PROMOTING PHILANTHROPY: THE ATTORNEY'S ROLE IN INTRODUCING DEVELOPING AND IMPLEMENTING A CHARITABLE COMPONENT OF A CLIENT'S ESTATE PLAN

-by-

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I. Introduction

A. The genesis of this paper originated form a sense of *mea culpa*: I realized that I seldom raise charitable planning options during my estate planning conferences with clients.

B. It is extremely difficult to explain the myriad of estate, gift and generation-skipping tax rules and introduce a variety of estate planning options in the short duration of the typical estate planning conference.

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

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

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

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

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

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

(a) work ethic

(b) community involvement

(c) philanthropic desires.

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

1. Reduction of estate taxes;

2. Increase of funds for charitable purposes; and

3. Income tax reduction

E. In particular, the concept of "matching" contributions for charity coming in part from the Internal Revenue Service and the beneficiary is appealing to some clients.

1. Matching contributions can range from:

(a) Dollar for dollar to;

(b) More than three dollars in tax reduction for one dollar from the beneficiary.

F. This paper will present a number of charitable planning options which can provide "matching" funding of philanthropic causes.

G. In closing, this paper will describe the steps to be taken in forming and operating a private foundation, answer fourteen common client questions and briefly examine two of the author's favorite charitable planning techniques.

II. Recent Charitable Tax Law Developments

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

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

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

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

(b) Can use an escalating or "shark fin" charitable lead trust to defer payments tp charity and maximize amount passing to family.

(c) Can be used by a donor with a reduced life expectancy.

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

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

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

6. Direct gift to charity of $100,000 from IRA by participants age 701/2 or older.

B. **Tax Law Changes Impacting Charitable Giving.** There have been a number of tax law changes which will have a direct impact on charitable planning:

1. New estate tax rate of 40% in 2013.

2. Increase of estate and gift tax exemption to $5,250,000 (indexed for inflation).

3. 3.8% surtax on net investment income over $200,000 (single taxpayers) or $250,000 (married taxpayers).

4. Increase in maximum income tax rate from 35% to 39.6% (or 43.4%).

5. Increase of capital gain tax rate from 15% to 20% (or 23.8%).

6. Direct charitable gifts of $100,000 from IRAs fro taxpayers 70½ or older.

7. Reinstatement of 3% floor on itemized deductions.

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

9. The actuarial value of the remainder interest of a charitable remainder trust must be at least 10% of the fair market value of the donated property.

10. A charitable remainder unitrust cannot have a payout greater than 50% of its initial fair market value.

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

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

13. Creation of safe harbor for use of mortality tables in connection with gifts to split interest trusts valued under the Section 7520 applicable federal rates.

14. Extension of the qualified appreciated stock exception for gifts to private foundations.

15. Private Letter Ruling 201216045 validated escalating charitable lead trusts.

16. Approval of the use of a "flip" unitrust funded with unproductive property.

C. These recent changes and their effect on popular charitable planning techniques will be addressed in the balance of this outline.

III. Tax Savings Available Through Charitable Giving

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

1. Maximum income tax rate of 39.6% for married taxpayers with taxable income in excess of $450,000 in 2013. ***IRC Section 1(i).***

(a) 33% on taxable income from $223,050 to $398,350.

(b) 35% on taxable income from $398,050 to $450,000.

(c) Maximum 39.6% rate imposed on single taxpayers above the $400,000 taxable income threshold.

2. New 3.8% surtax on investment income imposed by the Patient Protection and Affordable Care Act for:

(i) Individuals with net investment income of $200,000+.

(ii) Married couples with net investment income of $250,000+.

3. New capital gain tax rates:

(a) Capital gain rate of 23.8% for:

(i) Individuals earning more than $400,000.

(ii) Married couples earning more than $450,000.

(b) Reduced rate of 18.8% for individuals earning $200,000 to $400,000.

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

(a) Social Security wage base of $113,700 in 2013.

(b) OASDI taxes of 12.4% on self-employed persons in 2013, an increase from the 10.4% in 2011-2012.

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

B. **Estate Tax Deduction.**

1. Estate tax rate of 40%.

2. Estate, gift and generation-skipping tax exemptions of $5,250,000 (indexed for inflation).

C. **Income Tax Savings.**

1. Increase of marginal income tax rates and new 3.8% surtax will make charitable giving more attractive.

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

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

IV. Types of Charitable Organizations.

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

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

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

1. More than 50% of its assets; and

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

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

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

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

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

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

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

   (d) No investment and administrative burden.

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

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

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

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

3. **Fidelity Charitable Gift Fund**. In less than a decade, the Fidelity Charitable Gift Fund has become one of the largest charitable organizations in the United States.

V. Contribution Limits.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

D. **3% Floor on Itemized Deductions.** There was a reinstatement in 2013 of the 3% floor set on itemized deductions for married taxpayers in excess of adjusted gross income of $300,000 ($250,000 for single taxpayers) ***IRC Section 68(b)***:

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

(a) 3% of adjusted gross income over the threshold amount; or

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

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

3. The floor on itemized deductions was previously phased out over a five year period beginning in 2006:

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

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

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

VI. Types of Charitable Gifts.

A. **Outright Gifts.**

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

1. **Charitable Remainder Annuity Trust.**

2. **Charitable Remainder Unitrust.**

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

1. **Charitable Lead Annuity Trust.**

2. **Charitable Lead Unitrust.**

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

1. Will produce a charitable income tax deduction and, if appreciated property is gifted, taxable gain to the donor.

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

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

4. The American Council on Gift Annuities recommended a decrease in payout rates effective July 1, 2003.

(a) Most annuity rates decreased by 0.5% to 0.8%, depending on the age of the annuitant (age 60 and above).

(b) Charitable deductions have increased accordingly.

5. Advantages of a Charitable Gift Annuity

(a) Simplicity — one page contract is sufficient.

(b) No tax return, trust or trustee

6. Disadvantages of a Charitable Gift Annuity

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

(b) May constitute a security in certain states.

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

VII. Charitable Remainder Trusts.

A. Types of Charitable Remainder Trusts.

1. Charitable Remainder Annuity Trust.

2. Charitable Remainder Unitrust.

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

1. **Guaranteed Annuity Interest.**

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

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

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

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

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

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

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

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

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

6. **Applicable Federal Rates.**

   (a) The March 2013 applicable federal rate was only 1.4%, close to the record low of 1.0% (last seen in January 2013).

   (b) The chart listed below shows the fluctuation of the applicable federal rates in March 2013 and in the month of September over the last twelve years:

Month	§ 7520 Rate
March 2013	1.4%
September 2012	1.0%
September 2011	2.0%
September 2010	2.4%
September 2009	3.4%
September 2008	4.0%
September 2007	5.8%
September 2006	6.0%
September 2005	5.8%
September 2004	4.6%
September 2003	4.2%
September 2002	4.6%
September 2001	5.8%
September 2000	7.6%

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

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

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

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

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

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

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

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

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

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

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

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

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

   (a) Divorce;

   (b) Remarriage; or

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

VIII. Income Taxation of Charitable Remainder Trusts

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

B. **Unrelated Business Taxable Income.**

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

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

1. The tier system works as follows:

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

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

(c) Tax-exempt income.

(d) Return of principal.

2. Proposed regulations create additional ordering rules with "subtiers" within each tier:

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

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

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

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

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

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

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

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

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

C. **Minimum Distributions Rules**. Selection of "designated beneficiaries" and spreading IRA and qualified retirement plan benefits in accordance wit the new "minimum distribution rules" can reduce the double tax burden and obtain significant income tax deferred.

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

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

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

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

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

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

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

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

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

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

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

XI. Charitable Lead Trusts.

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

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

(a) **Charitable Lead Annuity Trust**. A charitable lead annuity trust is a charitable lead trust in which the "lead" charitable interest is a guaranteed annuity interest.

(b) **Charitable Lead Unitrust**. A charitable lead unitrust is a charitable lead trust in which the "lead" charitable interest is an amount calculated as a fixed income percentage of the value of the trust property, redetermined annually.

2. **Nonqualified Charitable Lead Trust.** Transfer to a nonqualified charitable lead trust are not deductible for estate or gift tax purposes. A nonqualified charitable lead trust may also be created during a donor's life ("inter vivos") or by will ("testamentary"). (The outline will address qualified charitable lead trusts.)

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

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

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

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

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

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

    (a) **Trust Document**. The trust document must either directly specify, or grant the trustee authority to select, the charitable organization to which the trust annuity or unitrust amount is paid.

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

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

2. **Guaranteed Annuity Interest.**

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

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

3. **Unitrust Interest.** A charitable lead unitrust must state a fixed percentage of the annual net fair market value of all trust property as the unitrust interest. Under Treasury Regulations Sections 20.2055-2(e)(2)(vii) and 25.2522(c)-3(c)(2)(vii), the unitrust payment must be payable at least

annually for a fixed term of years or until the death an individual or survivor of a group of individuals.

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

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

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

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

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

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

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

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

(a) More than one life can be used.

(b) Cannot base solely on another’s life (“per autre vie”).

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

1. **Charitable Lead Annuity Trust.**

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

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

(c) **Tax Savings.**

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

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

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

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

(iii) **Low Section 7520 Rates**. The current low applicable federal and Section 7520 rates make charitable lead trust an unusually beneficial estate planning technique.

2. **Charitable Lead Unitrust.**

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

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

(c) **Tax Savings.**

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

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

F. **Generation-Skipping Transfer Tax Savings.**

1. **Charitable Lead Annuity Trust.** Generation-skipping tax exemption cannot be allocated to a charitable lead annuity trust.

2. **Charitable Lead Unitrust.** Although generation-skipping tax exemption may be allocated to a charitable lead unitrust, the tax advantage may be limited since the unitrust is measured as a percentage of trust principal.

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

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

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

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

1. **September AFR.** The September applicable federal rate is only 1.0%.

2. **November 30, 2012 Deadline.** Charitable lead trusts funded by November 30 may use the September 1.0% rate.

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

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

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

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

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

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

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

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

2. See also ***Private Letter Ruling 200240027***.

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

XII. Private Foundation.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

F. **Excise and Penalty Taxes.**

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

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

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

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

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

2. **Penalty Taxes.**

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

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

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

      (iii) lobbying, electioneering and private grants;

      (iv) hazardous investments; and

      (v) excess business holdings.

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

G. **Operational Rules.**

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

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

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

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

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

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

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

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

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

(i) distributions to public charities;

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

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

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

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

(f) **Penalty Tax.** A foundation is subject to a penalty tax of 15% on any amount required to be distributed in respect to any taxable year which is not paid within twelve months of the end of the taxable year. Any amount still remaining undistributed after the expiration of a permitted correction period is subject to a 100% tax. Unlike the case with self-dealing (discussed below), no comparable penalty taxes are imposed on foundation managers under this rule. ***IRC Section 4942(a) and (b).***

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

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

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

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

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

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

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

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

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

(i) payment of excessive compensation;

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

(iii) loan agreements;

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(b) **Partnerships and Corporations**.

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

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

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

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

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

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

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

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

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

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

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

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

XIII. Fourteen Common Planning Questions.

1. I deduct my charitable gifts on Schedule A of my individual income tax return (Form 1040). I am aware that tax rates changed in 2013. Are there be additional limitations imposed on my itemized deductions this year?

Yes. There is a reinstatement of the floor set on itemized deductions for married taxpayers with adjusted gross income of more than $300,000 in 2013. IRC Section 68(b) sets a floor on itemized deductions equal to the lesser of (1) 3% of adjusted gross income; or (2) 80% of the allowable deductions. The floor does not affect charitable contribution deductions for taxpayers who otherwise have itemized deductions in excess of the 3% floor.

The 3% floor can limit a substantial amount of charitable deductions. For example, taxpayers with adjusted gross income of $1,000,000 and itemized deductions of $100,000 lose $30,000 of the deductions (3% of $1,000,000). However, it may have little impact on charitable deductions. Most taxpayers have deductible items (real estate taxes, interest, etc.) to be reported on Schedule A. These items would be phased out before charitable gists are considered.

High income taxpayers may fare worse. Taxpayers with adjusted gross income of $6,000,000 and itemized deductions of $200,000 lose $160,000 of the deductions (80% of $200,000).

2. I would like to make a gift to charity before year-end. Can I make a direct gift from my IRA?

Perhaps. Direct charitable gifts of up to $100,000 annually are allowed for taxpayers 70½ or older from an IRA under a special rule which previously expired on December 31, 2011. Direct gifts to charity from an IRA avoid both the recognition of income and any reduction of the charitable deduction on Schedule A for high income taxpayers. Please note that a married couple over age 701/2 with separate IRAs can gift up to $200,000 directly to charity under this reinstated legislation.

3. Should I designate a charity as the beneficiary of my IRA following my death?

Yes, if you are charitably inclined. IRA distributions are subject to income tax. Beneficiaries may postpone the payment of income tax by "stretching" the IRA distributions over life expectancy under the minimum distribution rules, but sooner or later you have to "pay the piper." If there is a charitable component of a client's testamentary estate plan, the designation of the charities as beneficiary of a portion or all of the IRA should be seriously considered.

4. Should I designate a charity as the beneficiary of my Roth IRA following my death?

Never. Roth IRA distributions are not subject to income tax. Beneficiaries may wish to "stretch" the IRA distributions over life expectancy to the maximum extent allowable under the minimum distribution rules to maximize income tax deferral. Charities should not be named as Roth IRA beneficiaries.

5. What is a private foundation? Should I give to a private foundation or a donor-advised fund?

In the words of Conrad Teitell, "a private foundation is a large body of money surrounded by people who want some." The formal definition of a private foundation is a charitable grant making organization which may be established, administered and controlled by a single donor or one or more individuals selected by the donor. The payment of grants and administration expenses are made from endowment principal and income, not from a fundraising program.

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

A donor-advised fund has the following advantages over a private foundation:

1. Gifts are deductible up to 50% of AGI.

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

3. Can deduct full fair market value of appreciated property.

4. No investment and administrative burden.[1]

Donor-advised funds are disadvantaged as opposed to a private foundation in the following areas:

1. A donor has more control with a private foundation.

2. Many donor-advised funds have geographical or purpose limitations.

3. Grant recommendations to a donor-advised fund are non-binding.

There are limitations on the amount which can be deducted in a given year for contributions to public charities, private foundations and donor-advised funds. Gifts of ordinary income property to public charities and donor-advised funds can be deducted at up to 50% of the donor's adjusted gross income for the year of the gift; similar gifts to a private foundation are limited to 30% of the donor's AGI. Likewise, gifts of capital gain property are subject to a 30% limitation for public charities and donor-advised funds (deducted at fair market value of the gift); gifts of capital gain property to a private foundation is limited to just 20% (and deducted at cost basis, unless the gift consists of publicly-traded stock). Gifts in excess of the AGI limitation can be carried forward for five years.

6. Can a private foundation be formed on an expedited basis before year-end?

Yes. As long as the entity (trust or non-profit corporation) is formed and funded by December 31, a 2013 income tax deduction can be obtained for the gift. The Service grants a retroactive tax exemption to private foundations if the Application for Recognition of Exemption (Form 1023) is filed in the subsequent year. Clients who wish to make year-end gifts may wish to consider using a donor-advised fund as the charitable recipient.

7. How can I involve my family in my private foundation? Can it last in perpetuity?

Family members can be designated to serve as officers and directors of a private foundation. If established as a Florida not-for-profit corporation, there must be at least three directors named. Although reasonable compensation can be paid for services rendered to a foundation, we strongly caution clients to be careful and conservative in this area.

[1] A private foundation is subject to certain operating and reporting rules such as the requirement to file an annual tax return (Form 990-PF, Return of Private Foundation) and pay an annual excise tax on its net investment income. These operating rules and restrictions are discussed on pages 8.32 through 8.41 of this outline.

Many clients wish to involve family members over several generations in foundation matters. Others are concerned that the foundation may drift from the original charitable intent and focus of the founder over a long period of time. Some of these clients have directed that the entire foundation be distributed over a 10-20 year period following the founder's death.

8. Can I receive a full income tax deduction for a gift of appreciated property to a private foundation?

Gifts of publicly-traded stock can be deducted at fair market value. Otherwise, appreciated property donated to a private foundation must be deducted at cost basis.

9. Should I consider funding a charitable remainder trust?

Probably not. The minimum payout rate for a charitable remainder unitrust is 5%. (Likewise, the minimum annuity payment under a charitable remainder annuity trust must be equal to 5% of the initial contribution.) The charitable income tax deduction is measured by valuing the income interest (whether measured by one or more lives or a term not to exceed 20 years) using (1) the applicable federal rate in effect in the month of the gift (or one of the two preceding months, if higher); (2) the rate of return payable to the income beneficiary; and (3) the life expectancy of income beneficiary (based on mortality tables).

In order to have a valid charitable remainder trust, the remainder interest passing to charity must be worth at least 10% of the initial trust principal. A 60 year old client cannot establish a lifetime charitable remainder annuity trust even if the 5% minimum payout is used when the AFR is 1% (the remainder interest would be actuarially valued at less than 6%).

The January 2013 applicable federal rate was only 1%, a record low. Interest rates will rise again some day, and charitable remainder trusts will come back in vogue.

10. I am a beneficiary of a charitable remainder trust. Should I decline receipt of the charitable remainder trust payments and maximize the amount passing to the remainder charities?

No. The failure to accept the trust distributions will jeopardize the tax-exempt status of the charitable remainder trust.

11. What is a charitable lead trust?

A charitable lead trust is a split-interest trust which pays either a fixed annuity or a percentage income amount to a charitable beneficiary for a fixed number of years or for the life of the donor (the "lead interest") and then distributes the remaining trust property to the non-charitable beneficiaries (the "remainder interest"). Transfers to a qualified charitable lead trust are deductible for estate or gift tax purposes. A qualified charitable lead trust may be created during a donor's life ("inter vivos") or by will ("testamentary"). The amount of the estate or gift tax deduction is limited to the actuarial value, at the time of the transfer to the trust, of the charitable interest. As is the case with charitable remainder trusts, there are two types of qualified charitable lead trusts: a charitable lead annuity trust and a charitable lead unitrust. A charitable lead annuity trust is a charitable lead trust in which the “lead” charitable interest is a guaranteed annuity interest. A charitable lead unitrust is a charitable lead trust in which the “lead” charitable interest is an amount calculated as a fixed income percentage of the value of the trust property, re-determined annually. In order to obtain an estate, income or gift tax deduction for a donor's transfer of a partial interest in property to a charitable lead trust, the charitable interest must be in the form of a guaranteed annuity or is a fixed percentage of the annual trust property.

The charitable beneficiary of a charitable lead trust must be a charitable organization to which contributions are deductible under IRC Sections 2055 or 2522. The trust document must either directly specify, or grant the trustee authority to select, the charitable organization to which the annuity or unitrust amount is paid and may also specify the method by which an alternate charitable organization is selected. In order to avoid inclusion in the donor's gross estate, the donor should not have the ability to direct how the payment amount is made to, or change, the charitable organization. The trust document may also grant the trustee the authority to select the charitable organization to which the annuity or unitrust amount is paid. The trust document should direct that the trustee may only select among charitable organization to which payments would be deductible. Again, to avoid inclusion in the donor's gross estate, the donor should not have the ability to direct how the payment amount is made to, or change, the charitable organization.

12. Should I use a charitable lead trust as an estate planning vehicle to pass assets to my children at a reduced estate tax cost?

Yes. The current low applicable federal rate makes a charitable lead trust an unusually beneficial estate planning technique.

The donor of a charitable lead annuity trust will receive an estate or gift tax deduction for the actuarial value of the annuity payable to the charity computed under Section 7520. The donor will, however, be subject to estate or gift tax for the actuarial value of the non-charitable remainder interest determined at the creation of the annuity trust.

The benefit to the donor is that the estate or gift exemption used on the transfer of the non-charitable remainder is discounted to reflect the present value of the charitable “lead” annuity stream computed using the Section 7520 rates (re-determined monthly by the Service). The donor may choose to discount the “lead” annuity stream using the Section 7520 rate effective for the month the trust is funded. The donor may instead choose to value the “lead” annuity stream using the Section 7520 rate for either of the two months preceding the month in which the trust was funded.

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

Here is an example of the estate tax savings generated by a 20 year CLAT when the applicable federal rate is only 1%:

1. Tom and Terry Taxpayer would transfer $10,000,000 worth of minority interest assets (which would receive an estimated valuation discount of 25%) to the Tom and Terry Taxpayer Charitable Lead Annuity Trust (the "CLAT").

   A. The CLAT would be invested by the CLAT trustee.

   B. The CLAT would pay $411,500 annually to the Tom and Terry Taxpayer Family Foundation (the "Foundation").

2. The Foundation will be controlled by the Taxpayer family (subject to certain restrictions) and any other persons they wish to name to the board of directors.

   A. The Foundation would be required to make a minimum distribution of 5% of the value of its assets to charity on an annual basis.

      (i) Since the Foundation would receive $411,500 from the CLAT in year one, the Foundation would be required to distribute a minimum of $20,575 (5% of $411,500) to charity at the end of its first year.

      (ii) In year two, the Foundation would receive an additional $411,500 from the CLAT thereby increasing the minimum distributions to charity to $41,150 (5% of $823,000). This increasing distribution pattern will continue with each year of the CLAT.

   B. The CLAT would terminate after twenty years.

      (i) The annual CLAT distributions to the Foundation would cease.

      (ii) The principal of the CLAT would be distributed to, or in trust for, the Taxpayer children.

      (iii) There will be no estate or gift tax on the distribution of the CLAT assets to the children.

3. In the event of the following financial performance, Tom and Terry Taxpayer could be shifting the amount which you are projected (under current tax law) to pay in estate taxes to the Foundation. The Taxpayer family could receive roughly the same dollar amount as they would if they do not establish the CLAT.[2]

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[2] Assuming a 7.2% after-tax annual return, the $10,000,000 asset base would grow to $40,000,000 in 20 years. Estate tax of $16,000,000 would be paid at a 40% marginal rate. The $24,000,000 balance would pass to Taxpayer children.

- Assuming that the CLAT earns 7.2% annually, the children would receive roughly $22,750,000 of assets in twenty years without paying the current 35% estate and gift tax.

- Growth on the CLAT principal in excess of 7.2% would also pass estate and gift tax free to Taxpayer family.

- In addition, the Tom and Terry Taxpayer Foundation (and its recipient charities) would have received $17,250,000 of assets ($411,500 per year for 20 years, assuming the same annual rate of return), to be used for many generations to come.[3]

20 YEAR CHARITABLE LEAD TRUST
(40% ESTATE TAX RATE & 7.2% ANNUAL RETURN)

BENEFICIARY	NO CLT	20 YEAR CLT
CHILDREN	$24,000,000	$22,750,000
FOUNDATION	NONE	$17,250,000
ESTATE TAX	$16,000,000	NONE
TOTAL	$40,000,000	$40,000,000

13. Can I "back load" the amounts passing from a charitable lead trust to charity during my life?

Yes. A charitable lead trust may provide for escalating payments to charity. The Service issued a private letter ruling earlier this year allowing for 20% annual increases of the annuity amount over a 10 year period. *Private Letter Ruling 201216045.* Based on this ruling and other authority, it is expected that a "balloon" or "shark fin" charitable lead trust would be allowed by the Service. (The GRAT rules only permit 20% escalating payments; however, there is no indication in the ruling on whether the Service would also limit the increase to 20% in this area.

14. I would like to leave my personal residence to charity following my death. Can I get an income tax deduction for this during my life?

Yes, if you gift the remainder interest to charity during your life. At a time when interest rates are low, the income tax deduction generated by this form of gift can be substantial.

[3] Assuming a 7.2% annual return, the $411,500 paid to the Foundation would grow to a cumulative $17,250,000 in 20 years.

A client can contribute a remainder interest in a residence to charity, retaining the right to reside in the residence for life, and obtain a charitable income tax deduction. This rule is different from the treatment of residences gifted to family, which requires estate tax inclusion under IRC Section 2036 for the retained right of enjoyment. As is the case with qualified personal residence trusts, the residence does not need to be the client's primary residence.

The client may deduct the present value of the charity's remainder interest in the depreciable and non-depreciable portions of the residence, using the applicable federal rate in effect at the time of the gift and the estimated useful life and salvage value of the depreciable portion of the property.

The amount of the tax deduction generated is substantial. A 70 year old client who gifts a remainder interest in a residence valued at $1,000,000 to charity when the applicable federal rate is 1% receives the benefit of a $749,613 charitable income tax deduction. (This assumes that the value of the land is $500,000 and the value of the residential structure is $500,000.) Even if the applicable federal rate increases to 4%, the tax deduction still exceeds $500,000.

This approach also works for the gift of a farm. Undivided fractional remainder interests can be gifted to more than one charity.

A gift tax return must be filed to report the gift. Form 8283 must also be filed with the client's tax return for the year of the gift. Special considerations must be made if the client decides to sell the real estate at a later time.

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