CHARITABLE GIVING FOR HIGH NET WORTH CLIENTS

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I. Charitable Remainder Trusts

The charitable remainder trust ("CRT") is an advanced charitable planning technique that provides both a charitable contribution for the donor and a continuing income steam. It also provides for deferral of gain on highly appreciated assets transferred to the CRT. When the irrevocable trust is established, two property interests are created – the income beneficiary (or beneficiaries) receives the right to annual payments from the CRT, and one or more tax-exempt charities receive the remaining property at the end of the trust term.

A. Types of Charitable Remainder Trusts

1. Charitable Remainder Annuity Trust

A charitable remainder annuity trust is required to pay a certain sum annually to one or more beneficiaries, at least one of which is not a charitable organization. Treas. Reg. § 1.664-2(a)(1)(i). The annual payment can be in the form of a fixed percentage of the initial fair market value of the assets contributed to the trust, or a fixed dollar amount. Treas. Reg. §§ 1.664-2(a)(1)(ii) and (iii). Additional contributions may not be made to a charitable remainder annuity trust, and the trust instrument must contain a provision prohibiting such additional contributions. Treas. Reg. § 1.664-2(b).

2. Charitable Remainder Unitrust

A charitable remainder unitrust is required to pay a fixed percentage of the net fair market value of its assets at least annually to one or more beneficiaries, at least one of which is not a charity. Treas. Reg. § 1.664-3(a)(1)(i). Because the assets must be revalued each year, the payout to the unitrust recipient will fluctuate. Additional contributions may be made to a charitable remainder unitrust as long as the trust instrument provides for the recalculation of unitrust payments in the event additional contributions are made by the donor. Treas. Reg. § 1.664-3(b). In addition to the standard fixed percentage unitrust discussed above, there are three other types of charitable remainder unitrusts.

a. Net Income Charitable Remainder Unitrust ("NICRUT")

A NICRUT pays to the unitrust recipient the lesser of the fixed percentage of the fair market value of the assets or the trust income as defined in Code Section 643(b). Treas. Reg. § 1.664-3(b).

b. Net Income with Makeup Charitable Remainder Unitrust ("NIMCRUT")

A NIMCRUT also pays to the unitrust recipient the lesser of the fixed percentage of the fair market value of the assets or the trust income, but allows for a "make-up" payment in years in which the trust income is greater than the fixed percentage if in prior years the trust was unable to pay out the fixed

percentage because the trust income was less than the fixed percentage. Treas. Reg. § 1.664-3(b).

c. Flip Unitrust

A Flip Unitrust is a charitable remainder unitrust that converts from a NICRUT or a NIMCRUT to a standard fixed percentage unitrust upon the occurrence of a date or an event beyond the control of the trustee or any other person. In order to qualify as a flip unitrust under Treasury Regulation § 1.664-3(a)(1)(i)(c), the trust's governing instrument must provide that (i) the conversion is triggered by a specific date or by an event the occurrence of which is not "discretionary with, or within the control of, the trustees or any other persons", (ii) the conversion occurs at the beginning of the taxable year that immediately follows the taxable year during which the triggering event occurs, and (iii) after the conversion, the non-charitable beneficiary must forfeit any balance in the "make-up" account.

Treasury Regulation § 1.664-3(a)(1)(i)(d) provides that the sale of unmarketable assets, marriage, divorce, death, and the birth of a child are all events "not discretionary with, or within the control of, the trustees or any other persons". The term "unmarketable asset" is defined in Treasury Regulation § 1.664-1(a)(7)(ii) as an asset that is not cash, a cash equivalent, or other asset that can be readily sold or exchanged for cash or cash equivalents. Examples of unmarketable assets include real property, closely-held stock, and unregistered securities for which there is no available exemption permitting public sale. Treasury Regulation § 1.664-3(a)(1)(i)(e) provides ten examples that further illustrate whether or not an event is within the control of the trustees or any other persons. The sale of publicly traded stock (Example 3), a determination by the non-charitable beneficiary's financial advisor that the trust should convert to the fixed percentage payout method (Example 9), and a request by the non-charitable beneficiary to convert to the fixed percentage payout method (Example 10) are included as examples of when an event is <u>within</u> the control of the trustee or any other person.

B. Sample Forms

1. Sample Inter Vivos CRUT Declaration for One Measuring Life - Rev. Proc. 2005-52
2. Sample Inter Vivos CRUT Declaration for a Term of Years - Rev. Proc. 2005-53
3. Sample Inter Vivos CRUT Declaration for Consecutive Measuring Lives - Rev. Proc. 2005-54
4. Sample Inter Vivos CRUT Declaration for Concurrent and Consecutive Measuring Lives - Rev. Proc. 2005-55
5. Sample Testamentary CRUT Declaration for One Measuring Life - Rev. Proc. 2005-56

6. Sample Testamentary CRUT Declaration for a Term of Years - Rev. Proc. 2005-57
7. Sample Testamentary CRUT Declaration for Consecutive Measuring Lives - Rev. Proc. 2005-58
8. Sample Testamentary CRUT Declaration for Concurrent and Consecutive Measuring Lives - Rev. Proc. 2005-59

C. Requirements

1. Irrevocable

The trust instrument must be irrevocable and must create a valid trust under applicable local law. Treas. Reg. § 1.664-1(a)(1)(i).

2. Payout

a. Amount of Payout

The stated annuity amount or unitrust amount must be at least 5% of the initial fair market value of the trust property and may be no more than 50% of the initial fair market value of the trust property. Code Sections 664(d)(1)(A) and 664(d)(2)(A).

Treasury Regulation § 1.664-3(a)(1)(i)(b)(3) provides that pre-contribution gain on the sale of an asset contributed to a NICRUT or NIMCRUT by the donor must be allocated to principal and not to trust income. However, if the trust instrument so provides and it is not prohibited under state law, any post-contribution gain on the sale of an asset may be allocated to income. This power may be either a mandatory or discretionary power given to the trustee under the trust instrument. Indiana law does not prohibit the allocation of gain to income.

b. Timing of Payout

Treasury Regulation §§ 1.664-2(a)(1)(i)(a) and 1.664-3(a)(1)(i)(g) provide that the trustee of a standard fixed percentage unitrust or a charitable remainder annuity trust created on or after December 10, 1998, may only pay the unitrust or annuity amount within a reasonable time after the close of the taxable year (due date for Form 5227 including extensions) if (i) the entire payout amount is characterized in the hands of the beneficiary as either ordinary income, capital gain or tax-exempt income, (ii) the trustee distributes property that the trust owned at the close of the taxable year in which the payout amount was due, and the trustee elects to treat the income generated from the distribution as occurring on the last day of the prior taxable year, (iii) the trustee distributes cash that was contributed to the trust with respect to which a charitable deduction was allowed, or (iv) the trustee distributes cash received as a return of basis in any asset that was contributed to the trust with respect to which a charitable

deduction was allowed and that was sold by the trustee during the year in which the annuity amount was due.

The final regulations contain the following example: CRT is a standard fixed percentage unitrust created after December 10, 1998. The unitrust amount payable from the trust for Year 1 was $100, and CRT had $95 of ordinary income under Code Section 664(b)(1) and no capital gain or tax-exempt income in Year 1. On April 1 of Year 2, the trustee distributed a capital asset owned by the trust on December 31 of Year 1 (fair market value of $5; adjusted basis of $2) plus $95 to the beneficiary and elected to treat the capital gain recognized upon the transfer of the asset as occurring on December 31 of Year 1 (Treasury Regulation § 1.664-1(d)(5) provides that the distribution of an asset is treated as a sale by CRT). Under the facts of this example, CRT is in compliance with the requirements of Treasury Regulation § 1.664-3(a)(1)(i)(g).

The trust will be deemed to have (i) engaged in an act of self-dealing within the meaning of Code Section 4941, (ii) received unrelated debt-financed income within the meaning of Code Section 514, (iii) received an additional contribution, and (iv) failed to function exclusively as a charitable remainder trust within the meaning of Treasury Regulation § 1.664-1(a)(4) if the trustee does not pay the annuity or unitrust amount by the end of the year or in compliance with the rules discussed above . Treas. Reg. §§ 1.664-2(a)(1)(i)(a) and 1.664-3(a)(1)(i)(g).

These rules do not apply to NICRUTs or NIMCRUTs, and trustees of these types of trusts can pay the unitrust amount any time prior to the filing of Form 5227 (including extensions). Treas. Reg. § 1.664-3(a)(1)(i)(j).

3. Short taxable year

The trust instrument must provide that the annuity or unitrust payment be pro rated in a taxable year that is less than twelve months and in the year in which the annuity or unitrust recipients' interest ends. Treas. Reg. §§ 1.664-2(a)(1)(iv) and 1.664-3(a)(1)(v). The payment must be pro rated based upon the number of days in the short taxable year. Id.

4. Appraisal requirements

A charitable remainder unitrust must value its assets annually. Treasury Regulation § 1.664-1(a)(7) provides that if a charitable remainder unitrust holds unmarketable assets (as defined in paragraph A.2.c. above) all required valuations must be performed by an independent trustee or determined by a "qualified appraisal" from a "qualified appraiser". This provision must be included in the trust instrument of all charitable remainder unitrusts created on or after December 10, 1998.

The term "independent trustee" is defined in Treasury Regulation § 1.664-1(a)(7)(iii), as a person who is not the grantor, a non-charitable beneficiary, or a related or subordinate party to the grantor, the grantor's spouse, or a non-charitable beneficiary. Code Section 672(c) provides that a "related or subordinate party" includes the grantor's spouse, father, mother, issue, brother or sister; employee of the grantor; a corporation or any employee of a corporation in which the grantor and the trust have significant stockholdings from the viewpoint of voting control; and a subordinate employee of a corporation in which the grantor is an executive.

The requirement that the value be determined by a "qualified appraisal" from a "qualified appraiser" is the same as that required under Treasury Regulation §§ 1.170A-13(c)(3) and (5) for substantiating the income tax charitable deduction for certain large gifts of property. A "qualified appraiser" is one who (i) holds himself out to the public as an appraiser, and (ii) proves through his credentials that he is qualified to appraise the type of property being valued. A qualified appraiser may not be the donor, the donee, any person related to, or regularly employed by, the donor or the donee, or a party to the transaction by which the donor acquired the property being appraised, unless the property being appraised is donated within two months of the date of acquisition and its appraised value does not exceed the purchase price. A "qualified appraisal" is one that (i) is made no earlier than 60 days prior to the date of contribution of the property and received no later than the due date for filing the return; (ii)contains specific information regarding the property contributed, the qualifications of the appraiser, the date of the appraisal, the fair market value of the property on the date of its contribution, the method of valuation and the specific basis for that valuation; and (iii) the appraisal fee is not based upon the appraised value of the property.

5. Correction of incorrect payments

The trust instrument must contain a provision requiring the trustee to pay to the annuity or unitrust recipient (in the case of an undervaluation) and the annuity or unitrust recipient to pay to the trustee (in the case of an overvaluation) and amount equal to the difference between the amount that was actually paid to the recipient and the amount that should have been paid to the recipient. Treas. Reg. §§ 1.664-2(a)(1)(iii) and 1.664-3(a)(1)(iii).

6. Term

The trust instrument must require payment of the annuity or unitrust amount for a period that begins with the first year of the trust and continues either for (i) the life or lives of a named individual living at the creation of the trust, or (ii) a term of years not to exceed twenty years. Treas. Reg. §§ 1.664-2(a)(5) and 1.664-3(a)(5). Treasury Regulation §§ 1.664-2(a)(5)(i) and 1.664-3(a)(5)(i) also provide that the annuity or unitrust interest may be measured by the shorter of either a term of years not to exceed 20 years or an individual life.

7. Charitable Recipient

a. Minimum required residual benefit to charity

For transfers of property after July 28, 1997, Code Sections 664(d)(1)(D) and 664(d)(2)(D) require that at the time of the transfer, the value of the remainder interest passing to charity must be equal to 10% of the value of the property transferred to the trust (the “10% test”). This requirement in effect limits the ability of a younger donor to create a CRT and designate himself or herself as the lifetime annuity or unitrust recipient. The 10% test depends on three factors:

- The term of the CRT or for lifetime CRT’s, the beneficiaries’ life expectancies;
- The payment amount each year; and
- The IRC 7520 rate.

b. 5% Probability of Exhaustion Test

In addition to the 10% test, the IRS also requires that a charitable remainder annuity trust meet the 5% exhaustion test – namely that a trust will not qualify for purposes of the charitable deduction where the probability that the charitable remainder beneficiaries will not receive any trust corpus exceeds 5%. Treas. Reg. §20.2055-2(b)(1), §25.2522(c)-3(b)(1) (which both provide that no deduction is allowable where a charitable transfer is subject to a condition “unless the possibility that the charitable transfer will not become effective is so remote as to be negligible.”)

In a low interest rate environment, the 5% probability of exhaustion test made it virtually impossible to use a charitable remainder annuity trust for planning. In Revenue Procedure 2016-42, the IRS provided language to be included in charitable remainder annuity trust instruments that would allow use of charitable remainder annuity trusts in low interest rate environments. In effect, the language requires an “early termination” of the trust in the event the value of the trust corpus minus the annual payment and multiplied by a specific discount factor falls below 10% of the initial trust corpus. In the event of this contingency the trust would terminate and distribute the remainder to the charity identified in the trust instrument.

The recommended language from the Revenue Procedure is as follows –

“The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the date of the Recipient's death or, if earlier, the date of the contingent termination. The date of the contingent termination is the date immediately preceding the payment date of any annuity payment if, after making that payment, the value of the trust corpus,

when multiplied by the specified discount factor, would be less than 10 percent of the value of the initial trust corpus. The specified discount factor is equal to [1 / (1 + i)] t, where t is the time from inception of the trust to the date of the annuity payment, expressed in years and fractions of a year, and i is the interest rate determined by the Internal Revenue Service for purposes of section 7520 of the Internal Revenue Code of 1986, as amended (section 7250 rate), that was used to determine the value of the charitable remainder at the inception of the trust. The section 7520 rate used to determine the value of the charitable remainder at the inception of the trust is the section 7520 rate in effect for [insert the month and year], which is [insert the applicable section 7520 rate].”

c. Designation of Charity

Treasury Regulation §§ 1.664-2(a)(6)(i) and 1.664-3(a)(6)(i) provide that a trust will qualify as a CRT as long as the trust principal remaining after the termination of the annuity or unitrust interest ". . . is required to be irrevocably transferred, in whole or in part, to or for the use of one or more organizations described in section 170(c) or retained, in whole or in part, for such use." When drafting charitable remainder trusts, it is important to properly reference either (or both) Code Sections 170(c) and 170(b)(1)(A). If the donor intends to benefit private foundations, a reference to only Code Section 170(c) should be included. If, however, the donor intends to only benefit public charities (and thus have higher AGI limitations), Code Section 170(b)(1)(A) must be referenced in the document.

The trust instrument may allow the donor to retain the right to amend the instrument to provide for the designation of charitable beneficiaries other than those initially designated. Rev. Rul. 76-7, 1976-1 C.B. 179; PLR 8919016; PLR 9445010.

8. Application of Private Foundation Rules

CRTs are subject to many of the private foundation excise taxes contained in Code Sections 4941-4945. As such, the trust instrument must provide that the trustee (i) will not engage in any act of self-dealing under Code Section 4941(d), (ii) will not make any taxable expenditures, as defined in Code Section 4945(d), (iii) will not make any investments that jeopardize the charitable purpose of the trust, within the meaning of Code Section 4944, and (iv) will not retain any excess business holdings, within the meaning of Code Section 4943(c). Code Section 508(e).

The excise tax on excess business holdings (Code Section 4943) and jeopardizing investments (Code Section 4944) will rarely apply to charitable remainder trusts because Code Section 4947(b)(3)(B) provides that those taxes will not apply to trusts if a charitable deduction was allowed for amounts payable to every remainder beneficiary, but not to any income beneficiary. Thus, if it is anticipated that the trust will meet the requirements of Code Section 4947(b)(3)(B), the trust instrument need not provide that

the trustee will not make jeopardizing investments or retain excess business holdings. Treasurer Regulation § 1.508-3(b).

9. Restrictions on Payments from the Trust

No amount other than the annuity or unitrust amount may be paid to or for the use of any person other than a charitable organization. Treas. Reg. §§ 1.664-2(a)(4) and 1.664-3(a)(4). Thus, the trust may not pay taxes, debts or expenses of administration upon the death of the annuity or unitrust recipient. Treas. Reg. § 1.664-1(a)(6), Examples (3) and (4).

10. Income Tax Charitable Contribution Deduction

When the CRT is created, the donor will receive an income tax charitable contribution deduction for the present value of the remainder interest that will pass to charity. The present value of a remainder interest in a CRT equals the fair market value of the contributed property reduced by the actuarial value of the income payments to be made to the income beneficiary or beneficiaries. Treas. Reg. §§ 1.664-2(c) and 1.664-4. The donor must then apply the charitable deduction rules of Code Section 170 to determine the amount of the deduction. Treas. Reg. §§ 1.664-2(d) and 1.664-3(d).

11. Gift Tax

As long as the donor and his or her spouse are the only income beneficiaries of the trust, there will not be a taxable gift for gift tax purposes upon the creation of the trust. However, if an individual other than the donor and his or her spouse is designated as the income beneficiary of the trust, the present value of the annuity or unitrust interest created by the donor is a taxable gift. Code Section 2511(a).

12. Estate Tax

On the donor's death if he or she is an income beneficiary, the value of the trust property would be included in his or her gross estate, but the estate would receive a corresponding deduction for the value of the property passing to the charitable beneficiary. Code Sections 2036 and 2055(a). <u>But</u> <u>see</u> <u>Atkinson v. Comm'r</u>, 115 T.C. No. 3 (2000) (where the Tax Court did not allow a charitable estate tax deduction when unitrust payments were not paid to the unitrust recipient and estate taxes were paid out of the trust)

D. Taxation of Non-Charitable Beneficiary

Code Section 664(b) provides rules for the taxation of distributions to non-charitable beneficiaries from charitable remainder trusts. This four-tier distribution provision requires that a charitable remainder trust is first required to distribute all current and undistributed income, followed by all capital gain income and undistributed capital gain income, and then tax-exempt income and undistributed tax-exempt income. Only at such time as all three of the foregoing categories of income are exhausted, can the charitable remainder trust characterize a distribution as a tax-free return of principal. Thus, for example if a trust is required to make an annual annuity payment of $5,000 and it receives $3,000 of interest and recognizes $1,000 of capital gain, the annuity recipient's payout would be characterized as $3,000 of ordinary income, $1,000 of capital gain and a $1,000 return of principal.

E. Taxation of Trust

Generally, a CRT is exempt from income tax at the trust level. Code Section 664(c). However, if the trust has any unrelated business taxable income within the meaning of Code Section 512, then Code Section 664(c)(2) provides that the unrelated business taxable income is subject to an excise tax equal to the amount of the income. The excise tax is reported and paid on Form 4720.

Treasury Regulation §1.664-1(c)(2) provides two examples regarding the interplay of the excise tax rules applicable to unrelated business income and the tiers of income distributed to the beneficiary.

Example 1. For 2007, a charitable remainder annuity trust with a taxable year beginning on January 1, 2007, has $60,000 of ordinary income, including $10,000 of gross income from a partnership that constitutes unrelated business taxable income to the trust. The trust has no deductions that are directly connected with that income. For that same year, the trust has administration expenses (deductible in computing taxable income) of $16,000, resulting in net ordinary income of $44,000. The amount of unrelated business taxable income is computed by taking gross income from an unrelated trade or business and deducting expenses directly connected with carrying on the trade or business, both computed with modifications under section 512(b). Section 512(b)(12) provides a specific deduction of $1,000 in computing the amount of unrelated business taxable income. Under the facts presented in this example, there are no other modifications under section 512(b). The trust, therefore, has unrelated business taxable income of $9,000 ($10,000 minus the $1,000 deduction under section 512(b)(12)). Undistributed ordinary income from prior years is $12,000 and undistributed capital gains from prior years are $50,000. Under the terms of the trust agreement, the trust is required to pay an annuity of $100,000 for year 2007 to the noncharitable beneficiary. Because the trust has unrelated business taxable income of $9,000, the excise tax imposed under section 664(c) is equal to the amount of such unrelated business taxable income, $9,000. The character of the $100,000 distribution to the noncharitable beneficiary is as follows: $56,000 of ordinary income ($44,000 from current year plus $12,000 from prior years), and $44,000 of capital gains. The $9,000 excise tax is allocated to corpus, and does not reduce the amount in any of the categories

of income under paragraph (d)(1) of this section. At the beginning of year 2008, the amount of undistributed capital gains is $6,000, and there is no undistributed ordinary income.

Example 2. During 2007, a charitable remainder annuity trust with a taxable year beginning on January 1, 2007, sells real estate generating gain of $40,000. Because the trust had obtained a loan to finance part of the purchase price of the asset, some of the income from the sale is treated as debt-financed income under section 514 and thus constitutes unrelated business taxable income under section 512. The unrelated debt-financed income computed under section 514 is $30,000. Assuming the trust receives no other income in 2007, the trust will have unrelated business taxable income under section 512 of $29,000 ($30,000 minus the $1,000 deduction under section 512(b)(12)). Except for section 512(b)(12), no other exceptions or modifications under sections 512-514 apply when calculating unrelated business taxable income based on the facts presented in this example. Because the trust has unrelated business taxable income of $29,000, the excise tax imposed under section 664(c) is equal to the amount of such unrelated business taxable income, $29,000. The $29,000 excise tax is allocated to corpus, and does not reduce the amount in any of the categories of income under paragraph (d)(1) of this section. Regardless of how the trust's income might be treated under sections 511-514, the entire $40,000 is capital gain for purposes of section 664 and is allocated accordingly to and within the second of the categories of income under paragraph (d)(1) of this section.

F. Common Mistakes with Charitable Remainder Trusts

1. Ownership of S Corporation Shares by a Charitable Remainder Trust

Law: Code Section 1361, Rev. Rul. 92-48, 1992-1 C.B. 301

Summary: A charitable remainder trust is a trust in which a certain amount, either an annuity or unitrust, is payable to an individual or individuals either for their lives or a term of years. Any amount in excess of what is distributed to the individual beneficiaries is accumulated for the charitable remainder beneficiaries. Under Code Section 1361, only individuals, estates, and certain trusts described in Section 1361(c)(2)(A) can own shares of an S Corporation. A charitable remainder trust, as defined in Section 664 does not qualify as a "subchapter S trust" under Section 1361. Thus, a charitable remainder trust is not a permissible shareholder of S Corporation shares.

Impact: An S Corporation will lose its S Corporation tax status on the day that a charitable remainder trust becomes a shareholder, and will thereafter be taxed as a C Corporation. However, the corporation may be eligible for relief from the termination of its S Corporation status under Code Section 1362(f).

2. NIMCRUT with a sprinkle power for a class of beneficiaries

Law: Code Section 674(c)

Summary: In order for a trust to qualify as a charitable remainder trust, no individual can have the power to alter the amount paid to any beneficiary (other

than a section 170(c) organization) if that power would cause that individual to be treated as the owner of the trust or part of the trust under Subpart E of the code. However, Section 674(c) (which is under Subpart E) provides an exception that allows an independent trustee to make disproportionate distributions among a class of beneficiaries. This is referred to as "sprinkling" the annual distribution.

Revenue Ruling 77-73 addresses this exception and provides a roadmap for utilizing this "sprinkling" power in the context of a charitable remainder trust.

Example: An individual would like to set up a NIMCRUT that would distribute the lesser of 5% or the net income annually for a 10-year term and would like the annual distributions to benefit his grandchildren while they are in college. The grandchildren are different ages and will be in college at different times. There will also be some years where multiple grandchildren will be in college at one time. Upon the end of the 10-year term, the remaining trust property will be distributed to a charitable beneficiary.

Using the "sprinkling" feature, an independent trustee has the discretion to alter the proportion of the annual distribution that each beneficiary receives. Therefore, when A and B are in college, but C is not yet in college, A and B can receive larger portions of the annual distribution. When C enters college, she will then receive a larger portion of the annual distribution.

Potential Pitfalls: Although the independent trustee has the ability to alter the proportionate share each beneficiary will receive, the lesser of the net income or 5% must be paid in full each year in order for the trust to qualify as a charitable remainder trust under Section 664. Although it would be useful under these circumstances for the trustee to accumulate some of the income to use in the years when there are more grandchildren in college at once, the trust would no longer qualify as a charitable remainder trust if the trustee accumulated any of the annual distribution. Thus, it is important that the power granted to the independent trustee to "sprinkle" the distributions does not grant the trustee any authority to accumulate trust dollars.

Additional Planning Tool: Another useful planning tool for this scenario is to use a FLIP-NIMCRUT. The trust initially could invest for appreciation instead of income with the goal of growing the trust corpus until such time as the triggering event for the "flip" to the unitrust payout. The flip event could occur when the oldest grandchild turns age 18. Once the flip event occurs, the independent trustee could distribute the unitrust amount unequally among the beneficiaries as discussed above.

3. Reformation of Charitable Remainder Unitrust

Law: PLR200649027

Summary: As a general rule, charitable trusts are irrevocable and not subject to amendment. However, the IRS may recognize a reformation of a charitable trust to correct a "scrivener's error."

In PLR 200649027 the trustee/income beneficiaries of a charitable remainder unitrust petitioned the local probate court for reformation of a NIMCRUT on the basis that the (i) attorney did not adequately explain the differences between a NIMCRUT and a straight unitrust payout, and (ii) current investment climate frustrated the trust's purpose of providing a suitable annual income stream to them. The IRS concluded that the reformation of the trust was not due to a scrivener's error, and the reformed trust would no longer be treated as a charitable remainder unitrust.

Impact: Only certain reformations of charitable remainder trusts are given effect. Care must be taken to ensure that the reformation qualifies as correction of a scrivener's error. In the situation discussed in the PLR, other alternatives may exist.

- First, the trustee could continue to administer the NIMCRUT in accordance with its terms with changes to the investment policy. By modifying the investment mix, the trustee could produce more income to increase the distributions to the unitrust recipient.

- Second, the trustee could terminate the NIMCRUT and distribute the actuarial value of the unitrust interest to the income beneficiaries.

4. Administration of Charitable Remainder Unitrust

Law: PLR 201714002 and PLR 201714003

Summary: The Trustee did not follow the trust instrument or state law when paying the unitrust amount and thus caused the trust to fail as a charitable remainder unitrust under Code Section 664(a). Further, the payments were subject to excise taxes under Code Section 4941 and 4945.

The trust was drafted as a NIMCRUT, and the investments were insufficient to pay the stated fixed percentage payout rate. As a result, the unitrust recipient was receiving only income payouts from the trust. Based upon the advice of the financial planner and the attorney, the trustee/unitrust recipient began paying out an increased amount of "income" by including capital gain in the income distribution amounts. The trust instrument did not include language allowing the trustee to allocate post-contribution capital gain to income, so this violated the terms of the trust instrument.

Impact: It is important when creating charitable remainder trusts to explain carefully to the donor the different types of trusts, and then it is imperative that the terms of the trust instrument be followed by the trustee.

5. Difference between 170(c) and 170(b)(1)(A)

Law: Code Section 170

Summary: Section 170(c) defines the term "charitable contribution" as a contribution or gift to or for the use of a permissible donee. There are five detailed categories of "permissible" donees, the most common of which is a charitable corporation or foundation created or organized under the laws of the United States.

Section 170(b)(1)(A) sets forth several types of 501(c)(3) organizations that are classified as public charities.

Impact: When drafting estate planning documents, including charitable remainder trusts and charitable lead trusts, it is important to properly reference either (or both) Code Sections 170(c) and 170(b)(1)(A). If the donor intends to benefit private foundations, a reference to only Code Section 170(c) should be included. If, however, the donor intends to only benefit public charities (and thus fall into the 50% of AGI limitation), Code Section 170(b)(1)(A) must be referenced in the document.

6. Charitable Remainder Trust – Subsequent Non-Charitable Income Beneficiary

Law: PLR 200204022, Code Section 2056(b)(8), Code Section 2523(g)

Summary: Code Sections 2523(g) and 2056(b)(8) provide that a marital deduction is only available if the surviving spouse is the sole unitrust non-charitable beneficiary.

Consider the following fact pattern: H and W wish to create a charitable remainder unitrust for a term of 20 years. They will be the initial concurrent and consecutive unitrust beneficiaries and their children will be the contingent unitrust beneficiaries should H and W pass away during the 20 year term.

Impact: Absent planning, H and W would be subject to gift tax and estate tax (should they pass away) on both the interest of the spouse and the interest of the children.

II. Other Items of Interest When Making Charitable Gifts

A. Assignment of Income Doctrine – When Is It Too Late to Make the Charitable Gift and Avoid Capital Gain?

- Law: *Ferguson v. Comm'r*, 108 T.C. 244 (1997); *Palmer v. Comm'r*, 62 T.C. 684 (1974)

- <u>Summary</u>: The assignment of income doctrine provides that income is taxed to the person who earns the income or otherwise creates the right to receive income. The mere anticipation or expectation of income at the time of a transfer, however, is insufficient to create a fixed right to earned income.

  In *Palmer*, taxpayers transferred shares to a private foundation. The taxpayers controlled the corporation and the foundation to which the shares were transferred. A day after the shares were transferred, the corporation redeemed the shares. The corporation deducted the value of the shares contributed to the foundation and the IRS challenged this deduction arguing that there was an anticipatory assignment of the proceeds of the redemption. The Court rejected the application of the assignment of income doctrine, and the IRS acquiesced to the decision and adopted a bright-line test that provides that the assignment of income doctrine will apply only if the donee is legally bound or can be compelled to surrender or redeem the shares.

  Despite the IRS's position, the Tax Court and the Circuit Courts of Appeal have not applied the bright line test, as adopted by the IRS, as the sole test for resolving anticipatory assignment of income issues. The Tax Court stated, "This Court has not adopted the 'bright-line test' for resolving anticipatory assignment of income issues and instead we have considered the donee's control to be merely a factor, albeit an important factor." Rauenhorst v. Comm'r, 119 T.C. 9 (2002).

  Despite the failure to adopt the bright line test across the board, Courts in applying other reasoning to resolve assignment of income issues have relied on similar tenants that embrace the theory behind the bright line rule. In Ferguson, the Tax Court stated that the "ultimate question is whether the transferor, considering the reality and substance of the circumstances, had a fixed right to income in the property at the time of transfer." 108 T.C. at 259. On appeal of the Tax Court's decision in Ferguson, the 9th Circuit Court of Appeals stated that once the right to receive income has "ripened" for tax purposes, the taxpayer who earned or created the right will be taxed on the gain realized from it, despite the fact the right to receive income was transferred by the taxpayer. To determine whether a right has "ripened" the court must "consider the realities and substances of the events to determine whether the receipt of income was practically certain to occur." Ferguson v. Comm'r, 174 F.3d 997 (9th Cir. 1999).

  In Ferguson, the Tax Court rejected what it called the taxpayer's attempt to "impose formalistic obstacles" to the application of the anticipatory assignment of income doctrine. Ferguson, 108 T.C. at 264. In that case the shares donated to the charity were subject to a tender offer and

merger agreement that had not been completed by the time of the gift of shares by the taxpayers to several charities. The taxpayers attempted to argue, relying on Palmer, that they were not liable for the gain on the subsequent sale of the stock because the donees were not legally obligated to sell the stock. In addition, according to the taxpayers the contribution was not made until after the date in which the tender offer was made. The Court stated, "The fact that the … shareholders may not have had a legal right to the proceeds prior to acceptance of the tendered or guaranteed shares…does not change our conclusion…." Id. The Court determined that based on the reality and substance of events it was practically certain that on the date of contribution that the merger and tender offer would be completed.

- Impact: If avoidance of capital gain on the sale of appreciated securities is the goal, it is important to make sure that the right to income has not "ripened" at the time of transfer. Otherwise, the gain on the sale may be taxed to the donor, despite the transfer to charity.

B. Satisfaction of a Personal Pledge of a Disqualified Person by the Private Foundation

- Law: Code Section 4941

- Summary: Code Section 4941 imposes a penalty tax on certain transactions between a private foundation and any disqualified person. A disqualified person is any substantial contributor to the foundation, any director of the foundation, any owner of more than 20% of any substantial contributor (a "20% owner"); any family member of a substantial contributor, a foundation manager, or a 20% owner (a "family member"); any corporation in which more than 35% of its voting power is owned by a substantial contributor, a foundation manager, a 20% owner or a family member; any partnership in which more than 35% of the profits interest is owned by a substantial contributor, a foundation manager, a 20% owner or a family member; or any trust or estate in which more than 35% of the beneficial interest is owned by a substantial contributor, a foundation manager, a 20% owner, or a family member.

  Self-dealing includes any direct or indirect: (i) sale or exchange or leasing of property between a private foundation and a disqualified person, (ii) lending of money or other extension of credit between a private foundation and a disqualified person, (iii) furnishing of goods, services or facilities between a private foundation and a disqualified person, (iv) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person, or (v) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation (each an "Act of Self-Dealing").

Treasury Regulation § 53.4941(d)-2(f)(1) specifically provides that "….if a private foundation makes a grant or other payment which satisfies the legal obligation of a disqualified person, such grant or payment shall ordinarily constitute an act of self-dealing ….".

➢ Impact: A grant by a private foundation in satisfaction of a personal pledge of a disqualified person is an Act of Self-Dealing. Care should be taken when entering into pledge agreements when a client makes individual contributions and when he makes contributions through his donor advised fund or private foundation.

Note: Until recently this same rule arguably applied to donor advised funds. However, Notice 2017-73 issued in December 2017 provides that a grant from a donor advised fund that fulfills the personal pledge of a donor, donor advisor or certain related persons would not be treated as a "more than incidental benefit" under Code Section 4967 if the following requirements are satisfied:

(1) The sponsoring organization makes no reference to the existence of any charitable pledge when making the distribution from the donor's donor advised fund (references to the name of the person who advised on the distribution are permitted);

(2) No donor/advisor receives, directly or indirectly, any other benefit that is more than incidental as a result of the donor advised fund distribution; and

(3) The donor/advisor does not claim a charitable contribution deduction for the donor advised fund distribution, even if the charity receiving the distribution mistakenly sends the donor/advisor a tax acknowledgement.

C. Substantiation Letters

When do they need to be issued?

➢ Law: Code Section 170, Treas. Reg. 1.170A-13

➢ Summary: A charitable contribution is deductible only if the contribution is verified under the requirements of Code Section 170. The substantiation requirements vary widely depending on the type and value of the property contributed.

With respect to cash, contributions over $250 must be acknowledged by the donee organization with a "contemporaneous written

acknowledgment." Cash contributions less than $250 require bank record or written communication from the donee.

With respect to property, contributions over $250 but under $500 must be acknowledged by the donee organization with a "contemporaneous written acknowledgment." With respect to contributions over $500, the donor must complete and attach Form 8283 (Noncash Charitable Contributions) to his or her income tax return. In addition to the foregoing requirements, for contributions over $5,000, the taxpayer must obtain a qualified appraisal from a qualified appraiser in accordance with Treasury Regulation § 1.170A-13. Note that Treasury Regulation § 1.170A-13(c)(1)(l) provides that no deduction will be allowed unless the appraisal requirement is satisfied. The IRS has taken a strict approach in its application of this rule. See, Mohamed v. Comm'r, T.C. Memo 2012-152; Hewitt v. Comm'r, 109 T.C. 258 (1997), *aff'd* 166 F.3d 332(4th Cir. 1998).

Note: The donee organization is not required to place a value on an in-kind contribution in the substantiation letter.

- Impact: The substantiation requirements vary depending upon the type and value of the property contributed. Ultimately, the taxpayer bears the burden of establishing that the substantiation requirements have been met.

Quid pro quo contributions

- Law: Code Section 6115
- Summary: A quid pro quo contribution is a payment to a charity that is made partly as a contribution and partly for goods and services. Any organization that receives a quid pro quo contribution in excess of $75 must provide the donor with a written statement acknowledging that the amount that is deductible is limited to the difference between the contribution less the value of the goods or services provided. The statement must also provide a good-faith estimate of the value of the goods and services provided by the organization.
- Impact: Any quid-pro quo contributions over $75 must be acknowledged in writing and contain statements regarding the value of goods and services received and limitation of the deduction.

Other Cases where No Substantiation lead to No Deduction

- *Mohamed v. Comm'r*, T.C. Memo 2012-152 (2012). An appraisal of real property that married taxpayers contributed to a CRUT was not performed by a qualified appraiser where the appraisal was performed by

the husband who was the donor, the taxpayer claiming the deductions, and, in his capacity as the trustee of the CRUT, the donee. The taxpayers also failed to include certain information in their attached statements to Form 8283 that is required for an appraisal summary, including bases in the properties, a bargain-sale statement and statements from a qualified appraiser. The court said that the taxpayers' mistakes could not be excused by substantial compliance because substantial compliance requires a qualified appraisal. An $18.5 million deduction was denied.

- *Hewitt v. Comm'r*, 109 T.C. 258 (1997), *aff'd without opinion*, 166 F.3d 332 (4th Cir. 1998). Petitioners claimed $121,000 in charitable deductions for contributions of non-publicly traded stock. The taxpayers did not attempt to obtain any appraisals and did not attach any appraisal summaries to their tax returns. The taxpayers failed to substantially comply with the regulations, because they completely ignored the appraisal requirement, failed to include any indication of the number of shares donated and failed to provide the method of valuation used to determine the fair market value. In this case, the Commissioner previously allowed a deduction to the extent of the taxpayers' basis in the stock and the court disallowed a charitable deduction in excess of that amount.

- *Lange v. Comm'r*, T.C. Memo 2005-176. Petitioner claimed $4,143 in charitable contribution deductions. He kept no records regarding the claimed contributions. Petitioner testified in vague terms about having made gifts of clothing and cash to the Salvation Army. The Court determined that he was not entitled to any deduction for these contributions.

- *Linzy v. Comm'r*, T.C. Memo 2011-264. The taxpayer in this case originally did not itemize her deductions. However, during the proceedings she asserted her right to itemize her deductions and claimed a number of charitable contribution deductions. The court allowed a number of charitable deductions. However, the court denied deductions of $2,400 and $7,500 because the taxpayer did not receive a contemporaneous written acknowledgment from the donee organization.

- *RERI Holdings I LLC v. Comm'r*, 149 T.C. No.1 (2017). The taxpayer in this case failed to provide the cost basis of the contributed property as part of its appraisal summary on Form 8283. The court said this omission could not be excused by "substantial compliance" because it prevented the appraisal summary from providing sufficient information to allow the IRS to evaluate the claimed charitable deduction. A $33 million deduction was denied.

(i) On May 24, 2019, the United States Court of Appeals for the District of Columbia affirmed the decision of the Tax Court in denying the entire charitable income tax deduction.

(ii) This case is a reminder of the importance of ensuring that all of the substantiation requirements with respect to charitable contributions are adhered or face the potential consequences of having a claimed charitable income tax deduction denied in full. In this case, the failure of simply not completing one box on Form 8283 to indicate the "Donor's cost or other adjusted basis," in and of itself, caused the total denial of the claimed deduction.

(iii) In 2003, the year in which the contribution was made in RERI Holdings I, LLC, the only authority for the disallowance of a charitable contribution deduction for the failure to comply with the substantiation requirements was Treas. Reg. 1.170A-13(c)(1)(i), under which the failure to satisfy the requirements results in a total denial of a deduction for the contribution.

(iv) Subsequently, Code Section 170(f)(11)(A)(i) was enacted, effective for contributions made after June 3, 2004, providing statutory authority for the denial of a charitable income tax deduction for failing to meet the substantiation requirements subject, however, to Code Section 170(f)(11)(A)(ii), under which the denial of the deduction does not apply if it is shown that the failure to meet such requirement "is due to reasonable cause and not willful neglect."

(v) Under Treas. Reg. 1.170A-13(c)(4)(iv)(C)(1), "[i]f a taxpayer has reasonable cause for being unable to provide the information … relating to the manner of acquisition and basis of the contributed property" in the appraisal summary, the deduction will not be disallowed if the donor attaches "an appropriate explanation" to the appraisal summary. Similarly, the Instructions to Form 8283 for Section B, Part I, provide that "If you have reasonable cause for not providing the information in columns (d), (e), or (f)," which includes the income tax basis information in column (f), "attach an explanation so your deduction will not automatically be disallowed."

- *Pankratz v. Comm'r*, T.C. Memo 2021-26 (2021). The Tax Court denied charitable deductions for a taxpayer's donations of oil and gas interests and a conference center due to the taxpayer's failure to attach appraisals to the tax returns that included those deductions.

- *15 West 17th Street LLC v. Comm'r*, 147 T.C. No. 19 (2016). The limited liability company contributed an easement to a charitable trust. The

substantiation letter from the charitable trust failed to disclose that no goods or services had been provided in exchange for the donation. The court noted that the doctrine of substantial compliance does not apply to the failure to obtain a substantiation letter that meets all statutory requirements. A $64.49 million charitable deduction was denied.

- *Chiarelli v. Comm'r*, T.C. Memo 2021-27 (2021). The Tax Court denied charitable contribution deductions of $89,110, $93,087 and $77,300 to a taxpayer for noncash charitable contributions because the taxpayer did not comply with the reporting requirements: did not maintain reliable written records in connection with noncash charitable contributions, did not substantiate contributions of property over $250, did not obtain and attach appraisals for property over $5,000.

- *Albrecht v. Commissioner*, T.C. Memo 2022-53 (2022). A donor contributed a collection of Native American jewelry and artifacts to a museum and executed a 5 page deed of gift with the museum. The IRS disallowed a charitable deduction, arguing that the deed of gift failed the Code Section 170(f)(8) contemporaneous written acknowledgment (CWA) requirement by not stating whether the museum provided any goods or services in exchange for the gift. The Tax Court noted that a deed of gift can serve as a CWA. The Court also provided that without an explicit statement in the deed regarding goods and services, it can still review the deed as a whole to determine whether the statutory requirement is met. However, the Court found that the donor's Deed of Gift failed to meet the requirement and disallowed the deduction.

D. Charitable Gifts of Cryptocurrency

- IRS Notice 2014-21 provides that cryptocurrency is property, so it will be treated as a noncash contribution subject to the substantiation rules discussed above, including appraisal and Form 8283 requirements discussed above. Most charitable organizations will have a gift acceptance policy that requires immediate sale, triggering the Form 8282 requirement.

- Additional concerns

  (i) Qualified appraisal
  (ii) Finding a qualified appraiser
  (iii) Volatile pricing and the filing of Form 8282
  (iv) When is virtual currency an ordinary income asset?
  (v) Tracking cost basis of cryptocurrency

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