, 2017

Elizabeth Leverage Hilles, J.D.*
Senior Philanthropy Adviser
University of Virginia Law School Foundation

** These materials are offered with thanks to Charles D. Fox, IV, Esq. and McGuireWoods, LLP for the amended use of certain portions of the "Estate Planning: Principles and Practice" course materials, 2017 spring semester session at the University of Virginia School of Law (Charles D. Fox, IV and Elizabeth Leverage Hilles, co-instructors).*

Assessing and Planning for Clients' Charitable Goals

SECTION 1 -- INTRODUCTION

Charitable giving is an important part of many individuals' estate plans, both during life and at death. Starting in 2006, Bank of America, and now U.S. Trust, began an ongoing study of high net-worth charitable giving. That study continues to show that charitable giving comprises an important part of high net worth client financial and estate planning. The most recent study was completed in 2016. "The 2016 U.S. Trust Study of High Net-Worth Philanthropy" (written and researched in partnership with the Indiana University Lilly Family School of Philanthropy). High Net-Worth Households were defined in the study as households with more than $200,000 in annual income and assets in excess of $1 million (excluding the value of their home). Surveys were mailed to over 20,000 households in the United States. The findings included the following statistics:

(1) 91% of the households made a gift to charity in 2015 compared to only 59% of the general population.

(2) On average high net-worth donors gave $25,509 to charity in 2015. In contrast, the general population gave $2,520 on average.

(3) Basic needs organizations drew the greatest percentage of High Net-Worth Households (63%) followed by religious (50%), educational (45%), environmental (42%), and health (40%) organizations.

(4) Over 40% have made a bequest to charity in their wills, 26% have established a foundation or donor advised fund, and 16% use a charitable remainder trust.

(5) Most respondents felt that repeal of the estate tax would not affect their charitable giving. 50% of the respondents said that elimination of the charitable income tax deduction would not cause their charitable giving to decline.

Moreover, a large amount is estimated to pass to charity. A 2003 study, which updated a 1998 study, concluded that at least $41 trillion would pass from older generations to younger generations between 1998 and 2052. At that time, the authors estimated that charities would receive between $6 trillion and $25 trillion during that period. John J. Havens and Paul G. Schervish, "Why the $41 Trillion Wealth Transfer Estimate is Still Valid," Planned Giving Design Center (Gift Planner's Digest, January 27, 2003, last updated May, 2011). In 2014, the authors performed an updated study factoring what they determined to be a 25% decline in household wealth (as measured by net worth) after the "Great Recession of 2007." John J. Havens and Paul G. Schervish, "A Golden Age of Philanthropy Still Beckons: National Wealth Transfer and Potential for Philanthropy Technical Report," Center on Wealth and Philanthropy, Boston College (May 28, 2014). In that study, they estimated that wealth transfer in the 55-year period from 2007-2061 will be $59 trillion, with between $6.3 trillion and $26.9 trillion going to charity.

This is not surprising considering the history of charitable giving by Americans. Americans are among the most generous people, ranking second only to Canadians in terms of average donations to charity. In 2016, Americans gave $390 billion to charities. This was a nearly $17 billion increase over charitable giving in 2015. Giving USA Foundation's "Giving USA 2017: The Annual Report on Philanthropy for the Year 2016," researched and written by the Lilly Family School of Philanthropy at Indiana University. Individuals gave $281.86 billion and contributed 72 cents of each dollar given to charity in 2016. Bequests totaled $30.36 billion. More than 1.5 million charities are registered in the United States.

Considering these numbers, estate-planning clients are likely to have charitable intentions that need to be assessed on "intake" forms and in initial meetings. Planned giving donors who have existing attorney-prepared estate plans have commented that reading information from or talking with a charity about charitable giving is the first time they have learned about various charitable giving options, and some express surprise and even disappointment that their advisors never discussed their philanthropic goals. Focusing solely on the intricacies of tax law and financial planning as they relate to plans for the client's lineal descendants and other family members yields an incomplete plan that will not meet the client's goals. Moreover, individuals are motivated to include charities in their overall plan primarily for non-tax reasons. See, for example "The Seven Faces of Philanthropy: A New Approach to Cultivating Major Donors," Russ Alan Prince and Karen Maru File (Jossey-Bass 1994) (suggesting seven personas of philanthropically-minded individuals: communitarian, devout, investor, socialite, altruist, repayer, and dynast). The advisor's responsibility and goal is to discern those motivations and inclinations and help the client plan for them in the most appropriate and tax-efficient way.

Once the advisor determines that a client is charitably inclined, there are often different ways to achieve the client's philanthropic goals in a way that best suits their personal and tax circumstances. Some of these techniques can produce large tax savings for the client and the family unit at a cost of only a modest amount of complexity or inconvenience.

SECTION 2 – OVERVIEW OF CHARITABLE GIVING TAX MATTERS

I. Income Tax Charitable Deductions -- Overview

The deductibility of lifetime charitable contributions for income tax purposes is subject to certain limitations that depend on the type of property donated, the tax classification of the charitable recipient, and the taxpayer's personal tax circumstances.

A. **Percentage Limitations**. There are "percentage limitations" on the amount that an individual may claim as a charitable deduction against his "contribution base" in any tax year. The “contribution base” refers to adjusted gross income without regard to net operating loss carryback for the year. IRC § 170(b)(1)(F).

50-Percent-Type Organizations. The maximum amount that an individual may claim as a charitable contribution deduction in a given year is 50 percent of his contribution base. The 50 percent limitation is available only for direct contributions to “public charities” (which category includes so-called private operating foundations and conduit foundations). IRC § 170(b)(1)(A). Organizations that fall into this category are often called “50-percent-type organizations.” However, as noted below, deductions for contributions “for the use of” public charities, which include contributions in trust, are limited to 30% of the contribution base.

30 Percent-Type Organizations. Deductions for contributions to organizations that are not public charities (so-called 30-percent-type organizations, which are primarily private nonoperating foundations) and contributions “for the use of” any charity are subject to a more restrictive limitation of 30 percent of the individual’s contribution base, or, if less, the difference between 50 percent of the individual’s contribution base and the amount of the individual’s contributions to 50-percent-type organizations. IRC § 170(b)(1)(B).

B. **Valuation Limitations**. In most cases, appreciated property held for over a year (long-term gain property) contributed to charity may be deducted at fair market value. With respect to certain appreciated property contributed to charity, however, the individual may be required to use the property’s tax basis, rather than its fair market value at the time of the contribution, to determine the deductible amount of the contribution. These special limitations are discussed below.

The chart on the following page summarizes the basic rules regarding percentage and valuation limitations.

Charity Type	Property Contributed	Contribution Base %	Deduction Value
Public Charity	*Cash* *Long-Term CG property*	*50%* *30%*	*Fair market value* *Fair market value*
Private Nonoperating Foundation	*Cash* *Long-Term CG property*	*30%* *20%*	*Fair market value* *Fair market value for publicly-traded securities; tax cost for other long-term CG property, including real estate and closely-held stock*
Supporting Organization	*Cash* *Long-Term CG property*	*50%* *30%*	*Fair market value* *Fair market value*
Charitable Remainder Trust with public charity as remainder beneficiary	*Cash* *Long-Term CG property*	*50%* *30%*	*Fair market value* *Fair market value*
Charitable Remainder Trust with private foundation as remainder beneficiary	*Cash* *Long-Term CG property*	*30%* *20%*	*Fair market value* *Fair market value for publicly-traded securities; tax cost for other long-term CG property, including real estate and closely-held stock*

C. **Ordering Rules**. The regulations prescribe ordering rules that govern which percentage limitations must be absorbed first. IRC § 170(d) and Treas. Reg. § 1.170A-10. Generally speaking, the rules prioritize 50% limitation contributions over 30% limitation contribution, and 30% limitation contributions over 20% limitation contributions.

EXAMPLE**:** In 2017, an individual contributes $25,000 in cash to a public charity and $15,000 in cash to a private nonoperating foundation. If the individual's contribution base is $60,000, the donation to the public charity falls within the 50 percent limitation for the individual ($30,000) and is fully deductible in 2017. The deductible amount of the $15,000 given to the 30-percent-type organization is whichever is less: (a) 30 percent of his contribution base ($18,000) or (b) the difference between his 50 percent limitation and his donation to the public charity

($30,000 - $25,000 = $5,000). Thus, the individual may deduct only $5,000 of his contribution to the private foundation in 2017.

D. **Five-Year Carryover.** A five-year carryover rule applies to amounts that an individual cannot deduct in a given taxable year. IRC § 170(d). The individual in the preceding example could therefore carry over the remaining $10,000 contribution that was not deductible in 2017 and, subject to the same percentage limitations, claim it as a charitable deduction in the first available succeeding year through the year 2022.

E. **Pease Limitation**. In addition to the percentage and valuation limitations discussed, the "Pease amendment" (named after Congressman Donald Pease who first sponsored the amendment in the early 1990s), puts a limit on most itemized deductions, including the income tax charitable deduction. IRC § 68. Total itemized deductions are reduced by the lesser of (i) three percent of the amount that a taxpayer's adjusted gross income (AGI) exceeds a certain threshold amount ($300,000 for married taxpayers who file jointly, $275,000 for heads of households and $250,000 for single persons (indexed for inflation annually)), and (ii) 80% of otherwise allowable deductions (charitable contributions, mortgage interest, and state and local income and property taxes). The extent of a taxpayer's loss of deductions is directly tied to AGI and is thus unique to the taxpayer. The limitation does not reduce the marginal value of charitable deductions, and a taxpayer's lower itemized deduction tax benefit may be balanced against the increased value of the deduction in her higher marginal income tax rate.

> EXAMPLE: A couple has $400,000 AGI and $100,000 in itemized deductions in 2017. Their AGI in excess of the $300,000 threshold is $100,000. They can deduct only $97,000 because their deductions are limited by the lesser of $3,000 (3% of $100K excess AGI) and $80,000 (80% of $100K itemized deductions).

F. **Limitations Based on Type of Property Donated.** The basic percentage limitations discussed above apply only to contributions of cash and ordinary income property (property that, if sold, would not result in long-term gain). Other limitations also apply.

1. Ordinary Income Property. In the case of ordinary income property, the value of the contribution for which an individual may claim a charitable deduction is limited to the contributed property's cost, not its fair market value. IRC § 170(e)(1).

2. Long-Term Capital Gain Property. For contributions of long-term capital gain property, different limitations may apply.

- If the charity is a 50-percent-type organization, the percentage limitation on the deduction is 30 percent of the individual's contribution base if the individual is valuing the property at its fair market value. IRC § 170(b)(1)(C)(i).

    - Step Down. The individual can increase the limit to 50 percent of his contribution base by electing to "step down" (reduce) the amount for which he is claiming a deduction by the amount of the long-term gain that would have been taxable had he sold the contributed property at its fair market value. IRC § 170(b)(1)(C)(iii).

      EXAMPLE**:** In 2017, an individual contributes $45,000 of appreciated securities to a public charity. The individual held the securities for more than one year before making the contribution. The individual's basis in the securities is $25,000. If the individual's contribution base is $60,000, he may deduct only $18,000 (30% of $60,000) of the contribution if he values the securities at fair market value for charitable deduction purposes. However, the individual may elect to step down the value of the securities for purposes of the deduction to $25,000 and deduct this amount in full, because it does not exceed 50 percent of his contribution base ($30,000). By stepping down the value, the individual has increased his charitable deduction for the current year.

      A taxpayer must consider the carryover rules when deciding whether to make the step-down election. In the preceding example, if the individual does not make the step-down election, he may carry over the $27,000 that is not deductible in 2017 to subsequent tax years. If he is in a 39.6 percent tax bracket, these additional deductions will create $10,692 in tax savings. If he makes the step-down election, the full $25,000 reduced value is deductible in 2017 but there is no carryover of any excess and no future tax savings from the contribution. In each case, the value of a larger immediate tax saving through a step-down election must be compared with the present value of future tax savings if step down is not elected. Step down can be more attractive where the amount of appreciation is small or the donor dies after making a large contribution so that there are no succeeding years of the donor to which the excess contribution may be carried.

- If the charity is a 30-percent-type organization, the percentage limitation on the deduction is the lesser of (a) 20 percent of the donor's contribution base, and (b) the excess of 30 percent of the contribution base over the amount of contributions of long-term capital gain property to 30-percent type organizations. IRC § 170(b)(1)(D).

- In addition to this percentage limitation, there is an **automatic** reduction of the amount for which an individual can claim a deduction in the case of long-term capital gain property (other than certain publicly-traded securities) donated to a private nonoperating foundation but not to any other 30-percent-type organization. The reduction again lowers the deductible amount to the adjusted cost basis of the property. IRC § 170(e)(1)(B)(ii).

  EXAMPLE**:** An individual contributes real estate valued at $10,000 to a private nonoperating foundation in 2017. The individual held the real estate for more than one year before the contribution. His basis in the property is $8,000 and his contribution base for the year is $50,000. If the individual made no other contributions during the year, he may claim a charitable contribution deduction of $8,000 for the contribution, which is his adjusted basis in the real estate. If the individual contributed to a 30-percent-type organization that is not a private nonoperating foundation, he could claim a deduction for the full $10,000 value of the real estate. In either case, the contribution would be fully deductible since the deductible amount does not exceed 20 percent of his contribution base.

  If the individual also contributed a second parcel of real estate worth $10,000 to a public charity in 2017, the individual may deduct only $5,000 of the gift to the 30-percent-type organization (whether or not a nonoperating private foundation), because his deduction for the latter gift is limited to the difference between 30 percent of his contribution base ($15,000) and the $10,000 value of the long-term capital gain property given to the public charity.

  The automatic reduction rule for gifts of long-term capital gain property to private nonoperating foundations does not apply to a donation of "qualified appreciated stock." This is defined as stock that is readily tradable on an established securities market.

3. Publicly-Traded Appreciated Stock and Cash Replacement. Charitable contributions of qualified appreciated property (publicly-traded securities) may be deducted at fair market value, avoid capital gain, and avoid qualified appraisal requirements (discussed below) regardless of amount. For these reasons, it is often advisable for an individual to use long-term appreciated securities when otherwise considering a cash gift. The donor gives the

securities to charity and uses the cash to buy the same securities on the open market. If the securities rise in value, the donor will have less taxable gain on a future sale because of the higher basis. If the securities decline in value, the sale will produce a loss, instead of the gain that may have been produced on a sale of the original securities.

EXAMPLE**:** Donor has $100,000 of cash and $100,000 of stock with a basis of $0. If donor gives the cash to the charity, he receives income tax savings of $39,600 if he is in the 39.6% tax bracket. Two years later, he sells the stock when it is worth $150,000. The capital gains tax on this sale is $30,000 ($150,000 gain x 20%). Thus, his net gain after paying tax is $120,000. If, instead, donor donates the stock to charity, he receives income tax savings of $39,600. He uses the $100,000 cash to replace the stock he has donated to charity. Two years later, he sells the stock for $150,000. The capital gains tax is $10,000 ($50,000 gain x 20%). Thus, the donor nets $140,000. This is $20,000 more than if the donor gave cash. In both cases, the donor receives the same income tax savings of $39,600.

4. Tangible Personal Property. A taxpayer may claim a fair market value deduction based on the contribution of long-term gain tangible personal property held for more than a year (and therefore subject to long-term capital gain treatment) only if the property can be used in a way related to the charitable donee's exempt purpose or function. Treas. Reg. § 1.170A-4(b)(3)(i). For both 50-percent-type and 30-percent-type organizations, the available deduction for tangible personal property unrelated to those exempt purposes will be reduced by the amount of long-term gain that would have been taxable had the taxpayer sold the property at its fair market value. IRC § 170(e)(1)(B)(i).

   If the charity sells, exchanges, or disposes of the donate tangible personal property within three years of the contribution, the taxpayer must obtain a written statement signed by an officer of the charity under the penalties of perjury either (1) certifying that the use of the property was related to the donee's exempt purpose or function and describing how the property was used and how such use furthered such purpose or function of the done, or (2) stating the intended related use of the property by the donee at the time of contribution and certifying that such use has become impossible or infeasible to implement. In the absence of such certification, the taxpayer's charitable deduction will be recaptured. If the property is sold in the first year, the charitable deduction is reduced to basis. IRC § 170(e)(1)(B)(i). If the property is sold after the first year and within three years of the gift date, the donor will include in taxable income the difference between the basis and the claimed deduction. IRC § 170(e)(7)(A).

Special valuation rules apply to donations of vehicles, boats and airplanes valued at more than $500. The applicable rules limit the allowable amounts of such deductions to the gross proceeds received by the charity from the sale of the donated vehicle and requires the charity to provide donors with a written acknowledgment of their contributions within 30 days of the donation. IRC § 170(f)(12).

5. Gift of an Undivided Interest in Property. A charitable deduction is allowed for a gift of an undivided portion of a donor's entire interest in property. The gift must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in the property and it must extend over the entire term of the donor's interest. IRC § 170(f)(3)(B); Treas. Reg. § 1.170A-7(b)(1).

   For example, a donor can give a charity both a remainder interest and an undivided interest in the same personal residence or farm by deeding his personal residence to charity and reserving the right for life to use the property during part of the year as a vacation home. See Rev. Rul. 76-473, 1976-2 C.B. 306. The donor will be entitled to a charitable deduction both for the value of the remainder interest and for the undivided portion of his life interest so donated. An undivided interest is also a good means of obtaining an immediate charitable deduction for a gift of a partial interest in tangible personal property. Thus, an art collector can contribute a fractional interest in his collection to a museum, retaining possession of the collection for a portion of each year equal to the fraction of ownership retained.

6. Bargain Sales. A bargain sale is a sale of property to a charity at less than fair market value. The excess of fair market value over the sale price represents a charitable contribution. The taxpayer must allocate his cost basis in the property between the portion of the property that is "sold" and the portion that is "donated" according to the relative fair market value of each. If the property has appreciated in value since the taxpayer acquired it, he will realize capital gain on the appreciation allocable to the portion that is "sold." IRC § 1011(b). As a result, the taxpayer may owe capital gains tax from the bargain sale, even though the sale price is equal to or less than his cost basis in the property.

   EXAMPLE**:** An individual owns 100 shares of appreciated stock with a basis of $4,000 and a fair market value of $10,000. The individual has held the stock for more than one year. Wanting to make a $6,000 donation to his favorite qualified charity, he sells that stock to the charity for $4,000. The amount of the individual's basis allocable to the "sale" portion of the bargain sale is $1,600 ($4,000 divided by $10,000, multiplied by $4,000). As a result, the individual will recognize long-term capital gain of $2,400

($4,000 minus $1,600), and will be entitled to an income tax charitable deduction of $6,000.

Assuming that the individual is in the 39.6 percent income tax bracket, had he instead sold the stock on the market for $10,000 and then donated the realized gain ($6,000) to charity, he would be $720 worse off than with the bargain sale. This is because, through the bargain sale, $3,600 of potential capital gain is avoided, which saves $720 in tax ($3,600 x .20).

G. **Substantiation Requirements**. A charitable income tax deduction will be allowed only if it is properly substantiated. Particularly for taxpayers who make large lifetime charitable gifts, the substantiation and record-keeping requirements are significant and involve a variety of complex rules for valuing property for income tax charitable deduction purposes. The record-keeping and return requirements for deductions for charitable contributions are found in Treas. Reg. § 1.170A-13.

1. Recordkeeping. For cash contributions to charitable organizations, a taxpayer may not claim a deduction for any cash or other monetary gift unless the taxpayer maintains as a record of the contribution a bank record or other written communication from the donee showing the name of the donee, the date of the contribution, and the amount of the contribution.

   If an individual makes a charitable contribution of property other than cash, he should obtain a receipt from the charity that shows the charity's name, the date and location of the contribution, and a description of the property contributed. If obtaining a receipt is impractical (e.g., because the donation is made at an unattended site, such as a clothing drop-off box) the donor may substitute his own written records. Treas. Reg. § 1.170A-13(b)(1).

   In addition to obtaining a receipt, a property donor should keep written records of any other information that may be necessary to substantiate the deduction (Treas. Reg. § 1.170A-13(b)(2)(ii)). For example, if the donor reduced the value of the property to its adjusted basis for purposes of the deduction, his records should include evidence of the property's basis.

   Charitable contributions over $250, whether in cash or kind, must be substantiated by a "contemporaneous" written acknowledgment by the charitable organization. An acknowledgment will be considered contemporaneous if it is made on or before the earlier of the date the return is filed or the due date for filing the return. The acknowledgment must include (1) the amount of cash and a description (but not value) of other property donated, and (2) a description and estimate of the value of any goods or services provided by the charity in consideration of the donation. The substantiation requirement applies to all charities, including family private foundations. IRC § 170(f)(8)); Treas. Reg. § 1.170A-13(f)).

Charitable contributions of non-cash property over $500 require the donor to maintain additional records. These records must contain information on the manner in which the donor acquired the property, the approximate date of acquisition, and, for property other than marketable securities, the cost or other basis of the property. If the donor held the property for more than six months before the contribution, the regulations require the maintenance of records on the property's basis only if such information is available. Treas. Reg. § 1.170A-13(b)(3)(i).

2. Appraisal Requirements – Contributions Over $5,000. For contributions of property (other than cash and publicly-traded securities), the donor must obtain a "qualified appraisal" and attach a completed "appraisal summary" to the tax return on which he first claims the deduction. These requirements apply in addition to the recordkeeping requirements previously discussed. To determine whether his contributions of property exceed $5,000, the donor must aggregate the values of similar items of property. For example, an individual who donates a number of paintings to different charities must aggregate the value of the paintings and satisfy the appraisal requirements if the aggregate value exceeds $5,000. Treas. Reg. § 1.170A-13(c)(7)(iii).

Among the more important requirements for a qualified appraisal are that the appraisal must be made not more than 60 days before the date of contribution, describe the property appraised and the method of valuation used, be signed by the appraiser, and recite the appraiser's address, taxpayer identification number, and professional qualifications. Treas. Reg. § 1.170A-13(c)(3). In addition, the appraisal must include a description of the fee arrangement between the donor and the appraiser. The appraiser generally cannot base his fee on a percentage of the appraised value of the property (Treas. Reg. § 1.170A-13(c)(6)(i).

In addition, the appraiser used for a qualified appraisal must meet various requirements set forth in the regulations. The appraiser must hold himself out to the public as an appraiser and must be qualified to make appraisals of the type of property being valued. In addition, the appraiser may not be connected in any way to either the donor or the charity. The regulations specifically prohibit the donor, the charitable donee, or an employee of either from acting as the appraiser. With certain limited exceptions, a party to the transaction in which the donor acquired the property that is being appraised, or an employee of that party, cannot be the appraiser. The regulations also contain a catch-all provision that disqualifies any appraiser whose relationship to any of the foregoing described parties would cause a reasonable person to question his independence. Treas. Reg. § 1.170A-13(c)(5).

Finally, the donor must complete an appraisal summary on a form prescribed by the IRS (currently Form 8283). The donor must obtain the signatures of the appraiser and the charitable donee on the form and attach it to the income tax return on which he first claims the deduction. Treas. Reg. §§ 1.170A-13(c)(2)(i)(B); 1.170A-13(c)(4).

Exceptions:

- Publicly-Traded Securities. Publicly traded securities are exempt from the qualified appraisal requirements. Any share of stock, subscription right, bond, debenture, or other evidence of corporate indebtedness for which market quotations are readily available on an established securities market fall in this exempt category. Treas. Reg. § 1.170A-13(c)(2)(ii).

- Nonpublicly-Traded Stock. The appraisal requirements are relaxed for charitable contributions of nonpublicly-traded stock where the claimed value of the donation exceeds $5,000 but does not exceed $10,000. In that case, no qualified appraisal is required and the donor must complete only part of the appraisal summary. Treas. Reg. § 1.170A-13(c)(2)(ii).

- Artwork. Under Rev. Proc. 96-15, 1996-1 C.B. 627, the IRS permits a donor to receive from the IRS a binding statement of value for purposes of fixing the charitable deduction for certain donations of artwork. The artwork must have been appraised at $50,000 or more. A taxpayer can rely on the IRS statement of value absent a misrepresentation of material facts in the application.

Failure to comply with substantiation requirements generally will cause the deduction to be disallowed. See Hewitt v. Comm'r, 109 T.C. 258 (1997) (charitable deduction reduced due to improperly completed Form 8283 and the absence of a "qualified appraisal"). See also Mohamed v. Comm'r, T.C. Memo 2012-152 (May, 2012) (multi-million dollar deduction for contribution of real estate to charitable remainder trust denied due to lack of qualified appraisal, despite IRS acknowledging that property donated was likely more valuable than donor claimed).

II. Estate and Gift Tax Charitable Deductions -- Overview

Transfers made by an individual during life or at death are subject to applicable federal transfer taxes. IRC § 2501 imposes a gift tax on transfers made during life, and IRC § 2055 imposes an estate tax on transfers made by reason of the transferor's death. There are various exclusions and exemptions that may apply to exclude the value of the transferred property from taxation, including unlimited marital deductions (IRC §§ 2523 and 2056) and unlimited charitable deductions (IRC §§ 2522 and 2055). There is also a unified credit against gift and estate tax (IRC §§ 2505 and 2010(c)) resulting in the exclusion of an additional $5,000,000 that an individual can shelter from gift or estate tax. That amount is indexed for inflation and in 2017 allows an individual to shelter $5,490,000, and a married couple to shelter $10,980,000. In addition, a gift of a present interest in property to an individual will be excluded from gift tax to the extent it does not exceed the annual gift tax exclusion amount, which in 2017 is $14,000 per recipient per year. IRC § 2503 (b)(1) and (2). Payments for tuition and medical expenses made directly to the provider are also excluded from gift tax. IRC §2503 (e).

In addition to gift and estate tax, a generation-skipping transfer (GST) tax is imposed on gratuitous transfers to individuals two or more generations younger than the transferor. IRC § 2611. Certain transfers will qualify for an annual GST tax exclusion similar to the annual gift tax exclusion, though qualifying transfers for the gift tax annual exclusion do not necessarily qualify for the GST tax annual exclusion. Like the gift and estate tax unified exemptions, there is a $5,000,000 GST tax exemption indexed for inflation allowing an individual to shelter $5,490,000, and a married couple to shelter $10,980,000, of generation-skipping transfers in 2017).

Gift, estate, and GST tax are assessed at a 40% maximum rate. IRC § 2001. Note that the GST tax is assessed in addition to any gift or estate tax applied, possibly yielding a combined tax rate in excess of 60%.

There are no percentage or valuation limitations on the gift and estate tax deductibility of charitable gifts during life or transfers to charity at death. An individual or her estate can claim unlimited charitable gift and estate tax deductions, as applicable, for the full value of the charitable interest transferred provided certain requirements are met.

- For an estate tax charitable deduction to apply, the amount to pass to charity must be ascertainable at the time of death. Merchants Bank of Boston v. Comm'r, 320 U.S. 256 (1943). For example, if the personal representative can determine amounts to pass to others without an objective standard, the charitable portion may not be ascertainable. Est. of Marine v. Comm'r, 97 T.C. 368 (1991), aff'd, 990 F.2d 136 (4th Cir. 1993) (charitable estate tax deduction denied because personal representative had full discretion to give up to 1% to each person who assisted decedent, making charitable remainder unascertainable at time of decedent's death).

- If federal estate taxes or other estate, inheritance, succession or legacy taxes are payable out of property for which a charitable estate tax deduction would otherwise be allowed, then the amount of the deduction will be reduced by the amount of taxes payable. IRC § 2055(c) and Treas. Reg. § 20.2055-3(a). This can result in a circular tax calculation: the reduction in the charitable deduction in turn increases the taxes payable that again reduces the charitable deduction. Treas. Reg. § 20.2055-3(b).

SECTION 3 – CHARITABLE GIVING METHODS

There are a variety of techniques and methods individuals can use to accomplish their philanthropic goals, and they vary in complexity and tax benefits. When advising an individual about charitable giving options, there are a few preliminary matters to keep in mind that apply to charitable giving regardless of the charitable giving technique proposed.

- Restricted Gifts. Donors and their advisors should consult the charity if the donor wishes to include restrictions on the use of a gift, whether created during life or through a testamentary disposition. Amounts designated for the charity's "general" or "unrestricted" use are always acceptable, but some restricted purposes may be against public policy (for example, a scholarship restricted by race at a state educational institution) or not able to be implemented (insufficient funds to name a building). Note also that the more narrowly the purpose is defined, the greater the risk that the intended use will be no longer be relevant or in need of funding at the time a bequest or trust remainder is realized. Charities may also have minimum funding levels to create a "named" fund or physical space. Generally speaking, gifts restricted as to purpose should be the subject of a gift agreement that sets forth the understanding between the donor and the charity. In every case, regardless of the nature of the restriction, the gift agreement should include *cy pres* language allowing for a different, related use should the donor's original purpose be impracticable or impossible to fulfill.

  The charity's planned giving office can help the advisor and donor craft language creating permissible preferences for restricted gifts that most nearly accomplish the donor's intent while allowing flexibility for changed future circumstances and assuring that the gift can used. Often, donors become more flexible once informed of the various options that are available and the charity's need for flexibility in using restricted funds received years or decades in the future.

- Illiquid Property. If the gifted property is to be unusual or illiquid property like real estate, artwork, or closely-held stock, planners should contact the charity to make sure it can accept and use the property. Charities have fiduciary duties to assess property to be sure that it can be accepted without creating undue liabilities or adverse tax consequences, and that it can be used for, or converted to, charitable use. Charities often will have written gift acceptance policies regarding acceptance of illiquid or unusual gifts.

- Identifying the Charity. The drafter has a responsibility to determine and use the precise legal name of the intended charitable recipient. Charities may have similar names, and failure to distinguish between the similarly-named charities can (and has) lead to post-death disputes. Careless drafting can also cause problems even if the ultimate intended result is reached. A recent, relatively benign, example includes a Northern Virginia attorney who named the "Charlottesville Humane Society" as a charitable beneficiary rather than the "Charlottesville-Albemarle SPCA." Although there was no dispute over what the decedent intended, the probate court required representations and acquiescence of all parties to the distribution, adding undue cost to the estate and to the charitable entities involved. Charity websites often have the proper legal name prominently located on the website, but some charities operate under a "doing business as" name, so care should be taken. Including the tax i.d. number of the intended charity and references to distributions to "a successor organization" if intended are also helpful.

The most common charitable giving techniques are summarized below.

I. Private Foundations

Individuals with significant charitable inclinations may wish to establish a private foundation as a permanent vehicle for their charitable giving. A private foundation provides an individual with the maximum degree of control and flexibility with respect to use of his assets for charitable purposes, both during the individual's life and after his death.

A private foundation may be organized as either a corporation or a trust. Under either form, the individual who establishes the foundation can set forth his preferences for future charitable giving in as much detail as he desires. The individual can outline a comprehensive giving program for the foundation when he creates it, or leave decisions to the discretion of the foundation's governing body. The individual can retain this decision-making authority himself and designate the person or persons who will have the authority after his death.

If the foundation has the appropriate charitable purposes, it can obtain federal tax-exempt status from the IRS by filing a Form 1023, Application for Recognition of Exemption. If an exemption is granted, donations to the foundation will be deductible for income, gift, and estate tax purposes.

As discussed in the percentage limitation section of this outline, the income tax charitable deduction for contributions to a private foundation is subject to certain limitations. In most cases, a private foundation established by an individual will be a nonoperating foundation and will therefore be treated as a 30-percent-type organization. Generally, only the basis of appreciated property donated to the foundation may be deducted, except for "qualified appreciated stock," the fair market value of which may be deducted, subject to a 20% limitation.

The date-of-death value of assets transferred to a tax-exempt private foundation will be included in the donor's estate under IRC § 2036 if the donor has the authority under the foundation's governing instrument to designate the charitable recipients of foundation gifts. Rifkind v. United States, 84-2 USTC ¶ 13,577 (U.S. Ct. Cl. 1984). Although the individual's estate will receive a corresponding charitable deduction, inclusion of the assets in the estate may affect the calculation of the marital deduction or the estate's ability to qualify for benefits under IRC § 303 (partial stock redemption), IRC § 6166 (installment payment of estate tax), or IRC § 2057 (deduction for qualified family-owned business interest ("QFOBI").

Taxation and Reporting. Because of past abuses of private foundations, they are now subject to numerous restrictive excise taxes and regulations. The applicable laws ensure that the foundation is used to further charitable purposes rather than to benefit the individual who established the foundation or his family (see IRC §§ 4940-4946 and the regulations thereunder) and do not interfere with the operation of a foundation created with purely philanthropic intentions. Potential taxes include the excise tax on net investment income (IRC § 4940), the tax on self-dealing transactions (IRC § 4941), the tax on failure to distribute income (IRC § 4942), the tax on excess business holdings (IRC § 4943), the tax on jeopardizing investments (IRC § 4944), and the tax on taxable expenditures (IRC § 4945).

Because of the rather complex reporting requirements imposed by the Internal Revenue Code and regulations, plus state law registration and financial reporting, usually only individuals who are willing to commit substantial resources to charitable endeavors conclude that a foundation is an appropriate vehicle. Many practitioners recommend minimum funding of $2 to $5 million.

II. Donor-Advised Funds

IRC 4966(d)(2) defines a "donor-advised fund" as (1) a fund or account owned and controlled by a sponsoring organization, (2) that is separately identified by reference to contributions of the donor or donors, and (3) where the donor (or a person appointed or designated by the donor) has or reasonably expects to have advisory privileges over the distribution or investments of the assets. All three prongs of the definition must be met in order for a fund or account to be treated as a donor-advised fund.

Although donors or their advisors may provide advice or recommendations with regard to fund distributions and investments, the charity maintaining the funds must have the ultimate authority over how the assets in the funds are invested and distributed. The sponsoring organization must have sufficient procedures and governance rules in place to ensure that the assets in its donor-advised funds accomplish charitable purposes and are used exclusively for charitable purposes. Donor-advised funds are prohibited from providing impermissible private benefits. Donor advised funds cannot be used to satisfy a donor's legally binding charitable pledge, and there may be a question of whether a donor advised fund should accept and continue to invest in closely-held stock, limited partnerships, or limited liability corporations. The IRS Donor Advised Funds Guide Sheet, which assists IRS agents in processing new donor-advised funds' Form 1023 applications for recognition of exemption under IRC § 501(c)(3), asks several detailed questions eliciting information on whether the fund meets exemption requirements.

To avoid the excise tax on taxable distributions under IRC 4966(a), a donor-advised fund can make distributions only to: (a) a public charity that is not a supporting organization controlled (directly or indirectly) by the donor or donor advisor, and that is not a Type III nonfunctionally integrated supporting organization; (b) the sponsoring organization; (c) some other donor-advised fund (whether or not sponsored by the same organization); or (d) any person for a charitable purpose (under IRC 170(c)(2)(B), i.e., religious, charitable, scientific, literary, educational, etc.), but only if the sponsor exercises expenditure responsibility (IRC 4945(h)).

In general, contributions to a donor-advised fund are treated as contributions to a public charity subject to the 50% contribution base limitation (as opposed to a 30% limitation for contributions to a private foundation). The donor receives an income tax charitable deduction in the year she creates her donor-advised fund and no further deductions based on future grant recommendations. A donor can also designate a remainder beneficiary of the fund to receive the remaining assets at the donor's death or the death of a designated family member (for example, if family members are given advisory privileges after the donor's death).

A donor-advised fund can be considered when a client is unwilling to undertake the complexities of managing a private foundation or when a client does not have sufficient assets to fund a private foundation. Sponsoring organizations include a wide range of organizations, from community foundations serving primarily local areas and interests, to large financial institutions. A donor-advised fund can be created with a much smaller contributions than those required to create a private foundation. For example, the Fidelity Charitable Gift Fund, as of 2016 the largest donor-advised fund sponsoring organization with over $15 billion in assets, requires a minimum contribution of only $5,000.

III. Beneficiary Designations

Designating a charity as a beneficiary of a will, revocable trust, life insurance policy, or retirement plan has the potential to allow a client to plan a significant gift while maintaining the flexibility to modify the plan later if family or other circumstances warrant. Beneficiary designations are revocable and will not affect a client's cash flow during life. In all cases, the donor's estate will receive an estate tax charitable deduction based on the full value of the charitable interest transferred, but because the designations are revocable, the donor will not receive a current income tax charitable deduction.

A. **Wills and Revocable Trusts**. Charitable bequests included in a will or revocable trust may be defined as a pre-residuary specific item or dollar amount, or may be defined as a percentage of the residuary estate. As discussed above, tax apportionment clauses must be drafted carefully to avoid a possible circular tax calculation and reduction in the available estate tax charitable deduction. In addition, the charitable amount must be ascertainable at death. Examples of basic bequest language include:

> Unrestricted bequest. "I give [X Dollar ($_______) or X percent (___%) of my residuary estate] to LEGAL NAME OF CHARITY, of CITY, STATE (tax i.d. _________), or its successor, for its general purposes, if such organization at the time of my death is an organization described in section 2055(a) of the Internal Revenue Code.
>
> Restricted bequest: "I give [X Dollar ($_______) or X percent (___%) of my residuary estate] to LEGAL NAME OF CHARITY, of CITY, STATE (tax i.d. _________), or its successor, if such organization at the time of my death is described in section 2055(a) of the Internal Revenue Code, to be used as follows: _____________________.

B. **Life Insurance**. Life insurance is a unique asset for funding a charitable gift because of its inherent leverage – premium payments are often far less than the death benefit payable, allowing a donor to make a much larger ultimate gift at lower cost than the cost of using most other assets. A gift of life insurance can be particularly indicated when, through the passage of time or growth in other financial assets, a client's existing life insurance policies are no longer needed for their original intended purpose (the children are now grown, the mortgage is now paid off, and so forth).

1. Beneficiary Designation Effective at Death. The most common way to use life insurance in charitable planning is to name a charity as beneficiary of part or all of the policy proceeds on the donor owner's death. The designation can be made on a beneficiary designation form provided by the life insurance company and can be modified during the donor's lifetime. On the policy owner's death, the proceeds will be included in her taxable estate under IRC § 2042, but the estate will receive an estate tax charitable deduction for the value of the proceeds distributed to charity under IRC § 2055.

2. Giving the Policy to Charity During Life. Life insurance can provide dual benefits when used in charitable giving because the policy can be transferred to the charity during the donor's lifetime, yielding a current income tax charitable deduction as well as a charitable distribution of proceeds at death. If the policy is transferred during life such that the donor no longer has "incidents of ownership," the proceeds will have been removed from the donor's taxable estate. The tax consequences of a lifetime transfer of a life insurance policy differ depending on the nature of the policy.

    a. Contribution of Paid-Up Policy. If the donor transfers a paid-up policy (for which premiums are no longer contractually due), the donor can claim an income tax charitable deduction based on the lesser of the policy's replacement cost or the donor's adjusted cost basis.

    b. Contribution of Premium-Due Policy. If the donor transfers a partially-paid up policy for which future premiums are due, the donor can claim a deduction based on the lesser of the policy's interpolated terminal reserve (cash value plus unearned premiums, minus loans) or the donor's adjusted basis. This value is typically slightly higher than cash surrender value.

       When making a contribution of a partially-paid up policy, the donor should plan to make future premium payments as they become due. The donor will be able to claim a charitable deduction for the amounts paid. Cash payments to the charity to cover premiums due will subject to the 50% contribution base limitation, but payments directly to the insurer may be deemed to be "for the use of" rather than "to" the charity and subject to the 30% limitation. IRC § 170(b)(1)(A) and (B).

If the donor ceases to pay the premiums, depending on the premium costs and the cash surrender value of the policy, a charity may decide to cash in a policy for which premiums are due rather than use unrestricted funds to pay those premiums. This could result in a smaller charitable gift than the donor originally intended.

The maximum charitable deduction for a lifetime contribution of a life insurance policy is limited to 50% of adjusted gross income (AGI) for gifts to public charities and 30% of AGI for gifts to private foundations. Like other charitable gifts, any excess deduction may be carried forward an additional five years. An insurance company can provide the donor with the valuation for any type of permanent policy, but the qualified appraisal requirements apply if the value to be claimed exceeds $5,000.

As discussed later, in addition to an outright charitable contribution and beneficiary designation of a policy, life insurance can be used to fund a charitable remainder trust.

C. **Retirement Benefits**. Retirement plan assets comprise a vast amount of individual wealth. According to a recent study by the Investment Company Institute, total U.S. retirement assets reached nearly $25 trillion in 2016. Many retirement savings vehicles, including traditional IRAs and qualified plans under IRC §§ 401(k), 403(b), and 457, are funded with pre-tax dollars and grow tax-deferred, allowing the plan assets to increase in value more quickly without diminution from taxes owed on dividends, capital gain, and other recognition events within the account. The amounts remain free of income tax until they are withdrawn by or distributed to the participant or other beneficiaries. At that point, they will be taxed as ordinary income to the recipient regardless of the actual nature of the plan's tax recognition events.

To ensure that tax-deferred retirement plans are used for their intended purpose (to provide support during retirement) and not as tax-free savings accounts for heirs, the Code prescribes a defined time when taxable distributions from tax-deferred plans must begin, the payout period over which distributions must be taken, and the amount that must be withdrawn. These rules affect both lifetime and post-death distributions. Failure to comply with the minimum distribution rules may result in the imposition of a 50% excise tax on late or insufficient distributions. The most important distribution rules are described below.

A participant in a qualified plan (unless she is a 5% owner of the business that maintains the plan), must start receiving distributions no later than April 1 following the year in which she attains age 70½ or retires, whichever is later. This is known as the "required beginning date" ("RBD"). The RBD for IRAs and 5% owners is April 1 following the year in which the participant attains age 70½ even if the participant has not yet retired. IRC § 401(a)(9)(C). For all years after the first year in which distributions must be taken, the distribution must be taken by December 31 of that year. A person's age is the age she will be at the end of the year in which a distribution is made.

At the participant's death, whether and for how long the account may continue to grow tax-deferred will depend on whether the participant died before or after her required beginning date and whether there is a Designated Beneficiary of the plan. A Designated Beneficiary is a beneficiary whose life expectancy is eligible to be used to calculate required minimum distributions after the participant's death. Only individuals and certain trusts can be Designated Beneficiaries. If the beneficiary is not an individual or a qualifying trust, the RMD will be calculated as if there were no beneficiary and can result in a five-year payout, which typically means far fewer years of tax-deferred growth. The rules regarding mandatory distributions are complex. IRC § 401(a)(9) and related regulations.

Of particular relevance for charitable planning purposes is the fact that for purposes of determining whose life expectancy is used to calculate post-death RMDs, the Designated Beneficiary will be determined on September 30 of the year following the year of the participant's death. Treas. Reg. §1.401(a)(9)-4, Q&A 4. Like most other non-individual entities, charities cannot be Designated Beneficiaries, and their presence on the determination date will cause the plan to be distributed as if there were no Designated Beneficiary. Thus, distributions to charities should be made before September 30 of the year following the participant's death. Other post-mortem planning techniques such as disclaimers or a distribution to satisfy a beneficiary's interest can also be used to eliminate other beneficiaries who could adversely affect post-death RMDs, including older beneficiaries. For example, if a deceased participant named a "good" beneficiary with a long life expectancy, "bad" beneficiaries (beneficiaries with short life expectancies or other non-individuals) can be eliminated by having the them disclaim their interest or by making a total distribution of their benefits prior to the September 30 cutoff date.

Taxation at Participant's Death. On an account holder's death, amounts remaining in the plan will be subject to estate tax in the participant's estate. In addition, pre-tax funded retirement assets are characterized as income in respect of a decedent (IRD), which means that they will also be subject to income tax upon distribution to any beneficiary that is subject to income tax. IRC § 691(a). The beneficiary may claim an income tax deduction for estate taxes paid with respect to the plan assets. IRC § 691(c). Depending on the size of the participant's estate and identity of plan beneficiaries, the plan assets could be subject to both estate and income tax, potentially reducing the value of the account significantly the hands of individual beneficiaries.

Charitable Planning with Retirement Plan Assets

Qualified Charitable Distributions (During Life). In most cases, it is not possible to avoid income tax on lifetime distributions from a qualified plan or IRA by "donating" the plan to a charity. Even if amount are distributed directly to the charity without passing through the participant's hands, the donation will be treated as a distribution taxable to the participant, followed by a charitable gift. Depending on the taxpayer's individual tax situation, the deduction may fully offset the income reported, resulting in a "wash" for tax purposes.

There is a limited exception for individuals age 70 ½ or older with respect to traditional and Roth IRAs. IRC section 408(d)(8) permits such individuals to make certain "qualified charitable distributions" to charity from traditional or Roth IRAs (but not qualified plans) without including the distributions in ordinary income. The rule permits an exclusion from gross income for certain otherwise taxable IRA distributions up to $100,000 per year to qualified charitable organizations described in section 170(b)(1)(A) other than supporting organizations or donor advised funds. The distribution counts toward the account owner's RMD for the year even though it is not included in the owner's gross income. The distribution must be made by the IRA administrator directly to the charity and cannot be first received by the account holder. The donor is not entitled to an income tax charitable deduction under IRC § 170 for any amount excluded from gross income under this provision. The exclusion is not available for a distribution to fund a charitable remainder trust, pooled income fund, or charitable gift annuity.

This provision may be particularly beneficial for individuals for whom a regular RMD withdrawal would bump them into a higher marginal income tax rate and for those who do not itemize deductions.

Designating a Charitable Entity as Beneficiary. Because transfers to charity avoid estate tax under the unlimited estate tax charitable deduction, and because charities are income tax-exempt entities, retirement assets can be ideal assets for funding charitable estate gifts. In addition to passing free of estate tax, if a charity is named a beneficiary of a qualified plan or IRA, the charity will receive the proceeds on the participant's death income tax-free by reason of its tax-exempt status, allowing the full distribution to avoid income tax otherwise payable by noncharitable beneficiaries. Thus, the assets will pass to a qualified charity free of both estate and income taxes, allowing 100 cents of every dollar to be used and invested by the charity for charitable purposes. By using retirement plan assets to fund the charitable portion of the estate plan, a donor may maximize the value of the usable estate.

> EXAMPLE**:** Client has an estate consisting of a $500,000 life insurance policy and $500,000 in a qualified plan. He wants to leave half of his estate to his spouse and half to charity. Assume he designates the charity as beneficiary of his life insurance policy and his wife as beneficiary of the qualified plan. The charity will receive the full $500,000 in life insurance proceeds tax-free. If the widow takes a distribution of the entire retirement plan and is taxed at a combined 40% tax rate, she will owe $200,000 in income tax, leaving only $300,000 after taxes. The total amount the Client will have transferred to his intended beneficiaries is $800,000. If instead Client designated the charity as beneficiary of retirement plan and left the life insurance to his wife, the charity and wife would both receive the full designated amounts tax-free, yielding a total gift of $1,000,000.

The example is oversimplified because it does not factor the spouse's ability to obtain further tax deferral of plan assets by rolling the plan over into her own name. An issue for consideration is whether the continued tax-deferred growth is likely to outpace the plan diminution for future required taxable distributions and taxes owed in the hands of individual beneficiaries. In many cases, the estate and income tax savings from using the IRD assets to fund a charitable bequest and giving other assets to noncharitable beneficiaries will yield a better net financial result.

Note that for most qualified plans, a spousal waiver must be obtained if the participant names any beneficiary other than the spouse.

Planning Notes

Primary or Continent Beneficiary Designation. A participant can designate a charity as a primary beneficiary to receive plan proceeds at the participant's death or as a contingent beneficiary to receive assets only if one or more of the primary beneficiaries are deceased. Any amount passing to the charity will pass free of income and estate tax. If the client wants to be sure that the charity receives at least a specified amount in the event the account is depleted during life, then a contingent make-up gift can be added to the client's estate plan.

> EXAMPLE**:** Client has an IRA worth $100,000, which he wants to leave to his alma mater. He wants to make sure that the college receives at least $75,000 to fulfill a capital campaign pledge he made. Client designates the college as beneficiary of the IRA and adds a bequest to his will that leaves to the college the sum of $75,000, reduced (but not below zero) by the value at his death of any IRA proceeds of which the college is the designated beneficiary.

Note that qualified plan or IRA proceeds should not be used to satisfy a pecuniary bequest to charity included in the participant's will or revocable trust. As with other kinds of income in respect of decedent, use of a qualified plan or IRA to fund a pecuniary (fixed amount) bequest will cause immediate recognition of income. Priv. Ltr. Rul. 201438014 (May 15, 2014).

Charitable Remainder Trust vs. QTIP Trust. In some instances, using retirement assets to fund a charitable remainder trust may yield better results as compared to a qualified terminable interest property (QTIP) trust for a surviving spouse. Consider the example of a client (Frank) who is married to Maureen, age 67. They have two sons, ages 39 and 43. Frank is considering funding a testamentary QTIP trust for Maureen with IRA assets. The QTIP trust would need to take IRA distributions over Maureen's life expectancy. If Frank dies when Maureen is 68 and has a life expectancy of 18.6 years, the QTIP trust will need to withdraw the entire account proceeds in about 19 years. If the account has a value of $2,000,000, the first-year distribution from the IRA to the QTIP trust will be $107,527 ($2,000,000/18.6). If Maureen lives past age 87, the entire account will have been withdrawn. Because the QTIP trust must distribute only income to the spouse, there still will be value preserved in the QTIP trust, but it all will be in an income taxable environment. Moreover, if Maureen dies shortly after Frank, Frank's two children will have to take the remaining IRA balance over Maureen's remaining life expectancy.

Instead, Frank could consider creating a testamentary charitable remainder trust (CRT) under his estate plan and designating the CRT as his IRA beneficiary. Because the CRT itself is a tax-exempt entity, it will not pay income tax upon collecting the qualified plan or IRA benefits, even if it takes a distribution of the entire plan balance immediately. The annuity or unitrust distributions to the CRT beneficiary will carry out the taxable income represented by the benefits, but possibly on a more favorable basis than if the benefits were payable directly to the beneficiary. Frank's estate also will receive an estate tax deduction for the actuarial value of the charitable portion of the CRT. The following example illustrates the effect:

> EXAMPLE: Frank makes his IRA payable to a testamentary charitable remainder unitrust. The CRUT will pay a 5% unitrust amount first to Maureen, for her life, then to his children for their lives. During Maureen's life, all assets in the CRUT could be invested tax-free, just as they would be if still in the IRA. With the CRUT, there is no increasing minimum distribution percentage required, as there would be under the required minimum distribution rules. Maureen starts with a distribution of about $100,000. On her death, Frank's children would continue to receive distributions from the CRUT for their lives, and the remaining CRUT assets would continue to be invested tax-free. Frank's estate would receive a charitable deduction equal to the remainder value of the CRUT, about $258,200.
>
> Assuming 6% growth and that Maureen dies after receiving 10 unitrust payments, her last payment will be about $108,060, and the CRUT will have about $2,161,200 of trust principal. Frank's sons can continue to benefit from these assets being invested tax free for their lives. Nine years later, when they are 59 and 63, the CRUT will have about $2,317,375 of trust principal and the sons will share a unitrust distribution of $114,974. At that point, Frank's sons will have received total distributions of about $1,003,375. Ten years after that, the CRUT will hold about $2,484,825, and Frank's sons will share a distribution of about $124,240. Frank's sons have received total distributions from the CRUT of about $2,193,500. Distributions continue for the rest of their lives.
>
> If Frank instead had created a QTIP trust for Maureen, Frank's two sons would need to take the remaining balance in the IRA over no more than 9 years (Maureen's remaining life expectancy). Assuming that the IRA earned about 6% per year and has $1,700,000 in it when Maureen dies, after receiving 10 annual distributions through the QTIP trust, her last distribution would have been $188,850. In the first year following her death, Frank's children must withdraw $197,674 ($1,700,000 ÷ 8.6). Nine years later, when they are 59 and 63, they will take the last distribution. Over that nine-year period, Frank's sons will receive total distributions from the IRA of $2,293,566. They will receive no further distributions.
>
> Comparing the QTIP and CRUT options, the CRUT in this example provides for longer tax-deferral as compared to the QTIP trust. At the same time, it still provides Maureen, during her life, with a likely steadily increasing income, assuming the trust assets return on average more than 5% per year. It also offers Frank's estate a charitable deduction.

A Note About Administrators and Custodians. A few issues may arise when attempting to designate a trust or other "unusual" beneficiary of an IRA or qualified plan.

- Some IRA and qualified plan administrators resist allowing a participant to designate a trust as a plan beneficiary or to create any designations outside of what the administrator's policy manual deems usual – even when the plan documents permit the designation. The administrator may insist that they cannot accept a designation to a trust or anything more complicated than outright to an individual beneficiary or estate. Practitioners should be prepared to persist in accomplishing their client's goals.

- IRA and qualified plan administrators often attempt to make a charity open an "inherited IRA account" to receive designated proceeds on the participant's death. The application form requires an individual staff member of the charity to provide his personal information, including birthdate, address, driver's license number, and Social Security Number. Such a request is improper and contrary to law. Charities are not "individuals" as set forth in IRC § 408(d) and, lacking human life expectancies, are not permissible owners of IRA accounts. Yet a plan administrator may insist, vaguely citing the requirements of the Patriot Act. One recommended approach that has been successful is to ask the financial firm to provide the legal basis for requiring a charity to open an inherited IRA account, remind the firm that the assets legally belong to the charity, and to move patiently up the chain of command as needed until the compliance or legal office is reached. "Charity IRA Beneficiaries Navigate Stormy Seas to Safe Harbors: Part II," Jeff Comfort, VP of principal gifts and gift planning at the Oregon State University Foundation, Planned Giving Today (August 2016).

IV. Charitable "Life Income" Gifts

A charitable "life income" gift is created when an individual makes a qualifying contribution to charity and retains a permissible lifetime interest in the contributed assets. If made during life, the individual will receive an income tax charitable deduction for the value of the remainder interest designated for charity. If made through a testamentary transfer, the decedent's estate can claim an estate tax charitable deduction based on the value of the remainder interest. The most common charitable life income gifts are explained below.

A. **<u>Gift of Real Estate with Retained Life Estate</u>**. A charitable deduction is allowed for income, estate and gift tax purposes for a charitable gift of a donor's remainder interest in a personal residence or farm, even though the donor retains the use of the property for herself or another noncharitable beneficiary for life or a term of years. The terms "personal residence" and "farm" do not include household furnishings or other tangible personal property. The donor may either retain a life estate or give one to others, and the life estate may include one or more lives. IRC § 170(f)(3)(B); Treas. Reg. § 1.170A-7(b)(3) and (4).

The donor will receive an income tax charitable deduction for the value of the charitable remainder interest. When valuing the allowable income tax charitable deduction for the remainder interest, depreciation and depletion of the donated real estate will be taken into account, and the value will be further discounted under the Treasury Department tables. Treas. Reg. §§ 1.170A-7(c); 1.170A-12. Depreciation and depletion are not taken into account for gift and estate tax purposes, however, and the donor or the donor's estate will receive an unlimited gift or estate tax charitable deduction for the full value of the charitable remainder interest.

If the donor retains a life estate for a beneficiary other than the donor, she will have made a taxable transfer to the life beneficiary of the life interest. For gift tax purposes, the life interest is a present interest and qualifies for the gift tax annual exclusion, and if the life tenant is the donor's spouse, the entire value of the property will qualify for the QTIP marital deduction election under IRC § 2056. If the donor reserves a life estate for herself and then for the life of another, she will have made a taxable future interest gift to the successor beneficiary that will not qualify for the gift tax annual exclusion. The donor can avoid making a current taxable gift to the successor beneficiary if the donor reserves the right to revoke the successor's interest. Treas. Reg. § 25.2511-2(c). If the donor does not exercise the right to revoke, a taxable transfer will occur on the donor's death.

In the case of a gift of a remainder interest to charity with a life estate reserved for the donor's life, the full fair market value of the property is included in the transferor's estate at death under IRC § 2036, but the estate will receive an offsetting estate tax charitable deduction under IRC § 2055.

Planning Note. A gift of real estate with a retained life estate will be governed by a gift agreement that will set forth the measuring term of the life estate, identify initial and successor life tenants, address what happens if the life tenant vacates the property during the measuring term, and provide options for the sale of the property during the term and any applicable division of proceeds or purchase of a new property. The agreement also should address the rights and responsibilities of the life tenants and remainder beneficiary, including maintenance, liability insurance, and usual repairs, all of which are typically the life tenant's responsibility. The charity should be given the right to access the property for periodic inspections. A carefully crafted gift agreement defining the parties' rights and responsibilities is essential to protect all parties from future misunderstandings and to address future contingencies.

B. **Pooled Income Funds**. A pooled income fund is a trust defined in IRC § 642(c)(5) that is established and maintained by a public charity. The pooled income fund receives gifts (usually cash or marketable securities) from a number of donors, and those gifts are commingled and invested. The donor, or the donor's designated beneficiary, receives annually a share of the fund's income based on the proportionate value of the donor's contribution as compared to the fund value on the contribution date. On the income beneficiary's death, the charity maintaining the fund receives the property outright to apply to its charitable purposes.

Contributions to pooled income funds qualify for charitable income, gift, and estate tax deduction purposes based on the present value of the charitable remainder interest as calculated pursuant to Treas. Reg. § 1.642(c)-6. The deductible value depends on the donor's age, the amount contributed, and the fund's assumed rate of return. If the income interest is given to someone else, the donor will be treated as making a present value gift of that interest for gift tax purposes. A donor does not generally recognize gain or loss immediately on the transfer of property to a pooled income fund. However, if a donor transfers property subject to indebtedness, the amount of the debt will be treated as a bargain sale under IRC § 1011(b), and the donor will realize gain in an amount equal to the amount that would have been realized if the donor had sold a fractional interest in the property in an amount equal to the indebtedness.

Pooled income funds have been used less frequently in recent years because of historically low corporate dividend and federal interest rate assumptions. Low investment income yields have reduced fund distributions, and donors often find charitable remainder trusts or charitable gift annuities more attractive planning options.

C. **Charitable Gift Annuities**. A charitable gift annuity is created when a donor transfers cash or other property to a charity in exchange for the charity's contractual commitment to pay the donor, another party (such as a spouse), or both, a fixed annuity for life. The contract amount remaining at the end of the term will be retained by the charity. If there are two annuitants, payments can be made to them jointly or successively. Payments may be made monthly, quarterly, semi-annually, or annually. The donor may claim income and gift or estate tax charitable deductions equal to the value of the property transferred, minus the fair market value of the retained annuity. Treas. Reg. § 1.170A-1(d).

The annuity amount is fixed at the time the contract is funded and will be based on the age of the annuitant(s) and applicable actuarial tables. Most charities offer annuitants the maximum recommended rates set forth by the American Council on Gift Annuities (http://acga-web.org/gift-annuity-rates), a nonprofit organization that periodically sets the rates to reflect current interest rate and investment performance assumptions. The suggested maximum rates are designed to produce a target gift to the charity equal to 50% of the initial contribution amount. Starting in November 2011, and reconfirmed as of April 2017, the ACGA uses a gross investment return expectation of 4.25% and an expense assumption of 1%.

Although the ACGA provides recommended annuity rates for annuitants as young as age five, most charities require an annuitant to have reached a much higher minimum age by the time annuity payments begin. Charities also require minimum funding amounts. The minimum age and funding requirements vary widely. For example, the American Cancer Society requires minimum funding of only $5,000 but a minimum annuitant age of 60, while Harvard University requires a minimum funding of $25,000 but permits annuitants to be as young as 40.

As of July 2017, the ACGA recommend annuity rates for a single-life gift annuity are:

Age	Rate	Age	Rate	Age	Rate
5-10	2.0	50	3.7	73	5.5
11-15	2.1	51-52	3.8	74	5.7

16-19	2.2	53-54	3.9	75	5.8
20-23	2.3	55	4.0	76	6.0
24-26	2.4	56-57	4.1	77	6.2
27-29	2.5	58	4.2	78	6.4
30-32	2.6	59	4.3	79	6.6
33-34	2.7	60-61	4.4	80	6.8
35-36	2.8	62-63	4.5	81	7.0
37-38	2.9	64	4.6	82	7.2
39-40	3.0	65	4.7	83	7.4
41-42	3.1	66-67	4.8	84	7.6
43	3.2	68	4.9	85	7.8
44-45	3.3	69	5.0	86	8.0
46	3.4	70	5.1	87	8.2
47	3.5	71	5.3	88	8.4
48-49	3.6	72	5.4	89	8.7
				90+	9.0

Unlike charitable remainder trusts (discussed below) and pooled income funds, where the obligation to make payments is limited solely to the contributed assets or segregated fund, a charitable gift annuity is considered a general obligation of the issuing charitable organization. For that reason, many states require issuing charities to be registered in the state and to maintain a certain level of reserves. Some states' registration and investment requirements are so strict that it is difficult or impossible for some out-of-state charities to offer gift annuities to residents of those states. This is not an issue for many charities that draw donors mostly from local areas, but large national health systems and universities can experience difficulty in offering charitable gift annuities to their entire donor base.

<u>Deferred, Flexible, and Commuted Payment Gift Annuities</u>. Charitable gift annuities can be structured in a few ways to address donor needs and wishes. A standard gift annuity begins making annuity payments immediately. If the annuity start date is deferred for more than one year after the contribution date (a "deferred gift annuity"), the annuitant will receive a higher annuity percentage payout when payments commence. IRC § 72(u). Regardless of how long the start date is deferred, the donor receives an income tax charitable deduction in the year of the contribution. A "flexible" deferred gift annuity allows the annuitant later to select his annuity start date from a range set forth in the contract, perhaps to coincide with retirement. The older the annuitant is at the time the payments begin, the larger the payments will be. A "commuted payment" deferred gift annuity allows the future payments to be compressed into a short payout period, perhaps to address a known need for future income for educational expenses or travel.

<u>Income Tax Matters</u>. Charitable gift annuities generally are taxed when established under the IRC § 1011 bargain sale rules. As mentioned, a charitable deduction is allowed in the year of the

transfer for the difference between the present value of the annuity contract and the value of the property contributed. Treas. Reg. § 1.170A-1(d).

As with any bargain sale, the donor must allocate his basis in the transferred assets between the sale portion and the charitable gift portion, and the donor may realize gain on the sale portion. However, if the annuity is non-assignable and the donor is either the sole annuitant for life or is one of the annuitants in a two-life annuity, any capital gain is recognized ratably over his life expectancy. Treas. Reg. § 1.1011-2(a)(4)(ii). Any unrecognized gain at the donor's death is not reportable if the annuity is a single life annuity. If the annuity pays over two lives, the succeeding annuitant continues to recognize any remaining gain under the same rules.

The annuity payments are taxed to the annuitant when received under IRC § 72. Under that section, an "exclusion ratio" is determined based on the ratio of the investment in the contract to the total expected return under the annuity. Treas. Reg. § 1.72-9. The exclusion ratio is applied to each payment to determine how much is a tax-free return on investment and how much is taxed as ordinary income or capital gain. For annuity contracts funded with cash or appreciated securities with a basis higher than zero, a portion of the annuity payment will be tax-free income over the annuitant's life expectancy.

<u>Gift and Estate Taxation</u>. If the donor names someone other than himself as an annuitant, the donor makes a gift to that person of the value of the annuity interest. If the annuity payments to the other annuitant are to begin immediately, the gift will be one of a present interest qualifying for the gift tax annual exclusion, and an annuity interest created for the donor's spouse will qualify for the unlimited gift tax marital deduction. Treas. Reg. § 25.2523(b)-1(b)(6)(ii). If the donor receives the initial annuity payments but gives a future annuity interest to another annuitant, the gift of the future interest will not qualify for the annual gift tax exclusion and will be a taxable gift on creation unless the donor retains the right exercisable by will to revoke the future interest. In that case, the taxable transfer will occur at death if the donor does not exercise the revocation right.

If a testator directs by will that his executor establish a charitable gift annuity for another, an estate tax charitable deduction will generally be allowed for the difference between the amount transferred to the charity and the present value of the annuity contract. Because the estate receives a stepped-up basis in the transferred assets, usually no capital gain should result. If the testator's spouse is the annuitant, the spouse's interest may qualify for the QTIP marital deduction election. Treas. Reg. § 20.2056(b)-7(c)(2).

Planning Notes

- Appreciated Property. A charitable gift annuity can be used to convert low-yielding appreciated securities into a fixed payments stream while avoiding part of the capital gain and deferring the rest over the donor-annuitant's life expectancy provided that the donor is an annuitant. If the donor is not an annuitant, all capital gain must be recognized in the first year. For married couples where one spouse plans to create a gift annuity for the other with property owned in the donor-spouse's sole name, the ownership of the property may need to be transferred to joint ownership to avoid immediate recognition of capital gain.

- Real Estate. A Flip charitable remainder trust, described below, is the preferred life-income gift option for contributions of real estate, but for those clients who prefer a fixed and guaranteed annuity to fluctuating remainder trust payments, real estate can be used to fund a charitable gift annuity if certain processes are followed. The charity is at risk in accepting real estate because its obligations to begin making annuity payment begin when the contract is executed. Thus, the charity will want to make sure the property is marketable before accepting it for a gift annuity, and it may ask the donor to accept a lower gift annuity rate and/or to defer annuity payments for at least two years to give the charity a chance to liquidate the property. The charity will do what it can to avoid using unrestricted general dollars to fund the annuity payments pre-sale.

  To avoid some of the risk, some charities may suggest a "put" arrangement by which the charity and a buyer enter into an agreement stating that if the charity receives a gift of the real estate, it has a certain period of time to require the buyer to purchase the property under certain conditions. The charity will not accept the property until it has located a buyer and knows it can sell the property for a specified price. As long as the charity is under no binding obligation to sell the property, the put arrangement should satisfy the requirements of Revenue Ruling 78-197 (sale of real estate will not be consider prearranged, and donor will not be taxed on capital gain, if charity is under no binding obligation to sell).

- Encumbered Assets. If real estate subject to a mortgage or other encumbered property is used to fund a gift annuity contract, the transfer of the property to the charity is treated as a sale even where the charity does not assume the debt as part of the transaction. Treas. Reg. 1.1011-2(a)(3); Crane v. Comm'r, 331 U.S. 1 at 12-14 (1947); Comm'r v. Tufts, 461 U.S. 300 at 310 (1983). This is true, even when the debt is nonrecourse. Guest v. Comm'r, 77 T.C. 9 (1981). In this case, the donor must recognize a pro rata portion of the recognized gain in the year the contract is created and cannot spread the gain over life expectancy. In some circumstances, this may make sense for certain donors when balancing the available current charitable deduction with the capital gains tax owed, but the numbers need to be evaluated carefully.

D. **<u>Charitable Remainder Trusts</u>**. A charitable remainder trust is an irrevocable trust defined in IRC § 664 under which one or more individuals receive a stated amount each year for a term of years (not exceeding 20) or for the life or lives of the individual(s), and the charity receives the remaining corpus at trust termination. <u>See</u> <u>also</u> Treas. Reg. § 1.6641(a)(1)(i). Like other charitable life income gifts, charitable remainder trusts are used primarily to provide income security to one or more noncharitable beneficiaries, while at the same time yielding income, gift and/or estate tax charitable deductions for the grantor. Charitable remainder trusts can also be used to convert low-yield appreciated securities into a reliable income stream while avoiding immediate recognition of capital gains tax on such assets that would otherwise be sold. A charitable remainder trust may be created during life or at death.

There are two main types of charitable remainder trusts that differ in the manner in which the stated annual amount to be paid to the noncharitable beneficiary is determined.

1. In a charitable remainder **annuity** trust, the stated amount must be a sum certain that is not less than five percent or more than 50 percent of the initial fair market value of the trust. IRC § 664(d)(1).

2. In a charitable remainder **unitrust**, the stated amount must be a fixed distribution that is not less than five percent or more than 50 percent of the value of the trust assets, determined annually. IRC § 664(d)(2).

In addition, the value of the remainder interest must be at least 10 percent of the net fair market value of the property contributed to the trust as of the date of its contribution. This 10-percent test is applied upon each transfer to the trust as of the date of the transfer in question. In addition, charitable remainder annuity trusts must satisfy a "5% probability of exhaustion" test under Revenue Ruling 77-374. That ruling requires all charitable remainder annuity trusts that will make payments for one or more lifetimes to have less than a 5% chance of corpus exhaustion.

There are four types of unitrusts:

- A <u>standard unitrust</u> pays the noncharitable beneficiary a fixed percentage of the net fair market value of the trust assets as revalued annually.
- A <u>net income unitrust</u> pays the noncharitable beneficiary the lesser of the trust's net income or the stated percentage each year.
- A <u>net income unitrust with a "makeup" provision</u> pays the noncharitable beneficiary the lesser of the trust's net income or the stated percentage and, if the income in any year exceeds the unitrust amount for the year, the excess is paid out to the extent necessary to make up for any shortfalls in prior years.
- A <u>"Flip" unitrust</u> begins as a net income unitrust and then converts to a standard unitrust on a triggering date defined in the trust document. Flip unitrusts may include "makeup" provisions. Flip unitrusts are discussed in more detail below.

The primary difference between a charitable remainder unitrust and annuity trust is that the amount of the annuity payment is fixed at the time the charitable remainder annuity trust is created, while the amount of the unitrust payment will fluctuate from year to year based on the value of the trust principal. Appreciation in an annuity trust inures solely to the charity's benefit, while appreciation in a unitrust benefits both the income beneficiary and the charity. Depreciation in an annuity trust will affect the charity almost exclusively because, unless the trust is fully depleted during the term, the income beneficiary will continue to receive the fixed annuity amount even when that amount represents a much higher percentage of the overall trust value (thus depleting it more quickly). Depreciation in a unitrust will result in lower payments to the income beneficiaries and a lower remainder to charity. An annuity trust may be better suited to noncharitable beneficiaries who want to minimize or avoid market risk; a unitrust will better suit a noncharitable beneficiary who wants to benefit from market upswings and is willing to risk decreases in unitrust payments.

Income Tax Deduction**.** If the charitable remainder trust is created during life, the grantor receives an income tax charitable deduction when the trust is created equal to the present value of the remainder interest. If the property passes outright to the charitable remainder beneficiaries at the end of the income term, the contribution is treated as "to" rather than "for the use of" the charities. If the charitable remainder beneficiaries are public charities, the percentage limitations for contributions to 50-percent-type organizations apply.

For an annuity trust the value of the remainder interest is computed by subtracting the present value of the annuity interest (determined under applicable Treasury Department tables) from the fair market value of the trust property. For a unitrust, the remainder interest is valued by reference to special tables contained in the income tax regulations. Treas. Reg. § 1.664-4.

IRC § 7520 requires the IRS to issue monthly valuation tables that affect the valuation of the charitable remainder interests. These tables use an interest rate assumption equal to 120 percent of the monthly Federal midterm rate in effect under IRC § 1274(d)(1). Generally, the applicable table will be the one promulgated for the month in which a taxable transfer occurs. However, if an income, estate or gift tax charitable deduction is allowable for more than an insignificant part of the transferred property, as is the case with a charitable remainder trust, the taxpayer may elect to use either the current month's table or the table applying to either of the previous two months. The § 7520 rate can have a significant impact on the qualification and available deduction for charitable remainder annuity trusts in particular.

Qualification as Tax-Exempt CRT in a Low 7520 Rate Environment. A low § 7520 rate can make it difficult to meet the 10% remainder value requirement for both annuity trusts and unitrusts, and the 5% probability of exhaustion test for an annuity trust. With a 2.2% § 7520 rate, an individual under the age of 27 cannot create a single-life unitrust, and a two-life unitrust requires income beneficiaries of the same age to be at least 39 years old. By comparison, a single-life charitable remainder annuity trust created with a 2.2% § 7520 rate requires the trust beneficiary to be at least 71 years old to meet the 10% remainder *and* the 5% probability of exhaustion test. A two-life annuity trust requires same-age income beneficiaries to be at least 73 years old.

The historically low IRC § 7520 rate in recent years has made it extremely difficult to create qualifying charitable remainder annuity trusts because trusts for all but older income beneficiaries violate the 5% probability of exhaustion test. In response, the IRS issued Revenue Procedure 2016-42, which provides a sample provision that may be included in a charitable remainder annuity trust agreement to remove the trust from the 5% probability of exhaustion test. The language defines a "date of contingent termination" that is the date immediately preceding the payment date of "any annuity payment if, after making that payment, the value of the trust corpus" based on certain calculations would be less than 10 percent of the value of the initial trust corpus. If the savings language is included in an annuity trust, a single-life trust can qualify with a beneficiary as young as 49, and a two-life trust can qualify with 61-year-old beneficiaries.

<u>Transfer Tax Effects</u>**.** When a lifetime charitable remainder trust is created, the grantor makes a gift of the income interest (unless retained by the grantor) as well as the remainder interest. The gift of the income interest qualifies for the annual exclusion because it is a present interest. If the donor's spouse is the only noncharitable beneficiary other than the donor, the income interest given will qualify for the unlimited marital deduction. IRC § 2523(g). The gift of the charitable remainder in all instances qualifies for the unlimited gift tax charitable deduction under IRC § 2055. In the case of a testamentary trust, the decedent's estate will receive an estate tax charitable deduction for the value of the remainder interest, and a marital deduction for the income interest if the spouse is the sole noncharitable beneficiary. IRC § 2056(b)(8). A bequest of the income interest to any other noncharitable beneficiary will be subject to estate tax.

If the annuity or unitrust beneficiary of a charitable remainder is a grandchild or more remote descendant of the grantor (a "skip person"), then there may be generation-skipping transfer tax ("GST tax") ramifications to the trust. No GST tax is incurred at trust creation because the charitable remainder beneficiary is treated as a non-skip person that has a present interest in the trust. IRC §§ 2651(e)(3), 2652(c)(1)(C). However, distributions from the trust to the skip person will be GST-taxable distributions. For example, if the trust is a charitable remainder annuity trust that pays $8,000 per year to the grantor's grandchild, each $8,000 distribution will be subject to the 40 percent GST tax. The grandchild must pay the $3,200 tax. IRC § 2603(a)(2).

The grantor can allocate GST exemption to the trust to avoid the GST tax. To fully exempt the trust, the grantor must allocate GST exemption equal to the value of the noncharitable income interest in the trust. IRC § 2642(a).

<u>Income Taxation of Trust and Beneficiaries</u>. A charitable remainder trust is expressly exempt from income tax under IRC § 664 even if it has undistributed income, unless it has any "unrelated business taxable income" for the year, in which case the trust will incur an excise tax equal to 100% of the UBTI realized. IRC § 664(c)(2). A charitable remainder trust must carefully track its

income because distributions carry out income taxable to the annuity or unitrust beneficiary. The payments from a charitable remainder trust during the noncharitable term will be taxed to the recipient in the following order:

1. First, as ordinary income to the extent of the trust's ordinary income for the year and undistributed ordinary income for previous years;
2. Second, as capital gain to the extent of the trust's capital gain for the year and undistributed capital gain for previous years;
3. Third, as other income (including tax-exempt income) to the extent of such income for the year and such undistributed income for previous years; and
4. Fourth, as a nontaxable distribution of trust corpus.

IRC § 664(b). Within a designated class, income will be treated as distributed first from those items within the class subject to the highest federal income tax rate and ending with the items subject to the lowest federal income tax rate. Treas. Reg. § 1.664(b). Thus, for example, within the ordinary income category, interest income would be treated as distributed before qualified dividend income.

Because of the tier system for the taxation of distributions to beneficiaries of charitable remainder trusts, any capital gains resulting from the sale of the contributed assets may ultimately be distributed and taxed to the beneficiary, but the beneficiary still is financially better off because the actual tax payments are deferred and spread over a multiple-year period.

<u>"Flip" Unitrusts</u>. One of the most flexible trust variations is the "flip" unitrust. The trust is formatted as a net income charitable remainder unitrust (with or without a makeup provision) that converts to a straight percentage charitable remainder unitrust upon the occurrence of a specified event.

The change from a net income unitrust to a straight unitrust must be triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustee or any other person (referred to as the "triggering event"). Permissible triggering events include the marriage, divorce, death, or birth of a child with respect any individual, and the sale of unmarketable assets such as real estate or artwork. Examples of impermissible triggering events include the sale of marketable assets and a request from the unitrust recipient or the unitrust recipient's financial adviser that the trust convert to the fixed percentage method. Treas. Reg. § 1.6643(a)(1)(i)(d) and (e).

The change from a net income unitrust to a straight unitrust must occur at the beginning of the taxable year of the unitrust that immediately follows the taxable year during which the triggering event occurs. Charitable remainder trusts are taxed on a calendar year basis. Thus, if the triggering event occurs on July 14, 2017, the conversion of the unitrust to a straight unitrust must occur on January 1, 2018. Following the conversion in the case of a net income unitrust with a makeup provision, the unitrust's governing instrument must provide that any makeup amount not paid as of the conversion date is forfeited. Treas. Reg. § 1.664-3(a)(1)(i)(c)(3).

During the pre-Flip phase, the unitrust can be invested for growth or total return to maximize growth before the income beneficiaries begin receiving full unitrust payouts. In increasing markets, this investment strategy should generate a higher unitrust payment post-flip because the value of the trust assets will have increased more quickly with only lower net income payments being made.

Flip unitrusts are often used to address the following situations:

- Illiquid Assets. The most common use of a flip unitrust is in connection with a gift of an illiquid or unmarketable asset, such as real estate, artwork, or closely-held stock. The triggering date on which the trust will convert to a straight unitrust payout could be defined as the date of sale or liquidation of the assets.

- Retirement Planning. Flip unitrusts are also useful in planning for an income beneficiary's retirement. The triggering event could be either a specific date or the date on which the donor reaches a certain age, such as age 67. The triggering date could also be defined as the donor's involuntary dismissal from employment, but the date should not be defined as the donor's "retirement" because that could be deemed to be a date impermissibly within the donor's control.

- Planning for Uncertainty. If a donor does not have a current or anticipated need for income, but wants to create a hedge against uncertainty about his future cash flow, a flip unitrust can be used to provide a safety net using a triggering date tied to involuntary termination of employment, total disability, or the death of an income-producing spouse.

Trust Term. The governing instrument of a qualified charitable remainder trust must require payment of the annuity or unitrust amount for a period that begins with the first year of the charitable remainder trust and continues for the life or lives of a named individual or individuals living at the creation of the trust or for a term of years not to exceed 20 years. If payments are made to a noncharitable entity such as a trust, the period of payment must be measured by a term of years not to exceed 20 years. If an individual receives an amount for life, it must be payable solely for the life of that individual. A period measured by the life of an individual may be tacked onto a period measured by a term of years if the individual is living on the date of the creation of the trust, but a period measured by a term of years may not succeed a period measured by the life of an individual.

Spousal Elective Share Waiver**.** In Revenue Procedure 2005-24, 2005-16 I.R.B. 909 (March 30, 2005), the IRS required a spouse to waive his right of election against a deceased spouse's estate in order for a charitable remainder trust to be valid. The IRS issued this revenue ruling in response to a perceived problem in states that permit surviving spouses to elect against the deceased spouse's "augmented estate" comprising both probate and non-probate assets, the latter of which in some states could include charitable remainder trusts. The IRS believed that the possible use of assets of a charitable remainder trust to satisfy a surviving spouse's elective share means that a noncharitable beneficiary could receive something other than the defined annuity or unitrust payments. The revenue procedure provided a safe harbor for those trusts that could be included in an augmented estate subject to the spousal election, protecting trusts with respect to which the spouse had irrevocably waived the right of election.

After receiving negative commentary on the rule, the IRS, through Notice 2006-15, 2006 I.R.B. 501 (February 3, 2006), indefinitely postponed enforcement of the safe harbor requirement. Until further notice, the IRS will disregard the existence of a surviving spouse's right of election against a charitable remainder trust as long as surviving spouse does not actually exercise the right of election.

Gifts of Appreciated Property. If the grantor owns low-dividend-paying appreciated securities, the use of those securities to fund a charitable remainder trust will yield an income tax charitable deduction for the remainder interest based on fair market value of the securities transferred. The trust can then sell the securities free of tax and invest in higher yielding securities. The grantor will have avoided immediate recognition of gain on the appreciation, received an income tax charitable deduction for the charitable portion of the appreciation, and obtained a higher (minimum 5%) "yield" on the assets through the annuity or unitrust payment received.

Contract for Sale of Stock in Place Before Gift Made. For contributions of non-publicly traded, including closely-held, stock, the IRS will impute gain to the donor when the donee charity is "legally bound or can be compelled by the corporation, to surrender the shares for redemption." Rev. Rul. 78-197, 1978-1 C.B. 83 (in response to Palmer v. Comm'r, 62 T.C. 684 (1974), in which the Tax Court rejected the IRS's attempt to impute gain for contribution of closely-held stock to a private foundation because the charity was not obligated to redeem the shares). These same rules should apply to arrangements between a donor and the trustee of a charitable remainder trust. Therefore, there should never be any prior understanding between the donor shareholder and the trustee or corporation about required stock redemption. The corporation should have complete discretion about whether and when to redeem the stock.

Insurance. Insurance on the life of a donor can be used to fund a charitable remainder unitrust. Priv. Ltr. Rul. 7928014 (Apr. 10, 1979). The trust should be structured as a net-income or net-income with makeup unitrust so that the donor can make additional contributions to the trust to cover future premium payments. The net-income-only requirement eliminates the need to make any payments from the trust when the only asset is the policy. If the donor continues to pay the premiums on the policy by making regular contributions to the unitrust, the donor will receive an income tax charitable deduction for the value of the remainder interest with respect to each premium payment. When the policy matures, the proceeds will be available to provide unitrust payments to the successor income beneficiary. The donor can include a make-up provision permitting the trustee to make up for payments not made prior to the death of the donor and the maturity of the policy.

Interests in S Corporations, LLCs or Partnerships. Charitable remainder trusts are not permissible S Corporation shareholders. A charitable remainder trust can hold interests in an LLC or partnership, but must be aware of unrelated business taxable income issues, which can generate the 100% excise tax already discussed, and the possible application of self-dealing rules under IRC § 4941(d) relating to a charitable entity's investment in a family-controlled partnership or LLC. See Priv. Ltr. Rulings 9448047 (Dec. 2, 1994) and 9114025 (April 5, 1991).

Retirement Plan Assets. As discussed above, tax-advantaged retirement plans can be used to fund a charitable remainder trust. Because the trust is a tax-exempt entity, it can collect the plan assets income tax-free, and the participant's estate will receive an estate tax deduction for the charitable remainder created. The annuity or unitrust distributions to the CRT beneficiary will carry out the taxable income represented by the benefits, but possibly on a more favorable basis than if the benefits were payable directly to the beneficiary, and the assets may be able to continue in a tax-free environment for a longer period than if the individual beneficiary was named.

Transfer of Debt-Encumbered Assets to a Charitable Remainder Trust. Using debt-encumbered property to fund a charitable remainder trust raises several potential problems and generally is inadvisable:

- Unrelated Business Taxable Income ("UBTI"). Unless the donor has held property for more than five years and the debt on the property has existed for more than five years, any transfer of debt-encumbered property to a charitable remainder trust will result in UBTI. IRC § 514(c)(2)(B). A charitable remainder trust that has UBTI will be subject to 100% excise tax on the UBTI generated by the trust. A transfer of debt-encumbered property that has been held by the donor for at least five years prior to the transfer and upon which the debt has existed for at least five years can avoid the unrelated business income tax for a period of ten years after the transfer.

- Application of the Bargain Sale Rules. When a donor transfers debt-encumbered or mortgaged property to a charitable remainder trust, the transaction is subject to the bargain sale rules of Section 1011(b) whether or not the trust, as a result of the transfer, becomes liable to make payments on the mortgage and the donor is relieved of the obligation. Treas. Reg. § 1.1011-2(a)(3). Thus, the donor will have to treat the sale portion as income received and pay capital gains tax on the difference between the value of the sale portion and the prorated adjusted basis in the property. Because the trust might make payments from income on a mortgage on which the donor remained liable, however, the trust may be treated as a grantor trust for income tax purposes, which will disqualify the trust as a charitable remainder trust. PLR 9015049. Commentators have discussed a number of creative approaches to using encumbered property to fund a charitable remainder trust, from the cleanest (having the donor pay off the mortgage or having the lender release the mortgage in exchange for other collateral), to funding the trust with a purchase option, including language prohibiting the trustee from making payments on the debt, or having the donor sell a fractional interest in the property to the charity. The IRS has issued rulings indicating its distaste for some of the more creative approaches, so great care must be taken if funding will include encumbered property.

Allocation of capital gains to income. If a provision is included in a net-income with makeup charitable remainder trust that defines ordinary income to include realized capital gains, the trustee should be able to generate a large amount of income by selling appreciated assets, and that income can be used to accelerate unitrust make-up distributions to the noncharitable beneficiary. The IRS has blessed this type of NIMCRUT in several private rulings, if several other requirements are satisfied. Note that pre-contribution gain must be allocated to principal. Treas. Reg. § 1.664-3(a)(1)(i)(b)(4).

Sample Forms and Drafting Notes. The Internal Revenue Service issued a series of revenue procedures in 2003 and 2005 providing updated sample trust forms for *inter vivos* and testamentary charitable remainder annuity trusts and charitable remainder unitrusts. The Revenue Procedures provide that a trust will be a qualified charitable remainder trust under IRC § 664 if the trust (1) creates a valid trust under local law, (2) refers to the applicable Revenue Procedure, and (3) is "substantially similar" to the sample instruments provided.

The sample forms and applicable Revenue Procedures are listed below:

Charitable Remainder Annuity Trusts

1. Inter Vivos Charitable Remainder Annuity Trust, One-Life (Rev. Proc. 2003-53)
2. Inter Vivos Charitable Remainder Annuity Trust, Term of Years (Rev. Proc. 2003-54)
3. Inter Vivos Charitable Remainder Annuity Trust, Two Lives (Consecutive) (Rev. Proc. 2003-55)
4. Inter Vivos Charitable Remainder Annuity Trust, Two Lives (Concurrent and Consecutive) (Rev. Proc. 2003-56)
5. Testamentary Charitable Remainder Annuity Trust, One Life (Rev. Proc. 2003-57)
6. Testamentary Charitable Remainder Annuity Trust, Term of Years (Rev. Proc. 2003-58)
7. Testamentary Charitable Remainder Annuity Trust, Two Lives (Consecutive) (Rev. Proc. 2003-59)
8. Testamentary Charitable Remainder Annuity Trust, Two Lives (Concurrent and Consecutive) (Rev. Proc. 2003-60)

Charitable Remainder Unitrusts

1. Inter Vivos Charitable Remainder Unitrust, One Life (Rev. Proc. 2005-52)
2. Inter Vivos Charitable Remainder Unitrust, Term of Years (Rev. Proc. 2005-53)
3. Inter Vivos Charitable Remainder Unitrust, Two Lives (Consecutive) (Rev. Proc. 2005-54)
4. Inter Vivos Charitable Remainder Unitrust, Two Lives (Concurrent and

Consecutive) (Rev. Proc. 2005-55)

5. Testamentary Charitable Remainder Unitrust, One Life (Rev. Proc. 2005-56)
6. Testamentary Charitable Remainder Unitrust, Term of Years (Rev. Proc. 2005-57)
7. Testamentary Charitable Remainder Unitrust, Two Lives (Consecutive) (Rev. Proc. 2005-58)
8. Testamentary Charitable Remainder Unitrust, Two Lives (Concurrent and Consecutive) (Rev. Proc. 2005-59)

Although the forms include helpful annotations for particular drafting situations and needs, they do not include certain provisions that are necessary or advisable from a tax, state law, or other practical perspective, so they should be used only as a starting point for drafters. For example:

- The forms do not include provisions for trustee replacement and succession.
- Trusts that include an income interest after the donor's death must include a special provision eliminating the successor beneficiary's income interest unless the successor beneficiary personally furnishes the funds to pay any estate tax apportioned against the trust and for which the trust is liable. If the successor life beneficiary fails to do so, the charity's interest takes effect immediately. Rev. Rul. 82-128, 1982-2 C.B. 71, mod. Rev. Rul. 72-395.
- To avoid gift tax on the creation of a successor income interest, the trust must include a provision under which the donor reserves the right to revoke or terminate the interest of the noncharitable beneficiary. Under applicable regulations, the power to revoke is exercisable only by will. Treas. Reg. §§ 1.664-2(a)(4), 1.664-3(a)(4). If the donor reserves this power, the secondary life interest is revocable and there is no gift at the time of the creation of the trust. By making the life interest revocable, the value of the trust would be included in the donor's estate under IRC § 2036 but should be partially offset by the charitable deduction for the charitable remainder interest determined as of the donor's date of death.

V. CHARITABLE LEAD TRUSTS

A charitable lead trust is often called the "reverse" of a charitable remainder trust because the charitable beneficiaries receive the "lead" payments during the trust term, and noncharitable beneficiaries (typically the grantor's descendants) receive the remainder interest. As with charitable remainder trusts, lead trusts may be one of two types: (1) an annuity trust, in which the charitable beneficiary receives a sum certain, or (2) a unitrust, in which the charity receives a fixed percentage of the value of the trust property as revalued annually. A charitable lead trust is flexible. It can allow the trustee to select charitable recipients or provide for specific charities. There is no minimum payout for a charitable lead trust, and no minimum or maximum term. The trust may be created during life or at death.

Unlike a charitable remainder trust, a charitable lead trust is not tax-exempt and will be subject to income tax as a complex trust under IRC § 641. The trust will receive a charitable income tax deduction for payments made during the trust term to charity under IRC § 642(c)(1)). Any income earned in excess of the amount distributed to charity will be taxed to the trust at typical trust rates.

The donor will receive an income (see below), gift and/or estate tax deduction only if each beneficiary of the lead interest is described as a qualified charitable organization under IRC § 170(c). IRC §§ 170(a), 2055(e)(2)(B), and 2522(c)(2)(B), respectively. For gift and estate tax purposes, the organization may be a public charity or a private foundation, including a private foundation affiliated with the donor. A donor may name one or more qualified charities to receive set portions of the income throughout the trust term or authorize the trustee to select charitable beneficiaries and allocate the income payment annually. Upon the transfer of assets to a qualifying CLT, the donor receives a deduction equal to the present value of the income interest payable to charity, as determined pursuant to IRC § 7520. The value of the remainder interest for noncharitable beneficiaries comprises a taxable transfer. The longer the charitable term and the higher the payout rate, the greater the value of the charitable interest and the lower the value of the taxable remainder.

A charitable lead trust is most often used by high net worth clients who want to plan for charity while transferring assets to descendants at reduced (or no) transfer tax cost. Because the values of the income and remainder interests are calculated at inception using the IRC § 7520 assumed rate of return, a CLT donor can achieve significant tax savings if the actual investment return on the trust assets during the trust term exceeds the assumed rate. Any excess value passes to the noncharitable beneficiaries free of transfer tax (but see discussion of GST tax planning below).

Income Tax Deduction for Grantor CLT. Generally, when the grantor creates a charitable lead trust, he will not receive an income tax charitable deduction. However, if the trust is structured as a "grantor" trust, in which the trust income is taxable to the grantor under the applicable income tax rules under IRC §§ 671-679, the grantor can claim a current income tax charitable deduction for present value of the charitable interest. The deduction will be subject to the 30-percent contribution base limitation (or the 20-percent limitation if long-term capital gain property is used to fund the trust) because contributions to a charitable lead trust are treated as "for the use of" the charitable donees. Treas. Reg. § 1.170A-8(a)(2).

As owner of the grantor trust property, however, the donor continues to be taxed on the income earned during the term of the trust without receiving any further income tax deductions for the amounts the trust pays to charity. Thus, the donor's upfront charitable deduction will be "recaptured" throughout the trust term. If the donor dies or ceases to be treated as the owner of the CLT before the deduction is fully recaptured, the remaining uncaptured part will be accelerated and taxed to the donor or the donor's estate. Grantor charitable lead trusts often invest at least in part in municipal bonds to avoid generating taxable income to the grantor, though such investments may reduce the amount of the remainder ultimately available to the noncharitable beneficiaries that can pass free of transfer tax.

If the charitable lead trust is not a grantor trust, the grantor will not receive any income tax charitable deduction for the amounts paid to charity, either when the trust is created or subsequently. However, the income generated by the trust's assets will be removed from the grantor's gross income, yielding the equivalent effect to the grantor of receiving an income tax charitable deduction each year.

Transfer Taxes. A charitable lead trust also can produce significant federal transfer tax benefits for the grantor or the grantor's estate. Upon creating the trust, the grantor makes a gift or bequest to charity of the present value of the charity's right to receive trust payments. The value of the charitable interest is determined by using the same tables and applicable monthly § 7520 interest rates used for charitable remainder trusts. If the charitable lead trust is an annuity trust, Table B of the Treasury tables is used. For a charitable lead unitrust, the special unitrust tables prescribed by Treas. Reg. § 1.664-4 are used. The gift qualifies for the federal gift tax charitable deduction under IRC § 2522 or the federal estate tax charitable deduction under IRC § 2055. The grantor also makes a taxable gift or bequest of the noncharitable remainder interest. With respect to an *inter vivos* trust, the gift of the remainder interest is a taxable gift and does not qualify for the annual gift tax exclusion because it is a gift of a "future interest."

Because there are no restrictions on charitable lead trust terms or percentage payouts, a practitioner can perform calculations using a number of combinations to minimize the value of the noncharitable remainder interest, and thus the value of the taxable transfer. If the trust investment performance exceeds the annuity or unitrust percentage over the trust term, the donor will have transferred that appreciation to noncharitable beneficiaries free of further transfer tax. If noncharitable beneficiaries are grandchildren or other skip persons, there are generation-skipping transfer tax considerations that must be addressed. They are discussed below.

Note that the grantor of a lifetime charitable lead trust should avoid retaining the right to designate the charitable beneficiaries of the trust. If the grantor dies during the charitable lead term, the trust property will be included in his estate and all transfer tax benefits of the trust will be lost. The grantor may give the trustee the power to select charitable beneficiaries for the annual charitable distributions, or to select among certain designated beneficiaries.

Zero-Out Charitable Lead Annuity Trusts. The term and payout of a lead annuity trust (but not a unitrust) can be calibrated carefully to minimize, or reduce to zero, the value of the taxable noncharitable remainder.

> EXAMPLE**:** If an individual transfers $100,000 to a charitable lead annuity trust to pay one or more charities a $7,800 annuity each year for 15 years, and the applicable IRC § 7520 rate is 2%, the annuity interest will be valued at $100,000 for gift tax purposes, and the trust remainder will be zero. Assuming the trust will in fact earns at least 7.8 percent, the entire $100,000 will pass to the remainder beneficiary at the end of the annuity term free of gift tax. The remainder beneficiaries will also receive any underlying appreciation in the trust property, plus any income earned in excess of 7.8 percent. To the extent that

investment performance is less than 7.8 percent, trust principal must be used to pay the annuity amount, and the noncharitable remainderman will ultimately receive less property. Because the grantor is not treated as making a taxable gift when the trust is created, the entire $100,000 will be excluded when the grantor's estate tax is computed.

The following illustration shows how the selection of a trust term affects the minimum required charitable lead annuity rate to "zero-out" the noncharitable remainder interest. The examples assume creation of a charitable lead annuity trust under a 2.2% monthly IRC § 7520 rate:

Trust Term in Years	Zero-Out Annuity Rate
10	11.2495%
15	7.8995%
20	6.2344%
25	5.2431%
30	4.5887%

As noted above, the gift tax value of the remainder interest in a lead unitrust cannot be reduced to zero because the unitrust payment is equal to a fixed percentage of the value of the trust assets determined annually. Thus, the unitrust principal will never be fully exhausted. The difference is significant. In the example noted above, if the individual instead transferred $100,000 to a 15-year charitable lead unitrust paying charity 7.8 percent of its annual value and using a 2% § 7520 rate, the donor will have made a taxable gift of $30,322.

Using Family Limited Partnerships. One way to reducing the down-side risk and create a high return asset for a charitable lead annuity trust is to create a family limited partnership and then fund the charitable lead annuity trust with discounted family limited partnership interests.

> EXAMPLE**:** Donor wants to transfer $1,000,000 to a charitable lead annuity trust for 15 years at a time when the § 7520 rate is 3%. The remaindermen are the donor's children. To "zero-out" the gift, the trust must pay the charity $84,000 each year. If the trust assets actually return 8.4% or more on average over fifteen years, at least $1,000,000 will pass to donor's children for a $0 gift tax cost. Moreover, the charity will have received $1,260,000 from the annual annuity payments. Unfortunately, the assets that donor was planning to use will only produce a return of 6.8%. Donor's solution is to create a family limited partnership and fund it with various assets, such as real estate and securities. Then he transfers limited partnership interests with a net asset value of $1,235,000 to the charitable lead annuity trust. Thus, the charitable lead annuity trust will achieve a return of $84,000 each year (6.8% of $1,235,000). To take into account the lack of control and lack of marketability of the limited partnership interests, the donor values those interests at a 19% discount, or at $1,000,000, for purposes of the transfer. The effective yield on the discounted value of the limited partnership interest is 8.4% ($84,000 ÷ 1,000,000). The charity will receive an annuity of $84,000, and the donor has reduced the taxable value of the remainder gift to his children to zero.

Testamentary Trusts. Although a testamentary charitable lead trusts can reduce the estate tax cost of transferring assets to beneficiaries, the beneficiaries are not necessarily better off than if the trust assets passed directly to them at the decedent's death with no charitable deduction. This is because use of a charitable lead trust postpones the time at which the noncharitable beneficiaries come into possession of the trust assets, and in most cases, the lost use of the trust assets by those beneficiaries during the charitable term will outweigh the estate tax savings from using the trust. However, the trust does provide benefits to charity that would not otherwise be available, so an individual with clear charitable inclinations may wish to use such a trust even though it may result in a cost to his family.

Generation-Skipping Tax Issues. Although the formation of a CLT is not subject to immediate generation-skipping transfer (GST) tax, if the remaining assets pass to "skip persons" (for example, the donor's grandchildren) at the end of the trust term, the expiration of the term will be a taxable termination resulting in GST tax. For a charitable lead unitrust, all or a portion of the donor's GST exemption can be precisely allocated when the trust is created, with an opportunity for leverage because the amount of the allocation necessary to produce a zero inclusion ratio is the discounted present value of the remainder interest rather than the value of the assets ultimately passing to the remainder beneficiaries. For a charitable lead annuity trust, however, GST exemption cannot be precisely allocated on trust creation because calculation of the future GST tax (and therefore, the appropriate allocation of the donor's GST exemption) is based in part on the value of the trust assets actually passing to the noncharitable beneficiaries at the end of the trust term.

The amount of GST exemption required fully to exempt a trust is the amount that will produce an "applicable fraction" of 1. Under IRC § 2642(e), a charitable lead annuity trust term is considered an "estate tax inclusion period" or ETIP, which means that the amount of GST tax assessed cannot be determined until the end of the trust term. Thus, for a lead annuity trust, the numerator of the fraction is the "adjusted GST exemption" (the GST exemption allocated to the trust compounded annual over the charitable term at the interest rate used to calculate the remainder interest on trust creation), and the denominator is the value of the trust property at the end of the trust term. This means that the applicable fraction for GST purposes cannot be determined until the end of the charitable annuity term. Thus, to exempt a charitable lead annuity trust from GST tax, the grantor must somehow determine how much GST exemption will equal the expected value of the trust when the charitable term expires.

> EXAMPLE**:** An individual creates a $1 million charitable lead annuity trust to pay an annual annuity of $70,000 to charity for 10 years, and to pay the trust principal remaining at the end of that period to his grandchildren. Assume that the § 7520 rate used to value the transfer is 2%, the gift tax value of the charitable gift is $700,640, and the gift tax value of the remainder is $299,360. If the individual allocates $299,360 of GST exemption to the trust on creation, the adjusted GST exemption would be $365,578 ($299,360 compounded at 2 percent annually for 10 years). If the trust principal has appreciated at

> a greater rate, the applicable fraction for GST purposes on trust termination will be less than 1 (and the inclusion ratio of the trust will be greater than zero). If the individual is still living at that time and has sufficient additional GST exemption left, he could make an additional allocation of GST exemption to the trust and avoid the shortfall. Otherwise, GST tax will be incurred when the charitable term expires. If the trust principal is worth less than the adjusted GST exemption when the charitable term expires, then the trust will be sheltered from GST tax, but the individual will have allocated too much GST exemption to the trust, leaving less for other transfers. There is no way to recover any excess exemption allocated to the trust in such a case.

Because it is generally impossible to predict the GST value, it is advisable to delay allocating GST exemption until the end of an annuity lead interest to avoid allocating too much or too little GST exemption.

Charitable lead unitrusts are not affected by IRC § 2642(e). For these trusts, the numerator of the applicable fraction is the amount of GST exemption allocated to the trust, with no adjustments, while the denominator equals the value of the property transferred to the trust, reduced by the amount of the charitable deduction allowed with respect to the transferred property, based on the present value of the charitable interest at the time of the transfer. IRC § 2642(a). Because of the distinction, the grantor of a charitable lead unitrust can use the GST exemption more effectively and more precisely than is possible with an annuity trust to transfer assets to remote descendants.

> <u>EXAMPLE</u>: An individual creates a $1 million charitable lead unitrust to pay an annual amount equal to 7 percent of the trust assets to charity for 10 years, and to pay the remaining trust principal at the end of the term to his grandchildren. At a 2% IRC § 7520 rate, the gift tax value of the charitable gift is $508,830, and the gift tax value of the remainder is $491,170. If the individual allocates $491,170 of GST exemption, the entire transfer to the grandchildren at the end of the term will be exempt from GST tax.

<u>Sale of Remainder Interest in a Charitable Lead Annuity Trust</u>. Some practitioners believe it is possible to avoid the IRC § 2642(e) problem for lead annuity trusts through the sale of the CLAT's remainder interest to an existing trust for grandchildren and more remote descendants that is entirely GST tax-exempt. There would be income tax consequences to the selling trust remaindermen (typically the children) and cost basis issues to address. This technique has not been blessed by the IRS, though some practitioners believe that if structured properly and all parties deal fairly and at arm's length, the technique should pass IRS scrutiny.

<u>Sample Forms</u>. In Revenue Procedures 2007-45, 2007-29 I.R.B. 89, and 2007-46, 200729. I.R.B. 102 (June 22, 2007), the IRS released sample charitable lead annuity trusts provisions, and in Revenue Procedures 2008-45 and 2008-46, the IRS released sample charitable lead unitrust provisions. These revenue procedures provide sample forms, annotations, and alternate provisions for inter vivos and testamentary charitable lead trusts. The suggested language is

similar in many respects to that previously provided by the IRS for charitable remainder trusts and to the form language already used by most practitioners. Sample forms are provided for both grantor and nongrantor charitable lead trusts and for a lead period measured by one or more lives as well as a term of years.