NATIONAL BUSINESS INSTITUTE
Tax Exempt Organizations from Start to Finish

HANDLING CONTRIBUTIONS AND TAX DEDUCTIONS

Michelle Huhnke
Sugar Felsenthal Grais & Hammer LLP
30 North LaSalle Street, Suite 3000
Chicago, Illinois 60602
(312) 704-2779
mhuhnke@sugarfgh.com

I. Types of Gifts: Advising Clients on Accepting Money and Property

A. Investment Rules: Uniform Management of Institutional Funds Act ("UMIFA")

1. UMIFA was drafted in 1972 and enacted in 47 states, including Illinois.

2. UMIFA articulated a duty of care for board members managing institutional funds. In administering powers regarding endowments and to make and retain investments, members of a governing board were required to "exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision." Board members were to consider:
   (a) The institution's long and short-term needs in carrying out its charitable purposes;
   (b) The institution's present and anticipated financial requirements;
   (c) The fund's expected total return;
   (d) Price-level trends; and
   (e) General economic conditions. [1]

B. Updated Investment Rules: Uniform Prudent Management of Institutional Funds Act ("UPMIFA")

1. UPMIFA was released in 2007 and is intended to modernize UMIFA. The investment and management principles it embraces are rooted in the modern Uniform Prudent Investor Act.

2. Illinois has enacted UPMIFA. 760 ILCS 51/1 et seq.

3. To that end, UPMIFA imposes a familiar standard on persons managing and investing a charitable fund. Those persons must act in good faith, with the care an ordinarily prudent person would exercise.[2]

4. A person who has special skills or expertise (or is selected because of representations about skill or expertise) must use those skills in the management and investment of the institutional funds.

5. UPMIFA further requires a charity when dealing with its assets and investments to:
   (a) Give primary consideration to donor intent;
   (b) Incur only reasonable costs in investments and management;
   (c) Make a reasonable effort to verify relevant facts;
   (d) Make decisions about each asset in the context of the exempt organization's entire portfolio, as part of an overall investment strategy;
   (e) Diversify investments unless due to special circumstances, the purposes of the fund are better served by not diversifying;
   (f) Dispose of unsuitable assets; and
   (g) Develop an appropriate investment strategy for the fund and the exempt organization ("EO").[3]

6. The Comment on Section 3 of the Model Act makes it clear that subsection (e)(5) "imposes a duty on an institution to review the suitability of retaining property contributed to the institution within a reasonable period of time after the institution receives the property. Subsection (e)(5) requires the institution to make a decision but does not require a particular outcome."

7. In making a decision about retaining versus selling an asset that has been donated, the institution must consider many of the factors listed above. For example, what is the cost of retaining and managing the asset? What is the donor's intent expressed through a gift agreement? How will the asset fit into the institution's portfolio and investment strategy?

C. Restricted Gifts

1. Restricted gift agreements can have unintended consequences. Care should be taken that a gift should achieve more than it costs the charity. Any project required by a gift agreement should be budgeted for with utmost care and detail and a comfortable margin for overruns.

2. Under UPMIFA, a "gift instrument" is "a record or records, including an institutional solicitation, under which property is granted to, transferred to, or held by an institution as an institutional fund."[4]
   (a) This definition makes it clear that the only terms that can bind a charity are those in writing.
   (b) A "record" does not have to be a donative instrument, however. It could include the organization's bylaws, or minutes of the board of directors, or a cancelled check.[5]

(c) A gift instrument may also include solicitation materials. If a contribution is made in response to a solicitation for a specific program, fund, or purpose, the solicitation materials may become part of the gift instrument in that case.[6]

3. Cy Pres Actions

(a) Cy pres actions were the traditional, judicial cure for charitable gifts that had become impossible or impracticable to execute.

(b) To reform the gift, the court would have to determine that the donor had "general charitable intent." In other words, if the donor had known that his or her specific program had failed, the donor still would have wished to benefit charity. An alternative gift – a "gift over" – is normally considered evidence that the donor did not have general charitable intent.

(c) The gift must be reformed as close as possible to the donor's original plan – hence "cy pres."

4. UTC

(a) The Uniform Trust Code includes a codification of cy pres.

(b) Unlike the common law, the UTC's provision does not require a finding of general charitable intent. Rather, the court may modify a charitable trust if "a particular charitable purpose becomes unlawful, impracticable, impossible to achieve, or wasteful."[7]

(c) Also, the presence a gift over in the instrument is normally not enough to thwart the application of cy pres. Rather, a gift over will take effect only if (i) it is a reversion to the donor, who is still living, and (ii) the charitable trust has been in existence for less than 21 years.[8]

(d) UPMIFA's provisions allowing for modification of restricted gifts, discussed below, does not apply to charitable trusts that are managed by corporate or individual trustees. The UTC's cy pres provision may help fill that gap.

5. UMIFA

(a) Among other provisions, UMIFA includes authority for releasing an unworkable restriction imposed by a gift agreement. A living donor may consent to such a release. If the donor is dead or disabled, paragraph (b) of Section 7 provides a remedy:

"[T]he governing board may apply in the name of the institution to the [appropriate] court for release of a restriction imposed by the applicable gift instrument on the use or investment of an institutional fund. The [Attorney General] shall be notified of the application and shall be given an opportunity to be heard. If the court finds that the restriction is obsolete, inappropriate, or impracticable, it may by order release the restriction in whole or in

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part. A release under this subsection may not change an endowment fund to a fund that is not an endowment fund."[9]

(b) The Commentary to Section 7 points out that the UMIFA remedy may only lift a restriction. It provides the example of a scholarship fund for students named "Brown" in Brown County, Iowa. A living donor may consent to modifying the scholarships so that other students in Brown County are eligible. The donor could also waive the geographical restriction or simply release the funds to the organization's general educational purposes.

6. UPMIFA

(a) UPMIFA broadens the provisions for fixing gift agreements. Where UPMIFA is passed, it is now possible to modify a gift restriction rather than the all-or-nothing release provided by UMIFA. [10]

(b) Note that UPMIFA also provides for modifying restrictions placed on the investment or management of a fund. If the restriction is impracticable or wasteful, if it impairs the management of the fund, or if, because of unanticipated circumstances, a modification will further the purposes of the fund, then the court may modify the investment restriction after the Attorney General has been noticed.[11]

(c) Finally, UPMIFA also allows charities to modify a restriction on a small, old fund without going to court. The fund must be less than $25,000 in value under the Model Act, must be older than 20 years. The Attorney General also must receive notice of the proposed change.[12]

D. Real Property:

1. Charities' attitudes about real estate have fluctuated with the market. At one point, many charities refused gifts of real estate. When values shot up, charities increasingly accepted these gifts. That may have changed again during the recession.

2. Carrying costs can be high. This is particularly true in the case of encumbered real estate. Donated land may have hidden environmental issues or expose the charity to liability in other ways.

3. Like many gifts of illiquid assets, the recipient charity may wish to have a sale plan before accepting a gift. Some charities have planned giving departments to manage such a gift. Other charities use consultants to deal with gifts of real estate.

4. Obviously, an exit strategy is not always called for. The real estate may be used in the charity's operations and charitable mission.

5. A qualified appraisal, discussed below, will be necessary to substantiate the deduction.

6. A gift to a private foundation results in a basis deduction only.

7. Note how the real property is held. Often real property is held in a limited partnership or limited liability company for risk management. If the property is so held, the deduction flows through to the partners or members. Each of them will apply the AGI percentage limitations on his or her own return. A contribution by a partnership or LLC may affect the partners differently.

8. A donor may choose to give a remainder interest in a personal residence or farm to the charity. In that case, the donor's contribution deduction is equal to the present value of the remainder interest. This is a simple, low-cost method that affords current use and a current deduction to the donor.

E. Business Interests

1. UBTI: Gifts of unincorporated business interests generate "unrelated business taxable income" for EOs. UBTI is taxed at corporate rates.[13]
   (a) Before accepting the gift, make sure the EO will have cash flow sufficient for any tax payments.
   (b) Make sure the gift is advantageous: will cash flow exceed the tax liability if the interest cannot be sold immediately?

2. Many EOs search for an exit strategy before may accept gifts of business interests in the period before an anticipated or hoped-for sale.
   (a) An issue that affects donors is whether the sale is binding at the time of the gift. If the business owner or owners are legally obligated to consummate the sale, the IRS will treat the donor as having sold the interest and made a gift of cash. This means that the donor is liable for the taxable gain and has no cash from the proceeds. Although the donor does have an offsetting deduction, the benefit of giving away appreciated long-term capital gain property is lost under the "assignment of income" doctrine.
   (b) Who is the buyer? If the EO is a private foundation, selling back to family members, related trusts, or related partnerships may be prohibited.[14] There is an exception from the prohibition against self-dealing for certain corporate redemptions.
   (c) If the buyer will be a family member, the EO should be sure to comply with the safe-harbor rules for excess benefit transactions. If the board complies with the procedures, a rebuttable presumption will be raised that the sale does not constitute an excess benefit transaction.

3. S corporation stock:
   (a) Charities are now eligible to be S corporation shareholders.
   (b) Charitable remainder trusts are not eligible S corporation shareholders.
   (c) A charitable lead trust could potentially be an S corporation shareholder if it is structured as a grantor trust.
   (d) An S corporation is likely to pass UBIT through to the shareholder.

F. Tangible Personal Property:

1. A qualified appraisal will be necessary if the value of the TPP is greater than $5,000.

2. A gift to a private foundation results in a basis deduction only.

3. A gift to a public charity results in a fair market deduction if the property will be used by the charity in a fashion related to its charitable purpose. For example, if a museum intends to use a gift of art for exhibit, education, or curation purposes, the full value of the art will be deductible (up to 30% of the donor's AGI).

4. Gifts of used cars, boats, planes.
   (a) Charity must provide acknowledgement within 30 days of the gift that states whether the vehicle will be used for related purposes or sold.
   (b) The deduction for a related-use vehicle is FMV. The donee must report a sale within 3 years, if the proceeds are greater than $500.
   (c) The deduction for a vehicle that will be sold is limited to the gross sales price.

5. Artwork
   (a) The usefulness of making gifts of partial, fractional interests in art has been curtailed.
   (b) The deduction for a gift of a fractional interest in artwork is recaptured if the donor doesn't convey his or her entire interest within a ten year period.[15]
   (c) The donor doesn't get the advantage of future appreciation in the work. When the donor makes subsequent gifts of partial interests in the work, the donor's deduction is limited to the lesser of the fair market value (i) based on the original gift or (ii) at the time of the subsequent gift.[16]

G. Marketable Securities

1. If a donor plans to make a gift of appreciated securities to a private foundation, make sure that the stock is not restricted. For example, post-

IPO stock that appears to be marketable may be subject to SEC restrictions or a contractual lock-up period.

2. Such stock may yet be qualified appreciated stock if it can be sold under SEC dribble-out rules or the underwriter consents.

3. A gift of stock to a private foundation is "qualified appreciated stock" if it does not exceed 10 percent of the outstanding shares.

II. Handling Unanticipated Funds with "Facts and Circumstances" Test

A. Many public charities qualify for public charity status under section 170(b)(1)(a)(vi) of the Internal Revenue Code (the "Code"). These organizations are supported by fundraising from a broad segment of the general public and from grants from governmental units. The organization must "normally" receive more than one-third of its support from these sources, exclusive of income received in the exercise or performance by the organization of its exempt purpose.

B. A publicly supported charity that does not meet the "mechanical" one-third test can also qualify under the "facts and circumstances" test. Such an organization must:

1. Receive 10% of its support from governmental units or contributions from the general public,[17] and

2. "An organization must be so organized and operated as to attract new and additional public or governmental support on a continuous basis. An organization will be considered to meet this requirement if it maintains a continuous and bona fide program for solicitation of funds from the general public, community, or membership group involved, or if it carries on activities designed to attract support from governmental units or other organizations described in section 170(b)(1)(a)(i) through (vi)."[18]
   (a) The IRS will particularly look at whether the scope of fundraising activities is reasonable in light of its charitable activities.
   (b) The IRS will take into consideration a fledgling organization's targeting its fundraising to the donors most likely to provide seed money, in its early years.[19]

C. The IRS will look at all pertinent facts and circumstances to see whether the organization is organized and operated to attract support. To meet the criteria laid out in the regulations and make a strong argument to be a public charity, the organization's board should attend to the following factors:

1. Percentage of support. The higher the percentage of public support is over 10%, the less the organization will have to do in other areas to show that it is publicly supported. In other words, an organization that received 25%

of its support from the public or from government will likely need to prove fewer other positive facts than an organization that received only 11% of its support from the public.

2. Board composition. If the board is broadly representative of the area in which the public charity works, the interests of the community, and related organizations, government or businesses, the organization is more likely to be considered a pubic charity. If the board appears to represent the personal or private interests of a family or a small number of donors, then this factor will not be met.

3. Sources of support. The regulations include an inquiry into how the organization meets the 10% requirement. If this is met because of donations by a "representative number of persons," or by a government grant, this factor will be satisfied. "In determining what is a 'representative number of persons,' consideration will be given to the type of organization involved, the length of time it has been in existence, and whether it limits its activities to a particular community or region or to a special field which can be expected to appeal to a limited number of persons."[20]

4. Public facilities and services. An organization that provides services or facilities directly to the general public will have additional evidence that it is publicly supported. The regulations provide the example of a museum that holds its buildings open to the public, an orchestra that gives public performances, and a conservation organization that provides educational materials to the public.[21]
   (a) An organization that is educational or a research facility and that provides research papers that are used in teaching or by the public will satisfy this factor.[22]
   (b) This factor could also be met by having participation in the organization's activity from members of the public with acknowledged expertise or who are community leaders.
   (c) The organization may also maintain a program directly in the community, such as community development, to meet this factor.
   (d) Finally, the regulations also provide that this factor could be met by the organization's receiving funds from another public charity or governmental agency that is itself publicly accountable.[23]

5. Membership organizations.

III. Charitable Contribution Deduction Limitations – Identity of the Donee

A. Public Charities

1. Intrinsically public institutions: churches, schools, hospitals.[24]

2. Publicly-supported organizations: generally, organizations that receive
   (a) more than 1/3 of their support from the general public[25] or
   (b) more than 1/3 of their income from receipts due to carrying out their charitable mission.[26]

B. Private Foundations

1. Not publicly supported; normally funded by single donor or family.[27]

2. Affords control over charitable mission to donor and family.

3. Subject to a 2% excise tax on net investment income, which includes capital gains.[28] This 2% is reduced to 1% if the private foundation meets certain distribution thresholds over the preceding five years.[29]

4. A private foundation must distribute (or expend for charitable purposes) 5% of its net asset value in each year.[30]

5. Transactions between foundations and insiders are virtually prohibited under the self-dealing rules.[31]
   (a) Donors, directors and officers are "disqualified persons."[32]
   (b) Almost no transactions permitted between the private foundation and disqualified persons. E.g.,
      (i) No sales or leases of property between a PF and DQ.[33]
      (ii) No interest-bearing loans from a DQ to a PF; no loans at all to a DQ;[34]
      (iii) No furnishing of goods, services or facilities between by a DQ to the PF unless free of charge and are used for charitable purposes.[35]
      (iv) No furnishing of goods, services or facilities by a PF to the DQ unless those goods or services are also available to the public and the terms are no more favorable than those available to the public.[36]

6. Excess business holdings prohibited: to simplify, a private foundation cannot hold 20% of the stock of an operating business or 35% if the business is controlled by a third party.
   (a) Permitted holdings are <u>decreased</u> by the holdings of disqualified persons.[37]
   (b) Five-year disposal period permitted for gifts of business interests to the foundation; the Secretary may provide an additional five-year period for large gifts or bequests that are difficult to dispose of.[38]

7. No "jeopardizing investments" other than those related to operation of charitable programs.[39]

8. No taxable expenditures:[40]
   (a) No grants or payments for lobbying;
   (b) No electioneering or voter registration activities;
   (c) No grants to individuals for travel or study without prior approval of scholarship program; and
   (d) No distributions to other private foundations without supervising the use of the funds by grantees.

C. Donor Advised Funds

1. A donor advised fund is effectively a hybrid. The donor establishes a separate fund operated under the rubric of a public charity.[41]

2. The Pension Protection Act of 2006 defined the term "donor advised fund."[42] It is any fund or account:
   (a) That is separately identified by reference to the contributions of a donor or donor;
   (b) That is owned and controlled by a sponsoring organization; and
   (c) With respect to which a donor (or any "donor advisor" appointed by the donor) has advisory privileges over the distribution or investment of the fund, because of his or her status as a donor.

3. Operation – Generally
   (a) Donor can make recommendations re: size of grants, choice of grantees, and terms of grants.
      (i) Parent organization normally makes payment as directed as long as the recommendations do not violate the parent organization's policies.
      (ii) It is crucial to investigate any restrictions on grantmaking when choosing a fund.
   (b) Donor advised funds are available through section 501(c)(3) public charities: e.g. Community Foundation of Northern Virginia; Jewish United Fund of Chicago.
   (c) They are also available through major financial institutions that have established charitable corporations for this purpose. For example, the Fidelity Charitable Gift Fund is the nation's largest DAF program.
   (d) Most donor advised fund programs provide a structure for involving family and having continuity of management.

4. Funding the donor advised fund is treated as a transfer to a ***public charity*** for purposes of deductibility, discussed below.
   (a) A gift of cash may be deducted up to 50% of the donor's AGI.
   (b) A gift of long-term appreciated property may be deducted at fair market value up to 30% of AGI, or, the donor may make the election to deduct his or her basis in the property up to 50% of AGI.

(c) The donor advised fund, depending on the sponsoring organization's policy, may not be required to make a minimum annual grant.

(d) The donor advised fund is not subject to the 2% tax that applies to private foundations.

D. Supporting organizations:

1. Tax-exempt organizations that support one or more public charities and therefore are treated as ***public charities***, despite not being publicly supported themselves.[43]

2. Three types of supporting organizations:[44]

(a) Type I: an organization that is "operated, supervised or controlled by" a public charity.

(b) Type II: an organization that is "supervised or controlled in connection with" a public charity.

(c) Type III: an organization that is "operated in connection with" a public charity.

3. Like donor advised funds, discussed below, these organizations were subjected to greater regulation by the Pension Protection Act of 2006.[45]

E. Private operating foundations:

1. A private operating foundation actively carries out a charitable mission; these are generally non-grantmaking institutions.[46]

2. These organizations are regulated as foundations but treated as ***public charities*** for purposes of the percentage limitation and the reduction rules.

IV. Lifetime Giving: Deduction Limitations and Valuation Rules

A. Basics:

1. ***Two Rules*** operate to reduce the value of a donor's lifetime charitable contribution. The application of these rules depends on the nature of the gift and the identity of the donee.

(a) ***Limitation rules***: Lifetime gifts to charities are deductible up to a certain percentage of the donor's adjusted gross income ("AGI").[47]

(b) ***Reduction rules:*** To simplify, the value of certain charitable contributions may be reduced to basis.[48]

2. A five-year carryforward is generally available for any excess deduction.

3. Note that itemized deductions are now subject to the "Pease" limitations, discussed below at Part VIII on new developments.

4. The deduction limitations ***do not apply*** to charitable gifts made at death. These are fully deductible from the estate tax (as long as all other requirements are met).[49]

5. See summary chart attached to this outline.

B. Gifts to Public Charities

1. Cash: Gifts of cash to public charities are deductible up to 50% of the donor's AGI.[50]

2. Long-term capital gain property:
   (a) Full fair market value of appreciated property is deductible.
   (b) Deduction is limited, though, to 30% of donor's AGI.[51]
   (c) Donor may make an alternative election: to deduct his or her basis in the property only, but up to the 50% AGI limitation. This would make sense if the donor has given away high-basis assets and wants a larger immediate deduction. Note that no carryforward is available for unused deduction if this election is made.

3. Short-term capital gain property: Deductible only to the extent of the donor's basis, up to 50% of the donor's AGI.[52]

4. Tangible personal property: This property receives the same treatment as long-term capital gain property ***if*** owned for longer than a year and ***if*** the donee charity uses the property in a way that is related to the charity's exempt purpose. The deduction is limited to 30% of the donor's AGI.[53]

C. Gifts to Private Foundations

1. Cash: Gifts of cash to private foundation are deductible only up to 30% of the donor's AGI.[54]

2. Long-term capital gain property:
   (a) The charitable donation is limited to 20% of the donor's AGI.[55]
   (b) Note: The charitable deduction is reduced by the amount that would have been long-term capital gain if the property were sold on the date of the donation.[56]
   (c) This reduction rule does not apply if the property is "qualified appreciated stock;" *i.e.*, marketable securities comprising 10% or less of the outstanding stock of the corporation.[57]

3. Short-term capital gain property: Same rule as for public charity gifts. A lifetime charitable donation is reduced by the amount that would have been short-term capital gain; in other words, this property is deductible only to the extent of the donor's basis. The deduction is further limited to 30% of the donor's AGI.[58]

4. Tangible personal property: This property is also subject to a reduction rule. Related use does not matter in this case. The value is deductible only to the extent of the ***lesser*** of fair market value or basis, up to 20% of AGI.[59]

D. "For the Use of" Limitation

1. Cash gift to a public charity that is "for the use of" the charity rather than given "to" the charity is deductible only to the extent of 30% of AGI.[60]

2. "For the use of" includes a gift of an income interest in property, whether or not held in trust.[61]

3. A gift of a remainder interest in a qualified charitable remainder trust is not considered "for the use of" the charitable remainder beneficiaries. However, if the charitable gift passed into a further trust for charity when the income term is over, the gift is considered "for the use of" the charity and the gift is limited.[62]

4. If the donee is required to hold the gift for the benefit of another organization, the gift may be considered "for the use of" charity.[63]

E. Partial Interests: In general, a donor may not deduct a gift of a partial interest in property.[64] A common example is that no deduction is available for a gift of the rent-free use of property.

1. Note that an undivided interest in property is not considered a partial interest. For example, if a donor owns a parcel of real estate, a gift of an undivided 25% interest in the parcel will qualify for a deduction.[65]

2. Further, a gift of a donor's entire interest in property will be deductible, even if it is a partial interest in the whole property. If the donor owns a life estate in certain property and no other interest, the donor's gift of the life estate to charity will be deductible.

3. The major exceptions to the rule that partial interests are not deductible are:
   (a) Charitable lead annuity and unitrusts;[66]
   (b) Charitable remainder annuity and unitrusts;[67]
   (c) Remainder interest in a personal residence or farm;[68] and
   (d) Conservation easements.[69]

F. Charitable Lead Trusts

1. A charitable lead trust ("CLT") is a trust in which a guaranteed annuity or unitrust is paid to charity in each year of a term, and the remainder interest passes to one or more individuals after the term is concluded.[70]

2. Annuity Payment
   (a) If the charitable lead trust is an annuity trust, the annuity must be a fixed or determinable amount.[71] According to sample forms promulgated by the IRS, an annuity may change by a specified amount. Many practitioners limit this change to 20% of the previous year's payment.
   (b) Unless the gift to the CLT is of cash, it is advisable to structure the annuity payment as a fraction. If the valuation of the property contributed is wrong, the annuity payment is corrected and no additional gift results.

3. Term. The term of a CLT can be one or more lives or a term of years.
   (a) There is no limitation on the term of years other than the rule against perpetuities. A term that would otherwise violate the rule against perpetuities is acceptable if the measuring lives for perpetuities period is drafted to lengthen the term, not shorten it. This regulation can save a trust that otherwise would fail under the rule: e.g., a testamentary CLT for a term of 30 years.[72]
   (b) If the CLT is for a term of a life or lives, the measuring lives must be the decedent or grantor's spouse, or a lineal ancestor of the remainder beneficiaries or a spouse of a lineal ancestor.[73]

4. Income (Charitable) Beneficiaries:
   (a) The Trustee may have the discretion to choose the charitable beneficiaries in each year. This power cannot be given to the grantors/donors, or estate tax inclusion will occur.[74]
   (b) The CLT can be used in conjunction with a private foundation or DAF.
      (i) This can provide a powerful tool to build up the endowment of the foundation or DAF. A distribution from the CLT to the foundation is not income for purposes of the private foundation rules.
      (ii) Again, the governing instrument of the foundation or DAF must be drafted so that the donors do not control the selection of charitable beneficiaries. To retain this power indirectly could result in estate tax inclusion.

5. Tax Deductions:
   (a) Gift tax deduction: If the CLT is funded during lifetime, the donor will receive a gift tax deduction equal to the present value of the charity's income interest.[75]
   (b) Estate tax treatment:
      (i) If the CLT is a testamentary CLT, then the donor's estate will receive an estate tax deduction equal to the present value of the charity's interest.[76]

(ii) Any inter vivos CLT should not be included in the grantor's estate at his or her death.

(c) Income tax treatment:

(i) If an inter vivos CLT is structured as a grantor trust, the grantor will receive an income tax deduction when the trust is funded, for the value of the annuity interest.[77] However, in future years all of the trust's income will be reported on the donor's return. The annuity or unitrust payment made to charity will not generate a deduction. A gift of an income interest is a "for the use of" gift; accordingly, the donor will be limited to deducting the gift up to 30% of his or her AGI.[78]

(ii) If the inter vivos trust is structured as a nongrantor trust, no income tax charitable deduction is available to the grantor. The CLT will, however, have an income tax deduction under section 642(c) for each year's charitable annuity or unitrust payment. The availability of the unlimited income tax deduction for the trust itself means that the trust property will grow unburdened or less burdened by income tax, ultimately for the benefit of the remainder beneficiaries. Treasury regulations may make it difficult to deduct the entire annuity amount. The trustee is required to treat the annuity as coming proportionately from all types of income earned by the trust.

(iii) Note: to the extent an annuity or unitrust payment constitutes UBIT, the CLT will not receive a charitable income tax deduction.[79]

(iv) If appreciated property is distributed in satisfaction of the annuity, then it will be treated as sold.

(d) Value of the annuity:

(i) To calculate the present value, the section 7520 rate is used. The donor may instead use the section 7520 rate from either of the two months preceding the date of the gift.[80]

(ii) It is often advisable to wait until the 20th of the month to find whether next month's rates will go up or down.

(iii) Lower interest rates make a CLT more advantageous. The value of the annuity is greater compared to the remainder, because the time value of money is worth less.

(e) Investments: The prohibitions against excess business holdings and jeopardy investments do not apply to CLTs if all of the income interests, and none of the remainder interests are devoted to charitable purposes <u>and</u> the charitable deduction was less than 60% of the amounts held in trust.[81] In other words, this exception would not apply to a zeroed-out CLAT; a CLAT with such a large charitable income interest would be subject to limits on business holdings.

(f) Depreciable Property: If the property is subject to depreciation recapture, that recapture amount will further reduce the charitable deduction.[82]

G. Charitable Remainder Trusts

1. Charitable remainder trusts reverse the structure of a CLT. The trust is established for the benefit of noncharitable beneficiaries for a life or lives or for a term of years. The remainder passes to one or more charities chosen by the donor or the trustee.

2. Unlike a CLT, a CRT is a tax-exempt entity.[83]

3. Term. The term of a CRT can be one or more lives or a term of years.
   (a) A term of years may not exceed 20 years.[84]
   (b) A CRT for life must be established for the benefit of the person or persons who are the measuring life or lives. A CRT cannot have a term of A's life if B is the income beneficiary.[85]

4. Annuity or Unitrust Payment
   (a) In every year, the trust must pay a unitrust amount – a percentage of the value of the trust assets in each year – or a fixed amount.[86]
   (b) Either a unitrust or an annuity payment may be expressed by a formula.
   (c) There are statutory limits on the annuity or unitrust payment.
      (i) The annuity payment must be at least 5% of the initial fair market value of the trust and cannot exceed 50% of the initial fair market value.[87]
      (ii) Similarly, a unitrust payment must be at least 5% and no more than 50% of the value of the trust, measured annually.[88]
   (d) Because a CRT is a tax-exempt entity, it is imperative to avoid grantor trust status. Therefore, if a donor is a trustee, he or she must not be given the power to sprinkle the annuity or unitrust payment among income beneficiaries.[89]

5. Remainder and Remainder (Charitable) Beneficiaries:
   (a) The remainder must have a present value of at least 10% of the property contributed to the trust.[90]
   (b) The grantor may fix the charitable remainder beneficiaries, or may give the discretion to choose charities to the trustee.
   (c) Like the CLT, the CRT can be coordinated with a private foundation or DAF. This affects the deduction limitations and reduction rules for the donor. If the remainder beneficiary is a private foundation, the funding of the CRT will be treated as a donation to a private foundation.

6. Tax Treatment of the CRT, Donor and Beneficiaries:
   (a) Gift tax deduction: If the CRT is funded during lifetime, the donor will receive a gift tax deduction equal to the present value of the charity's remainder interest.[91]
   (b) Estate tax treatment:
      (i) If the CRT is a testamentary CRT, then the donor's estate will receive an estate tax deduction equal to the present value of the charity's interest.[92]
      (ii) If the grantor/donor retained an income interest in an inter vivos CRT, it will be included in his or her estate. However, he or she will receive an offsetting deduction for the value of any property that passes to charity at the grantor's death or at the death of any other income beneficiary.
   (c) Income tax treatment:
      (i) As stated above, a CRT is tax exempt.
      (ii) If the remainder beneficiaries are limited to one or more public charities, a gift to the CRT will be treated as a transfer to a public charity, for purposes of the percentage limitations and reduction rules.
      (iii) Conversely, if the remainder beneficiaries may include a private foundation, then the funding of the CRT is treated as a gift to a private foundation.
      (iv) If a CRT receives UBIT, the UBIT is subject to a 100% tax.
      (v) Distributions to the beneficiaries are deemed to be made first from ordinary income, then capital gain, third from "other" or tax-exempt income, and fourth as a return of principal. Each tier's current and previously undistributed income must be exhausted before moving on to the next tier.
   (d) Value of the annuity:
      (i) To calculate the present value, the section 7520 rate is used. The donor may instead use the section 7520 rate from either of the two months preceding the date of the gift.[93]
      (ii) It is often advisable to wait until the 20th of the month to find whether next month's rates will go up or down.
      (iii) A CRT is more advantageous when interest rates are increasing. The value of the remainder is greater compared to the annuity or unitrust interest when the discount rate is higher.

7. Investment Issues
   (a) The trust agreement of a CRT must not restrict the trustee "from investing the trust assets in a manner which could result in the

annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets."[94]

(b) A CRT is not an eligible S corporation shareholder.

(c) Two private foundation rules do not apply to most CRTs: the prohibitions against excess business holdings and jeopardy investments. Section 4947(b) makes those provisions inapplicable if a charitable deduction was permitted for all remainder beneficiaries and not for any income beneficiary. Congress deems that the charitable interest is too remote during the income term to warrant restricting investments.

(d) A transfer of appreciated property will not result in gain recognition to the grantor; however, this rule does not apply if the property transferred has indebtedness in excess of its basis.[95]

V. Ordering the Deduction Limits

A. If a donor makes various donations in a single year, the limitations must be applied as follows:

1. First, 50% gifts to public charities;

2. Second, 30% gifts to private foundations;

3. Third, 30% gifts to public charities; and

4. Fourth, 20% gifts to private foundations.

B. The limitations do not stack on top of each other. Total deductions that are permitted in any year will never exceed 50% of AGI, and further, total deductions of long-term capital gain property will not exceed 30% of AGI.

1. First, a donor's cash gifts to public charities are deducted as fully as possible to the extent of 50% of his or her AGI.[96]

2. Then, the donor's cash gifts to private foundations are deducted, but only to the extent of the lesser of 30% of AGI or the donor's "unused" 50% deductibility: the difference between 50% of AGI and all of the donor's contributions to 50% organizations, including appreciated property (that hasn't come up in the hierarchy yet).[97]

3. Then, the donor's gifts to public charities of long-term capital gain property are deducted to the extent of 30% of AGI.[98]

4. Then, the donor's gifts of long-term capital gain property to private foundations are deductible to the extent of the lesser of 20% of AGI or the "unused" 30% deductibility (with respect to capital gain property). In other words, the donor may deduct this amount up to the lesser of 20% of

AGI or 30% of AGI, reduced by the amount of long-term capital gain property given to public charities under the 30% limitation.[99] Take note whether the gifts to the private foundation are subject to the reduction rule: are they qualified appreciated stock?

C. Assume a donor's AGI is $250,000 and he or she makes several gifts:

1. The donor gives:
   (a) $20,000 cash to public charities
   (b) $80,000 in long-term capital gain property to public charities
   (c) $40,000 in cash to private foundations
   (d) $10,000 in qualified appreciated stock (long-term capital gain property) to private foundations.

2. The limitations are thus calculated as follows:
   (a) First, the $20,000 in cash to public charities is fully deductible as it is less than 50% of AGI, or $125,000.
   (b) The $40,000 in cash to private foundations comes next. It is deductible up to the lesser of 30% of AGI, or $75,000 <u>or</u> 50% of AGI ($125,000) reduced by all transfers to public charities ($100,000). That means the $40,000 in cash gifts to private foundation is deductible only to the extent of $25,000 ($125,000 less $100,000). A $15,000 gift will carry forward.
   (c) Then, the $80,000 in long-term capital gain property to public charities is deducted to the extent of 30% of capital gain, or $75,000. A $5,000 amount will carry forward.
   (d) The $10,000 in long-term capital gain property given to private foundations will not be deductible; this will carry forward. This gift is not currently deductible because the 30% limit with respect to long term capital gain property is already exceeded for the year.

3. The donor may deduct:
   (a) $20,000 in cash to public charities, $25,000 in cash to private foundations, and $75,000 in long-term capital gain property given to public charities. The total is $120,000, which is less than 50% of AGI and therefore works.
   (b) The donor will carry forward $15,000 in cash given to private foundations, $5,000 in long-term capital gain property given to public charities, and $10,000 in long-term capital gain property given to private foundations.

VI. Gifts at Death Contrasted

A. The percentage limitations do not apply.

B. The reduction rules do not apply.

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C. There is no bar on gifts to foreign charities, which does apply during lifetime.

D. The substantiation rules do not apply to the charitable income tax deduction for trusts and estates (although good recordkeeping is always a good idea).

E. Gifts at death, however, miss the opportunity to avoid current income taxation on the income generated by the asset. If the asset is donated during lifetime, the donor receives a current deduction and avoids tax on any income from the asset.

F. IRD Assets: Income in Respect of a Decedent

1. There is a special advantage to charitable gifts that would be subject both to the estate tax and to the income tax at the donor's death or shortly thereafter.

2. The charitable estate tax deduction has greater leverage here because income taxation is also avoided. The net loss to family members may not be great.

3. Typical IRD assets are IRAs, 401(k) plans, receivables, and annuities.

VII. Substantiation Rules

A. Under $250

1. Cash: Get and keep a receipt.

2. Check: Retain the cancelled check.[100]

3. Non-cash gifts: charity must provide a receipt showing the date, location, and property. The donor's own tax records must contain evidence of value and basis.

B. Gifts of $250 or More

1. A "Contemporaneous written acknowledgment" is required.[101]

2. It must be received before the due date of the donor's return, including extensions.[102]

3. It must state the property or cash contributed.

4. It must also state whether the donor received any goods or services as a quid pro quo and if so, the value of those goods or services.[103]

C. Gifts of Property of $500 or More[104]

1. The donor must have the contemporaneous written acknowledgment.

2. The donor must also file Form 8283 ("Noncash Charitable Contributions").[105]

3. The donor must also have records reflecting how the donor originally acquired the donated property and its basis.[106]

D. Gifts of Property of $5,000 or More

1. Requires a qualified appraisal. [107]

2. An appraisal summary must be attached to the donor's tax return.

3. If the property is marketable securities, no appraisal is necessary.

4. If the property is nonpublicly traded stock, only a summary appraisal is necessary.

E. Gifts of Property of $500,000 or More

1. The entire qualified appraisal must be attached to the return.[108]

2. This rule does not apply to gifts of cash, inventory, publicly traded stock or intellectual property.

F. Gifts to a Donor Advised Fund: The sponsoring organization must confirm in writing that it has ownership and legal authority over the funds contributed to the donor advised fund.[109]

G. Gifts of Art

1. If the art is worth $20,000 or more, the full appraisal must be attached to the donor's return.[110] If any one piece of art is reported at more than $20,000, the donor must submit an 8x10 photo.[111]

2. If the art is worth more than $50,000, the donor may request a Statement of Value from the Art Advisory Panel. A fee of $2,500 is required for up to three items, then an additional $250 fee is due for each additional item.[112]

VIII. What's New and IRS Focus

A. American Taxpayer Relief Act of 2012 reinstated the Pease limitation on itemized deductions, first enacted in 1990.

1. The Pease limitation applies to single taxpayers with AGI over $250,000 and joint filers with over $300,000 in AGI.

2. Itemized deductions for such taxpayers will be reduced by the lesser of (i) 80% of total itemized deductions or (ii) 3% of the excess of the taxpayer's AGI over those limitation amounts. A recent report by the Independent Sector provides the following example:

   (a) In 2013, a joint-filing couple has an AGI of $400,000 and $100,000 in itemized deductions ($30,000, or 30 percent, of which are charitable donations)

   (b) The income above the $300,000 threshold for joint filers must be calculated: $400,000 - $300,000 = $100,000 in excess income

   (c) The $100,000 excess income is multiplied by 3 percent to determine the deduction limitation: $100,000 x .03 = $3,000 limitation on itemized deductions

   (d) The limitation is then subtracted from the otherwise allowable itemized deductions: $100,000 - $3,000 = $97,000 in allowable deductions

   (e) For these taxpayers, the Pease provision has reduced itemized deductions from $100,000 to $97,000.

   (f) The impact on the charitable deduction can be found by multiplying the amount of the limitation ($3,000) by the percentage that charitable donations comprise of total of deductions (30 percent):$3,000 x .30 = $900

   (g) The Pease limitation has reduced the charitable deduction by $900 from $30,000 to $29,100.

B. Under "ATRA," rollovers or distributions from IRAs directly to charities (by participants who are older than age 70½) were extended, retroactive to 2012 and through 2013. A person who took a mandatory distribution in December, 2012 may contribute those funds to charity in 2013 and treat the mandatory distribution as a charitable rollover.

C. The IRS is continuing to study the sources and uses of funds in the charitable sector and how those two issues related to the accomplishment of charitable purposes. The first phase of examination includes organizations with high levels of fundraising expenses, organizations reporting unrelated trade or business activity with relatively low program service expenditures, organizations with high rations of officer compensation relative to program service expenditures, and organizations with low levels of program service expenditures in comparison to total revenue.[113]

D. The Treasury Department Green Book for the 2014 budget recommends elimination of the two-tier excise tax on the net investment income of private foundations. The administration proposes a flat 1.35% tax rate. The proposal addresses the concern that the current system discourages a private foundation from significantly increasing its distributions in any given year. For example, a private foundation that would otherwise make larger-than-usual grants for disaster relief might instead keep its giving at a steady level. To increase giving would

increase the five-year average that the foundation would have to meet in future years, in order to qualify for the lower 1% excise tax rate.

E. Historically low interest rates have continued to focus interest on charitable lead trusts. The section 7520 rate for April, 2012 is 1.4%. As context, the lowest ever section 7520 rate was 1.0%, which applied in three months in 2012 and in January, 2013. This contrasts to pre-2008 rates of 5% and higher. The current low rates increase interest in using CLTs as a freeze vehicle: to succeed, a zeroed-out CLT created at this writing would have to beat a hurdle rate of only 1.4%.

F. The IRS recently released Nine Tips for Deducting Charitable Contributions, published as a "Tax Tip" on its website.

IRS rules require us to advise you that any opinion in this outline regarding a federal tax issue was not written to be used, and cannot be used, for the purpose of avoiding tax penalties. Thank you.

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[1] *Uniform Management of Institutional Funds Act,* Section 6 of the Model Act.
[2] *Uniform Prudent Management of Institutional Funds Act,* Section 3(b) of the Model Act.
[3] *Id.,* Prefatory Note and Section 3.
[4] *Id.,* Section 2(3).
[5] *Id.,* Comment on Section 2.
[6] *Id.*
[7] *Uniform Trust Code*, Section 413(a) of the Model Act.
[8] *Id.*, Section 413(b).
[9] *Uniform Management of Institutional Funds Act*, Section 7(b) of the Model Act.
[10] *Uniform Prudent Management of Institutional Funds Act*, Section 6(c) of the Model Act.
[11] *Id.*, Section 6(b) of the Model Act.
[12] *Id.,* Section 6(d) of the Model Act.
[13] Internal Revenue Code ("IRC") § 511(a)(1).
[14] IRC § 4941.
[15] IRC § 170(o)(3)(A).
[16] IRC § 170(o)(2).
[17] Treas. Reg. 1.170A-9T(f)(3)(i), (k)(2).
[18] Treas. Reg. § 1.170A-9T(f)(3)(ii), (k)(2).
[19] *Id.*
[20] Treas. Reg. § 1.170A-9T(f)(3)(iii)(B).
[21] Treas. Reg. § 1.170A-9T(f)(3)(iii)(D)(1).
[22] Treas. Reg. § 1.170A-9T(f)(3)(iii)(D)(2).
[23] Treas. Reg. § 1.170A-9T(f)(3)(iii)(D)(3).
[24] IRC § 170(b)(1)(A)(i) through (iii).
[25] IRC § 170(b)(1)(A)(vi).
[26] IRC §§ 170(b)(a)(A)(viii) and 509(a)(2).
[27] IRC § 509(a).
[28] IRC § 4940.
[29] IRC § 4940(e).
[30] IRC § 4942.
[31] IRC § 4941.
[32] IRC § 4946(a).

[33] IRC § 4941(d)(1)(A).
[34] IRC §§ 4941(d)(1)(B), (2)(B).
[35] IRC §§ 4941(d)(1)(C), 2(C).
[36] IRC §§ 4941(d)(1)(C), 2(D).
[37] IRC § 4943(c).
[38] IRC § 4943(c)(6) and (7).
[39] IRC § 4944.
[40] IRC § 4945(d).
[41] IRC § 4966(d)(2)(A).
[42] IRC § 4966(d)(2).
[43] IRC § 509(a)(3).
[44] IRC § 509(a)(3)(B).
[45] See, *e.g.*, §§ 509(f), 4943, 4958.
[46] IRC § 170(b)(1)(A)(vii).
[47] IRC § 170(b).
[48] IRC § 170(e)(1).
[49] IRC §§ 2055, 2055(d).
[50] IRC § 170(b)(1)(B).
[51] IRC § 170(b)(1)(C)(i).
[52] IRC § 170(e)(1)(A).
[53] IRC § 170(e)(1)(B)(i)(I).
[54] IRC § 170(b)(1)(B).
[55] IRC § 170(b)(1)(D)(i).
[56] IRC § 170(e)(1)(B(ii).
[57] IRC § 170(e)(5).
[58] IRC § 170(e)(1)(A).
[59] IRC § 170(e)(1)(B)(ii).
[60] IRC § 170(b)(1)(B); Treas. Reg. § 1.170A-8(a)(2).
[61] Treas. Reg. § 1.170-8(a)(2).
[62] *Id.*
[63] Rev. Rul. 75-359.
[64] IRC §170(f)(3).
[65] IRC § 170(f)(3)(B)(ii).
[66] IRC § 170(f)(2)(B).
[67] IRC § 170(f)(2)(A).
[68] IRC § 170(f)(3)(B)(i).
[69] IRC § 170(f)(3)(B)(iii).
[70] IRC § 170(f)(2)(B); Treas. Reg. § 1.170-6(c).
[71] Treas. Reg. § 1.170A-6(c)(2)(i)(A).
[72] Treas. Reg. § 20.2055-2(e)(2)(vi)(a).
[73] *Id.*
[74] IRC § 2036(a).
[75] IRC § 2522(c)(2)(A).
[76] IRC § 2055(e)(2)(B).
[77] IRC § 170(f)(2)(B).
[78] Treas. Reg. § 1.170A-8(a)(2).
[79] IRC § 681, Treas. Reg. § 1.681(a)-2(b).
[80] IRC § 7520(a).
[81] IRC § 4947(b)(3)(A).
[82] IRC § 170(e)(1)(A).
[83] IRC § 664(c)(1).
[84] IRC §§ 664(d)(1)(a), (2)(a).
[85] Treas. Reg. §§ 1.664-2(a)(3)(i), 1.664-3(a)(3)(i).
[86] IRC § 664(d).

[87] IRC § 664(d)(1)(A).
[88] IRC § 664(d)(2)(A).
[89] IRC § 674.
[90] IRC §§ 664(d)(1)(D), (d)(2)(D).
[91] IRC § 2522(c)(2)(A).
[92] IRC §2055(e)(2)(A).
[93] IRC § 7520(a).
[94] Treas. Reg. § 1.664-1(d)(3).
[95] Treas. Reg. § 1.1011-2.
[96] IRC § 170(b)(1)(A).
[97] IRC § 170(b)(1)(B)(i) and (ii).
[98] IRC § 170(b)(1)(C).
[99] IRC § 170(b)(1)(D).
[100] IRC § 170(f)(17).
[101] IRC § 170(f)(8)(A).
[102] IRC § 170(f)(8)(C).
[103] IRC §170(f)(8)(B).
[104] IRC § 170(f)(11)(B).
[105] Instructions for Form 8283 (Rev. December 2006).
[106] Treas. Reg. § 1.170A-13(b)(3).
[107] IRC § 170(f)(11)(C).
[108] IRC § 170(f)(11)(D).
[109] IRC § 170(f)(18).
[110] Instructions for Form 8283 (Rev. December 2006).
[111] Announcement 90-25.
[112] Rev. Proc. 96-15, Section 5.
[113] *IRS 2010 Annual Report and 2011 Work Plan.*

PERCENTAGE LIMITATIONS AND REDUCTION RULES

50% | 30% | 20%

	Cash	Long-term capital gain property	Tangible personal property (if long-term)	STCG or ordinary income property
Public charity	FMV	FMV, unless election is made to deduct basis up to 50% of AGI	FMV if charity employs in related use	Basis
Private foundation	FMV	Basis unless qualified appreciated stock, then FMV	Basis	Basis

Substantiation in Steps

Less than $250	$250 or More	Property > $500	Property > $5,000	Property > $500,000
Cash – receipt Check – cancelled check Non-cash - receipt	Contemp. written acknowledgment Incl. quid pro quo statement	Contemp. written acknowledgment File Form 8283 Maintain basis records	Contemp. written acknowledgment File Form 8283 Maintain basis records Qualified appraisal (unless marketable securities) and attach summary	Contemp. written acknowledgment File Form 8283 Maintain basis records Qualified appraisal (unless marketable securities) and attach full appraisal