RECENT DEVELOPMENTS IN CHARITABLE PLANNING

Estate Planning Council of Greater Miami
Miami, Florida

March 18, 2010

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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.

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 by a donor with a reduced life expectancy.

3. Use of inter vivos "shark fin" charitable lead trusts funded with illiquid investment likely to be sold before the end of the CLT term.

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

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

6. Use of testamentary charitable remainder trusts to receive Individual Retirement Accounts and qualified retirement plan benefits to avoid combined estate and income taxation.

7. Use of direct IRA rollovers to charity in 2006-2009.

B. **Recent Tax Law Changes.** The following tax law changes have had a direct impact on charitable planning over the last decade:

1. Charitable donations for Haitian relief paid before March 1, 2010 may be deducted in either 2009 or 2010.

2. Extension of IRA Charitable Rollover under the Pension Protection Act of 2006 for years 2008 and 2009, which provides tax-free treatment of IRA distributions for the first $100,000 distributions made to qualified charities. (Extension is expected for 2010.) Available to IRA owners who are at least age 70 ½. Many IRA owners were contributing their Required Minimum Distributions (RMD). ***Internal Revenue Code ("IRC") Section 408(d)(8).***

   Note: For 2009, the need to take RMDs was eliminated under the Worker, Retiree, and Employer Recovery Act of 2008 (H.R. 7327). Needless to say, this change has reduced the volume of IRA Charitable Rollovers in 2009.

3. Release of sample Charitable Lead Unitrust (CLUT) documents by the Service. ***Rev. Proc. 2008-45*** (*inter vivos CLUTs)* and ***Rev. Proc. 2008-46*** *(testamentary CLUTs)*.

4. Release of sample Charitable Lead Annuity Trust (CLAT) documents by the Service. ***Rev. Proc. 2007-45*** (*inter vivos CLATs)* and ***Rev. Proc. 2007-46*** *(testamentary CLATs)*.

5. Reduction of capital gain tax rate from 28% to 15%. ***IRC Section 1(h).***

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

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

8. The actuarial value of the remainder interest of a charitable remainder trust must be at least 10% of the fair market value of the donated property. ***IRC Section 664(4).***

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

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

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

12. 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 IRC Section 7520* applicable federal rates. ***Treasury Regulation Section 1.7520-3(b)(3).***

14. Extension of the qualified appreciated stock exception for gifts to private foundations. ***IRC Section 170(e)(5).***

15. Phase-out of 3% floor on itemized deductions and personal exemptions over a five year period which began in 2006. ***IRC Section 68(f).***

16. Final regulations on the minimum distributions from qualified retirement plans.

17. Issuance of new mortality tables.

18. New Form 990 (but not Form 990-PF).

19. New 990-EZ filing limits.

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

III. Tax Reform Legislation; Recent IRS Rulings

A. Charitable Deduction Changes in the 2011 Budget Proposals.

1. The proposed 2011 budget submitted by President Obama again seeks to limit charitable deductions to 28% for married couples filing jointly earning more than $250,000 (and individuals earning more than $200,000) beginning in 2011.

2. Senator Robert F. Bennett's (R-Utah) amendment included in the Senate's 2010 Budget Resolution opposes a limitation of the charitable deduction for taxpayers in the highest tax brackets.

3. There has been a vocal negative reaction to this proposal from the public sector:

(a) Independent Sector:

"President Obama's proposal to raise the funds necessary to implement health care reforms by reducing the tax incentives for charitable contributions by taxpayers earning more than $250,000 presents a Solomon's choice for the charitable community that will not be resolved easily. Experts disagree on the extent to which tax incentives affect the total contributions made by taxpayers, but they all agree that this change, would reduce charitable giving, with estimates ranging from $1.63 billion to over $7 billion per year. These contributions are needed more than ever in these difficult economic times. At the same time, charitable organizations face enormous challenges in finding resources to pay the rising costs of health care for the employees who are essential to carrying out their work for communities, and they see first hand the consequences to people coming to their organizations for services who are unable to afford health care coverage."

"We also believe it is appropriate, within the federal income tax's progressive rate structure, to give stronger incentives to individuals of substantial means to encourage them to meet their special leadership responsibility in giving back to the community."

(b) Council on Foundations:

"A reduction in the charitable deduction rate will reduce the current incentive for donors to give, thus reducing the amount of money available to support worthy nonprofits across the country. At a time when charities and nonprofits are faced with increasing demands from their communities, it is important that public policies support and encourage charitable giving. The Council strongly supports maintaining the current law with respect to itemized charitable deductions."

4. House Ways and Means Chairman Rangel (D-New York) has promised to hold hearings on the administration's proposed limitation of deductions.

5. The Center on Budget and Policy Priorities acknowledges that total charitable contributions are projected to decline by 1.3%.

B. Estate and Gift Tax Changes in the 2011 Budget Proposals.

1. New minimum term for Grantor Retained Annuity Trusts (GRAT).

(a) A minimum term of 10 years would be imposed; currently, a GRAT term may be as short as 2 years.

(b) This requirement would increase the risk of the grantor's death before the end of the term, resulting in a loss of the anticipated transfer tax benefit.

2. *IRC Section 2704* discounts.

(a) A new category of restrictions (“disregarded restrictions”) would be ignored when valuing interests in family-controlled entities if, after the transfer, the restrictions will lapse or may be removed.

(b) Disregarded restrictions would include:

(i) Limitations on the holder’s right to liquidate.

(ii) Limitations on a transferee’s ability to become a full partner or holder of an equity interest in the family-controlled entity.

(iii) Safe-harbors may be granted to avoid the application of *IRC Section 2704* if certain standards are met.

3. Consistency in values for transfer tax and income tax purposes.

(a) The basis of property received by death under *IRC Section 1014* would have to equal the value of that property for estate tax purposes.

(b) A reporting requirement would be imposed on the executor of the decedent’s estate and on the donor of lifetime gifts to provide the necessary information to both the recipient and the Internal Revenue Service.

4. Proposals would be effective as of the date of enactment.

C. **Pomeroy Bill – H. R. 4154:** Introduced by Rep. Earl Pomeroy (D-North Dakota), House Ways and Means Committee member, to freeze 2009 estate tax law.

1. Permanent extension of the 2009 estate tax levels without any enhancements.

(a) Estate tax exclusion of $3,500,000 with a 45% rate.

(b) Deduction for state death taxes.

(c) Basis adjustment rules will provide heirs with a basis equal to fair market value as of the decedent’s date of death.

2. Does not provide for portability of spousal estate tax exemption which would allow for a surviving spouse to elect to use any remaining portion of his/her deceased spouse’s exemption.

D. **Baucus Bill – S. 722: Taxpayer Certainty and Relief Act of 2009.** Introduced by Sen. Max Baucus (D-Montana), Chairman of the Senate Finance Committee to provide middle class tax relief and estate tax relief, in part by permanently extending certain expiring provisions.

1. Relief for the "middle class."

   (a) Continues the reduced dividend and capital gain rates through 2010:

      (i) 15% rate for dividends and capital gains for taxpayers in the 25% and 28% brackets; and

      (ii) 0% rate for dividends and capital gains for taxpayers in the 10% and 15% brackets.

   (b) Inflation index added for the AMT exemption.

2. Increased burdens for the "upper class."

   (a) Top rates of 36% and 39.6% would be revived in 2011 for "higher earners" (individuals with income exceeding $200,000 and married couples filing jointly with income exceeding $250,000).

   (b) Return of 20% capital gains rates in 2011 and continue to apply to qualified dividends.

3. Permanent extension of the 2009 estate tax levels with some enhancements.

   (a) Estate tax exclusion of $3,500,000 with a 45% rate.

   (b) Reunification of the estate and gift tax exemption beginning in 2010.

   (c) Inflation indexing for the estate and gift tax exemption beginning in 2011 in multiples of $10,000.

   (d) Portability of spousal exemption would allow for a surviving spouse to elect to use any remaining portion of his/her deceased spouse's exemption.

   (e) Basis adjustment rules will provide heirs with a basis equal to fair market value as of the decedent's date of death.

E. **McDermott Bill – H.R. 2023: Sensible Estate Tax Act.** Introduced by Rep. Jim McDermott (D-Washington) of the House Ways and Means Committee to provide reasonable and predictable reforms to the estate tax system.

1. Permanently set the estate tax exemption at $2,000,000 per spouse while adding portability for any portion of a deceased spouse's exemption which is unused.

2. Reunification of the estate and gift tax rules.

3. Establishment of progressive estate tax rates.

F. **Childers Bill – H.R. 1986:** Introduced early this year by Rep. Travis Childers (D-Mississippi) to reduce the estate tax, providing relief for hard working families in the face of the current economic crisis.

1. Would increase the estate tax exemption to $4,000,000.

2. Would reduce the rate to 40%.

G. **Noteworthy Revenue Procedures, Private Letter Rulings, and Court Rulings.**

1. <u>Revenue Procedure 2009-32</u>. Supporting Organization Documentation: Private foundations and donor advised funds can rely on an organization's status as a public charity based on either: (a) the charity's current IRS determination letter; or (b) information from the IRS Business Master File, which is available at irs.gov.

2. <u>Private Letter Ruling 200929018</u>. Some Grants are Not Taxable Expenditures. A private foundation created a grant program to assist foreign exchange students with secondary educational costs. It employed an objective and non-discriminatory selection criteria was and agreed to maintain records of the grantees' use of the funds for educational purposes. Thus, the private foundation complied with ***IRC Section 4945.*** Organizations which do not comply in making grants to individuals for travel, study or similar purposes will be subject to an excise tax for such expenditures.

3. <u>Private Letter Ruling 200928045</u>. Tax-Exempt Status Revoked for Providing Private Benefit: The Service revoked a charity's tax-exempt status because the charity served private interests rather than exclusively public interests when its website contained advertisements for books, CDs and other merchandise sold by the private business of the charity's President. Also, the charity intervened in a political campaign when it published a statement in opposition to a candidate for public office on its website. Both actions are prohibited in ***Treas. Reg. 1.501(c)(3)-1(c)(3(ii)***.

4. <u>Private Letter Ruling 200923005</u>. Gifts to a State Agency or Authority: Contributions made for public purposes to a governmental agency or authority created by the state legislature are deductible for income tax purposes under ***IRC Section 170(a)(1)***.

5. <u>Private Letter Ruling 200920031</u>. Charitable Lead Trust Distributions. When a CLT distributes appreciated securities to its charitable income beneficiary, the capital gains are realized and taxable to the CLT. (*Kenan* gain)

6. <u>Private Letter Ruling 200905015</u>. Charitable Gift to a Foreign Charity. This ruling illustrates the differences between income tax rules and estate tax rules pertaining to charitable gifts. ***IRC Section 170(c)(2)*** is clear that to be deductible for income tax purposes a gift must be made to a domestic charity (gifts to foreign charities will not qualify). ***IRC Section 2055*** does not require that the charitable organization be created or organized in the United States in order for a gift to qualify for an estate tax deduction.

7. <u>Private Letter Ruling 200816032</u>. Early Termination of Charitable Remainder Trust: The IRS found that no self-dealing occurred when the income beneficiaries, who were also the CRT trustees, terminated the CRT early in exchange for the actuarial value of their income interest.

8. <u>*J. Maurice Herman v. Comm'r*, Tax Court Memorandum 2009-205</u>. Deduction Denied for Conservation Easement. The Tax Court denied an income tax deduction claimed on the taxpayer's Form 1040 for the contribution of a portion of his right to add on to a historic building. While a conservation easement is a real property interest which may be given to a qualified organization for conservation purposes (under ***IRC Section 170(h)(1))***, the taxpayer contributed an *unspecified* 10,000 feet out of his 22,000 feet of potential development rights which did not preclude major modifications to the underlying structure. Additionally, the easement did not protect the underlying land.

IV. Tax Savings Available Through Charitable Giving.

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

1. Maximum income tax rate of 35% for married couples with taxable income in excess of $375,700 in 2010. ***IRC Section 1(i).***

   (a) Maximum rate would increase from 35% to 39.6% under the 2011 budget proposal.

   (b) The marginal rate for income between $232,950 and $375,700 would increase from 33% to 36%.

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

3. 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. Maximum estate tax rate of 45% for persons who pass away in 2009. ***IRC Section 2001(c).*** No estate tax for 2010 decedents (unless the estate tax is retroactively reinstated).

C. Income Tax Savings.

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

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

V. Types of Charitable Organizations.

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

B. Supporting Organizations. A public charity under ***IRC Section 509(a)(3)*** which provides support to one or more organizations described in ***IRC Sections 509(a)(1) or 509(a)(2)*** (supported organizations). Supporting organizations generally do not receive sufficient public support to be deemed public charities on their own and thus, must be sufficiently related to other public charities (discussed in Section XIII below).

C. 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 XIV below). ***IRC Section 509(a).***

D. 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)***.

E. **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).***

F. **Donor-Advised Funds.**

1. **Development of Donor-Advised Funds**. Many public charities and community foundations have established donor-advised funds in recent years.

   (a) A donor-advised fund is a separate fund (not a separate entity) within a public charity.

   (b) A donor may make non-binding charitable grant recommendations in connection with gifts to a donor-advised fund.

   (c) First defined in the Pension Protection Act of 2006.

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

   (a) Not subject to the annual 5% minimum distribution requirement imposed on private foundations.

   (b) Gifts are deductible up to 50% of adjusted gross income ("AGI").

   (c) Gifts of capital gain property are deductible up to 30% of AGI.

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

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

   (f) No investment and administrative burden.

3. **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.

4. **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.

VI. Contribution Limits.

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

1. **50% Limitation - Gifts to public charity and supporting organization.** ***IRC Section 170(b)(1)(A).***

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

B. Limitation on Gift of Capital Gain Property.

1. **30% Limitation - Gifts to public charity and supporting organization.** ***IRC Section 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 Carryforward 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 is a floor set on itemized deductions for married taxpayers in excess of adjusted gross income of $166,800 in 2009 ***IRC Section 68(b)***:

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

   (a) 3% of adjusted gross income; or

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

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

3. The floor on itemized deductions is being phased out over a five year period which began in 2006:

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

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

   (c) The floor will be eliminated in 2010. ***IRC Section 68(f).***

   (d) The "3% floor" will return in 2011.

VII. Types of Charitable Gifts.

A. **Outright Gifts.**

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

1. **Charitable Remainder Annuity Trust.**

2. **Charitable Remainder Unitrust.**

C. **Charitable Lead Trusts** (discussed in Section IX 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 ***IRC 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 approved a recommendation to reduce the expected return assumption from 5.75% to 5.25% effective February 1, 2009.

   (a) Most annuity rates decreased by 0.4% to 0.7%, depending on the age of the annuitants.

   (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.

7. Under Florida Statute Section 627.481, charities offering charitable gift annuities must:

   (a) Be continuously operated for at least five years prior to issuing first annuity.

   (b) Maintain a segregated reserve fund for outstanding annuity agreements. No more than 50% of the reserve fund may be invested in equities.

   (c) File a sworn statement/report regarding the reserve fund with the Florida Department of Consumer Services by March 31 each year.

8. Special planning opportunities:

(a) Deferred annuities.

(b) Gift annuity funded with remainder in personal residence.

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

VIII. Charitable Remainder Trusts.

A. Types of Charitable Remainder Trusts.

1. Charitable Remainder Annuity Trust.

2. Charitable Remainder Unitrust.

B. Requirements for Tax Deduction. In order to obtain an estate, income or gift tax deduction for a donor's transfer of a partial interest in property to charity, where the donor or other 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.** The February 2010 applicable federal rate ("AFR") is 3.4%. The chart below shows the fluctuation of the AFRs in the month of May of each of the last eight years:

Month	**§ 7520 Rate**
May 2009	2.4%
May 2008	3.2%
May 2007	5.6%
May 2006	5.8%
May 2005	5.2%
May 2004	3.8%
May 2003	3.8%
May 2002	6.0%

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 if so defined under the trust agreement or applicable local law. ***Treasury Regulation Section 1.664-3(a)(1)(i)(b)(3)***

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

(a) Divorce;

(b) Remarriage;

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

(d) Cannot provide for payments to continue for the life of someone other than the recipient.

(i) For example, settlor cannot establish a charitable trust for a child measured by the life of the settlor.

(ii) Limited to 20 years.

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 or his/her spouse 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)*.** The actuarial value of the charitable remainder interest must be at least 10% of the fair market value of the donated property in order to qualify as a charitable remainder trust. ***IRC Section 664(d)(4)***.

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 *IRC Section 664(d)(4)* can result in an unexpected failure to qualify as a charitable remainder annuity trust.

(a) **CRAT EXAMPLE:** Tom Taxpayer (age 40) gifts publicly traded stock worth $1,000,000 to a charitable remainder annuity trust, retaining an $80,000 annuity for his life. Assuming an applicable federal rate of 7%, the actuarial value of the charitable remainder interest is $90,000. 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 *IRC Section 664(d)(4)* and does not qualify as a charitable remainder annuity trust.

(b) **CRUT EXAMPLE:** Terry Taxpayer (age 40) gifts publicly traded stock worth $1,000,000 to a charitable remainder unitrust, retaining an 8.0% annual unitrust interest ($80,000 in year one) for her life. Assuming an applicable federal rate of 7%, the actuarial value of the charitable remainder interest is $100,000. 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 *IRC Section 664(d)(4)* and qualifies as a charitable remainder annuity trust.

(c) **MAY 2009 CRAT EXAMPLE:** Tom Taxpayer (age 40) gifts publicly traded stock worth $1,000,000 to a charitable remainder annuity trust, retaining an $50,000 annuity (the minimum allowed) for his life. Assuming an applicable federal rate of 2.4%, the actuarial value of the charitable remainder interest is $0. 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 *IRC Section 664(d)(4)* and does not qualify as a charitable remainder annuity trust.

G. **New Actuarial Tables.** On May 1, 2009, the IRS updated the Actuarial Tables used in valuing annuities, interests for life or terms of years, and remainder or reversionary interests under §7520. These regulations will affect the valuation of inter vivos and testamentary transfers of interest dependent on one or more measuring lives.

1. The actuarial tables must be updated every ten years to reflect new mortality data.

2. If you are using software, such as Tiger Tables, Number Cruncher, or PGCalc, in your practice, be certain to download these new Actuarial Tables; otherwise, your calculations will be inaccurate.

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

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

J. **Atkinson Case.** The failure to pay required annuity or unitrust payments to the individual income beneficiary resulted in the disqualification of the charitable remainder trust (and the loss of the charitable income tax and estate tax deductions). ***Estate of Melvine Atkinson v. Commissioner, 309 F.3d 1290 (11th Cir. 2002).***

IX. Income Taxation of Charitable Remainder Trusts.

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

B. **Unrelated Business Taxable Income.**

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

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

1. The tier system works as follows:

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

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

   (c) Tax-exempt income.

   (d) Return of principal.

2. Proposed regulations create additional ordering rules with “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% dividend tax rate can be utilized under the proposed regulation.

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

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

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

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

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

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

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

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

XI. 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.** *IRC 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.** *IRC Section 512(e)*, however, provides special rules applicable to Subchapter S corporations.

      (i) **Unrelated Business Taxable Income ("UBTI").** *IRC Section 512(e)(1)* provides that: (i) all items of income, loss, or deduction taken into account under *IRC 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.** *IRC 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.** *IRC 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 *IRC 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 *IRC 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 *IRC 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.** *IRC 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 *IRC Section 501(a)*) of the Internal Revenue Code.

XII. Charitable Lead Trusts.

A. Definition. 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 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. *See **Rev. Proc. 2007-45** and **Rev. Proc. 2007-46** for sample forms.*

   (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. *See **Rev. Proc. 2008-45** and **Rev. Proc. 2008-46** for sample forms.*

2. **Nonqualified Charitable Lead Trust.** Transfers 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 balance of this section of the outline will address qualified charitable lead trusts.

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 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 *IRC 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 organizations 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 of 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.

   (c) **Variation: Shark-Fin CLATs.** Like a shark-fin rising quickly out of the water, the amount of a Shark-Fin CLAT's annuity payments increases quickly.

      (i) Allowable under *Treasury Regulation Section 25.2702-3(b)(1)(i) and (ii)* as a qualified annuity is the irrevocable right to receive a fixed amount, which must be payable at least annually. The fixed amount is a stated dollar amount, to the extent to which it cannot exceed 120 percent of the stated dollar amount payable in the preceding year.

(ii) *Rev. Proc. 2007-45, 2007-29 IRB 89* (June 22, 2007): Payment requirements are not subject to any minimum or maximum and may provide for an annuity payment which is a fixed dollar or fixed percentage amount, but increases during the annuity period; provided that the value of the annuity is ascertainable at the time the trust is funded.

(iii) Comparison of a standard CLAT with a fixed annuity and a qualified CLAT with 20% increasing annuity payments (Shark-Fin), using assumptions of a 10 year term, $10,000,000 contribution and a *Section* 7520 rate of 6.0%.

YEAR	FIXED ANNUITY	20% INCREASING PAYMENTS
1	$ 1,358,677	$ 569,699
2	1,358,677	683,389
3	1,358,677	820,367
4	1,358,677	984,440
5	1,358,677	1,181,328
6	1,358,677	1,417,593
7	1,358,677	1,701,112
8	1,358,677	2,041,335
9	1,358,677	2,449,601
10	1,358,677	2,939,522

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. ***<u>Crown Income Charitable Fund v. Commissioner</u>, 98 T.C. 327 (1992).***

C. **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").

D. **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 *IRC 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 *IRC Section 7520* (redetermined monthly by the Service).

            (A) **Month of Creation.** The donor may choose to discount the "lead" annuity stream using the *IRC 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 *IRC 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 *IRC 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 IRC Section 7520 Rates**. The current extremely low *IRC Section 7520* rates make charitable lead trust a very effective 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 *IRC 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.

E. 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.

F. Income Taxation.

1. 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.

2. New Regulations expected under Section 642(c) to clrify tier rules applicable to charitable lead trusts.

G. 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. Is known to have an incurable illness or other deteriorating physical condition; and

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

3. **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.

    (a) The Service may rebut such presumption by "clear and convincing evidence."

    (b) General infirmities of old age not considered a terminal illness.

H. 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 nor 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.

I. Drafting Suggestions and Filing Requirements.

1. Establish a tier system for the allocation of payments to charitable beneficiaries (not contrary to state law).

2. Allocate trustee fees to income so they may be deducted by the trust.

3. File Form 1041 and Schedule K-1 and possibly, Form 1041-A and Form 5227.

4. Make quarterly tax payments if any unrelated business taxable income (UBTI). Use Form 990W.

XIII. Supporting Organizations

A. Definition. A public charity under ***IRC Section 509(a)(3)*** which provides support to one or more specified organizations described in ***IRC Sections 509(a)(1) or 509(a)(2)*** (supported organizations). Supporting organizations generally do not receive sufficient public support to be deemed public charities on their own and thus, must be sufficiently related to other public charities.

1. **Benefit of Supporting Organizations vs. Private Foundations.** As a supporting organization is classified as a public charity, contributions to it are eligible for greater income tax deductions than contributions to private foundations. (see Section VI above).

2. **Three Categories.** Type I, Type II, and Type III organizations vary based on the strength of the relationship between the supporting organization and the supported organization.

B. Type I Supporting Organization is "operated, supervised, or controlled by" its supported organization. A majority of the supporting organization's officers, directors, or trustees are appointed or elected by the supported organization. Donors to supporting organizations cannot (directly or indirectly) control the supported organization. The most common form of supporting organization is the Type I. An example of a Type 1 is a Blood Bank f a public non-profit hospital.

C. Type II Supporting Organization is "supervised or controlled in connection with" its supported organization. To meet this requirement, the control or management of the supporting organization must be vested in the same persons that control or manage the publicly supported organizations. This is the least common form of supporting organization.

D. Type III Supporting Organization is "operated in connection with" its supported organization. Donors to supporting organizations cannot (directly or indirectly) control the supported organization. Type III supporting organizations may not support foreign organizations. A supporting organization must meet both of these tests: (1) the "responsiveness" test; and (2) the "integral part" test.

1. **Responsiveness Test.** To meet the responsiveness test, the governing bodies of the supported organizations must have a significant voice in the investment policies of the supporting organization, the timing and making of grants, the selection of recipients, and directing the use of income or assets of the supporting organization. In addition, the supporting organization must meet at least one of the following requirements:

   (a) one or more members of the governing body of the supporting organization must be elected or appointed by the governing body of the publicly supported organizations; or

   (b) one or more of the members of the governing bodies of the publicly supported organizations must also be members of the governing body of the supporting organization; or

   (c) the governing body of the supporting organization must maintain a close and continuing working relationship with the governing bodies of the supported organizations.

2. **Integral Part Test.** The integral part test is satisfied if the supporting organization maintains a significant involvement in the operations of the one or more supported organizations that are dependent upon it for the support it provides. To meet the integral part test, the supporting organization must satisfy either:

   (a) ***But for* test.** The supporting organization must engaged activities that would normally be engaged in by the supported organization itself; or

   (b) ***Attentiveness* test.** The supporting organization (1) pays substantially (85%) all of its income to or for the use of one or more of the supported organizations and (2) provides enough support to ensure the attentiveness of supported organizations; and (3) pays a substantial amount of the total support of the supporting organization to supported organizations that meet the attentiveness requirement.

E. Pension Protection Act of 2006.

1. **"Functionally integrated" Type III supporting organizations.** Defined as those that are not required to make payments to supported organizations due to the activities of the organization related to performing the functions of or carrying out the purpose of supported organizations.

2. **"Non-functionally integrated" Type III supporting organizations** which meet the integral part test through the attentiveness test (vs. the "but for" test) will be subject to a new payout requirement (to be set by the Secretary of the Treasury).

3. **Reporting requirements.** Type III supporting organizations must provide information annually to each of its supported organizations to ensure that it is responsive to the needs of its supported organizations.

4. **Control restrictions.** Type I and Type III supporting organizations are prohibited from accepting gifts from persons who (directly or indirectly) control the governing body of a supported organization.

5. **Excess business holdings rules**. Rules which apply to private foundation would apply to "non functionally integrated" Type III supporting organizations.

F. Proposed Regulations.

1. Issued on September 23, 2009. Comments will be accepted for 90 days.

2. **Notification Requirements.** Annually, Type III supporting organizations must provide specific information to each of its supported organizations: (1) a description of the amount and type of support it provided to the supported organization in the past year; (2) a copy of it's' most recent Form 990; and (3) a copy of its' governing documents.

3. **Functionally integrated Type III supporting organization.** Defined as "functionally integrated" if it (1) engages in activities *substantially all* of which *directly further* the exempt purposes of its supported organizations; or (2) is the "parent" of each of its supported organizations.

4. **Non-functionally integrated Type III supporting organization.** Defined as "non-functionally integrated" if it distributes 5% of its non-exempt-use assets.

    (a) Waiver of the distribution requirement in the first year of new supporting organizations.

    (b) Existing supporting organizations must comply with distribution requirements within two years.

    (c) Set-asides do not count towards the distribution requirements in the proposed regulations and the ordering rule for carryovers of excess distributions is reversed.

    (d) Exceptions for failing to meet the distribution requirements will be permitted if a reasonable cause existed, such as incorrect valuation of assets, ministerial error, and unforeseen events (not willful neglect) and the failure was corrected within 180 days of its discovery.

(e) Attentiveness Test. A supporting organization must distribute at least one-third of the distribution requirement to one or more supported organizations that are attentive to it and to which the supporting organization meets the responsiveness test.

5. Transitional Rules will be provided in the Regulations.

XIV. 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 number of private foundation increased by 75% to approximately 57,000 from 1990 to 2000. The National Center for Charitable Statistics reported that there were 109,852 private foundations in the United States in 2006, with 79,765 filing with the Internal Revenue Service.

TOTAL ASSET LEVEL	TOTAL NUMBER OF FOUNDATIONS	NUMBER FILING WITH IRS	TOTAL REVENUE	TOTAL ASSETS
< $1,000,000	59,067	54,426	9,781,685,488	18,695,006,330
$1-10,000,000	45,956	20,545	14,809,331,978	69,864,509,042
$10-25,000,000	2,689	2,665	9,298,855,391	44,706,658,956
> $25,000,000	2,140	2,129	49,834,866,329	381,452,049,366
TOTAL	**109,852**	**79,765**	**$83,724,739,186**	**$514,718,223,694**

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 ***IRC Section 501(c)(3)*** for monetary damages resulting from any statement, vote, decision or failure to act regarding policy or organizational management unless:

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

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

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

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

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

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

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

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

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

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

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

E. Application for Federal Income Tax Exemption (Form 1023). A private foundation must file an Application for Recognition of Exemption (Form 1023) with the Internal Revenue Service to obtain a Federal income tax exemption as a ***IRC 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 1½ % 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 2½% (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 *IRC Section 507* and if organized as a corporation, in accordance with applicable state law. Some private foundations find the toll on human and charitable resources in meeting state and federal regulatory requirements is higher than anticipated.

1. **Public Charity**. A private foundation may be terminated by distributing all of its assets to a one or more organizations described in ***IRC Section 170(b)(1)(A)*** provided the organization has been in existence for a 60-month period. Reasons to consider this step include:

   (a) To ensure continuing management.

   (b) To maximize effective grantmaking.

   (c) To ease ongoing contributions and increase tax-deductibility of gifts.

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 ***IRC Section 4941*** or a taxable expenditure under ***IRC Section 507***. ***Private Letter Ruling 199826041.***