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ADVANCED ESTATE PLANNING

2013 TEXAS SCHOOL OF TRUST BANKING

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BIOGRAPHICAL INFORMATION

STEVEN W. NOVAK, J.D. is the managing partner of the Dallas office of The Blum Firm, P.C., a Fort Worth based law firm started in 1980 by Marvin Blum. The firm, comprised of seventeen attorneys, specializes in the areas of estate planning and probate, asset protection, and business and tax planning. Eight of the attorneys are also Certified Public Accountants. Nine, including Mr. Novak, are Board Certified by the Texas Board of Legal Specialization in Estate Planning and Probate Law, and two are Board Certified in Tax Law. Before joining The Blum Firm in 2006, Mr. Novak practiced law in Dallas at both Hughes & Luce, LLP, and Meadows, Collier, *et al* LLP.

Mr. Novak was born in Fort Wayne, Indiana and received his undergraduate degree in Political Science from the University of Kansas in 1997 and his J.D. from the University of Kansas School of Law in 2001. While attending the University of Kansas School of Law, he was a Note and Comment Editor for the *Kansas Law Review* and the Editor of the *2001 Kansas Criminal Procedure Survey.*

Mr. Novak is a member of the Taxation Section and the Real Property, Probate and Trust Section of the American Bar Association, and is a member of the Board of Governors for the Dallas Estate Planning Council. He is also a member of the State Bar of Texas, the Fort Worth Bar Association, the Dallas Bar Association, and the Dallas Association of Young Lawyers. Mr. Novak is a frequent speaker and author on a variety of topics in estate and business planning and was named a “Texas Rising Star” by *Texas Monthly* and *Law and Politics Magazine* in 2006, 2007, 2008, 2009, 2010, 2011, and 2012.

Unless otherwise set forth herein, to ensure compliance with requirements imposed by the Internal Revenue Service under Circular 230 for tax practitioners, The Blum Firm, P.C. mustinform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

TOP TEN REASONS TO SEND YOUR CUSTOMERS TO QUALIFIED ESTATE PLANNING OR TAX COUNSEL

1. The customer has no Will.

2. The customer has a Will that he prepared, that was prepared by a family member or friend, or that was prepared by the customer's real estate lawyer.

3. The customer's existing estate plan provides that the "estate tax exemption amount" and the "marital deduction amount" pass to <u>different parties</u> (children from a previous marriage/surviving spouse). **This easily-remedied situation will be what you will most likely encounter from this list, and also provides the most potential for disastrous consequences for the customer's family over the next few years of rising exemption amounts.**

4. The customer has a Will, but has no ancillary documents to provide for control of his or her assets in the event of disability (eg., power of attorney, medical power of attorney).

5. A customer with a high net worth has a Will or Trust that leaves his or her assets outright to his or children, rather than providing for Generation Skipping Trusts.

6. The customer individually has highly appreciated assets that he or she would like to sell.

7. The customer has a reduced life expectancy compared to other people his or her age.

8. The customer is very charitably inclined, but has not created any trusts or a private foundation.

9. The customer owns stock in a closely held business and the corporation may want to sell those assets within the next 5 to 10 years.

10. The customer indicates he or she is about to start a new business and has not been counseled on choice of entity considerations.

(Not all of these topics are addressed in the outline - but each of them is a "red flag" indicating your customer needs to be referred to a Board Certified Estate Planning or Tax Attorney)

ADVANCED ESTATE PLANNING

STEVEN W. NOVAK

Advanced estate planning is most appropriate for clients with estates well in excess of the estate tax exemption amount. Advanced estate planning techniques sometimes focus on "pre-funding" the inheritance of future generations by shifting wealth to future generations during the client's lifetime. Many pre-funding techniques can also be combined with gifts to charity, which is most attractive to clients who are already charitably inclined.

Below we have discussed a few popular wealth-shifting techniques, including the sale to a grantor trust, the 678 Trust, and the spousal access trust, as well as several charitable planning techniques.

I. GIFT AND/OR SALE APPRECIATING ASSETS TO GRANTOR TRUST

Selling assets to a grantor trust can help shift appreciation to the next generation free of estate and gift tax. The asset being sold to the grantor trust should be an asset that has a high appreciation potential. This will allow the client to maximize the appreciation occurring outside of his or her estate. The following discussion details the steps and implications involved in selling assets to a grantor trust.

A. GENERAL

The sale of assets to an intentionally defective grantor trust ("IDGT") is a useful value shifting technique. The transfer tax implications of a sale of assets to an IDGT are not explicitly addressed in the Code. Rather, the sale of assets to an IDGT utilizes the difference in the characterization of trusts for income tax purposes and transfer tax purposes. A grantor establishes a trust which is designed to be treated as a grantor trust for income tax purposes because of the application of the one or more of Sections 671 – 678 of the Code. The trust is also designed so that the grantor is not treated as retaining any interest in the trust which would cause inclusion in the grantor's taxable estate.

B. GRANTOR TRUST

The following are some methods to design the IDGT so that the grantor will be treated as the owner for income tax purposes:

1. Spouse as Beneficiary. If the IDGT provides that the spouse is a permissible beneficiary of income and principal, then the IDGT should be treated as a grantor trust in its entirety. Sections 677(a)(1) and (2).

2. Power of Grantor to Borrow from IDGT. If the IDGT provides that a grantor can borrow from the IDGT without providing adequate security for the loan, the IDGT will be treated as a grantor trust. Section 675(2).

3. Actual Loan from IDGT to Grantor. If the IDGT makes a loan to the grantor or the grantor's spouse and the loan is not adequately collateralized, or in the case of a loan to the grantor's spouse, then loan does not require provide for adequate interest, the IDGT will be treated as a grantor trust. Section 675(3).

4. Payment of Insurance Premiums. If the principal and income of the IDGT can be used to pay life insurance premiums on the life of the grantor or his spouse, then the IDT should be treated as a grantor trust. Section 677(a)(3). The IRS has gone back and forth on the issue of whether just the ability of the trustee to use trust income to make life insurance premium payments on the life of the grantor is sufficient to cause the IDGT to be treated as a grantor trust, or whether actual use of the trust income to make such payments is necessary.

5. Substitution of Trust Assets. The ability of the grantor to substitute assets of the IDGT for assets of equal value will cause the IDGT to be treated as a grantor trust if such power is exercisable in a non-fiduciary capacity without the approval or consent of someone in a fiduciary capacity. Section 675(4)(C). The IRS has refused to rule on the question of whether a power can be exercised in a non-fiduciary capacity on the grounds that it is a question of fact. PLRs 9437022, 9524032, 9642039, and 9713017.

6. Power to Spray Principal and Income. If a majority of the trustees of the IDGT are related or subordinate to the trustee and if the trustees have the ability to make discretionary distributions of principal and income, then the IDGT will be treated as a grantor trust. Section 674(c).

7. Power to Add Beneficiaries. If a non-adverse party has the power to add beneficiaries to the IDGT, the IDGT will be treated as grantor trust. Section 674.

C. GIFT OF SEED MONEY

The grantor will gift cash to the trust which will be used by the trustee to purchase assets from the grantor. There is no magic amount which the grantor must transfer to the trust. Most literature addressing this point recommends that the grantor make a gift of cash equal to at least 10% of the total purchase price, which provides for a 90% to 10% debt to equity ratio.

One attack made by the IRS on the sale of assets to an IDGT is that the sale is not commercially reasonable by claiming that the equity is too low. A larger gift from the grantor can lessen the likelihood of challenge by the IRS, although the leveraging of the lifetime gift tax exemption is not as effective with a higher cash gift. It may also help show the sale is commercially reasonable if the beneficiaries of the trust personally guarantee the promissory note (discussed below).

D. SALE OF ASSETS

The grantor will then sell assets to the trustee of the IDGT in exchange for cash as well as a promissory note.

E. PROMISSORY NOTE

The promissory note should be for a term of years and should bear interest at a rate equal to or in excess of the relevant applicable federal rate. The note can be structured to provide for payments of "interest-only" during the term, with a balloon payment of principal at the end of the term of the note. The benefit of structuring the note with a balloon payment is that it maximizes the asset base in the IDGT which will allow for a greater shift of appreciation out of the grantor's estate.

F. RISKS

1. Sale will not be respected

The IRS may attempt to assert that the sale should not be respected because it does not have commercially reasonable terms. The beneficiaries of the IDGT may wish to personally guarantee payments by the IDGT to the grantor in order to increase the likelihood that the sale will be respected.

2. Death of Grantor During Term of Note

Unlike the Grantor Retained Annuity Trust (GRAT), if the grantor dies while the note is outstanding, the assets sold to the IDGT will not be brought back into the grantor's taxable estate under either Sections 2036 or 2039. Rather the value of the note will be includable in the grantor's taxable estate under Section 2033. However, the IRS will likely assert that the death of the grantor turns off the grantor trust status of the IDGT at the moment of death and that the grantor must recognize income to the extent that the fair market value of the note exceeds the taxpayer's income tax basis in the assets sold to the IDGT.

3. Undervaluation of Assets

If hard-to-value assets are sold to the IDGT and the IRS successfully argues that the assets were worth more than the sales price, then the grantor may owe gift tax if the grantor has fully utilized the lifetime gift exemption. One way to mitigate this risk is to use a valuation adjustment clause in the sale documentation that complies with the holding in *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006) or *Wandry v. Commissioner*, T.C. Memo 2012-88.

In *McCord*, the taxpayers, a husband and wife, sold all of their limited partnership interests in a certain limited partnership to a GST exempt trust, their sons, and two charitable organizations. The taxpayers directed that a portion of the limited partnership interests equal in value to their remaining GST exemption amounts pass to the GST exempt trust. Second, a portion of the limited partnership interests worth approximately $6.9 million, reduced by the amount passing to the GST exempt trust, would pass to their sons. Third, a portion of the limited partnership interests worth $134,000 would pass to a charitable organization. Fourth, the limited partnership interests remaining after funding the first three gifts would pass to a second charitable organization.

Subsequent to the transfer, an independent appraisal of the limited partnership interests was obtained. Based on this appraisal, the GST exempt trust, the taxpayers' sons, and the charitable organizations entered into a confirmation agreement, in which they agreed on the exact percentage of limited partnership interests allocated to each of them. Under the transfer document, the limited partnership retained a "call" right with respect to the limited partnership interests transferred to the charitable organizations. Approximately three months after the confirmation agreement was signed, the limited partnership exercised its call right and redeemed the charitable organizations' interests in exchange for cash.

The taxpayers filed a gift tax return reporting this transaction. When the gift tax return was later audited, the IRS argued that the value of the limited partnership interests that actually passed to the GST exempt trust and the taxpayers' sons (collectively, the "noncharitable assignees") was greater than that which was reported on the gift tax return. The IRS's argument was successful in the Tax Court, which found in the IRS's favor. The case was appealed to the 5th Circuit.

The 5th Circuit ultimately held that the fair market value of the limited partnership interests must be determined as of the date of the gift and is not affected by subsequent events. Therefore, the confirmation agreement must be ignored and the IRS could not consider the exact percentage of partnership interests transferred to the noncharitable assignees. Rather, the IRS was bound by the formula clause, which directed that a portion of the limited partnership interests equal in value to approximately $6.9 million pass to the noncharitable assignees. As a result, the taxable portion of the gift would not be greater than $6.9 million.

We recently utilized the *McCord* technique for married clients who were planning to sell a business in which they owned a large amount of stock. They wanted to transfer a portion of this stock in a way that would benefit subsequent generations and one or more charitable organizations. They formed a grantor trust, naming their grandchildren and more remote descendants as beneficiaries and gifted a nominal amount of cash to the trust. The clients then sold a portion of their stock to the trust and a donor-advised fund. The transfer document directed that an amount of the stock with a value equal to a certain dollar amount (assume $1 million for illustration purposes) would pass to the trust. The remaining shares of stock would pass to the donor-advised fund. The trust executed a promissory note promising to pay $1 million to the clients in exchange for the stock. The portion passing to the donor-advised fund was treated as a charitable gift. We filed a gift tax return allocating GST exemption to the cash gift and reporting the above sale to the grantor trust.

The trust and the donor-advised fund subsequently agreed on an allocation of the shares, based on an appraisal that was performed by an appraisal firm. A few months after the above transaction took place, the business was sold to a third party. For several reasons, the appraised value was lower than the ultimate sales price. After repaying the promissory note to our clients, the trust was left with an amount of cash equal to the difference between the ultimate sales price for the shares it owned, less the amount repaid under the note. In the instant case, we expect that the trust will ultimately own assets with a value in the tens of millions of dollars from the sale, and the donor-advised fund will have approximately $1 million in assets. By using this technique, our clients were able to make these transfers free of gift tax and without using any of their GST exemptions.

The recent *Wandry* case recognized a much simpler approach than the formula allocation involving charities like the one in *McCord*. *Wandry* made it clear that the courts will respect adjustment clauses where the grantor of a gift states that if the value of the gifted assets is ever determined to be more than that assumed by the grantor, the amount of assets will be adjusted downward to reflect the differently determined value. Therefore, it is not necessary that a charity be involved for an adjustment clause to be respected.

II. "678 TRUSTS"

Structure. Many clients are seeking a vehicle that combines asset protection, estate tax savings associated with "estate freezes," and the continued ability to benefit from assets they have built up over the years. One such vehicle is the "678 Trust." The 678 Trust is named after the Internal Revenue Code Section upon which it is based.

The 678 Trust is established by the client's parents with a contribution of $5,000. The client is the primary beneficiary. It is structured initially as a "non-grantor" or "complex" trust for income tax purposes. Therefore, the 678 Trust is initially its own taxpayer for income tax purposes. However, the 678 Trust also includes a "Crummey" withdrawal right for the client. If the client refuses to withdraw the initial $5,000 contribution, the 678 Trust becomes a grantor trust *as to the client*. Thus, all income tax effects of the 678 Trust from that point forward become the responsibility of the client.

The income tax characteristics of the 678 Trust result in non-recognition of gain if the client sells assets to the 678 Trust, because he or she is considered to be the taxpayer on both sides of the transaction. Typically, the first use of the 678 Trust by the client is to sell some newly-acquired assets to the 678 Trust for a note. The note will have a face amount of the fair market value of the assets, and it could be guaranteed by the client's business or another trust. Once the 678 Trust has sufficient assets to be credit-worthy on its own, it can simply purchase new assets using its own credit.

It is important when the client transacts with the 678 Trust that the transaction be structured at fair market value, and that no gifts be made to the 678 Trust beyond the $5,000 contributed by the client's parents. Any additional gifts could alter the income tax and estate tax characteristics of the 678 Trust. Unlike the grantor trusts typically used in estate freeze situations, the 678 Trust does not include a power of substitution. However, the Trustee of the 678 Trust has full powers to transact business, buy and sell assets, etc.

Results. The assets of the Trust should be outside of the client's and the client's parents taxable estates for estate tax purposes and they should also be protected from creditors. The client's assets are frozen at the value of the note if he or she has sold assets to the 678 Trust. The Trustee of the 678 Trust has the ability to distribute 678 Trust assets to the client and his/her issue for health, education, maintenance, and support needs, and the client may be given a limited power of appointment over the assets of the 678 Trust to account for changes in family circumstances or the law. Upon the client's death, the 678 Trust will split into separate trusts for his or her children, and those trusts will be considered "complex" trusts for income tax purposes. The client's parents should allocate GST exemption to the 678 Trust, making it free of transfer taxes for generations.

Example:

Step 1: Parents of client ("Mom and Dad") create non-grantor trust (the "Trust") for the benefit of the client ("Son"). Mom and Dad initially fund the Trust with $5,000, and the Trust provides that Son has a Crummey withdrawal right over contributions to the Trust.

Step 2: Son receives notice of withdrawal right and refuses the right to withdraw the $5,000 contribution.

Step 3: Son sells new business opportunity to Trust for $100,000, receiving a nine year note in return. Son's existing business or another trust guarantees the note for a small fee.

Step 4: Mom and Dad file Form 709 Gift Tax Return, reporting a $5,000 gift to Trust and allocating $5,000 of GST exemption, making the Trust fully exempt from GST tax.

Step 5: Son manages and grows new business. If necessary, Son or his children may receive distributions of Trust income or principal.

Step 6: At the end of the nine year term, Son receives outstanding balance of note from Trust.

Step 7: Trust continues to own and operate business, and has sufficient capital to acquire new business opportunities. The Son and his children can benefit from Trust income or principal. The assets are protected from creditors. At Son's death, if Trust assets are worth $5,000,000, then Son has saved approximately $2,000,000 in estate tax.

III. SPOUSAL ACCESS TRUSTS

Spousal access trusts allow spouses to utilize some or all of their gift tax exemption while retaining access to the trust assets. Spouses may either create one spousal access trust or two, as described below:

a. Create One Spousal Access Trust

Husband and Wife enter into a marital property agreement, partitioning some of their community property into Husband's separate property. Husband creates a Trust for the benefit of Wife and transfers $5,120,000 of his separate property to the Trust, utilizing his lifetime gift exemption. The Trust is similar to a "Bypass Trust" normally created at first spouse's death but is created while both spouses are living. Wife has access to the Trust assets during her life, and the assets can stay in trust for the benefit of the children and later generations, free of estate and GST taxes. Husband will be the Grantor of this Trust and thus responsible for paying the Trust's income taxes. If desired,

the Trust may give Wife a "special power of appointment" to direct how assets pass at death.

Key Facts About Spousal Access Trusts:

a) Harvests one of the spouses' $5,250,000 exemptions, but in a way that allows one spouse to continue to benefit.

b) May result in grantor trust status for life, even if the spouses later divorce. (This aspect can be mitigated by giving a special trustee the right to reimburse the grantor for income tax purposes and/or the right to distribute assets outright to the spouse beneficiary in the event of later divorce. However, distributing assets outright will eliminate the benefits of the Trust and waste the exemption that was used to create it.)

c) One example where this technique may apply is if there is a large wealth disparity between the two spouses, and the "monied" spouse makes a gift to a Trust for the non-monied spouse.

b. Create Two "Mutual" Spousal Access Trusts

Each spouse may create a trust for the other so that both spouses utilize their exemptions and each spouse can benefit from the Trust created for his/her benefit. Creating two Trusts may also allow the spouses to be more comfortable parting with their property. However, there is a "catch" when each spouse creates a Trust for the benefit of the other spouse: the Reciprocal Trust Doctrine. The Reciprocal Trust Doctrine is a judicially-created doctrine that applies to situations where Husband creates a trust for the benefit of Wife, and Wife creates a trust for the benefit of Husband. If a court finds that the trusts are reciprocal, Husband will be treated as the trustor of the trust that Wife created for his benefit; and Wife will be treated as the trustor of the trust Husband created for her benefit. This treatment results in the assets in the Spousal Trusts included in their taxable estates.

In order to avoid the Reciprocal Trust Doctrine, the Spousal Trusts should not be interrelated, and they should not leave the trustors in approximately the same economic position as they would have been in had they created the trusts for themselves. Thus, the Spousal Trusts need to be sufficiently different from one another, and there are several ways to accomplish this:

1. Do not execute the Trust Agreements at the same time. The more time that passes between execution of the Trust Agreements, the better. One Trust should be focused on at a time, and each spouse should acknowledge that they understand that the beneficiary spouse of the first Spousal Trust is not required to set up a Spousal Trust for the other spouse.

2. Contribute different assets to the Spousal Trusts. For example, one trust could hold real estate while the other holds investment accounts.

3. Contribute different amounts to the Spousal Trusts. If the Spousal Trusts are still found to be reciprocal, the value that will be included in either spouse's estate cannot exceed the value of the smallest trust.

4. Appoint independent people as Trustee. Corporate Trustees are most preferable, but at the very least, you should consider not having Husband as Trustee of one Spousal Trust and Wife as Trustee of the other Spousal Trust.

5. Use differing powers of appointment. For example, one spouse may be given an inter vivos power of appointment while the other spouse is only given a testamentary power of appointment or no power of appointment at all. Or one spouse may be allowed to appoint trust property to anyone while the other spouse is only allowed to appoint trust property to charities.

6. Use differing distribution standards. For example, one trust may allow the Trustee to make discretionary distributions while the other trust has mandatory distribution provisions. Or one trust may require the Trustee to take into account the beneficiary's other sources of income while the other trust does not. Distribution standards may also be different for different beneficiaries.

7. Grant one spouse withdrawal rights and not the other spouse. The maximum amount a spouse of a grantor can withdraw from the Trust without the Trust assets being includible in the spouse's estate is the lesser of (i) the annual exclusion amount or (ii) the greater of $5,000 or 5% of trust assets. One spouse could be given this withdrawal right while the other spouse has none.

8. Use differing termination provisions. For example, one trust might continue until the legal limit (approximately 90-100 years) while the other trust might terminate at the spousal beneficiary's death, leaving assets to descendants, subject to lifetime trusts for the children of the husband and wife.

IV. CHARITABLE GIFT TECHNIQUES

Charitable gifts can be structured in many ways, from simple to complex. Gifts can be structured so that not only is the donor's charitable contribution deduction maximized, but the benefit the charity receives is also maximized. These techniques are discussed in more detail below.

A. OUTRIGHT CHARITABLE CONTRIBUTIONS MADE DURING LIFE

An individual can make a contribution of property (and cash) outright to a charity and receive a charitable contribution deduction on his or her income 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. Gifts of Cash. 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 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, including a mineral interest, 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, including mineral interests, 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 and 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 that is 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 decreases in value after the initial gift.)

This rule also applies for estate and gift tax purposes and 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 allowed would be 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 $5.12 million in 2012, or $1 million in assets in 2013), this would effectively reduce any federal estate taxes owed at the donor's death, which would be assessed at a 55% estate tax bracket (in 2013).

D. USING AN IRA TO FUND CHARITABLE BEQUESTS

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.

> Example: 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 $55,000 ($100,000 x 55% estate tax rate). Therefore, only a net amount of $45,000 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 $10,000 net of taxes from the $100,000 IRA ($100,000, less $55,000 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.

E. CHARITABLE GIFT ANNUITY

A charitable gift annuity allows the donor to receive a fixed income for life while avoiding market risks, possibly increasing the donor's rate of return at the same time. 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. This technique is more attractive in higher interest rate periods.

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 4.6% rate suggested by the American Council on Gift Annuities) to pay Bob and Jane $4,600 per year for the remainder of their lives.

Bob and Jane would receive an immediate tax deduction of about $25,479, resulting in tax savings of approximately $8,900. If Bob and Jane used unappreciated assets such as cash to purchase the annuity, a portion (about $3,635) 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 circumstances, they might consider a charitable gift annuity through a Community Foundation. The Community Foundation would allow for flexibility 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.

F. CHARITABLE LEAD TRUSTS

A charitable lead trust ("CLT") can bue used to make a gift of current income to charity, with the income-producing assets ultimately passing to the donor's heirs, resulting in reduced estate and gift taxes. A 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's 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 $682,645 (assuming that the CLT is structured as a grantor trust). The value of the remainder interest ($317,355) will be characterized as a gift to their children. Each spouse will use up $158,677 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 when the maximum estate tax rate is 55%:

	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	(998,010)	(174,545)*
Amount Passing to Children	$816,553	$1,640,018
Amount Passing to Charity	$750,000	$750,000

* Represents additional tax due at death from the lifetime use of $317,355 gift tax exemption.
Note: This illustration does not take into account the additional income tax benefits of charitable giving.

G. 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.

CRTs can be structured as "annuity trusts" or "unitrusts." In an annuity trust, the donor (and the donor's family members, if applicable) receives a yearly annuity during the term of the trust. In a unitrust, the donor (and the donor's family members, if applicable) receives an annual

payment equal to some percentage of the value of the trust's assets. An annuity trust operates much like the charitable gift annuity discussed in Section E, above. A unitrust serves to potentially increase the donor's current income, creating a hedge for the donor against inflation over the long term, and providing an income tax charitable contribution deduction to the donor.

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 twenty-year term 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 5% annually in an annuity to Husband and Wife. Husband and Wife would receive a payment of $150,000 per year. In addition, in the first year, they would receive a charitable contribution deduction of $449,910 (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 $7,118,577.

Note: As explained in Section H below, 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.

<u>Summary</u>:

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 $449,910 upon the transfer.

3. Husband and Wife receive income from the CRT of $150,000 per year, totaling approximately $3 million during their lives (assuming a survival period of twenty years).

4. When Husband and Wife both die, the CRT assets of approximately $7,118,577 pass to the charity of their choice (assuming a constant 8% growth rate and a survival period of twenty years).

H. 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 IX 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 the 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.

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