21st ANNUAL ESTATE AND CHARITABLE PLANNING INSTITUTE

ETHICAL CONSIDERATIONS

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I. Circular 230

In September 2012, the Treasury proposed significant modification to Circular 230 with the intention of simplifying the complex rules governing covered opinions in Prop. Treas. Reg. § 10.35. In December 2004, the Treasury and the IRS issued final regulations regarding covered opinions and other written tax advice. Since that time, public awareness of the standards for written tax advice has increased but the Treasury determined that the covered opinion rules have produced some unintended consequences and should be reconsidered.

Treasury received significant comments from practitioners indicating dissatisfaction with the difficulty and cost of compliance with the rules. Practitioners overwhelmingly concluded that the rules were overbroad, difficult to apply, and did not necessarily produce higher-quality tax advice. Treasury stated in its explanation that "many practitioners have stated that the rules unduly interfere with their client relationships and are not an ethical standard that everyone, including clients, can comprehend easily." Some suggested that the rules increase the likelihood that practitioners will avoid written tax advice and will provide oral advice to their clients instead in an attempt to avoid Section 10.35.

Additionally, practitioners were concerned that the strict rules regarding written tax opinions had resulted in wide use of disclaimer language on nearly every client communication, even those that did not contain tax advice. The use of disclaimers led some practitioners to believe erroneously they could disregard the standards in Section 10.35 and led to confusion because clients did not always understand the consequences of the disclaimer.

The proposed regulations remove Section 10.35 and apply one standard for all written tax advice under new proposed Prop. Treas. Reg. § 10.37. Section 10.37 provides that the practitioner must "base all written advice on reasonable factual and legal assumptions, exercise reasonable reliance, and consider all relevant facts that the practitioner knows or should know." The proposed rule and the removal of Section 10.35 eliminates the requirement that practitioners fully describe in writing all the relevant facts and the application of the law to the facts and eliminates the need for the Circular 230 disclaimer in documents and transmissions including emails.

Section 10.37 requires that a practitioner use reasonable efforts to identify and ascertain the facts relevant to the tax advice given. No change has been made to the current requirements in Section 10.37 that a practitioner "must not, in evaluating a Federal tax matter, take into account the possibility that a tax return will not be audited or that an issue will not be raised on audit." The new Section 10.37 does eliminate the provision in the current regulations that prohibits a practitioner from "taking into account the possibility that an issue will be resolved through settlement if raised." Treasury recognized the need of a practitioner to provide comprehensive written advice to a client including the existence or nonexistence of legitimate hazards that may make settlement more or less likely.

The disclosure provisions in the current covered opinion rules have been removed and accordingly would eliminate the use of a Circular 230 disclaimer in emails and other writings.

II. Attorney Disbarred for Conflicts of Interest

In a *per curiam* opinion, the Supreme Court of Florida in the *Fla. Bar v. Doherty*, 94 So. 3d 443 (Fla. 2012), disbarred an attorney for ethical violations that occurred when the attorney provided both legal and financial investment services to a client. Doherty was admitted to practice law in Massachusetts and New Hampshire in 1978 and was admitted to the Florida Bar in 1987. In addition to his law practice, Doherty worked as a financial advisor providing financial planning and investment services to clients.

In 1994, Doherty began a professional relationship with the client and her husband, first to provide financial services and eventually, in 2004, to provide legal services. The client's husband died in 2006 and later that year the client was diagnosed with cancer, at which time she asked Doherty to help her make a number of changes to her investments and her estate planning documents.

At the time her husband died, the client owned six annuity products. In an effort to simplify her investments, she asked Doherty to reduce the number of annuities from six to three. Doherty submitted applications to purchase three new annuities from Conseco Insurance Company but later withdrew those applications and submitted new applications to purchase three annuities from Washington National Insurance Company. Doherty would have earned a 10% commission on the Conseco annuities and a 7% commission on the Washington National Insurance annuities.

At the time these transactions took place, Doherty owed Conseco $86,370.54 due to "charge-backs" which were recaptured commissions on contracts sold to prior clients who had died during the early years of an annuity. Doherty had entered into a settlement agreement with Conseco by which he paid Conseco $10,000 toward the debt and agreed to pay 50% of any commissions he earned. Whether he sold a Conseco product or a Washington National product, Doherty owed 50% of his commissions to Conseco. The Conseco annuities would have been subject to a charge-back if the client had died within one year of the sale; the Washington National annuities were not subject to a charge-back provision.

Ultimately, the client died before any annuity sale could be completed. In addition to working with the client on her investments, Doherty worked to revise the estate planning documents. In the new documents, the client named Doherty as her personal representative and successor trustee. Doherty drafted two new trust agreements for the client's estate. The first, a real estate trust, held the client's condominium and directed that after her death the condominium unit be sold and the proceeds used to purchase annuities. The second trust was an educational trust for the client's grandchildren. After the client's death, the beneficiaries of her estate challenged Doherty's appointments as personal representative and successor trustee, and he was removed from these positions.

The referee found that Doherty assumed "multiple, concurrent yet discrete, professional roles" on behalf of the client acting as estate planner, trustee, successor trustee, financial product salesperson, personal representative, and attorney. The referee found that Doherty did not provide the client with any written document that advised her of his multiple and conflicting positions, and accordingly, the referee recommended that Doherty be found in violation of two ethical rules.

The first requires that a lawyer must not represent a client if there is a substantial risk that the representation of the client will be materially limited by the lawyer's responsibilities to another client, a former client, or a third person, or the lawyer's personal interest. The second is that a lawyer must not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security, or other pecuniary interest adverse to a client, without informed written consent.

The referee found four factors that aggravated the lawyer's breach of duty: (1) a prior disciplinary history including a two-year suspension in New Hampshire; (2) a selfish motive; (3) a refusal to acknowledge the wrongful nature of his misconduct; and (4) substantial experience in the practice of law. The referee did not find any mitigating factors, and recommended disbarment.

Doherty appealed the referee's report and recommendations to the Florida Supreme Court arguing that his sale of annuities to the client was not a "business transaction" as contemplated by the rules. The Supreme Court disagreed, adopting a plain reading of the language. The Supreme Court held that a lawyer's involvement in any business transaction with a client constitutes a violation of the rule unless the lawyer makes the required disclosures and obtains the client's informed consent. Doherty attempted to argue that he was merely brokering the annuity purchase and that the business relationship actually was between Washington Mutual or Conseco and the client. The Supreme Court held that whether acting as broker or actual salesperson, the lawyer had entered into a business transaction with the client without the necessary disclosures.

The Court also determined that where Doherty held himself out as both a lawyer and a certified financial planner and stood to earn a commission from the sale of annuities and a fee from the legal work, he was required to disclose his financial interest in the transactions to the client in writing and obtain her informed consent.

Doherty argued that disbarment was too harsh a penalty for the conflict of interest. The Supreme Court concluded that Doherty engaged in egregious misconduct in that he advised his client to take specific actions that would earn him a financial benefit and failed to disclose his personal interest to the client. Moreover, the Court agreed with the referee that four aggravating factors existed including a prior disciplinary history of similar behavior. The Supreme Court upheld the referee's determination of disbarment.

III. Third Party Suit Against Attorney Denied

In *Gallagher v. Keybank Nat'l Ass'n*, No. 09-CV-00474, 2011 U.S. Dist. LEXIS 107361 (N.D.N.Y. Sept. 22, 2011), the U.S. District Court for the Northern District of

New York addressed the question of whether a beneficiary of a charitable trust could bring suit against an attorney for negligence in drafting a charitable remainder trust. Plaintiff Gallagher was a beneficiary of a charitable remainder trust of which Keybank was the trustee. The trust was funded in either May or June of 2002 with shares of stock of Wyeth. Sometime after the trust was funded, Keybank determined that the trust did not qualify as a proper charitable remainder annuity trust under the tax code and advised the beneficiaries and the attorney who then drafted an amendment to the trust agreement which was signed on July 5, 2002.

Between the funding of the trust and the effective date of the amendment, the value of the Wyeth stock declined substantially. Plaintiff sued Keybank arguing that it had failed to property diversify the trust assets resulting in the loss of value of the trust assets. Keybank filed a third-party complaint against the attorney claiming that the attorney's failure to properly draft the trust as a qualifying charitable remainder annuity trust prevented Keybank from selling the Wyeth stock in a timely manner.

The attorney brought a motion to dismiss the third-party complaint. The Court determined that Keybank failed to allege facts sufficient to support a negligence cause of action against the attorney and dismissed the claim because "the general rule in New York is that liability for attorney malpractice extends only to parties in privity with the defendant attorney." Because neither the trust beneficiary nor the trustee had an attorney-client relationship with the drafting attorney, the cause of action could not stand.

Likewise, the Court denied Keybank's claims for indemnification and contribution against the attorney.

IV. Representing Fiduciaries

Kennedy Lee recently published an excellent article in the ACTEC L.J., Vol. 37, No. 3, entitled *Representing the Fiduciary: To Whom Does the Attorney Owe Duties?* The author analyzed the question of to whom an attorney owes a duty when representing a fiduciary. Most jurisdictions have adopted one of three approaches:

1. the traditional theory under which an attorney represents only the fiduciary and has no duties to a beneficiary;

2. the joint-client theory under which the attorney represents the fiduciary but also owes duties of loyalty and care to the beneficiary; and

3. the entity theory under which the attorney represents the entity such as the estate or the trust and does not represent directly the fiduciary or the beneficiary.

One of the most fundamental questions is how to handle the potential for conflicts of interest between the fiduciary and beneficiary under these various theories. Additionally, the duty to maintain confidentiality of information may conflict with the duty of disclosure under one or more of these theories.

A. MRPC 1.6

The Model Rule of Professional Conduct (MRPC) 1.6 states that:

> (a) a lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized to carry out the representation.

If a lawyer is deemed under one of the theories to have joint duties to the fiduciary and the beneficiaries, Rule 1.6 may leave the attorney in the untenable position of being required to both disclose information to a client and also be required to keep a client confidence. Rule 1.2 regarding the scope of representation allows the attorney and the fiduciary to agree in an engagement letter that the lawyer may disclose to beneficiaries certain information. If the lawyer also owes a duty under the law of the jurisdiction to the beneficiaries, those duties may limit the lawyer's duty of confidentiality as it relates to the fiduciary.

B. MRPC 1.7

MRPC 1.7 provides "a lawyer shall not represent a client if the representation of that client will be directly adverse to another client" and further provides that "when representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved."

In jurisdictions in which an attorney is deemed to owe duties both to the beneficiary and fiduciary, the lawyer must consider what possible conflicts may arise and how best to address them. Some conflicts of interest may be addressed in an engagement letter with the fiduciary and a separate letter to the beneficiaries outlining the scope of the lawyer's duties. Certainly, when direct conflicts between the fiduciary and the beneficiaries do arise, the attorney must advise the beneficiary to seek separate counsel. Transactions between the fiduciary and the beneficiary may present a clear case of conflicts of interest. Other conflicts may be more difficult to spot. For example, if a fiduciary requests the advice of an attorney as to the interpretation of a particular provision of a trust agreement, the fiduciary's decision may benefit some beneficiaries to the detriment of others. This may place an attorney in a position of conflict under MRPC 1.7.

C. MRPC 1.13

In jurisdictions under which the entity theory prevails, MRPC 1.13 may provide some guidance. The Rule states that "a lawyer employed or retained by an organization represents the organization acting through its duly-authorized constituents." Accordingly, the lawyer representing a trust or an estate represents the entity through its duly-authorized fiduciary. The lawyer is directed to act always in the best interest of the organization. In these circumstances, best practice would be to specify in the engagement agreement that the estate or trust, and not the fiduciary, is the client. Such an

engagement letter, however, is unlikely to have any limiting effect on any duties the fiduciary or attorney otherwise owe the beneficiaries of the estate or trust, unless the beneficiary also signs the agreement.

V. Client Due Diligence, Money Laundering, and Terrorist Financing

On May 23, 2013, the American Bar Association issued its formal opinion #463 indicating its position that the ABA Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing ("Good Practices Guidance") are consistent with the Model Rules of Professional Conduct including the duties of loyalty and confidentiality. The Financial Action Task Force on Money Laundering was created by the United States and other leading nations and issued guidelines for lawyers and others to assess money-laundering and terrorist financing risks. Some organizations and government agencies have suggested that lawyers should act as "gatekeepers" to the financial system because they are uniquely situated to monitor and control, or at least influence, their clients to deter wrongdoing.

The ABA has stated that the Model Rules do not mandate that a lawyer perform a gatekeeper role in this context and that Rules 1.6 and 1.18 would prohibit mandatory reporting of a suspicious client. Further, Rule 1.4(a)(5) would not allow an attorney to report a client without first informing the client.

The ABA's Good Practices Guidance was issued in support of the U.S. Government's efforts to combat money laundering and terrorist financing. The Good Practices Guidance are not to be construed as a statement of the standard of care governing lawyers, but rather, implement a risk-based approach and serve as a resource that lawyers can use in developing their own voluntary practice.

The Voluntary Good Practices Guidance recommends that a lawyer undertake Client Due Diligence "in appropriate circumstances to avoid facilitating illegal activity or being drawn unwittingly into a criminal activity." Under the Rules of Conduct, a lawyer must be satisfied that he can perform the requested services without abetting fraudulent or criminal conduct and without relying on past criminal conduct or fraud.

The ABA formal Opinion and Voluntary Good Practices Guidance outline numerous trouble areas that should alert the attorney to inquire further before undertaking representation. For example, the following pose additional risk that should give rise to further inquiry:

> 1. "Politically Exposed Persons" including senior government, judicial, or military officials, may justify enhanced due diligence because of the potential for corruption.
>
> 2. Clients or legal matters associated with countries that are subject to sanctions or embargos by the United Nations or are otherwise identified as having significant levels of corruption or other criminal activity.

3. Clients who ask the lawyer to handle actual receipt and transmission of funds.

4. Clients who request accelerated real estate transfers for no apparent reason.

5. Cash intensive businesses such as money services businesses, currency exchange houses, casinos and betting establishments.

6. Clients who have no address or multiple addresses without legitimate reasons, or in some cases, clients who operate seemingly unrelated and different businesses at the same address.

A lawyer may terminate representation once it has commenced if the lawyer has reason to believe that the client is engaging in, or plans to engage in, improper activities. Rule 1.16(b)(2).

The Voluntary Good Practices Guidance outlines three steps required to be taken in basic client due diligence:

1. Identify and appropriately verify the identity of each client on a timely basis.

2. Identify the beneficial owner and take reasonable measures to verify the identity of the beneficial owner of the client such that the lawyer is reasonably satisfied that the lawyer knows who the beneficial owner is. The lawyer is charged with determining who is the real party in interest where appropriate.

3. Obtain information to understand the client's circumstances and business depending on the nature, scope and timing of the services to be provided.

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The Changing Climate of Estate and Charitable Planning
What's Hot and What's Not

Ethical Issues in Gift Planning

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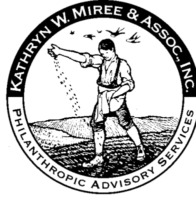

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**The Changing Climate of Estate and Charitable Planning:
What's Hot and What's Not**

Ethical Issues in Charitable Gift Planning

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I. The Current Platform for Ethics

A. What Is Ethics?

Ethics is critical to the professional practices comprising the gift planning field. Clients must trust advisors to act in the client's - not the adviser's - best interests in designing gifts and creating estate plans with wills, trusts, charitable entities, and beneficiary designations. As Michael Josephson, the founder of the Josephson Institute of Ethics, states: "Our future depends on ethics. Its challenges require a society of individuals wise enough and strong enough to do what is right."

B. Malfeasance and Misfeasance

The definition of ethics varies widely, depending upon whom you ask. Consider these definitions available through online dictionaries:

Ethics (Dictionary.com)[1]

1. A system of moral principles.
2. The rules of conduct recognized in respect to a particular class of human actions or a particular group, culture, etc.
3. Moral principles, as of an individual.
4. That branch of philosophy dealing with values relating to human conduct, with respect to the rightness and wrongness of certain actions and to the goodness and badness of the motives and ends of such actions.

Ethics (Miriam Webster)[2]

1. The discipline dealing with what is good and bad and with moral duty and obligation.
2. A set of moral principles: a theory or system of moral values.
3. The principles of conduct governing an individual or a group.
4. A guiding philosophy.
5. A consciousness of moral importance.

Ethics (Oxford Dictionaries)[3]

1. Moral principles that govern a person's or group's behavior.
2. The moral correctness of specified conduct.
3. The branch of knowledge that deals with moral principles.

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[1] www.dictionary.reference.com.

[2] www.miriam-webster.com.

[3] oxforddictionaries.com.

A further difficulty is that each profession describes ethical conduct differently, and state laws may impose varying standards. At the heart of all standards is the requirement that the interests of the client supercede the interests of the advisor, and that all facts and parties to the transaction be disclosed.

Most of us, fortunately, have few instances in which we find ourselves confronting ethical dilemmas. Or, perhaps, we do not see the ethical issues before us. Does this create misfeasance - a failure to recognize the ethical issue and act on it resulting in a disservice to our client - or malfeasance - an intentional failure to redress the issue? The purpose of this session is to raise awareness of some of the most common ethical issues in gift planning. Since gift planners work as a team and often involve multiple professional advisors and charitable gift planners, this look at the ethics in gift planning looks beyond legal ethics to include issues for accountants, trust officers, financial planners, insurance professionals, and even investment managers.

C. Sarbanes Oxley and The Push for Transparency and Accountability in the Nonprofit Sector

Every element of the nonprofit sector is under Congressional scrutiy. Headlines across the country in the late 1990's and early 2000 detailed corporate scandals involving fraud and mismanagement.[4] These stories prompted Congress to legislate accountability (The American Competitiveness and Corporate Accountability Act of 2002, also known as the Sarbanes-Oxley Act[5]) and increased scrutiny of the charitable sector. The Sarbanes-Oxley Act requires corporate boards to: maintain an independent and competent audit committee; hire an independent auditing firm not compensated by the corporation for other types of services (delineated in the statute); rotate the reviewing partner of the auditing firm at least every five years; have the CEO and CFO certify the company's statements (with criminal penalties for intentional false certification); prohibit loans to corporate directors and executives; and disclose internal control processes, corrections to past financial statements, off-balance sheet transactions, and material changes in operations or financial condition. While these provisions were directed at for-profit corporations, these standards may eventually be imposed on the nonprofit community, especially if stories of misuse of charitable funds continue.[6]

Similar news hit the nonprofit sector. Stories of misfeasance and malfeasance made headlines in the *Washington Post*, the *Wall Street Journal* and many more beginning with the William Aramony/United Way news, the New Era Foundation, and more recently, The Nature Conservancy insider dealing and non-cash gift valuation issues. These ongoing issues prompted a series of Congressional hearings, legislative reforms, and dramatic proposed regulations and legislation affecting donors and the nonprofit sector.

Congress has heard too many stories of egregious behavior on the part of donors and their advisors and has conducted hearings since 2004 to legislate the behavior of all parties to the gift transaction. The watchwords are "transparency and accountability." Transparency means that all details of the transaction should be revealed so that a third party can identify related parties and those who benefit. Accountability usually means fines or punishment for behavior that violates the rules. The cry for

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[4] Corporations creating headlines prompting Congressional action included (among others) WorldCom, Enron, and Global Crossing.

[5] Public Law No. 107-204 (July 30, 2002).

[6] An excellent article on the Sarbanes-Oxley Act and the implications or lessons for nonprofit management can be found at <www.guidestar.org/news/newsletter/sarbanes_oxley.jsp>.

transparency and accountability is generally directed at the charities, their officers, and their boards but has been extended to focus on individuals who run charities and have personal business interests that profit from that influence as a charity's officer or director.

For the attorneys who violate ethical standards the price can be high - the attorney can be disbarred for the failure to abide by the Ethical Standards of Conduct of the state bar association. For trust officers, they can lose their job and be banned from banking. Other professionals may also lose their license of professional designation.

II. The Many Professions (and the Ethical Codes of Conduct) Engaged in Charitable Gift Planning

A. An Overview

Rules of professional conduct, including ethical standards, are designed to cover all aspects of a member's practice and therefore address issues broader than the gift planning process. This chapter focuses on the ethical standards that affect charitable planning, specifically the receipt of commissions or fees, disclosure of fees, and relationships to the donor, professional education, and other factors impacting gift transactions. While standards of conduct and competence are similar from organization to organization, the policies on fees and commissions vary widely.[7]

B. The Attorney - The American Bar Association

The American Bar Association (ABA) publishes the American Bar Association Model Rules of Professional Conduct and Model Code of Professional Responsibility.[8] The rules are promulgated to provide standards for states as they consider and implement codes of conduct for their members. The ABA also issues rulings and creates task forces periodically to address emerging issues (such as multi-disciplinary practice groups[9] or the impact of the Internet on marketing and practice). Many states have adopted these rules and comments wholesale; others have adopted an edited version.

Attorneys are licensed to practice law by the state in which they practice. States test potential attorneys for competency, require ongoing education to remain in active practice, and oversee attorney conduct through disciplinary proceedings. Many states also require that attorneys receive training in ethics, mandating that a portion of the attorney's continuing legal education (CLE) requirement for the year comprise ethics courses. Many of the canons of ethics have applicability to the gift planning process.

C. The Accountant - The American Institute of Certified Public Accountants

The American Institute of Certified Public Accountants (AICPA) represents more than 330,000 members. Its ethical standards are incorporated into the American Institute of Certified Public Accountant's (AICPA) Code of Professional Conduct, including provisions on professional ethics,

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[7] These vary with the manner in which the professional is compensated for services.

[8] American Bar Association, Service Center, 541 North Fairbanks Court, Chicago, Illinois, 60611, 312-988-5522.

[9] http://www.abanet.org/cpr/mdpfinalrep2000.html

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independence, integrity and objectivity, responsibilities to clients, and responsibilities in tax practice.[10] The Code of Professional Conduct is divided into two sections: Principles, which provide a framework or context for the rules; and Rules, which address the manner in which professional services are delivered. The AICPA also issues "Interpretations of Rules of Conduct" and "Ethics Rulings" which are formal opinions on practice issues.
The heart of the ethical standards of the AICPA is set out in the Preamble, which places honorable behavior over personal benefit.[11]

> "These Principles of the Code of Professional Conduct of the American Institute of Certified Public Accountants express the profession's recognition of its responsibilities to the public, to clients, and to colleagues. They guide members in the performance of their professional responsibilities and express the basic tenets of ethical and professional conduct. The Principles call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage."

D. The Life Insurance Agent - Regulation of the Insurance Agent

The state insurance commissioner regulates insurance agents selling policies to residents of the state. The insurance commissioner's goal is to protect consumers through regulation of companies operating in the state and licensure of agents representing those companies. Therefore, an agent is required to register with each state in which she practices. Each state has its own set of registration requirements and standards. However, the state commissioners meet frequently and many subscribe to the Model Standards published by the National Association of Insurance Commissioners (NAIC).[12]

Many insurance agents seek certification as Chartered Life Underwriters (CLU) and/or Chartered Financial Consultants (ChFC). These designations, awarded by The American College in Bryn Mawr, Pennsylvania, signal that the agent has passed, a ten-course curriculum including insurance basics, estate planning, business succession planning, and financial planning. As a part of this accreditation process, the American College requires certified members to abide by a set of ethical standards. Violation of these rules puts membership or accreditation in jeopardy.

The standards of professional conduct for CLUs and ChFCs) have been established in the eight canons of behavior. These canons require the agent to conduct himself with dignity, avoid practices that bring dishonor on the profession, continue educational activities to maintain professional competence, assist others in the profession, and comply with all laws and regulations. These canons also emphasize maintaining integrity and building the image of the profession. Those certified by the American College are required to comply with all laws and regulations, including the IRS Code and Treasury Regulations. Of course, these standards are in addition to the standards required by the State Insurance Commissioner that licenses the agent. Many of the state and American College certification standards overlap.

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[10] http://aicpa.org/about/code/comp.htm.

[11] AICPA Code of Professional Conduct 51.02.

[12] More information on the National Association of Insurance Commissioners, including model language, is found at<www.naic.org/ consumer>.

E. Trust Officers

Trust officers serve as fiduciaries and officers of financial institutions and are not licensed by the state or federal government unless that officer also sells securities or engages in other forms of regulated conduct. However, trust officers are regulated by state bank examiners (if the bank is chartered by the state) or the federal Comptroller of the Currency (if the bank is a national financial institution).[13] These officers must also comply with state fiduciary and securities laws. Violation of these strict banking, fiduciary, or securities regulations may result in fines or criminal conviction.

Some trust officers receive accreditation as Certified Trust and Financial Advisors (CTFAs) through the Institute of Certified Bankers, a division of the American Bankers Association. This certification reflects a high level of experience, competency, and education concerning complex trust topics such as tax law, fiduciary responsibilities, personal finance, and investments. The Institute of Certified Bankers introduced the designation to encourage professionalism in the field, but does not promulgate separate ethical standards for its membership.

F. Financial Planners

The term "financial planner" is broad and includes any individual offering financial planning services to the public. The profession is not regulated under state or federal legislation and is less structured as a group than the life insurance, legal, or accounting professions. In the past, financial planners were organized under three primary organizations. These groups included the Institute of Certified Financial Planners (ICFP), the International Association for Financial Planning (IAFP), and the National Association of Personal Financial Advisors (NAPFA). On January 1, 2000, the ICFP and the IAFP groups merged to become The Financial Planning Association (FPA). NAPFA still exists as a separate organization.

Many planners have the designation "Certified Financial Planner" awarded by the Certified Financial Planner Board of Standards, Inc.[14] This organization places great emphasis on ethical standards and updated those standards in 2007. The Code of Ethics and Professional Responsibility has Seven Principals: Integrity, objectivity, competence, fairness, confidentiality, professionalism, and diligence.

Members of NAPFA, a group representing the fee-only group of planners, adhere to similar standards incorporated into the member's fiduciary oath. This oath provides:

NAPFA Code of Ethics

Objectivity: NAPFA members strive to be as unbiased as possible in providing advice to clients and NAPFA members practice on a fee-only basis.

[13] Although trust companies are often part of a bank, there are many independent trust companies. These independent companies are granted a charter through the same process required for a bank. Banks, and trust companies, elect to obtain a state or national charter. The state or federal body issuing the charter governs the conduct of the employees of the bank or trust company.

[14] Certified Financial Planner Board of Standards, Inc., www.cfp.net.

Confidentiality: NAPFA members shall keep all client data private unless authorization is received from the client to share it. NAPFA members shall treat all documents with care and take care when disposing of them. Relations with clients shall be kept private.

Competence: NAPFA members shall strive to maintain a high level of knowledge and ability. Members shall attain continuing education at least at the minimum level required by NAPFA. Members shall not provide advice in areas where they are not capable.

Fairness & Suitability: Dealings and recommendation with clients will always be in the client's best interests. NAPFA members put their clients first.

Integrity & Honesty: NAPFA members will endeavor to always take the high road and to be ever mindful of the potential for misunderstanding that can accrue in normal human interactions. NAPFA members will be diligent to keep actions and reactions so far above board that a thinking client, or other professional, would not doubt intentions. In all actions, NAPFA members should be mindful that in addition to serving our clients, we are about the business of building a profession and our actions should reflect this.

Regulatory Compliance: NAPFA members will strive to maintain conformity with legal regulations.

Full Disclosure: NAPFA members shall fully describe method of compensation and potential conflicts of interest to clients and also specify the total cost of investments.

Professionalism: NAPFA members shall conduct themselves in a way that would be a credit to NAPFA at all times. NAPFA membership involves integrity, honest treatment of clients, and treating people with respect.

NAPFA members distinguish themselves from other planners on the basis of the fees they charge for services; they do not accept commissions or referral fees for sales of products. Their standards of professional conduct, similar to other planners and professionals involved in gift planning, stress the importance of impartiality, the independence of the advisor, and full disclosure. Unfortunately, many financial planners are not members of either the FPA or the NAPFA and thus are not guided by any enforceable code of conduct.

III. The Non-Enforceable Codes of Ethics

In addition to the enforceable codes of ethics governing the various professions, there are also codes of ethics adopted by those who are members of segments of the gift planning population.

A. The Partnership for Philanthropic Planning

1. Membership

The Partnership for Philanthropic Planning (formerly the National Committee on Planned Giving) is a membership organization including for-profit and not-for-profit gift planners. According to the most recent membership survey conducted in 2007, approximately 85.3% percent of its members are development officers and nonprofit executives, 9.7% are professional advisors advising individual donors, and 5% were professional advisors advising nonprofit organizations.[15]

[15] http://www.pppnet.org/resource/gift-planner.html.

2. The Model Standards of Conduct for the Charitable Gift Planner

One of the first tasks undertaken by the National Committee on Planned Giving upon its creation was the formulation in 1991 of the Model Standards of Practice for the Charitable Gift Planner. The Model Standards were designed to address the occasional, but growing, number of abuses in the area of gift planning. These abuses consist primarily of the "selling" of charitable gifts to institutions in return for a cut or commission from the gift, the encouragement of the use of charitable gift techniques to "make money" without regard to charitable intent, and the encouragement of the violation of the law in completing a gift.

The issues of charitable intent and abuse have been hotly debated. However, the overwhelming majority of the gift planning industry joined together to agree on the following points that are a part of the model standards:

- Charitable intent should be the primary motivation for a charitable gift.
- The tax incentives for the gift, and all relationships of the parties involved in planning the gift, must be fully disclosed to the donor.
- Gift planners should be paid a salary, not a commission. Gift planners should not accept finder's fees or other fees designed to encourage bounty for gifts. The gift planner should not stand to profit personally from the execution of a gift.
- The gift planner should continually work to maintain a high level of knowledge of the field and should only provide advice or counsel in those areas in which he is qualified.
- Gift planners should always encourage the donor to get independent counsel from the donor's personal advisors.
- For-profit gift planners (attorneys, accountants, etc.) should encourage the donor to work with the charity to discuss the terms and type of gift to ensure that the gift will meet the needs of the charity. It is recognized that in some cases the donor will require anonymity. However, contact with the charity is encouraged even though the name of the donor is not revealed.
- The gift planner shall do everything possible to make sure the donor receives a full explanation of the gift.
- The gift planner shall encourage compliance with all laws and regulations in making the gift.
- Gift planners shall act with fairness, honesty, integrity and openness.

B. The Charitable Trade Groups

1. The Groups Representing Charities

The Association of Fund Raising Professionals represents the charitable industry as a whole. There are also numerous trade organizations representing charitable sectors, such as the Association for Healthcare Philanthropy (AHP), which represents development professionals in hospitals, and the Council for Advancement and Support of Education (CASE). There are groups representing religious organizations, such as the national Catholic Development Conference. Furthermore, there are specialty organizations, such as the American Association of Fundraising Counsel, a group that represents consultants to charities. These are membership organizations, although membership is generally dependent upon years of experience in the field and payment of a fee.

2. The Donor Bill of Rights

The Donor Bill of Rights was developed in 1993 by a group consisting of many of these trade organizations. Sponsors included the American Association of Fundraising Counsel (AAFRC), Association for Healthcare Philanthropy (AHP), Council for Advancement and Support of Education (CASE), and Association of Fundraising Professionals (AFP). The Donor Bill of Rights was then endorsed by Independent Sector, National Catholic Development Conference (NCDC), National Committee on Planned Giving (NCPG), National Council for Resource Development (NCRD), and United Way of America. The guidelines focus on the rights of the donor and the need for full disclosure to the donor when planning a gift.

The Donor Bill of Rights stresses the importance of informing the donor about the use of the gift, the organization's financial strength, and confidentiality, i.e., that the details of the relationship will be maintained confidentially. In addition, it prompts fundraisers to acknowledge gifts promptly, to recognize donors, and to respond promptly to donor questions. These standards deal primarily with donor relations and stewardship and do not specifically address conduct of related professionals in fundraising or fees and commissions. However, it does encourage full disclosure and the highest level of accountability to donors.

IV. The Key Issues

A. Raising the Issue of Charitable Giving to the Client

One of the most difficult aspects of charitable gift planning is determining how and when to introduce the idea of a charitable gift. Professionals who do not regularly engage in charitable gift planning often feel there is an inherent conflict in suggesting a charitable alternative when the client has not articulated that goal. Indeed, most professionals feel that her primary obligation in planning is to maximize the benefit to the client's family. Many professionals find it uncomfortable to suggest that the client divert dollars from family to charity.

How do you talk to potential donors about a charitable gift, and when is it appropriate? How does the conversation about the gift with the client fit within the ethical standards for the profession and for the industry as a whole? These are difficult questions for professionals committed to the highest standard of service. The quick response is that discussions about charitable giving are always appropriate when it is part of the general exploration of estate planning objectives; it is rarely appropriate when the professional promotes a charity of personal interest.

As discussed in the earlier session, consider the following questions:

- *Do you have charitable organizations that you currently support on an annual basis?*
- *Do you want to include a gift to any of these organizations or other charitable organizations as a part of your estate plan?*
- *If there were a way to make a gift to charity largely out of federal estate tax dollars, would you be interested in exploring options to accomplish that goal?*

If you want to explore the client's charitable planning goals and objectives in more detail, ask these questions.[16]

- *What are your values? What have been the principles that have guided how you have lived your lives, raised your family run your business?*
- *What charitable interests have you pursued as an outgrowth of your values?*
- *What have you learned from your giving? What would you do differently? Would you feel confident expanding your giving?*
- *What has been the most satisfying charitable gift that you have made? Why?*
- *How do you view your wealth in connection to your community, to society?*
- *What role has philanthropy played in your family? What role should philanthropy play? What value would it bring to your children and grandchildren?*
- *What core values would you like to express through your giving? What do you want to stand for?*
- *When they think about the challenges facing your community, what are your major concerns?*
- *Are any of these or should any of these concerns be the focus of your giving?*
- *What would you like to accomplish with your giving? What do you think is possible?"*

The key is to ask the questions to allow the client to express charitable giving in terms of a priority. If you raise the issue and the client is not interested, move on. If you raise the issue and the client does express an interest, then there is an opportunity to integrate charitable giving in the overall estate plan.

B. Compensation

Compensation is the most widely discussed and controversial aspect of gift planning; it is also the area in which most conflicts occur. Potential for conflict always exists when a party to a gift transaction is paid to ensure the gift takes place. In other words, advice to a donor is suspect when payment to the party issuing the advice is contingent upon the completion of the gift, i.e., paid if the transaction occurs but not paid if the transaction does not occur.

1. Gift Brokers

A persistent ethical issue concerns the payment of a fee or commission to receive a gift. There are two common scenarios. In the first, a "gift broker" approaches a charity, states that he is working with

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[16] Breiteneicher, Joe, "Advisor's Enthusiasm Helps To Shape Client's Charitable Role*,"* *Trusts & Estates* (August, 1996), p. 32.

a donor who wants to make a charitable gift but has not settled on a charity. For a fee, generally a percentage of the gift, the broker will convince the donor to name the charity. Many charities pay the fee to be named as the beneficiary of a charitable remainder trust or other gift simply because they see no disadvantage to doing so.. In the second scenario, the charity offers a commission to financial advisors, attorneys, stockbrokers, or anyone who brings a donor to the charity.

Sorting through compensation issues is not simple. Each professional on the planning team may be compensated in a different manner. Attorneys, accountants, and some financial planners charge an hourly fee. Trust officers and asset managers charge a fee based on the market value of assets in their care. Life insurance agents, stockbrokers, and real estate brokers generally receive a commission for a sale. Further, fees and commissions are paid for different purposes. There are commissions paid on transactions, referral fees paid when one professional (or other individual) refers a client to a service provider or an in-house customer to another sales area (such as when a broker in a securities firm refers a customer to the trust area), and service fees, for work done to advise on or assist in a specific transaction. The key to managing conflict is to assess the interests involved, reveal all compensation – where current or deferred – to the parties to the transaction, and avoid those.

2. Finder's Fees for Gifts

Gifts are not investments or products and should not be sold. The most obvious example of a gift sale occurs when a "gift broker" encourages a donor who has no charitable intent to make a gift solely to reduce or avoid taxes. The broker assists the donor in finding a suitable nonprofit, and charges the named charity a fee in exchange for its inclusion in the gift plan. The fee, paid in advance, generally ranges from 10 percent to 20 percent of the gift's value. All industry codes of ethics as well as the Philanthropy Protection Act of 1995 strictly forbid this practice.[17]

> **EXAMPLE:** Sandy Salesman approached John Jones with a way to increase John's income in retirement, avoid income taxes on highly appreciated stock, and eliminate estate taxes on insurance passing to family members. Sandy urged John to create a $500,000 charitable remainder trust funded with the highly appreciated stock. He explained to John that he would avoid capital gains on the contributed stock and receive a 7 percent or 8 percent income stream for life. John could then use the tax savings generated by the charitable deduction and a portion of the annual income from the trust to purchase a life insurance policy for his family. He recommended that the life insurance be purchased inside an irrevocable trust so that the assets will avoid taxation in the donor's estate. John thought the idea was wonderful, but had no charitable contacts or interests. Sandy offered to solve that problem for him.
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> Sandy approached three charities: a church, a social services organization, and a museum and explained the opportunity. For a fee of $75,000 or 15 percent of the funding amount (paid to Sandy), the charity would be named as the irrevocable beneficiary of the trust; John was willing to name the first charity to respond and pay the fee.
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> The social services agency responded quickly and paid the fee; the trust was executed naming the agency. Unfortunately, John died three weeks later. John's children got involved and immediately filed a petition to have the transaction set aside. The charitable remainder trust was

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[17] Public Law 104-62.

dissolved, and the property passed to the children. The charity not only received unwanted publicity for its role in the transaction, but lost its $75,000 fee.[18]

Less obvious examples of gift sales involve charitable gift annuities. Charitable gift annuities are similar to commercial annuities in that the donor's contribution secures a lifetime, guaranteed income stream. Gift annuities are distinguished by the facts they are issued by the charity and are designed to leave a charitable residuum (the gift). Since the charitable gift annuity is designed to leave a gift for charity, its rates are slightly lower than a commercial annuity, although higher than the typical income from stocks, taxable bonds, and certificates of deposit. Charities, intent on selling a product, may succumb to the pitfalls of selling annuities that produce a high return, but omit the charitable component. Advisors, who represent charities that are just launching or already engage in gift annuity programs, should counsel those nonprofits to use annuities as appropriate gift options rather than selling those annuities as a product.

3. Commissions Associated with Gifts

"Commissions associated with gifts" can be divided into two categories: commissions associated with securing the gift and commissions associated with products or services necessary to creation of the gift. In a world in which a commission earned through getting a donor to create a gift is considered highly unethical, the two are often confused.

The voluntary standards of conduct adopted by the National Committee on Planned Giving (The Model Standards of Conduct for the Charitable Gift Planner) and embedded in the Philanthropy Protection Act of 1995 prohibit commissions on gifts. Most professional codes of conduct, however, permit remuneration through commission. Indeed, some professionals – such as real estate brokers, stockbrokers, and insurance agents – are compensated purely on commission basis. Commissions can be sorted into various types, some of which may be appropriate with full disclosure and proper representation.

a. Commission to Obtain a Gift

Payment of commissions and fees to obtain gifts is an ongoing problem in the gift planning field. The conflict arises when the advisor to the donor – the one recommending the gift – is compensated only if the gift occurs. The salesperson (as advisor) has a personal interest in the gift transaction that is greater than the donor's interest, and he cannot offer impartial advice. For example, when an advisor recommends that a client purchase a charitable gift annuity from a charity that pays a commission to the advisor if the transaction is closed, the payment on closing lead him to focus on that option, since it pays a fee, rather than other gift forms that do not generate a commission.

A good example of this practice is evidenced by several national charities operating as national community foundations, which offer commissions to advisors that bring donors to the foundation. These charities solicit sales representatives, develop sales referral sources, and pay a commission of five, six, or even seven percent of the gift value to the sales representative. Other organizations pay a set fee to the referral source as a professional fee. These fees are often five or even ten times the standard

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[18] This example is based on a true story that took place in Arizona in the early 1990's.

professional fee for such a transaction, and roughly equivalent to a commission paid on the same transaction.

> **A STORY: NATIONAL HERITAGE FOUNDATION:** The National heritage Foundation was a nonprofit organization organized as a community foundation with headquarters in Falls Church, Virginia. The Foundation specialized in donor advised funds which it marketed to donors as foundation substitutes. It also became actively involved in marketing charitable split dollar life insurance plans to donors between 1997 and 1999 in which donors made a charitable donation to the Foundation and took a charitable income tax deduction for the full amount of the gift. The Foundation used the donations to purchase life insurance policies, the beneficiaries of which were both the donor's heirs and a charity selected by the donor. The Foundation charged a fee equal to 4.5% of the death benefit. In 1997, Dr. Juan and Sylvia Mancillas began contributing $85,000 a year for $7 million in life insurance, $5 million of which was designated for a trust for their sons (one of whom suffered a severe brain injury that left him seriously impaired) and $2 million of which was designated for the Sisters of the Incarnate Word. In 1999, the IRS determined these plans were not tax deductible and imposed penalties for transactions in which insurance premiums were paid by charities to benefit individuals. The Foundation had roughly 600 of these policies, including the Mancillas, at the time if the IRS action with fees of $25 to $90 tied to the policies. The Foundation did not notify the Mancillas, who continued to pay the premiums. However, to avoid the penalties, the Foundation modified the beneficiary designation to name the Foundation as the sole beneficiary of the policies. When the Mancillas learned what had happened seven years later, they sued the Foundation and were awarded $6.2 million. When this judgment pushed the Foundation into bankruptcy, additional issues were discovered, including a loan of $14 million in Foundation assets to Stellar Financial (the company that produced the Foundation's fund accounting software) without credit analysis or security other than the accounting software's source code, because Stellar's CEO also served as the Foundation's investment advisor (even though Stellar was not registered or licensed to manage investments). The Foundation assets used for the loan were the assets contributed in exchange for charitable gift annuities, which were already diminished by the fees the Foundation paid professional advisors who sent donors to the Foundation for charitable gift annuities. Donors with donor advised funds and charitable gift annuities at the Foundation learned a difficult lesson as those assets were used to cover the Foundation's debts.

The Model Standards of Conduct for the Charitable Gift Planner prohibit commissions on gifts. In addition, the salesperson may face regulation by the securities commission, since individuals selling gifts (those who take commissions on gifts) are not exempted under the Investment Company Act of 1940.[19] The Investment Company Act of 1940 exempts charities from the definition of an "investment company," so long as no part of the company's earnings benefits a private shareholder or individual. Since charitable gift annuities, pooled income funds, and charitable remainder trusts have an element of individual benefit (the income stream), Congress amended the Securities Act in the Philanthropy Protection Act of 1995 to exempt charities who offer and pool investment of such funds so long as the charity provides the donor with disclosure about the operation of the fund, the person soliciting the funds is either a volunteer or employed on the charity's fundraising staff, and the individual is not paid a

[19] 15 U.S.C. § 80a-3(c)(10).

commission for closing the gift.[20] Therefore, charities paying commissions to professionals who bring, and the individuals selling the securities, are covered by the Investment Act of 1940. In other words, charitable gift annuities, pooled income funds, and charitable remainder trusts are not considered securities when offered and managed as a part of the charity's regular activities, using staff compensated by set salary; these same gifts are considered securities if sold by outsiders for a fee.[21]

There has also been a flurry of activity by banks, brokerage firms, and mutual fund companies to create nonprofit charitable gift funds similar to the successful fund created by Fidelity Investments. Since 2001, Fidelity has grown from 2.649 billion and 27,601 funds to $7.589 billion in assets and 54,881 funds.[22] This fund is invested entirely in Fidelity mutual fund products, and thus generates substantial revenue to the for-profit company. These new entities pay commissions and fees to salespeople for generating additions to the fund.

b. Commissions Incidental to the Gift Transaction

Commissions for products that facilitate gifts are a step removed from a direct commission for a gift. Indeed, many of these products are appropriate for the gift arrangement. The donor may purchase insurance to replace the wealth transferred to charity; the insurance agent is paid a commission. The donor may need a professional to serve as trustee of a remainder trust or lead trust; the trust officer is paid a commission for new business at year end based on percentage of new trust fees developed. Or, if the donor has named himself as trustee, he may require the services of a broker, financial advisor, or other investment manager to manage or administer the trust assets; these individuals will be paid a transaction fee for brokering the transaction, or a portion of an investment fee for ongoing management. A trust or charity may sell real property; the real estate agent will take a commission. In all cases, the professional should disclose his compensation and personal benefit to the donor and advise the donor to obtain independent advice for the transaction.[23]

> **EXAMPLE:** Jane Johnson, age 78, used a local brokerage firm to manage her money. Jane decided to make a contribution to the local community foundation to benefit women. She had discussed this with the development director at the foundation and had worked with the officer to draft a designated fund agreement to meet her objectives. She then called her broker to transfer $500,000 to the foundation.
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> The broker responded quickly by insisting that Jane create an irrevocable trust at the brokerage firm's affiliated trust company rather than transferring the money to the foundation. "You can control the trust," he said, "but you'll lose control if the foundation gets the money." What he failed to mention was the $5,000 fee he would receive for establishing the trust and the annual

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[20] Public Law 104-62.

[21] For an excellent discussion of this issue, see the testimony of Barry P. Barbash, Director, Division of Investment Management, United States Securities and Exchange Commission concerning the Philanthropy Protection Act of 1995 before the Subcommittee on Telecommunications and Finance Committee on Commerce, <www.sec.gov/news/testimony/testarchive/1995/spch062.tx>.

[22] Fidelity Charity Fund 2012 Annual Report, http://www.fidelitycharitable.org/2012-annual-report/net-assets.shtml.

[23] The advisor that counsels the donor on a gift must be aware of this potential for conflict. For example, a trust officer that is counseling a donor on a life income gift may be more inclined to suggest a trust, that may mean ongoing revenue for the trustee, rather than a charitable gift annuity, which is held by the charity and does not require a trust.

revenue he would collect from the fee trailer[24] and transaction fees on the activity in the trust, all of which he would lose if the assets were transferred to the community foundation.

Jane was terribly confused by the conflicting advice offered by the community foundation and the broker. She called a friend who quickly understood and sorted out the transaction. Her friend encouraged her to fund the gift at the foundation and move her remaining assets from the broker to another investment manager.

Fees to consultants based on a percentage of funds raised by the consultant are never appropriate. For example, it is not appropriate to pay capital campaign fundraising counsel a fee equal to a percentage of the funds raised by the campaign. This compensation structure is specifically prohibited by the standards governing the Association of Fund Raising Professionals and the Partnership on Philanthropic Planning. This applies to all fundraising consultants – annual fund, major gift, capital campaign, and planned gift. These consultants represent the charity. Personal fees for gifts compromise the consultant's objectivity and his ability to determine if the gift is appropriate for the donor.

Similarly, industry standards of conduct prohibit commissions on gifts for the nonprofit's development professionals. A staff member who is paid on commission cannot be objective in evaluating the appropriateness of a gift for the charity or the donor. Moreover, he has an incentive to facilitate the completion of the gift without regard for resulting liability, poor publicity, or other cost to the charity. Boards that allow this practice invite penalties for violation of the intermediate sanction rules and fiduciary laws of the state.

4. Referral Fees

Referral fees are also common among the professions involved in gift planning. Normally, these fees flow from professional to professional to compensate the referring party for sending business to the other. The professional advisor who recommends a gift and will receive a referral fee or commission from the transaction must disclose the fee arrangement and ensure the donor has independent counsel. A professional that stands to profit personally from a transaction cannot advise a donor objectively.

Typically, professionals do not pay referral fees to charities nor do charities pay them to professionals.[25] These referral fees create the appearance of impropriety and must be examined closely for appropriateness. Most charities recommend professionals who provide prompt, professional service to donors. Likewise, professionals may occasionally recommend charity if a donor indicates a specific charitable objective that the professional knows the particular charity can meet.

C. Competency and Duress

Competency and duress in the execution of a will often go hand in hand as seen in the case of Brooke Astor. Competency is a difficult issue because there is no bright line test to determine an

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[24] A trailer is an ongoing commission stream paid to a broker for as long as the assets remain at the firm, or in the mutual fund paying the commission.

[25] See the Arizona State Bar Association Ethics Opinion in Section C below which permitted referrals so long as the referrals where not made in exchange for the attorney's donations to the institution.

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individual is competent, and it is difficult to define competency under most state laws. It is easy to get comfortable in a donor-charity relationship and even in a donor-advisor relationship.

FROM THE HEADLINES - BROOKE ASTOR: Brooke Astor, who died at the age of 105 in 2007. In 2009, her son, Anthony Marshall, 85, was convicted for defrauding his mother and stealing millions of dollars at a time when she was suffering from Alzheimer's and no longer competent. In the same criminal trial, her estate planning attorney, Francis X. Morrissey, jr., was convicted of fraud and conspiracy in addition to forging Mrs. Astor's signature on an amendment to her will.[26] Some estate planners now suggest that it may be appropriate to take extra steps in execution of estate documents to ensure competency of the client, either through a video statement of the client while executing the will, or through documented question and answer sessions in which the attorney determines competency. Might the same be appropriate for large gifts, especially if age or illness creates a possibility of incompetency.

FROM THE HEADLINES - LOUISE PETER: Competency can also be an issue in a gift creation. One of the most far reaching examples of competency to create a gift was the Texas lawsuit involving. While Louise Peter's name may not be as familiar to planners, but the issue of competency was one of the big issues in a nation wide antitrust trial involving hundreds of charities across the country. Ms. Peter, who suffered from dementia and Alzheimer's disease, inherited a large amount of money from her brother late in her life. her guardian alleged that soon after she received that inheritance the Lutheran Church-Missouri Synod began pressuring her to allow them to manage the money on her behalf. She transferred $1.5 million into a revocable trust and a charitable remainder unitrust, and gave the Synod $200,000 in exchange for charitable gift annuities. While the lawsuits that followed focused on whether the American Council on Gift Annuities and its members who set suggested rates for charitable gift annuities were in violation of the Sherman Antitrust Act and whether charities were illegally offering unregistered securities (that eventually required state laws and the Philanthropy Protection Act of 1995 to resolve) the real issues for planners were: 1) competency of the donor and 2) independent representation of the donor. Here's how this issue of competency and duress became a national issue.

PETER LAWSUIT CHRONOLOGY[27]

Date	Transaction
1993/1994	Louise T. Peters transfers $1.7 million to the Lutheran Foundation of Texas (and other Lutheran charities) to create a revocable trust, a charitable remainder trust, and $200,000 of charitable gift annuities.
June 1994	Ms. Peter's great niece, Dorothy Ozee, approaches the Lutheran Foundation stating she suspects undue pressure in pressuring Ms. Peter to transfer the assets. Ms. Peter did not have independent counsel.

[26] Eligon, John, "Brooke Astor's Son Guilty in Scheme to Defraud Her," New York Times (October 8, 2009).

[27] "Key Events in Gift Annuity Lawsuit: A Chronology," The Chronicle of Philanthropy (January 15, 1998).

Date	Transaction
September 1994	The Lutheran entities ask a state judge to declare Texas law authorizes and allows them to issue charitable gift annuities and serve as the trustee of a charitable trust.
December 1994	Ms. Ozee sued the Lutheran organization alleging a collusion to set rates for charitable gift annuities and wrongfully serve as trustee.
May 1995	U.S. District Judge Joe Kendall rules Lutheran charities were in violation of Texas law in issuing charitable gift annuities and serving as trustee.
June 1995	The Texas Legislature responds with legislation giving charities the legal right to offer charitable gift annuities and serve as trustee.
July 1995	U. S. Sen. Kay Bailey Hutchison (R-Texas) introduces legislation to exempt charitable gift annuities from the Sherman Act and Securities Act.
October 1995	Rep. Henry Hyde (R-Illinois, Chair, House Judiciary Committee) joins with other lawmakers to introduce a similar bill.
October 1995	Judge Kendall allows the lawsuit to move forward as a class against involving 1,900 charities affiliated with the American Council on Gift Annuities that had issued charitable gift annuities to donors as of December 30, 1990.
December 1995	President Clinton signs the Philanthropy Protection Act of 1995 to resolve the antitrust and securities issues.
December 1995	The defendants in the Texas lawsuit file for dismissal based on the PPA; plaintiffs amend charges saying the 1995 law doesn’t provide protection from antitrust issues.
September 1996	The U. S. District Court does not dismiss case based on the PPA.
April 1997	The First Circuit Court of Appeals refuses to dismiss the lawsuit.
July 1997	Congress approves - and President Clinton signs - a bill to exempt charities from antirust suits.
November 1997	The defendants appeal to the U. S. Supreme Court.
December 1997	The U. S. Supreme Court nullifies the Appellate Courts April 1997 decisions and instructs the Appeals Court to reconsider in light of the new federal legislation.

Date	Transaction
June 1998	The Fifth Circuit Court of Appeals terminated the federal litigation, but noted that state law issues were still open to resolution.

D. Wearing Multiple Hats

1. Representing the Charity and the Donor

Sometimes the advisor is asked to represent both the charity and the donor in the gift transaction. In many cases, this request is prompted by the donor, who is reluctant to spend the money to hire a separate attorney. This conflict is most likely to occur when the nonprofit and the donor have a long-term relationship and are therefore comfortable with the concept. The arrangement is inappropriate, because the charity and the donor have opposing interests: the donor has assets that the charity hopes to obtain. This conflict exists *without regard* to common goals about the ultimate use of the funds.
The conflict is most obvious when the professional is an attorney. The attorney cannot effectively represent the interests of both the charity and the donor. In addition, such representation is forbidden by the attorney's canons of ethics. If the charity agrees to pay the attorney's fee, and the attorney agrees to represent the donor in the transaction, he cannot also represent the charity in the same transaction. This transfer of representation – from the charity to the client – should be clearly communicated and reduced to writing. The charity cannot then inquire about conversations between the donor and charity or even the ultimate outcome of the gift, unless the donor chooses to reveal that information.

Conflicts are also possible when any professional renders advice to the donor that encourages completion of the gift. The professional's allegiance always will be to the client (the charity). Unless the professional severs his relationship temporarily with the nonprofit, the transaction will, at a minimum, appear to present a conflict of interest. Even when the professional has severed the relationship temporarily, the transaction may be suspect if the donor later changes his mind. A professional should encourage the donor to seek separate advice and retain separate advisors to complete the gift.

The professional who represents the charity is not obligated to make the donor obtain separate counsel. Many donors prefer to make decisions without outside advice. For example, when a donor decides to create a charitable gift annuity, make a gift to a pooled income fund, designate the charity in a beneficiary designation, or make a substantial outright gift, she may choose to do so without professional advice. For other transactions, such as a charitable remainder trust, a charitable lead trust, or a bequest, the donor will need professional advice since those gifts require legal documents. In those cases, conflict issues such as payment of professional fees or drafting documents for the donor's attorney may arise.

Attorney have the most obvious potential conflict and sometimes get into ethical issues in the interest of providing help or support to a charity of interest. Volunteering legal advice does not remove the attorney from the constraints of the standards of conduct. Consider these examples.

OREGON: The Oregon Ethics Committee of the Bar in Formal Opinion No. 1991-116[28] addressed a fact situation in which an attorney served as a board member of a nonprofit organization and

[28] Readopted as Formal Opinion 2005-116.

provided legal advice to that organization. Another individual associated with the charity asked the lawyer to do some estate planning involving both inter-vivos charitable remainder trusts and wills, both of which named the charity as the beneficiary. The Opinion addressed three issues:

1) Could the attorney represent the donors and the charity in the charitable remainder trust transaction? The Committee found he could not since there was a conflict between the interests of the donors and the charity.

2) Could the attorney represent only the donors in the charitable remainder trust transaction? The Committee found he could with full disclosure and consent of both parties.

3) Could the attorney prepare the donors' wills naming the charity as one of the beneficiaries? The committee found he could so long as he fully disclosed his relationship with the charity and received the donors' approval; the approval of the charity was not necessary because its interests were not deemed adverse in the transaction.

MARYLAND: The Committee on Ethics of the Maryland State Bar Association considered the question of whether a lawyers who served as Chair of the Church's Legacy Committee as a volunteer, and in that capacity encouraged members of the congregation to consider bequests to the Church under will, could prepare those wills free of charge for members of the Church. In their opinion,[29] the Committee relied on Rule 1.7 of the Maryland Rules of Professional Conduct governing conflicts of interest which prohibits a lawyer from representing a client if the representation of that client will be adverse to another client or materially limited by the attorney's responsibilities to another client or third person, or by the lawyer's own interest.[30] The Committee found that his interests as Chair of the Church Legacy Committee which was focused on planned and deferred gifts did compromise his professional judgement and that he could not represent both interests at the same time.[31]

2. Referrals Where There Are Connections

Many attorneys make gifts to charitable organizations because they have a great interest in the services provided by the nonprofit and want to ensure their continued operation in the community. In a 1998 opinion, the State Bar of Arizona was asked to consider whether an attorney who made contributions to a charity, could also accept client referrals from that charity.[32] The concern was ER 7.1(j), Ariz. R.S.Ct. 42 which states: "A lawyer shall not give anything of value to a person for recommending the lawyer's services, except that a lawyer may pay the reasonable cost of advertising or written or recorded communication permitted by these rules."

The Arizona Bar found that if the charitable donations were causal and unrelated to (and not conditioned on) the referrals those referrals were permissible so long as the charity was not functioning as a lawyer referral service. The opinion further noted that if the purpose of the donation was to secure

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[29] Maryland Ethics Docket 2003-08, 2003.

[30] Rule 1.7 of the Maryland Rules of Professional Conduct track Rule 1.7 of the ABA Model Rules of Professional Conduct.

[31] This opinion was later withdrawn, although the Committee on Ethics did not provide a reason for withdrawing the opinion.

[32] State Bar of Arizona Ethics Opinions 98-10, Referrals (December 1998).

referrals and was aimed an the individuals who needed legal services, it would likely violate the standards. In other words, the referrals must be incidental to the charity's work (and not its primary work) and the gifts should not be the consideration for the referrals.

3. Who Pays the Professional's Fee?

Sometimes the charity may offer to pay the professional fees incurred by the donor to complete the gift. Is this ethical? Does this create the appearance of conflict? One should consider the situation in which the donor and professional work through the gift only to determine that the gift is not in the best interests of the donor. Is the attorney under an obligation to complete the gift?

As a general rule, nonprofits are advised not to pay fees for the professional services rendered to the donor. There is nothing inherently unethical in the arrangement as long as it is disclosed, the transaction does not violate the professional's code of ethics (generally, i.e., the payment does not interfere with or affect the professional's conduct and advice), and the professional clearly represents the interests of the donor. This practice, however, may lead to questions and the appearance of impropriety. Moreover, perception *is* often reality for many observers.

If the donor's professional advisor is paid by the charity, the charity should disclose this fact to the donor in writing and make it clear that the professional represents the donor – not the charity – in the transaction. The professional should also inform the donor, in writing, that although the fee will be paid by the charity, the relationship is between the professional and the donor.

Payment of professional fees is also a problem for the charity. Professional fees charged for drafting documents or providing representation for a donor are the personal legal obligation of the donor. When the charity assumes those payments, the donor receives an economic benefit equal to the fee. This economic benefit should be reflected in the "goods and services" portion of the substantiation statement.[33]

There is a second issue relating to individual benefit conferred by a charity. Section 501(c)(3) of the Internal Revenue Code requires that "no part" of the net earnings of a tax-exempt organization can inure "to the benefit of any private shareholder or individual." If the IRS finds there has been individual benefit (called private inurement) the charity risks losing its tax-exempt status and the transactions may trigger penalties to the individual under the intermediate sanctions rules designed to prevent individuals from receiving personal benefit from charitable funds.[34] While there are no published cases equating payment of legal fees to private inurement, this may be because these fees are rarely revealed or discovered. The professional advisor should simply consider this risk with other factors in making the decision to move forward with this arrangement.

4. Volunteer Service and Representation

The professional may serve on the nonprofit's board of directors or professional advisory board. Can the professional effectively represent the donor while serving in a fiduciary role? Service on a board

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[33] See Chapter 8 for more rules on the substantiation requirements for charitable gifts.

[34] IRC § 4948(a)(1).

or advisory board does not disqualify the professional, although it does pose the appearance of conflict. The best way for the professional to address this potential conflict is by disclosing the relationships and clearly dedicating himself to representing the client in the transaction.

At other times, the professional may serve on the professional advisory board strictly to further business interests with the charity or with the charity's donors. This motivation invariably leads to ethical problems for both the charity and the professional; in addition, it may lead to intermediate sanctions (fines imposed by the Internal Revenue Service), if the professional personally benefits from charitable funds.

The potential conflict can be managed in one of two ways. First, when the professional is serving in a fiduciary or advisory role, he must put the charity's interests above his own personal interests. Second, the charity can reduce the potential for conflict by clearly explaining the fiduciary duties to the board candidates. The charity may also ask the professional to sign a conflict of interest statement in which he pledges to place the charity's interests above his own when he provides volunteer service.

5. Fiduciary Duties and Conflicts

A fiduciary is someone responsible for managing and handling funds that belong to another. In a gift planning context, fiduciaries include trustees of charitable remainder trusts and charitable lead trusts, trustees of revocable trusts for donors, or executors of estates with charitable provisions. Although banks have traditionally filled the fiduciary role, it is now common to see accountants, attorneys, insurance agents, or brokers serving in this capacity. Fiduciaries are generally paid for the services they provide.
A trustee is held to a higher standard of care than an ordinary individual. He has a duty to act in the best interests of the trust, to act in good faith, to act with the care of an ordinarily prudent person, to be loyal, and to balance the interests of the trust's beneficiaries (the nonprofit and the individual). Balancing the interests of the charitable and individual beneficiaries can be difficult.

> **EXAMPLE:** Ann Jenkins, an attorney representing the Small family, agreed to serve as trustee of Sam and Sally Small's charitable remainder annuity trust. Serving as trustee seemed to be an excellent way for Ann to keep in touch with her clients and collect an ongoing management fee. The trust was funded with property with little appreciation. The Smalls, ages 59 and 57, respectively, were interested in reducing taxable income and called Ann to instruct her to invest all the assets of the trust in tax-exempt bonds. The charitable beneficiary, the Guiding Light Mission, was extremely upset that the trust was to be invested in tax-exempt bonds, since it would limit the growth potential of the assets and the ultimate remainder. The attorney/trustee must now inform the client of her obligation to invest the trust to balance the best interests of both beneficiaries (and face losing a client) or follow the instructions of the client (and risk a lawsuit from the charity).

> **EXAMPLE:** In this very uncomfortable example, Sam Smith, who had been the John James' attorney for more than 40 years, agreed to serve as Executor of his $10 million estate, and had agreed during John's lifetime to serve as the trustee of a Family Trust. The attorney charged legal fees, Trustee fees, and a fee for serving as executor. John had no children, and his wife had predeceased him; at John's death, all amounts remaining after expenses and taxes were transferred to two charities. The charities were excited about the prospect of receiving a roughly $5 million bequest each from John's estate and begin to make plans to use those funds to

expand their services and improve their programs. However, five year later they were still waiting for the Family Trust to be dissolved and the estate to be distributed. Ultimately, they filed an action in the Probate Court to hasten those distributions, concerned that it was in the law firm's best interests to continue to hold the funds and collect the fees. Is there an ethical issue here?

E. Drafting Documents - Do They Understand What You Design?

Sometimes a donor retains an attorney or other professional who does not practice in the charitable or estate planning field. For example, the donor may ask her corporate attorney or real estate attorney to review the transaction. In those instances, the charity may volunteer to provide sample documents to the donor's attorney to ensure the transaction takes place. This action also raises conflict issues. One should consider the following questions:

- *Does the donor's attorney understand the transaction?* If the donor's attorney does not understand the transaction, it is unlikely the donor will receive competent advice about his options and how the gift will affect him.

- *Does the donor understand the transaction?* If so, who provided the donor with the analysis? It is not the charity's role to ensure that the advice received by the donor is competent. It is, however, a tenet of the Model Standards of Practice of the Charitable Gift Planner and the Donor's Bill of Rights that all aspects of the transaction should be disclosed to the donor so that he understands the gift's impact on him.

- *Is the attorney or nonprofit liable for providing a defective document to the donor's attorney?* Does liability attach if the gift is inappropriate? Often, professionals draft documents that are ready to be executed, even though they warn that the documents are provided as a sample. The professionals representing the donor and the charity understand the arrangement. This is clearly an issue that may be litigated in the future.

F. Unauthorized Practice of Law

Some charities and non-legal planning practices provide standard documents for trusts and bequests. This raises many issues, including the unauthorized practice of law which is defined at the state level. Sometimes planners step into traps when a practice may be approved under the state law in which they practice, but defined differently if the charity, the trust situs, or the donor resides in another state that defines unauthorized practice differently. The professional ethics rules of the legal profession generally prohibit assisting non-lawyers in this practice. This can begin as a simply act of good will by providing basic documents to a charity on a pro bono basis for use with their donors, and can transform into the unauthorized practice of law when the charity believes it is "helping donors make gifts" by providing those documents to them.

One of the most aggressive states in policing the unauthorized practice of law is Illinois which states in its Illinois Fraud and Deceptive Business Practice Act that "the assembly, drafting, execution, and funding of a living trust document or any of those acts by a corporation or a non-lawyer is an unlawful practice with the meaning of this Act."[35]

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V. Final Thoughts

At the end of the day, the following rules help the planner avoid the most serious ethical issues in a working relationship:

1. Understand the role of each party to the transaction, and the professional rules applicable to each participant.
2. Ensure each party to the transactions has independent representation.
3. Reveal all information (fees, relationships, other) in the transaction accurately.
4. Foster communication and education among professionals and nonprofits. Get to know each other. Network. Share ideas.
5. Focus on charitable intent.
6. Think about the impact of new planning ideas. Respect the law.

These rules ensure that the relationship between the professional advisor and charitable community will improve, that more gifts will be completed, and that philanthropy will prosper.

21st ANNUAL ESTATE AND CHARITABLE PLANNING INSTITUTE

THE CHANGING CLIMATE OF ESTATE PLANNING: WHAT'S HOT – WHAT'S NOT*

By: Ann B. Burns

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I. TAX LAW CHANGES FOR 2013 AND BEYOND

A. American Taxpayer Relief Act of 2012 (“ATRA”)

The American Taxpayer Relief Act of 2012 (“ATRA”) was signed into law on January 2, 2013 or as one noted tax expert says: “December 32.” This new tax law prevents many of the federal tax increases that otherwise would have taken effect on January 1, 2013, by making permanent many of the favorable tax reforms enacted since 2001. However, ATRA also increases the top tax rates for high-income and wealthier taxpayers.

1. Estate, Gift, and GST Tax Changes

ATRA makes permanent the federal gift and estate tax exclusion amount of $5 million, which is indexed for inflation to $5.25 million for 2013. A person may transfer up to $5.25 million cumulatively during lifetime and at death without incurring any federal gift or estate tax. In addition, ATRA increases the top federal gift and estate tax rate to 40% for 2013 and beyond. ATRA makes permanent a valuable estate tax provision introduced with the 2010 tax law reforms: portability of the federal gift and estate tax exclusion amount between spouses. A portability election allows a surviving spouse to utilize the unused federal gift and estate tax exclusion amount received from his or her last deceased spouse. Note, however, there is no inflation adjustment for the deceased spouse’s exclusion amount which, in essence, means the benefit will erode with inflation.

With respect to the federal generation-skipping transfer tax, ATRA makes permanent the GST exemption amount of $5 million, which is indexed for inflation to $5.25 million for 2013. ATRA also increases the federal GST tax rate from 35% for 2012 to 40% for 2013 and beyond.

2. Income Tax Changes for Individuals

ATRA raises income taxes for high-income taxpayers. For ordinary income, the new top tax rate increases to 39.6% for 2013 and beyond. This rate applies for single taxpayers with taxable income in excess of $400,000 and for married taxpayers filing jointly with taxable income in excess of $450,000. For long-term capital gains and qualified dividends, the new top tax rate increases to 20% for 2013 and beyond, and this rate applies for taxpayers in the top ordinary income tax bracket.

Federal Gift, Estate, and GST Tax Changes in the American Taxpayer Relief Act of 2012		
Provision	**2012**	**2013**
Estate Tax Exclusion Amount	$5.12 million	$5.25 million
Gift Tax Exclusion Amount	$5.12 million	$5.25 million
GST Exemption Amount	$5.12 million	$5.25 million
Estate, Gift, and GST Tax Rate	35%	40%

Gift Tax Annual Exclusion	$13,000	$14,000

Starting in 2013, a new 3.8% net investment income tax takes effect, a result of the Affordable Care and Potential Protection Act. This additional 3.8% tax applies for single taxpayers with modified adjusted gross income ("AGI") in excess of $200,000 and for married taxpayers filing jointly with modified AGI in excess of $250,000. Net investment income includes interest, dividends, capital gains, rental and royalty income, non-qualified annuities, and passive business activities.

Starting in 2013 is an additional increase of 0.9% in the Medicare tax. This additional 0.9% tax applies to an individual's wages and self-employment income that exceeds a threshold amount of $200,000 for single taxpayers and $250,000 for married taxpayers filing jointly.

ATRA also reinstates two previously-eliminated income tax provisions: (1) a phase-out of personal exemptions and (2) limits on certain itemized deductions. For 2013, these provisions apply for taxpayers who have AGI in excess of a threshold amount (for 2013, this is $250,000 for single taxpayers and $300,000 for married taxpayers filing jointly). For 2013, taxpayers may claim personal exemptions of $3,900 for the taxpayer, the taxpayer's spouse, and the taxpayer's dependents, but ATRA reduces the total amount of personal exemptions available by 2% for each $2,500 increment by which the taxpayer's AGI exceeds the threshold amount mentioned above. Also, under ATRA, a taxpayer's total amount of itemized deductions are reduced by 3% of the amount by which the taxpayer's AGI exceeds the threshold amount mentioned above (but that reduction cannot exceed 80% of otherwise allowable itemized deductions).

Charitable deductions are generally not reduced by this change, assuming that the taxpayer has other itemized deductions. This is because the reduction is primarily based on 3% of the amount that the taxpayer's AGI exceeds the threshold amount (not the total amount of itemized deductions). Assume married taxpayers filing jointly have AGI of $500,000 in 2013, and they pay a total of $50,000 in 2013 for state income taxes, real estate taxes, and home mortgage interest. Under ATRA, the reduction to their $50,000 of itemized deductions is $6,000 ($500,000 AGI minus $300,000 threshold, then multiplied by 3%). So, the taxpayers may deduct $44,000 ($50,000 minus $6,000). If the taxpayers also decide to make a $25,000 charitable gift in 2013, the reduction to their total amount of itemized deductions does not change—it is still reduced by $6,000 because the reduction is based primarily on their adjusted gross income. Therefore, in this example, the taxpayers could deduct the full $25,000 charitable gift without any reduction under ATRA. ATRA extended through 2013 the tax-free distribution of up to $100,000 from an IRA to a public charity for individuals who are 70-1/2 or older.

3. Income Tax Changes for Trusts

ATRA also raises income taxes for some trusts. For ordinary income, the new top income tax rate for trusts that are not grantor trusts is 39.6% for 2013 and beyond. This rate applies for trusts with taxable income in excess of $11,950. A grantor trust, on the

other hand, is ignored for income tax purposes, and all or a portion of the income, deductions and credits are treated as belonging directly to the trust's grantor.

For long-term capital gains and qualified dividends, the new top tax rate for non-grantor trusts increases from 15% for 2012 to 20% for 2013 and beyond, and this rate applies for trusts with taxable income in excess of $11,950. Also applicable to non-grantor trusts starting in 2013 is the new 3.8% net investment income tax, which applies for trusts with taxable income in excess of $11,950. The combined 2013 tax rate increases for non-grantor trusts with taxable income in excess of $11,950 is 8.4% on ordinary income and 8.8% on long-term capital gains and qualified dividends.

In general, non-grantor trusts report and pay taxes on ordinary income, dividends, and capital gains at the trust level. However, a non-grantor trust that is required to distribute or that actually distributes ordinary income can pass those income items on to one or more trust beneficiaries so that these items are taxed at each beneficiary's income tax brackets and rates instead of being taxed at the trust level. Capital gains, on the other hand, generally are trapped and taxed at the trust level.

If a non-grantor trust has not already paid out the trust's distributable net income to the beneficiaries by the end of the trust's tax year, the trustee generally has 65 days after the end of the tax year to do so. Because a trust's taxable income reaches the top tax rates at $11,950 for tax years 2013 and beyond, it is important for trustees to proactively monitor trust investments and income items and to consider whether making distributions is appropriate so that some or all of the income items can be passed on to the beneficiaries and taxed at their rates.

B. Administration's Fiscal Year 2014 Revenue Proposal

In February 2013, the Treasury released its general explanations of the Administration's Fiscal Year 2014 Revenue Proposals (also known as the "Green Book") which provided the details of the Obama administration's budget proposals. Several matters, if enacted, would significantly impact estate and charitable planning.

1. Restore Estate, Gift and Generation-Skipping Transfer Tax Parameters in Effect in 2009

The proposal would make permanent the estate gift and generation-skipping transfer tax parameters as they applied during 2009. The top tax rate would be 45% and the exclusion amount would be $3.5 million for estate and generation-skipping transfer taxes and $1 million for gift taxes. Portability of a spouse's unused estate and gift tax exclusion amount would remain permanent. The proposal would be effective for the estates of decedents dying and for transfers made after December 31, 2012.

2. Require Consistency in Value for Transfer and Income Tax Purposes

I.R.C. § 1014 provides that the basis of property acquired from a decedent is the fair market value of the property on the decedent's death but does not explicitly require

that the recipient's basis be the same as the value reported for estate tax purposes. I.R.C. § 1015 provides that the donee's basis in property received by gift is the donor's adjusted basis in the property increased by any gift taxes paid and limited to the fair market value of the gift for purposes of determining any subsequent loss.

The proposal would impose both a consistency and a reporting requirement. The basis of property received by reason of death under Section 1014 must equal the value of that property for estate tax purposes. The basis of property received by gift must equal the donor's basis determined under Section 1015. A reporting requirement would be imposed on the executor of the decedent's estate and on the donor of a lifetime gift to provide necessary valuation and basis information both to the recipient and to the Internal Revenue Service. Treasury could issue regulations to provide details about requirements for situations in which no estate or gift tax return is required to be filed.

The proposal would be effective for transfers on or after the date of enactment. One question which has arisen about this proposal is how to address adjustments in valuation made on audit.

3. Modify Rules on Valuation Discounts

This proposal was included in the 2013 Green Book but not in the 2014 Revenue Proposals, leaving some question as to whether the administration has abandoned the proposal or has postponed its work on the topic.

I.R.C. § 2704(b) provides that certain "applicable restrictions" that normally would justify discounts in the value of interests transferred for gift or estate tax value are to be ignored in valuing interests in family-controlled entities if those interests are transferred to or for the benefit of other family members. The purpose of these special rules is to result in the increase in the transfer tax value of those interests above the price that a hypothetical willing buyer would pay a willing seller because the appraiser would be required to ignore the rights and restrictions for that purpose. Treasury has determined that judicial decisions and the enactment of new statutes in many states have made Section 2704(b) inapplicable in many situations. This has resulted because an "applicable restriction" excludes a restriction imposed by default by state law.

Accordingly, the proposal would create an additional category of restrictions called "disregarded restrictions" that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will relapse or may be removed by the transferor or the transferor's family. Under this proposal, the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions that would be specified in the regulations.

Disregarded restrictions would include: (1) limitations on a holder's right to liquidate the holder's interest that are more restrictive than a standard identified in the regulations; and (2) a limitation on a transferee's ability to be admitted as a full partner or to hold an equity interest in the entity. For purposes of determining whether restriction may be removed by members of the family after the transfer certain interests held by charities or others who are not family members would be deemed to be held by the family

in order to avoid abuse. Treasury would have regulatory authority to create safe harbors. The safe harbors might include, for example, the exclusion of an operating business.

This proposal would apply to transfers after the date of enactment for entities subject to restrictions that were created after October 8, 1990, which is the effective date of Section 2704.

4. Require a Minimum and Maximum Term for Grantor Retained Annuity Trusts

Grantor Retained Annuity Trusts (GRATs) have become quite popular and are an effective tool for transferring appreciation to younger generations with a minimum of gift tax cost. Typically, a GRAT term is quite short and thus reduces the risk of the grantor's death during the term of the trust and the retained annuity interests are structured to be large enough to "zero out" the gift tax value of the remainder interest.

This proposal would require a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years for the term of a GRAT. The ten-year minimum was contained in previous versions of the Green Book, but the maximum term is new. The proposal also would include a requirement that the remainder interest have a value greater than zero at the time the interest is created although the proposal specifically states that the "minimum term would not prevent 'zeroing-out' the gift tax value of the remainder interest."

The intention seems to be to increase the risk that the grantor fails to outlive the GRAT term and the resulting loss of the transfer tax benefit. The proposal does not appear to prohibit a substitution of assets by the grantor of the trust in order to freeze the increase in value of the assets at any point during the term of the GRAT. The increase in mortality risk may make GRATs somewhat less popular, but the ability to zero out the GRAT means that GRATs will still be a fairly low risk planning tool.

5. Limit Duration of Generation-Skipping Transfer Tax Exemption

The generation-skipping transfer tax was enacted to prevent avoidance of the estate and gift tax through the use of a trust that gives successive life interests to multiple generations of beneficiaries. At the time of the enactment of the generation-skipping tax provisions, the law of most states included the common law rule against perpetuities or some statutory version of it. Thus, in most states, the practical effect was that the generation-skipping transfer tax exemption would benefit families for a long but finite period of time. Many states now have either repealed or limited the application of their perpetuities statutes with the effect that trusts that are exempt from generation-skipping transfer taxes may continue in perpetuity.

This proposal would provide that on the 90th anniversary of the creation of a trust the generation-skipping transfer tax exclusion allocated to the trust would terminate. The termination would be achieved by increasing the inclusion ratio of the trust to one, thus rendering it non-exempt from generating-skipping tax. Contributions to a trust from

different grantors are deemed to be held in separate trusts under Section 2654(b) and accordingly, each trust would have its own 90-year rule measured from the date of the first contribution by each grantor of that separate trust.

One exception is mentioned that would permit an incapacitated beneficiary's distribution to be continued to be held in trust without incurring generation-skipping transfer tax on distributions to the beneficiary as long as the trust was used for the sole benefit of the disabled beneficiary. At the beneficiary's death, the trust would be taxed for federal estate tax purposes.

This proposal would apply to trusts created after enactment and to the portion of any pre-existing trust attributable to additions made after the date of enactment.

6. Coordinate Certain Income and Transfer Tax Rules Applicable to Grantor Trusts

Numerous recent rulings have confirmed that a trust may be a wholly-grantor trust and taxable to the grantor for income tax purposes but not be included in the grantor's estate for estate tax purposes. Treasury has indicated that

> The lack of coordination between the income and transfer tax rules applicable to a grantor trust creates opportunities to structure transactions between the deemed owner and the trust that can result in the transfer of significant wealth by the deemed owner without transfer tax consequences.

In a complete surprise, Treasury has proposed that to the extent a trust is a grantor trust for income tax purposes and has entered into a non-taxable sale transaction with the grantor, the assets of the trust would be included in the gross estate of the grantor for estate tax purposes. Further, any distribution from the trust to a beneficiary during the grantor's life would be taxable to the grantor as a gift, and the termination of the trust during the grantor's life would be taxable as a gift.

Additionally, any other individual who is deemed to be an owner of the trust for income tax purposes, who engages in a non-taxable sale, exchange or comparable transaction with the trust, would likewise have estate or gift tax treatment of the trust assets.

Curiously, the proposal states that it would not change the treatment of any trust that is already includable in the grantor's gross estate under other sections of the tax code, specifically including grantor-retained annuity trusts. Possibly this reference is intended to assure that the trusts resulting after the annuity period of a GRAT would not be subject to this treatment.

The proposal would be effective with regard to trusts created on or after the date of enactment and with regard to any portion of a trust attributable to a contribution made on or after the date of enactment. Treasury would be given regulatory authority to create transition relief for certain existing grantor trusts such as irrevocable life insurance trusts.

7. Extend the Lien on Estate Tax Deferrals Provided Under Section 6166

Under I.R.C. § 6166, the estate tax payment on certain closely-held business interests may be deferred for up to 14 years from the filing of a timely estate tax return. The intention of this provision was to avoid the forced sale of a closely-held business for the payment of estate taxes. I.R.C. § 6324(a)(1) imposes a lien on estate tax assets for ten years following the decedent's death and, accordingly, the estate tax lien expires approximately five years before the due date of the final deferred payment.

In many cases, the IRS has had difficulty collecting the deferred estate tax and Treasury determined that the IRS requires an additional lien period. This proposal would extend the estate tax lien under I.R.C. § 6324(a)(1) throughout the entire I.R.C. § 6166 deferral period.

The proposal would be effective for the estates of all decedents dying on after the effective date as well as for all estates of decedents dying before the date of enactment as to which the lien had not yet expired.

8. Clarify GST Rules of Exclusion Trusts (HEETs)

Payments made by a donor directly to the provider of medical care for another person or directly to a school for another person's tuition are exempt from gift tax under I.R.C. § 2503(e). For purposes of the generation-skipping transfer tax, I.R.C. § 2611(b)(1) excludes any transfer that would not be treated as a taxable gift under I.R.C. § 2503(e). Thus, payments made by a donor for qualifying education and medical expenses for a younger generation recipient are exempt from both gift and generation-skipping transfer taxes.

In some cases, taxpayers have created health and education exclusion trusts (HEETs) which provide that the distributions may be made from the trust solely for medical expenses and tuition of younger generation beneficiaries. The taxpayers take the position that contributions to these trusts, because they can be used only for health and education, qualify for the generation-skipping transfer tax annual exclusion under I.R.C. § 2611(b)(1).

The proposal would clarify that the exclusion from generation-skipping transfer tax under I.R.C. § 2611(b)(1) applies only to a payment by a donor directly to the provider of medical care or to the school in payment of tuition and does not apply to trust distributions or contributions even if the purposes are limited to health and education.

The proposal would apply to trusts created after the introduction of the bill and to transfers to or from trusts after the date of enactment.

C. The Department of Treasury on November 19, 2012

The Department of Treasury on November 19, 2012, released its 2012-2013 Priority Guidance Plan. As stated in the introduction to the plan: "The plan represents

projects we intend to work on actively during the plan year and does not place any deadline on completion of projects." Ten priority items are included that impact gift, estate and fiduciary income tax matters.

1. Itemized Deductions

Treasury has been promising final regulations under Section 67 regarding miscellaneous itemized deductions of a trust or estate for a number of years. Proposed regulations were published on September 7, 2011 in response to the Supreme Court's decision in *Knight v. Comm'r.*, 552 U.S. 181 (2008). The Supreme Court in *Knight* determined that the Section 67(a) limitation on miscellaneous itemized deductions of 2% of adjusted gross income applied to expenses incurred by estates and trusts such as investment fees. The proposed regulations do not contain any particular safe harbors and appear to require fiduciaries to unbundle their fees in order to distinguish those expenses that are subject to the 2% floor and those that are not. Further guidance is needed as to this issue but has been postponed for several years.

2. Sample Charitable Remainder Trust Forms

Treasury intends to issue guidance concerning certain adjustments to the sample charitable remainder trust forms previously released under Section 664.

3. Private Trust Companies

Guidance concerning private trust companies under I.R.C. §§ 671, 2036, 2038, 2041, 2042, 2511, and 2601 should be forthcoming. In 2008, a proposed revenue ruling confirmed favorable tax conclusions with respect to a person serving as trustee of a private trust company. I.R.S. Notice 2008-63, 2008-31 IRB 261.

4. Uniform Basis of Charitable Remainder Trusts

Regulations under Section 1014 regarding uniform basis of charitable remainder trusts should be forthcoming. It is expected that Treasury guidance will consider the tax consequences of the sale by a remainder beneficiary of a charitable remainder trust of its interest in the trust.

5. Alternate Valuation

Final regulations under Section 2032(a) regarding the valuation impact of restrictions on estate assets during the six-month alternate valuation period. Proposed regulations were published in November 2011 in response to the *Kohler* case, T.C. Memo 2006-152. *Kohler* dealt with the post-death reorganization of a corporation and the impact of the post-death reorganization on valuation. The proposed regulations indicate that post-death changes in the character of assets will not be considered for the purpose of reducing the valuation of assets on the date of death.

6. Personal Guarantees

Guidance is expected under I.R.C. § 2053 regarding personal guarantees specifically with respect to whether claims that are paid after the date of death should be adjusted to the date of death by use of present value concepts. The forthcoming guidance may impact the use of *Graegin* notes requiring a discount back to date of death values of debts payable after the date of death. Treasury has indicated that changes in this area may require legislation rather than simple regulatory guidance.

7. Allocation of GST Exemption

Treasury has added to the list this year an indication that it may issue regulations under I.R.C. § 2642 regarding the allocation of generation-skipping transfer tax exemption to a pour over trust at the end of an estate tax inclusion period. The AICPA requested guidance on this issue in 2004, and it has now been added to the list. An example of this issue arises at the termination of a GRAT with a pour over into trusts for children and grandchildren.

8. Extension of Time to Allocate GST Exemption

Final regulations under I.R.C. § 2642(g) are expected regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were originally published in April 2008 and are expected to be made permanent.

9. Restrictions on Liquidation

Regulations are expected under I.R.C. § 2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships. This item relates directly to the administration's proposals in this area in the Green Book.

10. Gifts from Ex-Patriots

Treasury has indicated that it is giving its highest priority to issuing guidance under I.R.C. § 2801 regarding the tax imposed on U.S. citizens and U.S. residents who receive gifts or bequests from certain ex-patriots.

D. Portability of Unused Exclusion Amount

The IRS has issued temporary regulations which also serve as the text of proposed regulations concerning electing portability of a deceased spouse's unused exclusion amount by the surviving spouse. T.D. 9593 (6/18/2012). These regulations are effective for married spouses where the death of the first spouse to die occurs after December 31, 2010.

1. Making the Portability Election

The temporary regulations require that an executor electing portability make that election on a timely-filed estate tax return. The last return filed by the due date of the return, including extensions that were granted, will supersede any previously-filed return. An election is irrevocable once the due date (as extended) of the return has passed.

When an executor is not required to file an estate tax return under I.R.C. § 6018(a) the code does not specify a due date for a return filed for the purpose of making the portability election. The temporary regulations require that every estate electing portability file an estate tax return within nine months of the date of the decedent's death plus any extensions that were granted. Relief may be available under Treas. Reg. § 301.9100(1)-(3) to make a late portability election if no estate tax return was required and none was filed timely. The Service has not issued formal notice that I.R.C. § 9200 relief is available but appears to be willing to grant late portability elections if no gift tax return was required.

The portability election is required on a "complete and properly-prepared" estate tax return prepared in accordance with all applicable requirements although the regulations state that the estate need not report the value of certain property that qualifies for the marital or charitable deduction. If an executor chooses to make use of this special rule the executor must estimate the value of the gross estate including the property that would be subject to the marital or charitable deduction based on a determination in good faith and with due diligence regarding the value of the assets. The IRS has taken into consideration the cost and burden associated with filing an estate tax return and substantiating values where a return would not otherwise be required.

In order to opt out of portability, the executor must make an affirmative statement on the estate tax return indicating the decision not to have portability apply. If no estate tax return is required, and none is filed, the failure to file will be considered to be an affirmative statement signifying the decision not to make the portability election.

The regulations require that the portability election be made by a duly appointed executor or, if none is appointed, then any person in actual or construction possession of any property of the decedent. Typically, the election will be made by the executor of the estate or the trustee of the revocable trust. The Service has rejected the notion that the surviving spouse may make the election unless the surviving spouse serves in one of these fiduciary roles or if no executor or trustee is appointed and acting. Presumably, the decision of the executor would supersede the election of the surviving spouse if the surviving spouse were electing under the "person in possession" portion of the regulations. The regulations do attempt to address the issue of conflicting elections but leave the matter fairly unclear as to conflicting elections made by persons with equal priority.

2. Computing the DSUE Amount

The temporary regulations clarify that the new estate tax return will include the computation of the deceased spouse's unused exemption (DSUE) amount. Executors that

previously filed an estate tax return pursuant to the transitional rules will not be required to file a supplemental estate tax return using the revised form.

The DSUE amount is the lesser of (a) the basic exclusion amount, or (b) the excess of (1) the basic exclusion amount of the last deceased spouse of the surviving spouse, over (2) the amount with respect to which the tentative tax is determined on the estate of the deceased spouse. The temporary regulations also make clear that the term "basic exclusion amount" refers to the basic exclusion amount in effect in the year of the death of the first deceased spouse and further that the term is interpreted to mean "applicable exclusion amount."

3. Use of DSUE Amount by Surviving Spouse

The regulations provide that if the first deceased spouse's executor elected portability, and the decedent is the last deceased spouse of the surviving spouse, the surviving spouse may take into account the deceased spouse's DSUE amount in determining the applicable exclusion amount of the surviving spouse when computing a gift or estate tax liability on a transfer made by the surviving spouse. The DSUE amount may be applied to any transfers by the surviving spouse occurring after the date of death of the first deceased spouse. The regulations indicate that remarriage alone does not affect who will be considered the last deceased spouse and does not prevent the surviving spouse from including in the surviving spouse's applicable exclusion amount the DSUE amount of the deceased spouse who most recently preceded the surviving spouse in death. The temporary regulations also provide that for purposes of determining a surviving spouse's applicable exclusion amount the surviving spouse's last deceased spouse is identified as of the date of the taxable gift.

The temporary regulations also clarify the availability of the DSUE amount in the case where a surviving spouse is preceded in death by more than one spouse. In situations where the last deceased spouse either did not elect portability or had no DSUE amount available (or a smaller amount of DSUE amount available in comparison to a prior deceased spouse) the regulations clarify that the surviving spouse may not apply any DSUE amount from a prior deceased spouse.

4. IRS Authority to Examine Returns of Prior Deceased Spouses

The temporary regulations confirm the IRS's authority to examine returns of each deceased spouse of the surviving spouse to determine the allowable DSUE amount even if the period of limitations on assessment of tax under I.R.C. § 6501 has expired for the estate and generating-skipping transfer taxes on such returns. Upon examination, the IRS may adjust or eliminate the DSUE amount reported on the return. The IRS may make an assessment of additional tax with respect to the deceased spouse's return only within the period of limitations under I.R.C. § 6501. The ability of the IRS to examine returns of a deceased spouse applies to each transfer by the surviving spouse to which a DSUE amount is or has been applied. Returns and return information of a deceased spouse may be disclosed to the surviving spouse or the surviving spouse's state as appropriate under I.R.C. § 6103.

II. STATE COURT RULINGS

A. Ward had Capacity to Make Revocable Trust

The Indiana Court of Appeals has ruled that there was sufficient evidence of mental capacity to support the validity of a revocable trust agreement made by an 80-year-old who was under legal guardianship. *Joiko v. Fifth Third Bancorp (in re Joiko)*, 973 N.E.2d 107 (Ind. Ct. App. 2012). Kenneth Schaaf was Joiko's long-term accountant and also a beneficiary under an earlier trust agreement. Schaaf was appointed as temporary guardian of Joiko's person and estate in 2007. In 2009, Joiko asked the Court to remove Schaaf claiming that Schaaf was acting out of self-interest as an eventual beneficiary of the estate and failed to encourage Joiko's independence. The Court found no malfeasance by Schaaf but substituted Fifth Third Bancorp as guardian of the estate.

In 2010, Fifth Third filed a petition for instruction seeking approval to transfer Joiko's assets to a revocable living trust of which Fifth Third would act as trustee. The new revocable trust agreement changed the disposition of Joiko's estate, notably removing Schaaf as a beneficiary.

Schaaf moved to intervene alleging that Joiko did not have legal capacity to execute the new revocable trust agreement. At the hearing, the parties brought conflicting medical testimony about Joiko's competency. At the conclusion of the hearing the trial court found overwhelming evidence that Joiko had capacity to execute the revocable trust agreement and authorized Fifth Third to transfer Joiko's assets to the trust. Schaaf appealed.

The Appellate Court discussed the differing statutory definitions of capacity. The capacity of a settlor to make a trust under the Indiana Code was the same as the capacity of a testator to make a will, that is the person must be of "sound mind." An incapacitated person for purposes of a guardianship included a person who is "unable to manage in whole or in part his property or to provide self-care or both because of a mental deficiency." Schaaf argued that by definition a person incapacitated under the guardianship law does not possess the sound mind required to execute a will or trust. The Court disagreed finding that while the appointment of a guardian "conclusively establishes the fact of his inability to manage his estate" it does not necessarily establish "such unsoundness as would incapacitate him from making a valid will."

The Court determined that each person is presumed to be of sound mind to execute a will unless the contrary is shown. The Court determined that while the guardianship determination is *prima facia* evidence of unsound mind, a party seeking to uphold the execution of a trust may do so by carrying the burden to show that the ward had the requisite mental capacity at the time the trust was executed. In order to carry that burden the trustee was required to show that Joiko had capacity to know: (1) the extent and value of his property; (2) those who were the natural objects of his bounty; and (3) their worthiness, with respect to their treatment of and conduct toward him.

The Court found, based on testimony from primary care physicians, a psychiatrist, a psychologist and various bank representatives, that Joiko, although he had mild

dementia, was of sound mind and able to make his own decisions. The Court upheld the validity of the trust agreement.

B. Exercise of Power of Appointment Exceeded Scope

The California Court of Appeals addressed the question of whether the exercise of a power of appointment exceeded the scope of the power in *Sefton v. Sefton*, 206 Cal. App. 4th 875 (Cal. App. 4th Dist. 2012). J.W. Sefton Jr. (grandfather) executed his will in 1955 and later passed away in 1966. The will gave his son, Thomas Sefton (father), a life estate and gave father a power of appointment over the remainder estate to his "then living issue" identified in the will as his daughter Lori, his son Harley, and his son Thomas Jr.

Under the common law existing at the time grandfather executed his will and when he passed away, the term "then living issue" was considered as giving father a "non-exclusive power of appointment." This meant that father was required to provide at least a substantial part of the remainder estate to each of his children who survived him. Prior to father's death, the legislature passed Section 652 which changed the presumption of a power of appointment to "exclusive" meaning that father could exclude any of his then living issue unless grandfather's will specified a minimum or maximum amount to be distributed to each heir.

When father died in 2006, his will gave portions of his estate to his children, Lori and Harley, but excluded Thomas Jr. from any inheritance. The issue on appeal was whether the law in effect at the time of grandfather's death or at the time of father's death controls.

The Court concluded that in order to give effect to the intent of the testator, the law in effect at the time of grandfather's death must control. The law in effect at grandfather's death was that where the donor of a power of appointment designated a class of appointees and did not expressly give the donee any right of exclusion, no member of the designated class may be entirely excluded. Each donee must receive at least a substantial portion of the distribution of the appointed property. Accordingly, father's exclusion of Thomas Jr. was invalidated.

C. Rare Book Collection not Disposed of in Specific Bequest of Personal Property

Paul Gourary died in 2007 leaving an estate of approximately $17 million. His two-page will made a specific bequest of tangible personal property to his wife, Marianne, and the residue two-thirds to Marianne and one-third to his son John. *Matter of Gourary*, 932 N.Y.S.2d 881 (N.Y. Sur. Ct. 2011). The specific bequest of personal property read as follows:

> All household furniture and furnishings, books, pictures, jewelry and other articles of personal or household use including automobiles, and all stick [*sic*] pertaining to my apartment in a cooperative corporation owning premise 45

> East 85th Street, New York City, which I may own at the time of my death, I bequeath to my wife, MARIANNE C. GOURARY, if she survives me.

The estate tax return included a rare book collection valued at $5.2 million which Marianne as executor deemed to be included in the specific bequest to her. Son John objected.

Witnesses at trial included the Curator of Prints, Drawings and Photographs at the Yale University Art Museum, family members and the partner of the drafting attorney who was deceased.

The question before the Court was whether the decedent's intention had been to include the rare book collection in the specific devise or as a part of the residue. The parties both argued about the placement of commas in the phrase "household furniture or furnishings, books, pictures, jewelry and other articles of personal or household use" and whether the phrase "of personal or household use" modifies all that comes before it or only the phrase "other articles." The Court determined that engaging in a mechanical reading or the text could still result in several different by plausible constructions. One construction was that all "books" and "pictures" (but not manuscripts, pamphlets, etc.) are included in the specific bequest. Another would be that all items displayed are included, but those stored in boxes are not. A third was that all items located in the apartment are included, but those stored at the bank or elsewhere were not.

The parties deeply disputed which of them bore the burden of proof and whether the burden was by a preponderance of the evidence or by clear and convincing evidence. The Court was not successful in locating any helpful New York precedent regarding the burden of proving which of the possible alternative interpretations was valid. The Court reasoned that where ambiguity occurs in a will "almost by definition there can be no assumption of what the decedent intended."

The Court discussed two possibilities for allocation of the burden of proof under two conflicting policies. The Court could impose a presumption that the construction of the will proposed by the executor is correct placing the burden on the objectant. This allocation would arguably further the decedent's general intent as demonstrated by the choice of a particular person as her executor. Alternatively, where the executor herself is a beneficiary, and one who could benefit from a particular construction, the burden could be placed on her to prove that her interpretation is correct. This policy would further the general principal that a fiduciary owes loyalty to all beneficiaries and may not engage in self dealing.

The Court felt it was left in a situation similar to that of determining the "best interests of the child" in a custody and visitation proceeding between parents. Rather than impose a burden on one side or the other, the Court stated that its decision "is the Court's best evaluation, based on the evidence adduced at the hearing, of what decedent meant in executing the ambiguous will at issue here."

The Court determined that the single most important fact emerging from the hearing related to the meaning of "collection." The Court likened the collection to a separate entity: an amalgamation carefully assembled as a result of research, study and contemplation. The Court found that it was "difficult to believe that decedent intended to include this, his life's avocation, in the pedestrian phrases 'books, pictures . . . and other items of personal or household use.'" The Court felt that it was more likely that the absence of any mention of the collection which was a major asset of the estate was more akin to the decedent's substantial stock portfolio and other assets and passed as a portion of the residue of his estate.

Curiously, the Court also relied on a letter the decedent had written to his stepdaughter Corinne (Marianne's daughter) that Corinne would be taken care of from the two-thirds of the estate that he was leaving to Marianne. The Court reasoned that the collection was such a large share of the estate that decedent could not have intended to leave Marianne the entire collection plus two-thirds of the residue of his estate. The Court stated that a bequest of household or personal property generally is intended to leave a spouse of many years in a basically unchanged domestic setting. The Court noted that Marianne quickly sold large portions of the collection after the decedent's death indicating that retention of the collection was not necessary to maintain her home.

D. Impact of Stepparent Adoption

In two cases, one from North Dakota, and one from Montana, courts have struggled with the legal effect of the adoption of a child. In *Kraft v. Ramos (In re Estate of Boehm)*, 816 N.W.2d 793 (N.D., 2012). The Court determined that the adopted child was a devisee under the will. Alicia Ramos was born to Kelly McCormick and William Boehm in 1979. McCormick and Boehm did not marry, and eventually their relationship ended. In 1983, McCormick married Schumacher and Schumacher adopted Ramos. Boehm's parental rights were terminated.

In 1995, Emma Boehm, William Boehm's mother, executed a will dividing the residue of her estate into seven shares, one for each of her six living children, and one for the children of a deceased son. Emma Boehm also included a clause for the disposition of a share for any child who predeceased her after the will's execution. The clause provided:

> If any of my other children shall predecease me and leave issues surviving me, such surviving issue shall take by right of representation that share herein given such deceased child of mine. Should any of my children predecease me and leave no issue surviving me, then it is my will that the share of that deceased child shall pass and be divided among my surviving children, or their surviving issue by right of representation, as the case may be.

Emma Boehm died in 2010 and was predeceased by William Boehm who died in 2000.

The trial court determined that Ramos was a devisee under Emma Boehm's will and the personal representative appealed. Neither of the parties allege that Emma Boehm's will is ambiguous, but both argue that it should be construed in their favor.

The Court addressed the definition of the term "issue" in the North Dakota Uniform Probate Code and the treatment of an adopted person under the Uniform Adoption Act. The Probate Code provided that:

> An adopted person is the child of an adopting parent and not of the natural parent, except the adoption of a child by the spouse of a natural parent has no effect on the relationship between the child and either natural parent.

The adoption statute provided that:

> The adopted individual thereafter is a stranger to his former relatives for all purposes including inheritance and the interpretation or construction of documents, statutes, and instruments, whether executed before or after the adoption is decreed.

The Court determined that where a conflict existed between state statutes the provision of each chapter must prevail as to all matters in question arising out of the same subject matter. The Court determined that the Probate Code rule that the adoption of a child by the spouse of a natural parent has no effect on the relationship between the child and either natural parent creates an exception to the general adoption statutory provision that an adopted individual is a stranger to his natural parents for the purpose of inheritance. The Court thus applied the Uniform Probate Code rather than the Uniform Adoption Act. The Court determined that Ramos was a child of William Boehm and was a proper devisee under Emma Boehm's will.

In *In re Cecilia Kincaid Gift Trust*, 278 P.3d 1026 (Mont., 2012), the Montana Supreme Court reversed the district court's finding that a child adopted out of the family was a "lawful blood descendant" of the decedent. In December 1976, Cecilia Bates created a trust agreement under which her son, George Kincaid, was the sole beneficiary. George died in 2009.

Jennifer was the natural child of George Kincaid having been born after the trust was established and given up for adoption when she was a small child. The issue was whether Jennifer was a beneficiary upon George's death under the trust provision directing that the trust proceeds be distributed to George's "living descendants." The trust defined descendants as follows:

> As used herein, the term "descendant" or "descendants" shall mean lawful blood descendants in the first, second or any other degree of the designated ancestors; provided, however, that an adopted child and the lawful blood descendants of any such adopted child shall for all purposes

> be regarded as the lawful blood descendants of the adopting parent or parents and of any one who is by blood an ancestor of the adopting parent.

The district court determined that Jennifer was a "lawful blood descendant" of George Kincaid and should be included in the trust distribution. The trustees appealed.

The district court construed the "adopted child" language to describe only children who were adopted into the family by George. The trustees contend, however, that the adopted child language makes no distinction between children adopted into or out of the family. The trustees contend that under the plain language of the trust any adopted child is deemed to be a descendant of the child's adopting parent and not a descendant of the child's natural parent. The trustees contend that for purposes of the trust, Jennifer is deemed to be a child of her adoptive parents and not a descendant of George.

The Court determined that the language of the trust instrument was not ambiguous and concluded that the plain language of the trust agreement made no distinction between children adopted into the family and children adopted out of the family. The Appellate Court reversed the district court's determination and held that the plain language of the trust provided that any adopted child is deemed to be a descendant of the child's adoptive parents. Jennifer was determined not to be a descendant of George under the trust agreement because she was adopted out and, therefore, is regarded as the lawful blood descendant of her adopting parent.

E. Illegitimate Descendant Excluded

In *Matter of Dwight*, 949 N.Y.S.2d 921 (N.Y. Sur. Ct. 2012) addressed the question of whether the phrase "lawful issue" in a trust agreement included a child born out of wedlock. JPMorgan Chase as trustee brought a petition for advice and direction in interpreting the term "lawful issue" in a 1971 trust agreement. The grantor had three children, Maitland Sr., Jacqueline and Robert. Maitland Sr. was deceased and his one-third interest in the income had been distributed to his three children, Mary, Margaret and Maitland Jr. Maitland Jr. died and the question before the Court was whether his illegitimate child, Heather, should receive his share of the trust income.

Heather submitted a motion including affidavits from her paternal aunts, Mary and Margaret, a copy of her birth certificate listing Maitland Jr. as her father, photographs, letters, a copy of Maitland Sr.'s will naming Heather as a granddaughter and beneficiary, and a copy of Maitland Jr.'s will naming Heather as his daughter. The Court wrestled with the probate law under which use of the term "lawful issue" generally is indicative of an intent to exclude non-marital children and the paternity law which allows a non-marital birth father to legalize or legitimatize his child. Although the Court felt that her evidence supported her father's acceptance of her, the Court ruled that Maitland had not in fact legitimatized Heather prior to the death of his mother and accordingly Heather was not the legal issue under the trust agreement. In a truly perplexing ruling, the Court held that the evidence, if believed, "would permit her to take as a distributee under intestacy," but not under the trust agreement.

F. Reformation of a Trust for Mistake

The North Dakota Supreme Court analyzed its state statute allowing reformation of a trust agreement for mistake of fact or law and determined that where a mistake was made and the donor's actual intention could be determined, reformation would be allowed. In *Clairmont v. Larson (In re Larson Trust Agreement*, 2013 N.D. 85 (2013). Mr. and Mrs. Clairmont have four children. Their daughter, Cindy, was married to Greg, and they had four children, including a son Matthew. Cindy and Greg were divorced in 2001 and Greg remarried and had two additional children with his second wife.

Since 1991, the Clairmonts have created numerous trusts for the benefit of their grandchildren, and used different attorneys to draft each set of the trust agreements. Most of the trusts were created prior to Cindy and Greg's divorce and prior to the birth of Greg's two younger children. Several of the trust agreements contained provisions that if a grandchild died before attaining the age of trust distribution the assets would pass to his issue by right of representation, and if he left no issue, then to his "brothers and sisters and the issue of a deceased brother or sister by right of representation."

Matthew died in March 2011 without descendants. The Clairmonts petitioned the District Court to interpret the trust agreements to include only Matthew's brothers and sisters who are lineal descendants of the Clairmonts as beneficiaries of the trusts or, alternatively, to reform the trusts to this interpretation. The Clairmonts argued that a mistake was made in drafting the trusts if the phrase "brothers and sisters" is interpreted to include Matthew's siblings who are not lineal descendants of the Clairmonts.

The District Court determined that the children of Greg's second marriage were beneficiaries of the trusts because "brothers and sisters" as defined in N.D.C.C. § 30.1-04-07 includes relatives of the half blood as if they were of the whole blood. The District Court dismissed the Clairmonts' petition to reform the trusts ruling that the Clairmonts failed to establish a mistake of fact or law sufficient to reform the trust.

The District Court denied the Clairmonts' petition for reformation because the Clairmonts were unable to establish that they had considered the issue of whether half-siblings should be included in the phrase "brothers and sisters." At the time the trusts were created Greg and Cindy were still married to one another and the testimony was that the Clairmonts never considered the issue of children born of a second marriage.

The Appellate Court determined that the District Court misapplied the law as to trust reformations. It held that trust reformation cases "are inherently different from other interpretation cases, and therefore, the same legal principles do not apply. In reformation cases, a party claims the trust as it is currently written has an error and does not reflect the settlor's intent. The Court determined that the applicable North Dakota statute specifically allows a trust to be reformed even if the terms of the trust are unambiguous. In an interpretation case, on the other hand, if the trust document is unambiguous, the court cannot accept parol evidence of the testator's intent.

Given that the Appellate Court considered the settlors' intent to be paramount, it gave considerable weight to the testimony of the Clairmonts that they never intended to

make gifts to anyone other than their grandchildren who are their blood descendants. Additionally, the Appellate Court determined that Greg did not present any factual evidence disputing the Clairmonts' intention to exclude grandchildren who were not their lineal descendants and, accordingly, the Court allowed the reformation of the trust.

III. TAX LAW UPDATES

A. Executor Personally Liable for Federal Gift Tax

In *U.S. v. Macintyre*, 110 A.F.T.R. 2d, 2012-5151 (S.D. Tex. 2012), the executors of a donee's estate were found to have personal liability for the gift tax that had not been paid by the donor. In 1995, Howard Marshall made gifts to a grantor retained income trust in the amount of $35,939,316 and died shortly thereafter. The IRS assessed a gift tax against Marshall's estate, which the estate did not pay. The gift tax liability shifted to the donee, Eleanor Stevens, who died in 2007.

Pierce Marshall became the sole executor of Stevens' estate and Finley Hilliard was the trustee of Stevens' living trust. Marshall was informed that the IRS might assert donee liability against Stevens' estate but apparently did not believe that transferee liability could be asserted. The executor made distributions of personal property from the estate and paid rent on Stevens' vacant apartment for 12 months. Hilliard also was aware that the trust might be liable for unpaid gift taxes but used the trust funds to pay accounting fees, legal fees and other administration expenses. The government brought claims against both Marshall and Hilliard for personal liability for distributions made from the estate and trust to creditors with lower priority than the federal government.

The Federal Priority Statute, 31 U.S.C. § 3713, provides that a fiduciary has liability for distributing estate assets before paying a claim of the United States if the fiduciary knew or should have known of the United States' claim. Marshall and Hilliard argued that they did not have actual knowledge of the claim because they had received legal advice that the transferee liability did not apply. The Court determined that the knowledge requirement of the statute did not require actual notice, but instead, requires that the fiduciary had "notice of such facts as would put a reasonably prudent person on inquiry as to the existence of the unpaid claim."

The Court turned to Texas law to determine the priority of claims and determined that the debts of a descendant do not have priority over the government's claims, but certain expenses of administration of the estate do. Additionally, distributions made to beneficiaries do not have priority over the government's claims.

The Court held that the fiduciaries were personally liable for the distributions of the personal property and for the rent paid on the apartment past a reasonable amount of time. The expenses paid for administration of the estate including attorneys' fees and legal fees were not charged against the fiduciaries.

B. Fraud Penalty for Undervaluation of Estate Assets

In *Gaughen v. U.S.*, 109 A.F.T.R. 2d 2012-752 (M.D. Penn. 2012), a taxpayer timely filed a gift tax return listing gifts of ownership interests in seven parcels of real estate. The taxpayer obtained "restricted use appraisal reports" of each of the parcels. The IRS challenged the fair market value of the properties listed on the return and submitted appraisals indicating that the properties were undervalued by a total of $4,873,000. The IRS assessed an additional gift tax due and assessed a fraud penalty of $791,430 plus interest of $493,677. The taxpayer paid the taxes, penalty and interest and filed a claim for refund.

On a motion for summary judgment filed by the taxpayer, the Court addressed the question of whether any part of the underpayment could be attributed to fraud such that the 75% penalty under I.R.C. § 6663 was appropriate. Noting that issues such as intent or fraud are rarely suitable for summary judgment, the Court found three pieces of circumstantial evidence offered by the United States that were sufficient to demonstrate a genuine issue of material fact as to the taxpayer's state of mind when filing the gift tax return. Taking all the evidence in the light most favorable to the non-moving party, the Court determined that the extreme understatement of the valuation was circumstantial evidence of fraud. The taxpayer noted that four experts in the case all reached different determinations of fair market value and thus that the large discrepancy between the values listed by the IRS and the fair market value of the properties according to at least one of the appraisers should not be taken as evidence of fraud. The Court determined that these arguments impact the weight of the evidence but do not preclude the use of undervaluation as evidence of fraud.

Secondly, the Court found that the taxpayer's valuation of the properties was substantially lower than the tax-assessed values issues by the county and thus provided circumstantial evidence of a fraudulent intent.

Finally, the Court found that with respect to at least two of the parcels the taxpayer had negotiated a sales contract within a few months of the valuation date at substantially higher values. The taxpayer argued that sales of property occurring after the valuation date are not to be considered in determining fair market value except to the extent that the events were reasonably foreseeable on the valuation date. The Court found, however, that the taxpayer entered into at least one of the contracts prior to the valuation date and that the other was only four months after the valuation date. The Court determined that the taxpayer knew that he was undervaluing the properties on the return and intentionally ignored credible evidence of higher market valuations.

The taxpayer argued that he cannot be found liable for fraud because he relied in good faith on the valuation reports prepared by his expert, Mr. Foote. The Court held that reliance on a valuation by an expert is not an iron-clad defense in tax fraud cases and that a taxpayer must always exercise due care in obtaining an appraisal of fair market value. Shockingly, the record demonstrated that the taxpayer instructed his expert on how to value the properties. The taxpayer wrote a letter to his appraiser stating that "I need a restricted appraisal report very close to $65,000 supporting my conveyance."

Additionally, the taxpayer withheld from his appraiser certain information regarding the negotiated sales of the parcels and the appraiser testified that the information would have been "nice to know." The Court determined that a reasonable jury could determine that the taxpayer should not have adopted Foote's appraisals in light of the sales agreements he had negotiated. Finally, the Court reasoned that the taxpayer was a sophisticated taxpayer "with more than thirty-one years of experience in real estate." The Court denied summary judgment and allowed the fraud charges to be submitted to a jury.

C. Grantor Trust Rulings

In several rulings, the IRS has addressed questions related to the treatment of grantor trusts for income tax purposes. I.R.S. Priv. Ltr. Rul. 201216034 (Apr. 20, 2012). The service again ruled that a trust beneficiary will be treated as a grantor for income tax purposes under I.R.C. § 678(a)(1) of that portion of the trust over which the beneficiary had a withdrawal power that has not lapsed. Additionally, to the extent that the beneficiary fails to exercise the withdrawal power and the power lapses, he will be treated as having released a power while retaining the power of administration, exercisable in a non-fiduciary capacity, to acquire trust property by substituting other property of equal value. In this ruling, the primary beneficiary of a trust was also the trustee and had a *Crummey* withdrawal power that lapsed each year in the greater amount of $5,000 or 5% of the value of the trust property. The trust beneficiary was given the power to substitute other property of equivalent value in a non-fiduciary capacity.

The Service concluded that the primary beneficiary would be treated as the owner of the trust under I.R.C. § 678(a)(1) of that portion of the trust property over which his withdrawal power had not lapsed. Further, to the extent that the primary beneficiary failed to exercise a withdrawal power and the power lapsed, the primary beneficiary would be treated as having released the power while retaining the power to substitute assets. Assuming the primary beneficiary held a withdrawal power over all contributions to the trust, the primary beneficiary would be treated as the owner of the trust in its entirety.

In circumstances in which the trust is designed to be a wholly-grantor trust as to the settlor of the trust, that status in effect trumps the grantor status of individual beneficiaries who hold lapsing *Crummey* powers. I.R.S. Priv. Ltr. Rul. 201235006 (Aug. 31, 2012). In This ruling, the irrevocable trust was designed to provide rights of withdrawal to each of the taxpayer's children and grandchildren limited by the gift tax annual exclusion in effect at the time of each contribution and subject to lapse at the end of each calendar year or, if earlier, 30 days after the date of the contribution. Additionally, the settlor of the trust had the power exercisable at any time and from time to time in a non-fiduciary capacity and without the consent or approval of any other person to acquire or reacquire any trust assets by substituting other property of equal value. The Service determined that although the withdrawal rights granted to the beneficiaries resulted in treatment of the beneficiaries as owners of portions of the trust property, where the trust is a grantor trust under I.R.C. § 675(4) with respect to the settlor, then it is a grantor trust in its entirety with respect to the settlor notwithstanding

the withdrawal rights held by the beneficiaries that would otherwise make them owners under I.R.C. § 678(a).

In this ruling, the Service also confirmed that the settlor's power to reacquire the corpus of the trust by substituting other property would not result in the settlor possessing incidence of ownership under I.R.C. § 2042(2) in a life insurance policy held by the trust and further, that the trust property would not be includable in the settlor's gross estate under I.R.C. §§ 2033, 2036 and 2038.

D. Life Insurance and Irrevocable Insurance Trusts

The question of the valuation of life insurance policies continues to challenge taxpayers and courts alike. In *Schwab v. Comm'r.*, 111 A.F.T.R. 2d 2013-1746 (9th Cir., 2013), the Court addressed the question of the valuation of life insurance policies for income tax purposes but the Court's rationale might have useful extension to the estate and gift tax arena. Michael Schwab and Kathryn Kleinman, a married couple, were employees and the sole shareholders of Angels and Cowboys, Inc. Each purchased a variable universal life insurance policy through the company and the policies were held in a multiple-employer welfare benefit trust administered by a third-party company as part of a non-qualified employee benefit plan. The variable universal life policies were designed to allow a portion of the premiums to be invested in separate investment accounts within the policy. The taxpayers chose to invest their premium payments in an S&P 500 Index Fund. If investment returns had met expectations, the investment returns might have supported future policy premiums, but during the three-year period beginning in September 2000, the S&P 500 Index Fund declined nearly 34%.

To add insult to injury, the tax law favoring this type of employee-benefit plan changed and accordingly, the plan's administrator terminated the plan and distributed the insurance policies to Schwab and Kleinman.

The insurance policies were subject to surrender charges if Schwab and Kleinman allowed their policies to lapse or otherwise terminated them prior to a specific date. Additionally, the policies contained no lapse provisions specifying that the policies would not lapse in the first three years of coverage if the sum of the premiums paid was sufficient. At the time the policies were distributed from the plan the surrender charges exceeded the stated policy values. Distribution of the policies from the trust was a taxable event under I.R.C. § 402(b)(2) but the question for the Court was the value of the policy that was taxable.

The taxpayer argued that the policy values were negative, and accordingly, no tax was due. The Commissioner argued that the full stated value of the policy without regard to the surrender charges must be treated as income. The Tax Court determined that the valuation of an insurance policy under § 402(b) could take into consideration surrender charges as a part of an inquiry into a policy's fair market value. The Commissioner appealed arguing that surrender charges may never be considered when determining the "amount actually received" from an employee's trust under § 402(b)(2). The Commissioner argued that I.R.C. § 72(e)(3)(A) should be engrafted into § 402(b)(2) and with it the prohibition against consideration of surrender charges. The Tax Court and the

Ninth Circuit agreed that the Commissioner ignored the language of § 402 which provides that the taxable amount is the "amount actually distributed or made available." The Ninth Circuit reasoned that the taxable amount must be the fair market value of the insurance policy.

The Court reviewed several cases in which courts have found various methodologies for determining the fair market value of a life insurance policy. In one, the fair market value was determined to be the purchase price of a single premium policy, and in another, the replacement cost of purchasing a similar policy. The Court stated that "the fair market value of insurance contracts can be a slippery concept," and that a particular method for determining the value of an insurance policy may be appropriate in one situation but inappropriate in another.

The Court agreed with the Tax Court that the variety and number of insurance policies was simply too great to adopt a single general rule as to the valuation of all policies. The Court determined instead that in determining the fair market value of a policy surrender charges may be considered because they can affect the fair market value of the policy. The Court noted that just as variable universal life insurance policies did not exist when the courts decided prior cases "ever creative financial institutions are liable to devise new life insurance instruments that we cannot contemplate today." Although this ruling was good news for these taxpayers and appears to be the correct result, the question still remains as to the appropriate valuation of the many different types of insurance contracts on the market today.

Irrevocable life insurance trusts continue to cause planners headaches. In one Chief Counsel Memorandum, the Internal Revenue Service addressed the question of whether gifts to an irrevocable life insurance trust qualified for the annual exclusion. I.R.S. Chief Couns. Memo. 201208026 (Feb. 24, 2012). Taxpayers created an irrevocable life insurance trust and made contributions to it in order to pay premiums on life insurance on their lives. The trust provided that each beneficiary had the power to withdraw the annual exclusion amount under § 2503(b) in any year in which the transfer was made to the trust. However, a provision buried in the back of the trust document stated that all questions and disputes concerning the trust must be submitted to arbitration. The trust agreement prohibited a beneficiary from filing or participating in a civil proceeding to enforce the trust lest they be excluded from any further participation in the trust.

Although the arbitration clause was probably included to simplify the process of resolving trust disputes, the chief counsel determined that the clause prohibited a beneficiary from seeking civil redress under the document. In order for the withdrawal right to be a present interest that qualifies for the annual gift tax exclusion, the withdrawal right must be enforceable by the beneficiary. The memorandum indicated that "as a practical matter, a beneficiary is foreclosed from enforcing his withdrawal right in a State court of law or equity." Because the withdrawal rights were not legally enforceable, they did not constitute a present interest and the annual exclusion was denied.

E. Binding Effect of State Court Rulings on GST Trusts

The Service has addressed in several rulings the question of whether a state court's order construing or reforming a trust agreement will be recognized by the IRS for tax purposes. Sometimes these rulings appear to be directly at odds with one another.

In I.R.S. Priv. Ltr. Rul. 01220030 (May 18, 2012), the Service adopted the state court's determination. There, a settlor created a trust for her spouse for his lifetime. At the spouse's death, the property of the trust was divided equally among five separate trusts, one each, for a child, his three children, and the child of a deceased child. One of the grandchildren died, and the assets of her trust were distributed to her children and her trust terminated. Later, the settlor's child died and by the terms of the trust, the assets were distributable to the other "then existing trusts."

The trustees filed a petition in state court requesting construction of the term "then existing trusts" to determine whether the deceased grandchild was to take a share in spite of the fact that her trust had previously terminated. The trustees asked the court to consider that: (1) the settlor intended to equally divide trust property among all four of her grandchildren; (2) the grandchild's trust should be considered to be still in existence because it held a vested interest in the child's trust and a defeasible interest in the other grandchildren's trusts; and (3) because each grandchild's trust exists as long as it holds a defeasible interest in the other grandchildren's trusts, a trust for a grandchild who dies without issue should be divided in equal sharers among the other three grandchildren's trusts. The state court concluded that the settlor did intend for the assets of the child's trust to be shared by all four grandchildren's trusts including the trust of the predeceased grandchild.

The Tax Court then faced the question of whether the state court's construction caused the trusts to lose their GST-exempt status or caused any beneficiary of a separate trust to be deemed to have made a gift to the others for federal gift tax purposes.

The Tax Court began with an analysis of *Comm'r. v. Bosch*, 387 U.S. 456 (1967), in which the Supreme Court considered whether a state court's characterization of property rights was conclusive and binding on a federal court or agency in a federal estate tax controversy. The court there ruled that the decision of a state trial court as to an underlying issue of state law is not controlling when applied to a federal statute. In cases in which the highest court of the state has not ruled on an issue, the federal court sits in place of the state court.

The Service reviewed state statutes and determined that the state courts construe the term "trust property" liberally to include contingent interests and interests subject to divestiture and concurred with the state court's determination that the settlor intended the grandchildren to share equally the assets of the various trusts. Accordingly, the Service ruled that the construction of the phrase "then existing trust" did not cause the trusts to lose their exempt status for purposes of generation-skipping tax, and did not cause any beneficiary to be deemed to have made a gift to the others.

In a contrary ruling, the Service refused to recognize a state court reformation of a trust document for federal tax purposes. I.R.S. Priv. Ltr. Rul. 201243001 (Oct. 26, 2012). There, the decedent's estate plan provided that a portion of her estate would pass outright to her son. In a first amendment to her revocable trust agreement she instead provided that the portion of her estate would pass to her son, but if he disclaimed any part of his share, the disclaimed assets would pass to an irrevocable trust for the benefit of the son and his descendants. The son's intention had been to disclaim a part of his share of the estate with the result that that part would pass to an irrevocable trust for him and his children. However, his attorney discovered after the decedent's death, that a qualified disclaimer cannot be made by a person who is not the spouse of the grantor if the disclaimed property passes to a trust for the benefit of the disclaimant. The son did not file a qualified disclaimer but instead, in his capacity as trustee, petitioned the State Court to reform the provisions of the trust in order to have a part of the son's share placed in trust for him and his descendants. The State Court order was made contingent upon obtaining a favorable private letter ruling from the Internal Revenue Service.

The taxpayer took the position with the Service that the amendment created an ambiguity or a scrivener's error due to a mistake of law or fact, and accordingly, that the reformation was necessary to interpret the true meaning of the document. The Service reiterated the general rule that a state court reformation of a trust instrument is not binding on third parties including the Internal Revenue Service. Citing a long line of cases arising after *Bosch*, the Service indicated that it would give due regard to a state court order in circumstances in which a true mistake was sufficient grounds to reform a trust. In the present situation, the Service found no ambiguity in the trust amendment, determined that no real drafting error had been made, and refused to give effect to the state court ruling.

F. Gifts and Loans

It seems that courts wrestle frequently with the fine line between gifts and loans as they relate to estate and gift taxes. The bar is high to prove a valid debt for estate or gift tax purposes, especially among family members, and taxpayers sometimes have difficulty providing the necessary evidence to support the loan.

In one such case, a married couple had separate investment accounts with Merrill Lynch. *Derksen v. U.S.*, 110 Aftr. 2d 2012-6620 (E.D. Pa. 2012). Mrs. Derksen successfully played the stock market as a hobby and her individual account increased substantially in value. Mrs. Derksen suffered a stroke and turned over the management of her stock portfolio to Merrill Lynch. In April 1994, Mrs. Derksen's individual account was valued at approximately $435,000 and the couple's joint account was worth approximately $260,000. Mr. Derksen's individual account was valued at approximately $27,000. In May 1994, the couple transferred the assets in their joint account to Mr. Derksen's individual account.

The taxpayers testified that they intended to keep their estates as nearly equal as possible and that Mrs. Derksen "did not like the estate tax" and would wish to "keep their estate tax as low as would be legitimate to do so." Mrs. Derksen's daughter encouraged

her mother to sign a promissory note to her father in the amount of the difference between their accounts.

The $200,000 promissory note was listed as a receivable on Mr. Derksen's estate tax return when he died, although funds never transferred into his estate. The district court determined that there was no evidence that Mrs. Derksen received any value in exchange for the promissory note. The Court determined that agreements between family members should be viewed with particular scrutiny and that in the absence of any contemporaneous evidence to substantiate the alleged agreement between the parents found the debt to be invalid and disallowed the deduction on the estate tax return.

In *Lockett v. Comm'r.*, T.C. Memo. 2012-123 (Apr. 25, 2012), a taxpayer was able to survive the scrutiny of the court and substantiate family loans. There, the family created a family limited partnership and the partnership loaned funds to several of the partners. Each partner executed a promissory note that included terms of the debt such as interest rates and due dates. In several cases, the partner failed to make certain interest payments required under the promissory notes. In a couple of instances, the promissory notes sere not executed by the partners.

The Court determined that in the circumstances in which promissory notes were signed, amortization schedules were prepared, and the loan was included on the books of the partnership, the loans were valid and would be recognized for tax purposes. In the circumstances in which the partners failed to execute a promissory note, the transfers instead were treated as gifts for gift tax purposes.

G. Filling in the Blanks

Dr. Sommers owned a valuable collection of original art by world-famous artists and transferred 12 pieces of art from his home in New Jersey to his nieces' homes in Indiana and Illinois. *Sommers v. Comm'r.*, T.C. Memo. 2013-8 (Jan. 10, 2013). Shortly thereafter, Dr. Sommers consulted his estate planning attorney who instructed Dr. Sommers to obtain an appraisal of the 12 works of art. The appraisal came back substantially higher than anticipated at a value of $1,750,000, which was significantly more than Dr. Sommers' exclusion amount of $675,000. Dr. Sommers' estate planning attorney suggested that he and his nieces form a limited liability company to own the art and recommended that Dr. Sommers could make gifts of limited liability company units to the nieces over two or three years, in order to take advantage of both the increase in the exclusion amount to $700,000 and the annual gift tax exclusions.

An LLC was formed, Dr. Sommers transferred title to the 12 works of art to the LLC and Dr. Sommers and the nieces signed an operating agreement with certain transfer restrictions. On December 27, 2001, Dr. Sommers executed three documents entitled Gift and Acceptance of Capital Units which purported to transfer LLC units to each of the nieces although the number of units was left blank. On January 4, 2002, Dr. Sommers executed identical documents to effect an additional transfer of LLC units and again the number of units was left blank. In March 2002, the appraisal was completed and the estate planning attorney concluded that only about 15% of the LLC units could be transferred to the nieces without the payment of gift tax.

The nieces became alarmed about this outcome because they were concerned that Dr. Sommers was soon to remarry and would likely leave the remaining interest in the artworks to his new spouse. The recommendation was made that if the nieces agreed to pay any gift taxes attributable to the transfer, Dr. Sommers could transfer 100% of the ownership of the LLC to them. The nieces quickly agreed to be obligated to pay the 2002 gift tax. The estate planning attorney then filled in the blanks on the 2001 and 2002 gift documents with the result that 100% of the LLC units were transferred to the nieces.

At about that same time, and probably in connection with his decision to remarry, Dr. Sommers decided to change his estate plan by removing his nieces as beneficiaries of his estate and hired a new attorney to prepare his new estate planning documents. The lawyer notified the prior estate planning lawyer that her services were no longer needed.

Dr. Sommers then commenced an action against the nieces in state court alleging that the gifts of LLC interests were revocable or invalid. The arbitrator in that case recognized the possibility that Dr. Sommers had had a change of heart after the date of the transfers but determined that at the time he signed the gift documents he understood what he was doing and intended to make the gift. The arbitrator found that he left with his prior estate planning attorney the discretion to fill in the blanks after the appraisal was completed and that he never revoked this authority. Accordingly, the arbitrator concluded that Dr. Sommers made a valid irrevocable transfer of the artwork to the LLC and thereafter made valid gift transfers in December 2001 and January 2002 of all of his capital shares of the LLC to his nieces. The Superior Court confirmed the arbitrator's award and the Indiana Court of Appeals upheld the Court's determination.

Dr. Sommers died and his spouse filed a complaint in Probate Court essentially seeking to find that the gifts were either incomplete or revocable or to reform the gifts to reduce them to the maximum amount that could be transferred free of gift tax. The Probate Court concluded that the decedent intended to, and did, make completed gifts of the LLC units and that the nieces agreed to pay any gift tax penalties and interest associated with the decedent's 2002 gifts of the LLC units. The New Jersey Superior Court affirmed the Probate Court's judgment.

In the Tax Court proceeding on cross-motions for summary judgment, the Tax Court determined that the Indiana and New Jersey cases involved the same issue and applied the same legal principals as those before the Tax Court and, accordingly, the taxpayer was collaterally estopped from challenging the validity of the gifts. The Tax Court went on to determine that even if the prior state court actions did not amount to collateral estoppel the Court reached the same determination that the gifts were valid taxable gifts under federal law. Interestingly, the Court found that the parties' intent with respect to the blanks in the gifting documents was to have the original estate planning attorney carry out the terms of the original agreement and did not grant Dr. Sommers the right to alter, amend, revoke or terminate it. The Court found that essentially "filling in the blanks was to be a ministerial act" of completing the terms of the parties' original agreement.

H. The IRS Giveth and Taketh Away

In at least one recent ruling, the Service has granted relief to a taxpayer who acted reasonably and in good faith. I.R.S. Priv. Let. Rul. 201233011 (Aug. 17, 2012). In an earlier ruling, a taxpayer requested an extension of time to make a qualified terminable interest property election under § 2523(f)(2) for transfer of stock to a trust for the benefit of a spouse. The grantor had funded the trust which would otherwise have qualified for the QTIP election. A gift tax return was timely filed, but the QTIP election was not made. In I.R.S. Priv. Let. Rul. 20125021 (Jun. 25, 2010), the Service granted the taxpayer a 60-day extension from the date of the issuance of the PLR to file an amended gift tax return and make the QTIP election.

Subsequently, in I.R.S. Priv. Let. Rul. 201109012 (Mar. 4, 2011), the IRS revoked the prior ruling because it was contrary to other rulings made by the Service and contrary to statutory authority. The Service determined that the earlier ruling was in error and not in accordance with the current views of the Service. The time for filing a QTIP election on a gift tax return is expressly prescribed by I.R.C. § 2523(f)(4) and because the time is fixed by statute rather than by regulations, the Service did not have the authority to grant an extension. This ruling is consistent with numerous other rulings by the Service on this issue.

Subsequent to receiving the revocation notice, the taxpayer requested relief under I.R.C. § 7805(b) to limit the retroactive effect of the revocation of the earlier PLR. The taxpayer made the request because after having received the earlier favorable ruling, the taxpayer released from malpractice liability the law firm that had prepared and filed the gift tax return and neglected to make the QTIP election. Having released the law firm, the taxpayer had no recourse for the tax and penalties of the late QTIP election.

The IRS granted the taxpayer's relief because the taxpayer, in good faith, relied on the revoked PLR and applying the revocation retroactively would have been to the taxpayer's detriment.

In *Rossman v. U.S.*, 109 A.F.T.R. 2d 2012-985 (Ct. Fed. Cl. 2012), the taxpayer was not so lucky. The plaintiff was the executor of her mother's estate and sought a refund of penalties assessed against the estate for the late payment of the estate tax, claiming that the estate's failure to pay the tax in a timely manner should be excused because the delay was due to reasonable cause and not willful neglect. Mrs. Cusenza died on August 15, 2005. On April 12, 2006, the estate sought and received an extension until November 15, 2006 to pay the estate tax. On November 14, the estate tax return was filed showing a tax due of $810,276 plus interest for a total balance due of $842,555. Along with the return, a second application for time to pay estate taxes until February 15, 2007 was filed. The application was granted.

A third application for extension of time to pay was submitted one day before the expiration of the February 15, 2007 deadline. The Service again granted an extension of time to pay the estate tax until August 15, 2007. An additional estate tax payment of $100,000 was made on February 21, 2007, but as of August 15, 2007, the estate had not

fully satisfied its tax obligation, and did not seek an additional extension of time to make the payment.

Plaintiff argued that the estate's failure to meet the payment deadline was due to reasonable cause because: (1) the death of both of her parents in a close timeframe made it emotionally difficult for her to handle the tax consequences of the estate, including obtaining, financing and liquidating assets; (2) the "unprecedented credit crisis" impeded the estate's ability to pay the estate tax; and (3) her accountant failed to give her proper advice about the option of satisfying the estate tax liability through monthly payments. The Service argued that plaintiff, by failing to seek further extensions of time to pay the estate tax, did not exercise ordinary business care and therefore, could not rely on the reasonable cause provision of § 6651(a)(2) to avoid the penalties.

The Federal Court of Claims determined that the fact that the estate had sought and received several extensions of time to pay the estate tax indicated that the executor was neither under emotional distress nor in any other way prohibited from seeking appropriate extensions. The Court reconfirmed the long-standing principle that a taxpayer is not excused for having relied on an accountant or attorney for advice. The burden of timely filing and timely payment of tax lies directly with the executor. The Court, in a footnote, indicated that examples of reasonable cause might include unavoidable postal delays, reliance on erroneous advice given by an IRS employee, death or serious illness of the taxpayer or destruction of records by casualty. Mere neglect does not arise to reasonable cause.

IRS enforcement of tax laws is wide ranging and sometimes its methods can be surprising. *In re: Does*, 108 A.F.T.R.. 2d 2011-7499 (E.D. Cal. 2011). The Service sought the Court's permission to serve "John Doe" summonses on California's Board of Equalization to obtain real estate tax records for unnamed taxpayers between the years 2005 and 2010 who were involved in real estate transfers from parents to their children or grandparents to their grandchildren for little or no consideration. The Service was attempting to locate taxpayers for potential gift tax audits.

The IRS power to summon includes situations in which the identity of the taxpayer is unknown, but the Service must show that:

1. It's investigation relates to an ascertainable class of persons;

2. A reasonable basis exists for the belief that these unknown taxpayers may have failed to comply with the Tax Code; and

3. the Service cannot obtain the information from another readily available source.

The Service presented to the Court statistics certifying that this class of California residents involved in the identified real estate transactions were very likely to be in violation of the Tax Code. The case did not describe the methodology of the survey, but it was conducted by the Service and apparently supported a finding that at least 50% and up to 90% of individuals in the identified class failed to file gift tax returns. An IRS

attorney testified by declaration to the Court estimating that between 60% and 90% of taxpayers who transfer real estate for little or no consideration to family members failed to file gift tax returns. The Court determined that the Service had a reasonable belief that taxpayers in the identified class had failed to comply with the tax law.

The Court further determined that the documents were not readily available elsewhere because the Service had demonstrated that contacting each of the 58 counties in the state would have been unduly burdensome. The Court granted the Service's request to issue the John Doe summons.

IV. GRANTOR TRUST RULES*

A. What is a Grantor Trust

A grantor trust is a trust in which the settlor retains certain interests or control that cause him or her to be treated as the owner of the trust's assets for income tax purposes and, thus, any income, dividends, or gains from those assets are taxed to the grantor on the grantor's individual income tax return. These rules are outlined in I.R.C. §§ 673-678. These rules do not apply to charitable remainder trusts or pooled income funds. Treas. Reg. § 1.671-1(d).

An intentionally defective grantor trust (IDGT) is a trust that is structured so that the grantor is taxed on the trust's income for income tax purposes, rather than the trust or the beneficiaries, but is not taxed on the assets at death for estate tax purposes. The goals in creating an IDGT are:

1. The trust is defective for income tax purposes, meaning that the grantor will be taxed on the items of income, deductions, and credits, rather than the trust;

2. The trust is effective for estate tax purposes, meaning that the trust will not be includible in the grantor's gross estate;

3. The trust is a wholly grantor trust; and

4. The sale of assets to the trust is not treated as a taxable event.

While technically any grantor trust that is created on purpose, rather than inadvertently, is an "intentionally defective grantor trust," specific types of trusts that are commonly structured as grantor trusts are revocable trusts, irrevocable life insurance trusts, and charitable lead annuity trusts.

A grantor irrevocable life insurance trust (ILIT) is created during the settlor's life. Generally, the settlor will contribute cash or other assets to the trust, which the trustee will then use to purchase an insurance policy on the settlor's life. These trusts must be

* Portions of this outline were prepared by the author's partner Anne L. Bjerken and associate Brianna M. Mooty.

carefully structured so that the life insurance policy is not included in the settlor's gross estate and, in most cases, include *Crummey* withdrawal rights so that the settlor can make annual exclusion gifts to pay the premiums on the life insurance policy. To achieve these benefits, it is important that the settlor is not the trustee of the trust.

A grantor charitable lead annuity trust (CLAT) is structured so that the trust makes annual income distributions to a charitable organization for a term of years (or for one or more person's lifetimes), after which the remaining trust property passes to the remainder beneficiary. The trust is generally funded with rapidly appreciating assets so that the expected amount of the gift to the remainder beneficiary at the time the trust is created is small, resulting in little or no gift tax, but will ultimately exceed the amount that was subject to gift tax. If the trust is structured as a grantor trust, the donor has the added benefit of receiving a current charitable income tax deduction for the present value of the amount predicted to pass to charity.

A revocable trust is the most common grantor trust. This type of trust is used as a will substitute to avoid probate and all of the trust assets are includible in the settlor's estate. For that reason, this type of trust does not have the same tax benefits of other types of grantor trusts.

B. Who is a Grantor?

A grantor includes any person who creates a trust, or directly or indirectly makes a gratuitous transfer of property, including cash, to the trust. Treas. Reg. § 1.671-2(e).

Under the spousal attribution rules, the grantor is treated as holding any power or interest held by any individual who was the spouse at the time the power or interest was created, or who became the spouse of the grantor after creation (though the grantor is only taxed for the period after the individual became the spouse). IRC § 672(e)(1).

The spousal attribution rules apply if the spouse and the grantor are eligible to file a joint income tax return for the relevant period. There can be inadvertent problems in the application of these rules if:

1. The trust was not intended to be a grantor trust but the spouse is given certain powers;

2. The spouse is not a U.S. citizen or resident alien;

3. The grantor and the spouse have different taxable years; or

4. The grantor and the spouse later divorce (as this does not terminate the grantor trust status).

Gift splitting alone does not cause grantor trust issues, but some trusts with spousal interest may not be eligible for gift splitting.

A trust can be a wholly grantor trust or a partially grantor trust. A grantor (or other person) can be treated as the owner of:

1. The entire trust;
2. Specific trust assets;
3. Trust principal;
4. Trust income;
5. A pecuniary share; or
6. A fractional share.

A joint trust can be treated as a grantor trust as to both spouses. When one spouse dies, it is a partially grantor trust. When creating a grantor trust, including an intentionally defective grantor trust, the preference is always to have it be a wholly grantor trust. This significantly reduces the complexity of administering the trust.

With a wholly grantor trust, the grantor is taxable on all trust income, deductions, and credits in the computation of his or her personal income tax as if the trust didn't exist. Treas. Reg. § 1.671-3(a)(1). With a partially grantor trust, the grantor includes only the income, deductions, and credits relating to the assets or portion of the trust of which he or she is the deemed owner. If the grantor is treated as the owner of just the income of the trust, he would only take into account the items that would be reported by a current income beneficiary.

A person other than the settlor will be treated as the owner of any portion of a trust with regard to which that person has certain powers. I.R.C. § 678. Note that the spousal attribution rules do not apply to these powers – only the non-grantor power holder will be treated as the owner, not the power holder's spouse.

Common powers that result in a non-grantor being treated as the owner of a portion of the trust are:

1. A *Crummey* withdrawal power gives the beneficiary the ability to withdraw assets from the trust at the time a contribution is made. This power is used to give the beneficiary a present interest in the trust, making the gift to the trust a taxable event and complete gift for gift tax purposes, which qualifies the gift for the gift tax annual exclusion.

2. A "5 and 5" power is a particular type of withdrawal right founded under I.R.C. § 2514(e), which states that the lapse of a withdrawal right is not a taxable release to the extent that the amount does not exceed the greater of $5,000 or 5 percent of the aggregate value of the assets out of which the lapsed power could be satisfied.

C. Grantor Trust Powers

The main goals in creating a grantor trust are to ensure that the trust is a wholly grantor trust, there are no estate tax inclusion issues for the grantor, and the power that makes the trust a grantor trust can be "turned off" or toggled if necessary.

Power to Reacquire Property for Equivalent Value (Power to Substitute Assets) – § 675(4)(C). In the past, there was a concern that retention of this power would make the trust property includible in the grantor's estate, but that issue was resolved in Rev. Rul. 2008-22, which held that the power of substitution will not cause the value of the trust corpus to be included in the grantor's estate, if the trustee has the fiduciary obligation to ensure the grantor's compliance with the terms of the power by ensuring that the substituted property is of equivalent value and that the power cannot be exercised in a manner to shift income among beneficiaries.

If the grantor or another person (note that the Code says "any person," but Treas. Reg. § 1.675-1(b)(4) states that the power may be exercisable by a non-adverse party) has a nonfiduciary power to reacquire or swap trust property in exchange for assets of an equivalent value, the trust will be a grantor trust. It is preferable that the grantor retain this power. Even though statute states that "any person" may hold this power (and even though it says "reacquire" not "acquire"), the law is not as clear that the trust would be a wholly grantor trust if this power were held by someone other than the settlor.

Under current tax law, a transaction between a grantor and a trust deemed to be owned by that grantor is disregarded for income tax purposes and, under most circumstances, the trust is not included in the grantor's estate for estate tax purposes. This is why installment sales to intentionally defective grantor trusts are common transactions. However, the Department of Treasury's recently issued Fiscal Year 2014 Revenue Proposals would change that treatment.

Power Of Non-Adverse Trustee To Add Beneficiaries and the Power to Control Beneficial Enjoyment ("Sprinkling" Powers) (§ 674). If a non-adverse trustee has the power to add beneficiaries, the trust will be a grantor trust. I.R.C. §§ 674(b)(5) & 674(b)(6). For example, giving the trustee the power to add charitable beneficiaries can be a helpful tool to make the trust a grantor trust.

A non-adverse party is anyone who is not an adverse party. An adverse party is a person with a substantial beneficial interest in the trust whose interest would be adversely affected by the exercise or nonexercise of the power which the person possesses respecting the trust. I.R.C. § 672(a); Treas. Reg. § 1.672(a)-1. Note that, because of the spousal attribution rules under I.R.C. § 672(e), a spouse who has the power to control beneficial enjoyment of the trust, even if he or she is also an adverse party, will create a grantor trust because the grantor will be deemed to hold that power personally.

Additionally, under I.R.C. § 674, a trust is a grantor trust if the settlor or a non-adverse party (or both) has the power to dispose of beneficial enjoyment of either corpus or income without an adverse party's approval or consent. The power is sufficient to make the trust a grantor trust, even if it is held by the party only in a fiduciary role. The

existence of the power is determinative, unless it falls within an exception, as described below. This power can cause estate inclusion issues if held by the settlor. Therefore, it is important never to give this broad power to the settlor or the trust assets could be includible in his or her estate under I.R.C. §§ 2036 or 2038. The power should only be held by a non-adverse party.

A power to dispose of beneficial enjoyment includes: a power of appointment; a power to accumulate income; or a power to distribute trust income or corpus among the beneficiaries.

This power would seem to make any discretionary trust a grantor trust. However, there are a number of important exceptions (I.R.C. § 674(a)) to this rule:

1. The power to make trust distributions is limited by a reasonably definite standard. I.R.C. § 674(b)(5). Note that this is similar, but different to, the "ascertainable standard" for estate and gift tax purposes. A reasonably definite standard can also include standards such as "reasonable support and comfort," "to enable him to maintain his accustomed standard of living," or to "meet an emergency." Treas. Reg. § 1.674(b)-1(b)(5)(i). Language such as "pleasure, desire, or happiness," however, is not sufficient to create a reasonably definite standard. Id. The safest planning technique, however, is to use the phrase "health, education, support, and maintenance" as the support standard, as it will be effective for estate, gift, and income tax purposes.

2. The power to make trust distributions is exercisable by an independent trustee. I.R.C. § 674(c). An independent trustee is a person who is not a related or subordinate party. Examples of non-independent trustees include the spouse, parent, descendant, sibling (including half-siblings), or employee of the settlor, as well as a corporation in which the stock holdings of the settlor or the trust are significant from the perspective of voting control, or a subordinate employee of a corporation of which the grantor is an executive. Importantly, the following persons are not included as non-independent trustees: the settlor's nieces, nephews, grandparents, spouses of children and grandchildren, partners, attorneys, accountants, and financial advisors.

3. The power is to apply income to support a dependent of the settlor is not exercised. Treas. Reg. § 1.674(b)-1(b)(1). The obligation to support is determined under state law. If the power is exercised, however, the trust will be a grantor trust to the extent this power is exercised.

4. The ability to affect beneficial enjoyment is so remote that, if it were a reversionary interest, the interest would be worth less than 5% of the value of the trust. Treas. Reg. § 1.674(b)-1(b)(2).

5. The power is solely a testamentary power of appointment. Treas. Reg. § 1.674(b)-1(b)(3).

6. The power solely to allocate income to charity. I.R.C. § 674(b)(4).

7. The trust has only one beneficiary from whom income can be withheld temporarily or during the beneficiary's disability. I.R.C. § 674(b)(6) and (7).

Power To Borrow Trust Assets Without Adequate Interest Or Security – § 675(2). If a settlor, a non-adverse party (or both), has the power to enable the settlor or the settlor's spouse to borrow the trust corpus or income, directly or indirectly, without adequate interest or security, the trust will be a grantor trust. The mere existence of this power is enough to make the trust a grantor trust; the powerholder need not exercise the power.

This power is not ideal in all situations, however, as it can cause adverse estate tax consequences if used incorrectly and because there is some uncertainty as to what portion of the trust will be treated as a grantor trust. See *Benson v. Comm'r.*, 76 T.C. 1040 (1981) and *Holden v. Comm'r., T.C. Memo. 1975-29 (Feb. 19, 1975).*

If the power is held by a trustee (other than the settlor) who is authorized under a general lending power to make loans to any person without regard to interest or security, the trust will not be a grantor trust. If the grantor actually borrows trust corpus or income and repays within the same year, the trust will not be a grantor trust. Under a separate provision, I.R.C. § 675(3), a trust will be a grantor trust if the grantor actually borrows trust corpus or income and does not repay the loan (including interest) before the beginning of a tax year.

D. Terminating Grantor Trust Status

At some point, the settlor may decide that he or she no longer wants to be the deemed owner of the trust. The main technique to achieve this result is to give the settlor the ability to release the power that causes settlor trust status. If the document does not specify that the settlor has that power, the settlor or power holder could complete a disclaimer of the power or interest. It is not advisable, however, to toggle back and forth between grantor and non-grantor trust status.

E. Potential Problems with Grantor Trusts

Income for the Grantor's Spouse – § 677(a). If the trustee may distribute income to the settlor's spouse (or accumulate income for future distribution to the settlor or the settlor's spouse), without the approval or consent of an adverse party, the trust will be a grantor trust. As long as the beneficial interest is for the settlor's spouse, the trust assets will not be includible in either the settlor's or the settlor's spouse's estate, unless the trust is a valid marital deduction trust or the spouse also contributed to the trust (gift-splitting is not enough to cause inclusion here). One potential problem with using this power is that the grantor trust status terminates when the spouse dies – even if the settlor is still alive.

The trust is a grantor trust to the extent that trust income is:

1. Distributed actually or constructively to the settlor's spouse (this can be a discretionary income right);

2. Held or accumulated for future distribution to the settlor's spouse; or

3. Applied to pay premiums on life insurance on the life of the settlor's spouse.

Retained Reversionary Interests – § 673(A). Under I.R.C. § 673(A), a trust is a grantor trust as to the fiduciary accounting income portion of the trust if the settlor retains a reversionary interest in the corpus of the trust, which, at the time the trust is created, is valued at more than five percent. Even if I.R.C. § 673(A) does not apply because the interest does not exceed five percent, I.R.C. § 677(a)(2) will invoke grantor trust status as to income allocable to principal because of the reversionary interest. Reversions can be inadvertent, such as if a settlor is a possible beneficiary under an ultimate contingency paragraph of the trust. It is not advisable to use this power, because it can cause estate tax inclusion under I.R.C. § 2037 if the reversionary interest is greater than 5 percent of the trust immediately prior to the grantor's death.

Power To Deal With Trust Assets For Less Than Adequate Consideration – § 675(1). If the grantor, a non-adverse party, or both have a non-fiduciary power to purchase, exchange, or otherwise deal with or dispose of trust assets for less than adequate consideration, the trust will be a grantor trust. If the power is exercisable by the party only in a fiduciary capacity, it will not cause the trust to be a grantor trust. This power is generally not used because it can cause estate inclusion issues for the power holder. If the power is held by the settlor, it may cause issues under I.R.C. §§ 2036 or 2038. If the power is held by anyone else, the same problem would likely arise under I.R.C. § 2041.

Power to Vote Stock – § 675(4). If the grantor or any person has the nonfiduciary power to vote or direct the voting of stock in which the holdings of the grantor or trust are "significant" from the perspective of voting control, the trust will be a grantor trust. This power is not typically used to great a grantor trust because it can cause estate inclusion under I.R.C. § 2036(b). This is especially an issue if it is stock in a closely-held business. In some cases, attribution rules can apply to pool the votes of certain family members to create a "significant" interest that would cause this power to apply.

Power to Control Investment of Trust Funds – § 675(4)(B). Under I.R.C. § 675(4)(B), if a person has the nonfiduciary power to control the investment of the trust funds, the trust will be a grantor trust to the extent the trust funds consist of stocks or securities of corporations in which the holdings of the grantor or trust are "significant" from the perspective of voting control. The benefit to this power is that, by making the settlor an "investment advisor," but not the regular trustee, the settlor may have sole authority over the investment of the trust assets and make the trust a grantor trust, without causing inclusion for estate tax purposes. The settlor, however, cannot have: a) the power to vote the stock; or, b) the power to make distributions to beneficiaries. Note, however,

under many states' laws, an investment advisor is considered a fiduciary, in which case this power may not create a grantor trust.

Power to Remove a Trustee and Replace with Grantor – § 1.674(d)-2. While the power to remove, substitute, or add trustees may prevent a trust from qualifying under the exceptions for I.R.C. §§674(c) or (b), if the grantor has the unrestricted power to remove an independent trustee and replace him or her with anyone (including him or herself), then the trust will be a grantor trust. To achieve grantor trust status, but avoid estate tax inclusion, it is advisable to specify that the settlor can remove the trustee, but can only replace him or her with an independent trustee as defined in Treas. Reg. § 1.674(d)-2.

Power to Revoke the Trust – § 676. If the settlor retains the power to revoke, whether or not the power is exercised, the trust is a grantor trust. This power is not generally used (other than in trusts that function as will substitutes), because retention of this power will cause inclusion for estate tax purposes.

Payment of Life Insurance Premiums – § 677(a)(3). Under I.R.C. § 677(a)(3), the settlor will be treated as owning any portion of a trust the income of which is or may be used to pay premiums on life insurance policies on the life of the grantor or the grantor's spouse. Under Rev. Rul. 66-613, the IRS adopted the stance that "the grantor will be considered the owner … of the amount of the trust income which is used to pay the premiums on these policies of insurance" on the life of the grantor or the grantor's spouse.

F. S-Corporation Stock in a Grantor Trust

There are many restrictions on who can be a shareholder of a S corporation and non-qualified shareholders can terminate the corporation's S election. Shareholders of S corporations are limited to:

1. U.S. citizens;
2. Estates; and
3. Certain trusts (QSSTs, grantor trusts, and ESBTs).

A Qualified S Corporation Shareholder Trust (QSST) must distribute all income to the beneficiary and must only benefit one person. It is subject to income tax at the beneficiary's individual income tax rate. An Electing Small Business Trust (ESBT) is any trust that is not a QSST or a grantor trust. It is subject to tax at the highest income tax rate applicable to trusts. QSSTs and ESBTs must make an election with the IRS to qualify.

A grantor trust can be a qualified shareholder of a S corporation if the entire trust is owned by one individual who is a U.S. citizen or resident to be a permissible shareholder of a S corporation. Treas. Reg. § 1361(c)(2)(A)(i). A partial grantor trust or a wholly grantor trust deemed owned by two or more persons does not qualify as a Sub S shareholder. The trust can remain a qualified shareholder for up to two years following

the settlor's death. The deemed owner's estate is responsible for ensuring that the S corporation rules are not violated. I.R.C. § 1361(c)(2)(A)(i).

If a trust is partially a grantor trust and partially a non-grantor trust, the trustee can make an Electing Small Business Trust (ESBT) election for the non-grantor portion of the trust to allow the trust to remain a qualified shareholder. For the portion that is a grantor trust, the grantor trust provisions trump the ESBT election, so the grantor must include the proportionate share of the items of income, deductions, and credits on his or her personal income tax return. Treas. Reg. § 1.641(c)-1(c).

The Changing Climate of Estate and Charitable Planning
What's Hot and What's Not

Ten Smart Charitable Planning Ideas after the American Taxpayer Relief Act of 2012

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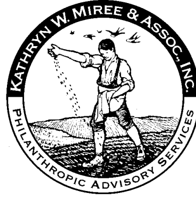

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Kathryn W. Miree is President of Kathryn W. Miree & Associates, Inc., a consulting firm that works with boards and staff of nonprofits and foundations to develop administrative policies, structure, and planned giving programs. She received her undergraduate degree from Emory University and her law degree from The University of Alabama School of Law. She spent 15 years in various positions in the Trust Division of AmSouth Bank where she was the manager of the Personal Trust Department before joining Sterne, Agee & Leach, Inc. to start its trust company. She established Kathryn W. Miree & Associates, Inc. in 1997.

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Ms. Miree is a frequent lecturer, co-author of *The Family Foundation Handbook* with Jerry J. McCoy (CCH Publishers) and author of *The Professional Advisor's Guide to Planned Giving* (CCH Publishers). She has served on the Editorial Advisory Boards of *Planned Giving Today* and *Planned Giving Design Center*. Her clients include a variety of nonprofits and foundations across the country.

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The Changing Climate of Estate and Charitable Planning
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I. The Current Environmental Challenges

The economic news has been uncertain or gloomy since 2000. Lower stock values, higher gas prices, fewer jobs, and the related economic turmoil have affected all donors. Even the wealthy – especially those holding concentrations in financial stocks, automotive stocks, mortgage backed bonds, or real estate – have felt the pinch. In this environment, planners must structure gifts in a way that maximize results using the many available gift planning options.

A. The Economic Impact on the Stock Market on Donors

The nature of financial markets is to move to reflect current economic conditions and fears, but markets have been particularly erratic since 2000. As a reminder, annual returns from 1999 through 2010 are shown in Table 6 and 7. The tables do not tell the full story. Mid-market fluctuations, the reduction or elimination of dividends, and tight credit markets have created even greater uncertainty for clients.

TABLE 1
MAJOR INDEX RETURNS 1999 – 2005

INDEX	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
DJIA	25.22%	-6.18%	-7.10%	-16.76%	25.32%	3.15%	-0.61%
S&P 500	19.53%	-10.14%	-13.09%	-23.37%	26.38%	8.99%	3%
NASDAQ	85.5%	-39.29%	-21.05%	-31.53%	50.01%	8.59%	1.37%
DJ World	31.54%	-17.36%	-21.02%	-15.63%	38.58%	19.23%	14.4%
Barclays LT Treas.	-15.13%	20.11%	3.5%	14.62%	1.38%	5.06%	2.7%
ML Muni Master Bond Index	-6.34%	18.10%	4.5%	10.73%	2.54%	5.45%	3.9%
Barclays Corp. Bond Index	-1.89%	9.1%	10.7%	10.17%	8.31%	5.41%	2%

TABLE 2
MAJOR INDEX RETURNS 2005 - 2012

INDEX	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*
DJIA	16.29%	6.4%	-33.8%	18.8%	11.0%	5.5%	7.3%
S&P 500	13.62%	3.5%	-38.5%	23.5%	12.8%	0.00%	13.40%
NASDAQ	9.52%	9.8%	-40.5%	43.9%	16.9%	-1.8%	15.90%
DJ World	23.01%	11.8%	-46%	37%	10.1%	-16.3%	13.60%

INDEX	2006	2007	2008	2009	2010	2011	2012
Barclays LT Treas.	1.85%	10.2%	20.64%	-13.17%	9.37%	34.01%	0.87%
ML Muni Master Bond Index	4.4%	4.18%	0.54%	9.4%	2.52%	10.64%	5.56%
Barclays Corp. Bond Index	4.3%	4.56%	-6.54%	18.68%	9.0%	8.15%	9.82%

B. Interest Rates and Donors

As interest rates have declined, the interest paid on bonds, certificates of deposit, checking accounts and other fixed income instruments that seniors and retired donors rely on for living expenses has also declined. For a look at how those rates have fluctuated over the last decade, see Table 3.

TABLE 3
PRIME RATES, QUARTERLY, 2000 – 2013

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Jan 1	9.5%	4.75%	4.25%	4%	5.25%	7.25%	8.25%	7.25%	3.25%	3.25%	3.25%	3.25%	3.25%
Apr 1	8%	4.75%	4.25%	4%	5.75%	7.75%	8.25%	5.25%	3.25%	3.25%	3.25%	3.25%	3.25%
July 1	6.75%	4.75%	4%	4.25%	6.25%	8.25%	8.25%	5%	3.25%	3.25%	3.25%	3.25%	3.25%
Oct 1	6%	4.75%	4%	4.75%	6.75%	8.25%	7.75%	5%	3.25%	3.25%	3.25%	3.25%	
Dec 1	5%	4.25%	4%	5%	7%	8.25%	7.5%	4%	3.25%	3.25%	3.25%	3.25%	

C. Interest Rates and Split Interest Gifts

Low interest rates have also had an impact on split interest gifts.

1. Split Interest Gifts With Remainders to Charity

In this environment, charitable income tax deductions for split interest gifts that pay income streams to donors with the remainder to charity are substantially lower than in the 2006-2007 years in which prime rates were in the 7% to 8% range. This has dampened interest in some donors in creating charitable gift annuities and charitable remainder trusts. Table 4 demonstrates the variance in the deduction using a 1.4% CFMR and a 5.8% CFMR for a $1 million charitable remainder trust, one life age 65.

TABLE 4
COMPARISON OF RESULTS FOR CHARITABLE REMAINDER ANNUITY TRUST AND UNITRUST
5% PAYOUT, ONE LIFE AGE 65

Type of Trust - 5% Payout	*Charitable Income Tax Deduction 1.4% CFMR*	*Charitable Income Tax Deduction 5.8% CFMR*
Charitable Remainder Annuity Trust	$235,224	$495,747
Charitable Remainder Unitrust	$447,400	$468,210

2. Split Interest Gifts with Remainder to Individuals

Lower charitable federal midterm rates increase the charitable deduction for lead trusts. This is because the lower the rate reduces the calculated value of the remainder (and increases the value of the charitable deduction). Table 5 calculates the charitable deduction for a $1 million gift for a charitable lead trust using a 1.4% CFMR and a 5.8% CFMR.

TABLE 5
COMPARING THE IMPACT OF THE CHARITABLE FEDERAL MIDTERM RATE ON THE CHARITABLE DEDUCTION

20-Year Term, 5% Payout	*Gift Tax Deduction 1.4% CFMR*	*Gift Tax Deduction 5.8% CFMR*
Charitable Lead Annuity Trust	$866,950	$582,920
Charitable Lead Unitrust	$636,270	$620,250

D. Congressional Activity and Changing Rules[1]

Scandals in the nonprofit sector have made headlines in the Washington Post, the Wall Street Journal and many more beginning with the William Aramony/United Way in 1992, John Bennett and the New Era Foundation in 1995, and The Nature Conservancy insider dealing and non-cash gift valuation issues highlighted by the Washington Post in 2001. These ongoing issues prompted a series of Congressional hearings, legislative reforms, and dramatic proposed regulations and legislation affecting donors and the nonprofit sector.

1. Proposals in Staff Discussion Draft

The Senate Finance Committee Staff drafted proposals which set the tone for reform:

✓Five-year review of tax-exempt status

- Every fifth year on anniversary of tax determination letter
- Goal to determine whether determination letter should remain in effect

[1] Many of these reforms have already made their way into legislation enacted since 2004.

- Looking for changes to articles and by-laws, conflict of interest policies, policies and procedures reflecting industry best practices, accreditation
- Outcome? No upside – only downside, revocation of status

✓**Imposition of private foundation self-dealing rules to public charities**

- Taxes on self-dealing, such as sale, exchange, or lease; lending money/credit; furnishing goods or services;; payments to government officials – unreasonable compensation excluded from the list

✓**Modification of intermediate sanction compensation rules to provide more accountability and ensure independent evaluation**

- Expand definition of disqualified person to include someone with substantial influence over the charity, to include corporations or partnerships where a disqualified person has substantial influence
- Increase taxes for prohibited transactions (self-dealing, jeopardizing investments, taxable expenditures) by an undetermined amount

✓**Creation of compensation rules**

- Limit compensation of private foundation trustees – either eliminate compensation to trustees of non-operating foundations, or limit that compensation to a statutory *de minimis* amount
- Limit compensation of disqualified persons
- Compensation of disqualified persons at non-operating private foundation (other than employees) must use comparable federal government rates for similar work and time
- Compensation of individuals over $200,000 ($75,000 for disqualified persons) requires the filing of additional attachments with the 990. All compensation exceeding these levels must be approved in advance each year by the board (excluding those with a conflict to the payment)

✓**Private foundation grantmaking reforms**

- Payment of expenses exceeding 10% of the foundation's expenses would require an additional filing, and the IRS would review it to see if it were "reasonable and necessary" and appropriate for consideration as a qualifying distribution
- Administrative costs above 35% of total expenses would be excluded as a qualifying distribution
- Eliminate excise tax on investment income in years when foundation pays out more than 12 percent of its investment assets
- Prohibit private foundation payments to donor advised funds
- Limit amounts paid for expenses. Expenses for travel, meals, lodging would be capped at the government rate or a separately published charitable rate (public charities would not be restricted to these amounts if the charity's board approves

expenses in excess of these amounts and reveals the expenditures on the 990)

✓**Increasing and leveraging enforcement**

- Give states the right to pursue federal tax law violations with the approval of the IRS
- Make changes to the 990 to make it more transparent, consistent, and easier to monitor
- Add Sarbanes-Oxley type penalties to include requiring a signature by the CEO attesting to the accuracy and completeness of the information
- Double or triple (for larger organizations) fines for the failure to complete and accurate 990
- Limit extensions by classifying extensions of greater than 4 months as a failure to file
- Require all charities to have an independent auditor review the Form 990 and/or annual report; the report would be attached to the Form 990 as a public document
- Exempt organizations with gross receipts over $250,000 would be required to have an independent audit of the organization's financial statements (and must address the organization UBTI). A new auditor must be used at leave every five years. For organizations with income over $100,000 but less than $250,00, the financial statements must be reviewed by a CPA
- Attach a chart showing affiliated exempt and nonexempt organizations with the 990. All charities must file a list of partnership interests.
- Charities with more than $250,000 in gross receipts must include the charity's performance goals (and how well they did in achieving them) for the current and upcoming year.
- Charities would have to report material changes in activities, operations, or structure.
- The charity's expenses would have to report expenses accurately on financial statements and Form 990.
- A charity would have to make its investment public upon request.
- Financial statements would have to be disclosed to the public.
- Charities with a web site would be required to post the information currently required to be disclosed – Form 1023, Determination letters, financial statements for the five most recent years.
- Audits of tax-exempt organizations and closing agreements would be disclosed without redaction.
- Form 990-Ts would become public, with editing allowed to cover trade secrets.
- Publicly-traded corporations would have to file an annual return showing all gifts over $10,000 (aggregated) for which a charitable deduction is claimed.
- Appropriate a portion of the private foundation investment income tax (or impose a 990/990 PF filing fee) to enforcement.

    - A portion would be allocated to state enforcement
    - Grant funds for charities that train other charities on best practices and inform the public about charities engaged in best

practices, with priority to those groups working with small charities
    - The five-year review discussed earlier
    - Accreditation

- Give U.S. Tax Court equity powers to rescind transactions, surcharge trustees, order accountings, substitute trustees, divest assets, stop activities, appoint receivers. The goals are to allow the U.S. Tax Court to remedy any detriment to a charity and ensure the charity's assets are used (and preserved) for philanthropic purposes. The new laws would create a working/review relationships between the state courts and U.S. Tax Court.
- The IRS or a board member may file an action with the U.S. Tax Court to remove an officer.
- A director or trustee may bring action against the charity in the U.S. Tax Court, and must detail actions taken to make corrections at the board/organization level.
- Individuals may file complaints directly with the IRS. There would be a $250 filing fee (or a $10,000 penalty for a frivolous filing).

✓Requirements for non-profit Governance

- Board members and trustees would be subject to a standard of care of an "ordinarily prudent person in a like position…under similar circumstances"; the director would have to act in the best interests of the mission, goals, and purposes of the charity; those with special skills or expertise would have a duty to use those enhanced skills. There would be federal liability for breach of these duties.
- When compensation consultants are hired to establish the reasonableness and appropriateness of compensation, that consultant must be hired by and report to the board (and must be independent.) Compensation for management positions must be approved annual and in advance (unless the only compensation change is an inflation adjustment). Compensation must be supported, explained, and publicly disclosed.
- The board must establish management policies and procedures and must review deviations.
- The board must establish, review, and approve program objectives and performance measures, and must approve "significant" transactions.
- The board must review and approve auditing and accounting principles and practices used to prepare the charity's financial statements; the board must also retain and replace the charity's independent auditor (must change every five years).
- The board must review and approve the budget and financial objectives, including significant investments, joint ventures, and business transactions.
- The board must exercise oversight of the charity's operations.
- The board must adopt a conflict of interest policy (which would be disclosed with the 990) – a summary of conflicts determinations would be provided on the 990.
- The board must create and oversee a risk management program – regulatory compliance and liability management.

- The board must establish a whistleblower policy (to address complaints and prevent retaliation).
- Boards would have no less than 3 or more than 15 board members. No more than one of these members may be directly or indirectly compensated by the charity (and that compensated person may not be board chair or treasurer.)
- At least 1 (or 1/5th) of a public charity's board members must be independent.
- Charity boards may not include:

  1. Individuals not permitted to serve on a publicly-traded company board under federal or state law
  2. Individuals criminally convicted of fraud or similar offense for five years after the conviction.
  3. Individuals convicted of a crime under the Federal Trade Commission, USPS, or State Attorney General for actions related to service as an officer or director of a charity for 5 years.

- The IRS would have the authority to remove a member, officer, or employee of a charity who violates the self-dealing, conflict of interest, excess benefit, private inurement, or charitable solicitation laws.
- Create an accreditation process to encourage "best practices" that would drive tax-exempt status, enable participation in CFC campaigns, and provide preference for government grants. This accreditation may occur through the IRS or through separately designated agencies.
- Adopt a federal prudent investor rule that mirrors current state rules.

2. June 2004: "Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities"

On June 22, 2004, the Senate Finance Committee met to hear testimony about the abuses in the nonprofit sector recently reported in the press. It was not a good day for charities. Witnesses behind curtains and with electronically altered voices discussed abuses in gifts of non-marketable property such as automobiles, housing abuses, excessive compensation, credit counseling, and self-dealing.

3. Panel on the Nonprofit Sector

The Panel on the Nonprofit Sector was convened at the encouragement of the U.S. Senate Finance Committee in October 2004. Its goal was to make recommendations on reform, both legislative and non-legislative. The team included more than 175 experts and leaders serving in a variety of nonprofit roles. The committee issued its Interim Report in March 2005. The final report was issued on June 24, 2005 and is available at www.nonprofitpanel.org and encompasses many of the recommendations in the staff draft report and in the Panel's interim report.

4. Senate Finance Committee April 2005: "Charities and Charitable Giving: Proposals for Reform"

The Senate Finance Committee reconvened to receive the report and hear testimony. The Panel on the Nonprofit Sector recommended reforms. The tone at that meeting was decidedly punitive and regulatory.

5. House Ways and Means Hearings: "Hearing on an Overview of the Tax-Exempt Sector"

The House Ways and Means Committee held hearings on April 20, 2005, to provide a better understanding of the issues before the Senate Finance Committee. The hearings focused on the history and growth of the tax-exempt sector, and current enforcement in place to address compliance.

6. Senate Finance Committee June 2005: "The Tax Code and Land Conservation: Report on Investigations and Proposals for Reform"

The Senate Finance Committee, on June 8, 2005, published its investigative report on The Nature Conservancy and conservation easement abuses and made recommendations for change. The Committee took testimony from regulators and parties with an interest in preserving deductions for conservations easements. The full report is available at the Senate Finance Committee website, http://finance.senate.gov.

7. And It Continues

Congress has continued to investigate the nonprofit sector. It focused on nonprofit hospitals in 2006/2007 and then engaged in intense scrutiny of large college and university endowments in 2008/2009. The focus will likely continue, especially for large "profitable" nonprofits with large pools of assets, just as consideration of reduction of tax benefits for wealthier taxpayers making charitable gifts remains an open question.

8. American Jobs Creation Act of 2004[2]

a. New Intellectual Property/Patent Laws

The IRS has identified intellectual property gifts as an area open to abuse. In early 2004, the 2004, the IRS published an information release and notice warning of increased scrutiny of such gifts.[3] The law governing the deductibility of patents and intellectual property was then changed under The American Jobs Creation Act of 2004.[4] Under current law, the charitable deduction for a gift of intellectual property ("any patent, copyright (other than a copyright described in section 1221(a)(3) or 1231(b)(1)(C)), trademark, trade name, trade secret, know-how, software (other than software described in section 197(e)

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[2] Pub. L. 108-357, 118 Stat. 1418.

[3] IR-2003-131, Notice 2004-7, 2004-3 I.R>B. 310

[4] Pub. L. No. 108-357 , 118 Stat. 1418 (2004).

(3)(A)(i)), or similar property, or applications or registrations of such property"[5]) is limited to the lesser of the patent's market value or the donor's basis.[6] However, if the donor notifies the donee of the intent to treat the charitable contribution as a qualified intellectual property contribution, the donor may deduct "qualified donee income" received on the patent or intellectual property in the years of receipt for the legal life of the interest, or through the 10th anniversary of gift.[7] These deductions are only allowed to the extent the aggregate of statutory percentages of income (the statute provides a table) exceeds the donor's original contribution.[8] In May, 2005, the IRS issued guidance and temporary regulations for intellectual property contributions.[9]

b. New Vehicle Donation Laws

Many national and local charities actively solicit gifts of used vehicles, many of which are handled through third-party firms serving as the charity's agent in the transaction and paid a percentage of the sale amount.[10] As an increasingly number of charities began to solicit used vehicles, observers inside Congress and the IRS became concerned about potential abuse. These concerns were heightened by a December 2003 General Accounting Office report that found taxpayers were taking overstated deductions for vehicle donations.[11] The GAO examined 54 transactions to compare the donor's charitable deduction to the net proceeds received by charity. In two thirds of the transactions, the charity received 5 percent or less of the amount claimed by the taxpayer. In December, the IRS issued a taxpayer alert explaining how taxpayers can avoid problems when gifting automobiles to charity.[12]

Within a year of this report, legislation was in place to address vehicle donation valuation. Effective January 1, 2005, Section 884 of the American Jobs Creation Act sets out new rules for valuation of donated vehicles exceeding $500.[13] When a donor contributes a vehicle to charity exceeding $500, special substantiation and valuation rules apply.[14]

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[5] IRC §170(e)(1)(iii).

[6] *Id.*

[7] IRC §§170(m)(2), (8).

[8] *Id.*

[9] Notice 2005-41, T.D. 9206, 70 FR 29450, May 23, 2005

[10] In Letter Ruling 200230007, the IRS confirms that a gift to a for-profit firm that receives and sells the property as the agent of the charity is a gift "to": a charity and qualifies for an income tax deduction under IRC Section 170(a) provided the gift is properly substantiated and otherwise complies with the regulations. See also Rev. Rul. 2002-67, 2002-47 I.R.B. 873.

[11] Vehicle Donations: Benefits to Charities and Donors, but Limited Program Oversight, Report to the Committee on Finance, U.S. Senate, GAO-04-73 (Nov. 2003).

[12] IR-2003-139.

[13] Pub. L. No. 108-357, 118 Stat. 1418, IRC §170(f)(12).

[14] The sales rule and first two exceptions are set out in IRC §170(f)(12); the third exception is created and all rules amplified in Notice 2005-44, 2005-25 IRB 1.

- *The sales rule*. If the charity sells the vehicle (outside of the three exceptions listed below), the donor's deduction is limited to the gross sales proceeds. The substantiation from the charity – provided within 30 days of the sale – must contain:[15]

    - The taxpayers name and tax identification number;
    - The vehicle identification number
    - A certification the vehicle was sold in an arm's length transaction between unrelated parties.
    - The gross sales proceeds
    - A statement that the donor may not deduct more than the gross sales proceeds.

- *The significant intervening use exception.*[16] A donor may deduct the vehicle's market value on date of gift if the charity plans to use the vehicle in a significant manner, such as in a "Meals on Wheels" program. In this case, the charity must provide an acknowledgement certifying the intended intervening use of the vehicle, the expected duration of that use, and a statement the vehicle will not be sold before the end of its intended use. The statement must be provided within 30 days of contribution.

- *The material improvement exception.*[17] A donor may deduct the vehicle's market value on date of gift if the charity plans to make major repairs or improvements to the vehicle that significantly increases its value. (A material improvement is not considered application of paint, removal of dents and scratches, cleaning or repairing upholstery, or installation of theft devices, and the improvement cannot be funded through a payment from the donor.) To support the deduction, the charity must provide an acknowledgement within 30 days of the date of contribution certifying the intended material improvement and statement the vehicle will not be sold before that material improvement is made.

- *The transfer or below-market-sale to a needy person exception*. The new legislation contained a provision allowing the Secretary to issue guidance or regulations allowing exceptions for the use of vehicles in direct furtherance of the charity's charitable purposes.[18] In Notice 2005-25, the IRS made an exception where the vehicle is either transferred or sold at below market price to a "needy individual." For example, the charity might give or sell the vehicle to an individual participating in a Welfare to Work Program, so that the needy individual can use the car to get to a job. (Selling the vehicle and using the sales proceeds for charitable purposes will not suffice.) The substantiation – which should be provided no more than 30 days after date of contribution – must contain certification that the charity will give the vehicle to a needy individual or that it will be sold to a needy individual at a price significantly below fair market value, and that the transfer will be in direct furtherance of the charity's mission.

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[15] IRC §170(f)(12)(B).

[16] IRC §170(f)(12)(A)(ii).

[17] *Id.*

[18] IRC §170(f)(12)(F).

When vehicles with a value of $500 or less are donated to charity, the general rules governing substantiation and valuation are applicable. A used-car pricing guide that provides pricing for like cars (same make, model, year) sold in the same area may suffice.[19] The valuation must take into consideration the car's condition at the time of gift.[20]

9. Pension Protection Act of 2006, H. R. 4[21]

On August 17, 2006, President Bush signed the Pension Protection Act of 2006 (H. R. 4) which included a charitable IRA rollover provision, as well as other charitable incentives and reforms. The charitable incentive of greatest interest to donors and advisors allows individuals to make annual transfers not exceeding $100,000 from traditional and Roth IRAs directly to most public charities (donor advised funds, §509(a)(3) supporting organizations, and private foundations are excluded) without including the amount in gross income. The provision, for donors age 70 ½ or older and for amounts that would otherwise be included in gross income, is applicable through 2007. Donors who may receive the greatest benefit from the new law include those who prefer to use tax burdened assets for lifetime gifts, those who have exceeded the 50% giving limitations, and those who do not itemize.

Other charitable incentives in the bill included an increase in the charitable deduction for businesses that contribute food inventory, a basis adjustment to the stock of S Corporations that contribute property to charity, an extension of the enhanced deduction for qualified book inventory to public schools (for C Corporations), and an increase in the charitable deduction limit for certain qualified conservation gifts. Each of these provisions is available through 2007.

There were more charitable reforms than charitable incentives in the bill. The reforms included an increase in excise taxes applicable to certain charities, recapture of the deduction value represented by the difference between cost basis and market value of a related use tangible personal property gift when the gift is not ultimately used for the charity's exempt purpose, an excess benefits transaction tax on amounts paid from a donor-advised fund or a type III supporting organization to certain related parties, application of the excise tax on excess business holdings to donor advised funds, increased substantiation requirements for gifts to donor advised funds, and new rules (including a directive to Treasury to create new payout requirement regulations) for type III supporting organizations which are not "functionally integrated type III supporting organizations".

Update #1: On October 3, 2008, the Congress passed and President Bush signed the Emergency Economic Stabilization Act of 2008, H.R. 1424 which extended the Lifetime IRA Transfer to Charity, the basis adjustment to the stock of an S corporation making a charitable contribution of appreciated property, and the enhanced deduction for contributions of food inventory, book inventory, and certain computer equipment and software through December 31, 2009.

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[19] One of the most well-recognized used-car pricing guides is the Kelly Blue Book, <www.kbb.com>.

[20] Rev. Rul. 2002-67, 2002-47 I.R.B. 873.

[21] http://thomas.loc.gov;

Update #2: On September 24, 2009 the Treasury issued proposed regulations for Type III supporting organizations that implemented the changes in the Pension Protection Act of 2009.[22] Specifically, the following were addressed:

- How to qualify as a Type III Supporting Organization
- Requirement to notify the Type III's supported organizations
- The responsiveness test
- The integral part test (for functionally integrated Type IIIs)
- The integral part test (for non-functionally integrated Type III's)
- Distribution requirements for non-functionally integrated Type III's
- Transitional relief

Following passage of the Act, the IRS issued a notice with interim guidance, and an advance notice of rule making on supporting organizations summarized below.

- IRS Notice 2006-109, Interim Guidance Regarding Supporting Organizations and Donor Advised Funds was published shortly thereafter focusing on four areas:
  - Criteria for private foundations that make distributions to supporting organizations that allow the foundation to determine if the supporting organization is a Type I, Type II, or Type III (and further distinguishing between a functionally-integrated Type III or non-functionally integrated Type III);
  - Clarification of the effective date for the new IRC §4958(c)(3) excise tax on excess benefit transactions with supporting organizations;
  - Exclusion of certain employer-sponsored disaster relief funds from definition of a donor-advised fund; and
  - Clarification of how the IRS will apply the new IRC §4966(a) excise taxes (relating to payments made pursuant to educational grants awarded prior to August 17, 2006)

- IRS Announcement 2007-87, Payout Requirements for Type III Supporting Organizations That Are Not Functionally Integrated, Advance Notice of Rulemaking. This proposal included four terms that included a proposed functionally integrated test for Type III Supporting Organizations, a payout requirement for non-functionally integrated Type III supporting organizations that would follow the minimum distribution rules for private, non-operating foundations, [23] the type of information a Type III supporting organization must provided to its supported organizations to demonstrate responsiveness, and modified requirements for Type III supporting organizations organized as trusts (the responsiveness test),

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[22] REG-155929-06; 74 F.R. 48672-48687.

[23] IRC §4942 qualifying distribution requirements; valuation of assets for the purpose of computing the distribution requirement would also follow the private foundation rules.

10. Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010

In 2010, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 changed the rules again.[24] Instead of returning to pre-2001 Act rates, Congress set the exclusion amount at $5,000,000 through December 31, 2012 (indexed for inflation as of 1/1/2012) and the top rate at 35%. (For 2010, taxpayers could use the $5,000,000 exclusion with a step up in basis, or elect the zero tax option with carryover basis.)

11. The American Taxpayer Relief Act of 2012

In early 2013, The American Taxpayer Relief Act of 2012[25] (ATRA) was enacted and made changes to the income, gift, estate, and generation skipping tax rates and calculations. The overriding concern of many observers was that Congress would modify or cap itemized deductions for all giving levels, essentially eliminating the value of the deduction for donors making larger gifts. This did not happen, although most believe the conversation is not yet over and may become a part of the budget and debt ceiling discussions still to come in 2013. President Obama's Budget, for example, would uncouple estate and gift tax rates, reduce the lifetime gift tax transfer exclusion amount to $1 million, reduce the estate tax exclusion amount to $3.5 million, eliminate the inflation adjustment, and increase the marginal rate to 45%. The ATRA of 2012 tax law changes impacting giving are summarized as follows:

a) *Charitable IRA Rollover.* The "Charitable IRA Rollover" was revived for another two years through the end of 2013. The charitable IRA rollover allows taxpayers age 70 1/2 or older to make distributions from their IRA directly to qualified public charities in an amount up to $100,000 in 2012 and 2013. The charitable IRA rollover was first introduced in the Pension Protection Act of 2006 for a two year period. It has subsequently been renewed for a two-year period every two years, although some years (such as this one) the renewal occurs so late that many miss the opportunity. Since the American Taxpayer Relief Act of 2012 was not signed into law until 2013, Congress allowed taxpayers who took a withdrawal from their IRA in December 2012 to make a cash contribution to charity of all or part of that amount before January 31, 2013 and treat it as a distribution from their IRA for 2012. They may also make a distribution from their IRA to a qualified public charity by January 31, 2012 and deem it to be a 2012 transfer.

b) *Income Tax Rates*. Income tax rates on higher-income taxpayers ($400,000 for single taxpayers, $425,000 for head of household, and $450,000 for married taxpayers filing jointly) were raised as expected. The new rate for taxpayers beyond threshold amounts is 39.6%.

c) *Capital Gains Rates.* Capital gains rates were raised at the same threshhold amounts, from 15% to 20%.

d) *Medicare contribution tax.* While not part of the Taxpayer Relief Act of 2012, provisions in the 2010 healthcare act calls for a Medicare contribution tax of 3.8% will be imposed on capital

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[24] Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, P.L. 111-312 (December 17, 2010).

[25] American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313.

gains, dividends, interest, and other unearned income in 2013 for taxpayers over $200,000 (for single taxpayers and heads of households) or $250,000 (for married filing jointly).

e) *The Pease Limitations (the 3% Rule).* As explained in more detail later, the Pease limitations on itemized deductions are reduced by the lessor of: a) 3% of amounts over $250,000 (single taxpayers), $275,000 (heads of household) and $300,000 (married, filing jointly) or b) 80% of the taxpayer's itemized deductions. The Pease limitations were phased out and eliminated in 2010, but reinstated in this legislation.

f) *Estate and Gift Tax Rates.* Estate and gift tax rates were maintained at the 2011 and 2012 $5 million exclusion amount, indexed for inflation. The indexed amount for 2013 was $5.25 million.[26] The tax rate was raised from 35% to 40%. Since estate and gift tax rates were slated to return to a $1 million exclusion amount and 55% top rate, this was a welcome result for affluent taxpayers with large estates.

E. Misfeasance, Malfeasance, and Lawsuits

Judging by the increasing number of lawsuits over the last ten years, charities are having a harder and harder time honoring donor commitments. The following five cases provide some perspective.

1. *William Robertson, et. al. v. Princeton University, et. al.*[27]

Charles S. and Marie H. Robertson[28] contributed $35 million in A & P stock to Princeton University in 1961 to create a supporting organization to fund the Woodrow Wilson School of Public and International Affairs "where men and women dedicated to public service may prepare themselves for careers in government service, with particular emphasis on the education of such persons for careers in those areas of the Federal Government that are concerned with international relations and affairs."[29] The Foundation, with assets of roughly $900 million in recent years, provided funds for the Woodrow Wilson School and also funded other budgets, including a $13million principal distribution to build Wallace Hall, a building designed to house the expansion of the Woodrow Wilson School as well as the Sociology Department and other programs.

During his lifetime, Mr. Robertson grew unhappy with the Foundation's spending patterns and the low numbers of students engaged in pursuit of diplomatic service, expressing his concerns in writing. The school dismissed his concerns explaining the world of diplomacy was no longer the same. Marie Robertson died in 1972 and Charles Robertson died in 1981. Their son William S. Robertson, his sisters Katherine Ernst and Anne Meier, and cousin Robert Halligan – also unhappy about the application of Foundation funds – filed a lawsuit in July 2002 to redirect funds to other universities that could fulfill the donors' goals. The suit alleged the school intentionally violated the donors' intent and further claimed

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[26] Rev. Proc. 2013-15, January 11, 2013.

[27] Docket No. C-99-02, Superior Court of New Jersey, Chancery Division: Mercer County

[28] Mrs. Robertson was the daughter of the founder of the A & P grocery chain.

[29] The language setting out the Foundation's purpose is taken from its Certificate of Incorporation. To provide context, in 1961 the U.S. and Russia were engaged in a cold war, the United States was involved in Vietnam, and President Kennedy was asking American to: "Ask not what your country can do for you – ask what you can do for your country."

Princeton was engaged in self-dealing with regard to the Foundation's investments and distribution of funds. The lawsuit involved numerous depositions and other discovery, costing Princeton over $40 million in expenses through December 2008 when the suit was settled.[30] The settlement required Princeton to transfer $90 million plus interest to the Foundation.[31]

2. *Howard v. Administrators of the Tulane Educational Fund*

From 1886 to 1901, Josephine Louise Newcomb contributed over $3.6 million to create the Sophie Newcomb College in Tulane University to advance "the cause of female education in Louisiana." The gift, worth approximately $75 million in today's dollars, established the first separate college for women in a university in the United States. After Katrina temporarily closed Tulane in the Fall of 2005, the Trustees voted to merge Newcomb College into Tulane and to absorb its endowment.

Two heirs of Josephine Newcomb – Parma Howard and Jane Smith – filed suit to enforce Ms. Newcomb's intent in maintaining a separate college. The district court judge dismissed the Newcomb heirs' lawsuit holding they had no standing to enforce the gift;[32] this ruling was affirmed by Louisiana Fourth Circuit Court.[33] The heirs appealed, and on July 1, 2008, the Louisiana Supreme Court vacated the dismissal and remanded the case to the trial court to allow the descendants of Ms. Newcomb to proceed with the lawsuit to enforce the gift's terms. In August 2008, a second lawsuit was filed in the district court of the Parish of Orleans by another Newcomb descendant, Susan Henderson Montgomery, also seeking to enforce the terms of the gift.[34] Ms. Montgomery filed a Motion for Summary Judgment with the Civil District Court in New Orleans which was denied in August 2009. Ms. Montgomery appealed, and in October 2010 the Fourth Circuit Court of Appeals in a 3-2 decision denied the appeal finding "Ms. Newcomb's will created an unconditional bequest to the Administrators of the Tulane Educational Fund."[35] The case history and court filings can be found at www.newcomblives.com.

3. *The Barnes Foundation's Petition to the Orphan's Court to Change Settlor's Intent*

Dr. Albert C. Barnes established the Barnes Foundation in 1922 to house his extensive Impressionist, Post-Impressionist and early Modern art collection (including many masterpieces with a collective current value of $6 billion) and to educate the working class about art. The collection – which was assembled and mounted by Dr. Barnes – was located in a modest structure in Merion, Pennsylvania,

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[30] Hathirimani, Raj, "Robertson Lawsuit Most Expensive in University History," *The Daily Princetonian*, www.dailyprincetonian.com (November 19, 2004); the lawsuit was settled on December 10, 2008 and approved by the court on December 12, 2008.

[31] "Robertson Lawsuit Settled," http://paw.princeton.edu/issues/2009/01/28/pages/7658/index.xml.

[32] *Howard v. Administrators of the Tulane Educational Fund*, unreported, Civil District Court, Orleans Parish, No. 2006-4200, Div. B-15.

[33] *Howard v. Administrators of the Tulane Educational Fund*, 970 So. 2nd 21 (Ct. App. 4th Cir. October 22, 2007).

[34] *Montgomery v. Administrators of the Tulane Educational Fund*, unreported, Civil District Court, Orleans Parish, No. 08-8619, Div. B-I.

[35] This lawsuit is still unfolding and further developments may have occurred after this article was written. Please check for recent developments at www.newcomblives.com.

a Philadelphia suburb. Dr. Barnes arranged the paintings and designed the art education curriculum himself. He did not intend to have the entity operate as a traditional museum.[36]

Dr. Barnes died in 1951. In 1991, the trustees went to court to amend the Foundation's governing documents which prevented the trustees from selling or loaning the art in the collection.[37] While the lawsuit – which cost the Foundation about $10 million in expenses – did not result in a change in the Foundation's by-laws, the Judge did allow the Foundation to take the art on tour raising about $16 million for renovations.[38]

In September 2002, the financially-strapped trustees filed another lawsuit seeking permission to move the art collection from the Merion building to a new building (to be constructed) in downtown Philadelphia; in addition, it asked the Court to allow it to expand the number of trustees from 5 – as designated by Dr. Barnes in the governing documents – to 15.[39] In early 2004, the Court approved the increase in the number of Trustees, deferring the decision on the move until other options to raise funds were explored. Then, on December 13, 2004, the Court of Common Pleas of Montgomery County, Pennsylvania, Orphans' Court Division granted the Trustees' request to move the Foundation's art gallery from Lower Merion Township, Pennsylvania to a new location in downtown Philadelphia. The court's 41-page published opinion[40] acknowledged the changes ran counter to the terms of the Foundation's 1922 charter and governing documents but noted there was "no viable alternative" for the financially-compromised charity.[41] An appeal to the ruling filed by an art student at the Foundation was dismissed by the Pennsylvania Supreme Court for lack of standing.[42]

4. *Tennessee Division of the United Daughters of the Confederacy v. Vanderbilt University*

In 1913, the Tennessee Division of the United Daughters of the Confederacy entered into the first of a series of gift agreements with George Peabody College for Teachers ("Peabody College") to raise $50,000 for the construction of a dormitory, a portion of which would provide rent-free housing for students of Confederate ancestry. The agreements spelled out key restrictions on the gift, including the requirement the dormitory bear the name of "Confederate Memorial Hall." The dormitory was completed in 1935, and for many years Peabody College, and Vanderbilt University following its merger with Peabody, abided by the terms of the gift. In 2002, however, Vanderbilt's President decided to rename the building (feeling "Confederate" created a marketing problem for the University).

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[36] According to the Foundation's press release the Foundation has a 3-year horticulture program, and a 2-year art and esthetics program with a 1-year seminar extension.

[37] Solis-Cohen, Lita, Maine Antiques Digest, March 2004 <http://www.maineantiquedigest.com/articles/mar04/barnes0304.htm>.

[38] *Id.*

[39] *Id.*

[40] *The Barnes Foundation,* No. 58,788 (12/13/04).

[41] Blum Debra E., "Court Ruling Could Influence Restrictions Donors Place on Bequests," *The Chronicle of Philanthropy* (January 6, 2005; "Court Allows Barnes Foundation To Move Collection to Philadelphia," *Nonprofit Issues,* December 16, 2004 – January 15, 2005 <www.nonprofitissues.com/public/features/leadfree/2004dec2-IS....>

[42] Blum Debra E., "Pennsylvania's Highest Court Allows Multibillion-Dollar Art Collection to Move," *The Chronicle of Philanthropy* (April 28, 2005).

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The United Daughters of the Confederacy, who were not consulted about or informed of the change, filed a lawsuit to compel Vanderbilt to honor the terms of the gift agreement. At trial, the court granted Vanderbilt's motion for summary judgment finding the obligation to comply with the gift agreements was "impractical and unduly burdensome." The Court of Appeals of Tennessee, however, reversed the trial court and upheld the gift agreement.[43] It gave Vanderbilt two choices: 1) either abide by the terms of the agreements between the United Daughters of the Confederacy and Peabody College; or 2) return the present value of the original gift to the United Daughters of the Confederacy. Vanderbilt decided not to appeal the decision and to honor the gift terms.

5. *Fisk University v. Georgia O'Keeffe Foundation*

In 1949, Georgia O'Keeffe, the widow of Alfred Stieglitz (and executrix of his estate), transferred the Alfred Stieglitz collection of 97 photographs and paintings to Fisk University in Nashville, Tennessee subject to a restriction that Fisk University would not at any time sell or exchange the pieces of the collection. Ms. O'Keeffe then contributed four additional pieces that were part of her personal collection for a total of 101 pieces. In 2005 Fisk University filed a petition in the Chancery Court of Davidson County asking the court to invoke the legal doctrine of *cy pres* to permit the sale of two of the paintings in the college citing the cost of maintaining the collection and other financial needs. The Georgia O'Keeffe Foundation originally filed to block the action; in 2006, the Georgia O'Keeffe Museum filed a petition, granted by the Court, to substitute the Museum for the Foundation, alleging the Museum was Georgia O'Keeffe's successor in interest and seeking through counterclaim to have the collection transferred to the Museum through right of reverter. In 2007, the Tennessee Attorney General was permitted to join the proceedings to protect the interests of the people of Tennessee.

A settlement with the Georgia O'Keeffe Museum involving a sale of several of the paintings was rejected, as was an outside offer from Crystal Bridges – Museum of American Art, Inc. involving the purchase of an undivided 50% interest that would allow the Crystal Bridges Museum and Fisk to share the college. In a pre-trial motion, the Court ruled the *cy pres* doctrine was not applicable because O'Keeffe had specific rather than general charitable intent when she transferred the collection to Fisk and that the Court had the power to order reversion if the Georgia O'Keeffe Museum could demonstrate Fisk breached the gift conditions. Following trial, the Court ruled that none of Fisk's actions had yet violated the gift terms and imposed an injunction that Fisk comply with the gift terms. Fisk appealed,[44] and in July, 2009 the Court of Appeals reversed the Trial Court's determination the Georgia O'Keeffe Museum had standing to sue finding the Museum had no right of reversion in either the 97 pieces transferred to Fisk from Mr. Stieglitz's Estate by Ms. O'Keeffe using her power of appointment, or the four pieces from Ms. O'Keeffe's personal collection gifted to Fisk.[45] The Court also found the Trial Court erred in dismissing the University's petition for *cy pres* relief after determining *cy pres* was not applicable because Ms. O'Keeffe's charitable intent was specific rather than general. The Trial Court did not determine *cy pres* relief was appropriate, but remanded the petition to the Trial Court for that determination.[46]

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[43] *Tennessee Division of the United Daughters of the Confederacy v. Vanderbilt University*, 174 S. W. 3rd 98, 203 Ed. Law Rep. 396 Ct.App., 2005.

[44] A copy of the appeal can be found on the Tennessean website at http://www.tennessean.com/assets/pdf/DN115593814.PDF.

[45] Slip Copy, 2009 WL. 2047376, Tenn. Ct. App., July 14, 2009 (No. M200800723 COAR3CV).

[46] *Supra.*

F. Yet, Donors Keep Giving

1. Giving USA Foundation *Giving USA 2013*

On June 16, 2013, Giving USA Foundation released *Giving USA 2013* reporting charitable gifts of $316.23 billion in 2012, and increase of 3.5% over 2012. As in years past, individuals accounted for most (79%) of the gifts. In fact, Giving USA 2013 reported that the largest single influence on increased giving was an addition $8.67 billion in gifts made by individuals. Table 6 shows the sources of 2012 charitable gifts, while Table 7 shows the charitable sectors who were the largest recipients of funds.

TABLE 6
SOURCES OF CHARITABLE GIVING, *GIVING USA 2013*

Source	*Amount in Billions*	*Percentage of Total*
Individuals	$228.93	72%
Foundations	$45.74	15%
Bequests	$23.41	7%
Corporations	$18.15	6%
Total	$316.23	100%

TABLE 7
RECIPIENTS OF CHARITABLE GIFTS, *GIVING USA 2013*

Sector	*Amount in Billions*	*Percentage of Total*
Religion	$101.54	32%
Education	$41.33	13%
Human Services	$40.40	13%
Foundations	$30.58	10%
Health	$28.12	9%
International Affairs	$19.11	6%
Public Society/Benefit	$21.63	7%
Arts, Culture, and Humanities	$14.14	5%
Environment/Animals	$8.30	3%

2. Statistics of Income Bulletin

The IRS publishes an annual *Statistics of Income Bulletin* that includes a state-by-state extraction of data on charitable giving drawn from income tax returns of taxpayers who itemize. The most current

report, published in Spring 2013, provides data from the 2011 tax year. Americans who claimed itemized charitable deductions (32.08 percent of those who filed returns) gave $174.99 billion to charity in 2011. Table 8 provides figures for all states.

TABLE 8
ITEMIZED DEDUCTIONS FOR THE TAX YEAR 2011[47]

State	*Number of Returns*	*Number of Taxpayers Taking Itemized Deductions*	*Number of Itemizers with Charitable Deductions*	*Value of Charitable Deductions (in thousands)*
Alabama	2,091,528	599,408	517,720	$2,941,578
Alaska	370,819	91,774	65,686	$317,935
Arizona	2,790,467	889,757	736,549	$2,793,440
Arkansas	459,333	303,097	240,572	$1,380,841
California	17,062,133	6,028,038	4,924,037	$22,033,273
Colorado	2,420,566	893,460	724,602	$3,244,052
Connecticut	1,747,468	754,344	627,472	$2,673,927
Delaware	434,239	152,485	124,457	$454,370
DC	329,718	130,804	107,122	$710,044
Florida	9,695,733	2,323,745	1,862,248	$9,674,105
Georgia	4,671,692	1,586,577	1,302,663	$6,575,664
Hawaii	661,948	206,481	167,891	$579,539
Idaho	671,392	214,619	171,699	$828,328
Illinois	6,122,028	2,126,709	1,730,798	$7,117,252
Indiana	3,018,318	804,573	634,550	$2,824,815
Iowa	1,421,065	452,341	364,914	$1,401,003
Kansas	1,325,121	405,756	329,677	$1,711,192
Kentucky	1,876,826	543,981	439,603	$1,846,471
Louisiana	2,022,779	468,653	361,160	$1,878,260
Maine	633,428	195,488	145,758	$431,841
Maryland	2,837,882	1,358,784	1,139,087	$4,942,200
Massachusetts	3,258,058	1,280,488	1,048,510	$4,179,551

[47] IRS Statistics of Income Bulletin Spring 2013.

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State	*Number of Returns*	*Number of Taxpayers Taking Itemized Deductions*	*Number of Itemizers with Charitable Deductions*	*Value of Charitable Deductions (in thousands)*
Michigan	4,676,744	1,407,181	1,174,285	$4,727,347
Minnesota	2,601,604	1,009,973	849,801	$3,150,615
Mississippi	1,286,776	302,290	250,502	$1,447,389
Missouri	2,729,064	813,160	644,442	$5,098,525
Montana	480,902	146,860	112,803	$510,292
Nebraska	868,468	264,847	219,641	$1,052,921
Nevada	1,297,925	365,099	290,775	$1,355,224
New Hampshire	678,296	237,001	178,579	$530,373
New Jersey	4,325,769	1,853,950	1,556,791	$5,240,369
New Mexico	914,444	232,048	175,635	$712,686
New York	9,387,780	3,372,882	2,819,562	$14,521,692
North Carolina	4,295,284	1,447,828	1,217,498	$5,494,798
North Dakota	343,814	72,270	52,731	$264,979
Ohio	5,508,810	1,678,968	1,305,919	$4,838,669
Oklahoma	1,617,355	425,348	336,365	$2,148,809
Oregon	1,758,128	681,593	542,630	$2,067,832
Pennsylvania	6,183,225	1,905,866	1,541,772	$6,023,086
Rhode Island	513,134	184,512	152,426	$425,114
South Carolina	2,090,773	619,503	525,894	$2,555,488
South Dakota	411,441	80,005	61,272	$439,607
Tennessee	2,902,907	679,010	550,399	$3,515,708
Texas	11,417,280	2,819,997	2,181,862	$19,027,145
Utah	1,159,631	445,585	384,348	$2,917,121
Vermont	320,656	95,489	69,193	$240,597
Virginia	3,801,986	1,513,949	1,236,419	$5,351,793
Washington	3,216,985	1,107,308	872,576	$3,648,593
West Virginia	791,595	148,549	105,354	$491,005

State	Number of Returns	Number of Taxpayers Taking Itemized Deductions	Number of Itemizers with Charitable Deductions	Value of Charitable Deductions (in thousands)
Wisconsin	2,772,794	991,428	791,370	$2,587,680
Wyoming	294,713	70,253	46,902	$462,926
United States	146,455,970	46,983,468 32.08% of all taxpayers	38,074,121 81.04% of all who filed	$174,989,004

II. Ideas 1 and 2: Simple But Smart

A. Accelerating Charitable Gifts

Sometimes the simplest planning concepts generate the most profound results. As the gift and estate tax rates shift under the schedules legislated in the 2001 Tax Act (EGTERRA) and slated income tax reductions are accelerated in the 2003 Tax Act (JGTRRA), planners must review assumptions made about tax benefits of planned gifts in current estate plans and consider changing the timing – and the form – of those gifts to maximize taxpayer benefits.

According to a recent IRS report in the Statistics of Income Bulletin, *Recent Changes in the Estate Tax Exemption Level and Filing Population*, there has been a dramatic drop in the number of estate tax returns filed since the 2001 Act. Estate tax filings dropped from 108,071 in 2001 to 45,070 in 2005, a drop of more than 58%.[48]

- *Accelerate gifts destined for charity that generate no income.* The easiest gifts to accelerate are those designated for charity under a will or will substitute that produce no current income. Classic examples include life insurance policies owned by the donor designating charity as the beneficiary, or valuable art collections headed for a museum (especially if the donor is downsizing and is concerned about the ongoing cost of insuring and safeguarding the assets).

- *Accelerate a testamentary gift of a home or farm by making a retained life interest gift*. A similar, but often overlooked asset is a home designated for charity under a will. The donor may want to transfer the home to charity today, retaining the lifetime right to remain in the home, and take a charitable deduction for the remainder interest.

  When a donor makes a gift of a remainder interest gift in a home or farm, it is impossible to know whether he may need to sell the real estate and move to an assisted care or long-term skilled nursing facility prior to death. The real property used for the gift may be his asset of greatest value, or simply the asset needed, to ensure housing needs are met. There are at least five ways to handle this problem.

  1. *A bargain sale of the residence*. If the donor knows he will need to sell the residence at the time the gift is in the planning process, a bargain sale may meet his goals. This

[48] Raub, Brian G. Recent Changes in the Estate Tax Exemption Level and Filing Population, Fall 2007 Statistics of Income Bulletin, Figure C, p. 115.

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means that the donor can sell the remainder interest to charity for a price that is less than the fair market value of the remainder interest. The donor can use the cash received from the sale portion to fund his housing needs. The sale triggers recognition of capital gain on the sale portion of the transaction under the bargain sale rules.

2. *A bargain sale of the remainder interest*. If the donor knows he will need some cash from the transaction, he can consider a bargain sale of the remainder interest, instead. This transaction triggers capital gains on the non-charitable portion of the transaction under the bargain sale rules.[49]

3. *A bargain sale of the residence or the remainder interest in the residence in exchange for a charitable gift annuity.* If the donor needs income, he may make a bargain sale of the residence or the remainder interest in the residence in exchange for a charitable gift annuity. This transaction triggers capital gains for the non-charitable portion of the transaction under the bargain sale rules.[50]

4. *A sale during the donor's life term*. If the need is not identified until well into the life interest, the donor and charity may decide to sell the home and split the proceeds of the sale. The donor will receive the proceeds attributable to his life interest remaining in the property, and the charity will receive the balance. Since many charities plan to sell the property upon receipt, this will allow the charity to receive the cash earlier than expected, and will provided the donor with needed cash. This transaction triggers capital gain on sale of the asset.

- *In 2006 and 2007 donors age 70 ½ or older were allowed to make a gift of up to $100,000 in assets from an IRA under the Pension Protection Act of 2006.* This option may be extended through extender legislation in 2008, but is currently not an option.

There is no single rule applicable to every client. Every taxpayer's personal and tax situation is different. The planner must consider the client's age and family obligations, the potential need to call on the assets, the need for flexibility, and his or her charitable objectives as well as the value of the tax deduction to the donor. Successful planning is predicated on careful consideration of the options, and selecting the gift plan that maximizes the charitable and tax benefits to the donor.

B. Using IRD Assets for Testamentary Gifts

Income in respect of a decedent (IRD) creates unique opportunities for charitable planning. IRD assets – including IRAs, savings bonds, untaxed compensation, or any asset on which income tax is due at death – are often avoided by gift planners because of unpleasant tax consequences if transferred during life. In an estate, however, these assets can work magic when used to make charitable gifts.

[49] *Id.* See Ltr. Rul. 8134106.

[50] *Id.* See Ltr Ruls. 8120089, 8305075 and 8806042.

1. The Basic Principles of IRD Planning

IRD is the term defining income that has accrued but not taxed at a decedent's death. These assets reach beneficiaries with a tax burden; the decedent's estate, the named beneficiary, or person or entity to which the asset is properly distributed is responsible for payment.[51] The untaxed income has the same character in the hands of the recipient it had in the hands of the owner.[52] Since the highest estate tax rate in 2013 is 40%, and the highest federal income tax rate is 39.6%, the two taxes can take a significant bite out of the asset's value at death.[53]

The goal of using IRD assets in testamentary charitable planning is simple: give the most highly taxed assets to charity, leaving the non-taxed assets for heirs. If the transfer is structured properly:

- The estate receives a charitable estate tax deduction for the gift to charity;
- The income in the property is allocated to the charity, an entity that pays no tax; and
- The non-charitable beneficiaries receive estate assets with a stepped-up basis and no inherent tax burden.

Many commonly-held assets have IRD, including the following:

✓ *Retirement plans*, such as qualified employee benefit plans, Keoughs, IRAs, and other retirement benefits funded with pre-tax income. This would not include defined benefit plans (where there is the right to certain benefits but no ownership or right of disposition of the assets funding those benefits), Roth IRAs, or portions of retirement plans funded with after-tax dollars.

✓ *Savings bonds* with accrued, untaxed income. The most common form of bond with untaxed income is the EE (Patriot) Savings Bond, which is purchased at a discount of face value, and accrues interest for up to 30 years. Until August 31, 2004, it was possible to convert EE Bonds to HH Bonds without triggering tax on the accrued income; the Treasury no longer allows such a conversion. It was also possible until August 31, 2004 to defer interest on HH Bonds; this option, too, has been eliminated.

✓ *Deferred compensation*.

✓ *Compensation earned – but not received* – before death. This includes any payment for remaining vacation or sick time accruing to the decedent.

✓ *Accounts receivable*, earned but not received before death.

✓ *Unrecognized income from annuities*, such as deferred annuities.

✓ *Remaining installment sale payments*.

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[51] IRC § 691(a)(1).

[52] IRC § 691(a)(3).

[53] Most states also impose a state estate tax and income tax. The state estate tax can be claimed in part or in whole as a credit against the federal estate tax; the state income tax adds an additional overall tax burden to the IRD.

- ✓ *Accrued interest* on stocks and bonds due at date of death.

Sometimes the inclusion of these assets in an estate is predictable. Retirement plans and savings bonds, for example, may comprise a large percentage of a decedent's assets. In other cases, the inclusion of the asset is not anticipated. An installment sale, for example, may have been executed after the estate plan was prepared. Only a few of these IRD assets will be explored in detail. However, the principles of IRD planning are equally applicable to all assets with this form of income.

2. Retirement Plan Gifts

Retirement plans represent a major asset in many estates due to two factors. First, companies that formerly offered defined benefit plans now find it less expensive to provide defined contribution plans. Defined benefit plans – often referred to as pension plans – require a company to maintain an actuarially calculated reserve to pay retirees a specific annual benefit for life. The retired employee does not own the assets generating the benefit, and the cash flow normally ceases at the death of the retiree. Define contribution plans allow a company to make a retirement contribution that vests (or becomes owned by) the employee after a specific period of service. The employee is then responsible for investing the assets to generate a sufficient return in retirement. Many of these plans allow employees to defer income to further build retirement assets. Second, the bull market of the 1990s increased the presence of retirement plans in estates. Individuals who had not yet retired found their plans grew dramatically, with or without additional contributions; those who had retired found the plans grew faster than required withdrawals were made.

a. Retirement Plans with Income in Respect of a Decedent (IRD)

Profit Sharing Plans: A profit sharing plan is funded on a defined contribution basis, meaning that the company decides each year how much it will contribute. Employees become vested with ownership depending upon years of employment and the terms for vesting set out in the plan. Once an employee is vested, the funds are the property of the employee and can be distributed, if funds remain at death, through a beneficiary designation.

IRC Section 401(k) Plans: A 401(k) plan allows an employee to contribute pre-tax earned income to the plan. Many times profit sharing plans include a 401(k) feature so that employees may grow retirement savings through profit sharing contributions and 401(k) contributions. 401(k) assets are owned by the employee and any funds remaining in these plans can be distributed through a beneficiary distribution. The plan document may limit the manner of distribution so it is important that the plan owner and advisor be familiar with plan limitations.

IRAs: IRAs may be the most common form of retirement plan. Contributions to IRAs accumulate and grow tax-free. Distributions from the fund are taxed as ordinary income. Assets remaining at death are the property of the taxpayer and may be distributed in accordance with beneficiary designations.

Keoghs: Keogh plans are structured much like IRAs, but are tax-deferred retirement savings plans for the self-employed. Participants in Keoughs are subject to the same restrictions on distribution (between ages 59 1/2 and 70 1/2) as are participants in IRA's.

b. Plans Not Characterized as Income in Respect of a Decedent

Pension Plans: Pension plans are company-funded retirement packages for employees. The traditional pension plan is a defined benefit plan, meaning that the employee, once vested, receives defined benefits from the plan at retirement. These benefits may continue for the life of the employee, or the life of the employee and his or her spouse. But the employee does not own the plan assets and cannot generally distribute those assets. The benefits cease at the employee's death, or at the second to die of the employee and his or her spouse.

Roth IRA: Roth IRAs are not included in the group of retirement plans with IRD. Roth IRAs are funded with after-tax dollars. The assets in the plan then accumulate, and are distributed, tax-free. Taxpayers were allowed to covert standard IRAs to Roth IRAs by paying the tax due and making an election to move the funds. While these assets can still be used to make charitable gifts, the gift does not carry the double tax benefit – avoiding ordinary income tax and estate tax – that gifts of IRD retirement plans generate.

3. Retirement Plan Gift Options

Retirement plans that offer opportunities for charitable planning include, but are not limited to, the following options.

✓ *Lifetime Outright Gift to Nonprofit Organization*

The only way to make a gift to charity under current law is to take a distribution from the plan, pay income tax on that distribution, make the gift to charity, and take a charitable deduction for the gift. Several obstacles prevent the taxpayer from receiving a $1 for $1 charitable gift credit for the gift. First, the charitable deduction is available only if the taxpayer itemizes (a group that in 2013 included 32.08 percent of all taxpayers). Next, many taxpayers receive limited benefit from itemized deductions because of the application of the three percent rule (reduced by legislation to 1% in 2008 and 2009, and eliminated in 2010 but revived in AFTRA 2012).[54] And finally, there may be other tax items on the taxpayer's return (such as prior year credits or carry forwards) that prevent the use of the deduction.

If the taxpayer has an excessive amount of funds in the IRA, he or she may choose to withdraw funds, pay the tax and make the gift to charity. If so, consider these ways to maximize that decision.

1. The withdrawn funds can be contributed to charity in exchange for an IRA. This generates a charitable deduction to cover part of the tax, removes the funds from the estate and generates an income in retirement.

2. The withdrawn funds can be contributed to a charitable remainder trust. If the taxpayer funds a charitable remainder trust, it is best to use appreciated funds and use the cash from the retirement fund distribution to replace the stock at a higher basis.

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[54] IRC § 68.

3. The taxpayer can make an outright distribution to charity. Again, the taxpayer should use appreciated stock, using the cash from the retirement plan distribution to replace the stock at a higher cost basis.

✓ *Lump Sum Distribution from Profit Sharing Plan Used to Fund Charitable Remainder Trust*

In the facts of Letter Ruling 200202078, the donor retired and received his retirement plan assets in the form of an in-kind distribution of company stock and other assets. He rolled a portion of the in-kind distribution into an IRA and received the balance of the shares outright. He transferred a portion the non-rollover shares to a charitable remainder trust. The taxpayer recognized ordinary income on the non-rollover shares to the extent of the retirement plan's basis in the stock. The net unrealized appreciation (the value of the shares in excess of the basis) was characterized as long-term capital gain. The IRS ruled that the contribution of the shares to charitable remainder trust did not trigger ordinary income or capital gain to the donor, and would not trigger tax to the donor or the trust upon subsequent sale (absent any unrelated business taxable income or a prearranged sale). This ruling was consistent with two earlier rulings involving retirement plan transfers to charitable remainder trusts.[55]

✓ *Outright Gift to Community Foundation at Death*

Retirement plan assets may also be used to make an outright gift to a community foundation. Community foundations offer donors a variety of options.[56] The transfer agreement can reserve the right to advise on distributions from the funds to the decedent's spouse and/or children, thereby providing family members with a means to make charitable distributions that they choose. (Advised Fund) The transfer can be made to a field of interest fund to benefit a particular area of the taxpayer's interest such as healthcare, education, welfare reform, etc. (Field of Interest Fund). The transfer can be made to a designated fund, designed to distribute funds annually to specific organizations. (Designated Fund) Or the transfer may be made to an unrestricted fund labeled with the donor's name.

✓ *Outright Gift to Private Foundation at Death*

When a donor has substantial funds to contribute to charity, the taxpayer may want to consider creating and funding a private foundation.[57] A private foundation is used by many families to teach family members about philanthropy and to control the distribution of charitable dollars. The consequence of a distribution to a private foundation is that some tax may be due. Private foundations are generally considered to be one of the lowest forms of charitable life simply because they are subject to regulations and excise taxes that public charities are not required to bear. One of those taxes is an excise tax due on the foundation income, defined as interest, dividends, rents, and royalties. The distribution of retirement

[55] See also LR 199919039, LR 200038050, and LR20035017.

[56] Get information about community foundations, and locate a community foundation in your community, by contacting The Foundation Center, <http://fdncenter.org>, or the Council on Foundations, <www.cof.org>.

[57] "Large" is a relative term. Private foundations are not cost-effective for assets of less than $1,000,000 and are really most appropriate at $3,000,000 to $5,000,000. See McCoy, Jerry J. and Kathryn W. Miree, *The Family Foundation Handbook (2008 Edition)* (CCH: 2007) for a full discussion of funding and managing family foundations.

plan assets to the private foundation may create taxable income if the proceeds are subject to the 2 percent excise tax on investment income.[58]

✓ *Testamentary Outright Gift to Nonprofit Organization*

One of the simplest ways to maximize distributions from retirement plans is to name a charitable organization as beneficiary of all or part of the remainder. A distribution to charity of retirement assets at death (through beneficiary designation) avoids payment of both income and estate tax.

Generally speaking, when a client is making both charitable and non-charitable distributions from an estate, the charitable distributions should be made from IRD assets such as a retirement plan. The simple act of making a bequest from a retirement plan rather than the estate generally increases the net assets available for family. The distribution, especially when it represents only a portion of the assets, should be structured to preserve elections of the individual beneficiaries receiving the remainder of the retirement assets. Consider these three options.

- *Create a separate IRA* to hold the gift to charity, and designate the charity as the sole beneficiary of that IRA. While this is no longer necessary to maximize recalculation options, it may make the client's wishes clearer and to ensure the distribution is made prior to the required distribution date.

- *Designate a share of the IRA* to the charitable beneficiary(ies).

- *Make the assets payable to the estate and draft the will to specifically allocate the IRA to the charitable share.*[59] Consider this sample language:

    ✓ *An in-kind distribution* – "I direct that my IRA held at Merrill Lynch be distributed to XYZ Charity." Note: this alternative is also appropriate for other IRD assets such as savings bonds, accounts receivable, etc. This will have the effect of having the charity or CRT recognize the income from the IRD asset.[60] If the charitable recipient is a public charity or charitable remainder trust, no income tax will be due.

    ✓ *A non-pro-rata distribution* – A non-pro-rata distribution means that the will specifically directs that the IRD asset be allocated to a particular beneficiary's share rather than have it split on a pro-rata basis among all estate beneficiaries. Sometimes state law and/or the will may allow an executor the discretion to make non-pro-rata distributions. If this is the case, and the executor elects to distribute the IRD assets to charity, it may be possible to

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[58] See IRC § 4940; See Ltr. Rul. 9341008 (July 14, 1993) and Ltr. Rul. 9838028; also see a different result for IRD from savings bonds under Rev. Rul. 80-118, 1980-1 CB 254.

[59] PLR 200452004 ruled an estate's assignment of IRAs to a charity as part of the residuary share of an estate would not cause the estate (or any estate beneficiary) to have taxable income.

[60] IRC § 691(a); Reg. § 1.691(a)-4(b)(2); Rev. Rul. 64-104, 1964-1 C.B. 223.

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avoid taxable income on distribution.[61] However, if either the state law or the will gives the executor this power, a distribution of the IRD assets to a specific beneficiary may trigger the tax as a taxable exchange among the beneficiaries.[62] The safest way to do this is to address the issue directly.

- ✓ *Language directing that the bequest be made with IRD assets to the extent possible* – This language provides the greatest protection. The will might say: "I instruct that all of my charitable gifts, bequests and devises shall be made, to the extent possible, from property that constitutes 'income in respect of a decedent' as that term is defined in the Internal Revenue Code."[63] This allows the executor to claim a deduction for the IRD in the portion of the IRD assets passing to charity. Without the language, the estate is limited to an estate tax deduction for the property and will not be able to claim an income tax deduction.[64]

Retirement plan proceeds should not be used to satisfy a debt or pledge, such as a capital campaign obligation. If plan proceeds are pledged on an enforceable debt or loan, the estate will be required to pay tax on the distribution.[65] Also remember that spousal consent is required for distributions from corporate retirement plans that are not paid to the spouse. Spousal consent is not required for distributions from IRAs.

✓ *Testamentary Gift in Exchange for Charitable Gift Annuity*

In an important 2002 ruling,[66] the IRS allowed a taxpayer to name a charity as the designated beneficiary of an IRA in exchange for a testamentary charitable gift annuity payable to a named individual beneficiary. Previous to this ruling, the IRS had approved designating a charitable remainder trust as the beneficiary of an IRA, but had not ruled on a similar arrangement with a charitable gift annuity. In this ruling, the court made four determinations: the IRA would not generate unrelated business income for the charity, the IRA would be included in the owner's gross estate for estate tax purposes, the estate could claim a deduction for the charitable portion of the charitable gift annuity, and the IRA proceeds would be income in respect of a decedent (IRD) to the charity, not the owner's estate. Unfortunately, the IRS did not discuss the potential IRD impact on the annuitant. This ruling adds a simpler option for IRA owners who want to create a life income arrangement for an heir at death.

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[61] Ltr. Ruling 9537011 (June 16, 1995).

[62] Rev. Rul. 69-486, 1969-2 C.B. 159.

[63] This language was recommended by Professor Christopher Hoyt, professor of law at the University of Missouri (Kansas City) School of Law in a presentation made at the National Conference on Planned Giving in October, 1999.

[64] *Crestar Bank v. IRS*, KTC 1999-279 (E.D. Va. 1999); *Van Buren v. Commissioner*, 89 T.C. 1101 (1987); *Riggs National Bank v. U.S.*, 352 F.2d 812 (Ct. Cl. 1965).

[65] *John T. Harrington Estate*, 2 TCM 540, Dec. 13, 1943, 405 (M)

[66] Ltr. Rul. 2002230018.

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✓ *Testamentary Gift to Charitable Remainder Trust*

Another way to structure retirement plan distributions is create a testamentary charitable remainder trust for the benefit of family members. Since a charitable remainder trust does not pay tax, the retirement assets are not subject to income tax.[67] Then, the estate will receive a charitable deduction for the charitable portion of the charitable remainder trust. Table 12 compares the result of an outright gift of a $250,000 retirement plan to family (for a $4,000,000 estate) and the gift of that retirement plan to a 5%, 20-year charitable remainder trust for family. The calculation assumes the gift was made in April 2012 (1.4% CFMR).

If the spouse is named as the sole beneficiary of the charitable remainder trust, his or her interest will qualify for the marital deduction[68] so that estate tax is avoided altogether at the taxpayer's death. The assets can then distribute income annually to the decedent's wife, or children. If the sole beneficiary is the decedent's spouse, a marital deduction is available so that all taxes are avoided.[69]

TABLE 9
COMPARISON OF $250,000 RETIREMENT PLAN TRANSFERRED TO FAMILY AND TO 20-YEAR 5% CRUT (ASSUMING $4,000,000 ESTATE, 35% TAX BRACKET, 15% CAPITAL GAINS BRACKET)[70]

	$250,000 Bequest of Retirement Plan to Family	*$250,000 Bequest of Retirement Plan to 5%, 20-Year CRUT*
Total Estate	$4,000,000	$4,000,000
Total Taxes on $250,000 Retirement Plan	$87,500	$0
Effective Tax Rate on Retirement Plan (federal taxes only)	35%	$0
Net Bequest	$162,500	$250,000
Net Savings vs. Bequest		$87,500

4. Options for Savings Bonds

U. S. Savings Bonds, first introduced in 1935, are a widely held asset. More than 55 million Americans own savings bonds with a value in excess of $186 billion.[71] Since many of these bonds have accrued, untaxed interest, these assets are popular for testamentary charitable planning.

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[67] Although it is important to note that the retirement plan distributions are considered to be Tier I income and may impact the taxation of payments to beneficiaries of the charitable remainder trust.

[68] IRC § 2056(b)(8).

[69] Ltr. Rul. 9253038.

[70] Calculations made using PGCalc, 10-1-2012.

[71] <www.aarp.org/financial-investsave/Articles/a2002-10-08-ussavingsbonds.html>.

There are three types of savings bonds issued by the United States Government: Series EE/E Bonds, Series I Bonds, and Series HH/H Bonds.[72]

- ✓ *Series EE Bonds.* Series EE Bonds (formerly Series E Bonds) are savings bonds issued at a discount by the U.S. Government.[73] For example, a purchaser pays $50 to purchase an EE Bond with a $100 face value. The bond matures at face value and then continues to accrue interest for up to 30 years.[74] Purchasers can elect to report the accrued interest on the bonds annually or to defer recognizing income until redemption; most chose to defer. When holders of Series EE/E Bonds with deferred income contribute the bonds to a charity during life, the gift is valued at the full fair market value of the bond (rather than the discounted value paid for the bond), but the donor must report the accrued interest (as ordinary income) in the year of the gift.[75] Conceptually, this is the opposite tax result from a gift of appreciated stock for which the donor receives a charitable deduction equal to market value and avoids the capital gains tax on the appreciation.[76] A donor would generally be better off to simply make a gift of cash.

  Series EE Bonds could be converted to HH Bonds (see below) through August 31, 2004, without triggering tax on the accrued interest in the bond.[77] However, the bond could not be transferred to another (charitable or non-charitable) beneficiary at this point without triggering the tax.[78] Likewise, Series EE/E Bonds cannot be reregistered in the charity's name during life without triggering the tax. The only way to avoid recognition of ordinary income on these bonds is to transfer them to charity through a specific bequest under the will (or, if the bonds are held in a revocable trust, through a testamentary disposition to charity in that trust).[79] A specific bequest of the bonds will shift the accrued income to charity and avoid taxation as income in respect of a decedent in the donor's estate.[80] This is not possible when bonds are owned jointly with right of survivorship, since these bonds will pass to the survivor and will not be subject to the terms of the will. The survivor of the two interests may leave the bonds to charity under will.

- ✓ *Series HH Bonds.* Series HH/H Bonds are savings bonds issued at face value that pay annual interest. When donors contribute Series HH/H bonds to charity during life, the gift is valued at the full fair market value of the bond. If, however, the HH/H bonds have been converted from EE/E bonds (and the interest was deferred, rather than paid, on conversion), the gift to charity will trigger

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[72] For detailed information on United States Savings Bonds, go to <www.publicdebt.treas.gov/sav/sav.htm>.

[73] For savings bonds redemption values, six month earnings as an annual yield, and yield from issue date for Series EE/E bonds can be found at www.publicdebt.treas.gov/sav/savreport.htm>>.

[74] Bonds purchased before November 1965 accrue interest for up to 40 years.

[75] Reg. § 1.170A-4(a)(3).

[76] Actually, the result is generally much worse, since the gain avoided on gifts of appreciated securities is long-term capital gain, while the income recognized on disposition of E or EE Bonds is taxed as ordinary income.

[77] <www.publicdebt.treas.gov/sav/savinvst.htm>.

[78] See Letter Ruling 8010082 for a discussion of this result.

[79] See Ltr. Rul. 8010082 (December 13, 1979) for further information on EE/H bonds. Also see Ltr. Rul. 9507008, where IRS ruled that savings bonds in a revocable trust with testamentary provisions used to discharge pecuniary bequest to charity triggered recognition of income in respect of decedent in the trust.

[80] IRC § 691(a)(1).

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the deferred ordinary income accrued during the period the donor owned the EE/E bonds.[81] Until August 31, 2004, the owner had an option to reinvest interest on these bonds; that is no longer possible.[82]

- ✓ *Series I Bonds.* Series I Bonds are the most recent addition to the savings bond options. These bonds, first offered in September, 1998, are sold at face value and pay interest that is adjusted twice a year to reflect increases in the Consumer Price Index for all Urban Consumers (CPI-U). Interest is compounded semi-annually. The bonds have a thirty year maximum, but may be redeemed for cash after a six-month holding period. The interest on the bonds is deferred for federal tax purposes during the life of the bond. The Bonds are exempt from state and local income taxes. The gain in these bonds is taxed as ordinary income in the year of maturity, redemption, or disposition. Therefore, these assets make poor gifts for charity during life, but make excellent gifts to charity under will.

Savings bonds may be owned in one of three ways: sole ownership, joint ownership, or sole with remainder beneficiary.[83]

- ✓ *Sole ownership* implies the bond is in a single individual's name; that bond will become a part of the owner's estate on death.

- ✓ *Joint ownership* gives full rights of ownership to both individuals. Either named owner can redeem the bond or exercise elections. Registering a bond jointly transfers ownership outside of the probate process at the first death; at the death of the survivor, the asset becomes a part of that individual's estate assets.
- ✓ *Sole ownership with a designated surviving beneficiary* leaves ownership rights with the registered owner, but names a beneficiary at death, again allowing the bond to bypass probate. This also allows a deferral of the tax on accrued income since the income will not be taxed until the bond is redeemed.

The accrued income in the bonds is classified as IRD. It is recognized when the bonds are disposed of, redeemed, or reach maturity, which occurs first.[84] The tax is generally paid by the named recipient. There is one exception to the rule. The executor may make an (irrevocable) election to report the interest on the decedent's final income tax return.[85] This option may create a better net result for the beneficiaries if the decedent's income tax rate is lower than the estate's. It is not recommended when a public charity (or private foundation) is designated to receive the bonds since it will result in payment of taxes when otherwise none would be due.

Savings bonds can be used in the same manner as retirement benefits in testamentary charitable plans. This includes the following options:

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[81] Ltr. Rul. 8010082.

[82] <www.publicdebt.treas.gov/sav/savinvst.htm>.

[83] See the Treasury web site cited earlier.

[84] Reg. § 1.691(a)-2(b); Rev. Rul. 4-104, 1964-1 C.B. 223.

[85] Rev. Rul. 68-145, 1968-1 C.B. 203.

- ✓ Make a specific devise of the bonds to a public charity (no income or estate tax should be due), a private foundation (a 2 percent/1 percent tax is paid by private foundations on all income), a community foundation advised fund, or other direct charitable beneficiary. This is best accomplished by including specific language to this effect in the will.

- ✓ Make a specific devise of the bonds to a testamentary charitable remainder trust. The charitable estate tax deduction for the charitable portion of the gift (the non-income portion) will reduce the estate tax, and the charitable remainder trust's tax exempt status (a charitable remainder trust pays no tax unless the trust has unrelated business taxable income) allows it to avoid tax on the accrued bond income. To ensure this result, the savings bonds should be transferred to the charitable remainder trust and redeemed inside the trust. (If the bonds are redeemed by the estate, the income will likely be included on the estate's income tax return. It is unclear whether the estate can claim a deduction when the proceeds are then transferred to the charitable remainder trust.)

C. Ideas #3 and #4: Gifts of Closely-Held or Family Owned Businesses

The family business is the single most important asset held by many individuals – for financial and emotional reasons. The business may represent the family's most significant source of income and also contribute to its stature in the community. In addition, a first generation owner may feel the business represents his life's work, uniquely reflecting his or her business principles.

Family businesses – C Corporations, S Corporations, LLCs, LLPs, partnerships, and other less formal arrangements – are often the largest single asset of wealthy clients. Consider these statistics:

- Family businesses represent 80 to 90 percent of all business entities.[86]

- Family businesses contributed 64% of GDP and employed 62% of the U.S. work force.[87]

- The generational transfer attrition rate is high. 70 percent do not survive to the second generation; 88 percent do not make it to the third generation; and 97 percent do not make it to the fourth generation or beyond.[88]

- A surprising 19 percent of family business participants have not created an estate plan other than writing a will; only 37% have strategic plans; and 85% of those that have identified successors pointed to family members.[89]

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[86] J. H. Astrachan and M. C. Shanker, "Family Businesses' Contribution to the U.S. Economy: A Closer Look," Family Business Review (September 2003).

[87] *Id.*

[88] Joseph Astrachan, Ph.D., editor, *Family Business Review*, www.ffi.org.

[89] University of Southern California Marshall School of Business, Facts On Family Businesses, <www.marshall.usc.edu>.

- Leadership of 39 percent of family enterprises will change hands over the next five years.[90]

- Wealth holders in family owned firms are interested in passing their wealth to the next generation, as well as their values. They want their descendants to earn their income and engage in philanthropy through giving and volunteering.[91]

III. Ideas 3 and 4: The Family Business and Charitable Donors

A. The Family Business Market

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[90] Raymond Institute/MassMutual American Family Business Survey (2003).

[91] Bankers Trust Private Banking/Deutsche Bank, Wealth with Responsibility Study (2000).

[92] J. H. Astrachan and M. C. Shanker, "Family Businesses' Contribution to the U.S. Economy: A Closer Look," Family Business Review (September 2003); Isabella McPeak, Family Business Statistics in the US, www.peakfamilybusiness.com/2011/10/25/family-business-statistics-in-the-us.

[93] *Id.*

[94] Joseph Astrachan, Ph.D., editor, *Family Business Review*, www.ffi.org.

[95] University of Southern California Marshall School of Business, Facts On Family Businesses, <www.marshall.usc.edu>.

[96] Raymond Institute/MassMutual American Family Business Survey (2003).

- Wealth holders in family owned firms are interested in passing their wealth to the next generation, as well as their values. They want their descendants to earn their income and engage in philanthropy through giving and volunteering.[97]

B. Creating a Charitable Gift in Conjunction with the Sale of a Family Business

Many of today's business owners have built their own companies and own all or the majority of the stock in their non-publicly traded corporation. As the business owner reaches retirement age he often sells the business. As a part of this planning process, the small business owner should consider combining personal charitable goals with the disposition of the business by gifting some of the closely held stock to a charitable remainder trust. The capital gain on the shares gifted to the charitable remainder trust will not be taxed, and the charitable deduction can help shelter gain on shares sold outside the trust. The trust's shares can later be purchased by the purchaser of the business at a fair market value.[98] In the example shown in Table 10, the donor is age 68, and spouse is age 65, the gift occurs in August 2013 (2% CFMR), the business has a total value of $5,000,000 and a basis of $1,000,000, and the gift to the 5% charitable remainder unitrust for their joint lives is $500,000.

TABLE 10
C CORPORATION STOCK TO CHARITABLE REMAINDER TRUST
$5,000,000 Market Value of Closely Held Business; $1,000,000 Tax Basis of Shares;
68 Year Old Donor with 65 Year Old Spouse; $500,000 5% Charitable Remainder Unitrust[99]

STEP ONE *$500,000, 5% CRUT*	*STEP TWO* *Sale of Remaining Shares to Purchaser*	*STEP THREE*
$500,000 Gift	$4,500,000 Sale	Purchaser buys $500,000 of stock from CRUT
$100,000 Tax Basis	($900,000) Tax Basis	
$357,020 Charitable Deduction	$3,600,000 Gain	
$25,000 First Year's Income	$540,000 Tax at 15%	

C. Creating a Charitable Gift When the Family Business Will Pass to the Next Generation

In another scenario, the closely held corporation may have many accumulated earnings that will be taxed to the recipient if distributed. In this case the charitably inclined business owner may want to contribute shares of the closely held stock to a charitable remainder trust. The closely held corporation can then use its accumulated earnings to buy back the stock and retire it as treasury stock. Key points include the following:

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[97] Bankers Trust Private Banking/Deutsche Bank, Wealth with Responsibility Study (2000).

[98] Note: You must avoid a prearranged/step transaction. There can be no repurchase agreement at the time of the contribution of the shares to the charitable remainder trust.

[99] Calculations made in August 2013 using 2% CFMR.

1. *If structured properly, there is no constructive dividend to the contributing shareholder and no adverse consequences to the corporation.*

2. The majority corporate owner/donor may still be the majority owner after the gift with planning.

3. *If the interest is less than a majority interest in the corporation, the IRS may require a minority discount be applied to the appraised value of the shares.*

4. *The redemption offer must be made to all stockholders. Even though all shareholders are offered the opportunity, the trust may be the only shareholder to redeem.*

5. There cannot be a prearranged sale agreement with this transaction.[100]

IV. Ideas 5 and 6: Gifts That Take Care of Family

A. Combining a Charitable Gift with Care of a Special Needs Family Members

Sometimes a parent or grandparent is faced with the responsibility of taking care of a disabled child. While federal or state medical assistance is available for those with no assets, families like to provide for special needs when possible without eliminating the possibility of outside coverage. In this case, the planner may want to couple a charitable remainder trust with a special needs trust.

A special needs trust involves a transfer of assets to a trust to make specific types of payments to the trust beneficiary without disqualifying that beneficiary for public assistance benefits such as SSI and Medicaid. There are three ways that this trust may be structured.

- It can be created by a family member, with the family member's funds, for the benefit of the disabled individual.
- It can be created through a court proceeding using the disabled individual's funds.
- It can be part of a pooled fund managed by charity.

✓ *A Special Needs Trust Created By a Family Member.* One of the most common approaches to creating a special needs trust is to create a trust for the benefit of a disabled individual using a family member's (not the disabled beneficiary's) funds. The trust must be created by a family member other than the trust beneficiary. In other words, Charles cannot take the assets left to him by his parents and create this type of trust. However, his parents could have created such a trust during life, or at death under their wills. The trust must also have a trustee, which can be

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[100] For the latest ruling on the assignment of income issue, see *Gerald A. Rauenhorst, et ux. v. Commissioner, 119 T.C. 9 (7 Oct 2002).* In these facts, the taxpayers owned stock in a closely-held company and warrants allowing the purchase of additional shares. The taxpayers were approached by a purchaser interested in acquiring taxpayers' stock and warrants. Following the purchase offer, the taxpayers assigned the warrants to four charities and sold their remaining stock to the purchaser. The four charities, in unrelated transactions, also sold their warrants to the purchaser. On audit, the IRS assessed the taxpayers with the capital gain on the warrants as an anticipatory assignment of income. The court dismissed the IRS claim, relying on the test in Revenue Ruling 78-197 that attributes income to the donor only if the donee, after receipt of the gift, is legally bound or can be compelled to sell. Since the charities had the option to sell, but were not obligated to do so, the capital gains were properly attributed to the charities.

anyone qualified to serve under state law other than the beneficiary. Once established, the trustee makes distributions to the beneficiary to meet the needs listed in the trust.

The government specifically recognizes special needs trusts, so long as they meet these requirements:

- It must be established by a family member (other than the beneficiary).
- It must be managed by a trustee (who is not the beneficiary).
- It must give the trustee absolute discretion to make distributions.
- It should not give the beneficiary more income or resources than permitted to qualify for benefits.
- It can only be used to provide supplementary needs.
- It must provide instructions for final arrangements (funeral expenses).
- It directs what will happen to assets left in the trust at death.
- It must protect assets from credits or agencies seeking funds to pay debts of the beneficiary or beneficiary's family.

✓ *Special Needs Trust Created by the Court*. Sometimes an individual who is disabled enough to qualify for social security owns assets and needs protection. In these cases, a special needs trust can be established by the disabled person's parent, grandparent, legal guardian or the court. This type of trust is permitted only if the individual is under age 65 at the time of creation of the trust. The trust is structured to make the same forms of discretionary payments but has one major distinction. At the death of the beneficiary, the funds remaining in the trust must first be used to repay any benefits that have been paid on the beneficiary's behalf.

✓ *Pooled Trusts*. Non-profit organizations in some states offer pooled special needs trusts. These non-profit serves as trustee, manages the money, and makes the distributions to the beneficiary. At the beneficiary's death, any remaining assets are held for the benefit of other disabled individuals. This type of trust can be funded by the beneficiary or the beneficiary's parents. However, all assets are transferred to the trust and are owned by the nonprofit.

The trust may make payments that contribute to the quality of life, rather than the essentials of life – such as vacations, eye glasses, a motorized wheelchair, or entertainment – but should not make payments for basic needs (housing, food, clothing) or fixed monthly payments that exceed set income limits. If it does, government benefits may be reduced or eliminated.

There have been several letter rulings from the IRS that allow a donor to pay the income stream of a charitable remainder trust to a special needs trust (or to make the distributions from the trust to meet special needs).[101] Normally, the charitable remainder trust distribution must be paid directly to the individual. Under the rulings, the distribution was allowed to be paid to a special needs trust, which then distributed the funds in a discretionary fashion to the disabled beneficiary. This allows a donor to create a charitable remainder trust to benefit both the disabled child as well as the charity.

[101] See, for example, Revenue Ruling 76-270, 1976-2 C.B. 194.

There is one caveat. This plan requires creation of two trusts: a special needs trust and a charitable remainder trust.[102] Further, taxpayers cannot rely on a letter ruling and must obtain their own ruling to be safe. Therefore, this arrangement is a bit more expensive than the normal trust creation.

B. Caring for Parents Using Charitable Gifts

An increasing use of charitable remainder trusts and gift annuities is to fund needs of elderly parents. Increasing nursing home costs and health care costs often result in an unanticipated depletion of assets requiring that children fund the cost of lodging and care. Create a charitable remainder trust with an income stream to the parents. This allows a child to receive a charitable deduction for the gift and to provide a stream of income to a parent. Gift tax must be paid (or unified credit used) on the value of the income stream created for the parent. In this example, the children created a $100,000 5.7% charitable gift annuity for the joint lives of parents, ages 78 and 82. This gift occurred in August 2013, 2% CFMR. The results are shown in Table 11.

TABLE 11
$100,000 6.5% CHARITABLE GIFT ANNUITY FOR AGES 78 AND 82

Principal Amount	$100,000.00
Charitable Deduction	$ 41,960.89[103]
Annual Income to parents (6.5%)	$ 5,700.00
Tax-free portion	$ 4,499.16
Ordinary income portion	$ 1,200.84

V. Idea 7: Gifts to Fund Retirement

It is easy to understand the popularity of charitable gift annuities as a planned giving option.

- Charitable *gift annuities are easy for charities to explain and donors to understand.*
- The *gift provides the donor with a guaranteed, specific income stream*. Often this income stream is higher than the donor can receive from a certificate of deposit, a U.S. Treasury bond, or other investment.
- The *transaction is part gift*, meaning that in creating a charitable gift annuity the donor also makes a gift to a favorite charity.
- The *gift generates a charitable income tax deduction for the donor* in the year in which the gift is made[104]
- The *transaction creates beneficial capital gain treatment* for the donor who contributes appreciated property.

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[102] For a ruling involving discretionary payments from the charitable remainder trust (without creating a separate special needs trust, see Revenue Ruling 77-73, 1977-1 C.B. 175.

[103] The gift portion is $58,039.

[104] Gift annuities involve an outright gift to charity deductible under IRC § 170(c). The contract element of the life interest is addressed in IRC §§ 501(m)(3)(E), -(5),514(c)(5).

- *Creating the gift is simple*, requiring a one or two-page governing instrument supplied by the charity.

A. Current Charitable Gift Annuity for Those in Retirement

Many retired individuals – or those planning for retirement – create charitable gift annuities to generate more income. In this example, Doug and Anita Jones, ages 70 and 71, used a maturing certificate of deposit to create a charitable gift annuity. The certificate of deposit had a renewal rate of .75% ($187.50); the charitable gift annuity provided a yield of 4.6% ($1,150). In addition, $290.43 of the charitable gift annuity payment is ordinary income, while the remaining $859.57 is tax-free return of income.

TABLE 12
CHARITABLE GIFT ANNUITY FOR COUPLE AGES 70, 71[105]

Contributed amount:	$25,000.00
Charitable deduction:	$ 7,722.63
Annuity amount (4.6%)	$ 1,150.00
Tax-free payments:	$ 859.57
Ordinary income:	$ 290.43

B. Deferred Charitable Gift Annuities for Those in 40's or 50's

Deferred charitable gift annuities offer a donor a way to make a series of contributions to a charity during high-income-earning-years in exchange for a series of charitable deferred gift annuities whose payments begin during retirement. Those payments can be structured so that they all begin on the same date.

TABLE 13
45 YEAR-OLD DONOR MAKING ANNUAL $25,000 PAYMENTS
AGE 45 THROUGH 54 [106]

Age at Date of Gift	*Amount of Contribution*	*CGA Rate * Notes the rate had to be reduced from published rates to meet the 10% test*	*Charitable Deduction*	*Annual Payment Single Gift*
45	$25,000	8.8%	$6,597.22	$2,200
46	$25,000	8.6%	$6,600.30	$2,150
47	$25,000	8.3%	$6,827.57	$2,075
48	$25,000	8.0%	$7,070.6	$2,000

[105] Calculations made in August 2013, 2% CFMR..

[106] Calculation uses rates effective through 12-31-11 - new rates effective 1-1-2012 are lower - check with your charity for a current illustration. Deductions based on 1.2% CFMR. Calculations increase age by 1 year for each calculation, assuming payments begin at age 65.

Age at Date of Gift	Amount of Contribution	CGA Rate * Notes the rate had to be reduced from published rates to meet the 10% test	Charitable Deduction	Annual Payment Single Gift
49	$25,000	7.8%	$7,100.95	$1,950
50	$25,000	7.5%	$7,373.12	$1,875
51	$25,000	7.3%	$7,422.69	$1,825
52	$25,000	7.1%	$7,479.86	$1,775
53	$25,000	6.8%	$7,797.19	$1,700
54	$25,000	6.6%	$7,874.98	$1,650
Total	$250,000		$72,144.48	$19,200

As an alternative, the donor can structure the payments so that the cumulative payments increase over retirement years by setting staggering start dates for the payments. This increase in payments will help the recipient overcome the effects of inflation during the retirement years.

C. Flexible Deferred Charitable Gift Annuity for the Ultimate Flexibility

A variation on the deferred gift annuity theme is the flexible deferred charitable gift annuity. Letter ruling 9743054 allows greater flexibility in the structure of deferred charitable gift annuities. This ruling allows a donor to contribute funds in exchange for a deferred charitable gift annuity and to retain the right to select the date on which the payments begin. The later the payment begins, the larger the annual payment will be. This allows the client control of the date payments start, and the amount of those payments. The following example shows the deferred payment options at various dates for a 60 year-old donor who creates a $25,000 flexible deferred charitable gift annuity.

TABLE 14
$25,000 DEFERRED FLEXIBLE GIFT ANNUITY; 45 YEAR-OLD DONOR;[107] CALCULATIONS ASSUME DONOR IS AGE 60, FIRST PAYMENT MAY BE MADE AS EARLY AS AGE 65 AND AS LATE AS AGE 74; CHARITABLE DEDUCTION $8,164.50

Effective Start Date	Age at Start Date	Annuity Payment Rate	Annuity Amount
9/30/2018	65	5.5%	$1,375
9/30/2019	66	5.8%	$1,450
9/30/2020	67	6.0%	$1,500
9/30/2021	68	6.3%	$1,575
9/30/2022	69	6.6%	$1,650

[107] Calculations based on ACGA rates in effect through 12/31/11. Rates have dropped since that time. Check with your charity to get a current illustration.

Effective Start Date	Age at Start Date	Annuity Payment Rate	Annuity Amount
9/30/2023	70	7.0%	$1,750
9/30/2024	71	7.5%	$1,875
9/30/2025	72	7.9%	$1,975
9/30/2026	73	8.3%	$2,075
9/30/2027	74	8.9%	$2,225

VI. Idea 8: Selecting the Right Asset

There may be times your client wants to make a charitable gift but does not have sufficient cash to do so. Sometimes the best asset to contribute – even if cash is available – is non-cash property such as real estate, securities or even a life insurance policy.

Selecting the right asset is an important element of gift planning. To pick the right asset, consider the donor's dependence on the asset or its income, the form of the gift, the tax benefits and the cost of making the gift. The following assets are most commonly used to make gifts in lieu of cash.

Marketable securities – Marketable securities (stocks and bonds) are appropriate for almost every type of gift. Publicly-traded stocks are the single most popular non-cash gift. Stocks often contain long-term appreciation, generate little income (on average, about 1.3%) and can easily be sold on receipt. The gift generates a charitable income tax deduction for the market value of the stock and allows the donor to avoid capital gains tax on the appreciation. Bonds are used to make gifts less frequently. Bonds generally have a higher income stream than stocks or cash and contain little or no appreciation. While bonds may be used to make gifts if cash is not available, they may not create as great a tax benefit for the donor as appreciated stock.

Privately held securities – Privately-held securities may be the single largest asset held by some clients. These securities make good assets for outright gifts, testamentary gifts and even charitable remainder unitrust gifts as long as there is some market or mechanism for sale after contribution. Always check with the charity before contributing privately-held stock since some will not accept this asset for pooled income funds or charitable gift annuities because of uncertainty of the timing and proceeds of sale. For the same reason, privately held securities may not be appropriate for a charitable remainder annuity trust unless the trust has other assets with which to make the annuity payment. The donor is required to obtain a qualified appraisal establishing the value of privately-held securities when the gift exceeds $10,000.

Real estate – Real estate (including commercial, residential, undeveloped land, timber, and oil and gas interests) makes an excellent outright gift, testamentary gift or contribution to a charitable remainder unitrust (with net income, net income with makeup or flip provisions), or even a deferred charitable gift annuity. Real estate is not generally appropriate for gifts to create a standard charitable gift annuity, charitable remainder annuity trust or pooled income fund because of the uncertainty of the asset's sale timing and proceeds. The donor is required to obtain a qualified appraisal when the

gift exceeds $5,000 and is generally required to supply an environmental assessment. The donor should also be prepared to supply details on the costs associated the property including taxes, maintenance and other costs.

Life insurance – Life insurance is an excellent gift for donors who have old policies that are no longer needed for protection of family or those who want to purchase a new policy to ensure a specific gift to charity at death. When the donor contributes an existing policy to charity, he receives a deduction equivalent to the policy's replacement value. Since the policy has no publicly established value, he must obtain a qualified appraisal when that value exceeds $5,000. If he contributes cash to the charity to purchase a new policy, he may deduct the cash contribution and any additional contributions made to make premium payments.

Tangible personal property – Collectibles, art or other tangible property may also make good assets for outright gifts, although they are poor choices for life income arrangements. The uncertainty of the timing and proceeds of sale make charities unwilling to accept these assets for charitable gift annuities or pooled income funds. In addition, the related use rule limits the deduction to the donor's basis unless the gift is used by the nonprofit in fulfilling its mission, and personal property gifts contributed to charitable remainder trusts are generally not deductible until sold. Donors are required to obtain qualified appraisals for gifts in excess of $5,000.

VII. Ideas 9 and 10: Gifts Where Gift and Estate Taxes are Not an Issue

The Tax Reform Act of 1969[108] created massive changes in the structure, form, and treatment of charitable entities, creating strict forms, tax structures, and operating rules for private foundations and charitable remainder trusts. These laws have created stress for planners over the years because it took expertise to get the forms and documents within the guidelines, and was even more limiting in the assets appropriate for entities and the effective long-term operation. Individuals who wanted to add a personal trust to their foundation or trust structure quickly found these creatures of the tax code allowed little variation or personalization.

Traditionally, few taxpayers have been affected by the estate tax. In the Summer 2005 *Statistics of Income Bulletin*, the IRS reported 1.17% of the 2.4 million decedents who died in that year had taxable estate returns. In that year, estate tax return filing was required with a gross estate of $1 million or greater. See Table 15 for an historical perspective on the number of decedents required to file estate tax returns, and the percentage of taxable returns.

[108] Pub. L. 91-172, title IV, § 901(c), Oct. 22, 1986, 83 Stat. 618.

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TABLE 15
POPULATION AFFECTED BY ESTATE TAX
SELECTED YEARS BETWEEN 1934 AND 2001[109]

Year	*Number of Deaths*	*Estate Tax Returns Filed*	*Number of Taxable Returns*	*% of Deaths Requiring Estate Tax Returns/Taxable*
1934	983,970	N/A	8,655	NA/.88%
1935	1,172,245	N/A	9,137	N/A/1.08%
1940	1,237,186	N/A	13,336	N/A/1.12%
1944	1,238,917	N/A	13,869	N/A/1.12%
1950	1,304,343	N/A	18,941	N/A/1.45%
1954	1,332,412	N/A	25,143	N/A/1.89%
1960	1,426,146	N/A	45,439	N/A/3.19%
1965	1,578,813	N/A	67,404	N/A/4.27%
1969	1,796,055	N/A	93,424	N/A/5.2%
1976	1,819,107	N/A	139,115	N/A/7.65%
1982	1,897,820	N/A	34,426	N/A/1.81%
1985	2,015,070	N/A	22,326	N/A/1.11%
1990	2,079,034	50,367	23,104	2.42%/1.11%
1995	2,252,471	69,755	31,563	3.1%/1.4%
1996	2,314,690	79,321	37,711	3.42%/1.63%
1997	2,314,245	90,006	42,901	3.89%/1.85%
1998	2,337,256	97,856	47,475	4.19%/2.03%
1999	2,391,398	103,979	49,863	4.35%/2.09%
2000	2,403,351	108,322	52,000	4.5%/2.16%
2001	2,363,100	Unknown	49,911	Unknown/2.11%
2002	2,363,100	Unknown	49,911	Unknown/1.17%

Going forward, even fewer decedents will be affected by estate tax. The Center on Budget and Policy Priorities estimated that only .25% of all decedents who died in 2009 with a $3.5 million exclusion

[109] All figures from 1934 through 1985 from Internal Revenue Service, fall 2002 Statistics of Income Bulletin, Table 17, Estate Tax Returns as a Percentage of Adult Deaths, Selected Years of Death, 1934-1999; number of deaths data 1996-1999 from National Vital Statistics Report, Vol. 49, No. 8, September 21,2001, p. 16; 2000 death figures from National Vital Statistics Reports, Vol. 51, No. 5, March 14, 2003, p. 3; data on estate tax returns filed 1990 through 2000 from Spring 2004 Statistics of Income Bulletin, “Federal Estate Tax Returns 1998-2001”.

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were subject to estate tax.[110] In the new era of $5 million exclusion (indexed for inflation) amounts for each individual for gift and estate purposes, in 2013 it is possible for a couple to transfer in excess of $10.5 million without incurring estate or gift tax. Since this limit will cover the transfers for the vast majority of all American taxpayers, those taxpayers are not free to pursue charitable gifts and create charitable structure without using traditional charitable gift forms.

A. Partial Interest Gifts - a World of Flexibility Without the Need for the Charitable Deduction

Under current law, a charitable deduction is not generally allowed for a gift of less than an entire interest in property.[111] For example, a donor who allows a charity to use a building rent-free has not made a charitable gift, since the leasehold is a partial interest in the property.[112] A donor who gives his paintings to a museum, retaining the right to hold those paintings for life, has not made a charitable gift because he has transferred less than a full interest in the paintings. There are some partial interest gifts that do qualify for a charitable deduction:

- Charitable gift annuities (technically a bargain sale);
  - Must have a charitable value of at least 10% at funding
  - Annuitants are limited to two lives
  - Contract must be fixed income for life (income may not vary)
- Charitable remainder annuity trust or charitable remainder unitrust[113]
  - Must have a charitable value of at least 10% at funding
  - Cannot be funded with mortgaged property
  - If funded with a personal resident, the donors/owners cannot continue to live in the property even if they pay a far rent because of of self- dealing rules (private foundation prohibited transaction rules)
  - Charitable remainder trusts are also subject to other prohibited transaction rules including jeopardizing investments and taxable expenditures
  - Flip unitrusts "flips" cannot be within the discretion of the trustee
- Pooled income fund;
  - May only be offered by publicly support IRC §501(c)(3) entities;
  - Variable income - whatever is produced by the units
- Charitable lead annuity trust or charitable lead unitrust (grantor and non-grantor forms);[114]
  - Prohibitions against self-dealing, excess business holdings, joepardizing investments, taxable expenditures
  - Generally do not use donor or spouse as Trustee if the goal is to remove assets from estate (non-grantor)

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[110] Center on Budget and Policy Priorities, www.cbpp.org.

[111] IRC §170(f)(3)(A).

[112] Reg. §1.170A-7(a).

[113] IRC §170(f)(2)(A). *See* Chapter 11 for more detail on charitable remainder trusts and pooled income funds.

[114] IRC §170(f)(2)(B). *See* Chapter 11 for more detail on charitable lead trusts.

- A remainder interest in a home or farm;[115]
    - Not allowed for commercial, undeveloped, or similar investment property
    - Charitable deduction may not include personal property
- An undivided portion of the donor's entire interest;[116] or
    - Must be an undivided portion of all interests - cannot separate income from underlying property interest
    - Cannot direct that income be separated for a term of years or a life
- A qualified conservation easement.[117]

Partial interest gifts that do not qualify include the following:

- *Gifts of future interests.* A gift of a future interest in a property is not deductible until all intervening interests in the assets or rights to possession or enjoyment of the property have expired or are no longer held by the donor or related party.[118][216] However, a gift subject to a condition or event so remote as to be negligible will not be disqualified.[119]

- *Gifts divided for the purpose of transfer.* The donor does not receive a charitable deduction for a gift that has been divided for the specific purpose of making a gift of a partial interest to charity.[120]

- *Work of art separated from copyright.* An artist may not receive a deduction for a work of art that is separated from its copyright for income tax purposes, although such a gift is deductible for estate and gift tax purposes.[121] A donor may own both the copyright and the original work - or just one of those. A creator/author or widow/widower, child or grandchild who inherited just the copyright or the original work and the copyright - by federal law retains the right to revoke a gift/ grant of a copyright - so a lifetime gift of the copyright or the copyright and the original work is not a gift of the donor's entire interest, so no income or gift tax deduction is allowed. A copyright owned by a third party ho did not inherit the copyright may give all or an undivided portion of the copyright to a charity, and if the donor owns both the copyright and the original work, the the donor must give both the copyright and the original work to charity for the gift to be deductible.[122]

- *Patents.* A gift of less than the entire interest occurs when the owner retains the right to license the patent to others, manufacture or use any product covered byt he patent or places conditions

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[115] IRC §170(f)(3)(B)(i).

[116] IRC §170(f)(3)(B)(ii).

[117] IRC §170(f)(3)(B)(iii).

[118] Reg. §1.170A-5(a)(1); "related" is defined in IRC §§267(b), 170(a)(3).

[119] Reg. §1.170A-14(g)(3).

[120] Laura Hansen Dean, presentation to the Houston Planned Giving Council, November 2012.

[121] IRC §2522(c)(3) (gifts) and IRC §2055(e)(4) (estates). Indeed, artists are not allowed an income tax charitable deduction for their works of art because those gifts are tangible personal property and limited to basis.

[122] A creator

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on the gift that would result in the patent being returned to the donor (unless the likelihood of that return is so remote as to be negligible).[123]

- *The right to use property at less than fair market rental.* Current there is not an income tax deduction or gift tax deduction because this is a non-qualified partial interest gift.

Examples of options for donors:

- An individual can make a gift of the income from stocks to a family member for life, and then the transfer of the assets and income to charity.
- An individual can transfer the income from an investment portfolio to charity for a term of years, with remainder to family.
- A donor can devise surface rights to a charity, with mineral rights to heirs.
- A donor can devise a percentage interest in a business' profit without transferring ownership (and absolving the charity from a share of the costs or obligations).
- Can give a museum a share of the interest in a collectible, or the right to display it for a portion of the year.

While most of these non-qualified gifts will not qualify for income tax deductions or estate tax deductions, the estate tax deduction is no longer important for the vast majority of the decedent population and creates opportunities through estates to transfer interests in non-qualified ways to meet personal planning goals.

B. Irrevocable Trusts with Charitable and Non-Charitable Beneficiaries

Combining personal and charitable goals becomes much easier when creating irrevocable testamentary trusts when the decedent has no concerns about estate and gift tax. Charitable remainder trusts and charitable lead trusts are rigid vehicles, and somewhat limiting in terms of contributed assets, required ranges of distributions, and the prohibited transaction rules applicable to these entities. If the donor is working in a testamentary environment and is not worried about estate tax, why not simply create an irrevocable split interest trust that fits the donor's goals? The trust can provide for payments or income and/or principal to the decedent's family members, heirs, or other beneficiaries and distribute the remainder to charity. Or, it can make payments to charities and/or individuals for a period of time (as determined by the decedent's spouse or other trustee) and then terminate to the donor's designated beneficiaries. In these situations, the focus should be on designing a set of distribution powers and terms that can be effectively administered, and managing the income tax consequences inside the trust. (If these are irrevocable trusts they will likely be taxed as complex trusts.)

Be careful with lifetime charitable split-interest gifts, however. If the gift does not qualify for the charitable deduction, the donor will have created a taxable gift. For example, the donor will lose the benefits non-taxable trust benefits of charitable remainder trusts, and the income tax benefits associated with charitable gift annuities.

C. Revocable Trusts

Revocable trusts are already used by many individuals to serve as their family giving platform. In this arrangement, the donor creates a revocable trust, transfers assets to the trust, assigns it a name

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[123] *Id.*

representing the family, and then gathers the family each year to make decisions about gifts to charities. While the donor receives no deduction when the trust is created, they maintain control over annual distributions. Annual distributions to charitable entities (under IRC §170(c)) qualify the donor (the grantor) for a charitable deduction. When additional funds are needed or the trust runs low, the donor simply transfers more money. These trusts often have a testamentary provision that either transfers the funds to family or to a donor advised fund for family, or even another entity. Or, the decedent/donor can transfer ownership to descendants leaving the trust in a revocable form, or direct that the entity become irrevocable at death.

The advantage of this approach is the creation of a formal platform that can be used to teach family members how to be effective philanthropists, and the flexibility it allows a family in both the timing and amount of its annual distributions. Using a donor advised fund platform offers similar flexibility, but a private foundation platform requires minimum annual distributions and has other restrictions. The disadvantage is that the assets belong to the donor and are not shielded from creditors, and individuals do not have as wide a variety of giving options as private foundations afford.[124]

VIII. Two Essential Approaches in Working with Clients on Charitable Gifts

Planned gifts have assumed greater relevance in the current economic environment. Donors – especially those with strong charitable intent –want to continue giving but are reluctant to give up current assets. Alternative giving options, such as bequests, beneficiary designations, and all forms of life income gifts, are a welcome solution. Therefore, planned gifts are assuming more prominence in comprehensive campaigns and ongoing giving programs. The most successful gift planners (charities and professionals) use planned gifts as a tool to achieve charitable goals, rather than as an independent planning discipline. Gift planning expands donor options, and can work for every charity with the discipline and preparedness to handle the gifts.

A. Preparing Clients by Setting Priorities

1. Donor Motivation

Motivation refers to the reasons a donor makes a gift; objectives refer to the results the donor wants to achieve in making a gift. A discussion of the gift's quantifiable results is often easier since it deals with objectives factors rather than the intangible feelings behind the gift. Sometimes objectives in making a gift are easy to articulate. Consider the following examples.

EXAMPLE 1: Oseola McCarty was an African-American sixth-grade dropout from Mississippi who made a living as a laundress. She lived frugally, saved her earnings, and made a $150,000 gift to the University of Southern Mississippi to establish a scholarship fund to enable other African-American women without resources to attend college.

EXAMPLE 2: Bill Gates, one of the world's richest men, has contributed over $21 billion to a family foundation. Among his multiple objectives were the eradication of polio in the world and the improvement of public education quality in the United States.

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[124] For example, private foundations may make grants to individuals and non-501(c)(3) foreign entities so long as the foundation exercises expenditure responsibility.

EXAMPLE 3: Walter Annenberg, one of the world's top philanthropists before his death in 2002, gave away in excess of $1 billion during his lifetime.[125] He gave because: "Giving is a mark of citizenship."[126] His objective in giving, which focused on institutions of higher education, was to improve the quality of and access to higher education in the United States.

These stories illustrate generosity in giving, as well as a focus on giving. One of the advisor's greatest challenges is to integrate the specific goals of the donor in a gift arrangement that is flexible enough to meet the needs of charity and stand the test of time. This ongoing conflict between the goals of the donor and the needs of charity is beneficial in encouraging dialogue about the structure of the gift. If, after discussion, the charity has no interest in the gift as restricted or designed, the advisor should either counsel the donor to modify the gift of help the donor identify a charity with that specific need.

In addition, the donor may have personal goals and objectives in making a gift. He may want to achieve a tax deduction for the gift. Since the deduction will depend on the form of the property contributed, the form of the gift created, and the donor's adjusted gross income, the advisor must determine whether that goal is achievable. On the other hand, the donor may want to generate additional income in retirement from a gift.

Wealthy donors may have more complex planning goals. A survey, conduct by Paul G. Schervish and John J. Havens at Boston College, found that the very wealthy have a strong interest in controlling the timing, direction, and level of giving to charitable organizations. Therefore, much of their giving (63 percent) is directed through donor-advised funds, trusts and family foundations.[127] Researchers felt this pattern indicated a realization that financial needs and charitable interests change over time and that their charitable giving mechanisms must be able to respond to these variances.

2. Tax and Financial Incentives in Planning

While the tax benefits are not generally the primary motivation for a gift, they do provide a tangible bonus for those who contribute to charity. It is difficult to establish general rules concerning the value of tax incentives to an individual donor since results will vary depending on the gift, the donor, and the following factors:

- *The charitable deduction depends in part on the form of property contributed* (cash, securities, real estate, tangible personal property), the donor's basis in that property (short-term loss, long-term loss, even, short-term gain, long-term gain), the type of gift made (current outright gift, current split-interest gift), and the donor's adjusted gross income (to determine the 20 percent, 30 percent, and 50 percent limits for the charitable deduction in the year.

- *Some gifts avoid income tax on capital gains on contributions, while others simply defer the gain.* Often, the result depends on the facts rather than the form of the gift. For example,

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[125] Ann Marsh, They Don't Expect To Take It With Them, Forbes 400, at 130 (Oct. 13, 1997).

[126] *Id.*

[127] Schervish, Paul G. and John J. Havens, The Mind of the Millionaire: Findings from a National Survey on Wealth with Responsibility, in New Directions in Philanthropic Fundraising, Understanding Donor Dynamics: The Organizational Side of Charitable Giving, edited by Eugene R. Tempel, No. 32 (Summer 2001), pp. 75-107 (a copy of the paper is available at www.bc.edu/bc_org/avp/gsas/swri/swri_features_recent_papers.htm.

capital gains on appreciated property contributed to a charitable remainder trust are not taxed because the trust is non-taxable (However, this income becomes part of the trust's accounting records and may eventually be distributed to the trust beneficiary as a part of the annual distribution stream and therefore subject to tax.) Contribution of appreciated long-term capital gain property to charity in exchange for a charitable gift annuity is treated as a bargain sale so long as the interest is non-assignable; the gain attributable to the donor's share of the gift (the present value of the annuity stream) is deferred and distributed over the expected life of the donor.[128] Contribution of long-term capital gain property to charity in exchange for a gift annuity for the benefit of someone other than the donor is taxed to the donor in the year of the gift.[129]

- *Many gifts made currently create multiple tax deductions, such as an income tax deduction, and a gift tax or estate tax deduction*. For example, a gift of a retirement plan to charity through beneficiary designation may avoid both income and estate tax on the gift. A grantor lead trust creates an income tax deduction for the donor, while a non-grantor lead trust creates estate and gift tax (but no income tax) deductions for the donor. The planner must be careful to explore all ramifications of the gift and explain the benefits to the donor.

- *The value of a charitable gift made through an estate is easier to calculate since the gift generates a dollar for dollar deduction for the charitable portion of the gift.* However, life income gifts, such as a charitable remainder trust created for a child, are not fully excluded from estate taxes since the portion representing the income interest for the children will be included in the estate. In addition, donors with non-taxable estates receive no benefit from the charitable deduction.

3. A Checklist for Goal Setting

Many clients have difficulty establishing goals for planning. Use the worksheet at Appendix A to lead them through the process of setting goals and prioritizing those goals. Common planning goals may include:

- Providing for sufficient assets for spouse and family and addressing special needs.

- Providing for children. This requires a discussion of the amount or nature of the property to be left to the child, and the form of the gift. The client should review whether the child is capable of financial asset management or if an advisor or trustee should be appointed.

- Providing for grandchildren. This also requires a discussion of how much and in what fashion. Can they handle financial asset management? Would a professional trustee be of benefit?

- Providing for special educational, rehabilitation, medical or remedial provisions that should be made for one or more dependents.

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[128] Reg. §1.1011-2(a)(4)(ii).

[129] Reg. 1.1011-2(a)(4)(i).

- Providing for the care of extended family members. Do you have any special concerns or needs that should be addressed in providing for your parents? Are there any other extended family members (or siblings?) that require special help?
- Creating a way to maintain control or allow for flexibility. How important is the ability to provide direction and meet needs?

- Establishing family values and philanthropic goals that are important.

- Support specific charities that the client has supported during his or her lifetime.

The worksheet allows the client to accomplish several goals. First, he is able to articulate priorities in planning. Second, he is prompted to quantify the costs of meeting those goals. For example, many individuals have not thought about the cost of providing for long-term health care, or providing a college education, or even the amount that they want to leave their children after death. The goal-setting process allows donors who have not quantified those goals to take the next step to talk with a financial planner, a CPA, or other professional that can help assign a dollar amount to a priority goal. Finally, he is able to take action to achieve goals, or make alternate plans if the goals cannot be met.

B. The Three Essential Questions

Many professionals are not comfortable raising the issue of charitable giving. These questions are designed to make that process easier. These questions may be incorporate into an intake questionnaire to identify charitable objectives.

- *Do you have charitable organizations that you currently support on an annual basis?*

- *Do you want to include a gift to any of these organizations or other charitable organizations as a part of your estate plan?*

- *If there were a way to make a gift to charity largely out of federal estate tax dollars, would you be interested in exploring options to accomplish that goal?*

If you want to explore the client's charitable planning goals and objectives in more detail, ask these questions.[130]

- *What are your values? What have been the principles that have guided how you have lived your lives, raised your family run your business?*

- *What charitable interests have you pursued as an outgrowth of your values?*

- *What have you learned from your giving? What would you do differently? Would you feel confident expanding your giving?*

- *What has been the most satisfying charitable gift that you have made? Why?*

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[130] Breiteneicher, Joe, "Advisor's Enthusiasm Helps To Shape Client's Charitable Role," *Trusts & Estates* (August, 1996), p. 32.

- *How do you view your wealth in connection to your community, to society?*
- *What role has philanthropy played in your family? What role should philanthropy play? What value would it bring to your children and grandchildren?*
- *What core values would you like to express through your giving? What do you want to stand for?*
- *When they think about the challenges facing your community, what are your major concerns?*
- *Are any of these or should any of these concerns be the focus of your giving?*
- *What would you like to accomplish with your giving? What do you think is possible?"*

The key is to ask the questions to allow the client to express charitable giving in terms of a priority. If you raise the issue and the client is not interested, move on. If you raise the issue and the client does express an interest, then there is an opportunity to integrate charitable giving in the overall estate plan.

IX. Final Thoughts

Effective planning is about meet client goals. Charitable planning allows the planner to combine goals to create the most effective result. Charitable planning after AFTRA 2012 offers many opportunities to meet donor needs, and provide a tax-reduction incentive. Incorporate questions about charitable goals in your intake questionnaire, and call any of today's sponsoring charities for more information or help in gift planning.

APPENDIX A
INDIVIDUAL GOAL SETTING WORKSHEET

Setting goals for care of family and distribution of funds is important. Use this chart to list your goals, and indicate the dollar figure required to fund those goals.

Priority	*Goal*	*$$ Required*
	Provide for personal lifestyle.	$
	Provide for family care and lifestyle.	$
	Provide for assets for children. Note: determine if that gift should be outright or in trust.	$
	Provide for assets for grandchildren.	$
	Provide for elderly parents or family.	$
	Provide for family members with disabilities or other special medical needs.	$
	Provide for charities supported during life.	$
	Provide for the U. S. Government's programs and activities through a gift to the Internal revenue Service.	$
	Other	$
		$
		$
		$
	TOTAL:	

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