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BACK TO SCHOOL IN TERMS OF PLANNED GIVING

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How will you be remembered when you are gone? Most answer that they hope they lived a life with meaning – that their life made a difference. Charitable planning is one of the key ways to achieve that kind of fulfillment. By planning charitable gifts, either during your life or at your death, you can create a legacy that will last for generations after you are gone.

Charitable giving is not just an option for the wealthy. Every person, regardless of the size of their estate, can benefit a charity through charitable giving. There are many techniques available, from simple to complex, providing varying degrees of tax benefits and often benefitting the family of the donor at the same time. Our law firm specializes in performing a comprehensive analysis of each client's individual situation, developing a strategy to accomplish their charitable giving and estate planning goals, and assisting the client in implementing the strategy. There are many techniques available, and the decision of which to utilize should be made on a case-by-case basis.

I. EARLY PLANNING

Sam Walton paid no estate tax. During his life, he paid no gift tax. This was not the result of a too-good-to-be-true tax shelter or an overly creative estate plan. Rather, it was the result of early planning, using recognized techniques to shift ownership interests to his children while there was little value in those interests. In all, Sam Walton saved approximately $28 billion in gift and estate tax merely by thinking ahead.

You don't need to be Sam Walton to take advantage of the estate and gift tax strategies that he employed. Like Sam Walton, you too can "pre-fund" your children's inheritance using certain techniques, freeing you to accomplish charitable goals at death. Furthermore, pre-funding of your children's inheritance can be accomplished with little or no gift or estate tax consequence. The primary concept in pre-funding an inheritance without making large gifts is the "**estate freeze**." Using estate freezing techniques such as sales to Defective Grantor Trusts (**DGT**), Grantor Retained Annuity Trusts (**GRAT**), and even simple loans can provide your children with significant resources. These techniques share the same basic characteristics. In all of them, the individual is retaining and "freezing" the current value of his assets through an annuity or note payment, while shifting the growth and income to the next generation. Mr. Walton was obviously very successful with this because he started planning early, when the value of Wal-Mart was relatively small.

In addition to GRATs and sales to DGTs, other non-charitable techniques that reduce estate tax, resulting in more flexibility for charitable bequests, include:

- Family Limited Partnerships ("FLP")
- Gift Trusts
- Private Annuities
- Qualified Personal Residence Trusts ("QPRT")
- Irrevocable Life Insurance Trusts ("ILIT")
- Self-Cancelling Installment Notes ("SCIN")

These non-charitable techniques are important in the charitable context for at least two reasons. First, if an individual can see during his lifetime that he has adequately provided for his children, he can more confidently move forward with charitable goals. Second, these techniques can be used in conjunction with some of the charitable techniques described below to create an enhanced plan that is beneficial to charity and family alike.

Of course, it is also important to start early with charitable planning. For example, starting a private foundation while children are young and allowing them to participate in foundation governance will give them experience in managing assets, and give the child a sense of the parents' charitable priorities, helping to create a family legacy of giving.

Appendix A outlines three simple scenarios for a person with a $20,000,000 estate. It shows the continuum of charitable planning as it relates to tax efficiency. The more that is left to charity, the lighter the tax burden. Roughly speaking, the foundation is funded half by the family and half by the IRS. Appendix A illustrates the importance of pre-funding an inheritance, as described above. The more an inheritance has been pre-funded, the more a person can leave to a foundation with the comfort that he has adequately provided for his children. The final scenario in Appendix A (leaving the bulk of an estate to a foundation) shows only one way to eliminate estate tax using charitable techniques. More complex techniques, some of which are described below, can significantly reduce or eliminate estate tax through charitable vehicles while still transferring significant assets to the family.

II. THE CONCEPT OF INHERITANCE

What is an inheritance? Most would say that it is the amount of money or property we receive from someone who has passed away. It may be time to start taking a broader view of this concept. For example, if mom and dad leave their child the family business, is it merely the value of the business they are leaving? It is clearly more than that – it is employment for the child, experience, a position of leadership within the company, and responsibility. Similarly, in the charitable context, when mom and dad leave assets to a family foundation, they have left substantial influence and leadership in the foundation's business, the opportunity to manage assets, and the ability to do public good. Consistent with the concept of raising a well-rounded child, it can be important, especially within wealthy families, to create an inheritance that is well-rounded, providing leadership and philanthropic opportunity, as well as monetary gain. Appendix B illustrates an estate plan structured to provide these benefits.

III. SPECIFIC PLANNING TECHNIQUES

A. OUTRIGHT CHARITABLE CONTRIBUTIONS DURING LIFE. An individual can make a contribution of cash or property outright to a charity and receive a charitable contribution deduction on his or her tax return, so long as certain requirements are satisfied. The contribution must be voluntary, the contribution must be made to a qualifying charity, and the donor must not receive value from the charity in return. An exception to the last requirement is that the donor may receive nominal value from the charity and still qualify for the charitable contribution deduction.

1. <u>Gifts of Cash</u>. A donor may deduct, as a charitable contribution, the amount of cash gifted to a charity.

2. Gifts of Property. In general, a donor may deduct the fair market value of property contributed to a charity. (See Section B, below, for restrictions.)

3. Quid Pro Quo Gifts. If the donor receives value (such as property or services) from the charity in exchange for his contribution, the donor must reduce his charitable contribution deduction by the fair market value of the property or services he received. Charities generally can provide this value to the donor.

B. SPECIAL RULES REGARDING ALLOWABLE CHARITABLE CONTRIBUTION DEDUCTION. The IRS has imposed certain restrictions on the charitable contribution deduction permitted to be taken by a donor based on the type of property contributed and the type of entity to which the property is contributed. The applicable rules are complicated, so they are summarily discussed below. A tax advisor should be consulted before a gift is made to charity.

1. Contributions of Cash. As stated above, a donor may deduct the amount of cash contributed to any type of charity.

2. Contributions of Property. Depending on the type of property contributed to a charity, the donor's deduction may either be limited to his basis in the property or be equal to the property's fair market value.

a. Deduction Limited to Donor's Basis. In the following situations, the donor's charitable contribution deduction is limited to the donor's adjusted basis in the property contributed:

- Appreciated property that would trigger ordinary income or a short-term capital gain if sold. This is generally a capital asset that has appreciated in value, but has been owned by the donor for less than a year.

- Appreciated tangible personal property contributed to a public charity or private operating foundation for a use unrelated to the charity's exempt purpose.

- Appreciated property, other than "qualified appreciated stock," contributed to a private non-operating foundation. Qualified appreciated stock is stock that has been held for more than one year and for which market quotations are readily available on an established securities market.

b. Deduction Equal to Property's Fair Market Value. In the following situations, the donor's charitable contribution deduction is equal to the property's fair market value:

- Property that would trigger a loss if sold. This rule applies when a depreciated piece of property is donated to any type of charity. The deduction is limited to the fair market value, which is actually lower than the donor's adjusted basis.

- Appreciated tangible personal property contributed to a public charity or a private operating foundation for a use related to the charity's exempt purpose.

- Appreciated real property or intangible personal property (such as stock) contributed to a public charity or a private operating foundation, provided that the asset has been owned for at least one year.

- Qualified appreciated stock contributed to a private non-operating foundation. Certain additional restrictions apply depending on the amount of stock contributed.

c. Donations of Vehicles. Although prior law allowed a donor to deduct the fair market value of automobiles, boats, and small airplanes contributed to charity, new laws provide that a donor may only deduct the amount of gross proceeds the charity actually receives when it sells the automobile, boat, or airplane.

3. New Pension Act Provisions - Undivided Interests in Tangible Personal Property. Until 2007, a charitable deduction was allowed for gifts of an undivided fractional portion of a donor's entire interest in tangible personal property (such as an undivided interest in a piece of art). If the gift was used in a manner related to the exempt purposes of the donee, the deduction was based on the relevant fraction of the entire fair market value of the property at the time of the contribution. If the donee's use was unrelated, the deductible amount was limited to the donor's basis in the property. The Pension Act of 2006 significantly restricted these deductions to eliminate perceived abuses.

a. *All interests owned by donor or donee*. All interests in the item must have been owned by the donor and the donee immediately before the contribution. §170(o)(1)(A). In other words, there can be no third party owners - only the donor and the donee charity. An exception exists if all persons who hold an interest in the property make proportional contributions of an undivided portion of the entire interest they hold. §170(o)(1)(B). This rule also applies for gift tax as well as for income tax purposes.

b. *Deduction for future gifts of undivided interests in the same property*. If the use of the property is related to the donee's exempt purpose, and the deduction is based on the fair market value of the property, there is a special limit on future gifts of additional undivided interests

in the same property (and the gift must be made to the same donee or else no deduction is allowed under the first new rule described above). In that situation the fair market value of any additional contribution is determined by using the lesser of (1) the property's fair market value at the time of the initial fractional contribution, or (2) the property's fair market value at the time of the additional contribution. §170(o)(2). Therefore, there will be no increased deduction allowed attributable to increases in the fair market value of the entire property after the time of the initial fractional gift. (However, consistency is not required where the property goes down in value after the initial gift.)

This rule also applies for estate and gift tax as well as for income tax purposes. §§2055(g) & 2522(e). This is critically important. For example, if an individual makes a gift of a fractional interest in property, and leaves the balance of the property to the charity at the individual's death, there can be a mismatch of estate inclusion and allowable deduction: the individual's remaining undivided interest would be included in the estate at its full value, but the estate tax charitable deduction would be allowed based on the value of the property at the time of the initial contribution.

c. *Recapture of deduction and recapture penalty*. A recapture of the income or gift tax (but not estate tax) charitable deduction will occur where the following events have not occurred within 10 years of the initial fractional gift or the donor's earlier death:

(i) if the donor does not contribute all of the remaining interest in the property to the donee (or if the donee is no longer in existence, to another §170(c) organization); AND

(ii) if the donee has not (a) had substantial physical possession of the property, and (b) used the property in a use related to the organization's exempt function. §§170(o)(3)(B) & 2522(e)(3)(B).

Accordingly, a gift of a fractional interest in property that is unrelated to the charity's exempt function can still be deducted initially based on the donor's basis (but not the full fair market value). However, if the property is not given a related use within the 10 year or earlier death period, the charitable deduction (plus interest) is recaptured. There is also a recapture penalty of 10% of the amount recaptured.

4. <u>New Pension Act Provisions - Tangible Personal Property Deductions</u>. A charitable deduction for contributions of tangible personal property exceeding $5,000 must be reduced or recaptured if the donee sells the property within three years of the contribution. §170(e)(7)(A). If the sale

occurs within the tax year of the contribution, then a reduction in the charitable contribution deduction is made to basis, and if the sale occurs after the first tax year but within three years, then the above-basis portion is recaptured. An exception to this rule exists if a certified statement by the donee is made stating that the property was for the organization's exempt purpose, how it was used for such purpose, or why it became impossible to do so.

5. Annual Percentage Limitations. Another limitation that the IRS imposes on charitable contribution deductions is that the deduction can be no larger than a certain percentage of the donor's "contribution base" (the contribution base is equal to the donor's adjusted gross income). In other words, depending on the specific contribution, the donor can only offset a certain percentage of his income with a charitable contribution deduction.

   a. 50% Limitation. Generally, the donor's charitable contribution deduction is limited to 50% of the donor's contribution base when (i) cash or (ii) property is contributed to a public charity or a private operating foundation.

   b. 30% Limitation. Generally, the donor's charitable contribution deduction is limited to 30% of the donor's contribution base when (i) cash or (ii) property that would trigger a loss or ordinary income if sold is contributed to a private non-operating foundation.

   c. 20% Limitation. Generally, the donor's charitable contribution deduction is limited to 20% of the donor's contribution base when property that would trigger a long-term capital gain if sold is contributed to a private non-operating foundation.

   Any excess charitable contribution deduction that cannot be taken in one year may be carried forward five years for the purpose of deducting the excess contribution on a future income tax return.

6. Substantiation Requirements. A donor must be able to substantiate his charitable contributions. Specifically, the donor must obtain a written acknowledgment from the charity for all contributions exceeding $250. If the donor is claiming a deduction with respect to property (other than cash, inventory, or marketable securities) that exceeds $5,000, the donor must obtain an appraisal but need not attach it to his tax return. However, if the donor contributed art that is valued at $20,000 or more, he must obtain an appraisal and attach the appraisal to his tax return.

7. Tax Deduction Deadlines. In order to be deducted in a certain year, contributions of property and cash must be received by the charity no later than December 31 of that year. However, if a cash gift is made by check or a credit/debit card, the donor need only mail the check or use the credit/debit

card by December 31 in order to claim the charitable contribution deduction for that year.

Note that the above rules and limitations generally apply to all charitable gifts made during life, whether outright or in another form discussed below.

C. CHARITABLE BEQUESTS AT DEATH. An individual may also make a donation to a charity at the individual's death through his Will. The donor's estate can then take a charitable contribution deduction equal to the fair market value of the gift (but no greater than the value of the donor's taxable estate for federal estate tax purposes). If the donor dies with a taxable estate (an estate with more than $2 million in assets in 2007), this would effectively reduce any federal estate taxes owed at the donor's death, which are assessed at a 45% estate tax bracket.

The estate tax exemption amount is set to remain at $2 million for decedents dying in 2007 and 2008. In 2009, the estate tax exemption amount rises to $3.5 million, is unlimited in 2010, and falls back to $1 million in 2011.

D. USING AN IRA TO FUND CHARITABLE GIFTS AND BEQUESTS.

1. <u>Bequests of Interests in IRAs</u>. If an individual plans to make a charitable gift at his or her death, naming a charity as the beneficiary of an IRA or other retirement plan can maximize the amount of money the charity receives, as well as the amount of money that the individual's family receives.

In addition, naming one's spouse as the primary beneficiary and a qualified charity as the secondary beneficiary of a retirement plan (or, in the alternative, the charity as the primary beneficiary) provides an individual with an opportunity to benefit their charity of choice with a minimal impact on their heirs.

IRAs and retirement plans are attractive vehicles for leaving assets to a charity because of the double taxation imposed on IRAs at death. Estate taxes are paid by the participant's estate on death, and income taxes are paid by heirs as withdrawals are made. This double taxation makes retirement plans extremely poor vehicles for passing wealth to one's descendants.

When an individual names a charity as the beneficiary of an IRA, the IRA is still fully includable in his or her taxable estate, but the estate receives a charitable deduction equal to the amount passing to the charity. Because the charity will not be required to pay income taxes on IRA withdrawals, the charity ultimately pockets the entire IRA. The impact on the individual's heirs is minimized by the fact that had they been named beneficiaries of the IRA, estate taxes and income taxes could have left them with as little as 20¢ on the dollar.

<u>Example</u>: Donor owns a $100,000 IRA. His wife predeceased him, and he has two children whom he names as beneficiaries of the IRA. If Donor dies

with a taxable estate, his $100,000 IRA could be subject to estate taxes as high as $45,000 ($100,000 x 45% estate tax rate). Therefore, only a net amount of $55,000 from the IRA would pass to his children. Distributions that they take from the IRA to pay the estate taxes will be subject to income taxes, as will distributions they take for their benefit during their lives. The income taxes generated by these distributions could be as high as $35,000 ($100,000 x 35% income tax rate). As a result, Donor's children could receive as little as $20,000 net of taxes from the $100,000 IRA ($100,000, less $45,000 in estate taxes, less $35,000 in income taxes). (Note: This example ignores the "income in respect of a decedent deduction" due to its limited benefit as an itemized deduction.)

Instead, Donor could name his favorite charity as the beneficiary of the IRA. His estate would receive a charitable contribution deduction in amount equal to the IRA, and the charity would receive the full $100,000. As the charity takes distributions from the IRA, it will not pay income taxes and will ultimately receive the full amount of the IRA.

Note: Because of the uncertainty of how much will actually remain in an individual's IRA at the time of death, if a specified amount is desired to pass to charity, the individual should include a provision in his Will leaving the charity of choice the desired amount, reduced by any amount passing to the charity by beneficiary designation on the individual's death.

2. Lifetime Charitable Contributions of IRAs. The Pension Protection Act of 2006 added the flexibility (through the end of 2007) to donate directly from an IRA to charity, within certain limitations. Under prior law, there was no provision in allowing the tax-free distribution from an IRA where the distribution was donated to a charitable organization.

New Law: Charitable Contributions in 2006-2007 of Individual Retirement Accounts. A person over age 70 ½ (at the time of charitable gift) may make charitable gifts directly from an IRA of up to $100,000 per year without having to report the distributions as taxable income. However, no charitable income tax deduction can be claimed. The effect is to change the rules for lifetime charitable gifts (but not charitable bequests, discussed above).

Things to Look Out for With the New Law.

(1) *Applies Only to IRAs*. The exclusion applies only to traditional IRAs and Roth IRAs, not other types of retirement plans like SEP IRAs or Simple IRAs.

(2) *Only in 2006-2007*. The exclusion applies only for transfers made during 2006 and 2007. While it is assumed by some that the new law will be extended, no concrete planning can yet be done based on that assumption.

(3) *Participant Must be Age 70 ½*. The individual must be at least age 70 ½ *at the time of the contribution*. (This is different from the rule requiring minimum distributions *in the same year* the individual reaches 70 ½.)

(4) *No Carryover*. As mentioned above, only $100,000 of charitable gifts of IRAs per year may qualify for the income exclusion. There is no carryover to future years.

(5) *Public Charities*. The charitable organization must be a public charity or a "conduit private foundation." Contributions to donor advised funds, supporting organizations and most private foundations do not qualify.

(6) *Favorable Treatment of Nontaxable Portion*. Charitable distributions from IRAs are deemed to come first from the taxable portion. This is favorable, because distributions from the nontaxable portion (attributable to nondeductible contributions to the IRA) are normally tax-free in any event. §408(d)(8)(D). Under normal rules, distributions are made pursuant to a ration between taxable and nontaxable portions – this changes that rule for distributions going directly to charity.

(7) *Pass Direct to Charity*. The distribution must pass directly from the IRA to the charity. §408(d)(8)(B)(i).

(8) *No Requirement for Administrators to Participate*. The new law permits distributions directly to charities, but does not require administrators to make such distributions. Many current plans do not have specific provisions in them that allow distributions to charities. While the new law allows such distributions, it will be up to the administrators whether or not to change their plans accordingly.

<u>Advantages of the New Law</u>.

(1) *Satisfies Minimum Distribution Requirements*. Charitable gifts from IRAs can also satisfy the annual minimum distribution requirement (in whole or in part). For example, if the minimum required distribution is 4% in a year, that requirement could be satisfied by a 3% contribution to charity and a distribution of 1%. In effect, the individual can make charitable gifts desired by the individual and also reduce the amount of distributions that would otherwise have to be made from the IRA.

(2) *If Donor Does Not Itemize*. Without the new rollover opportunity, when a person takes a distribution from an IRA, he reports it as income. If he uses it to make a charitable contribution, he can deduct the contribution as an itemized deduction. However, if he takes the

standard deduction and does not itemize, he gets no tax benefit from the charitable contribution. Many taxpayers who live in states without a state income tax (such as Texas) do not itemize. With the new rollover, the IRA distribution that goes to charity is excluded from income, so no charitable deduction is needed to offset the income.

(3) *Not Subject to Phaseout of Deductions*. Even if the person does itemize, high income taxpayers (income above $150,500; or $75,250 for Married Filing Separately) lose part of the deduction because of a phaseout of itemized deductions. (The phaseout has been 3%, but is only 2% in 2006 and 2007 and 1% in 2008 and 2009. §68(f)(2).) With the new rollover opportunity, the IRA distribution is not included in income, and there is no charitable deduction, so there is an automatic "wash." Without the rollover, there would be "no wash" for high income taxpayers, because the amount of income is greater than the deduction (since the deduction is reduced by the phaseout).

(4) *Social Security Recipients*. Social security recipients will be benefitted if excluding the IRA income keeps their income below thresholds that cause social security benefits to be subject to income tax.

(5) *No Percentage Limitation*. Donors who make such large gifts that they are subject to the 50% charitable deduction limitation are benefitted. It is better for them to have income exclusion than to have a charitable deduction that cannot be fully utilized.

(6) *State Income Tax*. Donors in states that do not allow or that place restrictions on state charitable income tax deductions are benefitted. Federal income exclusion will often also result in state income exclusion, which is much preferable to having state income with no offsetting charitable deduction.

E. LIFE INSURANCE. There are multiple options available when using life insurance as a means of making a charitable contribution. An individual may purchase a life insurance policy, naming his charity of choice as the beneficiary and the owner. The individual may then take a charitable contribution deduction against his income taxes for the fair market value of the life insurance policy and for the premium payments made by the donor each year.

A second option is for the individual to name the charity as the beneficiary of all or a portion of any life insurance policy currently in place or purchased in the future. This allows the individual to make a significant charitable contribution upon the individual's death and qualifies for an estate tax charitable contribution deduction. However, merely naming a charity as the beneficiary of the policy does not allow the individual to take a charitable contribution income tax deduction for the premium payments.

A third option is for the individual to name the charity as the irrevocable beneficiary of a life insurance policy. Doing so will prevent the individual from ever removing the charity as a beneficiary of the policy without the charity's consent. The individual may also be required to obtain the charity's consent before modifying the terms or amount of coverage. This option will not permit the individual to take a charitable contribution deduction during his life, but will permit the individual's estate to take a charitable contribution deduction upon the individual's death.

Insurance can also be used to fund a "**wealth replacement trust**." For example, if a person planned on leaving $5 million to his children at his death, but also was charitably inclined, he could create an irrevocable life insurance trust (ILIT) and fund it with a $5 million life insurance policy. If the ILIT is structured correctly, the proceeds would not be included in his estate and pass entirely to his children as their inheritance. He would then be free to leave his entire estate to charity and would pay no estate tax.

Finally, more advanced techniques use flexible life insurance policies in conjunction with a charitable trust such as a charitable remainder trust (described in Section I below) to produce benefits for both the charity and the family of the donor.

Example: Bob and Jane, wanting their favorite charity to ultimately receive $1 million, create a charitable remainder unitrust (a CRUT) that is designed to pay Jane up to 6% of the CRUT's assets annually (limited by the CRUT's income) in the event Bob dies prematurely, or Bob and Jane's children for five years if they both die prematurely. Following an initial gift from Bob and Jane of $10,000, the CRUT purchases two insurance policies. The first is a $500,000 face value fifteen year term policy with a provision for return of premiums if Bob lives for 15 years with no terminal illness, as well as a provision for an acceleration of benefits if Bob is diagnosed with a terminal illness. The second policy is a second-to-die universal life policy, also with a face value of $500,000. The gifts by Bob and Jane to the CRUT to allow the CRUT to pay the premiums on both policies will result in a partial charitable deduction for Bob and Jane, with the amount of the deduction increasing as they get older.

If Bob dies within 15 years, the first policy will pay the trust $500,000 and the CRUT will pay Jane up to $30,000 per year for the rest of her life. If both Bob and Jane die, then their children will split an annual payment of $60,000 each year for five years. If Bob lives longer than 15 years, then CRUT would receive a refund of the premiums paid for the first policy and could invest those funds to pay the premiums on the second policy. Of course, at the end of the unitrust term, the charity would receive the balance of the CRUT assets, which would likely be somewhere over $1 million if Bob died prematurely or $500,000 if he lived to his normal life expectancy.

An additional technique involves making a large initial gift to a CRT, and then funding an irrevocable life insurance trust with the income tax savings, is described in Section I below.

F. CHARITABLE GIFT ANNUITY. A charitable gift annuity is created when an individual transfers cash or other property to a charity in exchange for the charity's promise to pay an annuity to the individual for the individual's life. If property is

donated, the charity receives the entire property up front and can do whatever it wishes with the property. The donor's charitable contribution deduction is equal to the difference between the amount of cash or other property transferred to the charity and the actuarial value of the annuity.

For income tax purposes, the donor treats the transaction as a bargain sale to the charity. Therefore, as the donor receives annuity payments, a portion of the payments is taxed as capital gain. The remaining portion of the annuity payments is taxed as ordinary income.

Example: Bob and Jane are each 70 years old. They decide that they would like to keep the risk in their portfolio low while getting a little better return than the 5% they have been earning. They choose their favorite charity and invest $100,000 in a charitable gift annuity. The charity agrees (based upon a 5.8% IRC Section 7520 Rate and 5.9% rate suggested by the American Council on Gift Annuities) to pay Bob and Jane $5,900 per year for the remainder of their lives.

Using Bob and Jane's life expectancies, the total annuity payments to Bob and Jane will be $118,000, and the charity will receive approximately $145,000 after Bob and Jane's deaths. In addition, Bob and Jane would receive an immediate tax deduction of about $29,200, resulting in tax savings of approximately $12,500. If Bob and Jane used unappreciated assets such as cash to purchase the annuity, a portion (about $3,100) of each year's annuity payment to Bob and Jane would be tax-free.

What if Bob and Jane did not have a favorite charity, or what if they were involved in several charities, or what if the one charity they were involved in did not offer charitable gift annuities? In those circumstance, they might consider a charitable gift annuity through a Community Foundation. The Community Foundation would allow for flexibility in where the charitable funds were distributed, and Bob and Jane, or their family, could be involved in advising the Community Foundation on the family's changing charitable interests.

G. CHARITABLE LEAD TRUSTS - GENERALLY. A charitable lead trust ("CLT") is a trust that pays an annual payout to a charity for a fixed term of years (such as 10, 15, or 20), and at the end of the term, the trust assets pass to the donor's family (typically to the donor's children).

1. Tax Advantages of a CLT. The CLT removes assets from the donor's estate so that the donor avoids the estate tax on the assets, but when the term ends, the assets pass to the donor's children. With careful planning, a CLT can be structured so there is no estate or gift tax on the portion of the assets passing to the children at the donor' death.

2. When CLTs are Beneficial. The best time to create a CLT is when interest rates and stock prices are low. Currently, IRS interest rates are low, which serves to reduce the present value of the remainder interest that passes to the children and makes it easier to avoid paying gift tax on this amount. In addition, when stock prices are low, the assets have more potential to appreciate, which also increases the amount that later passes to the children.

3. Income Tax Consequences of a CLT. The income tax consequences of a

CLT depend on whether the CLT is structured as a grantor trust or a non-grantor trust. If the CLT is a *grantor trust*, the donor receives an income tax charitable contribution deduction when the CLT is created, but pays income tax each year on the trust's entire taxable income (with no deduction for the amount passing to charity each year). If the CLT is a *non-grantor trust*, the donor receives no up front income tax deduction, but the CLT gets a deduction each year for the amount passing to charity.

Example: Husband and Wife own $1 million worth of securities. They do not rely on the dividend income produced by the securities for their support. Husband and Wife expect the securities to appreciate in the future and would like their children to ultimately receive the securities. Husband and Wife are also involved in charitable activities and give approximately $50,000 per year to their favorite charities.

Husband and Wife decide to create a CLT in which the charity receives an annuity for fifteen years, naming their children as the remainder beneficiaries. Assuming that the securities grow at a rate of 8% per year and the CLT pays out 5% of its initial assets to the charity, the charity would receive an annuity payment of $50,000 per year. At the end of the fifteen-year term, the charity will have received a total of $750,000.

In the year that the CLT is created, Husband and Wife can take a charitable contribution deduction of $498,560 (assuming that the CLT is structured as a grantor trust). The value of the remainder interest ($501,440) will be characterized as a gift to their children. Each spouse will use up $250,720 of their $1 million lifetime gift tax exemption, and no gift tax will be due.

At the end of the CLT's fifteen-year term, Husband and Wife's children will receive assets worth $1,814,563, and no gift or estate taxes will be triggered on those assets. The following table illustrates the results of using a CLT:

	Without a CLT	With a CLT
Initial Value of Securities	$1,000,000	$1,000,000
Value of Securities in 15 Years	$1,814,563	$1,814,563
Less: Estate Tax	(816,553)	(225,648)*
Amount Passing to Children	$998,010	$1,588,915
Amount Passing to Charity	$750,000	$750,000

* Represents additional tax due at death from the lifetime use of $501,440 gift tax exemption.
Note: This illustration does not take into account the additional income tax benefits of charitable giving.

H. CHARITABLE LEAD TRUSTS - THE "ZEROED-OUT TESTAMENTARY CLT PLAN." Recently a new technique has developed utilizing a testamentary CLT that

eliminates estate tax at the decedent's death. Mom creates a trust for descendants and the trust has the right, upon Mom's death, to purchase all of the assets of Mom's estate for a note. Mom leaves all of her assets to a testamentary charitable lead trust. Therefore, the CLT would ultimately receive a note for which the descendants' trust would be the payor. Mom would receive a full estate tax deduction, and the trust would own all of the assets of the estate, with an obligation to pay the note payments. If the assets of the estate produced income above the level of the note payments, then the estate assets would ultimately be preserved while the CLT would satisfy its annuity obligations. The charity named in the CLT instrument could be a private foundation operated by the family, ensuring that all assets would be under the management of the family.

The zeroed-out CLT plan is complex and is most appropriate for larger estates in an environment with low interest rates and estate assets that produce a high income. In addition, court approval of the plan (particularly the negotiation of the note) will often be necessary to avoid the self-dealing rules associated with CLTs.

Example: Jane, the surviving spouse, has an estate valued at approximately $100 million. She executes an option agreement with a previously-established trust for her children that allows the trust to purchase all of the assets of her estate for fair market value upon her death. Her will provides that her entire residuary estate is to pass to a charitable lead annuity trust (CLAT) structured with a 20 year term and a 100% charitable deduction allowance. The charitable beneficiary named in the CLAT is a family foundation established by Jane. Jane passes away and the trust elects to exercise its option to purchase the estate assets for $100 million. It executes a 20-year note, using the federal long-term rate of 4.91%. The note is structured to pay principal each year so that the CLAT can satisfy its annuity obligation of $8,437,000. Over 20 years, the CLAT will transfer a total of $168,740,000 in assets to the family foundation. If the estate assets held in the descendants' trust appreciate or produce income at a rate of 8.437% or higher, they will be preserved. Following the 20-year CLAT term, the descendants' trust would receive the remainder, meaning that the final balloon payment of principal would pass immediately back to the descendants' trust.

The potential for success of the zeroed-out CLAT plan is greatly enhanced if Jane's primary asset is an interest in a family limited partnership. The partnership interest would be discounted to determine its fair market value, making the descendants' trust's obligation to the CLAT under the note considerably smaller.

I. CHARITABLE REMAINDER TRUSTS. When an individual creates and funds a charitable remainder trust ("CRT"), income from the trust is distributed back to the donor, and at the death of the donor, the remaining principal passes to the named charity. Alternatively, the CRT can be structured to continue after the donor's death for the benefit of the donor's family members (for either their lives or a fixed period of time), and at the death of the named family members, the remaining principal passes to the named charity.

1. Tax Advantages of a CRT. When a CRT is established, the grantor receives an income tax deduction for the value of the remainder interest (with special rules applying to property with a basis that is lower than the property's fair

market value). If appreciated assets are contributed to a CRT, the CRT can sell them with no tax due at the time of the sale. This provides an excellent opportunity to convert low income-producing assets to cash without a capital gains tax. In many plans, taxpayers use the savings to purchase life insurance (to be owned by an irrevocable trust for the benefit of family members) to "replace" the assets going to charity at the grantor's death.

2. When CRTs are Beneficial. The best time to create a CRT is when interest rates are high and the donor owns an asset that is highly appreciated. When interest rates are high, it is easier to meet the requirement that the CRT have a charitable remainder with an actuarial value of at least 10% of the value of the property transferred to the CRT. Because a CRT can sell property without income tax consequences (as noted below), a CRT provides the most benefit when a donor contributes property with a high fair market value but with a low income tax basis.

3. Income Tax Consequences. As noted above, the donor receives an up-front charitable contribution deduction equal to the value of the remainder interest when the CRT is created. The CRT is exempt from tax, so it does not pay capital gains tax or income tax as a result of its transactions. When the donor (or other family members) receive annual distributions from the CRT, the distributions may be subject to income tax based on a tiering system. The tiering system carries out trust income to the beneficiaries, with the tax treatment determined by the original character of the income when it was generated inside the trust. For example, if the CRT distributed income to the donor that was generated when the CRT sold stock, the donor would pay tax on the income at long-term capital gain rates.

Example: Husband and Wife, ages 65 and 64, own $3 million in highly appreciated stock that pays 3% in dividends each year (or $90,000). They have a $200,000 basis in the stock and are in the 35% federal income tax bracket. Husband and Wife decide that, given their age, they should maximize their income during retirement. They also want to make a charitable contribution to their favorite charity. Husband and Wife have three options with respect to the stock – keep the stock, sell the stock and use the proceeds to diversify their investments, or utilize a CRT.

If Husband and Wife merely keep the stock, they retain their $90,000 income stream, which will not increase unless the stock begins paying more dividends. Any charitable contribution that they make would potentially decrease this income stream.

If Husband and Wife sell the stock, they will be required to pay a capital gains tax of over $420,000 (proceeds of $3 million, less $200,000 basis, multiplied by 15% capital gains tax rate). Therefore, only $2.58 million will be available to reinvest in a higher income-yielding investment. Assuming the investment earns 6% before taxes, the sales proceeds of $2.58 million would produce about $155,000 in pre-tax income, or about $100,000 net of income taxes.

If Husband and Wife create a CRT, they can contribute the stock to the CRT,

and the trustee of the CRT can sell the stock tax-free and reinvest the proceeds. Therefore, the CRT would have a total of $3 million to invest (as opposed to the $2.58 million that Husband and Wife would have to invest had they sold the stock themselves). Assume that the CRT earns 8% and pays out 6% annually in an annuity to Husband and Wife. Husband and Wife would receive a payment of $180,000 per year. In addition, in the first year, they would receive a charitable contribution deduction of $794,964 (equal to the present value of the charity's remainder interest).

If Husband and Wife die in twenty years, the charity is projected to receive assets outright with a value of approximately $5,745,000.

Note: As explained in Section E above, the CRT is often combined with an irrevocable life insurance trust, commonly known as a "wealth replacement trust." Husband and Wife can use their income tax savings (generated by the charitable contribution deduction) and some of their extra annual cash flow to pay premiums on life insurance owned by the wealth replacement trust. The wealth replacement trust can be structured to benefit their children, thereby "replacing" the assets passing to charity through the CRT. An added benefit of a wealth replacement trust is that it can be structured so that it is excluded from Husband and Wife's estate, allowing the assets inside the trust to pass tax-free to the children.

Summary:

1. Husband and Wife transfer their stock, valued at $3 million, to the CRT.

2. Husband and Wife receive an income tax charitable contribution deduction of $794,964 upon the transfer.

3. Husband and Wife receive income from the CRT of $180,000 per year, totaling approximately $3.6 million during their lives (assuming a constant 8% growth rate and a survival period of twenty years).

4. When Husband and Wife both die, the CRT assets of approximately $5,745,000 pass to the charity of their choice (assuming a constant 8% growth rate and a survival period of twenty years).

J. PRIVATE FOUNDATIONS. A private foundation is a tax-exempt entity that operates to further its charitable purposes. Because a private foundation is exempt from tax, it can sell property without tax consequences. In addition, individuals can donate cash or other property to the foundation and receive a charitable contribution deduction (subject to the limitations noted above).
The first step is to create the entity, which is typically a Texas non-profit corporation with a board of directors of at least three individuals. The next step is to file a Form 1023 Application for Exemption with the IRS, to seek a Determination Letter declaring the entity to be tax exempt. The tax-exempt status has two benefits:

1. It allows contributors to take an income tax deduction for contributions made to the foundation.

2. It permits the foundation to avoid paying income tax on its income.

In order to obtain and maintain tax exempt status, the foundation is required to use its funds only for a "charitable purpose," which means it must conduct its own charitable programs or fund other charitable organizations.

Private foundations are subject to certain restrictions. "Disqualified persons" are generally prohibited from entering into "self-dealing" transactions with the foundation, even if the transaction is objectively in the best interest of the foundation. Disqualified persons include members of the board of directors, foundation managers, large donors, and entities related to them. In addition, private foundations are prohibited from having "excess business holdings," which means that disqualified persons and the foundation cannot, in the aggregate, own more than 20% of a business enterprise.

A foundation also prohibited from holding investments that jeopardize its charitable purpose and is required to distribute at least 5% of the value of its assets to other tax-exempt entities each year. Furthermore, a foundation that incurs "taxable expenditures," such as lobbying expenditures, is subject to tax penalties.

The donor and the donor's family can manage the foundation by being members of the foundation's board of directors. The board of directors determine what type of charitable programs will be conducted by the foundation and which charitable organizations will receive funding from the foundation. This allows the donor and the donor's family to participate in charitable giving by choosing which charities the foundation will support or by choosing the type of programs that the foundation will conduct.

The donor can contribute assets to the foundation during his life, as well as upon his death. The foundation will continue to exist long after the donor's death, providing a vehicle through which the donor's children, grandchildren, and great-grandchildren can participate in charitable giving.

K. SUPPORTING FOUNDATIONS. A supporting foundation is a tax exempt entity that is operated exclusively for the purpose of furthering the tax exempt purposes of another specific charitable organization. The foundation raises and manages its own funds, but all grants the foundation makes are for the purpose of furthering a specific charitable organization's exempt purposes.

To qualify as a supporting foundation, the foundation must be responsive to the needs and demands of the charitable organization that it supports. The foundation must also maintain a significant involvement in the supported organization's operations.

These requirements can be satisfied in one of the following ways:

1. The supporting foundation must be operated, supervised, or controlled by the supported organization (a "Type I Organization").

2. The supporting foundation must be supervised or controlled in connection with the supported organization (a "Type II Organization").

3. The supporting foundation must be operated in connection with the supported organization (a "Type III Organization").

   a. At least one of the directors of the supporting foundation's board must be elected by the supported organization. In addition, at least one member of the supporting foundation's board must also be a member of the supported organization's board.

   b. The supporting foundation must maintain a significant involvement in the operations of the supported organization so that the supported organization depends upon the supporting foundation for contributions.

A supporting foundation is treated for income tax purposes like a public charity. Contributions to the supporting foundation benefit from the more generous rules for charitable contribution income tax deductions that apply to public charities. Until 2006, all supporting organizations were not subject to the restrictions discussed above for a private foundation. Therefore, they could enter into transactions with "disqualified persons," can have excess business holdings, and is not required to distribute a minimum amount of assets each year.

The provisions of the new Pension Act of 2006 placed restrictions on most "Type III" supporting organizations so that they are treated more like private foundations. Type III organizations are the most common supporting organizations, so the new rules may have a chilling effect on the creation of these entities. In addition, private foundation distributions to Type III organizations no longer qualify toward the private foundation's minimum distribution requirements.

L. DONOR-DIRECTED PHILANTHROPIC FUNDS.

1. Through an Individual Charity. This is a fund that consists of one or more accounts established by a donor, which are created for the purpose of distributing funds to qualified charitable organizations. The account becomes the property of the charitable organization when it is established. However, the donor retains the right to recommend how the interest generated by the account should be used to further the organization's charitable purposes.

   The donor receives a charitable contribution income tax deduction for the year in which the account is established, governed by the rules for making contributions to a public charity. Because the account belongs to the charitable organization upon its creation, no income tax is generated by the account's earnings each year. Furthermore, the donor does not receive a

charitable contribution deduction in the future when distributions from the fund are made. However, if the donor contributes additional cash to the fund in future years, those contributions will qualify for the charitable contribution income tax deduction.

2. Through a Community Foundation. Often used as a simpler substitute for a private foundation, this is a fund created for the purpose of distributing funds to qualified charitable organizations when the donor does not know exactly which charities will be benefitted each year at the time of initial contribution. The donor retains the right to recommend how the funds should be distributed. The donor receives a charitable deduction for the year in which the account is established, governed by the rules for making contributions to a public charity. Because the account belongs to the community foundation upon its creation, there is no income tax on the account's earnings each year.

Appendix A

ESTATE TAX SCENARIOS

Assumptions:	
Value of Gross Estate	20,000,000
Estate Tax Exemption (per person)	2,000,000
Estate Tax Rate	45%

Scenario #1: Leave 100% of Estate to Children

Gross Estate	20,000,000
Amount Passing to IRS	7,200,000
Amount Passing to Children	12,800,000

Scenario #2: Leave 50% of Estate to Children, 50% to Foundation

Gross Estate	20,000,000
Amount Passing to IRS	3,483,871
Amount Passing to Children	8,258,065
Amount Passing to Foundation	8,258,064

Observations: The gift to the Foundation is borne roughly half by your children and half by the IRS.
Rather than viewing this as a reduced inheritance for your children, consider that part of their inheritance goes to them directly, and the rest of their "inheritance" comes to them in the form of a Foundation that they control, providing them substantial influence and the ability to do public good.

Scenario #3: Leave $4 Million to Children, Remainder to Foundation

Gross Estate	20,000,000
Amount Passing to IRS	0
Amount Passing to Children	4,000,000
Amount Passing to Foundation	16,000,000

Observation: Goal is to get as close to Scenario #3 as possible, by pre-funding your children's inheritance into Grantor Trusts for your children during your lives. Through advance planning, the bulk of your children's inheritance can be set aside for them in a way that costs little or no estate and gift tax.

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BACK TO SCHOOL IN TERMS OF PLANNED GIVING

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