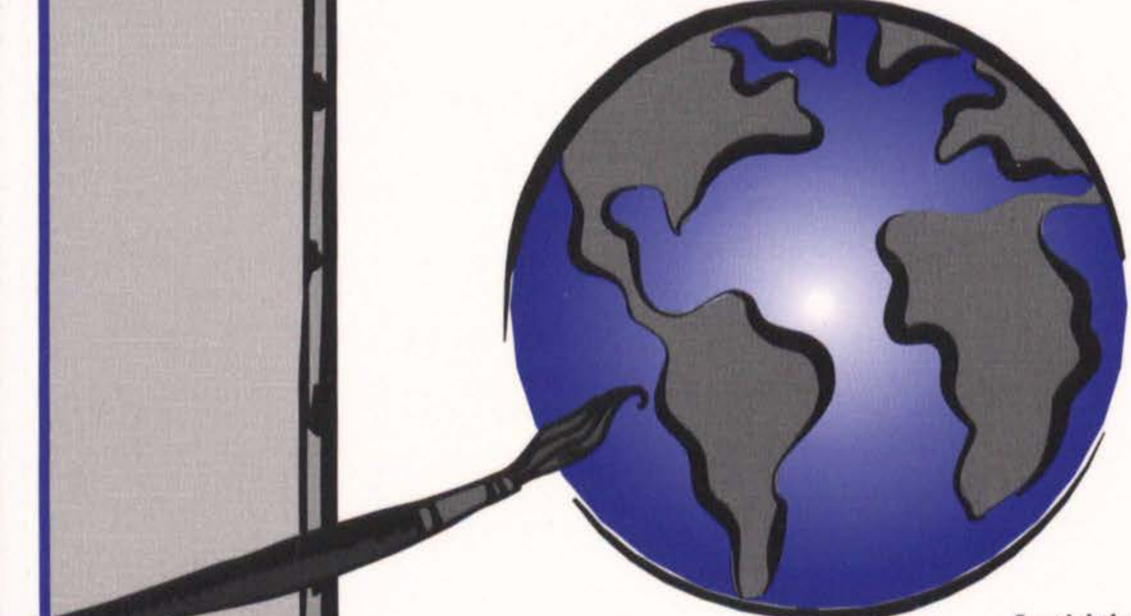
Conference Proceedings

Creativity in a Changing World



Special thanks to
Principal Event Sponsor:

Mellon

26th Conference on Gift Annuities

May 5-7, 2004 • Wyndham Palace Resort & Spa • Orlando, FL

Presented by the American Council on Gift Annuities

The American Council on Gift Annuities

thanks...

Mellon

Principal Event Sponsor

of the

26th Conference on Gift Annuities

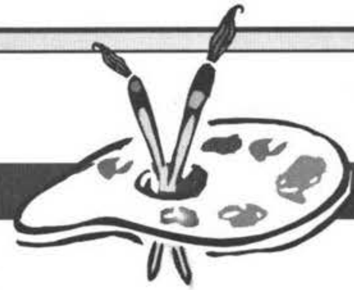
To Our Participants:

Please refer to the *Conference Program* for a complete agenda, including room assignments. The program also includes a diagram of the exhibit hall with a list of exhibitors.

The views expressed in these papers are those of the authors and do not necessarily reflect the opinions of ACGA, its staff, or its board members. ACGA does not guarantee the accuracy of the authors' comments and none of the material in these proceedings should be construed as legal advice. Readers are urged to consult their own legal counsel regarding any information found herein. Permission to reprint an individual paper must be secured from the author of that paper.

Neither ACGA nor the Wyndham Palace Resort & Spa is responsible for lost or stolen conference proceedings. Replacement cost for the conference proceedings is $60.

Creativity in a Changing World



26th Conference on Gift Annuities

For over seventy six years, the American Council on Gift Annuities (ACGA) – and its predecessor the Committee on Gift Annuities – has been serving America's charities and their donors. The Council is a nonprofit, information and education organization that provides assistance to charities with their gift annuity and planned giving programs.

Gift annuities have been a recognized form of giving in this country since the mid-1800s, and since the very first Conference on Gift Annuities which was held in 1927, the Council has been an important part of the growth of what we now know as planned giving. While gift annuities have their origins in religious and church-related organizations, over the years they have become a major part of the planned giving program of an ever-growing array of charities: colleges and universities, hospitals, museums, symphony orchestras, opera companies, children's homes, retirement centers, local and worldwide health and relief organizations, environmental groups, alumni associations and others too numerous to mention.

In recent years, the ACGA has been in the forefront of cooperating with the states as they increase their regulation and, when appropriate, exemption from regulation of charitable gift annuities issued by U.S. charities. In addition, we have closely monitored the movement of interest rates so that gift annuity rates can be changed as needed to insure a steady ultimate gift from newly issued charitable gift annuities.

The **26th Conference on Gift Annuities** promises to be the best ever. From an attendance of forty-seven at that first meeting in 1927, this oldest planned giving conference in the country has grown to hundreds of participants who come from every part of the U.S. and Canada, representing charities of every description. Welcome to the Wyndham Palace Resort & Spa in beautiful Orlando, Florida. Enjoy the conference!

Clint Schroeder
Chair, ACGA

2004 ACGA Board of Directors

Clinton A. Schroeder, *Chair*
Gray, Plant, Mooty, Mooty & Bennett, P.A.

Frank D. Minton, *Vice Chair*
Planned Giving Services

Elizabeth A.S. Brown, *Treasurer*
Moody Bible Institute

Betsy A. Mangone, *Secretary*
Mangone & Co.

Robert L. Coffman
Anderson University

Elaine D'Amours
Mount Holyoke College

Susan Gutchess
The Nature Conservancy

Rev. Donald M. Hallberg
ELCA Foundation

John B. Jacobs
American Baptist Foundation ABC

J. Lance Jacobson
Mayo Foundation

Cam Kelly
Smith College

Judy Y. Kirk
University of Minnesota Foundation

Lindsay L. Lapole, III
Salvation Army, USA Southern Territory

Rebecca Locke
American Red Cross

J. Douglas McDaniel
Salvation Army, Eastern Territory

James B. Potter
Planned Giving Resources

Jack Shakely
California Community Foundation

Terry L. Simmons
Thompson & Knight, L.L.P.

Laurie W. Valentine
Kentucky Baptist Foundation

Jeffrey K. Wilson
General Conference of Seventh-day Adventists

Actuary
Michael Mudry

Counsel
Conrad Teitell
Cummings & Lockwood

2004 Conference Committee

Lindsay L. Lapole, III, Chair
Robert L. Coffman
Rebecca Locke
Elaine D'Amours
Frank Minton
Susan Gutchess
Terry L. Simmons
J. Lance Jacobson
Laurie W. Valentine
Cam Kelly
Jeffrey K. Wilson

2004 Conference Staff

Gloria Kermeen, ACGA Manager
Patricia Brien
Barb Owens
Kay Ramsey
Kurt A. Reusze

Specialized Learning Tracks

Track I – Fundamentals
Track II – Advanced Planned Giving
Track III – Financial, Investment & Administrative Issues
Track IV – Issues and Trends in Gift Planning

Table of Contents

General Conference Information

Symposium

Thursday Morning Sessions

Table of Contents

Thursday Afternoon Sessions

Friday Morning Sessions

Educational Program Agenda

Wednesday, May 5

8:00 am – 7:00 pm .... **Registration Open**
9:00 am – 3:00 pm .... **Fundamentals Course**
3:15 – 5:00 pm .... **Symposium**
5:00 – 6:00 pm .... **Reception/Gathering in Exhibit Hall**
6:00 – 8:30 pm .... **Opening Dinner**

Keynote Address
Mark Olson, Board of Governors, Federal Reserve, Washington, DC

ACGA Chairman's Address
Clinton A. Schroeder
Gray, Plant, Mooty, Mooty & Bennett, P.A., Minneapolis, MN

Fundamentals Course

Everything You Could Possibly Ask About a Successful Planned Giving Program
Pamela Davidson, Davidson Gift Design, Bloomington, IN & James Gillespie, CommonWealth, Indianapolis, IN

This is the best investment of time you'll spend if you want basic information on virtually any part of establishing or running a successful planned giving program, including how to start a planned giving program, a primer on the top vehicles you should use, policies and procedures, and enlistment strategies for board and committees.

Symposium

Headline News: A Legislative and Regulatory Update in 50 Minutes or Less
Terry Simmons, Thompson & Knight, L.L.P., Dallas, TX

Since the last biennial conference, much has happened in Congress, with the IRS, Treasury and the Courts, and even at the state level that impacts gift annuities and gift planning generally. In this session, a quick survey of major developments in these regulatory and legislative spheres will be presented.

Trends in Planned Giving
Robert F. Sharpe, Jr., The Sharpe Group, Memphis, TN

This session will examine the current environment for planned gifts and ways donors and their charitable interests can best work together to make gifts that help meet both personal and philanthropic goals. Special emphasis will be placed on making gifts in light of investment market fluctuations, lower interest rates, reductions in income and capital gains tax rates, the reduction or elimination of estate taxes, political uncertainty, the aging of America's donor population and other factors.

Keynote Address

Our keynote speaker is **Mark Olson**, one of the seven governors of the **Federal Reserve Board**, appointed by the President of the United States and confirmed by the Senate. Coming straight from the source, Olson will address the group on *"Current Trends in the U.S. Economy."*

Thursday, May 6

7:30 am – 5:30 pm .... **Registration Open**
7:30 – 8:30 am .... **Continental Breakfast in Exhibit Hall**
8:30 – 9:45 am .... **Morning Breakouts**
9:45 – 10:15 am .... **Refreshment Break in Exhibit Hall**
10:15 – 11:30 am .... **Repeat Morning Breakouts**
11:45 am .... **Plenary Luncheon**

Gift Annuities: Rates, Risks, and Rewards
Speaker: Frank Minton, Planned Giving Services, Seattle, WA

1:30 – 2:45 pm .... **Afternoon Breakouts**
2:45 – 3:15 pm .... **Refreshment Break in Exhibit Hall**
3:15 – 4:30 pm .... **Repeat Afternoon Breakouts**
4:30 – 5:30 pm .... **Reception in Exhibit Hall**

Thursday Morning Breakouts

Track I
Understanding Gift Annuities
Elizabeth Brown, Moody Bible Institute, Chicago, IL

A short course on the basic rules governing charitable gift annuities, including types of annuity contracts, annuity rates, income, gift and estate tax effects and general principles for managing the annuity program and investing the annuity fund.

Track I
Plan Now – Pay Later!
Fundamentals of Testamentary Planning
Ellen Estes, Estes Associates, Woodbridge, CT

This session will explore the ways that donors can provide for their loved ones – and favorite organizations – through testamentary planning. It will include an overview of taxes and estate planning, and information about QTIP trusts, testamentary gifts to Charitable Remainder Trusts, Charitable Gift Annuities, Pooled Income Funds, and Charitable Lead Trusts. We will also review beneficiary designations under life insurance policies and IRAs at death.

Track I & II
Marketing to a General Constituency
Marc Carmichael, R&R Newkirk, Willow Springs, IL

A decade ago Frank Minton conducted a survey of educational and charitable organizations that asked planned gifts officers: "How were your planned gift donors first identified?" This program updates the Minton survey for 2003 and examines what the results mean for marketing in the new millennium.

Track II & III
Elementary, My Dear Watson:
Creative Solutions to Planned Giving Cases
Robert E. Harding, Gray, Plant, Mooty, Mooty & Bennett, P.A., Minneapolis, MN

Sometimes the solution to a planned giving problem can be a bit hard to see. This session will guide participants through several case studies, which show that the best approach is not necessarily the obvious one. The cases will present a variety of funding assets, family situations and donors' philanthropic and financial goals.

Educational Program Agenda

Thursday Morning Breakouts, con't.

Track II & III
Gift Acceptance Policies
Philip M. Purcell, Ball State University Foundation, Muncie, IN

Creating effective gift acceptance policies is essential to success in planned giving. Policies provide informed consent for the allowable types of gifts and protocol for acceptance and administration. Compliance with legal and ethical standards permit equitable treatment of donors and limitation of liability. This session will review techniques and templates for drafting and implementing effective planned giving policies and procedures.

Track II & III
Investing Trust Assets
J. Scott Kaspick, Kaspick & Company, Palo Alto, CA

Trustees must balance income and remainder interests, meet applicable regulatory rules and standards, and satisfy ever more demanding donors. This session will explore issues in developing and executing appropriate investment policies and practices for charitable trust assets.

Track II & III
Evaluating a Planned Giving Program: Infrastructure, Personnel and Marketing
Kathryn W. Miree, Kathryn W. Miree & Associates, Birmingham, AL

Learn how to analyze your charity's readiness for planned giving or evaluate your organization's current planned giving program. This session takes a practical look at the key planned giving program elements, including fundraising, infrastructure (policies, procedures, goals), personnel, marketing, and annual evaluation.

Track IV
Gift Planning Quiz
Jonathan Tidd, West Simsbury, CT

A series of brief cases and problems that raise real-world issues for gift planners. This session will be interactive.

Thursday Afternoon Breakouts

Track I
Personalizing Your Stewardship Plan
Cam Kelly, Smith College, Northampton, MA &
Rachel F. Moore, Williams College, Williamstown, MA

Planned giving shops are skilled at bringing in new donors. But how well are you stewarding the donors who are already in your program? This presentation looks at planned giving stewardship as a vital donor cultivation tool with the power to raise enormous future gifts and bequests.

Track I & II
Technology & The Internet: Are You Reaching All Your Donors?
Gary Pforzheimer, PG Calc Incorporated, Cambridge, MA

On-line fundraising has become an important marketing tool for many charities. Hundreds of institutions have added planned giving information to their web sites as part of this trend. This session will review the best practices and how they can help your marketing succeed. We will also cover tactics to generate traffic to your web site and ways to integrate your web site into your marketing plan.

Thursday Afternoon Breakouts

Track II
Gift Planning Opportunities with Retirement Plan Benefits
André Donikian, Pentera, Inc., Indianapolis, IN

This session will focus on new gift planning opportunities under the final MRD regulations and favorable rulings issued by the IRS. Special emphasis will be accorded to the treatment of employer stock in a retirement plan.

Track II
Turning Life Income Gifts Into Cash in Five Easy Steps
Karen Browning, The Nature Conservancy, Arlington, VA

How large is your gift annuity program? How much money does your organization have in trusteed assets? How many donors might consider relinquishing their right to income from their planned gift in order to allow your organization to use the gift immediately? This session will discuss a systematic approach to asking donors to relinquish their income interest in their gift annuity, pooled income fund, or charitable remainder unitrust, thereby effectively accelerating their gift to your organization. Donors receive an additional tax deduction, less income to report to the IRS, and the satisfaction of learning how their gift was used during their lifetime.

Track II & III
The Anatomy of a Successful Partnership: Planned Giving and the Treasury Office
Judy Peterson, University of Washington, Seattle, WA

The University of Washington's Treasury Office and Office of Gift Planning consider each other to be excellent "process partners." How did they get to be collaborative colleagues and how do they maintain mutual regard and beneficial problem solving? Are there elements of their success that can be applied to your institution? Judy Peterson and Nadine Faith will describe their respective departments' role in ensuring the good health of their working relationship.

Track II & III
Gifts of Real Estate: Overcoming Obstacles
David Wheeler Newman, Mitchell, Silberberg & Knupp, Los Angeles, CA

From the bargain sale rules to UBTI, from qualification rules for CRTs to environmental liabilities, there are few assets that create more challenges for gift planners than real estate. Yet these assets often fund very large gifts, making it worthwhile to methodically analyze each issue to increase the chances of making these gifts possible.

Track III
Tips from the Trenches: Proactively Managing Your Estate Settlement Program
Jackie Franey, Children's Medical Center Dallas, Dallas, TX

This session will focus on understanding the probate process and practical tips for proactively managing estate settlement, including the steps to take once you receive notification, monitoring the estate and determining distributions.

Track IV
State Regulation of Charitable Gift Annuities
James Potter, Planned Giving Resources, Baker, LA &
Edie Matulka, Planned Giving Services, Seattle, WA

This presentation will cover the manner in which states regulate issuance of gift annuities, recent statutory and enforcement changes, and the issues that charities should consider in determining in which states they will offer gift annuities.

Friday, May 7

7:00 am – 12:30 pm .... Registration Open

7:30 – 8:45 am .... Closing Breakfast

Speaker: Conrad Teitell
Cummings & Lockwood, Stamford, CT

9:00 – 10:15 am .... Breakouts

10:15 – 10:45 am .... Refreshment Break in Exhibit Hall

10:45 am – 12:00 Noon .... Repeat Breakouts

12:00 Noon .... Conference Ends

Friday Morning Breakouts

Track I
Fundamentals of Charitable Remainder Trusts
Joseph O. Bull, The Ohio State University, Columbus, OH

Perhaps the most often used instrument in the charitable gift planner's tool kit is the CRT. This session will explore the basic mechanics of these powerful instruments and practical applications of these trusts.

Track I & III
"No, I Really Didn't Get Anything Back, I Promise!" – Substantiating Charitable Gifts
Emanuel J. Kallina, II, Kallina & Associates, LLC, Baltimore, MD

The presentation will cover the substantiation requirements for donors and charities when a planned gift or outright gift is made to charity, including substantiation letters, insubstantial gifts, quid pro quo gifts and their deductibility and disclosure, appraisal requirements, Forms 8283 and 8282, other reporting forms and requirements, penalties for failure to comply, and finally an overview of professional malpractice policies.

Track I & II
Marketing to a Defined Constituency – Six Ways of Showing Choices
Peter V.K. Doyle, Wellesley College, Wellesley, MA

This presentation will include many images of direct mail and print advertisements that illustrate the variety of ways planned giving options can be communicated.

Track II
Funding Charitable Split-Interest Trusts with Difficult Assets
David Leibell & Daniel L. Daniels, Cummings & Lockwood, LLC, Stamford, CT

More and more wealthy families wish to execute charitable giving strategies with assets other than simple stocks and bonds. This session will describe the unique opportunities—and the special challenges—presented by using "difficult assets," such as closely held business interests, real estate, and alternative investments to fund charitable remainder trusts and charitable lead trusts.

Friday Morning Breakouts, con't.

Track II
Charitable Lead Trusts: The Sleeping Giants of Gift Planning
Jonathan D. Ackerman, Law Office of Jonathan D. Ackerman, Owings Mills, MD

Over the past several years, many gift planners have encouraged the establishment of charitable lead trusts. CLTs present unique challenges for the gift planner. What are the clues that someone is a good prospect for a CLT? And, do such opportunities pertain only to "mega" gifts for large charities or can smaller institutions benefit as well? Regardless of size, what resources are needed by the charity's representatives and how can gift planners position themselves in order to help facilitate the gift process? This presentation will explore these questions and provide some examples of how CLTs have been the quintessential "win-win" gift vehicle.

Track II & III
IRAs as Charitable Gifts
Jeremiah Doyle, Mellon Private Asset Management, Boston, MA

This session will discuss the mechanics of structuring a charitable gift of an IRA including the income tax and estate tax implications and how the gift affects the minimum required distribution rules.

Track II & III
Investing Assets for Charitable Gift Annuities
Thomas K. Anderson, State Street Global Advisors, Boston, MA

With the gift annuity the planned giving vehicle of choice for donors, charitable organizations are paying increased attention to investing gift annuity assets. In addition to briefly reviewing the underlying assumptions for gift annuities and their payouts, this session will focus on investment strategies to follow for success, including: diversification across asset classes; addressing state requirements; investment vehicles – moving beyond mutual funds; and insights from the pension world – dynamic asset allocation and different viewpoints on risk and return.

Track IV
When Planned Giving is Not the Only Hat You Wear
Betsy A. Mangone, Mangone & Co., Lakewood, CO

This session will focus on how to initiate and operate a planned giving program when you have multiple other responsibilities. We will examine where to begin the program and how to prioritize the activities in order to successfully launch and maintain your planned giving program.

Sponsors & Exhibitors

Sponsors

The American Council on Gift Annuities
would like to extend a special thanks to all of our event and amenity sponsors!

Mellon
Principal Event Sponsor

Northern Trust Company
Continental Breakfast Sponsor

Wells Fargo Bank
Luncheon Sponsor

The Bank of New York Planned Giving Services
Closing Breakfast Sponsor

Kaspick & Company
Name Badge Holder Sponsor

Exhibitors

Ashton Associates .... Booth 5
Quincy, MA

The Bank of New York Planned Giving Services .... Booth 28
West Paterson, NJ

Charitable Solutions, LLC .... Booth 3
Atlanta, GA

Crescendo Interactive, Inc. .... Booth 29
Camarillo, CA

Fiduciary Trust Company International .... Booth 13
New York, NY

Fifth Third Bank .... Booth 17
Cincinnati, OH

Hartford Life Insurance, Co. .... Booth 12
Simsbury, CT

Kelmore Investment Company .... Booth 4
Palo Alto, CA

Lynx Software Systems .... Booth 6
Irving, TX

Mellon .... Booth 21
Pittsburgh, PA

Microedge/NPO Solutions .... Booth 25
New York, NY

Mutual of Omaha .... Booth 27
Omaha, NE

National Committee on Planned Giving .... Booth 7
Indianapolis, IN

Northern Trust Company .... Booth 30
Chicago, IL

Pentera, Inc. .... Booth 18
Indianapolis, IN

PG Calc Incorporated .... Booth 20
Cambridge, MA

Planned Giving Services, Inc. .... Booth 19
Seattle, WA

Planned Giving Today .... Booth 9
Edmonds, WA

Prospect Information Network .... Booth 16
Daytona, FL

R & R Newkirk .... Booth 22
Willow Springs, IL

The Sharpe Group .... Booth 14
Memphis, TN

Smith Barney .... Booth 11
New York, NY

State Street Global Advisors .... Booth 23
Boston, MA

The Stelter Company .... Booth 15
Des Moines, IA

SunGard Philanthropic & Family Office Solutions .... Booth 2
Malvern, PA

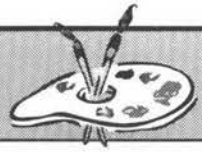
TIAA-CREF Trust Company, FSB .... Booth 1
St. Louis, MO

U.S. Bank Charitable Services .... Booth 26
Minneapolis, MN

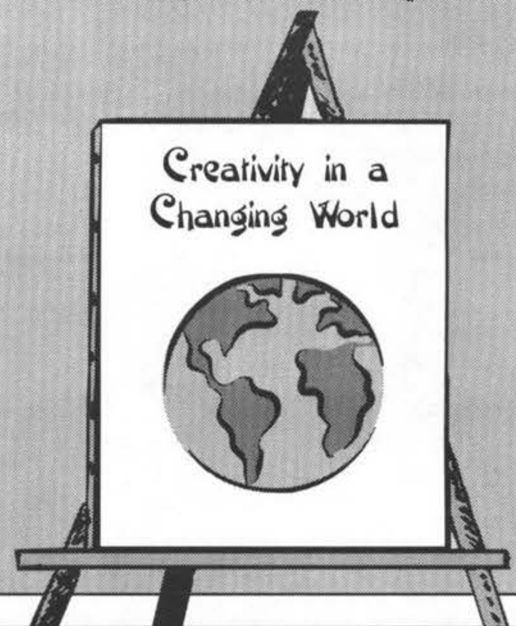
U.S. Trust .... Booth 24
Greensboro, NC

Wachovia Bank .... Booth 8
Winston Salem, NC

Wells Fargo Bank .... Booth 10
Dallas, TX



Conference Faculty



Conference Chair

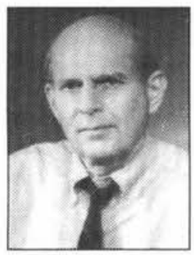
Lindsay L. Lapole has been the territorial planned giving director of The Salvation Army, Southern Territory since 1986. He had previously served as a planned giving director in the Kentucky/Tennessee and Florida divisions of The Salvation Army and in fundraising and volunteer management with the Boy Scouts of America. Lapole is a past director of the Georgia Chapter of the Association of Fundraising Professionals and is a past board member and president of the Georgia Planned Giving Council. He serves as chairman of the National Planned Giving Consultants Committee of The Salvation Army. Lapole is an at-large member of the Executive Committee of the American Council on Gift Annuities and serves on its Rates Committee and Long Range Planning Committee.

Plenary Session Speakers

Frank Minton is president of Planned Giving Services, which provides guidance in establishing, administering and marketing planned giving programs by nonprofit organizations. Previously, he served as director of planned giving and executive director of development at the University of Washington. Minton has served as president of the National Committee on Planned Giving and received its Distinguished Service Award in 1992. He is vice chairman of the board of the American Council on Gift Annuities, directed its survey of charitable gift annuities and currently chairs its Rates Committee. Minton is on the advisory board of *Planned Giving Today* and is a member of the Seattle Estate Planning Council and the Washington Planned Giving Council.

Mark W. Olson took office in 2001 to fill an unexpired term as a member of the Board of Governors of the Federal Reserve System ending in 2010. Before becoming a member of the Board, he served as staff director of the Securities Subcommittee of the Banking, Housing, and Urban Affairs Committee, U.S. Senate. The Securities Subcommittee's legislative jurisdiction included oversight of the Securities and Exchange Commission, accounting policy issues and the insurance industry. He is a former partner with Ernst and Young LLP and its predecessor, Arthur Young & Company. Olson began a career in banking in 1966 with First Bank System (now U.S. Bancorp), and served on the American Bankers Association Board of Directors and as Chairman of the ABA Government Relations Council. In 1986, at age 43, he became the youngest person ever elected as president of the American Bankers Association.

Clinton A. Schroeder, current chairman of the American Council on Gift Annuities is an experienced tax lawyer, Bar Association leader, a Fellow of the American College of Tax Counsel, a former member of the ABA House of Delegates and former Chairperson of the Tax Section of the Minnesota State Bar Association. He is a partner in the law firm of Gray Plant Mooty in Minneapolis, Minnesota. In 2002, Schroeder received the highest honor given to graduates of his alma mater, the University of Minnesota. In presenting this award, the university stated that Schroeder is "an authority on tax planning and philanthropy who has been a tireless civic leader who serves numerous nonprofit organizations and cares deeply about improving the lives of his fellow citizens."



Conrad Teitell is an estate-planning principal in the Connecticut and Florida based law firm of Cummings & Lockwood, resident in the Stamford, CT office, and chairs the firm's Charitable Planning Group. He is an adjunct visiting professor at the University of Miami Law School and is also director of the Philanthropy Tax Institute, where he lectures on taxes, philanthropy and estate planning. Teitell writes the monthly newsletter, *Taxwise Giving*. He is listed in *The Best Lawyers in America* and is the recipient of the American Law Institute/ American Bar Association's Harrison Tweed Award for Special Merit in Continuing Legal Education. Teitell is a recipient of the National Committee on Planned Giving's Distinguished Service Award, serves as counsel to the American Council on Gift Annuities and has spoken at every ACGA conference since 1968.

Conference Faculty

Fundamentals of Planned Giving Speakers

Pamela Jones Davidson has been a nationally recognized speaker in charitable gift planning for nearly two decades. She is president of Davidson Gift Design in Bloomington, Indiana, a consulting firm specializing in gift planning, planned giving program design and implementation, and training. Previously, she served as the executive director of planned giving and associate counsel for the Indiana University Foundation. Davidson is a past president of the National Committee on Planned Giving and is the current chair of NCPG's Ethics Committee. She serves on the editorial board of the Planned Giving Design Center and is a past board member and president of the Planned Giving Group of Indiana.

James E. Gillespie is president of CommonWealth, an Indianapolis, Indiana firm that provides comprehensive counsel in the area of planned gift development programs, specializing in training, mentoring and professional development. Previously, he was chief operating officer of the consulting division of Renaissance Inc. in Indianapolis. Gillespie was a professional development officer for Junior Achievement and the Indianapolis Symphony Orchestra. He is a lead faculty member of The Fund Raising School, a unit of Indiana University's Center on Philanthropy. Gillespie served on the board of directors of the National Committee on Planned Giving and was NCPG's conference chair in 2001.

Symposium Panelists

Robert F. Sharpe, Jr. is president of The Sharpe Group, which consults with a number of leading charities in implementing their major and planned gift development efforts. With offices in Memphis, Tennessee and Washington, DC, the Sharpe firm has worked with over 10,000 nonprofits nationwide during its 40-year history. In past years, Sharpe has practiced law with a major law firm specializing in income, estate, and gift taxation and corporate planning. Prior to his legal experience, he served as a development officer for a liberal arts college. Sharpe is a frequent speaker for several organizations and has served as a board member of a number of arts, educational and civic organizations.

Terry Simmons is a senior partner in the Dallas-based law firm of Thompson & Knight L.L.P. where he has a national practice in charitable gift planning, exempt organizations law and estate planning. He serves on numerous nonprofit boards and is co-editor and co-publisher of *Charitable Gift Planning News,* a national newsletter covering tax and legal developments in the planned giving and exempt organizations fields. Simmons is listed in *The Best Lawyers in America,* 2003-2004 (Trusts and Estates). He is a former president of the National Committee on Planned Giving and currently serves on the board of directors of the American Council on Gift Annuities.

Breakout Speakers

Jonathan Ackerman represents donors and tax-exempt organizations on a national basis through his law practice in Owings Mills, Maryland. He advises charities in their creation and operation, and advises families who desire to integrate philanthropy into their financial and estate plans. Ackerman is a past president of the National Committee on Planned Giving and past president of the Chesapeake Planned Giving Council. He served on the Ad Hoc Committee on Ethics and Accountability in the Nonprofit Sector for the Maryland Association of Nonprofit Organizations.

Thomas K. Anderson is a Principal of State Street Global Advisors. He is a Portfolio Manager and Team Leader in the firm's Charitable Asset Management group where he is responsible for setting asset allocation strategy and managing charitable trust portfolios for non-profit clients. Prior to this role, Anderson was a portfolio manager in the firm's Private Asset Management division, working with affluent investors. Prior to joining SSgA in 1998, he held marketing, product management, and communications roles with Funds Distributors Inc, State Street Research, Keystone Funds, and Liberty Mutual Insurance. He has 13 years of financial services and marketing experience.

Breakout Speakers

Elizabeth A.S. Brown is an attorney and Certified Public Accountant, and serves as assistant general counsel of The Moody Bible Institute of Chicago. Prior to joining Moody in 1983, she was an associate attorney with McDermott, Will & Emery in Chicago. At Moody, Brown assists donors with estate planning matters, and otherwise provides legal support for Moody's planned giving function. She serves as an executive committee member on the board of directors of the American Council on Gift Annuities.

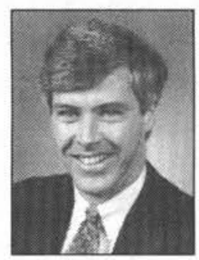
Karen Browning is director of bequests and annuities at The Nature Conservancy in Arlington, Virginia. She manages a team of seven gift planners who raised more than $19 million in gift annuities in fiscal year 2003. Previously, Browning directed the Cause-Related Marketing program at the Conservancy. She currently serves on the boards of the National Capital Gift Planning Council and the local Toastmasters council.

Joseph O. Bull is director of planned giving for The Ohio State University in Columbus, Ohio. Previously, he served as director of The Campaign for Alumni House at the university. Bull was previously director of gift planning, assistant university counsel and executive director of the North Carolina State University Foundation, and assistant director of gift planning for Duke University. He serves as president-elect on the board of the National Committee on Planned Giving.

Marc Carmichael is president of the R&R Newkirk Company, which provides planned gift training and promotional literature for hundreds of organizations. R&R Newkirk also publishes the *Charitable Giving Tax Service*, a four-volume reference library on planned giving and charitable estate planning. Carmichael is a past president, past conference chair and past editorial advisory chair of the National Committee on Planned Giving, and has served on the board of directors of the Chicago Planned Giving Council. He has spoken at national fundraising conferences, state bar association meetings and the National Conference on Financial Planning.

Daniel L. Daniels heads the Private Clients Group in Cummings & Lockwood's Stamford, Connecticut office, where he concentrates on estate and trust planning and administration. He is a fellow of the American College of Trust and Estate Counsel and is listed in *The Best Lawyers in America*. Daniels is a member of the American, Connecticut (Estates and Probate Executive Committee) and New York State bar associations.

André R. Donikian is president and editor in chief of Pentera, Inc., a comprehensive planned giving publishing and consulting company in Indianapolis, Indiana. Donikian has served as advisor to more than 300 charities and educational institutions throughout the United States. He is a nationally recognized attorney and consultant in the field and presents seminars on all aspects of planned giving. Donikian has served on the board of the National Committee on Planned Giving and the board of advisors of Union College. He is a founder and former board member of the Planned Giving Group of Indiana.



Jeremiah W. Doyle is estate planning strategist for Mellon's Private Wealth Management group and a senior director of Mellon Financial Corporation. He is the editor and co-author of *Income Taxation of Trusts and Estates*, a co-author of *How to Complete Estate Tax Returns* and the recently released treatise *Understanding and Using Trusts*, all published by Massachusetts Continuing Legal Education. He is a member of the American Bar Association, Massachusetts Bar Association, Boston Estate Planning Council and the Essex County Bar Association. He is president and also a member of the Executive Committee of the Boston Estate Planning Council and formerly a member of the Executive Committee of the Essex County Bar Association.

Breakout Speakers

Peter V.K. Doyle has been director of planned giving at Wellesley College for more than 13 years. He held similar positions at Harvard Medical School, Massachusetts Eye & Ear Infirmary, and Boston University School of Law, where he also served as executive editor of *The Brief,* a quarterly magazine for alumni and friends of the law school. Doyle is a former president of the Planned Giving Group of New England and is a member of the Canaras Group.

Ellen G. Estes founded the firm of Estes Associates to provide fund raising consulting services to nonprofit organizations nationwide. In addition to consulting, she specializes in presenting seminars for organizations, their boards, volunteers and prospects, designed to provide the basics of successful planned giving. Estes previously served as the first director of development of the Long Wharf Theatre in Connecticut and as legal counsel to the Campaign for Yale.

Jackie W. Franey is the planned giving officer at Children's Medical Center in Dallas, Texas where she has responsibility for all planned giving activities for the hospital. Previously, she served as the national director of planned giving for the American Heart Association – National Office where she assisted affiliates in designing, marketing and implementing their planned giving programs and provided technical expertise and training. Franey currently serves as president for the North Texas Chapter of NCPG and is on the Editorial Advisory Board of *Planned Giving Today.*

Robert E. Harding is a principal with the Gray Plant Mooty law firm in Minneapolis, Minnesota. For the majority of his 18 years of practice he has focused exclusively on charitable gift planning. He speaks regularly at regional and national conferences on planned gifts. Harding received undergraduate and graduate degrees in philosophy from Harvard University and a law degree from the University of Minnesota, where he was an editor of the Law Review and a member of the Order of the Coif.

Emanuel J. Kallina, II focuses his law practice on estate and charitable planning for high net worth individuals and has practiced extensively in the related fields of business law, corporate tax law, partnerships and real estate. He is a co-founder and member of the board of directors of the Planned Giving Design Center, a former member of the board of directors of the National Committee on Planned Giving, a co-founder of the Chesapeake Planned Giving Council, and chairman of the board and president of The James Foundation. Kallina has testified frequently before the IRS, has worked extensively with the staff of the various Congressional committees regarding charitable legislation, and heads a national group of charitable giving practitioners that meets informally with the IRS to discuss ruling policy in the planned giving area.

J. Scott Kaspick has over 20 years of experience managing planned gift assets. As associate treasurer of Stanford University and a member of the University's endowment management team he developed and implemented the investment approach and the systems for managing Stanford's then $150 million planned giving program. In 1989 he founded Kaspick & Company, which provides asset management, trust administration and policy consulting for over $2 billion in planned gift assets for charities nationwide. He is a frequent speaker at national and regional conferences, addressing financial issues relating to planned giving.

Cam Kelly has held the position of director of planned gifts and bequests since 1991 at her alma mater, Smith College in Northampton, Massachusetts. Prior to joining Smith's Advancement Office, she was an investment advisor with a small firm in Boston. Kelly is a Chartered Financial Analyst. She has served on ACGA's Board of Directors since 1994, and has also served on the board of the Planned Giving Group of New England. Kelly is president of the Hampshire Regional YMCA in Northampton.

Breakout Speakers

David T. Leibell is a principal in the Stamford, Connecticut office of Cummings & Lockwood LLC, practicing in the Private Clients Group and Charitable Planning Group. He worked in the financial services industry for several years, specializing in the financial aspects of estate planning. He is a frequent lecturer to lawyer and non-lawyer audiences throughout the United States and has authored many articles on charitable, estate and tax planning, including "CRTs and Difficult Assets," *Trusts and Estates Magazine* (April 2003) and "Unrelated Business Tax and Charitable Gifts," *Trusts and Estates Magazine* (June 2003), both co-authored with Daniel L. Daniels. Leibell has been appointed to serve as the 2004 Chairperson for *Trusts and Estates Magazine*'s Philanthropy Committee.

Betsy A. Mangone spent 16 years with the University of Colorado Foundation, serving as vice president of the office of charitable gift and estate planning and corporate vice president and director of development for the University of Colorado Health Sciences Center. In 1996 she started Mangone & Co., a charitable gift consulting firm now serving over 100 national and international clients. Mangone serves as a member of the executive committee for the American Council on Gift Annuities and is past president of the National Committee on Planned Giving. She is a member of the editorial advisory committee for *The Journal of Gift Planning* and a member of the Planned Giving Design Center Editorial Advisory Board. Mangone is a contributing member of *PG Mentor,* a publication for new planned giving officers.

Edith (Edie) Matulka has been with Planned Giving Services since 1997, where she has primary responsibility for assisting charities in complying with state regulations for issuance of gift annuities. She is the lead author of certain chapters of *Charitable Gift Annuities: The Complete Resource Manual.* A member of the Washington and Oregon State Bar Associations, she has spoken on gift annuities and state regulation at the Washington Planned Giving Council and American Council on Gift Annuities conferences. Matulka currently serves on the State Regulations Committee of the American Council on Gift Annuities.

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 is a past president of the National Committee on Planned Giving, a past president of the Alabama Planned Giving Council, a past president of the Estate Planning Council of Birmingham, Inc. and a past member of the board of the National Association of Estate Planners & Councils. Miree serves on the editorial advisory boards of *Planned Giving Today* and *Planned Giving Design Center.*

Rachel F. Moore is director of planned giving at Williams College in Williamstown, Massachusetts. Previously, she worked in planned giving at Smith College in Northampton, Massachusetts. Before entering the planned giving field, Moore served as a public relations officer for the Massachusetts state forests and parks agency, and worked as a writer in the Massachusetts governor's office. She volunteers for the American Red Cross and The Franklin Land Trust in western Massachusetts.

David Wheeler Newman chairs the Charitable Sector Practice Group at the Los Angeles law firm of Mitchell Silberberg & Knupp LLP. For over twenty years he has advised charitable organizations and their donors on the legal and tax aspects of planned giving. Newman is a former member of the board of the National Committee on Planned Giving, where he served as a member of its Executive Committee.

26th Conference on Gift Annuities

Judy Peterson is senior associate treasurer and chief operations officer for her alma mater, the University of Washington in Seattle, Washington. After spending a few years with a major accounting firm, she returned to the UW and has worked in the Treasury Office since it was formed in 1987. She currently is responsible for life income investments and administration. In addition, she manages operations, accounting and reporting for endowment and operating fund portfolios totaling nearly $2 billion.

Conference Faculty

Breakout Speakers

Gary Pforzheimer has been involved in planned giving for over 20 years, first with Harvard University's Planned Giving Office, and then with the company he founded and has led since 1985, PG Calc Incorporated. PG Calc designs, markets and supports software for planning giving marketing and administration. In May of 1995, Pforzheimer became the seventh recipient of the David M. Donaldson Distinguished Service Award, an award given by the Planned Giving Group of New England (PGGNE) to individuals for their special contribution and distinguished service to the planned giving community. He has served as vice president for programming, treasurer and director of communications for PGGNE.

James B. Potter was a planned giving executive for 20 years with two national charities, the Presbyterian Church (USA) Foundation and the American Lung Association. After five years of part-time consulting work, he became a full-time consultant in 1990, and is currently president of Planned Giving Resources in Baker, Louisiana. He has served on the board of the American Council on Gift Annuities since 1974 and has chaired their State Regulations Committee since 1989. Potter was awarded the 1999 Distinguished Service Award by the National Capital Gift Planning Council (then called the Planned Giving Study Group of Washington, DC).

Philip M. Purcell currently serves as the associate vice president for planned giving at the Ball State University Foundation in Muncie, Indiana. Formerly, he served as director of gift planning for the Central Indiana Community Foundation in Indianapolis where he worked with donors and professional advisors, as well as helping to create and direct the Planned Giving Resource Center serving area charitable organizations. Purcell currently serves as a volunteer on the Tax Exempt Organization Advisory Council for the Internal Revenue Service (Great Lakes States region). He teaches a course on Law and Philanthropy for the Indiana University School of Law and is a faculty member of the Indiana University Center on Philanthropy Fundraising School. Purcell is past president of the Planned Giving Group of Indiana.

Jonathan G. Tidd is a Simsbury, Connecticut attorney whose practice is limited to advising charitable organizations on gift planning issues. His clients include a wide range of educational, health care, arts, human rights and social service organizations. He is a member of the Connecticut, Illinois, Indiana and New York Bars. His articles on charitable gift planning have appeared in *The Journal of Taxation, Estate Planning, Trusts and Estates* and other professional journals. Formerly, Tidd served as planned giving director for New York University.

Model Standards of Practice for the Charitable Gift Planner

PREAMBLE

The purpose of this statement is to encourage responsible gift planning by urging the adoption of the following Standards of Practice by all individuals who work in the charitable gift planning process, gift planning officers, fund raising consultants, attorneys, accountants, financial planners, life insurance agents and other financial services professionals (collectively referred to hereafter as "Gift Planners"), and by the institutions that these persons represent.

This statement recognizes that the solicitation, planning and administration of a charitable gift is a complex process involving philanthropic, personal, financial, and tax considerations, and as such often involves professionals from various disciplines whose goals should include working together to structure a gift that achieves a fair and proper balance between the interests of the donor and the purposes of the charitable institution.

I. PRIMACY OF PHILANTHROPIC MOTIVATION

The principal basis for making a charitable gift should be a desire on the part of the donor to support the work of charitable institutions.

II. EXPLANATION OF TAX IMPLICATIONS

Congress has provided tax incentives for charitable giving, and the emphasis in this statement on philanthropic motivation in no way minimizes the necessity and appropriateness of a full and accurate explanation by the Gift Planner of those incentives and their implications.

III. FULL DISCLOSURE

It is essential to the gift planning process that the role and relationships of all parties involved, including how and by whom each is compensated, be fully disclosed to the donor. A Gift Planner shall not act or purport to act as a representative of any charity without the express knowledge and approval of the charity, and shall not, while employed by the charity, act or purport to act as a representative of the donor, without the express consent of both the charity and the donor.

IV. COMPENSATION

Compensation paid to Gift Planners shall be reasonable and proportionate to the services provided. Payment of finders fees, commissions or other fees by a donee organization to an independent Gift Planner as a condition for the delivery of a gift are never appropriate. Such payments lead to abusive practices and may violate certain state and federal regulations. Likewise, commission-based compensation for Gift Planners who are employed by a charitable institution is never appropriate.

V. COMPETENCE AND PROFESSIONALISM

The Gift Planner should strive to achieve and maintain a high degree of competence in his or her chosen area, and shall advise donors only in areas in which he or she is professionally qualified. It is a hallmark of professionalism for Gift Planners that they realize when they have reached the limits of their knowledge and expertise, and as a result, should include other professionals in the process. Such relationships should be characterized by courtesy, tact and mutual respect.

VI. CONSULTATION WITH INDEPENDENT ADVISORS

A Gift Planner acting on behalf of a charity shall in all cases strongly encourage the donor to discuss the proposed gift with competent independent legal and tax advisers of the donor's choice.

VII. CONSULTATION WITH CHARITIES

Although Gift Planners frequently and properly counsel donors concerning specific charitable gifts without the prior knowledge or approval of the donee organization, the Gift Planners, in order to insure that the gift will accomplish the donor's objectives, should encourage the donor, early in the gift planning process, to discuss the proposed gift with the charity to whom the gift is to be made. In cases where the donor desires anonymity, the Gift Planners shall endeavor, on behalf of the undisclosed donor, to obtain the charity's input in the gift planning process.

VIII. DESCRIPTION AND REPRESENTATION OF GIFT

The Gift Planner shall make every effort to assure that the donor receives a full description and an accurate representation of all aspects of any proposed charitable gift plan. The consequences for the charity, the donor and, where applicable, the donor's family, should be apparent, and the assumptions underlying any financial illustrations should be realistic.

IX. FULL COMPLIANCE

A Gift Planner shall fully comply with and shall encourage other parties in the gift planning process to fully comply with both the letter and spirit of all applicable federal and state laws and regulations.

X. PUBLIC TRUST

Gift Planners shall, in all dealings with donors, institutions and other professionals, act with fairness, honesty, integrity and openness. Except for compensation received for services, the terms of which have been disclosed to the donor, they shall have no vested interest that could result in personal gain.

Adopted and subscribed to by the National Committee on Planned Giving and the American Council on Gift Annuities, May 7, 1991. Revised April 1999.

Headline News: A Legislative and Regulatory Update in 50 Minutes or Less

Wednesday, May 5, 2004

Terry L. Simmons, J.D., LL.M
Senior Partner
Thompson & Knight L.L.P.
1700 Pacific Avenue, Suite 3300
Dallas, Texas 75201

Phone: 214-969-1419 Fax: 214-880-3373
e-mail: Terry.Simmons@tklaw.com

Table of Contents

I. A Brief Look At Congress

A. CARE Bill is Back Again

For the last several years, we have watched the seemingly endless march through Congress of the Charity Aid, Recovery and Empowerment Act, a/k/a the CARE Bill, formerly known as the Community Solutions Act. Last session, an earlier version of that legislation passed the House of Representatives, then languished in the Senate amid end-of-session political wrangling. The bill's old proponents, Senators Santorum and Lieberman, managed to get it re-introduced again early in the 2003-2004 term of Congress, and it was approved by the Senate Finance Committee, all in a matter of days, and approval by the full Senate followed.

This bill is largely the same as the final version seen last term, and includes both of the keystone provisions from last year's bill. Of foremost interest to gift planners is the Charitable IRA provision, permitting tax-free withdrawals from Individual Retirement Accounts (IRAs) to fund charitable transfers. The account owner would have to be at least 70-½ years old to use qualifying IRA distributions for direct charitable contributions, and at least age 59-½ for distributions to a split interest entity (e.g., a charitable remainder trust, charitable gift annuity or pooled income fund). The charitable deduction for non-itemizers is also included, up to a maximum deduction of $250 ($500 in the case of a joint return).

A number of smaller charitable changes, mostly from the 2002 versions of the legislation, are also included, including the following items:

- Expanded charitable deductions for contributions of food inventories and book inventories
- Expanded deductions for charitable contributions of scientific property used for research and for computer technology and equipment used for educational purposes
- Modifications to encourage contributions of capital gain real property for conservation purposes
- An exclusion of 25 percent of gains realized on sales or exchanges of land or water interests to eligible entities for conservation purposes
- An income tax exclusion for cost-sharing payments under the Partners for Fish and Wildlife Program
- A change in the treatment of S corporation charitable contributions of property other than cash (reducing a shareholder's basis by his or her allocable share of the corporation's basis in the contributed property rather than its value)
- Enhanced deduction for "qualified artistic charitable contributions" (i.e., certain contribution of literary, musical, artistic and scholarly compositions)

- An income tax exclusion for charitable volunteers' mileage reimbursements (up to the standard mileage rate prescribed for business use)

The bill would also impose several new "sunshine" provisions designed to enhance charities' accountability to donors, including the following:

- Disclosure of IRS determinations regarding charities

- Disclosure of the Internet Web site and name under which the organization does business

- Simplification of private foundations' reporting of capital transactions to the IRS;

- Specific disclosure that charities' tax returns (IRS Form 990) is publicly available

- Disclosure to state officials of proposed IRS actions related to charities (to aid state prosecution of wrongdoers)

- Expansion of penalties for preparers of Form 990

- A notification requirement for entities not currently required to file

- Suspension of tax-exempt status for certain terrorist organizations

On the Horse side, Representatives Roy Blunt (R - Missouri) and Harold Ford, Jr. (D - Tennessee) introduced HR 7 – the Charitable Giving Act. This bill resembled in many respects the CARE Bill that passed the Senate in April of 2003, but adds several foundation provisions. A primary difference would apply to IRA rollovers. Specifically, outright and planned gifts would be allowed beginning at age 70 ½.

First, the good news. HR 7 would reduce the present excise tax on foundation investment income from 2% to a flat 1%. A similar provision was included in last year's version of this legislation, and it had been anticipated that efforts would be made in the House to add this back.

In addition, however, HR 7 as introduced imposed new restrictions on the qualification of administrative expenses as qualifying distributions for purposes of the five-percent minimum distribution requirement. The sponsors expressed the view that charities should devote more of their assets to charitable distributions rather than rents and salaries. Foundations are already reeling from declines in the value of their investment assets over the last few years, so the reaction of the foundation community has predictably been one of widespread concern. Of course, it is clear that a foundation cannot responsibly carry out its activities without incurring some administrative expenses; moreover, the current climate seems to favor greater accountability and disclosure by all institutions, including foundations, and increased compliance will inevitably mean increased expense. The bill finally passed in the House still addressed the issue, but was a compromise more palatable to foundations.

The version of the CARE Bill that passed the Senate in April of 2003 included a provision (reportedly aimed at benefiting the Arkansas foundation that owns or will own a sizeable interest in the WalMart Corporation) that would give foundations an extra five years to divest extremely large holdings of corporate stock. One condition of this extension would be an increase in the payout requirement during the extension period from the current 5% to 12%. A rumor spread throughout the foundation community in the wake of the Senate passage of the CARE Bill that the House might make this 12% level mandatory for all foundations, but that turned out to be erroneous.

The support of the charitable community has been divided and fragmented by addition of the controversial proposal to exclude private foundations' administrative expenses from qualifying distributions for purposes of the minimum distribution requirement of Code Sec. 4942. Largely on the basis of press reports of foundations paying large salaries and other perquisites to directors and officers, legislators have questioned the use of these and other administrative expenses as qualifying distributions, and had originally said such expenses would be completely disallowed. *[Note – such compensation items have been subject to the self-dealing penalty since 1969.]* Some charitable groups, especially those heavily dependent upon grants, endorsed the proposal, while the Council on Foundations and others opposed it. The compromise included in the final version of HR 7 would increase the excise tax for self-dealing to 25%, limit qualified administrative expenses to those directly related to the conduct of charitable activities, grant-making and regulatory compliance. Compensation in excess of $100,000 annually to disqualified persons would not qualify as a reduction of the 5% minimum distributable amount. As to air travel, only travel at coach fares on regularly-scheduled commercial flights would qualify.

Senate Finance Committee Chairman Chuck Grassley, who steered the CARE Bill through his committee and the Senate earlier this year, has launched an inquiry into a number of practices of The Nature Conservancy. A series of critical articles in the *Washington Post* described various land transactions and other practices that the Finance Committee wants to examine. In a press release issued July 17, 2003, Chairman Grassley released the text of a seven-page letter in which he has asked the Conservancy to supply, by August 18, a vast amount of information and data on its contributions, transactions and governance, some of which will go back as far as ten years.

The Senate version of the CARE Bill included several new conservation tax incentives that would encourage sales to conservation organizations such as The Nature Conservancy. The committee's action in examining the land transactions of The Nature Conservancy is seen by many as endangering the passage of these new incentives as well as the continuation of such standard devices as the conservation easement. As Chairman Grassley put it in his press release, "Our goal in asking these detailed questions is to shed daylight on what's happened so we can hold the bad actors accountable and prevent wrongdoing in the future."

At the deadline for paper submission, negotiations between the Leadership of the Senate and House for final passage of a bill were ongoing.

B. Senate Budget/Tax Cut Bill Would Cut Back On Deductions For Patent Contributions

The version of the Bush Administration's "Jobs and Growth Tax Act of 2003" offered in the Senate Finance Committee by Chairman Charles Grassley would have changed the rules governing deductions for charitable contributions of patents. Currently, patents produce a deduction based upon their full value, while deductions for many similar types of property (e.g., copyrights) are limited to the donor's basis because their sale would produce ordinary income. Chairman Grassley's bill would have eliminated this disparity and dictate the lower deduction for all such contributions.

Under the bill, the deduction allowable for a charitable contribution of patents or similar property (for example, patent applications, copyrights, trade names, trade secrets, trademarks) is limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the contributed property (determined at the time of the contribution). This rule would apply to direct transfers of a patent or similar property to a qualified charity and to indirect transfers or other arrangements that are intended to disguise the contribution of a patent as a contribution of other property or otherwise to circumvent the rule of the proposal. While not enacted as part of the final tax bill, this provision will be seen again.

II. The Courts

A. Elderly Donor Had Capacity to Create CRT

Burson v. Presbyterian Church of Dinuba, 2002 California Appellate Unpubl. LEXIS 2429, Ct. of App. of Cal., Fifth App. Distr. (April 2, 2002). After Alma Hofer died in 1997, her daughter, Dona Burson challenged a charitable remainder trust she had created a year or so earlier. According to Dona, her mother was not in her right mind at the time she created the trust, and she sought to recover the trust property form the charitable beneficiary, her mother's church.

In 1990, when her mother was 80, Dona first brought a court action to take over her affairs. This effort was abandoned when Alma "went ballistic," but four years later Dona tried again. Alma fought back in court, and the matter was eventually settled with the Tulare County Public Guardian appointed as conservator for Alma. The court order settling the case permitted Alma to change her estate plan, to give up to $1.5 million to her church, and to create a charitable remainder trust.

Alma promptly created a $1.5 million CRT for her church and left the rest of her estate to her two daughters in equal shares. When Alma died in 1997, Dona was appointed administrator of her estate and in this capacity she sued the church to recover the CRT assets, alleging her mother had not been in her right mind when she created the trust. She also claimed the pastor of the church had exercised undue influence and fraud to induce her mother to create the trust. The trial court rejected her claim, finding that Alma fully understood what she was doing and the effect of her acts. This conclusion was based in part on the initial court order and on video taped meetings between Alma and her attorney.

On appeal, this decision was affirmed and the trust was upheld. Despite some testimony that Alma had various problems with such things as short-term memory and had difficulty in living independently, the court found that she met the applicable test. The appellate court pointed out that, because this case involved the validity of an inter vivos trust, it was not necessary that Alma have adequate testamentary capacity (i.e., the capacity to make a will). Rather, the key was whether she had transactional or contractual capacity. This requires that the person creating the trust must understand her rights and the nature, purpose and effect of her acts.

Alma's daughter relied upon five evidentiary factors to establish her claim that Alma lacked the requisite capacity: (1) Alma had suffered from Alzheimers' Dementia in the past; (2) by the time her trust was created, she needed 24-hour supervision and was unable to live independently; (3) she had short term memory deficits; (4) she did not understand who her heirs were; and (5) she thought her estate was larger that it actually was. Each of these claims was rejected as not controlling the result. There was adequate testimony that Alma had a longstanding desire to give her church a substantial gift, so it could build a new sanctuary. She did this with sufficient knowledge of the size of her estate and the effect of the gift upon her lifestyle and her childrens' inheritance. Thus, she understood sufficiently the nature and consequences of both her gift and the CRT.

This case is based upon California law, and various state laws may have different approaches to this issue of donor competence. Nevertheless, there are some good lessons here for gift planners. First, it is clear that mere forgetfulness, confusion or inconsistent actions and statements are typically insufficient to vitiate a donor's capacity. Alma Hofer clearly had a diminished ability to remember everything she had done, and there was contradictory evidence on both sides of this issue. Second, planners should always be aware of the potential for such controversies within the family of an elderly donor. Where a proposed gift is substantial in relation to the donor's overall estate, particular care should be taken to document the donor's intentions and his/her ability to understand the overall plan and its impact on his/her estate. In this case, videotapes of Mrs. Hofer's meetings with her attorneys proved helpful. (Video taping attorney meetings and document executions can be a double-edged sword, however.) As is usually the case, a bit of foresight and planning can help avert future problems.

B. Estate Taxes Reduce Charitable Deduction

Estate of Bradford v. Commissioner, T. C. Memo 2002-238 (September 23, 2002). When Marion P. Bradford died in 1996, he left an estate of about $3 million. A month earlier, he had signed a new will and a revocable trust. His estate plan provided for bequests of personal property to decedent's sister and his friend, Lizette L. Pryor, with the bulk of his property to divided between Lizette and a charitable foundation. The foundation was to last for five years, distributing its income and remainder to Northbrook Methodist Church (where Lizette was a member).

The dispositive plan was fairly traditional, with debts, expenses and death taxes to be paid from the residuary estate, and the balance divided between Lizette and the foundation. Under North Carolina law, the interest of the foundation is exempted from bearing any portion of the estate tax, unless the governing instrument provides otherwise. However, the Tax Court found that the language of Mr. Bradford's will and trust required that estate taxes be paid from the residue of the estate before distribution of the $1.3 Million charitable bequest to the foundation and deducted as a charitable transfer. Under that interpretation, the actual distribution to the foundation (and thus the estate tax charitable deduction) was reduced to $800,752.

The opinion of the Tax Court acknowledged that the full $1.3 million deduction would have been allowed under North Carolina law, but for the language of the will and the trust that required the taxes were to be paid before the balance was divided between Lizette and the foundation. Because the will and the trust overruled the North Carolina statute, they produced a threefold increase in the total federal and state death taxes payable.

Many estate planning attorneys regard the tax allocation clause as one of the most important provisions in an estate plan, if not the most important of all. This case bears out that characterization. To avoid such results, the draftsperson should consider specifically relieving the charitable share from taxes and expenses provisions or, at a minimum, consider providing that the provisions of state law reaching that result are applicable. In this case, the drafter of Mr. Bradford's estate planning documents apparently overlooked the fact that the tax payment plan provided would overrule the local law and reduce the charitable share of the estate. The worst possible approach is to ignore the point, as this is a tax saving opportunity that is easily achieved if only it is anticipated while the estate plan is being put together. Another potentially disastrous mistake – provide for one result in the testator's will and a different result in his/her revocable trust.

C. CRT Not a CRT If Not Administered Properly

Atkinson v. Commissioner, 309 F.3d 1291, No. 01-16536 (11th Circuit, 10/16/2002). Melvine Atkinson created a charitable remainder annuity trust in 1991, and funded it with $4 million. Under the trust, she was entitled to annuity distributions of $200,000 per year, but no distributions were ever made prior to her death. In the Tax Court, her estate argued that checks for the required distributions had been sent to Melvine, but she never cashed them. These uncashed checks were reported as assets on her estate tax return, but the Tax Court found no persuasive evidence that these checks were sent or that they ever even existed. The Tax Court further found that the trust was not a qualified charitable remainder trust; because it did not make distributions it failed to function as a CRT. Accordingly, the estate tax deduction for the trust was denied. The estate appealed the case to the Eleventh Circuit, characterizing the failure to make distributions as a "foot fault" rather than a serious breach. It renewed its argument about the checks that Melvine failed to cash, and pointed out that this resulted in more passing to charity upon her death. The Eleventh Circuit rejected this position and agreed that the distribution requirement cannot be ignored. The court also upheld the Tax court finding that the payment of estate tax attributable to a survivor annuitant's interest (the trust properly prohibited such payments) rendered the trust not qualified. Congress included the five percent minimum distribution requirement for a reason, and a trust that fails to make its distributions simply does not qualify.

Planners sometimes spend all their time worrying about the preliminary considerations and the drafting of the charitable remainder trust, without giving sufficient thought to how the trust will be administered. Despite the best of plans, the trust will not produce the desired tax benefits if it is not operated in accordance with its governing instrument, as well as the Code and Regulations. And this is not a shortcoming that may be corrected by a reformation action.

D. Tax Court Finds No Prearranged Sale of Contributed Warrants

Gerald A. Rauenhorst v. Commissioner, 119 TC No. 9 (10/7/2002). Gerald and Henrietta Rauenhorst contributed stock warrants to four charities on November 9, 1993, and the transfer was reflected on the books of the corporation three days later, on November 12. [Hint to readers – watch these dates.] The warrants permitted the holder to buy about 18 percent of the stock of NMG, Inc. for a total price of $712. Earlier, on September 28, 1993, another corporation (WGP) sent the management of NMG a letter stating its intention to purchase all of the stock of NMG. Management of NMG accepted the offer and on October 22, 1993 , the Board of Directors of WGP adopted a resolution authorizing management to proceed with the purchase. On November 22, the NMG shareholders (including the Rauenhorst's donees) entered into a purchase agreement and sold the shares on December 22 at a price of $7,598 per share. Each of the donees filed Form 8282 reporting the sale of the NMG stock. On audit, the IRS claimed that the $4,722,484 capital gain on the sale of this NMG stock was taxable to the Rauenhorsts, on grounds their transfer to charity was too late, and the gain had already accrued when they transferred the warrants to charity.

The Tax Court rejected the Internal Revenue Service contention, and required IRS to accept the holding of its own ruling in Rev. Rul 78-197, 1978-1 CB 83. There, a redemption of stock contributed to charity did not produce a taxable gain to the donor where the donee was legally bound, or could be compelled, to sell the shares. In this case, the Rauenhorst's transfer took place before there was any legally binding obligation to complete the sale.

This case provides some much-needed clarification for charitable gift planners. When a sale of property is imminent, it is often difficult to predict the tax consequences with any certainty. In its last case on this point, *Ferguson v. Commissioner*, 174 F3rd 997 (9th Cir., 1999), the Tax Court held against a donor on grounds the gain on contributed stock had "ripened" before the transfer. The *Rauenhorst* case provides a "bright line" test that helps clarify when a gift is too late to transfer the tax burden on sale of the gift property – if the donee is legally bound to go through with the sale, it is too late. For planners, one lesson is the importance of having stock transfers reflected on the books of the issuing corporation without delay.

E. "I Skipped School; Therefore I Shouldn't Have To Pay Estate Tax"

Estate of Earl C. Koester v. Comm'r, No. 02-71663 (9th Cir., 2/19/03), affirming TC Memo 2002-82 (3/28/02). The Koesters' wills, which were prepared by an attorney, failed to make use of the Unified Credit Amount available to the first-to-die spouse. As a result, all of their assets were taxed in the estate of the second-to-die (Mr. Koester), resulting in a taxable estate. The executors of Mr. Koester's estate argued that the Koesters' lack of education left them unaware of the intricacies of the estate tax law and the complexity of the tax code deprived them, as members of a class of less educated citizens, of their right to equal protection of the law. Thus, argued the estate, they should not be subject to estate tax. The Tax Court found the estate's arguments to be "misguided", and ruled for the IRS; the Ninth Circuit recently affirmed.
Had the estate prevailed, everyone short of a "full time" tax professional would be able to avoid estate tax.

F. Supreme Court Upholds Fraud Action Against Charitable Solicitor

In *State ex rel. Madigan v. Telemarketing Associates, Inc.*, a charitable organization called VietNow hired a professional fundraising firm named Telemarketing Associates to solicit donations to benefit needy Viet Nam veterans. The contracts between those parties provided, among other things, that Telemarketers would retain 85 percent of the gross receipts from Illinois donors, leaving 15 percent for VietNow. The campaign was effective, raising approximately $7.1 million between 1987 and 1995, of which a little more than $6 million was retained by Telemarketers and about $1.1 million went to VietNow.

The Illinois Attorney General challenged this in court, alleging that Telemarketers falsely told prospective donors that a significant amount of each dollar donated would be paid over to VietNow for its charitable endeavors, and that this represented fraud. The trial court dismissed the fraud claims on First Amendment grounds, and this was upheld on appeal by two State appellate courts.

The U.S. Supreme Court held that the State of Illinois could maintain an action alleging fraud when fundraisers deceive potential donors about how much of a contribution goes to further charitable purposes. Earlier Supreme Court decisions had held that high fundraising costs or failure to disclose the terms of fundraising contracts didn't constitute fraud per se, and struck down state limitations imposing a limitation on fundraising expenses. Nevertheless, the Court concluded, "when nondisclosure is accompanied by intentionally misleading statements designed to deceive the listener, the First Amendment leaves room for a fraud claim." On this basis, the Court sent the case back to Illinois for further proceedings.

G. No Scholarships Allowed From Trust for Student Loans; Cy Pres Denied

In re R.B. Plummer Memorial Loan Fund Trust, 266 Neb. 1 (Neb. 05/23/2003). C.R. Wiese, and Ralph Ballard Plummer died many years ago, and under his will each left the University of Nebraska Foundation a trust to be used for student loans. In 2001, the Foundation went to court seeking permission to use the funds in these trusts for scholarship assistance. The Foundation alleged that because of changes in the financial aid arena, students were reluctant to pursue loans from multiple sources because federal loans are available at competitive rates. As a result, portions of the income from these trusts were left unused each year.

The facts as of the end of 2001 bore this out — the Wiese Trust had a market value of $2,629,687, with an income balance of $249,443 that was not used for loans, and it had distributed only $10,630 in new loans. The Plummer Trust had a market value of $848,134, with an income balance of $633,196 that was not used for loans, and it had distributed $13,650 in new loans.

To rectify this situation, The Foundation asked the court to apply the doctrines of cy pres or deviation to allow it to give the annual unused income from the funds to students in the form of scholarships. The trial court determined that the continued use of the trusts for loans was neither impossible nor impracticable, so that cy pres and deviation were not appropriate; it denied the Foundation's requests to revise the trusts to allow them to distribute scholarships.

On appeal, the Nebraska Supreme Court affirmed the lower court and held that these trusts had to follow the donors' directions and offer loans rather than scholarships. [In re R.B. Plummer Memorial Loan Fund Trust, 266 Neb. 1 (Neb. 05/23/2003).] The doctrine of cy pres is a principle of construction based on a judicial finding of the donor's intention as applied to new conditions. It may not be applied to defeat the donor's intention. However, where the stated purpose cannot be accomplished because of changed conditions, and a more general charitable purpose is shown by the will, the cy pres doctrine may be resorted to, not to defeat the donor's intention, but to effectuate it. Here, the court found that the ultimate purposes of the trusts had not become impossible, impracticable, or illegal. There might well be a greater need for scholarships than for loans, but the court's function is to probate wills and not to write them. As a result, the doctrine of cy pres was not applicable.

Likewise, the doctrine of deviation was also not available to change these trusts. Deviation is another equitable principle applicable to charitable trusts. It is applicable to make changes in how a charitable trust is administered, while cy pres is used where a change of the settlor's specific charitable purpose is involved. Courts apply the deviation doctrine to allow trustees to deviate from the mechanical administration of the trust where circumstances not known or foreseen by the testator have come about, and where such change in circumstances in combination with the administrative means provided in the trust would defeat or substantially impair the accomplishment of the intended trust purpose. In this case, however, the Foundation sought to change the ultimate purposes of the trusts by allowing them to provide scholarships. Because this was an attempt to change the ultimate purposes of the trusts, the doctrine of deviation was also inapplicable.

H. Boat Contribution Torpedoed, Penalties Applied

Gabe W. Stewart Jr., et ux. v. Commissioner; T.C. Summary Opinion 2003-101. On their 1996 tax return, Gabe and Doris Stewart claimed two charitable contributions deductions for property gifts. They made a bargain sale to a church (selling real estate worth $200,000 for a price of $100,000), and contributed a 14-year-old motorboat they claimed was worth $10,000 to the Salvation Army. They had a letter from their real estate manager valuing the real estate at "$185,000 to $200.000," but did not get an appraisal for the boat. The Salvation Army did have the boat appraised. Their appraiser found that the boat had sunk at some point and had other problems, including a rotten transom, rusty cables, and a locked-up motor – he valued it at $500, and the Salvation Army later sold it for that amount.

At trial, the IRS and the Stewarts agreed on a value of $183,000 for the real estate sold to the church, and a deduction of $83,000 ($183,000 fair market value less the $100,000 sales price). As for the boat, however, the court accepted the IRS value of $500. That left the one remaining question of what penalties were due. For noncash charitable contributions of the sort made by the Stewarts, the Regulations provide specific record keeping and return requirements. The Tax Court summarized its view as follows — "While strict compliance with the record keeping and return requirements is not necessary, we have required that taxpayers must substantially comply with the regulation in order to claim the deduction for a charitable contribution." As for the Stewarts, they failed to comply or substantially comply, with those requirements for either the contribution of the real estate or the boat, in that they didn't get an appraisal for either deduction. For the real estate gift, however, they did rely upon the advice of their tax return preparer, but they claimed the boat contribution on their own, with no advice. The Tax Court concluded that the accuracy-related penalty of Code Sec. 6662 applied to the boat contribution, but not the real estate.

The court didn't state what the precise amount of the penalty would be, leaving this to further proceedings. The basic penalty of Code Sec. 6662 is twenty percent of the underpayment for a substantial valuation understatement. However, for a "gross valuation misstatement," where the claimed value is 400 percent of more of the correct value, the penalty doubles to forty percent. Since the Stewarts claimed a deduction of $10,000 for a boat found to be worth only $500, the larger penalty would seem to apply. It doesn't pay to exaggerate values!

III. Treasury and the IRS

Revenue Rulings and Procedures

A. IRS on Patent Transfers: Some Guidance, But We're Watching For Valuation Abuses

In **Revenue Ruling 2003-28, 2003-11 IRB 1 (2/26/2003)**, the IRS has provided some general guidance on the deductibility of various charitable transfers of patents. Reports elsewhere suggest that some donors of patents may be claiming excessive values for their charitable deductions, however, and the IRS says this ruling is not its final word on patent transfers.

Rev. Rul. 2003-28 deals with three different types of transfers, and the results are no surprise to knowledgeable gift planners. In all three situations discussed, the donee was a qualified public charity (a university). In Situation 1, the donor contributed a license to use a patent, but retained the right to license the patent to others. Predictably, the IRS held the retention of this (or any other substantial right) in the transferred patent violates the partial interest rule – so, no deduction. Situation 2 involved a contribution subject to a condition that the donee university continue to employ a particular individual (an expert in the technology covered by the patent) as a faculty member during the fifteen-year remaining life of the patent. If that individual ceases to be a member of the faculty before the patent expires, the patent will revert to the donor. The patent will expire 15 years after the date of the contribution to the university. Here again, the contribution is not deductible. Why? On the date of the contribution, the likelihood that the named individual (or, presumably, anyone else) will cease to be a member of the faculty before the patent expires is not so remote as to be negligible. So there is a greater-than-negligible chance that this patent will revert to the donor. Once again, the general rules applicable to all contributions render the contribution nondeductible on its facts.

Any patent contribution exceeding $5000 in value requires a qualified appraisal, and the regulations specifically require that an appraisal include the terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor or donee relating to the use, sale, or other disposition of the property contributed, including, for example, the terms of any agreement or understanding that restricts temporarily or permanently the donee's right to use or dispose of the donated property. [See Regs. §1.170A-13(c)(3)(ii)(D).] So the result in Situation 3 of Rev. Rul. 2003-28 is easy to anticipate.

Valuations of patent transfers seems to be an emerging issue, and the Internal Revenue Service has expressed an interest in this area. A report in the *New York Times* published subsequent to the release of this ruling implied that this was an area of growing abuse. The "Patents" column in the *Times* of March 17, 2003 (page C-2) quotes a report from the Internet Patent News, an e-mail newsletter, reporting what the newsletter described as an alarming trend of "donating bogus patents to universities and claiming big tax deductions." The *Times* article noted the recent release of Rev. Rul. 2003-28 and quoted an IRS spokeswoman as declaring "We're not done with this issue."

Patent donors should consider themselves warned. A complete and thorough appraisal by a qualified appraiser is always important, but it may be more important here than usual. There are many comparable situations in the past where press reports of valuation abuses eventually led to IRS enforcement initiatives – used cars, boats, gemstones and art works, to name just a few.

B. Some Help From IRS On Foundation Terminations

Background

The Internal Revenue Code imposes a number of restrictions and limitations on private foundations. It is basic human nature to avoid unpleasantness, and as a result many families seek to escape the foundation rules. Unfortunately, Congress tried to discourage such escapes by imposing an onerous tax under Code Sec. 507 on a foundation that undergoes a "termination" of its status as a private foundation for tax purposes. That tax could amount to as much as 100% of the foundation's assets, so it is something to be avoided if at all possible. As with most tax statutes, there are exceptions that create a right way and a wrong way to do this. These exceptions are the heart of the matter for planners seeking either to close down a private foundation or to change it into a public charity.

The Code provides (in Sec. 507(b)) two specific ways for a foundation to terminate its status, and thus escape all the burdens of private foundation status, without encountering the termination tax: (1) the foundation may transfer all of its net assets to a public charity that has been classified as a public charity for the past five years; or (2) it may transform itself into a public charity and operate as such for a period of five years. In addition, Code Sec. 507(b)(2) provides another route for a foundation that is ready to wind up its operations — it may transfer its assets to another foundation in a merger, liquidation or similar transaction; if this is done, the transferee is not treated as a new entity, but rather is deemed for tax purposes to be a continuation of the transferor.

Foundations seeking to wind up operations without incurring the dreaded termination tax must use one or another of these rules. Because of the severity of that tax, many foundations in this position have sought the protection and security of private letter rulings from the IRS National Office. The number of rulings requested on this issue became so great in recent years that it began to overload IRS rulings personnel. As a result, the IRS decided it would have to take steps to reduce the need for these rulings.

The IRS Responds

Initially, last May IRS issued **Revenue Ruling 2002-28, 2002-20 IRB 941**, which provided important additional guidance on foundation-to-foundation situations. It dealt with three common situations — one foundation that splits into two new ones to settle a family feud, a foundation in trust form that changes to a nonprofit corporation, and two foundations that merge into a third, newly-formed foundation. Rev. Rul. 2002-28 held that none of these transfers would cause a "termination" of the transferor foundations' private foundation status for tax purposes *unless* it voluntarily notified IRS of its intention to terminate. Thus that ruling carefully distinguished between a "termination" under Code Sec. 507 and other events that end a foundation's legal existence without effecting such a termination. However, it failed to address some other important questions regarding foundation terminations, especially those arising where foundations wind up their operations by transferring their assets to public charities, rather than to other private foundations.

Now, the Internal Revenue Service has issued another ruling, **Revenue Ruling 2003-13, 2003-4 IRB 1**, describing the tax consequences produced when a private foundation transfers all of its assets to a public charity. The new ruling confirms that this situation will generally avoid the termination tax, even if the public charity that receives the foundations's assets *lacks* a five-year history. The ruling also states that the recipient public charity may be a supporting organization (described in Code Sec. 509(a)(3)) or a section 509(a)(2) organization; this might come as a surprise to seasoned readers of the Internal Revenue Code, for the literal language of Code Sec. 507 refers only to public charities of the sort described in Code Sec. 509(a)(1). This ruling lays out a blueprint for making such distributions without incurring the termination tax.

These can be important clarifications for a family that has simply lost interest in the family foundation, or has found that the expense and bother of running a grants program and filing tax returns and other reports has become more than it wants to deal with. For example, a foundation in this position may now safely transfer its remaining assets to a donor-advised fund and thereby greatly reduce the aggravations it faces. Some national donor-advised funds have been around for fewer than five years, but the ruling indicates that even such a fund can be the recipient of the foundation's assets. Alternatively, the family may create a supporting organization for a favorite charity (or use an existing supporting organization) for this purpose.

This approach may offer advantages over simply giving the foundation's assets to that charity, for it can provide the family greater assurance that those assets will be used as intended and not just added to the general funds of the charity. Before Revenue Ruling 2003-13, many planners would have advised that either of these transfers might be inappropriate for this purpose.

IV. Private Letter Rulings

A. Can You Change a CRT's Valuation Date?

PLR 200233005 – This is another example of scrivener's error. Although the donors asked the attorney to include a January 1st valuation date in their CRT, the attorney provided for valuations to be made on the last day of the year. The donors asked the IRS to rule that amending the trust *ab initio* (from date of creation) to provide for a January 1st valuation date would not disqualify the trust, constitute self-dealing, or reduce their income tax deduction. The IRS complied, provided that that the donors secure a court order determining that there had been a scrivener's error and, if the trust valuations were different on the first and last days of the years in which the trust had been in existence, that the resulting overpayments or underpayments be made to correct the unitrust amounts. This is another example of a CRT provision which is not generally amendable, but which apparently can be reformed *ab initio* if the IRS is convinced attorney error was involved.

B. Shades of A Space Odyssey: CRT Reformers Say, "The Computer Did It!"

LR 200251010. Here, the IRS allowed for the correction of what would appear to be a hard mistake to miss. A donor wanted a charitable remainder unitrust, but the document that was drafted turned out to be a charitable remainder annuity trust. Given that many charitable remainder annuity trusts pay a stated "percentage of the initial net fair market value of the trust," while unitrusts pay a stated "percentage of the fair market value of the trust assets determined annually," it is conceivable that a person unfamiliar with these documents might have a mistaken understanding of what is being signed. In this case a computer (an automated trust drafting program) incorrectly described the terms of the trust. The IRS ruled that the judicial reformation would not disqualify the trust.

One of the challenging aspects of correcting a trust under this policy is documenting that a mistake was made rather than the taxpayer deciding in hindsight that a different structure of the trust is more desirable. The most straightforward way to document the mistake is to obtain a declaration by the drafting attorney acknowledging that a mistake was made. For obvious reasons, the drafting attorney may be reluctant to state in writing that he or she made a mistake. The IRS has accepted the declarations of other parties involved with the planning or administration of the trust to document the existence of a mistake and has even accepted the statement of the taxpayer that a mistake was made. The IRS' policy of allowing the correction of drafting mistakes is helpful in filling a gap left by the reformation legislation. (No word in this ruling on whether the computer and the "advisor" who inputted the data 'fessed up in court!)

C. Bequests of Retirement Plans

PLR 200234019 – The decedent's retirement plan accounts named his estate as the beneficiary, and his will left a percentage of the residue to charity and a percentage to individuals. Fortunately, the will allowed the executor to distribute assets among beneficiaries on a non pro-rata basis. The executor thus proposed to: allocate the retirement plans to the charities and not to the individuals; and to do so by assigning the estate's interests in the plans to the charities before the plans paid out. The IRS ruled that such an assignment would cause the IRD (income in respect of a decedent) inherent in the plans to be recognized by the charities on receipt of the plan distributions, not the estate. The executor was lucky: it can be hard to convince the plan administrator to accept the "assignment;" often they want to pay the distribution to the estate pursuant to the beneficiary designation. In such a case, the estate clearly does recognize the IRD, and the argument shifts to trying to take an income tax charitable deduction under IRC section 642(c). A better approach is to name the charities as beneficiaries on the plan beneficiary form (see PLR 200230018 discussed next).

D. CRUT Can Make Distributions To Trust For Beneficiary

LR 200240012 – An individual (we'll call her "A") has been adjudicated as an incapacitated person by the courts in two different states. Bank B is serving as guardian of A's estate and as trustee of a trust created for her benefit. That trust was created by a court order to protect A's assets, and requires income and principal to be used for A's benefit. For tax purposes, A is treated as the owner of the trust. Now, as part of court-approved estate planning for A, Bank B plans to establish a charitable remainder unitrust ("CRUT") for A. The CRUT will be funded with assets distributed from the existing trust to A's estate in guardianship. Current unitrust distributions from this CRUT will be paid for A's life to the existing trust for A's benefit. On A's death, the remaining assets in the CRUT will be distributed to a qualified charitable organization.

On these facts, the Internal Revenue Service held that the proposed CRUT will be a qualified charitable remainder trust for federal tax purposes. Although CRT distributions are generally required to be distributed to the individual beneficiary of the trust, the IRS issued a ruling last year (Revenue Ruling 2002-20, 2002-17 IRB 794) permitting distributions to a separate trust for the benefit of the individual beneficiary where he or she is a "financially disabled" person. Thus, the IRS apparently found that on these facts A is financially disabled. Accordingly, A will be entitled to an income tax charitable deduction for the creation of the trust.

This ruling is in line with the position announced by IRS in Rev. Rul. 2002-20. Previously, the published IRS view was that a CRT could make distributions to a separate trust for the CRT beneficiary only where that beneficiary was "incompetent." The change to permit this for any "financially disabled" beneficiary was a constructive step, since there are many situations where a beneficiary is clearly in need of protection but either the beneficiary or the family is reluctant to have the incompetency label attach. However, the new standard – financial disability – leaves open a number of questions. Presumably some of those questions will be resolved by future rulings. This ruling actually sheds little light, since the beneficiary here seems clearly to have met either the old standard or the new one. [After all, A was declared incapacitated by court orders in not just one but two states!] Watch for future developments in this area.

E. Estate Tax Charitable Deduction Denied For Settlement Proceeds Paid To Charity

In **Private Letter Ruling No. 200306002**, the Internal Revenue Service denied an estate's charitable deduction for an amount paid to a charity to settle litigation brought by the charity to contest the probate of a will providing it with no bequest. Decedent D had executed seven wills and one codicil over a thirty-five year period. In each of the wills, D expressly revoked all prior wills and codicils. Only the first of these wills ("the First Will") named Charity X as a beneficiary. When D died, his will left two specific bequests, established a trust for two individual beneficiaries, and left the remainder of his estate to one of those individuals. D's two sisters died before him.

When this will was presented for probate, his nieces and nephews and Charity X commenced an action contesting probate of the will. After a jury was selected for trial of this dispute, the parties settled the case by reducing the amounts payable to the individual beneficiaries and paying this amount to D's nieces and nephews, and Charity X in settlement of their claims.

The IRS noted that the appropriate inquiry in determining whether an amount paid to a charity pursuant to the settlement of a will contest is deductible for estate tax purposes, is whether the interest in issue reaches the charity pursuant to correctly interpreted and applied state law, regardless of whether the payment to the charity resulted from a good faith adversary proceeding. Here, Charity X was named as a beneficiary in D's First Will, which was executed thirty-five years earlier, but in none of the six subsequent wills or the codicil. It could not recover anything in court without proving, at a minimum, that the First Will was the appropriate one to probate, that it was valid, and that none of the subsequent wills revoked it. After reviewing the applicable state law, IRS concluded that there was little possibility that a State court would admit the First Will for probate. Accordingly, it concluded that Charity X had no recognizable, enforceable rights in D's estate under State law. The estate tax charitable deduction was thus denied.

F. Is a Transfer of Restricted Stock to a CRUT An Assignment of Income?

LR 200321010. A retired corporate officer participates in an executive stock purchase plan, and entered into several different stock restriction agreements in connection with purchases of stock under the plan, which give the corporation an exclusive option to buy the shares if the officer wants to transfer the shares, as well as the method and timing of the corporation's exercise of its option.

The officer wishes to establish a CRUT and transfer a portion of the corporate stock that he purchased under the plan to the CRUT. The transferred stock will remain subject to the terms of the stock restriction agreements under the plan. Whenever the trustee of the CRUT wants to sell or dispose of the stock, the corporation will have the right to purchase the stock for the price under the stock agreements.

The IRS looked to Palmer v. Commissioner, 62 T.C. 684 (1974), aff'd on other grounds, 523 F.2d 1308 (8th Cir. 1975), acq., 1978-1 C.B.2. The IRS noted that the test was whether the CRUT was legally bound or could be compelled by the corporation to surrender the stock for redemption at the time of the donation. Here, it determined that the corporation had a right of first refusal, but the CRUT was not legally bound and could not be compelled by the corporation to surrender the stock at the time of donation. Therefore, the transfer of corporation stock by the officer to the CRUT, followed by any subsequent redemption of the stock by the corporation, would not, upon the corporation's subsequent purchase, be re-characterized for federal income tax purposes as a redemption of stock followed by a contribution of the redemption proceeds to the CRUT. The IRS concluded that any redemption proceeds or sales proceeds received by the CRUT for the stock will not be treated as taxable income to the officer.

The Palmer precedent continues to be revisited and refined, both in the courts and in rulings by the IRS. This is, at least in recent years, one of the rare occasions when the IRS aligned itself favorably with the taxpayer (except for transactions essentially identical to the facts in Palmer). This is a not-uncommon fact situation, and the guidance is welcome news.

G. Borrowing Will Not Result in Unrelated Debt-Financed Income: IRS Concludes "Acquisition Indebtedness" Must Be "Indebtedness Related to Acquisition Or Improvement of Property"

LR 200320027. A charity invested in a common trust fund, made up of securities, under Code Sec. 584. To finance redemptions and to avoid having to make a large number of sales to eliminate shortfalls, a line of credit was established with a lender. The line of credit is to be used exclusively to finance redemptions, not to make additional investments. It is available only to bridge the period between distributions of cash in redeeming units, and the settlement date for securities sold to fund the redemption. The charity feels that the line of credit will be used infrequently.

The common trust fund's activity is conducted only to produce income, and would yield unrelated business taxable income to the charity, unless an exception applies. Code Secs. 512(b)(1) and (5) generally accept dividends, interest and capital gains from unrelated business taxable income. However, Code Sec. 512(b)(4) treats a certain percentage of such income as unrelated business taxable income if it is derived from debt-financed property. The charity's holding in the common trust fund is debt-financed property if there is acquisition indebtedness with respect to the fund at any time during the taxable year. So, the question becomes whether borrowing under the line of credit used to finance more orderly redemptions will be acquisition indebtedness under Code Sec. 514(c)(1).

The IRS determined that there did not appear to be any close connection between the debt and the acquisition or improvement of any property. So, it ruled that borrowing by a fund under a line of credit to facilitate redemption of units does not lead to unrelated debt financed income to a charity that invested in the fund, nor does it create any acquisition indebtedness for the charity.

H. CRT Winds Up Early – No Problem

LR 200324035. The Internal Revenue Service has issued yet another ruling confirming parties to a charitable remainder trust may terminate the trust early, with the charitable and noncharitable beneficiaries dividing the trust assets. Here, a charitable remainder unitrust (CRUT) provided for distributions for life to the donor, and thereafter for 20 years the unitrust amount is divided into shares and distributed among four of the donor's family members. On the earlier of the 20th anniversary of the death of the donor or the death of the last of the beneficiaries, the trust will terminate and distribute its remaining property to two charities. The donor died, leaving a will that terminated the interest of two of the successor beneficiaries, leaving two (we'll call them A and B) as the only noncharitable beneficiaries.

Now the parties (A, B, the two charities and the bank trustee) have agreed to terminate the trust. The trustee will determine the actuarial value of the of the two beneficiaries' income interests and the remainder interests of the charities under Code Sec. 7520, then distribute trust assets equal to such values to the beneficiaries. The distributions will be made in lump sums equal to the respective value of the various interests as of the date of termination. Such values will be determined using the discount rate in effect under Code Sec. 7520 on the termination date and using the methodology under Regulations §1.664-4 for valuing interests in CRUTs. Any distribution of assets in kind will be made in a pro rata manner.

On these facts, the IRS held that the termination of the trust will not be an act of self-dealing under Code Sec. 4941 and that the foundation termination tax under section 507(c) would likewise not apply. It based this conclusion on a number of preconditions: (1) state law allows the early termination; (2) all beneficiaries favor the early termination; (3) the trustees will use the regulations' formula for determining the present values of the income and remainder interests in a charitable remainder trust; (4) the income beneficiaries' physicians conducted examinations of the income beneficiaries and stated under penalty of perjury that they find no medical conditions expected to result in shorter-than-average longevity (under §§ 1.72-9); (5) the income beneficiaries have signed similar statements; and (6) any distribution of assets in kind will be made in a pro-rata manner. IRS stressed the fact that the proposed early termination would not result in a greater allocation of Trust assets to the income beneficiaries, to the detriment of the charitable remainder beneficiaries, than a non-early termination and was not discretionary with the Trustees.

The IRS concluded that the life income beneficiaries will be selling their interests in the Trust to the remaindermen in the proposed termination transaction. Accordingly, they will be taxed at capital gains rates on the amounts they receive in exchange for their interests in the CRT, but their basis is disregarded under Code Sec. 1001(e), which governs the sale of a partial interest in a trust. Thus, the full proceeds will be subject to tax.

One thing should be noted about this ruling. Although the holdings related partly to exempt organization issues (self-dealing and the foundation termination tax), the ruling was not issued by the IRS Exempt Organizations Division, the unit that normally has jurisdiction over such issues. Rather, it came from the "Passthroughs and Special Industries" unit, which is responsible for estate tax and trust issues. A similar earlier ruling, likewise emanating from the Passthroughs and Special Industries unit, reached largely identical conclusions on a similar termination where the charitable remainder beneficiary was a private foundation. See LR 200314021 in this outline. So what, you say? Well, both rulings characterized the termination as a sale by the life income beneficiaries of their interests in the trusts to the charitable remaindermen. In each case, the holding was that this sale did not give rise to an act of self-dealing. But such a sale by a disqualified person to a private foundation is necessarily a violation of the self-dealing rules. Thus, the earlier ruling seems wrong unless there are additional facts that do not appear. Under the standard rules, the taxpayer who received the ruling may depend upon it, even if it is wrong — but the rest of us cannot. The moral of this story is to proceed with caution if you plan to structure such an early termination of a CRT with a private foundation as its charitable beneficiary. You would be well advised to get your own ruling – and good luck if you try!

I. Cashing Out of Your CRT Early

PLRs 200310024 and 200314021 – The IRS has issued two more rulings in which the taxpayer proposes to terminate his CRT in exchange for a lump sum payment equal to the value of the remaining income interest. In PLR 200310024, "G" (the donor - income beneficiary) of a 5% net-income CRUT proposes to "sell" a portion of his income interest to the public charity designated as the remainder beneficiary, triggering a partial termination of the trust. The IRS ruled that: (a) despite the partial termination, the trust would continue to qualify as a CRT; (b) G has a zero basis in his interest, so that the entire amount received would be recognized as taxable gain; and (c) because the amount to be received by G would be due solely to his income interest in the trust, the sale would not be an act of self-dealing. In PLR 200314021, the taxpayer proposes to terminate a 12% CRUT pursuant to a court order, and distribute the trust assets in accordance with the present value of the income and remainder beneficiaries' respective interests. The remainder beneficiary is the taxpayer's private foundation. Again, the IRS ruled that the taxpayer has no basis in his income interest, and that there would be no self-dealing.

It is interesting how different the rulings are, despite addressing essentially the same fact pattern. The taxpayer in the second ruling had to get a physical exam and sign an affidavit attesting to his life expectancy; there were no such facts presented in the first ruling. The taxpayer in the second ruling represented that he would get a court order, and give notice of the hearing to both the state Attorney General and Secretary of State; there is no discussion of a court proceeding or notice in the first ruling. The second ruling has at least a page of discussion on the basis issue; the first ruling disposes of the issue in two sentences.

It is also interesting what was not discussed. There was no discussion of how the income beneficiary's interest was valued, whether the net-income feature of the trust in the first ruling was taken into account (what if the trust had only been earning 2% for the last several years?), or whether an appraisal was required. Also, in the second ruling, the remainder beneficiary was the taxpayer's private foundation. If the IRS really views this type of transaction as a sale of the income interest to the remainder beneficiary, why wasn't the sale an act of self-dealing? The payment of the present value of the income interest as a lump sum isn't self-dealing between the beneficiary and *the CRT* because the payment of the unitrust interest is specifically excluded from self-dealing under Reg. section 53.4947-1(c)(2)(i); however, that exception doesn't necessarily cover the sale of that interest by the beneficiary to *the private foundation.*

J. Purchase of a CGA With an IRA

PLR 200230018 – We have seen a number of rulings in which a decedent directed his/her IRA to a CRT for the benefit of family members or friends. In this ruling, the decedent will name the charity as his IRA beneficiary, and execute a CGA agreement with the charity, to be effective and funded at death, for the benefit of the family member or friend. The annuity amount will, of course, be dependent upon the actual funds received by the charity, the annuitant's age at that time, and the then-effective gift annuity rates. The IRS issued several helpful rulings. First, while the IRA value will be included in the decedent's taxable estate, the estate will be entitled to a charitable deduction for the value of the charitable portion of the CGA. Second, because the CGA will qualify under IRC section 514(c)(5), the charity will not recognize UBI and the transaction will not invalidate the charity's exempt status. Third, the IRD inherent in the IRA will be recognized by the charity, not the decedent's estate. The IRS did not address, however (presumably because they weren't asked), what the tax consequences to the annuitant would be. For example, will any portion of the payments be tax-free?

K. Early Termination of a CLT

PLR 20025045 – In this ruling, the IRS ruled that the early termination of a CLT, when the charity was to receive an undiscounted lump sum payment of its income interest, would not violate the self-dealing rules or trigger the termination tax of IRC section 507. This can be a useful idea if your CLT (like the trust in the ruling) has grown sufficiently in value that it can afford to pay off the charitable interest and the remainder beneficiaries are getting anxious for their distribution.

L. Divide and Conquer

PLR 200229046 – The first lesson in this ruling is "be careful when you draft the tax apportionment clause" (that's the clause that directs from which assets a decedent's estate taxes are to be paid). The decedent's living trust provided that the trust would pay taxes only with respect to assets held by the trust, and his CRT (which was to continue after the decedent's death) provided that the successor income beneficiaries had to pay any taxes assessed against the CRT (as is required by Rev. Rul. 82-128). Nonetheless, a dispute arose regarding who was responsible for the estate taxes generated by the continuing CRT income interests. In settlement of the dispute, the successor beneficiaries agreed to pay the estate tax generated by their interests, but CRT was divided into three new CRTs, one of which was immediately terminated. The terminated CRT was distributed to the income beneficiary and charitable remaindermen based on their respective actuarial interests (presumably the successor beneficiaries used their distribution to pay the estate taxes). The IRS first ruled that the mere division of the CRT into three new CRTs would not cause any of the trusts to fail to qualify. Secondly, the IRS ruled that the estate was entitled to an estate tax deduction for actuarial value of the remainder interests in the three new CRTs (or, if less, the actuarial value of remainder interests in the two continuing CRTs and the actual charitable distribution from the third terminating CRT). There are at least two interesting aspects to this ruling. First, the IRS passed very quickly by the issue of terminating the third CRT and distributing the trust assets to the income and remainder beneficiaries. Two other recent PLRs addressing this issue have gone into far greater depth on self-dealing and IRC section 507 termination tax issues (see PLRs 200127023 and 200208039.) Second, the IRS went into great depth on the question of whether the trust division would constitute a taxable exchange by the beneficiaries of their interest in the initial CRT for their new interests in the three new CRTs. While the IRS ruled that it did not in this case, one wonders if the IRS might not pursue this theory whenever an income beneficiary's interest in a trust is modified; for example, the situation in PLR 200215042 discussed above (see PLR 200231011).

V. Other News

A. NY Attorney General Proposes New Rules for Nonprofit Boards

In the wake of the Enron debacle and other recent corporate abuses, Congress stepped in to tighten corporate accountability and impose strict standards on corporate directors by means of the Sarbanes-Oxley Act passed last year. Inevitably, observers speculated about the parallels between the responsibilities of corporate directors and those of nonprofit directors, with a consensus that there are significant similarities. Sarbanes-Oxley, of course, applies primarily to publicly held corporations, and has no direct application in the nonprofit world.

But maybe that will change. In a recent press release, New York Attorney General Elliot Spitzer proposed that some of the corporate reforms in the Sarbanes-Oxley Act be extended to New York nonprofit organizations. This came as part of a comprehensive attempt to beef up New York's corporate accountability laws by updating obsolete provisions on corporate abuses and closing down loopholes and exceptions in the law.

Under Spitzer's proposal, nonprofit boards would be subject to a variety of new rules, including the following:

- Officers would be required to personally sign annual reports
- Audit committees would be required to oversee accounting
- Self-dealing would be the subject of a series of new rules

New York's position as a major center of nonprofit activity means that other states are likely to watch with interest if such a sweeping new set of rules is put into place there. Whatever the outcome might be for New York nonprofits, directors and trustees of nonprofit entities anywhere would be well-advised to take careful note of their responsibilities and pay close attention to their organizations' operations. If things go wrong, the first question is more likely now than ever to be "Where were the directors?"

B. Criminal Tax Penalty For DAF Abuse

Gift planners all know that a donor/adviser to a donor advised fund ("DAF") can't legally demand a "charitable" distribution that benefits himself/herself, but what is the risk if he or she tries to do so? A federal court in California provides one possible answer – criminal tax fraud! Here's the story.

Tim Mosley is, or was, in the insurance business in San Rafael, California. In 1995 he created a "foundation" (read DAF account) with the National Heritage Foundation ("NHF"). In each of the years 1995 through 1999, he sent funds to NHF earmarked for his account there. He told his tax return preparer that these were charitable contributions and claimed deductions on his tax returns. Pursuant to his instructions (requests), NHF issued checks on his account to San Domenico Convent of San Anselmo, California. In fact, however, these were not contributions but rather paid the tuition of his children at the San Domenico Primary Day School.

After an investigation by the Department of Justice, Mosley was charged with five counts of tax evasion (under 26 USC §7201). [The information filed with US District Court for the Northern District of California also included one count of filing a false corporate return based on false business expenses on his Schedule C.] Mosley admitted all of these facts, and on December 5, 2002, he pled guilty to all of these counts; he will be sentenced on March 13, 2003. The maximum penalty on the tax fraud charges is 5 years and/or a $100,000 fine, but the actual penalty meted out is subject to the Federal Sentencing Guidelines and the discretion of the court.

While no responsible DAF would knowingly participate in a scheme of this type, the outcome here provides a useful reminder that these rules are serious limitations and not mere technicalities. This report was based on a press release issued by the U.S. Attorney's Office in San Francisco, and there is no word on what action if any was taken against the DAF itself. Such instances have sometimes been used as justification for legislation in the past, and it is obviously important that Congress not develop the idea that such abuses are commonplace.

C. Sample CRAT Forms Emerge

For some time now, planners have eagerly awaited release of revised and updated charitable remainder trust (CRT) forms from the Internal Revenue Service. Now there is good news and bad news for those planners. First the bad news. Obviously, planners are most interested in the forms for charitable remainder unitrusts (CRUTs), which are the most often used type of CRT. That popularity arises in part because the CRUT offers more choices and alternatives – net income trusts, with or without makeup, and FLIP trusts, to name just a few. Well, those various CRUT alternatives mean more work and more decisions for the IRS as it tackles the forms update project. As a result, the powers that be decided to divide the forms project into two separate projects – a set of charitable remainder annuity trust (CRAT) forms that will proceed separately, and a more complex CRUT project that will take a bit longer due to the extra variables presented.

Now the good news. The IRS CRAT project team has completed its review process and the new forms have been released. The project resulted in eight separate Revenue Procedures, Rev. Procs. 2003-53 through 2003-60, each setting forth a complete sample trust instrument for one of eight different types of CRAT. Thus, the new forms follow the approach of the superseded samples, released in 1989 and 1990, rather than the first forms released in 1972.

The original forms from 1972 offered a number of alternative choices for various choices in drafting a CRT, so that a user had to piece together a trust instrument from all the choices available. The 1989 and 1990 updates took a more practical approach, with several separate Revenue Procedures, each setting forth a complete sample form. The 2003 CRAT forms follow the 1989-90 approach, making them simpler and easier for drafters to use.

Treasury officials had noted that the new releases would not attempt to set forth any new law or changes in the official government position on any CRT issues. Rather, the approach here and in the eventual CRUT release will be to clarify and summarize the law as it already exists, with emphasis on drafting concerns. Various CRT issues remain to be clarified, but these won't be clarified in the sample forms. Rather, those issues will be clarified by means of traditional IRS announcements – Revenue Rulings and Private Letter Rulings, and proposed changes in the Regulations.

999200 000007 Dallas 1707849.2

TRENDS IN PLANNED GIVING

Presented at

AMERICAN COUNCIL ON GIFT ANNUITIES
Orlando, Florida
May 5, 2004

By

Robert F. Sharpe, Jr.
President
The Sharpe Group

I. Introduction.

A. Variety of trends affecting planned giving.

1. Economics.

2. Demographics.

3. Legislation.

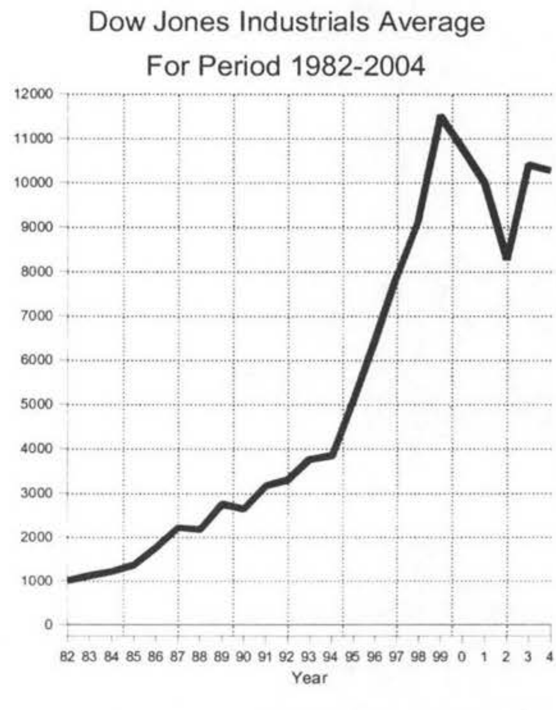
B. All are interrelated.

1. Will drive change.

2. Still time to plan and adjust.

II. Economics.

A. Fluctuating Markets.

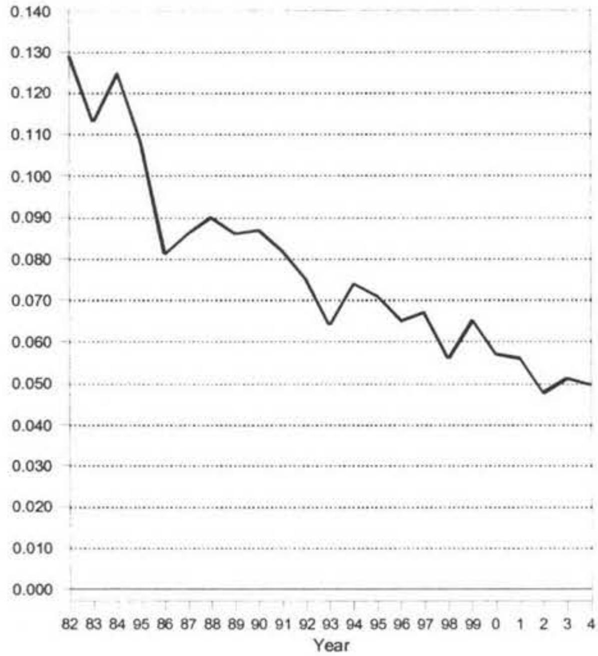


1. Uncertainty may be taking toll on charitable giving.

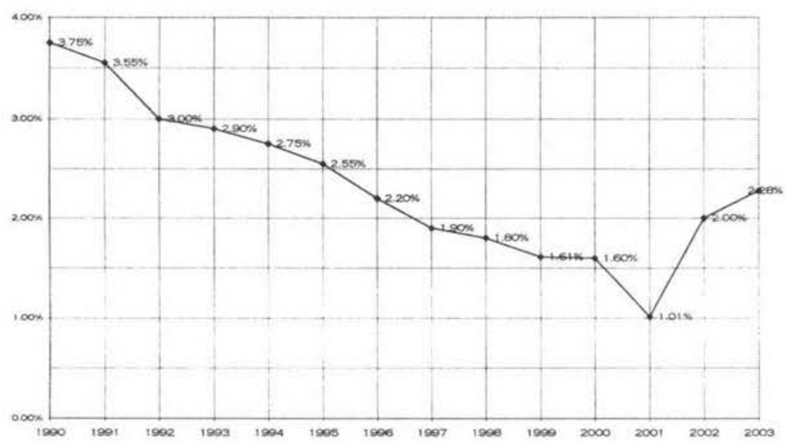
2. Many are interested in preserving wealth accumulated in the past.

B. Lower returns on investment.

Trend in Long-Term Treasury Yields
For Period 1982-2004



DOW Jones 30 Industrial Average
Average Annual Dividend Yield
1990 - 2004



1. Putting pressure on disposable income.

2. Lower taxes on dividends reduces this pressure off the wealthy.

C. Lower asset management and administrative costs.

1. Pressure on fees as gains and yields have moderated.

2. More interest in aggregating funds.

3. Effectively raising the minimum amount feasible for certain gifts.

Analysis of Minimum Trust Amount Based on Minimum Fee

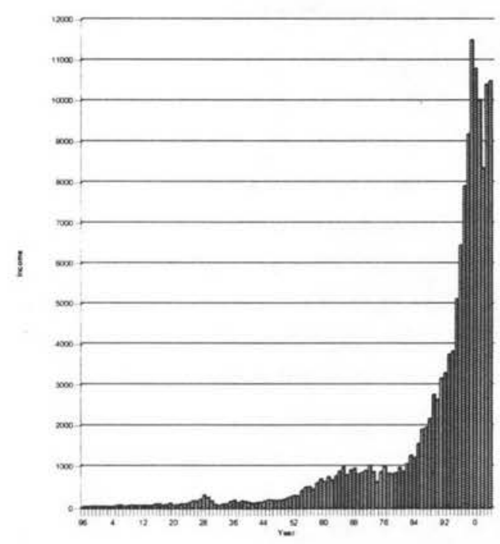
Total Return %	Percent Decline	Minimum Fee	Minimum Corpus For Fee to Be 10% of Return	Percent Increase	Amount of Total Return	Net to Distribute	Fee as % of Return	Fee As % of Corpus
15%		$10,000	**$665,000**		$99,750	$89,750	10%	1.50%
14%	-6.7%	$10,000	**$715,000**	7.5%	$100,100	$90,100	10%	1.40%
13%	-7.1%	$10,000	**$770,000**	7.7%	$100,100	$90,100	10%	1.30%
12%	-7.7%	$10,000	**$835,000**	8.4%	$100,200	$90,200	10%	1.20%
11%	-8.3%	$10,000	**$910,000**	9.0%	$100,100	$90,100	10%	1.10%
10%	-9.1%	$10,000	**$1,000,000**	9.9%	$100,000	$90,000	10%	1.00%
9%	-10.0%	$10,000	**$1,120,000**	12.0%	$100,800	$90,800	10%	0.89%
8%	-11.1%	$10,000	**$1,245,000**	11.2%	$99,600	$89,600	10%	0.80%
7%	-12.5%	$10,000	**$1,425,000**	14.5%	$99,750	$89,750	10%	0.70%
6%	-14.3%	$10,000	**$1,675,000**	17.5%	$100,500	$90,500	10%	0.60%
5%	-16.7%	$10,000	**$2,000,000**	19.4%	$100,000	$90,000	10%	0.50%

D. Increased deficits may ignite inflation.

1. This concern counteracts desire for higher fixed returns from investments.

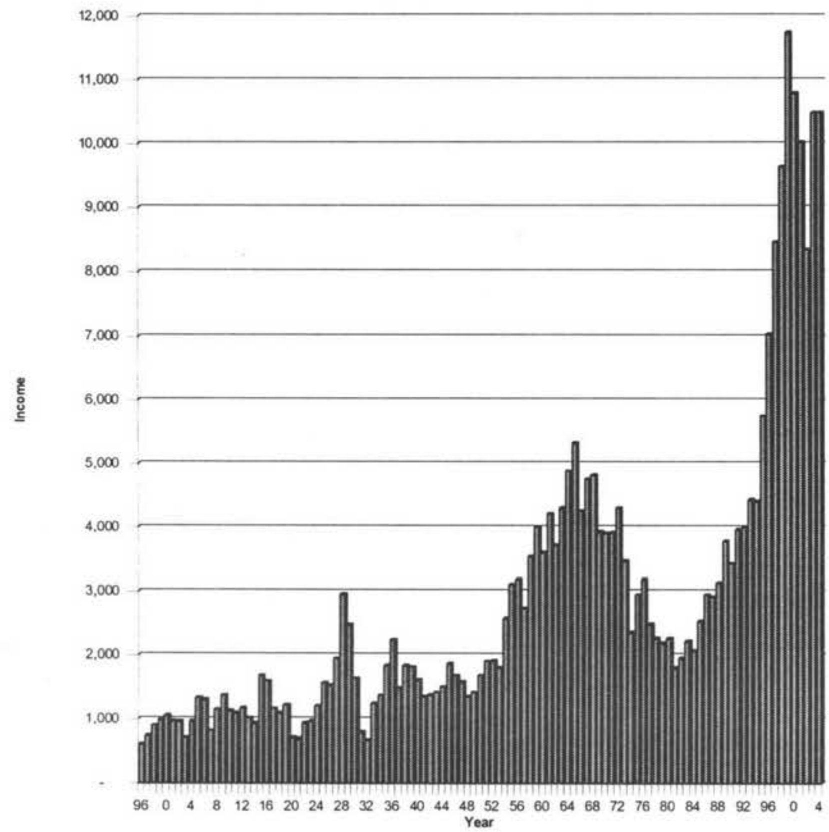
2. Note stagnation of Dow index during inflation of 1970s and 1980s.

Dow Jones Industrial Average
From 1896 to Present



3. Markets lost 60% or more of their value when adjusted for inflation.

Dow Jones Industrial Average
Inflation-Adjusted From 1896 to Present



4. Inflation may spur higher interest rates.

   a) Shifts the types of investments that are attractive.

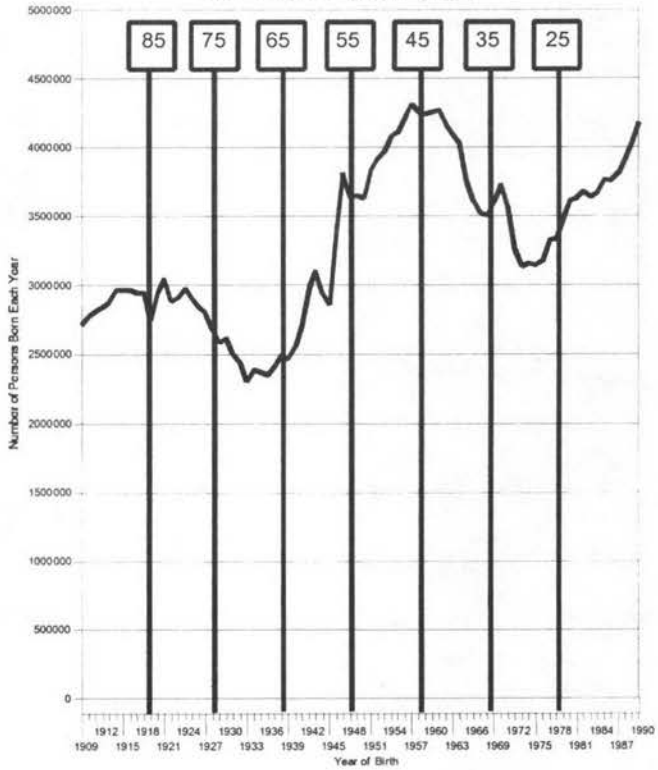
   b) Variable income investments gain favor.

III. Demographics.

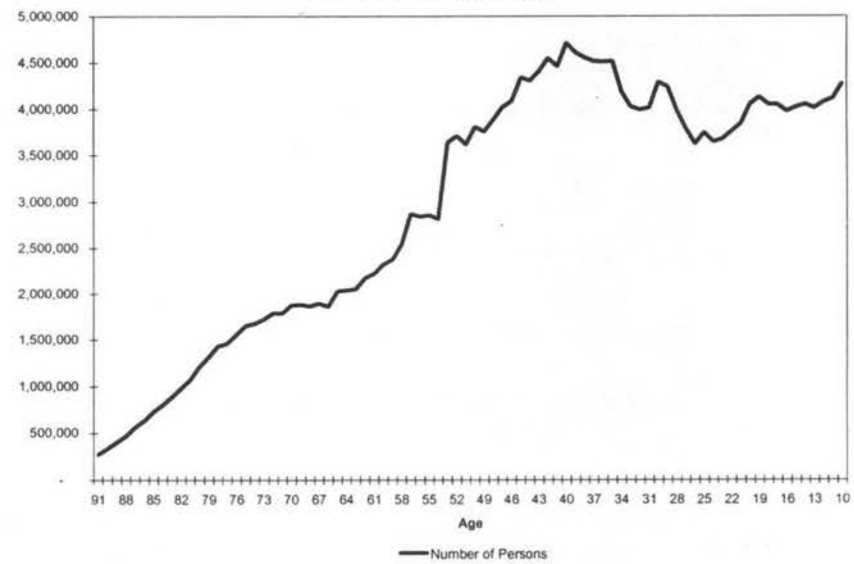
A. Population shift continues to unfold.

Number of Live Births In America

For Period 1909-1990



Number of Persons Alive Today



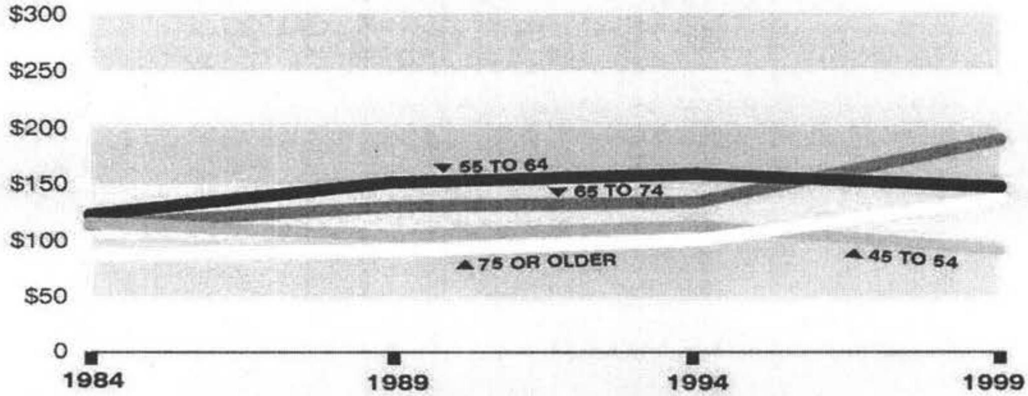
B. Donor population continues to age.

1. Traditional planned giving market may be shrinking.

2. Women make up majority.

3. Older persons control much of wealth.

Median household net worth by age of head of household, in thousands of 1999 dollars, 1984 to 1999



Note: Net worth data exclude the present value of future pension payments for persons nearing retirement.
Reference population: These data refer to the civilian noninstitutional population.
Source: Panel Study of Income Dynamics.

IV. Legislative and Regulatory Trends.

A. Tax law changes.

1. Cuts in ordinary income taxes.

2. Reductions in capital gains taxes.

3. Reductions in tax on dividends.

4. Estate tax exemptions rising and rates falling.

5. Gift tax exemption is frozen and rates are falling.

B. Impact of CARE Act.

1. On current giving.

2. On deferred gifts.

3. On bequests.

C. Changes in regulation.

1. Gift annuity regulation is eased in some states.

a) More programs registering.

b) Others continue to ignore insurance regulation.

2. More emphasis on securities laws.

3. Securities fraud charges have emerged.

4. Some are aggregating funds and increasing the importance of securities laws.

V. Implications of Trends in Environment for Gift Planning.

A. Fixed payment gifts continue to be attractive.

1. Gift annuities.

2. Charitable remainder annuity trusts.

a) Changes in tax rates for capital gains and dividends may make CRAT more attractive for some.

b) Tier structure may result in higher after-tax return than gift annuity for same amount with same payout would offer.

3. Charitable lead annuity trusts.

a) Low interest rates favor due to impact of federal discount rate.

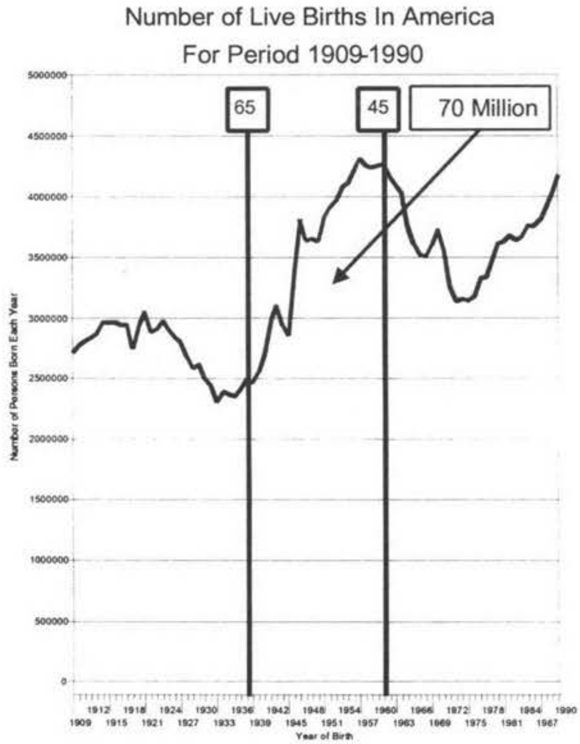
b) Inflation fears will rapidly quell interest should those concerns become greater.

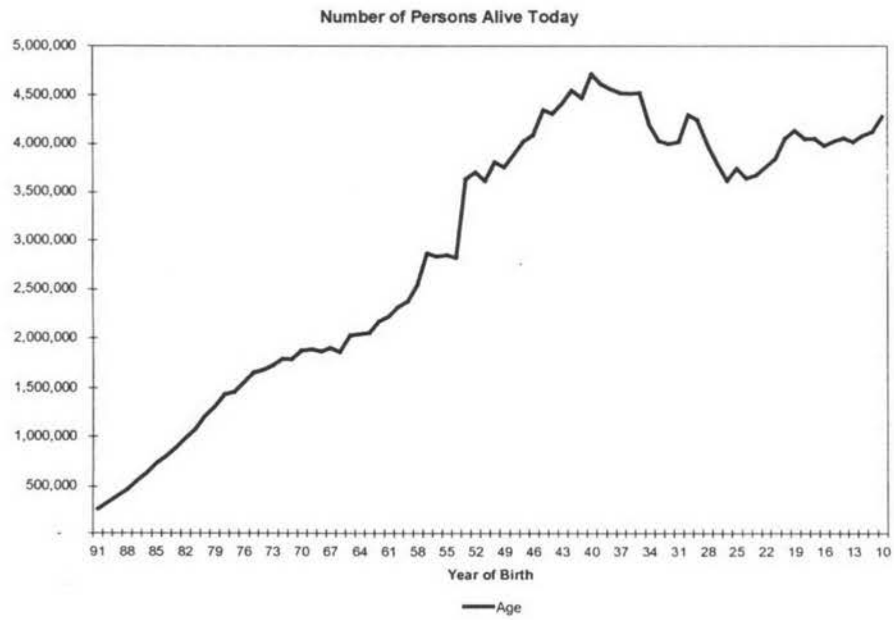
B. Variable income plans "in the wings."

1. Charitable remainder unitrusts.

2. Pooled income funds.

C. Important to be prepared to plan cost effectively for younger people.





1. Planned gifts hold appeal across age and wealth spectrum.

AGE AND WEALTH-BASED MATRIX

	-50 YOUNGER	50-70 MIDDLE-AGED	70+ OLDER
WEALTHY	A1 Gifts of Cash Appreciated Property Charitable Lead Trusts Term of Years Trusts Life Income Gifts for Others	B1 Gifts of Cash Appreciated Property Charitable Lead Trusts Term of Years Trusts Life Income Gifts for Others Deferred Gift Annuities	C1 Gifts of Cash & Property Charitable Lead Trusts Term of Years Trusts Life Income Gifts for Others CRT for Donor's Life Bequests Gift Annuities Life Insurance Beneficiary Retirement Plan Beneficiary Deferred Gift Annuities
MODERATE MEANS	A2 Gifts of Cash	B2 Gifts of Cash Appreciated Property Term of Years Trusts Charitable Trusts for Life Pooled Income Fund Deferred Gift Annuities	C2 Gifts of Cash Appreciated Property Bequests Charitable Trusts for Life Term of Years Trusts Pooled Income Funds Gift Annuities Retirement Plans & Insurance
LIMITED MEANS	A3 Gifts of Cash	B3 Gifts of Cash	C3 Gifts of Cash Bequests Gift Annuities Retirement Plans & Insurance

2. The "B1" segment will be vital source of funds over next two decades.

3. Less emphasis will be placed on "death gifts."

   a. Long life expectancies.

   b. Higher relative cost of administration.

4. More attention will be paid to gifts that produce gifts in relatively near term.

   a. Term of years remainder trusts.

   b. Term of years lead trusts.

   c. Gifts for life with intermediate income assignment.

5. Valuation of these gifts for FASB and other purposes is vital.

   a. Charitable deduction not intended to determine value to charity and often understates that value.

   b. The following table illustrates charitable deduction values at different historical dates with varying discount rates for a gift of $1,000,000 made to a charitable remainder annuity trust with a 72 year old life income beneficiary.

Discount Rate	Charitable Deduction
8.2%	$576,000
7.2%	$545,000
6.2%	$510,000
5.2%	$471,000
4.2%	$425,000

   c. Recently adopted NCPG valuation standards take an approach that is more in keeping with determining the expected value of the gift to the charitable recipient when any intervening interests have terminated. The value is based on the following:

      (1) The amount transferred.

      (2) Amount of payment.

      (3) Type of payment.

      (4) Length of deferral period.

      (5) Anticipated earnings.

      (6) Estimated expenses.

      (7) Opportunity cost while awaiting funds.

See www.ncpg.org for text of standards.

D. Lower estate taxes and other factors may lead to more "non-qualified" gifts such as bequests, remainders of retirement plans, revocable trusts, and others.

1. Tend to be more donor driven.

2. Difficult to quantify though increasingly large percentages of campaigns.

3. Important to discover donor driven gifts through marketing efforts.

4. Can be institution driven.

   a) Where revocable gifts are concerned, securities laws are paramount.

   b) Must stay in safe harbors.

5. But note that lower estate taxes may also lead to greater interest in irrevocable deferred gifts that give rise to immediate income tax savings, capital gain tax savings, asset protection and other benefits that are not available through revocable gifts.

E. Fund raising management issues.

1. Trend toward greater integration of planned and major gifts.

   a) Especially in smaller programs.

   b) Multiple factors driving this trend.

      (1) Demographics.

      (2) Economics.

      (3) Success of NCPG and others in educating advisors.

      (4) The internet.

      (5) Legislation such as CARE act and estate tax reductions.

2. More emphasis on costs/benefits.

a) Management looking to control costs.

b) Management looking to maximize income.

(1) Important to control process of valuation of gifts.

(2) Make certain that all that is left through estates is being received.

3. New Options for gift administration.

a) Bundling with endowments.

b) New providers entering field with very cost effective options.

VI. Issues in Planned Gift Marketing.

A. Important to shift more to age- and wealth-based approach.

AGE AND WEALTH-BASED MATRIX

-50 YOUNGER	50-70 MIDDLE-AGED	70+ OLDER	
A1 Gifts of Cash Appreciated Property Charitable Lead Trusts Term of Years Trusts Life Income Gifts for Others	B1 Gifts of Cash Appreciated Property Charitable Lead Trusts Term of Years Trusts Life Income Gifts for Others Deferred Gift Annuities	C1 Gifts of Cash & Property Charitable Lead Trusts Term of Years Trusts Life Income Gifts for Others CRT for Donor's Life Bequests Gift Annuities Life Insurance Beneficiary Retirement Plan Beneficiary Deferred Gift Annuities	PERSONAL VISITS SEMINARS MAIL INTERNET ARTICLES ADVERTISING
A2 Gifts of Cash	B2 Gifts of Cash Appreciated Property Term of Years Trusts Charitable Trusts for Life Pooled Income Fund Deferred Gift Annuities	C2 Gifts of Cash Appreciated Property Bequests Charitable Trusts for Life Term of Years Trusts Pooled Income Funds Gift Annuities Retirement Plans & Insurance	MAIL SEMINARS INTERNET PERSONAL VISITS ARTICLES ADVERTISING
A3 Gifts of Cash	B3 Gifts of Cash	C3 Gifts of Cash Bequests Gift Annuities Retirement Plans & Insurance	MAIL ARTICLES ADVERTISING SEMINARS PERSONAL VISITS

1. Appropriate plans will vary by age and wealth.

2. Communication means will vary as well.

B. Pros and cons of web-based communications.

1. Excellent way to reach younger persons of means.

a) Capital campaign issues.

b) Polaroid donors.

c) Lost of control an issue.

(1) With donors.

(2) With staff peers.

2. Older persons beginning to use the web more.

How Internet access changed

The percentage of each group who have Internet access. For example, reading from the first line: in 2000, 51% of all American men had access; in 2002, 60% of men had access.

	2000	2002
Men	51%	60%
Women	46	56
Race/Ethnicity*		
Whites	50%	60%
Blacks	34	45
Hispanics	43	54
Age		
18-29	69%	74%
30-49	60	67
50-64	45	52
65+	14	18

Will you ever use the Internet?

Asked of non-Internet users

	Will go online	Won't go online
All Non-users	40%	56%
Sex		
Men	46	49
Women	35	61
Age		
18-29	69	28
30-49	56	39
50-64	35	62
65+	16	79

Source: **"The Ever-Shifting Internet Population:** ***A new look at Internet access and the digital divide"*** Pew Internet and American Life Project, 2003
For full report, visit **http://www.pewinternet.org/reports/index.asp**

VII. Conclusion.

A. Planned giving is vitally important to maximizing funding for nonprofits in coming years.

1. Key is to balance benefits.

a) Donors.

b) Charities.

c) Financial service providers.

2. The traditional planned gift market is mature.

a) The number of "older" old is static.

b) Many are moving beyond active planning years.

3. New group of donors is emerging.

a) Tremendous potential.

b) Will not be business as usual.

B. More will be the same than will be different.

1. Timing of gifts will change.

2. Property used to fund gifts will shift over time.

3. Tax benefits come and go.

4. Basic motivations for charitable gifts are timeless.

About the Presenter

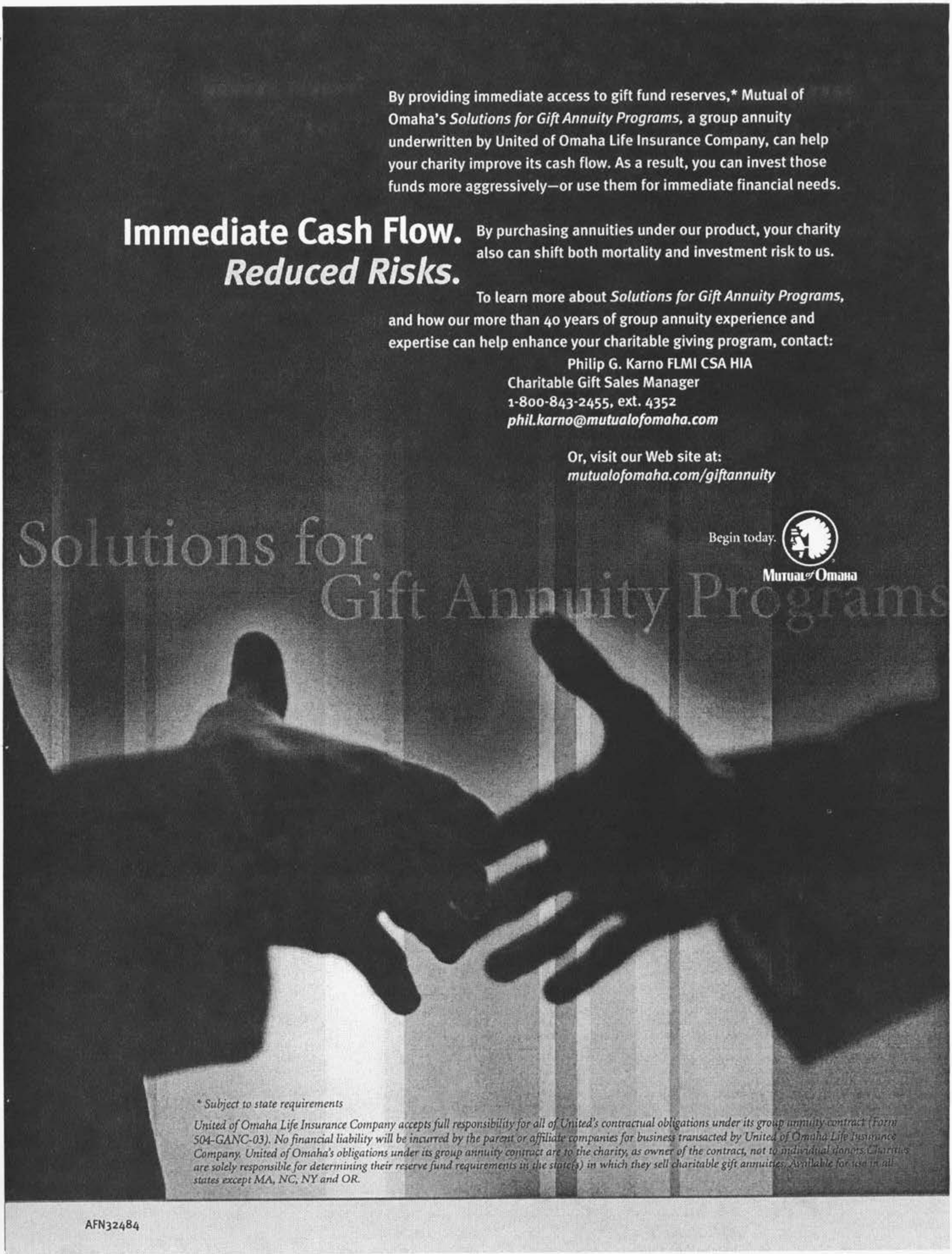
Robert F. Sharpe, Jr. is president of The Sharpe Group. A graduate of Vanderbilt University and Cornell University School of Law, he has in past years practiced law with a major law firm specializing in income, estate, and gift taxation and corporate planning.

Prior to his legal experience, he served as a development officer for a liberal arts college. He has authored many articles and other publications covering numerous gift planning topics. His remarks on this subject have been featured in the *Wall Street Journal*, *The New York Times*, *Newsweek*, *Forbes*, *Smart Money*, *CBS Market Watch*, *The Chronicle of Higher Education*, *Trusts & Estates*, *Kiplinger's* and other national publications.

The Sharpe Group consults nationwide with a number of leading health, education, social service, and religious organizations and institutions in implementing their major and planned gift development efforts. With offices in Memphis and Washington DC, The Sharpe firm has worked with over 10,000 U. S. nonprofits and many organizations and institutions worldwide during its 40 year history.

Mr. Sharpe is a frequent speaker for gatherings including Planned Giving Groups in New York, Los Angeles and other cities, the National Committee on Planned Giving National Conference, the American Bankers Association Trust Asset Management Conference, the Association of Fundraising Professionals National Conference, the Association for Healthcare Philanthropy Advanced Planned Giving Institute, Council for Advancement and Support of Education (CASE) National Conference, CASE Advanced Planned Giving Conference, the O.M.I. Non-Profit Tax Conference, and others.

Mr. Sharpe is an active volunteer and has served as a trustee of a number of arts, educational, and civic organizations.


By providing immediate access to gift fund reserves,* Mutual of Omaha's *Solutions for Gift Annuity Programs*, a group annuity underwritten by United of Omaha Life Insurance Company, can help your charity improve its cash flow. As a result, you can invest those funds more aggressively—or use them for immediate financial needs.
Immediate Cash Flow.
Reduced Risks.
By purchasing annuities under our product, your charity also can shift both mortality and investment risk to us.
To learn more about *Solutions for Gift Annuity Programs*, and how our more than 40 years of group annuity experience and expertise can help enhance your charitable giving program, contact:
Philip G. Karno FLMI CSA HIA
Charitable Gift Sales Manager
1-800-843-2455, ext. 4352
phil.karno@mutualofomaha.com
Or, visit our Web site at:
mutualofomaha.com/giftannuity
Solutions for Gift Annuity Programs
Begin today.
Mutual of Omaha
* Subject to state requirements
United of Omaha Life Insurance Company accepts full responsibility for all of United's contractual obligations under its group annuity contract (Form 504-GANC-03). No financial liability will be incurred by the parent or affiliate companies for business transacted by United of Omaha Life Insurance Company. United of Omaha's obligations under its group annuity contract are to the charity, as owner of the contract, not to individual donors. Charities are solely responsible for determining their reserve fund requirements in the state(s) in which they sell charitable gift annuities. Available for use in all states except MA, NC, NY and OR.
AFN32484

Understanding Gift Annuities

Elizabeth A.S. Brown
Assistant General Counsel
Moody Bible Institute
820 N. LaSalle
Chicago, IL 60610

I. What is a Gift Annuity?

A. Contract

B. Donor gives a certain amount of money; Charity agrees to pay fixed income for life.

C. General obligation of the Charity

1. Not dependent on charity's earnings.

2. All assets of Charity could be used to pay annuity obligation, not just the "annuity fund" or the amount of the gift.

3. Annuitants would likely stand in the same place as other unsecured creditors in the event of a bankruptcy.

D. Not a trust

1. There is no separate pool of assets supporting an individual annuity contract, or the annuity contracts in general.

2. "Annuity fund" is probably not protected from general creditors.

E. Gift

1. Emphasize gift rather than investment aspects.

2. Must have donative intent.

3. Commercial annuity rates are higher.

II. Types of Annuity Contracts

A. Single life – pays a fixed amount for one person's life.

B. Two-life – pays a fixed amount for two people's lives.

1. Joint – pays income simultaneously to the two annuitants, either jointly or in equal shares. After first death, full amount is paid to the other annuitant.

2. Successor – pays all of the income to one annuitant until his death, then to the other annuitant.

C. Immediate – begins to pay the annuity immediately.

D. Deferred – payments begin at a specified later date. Although typically the payout date is established at the time the gift is made, there seems to be some flexibility regarding changing the starting date at a later time. See P.L.R. 9743054, where the contract allowed the annuitant to elect the commencement date of the payments at any time after the annuitant reaches age 55. The deduction was based upon the earliest possible start date. Query whether the donor is entitled to a further deduction if he delays the start date.

E. Cannot have a charitable gift annuity for more than two lives.

III. Annuity Rates

A. Suggested rates established by the ACGA, based on assumptions regarding:

1. Mortality.

2. Rate of return.

3. Expense load.

4. Residuum. Since 1939, this assumption has been 50%. This means that, if Charity's earnings exactly meet assumptions, and the person dies when the actuarial tables say they're supposed to, and the expense assumption is also accurate, then at the annuitant's death the Charity will have 50% of the original gift left. In fact, many charities experience a much higher residuum than 50%. A 1999 survey of charities observed a mean residuum of 97.5%.[1]

B. Most charities follow ACGA rates. 94.6% of charities surveyed say that they either always or usually follow the ACGA rates.[2]

C. Richie v. ACGA et. al. This class action lawsuit, brought in 1995 and finally dismissed in 1999, alleged that charities following the uniform rates violated antitrust laws. The lawsuit led to legislation which specifically exempts gift annuities from antitrust laws. (See the Charitable Gift Annuity Antitrust Relief Act of 1995 and the Charitable Donation Antitrust Immunity Act of 1997.)

D. State regulation may affect rates.

---

[1] Report and Comments on the American Council of Gift Annuities 1999 Survey of Charitable Gift Annuities, presented by Frank Minton.
[2] Ibid.

E. IRS requires a minimum 10% gift. On occasion, the ACGA rates may not qualify.

F. Charity individuation. May use higher or lower rates. May have age limits. But there are several reasons for a charity NOT to exceed the ACGA rates:

1. Risk is minimized.

2. More money will remain for charitable work.

3. Charity does not need to hire an actuary and develop its own rate schedule.

4. ACGA rates have credibility with state insurance departments.

5. Focus on the "gift" rather than the "investment" aspects of the annuity.

G. Ongoing study of methodology for calculation of rates.

IV. Tax effects of gift annuities.

A. Income Tax

1. Charitable deduction. Reg. §1.170A-1(d)(1): "In the case of an annuity...purchased from an organization described in section 170(c), there shall be allowed as a deduction the excess of the amount paid over the value at the time of purchase of the annuity...purchased."

2. Value of the annuity. Reg. §1.170A-1(d)(2); Reg. §1.101-2(e)(1)(iii)(b)(2); Reg. §20.2031-7.

3. Taxation of annuity payments – IRC §72.

a. Exclusion Ratio – ratio of the "investment in the contract" to the "expected return." IRC §72(b); Reg. §1.72-4.

b. Expected Return – Reg. §1.72-5.

(1). Single life – calculated by multiplying the annual annuity payment by the multiple shown in Table V of Reg. §1.72-9 (Called the "expected return multiple.")

(2). Two-life – calculated by multiplying the annual annuity payment by the multiple shown in Table VI of Reg. §1.72-9. (Called the "expected return multiple.")

(3). Adjustments required if payments are to be made less frequently than monthly, or if first payment will cover a partial period. See Reg. §1.72-5(a)(2)(i).

(4). Note that different tables apply to pre-1986 contracts.

c. Investment in the Contract

(1). General rule of Reg. §1.72-6. Investment in the contract is the aggregate amount of premiums or other consideration paid, reduced by any return of premiums or any other amounts received which were excludable from income.

(2). However, in the case of a gift annuity, the "value of the annuity" (see above) is the investment in the contract. The amount deductible as a charitable contribution is not part of the investment in the contract. See Rev. Rul. 62-137, 1962-2 CB 28, which provides older valuation rules for charitable annuities, and states, "The values prescribed herein will apply for the purpose of determining the aggregate amount of consideration paid for the contract (investment in the contract) for purposes of section 72 of the Internal Revenue Code of 1954." Also see Rev. Rul. 70-15, 1970-1 CB 20, which states, "The amount in excess of the fair market value of an annuity contract purchased from an organization described in section 170(c) of the Code may not be treated as an 'investment in the contract'; such amount may be deducted as a charitable contribution."

d. Exclusion limited to investment; unrecovered investment.

(1). The total exclusion over the life of the contract cannot exceed the total investment in the contract. Thus, if the annuitant has recovered the entire investment in the contract, thereafter, his annuity payments are fully includible.

(2). Conversely, if the annuitant dies before the investment in the contract is fully recovered, the unrecovered investment is allowed as a deduction on his final income tax return.

(3). These rules do not apply to any annuities with a start date before 1986. For those contracts, the exclusion ratio remains the same for the life of the contract.

e. Example: Donor is 72 years old, gives $50,000 for a single-life gift annuity.

(1). Annuity Rate: 6.7%
(2). Annual Annuity: $3,350
(3). Charitable Deduction $19,175
(4). Investment in the Contract $30,825
(5). Expected life of the annuity 14.5 years
(6). Expected return = $3,350 X 14.5 = $48,575
(7). Exclusion Ratio:

$$\frac{\$30{,}825}{\$48{,}575}$$

(8). Tax-free portion of each payment:

$$\frac{\$30{,}825}{\$48{,}575} \quad X \quad \$3{,}350 = \$2{,}126$$

4. Capital Gains implications

a. Exchange of property for an annuity is considered a bargain sale. See Reg. § 1.170A-1(d)(3) and Reg. § 1.1011-2(a)(4)(i).

b. The "consideration" received in the bargain sale is the "value of the annuity" (determined in accordance with §2031 and the regulations thereunder.) The "basis" in the property sold is determined by multiplying the donor's basis in the property exchanged by a fraction whose numerator is the value of the annuity and whose denominator is the face value of the annuity.

c. Example: Donor, age 72, transfers appreciated securities to charity in exchange for an annuity that pays $3,350 per year per life. The fair market value of the securities transferred (and the face amount of the annuity) is $50,000. The donor's basis in the property transferred is $5,000.

The value of the annuity is $30,825, per IRS tables, and the charitable contribution is $19,175. ($50,000 minus $19,175). The donor's basis in the portion of the property "sold" is calculated as follows:

$$\$5{,}000 \quad X \quad \frac{\$\ 30{,}825}{\$\ 50{,}000} \quad = \quad \$3{,}082.50$$

d. The consideration received for the portion "sold" is $30,825, and so the gain which must be recognized is $27,742.50 ($30,825 minus $3,082.50).

e. If the annuity is nonassignable, the gain is reported ratably over the period of years measured by the "expected return multiple", which is equal to the donor's life expectancy, in our example, 14.5 years. $1,914 of gain must be reported each year.

f. Only the donor's life expectancy is considered. The survivor annuitant's life expectancy is not considered.

g. The maximum capital gain reportable in any year cannot exceed the amount treated as return of investment each year – in other words, the excludible amount.

h. Upon the death of the annuitant, no further gain must be reported. However, if there is a survivor annuitant, the unreported gain will continue to be reported on the same basis by the survivor annuitant.

i. In case of two-life annuity funded with joint property, gain is reported over the joint life expectancy.

B. Estate and Gift Tax

1. *Single life annuity established by the donor during his lifetime.* There is nothing to include in the donor's taxable estate, since his right to income terminates with death, and there is no remaining value in the contract.

2. *Annuity established by donor during life with a survivor annuitant.* The value of the survivor's interest is included in the donor's gross estate. IRC §2039. If the survivor is the donor's spouse, the marital deduction is available. IRC §2056(b)(7)(c). With non-spouse survivor annuitant, there may be tax due. Tax would likely be payable out of residuary estate.

3. *Annuity established at death for another beneficiary.* If a testator provides in his will or trust that an annuity should be established for someone else, e.g., a child, niece, etc. the entire amount of the annuity is included in his gross estate, and a charitable deduction is available for the charitable portion (same computation as for income tax.)

   a. If spouse is the only annuitant, marital deduction is available.

   b. Beware of two-life annuity established testamentarily for spouse and another beneficiary, e.g., wife, then daughter. There is no marital deduction available for the spouse's interest. Charitable deduction is still available, however.

4. Where donor establishes annuity for another beneficiary inter vivos, there are potential gift tax issues.

   a. If a donor establishes a single life annuity for another beneficiary, e.g., a sister, daughter, niece, etc., a taxable gift has been made. The gift does qualify for the annual exclusion ($11,000), as it is a "present interest". Face amount of annuity may be more than $11,000. Compare the non-charitable portion ("value of the annuity") with the exclusion amount.

   b. If a donor establishes a two-life annuity for himself and a survivor beneficiary, e.g., to donor during his lifetime and then to his daughter, he has made a completed taxable gift to his daughter, and this gift does not qualify for the annual exclusion, because it is not a present interest. Gift tax return would need to be filed, and donor would either pay tax or claim part of his unified credit. Problem can be avoided if donor retains the right to revoke the survivor's interest. Then a completed gift has not occurred, and there is no taxable event for gift tax purposes. However, the survivor's interest will be included in the donor's gross estate at death (see discussion above.)

   c. Note that gift tax is still an issue, even in 2010 and following.

5. Beware of an income tax issue when annuities are established out of a decedent's estate or a testamentary trust. If the donor's will or trust provides that "10% of my residual estate shall be paid to ABC

Charity to establish a single life gift annuity for the benefit of my niece, Susie," then 10% of the income earned by the estate during the period of administration will add to the face value of the annuity. However, someone has to pay the income tax on this income earned during administration. I believe there are three possible results:

a. If the annuity can be set up immediately (within one month of death?) possibly income can be avoided by back dating the annuity to the date of death.

b. If the annuity can be established immediately after the close of the estate's or trust's tax year, the estate or trust could report and pay tax on the income earned in the prior year, withholding the amount of tax due from the share used to establish the annuity. A charitable income tax deduction is available for that portion of the income which represents the charitable portion of the annuity.

c. If the annuity is established mid-year, the only possible result seems to be that the beneficiary will have to receive a Form 1041-K-1 for the non-charitable portion of the income which is added to the annuity, even though she does not actually receive the income. This is the least desirable result, as Susie will not understand why she has taxable income to report when she has not yet begun to receive the income from the annuity.

d. None of these issues exist if the bequest is stated as a specific dollar amount, as specific bequests generally do not benefit from income earned during administration. However, fairness would require setting up the annuity as soon as possible so that the beneficiary begins receiving income as the decedent intended.

6. Economic Growth and Tax Relief Reconciliation Act of 2001. (EGTRRA)

a. Estate tax is less likely to be an issue in the future. As of January 1, 2004, exemption equivalent is $1,500,000, gradually increasing to $3.5 million by 2009. Estate tax is repealed in 2010. In 2011, presumably we go back to a $1 million exemption unless Congress acts. So annuity is still a valid planning tool from an estate tax standpoint.

b. Gift tax - $1 million exemption, but tax stays in place.

7. Possible development for the future – IRA "rollover" into charitable gift annuity. Several proposals have been put forth over the last several years. This is not the law today, but it may be an opportunity for the future.

V. Managing the Annuity Fund

A. Segregation of assets

1. There is no general overriding requirement that annuity assets be segregated from the general assets of the charity. The obligation to pay the annuity is a contractual obligation backed by all of the charity's assets, not just the annuity fund.

2. State law may require that there be a segregated fund, and may dictate how much must be in the fund.

3. Prudence requires that the charity maintain a separate fund, at least in an accounting sense, designated the "annuity fund." This should be done for the following reasons:

a. This may provide greater protection to annuitants, as in some states there may be an argument that these assets are unavailable to general creditors if the charity goes bankrupt. This argument would be based on constructive trust or a similar theory. Although the ultimate success of these arguments is doubtful, bargaining position vis a vis other creditors in a reorganization might be improved. Surely, if the assets are not segregated, they will be gobbled up by general creditors.

b. A separate fund facilitates accounting and tracking of performance.

c. Charity may wish to employ a different investment strategy with annuity assets than for the general fund or the endowment fund, or it may be required to do so by state regulations. Charity may wish to have the fund, or part of it, professionally managed, or may wish to hire a different investment manager than for its other funds.

4. In some cases, further segregation within the annuity fund may be desirable. For example, it may be desirable to create a separate sub-fund for California annuities, since that state has rigid

investment restrictions. The charity would then be free to invest the remaining annuity funds as it wishes.

B. How much should be in the annuity fund? Stated another way, when may the charity take its share (the "gift") out of the fund and spend the money for its charitable programs? There are two basic approaches:

1. At a minimum, the charity should keep the required reserves in the annuity fund. This is the amount that, actuarially, will enable it to meet the obligations which it has incurred for all of its annuity contracts.

a. If this approach is taken, the charity will likely take some of the face value of the annuity out up front, and will invest only a portion of the funds received from the donor.

b. On a periodic basis, (at least annually), the charity will recalculate the required reserve based on the annuity contracts then in effect. If the annuity fund exceeds this amount, the charity can withdraw funds and add them to its general fund. If the fund is insufficient to meet the required reserves, the charity will have to add money to the annuity fund out of its general fund.

c. Under this approach, the death of an annuitant will not result directly in funds being made available to the charity. However, the termination of the contract will affect the reserve calculation at the end of the year (or whenever it is done). Stated differently, if the gift portion is taken out up front, there will be no "50% residuum". In effect, the charity has taken out the present value of the residuum at the beginning, and the residuum at the end should be zero.

2. A key issue is what assumptions are used to calculate the reserves.

a. There is one set of actuarial assumptions that are implicit in the IRS tables used to calculate the charitable deduction. These assumptions are not likely to be the ones used for the charity's reserve calculations. In the example above, a $50,000 annuity for 72-year-old donor produced a charitable deduction of $19,175. This does not mean that the charity can immediately take $19,175 out of the annuity fund.

b. There is another set of actuarial assumptions that determine the annuity rates. These assumptions may or may not be the ones the charity wishes to use in its reserve calculations.

c. State regulations may dictate a set of assumptions that must be used. (E.g., California.) In that case, the charity must use assumptions which are at least as conservative as the state regulation requires, at least for that portion of the fund. Keep in mind that the charity may choose to use assumptions which are more conservative than state regulation requires.

d. It is always best to be conservative in your assumptions, considering the long term of the obligations incurred. However, the assumptions must be reasonable, or the accountants may object.

3. The other approach is to account for each annuity contract individually.

a. Under this approach, the entire face amount of the annuity is invested.

b. Income earned in the fund is allocated to each contract, and payments are deducted from that contract.

c. When an annuitant dies, the amount remaining in that contract is transferred to the general fund.

d. In some instances, the contract may even be individually invested, e.g., a $100,000 Treasury Bond may be purchased to support a $100,000 annuity. But this strategy has become much trickier with the elimination of the 30-year Treasury, and with our current low-interest environment. There is probably no safe bond that will produce enough income to pay any gift annuity. Thus, some portion of the fund will need to be invested in equities, and/or principal will need to be paid out to meet the annuity payment. Furthermore, if interest rates rise and the value of the bond drops, the reserves may be insufficient.

4. Which approach is right for your charity?

a. How large is your fund? Are you constantly growing the fund through new contracts?

b. Is your actuarial risk diversified?

c. How confident are you in your investment performance? Do you regularly beat the assumptions underlying the annuity rates? (Keep in mind that the rates under older annuities were determined under different assumptions.)

d. How conservative is your organization?

e. What would be the implications if you had to add money to your annuity fund? Would your board and financial officer be able to accept this as a natural consequence of taking the less conservative approach?

f. Does your organization have reserve funds that could be used to fund a deficit in the annuity fund?

g. Consider hybrid approach. Segregate funds withdrawn from the annuity fund in a separate board-restricted (quasi-endowment) fund up to a certain percentage of the annuity fund. These funds are then available to replenish the annuity fund if needed.

C. Investing the Annuity Fund

1. Objectives

a. Meet or beat the return assumption which determines the rates. All things being equal, if you beat the assumption, your residuum will be greater than 50%, and if you do not meet the assumption, it will be less than 50%.

(1). The key figure is total return, including growth. It is not necessary to produce income equal to the return assumption, and certainly it is not necessary to produce income equal to the payout rate.

(2). Return is looked at on an average, multi-year basis. There may be years in which the assumption is not met. However, if, in any year, you do not meet your own assumption used to calculate the reserve, you may be forced to add money to the annuity fund.

b. Maintain sufficient liquidity to meet annuity payment obligations. In theory, the current income from the fund will not be sufficient to meet the annuity payment obligations, for two reasons:

(1). Investment focus is on total return, not income.

(2). Annuity rates contemplate dipping into principal, with only 50% remaining at termination of contract. If you have already withdrawn part or all of the excess over required reserves, then principal invasion is even more likely.

2. Specific investments

a. Stocks – acceptable within state regulation guidelines, and sufficient diversification. (Note: California limits equity portion of portfolio to 10%). Stocks historically have produced better returns than bonds in the long run, but are not likely to produce large amounts of current income, so liquidity needs must be met elsewhere in the portfolio.

b. Bonds – generally produce better income than stocks. But value of bonds may vary greatly with swings in interest rates. This could affect your reserve calculation. Long-term bonds more susceptible to value fluctuation.

c. Real estate – In some cases, real estate could be an appropriate investment for the annuity fund. It probably should be income producing, such as a triple net leased commercial property, or apartment building. This may produce a good long-term return, but there are different risks associated with real estate. And there are management issues, as well. Consider obtaining real estate exposure through REITs as an alternative.

d. Mortgages and land contracts may also be held in the annuity fund. Again, consider unique risks – default, foreclosure, etc.

e. Alternative investments, aka "Absolute return strategies", aka Hedge Funds. Understand the risks. Diversification is key.

3. Investment Principles to consider

   a. Asset allocation. Determine an asset allocation that is likely to produce the return that you need with a level of risk that you (and your board) are comfortable with.

   b. Diversification – among asset classes, and within each asset class.

   c. Discipline. Keep with your strategy for the long term, rebalance periodically.

4. Should you have professional investment management?

   a. In-house expertise?

   b. Size of portfolio

   c. Portfolio mix – equities v. fixed income

   d. Cost

   e. Use of mutual funds.

   f. Consider passive investment strategy.

   g. Charity is still liable to make annuity payments if professional managers do not perform to expectations.

5. Investment issues are far more difficult in the early years of the fund. It is much easier to achieve diversification in a larger fund, and the actuarial risk is less the larger the number of annuitants in the pool. Liquidity is also harder to achieve in a small fund, because generally, the more liquid, the smaller the return. Consider these issues when deciding whether to take excess out of the fund.

6. Reinsurance

   a. Possibly a way to manage actuarial risk, particularly on a very large contract or when the fund is just starting out.

   b. May be prohibited in some states.

c. Charity is still liable if insurance company goes under.

(1). Check company's rating.

(2). Use more than one company?

D. State Regulation

1. Do you need to register in your state?

2. Do you need to register in other states where your annuitants reside?

3. Reserve requirements.

4. Investment restrictions.

E. Administrative issues

1. Making timely payments. Need a method to produce checks and keep records.

a. Checks

b. Direct deposit

c. ACH

d. How do we find out when annuitants die?

2. Calculation of charitable deductions, capital gains, etc. Need to inform donor regarding tax matters.

3. Calculation of reserves.

a. Required by state regulation

b. For accounting purposes.

4. Tax reporting.

a. Annual 1099-R to all annuitants. Magnetic tape to IRS.

b. Calculate includible/ excludible portions, and keep track of when the investment in the contract is recovered.

c. Capital gains.

5. Software.

F. Decisions for your annuity program.

1. Minimum annuity contract.

2. Frequency of payment, or minimum payment allowed.

3. What types of assets will you accept in exchange for an annuity?

a. Publicly traded assets are obviously OK.

b. What about real estate?

c. Subchapter S stock – UBI upon sale.

4. Do you want any age limits?

5. Outsourcing.

G. Marketing – Note that ACGA's expense assumption does not include marketing costs.

VI. Comparing the annuity to other charitable giving vehicles.

A. Pooled Income Fund

1. PIF has a fluctuating (growing?) income stream.

2. All income is taxable.

3. Capital gains totally avoided on gifts of appreciated property, even if the income recipient is not the donor.

4. Assets are protected from the general creditors of the charity, but there is no guarantee of payments. Charity is only obligated to pay income earned in the trust.

5. Can create PIF for more than two lives.

B. Charitable remainder unitrust

1. Separately invested. Larger amount required to create a CRUT than a gift annuity.

2. Fluctuating income and valuation. In an income-only unitrust, beneficiary receives only income earned in the trust, up to the limitation. In standard unitrust, beneficiary receives a percentage of the fair market value of the trust assets, valued annually. Payment can go up or down.

3. Generally, all payments received are taxable income. There may be distributions of principal which are not taxed in a straight unitrust. Also, a unitrust may invest in tax-exempt securities (but watch out for accumulated capital gains.)

4. Assets in trust protected from general creditors of the charity. Income obligation is not backed by charity's general assets.

5. Complete elimination of capital gains (unless the tier system of income payouts dips into the capital gains layer.)

6. Can create for more than two lives (provided 10% rule is satisfied), or for a term of years up to 20.

7. Can provide for contingent income beneficiaries, or a class of income beneficiaries in a term of years trust.

C. Charitable remainder annuity trust

1. Separately managed trust. Requires larger amount to set up.

2. Annual payment is a fixed amount which does not vary.

3. Initially, complete elimination of capital gains. However, if principal is distributed, capital gains could be carried out under tier system.

4. Payment is not guaranteed by general assets of charity. If trust runs out of money, payments cease.

5. Assets protected from the charity's general creditors.

6. Can create for more than two lives, or for a term of years.

D. In general, gift annuity, PIF, and charitable remainder trusts all provide similar, albeit not identical, tax benefits, namely income tax deductions when established inter vivos, estate tax deductions at death, and some shielding from capital gains when funded with appreciated property.

Comparison of Life Income Gifts

	Gift Annuity	Pooled Income Fund	Charitable Remainder Unitrust	Charitable Remainder Annuity Trust
Fixed or variable payment	Fixed	Variable	Variable	Fixed
Growth in income payout?	No	Likely	Possibly, depending on payout rate	No
Payment guaranteed by charity's assets?	Yes	No	No	No
Assets in fund/ trust protected from Charity's general creditors?	No	Yes	Yes	Yes
Tax deduction on funding	Yes	Yes	Yes	Yes
Capital gains on funding with appreciated property	Partial avoidance. Deferral of remaining gain if donor is the annuitant	Completely avoided	Completely avoided (But may be paid out in "tier" system)	Completely avoided (But may be paid out in "tier" system)
Taxation of income payments	Partially taxable; partially excluded	Fully taxable	Generally taxable. Some portion may be tax-free return of principal or capital gain	Some portion may be tax-free return of principal or capital gain.
More than two lives?	No	Yes	Possibly, but must meet 10% rule	Possibly, but must meet 10% rule.
Term of years?	No	No	Yes, up to 20	Yes, up to 20
Separately managed?	No	No	Yes	Yes
Minimum to create	$1,000 or more	$5,000 or more	$50,000 or more	$50,000 or more
Payout rate	Suggested by ACGA rates	Actual income earned in trust	Determined by donor and charity when trust established	Determined by donor and charity when trust established.
Fund with real estate?	Probably not	Probably not	Yes	Only if income-producing or readily marketable
Fund with tax-exempt securities?	Yes	No	Yes, but be careful of capital gains	Yes, but be careful of capital gains

Plan Now – Pay Later!
Fundamentals of Testamentary Planning

May 6, 2004

Ellen G. Estes, LL.B.
Estes Associates
Woodbridge, Connecticut

Plan Now – Pay Later! Fundamentals of Testamentary Planning

I. **<u>Basics of the Estate Planning Process</u>** -

A. The goal of the estate planning process is ***to maximize a person's ability to make a difference*** – for the individual, for his or her family, and for the wider community. The process involves

1. The acquisition of assets
2. The wise management and investment of those assets, and
3. The planning for the careful disposition of those assets now – and in the future.

B. The most important aspects of any estate plan are the *Human Aspects*:

1. Providing for one's own happiness and security
2. Providing for spouse, children, parents, and others
3. Planning for retirement
4. Planning for special family needs and situations
5. Providing for favorite charitable organizations

C. In developing one's estate plan – there are several things to think about

1. What assets does the individual own?
   a. How are they owned (jointly? in the individual's own name?)
   b. Where are they located (real estate in several states?)
   c. How are they configured (stocks & bonds? real estate?)
   d. Retirement plans and Life Insurance (who are the named beneficiaries?)

2. What are the individual's primary ***lifetime*** planning goals and objectives?

3. Where does the individual want his or her assets to go later on?
   a. Family members
   b. Friends
   c. Favorite charitable organizations

D. Once an individual has made decisions about these issues – he or she will then want to consider the best ways to transfer assets to others. There are five basic ways to transfer assets –

1. **<u>Lifetime gifts</u>**: A gift is a lifetime transfer of assets. One can make gifts to family, friends and others during lifetime, and have the pleasure of seeing the donees enjoy those gifts.

2. **<u>Wills and Probate</u>**: A Will is a written document, executed in accordance with the formalities required by state law, to carry out a person's wishes at death. Under one's

Will a person can direct who is to receive his or her assets, name his or her executor, name trustees and guardians, set up trusts, make gifts to charity, and do important tax planning for the individual and his or her family. You should note that *all of the assets that pass to heirs under a person's Will are subject to probate.* If an individual should die intestate (without a valid Will) the laws of his or her home state will determine who will inherit those assets, and the state rules may have no resemblance whatsoever to where *the individual* wants his or her assets to go.

3. **Joint Tenancies with right of survivorship**: Under this arrangement two or more people (the "joint tenants") own the entire property jointly. When one of the joint tenants dies, the surviving joint tenant(s) takes the entire property. Because the ownership interest in the property is transferred to the survivor by operation of law, the interest will not go through probate. Please note that a person's Will does not have any power over the distribution of jointly owned assets.

4. **Contracts (such as Life Insurance and Retirement Plan Assets)**: Many assets can be transferred in accordance with the terms of a contract. For example, one can name the beneficiaries of his or her life insurance policy in the insurance contract. A person can designate the people who will receive benefits from his or her IRA or pension plan in the contract itself. All of these contracts specify who is to receive the assets later on. The person's Will has no power over the distribution of these assets.

5. **Trusts**: A trust is an arrangement whereby property is transferred with the intention that it be administered by one party - the trustee - for the benefit of another - the beneficiary (or beneficiaries.) A trust can be created during lifetime (a *living trust* or an *inter vivos* trust), or by Will (a *testamentary* trust.)

    a. By establishing a *living trust*, one can provide income to him or herself and/or others, rid oneself of investment responsibilities, and direct (in the trust agreement itself) to whom the trust assets will be distributed when the trust ends. Because the assets remaining in the trust will be distributed according to the terms of the trust agreement, that person's Will has no control over the distribution of these assets. Note also that the assets distributed according to the terms of a living trust do not have to pass through probate.

    b. A *testamentary trust* is a trust created under a Will and becomes effective upon the testator's death. The property that funds a testamentary trust will pass through probate.

Note: All of a person's assets, no matter how they will be transferred to heirs at death, are includable in his or her gross estate and will be subject to federal estate tax consideration. It is important to remember that ***just because some assets avoid probate does not mean that those assets will avoid estate taxes.*** Everything a person owns - or has a substantial interest in - will be part of his or her gross estate and subject to federal estate tax consideration at death – at least until the year 2010, when the estate tax is scheduled to be repealed. Between now and 2010, the gift and estate tax rates will be reduced, and the exemption amount will be increased (to \$3.5 million by 2009 – see tax discussion below.) However, during these years, the federal gift and estate taxes will be in effect, so it will be important for people to review their estate plans periodically with their advisers to make sure that their plans continue to accomplish their objectives – even as the tax laws change.

II. <u>The Federal Taxes Involved With the Transfer of Assets</u>

A. **<u>The Federal Gift Tax</u>** is a tax on the privilege of giving assets away during lifetime. An individual who makes a gift of more than \$11,000 to any other person during the year must file a federal gift tax return reporting these gifts, even if no tax will be due. If a gift tax is due, it is paid by the donor who makes the gift, not by the donee who receives the gift.

1. **<u>Federal gift tax rates</u>**: Under current law, the Federal gift and estate tax rates range from 18% to 48%. The gift and estate tax rates will be gradually reduced from a top rate of 48% in 2004, to a top rate of 45% in 2007. (See rate schedule at end of outline.) In 2010, although the estate tax will be repealed, the gift tax will remain, and the top gift tax rate will be the same as the highest income tax rate at that time – currently scheduled to be 35%.

2. **<u>Ways to reduce federal gift taxes:</u>**

a. *Marital deduction.* In general, unlimited gifts may be made between spouses, completely free of the gift tax. A deduction, called the *marital deduction*, eliminates the tax on these transfers. However, gifts of certain future interests and gifts of terminable interests will not qualify for the gift tax marital deduction. Therefore, these gifts are subject to gift tax consideration immediately.

b. *Annual Exclusion.* Gifts to individuals *in addition to* a spouse may be made each year *up to \$11,000 per donee*, completely free of the gift tax. There is no limit on the number of donees each year. This means that a person can give up to \$11,000 to each child, each grandchild, and to any other individual(s) each year, and not have to file a gift tax return or pay a gift tax on those transfers. Many individuals make such gifts on an annual basis to avoid gift taxes during their lifetimes and to reduce federal estate taxes later on. This is an important part of the estate planning process. (The annual exclusion is indexed for inflation.)

In order to qualify for the annual exclusion, the gift must be of a *present interest.* A gift is considered to be a "present interest" if the donee has all immediate rights to the use, possession, and enjoyment of the property. A gift of a "future interest," such as a remainder interest in a trust, will not qualify for the annual exclusion.

c. *Gift Splitting.* If spouses join in making gifts to others, they can give up to \$22,000 per donee each year, completely free of the gift tax. There is no limit on the number of donees each year. The gift must qualify as a gift of a present interest in order to qualify for gift splitting.

d. *Educational and medical exclusions.* An individual may pay the tuition and/or medical bills for another person, completely free of the gift tax. There is no limit on the amount of such payments, but, in order to avoid the gift tax, the payments must be made directly to the school (for tuition) or to the medical facility providing the medical care, not to the individual for whose benefit the payment is made.

e. *Exemption Amount.* We just saw that an individual can make unlimited gifts to a spouse, can make $11,000 gifts to family and friends – and can also pay the education and/or medical expenses of others each year - without having to pay gift taxes on these transfers. Under current law, individuals can *also* make additional lifetime gifts (up to $1 million) free of the gift tax. (This "tax-free" amount for ***lifetime gifts*** will remain at $1 million until Congress decides to change it.) There is a credit that eliminates the tax on these gifts. If an individual does not use up the credit during lifetime, the unused portion can be used to reduce estate taxes later on.

f. *Charitable Deduction.* Gifts to qualified public charities may be made completely free of the gift tax. A charitable deduction eliminates the tax. There is no dollar limit on gifts to qualified charities, so that individuals can make gifts to charity without paying any gift tax and without using up any of their exemption amount.

g. *Carryover Basis of the Assets Transferred.* For gifts of appreciated assets made during lifetime, the basis of the donated asset in the hands of the donee who receives the gift is generally the donor's cost basis, plus any gift tax paid by the donor ("carryover basis"). This means that when the donee later sells that asset, the amount of the capital gain will be computed using the donor's original basis (plus gift tax paid).

B. **The Federal Estate Tax** is a tax on the privilege of giving assets away at death. The estate tax currently is applied to estates larger than $1.5 million. This amount – which is called the "exemption amount" – will gradually increase to $3.5 million in 2009. (See phase-in schedule at the end of this outline.) If any estate tax is due, the tax is paid by the decedent's estate, not by the heirs who inherit from the estate.

1. **Federal estate tax rates**. Under current law, the gift and estate tax rates will be gradually reduced from a top rate of 48% in 2004, to a top rate of 45% in 2007. (See rate schedule at end of outline.) As noted above, the estate tax will be repealed in 2010 for individuals who die that year (but the gift tax remains in effect.) However, in 2011, the old estate tax law (with an exemption amount of $1 million and maximum tax rate of 55%) will be reinstated unless Congress acts to extend the new law.

2. **Examples of assets includable in the gross estate for estate tax purposes:**
   a. Real estate
   b. Stocks and bonds
   c. Cash and money in bank accounts
   d. Life insurance over which the decedent had an incident of ownership (e.g. the right to change the beneficiary)
   e. Jointly owned property

f. Share of partnership or business
g. Certain annuities and pension benefits (including IRA's Keogh's, etc.)
h. Property over which the decedent held a general power of appointment
i. Assets in a revocable trust

3. **<u>Ways to reduce federal estate taxes</u>**:

a. *Marital deduction.* In general, unlimited bequests (and other gifts taking effect at death, such as an interest in a trust) may be made to the surviving spouse, completely free of the estate tax.. A deduction, called the "marital deduction" eliminates the immediate tax on these transfers. In essence, the estate tax is postponed until the death of the second spouse. However, **gifts of certain future interests and gifts of terminable interests will not qualify for the estate tax marital deduction. Therefore, these transfers will be subject to estate tax consideration upon the death of the first spouse.**

- A "**future interest**" is an interest that cannot be enjoyed immediately – such as the remainder interest in a trust.

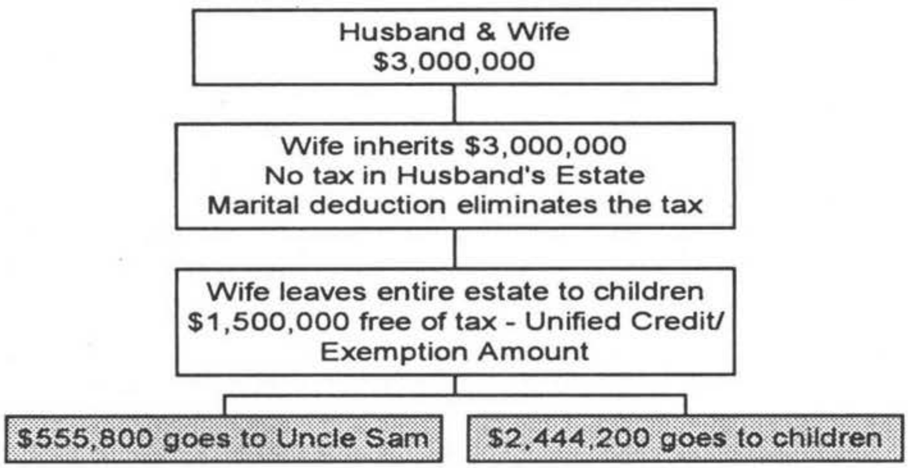
- A "**terminable interest**" is defined in the Internal Revenue Code as "one which may terminate or fail upon the lapse of time, the occurrence of an event or contingency, or the failure of an event or contingency to occur" – (such as a gift to my wife "for her lifetime", or "until she remarries"). There are a few specific exceptions to the terminable interest rule which allow terminable interest gifts to a spouse to qualify for the marital deduction. One important exception – the Q-TIP exception – is discussed in the section on testamentary charitable planning below.

b. *Exemption Amount* If an individual has not used up his or her $1 million exemption amount during lifetime by making otherwise taxable gifts, the unused portion can be used to reduce the federal estate tax at death. (As noted above, the exemption amount for estate tax purposes will gradually increase to $3.5 million in 2009.) For example, let us assume that Mr. Smith dies in 2004 (when the $1.5 million estate tax exemption amount is available) and that he had offset the gift tax on $200,000 of taxable gifts during his lifetime by using part of his gift tax exemption amount. At his death, the $800,000 unused portion of his gift tax credit will be available which, when combined with the additional $500,000 estate tax credit, will eliminate the estate tax on the first $1,300,000 of assets in his taxable estate. The balance of his estate will be fully taxable.

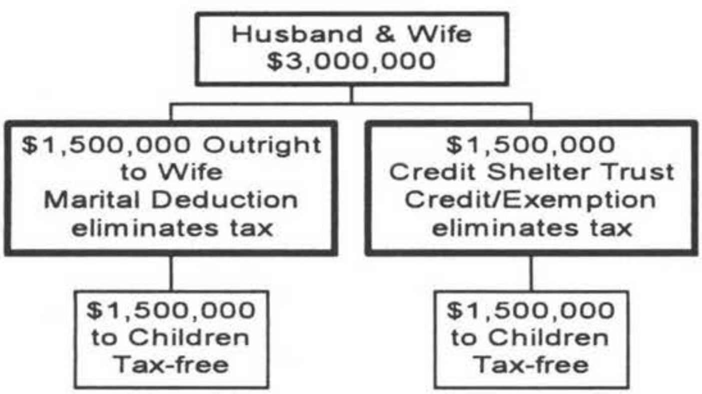
Also, in order to save estate taxes, it will be important for each spouse to fully utilize his or her exemption amount. For example, each spouse should consider setting up a "Credit Shelter Trust" to benefit the surviving spouse – and yet pass those assets tax-free to children at the second spouse's death. Under a Credit Shelter Trust the surviving spouse can receive all of the trust income for life, and can invade principal subject to certain standards: for the maintenance, support, education, and/or health of the surviving spouse; and the surviving spouse can be given the right to withdraw annually $5,000 or 5% of the trust assets, whichever is larger. The Credit Shelter Trust will qualify for the credit/exemption amount in the first estate, and will avoid taxation in the surviving spouse's estate later on. The following example demonstrates how such trusts can work.

Example: Husband and wife have an estate of $3 million. Husband dies in 2004 and wife dies in 2005. In each of those years the estate tax exemption amount is $1.5 million. Under Option #1 the husband leaves the entire $3 million outright to the wife. Under Option #2 the husband gives $1.5 million to the wife outright – and puts $1.5 million into a Credit Shelter Trust for the wife – remainder to children. Notice how the tax savings work in Option #2.

Option #1 - with no Tax Planning



Option #2 - with Planning



c. *Charitable deduction*.. Bequests to qualified public charities may be made completely free of the estate tax. A charitable deduction eliminates the tax. There is no percentage limit on the deductibility of bequests to qualified charities. This means that an individual can make unlimited bequests to favorite charities without having any estate tax to pay on these gifts, and without using any of his or her exemption amount.

d. *Stepped-up basis for assets transferred through the estate*. There are special beneficial tax rules that apply to assets transferred at death through an estate. Until the year 2010, when the estate tax is repealed, the heir who receives appreciated assets from a decedent will receive a "stepped-up" basis in those assets, instead of taking the decedent's basis (as would have been the case for a lifetime gift). The heir's basis will be the fair market value of the asset that was used on the decedent's federal estate tax return. Although the full fair market value of the asset will be included in the decedent's estate for *estate* tax purposes, any appreciation in value of the asset during the decedent's lifetime will avoid the capital gains tax. When the heir later sells the asset, the amount of the capital gain will be computed using the stepped-up basis.

However, in the year 2010, when the estate tax is repealed, the step-up in basis is also eliminated, so that the heir will take the *decedent's basis* in inherited assets that year. However, under a special exception in the law, executors are given the authority to allocate up to $1.3 million of appreciated assets ($4.3 million for a surviving spouse) to receive a step-up in basis. Like the other estate and gift tax provisions, these changes "sunset" in 2011, and the current step-up in basis for all assets transferred at death will be reinstated in 2011, along with the estate tax.

No matter what happens with the new tax law, it seems prudent for all of us – and our donors – to keep good records regarding the tax basis of all assets, since this information may be required later on.

C. **The Generation-skipping Transfer Tax (GST)** is a tax imposed on gifts to certain family members *in addition* to the federal gift and estate taxes outlined above. The GST generally applies when assets are transferred from one family member to another family member who is two or more generations down the line (a "skip person"). For example, a $4 million bequest from a grandparent to a grandchild is a generation-skipping transfer, and is generally subject to both the federal estate tax *and* the GST.

1. **GST rates**. Under the old law (prior to 2002) the GST rate was a flat rate of 55%. Under current law, the GST is the same as the highest Federal estate and gift tax rate – currently 48%

2. GST rates will gradually be reduced to 45% in 2007, along with the estate tax rates (see schedule at end of outline.) The GST tax is applied in addition to any federal gift or estate tax due on a transfer to a "skip person." The GST tax is paid out of the property subject to the tax.. The GST tax is repealed in 2010 for individuals who make GST transfers in that year. However, in 2011 the old GST law will be reinstated, unless Congress acts.

3. **Ways to reduce generation-skipping transfer taxes (GST):**

a. In 2004 there is a $1.5 million GST exemption allowed to every individual. This means, for example, that a grandparent can transfer up to $1.5 million to all grandchildren (not to each grandchild) free of the GST. (Starting in 2004, the GST exemption is the same as the Federal estate tax exemption.)

b. Gifts that qualify for the annual exclusion, or for the educational or medical exclusions, are exempt from the GST. This means that more assets can be transferred free of the GST with careful planning. For example, a grandparent can give $11,000 to each grandchild each year (and pay each grandchild's school tuition) and, generally, avoid both the federal gift tax and the GST on those gifts.

Note: Because of the intricacies of the new tax law – and the fact that it will continue to be phased in between now and 2010 – it is important that individuals meet with their own advisers to discuss their estate plans and find out if – and how – the new law will affect their plans. Especially if their estates are in excess of $1.5 million, ($3 million for married couples) it would be prudent to review their plans annually with their advisers to make sure to maximize the available tax benefits as the new law is phased in. This provides charities with a golden opportunity to remind our constituents to review their estate plans – and to encourage them to include our organizations in those plans.

D. **State Gift, Estate and Inheritance Taxes**

Many states impose gift, estate, and/or inheritance taxes which may also have an impact on an individual's estate plan. Since there are many states with different sets of tax laws, we will not discuss the details here. Just keep in mind that the laws of your donor's home state may have an impact on his or her estate, so that donors should discuss all of these issues with their advisers when doing their estate plans.

III. **How does all of this affect testamentary charitable planning?**

Most of us are familiar with the charitable gift options available during a donor's lifetime: outright gifts to favorite charities using different assets; life income gifts to provide income to the donor and/or another person; gift of residence retaining the life estate; charitable lead trusts that benefit charity now – and the donor's family later on; etc.. We know that there are often financial and income, gift, and estate tax benefits for the donor who makes charitable gifts during lifetime. However, what if a donor wants to support a favorite charity – but feels that he or she cannot make an irrevocable gift during lifetime? What are some of the other options for that donor?

A. **Charitable Bequests**. A donor can make a bequest in his or her will for the benefit of one or more charitable organizations. The decedent's estate will be entitled to an estate tax charitable deduction for the assets transferred to charity in this way.

1. **Benefits**: Approximately 2/3 of all planned gifts come in the form of bequests. Often the largest gift an individual can make – the Ultimate Gift – will be made through his or her Will. Therefore, encouraging your constituents to include your organization in their Wills and estate plans can build the pipeline to your future.

2. **Bequests can be made in a variety of ways. The donor can**:

   (a) Give a percentage of his or her estate

   (b) Give a fixed dollar amount

   (c) Give specific property – such as real estate or stocks

   (d) Give the residue of his or her estate – assets that remain after other bequests have been fulfilled

   (e) Make a bequest that provides a life income for a loved one – and also benefits a favorite charity (for example, a Testamentary CRT, CGA or PIF gift)

   (f) Make a bequest of an income interest to charity – with the remainder going to the donor's heirs (for example, a Testamentary Charitable Lead Trust)

   (g) Make a bequest in honor – or in memory – of a loved one

   (h) Make a contingent bequest – one that gives assets to a charity in the event that a specific named beneficiary should predecease the donor.

3. **Technical requirements**: Make sure to provide your correct legal name to your donors – so that their attorneys can draft the bequest language properly. Also, remember to suggest "saving" language – in the event that a restricted bequest cannot be used exactly as the donor originally intended – for example:

   "If at any time in the judgment of the Board of Directors of the XYZ Foundation the designated use of the bequest is no longer practicable or appropriate, the Directors shall use the bequest to further the general purposes of the XYZ Foundation, giving consideration, where possible, to my special interest as described above."

B. **Q-TIP Trusts** (more formally called a "Qualified Terminable Interest Property Trust"). A Q-TIP Trust is a trust that qualifies for the marital deduction – even though the interest given to the surviving spouse is technically a "Terminable Interest". The Q-TIP Trust is a trust that **benefits the surviving spouse** during his or her lifetime, after which the trust assets are distributed to the individuals or organizations named by the first spouse in the Will or trust document.

1. Benefits

(a) Provides income to the surviving spouse for life

(b) Surviving spouse may invade principal during lifetime

(c) The first spouse has control over the ultimate disposition of the trust assets, since, when the second spouse dies, the trust assets are distributed as the first spouse had directed – for example, to the children of a first marriage; or to a named charity

(d) Provides flexibility re income payments to the surviving spouse. Can be an attractive alternative to a CRAT or a CRUT for the surviving spouse.

(e) Qualifies for the marital deduction in the first estate – but subject to the estate tax in the second estate. (If the assets ultimately go to charity – the estate of the second spouse is entitled to an estate tax charitable deduction. In this case, the trust assets will completely escape the estate tax.)

2. Technical requirements

(a) In order to qualify as a Q-TIP Trust, the surviving spouse must be the ***only*** income beneficiary;

(b) The surviving spouse must be given the right to receive **all of the income from the trust at least annually**. In addition, the surviving spouse *may* have the right to invade principal for his or her own benefit;

(c) No person may have the power to appoint any part of the property to any person other than the surviving spouse, prior to the death of the surviving spouse;

(d) The decedent's executor must make an **irrevocable election** to deduct the value of the property on the federal estate tax return;

(e) The assets in a QTIP trust will qualify for the marital deduction in the first spouse's estate, and will be subject to the estate tax in the surviving spouse's estate later on.

3. Q-TIP Trusts are frequently used in situations of a second marriage – where the donor spouse wants to benefit the surviving (second) spouse for his or her lifetime – and then transfer the remaining Trust assets to the children of the first marriage. Here, the assets in the Q-TIP Trust will qualify for the marital deduction in the estate of the donor spouse – but will be subject to estate taxes later in the estate of the surviving spouse.

4. A Q-TIP Trust that pays all income to the surviving spouse – with the remainder going to a qualified charity – can be an attractive alternative to a Charitable

Remainder Annuity Trust or Unitrust. A Q-TIP Trust can provide maximum flexibility, since the surviving spouse may receive more income during his or her lifetime than would be available under a CRAT or a CRUT. In addition, as noted above, the assets in the Q-TIP Trust will qualify for the marital deduction in the first spouse's estate – and if the remaining assets go to qualified charities when the trust ends, the surviving spouse's estate will be entitled to a charitable deduction – thereby completely avoiding estate taxes on those assets.

C. **Charitable Gift Annuities – created under a donor's Will.** There may be situations where a donor would like to make a gift to charity – and also provide an annuity to a family member or friend – after the donor's lifetime. To accomplish these objectives a donor can establish a Charitable Gift Annuity under his or her Will (a "testamentary CGA".)

1. **Benefits:**

(a) Provides income to a surviving family member or friend

(b) The annuitant receives a fixed income at an attractive rate

(c) A portion of the annuity payments may be tax-free to the annuitant

(d) Donor's estate is entitled to an estate tax deduction for the gift to the charity

(e) Can provide a meaningful gift to your organization

2. **Technical requirements:**

(a) The donor must be certain to direct that a set dollar amount or percentage of the estate be transferred to a particular charity, conditioned on that charity's agreement to pay a specific annuity amount to a named beneficiary or beneficiaries. The annuity must be irrevocable and non-assignable, and the annuity payout must be ascertainable, although it can be stated with some flexibility. For example:

"Pay my sister, Jenny Jones, an annuity at the same rate that XYZ charity pays to other annuitants who are the age of Jenny Jones at the time of my death."

(b) The donor who establishes a CGA in his or her Will should also provide against the contingency that the charity may, for some reason, be unable or unwilling to accept the annuity agreement. For example:

"In the event that XYZ charity does not accept this bequest with all its conditions, I bequeath $4,000 to XYZ charity and $6,000 to my sister, Jenny Jones."

(c) In addition, the donor's Will should include a contingency clause covering the possibility that the named annuitant may predecease the donor – either by naming an alternative annuitant – or by leaving an amount outright to the charity.

(d) If the donor's Will provides for the establishment of a CGA for one or two survivors, the entire amount allocated for the annuity is included in the donor's gross estate for estate tax purposes. However, an estate tax charitable deduction is allowed for the value of the gift to the charity.

(e) If the donor's Will provides for the establishment of a CGA for the donor's surviving spouse for his or her lifetime, **the marital deduction will not be allowed** for the present value of the spouse's annuity interest. The reason is that the annuity for the surviving spouse is a non-deductible terminable interest (that does not qualify for the Q-TIP election.) The only estate tax deduction allowed is for the value of the charitable gift – the same deduction that would be available with a testamentary annuity for any annuitant.

D. **Charitable Remainder Trusts (CRT) – created under a donor's Will**. Another way to provide income to a family member or friend – and benefit charity – after the donor's lifetime, is for the donor to establish a Charitable Remainder Trust under his or her Will (a "testamentary charitable remainder trust").

1. Benefits:

(a) Provides income to a surviving family member or friend

(b) Donor's estate will be entitled to an estate tax deduction for the ultimate gift to the charity

(c) Charitable Remainder Trusts provide maximum flexibility –

- Flexibility as to income recipients (family members or friends)
- Flexibility as to level of income (donor chooses payout rate)
- Flexibility as to *type* of income (fixed or variable)

(d) **A way to make a really BIG DIFFERENCE to your organization**

2. Technical requirements:

(a) The donor will transfer assets to a Trustee – who will manage and invest the assets – and make payments, at least annually, to one or more individuals named by the donor.

(b) The Trust must qualify as a Charitable Remainder Annuity Trust (CRAT) or a Charitable Remainder Unitrust (CRUT)

(1) In order to qualify as a CRAT – the income beneficiary must have a "guaranteed annuity interest" - an irrevocable right to receive a guaranteed annuity (a determinable amount) payable at least annually for

(a) a specified term of years, or

(b) the life or lives of an individual or individuals, each of whom is living and ascertainable at the time of the transfer.

(2) In order to qualify as a CRUT – the income beneficiary must have a "unitrust interest" - an irrevocable right to receive payment, not less often than annually, of a fixed percentage of the net fair market value of the trust assets – determined annually. The trust can run –

(a) for a specified term of years, or

(b) for the life or lives of living individuals each of whom is living and ascertainable at the time of the transfer.

(c) The obligation to make income payments begins as of the date of the donor's death.

(d) The income payout must be at least 5% of the initial value of the trust, and cannot exceed 50% of the initial trust value.

(e) If the Trust qualifies as a CRAT or a CRUT, the value of the charitable remainder interest will qualify for an estate tax charitable deduction.

(f) If the surviving spouse is the **only** non-charitable beneficiary of a testamentary CRAT or CRUT, the spouse's income interest **will qualify for the marital deduction** in the donor's estate. (The Economic Recovery Tax Act of 1981 created this specific exception to the terminable interest rule for decedents dying after 1981.)

(g) If the income beneficiary(ies) include anyone other than the donor's surviving spouse, the total value of the income interest(s) is taxable in the donor's estate.

(h) If the CRT qualifies as a CRAT or a CRUT, and the surviving spouse is the only non-charitable beneficiary, the trust will also qualify for the charitable deduction in the surviving spouse's estate – so that the entire gift will escape estate taxes.

(i) Additional contributions may be made to a testamentary CRUT – but not to a testamentary CRAT.

E. Testamentary Pooled Income Fund gifts

1. Benefits:

(a) Donor can provide income to one or more survivors for life

(b) Donor's estate is entitled to a charitable deduction for the value of the charitable remainder interest

(c) If the donor's surviving spouse is the **only income beneficiary** the executor of the donor's estate can elect to qualify the value of the income interest for the marital deduction – under the Q-TIP rules – so that the surviving spouse's income interest will escape the estate tax.

2. Technical requirements:

(a) The donor must provide that a specific dollar amount or percentage of the estate be transferred to a particular charity's Pooled Income Fund, directing that the charity pay income to one or more named beneficiaries.

(b) The donor who makes a gift to a charity's Pooled Income Fund under his or her Will should also provide against the contingency that the Fund may, for some reason, be unable or unwilling to accept the gift.

(c) If the donor's Will makes a gift to a charity's Pooled Income Fund, providing an income to one or more survivors, an estate tax charitable deduction is allowed for the value of the remainder gift to the charity.

(d) If the income beneficiary is anyone other than the donor's spouse, the value of his or her income interest is taxable in the donor's estate.

(e) If the donor's surviving spouse is the **only** income beneficiary, the donor's executor can elect to have the value of the survivor's income interest qualify for the Q-TIP election. However, **the executor must make the Q-TIP election on the donor's estate tax return** – or the spouse's income interest will be subject to the federal estate tax. The marital deduction for Pooled Income Funds is not automatic – as it is for Charitable Remainder Trusts.

F. Testamentary Charitable Lead Trusts

1. Benefits:

(a) The Charitable Lead Trust pays an income to charity for a specified time – with the remainder going to individuals named by the donor – so that your organization can benefit from this gift immediately.

(b) The donor's estate is entitled to an estate tax deduction for the value of the charity's income interest – so that the trust assets go to heirs later on at a reduced estate tax cost.

(c) If the trust assets appreciate during the trust term, the heirs will ultimately receive the value of that appreciation tax-free.

(d) The donor can make a major gift to favorite charities at a relatively minimal cost to his or her family.

2. Technical requirements:

(a) In order for the value of the income interest to be deductible for estate tax purposes, it must be either a "guaranteed annuity interest" (CLAT) or a "unitrust interest" (CLUT).

(1) A "guaranteed annuity interest" is an irrevocable right to receive a guaranteed annuity – a determinable amount payable at least annually - for

(a) a specified term of years, or

(b) the life or lives of an individual or individuals, each of whom is living and ascertainable at the time of the transfer. The measuring life must be limited to the donor's spouse, a lineal ancestor, or the spouse of a lineal ancestor of all of the remainder beneficiaries.

(2) A "unitrust interest" is an irrevocable right to receive payment, not less often than annually, of a fixed percentage of the net fair market value of the trust assets – determined annually. The trust can run –

(a) for a specified term of years, or

(b) for the life or lives of living individuals each of whom is living and ascertainable at the time of the transfer. The measuring life must be limited to the donor's spouse, a lineal ancestor, or the spouse of a lineal ancestor of all of the remainder beneficiaries.

(b) There is no minimum income payout requirement for a CLAT or a CLUT (as there is for a CRAT and a CRUT).

(c) Additional contributions may be made to a testamentary CLUT – but not to a testamentary CLAT

(d) Trust income may be paid to any qualified charity chosen by the Trustee (need not name the income beneficiary charity(ies) in the Will.)

(e) The obligation to make income payments begins as of the date of the donor's death.

(f) If the trust assets are to be distributed to grandchildren (or other "skip persons") when the trust ends, the Generation-skipping Transfer tax rules will apply.

G. Testamentary gift of a residence – retaining the Life Estate

1. **Benefits:**

(a) Here the donor bequeaths his residential real estate (primary residence, vacation home, condominium, coop apartment, farm, etc.) to a charity – reserving the right to have a survivor live in and enjoy the property for his or her lifetime – then the property passes outright to the charity.

(b) Provides a convenient way to use real estate to benefit survivors – and charity.

2. **Technical requirements:**

(a) The donor must give a remainder interest in the property itself – not the proceeds of its sale.

(b) The value of the charity's remainder interest in the property will qualify for a charitable deduction in the donor's estate. In determining the present value of the remainder interest for *estate tax purposes*, depreciation and depletion need not be taken into account (as would be required when computing the income tax deduction for a lifetime gift.)

(c) The value of the surviving spouse's life estate will qualify for Q-TIP treatment – if he or she is the **only** life tenant of the property **and** the surviving spouse is entitled under the terms of the will to "personally occupy the house or to rent the house to others at any and all times during life." Merely giving the surviving spouse the right to life in the property for life is not sufficient. Also, the donor's executor must make the Q-TIP election on the donor's estate tax return.

H. Beneficiary designations of IRA's and other qualified plans

1. **Benefits**

(a) If retirement plan assets go to individuals at death, the Plan assets are subject both to income and estate taxes. On the other hand, if the donor designates a charity to be the beneficiary of his or her qualified plan at death – that gift will escape both income and estate taxes – and the charity will receive the full value from the Plan.

2. **Technical requirements:**

   (a) To avoid both income and estate taxes, the donor should designate a charity as the beneficiary on the plan's designation form – to make sure that the assets pass directly from the Plan to the charity.

   (b) If the Plan assets go through the donor's estate – they will be subject to both income and estate taxes.

   (c) Alternatively, the donor could designate an existing CRUT as the beneficiary – so that the Plan proceeds would go directly into the Trust to benefit one or more individuals for life, with the remainder going to charity. In this case, the value of the remainder interest would qualify for the estate tax charitable deduction. If the surviving spouse is the **only** income beneficiary of the CRUT, his or her income interest will qualify for the estate tax marital deduction. If anyone other than the surviving spouse is an income beneficiary, the income interest will be taxable in the donor's estate.

I. Beneficiary designations of Life Insurance policies

1. **Benefits**

   (a) One of the simplest and easiest ways for a donor to make a gift is to name your organization the beneficiary of an insurance policy on the donor's life.

   (b) Naming a charity as the beneficiary of a life insurance policy on the donor's life can be a simple substitute for a charitable bequest under a Will.

   (c) Naming a charity as beneficiary can be a convenient way to benefit a charity at death – without affecting other assets earmarked for the donor's family.

   (d) Upon the death of the insured, the proceeds of the policy are paid to your organization – and the donor's estate is entitled to an estate tax deduction.

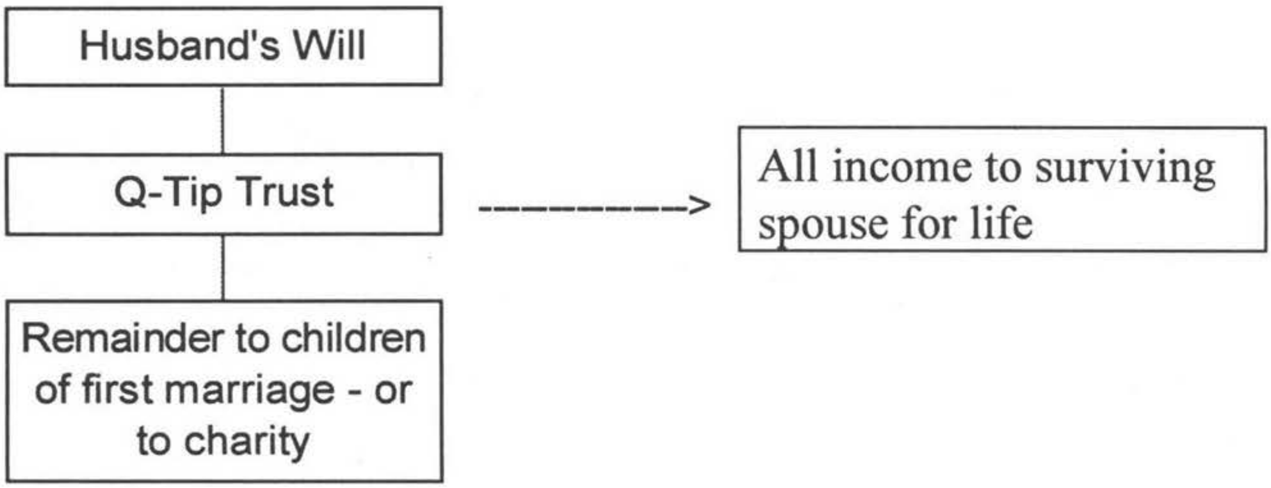
2. **Technical requirements**

   (a) The donor should name your organization as the beneficiary of all or a portion of the insurance proceeds on the beneficiary designation form.

   (b) This gift can provide flexibility for the donor – since he or she can name your organization as the sole beneficiary, or as a contingent beneficiary – to receive the proceeds only if a named individual beneficiary should predecease the donor. In the latter case, if proceeds are actually paid to charity – the donor's estate will be entitled to an estate tax deduction.

   (c) The donor can also name an existing CRUT – or a testamentary CRAT or CRUT to be the beneficiary of the proceeds of a life insurance policy.

Q-TIP TRUSTS



Benefits

- No Federal estate tax in first spouse's estate
- Preserves assets - to produce maximum return for surviving spouse
- Must use the entire trust income for the benefit of the surviving spouse
- No Federal estate tax in surviving spouse's estate if the remainder goes to charity
- Maximum flexibility to accomplish the donor's personal and charitable objectives

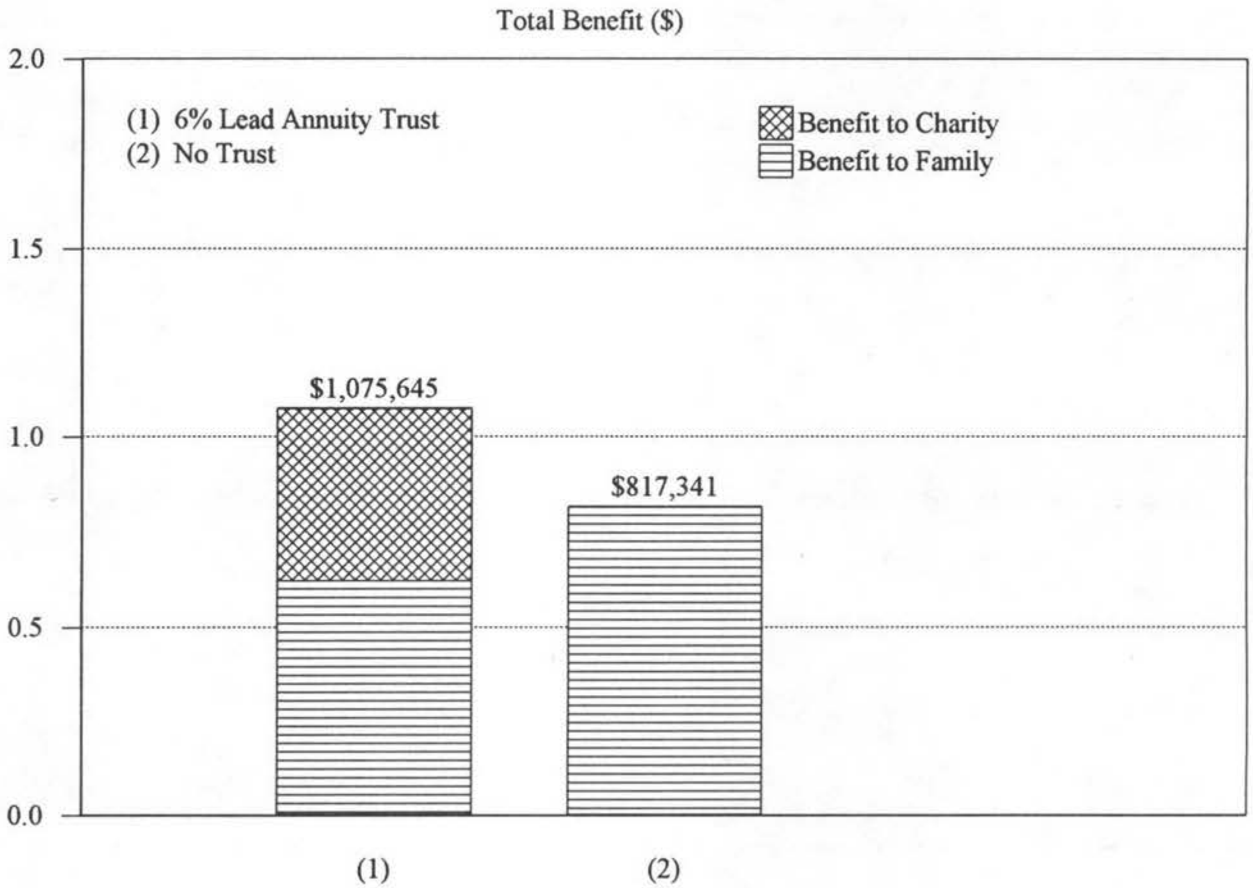
Ellen G. Estes, LL.B.
Estes Associates

February 28, 2004

Lead Trust Projections

Summary of Benefits

ASSUMPTIONS:
Testamentary Trusts established in 2004 for 15 years.
Lead Trust makes annual, end of period payments to Charity.
Original Principal of 500,000.
Beneficiary income tax bracket is 35% (phase in rate reductions), 15% for capital gains.
Value of donor's estate is 5,000,000. Prior taxable gifts are 0.
Income is 3%, capital appreciation is 4%.



IRS Discount Rate is 4.2%

The benefits shown in this example are for illustrative purposes only. Your exact benefits will depend upon the date you make your gift.

Example:

Gift of an IRA – as part of an Estate Plan

Situation

Mrs. Jones, a widow, has an estate worth $1.5 million. Her estate consists of $1,400,000 (which includes her home, jewelry, cash and securities), and a $100,000 IRA. She wants to leave $1,400,000 to her children, and $100,000 to your organization at her death. Mrs. Jones dies in 2004 – when the exemption amount for Federal estate tax purposes is $1.5 million (so there is no federal estate tax issue in this case.)

Option #1: Give the IRA to the children – and $100,000 in cash and stock to your organization.

	Cash & Stock to the Charity	IRA to children
	$100,000	$1,400,000 ($100,000 IRA; $1,300,000 other assets)
Income tax	0	35,000 (35% = assumed income tax bracket of children. 35% x $100,000 = $35,000)
Net	$100,000	$1,365,000

Option #2: Give the IRA to the Charity – and the cash and stock to the children.

	IRA to the Charity	Cash and stock to children
	$100,000	$1,400,000
Income tax	0	0
Net	$100,000	$1,400,000

Here, by giving the IRA to the Charity, and her home, jewelry, stock and cash to the children, the children actually receive $35,000 more – while the Charity receives the full $100,000 in either case. As you can see, leaving the IRA to charity after one's lifetime – and other assets to children and other heirs – really is the best way to go!

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) was signed into law by President Bush on May 28, 2003. The new law reduced tax rates on capital gain and dividend income, and accelerated the income tax rate reductions that were already scheduled.

Effective from January 1, 2003 to December 31, 2010, the MARGINAL INCOME TAX RATES for individuals are as follows:

10% 15% 25% 28% 33% 35%

The Economic Growth and Tax Relief Act of 2001 reduced federal gift and estate tax rates and provided a larger exemption amount for estates – phased in over a period of years. Under the Act, the estate tax will be completely repealed in 2010. However, the gift tax will remain – with the exemption amount for lifetime gifts limited to $1 million. (See chart below.) This law will expire in 2011 – and the basic tax rules that existed in 2001 will be reinstated (with higher income tax rates, higher gift and estate tax rates, and lower estate tax exemptions) – unless Congress acts.

Year	Lifetime Gift Tax Threshold	Estate Tax Exemption Amount	Highest Estate & Gift Tax Rate
2001	$675,000	$675,000	55% (+5% surtax)
2002	**$1 million**	**$1 million**	50%
2003	$1 million	$1 million	49%
2004	$1 million	**$1.5 million**	48%
2005	$1 million	$1.5 million	47%
2006	$1 million	**$2 million**	46%
2007	$1 million	$2 million	45%
2008	$1 million	$2 million	45%
2009	$1 million	**$3.5 million**	45%
2010	$1 million	Repealed !	Max gift tax rate = max inc tax rate
2011	$1 million	Reinstate:$1 million	55% (+5% surtax)

26th Conference on Gift Annuities

Marketing to a General Constituency

Presented by

Marc Carmichael, J.D.
President
R&R Newkirk Company
8695 Archer Avenue, #10
Willow Springs, Illinois 60480
(800) 342-2375
708-839-9207 (fax)
www.rrnewkirk.com
MarcCarmichael@msn.com

Marketing to a General Constituency

I. Introduction

Planned gift marketing has two primary goals: (1) To get prospects to "raise their hands" through some response mechanism that says to the planned gift officer: "I am someone you should be cultivating further," and (2) To encourage gifts that donors can accomplish on their own, through wills and beneficiary designations. The first goal, to encourage individuals within a general constituency to "raise their hands," or "self-identify," is the focus of this presentation.

In 1991, Frank Minton conducted a marketing survey of selected institutions that asked the basic question: How were your planned gift donors first identified? That survey (attached at the end of this paper) was the basis for a marketing presentation he made at the 1992 Conference on Gift Annuities. When Frank extended an invitation to make a presentation on marketing at the 2004 Conference on Gift Annuities, it seemed like a good time to update his 1991 survey, with the important addition of web sites and e-marketing as avenues of donor identification.

Survey participants were asked the following question: Looking at the recent history of planned gifts at your institution (January 2000 to the present), how were your donors first identified? How did they first appear on your "radar screen?" What percentage came from newsletter responses? Referrals from advisors? Web site hits? Donor seminars? In many cases, contact may have been initiated by staff through communications with previous planned giving donors, which is arguably a form of marketing (broadly defined). This category was No. 1 in the 1991 survey.

The 2004 survey contained eight classifications of gifts and 12 means of identification (including "other"). At the end of the form was an area for comments, including any details on "other" methods that resulted in donor identification at the respondent's institution. Results from colleges and universities were compiled and reported separately, then merged with all other organizations, as was done in the 1992 report.

How Persons Who Completed Planned Gifts Were *First Identified*

ALL CHARITIES

Type of Charity

- [x] College or University
- [x] Arts
- [x] Hospital
- [x] Social Services
- [x] Religious (other than College or University)

TYPE OF GIFT

HOW IDENTIFIED	Outright gift (planned giving office significantly involved)	Charitable remainder annuity trust or unitrust	Gift annuity	Pooled income fund	New bequest provision	Life insurance	All other planned gifts (life estate, lead trust, etc.)	All planned gifts
Previous planned giving donor	33 %	35 %	38 %	59 %	11 %	19 %	28 %	28 %
Responded to newsletter	11	8	11	6	9	9	4	13
Attended estate planning seminar	1	1	2	1	2	3	1	1
Responded to target mailing	10	2	17	3	17	10	6	17
Responded to article in institutional publication	2	1	3	1	2	2	6	3
Referral from professional advisor (attorney, financial planner, etc.)	5	9	2	3	11	14	18	6
Referral from donor or volunteer	8	2	3	2	6	4	5	4
Referral from member of development staff	17	17	8	19	15	13	2	13
Identified through annual giving solicitations	9	7	4	3	11	1	4	5
Website visit	1	1	1	1	2	.4	1	1
Responded to e-mail marketing	1	.4	.2	0	.4	.3	.1	.2
Other (all ways not listed above)	1	7	4	2	10	17	16	9

COLLEGES AND UNIVERSITIES

How Persons Who Completed Planned Gifts Were *First Identified*

Type of Charity

- [x] College or University
- [ ] Arts
- [ ] Hospital
- [ ] Social Services
- [ ] Religious (other than College or University)

TYPE OF GIFT

HOW IDENTIFIED	Outright gift (planned giving office significantly involved)	Charitable remainder annuity trust or unitrust	Gift annuity	Pooled income fund	New bequest provision	Life insurance	All other planned gifts (life estate, lead trust, etc.)	All planned gifts
Previous planned giving donor	34%	35%	41%	69%	11%	25%	37%	24%
Responded to newsletter	16	12	13	5	14	17	5	16
Attended estate planning seminar	0	2	1	1	2	4	0	1
Responded to target mailing	17	2	22	2	19	3	8	20
Responded to article in institutional publication	5	1	3	1	1	1	3	3
Referral from professional advisor (attorney, financial planner, etc.)	9	14	1	3	22	23	9	4
Referral from donor or volunteer	9	2	2	1	7	3	9	5
Referral from member of development staff	15	22	9	9	11	4	3	13
Identified through annual giving solicitations	5	8	3	4	11	0	0	4
Website visit	0	1	1	2	0	0	0	1
Responded to e-mail marketing	0	0	0	0	0	0	0	0
Other (all ways not listed above)	0	8	4	3	5	20	28	9

As Frank Minton wrote in his original report, "While the study cannot be called scientific, the results may be useful in directing our marketing efforts." Here are some broad conclusions:

A. Analysis of Data

1. The best prospect for a planned gift is a past donor.

2. Donors who arrange charitable gift annuities and pooled income fund contributions are most likely to make repeat gifts.

3. Targeted mailings are an important source of prospect identification, particularly for charitable gift annuities and bequests, followed by planned giving newsletters.

4. Planned giving newsletters are effective in turning up prospects for charitable remainder trusts and life insurance gifts, although referrals from development staff and professional advisors are also important.

5. Referrals from other development staff are of growing importance in identifying prospects.

6. Participant comments indicated that "print media" headed up the large "other" category of prospect identification.

7. Referrals from professional advisors accounted for the largest number of identified life insurance donors and a significant number of bequest provisions. Sophisticated gifts such as charitable lead trusts and remainder interests in farms and homes also had a high level of referrals from advisors.

8. Less than 1% of donor identifications resulted from web site hits or e-mail marketing efforts, with colleges and universities doing less well than other organizations.

9. Results from estate planning seminars declined from levels reported in the 1991 Minton survey, with religious organizations doing better than others.

10. Personal letters, personal visits, phone calls, enclosures with annual gift mailings, organized social gatherings and "word of mouth" are all contributing factors to donor identification at many organizations.

11. Results of the 2004 survey paralleled, for the most part, the 1991 survey, except for the apparent decline in seminar results (seminar saturation?) and an increase in the amount of target marketing by charities other than schools. Charitable gift annuities, especially, seem to have become a focus of target marketing, aimed undoubtedly at retired age groups.

12. Sources of planned gift prospects in order of importance are:

All Charities	**Educational Institutions**
Previous Planned Giving Donor	Previous Planned Giving Donor
Responded to Target Mailing	Responded to Target Mailing
Responded to Newsletter	Responded to Newsletter
Referral from Development Staff	Referral from Development Staff
Other	Other
Referral from Professional Advisor	Referral from Donor or Volunteer
Identified Through Annual Giving Solicitations	Referral from Professional Advisor
Referral from Donor Or Volunteer	Identified Through Annual Giving Solicitations
Responded to Article in Institutional Publication	Responded to Article in Institutional Publication
Website Visit	Website Visit
Responded to E-mail Marketing	Responded to E-Mail Marketing

B. Responses to question: "In general, which marketing techniques have been most effective for you?"

Comments from Colleges and Universities:

1. Newsletters and visits; web improving; working on more staff involvement/referral. Seminars are getting tougher; however, events featuring mission with a soft sell on gifts works still.

2. Personalized direct mail letter, postcards, newsletters and ads (in this order) have

been most effective when used in tandem. For example, when mailing a newsletter on annuities, our ads for the same period focused on annuities. Nothing replaces personal relationships with planned giving donors.

3. Obviously, we've had a lot of "repeat" donors. Printed materials have provided leads that turned into gifts. And we've trained development officers and got some referrals. We don't know to what extent the website has helped in developing leads/gifts.

4. Word of mouth, post cards, classmate/peer testimonials, staff (major gift) coordination.

5. Direct mail and print advertising.

6. I looked at the 94 life income gifts booked so far this fiscal year, plus the 156 booked last year, and found that in many cases we simply don't know what put these people into the PG frame of mind at the time they made their gift. E-mail and web pages have changed the mix only at the margins, in our experience. The overarching source of gifts is our direct mail and print work. Last, we have a 35% repeat customer rate from year to year, most of the time.

7. Newsletters and solicitations to current participants; however, the best is face to face visits.

8. Targeted mailings.

9. Most effective have been our inserts in annual fund mailings in identifying new bequests. We also got good response to a gift flyer last year announcing lower rates. The largest number of planned gifts came from referrals from major gift staff.

10. Planned giving does not operate in a vacuum here. It is a complementary and integral part of our development program, a natural extension. Another category includes "friends" so close to the institution that it is not possible to determine what led them to take action. The number of repeat gifts also supports the concept of close friends.

11. Targeted mailings for gift annuities. We've tried several kinds and they all worked well. "Telephone" category is when we didn't always get a good answer on the source of the gift. These could fall into any of the other categories!

12. Target mailings, newsletter, staff referrals.

Comments from Other Organizations

1. (Social service/religious organization). Ads in regular city newspapers and the Wall Street Journal. Donor "upgrades" are important and we are successful with seminars and personal letters.

2. (Public radio station). Referrals from allied professionals are not the most frequent source of leads, but are clearly the highest close rate. In addition, the previous planned giving donor is also a frequent source of new gifts. The inserts we include with all annual gift receipts are a good source of leads and of learning about bequest commitments (we included that under "identified through annual giving.") Our planned giving newsletter and our on-air promotion of planned giving also work well for us. Notes: Many of the gift annuities received in the past two years from people who are "previous donors" are the result of targeted mailings, newsletter and on-air promotion of the CGA. The format used here does not provide a way to reflect that fact, not that I could break it down much more anyway. Much of our "other" category is because we don't know the source, or because it was the result of on-air promos.

3. (Social services organization). Our program is still a relatively new, young program. As a result, the majority of gifts have come from direct mail. One item I did not list that has identified bequest donors primarily has been receptions held by our CFO. We invite strong prospects and often discover planned gifts during conversation.

4. (Hospital). Planned giving newsletter, annual solicitations, with check boxes related to planned gifts.

5. (Social services organization). Word of mouth.

II Elements of Planned Gift Marketing

The discussion of planned gift marketing lends itself to many truisms and adages: "If you throw enough jelly against the wall, some of it is bound to stick" comes to mind. The point is that success in planned gift marketing depends on persistent, regular, continuous cultivation and education of prospects. It also helps if you can find a particular marketing device or medium that is especially effective for your organization (more about that later). Everything starts, of course, by first identifying who those prospects are.

A. Who are our prospects?

Conventional wisdom suggests that the best planned gift prospects are people who (1) will receive personal satisfaction from assisting your organization, (2) are retired or nearing retirement age, (3) have sufficient wealth to make a major gift and (4) are childless or otherwise without family financial obligations.

B. Internal Marketing . . . Charity Begins at Home

Starting within your organization makes sense in planned gift development. Staff, retired staff, trustees and volunteers can all make referrals and, in many cases, gifts.

1. Train your fund-raising staff in basic planned gift techniques and opportunities and educate them on how to recognize prospects.

2. Present a program for your board on planned giving and explain their role in the program Ask for referrals and encourage members to make their own gifts.

3. Conduct planned giving seminars for your volunteers.

4. Stage seminars for current or retired staff. Ask for gifts and referrals.

C. External Marketing

1. Direct mail marketing program for prospects.

Successful planned giving programs usually include periodic mailings of charitable estate planning information (three or four times a year) to educate prospects about the benefits of planned giving. It is part of the long-term cultivation process that you must conduct so that your prospects become familiar with planned giving opportunities and remember your institution when they begin their serious estate planning.

The preparation of a planned giving newsletter can be time-consuming because of the legal and financial information required, as well as the preparation of success stories of planned gifts to your institution. If you do not have the legal and writing backup to produce a newsletter internally, you may wish to purchase one of the professionally published planned giving newsletters. The key to a successful newsletter is personalization of the artwork, photographs and copy to provide identification with your institution.

TIP: Use testimonials from donors wherever possible. They are *pure gold.* Ask donors to write, in their own words, "Why I gave to ___________." Impress upon them that their testimonial is almost as important as their gift. One planned giving officer helps donors organize their thoughts for testimonials by sending them a list of questions about how the gift came about, including their history of involvement with the organization, why they gave, the benefits, etc.

SELL THE SIZZLE of planned giving. Never try to tell readers everything you know in a planned giving article. Avoid technical jargon. Do readers really need to know all the nuances and distinctions of unitrusts, annuity trusts, gift annuities and pooled income funds? Initially, all they need to know is: A person can make an important gift, keep an income for life and still receive a substantial tax deduction. Market the benefits of planned giving, not the techniques. One of the weaknesses of buying a newsletter prepared by an outside firm is the risk of it appearing to be "canned" material. However, most of the newsletter services provide for a high degree of personalization of copy. Be creative!

Remember, always include in your mailing a response card to request informational booklets. This will provide qualified leads for personal follow-up. *TIP:* Add a space for e-mail addresses on your reply card. More donors are starting to use e-mail and may prefer this form of communication. You can improve response by including donor testimonials and articles on important programs – including photos. Response rates soar when you offer information on recent tax law changes or estate and financial planning materials that are useful to the reader. Involving the reader with "rate your estate plan" exercises or other self-testing articles also improve response.

Additional TIP: If you aren't delivering the informational booklet personally, *photocopy the reply card* and attach the photocopy to the booklet, so the prospect remembers he or she had requested the information. "Making the connection" is especially important with older persons, or executives/professionals whose gatekeeper screens mail; attaching the photocopied reply card helps avoid the booklet being treated as junk mail.

2. Newspaper and magazine advertising

Newspaper and magazine advertising can be expensive, and advertisements outside of institutional publications often elicit responses more motivated by tax savings than by charitable instincts. Converting these prospects into donors is more difficult. Pomona College used advertisements effectively in financial papers for many years by stressing the tax advantages of planned giving. They raised more than $50 million from non-alumni over a 35-year period. The Arthritis Foundation enjoyed success with a wills advertisement in *Modern Maturity* – clearly a case of choosing the right medium for their target market.

3. In-house publications.

Quarterly magazines, alumni publications, annual reports, etc., are all good sources of free marketing. Include planned giving articles and encourage readers to write or call for more information, or to clip and send back a coupon. Tuck "buck slip" cards with bequest information into other mailings. If you have a planned giving newsletter, tell readers they can be put on the mailing list.

Remember us in your will, please.

When you write or review your will, please consider leaving the College a charitable bequest for future generations of Ripon students. Ask your attorney to include such words as these:

"I give to Ripon College, Ripon, Wisconsin, for its general purposes all (or state percent) of the rest, residue or remainder of my estate, whether real or personal."

OR

"I give to Ripon College of Ripon, Wisconsin, the sum of $__________ dollars to be used for the general purposes of the College."

RIPON COLLEGE

Ripon, Wisconsin

Where there's a will, there's a way . . .

for Ripon students.

Since 1851 bequests and other special gifts have provided student scholarships and educational programs.

Check for further information:

- ❑ Charitable gift planning
- ❑ Wills and bequests
- ❑ Retained life income gifts

Name ________________________

Address ______________________

City __________________________

State ________ ZIP ____________

Phone ________________________

❑ Here is a gift of $ to help enhance Ripon's mission.

RIPON COLLEGE

300 Seward Street • P.O. Box 248
Ripon, Wisconsin 54971

4. Target marketing

Marketing to narrow interest groups within your constituency is a concept that depends on the ability to segment your mailing list. Many organizations, schools especially, are able to segment lists by age, which allows targeting of retiree groups and other age categories. Segmenting by annual gift size is feasible for organizations that wish, for example, to send a year-end-planning mailing to donors who give $100 a year or more. Hospitals and medical schools report success with specialized planned giving newsletter for medical staff and med school graduates. Lists can be segmented by gender for "Estate Planning for Women" mailings and seminars. It may be much more difficult to extract names for narrow categories such as executives, professionals or business owners, although list companies claim they can do it.

5. Estate planning seminars – for prospects

Development officers in years past have found estate planning seminars to be an effective method of exposing their prospects to the concepts of charitable estate planning and to develop qualified leads. To obtain the desired audience, invite those in your constituency that fit the profile discussed earlier. Don't emphasize planned giving exclusively, but discuss broader concepts of financial and estate planning with only a smaller segment devoted to charitable estate planning. Too narrow a focus on charitable gifts to your institution will appear contrived and not get the turnout you desire. Use outside professionals to take part in the program. They can be the advisors you are trying to cultivate through your other efforts. They will appreciate the opportunity to increase their visibility and will add credibility to the program. You may conduct the charitable estate planning segment to increase your visibility. If at all possible, hold the seminar on the location of your institution. This will provide a direct involvement with your organization that helps build the relationships you are trying to cultivate. Schedule one or more breaks so you can chat with attendees. *TIP:* Lexington House (859-277-6135) publishes *Classic Cases: The Estates of Famous Americans,* which provides fascinating illustrations of bad planning, complete with photos of deceased luminaries ($79.95).

6. Websites, e-mail and broadcast media

Every organization in 2004 should have a planned giving page on its website that, at the very least, announces to the world that bequests and other planned gifts are welcome, with information on whom to contact. Many planned gift donors have several organizations they wish to benefit and can be expected to surf the web for information. If an organization's website offers nothing on planned giving, it may be viewed as backward or not interested in planned gifts. A growing number of older individuals are adept at navigating the web and advances in technology have simplified access, even to the point where "surfers" do not even need a computer. Organizations typically provide planned giving menus that describe gift benefits of various outright and deferred gifts. It's not a good idea to overload your site with extensive text. Better to "sell the sizzle" and encourage readers to contact you for more information. It's important to add fresh material to your page regularly. Be sure to include your correct legal name, for bequest purposes. You can locate examples of planned giving pages by searching "planned giving" on a search engine. See especially www.pgcalc.com and the article by Gary Pforzheimer, *Internet Marketing for Planned Giving* (under Planned Giving Information). Once you establish your website, TELL THE WORLD ABOUT IT – on your stationery, planned giving newsletters and other publications.

Some organizations periodically send planned giving information to prospects who have e-mail addresses, putting together "listservs" for specific donor groups.

Planned giving public service announcements on local television have been produced by some organizations. The Cleveland Symphony and Chicago Symphony Orchestra have had good results with gift annuity commercials on the local classical music radio station.

D. Marketing to Professional Advisers

Every bequest provision and 80% of all other planned gifts will require the involvement of a donor's professional advisor. Conclusion? Educating professionals about the benefits of charitable estate planning and cultivating their interest in your institution may be almost as important as prospect cultivation.

Experienced professionals in planned giving have found that personal calls on attorneys, CPAs, trust officers and life underwriters who relate to your constituents can pay very big dividends over the long run. Many development officers confuse the kind of cultivation we are suggesting with projecting the idea that these professionals recommend your institution. If they will, that's fine. What we are suggesting is more subtle. It is that you provide a service for these professionals by exposing them to the basics of charitable estate planning. They will respect your expertise and learn more about your institution in the process. When their clients, who are your prospects, are doing their serious estate planning, the rapport you have developed will make the gift easier to negotiate and enable you to make stronger suggestions which may result in larger gifts.

If you have the budget for it, you might consider purchasing a direct mail newsletter for professional advisors. This will put your institution's name in front of them on a regular basis. You will be pleasantly surprised by the number of contacts you will receive from advisors. This can be a very effective tool for advisor cultivation.

Some organizations establish planned giving advisory councils (not necessarily the same group as the planned giving committee). The council might be made up of 12-16 professionals, equal numbers of CPAs, CLUs, trust officers and estate planning attorneys who meet quarterly for educational programs on charitable gift planning topics. The primary purpose is education, but members also agree to be available for pro-bono work for the sponsoring organizations, such as speaking at seminars and assisting with technical questions. The members are not expected to make gifts, or even referrals, but the connection with the charity is beneficial . . . not to mention the education they receive in gift planning. Advisory councils sometimes have membership of 100 or more, with a core group that provides technical assistance. Members receive a professional adviser newsletter, attend planned giving seminars 3-4 times a year, and may request consultation for their clients with a nationally-known planned giving expert that is on retainer with the organization.

While you should concentrate your seminar efforts on prospects, do not overlook the opportunity for cultivating professional advisors through seminars. You will find that mixing prospects and professionals in a seminar audience will not be worthwhile. Their level of understanding and interests are usually too far apart. You will probably fail to communicate effectively with either segment of the audience.

If you plan on holding three or four seminars a year for prospects, consider an annual estate planning seminar for professionals. Deal with creative estate planning concepts, recent changes in the law affecting estate planning, and be brief but effective in getting across the concepts of planned giving.

Be professional in all aspects of the seminar. By enabling professionals to keep up-to-date in their field, you will have a good turnout and a successful seminar. In fact, since many attorneys and CPAs must validate so many hours of continuing education each year, you should inquire about obtaining accreditation from the Bar and CPA associations. But allow plenty of lead time to assure timely approval. You even can charge a reasonable fee, which will probably cover most of your expenses. *TIP:* Thursdays and Fridays are the best day for seminars. Forget Mondays.

The Heritage Guild

MEMBERSHIP APPLICATION

Name(s) ____________

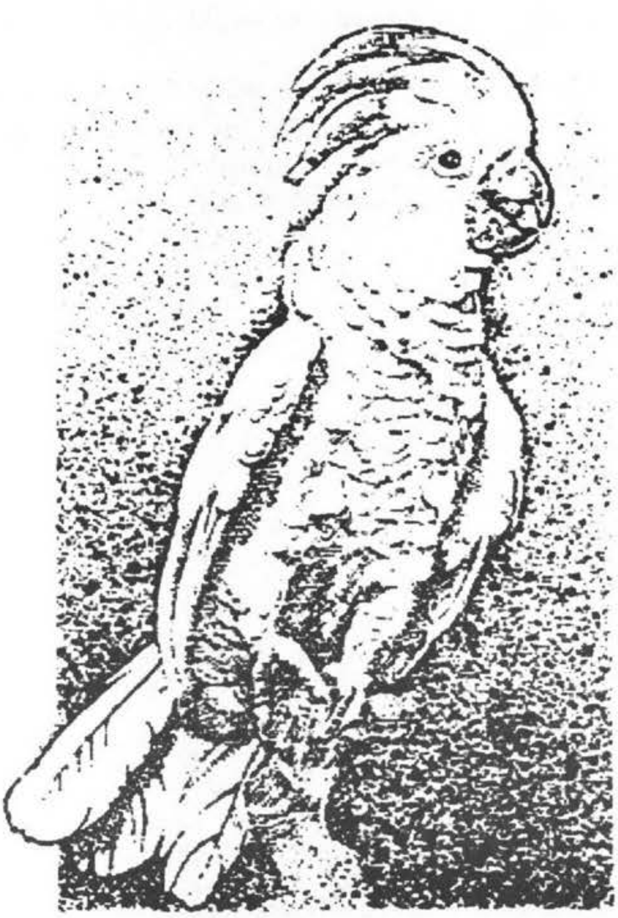
Address STATE ST

SAN DIEGO CA 92101

Phone - 4398

Please briefly describe the estate gift that qualifies you for Guild membership (all information submitted will be kept confidential):

We have designated the zoo as beneficiary for 20% of our estate (current value of approxi-mately $200,000).



E. Service after the gift.

When you consider that past donors are your best prospects for new planned gifts, it's clear that continued cultivation and recognition are paramount for a successful program. Recognition can take many forms, but most programs should include:

1. Heritage society membership for bequest donors.
2. Publicity (if the donor permits) in appropriate publications.
3. Invitations to dinners and other functions.
4. Tours of your facility or campus.
5. Thank you letters to families of deceased donors who made gifts at death.
6. Appropriate tangible recognition: certificates, plaques, figurines, etc.

It's wise to give some thought to the name of your recognition society. Try to use something emblematic of your institution. "Heritage Society" or "Legacy Society" are common names, but some organizations choose the names of their founders. Here are some names that surfaced on the Gift-PL list serv recently:

"Gifts to the Sea" (Center for Marine Conservation)
"George Bird Grinnell Society" (National Audubon)
"Rara Avis Society" (National Wildlife Federation)
"Rachel Carson Society" (Sierra Club)

Lyric Opera of Chicago has the "Overture Society" and Roosevelt University (FDR) encourages membership in "The Fireside Circle," recalling the President's fireside radio chats. The author's favorite is a school out west (the OLD West) that established the "Boot Hill Society!"

1992 SURVEY

How Persons Who Completed Planned Gifts Were First Identified

ALL CHARITIES

Type of Charity

- ✓ College or University
- ✓ Arts
- ✓ Hospital
- ✓ Social Services
- ✓ Religious (other than College or University)

TYPE OF GIFT

HOW IDENTIFIED	Outright Gift (Planned Giving Office Significantly Involved)	Charitable Remainder Annuity Trust or Unitrust	Gift Annuity	Pooled Income Fund	New bequest provision	Life Insurance	All Other Planned Gifts (Life estate, lead trust, etc.)	All Planned Gifts
Previous Planned Giving Donor	46%	28%	44%	23%	10%	21%	42%	26%
Responded to Newsletter	5	30	6	27	3	3	2	7
Attended Estate Planning Seminar	2	7	4	1	31	0	0	15
Responded to Target Mailing	0	0	7	2	17	10	0	9
Responded to Article in Institutional Publication	1	2	3	3	3	0	0	2
Referral from Allied Professional (attorney, financial planner, etc.)	4	17	2	1	8	35	2	7
Referral from Donor or Volunteer	23	9	24	37	15	16	50	23
Referral from Member of Development Staff	10	3	3	2	2	3	1	3
Identified Through Annual Giving Solicitations	3	0	2	1	6	3	1	3
Other (all ways not listed above)	6	4	5	3	5	9	2	5

In general, which marketing techniques have been most effective for you?

All numbers are percentages. Read columns from top to bottom.

1992

How Persons Who Completed Planned Gifts Were First Identified

COLLEGES AND UNIVERSITIES

Type of Charity

✓ College or University ___ Arts
___ Hospital ___ Social Services
___ Religious (other than College or University)

HOW IDENTIFIED / TYPE OF GIFT

	Outright Gift (Planned Giving Office Significantly Involved)	Charitable Remainder Annuity Trust or Unitrust	Gift Annuity	Pooled Income Fund	New bequest provision	Life Insurance	All Other Planned Gifts (Life estate, lead trust, etc.)	All Planned Gifts
Previous Planned Giving Donor	45%	26%	54%	32%	2%	13%	30%	26%
Responded to Newsletter	8	31	9	16	5	9	10	10
Attended Estate Planning Seminar	0	4	3	3	1	0	0	2
Responded to Target Mailing	0	0	8	5	44	0	0	19
Responded to Article in Institutional Publication	1	1	2	8	5	0	0	3
Referral from Allied Professional (attorney, financial planner, etc.)	5	17	2	3	10	39	20	9
Referral from Donor or Volunteer	1	4	5	16	2	0	10	4
Referral from Member of Development Staff	21	6	5	5	8	9	10	9
Identified Through Annual Giving Solicitations	7	0	3	3	7	9	5	5
Other (all ways not listed above)	12	11	9	9	16	21	15	13

In general, which marketing techniques have been most effective for you?

All numbers are percentages. Read columns from top to bottom.

ELEMENTARY, MY DEAR WATSON

Creative Solutions to Planned Giving Cases

by

ROBERT E. HARDING
GRAY, PLANT, MOOTY, MOOTY & BENNETT, P.A.
500 IDS Center
80 South Eighth Street
Minneapolis, MN 55402
Phone: (612) 632-3091
Fax: (612) 632-4091
robert.harding@gpmlaw.com

ELEMENTARY, MY DEAR WATSON

Creative Solutions to Planned Giving Cases

I. The Hound of the Baskervilles – Donating a Condominium Unit

Condominiums and their close relations, apartments in housing cooperatives, are subject to the bylaws of the condominium (or cooperative housing) association. The bylaws often place narrow restrictions on the sale or gift of a unit. These rules are designed to protect the condominium owners by ensuring desirable neighbors, preventing owners from renting their condominiums to outsiders and otherwise maintaining a congenial atmosphere. Unfortunately, these same rules can play havoc with an owner's plan to give his or her unit to a charity.

A. The Situation

1. In an effort to escape the shattering memory of his encounter with the hellish hound of the Baskervilles, Sir Henry has sold Baskerville Hall, emigrated to the United States and purchased a condominium in Chicago.
2. Years of city life have not laid his nightmares to rest, and he has decided to move to a ranch in Wyoming.
3. Given his vast wealth, he feels no need to sell the Chicago condo. Instead, he plans to donate it to his favorite charity, the Humane Euthanasia of Animals League.
4. Unfortunately the condominium association bylaws prohibit an owner from transferring a unit, gratuitously or otherwise, to any transferee other than an individual approved by the board. The condominium association board is willing to bend a bit, however, and allow the gift to HEAL, provided that HEAL has already entered into a purchase agreement with an individual buyer approved by the board.
5. What should Sir Henry do? (About the condominium gift, that is. His nightmares raise other issues that are beyond the scope of this presentation.)

B. Outright Gift of Condominium Unit

a. The risk with an outright gift is that Sir Henry will probably be taxed on the gain when HEAL sells the condo to the pre-approved buyer. The IRS reached a similar conclusion in Field Service Advice 2001-49-007. Although Sir Henry could certainly pay the tax because of his vast wealth, *supra,* at I.A.3, he would rather not. After all, donors are not supposed to have to pay to make charitable gifts.

C. Transfer to Short-Term CRT

Interestingly, the condominium bylaws do not require that an individual transferee of a condominium unit live there (they do, however, prevent an individual owner from renting the unit to someone else). This small loophole in the bylaws presents an interesting opportunity.

1. Sir Henry creates a CRT with an individual trustee and transfers the condo to the trustee without any pre-arranged agreement to sell to a particular buyer or within a specified period of time. The individual trustee is pre-approved by the condominium association.
2. The CRT makes the minimum annual payout, 5 percent, and runs for a short term, *e.g.*, 2 years.
3. Sir Henry is allowed an immediate income tax deduction for almost the entire fair market value of the condominium unit (assuming that he obtains a "qualified appraisal" of the unit within the prescribed time limit).
4. Once the trust is funded, the individual trustee can list the condo or otherwise look for a buyer. If one is found and approved by the board, the trustee can consummate a sale without violating the condominium association bylaws.
5. Sir Henry can give HEAL the payments he receives from the CRT, generating income tax deductions which offset the taxable income to him.
6. Instead of giving each annual payment to HEAL, should Sir Henry donate his remaining CRT income interest to HEAL after the condominium is sold? Probably not. A donor of a CRT who gives his remaining CRT interest to the charitable remainder beneficiary, causing the CRT to terminate early and distribute its assets to the charity, will be allowed an income tax deduction for that gift only if he had no plan to make that gift when he set up the CRT. *See* Treas. Reg. § 1.170A-7(a)(2). In Sir Henry's case, it may be hard to argue that there was no pre-arranged plan.

D. Is the Short-Term CRT Plan an Abusive Scheme Subject to Challenge by the IRS?

The IRS will typically challenge a "creative" use of a CRT on one of three grounds: (i) the "donor" has no genuine donative intent, (ii) the amount of the income tax deduction allowed to the donor will not be commensurate with the amount the charity actually receives, or (iii) the donor obtains unintended tax avoidance benefits, such as those purportedly generated by the infamous "accelerated CRT." Arguably, Sir Henry's plan exhibits none of those features:

1. Sir Henry clearly has donative intent. In fact, he would have preferred to give HEAL the condo outright. Only the condo association's bylaws deterred him from doing so.

2. There is nothing to suggest that the actual value of the charitable remainder will be impaired: no tricky payout, no funny definition of trust income, and no manipulation of trust investments, any of which might be questionable factors in the eyes of the IRS.
3. Provided that there is no pre-arranged sale, there would seem to be no abusive avoidance of capital gains tax. Had Sir Henry been able to give the condo outright without a pre-approved buyer in place, HEAL could have sold the unit without tax to Sir Henry. Thus, the fact that he achieves the same result with a CRT should not be considered abusive. Notice that the condo association's board has not insisted that the trustee sell the condo before the term of the CRT ends. Had it done so, the plan might run afoul of FSA 2001-49-007, cited above.
4. What happens if the trustee does not sell the condo before the trust term ends? The governing instrument requires that the trustee distribute the condo to HEAL, but the condo association's bylaws apparently prohibit that. If the trustee succeeds in selling the property before the trust term ends, this issue is moot. On the other hand, if the trust term ends without a sale, a dispute between the trustee, HEAL and the condo association could come up. There are, however, two possible solutions. First a CRT is allowed a reasonable period to wind up after its term ends. Treas. Reg. § 53.4947-1(b)(2)(iii). Second, the now purely charitable trust with the individual trustee could continue as a supporting organization for HEAL under IRC § 509(a)(3), provided that a state court orders an appropriate reformation of the trust agreement.
5. **Caution:** this plan should avoid capital gains tax for Sir Henry under the condominium association bylaws described here. Each condo association's bylaws are different, and some bylaws may be so restrictive that it is impossible to make any kind of charitable gift without a pre-arranged sale and the attendant adverse capital gain tax consequences.

II. The Sign of Four(ty) – Funding a Life Income Gift with S Corporation Stock

Closely held businesses are often organized as S corporations. A few years ago, Congress liberalized the definition of a permissible S corporation shareholder to include charitable organizations (but not CRTs). There are, however, hidden tax burdens associated with charitable gifts of S corporation stock. As a result, the conventional wisdom about the funding of life income gifts may not hold true in this area.

A. The Situation

1. Dr. Mortimer, Sir Henry's personal physician, has followed his principal patient to America where he has established a medical equipment business specializing in defibrillators. He runs the business as an S corporation which he hopes to sell sometime in the near future. He has put out feelers but has not begun negotiating with a particular buyer.

2. Dr. Mortimer, an avid lepidopterist, would like to use $100,000 of his S corporation stock to set up a life income gift with his favorite charity, Butterflies Forever. He does not have a strong preference between an annuity and a unitrust payout but would like the highest rate that BF can offer him.
3. Mortimer's combined federal and state capital gains tax rate is 20 percent. The combined marginal state and federal corporate tax rate in Minnesota, where Mortimer lives and where his corporation and BF are incorporated, is 40 percent (there is no special lower capital gains rate for federal or state corporate income tax purposes). *E.g.*, IRC § 11(b). Mortimer has a nominal basis in his shares.
4. Mortimer expects that his corporation will be bought by an individual or a group of individual investors.

B. Transfer of S Corp Stock to a CRT

Because a CRT is not a permissible S corporation shareholder, *see* IRC §§ 1361(b)(1)(B) and (c)(2), a transfer of some of Mortimer's shares to the CRT will terminate the S election. Under normal circumstances, the election cannot be reactivated for five years. IRC § 1362(g). The likely buyers for Mortimer's corporation are individuals who would like to purchase an S corporation because of the tax advantages. Terminating the S election will make the stock less attractive, rendering a sale harder at Mortimer's target sale price.

C. Establishing a CGA with S Corporation Stock

A charity is a permissible S corporation shareholder, IRC §§ 1361(b)(1)(B) and (c)(6), so funding a CGA with S corporation stock will not terminate Mortimer's S election. There is, however, another disadvantage.

1. BF takes Mortimer's basis when he transfers some of his stock to BF in exchange for the CGA. Thus, if a buyer is found and a sale consummated, BF will have capital gain on the sale of its shares roughly equal to their purchase price of $100,000.
2. Under a special rule, gain realized by a charity on the sale of S corporation stock is unrelated business taxable income which is taxable to the charity at normal corporate rates. IRC § 512(e)(1)(B)(ii). The combined federal and Minnesota corporate rate is roughly 40 percent. Thus, when BF sells its shares, it will be left with only $60,000.
3. Assuming BF is aware of this rule, it will presumably write a gift annuity at only 60 percent of the rate it would offer had the CGA been funded with cash or publicly traded stock.

D. Sale by Mortimer/Funding of CGA with After-Tax Sale Proceeds

Suppose, instead, that Mortimer waits until he sells the S corporation, pays the capital gains tax at a combined rate of 20 percent, and funds the CGA with the after-tax proceeds from the sale of the $100,000 black of shares. Somewhat surprisingly, this yields a better result, given his objectives.

1. If Mortimer sells the $100,000 block of shares, he will have $80,000 of proceeds from that sale after he pays federal and Minnesota capital gains tax at a combined rate of 20 percent.
2. If he then funds the CGA with cash, he will receive an annual payment 33 percent higher (80,000 ÷ 60,000 = 133%) than he would if he funded the CGA with S corporation stock as described above.
3. Note that the income tax deduction consequences of this alternative are a mixed bag when compared with the CGA funded by means of the S corporation stock. If Mortimer funds the CGA with the after-tax cash, the starting point for the computation of his deduction is lower - $80,000 as compared with $100,000. On the other hand, with the cash transfer he has a higher deduction limit – 50 percent of adjusted gross income as opposed to 30 percent.

III. The Case of the Quiescent QTIP—Funding a Life Income Charitable Gift for a Surviving Spouse with a Retirement Account

Most gift planners know that a tax-favored retirement account (IRA, 401(k), etc.) is normally the best asset to leave to charity at death (or at the surviving spouse's death). Under current law, if left to children, a retirement account will be subject to one more tax (income tax) than most other assets. This will be true even if the estate tax is permanently repealed in the face of massive projected budget deficits. If the donor wishes to provide an income stream for a surviving spouse out of the account before the charitable gift occurs, the question is how best to set up that plan.

A. The Situation

1. The stolid and workmanlike Inspector LeStrade, finally fed up with being outdone, shown up, and generally embarrassed by the brilliant and edgy Sherlock Holmes, accepted the job of Chief Detective with the Boston Police Force.
2. At his retirement, his principal asset other than his and his wife's home was a very substantial retirement account.
3. Because the account is the couple's main source of retirement income, LeStrade would like as much of the account as is necessary to be used to provide for his wife if she survives him.

4. The Inspector would also like whatever remains in the account at the surviving spouse's death to go to The Gumshoe Players, a nonprofit reparatory theater that specializes in dramatic thrillers and theatrical adaptations of mystery novels. His wife does not share his fondness for the Gumshoe company. In fact, she finds their productions juvenile and repellant.
5. What should LeStrade do with his retirement account?

B. Testamentary CRT for Spouse

LeStrade could designate a CRT for his wife as the beneficiary of the account. If he sets this arrangement up properly, only amounts distributed to her from the retirement account assets held in the CRT will be subject to income tax. The balance of the account will accumulate tax free in the CRT for ultimate distribution to Gumshoe. *See* IRC § 664(c). This plan has an obvious downside, however.

1. A CRT would make a defined unitrust or annuity payment to Mrs. LeStrade. By definition, the trust cannot make any other payments to her. If LeStrade has underestimated the amount she will need when he sets the payout rate, she is out of luck.
2. LeStrade could build in a fudge factor, setting the payout percentage higher than what he thinks his wife will need. This approach has its limits, however. First, the payout cannot be so high that the trust fails the 10 percent minimum charitable remainder test (and the 5 percent probability test if the trust is a CRAT). Second, even if the trust passes those tests, Mrs. LeStrade may end up getting more than she will need and, *ex hypothesi,* none of that excess will ever benefit The Gumshoe Players.

C. QTIP for Wife with Charitable Remainder

To qualify for an estate tax marital deduction, a QTIP (qualified terminable interest property) trust must pay all its income to the surviving spouse for life, and no one may have a power to appoint trust property to anyone other than the surviving spouse. IRC § 2056(b)(7). The donor specifies in the trust's governing instrument where the property will go at the spouse's death, and the donor can give the trustee discretion to distribute principal to the spouse. At the surviving spouse's death, the QTIP trust is included in his or her gross estate for federal estate tax purposes. IRC § 2044. A QTIP trust for Mrs. LeStrade with remainder to the Gumshoes may be a better receptacle than a CRT for LeStrade's retirement account.

1. LeStrade would designate the QTIP as the beneficiary of the retirement account. After his death, the QTIP trustee would make taxable withdrawals from the account and distribute them to Mrs. LeStrade to satisfy the "all income" requirement for a QTIP. The balance of the

account would continue in a tax-free mode until her death and would then be distributed via the QTIP trust to the Gumshoes.

2. For the QTIP trust and the retirement account both to qualify for the estate tax marital deduction, both must meet the QTIP "all income" requirement. There are several ways to do this. The simplest is described in Rev. Rul. 89-89. Under that ruling, the QTIP trustee must distribute to Mrs. LeStrade each year an amount at least equal to all of the retirement account income and all of the QTIP income for that year.
3. If LeStrade gives the trustee discretion to distribute additional amounts to his wife as needed to maintain an appropriate standard of living, he will achieve the flexibility to provide adequately for her without needlessly subjecting retirement assets to income tax.
4. At Mrs. LeStrade's death, the QTIP trust will be included in her gross estate, but will be offset in full by an estate tax charitable deduction because it will be distributed to the Gumshoes. Thus, the retirement account will escape estate tax entirely at each death.
5. Only retirement account assets which Mrs. LeStrade needs for living expenses are distributed to her. The balance is preserved for The Gumshoe Players. LeStrade does not have to count on his wife to distribute any of the retirement account assets to them.

IV. A Study in Scarlet—Avoiding Self-Dealing Problems with a CGA

CRTs are subject to the federal self-dealing prohibitions that apply to private foundations. IRC § 4947(a)(2). These rules prevent a CRT from entering into certain financial transactions with the donor or other "disqualified persons." Self-dealing issues often come up when a donor proposes to fund a CRT with an interest in, or property connected with, a closely held business. Compounding these problems is the mysterious concept of "indirect" self-dealing. Although the initial tax on self-dealing is modest, if the self-dealing transaction is not "corrected" (in effect, reversed), a second tax in an aggregate amount of 250 percent will be imposed. This enormous second-tier tax acts as a practical prohibition on most acts of self-dealing.

A. The Situation

1. Stapleton of Merripit House did not, contrary to what Arthur Conan Doyle would have us believe, die attempting to cross the treacherous quicksand of the Grimpen Mire.
2. He escaped safely, fled to America, and set up a new business in the form of a C corporation—House of Hellatious Hounds. Stapleton is the sole owner.
3. HHH operates a kennel which caters to very large dogs, its specialty being a Great Dane/Russian Wolfhound mix.
4. Stapleton owns the kennel building and leases it to HHH.
5. Stapleton is contemplating a sale of the corporation and the kennel building to a third party. He anticipates that the purchaser will wish to buy the assets of the corporation, not the stock.

6. Stapleton would like to use some of the assets of the kennel business to fund a life income charitable gift with Foundation for Atavism and Curse Tracing (acronym: FACT), a Section 501(c)(3) educational organization which studies, and disseminates information about, the reappearance of sociopathic traits in later generations of wildly dysfunctional families.
7. The purchaser will buy the assets of HHH, not the stock. Funding the life income gift with HHH stock would not avoid tax on the asset sale because that sale occurs within a taxable corporation. Therefore, Stapleton has decided to keep the stock and use the building to fund the life income gift.
8. How should Stapleton structure his life income gift?

B. CRT Funded with Building

Because HHH rents the kennel building from Stapleton, this plan runs smack into the problem of self-dealing.

1. Because Stapleton owns all the stock of HHH, the corporation is a disqualified person with respect to the CRT. IRC § 4946(a)(1)(E).
2. A lease of property from a CRT to a disqualified person is an act of self-dealing, IRC § 4941(d)(1)(A), and there is no applicable exception. *Cf.* IRC § 4941(d)(2)(C).
3. If Stapleton funds the CRT with the building as planned, both HHH and the CRT will be hit with the initial self-dealing taxes. Those taxes, in the aggregate, are 7½ percent annually of the "amount involved," which in this case is the greater of the fair rental value of the building or the actual rent paid. Treas. Reg. § 53.4941(e)-1(b)(2)(ii). Thus, paying those taxes on a short-term basis might not be especially burdensome, and therefore might be a reasonable price to pay for being able to take advantage of the CRT arrangement.
4. Unfortunately, the 250 percent second-tier tax will be imposed if the act of self-dealing is not corrected within the "taxable period," IRC § 4941(b), which normally ends when the IRS mails a notice of deficiency with respect to, or assesses, the first-tier tax. Treas. Reg. § 53.4941(e)-1(a)(1). Thus, the window of opportunity to correct the act of self-dealing by means of a sale of the corporation is severely limited.

C. Fund a CGA with Building

1. Because FACT is a public charity, the self-dealing rules do not apply to it.
2. If Stapleton is willing to accept a fixed payment and if FACT is willing to write a gift annuity in exchange for the building, this may be a preferable alternative.
3. FACT will probably discount the gift annuity rate to reflect the fact that it cannot know, at the time it enters into the CGA agreement, what price it will receive for the building and when the sale will occur.
4. FACT must be sure that the rent it receives from HHH is at a fair market rate.

V. The Case of the Cantankerous Child—Terminating a Problematic CRT

Although CRTs start with the best of intentions, they can turn out badly. Any number of factors can contribute to an unwelcome result, but a non-liquid asset which turns out to be hard to sell and a resentful beneficiary can produce an explosive combination. If the charitable remainder beneficiary is also the trustee, extracting itself from this kind of situation can be trying.

A. The Situation

1. Vernon Maybee, a Hollywood actor cast in the lead in a number of Sherlock Holmes movies, thought he had made a smart investment when he bought a parcel of bare land on the outskirts of a city in the western sunbelt.
2. He was even more taken with his business acumen later on when he put the by now highly appreciated land into a newly created, solely-owned C corporation, The Speckled Band, Inc.
3. Maybee now thinks it would be nice to sell the corporation. He also believes his only child, Smedley, is a spendthrift.
4. Congratulating himself on his estate planning foresight, he puts all of the Speckled Band stock, together with a portfolio of publicly traded stock of roughly equal value, into a flip NIMCRUT. Vernon names his favorite charity, Sherlock Holmes In Theaters as trustee and remainder beneficiary. The trust makes payments to him for life, then to Smedley for his remaining life. Because the trust is a NIMCRUT until the Speckled Band stock is sold and because that stock pays no dividend, the annual payout during the trust's first phase is roughly half of the specified unitrust percentage.
5. Vernon dies soon after funding the trust.
6. The Speckled Band stock proves hard to sell. A buyer would rather purchase the land directly to avoid hidden corporate liabilities, but the CRT would rather sell the stock to avoid tax on gain at the corporate level. To make matters worse, a portion of the parcel is blessed with a 30 percent grade in an otherwise virtually flat landscape.
7. Smedley does not share his father's charitable intent and is outraged that he is receiving only a fraction of what the trust would pay him if the corporation could be sold.
8. What should the charitable trustee do?

B. Terminate the Trust According to Actuarial Values

1. Under applicable state law, Smedley and the charity can terminate the trust by petitioning the district court.
2. They will ask for an order distributing the trust's assets to Smedley and the charity in proportion to their respective actuarial interests, computed using IRS tables for unitrust income interests and remainder interests.

3. Unfortunately, the termination is treated as a sale of Smedley's interest in exchange for his distribution. PLR 89-48-023. In addition, he is treated as having a zero basis in his unitrust interest. IRC § 1001(e). As a result, the entire distribution to him from the CRUT is taxable long-term capital gain. Rev. Rul. 72-243, 1972-1 C.B. 233
4. Smedley rejects this proposal and continues to complain, threatening litigation.

C. Exchange of Unitrust Interest for CGA

1. Smedley transfers his unitrust interest to the charity in exchange for its promise to pay him an annuity with a present value equal to slightly less than 90 percent of the value of that interest, all computed under IRS tables.
2. Because the charity then owns all the legal and beneficial interests in the trust, the trust will terminate automatically and distribute all of its property to the charity. The charity can reinvest those assets to support the annuity payments.
3. The annuity will qualify as a charitable gift annuity because the charitable gift resulting from the exchange is at least 10 percent of the value of the unitrust interest. *See* IRC §514(c)(5)(A).
4. For reasons similar to those discussed in B. above, Smedley realizes bargain sale gain equal to the entire value of the annuity, but instead of reporting all of that gain in the year the trust terminates, he reports it ratably each year as part of his CGA payment. PLR 2001-52-018.
5. Smedley will be allowed an income tax deduction equal to the difference between the present value of the donated unitrust interest and the actuarial value of the CGA received in exchange. Treas. Reg. § 1.170A-7(a)(2)(i).
6. In general, the gift tax consequences of this type of arrangement will depend on the structure of the CRT. Remarkably, there are cases in which the income beneficiary *will not* be allowed a gift tax charitable deduction for the charitable gift. In this case, however, it appears that Smedley's gift of his remaining unitrust interest to the charity is deductible for gift tax purposes. *See* IRC § 2522(c)(2).
7. Because half of the CRUT's assets have been invested in non-income producing property (the C corporation stock), Smedley has been receiving a payment roughly equal to one-half of the specified unitrust percentage. As shown on Exhibit A, Smedley's annual payment will go up by about 40 percent if he adopts this plan.

VI. The Case of the Missing Gain – Funding a Life Income Gift with a Sole Proprietorship

A sole proprietorship is an unincorporated business operated by one individual. Sole proprietorships and their assets are typically difficult to use in planned giving. Even so, there are some opportunities.

A. The Situation

1. Holmes himself has also moved to the U.S., motivated primarily by the higher fees he can earn here and his need to maintain his increasingly costly opium habit. He operates his detective business as a sole proprietor, and as you might expect, it becomes wildly successful. He estimates that the FMV of the business is now $1,000,000.
2. The only business asset is "goodwill," *i.e.*, his name and reputation, his client contacts and similar business-generating intangible assets. His basis in these assets is zero.
3. Holmes has been talking informally with a potential buyer but has not entered into formal sale negotiations. The buyer has told Holmes that he would like to hire him as a consultant for a few years to help him run the business and maximize the value of the business name.
4. Because crime has no season, Holmes has new cases coming in on a regular basis.
5. Holmes wants to make a charitable gift to his favorite charity, Deerstalkers Anonymous, which runs a 12-step program for individuals addicted to out-of-date tweed clothing and overly strong pipe tobacco. Holmes also wants to receive lifetime income.

B. Funding a CGA with the Sole Proprietorship

This would involve Holmes transferring the goodwill to DA, DA hiring Holmes as a consultant and operating the business, and DA beginning sale negotiations with the potential buyer. Any net income DA receives while it operates the business will be UBTI. Presumably, this is not the kind of arrangement a charity would be willing to enter into. In addition to generating UBTI, it presents administrative problems which a charity is not equipped to handle, and it creates exposure to types of liability the charity does not normally confront.

C. Funding a CRT with the Sole Proprietorship

The risk with this plan is that it may not avoid tax on the gain when the business is sold. If a CRT has UBTI, it loses its tax exemption for the year. *See* IRC § 664(c). Holmes' business generates taxable, active business income on a continuous basis. If Holmes puts the goodwill in a CRT which operates the business until a sale, the CRT will most likely have UBTI, and the sale will be taxable. The trustee could try to avoid UBTI by trying to accelerate expenses and defer income while the trust operates the business. Unfortunately, that strategy will work for a limited time at best. If Holmes tries to ensure that the sale will occur during the "no income" period, he runs the risk of creating a pre-arranged sale. If he avoids negotiations in an effort to prevent a pre-arranged sale, he runs the risk that the sale will not close during the "no income" period. In short, this plan puts Holmes and the CRT between a rock and a hard place.

D. CRT Funded with Stock of Incorporated Business

Holmes could avoid the UBTI problem by incorporating the business, then transferring the stock to the CRT. The CRT could then negotiate a sale with the potential buyer. This approach has several disadvantages:

1. Although it is likely that the incorporation of the business will be tax free, it is not entirely certain. *See* IRC § 351.
2. The goal here is to avoid tax on gain, so the buyer must purchase the stock: if the buyer purchased the goodwill out of the new corporation, the corporation would pay tax on the sale. A buyer typically would prefer to buy assets rather than stock, both to obtain a step-up in basis for tax depreciation purposes and to avoid hidden corporate liabilities. He will therefore discount the purchase price substantially if forced to buy stock.
3. The potential buyer has said that he would like to hire Holmes. If the CRT's negotiations for the sale of the stock are tied to Holmes' negotiation of an employment contract, it is arguable that an act of self-dealing has occurred because the CRT used its assets to negotiate a deal for Holmes' benefit. *See* IRC § 4941(d)(1)(E).

E. Sale of Business by Donor Followed by Funding of CRT with Cash

This plan avoids all of the problems identified with the three preceding alternatives. It does not avoid tax on the gain on a sale of the goodwill, but it does generate an income tax deduction which will partially shelter that gain. Because of the discount a buyer would require in order to be willing to buy the stock, the difference between this alternative and the plan under D above (assuming all its problems could be solved) may not be very great. The increased certainty of the tax consequences and the reduced complexity make this approach worth considering.

This outline is based on the federal tax law in effect on the date it was completed: March 4, 2004. It is only a summary of the subject matter it addresses, and it is intended to provide information of a general nature only. It should not be construed as a comprehensive treatment or as legal advice or legal opinion on any specified facts or circumstances. Readers are urged to consult with an attorney concerning their own situations and any specific legal questions they may have.

GP:1557118 v1

EXHIBIT A

Exchange of Unitrust Interest for CGA - Illustration

1. Assumptions

a.	Age of income beneficiary:	58
b.	Trust payout percentage:	7%
c.	Installment period:	Quarterly
d.	Current value of trust corpus:	$200,000
e.	Income beneficiary's combined federal and state income tax rate:	30%
f.	Rate of income generated on reinvestment of tax savings:	5%
g.	Date of exchange: 3/04	
h.	Annual payment from CRUT, assuming that ½ of trust property is non-income producing and balance of trust assets generate 7% income:	$ 7,000

2. Computation of Annual Income to Beneficiary

a.	Current value of trust corpus		$200,000
b.	Present value of unitrust interest		$146,366
c.	Maximum annuity payment which yields 10% charitable gift		
	i.	ordinary income	$ 4,544
	ii.	capital gain	$ 5,102
	iii.	total	$ 9,646
d.	Income from reinvestment of tax savings		
	i.	charitable deduction	$ 14,739
	ii.	tax savings from charitable deduction	
		14,739 x 30% =	$ 4,422

iii. income from tax savings

4,422 x 5% = $ 221

e. Total Income (c.iii + d.iii) $ 9,867

f. Increase in income

9,867 ÷ 7,000 = 141%

GP:1557118 v1

Gift Acceptance Policies and Procedures

May 6, 2004

Philip M. Purcell, J.D., CFRE
Vice President for Planned Giving
Ball State University Foundation
ppurcell@bsu.edu
(765) 285-7070

Gift Acceptance Policies and Procedures

Philip M. Purcell
Ball State University Foundation
ppurcell@bsu.edu
(765) 285-7070

I. Why Create Gift Acceptance Policies and Procedures?

A. Establishment of philosophy of program.
B. Informed approval of program by staff leadership, counsel and Board of Directors.
C. Education of staff, Board of Directors, volunteers and donors.
D. Compliance with legal responsibilities such as disclosure requirements, due diligence, Philanthropy Protection Acts, IRS rules, state gift annuity laws, etc.
E. Risk management. Limitation of liability.
F. Documentation for historic record.
G. Compliance with privacy laws: Health Insurance Portability and Accountability Act of 1996 (HIPAA), U.S. Family Educational Rights and Privacy Act (FERPA), Gramm-Leach-Bliley Act of 1999.
H. For foundations related to tax-supported public entities (universities, libraries, etc.), consideration of issues relative to the application of public record laws to the privacy of donor records.
I. Efficient and effective management of gifts.
J. Clarify staff responsibilities.
K. Coordination of all forms of giving: annual, major, capital, planned and endowment.
L. Equitable treatment of donors with regard to gift acceptance and recognition.
M. Uniform process for treatment of exceptional circumstances and gifts.
N. Consideration and implementation of NCPG Valuation Standards.
O. Consideration and implementation of CASE Campaign Reporting Standards.
P. Implementation and compliance with FASB standards.
Q. Implementation and compliance with NCPG Model Standards of Practice and other ethical standards.
R. Prevent conflicts of interest.

II. When to Create Gift Acceptance Policies and Procedures?

A. Inception of fundraising program.
B. Inception of planned and/or endowment giving program.
C. Preparation for capital campaign.
D. Anytime! Once created, amend as needed to create a "working" document.

II. How to Create Gift Acceptance Policies?

A. Review samples from colleagues, peer institutions and consultants. **Resources:**

- *Planned Giving: Management, Marketing and Law*, Ronald R. Jordan and Katelyn L. Quynn, Jossey-Bass Publisher;
- *Fine-Tuning Your Gift Acceptance Policies*, Kathryn W. Miree, 1999 NCPG Educational Video (www.ncpg.org);
- *Understanding and Drafting NonProfit Gift Acceptance Policies*, Kathryn W. Miree at www.giftplanners.com;
- *PlannedGiving.com* (Sample Gift Acceptance Policy Manual), T. Joseph McKay (www.plannedgiving.com);
- *The Complete Guide to Planned Giving,* Debra Ashton (www.debraashton.com).

B. Collect any existing policies and procedures currently in place – in whatever form! Review minutes from past Board or Committee meetings for resolutions. Consult legal counsel and the business office for documentation of existing policies and procedures.
C. Prepare a first draft. *Make your policies to fit your institution!*
D. Circulate first draft to key internal staff (foundation, development, business office, etc.) and external colleagues.
E. Edit as necessary. Research issues as necessary.
F. Seek approval from staff leadership, including Chief Development Officer, Chief Financial Officer and Chief Executive Officer. Incorporate suggestions as appropriate.
G. Seek approval from legal, financial, fundraising and auditing counsel. Incorporate suggestions as appropriate.
H. Seek approval from Board of Directors' Development Committee or similar standing or ad hoc committee. Recommendation of approval to full Board of Directors by this committee.
I. Final approval by Board of Directors.
J. Amend as needed to remain current with law, internal policies and best practices. Amendment process can include review by staff and counsel with final approval by the Board of Directors

III. What to Include in Gift Acceptance Policies?

A. General Statements
   1. Philosophy Statement
   2. Authorization of Gifts and Negotiation
   3. Policies
      a. Protocol for exceptions
      b. Ethical standards
      c. Independent counsel
      d. Confidentiality

B. Types of Planned Gift Arrangements
   1. Bequests
   2. Retirement Plan Designations
   3. Charitable Gift Annuity (Immediate and Deferred)
   4. Charitable Remainder Trusts (Charity as Trustee)
   5. Pooled Income Fund
   6. Charitable Lead Trusts (Charity as Trustee)
   7. Life Insurance
   8. Remainder Interest/Retained Life Estate
   9. Bargain Sales
   10. Conservation Easements

C. Assets for Gift Planning
   1. Gifts of Real Estate
   2. Gifts of Tangible Personal Property
   3. Gifts of Intangible Personal Property
   4. Transfer Procedures

D. Endowment Gifts
   1. Compliance with Uniform Management of Institutional Funds Act
   2. Documentation Protocol
   3. Policies: Investment, Spending, Fees, Restrictions

E. Documentation
   1. Receipts for Gifts
   2. Documentation of Gifts
   3. Documentation of Gift Restrictions
   4. Reporting Non-Cash Gifts

F. Valuation, Accounting, Campaign Crediting and Recognition
   1. Valuation of Gifts
   2. Financial Accounting of Gifts
   3. Campaign Crediting of Gifts
   4. Recognition of Gifts

G. Appendix
   1. Real Estate Gift Checklist
   2. Stock and Other Outright Gift Transfer Procedure
   3. Trustee Agent Procedure (CRT, CLT, PIF, GA)
   4. Model Standards of Practice for Charitable Gift Planner
   5. Other

Sample Policies and Procedures

Note: This sample is for instructional purposes only. This is not a comprehensive set of policies and procedures. Please consult your legal and financial counsel to determine policies and procedures appropriate for your charity. No legal or financial advice is intended.

<u>Development Program Gift Acceptance</u>

<u>Policies and Procedures</u>

<u>Philosophy Statement</u>

____(Name of Charity)___ encourages donors to make both outright and planned gifts to supports its mission of ____. For over ____ years, ____(Name of Charity)____ has been serving ________________ by providing _____(services)________________.

<u>Authorization</u>

The _____ Charity (hereinafter "Charity") encourages donors to make both outright and planned gifts for current support and for endowment. The types of planned gifts encouraged include bequests, pooled income fund gifts, charitable gift annuities (immediate and deferred), charitable remainder trusts, charitable lead trusts, remainder interests, bargain sales, conservation easements, gifts of life insurance, endowment gifts and retirement plan designations, as well as gifts of involving assets such as real estate, tangible personal property and intangible personal property of various types. Other gift arrangements are subject to approval by the Charity Board of Trustees (hereinafter "Board") or its Executive Committee.

<u>Policies</u>

1. **Primacy of charitable intent.** The Charity shall promote those gifts that serve to fulfill its mission and that comply with established legal and ethical fundraising laws and standards. To this end, the Charity reserves the right to refuse gifts that do not fulfill its mission or that violate any legal or ethical law or standard.

2. **Assistance to donors.** The policy of the Charity is to inform, serve, guide, provide financial/tax illustrations or otherwise assist donors who wish to support the Charity's activities.

3. **Independent counsel encouraged.** Persons acting on behalf of the Charity shall not provide legal and/or tax advice and in all cases encourage the donor to discuss the proposed gift with independent legal and/or tax advisors of the donor's choice so as to

ensure that the donor receives a full and accurate explanation of all aspects of the proposed charitable gift.

4. **Authorized to negotiate.** The Charity Executive Director and Planned Giving Director are authorized to negotiate planned and endowment gift agreements from prospective donors following policies and procedures approved by the Board as authorized in this document. Additional staff and legal counsel will be consulted and informed as planned and endowment gifts are negotiated, particularly as their expertise is needed to evaluate the appropriateness and cost efficiency of potential gifts.

5. **Signatory authority.** All forms, agreements and other documents necessary to accept and enter into planned gift arrangements as authorized in this document shall be signed by the Charity Executive Director on behalf of the Charity.

6. **Legal counsel review.** All planned giving agreements requiring execution by the Charity, or which deviate from the arrangements outlined in this document, shall first be reviewed and approved as to form by the Charity's legal counsel and the donor's counsel.

7. **Ethical standards.** All gifts will be negotiated in compliance with the National Committee on Planned Giving's Model Standards of Practice for the Charitable Gift Planner (See Appendix) and the Code of Ethical Principles and Standards of Professional Practice of the Association of Fundraising Professionals (See Appendix).

8. **Reporting annual and campaign totals.** Unless otherwise indicated, all annual gifts and campaign totals shall be reported in accordance with the current Association of Inc. Philanthropy (AHP)/Council for Advancement and Support of Education (CASE)/Association of Fundraising Professionals (AFP) *Fund-Raising Standards.*

9. **Donor recognition.** The Charity offers individual recognition and stewardship of donors pursuant to the procedures stated herein. Donor recognition and stewardship shall be done in a manner that is fair and consistent for all donors, yet allowing a flexible approach that permits personalized opportunities for recognition that satisfies the interests of donors. All requests for donor anonymity shall be respected.

10. **Confidentiality.** The Charity Board and staff with regard to any information, records, letters and personal documents pertaining to donors, gifts, etc shall adhere to strict confidentiality.

11. **Financial accounting.** All gifts shall be accounted for in the audited financial records of the Charity in a manner approved by the Charity Board and Executive Director, and in accordance with the appropriate accounting standards such as the current Financial Accounting Standards Board (FASB) statements (e.g., FASB Statements 116, 117 and 136).

12. **Charitable gift annuities authorized.** The Charity is authorized to issue charitable gift annuities, immediate and deferred, and invest assets contributed for annuities. The Charity may employ agents and advisors to facilitate the investment of these assets. The Charity shall endeavor to comply with the laws of all states in which gift annuities are offered.

13. **The Charity as trustee.** The Charity may serve as trustee of charitable remainder trusts, charitable lead trusts and pooled income funds where the Charity is the sole named irrevocable charitable beneficiary and said assumption of trustee responsibilities is approved by the Charity legal counsel. The Board reserves the right to hire or select a successor trustee or other fiduciary agent for any charitable remainder trust, lead trust or pooled income fund for which the Charity serves as trustee. The Board also reserves the right to charge a management fee sufficient to cover administrative costs, and this fee may be an expense of the respective trusts or pooled income funds.

14. **Procedure for approval of exceptions.** Where the acceptance of a gift or a deviation of these policies require approval of the Board as hereinafter set forth, such approval, in the event the decision needs to be made before a scheduled meeting, may be given by the Executive Committee of the Charity Board.

TYPES OF PLANNED GIFT ARRANGEMENTS: PROCEDURES

1. Charitable Gift Annuity (Immediate and Deferred)

A. Description.

The charitable gift annuity is a combination of a gift to the Charity and an annuity income for the donor and/or another designated by the donor. The gift annuity agreement is a contract between the Charity and the donor. The donor transfers appreciated property or cash to the Charity and the Charity promises to pay a given amount monthly, quarterly, semiannually, or annually to one annuitant for life or two annuitants jointly or successively for both lives. The Charity uses a rates of return based upon rates recommended by the American Council on Gift Annuities chartered as a rate of return based on the age of the annuitant(s). Part of the payment is interest earned and taxable as ordinary income to the annuitant. Part of each payment is tax-free return of principal. However, if an annuitant survives past his or her life expectancy, all later annuity payments will be ordinary income. Cash or appreciated property may be transferred to the Charity in exchange for a gift annuity. With appreciated property, a portion of the capital gains tax is avoided. Part of the gain is allocated to the charitable gift amount and there is no capital gains tax on that portion. The rest of the gain is allocated to the annuity portion and is taxed each year over the projected life expectancy of the annuitant.

The Charity may enter into charitable gift annuity contracts requiring it to pay fixed dollar amounts to the donor and/or any other beneficiary(s). The payments may be on a current payout or a deferred payout basis. The Charity will guarantee the contractual payments. The contract shall be in writing. While each contract will be different for each prospective donor, certain policies, terms and conditions will apply to all annuity contracts.

Like the immediate payment gift annuity, the deferred payment charitable gift annuity is a contract between the Charity and the donor, paying a guaranteed lifetime annuity to no more than two income beneficiaries in return for a gift of cash or publicly traded securities. Income is guaranteed by the Charity. Income payments begin at least one year after the date of the gift or later as designated by the donor. The donor may reserve the right to defer the beginning date, or to commute the payments within a shorter time period. Payment must begin within ten years of the date of the gift. The annuity rate is based on the age of the beneficiary when the annuity is established, but takes into consideration the number of years of income deferral. The longer the period of deferral, the higher the yield. Actual payments will be based on rates published by the American Council on Gift Annuities.

Higher payment rates and larger charitable contributions are available under the deferred payment gift annuity, but the portion of income, which is tax-free, is smaller. There is no tax on the appreciation of the annuity during the deferral period.

This plan is of particular interest in retirement planning because there are no federally regulated limits on the amount of money transferred to establish deferred payment gift annuities as there are with IRAs. The income rate can be quite high depending on the length of deferral. There is a charitable deduction in the year the deferred payment gift annuity is established.

B. Procedures for gift annuities.

1. The minimum acceptable gift for an annuity contract will be $10,000.

2. Annuities may be paid on a quarterly, semiannual or annual basis, and in the case of annuity gifts of fifteen thousand dollars ($15,000) or more, monthly. The first payment will be prorated from the contract date through the first annuity payout date. Annuity payment amounts will be rounded upward to the nearest dollar to ensure that each payment will be the same amount.

3. The maximum payment rate will be based on the age of the income beneficiary, or joint lives if payout is based upon joint beneficiaries, in accordance with rates established by the American Council on Gift Annuities. To conform to the federally mandated "Clay Brown Rule," no gift annuity contract shall be issued unless the donor's charitable deduction exceeds ten percent (10%) of the amount transferred for the annuity.

4. The annuity contract will be based upon no more than two beneficiaries who have each reached a minimum age of fifty years old by the time payments are scheduled to begin.

5. The gift annuities may only be established with cash or publicly traded securities listed on a recognized stock exchange.

6. Proceeds from annuity contracts sold will be invested by Charity in accordance with investment policies established from time to time by the Charity and the Finance Committee of the Charity, Inc. Board of Directors. Funds may be commingled with other investment portfolios or endowment funds of the Charity.

7. Assets may not be added to an existing annuity, but there is no limit to the number of annuities a donor may establish.

8. The same policy guidelines will apply to a deferred payment charitable gift annuity as to immediate payment gift annuities, except that the minimum age limit will be 40 years old for establishing a deferred payment gift annuity, with the income payments not scheduled to begin before any beneficiary is 50 years old.

9. Compliance with tax reporting (e.g., IRS 1099-R forms to donors and copies to IRS, blank IRS 8283 forms to donors, etc.) shall be coordinated between the Executive Director, other appropriate staff and any fiscal agents employed by the Charity.

10. Gift annuities shall be managed by the Charity and the Charity may employ agents and advisors to assist with the administration and investment of gift annuity assets. The Charity shall bear all costs related to the implementation, administration, and investment fees regarding any gift annuity contract. The Charity may choose to reinsure the gift annuity payment obligations.

11. A disclosure letter in compliance with current federal (Philanthropy Protection Acts of 1995 and 1997) and/or state laws and regulations shall be provided to all gift annuity donors explaining the nature of the annuity payment obligation (see Appendix for sample disclosure letter).

12. All gift annuity donors shall be provided a summary explaining the potential income (e.g., and taxable nature of income) and potential tax implications (e.g., income tax deduction, capital gains tax savings, gift/estate tax implications) associated with the donation. Donors shall be advised to share these summaries with their independent professional advisors.

13. The Charity shall retain the original copy of all gift annuity contracts, tax information summaries, etc.

14. The Charity shall seek to comply with the laws regulating gift annuities in any state in which a donor may reside. The Charity reserves the right to refuse gift annuity

donations from donors who reside in states where the gift annuity regulations are considered to be unreasonably restrictive or compliance costs are prohibitive.

2. Charitable Remainder Trusts (The Charity as Trustee)

A. Description.

The charitable remainder trust is a separately administered trust established by the donor. It provides for payments to the donor and/or other named beneficiary (ies) either for life or a term of years (not exceeding twenty), whereupon the remaining trust assets are distributed to one or more charities. These trusts may be established during life ("inter vivos") or at death ("testamentary").

A charitable remainder annuity trust pays a fixed amount, which must be at least 5 percent of the fair market value of the assets initially contributed to the trust. This amount does not change, and no additional gifts may be made to the annuity trust after its creation.

A charitable remainder unitrust pays a fixed percentage of at least 5 percent of the fair market value of the assets, as valued annually. Because the value of the assets can be expected to change from year to year, the unitrust payment will vary in amount each year. Additional contributions may be made to the trust after it is established. Three variations of the unitrust are possible:

a. A "straight" or "regular" unitrust pays the stipulated amount, even if it is necessary to invade principal to do so.
b. The "net income" unitrust pays the lesser of the stipulated amount or the actual net income, so principal would not be invaded.
c. A "net income with make-up" unitrust is like the net income unitrust except that excess earnings can be applied to cover accrued deficiencies resulting from the net income being less than the stipulated amount.
d. A "flip" provision may be included in a "net income" unitrust (with or without a make-up provision) to allow this trust to change or flip into a "regular" unitrust at a later date or upon the occurrence of a specific event, such as the sale of a certain asset (e.g., real estate or closely held stock) which has been donated to the trust.

The Charity encourages donors to consider naming the Charity as remainder beneficiary of charitable remainder trusts. However, for the Charity to serve as trustee of charitable remainder trusts, certain procedures must be followed as stated below.

B. Procedures for charitable remainder trusts with the Charity as trustee:

1. The Charity reserves the right to decline serving as trustee for any trust that may or may not comply with these policies and procedures. The Executive Director

and other appropriate staff may choose to recommend the Charity as trustee in selected circumstances. The Charity will not broadly advertise its services as trustee. The decision to serve as trustee will be determined on a case-by-case basis, solely at the discretion of the Charity Board.

2. The minimum amount for a charitable remainder trust for which the Charity is trustee will be $100,000 (i.e., the initial amount donated to the trust). Additions may be made to a unitrust at any time for any amount, entitling the donor to an additional income tax deduction.

3. The income beneficiaries' suggested minimum age must be at least 45 years of age unless the trust is for a term of years, in which case the beneficiaries may be any age. In any event, the charitable remainder trust must comply with the federal legal requirement that the charitable deduction to be claimed for the trust gift equal at least 10% of the fair market value of the assets donated to the trust. This "10% rule" effectively limits the age and number of beneficiaries, as well as the payout percentage of the trust.

4. The number of beneficiaries shall be limited to two where payments are to be made for the life of the beneficiaries. Subject to the 10% rule, more than two beneficiaries are allowed for trusts that pay income for a term of years.

5. The maximum stated payout percentage shall be 8%. Note: The maximum payout percentage by law is 50%. The minimum stated by law is 5%.

6. The Charity shall not serve as trustee of charitable remainder trusts for which there are charitable remainder interests other than the Charity and of which the Charity is not an irrevocable beneficiary. The donor may reserve the right to remove the Charity as trustee. In all cases, the Charity shall reserve the right to remove itself as trustee at any time for any reason.

7. An independent fiduciary agent may be hired to invest and manage the charitable remainder trust funds. Prospective donors may be provided investment prospectus of mutual fund options, etc. provided by the fiduciary agent. However, in no case shall the Charity's investment authority as trustee be legally restricted by the donor, fiduciary agents or other persons.

8. Income will generally be paid on a quarterly basis, unless a donor or other circumstances suggest a more or less frequent payment schedule. If acceptable and appropriate, the Charity may directly deposit payments into beneficiary bank accounts. Payment of income shall be coordinated between the Executive Director, other appropriate staff and any fiscal agents employed by the Charity.

9. Compliance with tax reporting (e.g., IRS K-1/1040 forms to donors and copies to IRS, blank IRS 8283 forms to donors, IRS form 5227, etc.) shall be

coordinated between the Executive Director, other appropriate staff and any fiscal agents employed by the Charity.

10. Charity staff and fiduciary agents shall comply with all current laws and regulations to assure that any assets or investments accepted into or invested on behalf of a charitable remainder trust for which the Charity may serve as trustee, shall not disqualify the charitable remainder trust as a tax exempt trust pursuant to current legal rules and regulations. For example, no assets subject to a debt or mortgage may be accepted into a charitable remainder trust; a donor may not live on or use real estate donated to a charitable remainder trust; no assets that earn unrelated business taxable income may be accepted into or invested on behalf of a charitable remainder trust. Further, acceptance by a charitable remainder trust of S corporation stock will immediately cause the corporation to lose its S corporation status.

11. The Charity shall comply with all current laws and regulations, including the Philanthropy Protection Acts of 1995 and 1997, with regard to disclosure to donors and income beneficiaries concerning the investment management of charitable remainder trusts for which the Charity may serve as trustee. The Charity shall not co-mingle the investments of charitable remainder trusts for which it may serve as trustee with other Charity endowment assets or investments. Rather, each charitable remainder trust for which the Charity may serve as trustee shall be independently managed and invested.

12. All charitable remainder trust donors who establish a trust with the Charity as trustee shall be provided a summary explaining the potential income (e.g., and taxable nature of income) and potential tax implications (e.g., income tax deduction, capital gains tax savings, gift/estate tax implications) associated with the donation. Donors shall be advised to share these summaries with their independent professional advisors.

13. Charity staff will meet at least once each year with any and all hired fiscal agent(s) to review trust investment performance, investment guidelines, questions raised by the donor(s) and/or income beneficiary (ies), tax reporting issues, income payment protocol, etc. These meetings will be documented to provide a permanent record of due diligence by the Charity.

14. Charity staff will meet at least once each year with the donor and income beneficiary (ies) to review trust investment performance, investment guidelines, questions raised by the donor(s) and/or income beneficiary (ies), tax reporting issues, income payment protocol, etc. These meetings will be documented to provide a permanent record of due diligence by the Charity.

15. Income will generally be paid on a quarterly basis, unless a donor or other circumstances suggest a more or less frequent payment schedule. If acceptable and appropriate, the Charity may directly deposit payments into beneficiary bank

accounts. Payment of income shall be coordinated between Charity staff and any fiscal agents employed by the Charity.

16. The Charity shall retain an original copy of all charitable remainder trust documents, tax information summaries, etc.

17. In all cases, donors shall retain and pay their own legal counsel who will prepare the charitable remainder trust document. The Charity shall not pay donor or donors' legal counsel for trust document preparation. The Charity may provide copies of the Internal Revenue Service prototype charitable remainder trust forms to prospective donors with appropriate disclaimers and explanation. **Note:** In cases where the Charity is a remainder beneficiary, but not trustee, then a copy of the trust document may be respectfully requested, as well as an annual report of the trust's value.

18. The Charity legal counsel shall review all charitable remainder trust documents prior to signature for all trusts in which the Charity is named trustee. In all such cases, the trust document shall require that the laws of the state of Kentucky will govern the trust.

19. Charity services as trustee pursuant to these policies and procedures shall be covered under new or existing liability insurance policies.

20. All or any portion of the costs associated with the Charity serving as trustee of charitable remainder trusts may be paid from each trust's income and/or principal as stipulated in the trust document pursuant to the current Charity Fee Policy. The Charity may choose to waive these fees and pay such costs from the operating or other budget, solely at the discretion of the Charity Board.

3. Life Insurance

A. Description.

There are various methods by which a life insurance policy may be contributed to the Charity. The procedures for gift acceptance may vary depending on the nature of the donated policy.

B. Procedures for a gift of life insurance.

1. **A donor may assign irrevocably a paid up policy to The Charity.** The donor will need to complete and sign the appropriate life insurance company form to evidence a change in ownership and beneficiary status naming the Charity as both. The donor's income tax charitable deduction equals the *cash value* of the policy, less any outstanding loans, etc. IRS form 712 must be signed by the life insurance company representative and filed by the donor with his/her IRS form 8283 to claim the deduction.

2. **A donor may assign irrevocably to the Charity a life insurance policy on which premiums remain to be paid.** The donor will need to complete and sign the appropriate life insurance company form to evidence a change in ownership and beneficiary status naming the Charity as both. The donor's income tax charitable deduction equals the *interpolated terminal reserve value* of the policy, less any outstanding loans, etc. IRS form 712 must be signed by the life insurance company representative and filed by the donor with his/her IRS form 8283 to claim the deduction. As the new owner, the Charity will receive future premium notices and be responsible for payment. However, the donor may wish to make future charitable gifts equal to or exceeding the premium payment amount. So long as the donor is not legally obligated to make these gifts, nor the Charity legally obligated to use gifts for premium payments, he/she will be entitled to an income tax charitable deduction for the value of the gift.

3. **A donor may name the Charity as primary or successor beneficiary (but not owner) of a life insurance policy.** The donor will need to complete and sign the appropriate life insurance company form to evidence a change in beneficiary status naming the Charity as primary or successor beneficiary. The donor will not receive a current income tax charitable deduction because The Charity is not the named owner. However, an estate tax charitable deduction is available for the amount given the Charity at the death of the insured. The donor will continue to be responsible for premium payments as the policy owner.

4. **Charitable Reverse Split Dollar life insurance.** Pursuant to current IRS regulation, the Charity shall not accept or promote gifts of charitable reverse split dollar life insurance. A common trait of a split dollar policy is the naming of more than one owners of the policy (e.g., charity and donor or donor's children).

4. Bequests

A. Description.

A bequest gift may be included in a donor's estate plan as a part of the donor's will, inter vivos ("living") trust, or as a beneficiary designation of a life insurance policy, commercial annuity, retirement plan, etc. The encouragement of bequests will be one of the highest priorities of the Charity.

B. Procedures.

1. Sample bequest language for restricted and unrestricted gifts, including endowments, will be available to donors and their attorneys to ensure that the bequest is properly designated.

2. Donors may be asked to provide a confidential copy of that section of that portion of their will, trust or other estate plan document naming the Charity

as a beneficiary. Reasons for this request include: an opportunity to offer the donor appropriate recognition if permitted; to be certain that the Charity and its geographic location are spelled correctly; to become aware of gift restrictions that may be impossible, impractical or illegal to comply with and to offer alternatives; to maintain a permanent record so that the Charity may be in a position to be aware of and assist fulfillment of the estate gift years later; and to assist the Charity with its long-range planning.

3. During the probate of estates containing a bequest to the Charity, and during the post-death administration of revocable trusts and/or beneficiary designations from retirement plans, life insurance, commercial annuities, etc. intended to benefit the Charity, the Executive Director, in consultation with the Charity legal counsel, shall coordinate the Charity's dealings with the attorney, family and personal representatives of the estate.

4. With regard to a bequest of real estate, closely held stock, partnership interests, etc., acceptance shall be conditioned upon the advice of legal counsel, business office, etc. Issues upon which acceptance may be conditioned include potential debts, mortgages, liabilities, taxes owed, insurance and other carrying costs, marketability of the asset, etc.

ASSETS FOR GIFTS: PROCEDURES

1. Gifts of Real Estate

A. Description

Gifts of real estate may be made in various ways: outright, charitable remainder trusts, remainder interests, gift annuity, bargain sale, etc.

B. Procedures for a gift of real estate.

1. The donor shall secure a qualified appraisal of the property. The donor must file a copy of this appraisal with the IRS 8283 form in order to receive the income tax charitable deduction. The Charity may secure its own appraisal for insurance purposes, etc.

2. The Charity shall independently determine if the donor has clear title to the property. Legal counsel may be hired by the Charity as needed to complete any real estate gift. See Appendix for a checklist of issues to be considered with gifts of real estate.

3. The donor shall secure a Phase 1 environmental audit. Phase 2 or 3 audits may be necessary if the Phase 1 so indicates possible contamination. No property containing environmental defects shall be accepted prior to their removal or securing other remedies assuring that the Charity assumes no liability. In the

case of gifts of personal residences, the donor may instead secure a home inspection by a qualified engineer or home inspector instead of an environmental audit.

4. Mortgaged property may be accepted as an outright gift provided the property has sufficient equity to justify assumption of the liability and provided the property is marketable. A donor's charitable deduction may be reduced due to the mortgage accepted by the Charity, and the donor may be subject to capital gains income tax liability on the portion of the property value subject to mortgage. Mortgaged property may not be accepted into a charitable remainder trust pursuant to current law.

5. If real estate is donated to a charitable remainder trust with the Charity as trustee, the preferred type of trust is a net income unitrust with a "flip" provision, allowing the trust to convert to a regular unitrust once the real estate is sold.

6. If real estate is donated in exchange for a gift annuity, the Charity must be certain the property is marketable and may consider negotiating an annuity rate lower than normal to account for carrying costs, insurance, etc. Another technique is to use a deferred annuity contract to allow sufficient time to sell the real estate.

7. In the event a gift of real estate is made by bequest, an extensive review, including appraisals, environmental audits, personal inspection, legal review, etc. shall be conducted prior to acceptance. Acceptance may be declined if such review should reveal potential liabilities, costs, or other problems.

2. Gifts of Intangible Personal Property (publicly traded stock, bonds, U.S. Savings Bonds, mutual fund shares, federal reserve items, cash)

A. Description

Donors may make gifts of marketable stock, bonds, U.S. Savings Bonds, mutual fund shares, Federal Reserve items, and cash. As with any gift, the donor shall be required to hold and convey clear title to the Charity. Donors shall be advised of applicable tax filing requirements.

B. Procedures

1. **Gifts of publicly traded stock, securities, corporate or municipal bonds.**

a) **Wire delivery.** If assets are to be delivered from a brokerage account, bank or corporate account, etc., and they are Depository Trust Company (DTC) eligible, the current delivery instructions shall be used. See Appendix for current instructions.

b) While the official gift receipt shall advise the donor that the IRS assigns the duty of establishing value upon the donor (using the IRS 8283 form), the donor may be advised that his/her gift is the value (for publicly traded stock, the average of the high and low values) on the date of transfer. While law indicates that transfer (donation) occurs when ownership is changed on the books of the issuing corporation, the shift in control should be sufficient, i.e., the date the stock is received into the Charity's account.

c) **Mail delivery.** If the assets are not DTC eligible, or if the donor wishes to donate the original certificates, the properly endorsed certificates (unsigned) and a signed stock power form should be mailed in separate envelopes to prevent theft to the Executive Director. In the case of mailed stock certificates, the date of delivery (gift) may be advised to be the postmark date. The original mailing envelope with the postmark date shall be retained in the donor's file.

d) **Personal delivery.** If the stock or bond certificates are hand-delivered, then the date of transfer (donation) is the day that the certificate is unconditionally given to the Charity or the Charity's agent (bank, broker, etc.). The donor may sign the certificate to evidence transfer, or a separate stock/bond power form may be signed and delivered with the certificate. See Appendix for sample stock/bond power form.

   1. **Brokerage accounts.** If a donor indicates that he/she wishes the Charity to establish an account with the donor's broker into which assets may be transferred and sold (i.e., so that the donor's broker may be rewarded with a commission), and the proceeds given to the Charity, then the Executive Director is authorized to open and close said accounts. **Gifts of mutual fund shares** usually require this procedure since mutual fund companies typically do not transfer these shares by DTC.

   2. **Gifts of cash.** Gifts of cash may be accepted by check, credit card, payroll deduction, or electronic fund transfer (EFT) pursuant to current procedures.

   3. **Federal Reserve Items.** U.S. Treasury bonds, government bonds, treasury bills, etc. shall be transferred pursuant to current procedures.

   4. **U.S. Savings Bonds.**

      a) Series E Bonds. Series E bonds may be donated to the Charity by converting them to Series HH bonds in the name of the Charity or by cashing the Series E bonds and donating the proceeds. In no event does the donor escape the accrued income tax liability upon transfer.

b) Series HH Bonds. Series HH bonds may be donated to the Charity by registering them in the name of the Charity or by cashing the Series HH bonds and donating the proceeds. In no event does the donor escape the accrued income tax liability upon transfer.

DOCUMENTATION: PROCEDURES

1. Receipts for Gifts.

A. Description.

The Charity shall comply with all state and federal laws, regulations, rules and rulings with regard to providing donors a receipt for his/her gift, including Internal Revenue Code sections 170(f)(8) and 6115, 16 CFR Parts 1 and 602, and Reg. Sec. 1.170A-1 and 13 and any amendments to these rules.

B. Procedures.

1. **Cash contributions.** The Charity shall provide a receipt, letter or other written communication acknowledging receipt and appreciation, the name of the donee, the date of the receipt's preparation (not necessarily the date of the gift in some cases), the amount of the gift and all other statements to comply with current law (e.g., a statement that no goods or services were received by the donor in exchange for the gift).

2. **Contributions of assets other than cash.** The Charity shall provide a letter or other written communication acknowledging receipt and appreciation for the gift, describing the assets donated (no dollar value needs to be stated as defined by law), the dollar amount credited to the donor for recognition purposes, and that no goods or services were received by the donor in exchange for the gift. In the case of stock gifts, an illustrative calculation (using the average of the high and low) may be included. In the case of gifts of scientific equipment, inventory, etc., the law may require statements of other specific assurances. In all cases of non-cash gifts, donors shall be advised of their responsibility to assign value for purposes of the income tax charitable deduction, using IRS form 8283.

3. **Planned Gifts.** The Charity shall provide a summary of accounting and tax information to donors who establish planned gifts such as gift annuities, pooled income funds, and charitable remainder or lead trusts with the Charity as trustee. A copy of the deduction calculation, IRS 8283 form and instructions, gift document, etc may accompany these summaries. The summary may include an overview of the deduction calculation, projected income payout, capital gains tax and gift/estate tax ramifications, etc. In all cases, donors shall be encouraged to share this information with their accountants, attorneys and other professional advisors.

Real Estate Gift Consideration Checklist

Prospective Donor:

____

Location of Property:

____

____

Type of Property (personal, residence, farm, commercial, etc.):

____

Proposed Gift: ___Outright ___Estate ___CRT ___GA ___Remainder ___Barg. Sale

1. Ownership

Title – Donor's current ownership interest

_____ Warranty Deed
_____ Quitclaim Deed
_____ Sheriff's Deed
_____ Other (please specify) _______________

Copy of Deed in Charity File: ____ yes ____ no

Warranty Deed prepared on behalf of Charity: ____ yes ____ no

Current Updated Abstract: ____ yes ____ no

Title Insurance owned by donor: __ yes __ no Copy in file: __yes __no

New Title Insurance to be purchased: ___yes ___no
Who will purchase (Charity or Donor?) ____________________________

2. Environmental Review

Personal Inspection by Charity Staff: date __________

Types of Review to be conducted: ____________________________________

Inspection by qualified home inspector: date _________

Pre-Phase I Review: date __________ by ________________________________
Phase I EA: date __________ by ______________________________________
Phase II EA: date __________ by _____________________________________
Phase III EA: date __________ by ____________________________________

3. Marketability

Current Qualified Appraisal ____ yes (Date: _____________) no _____

New Qualified Appraisal to be completed by date __________

Name/Contact Information for Appraiser: ________________________________

____

Describe recent efforts to sell property (e.g., Efforts to sell, donate, etc.):

____

____

Name all listing agents used for property within the last two years:

____

____

Any current mortgage, lien, debt, encumbrance, on property within the last two years: ____

____

Current zoning classification/description of property: ______________________

Describe condition of property: ______________________________________

____

Describe surrounding neighborhood, properties, etc:

____

Are property taxes paid to date: ____ yes ____ no (Amount owed: $_________)
(Approximate annual property tax liability: $_________)

Property insurance currently on property: ____ yes ____ no
(Approximate annual coverage amount: $_________)

4. Counsel

Charity Legal Counsel for transfer: ____________________________
Donor Legal Counsel for property transfer: ____________________________
Charity Listing Agent for property: ____________________________

MODEL STANDARDS OF PRACTICE FOR THE CHARITABLE GIFT PLANNER

PREAMBLE

The purpose of this statement is to encourage responsible gift planning by urging the adoption of the following Standards of Practice by all individuals who work in the charitable gift planning process, gift planning officers, fund raising consultants, attorneys, accountants, financial planners, life insurance agents and other financial services professionals (collectively referred to hereafter as "Gift Planners"), and by the institutions that these persons represent.

This statement recognizes that the solicitation, planning and administration of a charitable gift is a complex process involving philanthropic, personal, financial, and tax considerations, and as such often involves professionals from various disciplines whose goals should include working together to structure a gift that achieves a fair and proper balance between the interests of the donor and the purposes of the charitable institution.

I. PRIMACY OF PHILANTHROPIC MOTIVATION

The principal basis for making a charitable gift should be a desire on the part of the donor to support the work of charitable institutions.

II. EXPLANATION OF TAX IMPLICATIONS

Congress has provided tax incentives for charitable giving, and the emphasis in this statement on philanthropic motivation in no way minimizes the necessity and appropriateness of a full and accurate explanation by the Gift Planner of those incentives and their implications.

III. FULL DISCLOSURE

It is essential to the gift planning process that the role and relationships of all parties involved, including how and by whom each is compensated, be fully disclosed to the donor. A Gift Planner shall not act or purport to act as a representative of any charity without the express knowledge and approval of the charity, and shall not, while employed by the charity, act or purport to act as a representative of the donor, without the express consent of both the charity and the donor.

IV. COMPENSATION

Compensation paid to Gift Planners shall be reasonable and proportionate to the services provided. Payment of finders fees, commissions or other fees by a donee organization to an independent Gift Planner as a condition for the delivery of a gift are never appropriate. Such payments lead to abusive practices and may violate certain state and federal regulations. Likewise, commission-based compensation for Gift Planners who are employed by a charitable institution is never appropriate.

V. COMPETENCE AND PROFESSIONALISM

The Gift Planner should strive to achieve and maintain a high degree of competence in his or her chosen area, and shall advise donors only in areas in which he or she is professionally qualified. It is a hallmark of professionalism for Gift Planners that they realize when they have reached the limits of their knowledge and expertise, and as a result, should include other professionals in the process. Such relationships should be characterized by courtesy, tact and mutual respect.

VI. CONSULTATION WITH INDEPENDENT ADVISORS
A Gift Planner acting on behalf of a charity shall in all cases strongly encourage the donor to discuss the proposed gift with competent independent legal and tax advisers of the donor's choice.

VII. CONSULTATION WITH CHARITIES
Although Gift Planners frequently and properly counsel donors concerning specific charitable gifts without the prior knowledge or approval of the donee organization, the Gift Planners, in order to insure that the gift will accomplish the donor's objectives, should encourage the donor, early in the gift planning process, to discuss the proposed gift with the charity to whom the gift is to be made. In cases where the donor desires anonymity, the Gift Planners shall endeavor, on behalf of the undisclosed donor, to obtain the charity's input in the gift planning process.

VIII. DESCRIPTION AND REPRESENTATION OF GIFT
The Gift Planner shall make every effort to assure that the donor receives a full description and an accurate representation of all aspects of any proposed charitable gift plan. The consequences for the charity, the donor and, where applicable, the donor's family, should be apparent, and the assumptions underlying any financial illustrations should be realistic.

IX. FULL COMPLIANCE
A Gift Planner shall fully comply with and shall encourage other parties in the gift planning process to fully comply with both the letter and spirit of all applicable federal and state laws and regulations.

X. PUBLIC TRUST
Gift Planners shall, in all dealings with donors, institutions and other professionals, act with fairness, honesty, integrity and openness. Except for compensation received for services, the terms of which have been disclosed to the donor, they shall have no vested interest that could result in personal gain.

Adopted and subscribed to by the National Committee on Planned Giving and the American Council on Gift Annuities, May 7, 1991. Revised April 1999.

American Council on Gift Annuities

26th Conference on Gift Annuities

Investing Trust Assets

J. Scott Kaspick

Trustees must design and execute portfolios appropriate to the needs of charitable trusts, balance income and remainder interests, meet applicable regulatory rules and standards, and satisfy ever more demanding donors. This session will explore the issues in developing and executing appropriate investment policies and practices for charitable trust assets.

Mr. Kaspick founded KASPICK & COMPANY in 1989. The company is the largest specialized manager of planned giving assets in the country with $2.4 billion in planned giving assets and more than 3,500 charitable trusts currently under management. From 1983 to 1989, Mr. Kaspick was Associate Treasurer of Stanford University and a member of the endowment management team. While there he developed the investment approach and systems for managing Stanford's then $150 million planned giving program. Mr. Kaspick has a BA in Economics from California State University and an MBA from Stanford University.

J. Scott Kaspick
Managing Director
KASPICK & COMPANY
555 University Avenue
Palo Alto, CA 94301
650-322-5477
www.kaspick.com

INVESTING TRUST ASSETS

J. Scott Kaspick, Managing Director, KASPICK & COMPANY

Investing planned gift assets is in many ways similar to investing other assets such as endowment funds and foundation assets, retirement funds, or even personal portfolios. However, there are important differences. This paper explores the theoretical basis for investing planned gift assets as well as the legal standards that guide trustees in planned gift portfolio design and execution. We devote particular attention to the reasons why the investment of planned gift assets differs from the investment of endowments and use this comparison as a way to evaluate the new Harvard Private Letter Ruling which allows limited use of endowment funds as an investment vehicle for planned gifts. Finally, we identify a set of criteria for evaluating the success of planned gift investment programs.

I. The Theoretical Underpinnings of Institutional Portfolio Design.

A. The design challenge: achieving target returns with acceptable risk. A primary purpose of endowment, trust, or even personal portfolios is to support a regular distribution (typically known as the annual "payout" for endowments or trusts) from the portfolio over long periods of time. The challenge for any portfolio with a longer-term horizon is to produce returns that are high enough to both make the desired payout and grow the portfolio value enough to offset the effects of inflation. If the portfolio growth is less than the rate of inflation, both the principal value and the amount of payout it can support will erode away over time.

Historically, portfolios have been designed using a combination of debt (i.e., bonds) and equity (i.e., stocks). While bonds provide stability by dampening volatility in returns from year to year, their returns over time barely offset inflation. Equities on the other hand, provide returns that on average are high enough to make reasonable payouts and reinvest enough to offset inflation, but their returns are highly volatile from year to year. Table 1 shows average annual compound returns for stocks and bonds as well as the average annual inflation rate since 1926. The same data are provided by decade to show how much more stock returns vary compared to bond returns.

Table 1: Average Annual Compound Returns and Standard Deviations

Period	U.S. Large Co. Stocks	U.S. Int/LT Govt. Bonds	Inflation CPI
1930-1939	-0.1	4.7	-2.0
1940-1949	9.2	2.2	5.4
1950-1959	19.4	1.0	2.2
1960-1969	7.8	3.0	2.5
1970-1979	5.8	6.6	7.4
1980-1989	17.5	12.1	5.1
1990-1999	18.2	7.6	2.9
2000-2003 (4 years)	-5.3	8.5	2.2
1926-2003 AACR	10.4	5.4	3.0
1926-2003 Std. Dev.	20.4	6.4	4.4

Risk is exposure to the possibility of loss. There are many types of risk in portfolio management, but here we will focus on two primary risks addressed in portfolio design. First is the risk that the purchasing power of the portfolio (and therefore the amount of payout it can provide) will erode (or erode faster than expected) due to lower than expected returns over time. Second is the risk that the market value of the portfolio will fall dramatically in any short period, substantially reducing the amount of the annual payout. This second risk is particularly acute for endowments and standard trusts that typically pay out a fixed percentage of market value each year.

The risk of failing to achieve target returns over time is a function of the period over which the target is to be achieved, skill in portfolio design, and luck. Setting skill aside for now, the risk of being unlucky is greater for shorter periods. For example, from 1926 to 2003, the annual returns for U.S. large company stocks varied between a low of –43.4% in 1931 and a high of +54.0% in 1933. The returns by decade shown in Table 1, however, vary from a low of –0.1% in the decade of the 1930s to a high of 19.4% in the decade of the 1950s. Investors were also very fortunate in the 1980s and 1990s. The longer the time period, the greater the chance of achieving the expected average return of 10.4% (assuming constant exposure to the market), but even 20-year rolling returns for the S&P 500 have varied from a low of about 4% to a high of about 18%.

The common unit of measure for volatility is standard deviation. (Standard deviation is a measure of variability around the expected mean or average outcome. Statistically, two-thirds of all results can be expected to occur within one standard deviation and 95% within two standard deviations of the mean.) Over the past 78 years, the S&P 500 has provided an average annual compound return of 10.4% per year with a standard deviation of 20.4%. During the same period, a 75/25 mix of intermediate and long-term government bonds earned 5.4% per year, but with a much lower standard deviation of 6.4%. One can see, in Table 1 above, the significantly greater variation in stock returns compared to bond returns, even when looking at returns over a decade. Finally, note the tradeoff between risk and return. The return to the mix of government bonds is relatively stable, but it could not provide a 5% payout and still offset inflation since the mix has outperformed inflation by only 2.4% per year. Stocks could easily support the 5% payout, outperforming inflation by 7.4% per year, but the high variation in returns would result in unacceptable probabilities of underperforming the target return over time.

B. <u>How much return is needed?</u> As noted above, a typical goal for most endowments and many trusts is to maintain the portfolio's real value (i.e., net of inflation) over time. The return required to maintain the portfolio's real value can be stated as follows:

Minimum Target Return (net of all costs) = Payout Rate + Cost Rise Rate

1. <u>Endowments.</u> For endowments, payouts are typically about 5%. For most educational institutions and many other labor-intensive organizations, costs rise faster than the general inflation rate, arguably by about 1%. A long-term inflation rate of 3% plus a 1% margin generates a 4% cost rise rate. The minimum target return net of costs would therefore have to approximate 9% to avoid eroding the endowment base.

2. <u>Charitable Trusts.</u> Unlike endowments, trusts are not perpetual, but erosion of value is still a concern, especially with longer term trusts. We assume a typical trust term of 20 plus years, so erosion of payout and principal is an issue; indeed the higher the payout rate, the greater the issue. Payout rates for longer term trusts should range between 5%

and 6%. Assume an average 5.5%. The cost rise rate for income beneficiaries is probably equal to the general inflation rate of 3.0%. A 5.5% payout plus a 3% inflation rate would result in targeting net returns at about 8.5%. Higher expected costs for charitable trusts of about 0.5% due to much smaller sizes and the cost of trust administration must also be considered.

C. Given the return target, how can we reduce the risk? A return target of 8.5% to 9.0% requires that 70% to 80% of the portfolio be invested in stocks, given long-term return expectations. This level of stock exposure translates to a standard deviation of about 16%. Statistics tells us that with this return and standard deviation, we can be 95% confident that annual returns, while *averaging* 8.5%-9.0%, will range from –23.5% to +41%. This wide range of possible annual returns represents a significant risk to the annual payout. Such a high equity mix also results in significant risk of not achieving the target average return, even over twenty year periods.

   The central portfolio design challenge, therefore, is a quest to reduce the variability of outcomes, while preserving the return goal.

D. Three approaches to achieving target returns with acceptable risk. There are three primary approaches to portfolio management an investor can take.

   1. Superior security selection. Most institutional investors believe that developed equity markets are weakly to moderately efficient and that therefore only a small percentage of managers can demonstrate an ability to add value after costs over any sustainable period of time. This is because efficient markets ensure that many buyers and sellers constantly evaluate every bit of new information and quickly adjust stock prices in response. Greater prospects for adding value through security selection might be available in private equities or through computerized methods for finding and exploiting many small market inefficiencies. *Generally, institutional investors do not expect to add much value over the market return through superior security selection.*

   2. Successful market timing. Most institutional investors believe that market timing, i.e., trying to outguess market directions, is futile. At the same time, there is some evidence that fear and greed can periodically distort market prices. The tech stock bubble in the late 1990s is the latest example. Whether one can consistently improve risk-adjusted returns by making market bets is highly questionable and the approach is generally rejected as too risky by institutional investors. *Institutional investors realize that being out of a market for even short periods can significantly reduce the odds of achieving the average market return over time.*

   3. Diversification. The main tool institutional investors use to maintain (or increase) target returns, while reducing variability and the risk of failing to achieve the target return, is diversification. Diversification can be across individual company stocks or bonds within an asset class or across asset classes (e.g., U.S. large company stocks, international stocks, or REITs) within a portfolio. Broad diversification, generally known as "Modern Portfolio Theory," is discussed below.

E. Modern Portfolio Theory and practice. Modern Portfolio Theory is based on the analytical frameworks provided by 1990 Nobel laureates Markowitz, Sharpe, and Miller. While these theories are based in economics and statistics beyond the scope of this review, we will summarize some of the key principles. The quantitative approaches (i.e., the "science" of portfolio design) are usually combined with qualitative judgment (i.e., the "art" of portfolio design) to develop the investment approaches commonly used today.

1. Diversification is the cornerstone of modern portfolio design. Absent abilities to outperform markets by superior stock picking or successful market timing, institutional investors use the benefits of diversification to reduce the risk of sharp drops in market value as well as to increase the probability of achieving target returns over time. Modern portfolios diversify at both the security level and the asset class level.

   a. Security diversification. Security diversification (e.g., holding many large company stocks) is used to reduce or eliminate the risk of individual companies, leaving only the risk of the market itself.

   b. Asset class diversification. Asset class diversification (e.g., holding a mix of large and small, foreign and domestic, developed and emerging markets' stocks) in turn reduces the risk inherent in each of these markets individually. Designing a portfolio with exposure to many asset classes can dramatically reduce the expected short-term volatility as well as the potential variability of the target portfolio return over time.

2. Correlation is the key to diversification benefits. Diversification works at either the security level or the portfolio level because neither individual securities nor individual asset classes react to the same information in the same way, at least much of the time. Assets that tend to move together or perform similarly have high correlation coefficients and those that do not have low correlation coefficients.

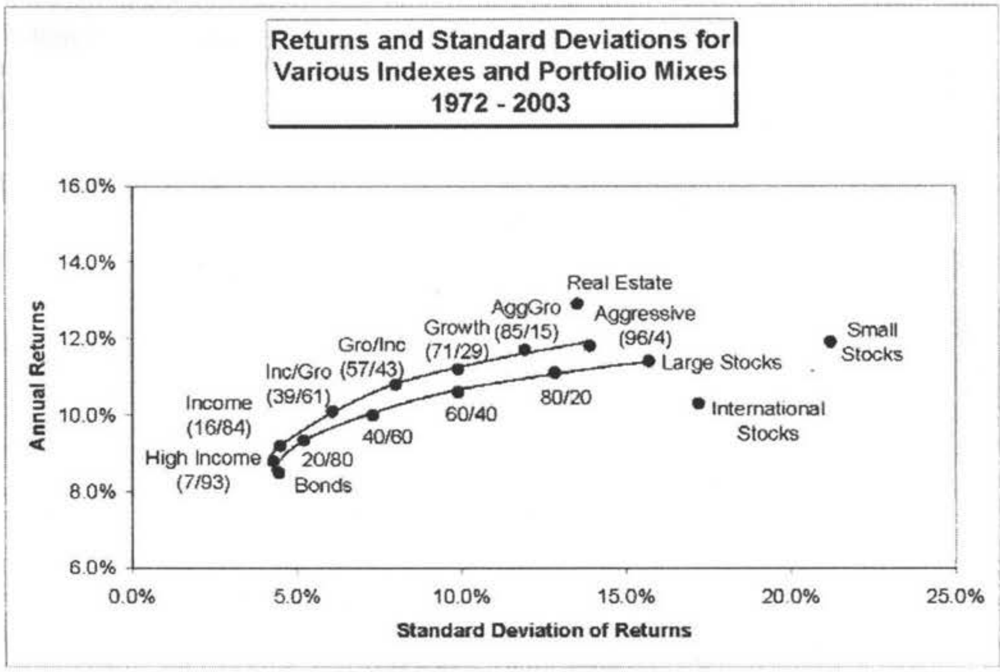
3. Risk, return, and correlation data. In Table 1, we reviewed risk and return data for U.S. stocks and bonds since 1926. In Table 2, we show risk and return data for a broader array of publicly-traded asset classes used by most institutions. Since some of these asset classes have not been around as long, average annual compound return data are provided since 1972. As a way of illustrating the diversification (i.e., lack of correlation) across these asset classes, we also provide annual returns for each asset class for the past 10 years, boxing the asset class with the highest return. (Additionally, a dotted box is used if bonds provided the highest annual return.) Although we do not show the correlation coefficient data here, they can be calculated from the return data for each asset class. While return, standard deviation, and correlation data are not perfect for prediction purposes, they are an effective starting point for determining the desired mix of asset classes within a portfolio. This is the first step in portfolio design.

Table 2: Historical Returns for Various Asset Classes

YEAR	S&P 500	Russell 2000	EAFE (Int'l)	Emg Mkts Free	NAREIT (Real Est.)	LB Int. G/C (Fixed Inc.)
1994	1.3%	-1.8%	7.8%	-7.3%	3.2%	-1.9%
1995	37.5%	28.5%	11.2%	-5.2%	15.3%	15.3%
1996	23.1%	16.5%	6.1%	6.0%	35.3%	4.1%
1997	33.2%	22.4%	1.8%	-11.6%	20.3%	7.9%
1998	28.8%	-2.6%	20.0%	-25.3%	-17.5%	8.4%
1999	21.0%	21.3%	27.0%	66.4%	-4.6%	0.4%
2000	-9.1%	-3.0%	-14.2%	-30.6%	26.4%	10.1%
2001	-11.9%	2.5%	-21.4%	-2.4%	13.9%	9.0%
2002	-22.1%	-20.5%	-15.9%	-6.0%	3.8%	9.8%
2003	28.7%	47.3%	38.6%	56.3%	37.1%	4.3%
Past 5 Years	-0.6%	7.1%	-0.1%	10.6%	14.3%	6.7%
Past 10 Years	11.1%	9.5%	4.5%	0.2%	12.1%	6.6%
1972-2003						
32 Yr AACR	11.4%	11.9%	10.3%	n/a	12.9%	8.5%
Std. Dev.	15.7%	21.2%	17.2%	n/a	13.5%	4.5%

4. <u>Basic portfolio design: the efficient frontier.</u> The lower line in Figure I below illustrates risk and return calculations for a simple two asset class portfolio. At the left, the extreme position represents a portfolio invested 100% in the Lehman Brothers Intermediate Government/Corporate Bond index. At the right extreme is a portfolio invested 100% in the S&P 500. The intermediate points show how return and risk are reduced as bonds are added to a 100% stock portfolio or stocks to a 100% bond portfolio. Portfolio theory would suggest that the portfolios along this line create an efficient frontier. Any mix of stocks and bonds on this line is efficient since all individual company risk has been diversified away. The only way to add return is to take on more risk (i.e., to move along the efficient frontier from left to right). The only way to reduce risk is to accept lower returns.

Figure I



5. Modern portfolio design: shifting out the efficient frontier. Again, our design challenge is to achieve the target return while also reducing the expected short and long term variability. To achieve this goal, we need to shift the efficient frontier up and to the left, either reducing the standard deviation for our target return, or increasing the return we can get for any given standard deviation. Absent better stock-picking or successful market timing, there is only one way to achieve this desired shift: by adding asset classes with similar or somewhat higher risk and return characteristics, but low correlations. In Figure I, the shift is achieved by adding higher risk, higher return asset classes like U.S. small capitalization stocks, international stocks, and REITs.

6. The result: target return with lower risk. As can be seen in Figure I, the shifting of the efficient frontier that comes from diversifying across several asset classes that are not highly correlated allows us to reduce the level of risk for any level of return. Alternatively, we can increase the return for any given level of risk. Either way, diversification is the most powerful tool available to investors of all types to reduce portfolio risk. This ability to use asset class diversification (even with risky individual asset classes) to reduce overall risk drove a major change in the standards governing trustees in investing trust assets, namely the adoption of the Prudent Investor Act in the 1990s.

7. First use the "science" then apply the "art." The approach described above, using expected returns, standard deviations, and correlations to determine an efficient mix of asset classes within portfolios, is generally known as "mean-variance analysis." While computers can easily spit out the best combinations of assets (better known as "efficient portfolios") based on these three variables, actual portfolio design is not that simple. We have already seen how returns can vary dramatically through time, affecting both standard deviations and correlations. Even worse, correlations among asset classes can

become much higher in times of stress, as in 1973-74. Therefore, while mean-variance analysis is helpful in the preliminary stages of design or to evaluate possible changes on the margin, other qualitative judgments (i.e., the art of portfolio management), must be overlaid on the simple analytical results.

F. Other guiding principles. Several other guiding principles generally guide institutional investors.

   1. Take the long view. Maintaining long-term target asset allocations rather than attempting to out-guess the markets by moving in and out of asset classes is the norm. Any deviation from long-term targets increases the risk of not achieving the target returns.

      a. Reversion to the mean will happen. It's just not clear when. Asset class returns tend to revert to their means over time. It follows that the greater the over or under-performance, the more significant the eventual correction. However, even strong over or under-performance can persist for long periods of time, making bets on the actual timing of the mean reversion risky. Several well-known institutional investors threw in the towel in the mid-1990s fearing an overvalued market, only to miss out on the very high returns that followed.

      b. Rebalancing. Disciplined rebalancing towards long-term target allocations tends to reduce exposure to overvalued assets and add exposure to those more fairly valued.

      c. Extreme situations. Some institutional investors believe that the infrequent extreme situations experienced periodically, perhaps due to herd behavior (like the tech bubble) present opportunities to add value and should be taken advantage of. Essentially these institutions are willing to place some bets, but only when they believe the odds are heavily stacked in their favor. As we have seen, the cost of being wrong can be very high.

   2. Active vs. passive. The debate regarding the use of passive or active managers rages on. While few active managers outperformed in the late 90s, many did in the following market downturn. In some asset classes that are considered less efficient (e.g., foreign stocks) active managers tend to have a stronger tendency to outperform. Also, active managers tend to outperform in weaker markets, due to their cash holdings.

   3. Finding and adding new asset classes. While large institutional investors usually avoid market timing, they do constantly seek new asset classes (especially those with low correlations to existing classes) to add to their portfolio mix. Emerging markets (equity and debt), venture capital, hedge funds, absolute return strategies, TIPs, and commodities all have return-enhancing or risk-reducing roles in many institutional portfolios. Typically the larger endowments act first, followed by smaller endowments, pension funds, and individual investors. Later we will address the difficulties of using some of some of these asset classes in charitable trust portfolios.

II. The Legal Standard Guiding Trustee Investment Behavior.

A. The Uniform Prudent Investor Act. As modern portfolio theory, practice, and portfolio design for major endowments and others evolved over the 1970s and 1980s, a gap developed between the laws governing trust investments and best practice portfolio management. In 1992, the American Law Institute addressed this issue with the release of its Restatement (Third) of Trusts: Prudent Investor Rule (1992). The Restatement let to the development of the Uniform Prudent Investor Act (UPIA), which was drafted by the National Conference of Commissioners on Uniform State Laws in 1994 and approved by the American Bar Association in 1995, with the recommendation that it be enacted by the individual states. The Act, or reasonable approximations, is now law in most states.

Prior to the development of the Prudent Investor Rule, trustee investment decisions were governed by the Prudent Man Rule, which focused on the risk of individual investments without regard to the whole portfolio. The advent of the Prudent Investor Rule was a major departure and a significant recognition of the power of Modern Portfolio Theory.

The Prefatory Note to the Act states that while "this Act is centrally concerned with the investment responsibilities arising under the private gratuitous trust, . . . Nevertheless, the prudent investor rule also bears on charitable and pension trusts, among others."

B. Summary of the Act by section.

1. Prudent Investor Rule.

   a. A trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the Prudent Investor Rule.

   b. However, the Prudent Investor Rule may be expanded, restricted, eliminated, or otherwise altered by specific provisions of the trust. A trustee is not liable to beneficiaries to the extent the trustee acted in reasonable reliance on the provisions of the trust.

2. Standard of Care; Portfolio Strategy; Risk and Return Objectives.

   a. A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

   b. A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy with risk and return objectives reasonably suited to the trust.

   c. Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

      i. General economic conditions.

      ii. Possible effect of inflation or deflation.

      iii. Expected tax consequences of investment decisions or strategies (In the notes, the Act states that "taxable investors, including trust beneficiaries, are in general best served by an investment strategy that minimizes the taxation incident to portfolio turnover." The notes also state, "When tax considerations affect beneficiaries differently, the trustee's duty of impartiality requires attention to the competing interests of each of them.")

iv. The role each investment or course of action plays within the overall portfolio.

v. Expected total return from income and appreciation.

vi. Other resources of the beneficiaries.

vii. Needs for liquidity, regularity of income, and preservation or appreciation of capital.

viii. An asset's special relationship or value, if any, to the purposes of the trust or one or more beneficiaries.

d. A trustee shall make reasonable effort to verify facts relevant to the investment and management of trust assets.

e. A trustee may invest in any kind of property or type of investment consistent with the standards of the act.

f. A trustee with special skills or expertise has a duty to use them.

3. Diversification. A trustee shall diversify investments of the trust unless trustee determines that, because of special circumstances, the trust purposes are better served without diversification. While the Act does not further define diversification, the comments in the Restatement itself address asset class diversification. The comments also observe that pooled investments such as mutual funds and bank common trust funds are especially suitable for small portfolios like trusts.

4. Duties at Inception of Trusteeship. Within a reasonable time after accepting trusteeship or receiving assets, trustee shall review trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with purposes and terms of the trust and the requirements of the Act.

5. Loyalty. A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries. The notes further indicate, "A fiduciary cannot be prudent in the conduct of investment functions if the fiduciary is sacrificing the interests of the beneficiaries." The notes also state "No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries, for example, by accepting below-market returns."

6. Impartiality. If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries. The comments note especially *conflicts between beneficiaries interested in income and those interested in principal*, as is usually the case with charitable remainder trusts.

7. Investment Costs. In the investment and management of trust assets, a trustee may incur only costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.

8. Reviewing Compliance. Compliance with the Prudent Investor Rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.

9. Delegation of Investment and Management Functions. A trustee may delegate investment and management functions that a prudent trustee or comparable skills could properly delegate under the circumstances. Trustee shall exercise reasonable care, skill, and caution in:

    a. Selecting an agent.

    b. Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust.

    c. Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

III. Investing Planned Gifts – Unique Requirements and Issues.

A. How is charitable trust management different from endowment management? We have seen how modern investment practice for all types of portfolios draws from the same theoretical base. We have also seen that the Prudent Investor Act provides specific guidance for trustees in investing split interest trusts like charitable remainder trusts. Since the investment focus of most charities is on their endowment funds, and the responsibility for charitable trust investment typically is assigned to the finance office, it is useful for charities to compare and contrast the objectives and requirements for endowment investing with those of planned gifts. Unlike charitable trusts, which are typically subject to the provisions of the Uniform Prudent Investor Act (UPIA), endowment practices are generally driven by the Uniform Management of Institutional Funds Act (UMIFA).

B. The differing time horizons and the split interest nature of charitable trusts are the source of most differences. Most of the investment principles governing UMIFA and the Prudent Investor Act are the same and both reference the Prudent Investor Rule. However, the key differences between endowment management and planned gift management arise from differences in the time horizons: limited and unpredictable for planned gifts, typically perpetual and predictable for endowments. In addition, while the income and remainder beneficiaries are the same for endowments, the income and remainder beneficiaries for planned gifts are separate parties with potentially conflicting interests.

C. Summary of other important differences between endowments and charitable trusts. Below we identify some other important ways in which planned gifts differ from endowments, which might call for different investment strategies:

    1. Payout rates can vary widely. Endowments are typically concerned with preserving the real value of principal in perpetuity. The payout or distribution is usually established as the amount that can be paid currently while reinvesting enough to offset inflation. For planned gifts, payouts are set typically by the terms of the gift and can range from very low (e.g., a "seasoned" annuity trust) to very high (e.g., a charitable remainder trust created to provide education funding over a short fixed term of years).

    2. Life expectancies or terms can vary widely. Endowments typically have a perpetual horizon while planned gifts have horizons that can range from very short to very long

(but never perpetual). In addition, the timing of the maturity of a planned gift is usually determined by one or more lifetimes and is, therefore, somewhat unpredictable.

3. Significantly smaller size portfolios. Rarely does the size of a charitable trust or other planned gift reach the level of even a small endowment fund.

4. Definition of "income" available for payout can vary widely. Some charitable trusts can make payouts from total return (like most endowments), while others can distribute only "income." Definitions of income can vary widely, even by state.

5. Trust payouts are taxable under the four-tier system. This creates a sensitivity to ordinary income and short-term gains as well as the need to maintain trust and tax accounting records, not required by endowments.

6. Trusts cannot use "smoothing rules". Endowments typically base payouts on a 12-quarter average of market values, while most charitable trust payouts are determined by the market value at the beginning of each year. The lack of any smoothing of market values for determining payout amounts means that payment volatility is increased. As a result, there is greater sensitivity to market fluctuations and downside volatility.

7. Inability to incur Unrelated Business Taxable Income (UBTI). While an endowment can incur UBTI and simply pay the tax on it, charitable trusts that incur any UBTI at all become fully taxable. This effective loss of tax exemption is a catastrophic result for a charitable trust and must be avoided by trustees.

8. Non-qualified investors. Many charitable trusts do not meet "qualified investor" rules as defined by the SEC and therefore cannot invest in certain investment strategies, such as hedge funds and private equities.

9. Separate tax ID. Each charitable trust has a separate tax ID, and therefore is considered a separate investor in many private investment offerings.

10. Investments restricted to charitable interests. Some investment options are available only to charitable entities and therefore the split interest nature of charitable trusts disqualifies them from investing in these offerings.

11. Need for timely valuations and accounting data. It typically takes some length of time for endowments to collect and determine returns and complete the related accounting at quarter end or year end. The timing of valuation, payment, and tax data is significantly more critical for charitable trusts than for endowments.

12. Need for detailed tax accounting data. The income tax character of each transaction in the portfolio of a charitable trust must be tracked and recorded in order to properly characterize the income paid to beneficiaries. Endowments have no need to and typically do not track this level of detailed information.

D. Trustee duties for endowments compared to charitable trusts. In addition to the differences between charitable trust portfolios and endowment funds noted above, there are important distinctions in the duties of endowment and planned gift trustees.

1. Endowments typically focus on maximizing payout while maintaining real principal. Endowment trustees are typically concerned with questions regarding the endowment's objective, how much payout can be provided, and how the fund will maintain its purchasing power over time. Answers to these questions drive the portfolio design.

2. <u>The standard of care for the trustee of a planned gift is broader than for the trustee of an endowment.</u> Trustees of planned gifts have to be concerned about a wider range of issues since they must address a more complex set of conflicting interests. In addition, each trust's unique circumstances must be addressed individually. Finally, the charity trustee must balance the needs of the income beneficiary against its own needs as the remainder beneficiary. All of these factors create portfolio design issues not present in endowment management:

   a. A range of portfolio designs is required to accommodate the wide variety of terms, objectives, beneficiary ages, payout rates, and definitions of income involved in planned gifts. While endowments usually have one design (typically a 70%-85% equity mix), a planned giving program can require equity mixes ranging from 0% to 85%, and in some cases higher.

   b. The Prudent Investor Act requires the trustee to be sensitive to tax effects, including portfolio turnover. Endowments can be insensitive to the tax effects of portfolio turnover or of changing managers and rebalancing, but planned gift managers must be acutely aware of the tax implications of their decisions.

   c. The Prudent Investor Act requires the trustee to take into account the needs of the beneficiaries for regularity of income and preservation (or appreciation) of capital. Endowments can use multi-year smoothing rules to dampen changes in payout, but charitable trust payments are typically based on January 1 annual valuations. The lack of smoothing rules for charitable trusts requires portfolio designs that reduce fluctuations in income and dampen losses of principal value.

   d. While planned gift donors cannot direct or control the investments of their charitable trusts, they can contribute illiquid assets, request that assets be held rather than sold (e.g., municipal bonds), or provide assets that should be kept rather than sold (e.g., high coupon bonds contributed to a net income trust). Each of these situations must be addressed and perhaps managed individually.

   e. A trustee of a charitable trust can violate the trustee's duties by failing to:

      i. provide appropriate portfolio designs under the Prudent Investor Rule
      ii. adequately address possible inflation, deflation or other economic conditions
      iii. provide appropriate investment design options
      iv. address tax or volatility sensitivities
      v. address important individual trust needs
      vi. address differing definitions and needs for income
      vii. use its full level of skills and expertise as trustee

3. <u>Trustees of planned gifts have a duty of loyalty and impartiality.</u> In addition to the duty to provide a suitable investment approach and to address the unique needs of each charitable trust beneficiary, the trustee must also decide how to balance conflicts between the interests of the income beneficiary and the interests of the charity as remainder beneficiary. The trustee's potential for conflict in carrying out these duties is heightened if the trustee is also the remainder beneficiary since the trustee can violate

these duties either by failing to protect its own remainder interest or by overlooking the interest of the income beneficiary in order to benefit the remainder beneficiary.

E. Are endowments suitable for charitable trust investments? The investment of endowment assets and planned gift assets follows the same general investment principles outlined by Modern Portfolio Theory and practice. However, the different legal standards and needs of planned gifts relative to endowments suggest some level of incompatibility between the two. In addition, the presence of UBTI in most endowments and the complex accounting for income and gains required by charitable trusts has usually forced charities to keep the two separate.

However, if the UBTI and tax characterization issues could be eliminated, two major obstacles that render the endowment unacceptable as an investment vehicle for planned gifts would be gone. Would this mean the endowment could be considered by charity trustees as an option for investing some or all of its charitable trusts? This question has been made timely by the announcement by Harvard University of a recent Private Letter Ruling allowing the University to utilize its endowment as an investment vehicle for certain of its charitable trusts.

IV. The Harvard Private Letter Ruling (PLR).

In a recent Private Letter Ruling requested by Harvard University, the Internal Revenue Service approved a plan that allows certain charitable trusts to participate in the University's endowment investments. These charitable trusts will not be "invested in" the endowment in the usual sense, but will instead be allowed to acquire a contract from the endowment providing for the trust to earn a return equal to the return earned by the endowment. In addition, the trust will receive as a distribution the endowment's spending rate. There are several other limitations on this strategy, including a requirement that all of the income to the beneficiary be taxed as ordinary income and that the sole charitable remainder beneficiary be the University. Below we analyze in detail some of the practical implementation aspects of this approach.

A. Motivation Behind the PLR. The likely primary motivation behind the Harvard PLR is to increase the value of the University's gifts by boosting the trust's expected investment returns. Secondarily, the institution likely believes that offering the ability to invest trusts "in" or at least alongside a prestigious endowment, with access to investment skills and approaches typically not available to individual donors, will increase gift flow as well.

1. Improving expected returns. Most charitable organizations today understand that their endowment assets will likely achieve a higher rate of return than their charitable trust assets. Harvard, due to the sheer size of its endowment and the sophisticated public and private investment approaches available to it, has been quoted as expecting its endowment to earn as much as 400 basis points over its existing charitable trust investment approach. Others have suggested that the margin for most endowments would be a more modest, but still significant, 200 basis points. An additional two percent per year over the life of a typical planned gift could result in significantly greater values for both income and remainder beneficiaries.

2. What drives the higher relative returns for endowments? The primary reason for the return margin between charitable trusts and endowments is the inclusion in large endowments of significant allocations to private equities such as venture capital, hedge funds, and absolute return and other strategies. Unfortunately, issues regarding UBTI, complex valuations, qualified investor rules, the split interest nature of the planned gifts,

the need to characterize income and gains, the timing of valuation data, and the relatively small trust sizes have made the use of private equities highly problematic for planned gifts. In addition to investing in private equities, the typical endowment is significantly larger than the typical portfolio of planned gifts, which means that the cost of implementing the same portfolio design (even if fully available) would likely be less for the endowment. We estimate this cost differential at somewhere around 20 basis points (excluding trust administration costs) depending on the endowment size.

B. What Does the PLR Accomplish? The Harvard PLR resolves some of the issues that have been impediments to investing charitable trust assets directly in private equities or in endowments that hold private equities. However other issues are not resolved and some significant new complexities are created by the approach.

1. Eliminating UBTI. The proposed investment structure appears to work around the UBTI issues, which have been a significant impediment to investing charitable trusts in most alternative assets. The elimination of the UBTI is apparently achieved by making the relationship between the trust and the endowment a contract rather than an ownership interest. (Note that passage of currently pending legislation, the CARE Act, would significantly reduce the UBTI impediment for charitable trusts.)

2. Eliminating the need to account for complex tax accounting. Difficulties in characterizing the various types of income and gains for tax purposes (e.g., income vs. gain, qualified vs. non-qualified income, pre- and post-effective dates for tax changes) are resolved by having all distributions (up to the endowment payout rate) categorized as ordinary (non-qualified) income. While this compromise appears to resolve the significant accounting problems, it significantly increases the tax rate on the beneficiary's interest, effectively reducing the value of payments by about 17%, as explained below.

   Under the PLR, distributions greater than the endowment payout rate are characterized for tax purposes as short or long term gains or losses depending on the character of the gain generated by the sale of the units. Again, this approach helps to sidestep the need for complex endowment accounting, but it creates the unusual outcome that higher payout rates will incur lower overall tax rates for beneficiaries, which may encourage donors to seek higher payout rates from charitable trusts.

3. Other regulatory issues are still unclear. It is not clear, however, whether SEC regulations regarding qualified investor rules and limited number of investors requirements for non-registered securities are resolved by the PLR approach.

4. Timing issues remain. The timing of annual valuations needed for payments and tax reporting (if payments require any purchases or sales of units at year end) will still be dependent on how rapidly the endowment's year-end unit values can be determined.

5. Valuation issues may still exist. Many endowments operate on fiscal years and provide only estimates of unit values at calendar year end. It is not clear whether the charitable trust tax accounting rules (or perhaps the income beneficiaries) will require a more accurate assessment of calendar year-end values (e.g., including transactions on "as of" dates rather than on posting dates, or requiring more accurate year-end appraisals of value for private equities) since charitable trust payments are typically based on January 1 starting values without any smoothing rules.

C. Quantitative Analysis of the Outcomes for Remainder and Income Interests

The taxation of the beneficiary's distributions (up to the charity's endowment payout rate) at the highest federal and state tax rates significantly affects the value of the income flow to the income beneficiaries and makes the balancing of these interests more complex. In a more tax-efficient portfolio, such as the KASPICK & COMPANY standard Growth objective mix, less than half of the payout would be subject to the highest tax rate, with the balance taxed at the long-term capital gains rate. The reduction in after-tax income for a 5% standard unitrust in the first year if all of the distribution were taxed as ordinary income would be approximately 17%.

1. What level of incremental return produces the same outcome for the income beneficiary? Investing a charitable trust in an endowment with significant alternative assets can be expected to result in the trust earning higher investment returns and, thus, the creation of larger portfolio values. Higher trust values would result in standard unitrusts distributing larger payouts to income beneficiaries over time. However, the cumulative *after-tax* outcome for the donor might be better or worse, depending on the type of trust, its term, and the difference in return between the endowment and the non-endowment strategies.

   In the table below, we show how much *additional* return the endowment would have to earn over and above a more tax-efficient strategy each year to make the income beneficiary's real (inflation-adjusted) cumulative payments equal on an after-tax basis.

   Table 3: 5% Standard Unitrust

   Trust Horizon

	5 Yrs.	**10 Yrs.**	**15 Yrs.**	**20 Yrs.**	**25 Yrs.**
Additional Investment Return Required Per Year	9.4%	4.2%	2.7%	2.0%	1.6%

   Assumes a 5% endowment payout. The tax-efficient strategy is based on KASPICK & COMPANY's after-tax results in 2003 for a 5% unitrust. Assumes federal rates of 35% and 15%, and state taxes of 9.3%. Fees are charged to the trust. Discount at the inflation rate, 3.25%.

   Clearly, for short horizon trusts, it requires a near impossible assumption about the additional return from the endowment for the new strategy to be a reasonable choice for the income beneficiary. The additional return required drops as the expected horizon lengthens. The endowment would have to consistently earn 2.0% per year more for the cumulative real beneficiary payments from a charitable remainder unitrust with a 20-year horizon to be the same after-tax.

2. What is a reasonable return margin for most endowments? Excluding the very largest endowments, we believe two percent is a reasonable performance margin assumption going forward for endowments with 25%-30% of their assets in a diversified mix of top-quality private equities. Clearly, however, the expected marginal return of the endowment, and the probability of achieving that return advantage are the key considerations for trustees in projecting outcomes for the income and remainder interests.

3. What outcome does a 2% differential produce for the charity? Assuming a 2% return differential, we show below the projected real remainder value and real cumulative income for a $1 million, 5% standard unitrust over various time horizons. The numbers assume an 8.2% return from a typical diversified 70/30 mix compared to an endowment portfolio

producing a 10.2% return, 2% higher per year. Values are discounted at the expected cost rise rates of 3.25% for the income beneficiaries and 5.0% for the charity remainderman.

Table 4: $1MM, 5% Standard Unitrust - Real Cumulative Income

	10 Yrs.	15 Yrs.	20 Yrs.	25 Yrs.
KCo. 70/30 Mix	354,554	528,008	698,964	867,455
End. w/ +2% Return	320,337	501,173	697,355	910,187
% Difference	-9.7%	-5.1%	-0.2%	+4.9%

Table 5: $1MM, 5% Standard Unitrust - Real Remainder Value

	10 Yrs.	15 Yrs.	20 Yrs.	25 Yrs.
KCo. 70/30 Mix	841,209	771,536	707,633	649,025
End. w/ +2% Return	1,019,212	1,028,955	1,038,792	1,048,723
% Difference	+21.2%	+33.4%	+46.8%	+61.6%

The benefits of higher returns to trust portfolios are clear. Unfortunately the PLR approach achieves this benefit (except for very long horizon trusts) without a commensurate sharing of the increased value with the income beneficiary. Up to horizons of 20 years, the charity's remainder value is significantly higher, while the income beneficiary suffers a loss in real, after-tax income.

4. Given these numbers, how might donors change their behavior? We suspect that while most donors would jump at the chance to invest alongside a major endowment, many donors and their advisors will pause upon seeing numbers like these. Our experience has been that provided with a thorough analysis of the long-term effects, a high proportion of beneficiaries will accept a small reduction in their income in order to provide the charity with a significant increase in remainder value. However, if the difference is too large, many donors will choose to preserve value for the income beneficiary even if the charity's remainder value is diminished somewhat. Planned gifts are, after all, part gift and part investment. Harvard representatives seem to agree with this expectation of donor behavior, stating that there will be exceptions, but that the endowment option will likely appeal most to beneficiaries with long life expectancies.

5. New gifts vs. existing gifts. Convincing existing charitable trust donors to consent to this switch when the effect can be an immediate 17% drop in income might be more difficult than proposing this option for a new charitable trust. It is also likely that the income tax implications will change some beneficiary payout decisions (see below).

6. What if private equities don't deliver expected higher returns? Investors should question the return assumptions for private equities. These investments are relatively new, vary significantly in approach, have return estimates that may be influenced by survivor bias, and are now experiencing dramatically increased dollar flows. If returns are less than predicted (i.e., if something less than the hoped for 2% margin is achieved), the charity remainderman will likely be at least as well off as they would have been if the trust had been invested in a tax-efficient, non-endowment strategy. The income beneficiaries, however, would be significantly worse off due to the higher tax on their distributions.

D. Will Donors Demand Higher Payout Rates?

It is likely that some beneficiaries of new trusts will demand higher payout rates "in exchange for" the higher expected returns earned by their charitable trust invested in the endowment. This might, in fact, represent a more equitable sharing of the value created by the higher expected returns. Over the years, we have provided illustrations demonstrating that higher payout rates often result in lower lifetime income for beneficiaries and in significant erosion of real income over time. However, a 1% increase in payout rate in response to a projected 2% increase in total return from the endowment will not cause a greater long-term erosion of purchasing power over time, and it will increase total real value. The two tables below show the effects on the income and remainder beneficiaries of raising payouts by 1% relative to the starting point of investing outside the endowment.

Table 6: $1MM, Standard Unitrust - Real Cumulative Income

	10 Yrs.	15 Yrs.	20 Yrs.	25 Yrs.
5% Payout-Outside Endowment	354,554	528,008	698,964	867,455
5% Payout-End w/+2% Return	320,337	501,173	697,355	910,187
6% Payout-End w/+ 2% Return	387,822	591,759	802,686	1,020,843
5% Outside vs. 6% in Endowment	+9.4%	+12.1%	+14.8%	+17.7%

Table 7: $1MM, Standard Unitrust - Real Remainder Value

	10 Yrs.	15 Yrs.	20 Yrs.	25 Yrs.
5% Payout-Outside Endowment	841,209	771,536	707,633	649,025
5% Payout-End w/+2% Return	1,019,212	1,028,955	1,038,792	1,048,723
6% Payout-End w/+ 2% Return	926,369	891,613	858,160	825,963
5% Outside vs. 6% in Endowment	+10.1%	+15.5%	+21.3%	+27.3%

1. Effect of 1% higher payout on the income interest. It is clear from Table 6 that adding one percent to the payout rate provides a greater sharing of the additional value created by the assumed 2% return increment from investing in the endowment. The one percent higher payout provides income beneficiaries with slightly higher real cumulative income rather than less (for periods up to 20 years) relative to investing outside the endowment with the same 5% payout.

2. Effect of 1% higher payout on the remainder interest. While increasing the payout by one percent appears to be a reasonable way of offsetting the reduced after-tax beneficiary income created under the PLR approach, Table 7 shows that achieving this balance reduces the value of the charity's remainder by about 10% for 10-year periods (926,369 vs. $1,019,212) and approximately 17% for periods of twenty years ($858,160 vs. $1,038,792) relative to the 5% payout trust invested in the endowment. Still the percentage increase in remainder value (relative to investing outside the endowment) is still high as shown by the percentage calculations in the last line of the table.

3. The risk of higher payouts. Higher payout rates that are not accompanied by higher returns create loss of value for both parties.

   a. For the remainder beneficiary: As long as the realized increase in returns is greater than the increase in payout, the charity will be better off. However, if the actual returns achieved over the trust life are less than the increase in payout, the increased payout will have a strong negative effect on the remainder value.

b. For the income beneficiary: The increased payout will provide a higher initial income (and likely reduce the higher tax bite on payments). However, if returns are reduced, the beneficiary would likely experience erosion in their real purchasing power over time.

E. <u>Trustee Duties are Likely to be More Problematic Under the PLR Approach</u>

One of the key requirements of the Prudent Investor Act is the duty of trustees of split interest trusts to balance the interests of the income and remainder beneficiaries. Prior to the compromises of the PLR, prudent actions that increased portfolio returns (absent high levels of short-term gains or poor risk characteristics) benefited both interests since portfolio growth resulted in income growth. The approach outlined in the PLR introduces four factors that will make trustees' decisions more difficult.

1. <u>Balancing interests becomes more difficult.</u> As the analysis above has shown, the compromise necessary to avoid the UBTI and income character issues that arise by investing in the endowment creates a significant negative income tax consequence for income beneficiaries. This new twist, increasing the remainder interest but slightly hurting (or being neutral to) the income interest, makes it more difficult to achieve an economic balance between the two. The need to quantitatively evaluate the tradeoffs will place a significant new analytical burden on trustees. Even if the donor consents to the arrangement, the trustee still must independently decide how to invest the trust. The trustee must determine that investing the trust in the endowment satisfies its obligation to balance the interests of the income and remainder beneficiaries and that the risk of failing to achieve the desired result is a reasonable risk to take.

2. <u>Higher payout rate choices by donors increase the negative consequences of failing to achieve the higher returns.</u> On the margin, donors (of new trusts) may demand increased payout rates in order to achieve a more reasonable balancing of interests. However, higher payouts create a smaller margin of error for trustees in balancing the interests of all parties under predicted outcomes. In other words, the trustee might need a higher level of confidence in its expected investment outcomes if payout rates are increased.

3. <u>Trustee confidence in the expected returns of private equities is key.</u> Trustees can be relatively confident when using long-term return assumptions for public asset classes since these are well-established in theory and practice. However, using risk and return assumptions for private equities to drive portfolio construction may be more problematic. Private equities as an investment type have a relatively short history, expected returns and risk levels are the subjects of great debate, and significant additional cash flows into these investments (particularly from pension funds which tend to trail endowment behavior) may reduce future returns from these investments.

4. <u>Disclosure and reporting requirements.</u> Trustees investing charitable trusts in their own endowments are likely to find that their duties under the Prudent Investor Act and possibly the Philanthropy Protection Act require a greater level of disclosure and reporting than they are used to providing for their endowment investments. It is not clear whether or not the PLR approach avoids the disclosure requirements of the Philanthropy Protection Act since the trusts are invested in a contract and thus are not

commingled in a traditional way. In any case, the trustee will likely need to demonstrate through quantitative analysis to donors (and to itself) the benefits of this approach. Such analysis would need to assess the expected returns and risks of the endowment relative to other traditional investment approaches, the impact on the beneficiaries' taxes, and identify what could go wrong. After-the-fact reporting of results may also need to show more detail on the endowment than the trustee currently provides to constituents, particularly if results are less than expected.

F. The Structure Will Not Accommodate All Trusts.

While investing trusts under the PLR approach might be beneficial for both parties in some circumstances, the trustee will still need to accommodate many situations where the endowment is not a good option. These include:

- Trusts with remainder beneficiaries other than the trustee charity
- Trusts with tax-exempt portfolios
- Trusts requiring custom portfolio mixes
- Trusts with short remaining horizons (either new trusts or trusts nearing expected termination)
- Trusts that require a portfolio mix with less potential volatility than the endowment (e.g., elderly donors with significant income sensitivity)
- Many lead trusts and other taxable trusts
- Gift annuity pool assets that are subject to state investment restrictions
- Most annuity trusts since the total payment is a fixed amount for the life of the trust and the after-tax beneficiary payment would be significantly reduced by the higher tax rate
- Trusts for donors who do not consent to the income tax consequences of the endowment strategy
- Trusts trying to minimize current distributable income

G. Summary. The Harvard PLR provides a creative approach to adding private equity investments to charitable trusts. On that basis, it is an exciting development. However, the approach raises some new issues. In considering this approach, keep in mind two key points:

1. It is the possibility of higher returns, not the endowment itself, that creates value. The most promising route to higher returns is to include private investments in charitable trusts, but gaining access to these investments presents a number of obstacles. Because of these obstacles (UBTI, tax accounting, valuation, qualification, size, etc.) charities are looking to their endowments as an option for investing charitable trusts.

2. Investing charitable trusts in the trustee's own endowment, however, may be problematic.

   a. As we saw in Section III above, there are some significant compatibility problems between charitable trusts and endowments since critical objectives are not aligned.

   b. There are also significant accounting requirements for charitable trusts that are difficult for endowments to meet.

   c. The Harvard PLR addressed some of these issues by making all endowment distributions ordinary income, but this compromise creates new problems. The trustee now faces a conflict (a complex one at that) when trying to balance the interests of the income and remainder beneficiaries.

d. This conflict creates additional disclosure and reporting issues for the charity trustee. The disclosure materials will have to address some complex issues including the fact that the endowment holds assets with unclear risk and return characteristics.

e. The ideal solution is one that would permit access to the return-enhancing possibilities of private equities. It would be an endowment-like design, but adjusted for the unique needs of planned gifts: providing greater tax efficiency, tracking of income characteristics, dampening of portfolio volatility, and providing greater protection against downside volatility.

V. Success Criteria for Investing Planned Gifts

We have reviewed the theoretical underpinnings of Modern Portfolio Theory and practice, and the legal requirements guiding trustees in the investment of trust assets where interests are split between income beneficiaries and remaindermen. We have also looked at how trust investing differs from endowment investing. Given this information, how can a charity determine the appropriateness and effectiveness of its planned gift investment approach?

We believe the following objectives should be met.

1. The investment approach meets the diversification and other requirements of the Prudent Investor Act and offers a level of sophistication that will appeal to the charity's donors and beneficiaries. The investment approach is documented.
2. There is a range of diversified stock/bond mixes with differing risk/return profiles to meet the needs of all trusts.
3. Individual donor's needs for custom mixes or for the charity to handle restricted or illiquid assets can be met.
4. Performance is correctly calculated (net of fees) and is good relative to appropriate market benchmarks.
5. Given the lack of smoothing rules, volatility (particularly downside) is dampened.
6. Beneficiary distributions are tax-efficient.
7. Short-term gains are minimized.
8. A significant portion of the distribution is taxed as qualified income or long-term gains rates.
9. Similar trusts (e.g., same trust type, trust term, and payout rate) have similar returns.
10. Reasons for investing trusts differently from policy are well documented.
11. Before signing the trust agreement, donor/beneficiaries are provided with a description of the investment approach along with expected outcomes and risks.
12. Donors receive quality reporting that includes a list of assets, performance relative to benchmarks, and reasons for deviations.
13. Costs incurred are reasonable for the services provided.

Evaluating a Planned Giving Program: Infrastructure, Personnel, and Marketing

Evaluating a Planned Giving Program: Infrastructure, Personnel, and Marketing

Knowledge, discipline, and structure are critical to the success of a planned giving program. The best way to build a solid program is to evaluate (or audit) your development program to develop a solid implementation plan that fits your charity's strengths, weaknesses, donor opportunities, and culture.

I. An Overview of the Process

Every planned giving program can benefit from evaluation, but arranging for an evaluation may be challenging. A planned giving program audit costs money and requires the time of key staff and board members. If you are the staff in the trenches, you may be required to convince your executive staff that such a review will yield substantive results. This session gives you the tools and information you need to make a case for evaluation, understand what it entails, and set expectations for outcomes.

A. The Purpose of the Review

The most common reasons a charity might evaluate its planned giving program include starting a new planned giving program, revitalizing a stalled program, moving a mature program to the next level, or incorporating planned gifts in a capital campaign.

1. Initiating a Planned Giving Program.

Development programs usually start with the basics: annual fund, special events, and/or membership. Some charities never move beyond this stage, while others move quickly to the next level of major gifts, capital campaigns, and ultimately to planned gifts. When a charity is considering the move to planned giving, an audit allows the charity to prepare for additional responsibilities that come with planned giving, make changes in its infrastructure necessary to support planned giving, and incorporate the necessary steps into the next year's implementation plan.

2. Revitalizing a Stalled Program

There are many reasons a planned giving program may stall. Budgets run short and planned giving marketing (and staffing) is cut to save money; the individual responsible for planned giving leaves and is not replaced; the organization undertakes a major change in programming and planned giving focus is lost; or a new executive staff (or board chair) is put in place and wants to move away from planned giving. Sometimes, the explanation is even simpler. The program has been run for the same way for the last ten years, with the same marketing efforts directed at the same donor group. With the repetition, new commitments fall off. A planned giving audit can pinpoint the weaknesses in the current program, identify the barriers, identify the opportunities for growth, and chart a growth for the future.

3. Moving to the Next Level of Planned Giving

Most planned giving programs begin with the basics: bequests, beneficiary designations (insurance and retirement plans) and non-cash gifts. The program may be staffed by a general development officer who is also responsible for major gifts, capital gifts, or other development responsibilities. Now the charity is ready to move to the next level, offering charitable gift annuities, charitable remainder trusts, charitable lead trusts, and establish an endowment. An audit will help identify staffing needs, develop a marketing plan, and set a budget, goals, and objectives.

4. Engaging in Capital Campaign

Some charities consider planned gifts for the first time in the context of a capital campaign. In this setting, there is much to distract the planned giving officer. An evaluation will answer questions about the resources needed to support planned giving in the campaign, the percentage of the campaign allocated to planned gifts, identify counting and valuation issues, and even bring focus to asset management issues.

B. The Benefits of the Review

Regardless of the reason for initiating the audit, the benefits are clear. An audit:

- Provides an objective analysis of the current fundraising and/or planned giving operation of the charity;
- Identifies program strengths on which planned giving can build;
- Identifies weaknesses that must be addressed in an implementation plan;
- Identifies donor segments most likely to respond;
- Allows the charity to set goals and objectives for its program;
- Facilitates the development of a budget and allocation of funds to the most critical areas of program infrastructure, staff, and marketing;
- Crystallizes the duties and staff requirements for the planned giving officer;
- Makes a case for the budget, scope, and expected results of the planned giving program.

II. The Review Team

An effective review can never be made by development staff alone. It takes a joint effort of key members of the charity's staff and often, outside counsel.

A. Executive Staff

A successful planned giving program requires the support of the organization's CEO who controls work priorities, budget, staffing, and goals and evaluates staff performance. If planned giving is not a priority, if the CEO does not understand the goals and objectives of a planned giving program, and does not understand its relationship to the charity's other fundraising programs, the program may not receive the resources necessary to succeed.

B. Fundraising Staff

The development staff may not be familiar with planned gifts and may have concerns the program will negatively impact other development efforts (annual fund, membership, major gifts, capital campaign). Participating in the audit, and being the first to receive the audit results will help them understand the role of planned giving in development and its potential to build and cement relationships for current donors.

C. Financial Team

Surprisingly, the charity's financial team can be one of the greatest impediments to planned giving. The CFO is responsible for setting policies and procedures – without an understanding of the process, these policies may be designed in a way that makes it more difficult to close gifts. For example, the finance staff may not understand the importance of flexibility in gift planning, the need to designate gifts, or the importance of an annual reporting of endowment impact. As the group responsible for managing the endowment, they may also resist discussing or publishing endowment investment results for fear the information will generate too many questions. As key players, they must buy into the evaluation results.

D. The Board

The board is also an essential element of a successful planned giving program evaluation. The board approves the organization's strategic plan, annual budget, and staff priorities. The Development Committee of the board will also be required to set priorities for planned giving, assist in development of the programs, and report progress to the board. They are also potential donors, and can provide important insights into marketing and goal setting.

E. Consultant

A planned giving evaluation is not as simple as using a checklist to create a single model for every charity. Instead, it requires a great deal of subjective judgment and a synthesis of ideas to achieve a plan that fits the fundraising maturity, budget, and culture of the organization. While a consultant is not absolutely necessary, an outside voice (with experience) may provide the expertise and insight needed to provide an accurate assessment, and to get the buy in of the key staff and board at the conclusion of the process. An outside voice may also be able to raise issues with staff and board – and be heard – when internal staff voices would not be heard. Not every organization can afford consulting advice. Look for local resources – a consulting firm or a Nonprofit Resource Center. Or, seek grants from foundations or corporations for that purpose.

III. Collecting Essential Facts

A. Key Legal Documents

The following documents govern the operation of the charity, and are essential to any review of fundraising, especially if changes to current activities and operations are anticipated.

- *The Articles of Incorporation* –This document gives the charity its life – its organizational purpose and existence.

- *Trust document* – On rare occasion, the organization is created by trust rather than as a nonprofit corporation. This happens if the charity is created under a will, or for some other reason created in this less flexible form.

- *By-laws* – The by-laws set the operational patterns for charity. The by-laws specify the board composition, officers, meetings, responsibilities, key staff positions, standing committees, and the method of making changes.

- *Tax determination letter* – The tax determination letter is the IRS's ruling on the organization's tax status (whether created by nonprofit corporation or trust). The tax determination letter is issued in response to the filing of the charity's Form 1023 and may be reissued if there are changes to the organization's name, purpose, or operation.

- *Board resolutions relating to development, fundraising, or endowment.* Boards may adopt resolutions relating to fundraising, and then lose sight of those resolutions as the board turns over or changes.

- *Other legal documents.* Sometimes a charity operates subject to court orders or settlements, or under the direction of other legal directives. Examples may include orders from the state Attorney General relative to fundraising solicitation or activity, directives following a lawsuit, or other similar orders.

Review these documents to make sure the charity is operating within its charter, and within current legal directives. Notes changes that must be made an the conclusion of the evaluation. Any changes recommended as a result of the evaluation should be referred to legal counsel for resolution.

B. Organizational Fundraising History

A readiness audit begins with a review of the history of the organization's fundraising activities. Make a list of all fundraising activities conducted by the nonprofit, the date the activities were initiated, its frequency (annual, quarterly) and its purpose. The fundraising purpose is important to evaluating the current value of the fundraising. For example, a special event may be planned to raise money, to spread the nonprofit's mission, to identify new annual fund donors, or to give the board something to do. Nonprofits may fall into a pattern of repeating events annually without evaluating the value those events bring to fundraising, or the cost in staff and volunteer time and effort.

Planned giving is an additional fundraising activity and should be balanced with a reasonable and logical schedule of other activities. The audit of activities may highlight some fundraising activities that should be discontinued or changed to achieve a more positive result.

C. Fiscal Fundraising History

The fiscal fundraising history review focuses strictly on the dollars involved in fundraising.

1. Revenue

Record the total funds raised from the annual fund, major gifts, government grants, foundation grants and planned gifts over the last ten years. Create separate line items for each fundraising event that generates significant income or significant activity to the nonprofit. For example, if the organization has focused on building board giving, show that as a separate item. The key is to develop a system that reveals the material strengths and weaknesses of your fundraising efforts.

2. Expenses

In addition, record the number of staff, and budget dollars allocated to development over the period. The relationship of staff and budget to dollars raised may reveal that income drops when staff becomes overloaded and may make the case to add staff at appropriate intervals. Graph the results looking for patterns. Indicators of a healthy fundraising program ready for planning giving include:

Consistent, growing annual fund numbers.
Diversity in annual fund efforts with new initiatives added and maintained over time.
Participation by the board and immediate consistency of the organization (for example, in a health care support organization I would expect not only the board but the doctors associated with that field to be involved).
Well-organized capital campaign and/or endowment effort with broad participation.
Some unanticipated planned gifts.

Absence of any of these factors will not doom a planned giving program just as the presence of those factors will not ensure success. However, an organization that has not matured its annual fund effort should not move to planned giving without doing more work at the basic level.

D. Organizational History

Simply recording the types of fundraising activities and the dollars generated by those activities does not provide the full picture. It is now necessary to recall any major events in the organization's history that may have impacted mission or the ability to raise funds. Recall and record the significant events in the timeline of the organization's history. Describe the events as fully as possible. Look for significant positive messages that can be used in the case statement for planned giving. Also look for negative events that must be addressed and explained in raising long-term funds for the organization.

IV. The Infrastructure Evaluation

A planned giving program cannot prosper without a sound organizational infrastructure. Infrastructure also ensures accountability to donors and to regulatory authorities.

A. Mission and Purpose

Charities sometimes lose sight of mission and purpose, especially when they are successful, growing, and attracting public and private funds. Try this test. Do you know your charity's mission statement? Could key members of your staff recite it? How about the board? The mission statement should be a clear, concise, one sentence statement describing the organization (XYZ Charity is a nonprofit organization) that says what it does, who it serves, and the geographic area in which it provides those services. The mission statement should accurately reflect the current operation and direction of the charity, and should be on every printed piece that leaves the office.

The mission statement and purpose has additional import for planned giving. If the organization has a short-term mission and purpose, donors may be less inclined to make deferred gifts to support its future; if, on the other hand, the mission and purpose are perpetual, those long-term needs form the basis of the deferred gift appeal.

B. Strategic Plan

It is virtually impossible to talk to donors about funding the future without having some clue about the form and goals of that future. A strategic plan is the only way to build this picture. (For this discussion the term "strategic planning" is used to broadly describe a process designed to reaffirm whom the organization serves, why it serves that group, and how it will meet that mission and deliver the services.) Fundraising is a critical element of fulfilling mission and must be addressed as a part of this process.

1. The Benefits of Planning

The strategic planning process allows you to identify known issues, surface potential hurdles, and make a plan to address them in a thoughtful and logical order. This leads to more effective decision-making, staffing, and prioritization of activities. It also creates a common vision for board, staff, and volunteers, and allows you to seize opportunities that allow you to move faster, or more strongly, down the intended path.

2. The Recommended Process

Strategic planning can be a frustrating experience if handled poorly. A bad planning process will waste time, money, and energy and will dampen, rather than strengthen, the planning momentum. It is therefore important to use an experienced, professional strategic planning firm. Gather the names of strategic planning firms – especially those with experience in the nonprofit arena – and ask them to submit proposals for the service. Interview the top 3 to 5 respondents and select the firm that will fit the organization's culture and has a proven track record.

C. Board Structure

The board is ultimately responsible for the nonprofit. By law they have a fiduciary responsibility to ensure the nonprofit is making effective use of its charitable funds, and accounting accurately to the government and the public. Often boards are comprised of individuals with programmatic strength but who have little knowledge (or comfort) with fundraising. The strongest board has a mixture of both talents. Use the following process to analyze the charity's board.

1. List the Critical Board Skills

List the critical skills needed on the board. Skills you may need include:

- Leadership
- Financial skills
- Fundraising experience
- Grantwriting
- Organizational skills
- Staff/program evaluation skills
- Political/social connections
- Special events experience
- Contacts with people or organizations representing the nonprofit's constituency
- Program administration experience
- Prior success with nonprofit boards
- Planned gift donors
- Major gift donors

2. Review the Current Board's Strengths and Weaknesses

Compare the required skills to the skills held by the board to identify those required for the "perfect" board. Share the characteristics needed for new members with the nominating committee. The more clearly you describe the individuals you need, the more likely you are to turn up good members. This strategic board building exercise will add strength to your ability to manage change within the organization and will ensure your ability to continue to move forward.

3. Identify Candidates to Fill the Spots

Identify several potential candidates for each role. Rate each candidate's name to determine the individuals that have the highest degree of contact with the organization. Common qualifiers include:

Wealth (donor potential)
Generous contributor (history of support)
Family history of support
Good media/press contacts
Contacts with segments of the community that you want to reach
Experience with the services you offer
Experience in your nonprofit field
Experience in the nonprofit sector
Experience with fundraising in the nonprofit sector
Delivery of the services you need
Family use of your services
Grant seeking experience
Time to contribute
Easy to work with
Successful board experience
Political connections (community influence)
Other factors that you have found important

D. Fiscal Policies and Procedures

Scandals in the nonprofits world (and corporate world) have placed greater emphasis and attention on accountability. Nonprofits no longer get "the benefit of the doubt" when accounting practice lead to embezzlement or improper use of funds simply because the organization does good things in the community. Every nonprofit should have written policies and procedures designed to ensure integrity in the use of the funds. These policies should address who controls the money (with dual controls for transactions in excess of certain amounts), how the budgeting process occurs, and how spending is monitored. It should also include standards and timing of the audit, verification of assets and asset values, acquisition of insurance for the charity's assets, actions, and board, and investment management policies.

E. Gift Acceptance Policies and Procedures

Every charity should adopt a set of gift acceptance policies to guide the development staff in the acceptance of major and planned gifts. The gift acceptance policies should address:

- The types of gifts that can be accepted, with an emphasis and detail about real estate, closely-held stock, tangible personal property, and other non-cash gifts;
- The acceptance process for these gifts, including the issues to be raised, and the assignment of responsibility for final decision on acceptance;
- Standards for restrictions, and dollar limits on naming opportunities of exhibits, rooms, single year sponsorships, and permanent endowments;
- A position statement indicating whether the charity will serve as Trustee, and if so, under what circumstances; and
- The restrictions on specific uses of gifts, including commitments to endowment for long-term use.

Check the content of the policies, and the schedule on which they have been reviewed and edited. Annual review is recommended.

F. Stewardship Policies and Procedures

Taking care of donors is as important as acquiring donors. Review the nonprofit's practices in this area. The organization should have written stewardship policies detailing the types of thank-yous sent to donors (and who signs them, with an emphasis on a signature from the CEO for larger amounts), the timing of those acknowledgements, and other methods of keeping in touch or thanking donors during the year. For example, there may be a major donor dinner, the charity may print donors' names in an annual report, or even run a full page newspaper "thank you" on an annual basis. Good stewardship does not have to cost a lot of money – but it does take planning and follow through.

One way to measure success in this are is to measure donor retention from year to year. Organizations without stewardship policies often have no idea how many (or the percentage) of donors are retained year over year.

G. Investment Management Policies and Procedures

The board of a nonprofit organization has a fiduciary obligation to effectively manage the assets entrusted to it. Since at least a portion of the board changes each year, the way to ensure consistency and focus in asset management is to adopt a set of written investment management policies. These policies should:

- Detail the amount kept in operating reserves (generally a percentage of the annual operating budget), and provide standards for the form of investment of these assets. For example, you may limit investment of operating reserves to Treasuries, Government Agencies, certificates of deposit, or other A rated fixed income investments with maturity not greater than 90 days, or 180 days, or 1 year.

- Set a spending policy for long-term assets (endowment).

- Set an asset allocation policy for your endowed assets, and benchmarks for each sector. For example, the benchmark for the equity portion may be the S & P 500 if you are using a manager whose goal is to outperform the broad equity market, the BARRA (or Russell) Growth Index if you have selected a growth manager, or the BARRA (or Russell) Value Index if you have selected a value manager.

- Set a schedule for regular review of the portfolio performance compared to the benchmarks.

H. Endowment Structure

Begin the endowment evaluation by asking key staff members (and board members) the following questions:

1. Does your organization have an endowment?
2. What is the market value of your endowment?
3. What is the current asset allocation of your endowment?
4. How has that asset allocation changed over the last year with the dramatic changes in the stock market?
5. What was the total return on your endowment last year? (And, what is total return?) What was the total return over the last five years?
6. How do your total returns compare to the blended index return?
7. What is the spending policy for your endowment?
8. Are there any restrictions on terms a donor can impose on endowment gifts?
9. Are there any restrictions on the type of assets that can be contributed to your endowment?
10. Who makes decisions about distributions from your endowment?

If this group of key stakeholders is unable to answer the majority of these questions, it is time to bring more definition and attention to the endowment, which is critical in long-term planned giving success.

If the organization does not have an endowment or policies to govern gifts to it, ask these questions:

1. What happens to planned gifts that come in as bequests, beneficiary designations, or at the termination of charitable remainder trusts?
2. Is long-term funding a priority for the organization? How was this addressed in the most recent strategic plan?
3. How does the board feel about the role of endowment? Are there any concerns?
4. How does staff feel about the role of endowment? Are there any concerns?

The answers to these questions indicate the course of action required to establish and build endowment.

I. Database and Database Management

The donor database is one of the greatest sources of information to determine organizational readiness. Most organizations do an excellent job of maintaining information on the sources of their income but have spent less time thinking about how they will use the information to research trends and opportunities. Information the organization should have about its donors includes:

1. Donor name, address, phone, fax, e-mail, alternate addresses.
2. If corporate, the names of the key contacts and decision makers.
3. If personal, key family members and decision makers (also potential multi-generational contacts).
4. Dates, amounts, and types of gifts.
5. Method of solicitation, and name of person making the solicitation if personal contact involved.
6. Donor's areas of interest.
7. Donor's points of contact with the organization.
8. Record of any special donor recognition.

The organization should maintain this information in a data base format that is easy to access and manipulate in report form. The information in this database represents the initial search area to identify potential planned gift donors.

Record keeping for donors is only part of the story. It is also important to maintain a history of the results of the organization's various fundraising activities. How did that donor's find you? Why did they call? Why did they make the gift? History that is useful includes:

Personal use of the organization
Family use of the organization
Service on board
Contact with board member
Contact with staff member
Newsletter
Seminar
Media
Annual fund contact
Membership drive
Special event
Professional advisor referral
Direct mail response

While this may seem like information overload, good data provides the most accurate information for planning. Over time, this information will guide the organization on whether to spend additional money on newsletters or direct mail, and will provide such information as whether a lunch format for seminars is more effective than a breakfast.

J. Reporting and Measurement

Reporting and measurement are integral to evaluation of a planned giving program. Not only does it prompt staff to set clear goals and objectives, it ensures the charity measures the components and activities necessary to achieve those outcomes. The most effective reports measure dollars, calls, commitments, activities, board participation, and even training sessions. Assemble the fundraising and planned giving reports from the past five to ten years (depending upon the scope of the review). If there are no reports, add reporting and measurement to the list of "to do" items recommended by the evaluation report.

K. Planned Giving Recognition Society

Organizations beginning or expanding a planned giving program should have a planned giving recognition society to recognize and cultivate donors who make deferred gift commitments. In the evaluation check:

- The organization's name – does it reflect a long-term purpose and distinguish itself from annual fund categories?

- Its membership qualifications – are membership standards easily understood and distinguished from annual gifts or multiple years of giving?

- Its membership roster – look at year over year membership numbers. Are the numbers growing? What is the pattern?

- Membership verification – how often is membership verified?

- Membership contact – are there recognition events to thank planned gift donors?

- Society visibility – how is the society positioned in newsletters, magazines, the annual report, and on the Internet? Are other methods of inviting membership used?

V. The Staff Evaluation

The finest planned giving plan in the world will not be effective without the staff to implement the plan. Bodies alone are not enough – they must be the right bodies with the right skills and appropriate priorities. Here's what to look for.

A. Staff Structure

There is no magic staff structure that works for every organization. Planned giving is staffed in a variety of ways, depending upon the charity's budget, staffing history, donor location and marketing plan. Sometimes, a nonprofit decides to tackle planned giving without adding staff on the mistaken assumption that brochures and educational materials will generate gifts. Success results from relationships, not mailings. Planned giving is labor intensive and requires personal contact with donors. Staff must be available to review records to identify potential donors, to make calls on those donors, to answer questions, and to manage acceptance of gifts. Therefore, the charity must either add staff or rearrange current staff responsibilities to free time for planned giving activities.

B. Job Descriptions

Charity should have job descriptions for staff – including planned giving officers – that include the job skills and minimum requirements. The job description should be available during the interview process so that the applicant will have a clear understanding of the expectations prior to her acceptance of the position. The job description will vary widely from nonprofit to nonprofit due to the fact that the planned giving officer may spend from 5 percent to 100 percent of her time in planned giving, and the remainder supporting other development work. (Elements are listed below.) Talk to the staff in the job and compare the skills to those listed on the job description.

- *Job title*
- *Title of supervisor* – Person to whom the planned giving officer reports
- *Title of subordinates (those that the planned giving officer will supervise)* – How much staff, and what level of responsibility?
- *Education required*
- *Experience required*
- *Licenses, or certifications required*
- *Technical skills:* Planned giving software management, basic word processing/spreadsheet software, presentation software, database management, etc.
- *Personal qualities* (suggestions taken from actual ads): Motivated, innovative, comfortable in front of people, good decision-making skills, good interactive skills, goal oriented, high energy, excellent communication skills.
- *Duties and responsibilities:* Develop and implement a planned giving marketing strategy, make calls (at least 50% of each day) on prospective donors, train staff at nonprofit to identify planned gift donors, develop liaison and communication with professional community, develop annual budget for planned giving program, prepare publications for planned giving program, provide technical assistance in gift planning

D. Allocation of Time

NCPG's most recent survey of gift planners, the Gift Planner Profile 4, revealed few staff devoted their time exclusively to planned giving. Time allocated to planned giving was reported as follows:

TABLE 1
NCPG Gift Planner Profile 4
Nonprofit Staff Time Allocated to Planned Giving

Time Spent on Planned Giving	*Percentage Responding*
0%	1.7%
1-24%	39.0%
24-49%	15.6%
50-74%	11.8%
75-99%	14.8%
100%	17.0%

The allocation of time should be clearly spelled out in the job description, or in some other clear manner communicated to the employee.

E. Goals

Goals drive activity. Or, to say it another way, people prioritize activities on which they are evaluated. Planned giving staff should have clear goals detailing the number of calls, proposals, new recognition society members, staff training sessions, realized gifts, or other objective measures of their success. These measures should always include non-financial goals (related to program infrastructure, marketing activities, and commitments) as well as financial goals, especially in the early years of the program.

F. Annual Evaluation

All employees should have an annual evaluation of their performance, measuring their ability to stay on task, meet their goals, and build relationships with donors.

VI. The Marketing Evaluation

The evaluation of the charity's marketing plan involves a review of its marketing strategies, marketing activities, marketing materials, and results.

A. The Marketing Strategy

The charity should have a marketing strategy that places a priority on activities that are most likely to be effective, and have the most reasonable cost ratio. The staff should be able to explain its key donor segments, identify activities that are most productive, and explain how they reached this conclusion. The strategy (or strategies) should be reflected in its marketing plan.

B. Marketing Activities

The charity should have a list of its marketing activities and a marketing plan. The activities and marketing plan should reflect the marketing strategy. They should also reflect a diverse base of activities to reach its various donor segments.

C. Marketing Materials

Planned giving marketing materials are designed to educate donors and to prompt action. The nonprofit must select materials that support the essential elements of its marketing plan and should avoid showering donors with an overload of information. The purpose of planned giving marketing materials is to bring the nonprofit development officer into contact with an interested, focused planned giving prospect and to direct that prospect to the next level of action. These materials should "peak" the interest of the potential donor. Marketing materials do not close planned gifts.

Planned giving is a concept that is simple in theory but difficult in application. The tax laws provide great flexibility for the donor, but complicate the task of finding the best answer. These printed materials must anticipate common questions and provide consistent responses. The challenges facing the nonprofit in delivering the planned giving message include:

- The donor's lack of knowledge of basic estate planning;
- The donor's lack of knowledge of the basic charitable planning options;
- The professional advisor's lack of knowledge of basic estate planning; and
- The professional advisor's lack of knowledge of basic charitable planning options.

1. Branding

Branding allows the charity to reinforce its image and message with its donors and the public. Check the consistency of the pieces.

- Is the logo used on all pieces? Is it used consistently (font, size, colors, placement)?
- Do the marketing pieces have a consistent look? Can the planned giving pieces be distinguished from other marketing pieces?
- Do the planned giving marketing pieces contain the planned giving case statement?

2. Brochures

Brochures are available in a variety of forms and formats. The planned giving officer does not need a brochure for every type of gift. Instead, the officer should select those brochures that deal with the most commonly raised planned giving questions, or those brochures that have the greatest likelihood of sticking with the donor and keeping the nonprofit name in front of the prospect during the year. Key questions to raise in evaluating brochures include:

- Does the brochure have the nonprofits logo? (Is it branded properly?)
- Is it current?
- Is it accurate?
- How is it used?
- Is it effective?

3. Newsletters

Newsletters keep charitable planning issues and the nonprofit name in front of prospective donors and professional advisors throughout the year. While newsletters are not an essential element of a start-up planned giving program, they represent an effective way to reach prospective donors and to communicate the importance of charitable planning. Does the organization's newsletter:

- Focus on completed gifts and the donor that made those gifts?

- Contain a personal testimonial or message from donors who have made planned gifts that explain in their own words the reasons for the gift?

- Feature an easy to read and understated piece on a planned gift form (preferably the form that was used to make the gift in the featured item)?

- Snag the reader with bits of information on taxes, tax laws, etc.?

- Contain photographs of the nonprofit donors, nonprofit staff, or successful nonprofit?

- Feature the recognition society and provide a description of how to become a member?

- Provide a response mechanism to request additional information or to allow the donor to notify the nonprofit of inclusion in the donor's will?

4. Other Written Communications

Review the organization's annual report, newsletters, magazines, and other regular publications. Is planned giving mentioned in each of these? If not, are there opportunities to include a planned giving or endowment message? If so, is the message consistent with other publications, accurate, and effective?

D. Website

Websites offer a 24-7 way to reach potential donors and educate them about planned giving options. However, some websites are indecipherable. Review the following points:

- Is the site easy to find?
- Is the nonprofit identify and mission clear to browsers?
- Are changes made to the site, and planned giving segment, periodically to update data and add interest?
- Is there useful data or information for browsers?
- Is there a way for browsers to give you their name, address and contact information, and get in touch with the charity's staff?
- Are there staff photographs, telephone numbers, and e-mail contacts provided?
- Does the charity check the site regularly and respond promptly to inquiries?
- Is the newsletter online? How about key brochures?
- Is there a calendar with a list of activities and methods of registering for events?
- Does the site include donor stories?
- Is the reader engaged? Can he interact with the site?
- Can the charity monitor traffic to the site?
- Is information for professional advisors provided on line? (Professional registration forms, bequest language, "how to name the charity," etc.)

E. Segmentation of Donors

The charity should be able to identify its top donor segments, defining them by age, sex, connections with the nonprofit, location, and other characteristics. These segments should be reflected in the tables on the donor database. The marketing plan should reflect plans to address these segments.

F. Professional Advisor Outreach

Professional advisors represent a critical link to the donor community, and also serve as important advisors in gift planning.

1. Database of Top Advisors in Market Area

The charity must be able to make recommendations to donors who need planning assistance, must be able to get professional help when needed, and should develop contacts with key advisors in their marketing and service area. The data should include as much information as possible about the advisor, including areas of specialty, degrees, family information, and firm size.

2. One Page Information Sheet for Advisors

When charities begin to ask donors to make planned gifts, advisors may call to request instructions on the proper way to designate the charity in a gift, to request sample bequest language, or to ask for help in structuring a gift. A donor who names the "Boy Scouts" as beneficiary of a bequest and then retires to another city creates confusion about the "Boy Scout" office intended to receive the gift. Similarly, a donor who names the "Children's Hospital" may unwittingly create confusion if there are three or four hospitals in the area that handle medical treatment for children. The easiest method of establishing the charity's legal name is to develop a simple instruction sheet setting out the legal name of the organization (specifying the foundation name if the nonprofit prefers that donors make planned gifts to the foundation rather than the operating organization), the address, the tax identification number, the contact person, and any restrictions on gifts or endowment opportunities. Check to ensure the charity has some method of communicating these facts.

3. Sample Bequest Language

Bequests may take various forms. Knowledge of the alternatives provides a donor with the flexibility to make a gift without knowing the exact amount available. Check to see if the charity has basic language to assist attorneys in naming it in estate plans.

4. Professional Advisory Council

A professional advisory council may represent an efficient way to make contact with the professional community, or a way for small charity to obtain basic professional advice to review gift acceptance policies, newsletter text, and develop donor profiles. The key to successful use of an advisory council is to know the goals in creating the council. A council is a lot of work, and should not be created without purpose. Key questions to raise about an advisory council include:

- What is the purpose of the advisory council?
- How many members are there? What are the terms?
- Is there a job description for the members? Is this shared with potential members before they agree to serve?
- How often does the council meet?
- What are the council's activities?
- How effective is the council in advancing planned giving?
- How is the effectiveness of the council measured?

5. Newsletters

Advisor newsletters may represent a way to educate the professional community and create visibility for the charity. However, the charity should have specific goals and objectives in mind, and be mindful of other newsletter resources available to the advisor group, before deciding to use this marketing format. (For more information on marketing to professional advisors, see the article by Kathryn Miree on the topic in the Fall 2003 issue of the Journal of Gift Planning.)

6. Seminars

Seminars also offer a way to position the nonprofit in the professional community, and to educate the professional community. Seminars must be valuable, however, and scheduled in a time and place designed to attract the largest audience. If the charity conducts seminars, these questions may be appropriate:

- How are seminar topics selected?
- How are speakers selected?
- Are the seminars evaluated? If so, what do the evaluations reveal about the quality of the presentation, and the value to the participant.
- How many invitations are mailed? How many professionals attend?
- Does the charity receive follow up inquiries? Of what type?

G. The Marketing Plan

The marketing plan must be tailored to meet the goals of the nonprofit; this means that each organization's marketing plan will be different. Assess the plan by raising the following questions:

- Does the charity have a marketing plan?
- When was it adopted? How often is it reviewed? Who reviews it before adoption?
- What are the key activities in the plan? Are these activities:
    - Directed at the key donor segments?

- Reflect the reality of the geographic reach of the organization and its staff?
    - Properly staffed for response?
- Does the plan have measurable goals and objectives?
- Is the staff person(s) responsible for implementation reflected in the plan?
- Does the plan have a calendar or timeline? Has the charity met the plan deadlines?

H. Annual Evaluation

A planned giving program is not static. An end of the year soul searching exercise can provide a great deal of insight. The review must be objective and subjective and should cover the following activities.

- *Are calls evaluated?* Calls should be counted and measured for effectiveness. Objective summaries might include:

    The number of calls made on prospective donors.
    The number of gifts or commitments resulting from those calls.
    The number of dead end calls.
    The number of gift proposals that were requested/prepared.
    The number of seminars conducted.
    The number of attendees at those seminars.
    The number of follow up calls from the seminars.
    The number of follow up calls from mailings.

    Subjective reviews might include:

    Were the candidates properly qualified before the call?
    Was the purpose of the call clear to the donor?
    Were the charity able to follow up quickly on questions raised by the donor? (Did it have the time and resources?)
    Could the charity have benefited from the participation of a key volunteer? Or, did a joint call with a key volunteer slow the effort?
    Did the charity raise the donor's expectations of and image of your organization as a result of the call?

- *Is seminar activity evaluated?* Seminars require a great deal of time and effort. Many development offices feel compelled to offer seminars (everyone else is, and certainly donors need to be educated!) but they are disappointed in the results. Evaluate these issues following a seminar.

    How many invitations were sent, and how many individuals responded?
    How many of the donors that indicated that they would attend actually attended?

Did you get any follow up inquiries following the seminars? Did the charity make an effort to contact each attendee? Did it make contact with the donor during the seminar? Did it qualify the invitees based on the topic of the seminar? Did it make the seminar relevant to their needs?

Did the charity survey the seminar participants on the time, place, length, and content of the seminar? What was the response?

Were the seminars too large? Did the charity attempt to invite as many donors as possible and make the topic as broadly appealing as possible? Or did it restrict the size and content to focus on various types of donors? If the charity used smaller seminars, was the feeling intimate, or did the atmosphere reflect a feeling that the attention was too focused on the participant? (Rat in a trap…)

- *Value of collateral material.* How effective were the printed materials? Did the organization measure response to the newsletter? To the end-of-year mailing? To the special solicitation in conjunction with the capital campaign? To the special appeal related to the anniversary event? Pamphlets and brochures are expensive. Measure the response to these pieces to the degree possible.

- *Success of the recognition society.* Recognition societies are often not used to their fullest capacity. Ask the following questions.

How much did the recognition society develop during the year?

How often did the nonprofit publish the names of new and current members in its newsletter or other general circulation publication? Did the organization experience an increase in interest when the names of members were published?

Did the nonprofit conduct an annual dinner/lunch recognition event? If so, what percentage of the members attended? Did the event recognize new members? Special members? Did that recognition inspire others to do more?

Did the development office make calls to solicit new members? How were those calls made? Was the purpose of the calls to solicit any planned gift or was the call limited to an "ask" for a bequest? What percentage of new contacts agreed to become a member? What types of commitments were made by the new members (i.e., life insurance? bequest? CRT?)

What percentage of the nonprofit board and staff are members of the recognition society? Were the board and staff solicited during the year? Who made the solicitations? Who was most effective in making the solicitations?

* *The professional advisory board.* Management of the professional advisory board takes time, energy and in some cases, money. Did the PAB prove valuable during the year?

  How many meetings of the PAB were held during the year? What percentage of the members attended?

  Describe the activities of the PAB? Did the PAB set an agenda and follow it? Did the PAB set goals? Did the PAB conduct activities?

  How many referrals did you get from PAB members? Was there an increase in interest and activity? Were there follow up calls from PAB members after meetings?

  How helpful and active were PAB members? Did members make calls with the development staff? Were the calls successful? Did the ratio of commitments for the recognition society or planned gifts increase as a result?

  Were the PAB members more successful on recognition society calls, technical calls, or fishing expedition calls?

  Did any members of the PAB make a gift or commitment personally during the year? Did any of the members contribute gifts through their institutions, either in cash or in kind? Is there potential to do more?

  Should number of PAB members be increased? Should the members be changed?

* *Board training.* The nonprofit board is an important resource for the planned giving program. Many organizations conduct training, but are not sure what to expect.

  Was board training conducted during the year? Was the training successful? How was it measured?

  Were the sessions effective? Were goals set? Were the sessions too long/too short? Were the sessions focused? Was the training conducted at a regular meeting? Or was the session part of a special retreat?

  Did planned gifts result from the board training sessions? What types of gifts? What prompted the gift? Did the educational material "click"? Did the board member simply report a gift to you that had been made previously? What did you learn from the gift?

Did the percentage of the board that is a member of the recognition society increase? Were participation goals met? Was the increase a result of training or a result of a personal call on the board member? Did the training set the stage to the make the personal call on the board member?

VII. Using the Results

Analyze the results from the questions raised in the review. Identify the financial and organizational strengths. Isolate the financial and organizational weaknesses. Look at changes that have occurred in the organization's structure over time and determine if those changes were planned or forced.

Present the results of the evaluation – including recommendations – to key staff members, the Development Committee, and the full Board. Accompany the report with the budget necessary for implementation, and the goals and objectives of each part of the plan. The presentation to the board will be far more effective if the Development Chair (volunteer and peer board member) is involved in the presentation. If an outside consultant was used for the study, involve the consultant in the presentation as well.

The process should energize the staff and volunteers, and bring renewed energy to its approach to donors. A well prepared plan will be easy to advance. And having a foundation for each recommendation – as well as clear objectives for recommended activities – will make implementation easy.

Kathryn W. Miree
Kathryn W. Miree & Associates, Inc.
P. O. Box 130846
Birmingham, Alabama 35213
205-939-0003
205-939-3781 (fax)
kwmiree@giftplanners.com
www. giftplanners.com

APPENDIX
CHECKLIST FOR REVIEW

I. Essential Documents

____ Articles of Incorporation (or trust document)
____ By-laws
____ Tax determination letter
____ Board resolutions relating to development, fundraising, or endowment
____ Other legal documents
____ Fundraising history (by activity)
____ Fundraising history (by dollars)
____ Organizational history

II. Infrastructure Evaluation

____ Mission and purpose
____ Strategic plan
____ Board list and structure
____ Fiscal policies and procedures
____ Gift acceptance policies
____ Stewardship policies and procedures
____ Investment management policies and procedures
____ Endowment spending policy
____ Endowment governing documents
____ Endowment assets
____ Database tables and structure (also, count of key donor activity levels)
____ Historical fundraising reports
____ Planned giving recognition society

III. Staff Evaluation

____ Staff names, titles, functions
____ Staff job descriptions
____ Staff Goals

IV. Marketing Evaluation

____ Marketing strategy
____ Marketing plan
____ Copy of all marketing materials
____ Website location
____ List of donor segments
____ Count of professional advisors
____ Marketing materials used for professional advisors
____ Professional advisory council structure (organizing documents)

A Gift Planning Quiz

Presented at the

26th Conference on Gift Annuities

May 6, 2004

Jonathan G. Tidd
Attorney
West Simsbury, Connecticut

1. Donna, aged 78, a resident of Boston, sets up a $282,364 gift annuity using highly appreciated securities. She does this in Month 3, for which the IRS discount rate is 3.4%. For Month 2, the discount rate was 4.0%; for Month 1, the discount rate was 4.4%. Charity, which issued the gift annuity, sends Donna a computer-generated illustration of the tax consequences of the gift arrangement based on the Month 1 discount rate. On her federal income tax return for the year of the gift, Donna's accountant claims a charitable deduction per the illustration but takes no other action or steps in this regard.

   <u>Question</u>: Assuming <u>no other facts</u>, is the illustration accurate, and is Donna's tax return correctly prepared?

   <u>Second Question</u>: Assuming <u>no other facts</u>, will Charity's 1099Rs sent to Donna with respect to this gift be correct?

2. Charity invites donors to make contributions via credit card. Charity's written material on such contributions states that Charity will "credit" donors with having made a gift on the postmark date of the envelope containing the needed credit card information if the information is mailed.

   <u>Question</u>: Based just on the facts presented here, is there something amiss, something misleading, possibly, about Charity's written material? See Rev. Rul. 78-38.

3. Jane and her brother Jim own a very valuable tract of real estate as equal co-owners (tenants in common). Jane and Jim, aged 74 and 71, want to use the property to establish a charitable remainder unitrust (a flip trust).

   <u>Question</u>: Any problems with this plan?

4. In 1996, Kathy set up a revocable living trust and transferred a large amount of assets to the trust. The trustee of the trust is Bob, Kathy's brother, an investment adviser. Kathy wants to use assets held by the trust to establish a gift annuity (for her life alone) with Charity.

   Question: What questions need to be asked and answered to know whether Kathy's proposed plan, as stated, can be carried out?

5. Kathy's brother Bob wants to know whether he can use assets either in (a) his private foundation or (b) a donor-advised fund he has established at a community foundation to establish a gift annuity for himself alone.

   Can he?

6. In response to the answer given to question #5, Bob says, "But last year, I used assets in my foundation to pay a pledge I made to my college. Are you telling me this was improper?"

   Question: What do we need to ascertain in order to be able to answer Bob's question?

7. Two weeks ago, Elizabeth transferred a check in the amount of $40,000 to XYZ Charity to establish a gift annuity. At this point, Elizabeth, who has not signed the gift annuity agreement XYZ sent to her, wants to back out of the gift annuity and re-consider her gift planning options.

   Questions: [1] Any tax or other legal problems with what Elizabeth wants to do? [2] Would the situation be different legally if Elizabeth had made either an outright donation or a transfer to a charitable remainder trust?

8. In 1990, Don established a 10% charitable remainder annuity trust that was to make payments to him for life, then to his wife Dora for life. In 1999, Don passed away, survived by Dora.

Since 2000, the trust assets have been eroding away at a significant rate.

Beginning in July 2001, Dora has received but has refused to cash her payout checks from the trust.

Question: How do we size up this situation?

9. Donor uses a life insurance policy to establish a gift annuity.

The essential facts concerning the policy are these:

cash value = $170,000

net premiums paid = $100,000

policy loan = $0

Question: Given that Donor realizes a chunk of ordinary income for federal income tax purposes under the bargain sale rules, how should the issuing organization report this income to Donor? Put another way, how should Donor report this income?

10. In 1996, Ted, then aged 84, a resident of Florida, made a will and shared a copy of his will with ABC College, a Massachusetts charity. Under the will, ABC was to receive from Ted, an alumnus and long-time supporter of ABC, 25% of Ted's estate -- then valued at about $2 million.

In August of 2003, Ted died, having moved to Easy Acres Assisted Living Facility in December 1999. ABC has just learned that in June 2003, Ted made an entirely new will under which 25% of his estate was left to Linda Jaguar, a nurse at Easy Acres, $10,000 was left to ABC, and the balance of Ted's estate was left to American Predator Bank as trustee of a perpetual charitable foundation.

Ted's final will was prepared by the Tampa law firm of Cheetem, Robbem & Plunder -- a firm with which Ted apparently had no prior relationship.

<u>Question</u>: How do we size up this situation?

11. A "PRE-ARRANGEMENT" SITUATION FOR DISCUSSION -- LETTER RULING 8533006

A. Facts

Jill wants to establish a charitable remainder unitrust with real estate. The trustee will be a charity.

Neither Jill nor the charity want to go forward with the proposed trust, however, until a buyer is at hand.

<u>Question</u>: Would it be all right insofar as Jill's tax position is concerned for the charity, as prospective trustee, to enter into an agreement with a third party that if the charity acquires title to Jill's land as trustee, it will sell and the third party will buy the land?

B. Letter Ruling 8533006

Donor enters into <u>a legally binding pledge</u> to donate land via undivided fractional interests over 4 or 5 years.

The prospective donee enters into an agreement with Buyer 1) to sell to Buyer all the fractional interests it receives, and 2) to take any steps needed to enforce Donor's pledge.

Ruling: IRS essentially says "no problem" re Donor's capital gain tax position.

12. TWO DATE-OF-GIFT CASES

Case #1: Donor calls his broker and instructs the broker to give 1,000 shares of IBM stock held in Donor's brokerage account to Donor's charity. Donor does this on October 11.

a. Assume the Broker opens a temporary account in the name of the charity and transfers the 1,000 shares to the account on October 15. When is Donor's gift complete in this case? See Morrison (Tax Court 1987).

b. Assume the brokerage firm has a "Charitable Gift Account" into which the stock is moved on October 15. Assume the charity learns of the transfer to the Charitable Gift Account on October 18 and at that point gives instructions to the brokerage firm to transfer the stock to the charity's regular gift clearing account. When is the gift complete in this case?

c. Assume the broker wires the stock from Donor's account via DTC on October 12 and that the stock lands in the charity's account on October 13. When is the gift complete in this case?

d. Same facts as in case "c" except that the stock is wired to the wrong account (the brokerage firm's error). The error is not discovered until October 29. At that point, Donor is given the choice of retrieving the stock or letting the stock be transferred to the charity's account. The Donor, on the 29th, gives instructions for the stock to be transferred to the charity's account. The transfer occurs the same day.

When is the gift complete in this case?

Case #2: Charity acts as the trustee of various charitable remainder trusts. On October 18, Donor, intending to set up a CRT of which Charity will be trustee, has stock wired to Charity's general gift acceptance account at Bank.

At this point, there is no written agreement in place for the intended trust.

a. Is there a completed gift as things stand in this set of facts?

b. What stands to happen if Charity now sells the stock out of its general gift acceptance account?

13. Don, aged 70, gives a policy of insurance on his life to his college. The effective date of the gift is December 8, 2004. The pertinent facts concerning the policy are these:

Net Premiums Paid	\$ 42,500
Cash Surrender Value	\$102,000
Policy Loan	\$ 0

Don's adjusted gross income for 2004 is reliably projected to be \$150,000.

<u>Question</u>: Assuming <u>no other facts</u>, to what federal income tax charitable

deduction will Don be entitled to claim for this gift for 2004?

Note: There are two different answers for which full credit will be given, provided the answer is supported with correct explanation.

Personalizing Your Stewardship Plan

Presented at
The American Council on Gift Annuities
26th Conference

Orlando, Florida
May 5-7, 2004

Cam Morin Kelly
Director of Planned Giving
Smith College
Northampton, Massachusetts
(413) 585-2666
ckelly@smith.edu

Rachel F. Moore
Director of Planned Giving
Williams College
Williamstown, Massachusetts
(413) 597-4282
Rachel.F.Moore@williams.edu

Are Your Current Donors Your Best Prospects?

Over the years we've gathered plenty of empirical evidence supporting the adage: "your current donors are your best prospects." Our programs consistently receive repeat inquiries from donors who already participate in our life income gift programs. We reviewed five years of data and found that our hunches were right: repeat donors to Smith and Williams were a continuing and important source of new gifts. For example:

- At Williams, each year between 60-80% of life income gifts were from repeat donors (although as a percentage of total dollars raised, these gifts varied tremendously from year to year). Williams' repeat gifts were mostly to pooled income funds.
- At Smith, between 30-40% of life income gifts were from existing planned giving participants, consistently representing 20-35% of the dollars raised. While the majority of Smith's repeat gifts were from gift annuitants, <u>all</u> of the pooled income fund gifts were additions to existing funds.

This is an entirely unscientific study, which simply provides a glimpse into two very similar non-profit institutions. In the spirit of full disclosure, we both represent venerable New England liberal arts colleges. Williams was founded in 1793 as a men's college. Smith was founded in 1875 as a college for women, dedicated to providing young women with an education "equal to that available to men." Not coincidentally, both of these colleges were founded by bequests from forward-looking philanthropists, Ephraim Williams and Sophia Smith, respectively. Smith is still a women's college, with a student body of 2,700 and an alumnae population of 40,000. Williams, now co-ed, has 2,000 students and 22,000 alumni.

Although our institutions are similar, we believe that our observations transcend the boundaries of educational, medical, religious, environmental, and social service charities. Our contentions are simple: (1) Donors to pooled income funds are the most likely to make repeat gifts. In fact, <u>most</u> pooled fund donors make an additional gift at some time in their lives. (2) Women especially are likely to fund multiple gift annuities, appreciating the fixed income and safety of the gift. (3) Donors of pooled fund gifts and charitable gift annuities sometimes move on to create significantly larger charitable trusts or to include our institutions in their testamentary arrangements. The <u>number</u> of donors who do this may not be statistically significant, but the <u>size</u> of the subsequent gifts they make is noteworthy.

People who like your organization try you out with small gifts and then come back with larger ones when they are satisfied. Whether your current donors are, in fact, your "best" prospects, they are certainly your most captive and easily identified audience and represent a tremendous source of potential future gifts and bequests. They deserve significant staff attention.

How to make them come back for more?

The first thing to remember is (yet another) saying: "There is no such thing as a form letter." Professionals in for-profit marketing may be surprised by this statement, but if you have experience in raising major gifts you know that, no matter how hard you try to streamline your promotional and donor relations work, one size does not fit all where major donors are concerned. The essence of major gifts work is to help individual donors connect meaningfully with your charity – that is, in a way that is meaningful to them.

More and more successful planned giving programs are segmenting their marketing efforts, targeting different groups with individualized messages. For instance, we know that promoting charitable gift annuities to 40-year-olds doesn't work, nor is it productive to pitch them to 90-year-olds (but for different reasons). We know that marketing charitable remainder trusts to potential $5,000 donors doesn't make sense either. We have learned that we need to identify our audience and tailor our messages accordingly.

The analogy is clear: to achieve "donor retention" we need to pay attention to our audience just like we do when we market. But we have an enormous advantage on the stewardship side: we already know a lot about our individual audience members. Targeted stewardship is a modified major gifts program, custom tailoring messages to donors. However, few planned giving shops have the personnel, time, or resources to develop and implement individualized stewardship plans for each and every planned gift donor. How can we prioritize? Can we break our donors into target groups?

Make the task manageable by segmenting your audience

Charitable Gift Annuities
Let's begin with an obvious sub-category: charitable gift annuitants. This may be your largest group of participants, especially if you're a religious-based organization. You know a lot about these donors. You know how old they are; that they need/want fixed income; you know what kind of assets they donated to fund their charitable annuities; you know where they live; you know that they count on hearing from you at least once (and perhaps up to four times) per year with their annuity payments; and you know that they care about your charity's mission. Use this knowledge to keep cultivating them.

- Emphasize Safety: Often gift annuity donors choose this type of gift because they like the security of fixed income. Don't miss a single opportunity to emphasize the safety of the gift assets and the donor's income stream, underscoring how the assets are managed and the financial stability of your institution. Even though investment gains don't translate into more income for them, you're in a contract with these donors so it's your job to let them know that the contract is secure and backed by your institution's financial strength.

- Provide "inside" information: If rates are moving one way or another, it's a perfect time to let your "insiders" know with a special note. When rates were moving south we saw many repeat gifts from annuitants who liked their current arrangement and wanted to lock in a higher rate with an additional CGA.

  Do you have long-time annuitants who are now much older than when they first funded gifts? You know their ages. How about letting them know that they can take advantage of much higher rates than those they currently receive, based on their age? They'll appreciate that you are looking out for their interests.

- Use your quarterly checks: Keep your charity's mission in the forefront when your donors open their quarterly checks. Do the checks have "thank you" from your institution printed on them, reminding the recipient that the check is connected with their philanthropy? Enclose information that they might not get any other way, such as late-breaking news that won't appear in periodicals for weeks or months. Remind them that there are real people in the planned giving office who will be happy to answer their questions — give them your name and number, enclose your photo, refer them to your website.

Deferred Payment Gift Annuities

All of the above are good stewardship tools. But how do they affect your deferred payment gift annuity donors? Aha! They don't. Deferred annuity donors won't receive anything from you (except more marketing materials) until their annuities start paying them income in the future. Is this a missed opportunity? You bet it is! But it need not be.

Craft some kind of communication specifically to let your deferred gift annuity donors know that you remember them and you are grateful. If you send a stuffer with CGA payments, send the stuffer alone to your deferred donors. It will remind them that they are important benefactors of your institution. If you invite life income gift donors to broader stewardship efforts (such as a scholarship luncheon) don't forget to include your deferred annuitants.

Deferred payment gift annuity donors may, in fact, be the group that is most likely to renounce their interest in a life income gift. After all, they didn't need income at the time they funded the gift; they've never received any payments from it — maybe they don't need it! These donors have an additional gift at their fingertips, but they may not know it unless you point it out to them. When a donor is unsure whether she really needs the income, offer her the opportunity to renounce her interest and see her gift put to work at your institution right away. Remind her of the additional charitable deduction that's available to her.

Use your organization's other external gift officers to steward the deferred donors. Coach your colleagues to consider deferred annuity donors as "potential donors" rather than "closed gifts."

Pooled Income Funds

Let's keep segmenting. Pooled income fund donors are a different kettle of fish. Pooled funds used to be the gift of choice for life income donors, but with interest rates at historically low levels they have fallen out of favor at many institutions. Pooled funds can see the highest volume of repeat donors (remember Williams' statistics regarding repeat pooled fund gifts). Bear in mind that at both of our institutions our minimum gift level for pooled income fund gifts is just $5,000 and additions can be made in increments of $1,000 at Williams and $2,000 at Smith. Our pooled funds are designed specifically to encourage repeat gifts.

What tools do we have to communicate with our pooled fund donors and to encourage repeat gifts? As with the gift annuitants, our pooled fund donors receive regular payments from our programs. Do you use these payments as opportunities to communicate? How about enclosing with the check a quarterly or annual report from your fund manager? Provide the details of the investment strategy, the asset allocation for the fund, the long-term investment objectives and the results, both in terms of income and market value of the fund. Remind donors of how a pooled fund works (especially the constraints that may result in lower income than some other gift types may offer). Re-state frequently how many units the donor has in the pool, which pool they are in, and the unit value of the pool. These donors like to be able to calculate what their original gift is now worth.

Remind the donors, constantly, of the charitable objective of their gifts. Participation in a pooled income fund is a charitable gift plan, not an investment plan. You cannot repeat this often enough. In a difficult economic environment, ask your fund manager to help you with language that will soften less-than-stellar income yields. Bring it all back to the mission and accomplishments of your organization, and remind them that their generosity is making your good work possible.

Use your pooled fund communications as a cross-selling opportunity. Older donors, who have been in the pooled fund for a while, may not realize that they are now eligible for high gift annuity rates. Let them know!

Charitable Remainder Trusts

Now we move on to the place where the larger dollars often reside, the charitable remainder trusts. We all know that we have unitrusts and annuity trusts, and that some of the unitrusts are net income or flip trusts. Remember our basic rule: there is no such thing as a form letter! We do not mean simply that a CRUT donor shouldn't get the same report as a CRAT donor. For stewarding and cultivating trust donors there's more to consider than the character of their trusts.

Here are 3 examples:

(1) **The "Innies"** - How many of your trusts have originated in your office and are trusteed by your institution or your preferred institutional trustee? That's one group. If anyone is getting proper attention from your institution, we're betting it's this group.

(2) **The "Outies"** - How many trusts have originated elsewhere, but you've been notified that your institution is irrevocably included, and you've booked your share and given gift recognition? Don't you love these people? They're so generous, and they're so little trouble! However, from a stewardship point of view, remember that they don't receive annual reports from you about their trust performance – that's coming from the institution that manages the assets. You thanked them when you booked their trust, but what do they hear from you now?!

(3) **The "Maybes"** - What about the trusts in which you are mentioned as a revocable beneficiary? Do you target these donors for visits? Do you enlist your Major Gifts colleagues to help cultivate them? Sometimes you can secure irrevocable commitments with very little additional work. Do you have standard irrevocable language on hand, so they can go to their lawyer for an addendum? Look at these trusts as prospective gifts that you may be able to book for your current campaign, or for another purpose that is meaningful to the donor.

There are a few other groups that deserve consideration. What about widows and widowers whose spouses set up the trusts from which they continue to receive income? Or children who receive income from a trust established by a parent. These income beneficiaries have second-hand relationships with your institution, and now the primary contact is gone. Are these family members worthy of special attention?

Take a look at any perpetual trusts that pay to your organization and talk to your finance office about them. Who builds a relationship with the asset manager? Who checks to ensure proper trust administration? Is it possible that some of these trusts could be terminated now instead of lasting in perpetuity while a trustee continues to earn fees?

What about donors who elect to serve as their own trustee? Can/should you provide "advice" to them, especially when they call you because they've gotten into trouble with the complicated investment and reporting requirements? It might be helpful to send any of the following information to help them with the weighty fiduciary duty of self-trusteeing a CRT:

- Annual letter of reminder regarding tax forms, filing requirements, deadlines;
- Ask for annual evaluations for FASB purposes – it gives you another chance to be in touch and thank the donor;
- This is a place where active stewardship can make a difference in the remainder left for charity, if your continued contact with the donor helps him do a better job managing the trust.

Bequest Intentions

There is another revocable gift in your file: the bequest intention. Some institutions formally count bequest intentions by giving credit toward a campaign or a class reunion. Other institutions do not give formal credit because of the revocable nature of these gift intentions. It is the latter that have the larger task. If you can't give credit for a bequest intention, how do you make the donor feel like he or she is making a difference?

A bequest society is one formal way to include these future donors in the life of the organization, providing them with public recognition, invitations to special events, and regular contact from you. We know from experience that once bequest donors are publicly acknowledged they are less likely to change their minds.

There are many creative ideas that you can use to periodically "touch" these donors and thank them. In our institutions, our constituencies are scattered across the nation and the world so it's hard to plan events for bequest society members. With a widespread membership base it is effective to welcome new members with a small gift, such as a lapel pin, and to send letters from the organization's chief executive officer or board chair.

If you are a regionally based organization, or if your far-flung membership gathers from time to time, stewardship events are a real option. How about a publication or a sign recognizing bequest society members at a campaign grand finale? For the educational institutions, be creative at annual reunions.

Smith gives bequest society members small gifts at reunion, and makes a special effort to salute society members participating in their 50th reunion celebration. Carleton College's bequest society hands out free ice cream at reunion. The University of Rochester invited bequest society members on a special tour through the brand new Newborn Intensive Care Unit at their medical center.

Be creative! Remember to emphasize your charitable mission whenever possible. And don't rely entirely on events or you will miss lots of important people.

If donors with bequest intentions or life income gifts really want to make an immediate impact, encourage them to make expendable gifts during their lifetime toward the same purpose. These gifts can be much smaller than the ultimate bequest, but they will help the donor feel invested in the life of your institution. They will have the satisfaction of seeing their gifts in action. For instance, if a donor's bequest intention is designated for a scholarship fund, the donor can make annual gifts for scholarships from a named expendable fund. Steward such a donor as you would the donor of an endowed scholarship fund. In fact, try to fold all bequest intention donors into stewardship events germane to the purpose of their bequest.

Keep in mind that there are gender differences in how donors make gifts and include charities in their estate plans. At Smith, where the constituency is 99% female, alumnae are more apt to leave the college a large bequest than to make a large lifetime gift. This is true at all of the women's (and formerly women's) colleges. Remember: women generally outlive their husbands, and women control 51% of the wealth in this country.

IRAs and other Testamentary Gifts

Many people who do not have a will (or don't think they are old enough to have one!) actually do have assets that require them to plan for testamentary disposition. Retirement accounts and insurance policies are two very common holdings. Remind your donors that they can include your organization as a beneficiary of these assets, regardless of whether they have a will or not. Give them a way to notify you if they've done so. Then fold them into your regular bequest society stewardship efforts.

The attached Beneficiary Designation Form has proved useful at Smith, both for the planned giving staff and for the financial office. In the years to come the college will have on file a signed form documenting a donor's bequest intention (a great opportunity for future generations of planned giving officers to serve as stewards!).

Integration with the larger development program

Sometimes one development staff member wears all the hats. In bigger shops staff members have to work harder at integration. Communicate regularly with the people in your office who are in charge of stewardship or donor relations. There will undoubtedly be opportunities where you can piggyback your future donors onto their efforts. Here are some examples that have worked for us:

- Scholarship Luncheon – invite planned gift donors who've designated gifts for scholarship to meet students;
- Thank-a-thons – student callers make "thank you" calls to donors to specific initiatives, even if their gifts aren't available to your organization yet;
- Bequest Society – ask all traveling staff to consider visiting these folks in order to thank them while they're alive and share with them news about the part of the organization that their bequest will benefit;
- Include them in communications from your organization: for instance e-mail blasts that contain current successes and news;
- Program reports – if you have internal activity reports from students or others benefiting from your organization, share them with bequest intention donors.

Good customer service = Good donor relations

Reminder: Donors try you out with small gifts and then come back with larger ones if you instill confidence. Good administration is one of the most powerful stewardship tools you can use.

- Offer a direct deposit option. This small efficiency can make a world of difference to an elderly donor.
- When sending tax information in January, don't forget to add nuggets of information about your charity's effectiveness in fulfilling its mission.
- Send duplicate tax information in January to all donors who made gifts in the previous calendar year (even though you gave them the information at the time they made the gift). You will be amazed at how much they appreciate it!
- Target visits – analyze the profile of your institution's repeat donors. Share this profile with other traveling staff and make it a point to visit these people.

Don't be afraid to talk with your financial office or outside manager to collaborate on innovative ways to get information to your donors as a form of stewardship. Go ahead and mix financial information with reminders about your mission. Always be ready to inject a donor relations perspective when administration is the subject.

Engage in a customer satisfaction survey. Williams conducted a year-end pooled income fund survey and the results were affirming: 29% of the PIF participants responded. All but one were pleased with the delivery of their payments and the flow of information they receive from the college. The one exception had recently experienced a mistake on the part of an outside service provider, and the survey allowed the staff to correct the mistake before any real harm was done.

Of the survey respondents, one-third requested additional information on:

- Directing their PIF income to the college's annual fund;
- Establishing direct deposit;
- Renouncing their life interest in their PIF so it could go to work at the college immediately; or
- Current gift annuity rates.

Summary

There is no cookie cutter approach to stewardship, therefore no two programs' efforts will look the same. You have to consider the structure of your program and your available resources and decide on a course that makes sense for your constituency, and that is practical for your staff to manage. However, with those caveats in mind, we believe it is best to try to personalize your stewardship efforts as much as you can, by segmenting your program to make the task more manageable.

Good Luck!

~BENEFICIARY DESIGNATION FORM~

I have named Smith College as a beneficiary of a: (check as many as apply)

- ❑ mutual fund;
- ❑ retirement account;
- ❑ charitable trust;
- ❑ life insurance policy,
- ❑ other (please specify) ______________________________

Fund/Company name (optional):

____

Smith is listed as a: (check one)

- ❑ primary beneficiary
- ❑ secondary beneficiary
- ❑ contingent beneficiary

Approximate dollar value (optional):

$______________________

If/when this gift is received by Smith College it is my wish that the College use these funds for the following purpose(s):

____

____

If, in future years, circumstances have changed so significantly that it is no longer practical to use my gift in this manner, the Trustees of Smith College may use the gift for other purposes which, in their opinion, most closely fit my intent.

As a result of notifying Smith of this intended gift I understand that I am eligible to join **The Grécourt Society**, Smith's honorary recognition society for individuals who have named the College in their estate plans.

- ❑ I wish to become a member.
- ❑ I wish to become an anonymous member and request that my name not be listed publicly.
- ❑ I do not wish to become a member.

______________________	______________________
(Signed)	(Print Name) (Class Year)
______________________	______________________
(Address)	(Phone)
______________________	______________________
(Address)	(Date)

Please return this form to: Planned Gifts & Bequests, Smith College, Alumnae House, 33 Elm Street, Northampton, MA 01063. Fax: (413) 585-4677 *6/1/00*

ARE YOU REACHING ALL YOUR DONORS?

Presented by:
Gary M. Pforzheimer
President
PG Calc Incorporated
129 Mt. Auburn Street
Cambridge, MA 02138
e-mail gary@pgcalc.com
web: www.pgcalc.com

ARE YOU REACHING ALL YOUR DONORS?

I. Integrated marketing strategies

A. Planned Giving Marketing Goals

Depending on whether you are just starting or have a developed program, what does that mean your marketing program?

Where you are in your program will also determine what you should be doing with your PG web site.

Are you focused on attracting prospects?

Is your goal to educate a known group of prospects?

Is your challenge to increase the communication with those prospects?

Are you trying to close gifts more than anything else?

What kind of content do you need to provide your constituents?

Should your web site have different goals from your traditional marketing?

B. Your Constituents

Depending on where you are in your planned giving program will determine not only how you need to be marketing, but also to whom you need to market.

i. Know your audience

Research from 2002 PEW Internet & American Life Project
56% of Americans go online, only 15% over 65 have access to the Internet compared to 51% of those 50-64.

Today's seniors are least likely; it's the pre-retirement (50-64) that are the most wired.

The ones who are online are the wealthy and educated; more men than women (60/40).

Wired seniors are devoted Internet users; 69% of wired seniors go online daily versus 56% of all Internet users:

- E-mail – stay connected
- Top Activities:
  - Hobby info
  - News
  - Health and Medical Info
  - Browsing
  - Weather

- **ii.** Current and past donors (deferred and annual)
- **iii.** Alumni, patients, congregants, relatives, friends
- **iv.** Board members/volunteers/auxiliary
- **v.** People who have been helped by your organization
- **vi.** Staff (present and retired)
- **vii.** Allied professionals

C. How Advanced is Your Planned Giving Marketing Program?
Where are you on the marketing spectrum?
Are you comfortable where you are or do you want to move somewhere else on the spectrum?
Is there a "right" place to be for everybody?

D. Integration of Traditional and Electronic Marketing
- **i.** Newsletters
- **ii.** Seminars
- **iii.** Web Site

E. Developing a culture of integrating traditional and electronic marketing
- **i.** How to go from traditional content to web publishing
- **ii.** Be clear about who is responsible for your web design, content, and maintenance
- **iii.** Always ask "Is this on the web, too?"

F. From Traditional Content to Web Publishing
- **i.** What not to do!
- **ii.** Take advantage of the media
- **iii.** Be consistent with the experiences your audience has with the web
- **iv.** Be sure your traditional marketing drives traffic to your web site!

G. Marketing Measurements
- **i.** Lead generation
- **ii.** Qualified lead generation
- **iii.** Different measures for different media
- **iv.** How to measure the effectiveness of your electronic presence
- **v.** Science or art?

H. Web Response Types
- **i.** Look at web response alternatives
- **ii.** Reads (hits)
- **iii.** Direct responses (returns)
- **iv.** Indirect responses (mentions)

II. Execution

A. Culture / Environment

- **i.** What does your organizational structure look like?
- **ii.** Centralized vs. decentralized resources
- **iii.** What is the political climate in your organization?

B. Resources for Your Internet Presence

- **i.** Manage technical staff to develop and maintain your organization's web site.

  Generally highest associated cost, in resources and response time. It's a centralized resource and not dedicated to the development organization.

  Less Flexibility = Work on their schedule not yours

- **ii.** Direct and manage the site, subcontract the design and implementation to an outside firm, but your organization continues to maintain the site.

  Temporary solution 1-3 years

  This requires use of a technical resource, but could be as little as a part-time person.

  Maintenance can be time consuming and difficult

- **iii.** Hire a vendor to create and maintain your web presence

  Your department hires a vendor to create and maintain your web presence. These are companies who specialize in creating planned giving web sites and content.

- **iv.** Purchase software applications and total solutions

  Requires technical staff.

  You want to keep control of your site without having to hire a technical staff. The purchase of software tools and solutions are available.

  Generally this is an organization-wide strategy decision not a department level one.

  This model has substantial costs associated.

C. Web Site Vendors - Planned Giving – See Appendix 1

D. Re-examine Your Needs

i. It doesn't matter if your site is new or not

ii. Your Internet presence represents your organization

iii. Your marketing plans change regularly and so should your web site

iv. Treat your planned giving site as any other part of your marketing plans - review strategically

Just as you review your objectives, budget, plans every year you should also review your web needs

Maybe plan a joint effort with major gifts.

III. Best Practices

A. PG Calc's philosophy

There's not one best way because it's always evolving

B. Showcasing and innovation

Appendix 1 - Web Site Vendors: Planned Giving

There are many approaches to establishing a web presence. Generally, though, there are four primary choices available along the web site development continuum:

Internal **Outsource**

Internal

There is a technical staff available to develop and maintain your organization's web site. Generally this approach has the highest associated cost.

Outsource

Direct and manage the site, subcontract the design and implementation to an outside firm. Your organization continues to maintain the site. This approach requires use of a technical resource, but could be as little as one part-time person.
The work is usually completed by a local web design firm/web consultant.

Hire a vendor to create and maintain your web presence. There are several companies who specialize in creating planned giving web sites.
Future Focus, Virtual Giving, The Stelter Company, Pentera, Robert F. Sharpe & Company, Crescendo.

You want to keep control of your site without having to hire a technical staff. The purchase of software applications and total solutions are available. Generally this is an organization-wide strategy decision, not a department level one. This model can have substantial costs associated with it.
Convio, eTapestry, UJC FedWeb and content management companies that are industry specific: Ingeniux, Synthenet.

Note: Contractual obligations vary per vendor, generally anywhere from 1-3 years.

Future Focus

Planned Giving web site company.
Pricing and Feature Explanations: *http://www.futurefocus.net/examples.htm*
They also offer free web pages for charities that qualify.
http://www.futurefocus.net/freepages/qualifications.htm

Virtual Giving
Planned giving web site company.
Pricing and Feature Explanations
http://www.virtualgiving.com/pdf/pricing-Web.pdf

The Stelter Company
Planned giving direct marketing company. Specialize in donor marketing material, brochures, newsletters, web sites and other web-based products.
Feature Explanations: http://www.stelter.com/web/pf/index.html

Pentera
Planned giving direct marketing company. Specialize in donor marketing material, brochures, newsletters, web sites and other web-based products.
http://www.pentera.com/web.pdf

Robert F. Sharpe & Company, Inc.
Planned giving company comprised of three divisions: donor publications, training and marketing support.
http://www.rfsco.com/

Crescendo
Planned giving software company with a division for customized web pages.
http://www.giftlegacy.com/gleg_home_plans.jsp

Convio
Software company for not-for-profit organizations that are looking for a total integrated approach to building online relationships with constituents. A content management system/web site is part of that solution.
Feature Explanations:
http://www.convio.com/product_info/ConvioWebsiteCenter.pdf

eTapestry
Fundraising software company specializing in online donor cultivation.
http://www.etapestry.com/whatisit/whatisit_fs.html

Synthenet
According to their web site: "The key to interactive business solutions."
http://www.synthenet.com

Ingeniux
Content Management Solutions.
http://www.ingeniux.com

Case 1 - Major Medical Institution

Large PG office
Deduction calculator on web site for donors 2.5 years ago
Director was against at first – not web savvy, didn't think donors were online but succumbed to peer pressure, now he is sold
2-3 leads a week requiring follow-up.

80-100 GA contracts and 5 are directly attributed to Donor calculator - 5% response.
Use the reports, but don't currently market it, but they did when first published it in newsletters and mailings.
Getting new donors not just existing ones. About half of the ones who contact them were not in their database.

Catalyst to start the communication process
Appears that anyone entering from this source has a quicker than average time per gift closing.

Process: require notification to run a calc, but that policy is changing soon.
Checks against donor database and assigns to appropriate PGO

Case 2 – Children's Fund

Q: How long did they have a deduction calculator?
A: 2.5 years

Q: Did they market it and if yes, how?
A: In their newsletter. Also, just got CA registration and will do a large postcard mailing in CA that will mention GC's.

Q: Was GC the catalyst for making the gift or was there contact before?
A: Both. Prior contact no prior contact.

Q: What was their involvement in this process?
A: Sounded pretty hands on. Bob follows up with people if they leave personal info.

Q: How long did it take the gift to close?
A: 90 days.

Q. Where they surprised, if so why?
A: People who go and look at it have an interest.

Q: Did this confirm PG Calc's beliefs that the internet is just the starting point of communication and that gifts don't actually "close" online.
A: He agreed completely.

26th Conference on Gift Annuities

Planned Gifts in Retirement Planning

Orlando, Florida

May 5-7, 2004

André R. Donikian, J.D.
President
Pentera, Inc.
8650 Commerce Park Place, Suite G
Indianapolis, Indiana 46268

(317) 875-0910
ardonikian@aol.com
www.pentera.com

Care Act of 2003 (S. 476) and Charitable Giving Act (H.R. 7)

I. Tax-Free Rollovers

A. Prior law:

1. Direct or indirect transfers from **QRPs** and **IRAs** to charity during life is a taxable event to donor.

2. Donor is considered to have withdrawn from **QRP** or **IRA**—a taxable event—and contributed proceeds to charity—a potentially offsetting deductible event, **unless**

   a. **Donor does not itemize**—however, portion of gift over standard deduction is deductible.

   b. Contribution exceeds **percentage-deduction ceiling** of 50% of adjusted gross income (AGI).

   c. **AGI** exceeds $142,700 in 2004, thus triggering the **3% reduction rule.**

Example (1): A donor whose **AGI** is $100,000 withdraws $150,000 from his **IRA** and contributes the distribution to charity.

AGI	$100,000
IRA withdrawal	$150,000
New **AGI**	$250,000
Maximum allowable charitable deduction 50%	<$125,000>
New taxable income	$125,000
Excess contribution (carried over to next year)	$ 25,000

Example (2): Same facts as above. Impact of 3% rule–

New **AGI** with distribution	$250,000
Threshold amount for 2004 (estimated)	<$142,700>
Excess **AGI**	$107,300
Disallowed itemized deductions 3%	<$ 3,219>
Thus, maximum allowable charitable deduction reduced from	$125,000
to	$121,781
A loss of	$ 3,219
or, in terms of net tax savings	$ 1,127

Note: Threshold amount will be phased out starting in 2006 and repealed in 2010.

d. **State tax may not be recouped.**

(1) Withdrawal subject to both federal and state income tax.

(2) In states that have a gross income tax (e.g., Ind., and see table), donor would not benefit from a separate charitable deduction.

Result: Donor has a net-tax increase equal to the amount of the state income tax.

Example:

IRA withdrawal	$100,000
Federal income tax (35%)	$ 35,000
State income tax (7%)	$ 7,000
Charitable income-tax deduction	$100,000
Federal income-tax savings	$ 35,000
State income-tax savings	-0-
Net additional tax cost	$ 7,000

e. **Not all of life-income gift contributions deductible.**

A donor who uses retirement-plan benefits to fund a **CRT** or a gift annuity can deduct only a portion of the contribution equal to the present value of the remainder interest.

So the donor would incur a tax liability on the present value of his or her "income" interest.

B. Who stands to benefit from these new rules, assuming they are enacted.

1) Deferred gifts: Why would an **IRA** owner roll over benefits into one of these life-income plans?

2) Outright gifts:

State Individual Income Taxes (Tax rates for tax year 2001–as of January 1, 2001)

State	Symbol	Min Income Tax Rate	Max Income Tax Rate	ST Cap Gain Rate	LT Cap Gain Rate	Deduct Contributions?	Notes
Alabama	AL	2.00	5.00	5.00	5.00	Yes	
Alaska	AK	0.00	0.00	0.00	0.00	No	No state income tax
Arizona	AZ	2.87	5.04	5.04	5.04	Yes	
Arkansas	AR	1.00	7.00	7.00	4.90	Yes	Capital-gain rate is 70% of state income-tax rate for long term gain
California	CA	1.00	9.30	9.30	9.30	Yes	
Colorado	CO	4.63	4.63	4.63	4.63	Yes	Allows $1,200 ($2,400 married) credit for interest, dividends, and capital gains; No tax on capital gain for in-state businesses.
Connecticut	CT	3.00	4.50	4.50	4.50	No	
Delaware	DE	2.20	5.95	5.95	5.95	Yes	
Florida	FL	0.00	0.00	0.00	0.00	No	No state income tax
Georgia	GA	1.00	6.00	6.00	6.00	Yes	
Hawaii	HI	1.50	8.50	8.50	8.50	Yes	
Idaho	ID	2.00	8.20	8.20	8.20	Yes	60% reduction in capital-gain tax provided for cap gain produced in Idaho
Illinois	IL	3.00	3.00	3.00	3.00	No	Flat rate
Indiana	IN	3.40	3.40	3.40	3.40	No	Flat rate
Iowa	IA	0.36	8.98	8.98	8.98	Yes	
Kansas	KS	3.50	6.45	6.45	6.45	Yes	
Kentucky	KY	2.00	6.00	6.00	6.00	Yes	
Louisiana	LA	2.00	6.00	6.00	6.00	Yes	May deduct 50% of charitable deductions if itemized on federal return
Maine	ME	2.00	8.50	8.50	8.50	Yes	
Maryland	MD	2.00	4.80	4.80	4.80	Yes	
Massachusetts	MA	5.60	5.60	5.60	5.00	Yes	Flat rate; Long-term gain taxed at lower rates based on length of time security has been held
Michigan	MI	4.20	4.20	4.20	4.20	No	Flat rate
Minnesota	MN	5.35	7.85	7.85	7.85	Yes	
Mississippi	MS	3.00	5.00	5.00	5.00	Yes	

State	Symbol	Min Income Tax Rate	Max Income Tax Rate	ST Cap Gain Rate	LT Cap Gain Rate	Deduct Contributions?	Notes
Missouri	MO	1.50	6.00	6.00	6.00	Yes	
Montana	MT	2.00	11.00	11.00	11.00	Yes	
Nebraska	NE	2.51	6.68	6.68	6.68	Yes	
Nevada	NV	0.00	0.00	0.00	0.00	No	No state income tax
New Hampshire	NH	0.00	0.00	0.00	0.00	No	State income tax on dividends and interest only
New Jersey	NJ	1.40	6.37	6.37	6.37	No	
New Mexico	NM	1.70	8.20	8.20	8.20	Yes	
New York	NY	4.00	6.85	6.85	6.85	Yes	
North Carolina	NC	6.00	7.75	7.75	7.75	Yes	
North Dakota	ND	2.67	12.00	12.00	12.00	Yes	
Ohio	OH	0.69	6.98	6.98	6.98	No	
Oklahoma	OK	0.50	6.75	6.75	6.75	Yes	
Oregon	OR	5.00	9.00	9.00	9.00	Yes	
Pennsylvania	PA	2.80	2.80	2.80	2.80	No	Flat rate
Rhode Island	RI	3.83	10.10	5.10	5.10	Yes	25.5% Federal tax liability for income and cap gains
South Carolina	SC	2.50	7.00	7.00	3.92	Yes	
South Dakota	SD	0.00	0.00	0.00	0.00	No	No state income tax
Tennessee	TN	0.00	0.00	0.00	0.00	No	State income tax on dividends and interest only
Texas	TX	0.00	0.00	0.00	0.00	No	No state income tax
Utah	UT	2.30	7.00	7.00	7.00	Yes	
Vermont	VT	3.60	9.50	4.80	4.80	Yes	24.0% Federal tax liability for income and cap gain
Virginia	VA	2.00	5.75	5.75	5.75	Yes	
Washington	WA	0.00	0.00	0.00	0.00	No	No state income tax
West Virginia	WV	3.00	6.50	6.50	6.50	No	
Wisconsin	WI	4.60	6.75	6.75	2.70	Yes	May receive a 5% tax credit for charitable contributions, even if you don't itemize on your federal return
Wyoming	WY	0.00	0.00	0.00	0.00	No	No state income tax
Dist. of Columbia	DC	5.00	9.00	9.00	9.00	Yes	

Sources: (1) The Federation of Tax Administrators
(2) Small Business Survival Committee 2000 (see report at www.sbsc.org/media/pdf/sbscindex2000.pdf)

PLANNED GIFTS IN RETIREMENT PLANNING

I. Introduction

In April 2002, the IRS announced final regulations that both greatly simplify and make more beneficial minimum required distributions (**MRDs**) from **IRAs** and qualified retirement plans (**QRPs**).

The final regulations largely adopt the proposed regulations issued in 2001 with a few major changes and many minor clean-up changes. The sections impacted are **Prop. Reg. §§1.401 (a)(9)-0** through **1.401(a)(9)-8; 1.403(b)-2; 1.408-8** and **54.4974-2.**

No major changes were made in the final regulations in cases in which the taxpayer wants to name a charitable organization as a beneficiary of a **QRP** or **IRA** plan. Previously, such a designation typically would have resulted in the most unfavorable distribution scheme.

II. Background

A. The required beginning date (**RBD**) is the date when you must start taking distributions from your **QRP** and **IRA**

B. **RBD** is April 1 of the year following the year you reach $70^1/_2$. (1st half birthday—following year; 2nd half birthday—two years)

1. Can you withdraw before **RBD**?—Yes, but you don't have to. *Note:* Withdrawals before age $59^1/_2$ may be subject to 10% penalty plus income tax

2. Why wait?—If you don't need the money, you can continue tax-free build-up and leave more money for your later years or to your heirs

C. Under the Old Rules

Two irrevocable major decisions had to be made by **RBD**

1. Elect a payment schedule—a fixed schedule, a schedule where you recalculate each year, or a hybrid method available only to spouses, and

2. Pick a designated beneficiary.

D. Under the New Rules

The final regulations make major simplifications to the rules, including the calculation of the required distributions after death. The final regulations simplify the rules by

1. Providing a simple, uniform lifetime table that all participants can use to determine the **MRD** during their lifetime. This makes it far easier to calculate the **MRD** because participants would

   a. no longer need to determine their beneficiary by the **RBD**,

   b. no longer need to decide whether or not to recalculate their life expectancy each year in determining **MRD**, and

   c. no longer need to satisfy a separate incidental death-benefit rule.

2. Permitting the **MRD** during the **participant's lifetime** to be calculated without regard to the beneficiary's age (except when required distributions can be reduced by taking into account the age of a beneficiary spouse who is more than 10 years younger than the participant).

3. Permitting the beneficiary to be determined as late as 9/30 of the year following the year of the participant's death. This allows

   a. the participant to change designated beneficiaries after the **RBD** without increasing the **MRD** and

   b. the beneficiary to be changed after the participant's death, such as by one or more beneficiaries **disclaiming**, establishing **separate accounts**, or being **cashed out.**

   c. When should P name **DB**(s)?

4. Permitting the calculation of post-death minimum distributions to take into account a participant's or beneficiary's remaining life expectancy at the time of death, thus allowing distributions in all cases to be spread over a number of years after death.

5. These simplifications would also have the effect of reducing the **MRD**s for the vast majority of participants.

Note: Whenever the term "participant" is used, it may refer to either a participant in a qualified retirement plan or an **IRA** owner.

III. Lifetime Distributions

The **MRD** rules are designed to force distribution from plans, subjecting them to income tax and not allowing funds to remain in the plan where they enjoy the benefits of tax-deferred growth. The most important new planning aspect is the ability to allow more funds to stay longer in the plan.

A. **MRD** Under the Final Regulations

1. The **MRD** is, with one exception, determined the same way, regardless of the identity of the **DB** at the **RBD**. Except when the sole **DB** is the participant's spouse who is actually more than 10 years younger than the participant, the **MRD** is calculated under the **uniform lifetime table** found in **Reg. §1.401(a)(9)-5, A-4.**

2. To determine the **MRD** using the uniform lifetime table, simply divide the fund balance at the end of the previous year by the "distribution period" factor that corresponds to the plan participant's age for the current year.

Example: *Helen is 77. Her account ended the prior year with a balance of $500,000. This year Helen must take an MRD of $23,585 ($500,000 ÷ by 21.2).*

3. The uniform lifetime table is based on the joint life expectancy of a person the age of the participant and a beneficiary who is 10 years younger.

4. If the **spouse** is the sole beneficiary and is more than 10 years younger, then the applicable distribution period is the **longer** of either the **uniform lifetime table** or the **actual joint life expectancy** of the spouses.

5. A longer distribution period means smaller minimum withdrawals each year.

6. The uniform lifetime table is based on the **recalculation method.** Under the new proposed regulations, selection of a method is neither required nor available.

Uniform Lifetime Table

The following new life-expectancy table is to be used to calculate lifetime distributions. In case your beneficiary is your spouse who is more than 10 years younger than you, you would use the actual joint life expectancy of you and your spouse based on the regular joint life-expectancy table. The uniform lifetime table is not used by IRA beneficiaries to compute required distributions on their inherited IRAs.

Age of IRA Owner or Plan Participant	Life Expectancy (in years)	Age of IRA Owner or Plan Participant	Life Expectancy (in years)
70	27.4	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115 and older	1.9

B. Designating Charity No Longer Penalized

1. These new rules are a boon to charitably minded participants. Previously, there was a significant disincentive to naming a charity as a beneficiary of plan proceeds. Because a charity has no life expectancy, such a designation caused the **MRD** to be calculated according to the single life expectancy of the participant. This subjects more of the plan benefits to current income taxation and allows less of the funds to remain for ultimate distribution to charity.

2. Plan participants now can name a charity as a beneficiary without a negative impact on the **MRD** during life. The **MRD** will be calculated according to the uniform lifetime table and distributed over the recalculated life expectancy of the participant and a beneficiary 10 years younger, **regardless** of who the beneficiary is.

3. This has significant planning ramifications for those persons who wish to designate charity as a beneficiary of retirement-plan benefits at death. Under **IRC §691**, death proceeds of plans covered by these regulations are considered to be *income in respect of a decedent* (**IRD**) to the extent they exceed the participant's basis. In most cases, that basis will be zero. As such, they are treated as taxable income in the hands of the recipient.

4. If a person plans to make charitable gifts at his or her death, it is generally preferable to fund such gifts with **IRD**.

    a. The tax-exempt charity will not have to pay income tax on the **IRD**.

    b. If noncharitable beneficiaries received the **IRD**, such beneficiaries would have to pay the income tax. The potential combined federal estate and income taxes on **IRD** can often well exceed 60%* of the total value of the **IRD**.

*Eventually in 2006: (1 - .45) .35 + .45 = 0.6425 or 64.25% effective top tax rate

IV. Distributions After Death of Participant—Overview

While the identity of the **DB** during the lifetime of the participant does not matter in determining the **MRD** during the participant's lifetime, the identity of the **DB** at the death of the participant is still critical in determining how and when funds must be distributed under the final regulations. In most cases, it will continue to be desirable to stretch out the payments as long as possible.

These new rules are particularly generous in providing September 30 of the calendar year following the year of the participant's death as the **designation date** to identify the designated beneficiaries from within the pool of existing beneficiaries.

The participant's designated beneficiary will be determined based on the beneficiaries designated as of September 30 of the calendar year following the calendar year of the employee's death. Consequently, any person who was a beneficiary as of the date of the employee's death but is not a beneficiary as of that later date (e.g., because the person disclaims entitlement to the benefit in favor of another beneficiary or because the person receives the entire benefit to which the person is entitled before that date) is not taken into account in determining the participant's designated beneficiary for purposes of determining the distribution period for **MRDs** after the participant's death.

Note: It is very important to have one or more **DBs** in place as soon as the plan is established, even though you do not have to have one before your **RDB** or until you die. Death forecloses the opportunity to designate **DBs**.

A. Postmortem Planning Whether Death Occurs Before or After RBD

While it is **not possible to name new DBs not already identified at the participant's death**, it is possible to do a significant amount of postmortem planning to achieve the best results. Depending on the identity of the **DB** or **DBs** at the date of death of the participant, distribution of the plan proceeds may be subject to a variety of options. Generally, the identity of the least "favorable" **DB**—that is, typically, the one with the **shortest life expectancy**—will control the time over which distributions can be stretched.

1. **Separate accounts.** During the period from the date of death to the end of the next calendar year, it may be possible to effectively transfer a plan with multiple beneficiaries to "separate accounts," each of which will be treated as a separate fund for purposes of determining the period over which the proceeds must be distributed.

2. **Disclaimers.** Another way to remove "unfavorable" beneficiaries is for such beneficiaries to "disclaim" their interests. For instance, if a primary beneficiary, aged 64, disclaims in favor of a contingent beneficiary, aged 38, the distribution can likely be based on the younger person's life expectancy.

3. **Cashing out.** Still another way to remove an "unfavorable" beneficiary is to pay that beneficiary his or her full share of the proceeds prior to the end of the year following the year of the participant's death.

V. New Possibilities for Charitable Planning

The changes introduced by these new proposed regulations create several new charitable-planning opportunities. Carrying out some of these opportunities may be as simple as changing a beneficiary designation.

A. Designating a Charity as Beneficiary.

It is now possible for a participant to designate a charity as the beneficiary of an **IRA** without concern about the impact of that decision on the **MRD**—either before or after the **RBD**. Such a designation will not cause an acceleration of the **MRD**.

1. **Charity as sole beneficiary.** Obviously, no problem. Distributions to participant according to uniform lifetime table. At participant's death, whatever is left is distributed to charity.

2. **Charity as partial beneficiary while participant is alive.** Again, no problem. Distribution to participant according to uniform lifetime table.

3. Charity as partial beneficiary at participant's death.

   a. Cash out charity by 9/30 of the year following the year of participant's death, or

   b. Create separate accounts by 9/30 of the year following the year of participant's death.

   c. At death, the participant's estate will receive the estate-tax charitable deduction because the benefits pass to charity.

      The participant's noncharitable beneficiaries will avoid the income-tax consequences of receiving **IRD**.

      Charity being tax-exempt pays no income tax on distribution.

B. Changing Existing Designation for Participant Already Receiving Benefits.

A Participant may have decided either not to name a charitable beneficiary or to rely on noncharitable beneficiaries to disclaim in favor of charitable beneficiaries, to avoid the negative **MRD** implications of naming a charity.

1. Under the new rules, the participant may be able to change to a more favorable **MRD** schedule regardless of the identity of the beneficiary or beneficiaries. Before this was not possible after **RBD**.

2. This also presents the opportunity to modify beneficiary designations to include a charity without losing the benefits of the more attractive **MRD** distribution schedule under the new rules.

C. Use Postmortem Planning to Optimize Distributions.

1. If a participant does have one or more charitable beneficiaries, the new rules allow for significant postmortem planning to create optimum distribution schedules for individual beneficiaries.

2. It may be possible to **create a separate account for the charity** or, alternatively, to **cash the charity out.**

3. This prevents the participant from being deemed to have no designated beneficiary, causing the benefits to be distributed over the participant's life expectancy at the time of death under the fixed-term method (if death occurs at or after **RBD**) or under the five-year rule (if death occurs before **RBD**).

4. Once the charity is cashed out or parked in a separate account, distributions will be made over the life expectancy of the oldest beneficiary or the separate life expectancy of the beneficiaries.

   Example: Participant directs $50,000 to charity, balance of $1,000,000 to child.

   Possible Solutions:

5. **Disclaimer** is yet another option to stretch out payout period. For example, if a 60-year-old beneficiary disclaims leaving a 30-year-old as the only beneficiary, distributions will be made over life expectancy of 30-year-old.

   Of course, an individual beneficiary can also disclaim in favor of charity named as a contingent beneficiary. The disclaimer must follow strict requirements to qualify.

D. Direct Proceeds to a Qualified Charitable Remainder Trust.

1. A distribution to a charitable remainder trust generates a charitable estate-tax deduction for a portion of the value of the benefits passing to the trust and provides a source of income for a noncharitable beneficiary or beneficiaries, either for life or for a term not to exceed 20 years.

2. Because of the estate-tax savings and because the noncharitable beneficiary avoids income tax on **IRD**, the actual out-of-pocket cost of the gift to charity may be substantially reduced, measured in present-value terms, to the noncharitable beneficiary or beneficiaries.

3. When the trust terminates, the remaining trust assets are distributed to the designated charity for purposes specified by the participant.

4. **IRD** deduction not available to **CRT** beneficiary. It is trapped in the trust as tier 4 basis and will come out only after all IRD is distributed. (See **PLR 199901023.**)

   Query: Any reason to name spouse beneficiary of **CRT** funded with **IRA**?

E. Pooled Income Fund

Similar to CRT.

F. Gift Annuity

IRA benefits used to fund a testamentary gift annuity will be included in decedent's gross estate and an estate tax charitable deduction will be allowed for the "remainder" interest.

Charity will not recognize taxable income upon receiving the distribution on the present value of the annuity, nor will the donor's estate or the annuitant, according to Frank Minton.

Each annuity payment will be fully taxable as ordinary income to annuitants (PLR 200230018).

G. Charitable Lead Trust

Taxed in the year received. Trust is tax-exempt.

VI. Testamentary Gifts of Retirement-Plan Assets (IRD) v. Other Assets

Decedent owns a $4,000,000 estate that consists of $3,000,000 in securities and a $1,000,000 IRA. He wishes to provide $1,000,000 to his favorite charities and the balance to his children. Which asset produces the more cost-effective gift?

	Children	Charity
Securities	$1,000,000	$1,000,000
Less: attributable FET 45%	-0-	<450,000>
income tax		-0-
Net benefit	$1,000,000	$ 450,000
IRA	$1,000,000	$1,000,000
Less: attributable FET 45%	-0-	<450,000>
income tax*	-0-	<192,500>
Net benefit	$1,000,000	$ 357,500**

Children better off by $192,500 if they receive securities.

*Income tax: 35% of ($1,000,000 - $450,000).

**Compared to $212,000 in 2001.

VII. Nonqualified Charitable Trusts

A. Background

A trust can be named a beneficiary for **MRD** purposes and the trust beneficiaries treated as **DBs** if:

1. The trust is valid under state law.

2. Beneficiaries are identifiable.

3. Trust is irrevocable or will be on participant's death.

4. Documentation must be provided to the administrator of the plan,

5. All beneficiaries are individuals.

Then the retirement benefits can be distributed over the life expectancy of the oldest individual beneficiary.

B. Charitable Aspects

1. Charitable gift from trust to take place at P's death.
   IRA to trust for benefit of child and $100,000 to charity.
   Trust remainder to grandchildren.

   a. Include provision in trust that no retirement benefits can be used to pay charity, or

   b. Buy-out charity before designation date.

2. Charitable gift from trust after designation date

   a. **IRA** to trust, children **DBs**, charity remainder beneficiary

      1. Create CRT

      2. Conduit trust

C. Income-Tax Consequences

Participant designates revocable living trust as beneficiary of her $1,000,000 **IRA** and $1,000,000 liquid assets. At her death the trust is terminated and distributes assets equally to her son and charity. She directs that charity's share be funded with **IRA**.

1. Is the designation effective to allocate **IRD** to charity, which is tax-exempt?

2. What if it was a will instead of revocable trust?

3. What if the trust or will is silent and state law does not provide trustee or personal representative with power to select assets.

4. What if participant directs trustee or personal representative to select assets in its discretion to fund separate shares?

   The **IRS** has determined that **IRA** funds to be distributed to charity but not specifically earmarked for charity in a beneficiary designation are **IRD** to the estate. The **IRS** did, however, determine that under the facts set out in the ruling the funds are deductible by the estate in the year of the receipt as gross income permanently set aside for charitable purposes (**PLR 2002221011**).

5. Another approach

6. Distributions in later years:

   a. Estate

   b. Trustee

VIII. Diamond in the Rough: Employee Stock in a Qualified Retirement Plan

Qualified retirement plans harbor a vast segment of the liquid wealth of America and are considered to be a fertile source of planned gifts. What is less known is that 46% of QRP assets consist of employer stock. Such stock is accorded favorable capital-gain treatment when sold if it has been withdrawn in a lump-sum distribution (LSD). This presents a terrific gift-planning opportunity in inter-vivos planning. But complex rules govern the favorable tax treatment that makes it possible to obtain the full benefit of charitable gifts of employer securities.

A. Donor, a participant in XYZ, Inc.'s **QRP** receives an **LSD** valued at $1,200,000 that consists of XYZ stock. Employer contributions on Donor's behalf of employer stock equal $200,000 (**PLR 199919039**).

1. Net unrealized appreciation (**NUA**) is equal to...

2. How will the **LSD** be treated for **FIT** purposes?

3. Does it matter if XYZ is closely held or publicly traded?

4. Does it then make sense for participant to invest entire share in employer stock?

5. What if donor rolls over the **LSD** into an **IRA**?

    a. Advantage

    b. Disadvantage

B. **To qualify for favorable treatment, the LSD must be:**

1. From a §401(a) qualified plan—**IRA, SEP,** and 403(b) never qualify

2. Because of employee's death or

3. After employee attains age $59^1/_2$ or

4. Because of separation from service and

5. A distribution within one taxable year of the recipient's entire balance in all aggregated plans determined as of the most recent triggering event.

C. What would the **FIT** consequences be:

1. Five months later if Donor sells XYZ shares for $1,500,000.

2. Fourteen months later, if Donor sells XYZ shares for $2,000,000.

3. After distribution, if Donor makes a gift of the XYZ shares valued at $1,500,000 to charity.

D. At the time of distribution, Donor elects to roll over $300,000 XYZ shares into a CRT.

1. Is Donor allowed a deduction?

2. CRT sells the shares.

E. Donor dies after receiving distribution at $1,200,000 and still worth the same. Two years later, beneficiary sells XYZ shares at $2,000,000.

1. Estate tax at death

2. Income tax at death

3. Income tax at sale by beneficiary

F. What if D died before taking a distribution and instead employer securities are distributed to D's beneficiary. XYZ stock is worth $1,200,000.

Query: Donor, terminally ill, owns $2,000,000 401(k) of which $1,000,000 is employer securities.

Turning Life Income Gifts Into Cash In Five Easy Steps

by
Karen Browning
Director of Gift & Legacy Programs
The Nature Conservancy

The Nature Conservancy
SAVING THE LAST GREAT PLACES ON EARTH

Introduction:

As planned giving professionals and advisors, we have been successful in assisting donors with charitable life income arrangements. For example, as of December 31, 2003 The Nature Conservancy had more than $183.5 million in life income assets under management.

Donors make these gifts for numerous reasons. However, people's circumstances do change. The strength of the donor relationship to the charity may increase over time, leading to a desire for the donor to see his gift used during his lifetime. The stream of income may no longer be needed or some donors may be interested in an additional tax deduction. Finally, some donors may just be tired of dealing with the K1s and 1099s that come from their planned gift. Donors experiencing these changes may not be aware they can relinquish their right to receive income from their planned gifts or that they can assign the income interest to the charitable beneficiary.

In early 2000, consultant Jay Steenhuysen of Steenhuysen & Associates suggested we approach some of our existing planned giving donors with the idea of gift acceleration. At the time, our life income gifts were at an all-time high and we were mainly focused on closing new gifts. However a few years later, as the economy continued to slump and new gifts decreased, we kept returning to the idea of gift acceleration. The Nature Conservancy has approximately 2,650 gift annuity donors who have made gifts worth more than $87,500,000. If we could accelerate five percent of those gifts, we could immediately make available $4.4 million for conservation.

This paper describes a process started in 2003 wherein The Nature Conservancy contacted select planned giving donors to ask them to relinquish their income interest in their planned gifts. We've called this program "Gift Acceleration" because it accelerates life income gifts for immediate use. It is important to note that only income beneficiaries can relinquish their income interest. In most cases the donor is also the income beneficiary. For the remainder of this paper, donor will mean income beneficiary unless specified.

The Gift Acceleration program consisted of a mailing followed by at least one phone call and/or letter(s). Developing this process took longer than we anticipated, but we've been pleased with the results. After reading this paper, you may decide that your organization may or may not wish to approach donors on such a mass scale, but at least you will be equipped to accept an income interest.

Before proceeding to the steps, let's look at an example.

> In July 1995, donor Mr. Woods contributed appreciated securities worth $42,736.25 in exchange for a gift annuity to benefit himself. The recommended ACGA rate for a sole beneficiary of his age was 6.7%. At that time he was entitled to a charitable income tax deduction of $21,144.61. In 2003 he responded to the Gift Acceleration proposal to relinquish his income interest in this gift. He stated that his financial circumstances had changed and he no longer needed the income from this gift. By relinquishing his income interest, he was entitled to an additional charitable income tax deduction of $22,925.43 and his gift was put to use

immediately for conservation in the state of New York. Due to the fact the CMFR has decreased to all time lows, the total deduction for Mr. Woods original gift plus the relinquished income interest ($21,144.61 + $22,925.43 = $44, 070.04) is greater than his original donation of $42,736.25. (Side note: upon completion, Mr. Woods asked if he could relinquish other gift annuities he had through other organizations.)

Step One: Develop compelling reason for acceleration

Is there one particular project your organization is working on that would compel people to give up their income interest? It could be a building campaign, an acquisition of a key conservation property, a breakthrough in research, or a scholarship fund. Whatever the reason, prepare the case for why your organization is taking this unusual step and approaching its donors to give up their income interest. Jay Steenhuysen's research suggested that a specific project or program would be more compelling than a general request for support. However at the Conservancy, many of our planned gifts are designated for conservation work in a particular state, country or conservation area.

As you may know, the Conservancy is an international organization with many programs. One consideration we had to address was how to approach donors about a specific project when they had already designated their gifts elsewhere. In the end, we decided to make a general proposal listing several current projects that needed capital. We customized the proposal to state the donor's gift designation (if other than for the general purposes) and the approximate charitable income tax deduction they would receive from this relinquishment. Sample proposal letters are included in the attachment.

When you are developing the proposal, think about internal audiences that need to be notified about this program. Would a concept paper help to win approval and resources necessary for the program? We wrote such a paper and notified fundraisers throughout the organization in case a donor called with questions. We held a meeting with our planned giving officers who would be making the follow up calls to the selected donors. Finally, we notified our financial managers and co-trustees to let them know we were undertaking such an effort.

Considerations:

- Does your organization allow donors to designate or restrict their planned gifts to a particular program versus a gift for the general purposes of the organization? How will this be addressed in the proposal?

Step Two: Identify donors and develop materials needed

Look at a list of your existing donors. You may already know donors who have said something to the effect of, *"I really don't need additional income."* Think about donors with whom you have a close relationship. Do you have donors who are unhappy with the downturn in income from their pooled income fund? If a pooled income fund has followed the bond markets, the income being generated has decreased. One of the Conservancy's pooled funds has gone from generating approximately 12% income in the 1980s to less than 6% now. Donors may be willing to relinquish the $400 per year that gift is generating.

Are your donors in a moves management system? For donors in moves management, we contacted their moves manager and inquired about this strategy. Some moves managers thought this was a great idea and told us to include the donor in the program. Other moves managers decided to personally bring this request to the donor.

For the Conservancy's first effort, we selected donors who had made a one-time charitable gift annuity of less than $10,000. We excluded donors who were making annual gift annuity gifts or who had made a gift annuity gift in the past 30 months. We also excluded donors (income beneficiaries) over the age of 90. Since our program strategy was to send a proposal letter and follow with a phone call, we selected people for whom we had active telephone numbers.

Once you have narrowed down your prospect pool, you'll need to develop the materials for the acceleration mailing including the proposal, the relinquishment agreement, and the follow up materials. Make sure the proposal letter you developed in Step One includes disclosure information and a request that the donor consult their financial or tax advisor before proceeding with this gift. We created a merge file to capture the data for each donor. This merge file was also used for creating customized relinquishment agreements.

We worked with our outside legal counsel to draft relinquishment documents based on the different gift vehicles: gift annuity, pooled income fund, charitable remainder trust. Sample documents are in the attachment.

At this time, run calculations to determine the approximate deduction for each donor who may relinquish an income interest. Instructions for determining additional deductions using PG Calc are included in the attachment. For gift annuities, remember to choose the lowest CMFR of the past three months to maximize the charitable income tax deduction. This is because you are not calculating the upfront charitable income tax deduction at the time of gift, but instead you are calculating the present value of the future income stream that beneficiary will receive. By using the lowest CMFR the value of the income interest (which equals the deduction) will be greater.

Finally, take this opportunity to think through the program's next steps. What needs to be done after the proposals are mailed? What additional materials should be developed now? We outlined the various steps each gift officer would take in this process. Since we had several fundraisers who would be making calls, we wanted to ensure consistency. We established procedures to record this effort in our fundraising database to ensure that if someone declined this proposal, he would not be solicited again.

We developed a calling script that outlined the reasons for the program and helped begin the conversation with donors. We also developed template letters for follow up that could be sent immediately after the conversation took place. Finally, we developed the tax letters that would be sent to donors who agreed to relinquish their income interest.

Considerations:

- When interest rates are low, gift annuities may be the highest income-producing asset for your donors, so you may not want to approach people who have gift annuities with payouts of 8.5% or greater.
- Some repeat donors may be willing to accelerate one of their first gifts if it was made when they were younger and the annuity rate was lower.
- A charity may also consider approaching donors about relinquishing their income interest in a charitable remainder trust and donating that to fund a charitable gift annuity.

<u>Step Three: Mail and call to follow up</u>

Each letter contained a proposal, a relinquishment form, and a return envelope. We staggered the mailing slightly to help make the follow up calls more manageable. We planned for the follow up calls to take place approximately two weeks after the donors received the proposal. The proposal stated, *"I expect that you might have questions about the details of this gift. To make this process easier for you, I have asked one of our gift planning specialists to contact you during the week of September 23rd to address any such questions. Should you wish not to be contacted or if you need information sooner than the 23rd, please contact me at (xxx) xxx-xxxx or by email at legacy@tnc.org."*

As anticipated, some donors responded and asked not to be contacted. However, no one was unhappy with the proposal. A few said the proposal was "interesting" but that they needed the income. Several donors completed and returned the relinquishment forms before any personal contact was made.

Prior to the start of the follow up calls, we held a confidence-building session with the callers to review the script and prepare them for questions. This type of calling was more of a solicitation than many of our gift planners were used to making. That is why the "dress rehearsal" was so important. It took a few calls to raise our comfort level with making such a request. Two donors expressed dismay that we would ask them to relinquish a gift. Callers diffused their concerns and acknowledged that we understood that not everyone may be in a position to make such a donation. After every call where a donor declined this request, a note was sent thanking them for the opportunity to discuss such a gift. If we were unable to reach the donor, a hand-written note was sent thanking them for considering the proposal and listing ways they could contact us.

It is interesting to note that during the follow up calls, several donors pledged new gift annuity gifts and a few committed to making an outright gift to support the Conservancy.

Considerations:

- The follow up is critical to the success of this program. When sending the proposal, make sure you'll be able to call when you say you will. If the donor says they have not had time to review the materials, ask if you could check back in one week. It doesn't matter what the time frame is as long as a plan is set up.

Step Four: Complete forms and tax letters

When donors agreed to relinquish their gifts, we first ensured that they had the most recent and correct relinquishment agreement. Once signed agreements were returned, we prepared a tax letter for donors to review with their advisor describing the value of the gift and how the donor could claim the charitable income tax deduction. We included IRS Form 8283 with each tax letter since any income interest over $500 must be reported on Part A of the 8283. If the value of the income interest is greater than $5,000, it is necessary to obtain a qualified appraisal and complete section B of Form 8283 to be filed with income tax forms when the deduction is claimed. While any organization can run the calculations to determine the charitable deduction from relinquishing the income interest, a qualified appraiser must complete the appraisal and sign Form 8283. The appraiser has to be someone outside of the charity, such as an accountant or planned giving consultant who is familiar with determining charitable deductions for planned gifts and for relinquished income interests. We identified several possible appraisers to use for this effort.

While the IRS does not specifically address whether the deduction is subject to a 50-percent or 30-percent of gross income limitation, we followed Frank Minton's guidance that deduction limitations follow the asset used to fund the original gift. If the original gift was cash, donors may use their deduction up to 50% of their AGI; for an original gift of long-term appreciated property (typically stock) the deduction may be used up to 30% of their AGI.

Considerations:

- Is the relinquished income interest greater than $5,000 thus necessitating an appraisal?
- Who will prepare and pay for such appraisal?

Step Five: Accelerate gifts & think about other ways to promote idea

Once signed relinquishment agreements have been received, contact the investment manager for that gift and request the gift be terminated from the fund. Or if it is a trust, the trust needs to be terminated. Proceeds can then be put to immediate use. For donors in moves management, a report on how the gift was used is a wonderful next step in continued cultivation.

In addition to the proactive outreach program, think about other places where Gift Acceleration could be promoted. What type of regular communications do you send to your planned giving donors? We've added the idea of relinquishment in a PS in several donor communications. The following PS was used in the annual report for our pooled income fund:

PS. If your financial situation permits, you may want to consider donating your right to receive income from the Long Term Income Fund for immediate use in our critical conservation projects. You would receive a significant income tax charitable deduction and The Nature Conservancy would be able to immediately direct the proceeds from your gift to top priority conservation projects worldwide. Please let me know if this idea appeals to you and I will provide further information.

We learned that another organization posted the question, *"Do you still need income from your planned gift?"* in a newsletter and received a handful of responses. We plan to take this idea a step further and are preparing a donor profile for our Legacy newsletter on a donor who relinquished his gift annuity. This same profile will be posted on our website. Finally, we have used the concept of accelerating a planned gift in case studies in fundraising training.

Considerations:

- If your organization is not ready to conduct a Gift Acceleration program, are there places where the idea could be tested?

Conclusion & Results

To date, the Conservancy has undertaken two Gift Acceleration campaigns which have accelerated more than $530,000 worth of gifts. The response rate for the first campaign was 11.9%. The response rate for the second campaign was 10.6%. We have accelerated gifts that range from $5,000 to $100,000 from gift annuities to charitable remainder unitrusts. We view our two efforts as being highly successful and plan to continue to promote the Gift Acceleration program. We also view this program as an additional tool for fundraisers to use when speaking to donors. We have raised awareness that an income interest is an asset. We're not suggesting that charities promote giving an income interest in an already established life income gift vs. giving a new outright gift, but there may be times when this may be a great option for a donor and for a charity.

In addition to Gift Acceleration, we have become more creative at other ways to share a part of an income stream. Again we're trying to add a component of a current gift to a planned gift. We've explored asking donors to name The Nature Conservancy as a partial beneficiary of a trust. We've also asked for a small outright gift at the time a life income gift is created. For gifts of real estate, perhaps the donor would consider carving off a percentage as an outright gift.

All of these ideas can complement your life income gift program and help donors see the impact their gift will make while they are living.

<u>Appendix – Sample Proposal Letter</u>

Date
Dear XX

As a planned giving donor to The Nature Conservancy, you have shown a deep commitment to protecting a natural legacy for future generations. In the past year alone, generous supporters like you have enabled us to achieve conservation milestones worldwide, from a ground-breaking collaboration with the Chinese government to preserve the Meili Snow Mountains of the Yunnan Province, with golden monkeys and red pandas, one of the biological hotspots of the world; to a nationally acclaimed purchase of 151 square miles in the spectacular San Luis Valley of Colorado.

This year holds even more exciting opportunities for conserving nature in the United States and abroad. In Mexico's Calakmul Biosphere Reserve, for instance, the Conservancy is helping a local nonprofit acquire 586,000 acres of tropical forest harboring some 3 to 5 *billion* migratory birds. The purchase price of this forestland is less than $20 an acre, an incredible conservation bargain when compared to current land prices in the United States.

We are committed to continuing such bold, innovative conservation work. Though many assumed it couldn't be done, we recently acquired 11,500 acres *along the bottom* of Great South Bay — the nation's largest underwater conservation purchase to date — as part of our effort to protect and restore the entire 120-mile coast of Long Island's South Shore. We also partnered with Great Northern Paper, Inc. in Maine to protect jobs while conserving more than 240,000 acres in the forest around Thoreau's storied wilderness of Mount Katahdin.

Conservation opportunities like these, as central as they are to our work, require significant capital. We are therefore making an unusual request of you: if your financial situation permits, please consider donating your right to receive income from your charitable gift annuity.

If you find such a gift might indeed be possible, let me tell you how it would work. First, you would reassign the income stream from your gift annuity, as well as the right to receive any future payments from that gift, to The Nature Conservancy. In exchange, you would receive a significant income tax charitable deduction for the year of your donation. For example, if you were to donate back to the Conservancy the income from the gift annuity that you established on DATE, you would receive a $XXXX charitable deduction if you made the gift this spring.

For unrestricted gifts use this sentence: The Nature Conservancy would then immediately direct the proceeds from your gift to top priority conservation projects worldwide. You would, in effect, be earmarking your gift for conservation's most timely and urgent needs. *For restricted gifts use this sentence:* The Nature Conservancy would then immediately direct the proceeds from your gift to top priority conservation projects in [designated area], as you originally desired. You would, in effect, be earmarking your gift for conservation's most timely and urgent needs.

I have enclosed an agreement that you can complete if you choose to donate your right to receive income from your annuity. *(For donors with multiple gift annuities substitute the following for* *the above sentence: I have enclosed a sample agreement for you to review and will be happy to send you a completed version for any annuities that you would be interested in donating at this time.)* We fully understand that not everyone is in a position to comfortably make such a donation. So, in making this request, we do hope and trust that you will consult with your own financial advisors before deciding if this option is appropriate for you.

I expect that you might have questions about the details of this gift. To make this process easier for you, I have asked one of our gift planning specialists to contact you during the week of February 24th to address any such questions. Should you wish not to be contacted or if you need information sooner than the 24th, please contact me toll-free at (877) 812-3698 or by email at legacy@tnc.org.

Finally, our deepest thanks for considering this gift and for your ongoing support of the Conservancy's work. Please know that the lands and waters we all fight to protect, are forever safer for your generosity.

Sincerely,

Angela W. Sosdian
Director of Gift Planning

Appendix – Follow up letters

Note for when there is no number available

Dear _____,

I'm writing to follow up on a letter sent by Angela Sosdian regarding your gift annuity with The Nature Conservancy. We have tried to reach you but do not have a current phone number on file. If you are at all interested in learning more about how we could put your gift to work immediately, please contact me at ____________________.
Thank you for your continued interest and support.

Sincerely,

Thank you note – considering

Dear _____,

Thank you for the opportunity to speak with you about your gift annuity. We sincerely appreciate your continued support of The Nature Conservancy.

I understand that the decision to accelerate your gift annuity is one that requires thoughtful consideration. Please take your time and let me know if you have additional questions. I will contact you again [next week or in _____ week(s)]. In the meantime, thank you for your consideration.

Sincerely,

Thank you note – decline

Dear _____,

We thank you for the opportunity to discuss your gift annuity. Please know how much we appreciate the support you have provided The Nature Conservancy over the years. Because of generous individuals like you, the Conservancy can save the Last Great Places around the world.

Thank you again for your time and consideration.

Sincerely,

Appendix – Follow up letters continued

Thank you note – accept

Dear ______,

On behalf of The Nature Conservancy, I would like to thank you for agreeing to give up the future income payments from your charitable gift annuity. Through this generous decision, you will enable us to put the funds to work today for our critical conservation needs.

I have included an agreement that you should complete in order to donate your right to receive income from your gift annuity. Please complete the agreement and return to me in the enclosed envelope. Once we have received this document, we will end future payments. We will also confirm the tax deduction you may claim for the relinquishment.

We appreciate your support in helping The Nature Conservancy carry out its ambitious plans now. Should you have any questions, please do not hesitate to call me toll-free at 877-812-3698.

With best wishes,

Appendix – Sample Relinquishment Agreement

RELINQUISHMENT OF REMAINING LIFE ANNUITY INTEREST
IN CHARITABLE GIFT ANNUITY

THIS RELINQUISHMENT, made this ________ day of ____________________________, 2003, by **name of donor** of **address**, hereinafter referred to as the "Donor."

WITNESSETH:

WHEREAS, the Donor and THE NATURE CONSERVANCY, a District of Columbia non-profit corporation with its principal office at 4245 North Fairfax Drive, Arlington, Virginia 22203, hereinafter referred to as the "Payor," entered into a charitable gift annuity agreement on **gift date**, whereby the Payor provided the Donor with an annual annuity of **amount of original annual annuity**, payable **quarterly**, for the remainder of **her/his** life, hereinafter referred to as the "gift annuity," in exchange for certain property; and

WHEREAS, the Donor retained the right to relinquish her interest in all remaining payments due **her/his** in paragraph 1 of the gift annuity; and

WHEREAS, effective immediately, the Donor desires to irrevocably relinquish **her/his** interest in all remaining payments due her since she no longer needs the income which **she\he** originally believed that she required.

NOW THEREFORE, the undersigned does hereby irrevocably renounce any and all rights to any future payment of the annuity amount from the gift annuity. The first payment that the Donor will not receive would have been made on ______________, 2003. The Donor expects to receive a charitable income tax deduction as a result of this renunciation.

IN WITNESS WHEREOF, the undersigned has affixed **her/his** signature as of the date first written above.

____

Name of donor, Donor

Notorization required if renunciation amount is over $5,000.

STATE OF ____________________

COUNTY OF __________________

I, ___________________________, a Notary Public in and for said County and State, do hereby certify that **name of donor** personally appeared before me this day and acknowledged the due execution of the foregoing Relinquishment.

Witness my hand and notarial seal, this the ______ day of __________________, 2003.

____
Notary Public

My commission expires: __________________

This document is used as a form to accomplish the relinquishment of life income interests in a charitable gift annuity. This document is drafted for use with a particular form charitable gift annuity instrument and with reference to the laws of the Commonwealth of Virginia. The author and those connected with the preparation of this document cannot assure that this document will be appropriate for other instruments or in other states. Please consult your own institution's counsel to make sure the document is appropriate for your institution's form documents. The author is not licensed as an attorney and is not intending to provide legal advice to others by including this document as an attachment to her materials.

<u>Appendix – Sample Tax Letter</u>

Dear _______,

On behalf of The Nature Conservancy, I would like to thank you for agreeing to give up the future income payments from your gift annuity. Through this generous decision, you will enable us to put the funds to work today towards critical conservation needs.

As you will see in the enclosed calculations, your life interest in the $5,000 cash charitable gift annuity you established on October 20, 2000 is $3,081.20, entitling you to a charitable deduction in this amount. You may use this deduction (and any other charitable deductions for gifts of cash you have made this year) up to 50 percent of your adjusted gross income.

As with any charitable gift, please be sure your tax and/or legal advisor checks these figures carefully before using them on your tax return. In addition, you should fill in and attach the enclosed form 8283 to your return. This form is needed for all gifts where the value of the charitable deduction exceeds $500. However, section B of the form only needs to be completed when the deduction exceeds $5,000.

So that you may claim a deduction, we must specify that The Nature Conservancy is providing no goods or services in connection with this contribution.

We appreciate your support in helping The Nature Conservancy carry out its ambitious plans now. Should you have any questions, please do not hesitate to call me toll-free at 877-812-3698.

With best wishes,

Appendix – Sample PG Calc Chart

THE NATURE CONSERVANCY

Prepared for:
Gift Acceleration Program
February 27, 2004

Deduction Calculations

Non-Charitable Interests for $5,000 Gift

	Charitable Gift Annuity
Income Rate	**8.2%**
One Life 78 [10/20/1925]	$3,081

Gift Date 5/8/2003

Prepared by: The Nature Conservancy — IRS Discount Rate is 3.6%

These calculations are for illustration purposes only and should not be considered legal, accounting, or other professional advice. Your actual benefits may vary depending on the timing of the gift.

Appendix – Instructions for calculating life income interests using PG Calc

Using PG Calc to Calculate the Deduction for the Renunciation of a Charitable Gift Annuity:

1. **Chart Selection**: select *"Non-charitable Interest Dollars"*
2. **Date of Gift**: use the date of renunciation (for the illustration in the letters, we used 3/1/2003 as the gift date)
3. **Discount rate**: we used the February discount rate of 4% in the illustration in the letters. You want to use the lowest available discount rate for these calculations
4. **Birthdates**: use the birthdates for the income beneficiaries that are still active on the gift (if a beneficiary has died, do not use that person's birthdate in the calculation)
5. **Principal Value**: use the value of the original gift
6. **Gift Options**: Select the *Charitable Gift Annuity* option

   Enter the original annuity rate and payment frequency

7. **Select View** and you will see the deduction for this calculation

Using PG Calc to Calculate the Deduction for the Renunciation of a Deferred Gift Annuity:

1. **Chart Selection**: select the *Actuarial Calculations* chart
2. **Date of Gift**: Enter the date of renunciation and select the *lowest* of the 3 available discount rates. For the illustration in the letter, we used 3/1/2003 and 4% for February.
3. **Birthdates**: enter the birthdate(s) of the living beneficiaries of the gift
4. **Principal Value/Cost Basis** window: Enter ten times the original gift amount. If the gift amount was $10,000 for example, enter $100,000. No cost basis is necessary.

   Per PG Calc: The reason for gift amount adjustment is to assure that PG Calc computes the annuitant's investment in contract. PG Calc limits the investment in contract that it calculates to be no more than the gift amount. Since the deferral period has shortened or disappeared since the gift date, the annuitant's investment in contract may not actually exceed the original gift amount. Entering a gift amount that is ten times the original gift amount will prevent PG Calc from incorrectly limiting the investment in contract it computes.

5. **Gift Options Window**:
   If first payment is more than one year after date of renunciation, select *Deferred Gift Annuity*
   If payments have started or are less than one year after date of renunciation, select *Charitable Gift Annuity*

   If *Deferred Gift Annuity* was selected, enter the annuity amount in dollars actually specified in the contract in the "Payout Rate" field. Use the annual annuity amount in this field and then select the payment frequency as stated in the original contract. Select **NO** when asked *Recalculate this annuity rate to allow for the deferral of payments?*

   If *Charitable Gift Annuity* was selected, enter the annual annuity amount in the Payout Rate field and select the payment frequency as stated in the original contract.

6. **View** your chart…The investment in contract value listed on Line 9 of the Actuarial Calculations chart equals the present value of the annuitant's interest on the date of renunciation. This equals the investment in contract.

Calculating the Deduction for the Renunciation of a Pooled Income Fund:

1. **Chart Selection:** select "Non-charitable Interest Dollars"

2. **Date of Gift**: use the date of renunciation (date the renunciation documents were signed)

3. **Discount Rate**: use the default rate, unlike CGAs the rate makes no difference on the final deduction

4. **Birthdate**(s): use the birthdates for the income beneficiaries that are still active on the gift (if a beneficiary has died, do not use that person's birthdate in the calculation)

5. **Principal Value**: use the fair market value as of the date of renunciation provided by the Fund Administrator

6. **Gift Options**: select the applicable trust type (LTIF, GIF, PIF, etc) *your calculation program should already be set up with the highest rate of return for the past 3 year*

7. **Select View** and you will see the deduction for this calculation

Appendix – Gift Acceleration program protocol

- You will be assigned a group of donors.
- You will receive a spread sheet with FMS number, name, city, state, original gift date, gift amount, annual annuity, quarterly payment, deduction if they accelerate, and gift restrictions, if any.
- Original gift files will be pulled and delivered to you.
- Prior to call, please check FMS. Look for any personal interactions, number of gifts made, length of membership and any other personal information.
- Make call and ask if donor would like to accelerate gift.
- Please note that if the deduction from this gift is over $5,000, we will need to mention the need for an appraisal and the need to have the document notarized.
- Also please note if the donor has multiple CGAs you will need to ask them which gift they want to accelerate. You may need to run calcs for other deductions. They were quoted a deduction on the acceleration of the smallest gift that they made.

- If donor says yes, ask if they have any questions about the acceleration document. Ask them to complete it and return it to your attention. BRE envelope was included with proposal. You may explain that we will acknowledge the gift and prepare documentation so they may claim an income tax charitable deduction. Make appropriate FMS entry.

- If the donor says yes and they have multiple gifts please ask which gift they would like to accelerate. You may contact Adrienne and she will create a contract for the correct gift annuity, if different than the sample we enclosed. This will go out with a cover letter thanking them for their interest and support. Make appropriate FMS entry.

- If donor says they would like to think about it, ask them if you may follow up with them in a few weeks. Please complete hand written note (template created) thanking them for their consideration and reiterating when you'll be back in touch. Make appropriate FMS entry.

- If the donor says thank you but they can not give up this income, thank them and follow up with a hand written note (template created) thanking them for their time and support of the Conservancy. Make appropriate FMS entry.

Please keep track of the number of calls you've made and the outcome. We'll want to roll up this information into our final report.

Appendix – gift checklist

DONOR__________________________________DATE OF GIFT______________________

FMS# _______________________

RELINQUISHMENT CHECK LIST

DATE

1. Received signed relinquishment agreement ______

2. Call and thank donor ______

3. Fax copy of signed relinquishment agreement and calcs to finance administrator ______

4. Fax copy of relinquishment to bank. If pooled fund, get final FMV from trustee. ______

5. Enter FMS interaction for gift ______

6. If deduction is over $5k, forward info to appraiser ______

7. Send tax letter to donor with Calcs (Non-Charitable Interest dollars, NOTE: If CGA, use lowest discount rate), copy of agreement stamped "COPY", and Form 8283 and instructions. ______

8. All correspondence and original signed agreement to go in Donor's Life Income file. ______

ANATOMY OF A SUCCESSFUL PARTNERSHIP:

PLANNED GIVING AND THE TREASURY OFFICE

University of Washington

Presented by: **Judy Peterson, Chief Operations Officer**
Nadine Faith, Director of Gift Planning

May 2004

ANATOMY OF A SUCCESSFUL PARTNERSHIP

Planned Giving and the Treasury Office

I. Where We Were Then

A. Poor communication between offices
B. Different views of mission
C. Lack of understanding about the challenges facing each area
D. Unclear sense of who had responsibility for mitigating risk
E. Inadequate training/supervision of accounting staff
F. Insufficient comprehension of investment management philosophy for gift planning staff
G. "Blaming" mentality

II. Where We Are Now

A. Belief in shared mission
B. Mutual respect for each other's department and staff
C. shared cultural values vis-à-vis communication and partnership process
D. Shared approach to risk analysis and problem solving
E. Trust
F. Candor

III. The Road Between – or – How We Got Here

A. Joint retreats
B. Process reviews
C. Regular combined staff meetings
D. Periodic informal manager's meetings
E. Cross-training
F. Long-term commitment to total quality management process in Treasury Office, especially to values of customer service and problem solving
G. Long-term commitment to principles of teamwork, candid communication and service in Gift Planning

IV. Institutional Support

A. Administrative Orders describing clearly delegated responsibilities and authority
B. Implicit and explicit leadership expectation of collaboration and cooperation
C. Shared access to legal counsel
D. Shared access to relationship with investment manager and trust administrator

CHARITABLE GIFTS OF REAL PROPERTY

DAVID WHEELER NEWMAN
MITCHELL SILBERBERG & KNUPP LLP
PH: (310) 312-3177
FAX: (310) 231-8371
DWN@MSK.COM

CHARITABLE GIFTS OF REAL PROPERTY

DAVID WHEELER NEWMAN

I. Amount of Deduction.

A. General Rule. The Donor may generally obtain a charitable contribution income tax deduction equal to the full value of the real property contributed.

B. Equity Limitation. The charitable contribution deduction is limited to the Donor's equity in the property. The full value of the property is therefore reduced by the outstanding balance of any mortgage, or the amount of any other liability, which encumbers the property. The results are the same whether the charity assumes the debt or simply receives title to the property subject to the debt.

C. IRC Section 170(e), Limitation. The charitable contribution deduction is future reduced by the amount of gain which would not have been long-term capital gain if the property had been sold by the Donor at its fair market value. Depreciation previously taken and subject to the recapture rules would reduce the amount of the charitable contribution deduction otherwise allowable.

D. AGI Limitation. The deduction is generally limited to 30% of the Donor's adjusted gross income. The donor may elect instead to reduce the amount of the total deduction to his tax basis in the property, in which case the reduced deduction may offset up to 50% of the donor's adjusted gross income.

II. Gain Recognition.

A. In General. In addition to the charitable income tax deduction, the other major tax benefit arising from a gift of appreciated property is the opportunity to avoid recognition of capital gain. The capital gains tax which is avoided, when added to the tax savings which results from the deduction, dramatically reduces the after-tax cost of charitable giving.

- Example. Assuming donor in the maximum federal and 5% state income tax bracket, the after-tax cost of a gift of $100,000 cash is reduced by approximately $40,000 (the tax savings resulting from the charitable deduction) to $60,000. If the donor instead contributes land with a value of $100,000, with a cost basis $20,000, the after-tax cost of the gift is further reduced by the approximately $16,000 of capital gains tax the donor would have had to pay had the property instead been sold. The combined tax saving in this illustration results in a total government subsidy of 56% of the value received by charity.

B. Capital Losses. The value of some properties includes unrealized capital *losses* rather than gains -- after all, there is no rule that says property can only increase in value. If such a property is the asset to be contributed, it is generally preferable for the donor to sell the property and recognize the capital loss, and to then contribute the proceeds of sale. Contribution of a property with a built-in loss will result in the loss of the tax benefit of that loss.

III. Bargain Sales.

A. In General. A bargain sale is a part gift, part sale transfer of property to charity. Real property is ideal for bargain sales. A bargain sale donor is entitled to a charitable contribution deduction equal to the difference between the property's fair market value and the amount received from the charity.

B. IRC Section 1011(b) Basis Allocation. The Donor may recognize some capital gain in a bargain sale transaction because the transfer consists of both a gift and sale element. The Donor's tax basis in the property must be allocated between the gift and sales components, using the following formula:

$$\frac{\text{Amount Realized}}{\text{Fair Market Value}} \quad \text{X} \quad \text{Adjusted Basis}$$

The difference between the amount realized in a bargain sale transaction and the tax basis allocable to the sale element constitutes a taxable gain to the Donor.

- Example. Assume donor owns property adjacent to the charity's existing campus. The charity would like to acquire the property, and the donor is willing to sell it to the charity at a bargain price.

Fair market value	1,000,000
Adjusted basis	200,000
Amount realized	300,000

Allocation of Basis

$$\frac{\text{Amount Realized}}{\text{Fair Market Value}} \quad \text{X} \quad \text{Adjusted Basis}$$

$$\frac{300{,}000}{1{,}000{,}000} \quad \text{X} \quad 200{,}000 = \qquad 60{,}000$$

Gain Calculation

Amount realized	300,000
Bargain sale basis	(60,000)
Gain recognized	240,000

C. Tax Character of Gain. The Donor may recognize ordinary income from the recapture of depreciation under IRC Section 1245 or 1250. Moreover, capital gain attributable to unrecaptured Section 1250 depreciation will be subject to the special long-term capital gains rate of 25%.

- Example. Assume the same facts as the previous example. The property includes a building on which the donor has claimed depreciation of $400,000. Of this amount, $100,000 is treated as "excess depreciation", subject to recapture as ordinary income under IRC Section 1250. The remaining $300,000 would be subject to the special federal long-term capital gains rate of 25% if the property were sold. In the bargain sale transaction, a pro-rata portion of each category of income will be recognized by the donor:

Bargain Sale Percentage	30%
Ordinary Income Recapture	30,000
25% Capital Gain	90,000
15% Capital Gain	120,000
Total Gain	240,000

IV. **Encumbered Property.**

A. Outright Gifts. If property is transferred to charity subject to a liability, the amount of the liability is treated as an amount realized for purposes of applying the bargain sale rules described above, even though the charity does not agree to assume or pay the liability.

B. UBTI. Debt-financed income, which is one category of unrelated business taxable income, arises when there is acquisition indebtedness with respect to the property producing the income (e.g., gain from sale of that asset). UBTI makes a gift much less attractive to a charity since it must pay tax at regular rates when it disposes of the property on the portion of the gain attributable to the debt. This requires the charity to evaluate the gift on an after-tax basis.

C. Avoiding Acquisition Indebtedness. Acquisition indebtedness results if the charity (or charitable remainder trust) assumes the debt or takes the property subject to a debt that is not sufficiently aged. To avoid acquisition indebtedness, the debt must have been placed on the property five years before the gift, and the donor must have owned the property for five years. In no event should the charity assume the debt.

- Example. Assume the same facts as the prior two examples. The amount realized to the donor - $300,000 - arises because she transferred the property to charity subject to a mortgage she placed on the property three years ago. Shortly thereafter, the charity arranges to sell the property for its market value, $1 million. The portion of the gain recognized by the charity which is taxable UBTI from debt financed income is calculated as follows:

Amount Realized	1,000,000
Carry-Over Basis	140,000
Cost Basis	300,000
Total Basis	440,000
Gain Realized	560,000

The portion of the gain realized taxable as debt financed income is determined by the ratio of acquisition indebtedness to the basis of the debt-financed property:

$$\frac{\text{Acquisition Indebtedness}}{\text{Basis of Property}}$$

$\frac{\$300,000}{\$440,000}$	68%
.68 x gain of 560,000	380,800
Tax at 35%	133,280
Net Proceeds	866,720

D. Charitable Remainder Trusts. Funding a charitable remainder trust with encumbered property requires a thorough analysis regarding the liability on the property. If the debt is sufficiently aged to avoid the UBTI issue discussed above, and if it can be determined that the donor is not personally liable for the debt, by contract or by statute, it may be possible for the donor to transfer property to the trust, subject to the liability, in which case the bargain sale rules discussed above will apply to determine the recognition of gain resulting from this transfer. If the donor is personally liable for the debt, a transfer of the property to the trust subject to the debt may prevent the trust from qualifying as a charitable remainder trust. In this situation, it may be possible for the trust to be funded with the equity in the property (only if the debt is sufficiently aged), as follows:

1. The donor transfers an undivided interest in the real property to the trust.

2. The donor retains an undivided interest in the property that, when sold, will yield enough cash to pay off the entire liability.

3. The donor and the trust enter into a written co-tenancy agreement which spells out the rights of the donor and trust with respect to the property. In this agreement, the donor indemnifies the trust from liability for the debt.

4. The donor and the trust, as co-tenants, join together in selling the property.

5. The donor uses his or her share of the sales proceeds to repay the debt.

- Example. Charitable Remainder Trust Funded With Encumbered Property. Larry, age 70, owns an apartment building with a depreciated basis of $200,000 and a current fair market value of $1,000,000. The property is encumbered by a mortgage resulting from refinancing with a current balance of $300,000. Larry would like to use his $700,000 equity in the property to fund an 8% charitable remainder net income unitrust.

CRT factor	40%
Co-tenancy split	700,000/300,000
Basis of retained portion -- 30% of 200,000	60,000
Amount realized	300,000
Adjusted basis	(60,000)
Gain recognized	240,000
Deduction – 40% of 700,000	280,000

V. **Partial Interest in Real Estate**.

A. General. No charitable deduction is allowed (for income, estate or gift tax purposes) to a charitable gift of less than the donor's entire interest in a piece of property. While there are exceptions to this general rule which form the basis for the field of planned giving, these exceptions are narrowly construed by the IRS and the courts.

B. Exceptions.

1. A contribution of the donor's entire interest in the property may be deducted, even if what the donor owns is a partial interest.

2. A remainder interest in a charitable remainder trust or pooled income fund.

3. The income interest in a charitable lead trust. Note that while contributions to all qualified charitable lead trusts will qualify for the gift and estate tax deduction, only contributions to those which are also grantor trusts will qualify for the income tax deduction. IRC §170(f)(2)(B).

4. A remainder interest in a personal residence or farm.

5. An undivided portion (not in trust) of the donors's entire interest in the property.

6. A qualified partial interest for conservation purposes. IRC §170(F)(3)(B).

C. Common Violations.

1. A gift of the right to use property without the transfer of ownership.

2. Retention by the donor of substantial rights to the property.

VI. **Remainder Interest in Personal Residence.**

A. General. The term "personal residence" is defined in the Treasury Regulations to include a vacation home. The charitable contribution deduction is equal to the present value of the remainder interest in the property, discounted to take into account the value of the donor's retained life estate.

B. Combination With Gift Annuity. This is a popular variation on the bargain sale transaction. The actuarial value of the annuity received is treated as the amount realized by the donor in connection with the transfer. The amount of any liabilities to which the property is subject is also treated as part of the amount realized.

1. The allocation of basis to the property transferred, and the resulting capital gain, is determined in a manner similar to the allocation in bargain sales transactions. If a discharge of liabilities occurs, the basis must be allocated among the retained life estate, the annuity portion, the discharge of liability portion and the gift portion of the property transferred.

2. Gain attributable to the discharge of the liability is recognized by the donor in the year of transfer, but gain attributable to the value of the annuity is spread ratably over the life expectancy of the annuitants if the annuity is nonassignable.

- <u>Example</u>. Gift Annuity Funded With Remainder in Personal Residence

Donor age 75, market value	1,000,000
Liability	200,000
Basis	400,000

<u>Calculation of Annuity</u>

Market value	1,000,000
Less liability	(200,000)
Equity	800,000
Value of remainder (factor 62.5%)	500,000
Annual annuity	40,000

<u>Gain Recognition</u>

Liability	200,000
Liability allocable to Remainder (62.5%)	125,000
Present value of annuity	335,000
Total amount realized	460,000
Bargain sale basis	
460/1,000 X 400,000	184,000
Portion allocable to liability	
125/460 X 184,000	50,000
Liability	125,000
Allocated basis	(50,000)
Gain this year	(75,000)
Gain over term of annuity	201,000

<u>Charitable Deduction</u> 165,000

In some states, including New York, do not allow a gift annuity to be issued in exchange for an interest in real estate. Other states, including California, restrict the categories of investment in which gift annuity reserves may be held - typically government bonds. As a general rule, a charity subject to these limitations should have adequate surplus funds in its gift annuity account to allow the residential remainder to be placed in the surplus in exchange for surplus funds being transferred to the required reserve.

VII. **Appraisal Requirements and Valuation Issues.**

A. In General. Donors must obtain qualified appraisals for charitable contributions of certain property, including real estate, if the claimed value of the property is greater than $5,000.

B. IRS Form 8283. The Donor must attach this form for his tax return for the year in which the deduction for the gift is claimed.

1. The appraisal must me made not earlier than 60 days before the date of the contribution, and before the filing of the tax return on which the deduction is first claimed.

2. The appraisal must be performed by a Qualified Appraiser, who is someone who holds himself out the public as someone who does this type of valuation, or who performs appraisals on a regular basis, and is qualified to appraise the type of property involved. Note that the appraiser need not hold any particular certification or license to be a qualified appraiser for this purpose. A qualified appraiser may *not* be the donor, a person not sufficiently independent of the donor or donee.

3. The appraisal must include:

- Description of the property
- Date of gift
- Terms of any agreement relating to use of the property
- Name, address, etc. of the qualified appraiser
- The appraiser's qualifications
- The specific standard of valuation used (e.g. replacement cost, capitalization of income of sales of comparable property)

C. Timing. The appraisal must be made no earlier than 60 days before the gift. It must be received before the due date (including extensions) of the return on which a deduction for the gift is first claimed.

D. Valuation Adjustments. The same discounts that work to the taxpayer's benefit for gift and estate tax purposes -- e.g. discounts for lack of control and marketability that affect the value of a partial interest in real estate or an interest in a family limited partnership -- must also be taken into account when determining the amount of the charitable deduction.

E. Disclosure by Charity. If the charity disposes of the contributed property within 2 years of the gift, it must notify the IRS of the sales price using Form 8282.

VIII. Environmental Hazards.

Charity as owner (in the case of an outright gift), or as trustee (in the case of a gift in trust) may be exposed to liability for the expense of cleaning up hazardous waste.

A. Environmental Review Policies. Many charities have adopted policy that the organization may not accept a gift of real property without first evaluating the environmental risks.

1. An evaluation can uncover problems and help quantify the costs of correcting them.

2. The evaluation may also protect the charity against problems that are discovered later, since the organization has exercised due diligence in investigating the property, even if problems which later come to light are not discovered in the evaluation.

3. If the evaluation uncovers a hazardous waste problem, the person arranging for the evaluation must 'notify eventual purchaser of material problems.

IX. Practical Issues.

A. Property Management. Among other considerations, the charitable organization must determine if it has adequate administrative resources to act as a property manager of real property on the assumption that the property will be held and operated for some time prior to sale.

B. Negative Cash Flow. Similarly, the organization must analyze the operating income (if any) and expense arising from the property to determine the likelihood and extent of any negative cash flow. It is a financial decision to determine whether the organization is willing to fund any negative cash flow associated with real property received from donors.

DAVID WHEELER NEWMAN
MITCHELL SILBERBERG & KNUPP LLP
PH: (310) 312-3177
FAX: (310) 231-8371
DWN@MSK.COM

Proactively Managing Your Estate Administration Program

Thursday, May 6, 2004

Jackie W. Franey
Planned Giving Officer
Children's Medical Center Dallas
Dallas, Texas

I. INTRODUCTION

Estate administration is the process of reviewing documents when an individual who has named a charity in his/her estate plan has died. The goal of estate administration is to ensure that the charity receives all that it's entitled to under the decedent's estate plan, as quickly as possible. In order to accomplish this, you must know what documents to review, what information must be monitored and have a general understanding of the probate and trust administration legal processes.

Implementation of an internal estate administration system for your charity provides several significant benefits:

- It permits the development office to track estates and trusts to develop relationships with other contact sources for future gifts such as decedent's family members, personal representatives, trustees and estate counsel.
- It permits the development office to communicate in a timely manner to the decedent's family and be responsive to their desires.
- It provides a timely tracking system for all outstanding estates and trusts thereby allowing your charity to project current and future trust and estate income.
- It provides potential cost savings through use of in-house processing of estates and trusts, while using outside counsel to advise and handle more complex legal matters that require professional assistance.
- It permits your charity to promptly update the development office's donor management system with information received during the estate administration process.

II. OVERVIEW

The following is a list of the documents that we are entitled to receive from the personal representative of an estate when the decedent has named a charity as a beneficiary under the Last Will and Testament. The documents are listed in the order in which they are normally received. In your state, the documents may be called something else, but the purpose may be very similar.

Notice of Administration

The typical progression of an estate begins with notification from the personal representative or the decedent's attorney. A copy of the Last Will and Testament usually accompanies the notification. If you do not receive a copy of the Last Will and Testament, then one should be requested.

In a trust administration, there may not be a formal notification. Instead, your charity may receive correspondence from an attorney for the trustee, or the trustee, indicating that you have been named as a beneficiary in the trust.

Last Will and Testament

The *Last Will and Testament* tells what type of bequest has been given to your charity. There are different types of bequests: specific, residuary and contingent.

Specific: These bequests are paid after all claims against the estate have been met and before the residual beneficiaries are paid.

Residuary: These bequests are paid after specific bequests, taxes and expenses have been paid. A partial distribution may be made once the residual interest is finalized. In most cases, we ask the executor to make a partial distribution of the residual interest.

Contingent: These bequests are contingent on a future event such as the death of a primary beneficiary, or the death(s) of surviving heir(s). There is always a possibility that the contingent beneficiary will receive something, although remote.

Trusts

There are three main types of *trusts*: testamentary (the trust is established at the death of the decedent through his Last Will and Testament, revocable (living trust arrangements) and irrevocable. A charity can learn the terms of the testamentary trust by having a copy of the decedent's Will. Information on revocable trusts is normally confidential until they become irrevocable; while a charity may or may not learn the terms of a charitable remainder trust. In many cases, the donor retains the right to change the remainder beneficiaries.

Charitable Remainder Trusts: If a charity is an irrevocable remainder beneficiary in the trust, income must be recorded once the net present value of the future gift is known. While it may be many years before the remainder beneficiary receives the gift, the "future interest" needs to be tracked, using the age and gender of the income beneficiaries.

Inventory

In most states, a detailed inventory and valuation must be filed after the personal representative for the estate has been appointed. The Inventory lists all the assets of the decedent as of date of death and places a value on them. Everything from money in bank accounts, stocks, bonds, real estate, etc. can be reflected on the Inventory. If a charity is a residual beneficiary, then it's entitled to a copy of the Inventory.

The length of the estate administration process can be predicted using the Inventory. If the estate is valued over $1,500,000 during 2004 (increasing to $3,500,000 by 2009) it usually takes 16-18 months to administer the estate due to the filing of an estate tax return. On average, most estates take about nine months to a year to complete.

The Inventory also allows a charity to estimate the value of the bequest when there is a residual interest in an estate. If the gift is a remainder or residual gift, review the Inventory for noncash assets. It might be helpful to request to the attorney that the assets are liquidated and cash is distributed, rather than inheriting an interest in real estate, for example. Different types of assets can result in potential problems for your charity. After the Inventory is received, calendar about 6-8 months for receipt of the Final Accounting and distribution of all funds.

Estimating the Value of a Bequest

If a charity is named to receive a specific bequest, you can assume you will receive that specific amount. If, however, the assets of the estate are insufficient to pay all the specific bequests, then the gifts are usually reduced proportionally. Check the statutes in your state for the process of abating the gift and gift reductions.

Determining the remainder or residual gift is sometimes more art than science. A good rule of thumb is to determine the net value of the estate from the Inventory, or from the trust asset statement. Allow a certain percentage (i.e. 10%) of the net value of the estate to be allocated for services provided by the personal representative and/or attorney for the estate as well as payment of claims to creditors of the estate (i.e. funeral, miscellaneous bills, etc.). After this computation is made, subtract all specific bequests. The remaining figure represents the residual portion of the estate. You can then multiply this figure by the percentage of the residual stated in the Last Will and Testament to calculate the expected amount of the bequest.

Develop a relationship with your business office/finance department and understand the accounting rules that pertain to estate administration. The estate administrator must work closely with the accountant who will be booking these gifts as income to assure that the estimated amount is supportable, the time frame for receiving the income is reasonable and any restrictions are properly classified.

Final Accounting and Petition for Discharge

The Final Accounting and Petition for Discharge is due twelve months unless an estate tax is due and the Personal Representative has filed a Notice of Estate Tax Due (which automatically extends close due date to twelve months from due date of 706). Within thirty days from the date of service of the Final Accounting and Petition for Discharge, the personal representative should (and in some states must) distribute the estate. In some states with the thirty-day requirement, the thirty-day waiting period may be waived if all interested parties consent to waiver. In addition, the Final Accounting should be reviewed for Personal Representative and attorney fees and estate expenses.

During trust administration, due to the absence of court related processes (such as the need to file an Inventory with the court); it can be more challenging to determine when the gift will be distributed. On average, it can take 8-12 months for gifts to be distributed; due primarily to the tax filing requirements that must be fulfilled by the trustee. Accounting rules dictate at what point you must include on the general ledger the value of a trust interest. Variables in this determination include the type of trust, the terms of the trust and the valuation information. In addition, you should request a final trust accounting or statement.

See Exhibits for a sample of a Receipt and Release to be signed by any charity receiving a distribution from an estate. You should review any Receipt and Release with counsel as to its appropriateness. Be especially careful of indemnification language and other language that greatly limits a personal representative's or trustee's liabilities in discharging its duties.

III. ADMINISTRATION OF BEQUEST FILES

Developing a good calendar system is essential to proactive estate administration. It is imperative that all estates be regularly monitored to ensure that all funds due your organization are received in a timely manner and that no complications occur which could jeopardize the gift or your charity. (i.e. inheriting contaminated real property). It is also recommended that a good working relationship be developed and maintained with other nonprofits. Estate and trust complications can more easily be resolved if all the beneficiaries work together.

The following outlines normal practices with regard to managing estate files from the time of first notification until final distribution from the estate or trust is received.

Initial Correspondence

After a Notice of Administration is received from the personal representative or his/her attorney, write a letter thanking them for the notification. Request that all future correspondence be sent directly to the Estate Administrator and provide information on the complete legal name, address and tax identification number. Include an IRS W-9 form and IRS Tax Exempt Letter (501(c)(3) letter - most attorneys and trustees will request this information. If necessary, also request a copy of the Last Will and Testament and/or Trust Agreement at this time. Make a notation on your calendar or use a database tracking system to follow-up with the personal representative or his/her attorney to confirm that requested information was received (30 days is a good estimate).

If an attorney is unwilling to provide a copy of the Last Will and Testament, go to the courthouse to obtain a copy or explain to the attorney that the exact wording of the language of the decedent is needed. It may be helpful to inform the attorney that the reason you would like the language is to ensure that the wishes of the deceased are followed regarding the use of the funds. In some cases, informing the attorney that your auditors regularly review estate files for accuracy of information related to estate administration may assist in securing the necessary language.

If an attorney or trustee is reluctant to provide a copy of the trust (since a trust is not filed with the court), then discuss with the trustee that your charity is a beneficiary and is entitled to information regarding the gift. (Often this is the law). If the trustee wants, he/she can block out the other gifts in the trust. Be careful, however, that you understand all the terms of the trust that relate to your gift. For example, if the attorney sends you information that you have a 25% remainder interest in the trust after specific bequests are made, you need to know the total amount of the specific bequests in order to determine the true value of your gift.

Upon notification of an estate or trust, a paper file is opened. It may be helpful to use a legal document checklist to ensure that the proper documents are placed in the file (See Exhibits for checklist). At a minimum all files should contain:

- Copy of Decedent's Last Will and Testament, codicils and/or trust
- Copy of the Inventory and Appraisement
- Written information regarding the value of the trust (preferably a list of assets)

- Copy of all accountings if charity has a remainder interest
- Copies of all checks received
- Copies of all correspondence sent to and received from the personal representative or his/her attorney

If there are complications in an estate, you may want to separate out those physical files from the other files to monitor them more closely. Regularly review the status of all legal matters on a monthly basis. Establish a tracking system using the following guidelines:

- <u>If a specific bequest:</u> calendar 9-12 months for review
- <u>If a residuary interest:</u> calendar 4-5 months to receive a copy of the Inventory or asset statement, which shows the total value of the decedent's estate. Then calendar approximately 4-6 months to follow-up that the estate is closing.
- <u>If a residuary interest in an estate or trust exceeding $1,500,000</u>: calendar 16-18 months for final distribution or follow-up. Make a note in your file that an IRS form 706 (Federal tax filing) is required.
- <u>If a remainder interest and the Inventory show that there is real estate to be sold:</u> notify the personal representative or his/her attorney that you would like to receive an all cash distribution
- <u>If the remaining asset is a tax reserve</u>, find out how long a tax reserve can be held in your state and calendar for that amount of time to then review the file. Most estates and trusts withhold a tax reserve to pay for the final taxes and miscellaneous expenses of the estate/trust after the bulk of the funds have been distributed.

Open files: Open files should be separated into two types, "active" and "inactive". Active files are those estates or trusts where we can predict when and how much we will receive. Inactive files involve either funds to be received at a later, undeterminable date, or contingent interests where funds are not definite.

Restricted gifts: The two most common types of restrictions are: 1) when the decedent requests that the money be used for a specific purpose only, or 2) when the decedent requests that the money be used only in a specific geographical area. You will need to properly account for all restricted gifts for audit purposes. If a restriction is designated by the donor that you cannot fulfill, you may need to decline the gift.

Throughout the Administration of the Estate

Throughout the administration of the estate, acknowledge correspondence from the personal representative or his/her attorney in writing. Determine who will be the primary contact for the personal representative or his/her attorney and at what point in time the planned giving staff person may cultivate the donor's heirs/family and the executor and/or other advisors. In some cases, the planned giving staff person will already have a relationship with the attorney – how will you communicate between the role of the attorney as executor and the attorney as donor advisor?

As the processing of estates becomes an established routine, there should be certain policies or general guidelines that must be established. Examples of these are: 1) distributions for a bequest should be in cash rather than in-kind whenever possible, 2) in those states where applicable, do not sign off on attorney and/or personal representative fees before the administration of the estate is complete.

Distributions from the Estate

Upon receipt of distributions from the estate, write the personal representative and/or his attorney a thank-you letter. Acknowledge other heirs and family members as appropriate and work closely with planned giving staff so they can steward heirs, family members and advisors connected with the estate. If appropriate, share with the family how the funds will be used to further the mission of the organization. Carefully review the receipting language before signing off on a distribution because you may be waiving an accounting, stating you've received full distribution, etc.

It is important that your charity establish guidelines outlining who is authorized to execute the estate/trust documents such as the Receipt and Releases, distribution directives and any court filings. Guidelines should require that all parties signing such documents should be versed in the particulars of the information and language of the document or should seek proper review and consultation with an individual knowledgeable with such documents prior to signing off. Failure to properly review estate/trust documents may result in assumption of unnecessary liability by your charity or loss of bequest or trust income.

Keep track of perpetual and charitable remainder trusts separately and work closely with your business office/finance department and the planned giving staff. The planned giving staff can steward those donors that have irrevocably named your charity as a remainder beneficiary and build relationships with the advisor(s) before the death of the donor and/or income beneficiaries. If you are aware of a charitable remainder trust where the donor(s) retained the right to change the remainder beneficiaries, then it is critical for the planned giving staff to steward the donors to remain as a beneficiary.

Perpetual trusts last forever and under accounting rules, the income received from them, as well as the charity's percentage share of the principal must be accounted for in the audit. Perpetual trusts pay out income only, with the principal remaining untouched. Obtain a copy of the trust's accounting each year, as close to Dec. 31st (end of charity's fiscal year) as possible in order to have the most current fair market value information.

Closing the File

When the Final Accounting and Petition for Discharge are received, review them prior to the hearing set by the court to confirm the estate has been administered properly. If the Final Accounting and Proposed Distribution appear to be in order, calendar thirty days for receipt of funds, and in those states where applicable, sign the Receipt of Petition for Discharge and Accounting and Consent to Distribution. Upon receipt of the final distribution, the estate file is closed.

Closed files: Closed files can be organized by fiscal year. At the end of the fiscal year and after the audit is complete, closed files can be separated out and placed in storage. Determine records retention procedures for closed files. The current guideline is that estate administration documents must be retained for the life of the corporation, although miscellaneous correspondence might not have to be retained that long.

Generally speaking, it takes 6-18 months to close an estate (from receipt of original notice of death to all funds distributed). With trusts, since the court is not involved, the timetable can be much shorter. Sometimes, you will learn of the death of the decedent and receive the funds at the same time.

Audit procedures: Audit approaches do vary since they are dependent on the auditor's assessment of controls in place over estate administration as well as their knowledge of the estate process. Be prepared for the auditors to select a random sample of bequest receivables open at year-end, as well as the largest expectancies. They will want to review the calculation for the amount you expect to receive, your logic for the date(s) you expect to receive distribution(s) and copies of the wording, which indicates any donor restrictions.

The auditors will be interested in looking at any bequests that have stipulated or unusual payout periods. They will also want to see trust statements related to perpetual trusts and documents to support the premise that the trusts were set up into perpetuity. In addition, if you have received any non-cash distributions, they will want to understand how you arrived at the value used to record the gift and understand any liabilities associated with the asset.

IV. *WHEN TO CALL AN ATTORNEY*

Often situations arise in estate and trust administration when an attorney needs to be contacted in order to protect your charity's interest. Confirm the timeline for filing a response – often times you have twenty days or less to respond or you lose your right to contest. Determine procedures for when to call an attorney and the standard maximum percentage of a gift that will be spent on attorney's fees. For example, you could set a maximum of five percent of any gift – therefore for a potential distribution of $100,000 – you would be setting a ceiling of $5,000 in discussing a fee structure with the attorney.

The common scenarios described should be viewed in conjunction with your own internal legal department requirements.

- You've written and called the executor/trustee to request appropriate information, and your telephone calls and letters have gone unanswered.
- You've been served a Summons and Complaint, or been notified of a legal challenge to a will or trust. For example, someone is challenging the validity of the will.
- You've reviewed a pleading and found something unusual.
- You've received a document and you've exhausted resources to try to understand it (a volunteer, board member, another nonprofit beneficiary).
- You've noticed that your organization is misidentified in a will or trust—name or address is incorrect. You've tried, through correspondence to and/or telephone calls with the estate/trust attorney to clarify matters, and more documentation is required. A pleading/affidavit may need to be filed with the court to resolve it.
- The executor/trustee is delaying closing the estate/trust past a reasonable amount of time.

You will need to share with your business office/finance department a list of all estates in litigation, the issues involved, the likelihood of settlement, and the amount of bequest income at stake, the names of the attorneys representing your organization who are involved, and a projected timeframe for settlement. This information is particularly important if the value of a recorded bequest receivable could be impaired by the litigation.

V. WHAT TO KNOW ABOUT NON-CASH ASSETS

Distributions for a bequest should be in cash rather than other assets whenever possible. Sometimes, as a beneficiary, your charity might be asked to accept real estate (land, homes, condominiums, etc.), personal property and furnishings (jewelry, artwork, mobile homes, etc.), vehicles, stock, bonds, certificates of deposit, notes receivable (mortgages), royalties or mineral rights. You can always disclaim an asset because you do not want it or have concerns about accepting it.

If you accept non-cash assets, provide your business office/finance department with a list of these assets and a reasonable market value for each. If a reasonable market value cannot be determined, they will determine the amount to record (e.g. $1.00) so that ownership of the asset will not be forgotten.

Let your business office/finance department know of any liabilities assumed in accepting the asset, i.e. with real property – real estate taxes, maintenance costs, etc. If you do retain securities, they will need to know any interest or dividends earned subsequent to the date of receipt, since this income will be accounted for as investment income and not as bequest income.

Most importantly, work on procedures for disposing of the assets, preferably before accepting non-cash assets. Advise your business office/finance department of any contracts signed for the sale of these assets. If real estate is sold for an amount different from the amount recorded as the fair market value when the gift was accepted, the gain or loss is not bequest income but gain or loss on the sale of an asset, and will be treated differently for income purposes.

Here is a brief listing of the relevant information needed to monitor various types of non-cash assets:

- **Real estate:** the type of property (i.e. residential or commercial), the property address, as well as whether the property is income producing, any liens or toxic problems. The appraised value should be provided by the attorney for the estate/trust. It is also important to note whether (and when) the property is sold for payment of taxes.
- **Insurance:** the insured name and address, owner name, company name and premium payments.
- **Promissory Notes:** the principal amount, interest rate, maturity, whether current, foreclosure or secured and any terms.
- **Royalties:** the date the interest was received (i.e. oil/gas leases), the county and state location (if applicable) and a description of the royalty interest.
- **Securities:** the name and type of stock, number of shares, the value on the date of transfer and date and value when sold.

VI. PARTNERING WITH THE BUSINESS OFFICE/FINANCE DEPARTMENT

Accounting standards require that all receivables must be recorded as income. Distributions from bequests are regarded as receivables, and accordingly, must be entered into the General Ledger by accounting. An expectancy should be recorded after the will is declared valid by probate, no uncertainties as to the likelihood of receiving the gift exist and the amount of the bequest can be determined. Bequests that are conditioned upon future or uncertain events should not be recorded until the conditions are substantially met.

The business office/finance department will need a listing of bequest receivables that indicate the expected date of receipt. They will separate those bequests to be received within the fiscal year from those to be received after the end of the fiscal year. Additionally, the business office/finance department will need to have available how the amounts due were calculated, how the expected distribution date was determined and language from estate documents that indicate donor imposed restrictions. If the distribution from an estate is less than the amount expected and the amount estimated was recorded by the business office/finance department as a bequest receivable, you must advise them. The amount, which will not be received, will probably be written off as a loss of an asset.

At the end of a fiscal year, the auditors will be looking for a roll-forward of bequest receivables. You may be asked to prepare this. The schedule would show all bequest receivables recorded as of Dec. 31st (end of charity's fiscal year) of the previous year, less cash received during the year, plus or minus all adjustments to expected receipts to arrive at the balance as of the end of the current fiscal year (Dec. 31st).

If you receive statements periodically from trustees, you should perform several clerical checks. First make sure the beginning balance of the statement ties to the ending balance of the last statement you received. Expect to see trustee's and accountant's fees. The trustee's fees should be in line with the statutory rates or normal rates charged by the bank or investment house administering the trust.

With the help of your estate records, you should be able to quickly compare the list of beneficiaries and validate that disbursements were made appropriately. Review the disbursements made from the trust for any unusual items. If any other disbursement looks unusual or you do not understand the description, call the trustee and ask for an explanation. If you need further clarification, discuss the issue with your CFO or other staff person in a position to assist with estate issues.

If the trust is a perpetual trust or one that will be active for a long period of time, you may want to ask the trustee what percentage is being invested in stock versus in fixed instruments. You may want to review this mix with someone with financial expertise to determine if the mix makes sense. If 80% is in equities, or 100% is in fixed income, you may need to ask the trustee to alter the composition of the investments to better address the market risk and growth of principal.

VII. PLANNED GIVING: BUILDING THE CASE FOR SUPPORT THROUGH YOUR ESTATE ADMINISTRATION PROGRAM

For many charities, a gift from an individual's estate plan represents the ultimate gift from the donor. But this income didn't just "happen" – planned giving represents the relationship with donors as they fulfill their philanthropic goals to support the charities and missions that are important to them and estate administration represents our responsibility to fulfill their philanthropic goals. Both sides carry equal weight in the equation – securing the gift commitment and securing the gift dollars.

A pro-active estate administration process enables your charity to learn what a typical "planned giving donor" looks like:

- Was this person male or female?
- What was the age of this person at death?
- What relationship did this individual have with your charity: a long-term donor from direct mail, a volunteer or board member, a family member of a long-term donor or volunteer or a person who had experience with your charity's mission?
- Was the bequest a specific, percentage or residual gift?
- How many charities were included in the will?

In addition, information such as the average size bequest and number of gifts from estate administration will enable you to determine if you are "growing" the program. While it is important to track the total dollar amount – how many estates does this figure represent? How many "large" gifts does this figure represent?

This analysis of information through the estate administration process provides valuable insight on how to market your program, both internally to volunteers and staff and externally to donors and advisors. For example, is your exact legal name being used? Another example would be the working relationship with personal representatives and trustees – providing excellent customer service through the estate administration process could lead to building a relationship with an advisor who is assisting a donor to support the mission of your charity.

The analysis also will enable you to determine how many gifts are coming to fruition from long-term donors and donors that have been cultivated by planned giving staff. You should also "bump up" gifts from a donor's estate against your direct mail/annual campaign file to determine if there was ever an existing relationship. The story of a \$5 or \$10 donor that included your charity in the will and never shared this information should be shared with senior management. In addition, track life-income gift donors to determine how many of them also include your charity in their estate plans.

In conclusion, this type of information helps to "build the case for support" for pro-active estate administration and investing in a planned giving program. *As you manage your estate administration process, think about the opportunities to build your planned giving program!* Use these steps to proactively manage the estate administration process and deepen the commitment to planned giving:

- Educate management on the difference between planned gift commitments and estate administration
- Provide excellent customer service to personal representatives and trustees
- Thank, thank, thank and cultivate heirs
- Analyze donors including your charity in their estate plans
- Track number and size of estates on an annual basis
- Track the average size of a bequest and whether specific, residual or percentage
- Implement a tracking mechanism to proactively manage the process

children's
MEDICAL CENTER

Jackie W. Franey
Planned Giving Officer
Children's Medical Center Dallas
2777 Stemmons Freeway
Suite 1025
Dallas, Texas 75207-2230
Email: jackie.franey@childrens.com
Phone: (214) 456-5339
Fax: (214) 456-8399

Some excerpts from the 2003 NCPG conference presentation – Implementing an Effective Administration Program to Increase Your Bottom Line – co-presented with Alvin Blitz

RECEIPT AND RELEASE

WHEREAS Section C.6 of the Will of Jane Smith., deceased, reads (in part) as follows:

> "I give Five Thousand Dollars ($5000) to each of the following organizations…….CHILDREN'S MEDICAL CENTER, Dallas, Texas"

WHEREAS, Bank of America, N.A., (formerly NationsBank of Texas, N.A.,) is the duly appointed, qualified and acting Independent Executor under the Will and of the estate of said decedent and is referred to below as the Executor.

NOW, THEREFORE, the undersigned, XXXXX an authorized representative of Children's Medical Center, Dallas, Texas hereby:

1. Certifies and warrants to the Executor that the organization represented by the undersigned is the identical beneficiary named and designated in the above-quoted provision of said Will.

2. Certifies and warrants to the Executor that XXXXX has the authority from the organization to receive the property described in paragraph 3 below and to execute this receipt and release on behalf of the organization. A corporate resolution evidencing this authority is attached hereto.

3. Acknowledges receipt from the Executor of $5,000 being the subject matter of the bequest to the undersigned under the above-quoted provision of said Will.

4. Accepts the property herein receipted for in full satisfaction and discharge of the bequest to the undersigned under such quoted provision of said Will.

EXECUTED this ____ day of January, 2004

____

STATE OF ____________________ §

COUNTY _______________________ §

BEFORE me, a Notary Public, on this day personally appeared XXXXX, an authorized representative of Children's Medical Center, Dallas, Texas, known to me to be the person whose name is subscribed on the foregoing instrument and acknowledged to me that he/she executed the same for the purposes and consideration therein expressed.

GIVEN under my hand and seal of office this ____ day of January, 2004.

____
Notary Public in and for Dallas County, State of Texas

My Commission Expires________________

ESTATE ADMINISTRATION FORM

Donor: Name: ______________________________

Domicile: ______________________________

Date of Death: ____________ Date of Will: ____________

Attorney: Contact: ______________________________

Firm: ______________________________

Address: ______________________________

Telephone: ____________ Fax No.: ____________

Personal Representative: Name: ______________________________

Address: ______________________________

Telephone: ____________ Fax No.: ____________

Trustee: Contact: ______________________________

Bank: ______________________________

Address: ______________________________

Telephone: ____________ Fax No.: ____________

Charity's Distribution (Share/Percentage): ____________________

Restrictions (if any): ______________________________

Paragraph of Will/Trust Providing for Gift: ____________________

Charity's Affiliation with Testator/Settlor: ____________________

____

Other Estate/Trust Information: ______________________________

Other Charitable Beneficiaries: ______________________________

Distributions Received:

1. **Date Received:** __________ **Amount:** __________
2. **Date Received:** __________ **Amount:** __________
3. **Date Received:** __________ **Amount:** __________

Documentation Received:

- ☐ Notice of Estate Settlement
- ☐ Will/Trust Document
- ☐ Death Certificate
- ☐ Confirmation that Bequest or Gift will be paid in full
- ☐ Inventory
- ☐ State Inheritance Tax Return/Federal Estate Tax Return
- ☐ Notice of Audit **(12-18 months)**
- ☐ Account **(12-18 months)**
- ☐ Receipt and Release
- ☐ Final Distribution

Letters:

- ☐ Initial Attorney Contact Letter **(Immediate)**
- ☐ Sympathy Letter **(Immediate)**
- ☐ Will/Trust Follow-Up Letter **(3 months)**
- ☐ Inventory Follow-up Letter **(10 months)**
- ☐ State Inheritance Tax Return/Federal Estate Tax Return **(10-15 months)**
- ☐ Advance Distribution Letter
  Specific Bequests **(12 months)**
  Residuary Bequests **(15 months)**
- ☐ Distribution Thank You Letter
- ☐ Distribution Follow-Up Letter
- ☐ Insolvency Letter **(15 months)**
- ☐ Investment Mix Letter

Procedure:

- ☐ 501(c) 3 Letter
- ☐ W-9 Form

- ☐ **Bequest Database**
- ☐ **Ticklers**
- ☐ **Report for Finance**

First Letter

Requesting Copy of Will

April 2, 2004

Mr. John W. Smith
Law Offices of John W. Smith
P. O. Box 12345
Anytown, USA 12345-7090

RE: *Jane Doe Estate*

Dear Mr. Smith:

Thank you for your recent correspondence regarding the estate of Jane Doe. We are extremely grateful for Mrs. Doe's generosity in providing for Children's Medical Center Dallas in her estate and enabling us to continue our mission to make life better for children.

For your convenience, we have enclosed a completed W-9 form indicating our Tax Identification Number, our status, and our correct address for your records. This is the appropriate address for all future correspondence regarding the estate of Jane Doe. We have also enclosed an IRS 501(C)(3) letter.

In order to complete our records and meet our audit requirements, we would appreciate the following information:

- A copy of the Will (or pertinent page[s] thereof)
- An estate Inventory, when available
- The name and address of appropriate family member(s) to whom we may extend our condolences and express our appreciation.

If you have any questions, please feel free to contact me at (800) 555-1212. I look forward to working with you and appreciate your efforts in the administration of this estate.

Sincerely,

Ms. Mary Jane Smith
Estate Administrator

April 2, 2004

Mr. John W. Smith
Law Offices of John W. Smith
P. O. Box 12345
Anytown, USA 12345-7090

RE: *Jane Doe Estate*

Dear Mr. Smith:

During a recent review of our trust and bequest files, a distribution that has been expected for some time from the estate of Mrs. Jane Doe has not been received. In addition, we have no record of receiving a response from you to our inquiry letter dated XXXX (copy enclosed).

The purpose of this letter is to request an update on the status of this estate's distribution schedule. Please provide us with any information for our files that would be useful to adjust our accountings to reflect an accurate date to anticipate receipt of the final distribution from this estate.

We appreciate your attention to this matter and look forward to hearing from you soon.

Sincerely,

Ms. Mary Jane Smith
Estate Administrator

Enc.

April 2, 2004

Mr. John W. Doe
123 Main Street
Anytown, USA 12345-7090

Dear Mr. Doe:

On behalf of Children's Medical Center Dallas please accept our deepest sympathy on the death of your mother, Mrs. Jane Doe. We appreciate her philanthropic support in our mission to make life better for children by including a bequest in her will.

Your mother's generous gift to Children's is helping to improve the lives of children. Not just one child, but all children in our community and beyond as we continue to impact patient care, research, education and advocacy issues that reach across the globe. We soothe and support our patients and their families through a variety of programs that touch the heart, soul and mind. Because illness and injury affect so much more than just the physical body, our innovative "whole child" approach to treatment is a vital component in restoring good health, giving kids that much more of a chance to grow into healthy, well-rounded adults.

We know that mere words cannot console you at a time of such great loss, but we hope you will find comfort in the knowledge that your mother's gift will enable us to continue to *make life better for children.*

Sincerely,

Ms. Mary Jane Smith
Estate Administrator

GLOSSARY OF TERMS

Abandoned Funds - Assets of a decedent that are unclaimed.
Accounting - The accounting lists all financial transactions of the executor or trustee from date of death to a final date near when distribution is to occur.
Affidavit – Written statement of fact voluntarily signed and sworn to before a person having authority to administer an oath.
Amendment - A change or addition to a trust.
Ancillary Administration – Process of putting through *probate* property owned by a deceased person in the state where it was owned, not in the state in which he or she lived.
Assets – Money and *real* and *personal property* owned by a person or organization.
Beneficiary – Person who is named to receive some benefit or money from a legal document such as a *trust*, life insurance policy or *will*. Can also be referred to as legatee.
Bequest – Gift provided through a will.
CRT - Charitable Remainder Trust (See also **Trust, Remainder/Residuary Interest)**
Codicil - An additional statement/change used in conjunction with a person's will.
Community property – Property acquired during marriage that was not a gift to or inheritance of one spouse or specifically kept separate.
Consent - Agreement to a procedure. Note: Silence (not signing or filing an objection) is construed in some states as consent.
Contingent interest - Gift is conditioned upon another event, which may or may not occur.
Credit estate tax – State tax on the assets of someone who has died. Applies only to estates that are required to pay federal estate taxes. Estates do not pay double taxes but instead, by paying a credit estate tax, "rebate" part of the federal estate tax owed back to the state.
Creditor – Person or corporation to whom money is due.
Decedent – Person who has died and left property to be administered.
Devise - Interchangeable term for bequest; gift made through a will.
Discharge - Release of duty or liability; entered by the court at the close of a legal process.
Disclaimer - Can disclaim the portion of the estate comprised of the unacceptable assets. This course of action requires filing with the court.
Distributee – Person who inherits; an *heir*.
Distribution - Payment (may be full or partial) of bequest/devise.
Domicile Rule - the domicile of the decedent is the place where (s)he lived at the time the will was executed (signed). This is the appropriate location for distribution of the bequest.
Donor – Person or corporation who gives a gift or confers a power to another.
Executor – Person or corporation appointed in a *will* or by a court to settle the estate of a deceased person. (Female version of executor is "executrix.")
Federal estate tax – Federal tax assessed against the assets of a person who has died if the value exceeded $1,500,000 in 2004-05. Filed on IRS form 706.
Final Distribution - The last portion of the payment to an organization or person, "in full."
501 (c)(3) - IRS form letter recognizing an organization's tax exemption status.
Guardian – Person or corporation appointed by a court to handle the affairs or property of another who is unable to do so because of incapacity or because he/she is under the age of majority.
Heir – Person or corporation designated to inherit property from someone who has died.
Homestead exemption – State law that allows the head of the family to keep certain property (i.e., a home) safe from *creditors*.
Intestate – Dying without a valid *will*.

Inventory – Detailed accounting of articles of property with their estimated value, required by the court to settle most estates.
Irrevocable Trust - A trust that cannot be revoked. Revocable trusts usually become irrevocable at death.
Issue – Offspring descended from a common ancestor (children, grandchildren, etc.)
Joint tenancy with the right of survivorship – Form of ownership in which property is equally shared by all owners, automatically transferred to the surviving owners at death.
Letters testamentary – Court documents obtained by the *personal representative* that confirms his or her authority to settle a deceased person's estate. Also known as Letters of Administration.
Life Estate - A benefit that passes to one for his or her lifetime.
Living Trust Agreement - Created by an individual during his/her life that sets for how assets are to be administered during his/her life and distributed at his/her death.
Newly Discovered Assets - Assets not known of at the time an estate was originally opened and in probate.
Notice – Information about certain facts. The *personal representative* is usually responsible for serving notice to all interested parties that the estate of the deceased is open for probate.
Notice of Administration - The first document filed by an attorney to begin probate of a decedent's will and/or any codicils.
Order – Written command or direction by a judge or court clerk; may outline a decision of the court, direct or forbid an action, or may be the final decision of the court.
Partial Distribution - a part or percentage of the full benefit to which the person or organization is entitled.
Perpetual trusts - Trusts which last forever or until the principal of the trust is too small to justify a trust.
Per Stirpes - refers to one's direct lineage of inheritance by law.
Personal property – Property other than land and fixtures.
Personal representative – Person named in a will or appointed by a court to settle an estate. See also *administrator* and *executor*.
Petition to Determine Homestead Status - asks the Court to determine how real estate should be transferred through an estate (whether it qualifies as Homestead property.)
Petition to Discharge - asks the Court to release the liability of the person administering the estate, that the person's duties have been fully performed.
Petition to Extend Time - asks the Court to grant additional time (beyond the statutory deadline) to file required documents.
Petition to Reopen Estate - asks the Court to reopen the probate administration of the estate after it has already been closed (usually when an asset has been newly discovered).
Pleadings - Documents prepared by an attorney (or a person acting as their own attorney) filed with the court. Includes caption which contains the court's name, case number and parties involved.
Principal - The originating value of the trust or a promissory note. "Interest" or income is what is earned based on the value of the principal.
Probate – Legal process of establishing the validity of a deceased person's last will and testament. A will goes through probate, a trust does not. In addition, assets that pass via a beneficiary designation (ira, insurance, etc) typically are not included in probate.
Real Property/Real Estate – Land, including building(s) on it and its natural assets.
Remainder Interest - Usually the interest that remains in an estate or trust, after it has continued for the benefit of another - sometimes for their lifetime.

Reserve Distribution - Usually a distribution that comes from a reserve fund maintained for IRS clearance, or income that was earned in the process of closing out a trust.
Resident Agent – Person living in a state who is authorized to accept legal documents on behalf of another.
Residuary Estate – That part of the estate remaining after all *bequests* have been made and claims satisfied.
Residuary Interest - A gift of the "residue" of decedent's will or trust is what's left after other gifts, if any (called Specific Gifts or "Special" Gifts), have been made.
Small Estate Administration – Simplified process for probating estates that are less than a specified dollar limit set by state law. Also known as Summary Administration.
Specific Bequests - A gift, which is not a residuary gift but is specifically described.
Statements - Accounting of assets on-hand, income, expenses and activities transacted.
Stock Power Form - Form used to transfer ownership of stock, usually requires "medallion signature".
Tenancy By Entirety – Form of spousal ownership in which property is equally shared and automatically transferred to the surviving spouse. While both spouses are living, ownership of the property can be altered only by divorce or mutual agreement.
Testamentary Trust - A trust created within a will.
Testate – Leaving a valid *will.*
Testator/testatrix - The person who wrote a testamentary document, or a will.
Trust – Legal document that transfers money or property for the benefit of another.
Trustee (co-trustees) - Person(s) or entity that is administering a trust for the benefit of another. The Trustee has a fiduciary duty to the beneficiaries of the trust.
Trustor(s) - Person(s) who create a trust. Also known as the Donor(s).
W-9 - IRS form used for tax-filing purposes.
Waiver - Agreement to forego future information, a process requirement, or right.
Waiving an Accounting - In estate or trust matters an attorney may request that you waive the filing requirement of an accounting. It is not recommended that an accounting be waived if the charity has a residuary interest.
Will – Legal document declaring how a person wishes to dispose of his or her property to *heirs* or *beneficiaries* after death. A will can be changed at any time.
Will contest – Challenge of a *will* by a person who believes the will is unfair, invalid, or that one or more of its provisions does not accurately reflect how the deceased person wanted his or her property distributed.
Witness – Person who is present at an event or at the signing of a document such as a will, real estate closing document, stock power form, beneficiary receipt, etc.

State Regulation of Charitable Gift Annuities

James B. Potter
President
Planned Giving Resources, Inc.
P.O. Box 665
Baker, LA 70704-0665
(225) 774-6700
FAX: (225) 775-6910
E-mail: JimBPotter@aol.com

Edith Matulka, J.D.
Vice President
Planned Giving Services, Inc.
1910 Fairview Avenue E., #102
Seattle, WA 98102-3620
(206) 329-8144
FAX: (206) 329-8230
E-mail: EMatulka@plannedgivingservices.com

INTRODUCTION

In 1939 the State of New York became the first state to regulate charitable gift annuities. In the intervening years, 44 other states have enacted legislation pertaining to the issuance of gift annuities. Frequently when discussing gift annuity registration requirements the states are divided into different categories — e.g., "regulated" or "permit" vs. "exempt " or "notification." However, in order to comply with state regulations, charities need to look beyond the categorizations and understand what the statutes actually require. (As an example, Florida - often referred to as an "exempt" state - actually has more burdensome regulation than North Dakota, a "regulated" state.)

Another important aspect in complying with state regulation is to remember the old adage that "the only thing constant is change." There are five states, plus the District of Columbia, that currently have no legislation specifically addressing issuance of gift annuities. While it is important to monitor such states for enactment of new legislation, being aware of revisions to existing gift annuity statutes or regulations is equally (and sometimes more) important. This paper will outline the key issues to understand about state regulation, as well as discuss changes that have already been adopted or are in the works and how those changes impact charities.

STATE REQUIREMENTS

When a charity has already registered in various states to issue gift annuities, or is trying to determine where, when or whether to register, it is extremely important that it understand what is involved in completing, and in some cases maintaining, the registration. While discussing the specific statutory and procedural requirements for each state would go well beyond the page limits for this paper, there are certain issues that warrant particular attention because of their impact/significance. (For a summary of requirements state by state, see Appendices 1 and 2.)

Segregated Reserve Fund

Fifteen states require a charity to establish an annuity reserve fund: Alabama, Arkansas, California, Florida, Hawaii, Maryland, Montana, New Hampshire, New Jersey, New York, North Dakota, Oregon, Pennsylvania, Washington, and Wisconsin. The fund is to be segregated, held separate and distinct from other assets of the organization, and its assets may not be used to pay any obligations other than annuity payments. The amount required to be held in the fund is generally calculated based on an actuarial methodology, utilizing mortality tables and interest rates that can vary from state to state. Some states require a surplus, most often an additional 10% of the calculated reserve. However, in New Jersey and Wisconsin the surplus is the <u>greater</u> of 10% or $100,000. (Thus, until a charity's calculated reserves exceed $1 million, the required surplus will be $100,000.) For a charity just launching a gift annuity program that includes either state, this in effect creates a minimum fund balance requirement of $100,000. Arkansas has a minimum as well, requiring that the fund hold at least $50,000.

Although a charity need not register in New York until its required reserves for annuities in all states exceed $500,000, a segregated reserve fund must be maintained as soon as a charity commences issuance of annuities in the state. Until the threshold is reached, the reserve requirement is 125% of the calculated reserve, although in most instances this is still not likely to require more to be placed in reserve than what was contributed for the annuity.

While segregating the assets tends to be a focal point of discussion for a charity undertaking the registrations, ensuring that the fund continues to hold sufficient assets should be the ongoing focus of a charity once it is registered. When investments do well for an extended period of time, it is easy to get lulled in to thinking that the fund value will always increase, and fail to monitor the reserve requirement during the year. Such inattention can lead to an unpleasant discovery of an under-reserved fund when completing the annual report – unfortunately after the reporting period has concluded. Charities should at least run a preliminary reserve calculation a few weeks before fiscal and calendar year ends, to allow time for additional assets to be shifted, if needed, to the reserve fund prior to year-end.

Restrictions on Investment of Reserve Fund

Arkansas, California, Florida, and Wisconsin all place specific limitations on how the segregated reserve fund is invested. In general, the investment limitations imposed are:

- government bonds allowed without limit;
- corporate bonds generally limited only as to percent in any one company, except in California where they are included in limit on publicly-traded securities;
- stock limited to 10 - 20 percent of required reserve assets, depending on the state;
- mutual funds have various limitations including unlimited except a 10-percent limit on any one fund (Florida), limited to 10 or 20 percent (Arkansas and Wisconsin, respectively), or allowance only by advance written consent (California);
- real estate is not permitted as a reserve investment in California, and is limited to 5 – 20 percent of reserve assets in other states.

As California requires a "California only" reserve fund, the restrictions apply only to reserves held for California residents. Three states (Arkansas, Florida, and Wisconsin) allow a charity the option of creating a state-specific fund; otherwise the investment restrictions apply to reserves held for all annuities.

Five other states — Maryland, New Hampshire, New Jersey, New York, and Washington — have statutes or regulations that specifically mention investment of reserve fund assets, with each requiring investment in accordance with a "prudent investor" standard.

Investment of the reserve assets tends to get a lot of attention at the time of registration. However, just as with the fund balance, the investments should be monitored throughout the year. Particular attention should be paid in those states that still impose specific restrictions, to ensure compliance at the end of the reporting period.

Annual Reporting

Certain states (Arkansas, California, Hawaii, Maryland, New Jersey, New York, Oregon, Washington, and Wisconsin) have a detailed annual reporting requirement, involving either use of a specific state form or a statement from a CPA (either in the audited financial statements or separate). Washington and Wisconsin specifically require an actuary to verify the reserve requirement as part of the annual filing.

A few other states involve minimal annual reporting: Alabama, Georgia, Oklahoma, and North Dakota require annual submission of audited financial statements, while Florida uses a sworn statement in lieu of a detailed annual reporting. (The agent registrations required by Alabama, of those that market gift annuities in the state or that are authorized to sign gift annuity agreements on behalf of a charity, must also be renewed annually.) Montana and New Hampshire both require annual re-notification of a charity's qualification under the applicable state gift annuity exemption law.

While most of the annual filings are based on a charity's fiscal year, New York, Washington, and Wisconsin all require filing on a calendar year basis, with the reports due by March 1 each year. Montana's annual re-notification is also due on March 1. In New Jersey a charity may elect to file based on its fiscal year; otherwise the report is due 120 days after calendar year end. Failure to timely file could result in the assessment of fines, and/or suspension or revocation of authorization to issue annuities in the state. Oregon has been fining charities for late filings since 2002, in the amount of $250; Washington began doing so in 2003, in the amount of $2,500. Although many states send annual notices regarding the filing requirement, a charity should have its own internal reminder as the lack of such notice would not excuse a failure to timely file.

Unrestricted assets

Twenty-two states require a charity to have a minimum amount of unrestricted assets, ranging from $100,000 to $2 million, at the time it enters into any annuity. These are general assets of the charity and do not need to be segregated from other assets or placed in the reserve fund. While the statutory language varies, the most common definition is "unrestricted cash, cash equivalents or publicly traded securities, exclusive of the assets funding the annuity." The unrestricted designation is to ensure that the assets are not limited to another purpose (such as an endowment, scholarships, building fund, etc.) that would be inconsistent with using the assets to make annuity payments if needed. A related issue is Hawaii's requirement that a charity have a net worth in the State of $5 million, a requirement that most mainland-based charities are unable (or unwilling) to meet.

While many of the states with a minimum asset requirement do not call for an annual filing, those states that do are likely to suspend a charity that falls below the minimum, until such time as it can prove it has sufficient assets. A charity would be wise to suspend its activity, on its own initiative, in any state in which it no longer meets the minimum asset requirement.

Years-in-operation

Many states require a charity issuing gift annuities to have been in operation for a certain period of time, ranging from 3 to 10 years. While in general it is a matter of the charity having been in existence for the requisite time, there is an in-state component to the years-in-operation requirement for Maryland and Oregon. Both states have different categories under which a charity registers to issue gift annuities. In Maryland a charity must provide proof of activity related to the applicable category, either religious or educational. Oregon has more categories, not all of which have a years-in-operation requirement. However, many charities must document activity in the state through proof of registration with another state agency for the requisite period of time, in order to obtain a permit to issue gift annuities in the state.

In general once this criterion has been met there is no need to monitor it, as it is not going to change. There is, however, a need to maintain activity in Maryland, and to keep current with any applicable state agency registrations in Oregon. In addition, the issue can arise anew if an organization creates a Foundation with the intent to include issuance of gift annuities among its activities. Some states do not allow a newly formed Foundation to "piggy back" on the years of operation of the main organization, requiring it instead to meet the 3 to 10 year operation requirement on its own. This can result in the Foundation issuing annuities in most states, while the main organization continues to issue in others in which the Foundation is not yet qualified.

Other State Filings

Certain states require registration with state agencies beyond the department of insurance in order to issue gift annuities. In addition to the initial registration, this can result in annual filings and/or fees.

Seven states (Florida, Maine, New Jersey, Oklahoma, Oregon, South Dakota, and Washington) require registration to do business in the state. Generally this filing is with the Secretary of State's office, with fees ranging from $25 to $300. Registration may also be required with the agency charged with monitoring charitable activity within the state, often the Attorney General's office, although in some instances a charity may be exempt from such filing. Included in the states requiring this charitable registration are New Jersey and Oregon, along with Kentucky, New Hampshire, and Pennsylvania. As with annual reporting pertaining to gift annuity registrations, it is important that a charity keep track of any annual reports, and corresponding due dates, for these registrations.

New Developments

The issues identified in the preceding section may impact a charity's decision on whether or not to issue annuities in a given state, and may continue to impact how a charity conducts its gift annuity activities. Thus, it is important to be aware of changes in statutory and procedural requirements, as well as in state enforcement actions.

Statutory

Enacted

New gift annuity legislation took effect in **Montana** on April 24, 2003. Charities issuing gift annuities in the state must have a minimum of $100,000 in unrestricted assets or $300,000 net worth, have been in continuous operation for at least 3 years, and maintain a separate annuity fund. Charities unable to meet all three requirements may still issue gift annuities in the state if they reinsure. Specific disclosure language must also be included in the annuity agreements. Notification to the state is required, which can be done concurrent with entering into the first annuity in the state. As noted earlier, annual notification is also required.

Impact: A charity that has already issued an annuity to a Montana resident should submit an initial notification as soon as possible. Under the statute, annuities issued prior to enactment of the law are "qualified" annuities. A charity that has not issued an annuity in the state may submit its notification in anticipation of doing so, or elect to hold off until such time as an annuity is issued. If the latter, some system should be in place that will serve as a reminder of the need to notify the state at that time.

- - - - -

The long anticipated change in **New Jersey** regarding investment of the annuity reserve fund, substituting the prudent investor standard for specific restrictions, finally occurred with the passage of Bill No. A2760, signed by the Governor on January 9, 2004. The legislation took effect immediately.

Impact: A charity registered to issue gift annuities in New Jersey must invest all of its annuity reserves, not just the reserves for New Jersey annuities, in accordance with the state's requirements. This is true regardless of whether a charity issues 99 percent of its annuities in New Jersey, or 99 percent in states other than New Jersey. For a charity not otherwise subject to restrictions, a decision to register in New Jersey required a significant shifting of reserve investments, and led to great frustration at the inability to invest in a manner that would protect the assets for purposes of making annuity payments while maximizing returns so as to increase the ultimate benefit to charity. For this reason, many charities opted not to issue in New Jersey.

With this change, there are now only four states with specific investment restrictions: Arkansas, California, Florida, and Wisconsin. Since California's restrictions apply to just the reserves for that state, only registration in the other three has the potential to impact investment of all reserves held by a charity. With Florida's investment restrictions having been eased in 2002, and with all three allowing a charity the option of creating a state-specific fund, a charity wishing to issue gift annuities in all states now has more flexibility in the manner in which it invests.

Pending

Prompted by the defaults of two **Arizona**-based nonprofits (Mid-America Foundation and Arizona Baptist Foundation), the state's Department of Insurance, Office of the Attorney General, and Corporation Commission - Securities Division drafted a bill to modify the current gift annuity law. Fortunately the charitable community was afforded an opportunity to comment, resulting in changes to the bill before it was introduced.

Under current law, issuance of charitable gift annuities is not insurance, and a charity need only include specific disclosure language in the annuity agreement. No filing with the Department of Insurance is required. As introduced, the new bill:

- requires a charity to have been in existence for at least 3 years, have $300,000 in unrestricted cash, cash equivalents, or publicly traded securities, and have audited financial statements for the two years prior to entering into a gift annuity agreement;
- requires a detailed disclosure statement, to be given to gift annuity donors at least 7 days before the contribution is made. The disclosure is to include a description of the organization (name and address, date and state of incorporation, and current operations, functions, and services), its total net assets for each of the last two fiscal years, a statement that additional financial information is available upon request, and a specific disclosure (expanded from the one currently required in the agreement);
- requires compliance with the Philanthropy Protection Act;
- creates a specific cause of action for the donor, allowing recovery of the contribution amount (less any payments received), plus costs and fees, with such action to be brought within two years of discovery of a charity's noncompliance with the law's requirements; and
- prohibits commissions.

Impact: Should the law be enacted as it now reads, the changes will likely have minimal impact on most charities. Many of the requirements are probably being met already, and there are no dramatic changes such as imposition of reserve restrictions or requiring application for a permit. The most immediate change will be the need to create a specific disclosure statement for use with Arizona donors, and the requirement that it be given at least seven days prior to the donor making the contribution. First, charities will have to determine exactly what information to put in the disclosure. While the bill lists certain requirements, some of them are rather open-ended, and the list itself is preceded with the phrase "including, but not limited to." Charities will also need to determine at what point to provide the disclosure, weighing between overwhelming a prospective donor at the preliminary stage and avoiding the need to return a check sent unexpectedly by a donor with whom there had been only minimal contact. And though in practice it may be a remote possibility, the two-year window of opportunity for a donor to seek return of the contribution because of a charity's failure to comply creates a sense of uncertainty.

- - - - -

Legislative activity is also underway in **Hawaii,** focused on reducing the requirement that a charity have a net worth in the state of $5 million in order to obtain a permit to issue gift annuities.

Impact: At the time this paper was submitted several versions of the legislation were being circulated, making an analysis premature.

- - - - -

In **New York**, legislation is being drafted that would amend the existing statute by removing the limitation on accepting only contributions of cash or marketable securities for gift annuities. While the desire to change the statute is prompted in particular by the inability accept real estate, it is likely that the new legislation would allow for contributions of "cash and other property," language used in most other states.

Impact: Although some charities as a matter of policy choose to accept only contributions of cash or securities, others accept real estate or other assets in certain circumstances. Since New York is the only state that limits the nature of the contributed assets, the change would restore the choice to charities.

<u>Proposed</u>

The **Arkansas** Insurance Department is considering a request by certain charities in the state for a waiver from the investment restrictions that apply to the segregated reserve fund. Whether or not the waiver request is granted, the Insurance Department is also expected to propose that legislation be introduced in the next regular legislative session (in 2005) substituting a prudent investor standard for the current restrictions.

In the meantime, the Insurance Department has clarified that a charity domiciled in a state that regulates investment of gift annuity reserves, including those that use a prudent investor standard, may invest in accordance with the laws of its state of domicile. A charity not domiciled in such a state, but subject to investment regulation by being registered in other states, may seek permission to continue investing in the manner required by such other states, by arguing that it would be appropriate to invest the Arkansas reserves with those of other states in a consistent manner.

Impact: If the waiver and/or legislative change were to happen, it would further expand the number of states in which a charity has substantially more flexibility in investment of gift annuity reserves. While for many charities Arkansas is not among the states with the highest concentration of potential donors, for national organizations that want to be able to offer annuities in all states it would be a significant change.

- - - - -

Efforts continue within the **California** charitable community to obtain a change in the investment restrictions imposed on the annuity reserve fund. An earlier proposal to switch to a prudent investor standard met with objections from the Department of Insurance regarding enforcement of such a subjective standard. Legislation currently pending would increase the reserve assets that can be invested in equities to 50 percent (from the current 10 percent).

Impact: Charities that have registered to issue gift annuities in the state have long felt that the current investment restrictions unnecessarily and unfairly limit their California donors' philanthropic goals, by reducing the value of the gift to charity. This perception, coupled with a high initial filing fee, and annual renewal fees, has led other charities to not offer gift annuities in California. Modifying the restrictions would provide greater flexibility in investing the reserve assets, with a hoped for result of increased returns and maximized benefits for charities upon termination of annuities.

Procedural

While New York has conducted audits of charities' gift annuity programs for years, striving to do so every five years, Washington State conducted its first audit in 2003. The California Department of Insurance, on the other hand, each year conducts a detailed review and analysis of the annual statement that is required. An on-site audit would likely be conducted only if the DOI felt the charity was not forthcoming on requests for additional information, or if a statement for a particular year points to a serious problem.

Impact: Charities need to be aware that such audits can be, and are being, conducted, and recognize that organizations may be required to produce records relating to particular annuities, policies and procedures, the segregated reserve fund, and other financial information. The expense of an on-site audit is borne by the charity, and California frequently invoices charities for review time pertaining to the annual statements.

Enforcement

For the last several years, the **Washington** Office of the Insurance Commissioner has fined charities that have issued gift annuities prior to receiving a permit. In the past such fines consistently included a penalty $100, plus $25 for each year since the charity entered into its first Washington annuity and $5 for each Washington annuity (both part of the annual filing for registered charities). However, in mid-2003 the OIC began asking more detailed questions about when and how a charity became aware of the registration requirement. In some cases, the assessed penalty has been $100 or $500 per existing Washington annuity, in addition to payment of the back annual fees. In addition, effective July 27, 2003 the law in Washington changed regarding unauthorized operation of an insurance business (how the OIC views not only unlicensed commercial insurers but charities issuing gift annuities without a permit), making it a class B felony rather than a misdemeanor. It appears quite likely that larger fines (applicable statutes provide for fines of up to $10,000 or $25,000) will be imposed in the future.

Oregon has also begun imposing fines for issuance of gift annuities without a permit, so far not exceeding $1,000. In both states, the charity must sign a stipulation and order that recites the facts surrounding the noncompliance and notes the penalty being assessed. These documents are public records, and placed on the respective insurance department's website.

Impact: Many charities have felt that it was acceptable to issue an annuity in a state without a permit, even if the statute required obtaining a permit before doing so. While only two states are imposing fines, the potential is there for other states to do so as well, and charities should be cautious. State insurance departments do not share the view that a charity is subject to regulation only if it is domiciled in or has a physical presence in the state. The defaults in Arizona came to the attention of all the insurance departments, and they want to avoid a similar situation in their states. While it is still not a common occurrence, insurance departments do become aware of charities' gift annuity activity, and they do issue cease and desist orders. If a charity is not registered, and would be unable to do so, it would be wise to cease activity in the particular state. Likewise, a charity would be unwise to continue issuing in Washington without a permit because of the law change. While it is more likely that civil penalties, rather than criminal charges, would be sought, it is not a comfortable position in which to put one's organization.

CONCLUSION

Among the 45 state statutes that govern issuance of charitable gift annuities, almost one-third have very similar requirements. Of the most regulated states, one-half have made, or are considering, statutory or procedural changes that will ease burdensome requirements. However, state regulation remains far from uniform, a situation that is unlikely to change dramatically in the near future. Therefore, charities must continue to be aware of the peculiarities of different states, and stay informed about changes as they occur, in order to remain compliant.

State Filing Required (Department of Insurance)

I. STATE LAW REQUIRES SEGREGATED RESERVE, ANNUAL REPORTING, AND/OR DETAILED APPLICATION (12):

State	Years in operation	Board resolution	Disclosure in agreement	Reserve required	Investment limitations	Other registrations	Notes:
AL	---	---	yes	yes	---	---	Regulated by Securities Department rather than Insurance
AR	5	yes	---	yes[1]	less strict[2]	---	[1] May elect to segregate AR annuitants; [2] waiver possible
CA	10	yes	---	yes[3]	strict[3]	---	[3]CA annuitants only
FL	5	---	yes	yes[4]	less strict[4]	yes[5]	[4] May elect to segregate FL annuitants; [5]registration w/ Sec. of State
HI	10 in HI	---	---	yes	---	---	Law requires $5 million of assets in Hawaii
MD	10 in MD	---	yes	yes	---[6]	---	[6] Prudent investor standard
ND	---	---	---	yes	---	---	
NJ	10	yes	---	yes	---[7]	yes[8]	[7] Prudent investor standard; [8]registration w/ Division of Revenue and Dept. of Law and Public Safety
NY	10	yes	---	yes	---[9]	---	[9] Prudent investor standard
OR	0-20[10]	---	yes	yes	---	yes	[10] Depends on the type of charity
WA	3	---	---	yes	---[11]	yes[12]	[11] Prudent investor standard; [12] registration w/ Secretary of State; Organization must have $500,000 unrestricted net assets
WI	10	---	---[13]	yes[14]	less strict[14]	---	[13] Newly registering charities may be asked to include disclosure; [14] may elect to segregate WI annuitants

II. STATE LAW PROVIDES FOR EXEMPTION - NOTIFICATION REQUIRED (16):

State	Years in operation	Board resolution	Disclosure in agreement	Reserve required	Available assets	Other registrations	Notes:
AK	3	---	yes	---	$300k	---	
CT	3	---	yes	---	$300k	---	
GA	3	---	yes	---	$300k	---	
ID	3	---	yes	---	$100k	---	
IA	3	---	yes	---	$300k	---	
MN	3	---	---	---	$300k	---	Regulated by Securities Department rather than Insurance
MS	3	---	yes	---	$300k	---	
MO	3	---	yes	---	$100k	---	
MT	3[15]	---	yes	yes[15]	$100k[15, 16]	---	[15] Waived if reinsured; [16] $100,000 in unrestricted assets or $300,000 net worth
NV	3	---	yes	---	$300k	---	
NH	3	---	yes	yes	$300k	---	Annuity rates must not exceed ACGA suggested rates
NM	3	---	yes	---	$300k[17]	---	[17] Either in unrestricted assets or reserve fund
NC	3	---	yes	---	$100k	---	
OK	3	---	yes	---	$100k	---	Annual submission of audited financial statement
TN	3	---	yes	---	$1 mil.[18]	---	[18] $300,000 for TN colleges or universities
TX	3	---	yes	---	$100k	---	

No State Filing Required (Department of Insurance)

III. STATE LAW PROVIDES FOR EXEMPTION - NO NOTIFICATION REQUIRED (17):

State	Years in operation	Board resolution	Disclosure in agreement	Reserve required	Available assets	Other registrations	Notes:
AZ	---	---	yes	---	---	---	
CO	3	---	yes	---	---	---	
IL	20[19]	---	---	---	$2 mil.[19]	---	[19] Waived if annuities reinsured
IN	---	---	---	---	---	---	
KS	---	---	---	---	---	---	May voluntarily seek a "no objection" letter from Securities Dept.
KY	---	---	---	---	---	yes[20]	[20] Certain charities must file copy of Form 990 with Attorney General
LA	---	---	---	---	---	---	
ME	5	---	---	---	---	yes[21]	[21] Registration w/ Secretary of State (qualified as foreign corporation)
MA	---	---	---	---	---	---	
MI	---	---	---	---	---	---	
NE	3	---	---	---	---	---	
PA	3	---	yes	yes	$100k	yes[22]	[22] Certain charities must register w/ Dept. of State (gen. solicitation law)
SC	5	---	---	---	---	---	
SD	10	---	yes	---	$500k	yes[23]	[23] Registration w/ Secretary of State (qualified as foreign corporation)
UT	---	---	---	---	---	---	
VA	3	---	yes	---	$100k	---	
VT	3	---	yes	---	$300k	---	

IV. STATE LAW DOES NOT SPECIFICALLY ADDRESS GIFT ANNUITIES (6):

DE[24] D.C. OH[25] RI WV WY

[24] Insurance Code definition of annuity excludes those issued by tax-exempt organizations.

[25] Ohio previously provided for an exemption from securities law under now rescinded administrative rule. Recent Court of Appeals case held gift annuities not subject to insurance regulation (Ohio Supreme Court declined to hear appeal).

Appendix 2

State Regulations of Charitable Gift Annuities

State	Contact State for Permit / Notice	Disclosure Wording	Effective Date of Law	State Contacts	
				Contact Name	Phone Number
AL	Notice	Yes	4/9/1997	Rena Davis	334-242-2984
AK	Notice	Yes	10/1/2001	Janice Stamper	907-269-7905
AR	Permit	No		John Shields	501-371-2766
AZ		Yes	4/9/1997		
CA	Permit	Yes		Carol Harmon	415-538-4420
CO	No	Yes	1995		
CT	Notice	Yes	1/1/2000	Nancy Monahan	860-297-3804
DE			[Silent State]		
DC			[Silent State]		
FL	Notice	Yes	5/15/1996	Terry Reynolds	850-413-2430
GA	Notice	Yes	7/1/2000	Kimberly Raper	404-657-9205
HI	Permit	No		Paul Yuen	808-586-2790
IA	Notice	Yes	7/1/2001	James Thornton	515-281-4271
ID	Notice	Yes		Carol Anderson	208-334-4309
IL	No	No	1995	[See web site]	
IN	No	No		[Blanket Exemption]	
KS	No	No		Steve Wassom	785-296-3307
KY	No	No		[Blanket Exemption]	
LA	No	No		[Blanket Exemption]	
MA	No	No		[Blanket Exemption]	
MD	Permit	Yes	9/30/1995	Howard Max	410-468-2205
ME	No	No		[Blanket Exemption]	
MI	No	No		[Blanket Exemption]	
MN	Notice	No	1996	Diane Walters	651-296-4973
MO	Notice	Yes	8/28/2001	Joe Haverstick	573-526-5235
MS	Notice	Yes	7/1/2001	Kathy French	888-236-6167
MT	Notice	Yes	4/24/2003	Richard Kain	406-444-4448

NC		Notice	Yes		11/1/1998	Carolyn Thomas	919-733-5060 Ext. 345
NE		No		No	1996	[Blanket Exemption]	
NV		Notice	Yes		10/1/1999	Guy Perkins	775-681-7660
NH		Notice	Yes		5/28/1999	Karen Jensen	603-271-3591
NJ	Permit			No		Adelaide Phelan	609-292-5427 Ext. 50328
NM		Notice	Yes			Diana Bonal	505-827-4561
NY	Permit		Yes		5/13/1999	John Lucchesi	212-480-4778
ND	Permit		Yes		1998	Leona Ziegler	701-328-3328
OH					[Silent State]		
OK		Notice	Yes		7/21/1998	Todd Hopper	405-521-3996
OR	Permit		Yes		11/14/1995	Donna Bleiler	503-947-7275
PA		No	Yes		12/16/1996		
RI					[Silent State]		
SC		No		No		[Blanket Exemption]	
SD			Yes		7/1/2001		
TN		Notice	Yes		6/12/2001	Phil Adams	615-741-1670
TX		Notice	Yes		9/1/1995	John Carter	512-305-7722
UT		No		No		[Blanket Exemption]	
VA		No	Yes		3/31/1996		
VT		No	Yes		7/1/2001		
WA	Permit		Yes			James Tompkins	360-407-0537
WV					[Silent State]		
WI	Permit					Steve Junior	608-267-4388
WY					[Silent State]		
Totals	10	18	29	15		[Full details at: http://www.pgresources.com/regs.html]	

Fundamentals of Charitable Remainder Trusts

Joseph O. Bull
Director of Planned Giving
The Ohio State University
Columbus, Ohio

What is a Trust ?

- Separate Legal Entity
  - Tax ID Number
  - Annual Tax Return
- Owns and Administers Property
- Governed by state law and trust instrument
- *Inter Vivos* vs. Testamentary

A Trust is Not a Trust Until...

1. Grantor
2. Delivers Trust Property
3. With Intent of Creating a Trust
4. To Trustee
5. Trustee Manages Property for Beneficiaries
6. Trust is Operated for Lawful Purpose

Charitable Remainder Trusts

- Charitable Trust
  vs.
  Charitable Remainder Trust
  vs.
  Qualified Charitable Remainder Trust
- 1969: the beginning of the modern era in Planned Giving

• A ***Trust*** is a separate legal entity. Examples of other legal entities include corporations and individuals.

• The purpose of a trust is to hold/own and administer property on behalf of someone.

• The person who creates the trust is known as the *grantor*. Occasionally, this person is referred to as the *settlor*.

• The person or corporate entity who administers the property within the trust is known as the *trustee*.

• The person or entity on whose behalf the trust is established and administered is known as the *beneficiary*.

• *Inter Vivos* trusts are created during the lifetime of the grantor. Testamentary trusts are created through the will of the grantor and do not take effect until the grantor's death.

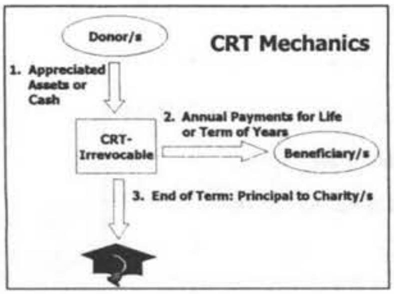
• Trusts are governed by state law. The trust's grantor may choose the state whose law governs a particular trust. This designation is made in the trust document. There is no requirement that either the grantor or the beneficiary be a resident of the state whose law governs the trust.

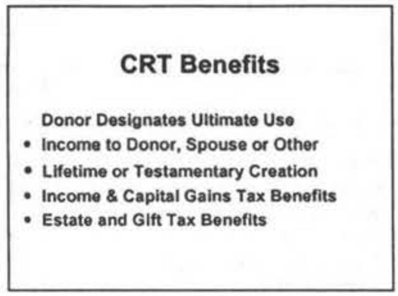
• There are six distinct requirements for a trust to exist. Those requirements are listed in the middle slide above. These basic requirements were derived from English common law and are consistent from state to state.

• The Tax Reform Act of 1969 created the charitable remainder trust as we know it today. If the many provisions of the Internal Revenue Code are followed precisely, the charitable remainder trust will qualify for several favorable tax treatments (those provisions will be discussed in detail on the pages that follow). Such a trust is sometimes known as a qualified charitable remainder trust.

• If one or more of the provisions are not followed, the trust will still be a charitable remainder trust. However, it will not qualify for the favorable tax treatments and will be treated for federal tax purposes as any other trust.

• Charitable organizations can also receive funds from trusts that are not structured as charitable remainder trusts. These are known as charitable trusts. Specifics of these trusts are beyond the scope of this paper and presentation.





- Internal Revenue Code (IRC) Section 664 and Section 1.664-1(a)(1) of the Internal Revenue Regulations set forth the required provisions for a charitable remainder trust.
- Six basic requirements must be met:
    1. Grantor/Donor creates an irrevocable trust and contributes property to it.
        - From a practical perspective, the property contributed is generally an appreciated capital gain asset, with cash being the second most used asset.
    2. The trust sets forth a specified payment, made at least annually, to one or more beneficiaries, at least one of which is not a charity.
        - Generally, the beneficiaries are from a group which includes the donor, donor's spouse and donor's children. Other potential income beneficiaries are grandchildren, nieces/nephews, friends and employees.
        - While a charity may be an income beneficiary, that is not commonly done.
        - The ability to name beneficiaries from such a diverse pool provides a powerful planning tool for the charitable gift planner and the donor.
    3. The annual income payment is a set percentage of either the initial value of the assets placed in the trust (annuity trust) or the annual value of the trust's assets (unitrust).
        - This percentage is set at the trust's inception and cannot be changed.
    4. The annual income payments are made for a period of time measured by the life of the beneficiary (lives of the beneficiaries) or for a term of no more than 20 years.
        - Sophisticated planning can include a provision such as "income to my wife for her lifetime and then to my children for twenty years."
    5. At the end of the trust, all property remaining must be distributed to one or more charitable organizations.
    6. At the inception of the trust, the anticipated charitable remainder, as calculated by the IRS formulas, must be at least 10% of the value of the assets contributed to the trust.
- If all 6 requirements are met, then the CRT is qualified. As such, it is a tax-exempt entity (general trusts are taxable), and the donor can claim certain tax benefits.
- A CRT is a split-interest trust, meaning that multiple parties have an interest in the trust.
- The charitable gift planner must remember that the primary purpose of the CRT is to make a charitable contribution and must be sure that a potential donor understands that fact. While the CRT is a powerful tool in a donor's financial and estate planning, at its core, it is a gift. This gift will be utilized according to the donor's wishes.

Charitable Remainder Annuity Trust

- Pays a "sum certain" at least annually
- $\geq$ 5% of trust's initial value... $\leq$ 50%
- $$ amount or %
- *NO* Additional Contributions

• IRC Section 664(d)(1) defines the CRAT.

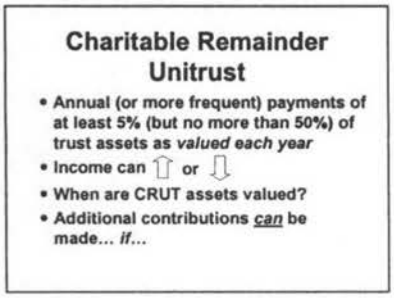
• The income payment is a fixed percentage (not less than 5% nor greater than 50%) of the initial fair market value of the assets contributed to the trust. That amount *never* changes.

•The trust document can define the income payment as a set dollar amount or as a percentage of initial assets. Most commonly, the percentage is used.

• Income payment obligation is limited to the trust assets. In other words, if the payments are excessively higher than the investment returns of the trust over a period of time, the CRAT has no obligation to continue payments after the trust's principal is exhausted.

• After the trust is established, no additional contributions may be made to it.

- Care must be taken when a donor wants to fund a CRAT with several different assets.
- For example, suppose a donor wishes to establish a CRAT and fund it with General Motors stock, some mutual fund shares and a small CD. It would be logistically difficult for all of those assets to arrive to the trustee on the same date. If the trust is established on Day 1 with the GM stock, the mutual fund shares and the CD cannot be added to the trust, even if the trustee obtains possession of them on Day 2. Day 2 would be considered an impermissible additional contribution.
- In that scenario, the trustee would be well advised to create an escrow account to hold the assets as they arrive. Once all the assets are in the escrow, the trustee can transfer them to the CRAT from the escrow account.



- IRC Section 664(d)(2)-(3) defines the CRUT.

- The income payment is a fixed percentage (not less than 5% nor greater than 50%) of the fair market value of the assets as valued each year.

- That fixed percentage *never* changes; however the amount of income is likely to change each year as the trust's assets increase or decrease in value. It is important to inform prospect donors of the fact that trust income can go down as well as up.

- Trust assets are valued on the first business day of each year (January 2, 3 or 4).

- Additional contributions may be made to a CRUT.
  - Each additional contribution must meet the income tax deduction requirements discussed above.
  - At the time of the additional contribution, the anticipated charitable remainder of the additional contribution, as calculated by the IRS formulas, must be at least 10% of the value of the additional assets contributed to the trust.

Does Baskin-Robbins Sell CRUT's ?

- Standard Unitrust
- Net Income Unitrust
- Net Income Unitrust with make-up
- Flip Unitrust

- IRC Section 664(d)(2)-(3), and the Regulations there under, define 4 CRUT varieties:

1. Standard Charitable Remainder Unitrust (Stan-CRUT)
   - Pays the stated percentage, no matter what
   - If trust principal must be invaded to make the payment, so be it.
   - Total Return investment philosophy works well with this type of CRUT.

2. Net-Income Charitable Remainder Unitrust (NICRUT)
   - Net Income = *lesser* of the stated percentage or actual trust income
   - Income is defined by state law and is generally interest and dividends.
   - Capital appreciation is generally not considered distributable income; however, the trust document can contain a provision which includes capital appreciation in its definition of income.

3. Net-Income with Make-up Charitable Remainder Unitrust (NIMCRUT)
   - Net Income = *lesser* of the stated percentage or actual trust income
   - Years where income paid by the trust is less than the stated percentage can be made up in years where income earned by the trust is greater than the stated percentage. This requires very sophisticated accounting by the trustee.
   - The investment environment over the past decade has made it very difficult for there to be any make-ups for past below-stated percentage payments.
   - Both NIMCRUTs and NICRUTS are excellent vehicles to which donors can contribute non-income-producing real estate or other difficult-to-value assets.
   - NIMCRUTs can be used as a "build-up" trust. Donors contribute annually to the NIMCRUT, and the trustee invests for low return and high growth. At some point in the future, generally retirement, the trustee switches investment philosophies to maximize returns. This higher return can then be distributed to the income beneficiaries.

4. "Flip" CRUT
   - In 1998, the Regulations were amended to permit a NICRUT or a NIMCRUT to convert into a Stan-CRUT.

"Flipping" Over a CRUT

- Harsh realities of the NIMCRUT in the "booming" 1990's
- One Flip and One Flip Only !
- SCRUT status begins taxable year following triggering event
- Triggering Event
- Real estate & Hard-to-value assets

- Example: Don funded an 8% NIMCRUT with real estate. The trustee of Don's CRUT sold the real estate in year 2 and invested the proceeds in a balanced stock/bond portfolio. The NIMCRUT limits Don's payments to the lesser of actual income or the stated 8%, and income is defined as interest and dividends. In today's market, the income of the trust is only around 3%, far below Don's expectation of 8%.
- The Flip-CRUT would have been a much better option for Don.
- The Flip-CRUT begins as either a NICRUT or a NIMCRUT and "flips" to a Stan-CRUT upon the occurrence of a "triggering event."
    - Only one flip is permitted during the existence of the trust.
    - It becomes a Stan-CRUT on January 1 of the year following the triggering event.
    - Any make-up remaining in a NIMCRUT is forfeited at the time of the flip.
    - The stated pay-out percentage does not change with the flip.
- The triggering event must be stated in the trust instrument and must be either:
    - A specific date or
    - A single event whose occurrence is not discretionary with, or under the control of, the trustee or any other person
- 7 examples of permissible triggering events are listed in Reg. Sec. 1.664-3(a)(1)(i)(e):
    1. Sale of donor's former personal residence
    2. Sale of securities when there is no securities exemption permitting a public sale
    3. When the income recipient reaches a certain age
    4. When the donor gets married
    5. When the donor divorces
    6. When the income recipient's first child is born
    7. When the income recipient's father dies
- 3 examples of impermissible triggering events:
    1. Sale of publicly traded stock
    2. A request by the income recipient
    3. A determination by the income recipient's financial advisor
- Most common Flip-CRUT scenario: donor has an "unmarketable asset" (generally a parcel of real estate or another hard to value asset). The triggering event is the sale of that unmarketable asset.

CRT: Income to Beneficiary

- **Four Tiers of Income**
  - Ordinary Income
  - Capital Gain Income
  - Tax-free Income
  - Return of Principal
- **Example**
  - 5% CRAT...$100k stock, $20k basis
  - Trustee sells stock...capital gain = ____
  - $3k interest & dividends...CRAT pays $____
  - How is Beneficiary taxed?

- Trust income is taxed to the recipient in a 4 tier system under IRC Sec. 664(b):
  1. Ordinary income, to the extent the trust has ordinary income, for the current year and any undistributed ordinary income from prior years. Current federal income tax rates top out at 35%.
  2. Capital gain, to the extent the trust has capital gain for the current year and any undistributed capital gain from prior years. Current federal tax rates can be as low as 15%.
  3. Other income (*e.g.* tax-free income) to the extent that the trust has other income for the current year and any undistributed other income from prior years
  4. Distribution from trust corpus (a.k.a. return of principal) which is also tax-free
- The 2001 and 2003 Tax Acts created different rates for different types of capital gain as well as creating a special 15% rate for qualified dividends earned from stock of domestic corporations. These rates must be taken into account in CRT trust accounting.
- From a trust management perspective, it is beneficial to invest CRT assets to produce as much 15% dividend income, tier 2 income and tier 3 income as possible.
- Answers to Example above:
  - Capital Gain: $100,000 - $20,000 = $80,000 gain
  - CRAT pays 5% of $100,000 = $5,000
  - $3,000 of interest and dividends is Tier 1 income.
  - $5,000 - $3,000 = $2,000 of Tier 2 income
  - $80,000 capital gain - $2,000 paid = $78,000 of gain to be recognized before any income from Tier 3 can be recognized
- Don't fall into this trap:
  - Donor has an asset identical to the one in the Example above
  - Donor asks the CRAT trustee to invest in tax-free municipal bonds so that he "can get some tax-free income from my CRAT."
  - Even though the bonds produce tax-free income, the 4 Tier System mandates that the income be recognized as Tier 2 income until the $80,000 gain is exhausted before any Tier 3 income can be recognized.

CRT: Income Tax Issues

- Tax-exemption of the CRT
  - CRT does not pay capital gains tax on sale of appreciated assets
  - CRT does not pay income tax
  - Excess income can be accumulated without tax
- No Capital Gains Tax to Donor
  - Donor does not pay on transfer of appreciated assets to CRT

CRT: Income Tax Issues

Charitable Income Tax Deduction
- Estimate of what Charity will receive
- ≥ 10% of trust's initial value
- 5% Probability Test for CRAT's
- Deduction Ceilings
  - Cash: 50% AGI
  - Appreciated LT Capital Gain Property
    - → 30% AGI
    - → No Capital Gains Tax

CRT: Income Tax Issues

- Factors in Determining the Charitable Income Tax Deduction
  - Type of CRT
  - % Payout
  - Frequency of Payments
  - Length of Trust Term
  - § 7520 Rate

- At the inception of the trust, the anticipated charitable remainder, as calculated by the IRS formulas, must be at least 10% of the value of the assets contributed to the trust. For example, a $100,000 CRT must generate a charitable deduction of $10,000 or more.
- The 5% Probability Test
  - Applies to CRAT's only, but not to CRAT's that exist for only a fixed term of years.
  - Articulated in Rev. Rul. 77-374.
  - CRAT must have less than a 5% chance of corpus exhaustion.
  - If the CRAT fails this test, no charitable deduction is allowed.
  - The major PG software packages automatically calculate this and warn you.
- Charitable Deduction Ceilings
  - The amount a donor can deduct on his/her Form 1040 depends on the type of asset contributed to the CRT.
  - If a donor reaches the deduction ceiling in the year of the gift, any unused deduction can be carried-forward and deducted within the next five years.
- 5 factors determine the amount of the charitable income tax deduction
  1. CRAT's and CRUT's produce different charitable deductions. Generally, a CRUT produces a higher deduction than a CRAT.
  2. The higher the trust payment rate, the lower the charitable deduction
  3. The more frequent the payments, the lower the charitable deduction. For example, quarterly payments produce a lower deduction than annual payments.
  4. The longer a trust lasts, the lower the charitable deduction. For example, a 20 year term of years CRT produces a lower deduction than a 15 year term of years. Likewise, a CRT payable over the life of a 65 year old produces a smaller deduction than a CRT payable over the life of a 75 year old, because the 65 year old is supposed to live longer according to actuarial tables.
  5. IRC § 7520 defines the interest rate to be used to determine the value of "any annuity, any interest for life or a term of years, or any remainder or reversionary interest…" Sometimes this rate is referred to as the Applicable Federal Rate. This rate is the annual rate of return that the IRS assumes the CRT assets will earn during the existence of the CRT. This rate changes monthly. The higher the 7520 rate, the higher the charitable deduction. The donor can select from the 7520 rate from the month of the gift or either of the previous two months in calculation his/her charitable deduction.

CRAT vs. CRUT Deductions

Age	CRT %	CRT Type	*Pmt. Freq.*	AFMR §7520	Charitable Deduction
72	5%	CRAT	Qtrly	4.2%	$53,993
72	5%	CRUT	Qtrly	4.2%	$56,527
		CRAT	Annual		$54,700
		CRUT	Annual		$56,982

CRAT vs. CRUT Deductions

Age	CRT %	CRT Type	Pmt. Freq.	AFMR §7520	Charitable Deduction
72	5%	CRAT	Qtrly	4.2%	$53,993
72	5%	CRUT	Qtrly	4.2%	$56,527
80		CRAT			$66,850
80		CRUT			$68,179

72 = 14 years life expectancy ... 80 = 9 years

CRAT vs. CRUT Deductions

Age	CRT %	CRT Type	Pmt. Freq.	*AFMR §7520*	Charitable Deduction
72	5%	CRAT	Qtrly	4.2%	$53,993
72	5%	CRUT	Qtrly	4.2%	$56,527
		CRAT		6.0%	$59,137
		CRUT		6.0%	$56,840

CRAT vs. CRUT Deductions

Age	CRT %	CRT Type	Pmt. Freq.	AFMR §7520	Charitable Deduction
72	5%	CRAT	Qtrly	4.2%	$53,993
72	5%	CRUT	Qtrly	4.2%	$56,527
72/72		CRAT			$41,487
72/72		CRUT			$45,190

72/72 = 18 years life expectancy...72 = 14 years

CRAT vs. CRUT Deductions

Age	*CRT %*	CRT Type	Pmt. Freq.	AFMR §7520	Charitable Deduction
72	5%	CRAT	Qtrly	4.2%	$53,993
72	5%	CRUT	Qtrly	4.2%	$56,527
	8%	CRAT			$30,464*
	8%	CRUT			$42,059

* Fails 5% Probability Test...6.6% AFMR to pass

CRT: Estate & Gift Tax Issues

- Estate Tax Deductions - *Inter Vivos* CRT's
  - Donor as Sole Income Beneficiary
  - Donor & Spouse as Income Beneficiaries
  - Donor as 1st Beneficiary Followed by Non-Spouse Beneficiaries
- Estate Tax Deduction - Testamentary CRT's
  - Surviving Spouse as Sole Beneficiary
  - Non-Spousal Income Beneficiaries
- Gift Tax Implications - *Inter Vivos* CRT's
  - Donor and/or Spouse as Income Beneficiary
  - Non-Spousal Income Beneficiary

Inter Vivos CRT's:

1. Gift Tax Implications
   - As one of the beneficiaries will always be a charity/charities in a CRT, the value of the charitable remainder portion qualifies for the unlimited charitable gift tax deduction. In other words, no gift tax will be due on the charitable portion.
   - When the grantor is not an income beneficiary, the grantor is deemed to have made a gift equal to the value of the income interest to the named beneficiary/beneficiaries.
   - This is a present interest and is subject to the annual gift tax exclusion. To the extent that the value of the income interest exceeds the annual exclusion, it is subject to the Federal Gift Tax.
   - If the donor names himself and his spouse as income beneficiaries, the spouse's interest qualifies for the unlimited marital gift tax deduction.
   - If the donor names herself and someone other than her spouse as income beneficiaries, the donor can avoid the gift tax on the non-spousal interest by retaining the right, exercisable by her will, to revoke the non-spouse's interest.
2. Estate Tax Implications
   - If the donor was the sole income recipient, the value of the CRT assets is included in the donor's estate, but the transfer of the CRT assets to charity qualifies for the unlimited estate tax charitable deduction, resulting in no tax due.
   - If the donor's spouse is the sole succeeding recipient of the CRT income, the spouse's interest qualifies for the unlimited estate tax marital deduction and the charity's interest qualifies for the charitable deduction, resulting in no tax due.
   - If the donor's spouse and another person are succeeding income recipients, the marital deduction does not apply. Therefore, the charitable portion is not taxed, but the non-charitable portion is subject to the federal estate tax.
   - If someone other than the donor's spouse is the succeeding income recipient, and the donor retained the power to revoke that income interest (to avoid the gift tax), the non-charitable interest is included in the donor's taxable estate. If the donor did not retain the right to revoke (thereby making it subject to the gift tax), the non-charitable interest is not included in the donor's taxable estate.

CRT: Estate & Gift Tax Issues

- Estate Tax Deductions - *Inter Vivos* CRT's
  - Donor as Sole Income Beneficiary
  - Donor & Spouse as Income Beneficiaries
  - Donor as 1st Beneficiary Followed by Non-Spouse Beneficiaries
- Estate Tax Deduction - Testamentary CRT's
  - Surviving Spouse as Sole Beneficiary
  - Non-Spousal Income Beneficiaries
- Gift Tax Implications - *Inter Vivos* CRT's
  - Donor and/or Spouse as Income Beneficiary
  - Non-Spousal Income Beneficiary

Testamentary CRT's:

1. There are no Gift Tax implications as the gift tax applies only to lifetime gifts.

2. Estate Tax Implications
   - If the donor's spouse is the sole recipient of the CRT income, the spouse's interest qualifies for the unlimited estate tax marital deduction and the charity's interest qualifies for the charitable deduction, resulting in no tax due.
   - If the donor's spouse and another person are succeeding income recipients, the marital deduction does not apply. Therefore, the charitable portion is not taxed, but the non-charitable portion is subject to the federal estate tax.
   - If someone other than the donor's spouse is the succeeding income recipient, the non-charitable interest is included in the donor's taxable estate.

Philanthropy Protection Act of 1995

- Background
- PG is about more than tax law
- PPA exempts charitable common funds from federal securities law
- Requires "disclosure" to donors

• In the early 1990's, a class action lawsuit was brought against any charitable organization who issued charitable gift annuities using the ACGA's recommended rates. The cause of action alleged violation of the Sherman Anti-trust Act and the federal securities laws.

•The gift annuity/ACGA issues are beyond the scope of this presentation. However, the securities issues apply to any discussion of CRT's.

•The Philanthropy Protection Act of 1995, as well as the Charitable Gift Annuity Antitrust Relief Act of 1995, were the result of the charitable community coming together in response to the class action lawsuit. Terry Simmons, a partner of the Dallas law firm Thompson & Knight as well as a past president of the National Committee on Planned Giving and a current ACGA board member, lead the charge in marshalling these two pieces of legislation through Congress.

•The purpose of the PPA is to protect both charities and donors. It exempts charitable common funds from the full requirements of the Investment Company Act of 1940. It protects donors by requiring that charities provide "to each donor to such fund, at the time of the donation...written information describing the material terms of the operation of such funds."

•If the charity serves as trustee of a CRT, and the charity commingles its CRT assets, it must provide the written disclosure.

•"Material terms" is not defined in the legislation.

- It is clear that mutual-fund style disclosure is not necessary.
- A good rule of thumb is to not have so much information that a 75 year old widow would be confused.
- The Goldilocks Principal applies here: not too little, not too much, but just the right amount of information
- Examples of disclosure statements are available from various PG vendors.

Operation of the CRT

- Trustee Selection
- Trust Management
- Trust Administration
- Communication with the Charity

Trustee Selection

- Who *can* be the trustee?
  - Bank or Trust Company
  - Donor as Self-Trustee
  - The Charitable Organization
- Who *should* be the trustee?
  - Type of property funding the trust
  - Existing relationships
  - Fees
- Provision for Successor Trustee

• Any time real estate or closely-held stock funds a CRT, the donor should **never** be sole trustee. It is very easy to run afoul of the self-dealing provisions of the Code and Regs.

• Self-dealing can disqualify the tax-exempt status of the CRT for the year of the self-dealing. Should that be the year of the gift, the income tax charitable deduction would not exist, and the donor would be required to recognize all the capital gain on the property donated to the trust.

•Charities should exercise great caution before embarking on a program of serving as trustee of CRT's. The accounting and investment infrastructure must be in place for success in this endeavor.

Trust Management

- Investment of trust assets
  - When to sell the initial asset?
  - What is a prudent investment strategy?
- Split-interest trust means the trustee has a split-fiduciary duty
- Can a 5% trust actually be better for the donor than a 9% trust?
- The Net-Income with Make-up Unitrust Trap

Trust Administration

- Will the payments be made on time?
- Filing appropriate forms with the IRS and the income beneficiary
- Four-tiers of income must be reported to the income beneficiary

• Yield and Total Return are critical concepts to the effective management of a charitable remainder trust.

• Yield is the amount of cash generated by investments, while total return adds the amount of asset appreciation to the yield figure.

• The trustee has a duty to both the income beneficiary and the charitable beneficiary. Any investment strategy favoring one over the other is a breach of that duty.

• Many states have adopted the Uniform Prudent Investor standards as well as the Uniform Management of Institutional Funds Act. These statutes have great impact on the management of the trust.

•Trust administration is where a charity can provide excellent or slip-shod customer service.

- Be sure that income checks are mailed on time to the correct address
- The income payments provide wonderful stewardship opportunities
- Be sure to mail IRS forms on time

CRAT's Appeal To Donors Who:

- Prefer fixed payments
- Have appreciated, low yielding assets
- Can donate $100,000 (or more)
- Wish to retain tax-exempt income
- Are concerned about asset management

CRAT's Appeal To Donors Who:

- How To Fund:
  - Appreciated, liquid property
  - Bonds...Tax-exempt bonds
  - Cash
- Do not use:
  - Real estate
  - Mortgaged property
  - Hard to sell property

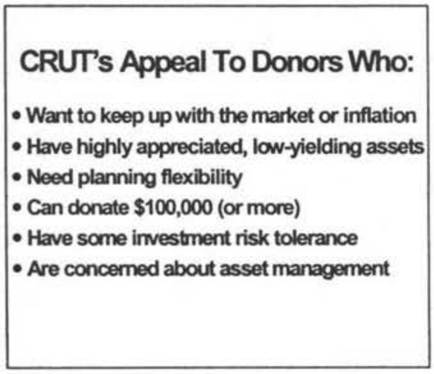
• The $100,000 limit is a practical one. Most trust companies will not manage a trust of less than that amount.

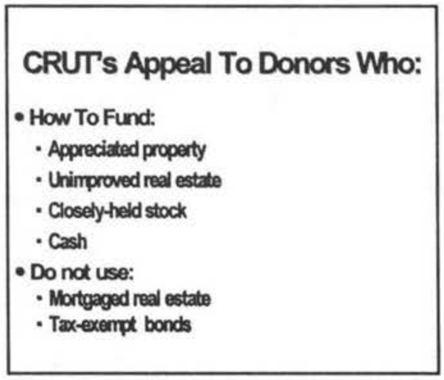
• If a donor contributes tax-free bonds to a CRAT, and the trustee retains those bonds, the 4 Tier System allows that income to be taxed in Tier 3 as tax-free to the income recipient. This is because there is not Tier 1 or Tier 2 income in the CRAT.

• By donating appreciated property, the donor has an extra tax benefit, the avoidance of capital gains tax on the transfer of the asset.

• Because a CRAT must make payments, real estate is a risky asset to use to fund a CRAT. If real estate remains unsold in the CRAT at the time an income payment is due, the trustee will be obligated to transfer an undivided partial interest in the real estate to the income beneficiary in order to meet the payment requirement.

• Mortgaged property disqualifies the CRT as a tax-exempt trust.





• As CRUT payments are based on the annual value of the CRUT, the income recipient receives more as the assets of the trust grow. This allows the income to grow with a rising market or with inflationary pressures.

•The converse is also true: if the CRUT assets decrease in value, the income recipient receives less income. This is an important point to inform donors of.

• CRUT's can be invested slightly more aggressively than can CRAT's due to the annual revaluation.

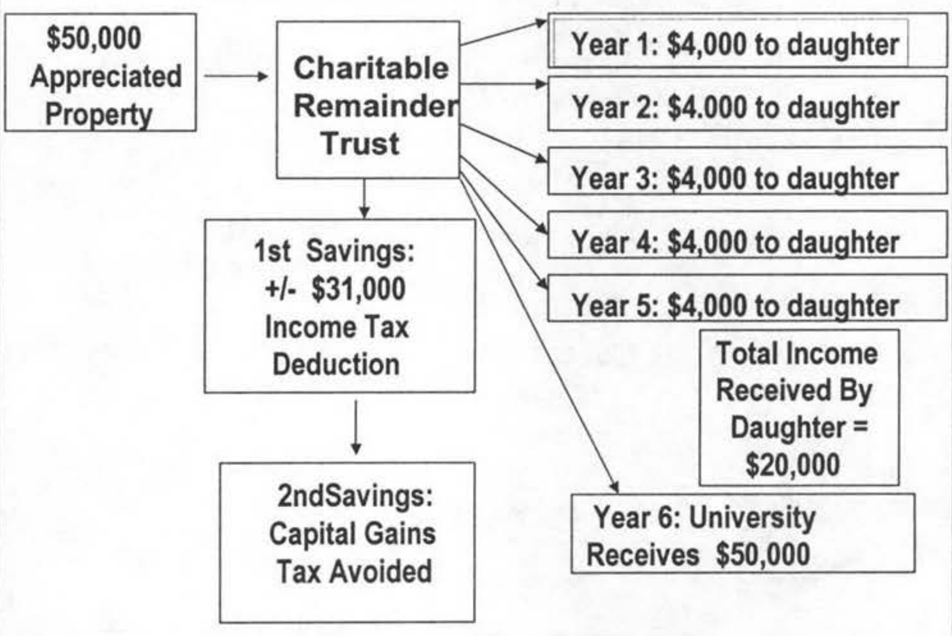
• NICRUT's, NIMCRUT's and Flip-CRUT's are all excellent vehicles for gifts of real estate, closely held stock and other hard to value assets.

• As with the CRAT, mortgaged property within a CRUT disqualifies it as a tax-exempt trust.

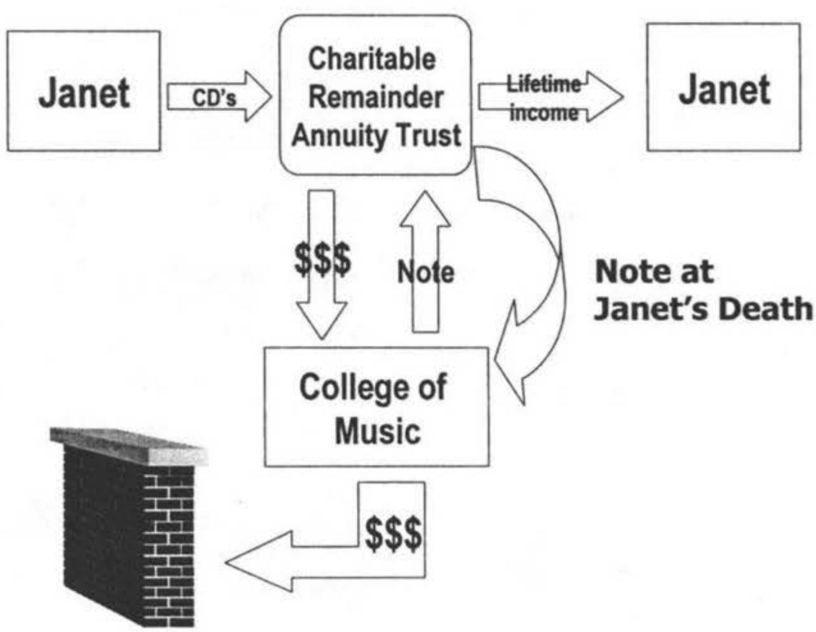
• Tax-exempt bonds are not a good asset for a CRUT, if the strategy is to hold onto the bonds. The bonds pay a fixed amount. Should the bonds increase in value on the open market, the income does not change. In that case, bonds would have to be sold in order to meet the income requirement of the CRUT.

"I have children in college right now."

COLLEGE EXPENSE TRUST



The Impatient Dean



Retirement Plan
Frequently Asked Questions

- **Can I give my IRA to charity now?**
  - **Yes, but...**
  - **Heavy taxes to be paid**
- **Can I put my IRA into a CRT?**
  - **Currently: same as above**
  - **At your death: YES**
- **CARE Act**

A. Can I transfer my IRA to a CRT now?

1. Yes....BUT...
2. This transfer is deemed to be a withdrawl of entire IRA balance
3. Income tax is due on entire amount of IRA
4. The charitable deduction will offset some of that tax

B. There is a proposal in Congress to allow the transfer of an IRA to a charity or to a CRT.

1. Such a transfer would not trigger the income tax.
2. CARE Act in the Senate...HR 7 in the House of Representatives.
3. Have your government relations folks work on this issue!

C. Naming a CRT as beneficiary of an IRA

1. Spouse, child, etc. will receive income from the CRT
2. Excellent to protect children from a prior marriage or to provide income to a needy sibling and one's children

"NO, I REALLY DIDN'T GET ANYTHING BACK, I PROMISE!"

Substantiating Charitable Gifts

26th Conference on Gift Annuities

Presented by the
American Council on Gift Annuities

May 5-7, 2004
Wyndham Palace Resort & Spa
Orlando, Florida

Emanuel J. Kallina, II, Esq.
Michael P. Panebianco, Esq.

Kallina & Associates, LLC Φ 6507 York Road Φ Baltimore, Maryland 21212
410-377-2170 Φ 410-377-2179 (fax) Φ ejk@kallinalaw.com Φ www.kallinalaw.com

1. **Introduction**

1.1. A donor to charity must substantiate his or her charitable contribution in order to be entitled to a tax charitable deduction. However, the rules governing "substantiation" are minefield: there are unbelievably detailed, complex, and in many cases unforgiving. A small mistake in this area can totally frustrate the donor's intended deduction.

1.2. The purpose of this outline is to navigate the reader through the minefield to ensure that the donor's charitable deduction is not denied by the IRS. Throughout this outline, the donor is assumed to be an individual. If the donor is a partnership, C corporation, S corporation, or other entity, please check the Code and Regulations to ensure that there rules are the same, as there are some differences.

1.3. Finally, whenever possible, the Code and Regulations have been paraphrased to make this outline significantly easier to read and understand, but please refer to the original source to confirm our citation.

2. **Gifts of MONEY of Less than $250**

2.1. The donor must maintain the following records in order to prove the charitable deduction claimed:

2.1.1. a cancelled check,

2.1.2. a receipt, i.e. letter or other communication, from the charitable donee showing the name of the donee, the date of the contribution, and the amount of the contribution, or

2.1.3. in the absence of a cancelled check or receipt from the charitable donee, other reliable written records showing the name of the donee, the date of the contribution, and the amount of the contribution.

2.2. Note: The reliability of the written records is determined on the basis of all of the facts and circumstances of a particular case. The burden is on the taxpayer to establish reliability. See 1.170A-13(a)(2)(i) for factors that evidence the reliability of the records.

3. **Gifts of PROPERTY with Claimed Deduction of Less than $250**

3.1. The donor must maintain for each contribution a "receipt" from the charitable donee showing the following information:

3.1.1. the name of the donee,

3.1.2. the date and location of the contribution, and

3.1.3. A description of the property in detail reasonably sufficient under the circumstances. Although the fair market value of the property is one of the circumstances to be taken into account in determining the amount of detail to be included on the receipt, such value need not be stated on the receipt.

3.2. A "receipt" is a letter or other written communication from the donee acknowledging receipt of the contribution, showing the date of the contribution, and containing the required description of the property contributed. A receipt is not required if the contribution is made in circumstances where it is impractical to obtain a receipt (e.g., by depositing property at a charity's unattended drop site). In such cases, however, the taxpayer shall maintain "reliable written records" with respect to each item of donated property that include the information required by Reg. Sec. 1.170A-13(b)(2)(ii). Note: the donor has the burden of proving the reliability of the records.

3.2.1. The rules described in Section 2.2. above apply in determining whether the taxpayer has maintained "reliable written records."

3.2.2. In addition, such "reliable written records" shall include the following information:

3.2.2.1. the name and address of the donee charity.

3.2.2.2. the date and location of the contribution.

3.2.2.3. A description of the property in detail reasonable under the circumstances (including the value of the property), and, in the case of securities, the name of the issuer, the type of security, and whether or not such security is regularly traded on a stock exchange or in an over-the-counter market.

3.2.2.4. The fair market value of the property at the time the contribution was made, the method utilized in determining the fair market value, and, if the valuation was determined by appraisal, a copy of the signed report of the appraiser.

3.2.2.5. In the case of property to which Code Section 170(e) applies, the cost or other basis, adjusted as provided by Section 1016, the reduction by reason of Code Section 170(e)(1) in the amount of the charitable contribution otherwise taken into account, and the manner in which such reduction was determined. A taxpayer who elects under Reg. Sec. 1.170A-8(d)(2) to apply Code Section 170(e)(1) to contributions and carryovers of 30 percent capital gain property shall maintain a written record indicating the years for which the election was made and showing the contributions in the current year and carryovers from preceding years to which it applies. For the definition of the term "30-percent capital gain property," see Reg. Sec. 1.170A-8(d)(3).

3.2.2.6. If less than the entire interest in the property is contributed during the taxable year, the total amount claimed as a deduction for the taxable year due to the contribution of the property, and the amount claimed as a deduction in any prior year or years for contributions of other interests in such property, the name and address of each organization to which any such contribution was made, the place where any such property which is tangible property is located or kept, and the name of any person, other than the organization to which the property giving rise to the deduction was contributed, having actual possession of the property.

3.2.2.7. The terms of any agreement or understanding entered into by or on behalf of the taxpayer which relates to the use, sale, or other disposition of the property contributed, including for example, the terms of any agreement or understanding which:

3.2.2.7.1. Restricts temporarily or permanently the donee's right to use or dispose of the donated property, 3.2.2.7.2. Reserves to, or confers upon, anyone (other than the donee organization or an organization participating with the donee organization in cooperative fundraising) any right to the income from the donated property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire, or

3.2.2.7.3. Earmarks donated property for a particular use.

4. <u>Gifts of MONEY or PROPERTY of $250 or More</u>

4.1. In addition to the rules described in Section 2 and 3 above, whichever is applicable, the donor must obtain a "contemporaneous written acknowledgement" (often called a "substantiation letter") from the donee charity in order to be entitled to a charitable deduction. (Code Section 170(f)(8) and Reg. Sec. 1.170A-13(f)).

4.1.1. A "contemporaneous written acknowledgement" must contain the following:

4.1.1.1. The amount of cash and a description (but not value) of any property other than cash contributed;

4.1.1.2. A statement as to whether the donee charity provided any goods or services in consideration, in whole or in part, for any cash or property received from the donor; and

4.1.1.3. A description and good faith estimate of the value of any goods or services provided by the donee charity to the donor, if any, or if such goods or services consist solely of intangible religious benefits, a statement to that effect.

4.1.1.4. A statement that the donee charity provided intangible religious benefits to the donor, if such benefits were provided. However, a description or value of these benefits does not need to be included.

4.1.2. "Goods or services" are defined as cash, property, services, benefits, and privileges.

4.1.3. The "contemporaneous written acknowledgement" is considered to be contemporaneous if the donor obtains the acknowledgment on or before the earlier of (i) the date on which the donor files a return for the taxable year in which the contribution was made, or (ii) the due date (including extensions) for filing such return. ***In other words, the receipt must be "in hand" before filing the tax return.***

4.1.4. Intangible Religious Benefits Exception. An "intangible religious benefit" means any intangible religious benefit which is provided by an organization organized exclusively for religious purposes and which generally is not sold in a commercial transaction outside the donative context.

4.1.5. Token or Insubstantial Benefit Exception. Insubstantial goods or services provided by the charitable donee to the donor do not have to be described in the contemporaneous written acknowledgement. Goods or services that have insubstantial value under the guidelines are provided in Rev. Proc. 90-12 and annually thereafter. *What does this mean?* IRS Publication 1771 explains it as follows: the goods or services are considered insubstantial if the payment occurs in the context of a fund-raising campaign in which the charitable organization informs the donor of the amount of the contribution that is a deductible contribution, and (i) the fair market value of the benefits received by the donor does not exceed the lesser of 2 percent of the payment or $76 ($82 for 2004), or (ii) the payment is at least $38 ($41 for 2004), the only items provided to the donor bear the organization's name or logo (e.g., calendars, mugs, or posters), and the cost of these items is within the limits for "low-cost articles," which is $7.60 ($8.20 for 2004). Note: The dollar amounts are for 2001 and are adjusted for inflation for the year 2004 by Rev. Proc. 2003-85. You may also contact IRS Exempt Organizations Customer Account Services at 877-829-5500 for annual inflation adjustment information.

4.1.6. Membership Benefits Exception. Annual membership benefits offered to a taxpayer in exchange for a payment of $75 or less per year that consist of any annual recurring rights or privileges that the taxpayer can exercise frequently during the membership period, such as: (i) free or discounted admission to the organization's facilities or events, (ii) free or discounted parking, (iii) preferred access to goods or services, (iv) discounts on the purchase of goods or services; and (v) admission to member-only events sponsored by donee organization, where the cost per person (not including overhead) is within the limits established for "low cost articles" under Code Section 513(h)(2).

4.1.7. Note: If the donor makes more than one charitable contribution of $250 or more to the same charitable donee during the same taxable year, the donor may substantiate the contributions with one or more contemporaneous written acknowledgement from the charitable donee.

5. **Additional Requirements for Gifts of PROPERTY with Claimed Deduction of More than $500 and Not More than $5,000**

5.1.1. In addition to obtaining a contemporaneous written acknowledgment from the donee charity, the donor must maintain the following written records that include the following information with respect to such item of donated property, and must complete Part 1 of Form 8283 (a copy of which is attached to the back of this outline):

5.1.1.1. The manner of acquisition, e.g. by purchase, gift, bequest, inheritance, or exchange, and the approximate date of acquisition of the property by the taxpayer or, if the property was created, produced, or manufactured by or for the taxpayer, the approximate date the property was substantially completed.

5.1.1.2. The cost or other basis, adjusted as provided by Section 1016, of property, other than publicly traded securities, held by the taxpayer for a period of less than 12 months immediately preceding the date on which the contribution was made and, when the information is available, of property, other than publicly traded securities, held for a period of 12 months or more preceding the date on which the contribution was made.

5.1.2. Note: If the donor is not able to provide information on either the acquisition date of the property or the cost basis, and the donor has reasonable cause for not being able to provide such information, the donor shall attach an explanatory statement to Form 8283. If the donor has reasonable cause for not being able to provide such information, the donor will not be disallowed a charitable contribution deduction under Code Section 170.

6. **Additional Requirements for Gifts of PROPERTY with Claimed Deduction of More than $5,000.**

6.1. Generally, a donor who claims or reports a deduction of more than $5,000 must comply with the following three requirements:

6.1.1. Obtain a "qualified appraisal" (defined below) for such property contributed. If the contributed property is a partial interest, the appraisal shall be of the partial interest.

6.1.2. Attach a fully completed "appraisal summary" (defined below) to the tax return (or, in the case of a donor that is a partnership or S corporation, the information return) on which the deduction for the contribution is first claimed (or reported) by the donor.

6.1.3. Maintain records containing the information required by Section 3.2.2. of this outline.

6.2. There is an exception to this requirement as set forth below relating to Publicly Traded Securities.

7. **Publicly Traded Securities**

7.1. In general. A security is (i) a share of stock in a corporation; (ii) a right to subscribe for, or to receive, a share of stock in a corporation; or (iii) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. Publicly traded securities, in general, are securities for which (as of the date of the contribution) market quotations are readily available on an established securities market. However, to determine which substantiation rules apply the following distinctions must be made:

7.2. Publicly Traded Securities defined in Reg. Sec. 1.170A-13(c)(7)(xi)(A).

7.2.1. Market quotations are considered readily available on an established securities market with respect to this type of security if:

7.2.1.1. The security is listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations are published on a daily basis, including foreign securities listed on a recognized foreign, national, or regional exchange in which quotations are published on a daily basis;

7.2.1.2. The security is regularly traded in the national or regional over-the-counter market, for which published quotations are available; or

7.2.1.3. The security is a share of an open-end investment company (commonly known as a mutual fund) registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 to 80b-2), for which quotations are published on a daily basis in a newspaper of general circulation throughout the United States.

7.2.2. Substantiation Rules.

7.2.2.1. If the fair market value of the gift is less than $250, the donor must comply with the rules outlined in Section 3 above.

7.2.2.2. If the fair market value of the gift is between $250-$499, the donor must comply with the rules outlined in Section 4 above.

7.2.2.3. If the fair market value of the gift is $500 or more, the donor must comply with the rules outlined in Section 5 above.

7.3. Publicly Traded Securities defined in Reg. Sec. 1.170A-13(c)(7)(xi)(B).

7.3.1. Market quotations are considered readily available on an established securities market with respect to this type of security if all of the following five requirements are met:

7.3.1.1. The issue is regularly traded during the computational period in a market that is reflected by the existence of an interdealer quotation system for the issue,

7.3.1.1.1. The term "computational period" means weekly during October through December (beginning with the first Monday in October and ending with the first Sunday following the last Monday in December) and monthly during January through September (beginning January 1).

7.3.1.1.2. The term "interdealer quotation system" means any system of general circulation to brokers and dealers that regularly disseminates quotations of obligations by two or more identified brokers or dealers, who are not related to either the issuer of the security or to the issuer's agent, who compute the average trading price of the security. A quotation sheet prepared and distributed by a broker or dealer in the regular course of its business and containing only quotations of such broker or dealer is not an interdealer quotation system.

7.3.1.2. The issuer or an agent of the issuer computes the average trading price for the issue for the computational period,

7.3.1.2.1. The term "average trading price" means the mean price of all transactions (weighted by volume), other than original issue or redemption transactions, conducted through a United States office of a broker or dealer who maintains a market in the issue of the security during the computational period. For this purpose, bid and asked quotations are not taken into account.

7.3.1.3. The average trading price and total volume of the issue during the computational period are published in a newspaper of general circulation throughout the United States not later than the last day of the month following the end of the calendar quarter in which the computational period ends,

7.3.1.4. The issuer or its agent keeps books and records that list for each transaction during the computational period involving each issue covered by this procedure the date of the settlement of the transaction, the name and address of the broker or dealer making the market in which the transaction occurred, and the trading price and volume, and

7.3.1.5. The issuer or its agent permits the Internal Revenue Service to review the books and records described in Section 2.6.2.4 above with respect to transactions during the computational period upon giving reasonable notice to the issuer or agent.

7.4. Exception. Securities described in Reg. Sec. 1.170A-13(c)(7)(xi)(A) or (B) will not be considered publicly traded securities if:

7.4.1. The securities are subject to any restrictions that materially affect the value of the securities to the donor or prevent the securities from being freely traded, or

7.4.2. If the amount claimed or reported as a deduction with respect to the contribution of the securities is different than the amount listed in the market quotations that are readily available on an established securities market pursuant to Reg. Sec. 1.170A-13(c)(7)(xi)(A) or (B).

7.5. Substantiation Rules.

7.5.1. If the fair market value of the gift is less than $250, the donor must comply with the rules outlined in Section 3 above.

7.5.2. If the fair market value of the gift is between $250-$499, the donor must comply with the rules outlined in Section 4 above.

7.5.3. If the fair market value of the gift is between $500 - $5,000, the donor must comply with the rules outlined in Section 5 above.

7.5.4. If the fair market value of the gift is more than $5,000, the donor must comply with the rules outlined in Sections 6.1.2 and 6.1.3 above.

8. **<u>Non-Publicly Traded Securities defined in Reg. Sec. 1.170A-13(c)(7)(ix)</u>**.

8.1. Definition. Securities within the meaning of Code Section 165(g)(2) which are not publicly traded securities as defined in Reg. Sec. 1.170A-13(c)(7)(xi).

8.2. Substantiation Rules.

8.2.1. If the fair market value of the gift is less than $250, the donor must comply with the rules outlined in Section 3 above.

8.2.2. If the fair market value of the gift is between $250-$499, the donor must comply with the rules outlined in Section 4 above.

8.2.3. If the fair market value of the gift is between $500 - $5,000, the donor must comply with the rules outlined in Section 5 above.

8.2.4. If the fair market value of the gift is more than $5,000, the donor must comply with the rules outlined in Section 6 above.

9. **<u>Non-Publicly Traded Stock defined in Reg. Sec. 1.170A-13(c)(7)(x).</u>**

9.1. Definition. Any stock of a corporation (evidenced by a stock certificate) which is not a publicly traded security. The term stock does not include a debenture or any other evidence of indebtedness.

9.2. Substantiation Rules.

9.2.1. If the fair market value of the gift is less than $250, the donor must comply with the rules outlined in Section 3 above.

9.2.2. If the fair market value of the gift is between \$250-\$499, the donor must comply with the rules outlined in Section 4 above.

9.2.3. If the fair market value of the gift is between \$500 - \$5,000, the donor must comply with the rules outlined in Section 5 above.

9.2.4. If the fair market value of the gift is between \$5,000 - \$9,999, the donor must comply with the rules outlined in Section 6.1.2 and 6.1.3 above.

9.2.5. If the fair market value of the gift is \$10,000 or more, the donor must comply with the rules outlined in Section 6 above.

10. **Gifts Made by Payroll Deduction**

10.1. A contribution made by means of withholding from a taxpayer's wages and payment by the taxpayer's employer to a donee organization may be substantiated, for purposes of Code Section 170(f)(8), by both—

10.1.1. A pay stub, Form W-2, or other document furnished by the employer that sets forth the amount withheld by the employer for the purpose of payment to a donee organization. For the purpose of applying the \$250 threshold provided in Code Section 170(f)(8)(A), the amount withheld from each payment of wages to a taxpayer is treated as a separate contribution; and

10.1.2. A pledge card or other document prepared by or at the direction of the donee organization that includes a statement to the effect that the organization does not provide goods or services in whole or partial consideration for any contributions made to the organization by payroll deduction.

11. **Unreimbursed Expenses.**

11.1. Out-of-pocket expenses that are incident to the performance of services to a charitable organization may be deductible as a charitable contribution.

11.2. The donor will be treated as having received a contemporaneous written acknowledgment of those expenditures if he or she:

11.2.1. Has adequate records described in Section 2 of above; and

11.2.2. Obtains by the date described in Section 4.1.3. above, a statement prepared by the donee organization containing:

11.2.2.1. A description of the services provided by the taxpayer;

11.2.2.2. A statement of whether or not the donee organization provides any goods or services in consideration, in whole or in part, for the unreimbursed expenditures; and

11.2.2.3. The information described in Sections 4.1.1.3. and 4.1.1.4. above.

12. **Gifts to CRTs and CLTs**.

12.1. The donor must attach a copy of the governing instrument to his or her Form 1040 accompanied by a statement showing the computation of the deduction being claimed. Copies of the appraisal and appraisal summary may have to be attached.

12.2. Note: a contemporaneous written acknowledgment from the charity is not required for gifts to CRTs and CLTs (Reg. Sec. 1.170A-13(f)(13)).

13. **Gifts to Pooled Income Funds**.

13.1. The donor must attach a copy of the pooled income fund agreement along with the pooled income fund plan to his or her Form 1040. A statement showing the computation of the deduction being claimed must also be attached to the Form 1040.

13.2. The donor must have a contemporaneous written acknowledgment from the charity in order to deduct a gift of a remainder interest of $250 or more.

14. **Gifts to Charitable Gift Annuities and Deferred Payment Gift Annuities**.

14.1. The charitable deduction is claimed on Schedule A of the donor's Form 1040 along with a statement giving details of the gift, which includes a computation of the deduction being claimed.

14.2. The donor must have a contemporaneous written acknowledgment from the charity in order to deduct the gift portion of a gift annuity or a deferred payment gift annuity of $250 or more.

15. **Gifts of Remainder Interests in Personal Residences and Farms**.

15.1. The IRS has not provided any guidance as to the substantiation requirements.

15.2. It would be wise to apply the $250 or more requirements to such gifts.

16. **Gifts of Art Valued at $20,000 or More.**

16.1. Generally, the donor does not need to attach a copy of the qualified appraisal to the appraisal summary (Form 8283, Section B). However, if the total deduction for art is $20,000 or more, a complete copy of the signed qualified appraisal must be attached to the appraisal summary.

16.2. In addition, for individual art objects valued at $20,000 or more, a photograph must be provided upon request. The photograph must be of sufficient quality and size (preferably an 8x10 inch color photograph or a color transparency no smaller than 4x5 inches) to fully show the object.

17. **Qualified Appraisal**

17.1. Definition. A "qualified appraisal" is an appraisal document that—

17.1.1. Relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property nor later than the due date (including extensions) of the return on which a deduction is first claimed (or reported in the case of a donor that is a partnership or S corporation) under Code Section 170 with respect to the donated property, or, in the case of a deduction first claimed (or reported) on an amended return, the date on which the return is filed.

17.1.2. Is prepared, signed, and dated by a "qualified appraiser" (defined Section 3.2);

17.1.3. Includes the information described in Section 17.2. below; and

17.1.4. Does not involve a prohibited appraisal fee described in Section 19 below.

17.2. Information included in qualified appraisal. A qualified appraisal must include the following information:

17.2.1. A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;

17.2.2. In the case of tangible property, the physical condition of the property;

17.2.3. The date (or expected date) of contribution to the donee;

17.2.4. The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor or donee that relates to the use, sale, or other disposition of the property contributed, including, for example, the terms of any agreement or understanding that—

17.2.4.1. Restricts temporarily or permanently a donee's right to use or dispose of the donated property,

17.2.4.2. Reserves to, or confers upon, anyone (other than a donee organization or an organization participating with a donee organization in cooperative fundraising) any right to the income from the contributed property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire, or

17.2.4.3. Earmarks donated property for a particular use;

17.2.5. The name, address, and taxpayer identification number of the qualified appraiser; and, if the qualified appraiser is acting in his or her capacity as a partner in a partnership, an employee of any person (whether an individual, corporation, or partnerships), or an independent contractor engaged by a person other than the donor; the name, address, and taxpayer identification number of the partnership or the person who employs or engages the qualified appraiser;

17.2.6. The qualifications of the qualified appraiser who signs the appraisal, including the appraiser's background, experience, education, and membership, if any, in professional appraisal associations;

17.2.7. A statement that the appraisal was prepared for income tax purposes;

17.2.8. The date (or dates) on which the property was appraised;

17.2.9. The appraised fair market value (within the meaning of Reg. Sec. 1.170A-1(c)(2)) of the property on the date (or expected date) of contribution;

17.2.10. The method of valuation to determine the fair market value, such as the income approach, the market-data approach, and the replacement-cost-less-depreciation approach; and

17.2.11. The specific basis for the valuation, such as specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.

17.3. Number of qualified appraisals. For purposes of Section 6.1.1., a separate qualified appraisal is required for each item of property that is not included in a group of similar items of property (defined as property of the same generic category or time, such as stamp collections, books, paintings, etc.) See Reg. Sec. 1.170A-13(c)(7)(iii). Only one qualified appraisal is required for a group of similar items of property contributed in the same taxable year of the donor, although a donor may obtain separate qualified appraisals for each item of property. A qualified appraisal prepared with respect to a group of similar items of property shall provide all the information required by Section 17.2. for each item of similar property, except that the appraiser may select any items whose aggregate value is appraised at $100 or less and provide a group description of such items.

17.4. Retention of qualified appraisal. The donor must retain the qualified appraisal in the donor's records for so long as it may be relevant in the administration of any internal revenue law.

18. **Qualified Appraiser.**

18.1. Definition. The term "qualified appraiser" means an individual who includes on the appraisal summary, a declaration that—

18.1.1. The individual either holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;

18.1.2. Because of the appraiser's qualifications as described in the appraisal, including the appraiser's background, experience, education, and membership, if any, in professional appraisal associations, the appraiser is qualified to make appraisals of the type of property being valued;

18.1.3. The appraiser is not one of the persons described in Section 18.4.; and

18.1.4. The appraiser understands that an intentionally false or fraudulent overstatement of the value of the property described in the qualified appraisal or appraisal summary may subject the appraiser to a civil penalty under Code Section 6701 for aiding and abetting an understatement of tax liability, and, moreover, the appraiser may have appraisals disregarded pursuant to 31 U.S.C. 330(c).

18.2. Exception. An individual is not a qualified appraiser with respect to a particular donation, even if the declaration specified Section 17.2. above is provided in the appraisal summary, if the donor had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property (e.g., the donor and the appraiser make an agreement concerning the amount at which the property will be valued and the donor knows that such amount exceeds the fair market value of the property).

18.3. Numbers of appraisers. More than one appraiser may appraise the donated property. If more than one appraiser appraises the property, the donor does not have to use each appraiser's appraisal for purposes of substantiating the charitable contribution deduction. If the donor uses the appraisal of more than one appraiser, or if two or more appraisers contribute to a single appraisal, each appraiser shall comply with the various requirements, including signing the qualified appraisal and appraisal summary.

18.4. Qualified appraiser exclusions. The following persons cannot be qualified appraisers with respect to particular property:

18.4.1. The donor or the taxpayer who claims or reports a deduction under Code Section 170 for the contribution of the property that is being appraised.

18.4.2. A party to the transaction in which the donor acquired the property being appraised (i.e., the person who sold, exchanged, or gave the property to the donor, or any person who acted as an agent for the transferor or for the donor with respect to such sale, exchange, or gift), unless the property is donated within two (2) months of the date of acquisition and its appraised value does not exceed its acquisition price.

18.4.3. The donee of the property.

18.4.4. Any person employed by any of the foregoing persons (e.g., if the donor acquired a painting from an art dealer, neither the art dealer nor persons employed by the dealer can be qualified appraisers with respect to that painting).

18.4.5. Any person related to any of the foregoing under Code Section 267(b), or married to a person who is in a relationship described in Code Section 267(b) with any of the foregoing persons.

18.4.6. An appraiser who is regularly used by any person described in Sections 18.4.1., 18.4.2., or 18.4.3. above and who does not perform a majority of his or her appraisals made during his or her taxable year for other persons.

19. **<u>Appraisal Fees.</u>**

19.1.1. In general. No part of the fee arrangement for a qualified appraisal can be based, in effect, on a percentage (or set of percentages) of the appraised value of the property.

19.1.2. Exception. The above restriction does not apply to a fee paid to a generally recognized association that regulates appraisers provided all of the following requirements are met:

19.1.2.1. The association is not organized for profit and no part of the net earnings of the association inures to the benefit of any private shareholder or individual (these terms have the same meaning as in Code Section 501(c)),

19.1.2.2. The appraiser does not receive any compensation from the association or any other persons for making the appraisal, and

19.1.2.3. The fee arrangement is not based in whole or in part on the amount of the appraised value of the donated property, if any, that is allowed as a deduction under Code Section 170 after Internal Revenue Service examination or otherwise.

20. **Appraisal Summary (aka Form 8283, Section B)**

20.1. Definition. The term "appraisal summary" means a summary of a qualified appraisal that—

20.1.1. Is made on Form 8283;

20.1.2. Is signed and dated by the donee;

20.1.3. Is signed and dated by the qualified appraiser who prepared the qualified appraisal; and

20.1.4. Includes the information described in Section 20.1.5. below.

20.2. Information included in an appraisal summary. An appraisal summary shall include the following information:

20.2.1. The name and taxpayer identification number of the donor;

20.2.2. A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was contributed;

20.2.3. In the case of tangible property, a brief summary of the overall physical condition of the property at the time of the contribution;

20.2.4. The manner of acquisition (e.g., purchase, exchange, gift, or bequest) and the date of acquisition of the property by the donor, or, if the property was created, produced, or manufactured by or for the donor, a statement to that effect and the approximate date the property was substantially completed;

20.2.5. The cost or other basis of the property adjusted as provided by Code Section 1016;

20.2.6. The name, address, and taxpayer identification number of the donee;

20.2.7. The date the donee received the property;

20.2.8. A statement explaining whether or not the charitable contribution was made by means of a bargain sale and the amount of any consideration received from the donee for the contribution;

20.2.9. The name, address, and taxpayer identification number of the qualified appraiser who signs the appraisal summary and of other persons as required by Section 3.1.2.5. above;

20.2.10. The appraised fair market value of the property on the date of contribution;

20.2.11. The declaration by the appraiser described in Reg. Sec. 1.170A-13(c)(5)(i);

20.2.12. A declaration by the appraiser stating that—

20.2.12.1. The fee charged for the appraisal is not a prohibited fee appraisal; and

20.2.12.2. Appraisals prepared by the appraiser are not being disregarded pursuant to 31 U.S.C. 330(c) on the date the appraisal summary is signed by the appraiser; and

20.2.13. Any other information required by Form 8283 or its instructions.

20.3. Signature of the original donee. The person who signs the appraisal summary for the donee shall be an official authorized to sign the tax or information returns of the donee, or a person specifically authorized to sign appraisal summaries by an official authorized to sign the tax or information returns of such donee.

20.3.1. In the case of a donee that is a governmental unit, the person who signs the appraisal summary for such donee shall be the official authorized by such donee to sign appraisal summaries.

20.3.2. The signature of the donee on the appraisal summary does not represent concurrence in the appraised value of the contributed property. Rather, it represents acknowledgment of receipt of the property described in the appraisal summary on the date specified in the appraisal summary and that the donee understands the information reporting requirements imposed by Code Section 6050L and Reg. Sec. 1.6050L-1. In general, Reg. Sec. 1.6050L-1 requires the donee to file Form 8282 in the event the donee sells, exchanges, consumes, or otherwise disposes of the property (or any portion thereof) described in the appraisal summary within two (2) years after the date of the donor's contribution of such property.

20.4. Information unavailable or signature unattainable – If the donor is not able to provide information relating to the manner of acquisition, the basis of the contributed property, or is unable to obtain the donee's signature, the charitable deduction will not be disallowed if the donor provides an appropriate explanation which is attached to the appraisal summary.

21. Definition and Examples of Money and Property (and when gift is deductible)

21.1. Money

21.1.1. In General. "Money" is considered to be cash and cash equivalents.

21.1.2. Cash Equivalents

21.1.2.1. Payments by Check. The donor is entitled to deduct charitable contributions paid by check when the check is mailed or unconditionally delivered to the charity, provided that the check subsequently clears in due course and there are no restrictions as to the time and manner of its payment. Estate of Spiegel, 12 TC 524 (1949). Consequently, a charitable contribution made by check and mailed at the end of December is deductible in the taxable year it was mailed, even though the charity doesn't receive the check, and/or if the check isn't charged against the donor's bank account, until the following taxable year.

21.1.2.2. Payments by Credit Card. A contribution made to a qualified charity by a charge to a bank credit card is deductible as a charitable contribution in the year the charge is made regardless of when the bank is repaid. The Service has concluded that there are distinctions between contributions made by the use of credit cards and contributions made by debenture bonds and promissory notes. Since the cardholder's use of the credit card creates the cardholder's own debt to a third party, the use of a bank credit card to make a charitable contribution is equivalent to the use of borrowed funds to make a contribution. Rev. Rul. 78-38.

21.1.2.3. Promissory Notes. A debenture bond or a promissory note issued and delivered by the obligor to a charitable organization represents a mere promise to pay at some future date and is not a "payment" for purposes of deducting a contribution under Code Section 170. However, a deduction is allowable under Code Section 170 for the payment made to redeem the bond or for the required face amount payments made to the holder of the note irrespective of whether the payments are made to the charitable organization or to a subsequent transferee. Rev. Rul. 68-174.

21.1.2.4. Letters of Credit. Notwithstanding the rule with respect to promissory notes, the Service has privately ruled that a donor who executed an irrevocable banker's letter of credit was entitled to a charitable deduction for the full amount as of the date the letter of credit was established by the donor even though the charity did not draw upon the full amount until the following tax year. LTR 8420002.

21.1.2.5. Pledges. For income tax purposes, pledges are deductible in the year that they are fulfilled. Rev. Rul. 75-348. Noteworthy: satisfaction of a pledge with appreciated or depreciated property does not result in a taxable gain or a deductible loss. Rev. Rul. 55-410.

21.1.2.6. Options. Since an option is merely a promise to sell certain property at a certain price in the future, the donor of an option is only entitled to a charitable deduction in the year that the charity exercises the option. The amount of the charitable contribution deduction is equal to the excess of the fair market value of the property on the date the option was exercised over the exercise price. Rev. Rul. 82-197; LTR 8825069; LTR 8849018; and LTR 9335057.

21.1.2.7. Interest-Free Loans. A donor is not entitled to a charitable income tax deduction for interest-free loans to charity because they are disallowed under Code Section 170(f)(3)(A) as gifts of a partial interest.

21.2. Property

21.2.1. In General. "Property" is defined as other than cash or cash equivalents. The donor must part with dominion and control over the property and not retain any ownership rights in the property in order for the gift to be considered a "payment" for purposes of Code Section 170 for which the donor will be able to claim a charitable deduction.

21.2.2. Examples

21.2.2.1. Stock. When the donor unconditionally delivers or mails a properly endorsed stock certificate to a charitable donee or the donee's agent, the gift is considered complete on the date of delivery or, if such certificate is received in the ordinary course of the mails, on the date of mailing. If the donor delivers the stock certificate to his bank or broker as the donor's agent, or to the issuing corporation or its agent, for transfer into the name of the donee, the gift is considered complete on the date the stock is transferred on the books of the corporation. Reg. Sec. 1.170A-1(b). Note: if the stock does not have a readily ascertainable market quotation, the contribution may be deductible only to the extent of the donor's basis in the stock. See LTR 9504027, in which the IRS held that stock without a readily available market quotations did not fit into the definition of "qualified appreciated stock" under Code Section 170(e)(5).

21.2.2.2. Real Estate. The gift is considered complete when the donor unconditionally delivers an executed deed to the charitable donee or the donee's agent transferring the real property to the charity, the gift is considered complete. See Johnson v. U.S., 280 F. Supp. 412 (1967) and Alioto v. Comr., 40 T.C.M. 1147 (1980). A transfer of an entire interest in the real property qualifies for a charitable deduction under Code Section 170 pursuant to Reg. Sec. 1.170A-7(a)(2), and the donor is entitled to a charitable deduction in the year the gift is considered complete.

21.2.2.3. Assignment of Debts and Accounts Receivable. A gift of an irrevocable assignment of either a debt or an account receivable to a charity is considered complete as of the date of the irrevocable assignment, even though the charitable donee does not gain control of the funds until the following tax year. Pauley v. U.S., 459 F.2d 624 (9th Cir. 1972).

21.2.2.4. Contract Rights. Generally, the donation of contract rights entitles the donor to a charitable deduction in the year contributed. See Rev. Rul. 68-113 and Rev. Rul. 84-1. However, if the gift of a contract right is characterized as a service, no charitable deduction will be allowed. See Rev. Rul. 57-462 and Rev. Rul. 67-236.

21.2.2.5. Patents. A donor who either owns a patent or an undivided interest in a patent is entitled to a charitable deduction under Section 170 if he donates his entire interest in the patent to a charitable organization. Rev. Rul. 58-260.

21.2.2.6. Royalties. If a donor assigns right to receive royalties (but not the underlying patent or copyright) to a charitable donee, the donor must include the royalty in his or her gross income, but will be entitled to a corresponding charitable deduction for the amount of the royalties actually paid to the charity. The donor must assign both the royalties and the source of the royalties to the charitable donee in order to avoid inclusion of the royalties in the donor's gross income. Moore v. Comr., 27 T.C.M. 536 (1968).

21.2.2.7. Life Insurance Policies. A donor must contribute his full rights of ownership in the life insurance policy to the charitable donee in order for such contribution to qualify for a deduction under Code Section 170. Rev. Rul. 76-143.

21.2.2.8. Artworks and Other Tangible Personal Property. The date property is received by the donee charity, or its agent, is the delivery date. Accordingly, the donor is entitled to a charitable deduction in the year of the delivery date.

22. **Donee Disclosure, Reporting Requirements, and Penalties**

22.1. Quid Pro Quo Gifts

22.1.1. Definition - a payment made partly as a contribution and partly in consideration for goods or services provided to the payor by the donee organization. A quid pro quo contribution does not include any payment made to an organization, organized exclusively for religious purposes, in return for which the taxpayer receives solely an intangible religious benefit.

22.1.2. Disclosure - If an organization described in Code Section 170(c) (other than paragraph (1) thereof) receives a quid pro quo contribution in excess of $75, the organization shall, in connection with the solicitation or receipt of the contribution, provide a written statement which—

22.1.2.1. informs the donor that the amount of the contribution that is deductible for Federal income tax purposes is limited to the excess of the amount of any money and the value of any property other than money contributed by the donor over the value of the goods or services provided by the organization, and

22.1.2.2. provides the donor with a good faith estimate of the value of such goods or services. See Reg. Sec. 1.6115-1 for the definition of a "good faith estimate" and examples.

22.2. Donee Disposition of Gifts (Form 8282 – a copy is attached at the end of this outline)

22.2.1. If the donee of any charitable deduction property sells, exchanges, or otherwise disposes of such property within 2 years after its receipt, the donee shall file Form 8282 showing:

22.2.1.1. the name, address, and TIN of the donor,

22.2.1.2. a description of the property,

22.2.1.3. the date of the contribution,

22.2.1.4. the amount received on the disposition,

22.2.1.5. the date of such disposition, and

22.2.1.6. any other information requested on Form 8282.

22.2.2. The term "charitable deduction property" means any property (other than publicly traded securities) contributed in a contribution for which the donee charity signed an appraisal summary (Form 8283, Section B). Code Section 6050L and Reg. Sec. 1.6050L-1.

22.2.3. Exception. Form 8282 does not have to be filed if:

22.2.3.1. at the time the original donee signed the appraisal summary, the donor had signed a statement on the Form 8283 that the appraised value of the specific item was not more than $500. If Form 8283 contains more than one similar item, this exception applies only to those items that are clearly identified as having a value of $500 or less. However, for purposes of the donor's determination of whether the appraised value of the item exceeds $500, all shares of nonpublicly traded stock, or items that form a set (e.g. a collection of books written by the same author, components of a stereo system, or six place settings of a pattern of silverware), are considered one item, or

22.2.3.2. the item was consumed or distributed in fulfillment of the donee charity's charitable purpose.

23. **Donee Penalties**

23.1. Failure to meet disclosure requirements applicable to quid pro quo contributions. Pursuant to Code Section 6714, if an organization fails to meet the disclosure requirements of Code Section 6115 (or if the disclosure is incomplete or inaccurate) with respect to a quid pro quo contribution, such organization shall pay a penalty of $10 for each contribution in respect of which the organization fails to make the required disclosure, except that the total penalty imposed with respect to a particular fundraising event or mailing shall not exceed $5,000. No penalty shall be imposed with respect to any failure if it is shown that such failure is due to reasonable cause. The IRS has not defined "reasonable cause".

23.2. Failure to file Form 8282. A penalty may be imposed, pursuant to Section 6721, if the donee charity fails to (i) file Form 8282 by the due date, (ii) include all of the information require, or (iii) include correct information. The penalty is generally $50 for each return (up to a maximum $250,000 per calendar year).

24. **Donor Penalties**

24.1. Accuracy Related Penalty (Code Section 6662) – shall apply to the portion of any underpayment which is attributable to one or more of the following:

24.1.1. Negligence or disregard of rules or regulations.

24.1.2. Any substantial understatement of income tax.

24.1.3. Any substantial valuation misstatement.

24.1.4. Any substantial overstatement of pension liabilities.

24.1.5. Any substantial estate or gift tax valuation understatement.

24.2. Fraud Penalty (Code Section 6663) – If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.

24.3. Reasonable Cause Exception (Code Section 6664)

24.3.1. In general. No penalty shall be imposed under Code Section 6662 or 6663 with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

24.3.2. Exception to the Exception. When the underpayment is attributable to a substantial or gross valuation overstatement with respect to charitable deduction property (defined as any property contributed by the taxpayer in a contribution for which a deduction was claimed under Code Section 170, but does not include any securities for which market quotations are readily available on an established securities market), the reasonable cause exception does not apply unless:

24.3.2.1. the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and

24.3.2.2. in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

24.4. Interest (Code Section 6601) – If the donor underpays his or her income tax due to an overvaluation of a charitable contribution, the interest on the underpayment begins from the date the tax was due to the date of payment. The interest on such amount will be equal to the federal short-term rate plus three percentage points. In addition, interest is imposed on any accuracy-related or fraud penalties.

25. **Appraiser Penalties**.

25.1. Any appraiser who falsely or fraudulently overstates the value of the contributed property referred to in a qualified appraisal or appraisal summary that the appraiser has signed may be subject to a civil penalty under Code Section 6701 for aiding and abetting an understatement of tax liability.

25.2. In addition, appraisals may be disregarded pursuant to 31 U.S.C. 330(c).

Substantiation Outline-Final.doc

Substantiation Chart

Type of Gift	Fair Market Value of Gift	Substantiation Letter from Donee Charity	Qualified Appraisal	IRS Forms
Cash	Less than $250	**No**	**No**	**1040 Sch. A**
	$250 or more	**Yes**	**No**	**1040 Sch. A**
Property Other Than Cash (generally)	Less than $250	**No**	**No**	**1040 Sch. A**
Property Other Than Cash (generally)	$250-499	**Yes**	**No**	**1040 Sch. A**
Property Other Than Cash (generally)	$500 or more	**Yes**	**Depends**	**1040 Sch. A** **8283 Section A or B**
Publicly Traded Securities defined in Reg. Sec. 1.170A-13(c)(7)(xi)(A) - a security or share in an open-end investment company for which quotations are available and/or published daily.	Less than $250	**No**	**No**	**1040 Sch. A**
	$250-$499	**Yes**	**No**	**1040 Sch. A**
	$500 or more	**Yes**	**No**	**1040 Sch. A** **8283 Section A**
Publicly Traded Securities defined in Reg. Sec. 1.170A-13(c)(7)(xi)(B) - a security traded in the interdealer quotation system for which the issuer computes the average trading price (which is published during or after the computation period) and keeps records of all transactions that the IRS may review.	Less than $250	**No**	**No**	**1040 Sch. A**
	$250-$499	**Yes**	**No**	**1040 Sch. A**
	$500-$5,000	**Yes**	**No**	**1040 Sch. A** **8283 Section A**
	over $5,000	**Yes**	**No**	**1040 Sch. A** **8283 Section B**
Non-Publicly Traded Securities defined in Reg. Sec. 1.170A-13(c)(7)(ix) - securities within the meaning of Section 165(g)(2) which are not publicly traded securities as defined in Reg. Sec. 1.170A-13(c)(7)(xi).	Less than $250	**No**	**No**	**1040 Sch. A**
	$250-$499	**Yes**	**No**	**1040 Sch. A**
	$500-$5,000	**Yes**	**No**	**1040 Sch. A** **8283 Section A**
	over $5,000	**Yes**	**Yes**	**1040 Sch. A** **8283 Section B**

Substantiation Chart

Type of Gift	Fair Market Value of Gift	Substantiation Letter from Donee Charity	Qualified Appraisal	IRS Forms
Non-Publicly Traded Stock defined in Reg. Sec. 1.170A-13(c)(7)(x) - any stock of a corporation which is not a publicly traded security - does not include a debenture or any other evidence of indebtedness.	Less than $250	**No**	**No**	**1040 Sch. A**
	$250-$499	**Yes**	**No**	**1040 Sch. A**
	$500-$5,000	**Yes**	**No**	**1040 Sch. A** **8283 Section A**
	More than $5,000 but Less than $10,000	**Yes**	**No**	**1040 Sch. A** **8283 Section B**
	$10,000 or more	**Yes**	**Yes**	**1040 Sch. A** **8283 Section B**
Artwork	More than $5,000 but Less than $20,000	**Yes**	**No**	**1040 Sch. A** **8283 Section B**
	More than $20,000	**Yes**	**Yes**	**1040 Sch. A** **8283 Section B**

Form **8282**
(Rev. September 1998)
Department of the Treasury
Internal Revenue Service

Donee Information Return

(Sale, Exchange, or Other Disposition of Donated Property)

▶ **See instructions.**

OMB No. 1545-0908

Give a Copy to Donor

Please Print or Type

Name of charitable organization (donee) | **Employer identification number**

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

Part I Information on ORIGINAL DONOR and DONEE Receiving the Property

1a **Name of the original donor** of the property | 1b **Identifying number**

Note: *Complete lines 2a - 2d only if you gave this property to another charitable organization (successor donee).*

2a **Name of charitable organization** | 2b **Employer identification number**

2c Address (number, street, and room or suite no.)

2d City or town, state, and ZIP code

Note: *If you are the original donee, skip Part II and go to Part III now.*

Part II Information on PREVIOUS DONEES — Complete this part only if you were not the first donee to receive the property.

If you were the second donee, leave lines 4a - 4d blank. If you were a third or later donee, complete lines 3a - 4d. On lines 4a - 4d, give information on the preceding donee (the one who gave you the property).

3a **Name of original donee** | 3b **Employer identification number**

3c Address (number, street, and room or suite no.)

3d City or town, state, and ZIP code

4a **Name of preceding donee** | 4b **Employer identification number**

4c Address (number, street, and room or suite no.)

4d City or town, state, and ZIP code

Part III Information on DONATED PROPERTY — If you are the original donee, leave column (c) blank.

(a) Description of donated property sold, exchanged, or otherwise disposed of (if you need more space, attach a separate statement)	**(b)** Date you received the item(s)	**(c)** Date the first donee received the item(s)	**(d)** Date item(s) sold, exchanged, or otherwise disposed of	(e) Amount received upon disposition

For Paperwork Reduction Act Notice, see back of form.
ISA
STF FED6535F

General Instructions

Section references are to the Internal Revenue Code.

Purpose of Form

Donee organizations use Form 8282 to report information to the IRS about dispositions of certain charitable deduction property made within 2 years after the donor contributed the property.

Definitions

Note: *For Form 8282 and these instructions, the term "donee" includes all donees, unless specific reference is made to "original" or "successor" donees.*

Original donee. The first donee to or for which the donor gave the property. The original donee is required to sign an Appraisal Summary presented by the donor for charitable deduction property.

Successor donee. Any donee of property other than the original donee.

Appraisal summary. Section B of **Form 8283,** Noncash Charitable Contributions.

Charitable deduction property. Property (other than money or certain publicly traded securities) for which the original donee signed, or was presented with for signature, the Appraisal Summary (Form 8283, Section B).

Generally, only items or groups of similar items for which the donor claimed a deduction of more than $5,000 are included on the Appraisal Summary. There is an exception if a donor gives similar items to more than one donee organization and the total deducted for these similar items exceeds $5,000. For example, if a donor deducts $2,000 for books given to a donee organization and $4,000 for books to another donee organization, the donor must present a separate Appraisal Summary to each organization. For more information, see the Instructions for Form 8283.

Who Must File

Original and successor donee organizations must file Form 8282 if they sell, exchange, consume, or otherwise dispose of (with or without consideration) charitable deduction property within 2 years after the date the original donee received the property. See **Charitable deduction property** earlier.

Exceptions. There are two situations where Form 8282 does not have to be filed.

1. Items valued at $500 or less. You do not have to file Form 8282 if, at the time the original donee signed the Appraisal Summary, the donor had signed a statement on Form 8283 that the appraised value of the specific item was not more than $500. If Form 8283 contains more than one similar item, this exception applies only to those items that are clearly identified as having a value of $500 or less. However, for purposes of the donor's determination of whether the appraised value of the item exceeds $500, all shares of nonpublicly traded stock, or items that form a set, are considered one item. For example, a collection of books written by the same author, components of a stereo system, or six place settings of a pattern of silverware are considered one item.

2. Items consumed or distributed for charitable purpose. You do not have to file Form 8282 if an item is consumed or distributed, without consideration, in fulfilling your purpose or function as a tax-exempt organization. For example, no reporting is required for medical supplies consumed or distributed by a tax-exempt relief organization in aiding disaster victims.

When To File

If you dispose of charitable deduction property within 2 years of the date the original donee received it and you do not meet exception **1** or **2** above, you must file Form 8282 within 125 days after the date of disposition.

Exception. If you did not file because you had no reason to believe the substantiation requirements applied to the donor, but you later become aware that they did apply, file Form 8282 within 60 days after the date you become aware you are liable. For example, this exception would apply where an Appraisal Summary is furnished to a successor donee after the date that donee disposes of the charitable deduction property.

Missing Information

If Form 8282 is filed by the due date, you must enter your organization's name, address, and EIN and complete at least Part III, column (a). You do not have to complete the remaining items if the information is not available. For example, you may not have the information necessary to complete all entries if the donor's Appraisal Summary is not available to you.

Where To File

Send Form 8282 to the Internal Revenue Service, Ogden, UT 84201-0027.

Penalty

You may be subject to a penalty if you fail to file this form by the due date, fail to include all of the information required to be shown on this form, or fail to include correct information on this form (see **Missing Information** above). The penalty is generally $50. For more details, see section 6721.

Other Requirements

Information you must give a successor donee. If the property is transferred to another charitable organization within the 2-year period discussed earlier, you must give your successor donee all of the following information.

1. The name, address, and EIN of your organization.

2. A copy of the Appraisal Summary (the Form 8283 that you received from the donor or a preceding donee).

3. A copy of this Form 8282, within 15 days after you file it.

You must furnish items **1** and **2** above within 15 days after the latest of the date:

- You transferred the property.
- The original donee signed the Appraisal Summary, or
- You received a copy of the Appraisal Summary from the preceding donee if you are also a successor donee.

Information the successor donee must give you. The successor donee organization to whom you transferred this property is required to give you their organization's name, address, and EIN within 15 days after the later of:

- The date you transferred the property, or
- The date they received a copy of the Appraisal Summary.

Information you must give the donor. You must give a copy of your Form 8282 to the original donor of the property.

Recordkeeping. You must keep a copy of the Appraisal Summary in your records.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	3 hr., 7 min.
Learning about the law or the form	35 min.
Preparing and sending the form to the IRS	41 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **DO NOT** send the form to this address. Instead, see **Where To File** on this page.

Form **8283**

(Rev. October 1998)

Department of the Treasury
Internal Revenue Service

Noncash Charitable Contributions

▶ **Attach to your tax return if you claimed a total deduction of over $500 for all contributed property.**

▶ **See separate instructions.**

OMB No. 1545-0908

Attachment Sequence No. **55**

Name(s) shown on your income tax return | **Identifying number**

Note: *Figure the amount of your contribution deduction before completing this form. See your tax return instructions.*

Section A — List in this section **only** items (or groups of similar items) for which you claimed a deduction of $5,000 or less. Also, list certain publicly traded securities even if the deduction is over $5,000 (see instructions).

Part I **Information on Donated Property** — If you need more space, attach a statement.

1	**(a)** Name and address of the donee organization	**(b)** Description of donated property
A		
B		
C		
D		
E		

Note: *If the amount you claimed as a deduction for an item is $500 or less, you do not have to complete columns (d), (e), and (f).*

	(c) Date of the contribution	**(d)** Date acquired by donor (mo., yr.)	**(e)** How acquired by donor	**(f)** Donor's cost or adjusted basis	**(g)** Fair market value	**(h)** Method used to determine the fair market value
A						
B						
C						
D						
E						

Part II **Other Information** — Complete line 2 if you gave less than an entire interest in property listed in Part I. Complete line 3 if conditions were attached to a contribution listed in Part I.

2 If, during the year, you contributed less than the entire interest in the property, complete lines a - e.

a Enter the letter from Part I that identifies the property ▶ ______________. If Part II applies to more than one property, attach a separate statement.

b Total amount claimed as a deduction for the property listed in Part I: **(1)** For this tax year ▶ ______________ .

(2) For any prior tax years ▶ ______________ .

c Name and address of each organization to which any such contribution was made in a prior year (complete only if different from the donee organization above):

Name of charitable organization (donee)

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

d For tangible property, enter the place where the property is located or kept ▶ ______________

e Name of any person, other than the donee organization, having actual possession of the property ▶ ______________

3 If conditions were attached to any contribution listed in Part I, answer questions a - c and attach the required statement (see instructions).

		Yes	**No**
a	Is there a restriction, either temporary or permanent, on the donee's right to use or dispose of the donated property?		
b	Did you give to anyone (other than the donee organization or another organization participating with the donee organization in cooperative fundraising) the right to the income from the donated property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire?		
c	Is there a restriction limiting the donated property for a particular use?		

For Paperwork Reduction Act Notice, see page 4 of separate instructions. Form **8283** (Rev. 10-98)

ISA
STF FED6539F.1

Name(s) shown on your income tax return	Identifying number

Section B — Appraisal Summary — List in this section only items (or groups of similar items) for which you claimed a deduction of more than $5,000 per item or group. **Exception.** Report contributions of certain publicly traded securities only in Section A.

If you donated art, you may have to attach the complete appraisal. See the **Note** in Part I below.

Part I Information on Donated Property — To be completed by the taxpayer and/or appraiser.

4 Check type of property:

☐ Art* (contribution of $20,000 or more) ☐ Real Estate ☐ Gems/Jewelry ☐ Stamp Collections

☐ Art* (contribution of less than $20,000) ☐ Coin Collections ☐ Books ☐ Other

*Art includes paintings, sculptures, watercolors, prints, drawings, ceramics, antique furniture, decorative arts, textiles, carpets, silver, rare manuscripts, historical memorabilia, and other similar objects.

Note: *If your total art contribution deduction was $20,000 or more, you must attach a complete copy of the signed appraisal. See instructions.*

5	(a) Description of donated property (if you need more space, attach a separate statement)	(b) If tangible property was donated, give a brief summary of the overall physical condition at the time of the gift	(c) Appraised fair market value
A			
B			
C			
D			

	(d) Date acquired by donor (mo., yr.)	(e) How acquired by donor	(f) Donor's cost or adjusted basis	(g) For bargain sales, enter amount received	See instructions (h) Amount claimed as a deduction	See instructions (i) Average trading price of securities
A						
B						
C						
D						

Part II Taxpayer (Donor) Statement — List each item included in Part I above that the appraisal identifies as having a value of $500 or less. See instructions.

I declare that the following item(s) included in Part I above has to the best of my knowledge and belief an appraised value of not more than $500 (per item). Enter identifying letter from Part I and describe the specific item. See instructions. ▶ ____________

Signature of taxpayer (donor) ▶ Date ▶

Part III Declaration of Appraiser

I declare that I am not the donor, the donee, a party to the transaction in which the donor acquired the property, employed by, or related to any of the foregoing persons, or married to any person who is related to any of the foregoing persons. And, if regularly used by the donor, donee, or party to the transaction, I performed the majority of my appraisals during my tax year for other persons.

Also, I declare that I hold myself out to the public as an appraiser or perform appraisals on a regular basis; and that because of my qualifications as described in the appraisal, I am qualified to make appraisals of the type of property being valued. I certify that the appraisal fees were not based on a percentage of the appraised property value. Furthermore, I understand that a false or fraudulent overstatement of the property value as described in the qualified appraisal or this appraisal summary may subject me to the penalty under section 6701(a) (aiding and abetting the understatement of tax liability). I affirm that I have not been barred from presenting evidence or testimony by the Director of Practice.

Sign Here Signature ▶ Title ▶ Date of appraisal ▶

Business address (including room or suite no.)	Identifying number
City or town, state, and ZIP code	

Part IV Donee Acknowledgment — To be completed by the charitable organization.

This charitable organization acknowledges that it is a qualified organization under section 170(c) and that it received the donated property as described in Section B, Part I, above on ▶ ____________ (Date)

Furthermore, this organization affirms that in the event it sells, exchanges, or otherwise disposes of the property described in Section B, Part I (or any portion thereof) within 2 years after the date of receipt, it will file **Form 8282,** Donee Information Return, with the IRS and give the donor a copy of that form. This acknowledgment does not represent agreement with the claimed fair market value.

Does the organization intend to use the property for an unrelated use? . . . . ▶ ☐ Yes ☐ No

Name of charitable organization (donee)	Employer identification number	
Address (number, street, and room or suite no.)	City or town, state, and ZIP code	
Authorized signature	Title	Date

STF FED6539F.2

Instructions for Form 8283

Department of the Treasury
Internal Revenue Service

(Revised October 1998)

Noncash Charitable Contributions

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

Purpose of Form

Use Form 8283 to report information about noncash charitable contributions.

Do not use Form 8283 to report out-of-pocket expenses for volunteer work or amounts you gave by check or credit card. Treat these items as cash contributions. Also, **do not** use Form 8283 to figure your charitable contribution deduction. For details on how to figure the amount of the deduction, see your tax return instructions.

Additional Information

You may want to see **Pub. 526,** Charitable Contributions (for individuals), and **Pub. 561,** Determining the Value of Donated Property. If you contributed depreciable property, see **Pub. 544,** Sales and Other Dispositions of Assets.

Who Must File

You must file Form 8283 if the amount of your deduction for all noncash gifts is more than $500. For this purpose, "amount of your deduction" means your deduction **before** applying any income limits that could result in a carryover. The carryover rules are explained in Pub. 526. Make any required reductions to fair market value (FMV) before you determine if you must file Form 8283. See **Fair Market Value (FMV)** on page 2.

Form 8283 is filed by individuals, partnerships, and corporations.

Note: *C corporations, other than personal service corporations and closely held corporations, must file Form 8283 only if the amount claimed as a deduction is over $5,000.*

Partnerships and S corporations. A partnership or S corporation that claims a deduction for noncash gifts over $500 must file Form 8283 with Form 1065, 1065-B, or 1120S. If the total deduction of any item or group of similar items exceeds $5,000, the partnership or S corporation must complete Section B of Form 8283 even if the amount allocated to each partner or shareholder does not exceed $5,000.

The partnership or S corporation must give a completed copy of Form 8283 to each partner or shareholder receiving an allocation of the contribution deduction shown in Section B of the partnership's or S corporation's Form 8283.

Partners and shareholders. The partnership or S corporation will provide information about your share of the contribution on your Schedule K-1 (Form 1065 or 1120S).

In some cases, the partnership or S corporation must give you a copy of its Form 8283. If you received a copy of Form 8283 from the partnership or S corporation, attach a copy to your tax return. Deduct the amount shown on your Schedule K-1, not the amount shown on the Form 8283.

If the partnership or S corporation is not required to give you a copy of its Form 8283, combine the amount of noncash contributions shown on your Schedule K-1 with your other noncash contributions to see if you must file Form 8283. If you need to file Form 8283, you do not have to complete all the information requested in Section A for your share of the partnership's or S corporation's contributions. Complete only column (g) of line 1 with your share of the contribution and enter "From Schedule K-1 (Form 1065 or 1120S)" across columns (c) - (f).

When To File

File Form 8283 with your tax return for the year you contribute the property and first claim a deduction.

Which Sections To Complete

If you must file Form 8283, you may need to complete Section A, Section B, or both, depending on the type of property donated and the amount claimed as a deduction.

Section A. Include in Section A only items (or groups of similar items as defined on this page) for which you claimed a deduction of $5,000 or less per item (or group of similar items). Also, include the following publicly traded securities even if the deduction is more than $5,000.

- Securities listed on an exchange in which quotations are published daily,
- Securities regularly traded in national or regional over-the-counter markets for which published quotations are available, or
- Securities that are shares of a mutual fund for which quotations are published on a daily basis in a newspaper of general circulation throughout the United States.

Section B. Include in Section B only items (or groups of similar items) for which you claimed a deduction of more than $5,000 (omit publicly traded securities reportable in Section A). With certain exceptions, items reported in Section B will require information based on a written appraisal by a qualified appraiser.

Similar Items of Property

Similar items of property are items of the same generic category or type, such as stamp collections, coin collections, lithographs, paintings, books, nonpublicly traded stock, land, or buildings.

Example. You claimed a deduction of $400 for clothing, $7,000 for publicly traded securities (quotations published daily), and $6,000 for a collection of 15 books ($400 each). Report the clothing and securities in Section A and the books (a group of similar items) in Section B.

Special Rule for Certain C Corporations

A special rule applies for deductions taken by certain C corporations under section 170(e)(3) or (4) for contributions of inventory or scientific equipment.

To determine if you must file Form 8283 or which section to complete, use the difference between the amount you claimed as a deduction and the amount you would have claimed as cost of goods sold (COGS) had you sold the property instead. This rule is **only** for purposes of Form 8283. It does not change the amount or method of figuring your contribution deduction.

If you do not have to file Form 8283 because of this rule, you must attach a statement to your tax return (similar to the one in the example below). Also, attach a statement if you must complete Section A, instead of Section B, because of this rule.

Example. You donated clothing from your inventory for the care of the needy. The clothing cost you $5,000 and your claimed charitable deduction is $8,000. Complete Section A instead of Section B because the difference between the amount you claimed as a charitable deduction and the amount that would have been your COGS deduction is $3,000 ($8,000 − $5,000). Attach a statement to Form 8283 similar to the following:

Form 8283 — Inventory

Contribution deduction	$8,000
COGS (if sold, not donated)	− 5,000
For Form 8283 filing purposes	= $3,000

Fair Market Value (FMV)

Although the **amount** of your deduction determines if you have to file Form 8283, you also need to have information about the **value** of your contribution to complete the form.

FMV is the price a willing, knowledgeable buyer would pay a willing, knowledgeable seller when neither has to buy or sell.

You may not always be able to deduct the FMV of your contribution. Depending on the type of property donated, you may have to reduce the FMV to get to the deductible amount, as explained next.

Reductions to FMV. The amount of the reduction (if any) depends on whether the property is ordinary income property or capital gain property. Attach a statement to your tax return showing how you figured the reduction.

Ordinary income property is property that would result in ordinary income or short-term capital gain if it were sold at its FMV on the date it was contributed. Examples of ordinary income property are inventory, works of art created by the donor, and capital assets held for 1 year or less. The deduction for a gift of ordinary income property is limited to the FMV minus the amount that would be ordinary income or short-term capital gain if the property were sold.

Capital gain property is property that would result in long-term capital gain if it were sold at its FMV on the date it was contributed. It includes certain real property and depreciable property used in your trade or business, and generally held for more than 1 year. You usually may deduct gifts of capital gain property at their FMV. However, you must reduce the FMV by the amount of any appreciation if any of the following apply.

- The capital gain property is contributed to certain private nonoperating foundations. This rule does not apply to qualified appreciated stock.
- You choose the 50% limit instead of the special 30% limit.
- The contributed property is tangible personal property that is put to an **unrelated use** (as defined in Pub. 526) by the charity.

Qualified conservation contribution. If your donation qualifies as a "qualified conservation contribution" under section 170(h), attach a statement showing the FMV of the underlying property before and after the gift and the conservation purpose furthered by the gift. See Pub. 561 for more details.

Specific Instructions

Identifying number. Individuals must enter their social security number or individual taxpayer identification number. All other filers should enter their employer identification number.

Section A

Part I, Information on Donated Property

Line 1

Column (b). Describe the property in sufficient detail. The greater the value, the more detail you need. For example, a car should be described in more detail than pots and pans.

For securities, include the following:

- Name of the issuer,
- Kind of security,
- Whether a share of a mutual fund, and
- Whether regularly traded on a stock exchange or in an over-the-counter market.

Note: *If the amount you claimed as a deduction for the item is $500 or less, you do not have to complete columns (d), (e), and (f).*

Column (d). Enter the approximate date you acquired the property. If it was created, produced, or manufactured by or for you, enter the date it was substantially completed.

Column (e). State how you acquired the property (i.e., by purchase, gift, inheritance, or exchange).

Column (f). Do not complete this column for publicly traded securities or property held 12 months or more. Keep records on cost or other basis.

Note: *If you have reasonable cause for not providing the information in columns (d) and (f), attach an explanation.*

Column (g). Enter the FMV of the property on the date you donated it. If you were required to reduce the FMV of your deduction or you gave a qualified conservation contribution, you must attach a statement. See **Fair Market Value (FMV)** on this page for the type of statement to attach.

Column (h). Enter the method(s) you used to determine the FMV. The FMV of used household goods and clothing is usually much lower than when new. A good measure of value might be the price that buyers of these used items actually pay in consignment or thrift shops.

Examples of entries to make include "Appraisal," "Thrift shop value" (for clothing or household goods), "Catalog" (for stamp or coin collections), or "Comparable sales" (for real estate and other kinds of assets). See Pub. 561.

Part II, Other Information

If Part II applies to more than one property, attach a separate statement. Give the required information for each property separately. Identify which property listed in Part I the information relates to.

Lines 2a Through 2e

Complete lines 2a - 2e only if you contributed less than the entire interest in the donated property during the tax year. On line 2b, enter the amount claimed as a deduction for this tax year and in any prior tax years for gifts of a partial interest in the same property.

Lines 3a Through 3c

Complete lines 3a - 3c only if you attached restrictions to the right to the income, use, or disposition of the donated property. An example of a "restricted use" is furniture that you gave only to be used in the reading room of an organization's library. Attach a statement explaining **(1)** the terms of any agreement or understanding regarding the restriction, and **(2)** whether the property is designated for a particular use.

Section B

Part I, Information on Donated Property

You must have a written appraisal from a qualified appraiser that supports the information in Part I. However, see the **Exceptions** below.

Use Part I to summarize your appraisal(s). Generally, you do not need to attach the appraisals but you should keep them for your records. But see **Art valued at $20,000 or more** below.

Exceptions. You do not need a written appraisal if the property is:

- Nonpublicly traded stock of $10,000 or less,
- Certain securities considered to have market quotations readily available (see Regulations section 1.170A-13(c)(7)(xi)(B)),
- A donation by a C corporation (other than a closely held corporation or personal service corporation), or
- Inventory and other property donated by a closely held corporation or a personal service corporation that are "qualified contributions" for the care of the ill, the needy, or infants, within the meaning of section 170(e)(3)(A).

Although a written appraisal is not required for the types of property listed above, you must provide certain information in Part I of Section B (see Regulations section 1.170A-13(c)(4)(iv)) and have the donee organization complete Part IV.

Art valued at $20,000 or more. If your total deduction for art is $20,000 or more, you must attach a complete copy of the signed appraisal. For individual objects valued at $20,000 or more, a photograph must be provided upon request. The photograph must be of sufficient quality and size (preferably an 8 × 10 inch color photograph or a color transparency no smaller than 4 × 5 inches) to fully show the object.

Appraisal Requirements

The appraisal must be made not earlier than 60 days before the date you contribute the property. You must receive the appraisal before the due date (including extensions) of the return on which you first claim a deduction for the property. For a deduction first claimed on an amended return, the appraisal must be received before the date the amended return was filed.

A separate qualified appraisal and a separate Form 8283 are required for each item of property except for an item that is part of a group of similar items. Only one appraisal is required for a group of similar items contributed in the same tax year, if it includes all the required information for each item. The appraiser may group similar items with a collective value appraised at $100 or less.

If you gave similar items to more than one donee for which you claimed a total deduction of more than $5,000, you must attach a separate form for each donee.

Example. You claimed a deduction of $2,000 for books given to College A, $2,500 for books given to College B, and $900 for books given to a public library. You must attach a separate Form 8283 for each donee.

See Regulations section 1.170A-13(c)(3)(i) - (ii) for the definition of a "qualified appraisal" and information to be included in the appraisal.

Line 5

Note: *You **must** complete at least column (a) of line 5 (and column (b) if applicable) before submitting Form 8283 to the donee. You may then complete the remaining columns.*

Column (a). Provide enough detail so a person unfamiliar with the property could identify it in the appraisal.

Column (c). Include the FMV from the appraisal. If you were not required to get an appraisal, include the FMV you determine to be correct.

Columns (d) - (f). If you have reasonable cause for not providing the information in columns (d), (e), or (f), attach an explanation so your deduction will not automatically be disallowed.

Column (g). A bargain sale is a transfer of property that is in part a sale or exchange and in part a contribution. Enter the amount received for bargain sales.

Column (h). Complete column (h) only if you were not required to get an appraisal, as explained earlier.

Column (i). Complete column (i) only if you donated securities for which market quotations are considered to be readily available because the issue satisfies the five requirements described in Regulations section 1.170A-13(c)(7)(xi)(B).

Part II, Taxpayer (Donor) Statement

Complete Part II for each item included in Part I that has an appraised value of $500 or less. Because you do not have to show the value of these items in Part I of the donee's copy of Form 8283, clearly identify them for the donee in Part II. Then, the donee does not have to file **Form 8282,** Donee Information Return, for items valued at $500 or less. See the **Note** on page 4 for more details about filing Form 8282.

The amount of information you give in Part II depends on the description of the donated property you enter in Part I. If you show a single item as "Property A" in Part I and that item is appraised at $500 or less, then the entry "Property A" in Part II is enough. However, if "Property A" consists of several items and the total appraised value is over $500, list in Part II any item(s) you gave that is valued at $500 or less.

All shares of nonpublicly traded stock or items in a set are considered one item. For example, a book collection by the same author, components of a stereo system, or six place settings of a pattern of silverware are one item for the $500 test.

Example. You donated books valued at $6,000. The appraisal states that one of the items, a collection of books by author "X," is worth $400. On the Form 8283 that you are required to give the donee, you decide not to show the appraised value of all of the books. But you also do not want the donee to have to file Form 8282 if the collection of books is sold. If your description of Property A on line 5 includes all the books, then specify in Part II the "collection of books by X included in Property A." But if your Property A description is "collection of books by X," the only required entry in Part II is "Property A."

In the above example, you may have chosen instead to give a completed copy of Form 8283 to the donee. The donee would then be aware of the value. If you include all the books as Property A on line 5, and enter $6,000 in column (c), you may still want to describe the specific collection in Part II so the donee can sell it without filing Form 8282.

Part III, Declaration of Appraiser

If you had to get an appraisal, the appraiser must complete Part III to be considered qualified. See Regulations section 1.170A-13(c)(5) for a definition of a qualified appraiser.

Persons who cannot be qualified appraisers are listed in the Declaration of Appraiser. Usually, a party to the transaction will not qualify to sign the declaration. But a person who sold, exchanged, or gave the property to you may sign the declaration if the property was donated within 2 months of the date you acquired it and the property's appraised value did not exceed its acquisition price.

An appraiser may not be considered qualified if you had knowledge of facts that would cause a reasonable person to expect the appraiser to falsely overstate the value of the property. An example of this is an agreement between you and the appraiser about the property value when you know that the appraised amount exceeds the actual FMV.

Usually, appraisal fees cannot be based on a percentage of the appraised value unless the fees were paid to certain not-for-profit associations. See Regulations section 1.170A-13(c)(6)(ii).

Part IV, Donee Acknowledgment

The donee organization that received the property described in Part I of Section B must complete Part IV. Before submitting page 2 of Form 8283 to the donee for acknowledgment, complete at least your name, identifying number, and description of the donated property (line 5, column (a)). If tangible property is donated, also describe its physical condition (line 5, column (b)) at the time of the gift. Complete Part II, if applicable, before submitting the form to the donee. See the instructions for Part II.

The person acknowledging the gift must be an official authorized to sign the tax returns of the organization, or a person specifically designated to sign Form 8283. After completing Part IV, the organization must return Form 8283 to you, the donor. You must give a copy of Section B of this form to the donee organization. You may then complete any remaining information required in Part I. Also, Part III may be completed at this time by the qualified appraiser.

In some cases, it may be impossible to get the donee's signature on the Appraisal Summary. The deduction will not be disallowed for that reason if you attach a detailed explanation why it was impossible.

Note: *If the donee (or a successor donee) organization disposes of the property within 2 years after the date the original donee received it, the organization must file* ***Form 8282,*** *Donee Information Return, with the IRS and send a copy to the donor. An exception applies to items having a value of $500 or less if the donor identified the items and signed the statement in Part II (Section B) of Form 8283. See the instructions for Part II.*

Failure To File Form 8283, Section B

If you fail to attach Form 8283 to your return for donated property that is required to be reported in Section B, your deduction will be disallowed unless your failure was due to a good-faith omission. If the IRS asks you to submit the form, you have 90 days to send a completed Section B of Form 8283 before your deduction is disallowed.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: **Recordkeeping,** 20 min.; **Learning about the law or the form,** 29 min.; **Preparing the form,** 37 min.; **Copying, assembling, and sending the form to the IRS,** 35 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.

Marketing to a Defined Constituency - Six Ways of Showing Choices

Peter V. K. Doyle
Director of Planned Giving
Wellesley College
Wellesley, Massachuestts

Marketing to a Defined Constituency -
Six Ways of Showing Choices

This session is 95% photographic. We will look at images of print advertisements, direct mail brochures, reply devices, postcards, and teasers that appear on envelopes.

For production reasons, the conference proceedings book cannot include these images, but I will be happy to send copies of the images upon e-mail request to me at pdoyle@wellesley.edu

The six areas that are covered in the presentation:
- "product" advertising in planned giving
- "image" advertising in planned giving
- single message approaches
- multi-message approaches
- self-produced PG marketing materials
- "Madison Avenue" PG marketing materials

Funding Charitable Split-Interest Trusts With Difficult Assets

David T. Leibell
Daniel L. Daniels

Cummings & Lockwood LLC
Stamford, Connecticut

Table of Contents

FUNDING CHARITABLE SPLIT-INTEREST TRUSTS WITH DIFFICULT ASSETS[1]

David T. Leibell, Esq.
Daniel L. Daniels, Esq.
Cummings & Lockwood LLC, Stamford, Connecticut

INTRODUCTION

Traditionally, charitable remainder trusts have been funded primarily with publicly traded marketable securities. This is changing. With the recent stock market declines and the introduction of the Flip Charitable Remainder Unitrust (FLIPCRUT) in 1998, more CRTs are being funded with what could be called "difficult assets," such as real estate, closely held business interests and even tangible personal property. These assets are "difficult" because they can result in a number of unanticipated tax problems for the creator of a CRT that rarely arise for trusts funded with cash or marketable securities--including onerous private foundation excise taxes, reduction or denial of the expected charitable deduction, gift tax and even full taxation of the gain on the property used to fund the trust. Difficult assets, particularly closely-held stock, have long been used as the funding vehicle for the CRT's cousin, the charitable lead trust, presenting another set of complex tax traps for the unwary practitioner. This outline will review the basic tax treatment of CRTs and CLTs and address some of the common problems presented when difficult assets are used to fund these charitable vehicles.

CHARITABLE REMAINDER TRUSTS

I. CRT FUNDAMENTALS—A QUICK OVERVIEW

A. CRT Defined

1. A CRT is a trust which provides for the payment of (i) a specified distribution, at least annually, (ii) to one or more beneficiaries, at least one of which is not a charity, (iii) for life or for a term of years (**not to exceed 20**), (iv) with an irrevocable remainder interest to be held for the benefit of, or paid over to, charity.

2. The specified distribution to be paid at least annually must be either (i) a **sum certain** which is not less than **5%** nor more than **50%** of the **initial fair market value** of all property placed in trust (in the case of a charitable remainder annuity trust) or (ii) a **fixed percentage** which is not less than **5%** nor more than **50%** of the net fair market value of the trust assets **valued annually** (in the case of a charitable remainder unitrust).

3. A **qualified** CRT is exempt from all taxes for any taxable year of the trust except a taxable year in which it has **unrelated business taxable income**.

4. A **qualified** CRT is a trust with respect to which a deduction is allowable under IRC §§ 170, 2055 and 2522.

B. CRT Regulatory Overview

1. Tax Reform Act of 1969.

Prior to 1969, individuals were creating *inter vivos* and testamentary trusts with non-charitable income interests and charitable remainder interests and taking income, gift and estate tax charitable deductions. Without statutory guidelines in place to guarantee the charitable remainder interest, some of these trusts were manipulated so that there was very little which passed to charity at the end of the trust term. In order to create a better correlation between the charitable deduction and the amount the charity ultimately received, Congress, in 1969, enacted IRC § 664 which sets forth the parameters for how a CRT must be structured in order to qualify for the income, gift and estate tax charitable deductions under IRC §§ 170, 2522, and 2055 and in order for the trust to be a tax-exempt entity.

2. Tax Reform Act of 1997 and the 1998 Final CRT Regulations.

By the early 1990s, certain abusive CRT techniques including the "Accelerated CRUT" were being marketed to very high net-worth individuals as vehicles for diversifying out of large concentrated stock positions with virtually no capital gains tax. For example, the Accelerated CRUT was a 2-year term, 80% payout CRT that manipulated the rules on the taxation of distributions out of a CRT to return approximately 90% of the contributed amount back to the Grantor tax free. This was at a time when the federal capital gains tax was 28%. In 1997, Congress amended IRC § 664, adding two additional requirements -- (1) the 10% minimum remainder test and (2) the 50% maximum payout. On December 10, 1998, the Treasury issued final regulations addressing perceived abuses involving CRTs. The final regulations (i) provide rules for the timing of CRT distributions, (ii) prohibit the allocation of pre-contribution capital gain to trust income but permit post-contribution capital gain to be allocated to trust income and (iii) make IRC § 2702 applicable to NICRUTS, NIMCRUTS and FLIPCRUTS. These code changes and the Regulations have curbed abusive CRT planning. Unfortunately, the 10% minimum remainder test has made CRTs less attractive to individuals under the age of 50 (particularly if there is more than one non-charitable beneficiary), since it limits the payout percentage that can be chosen. On a more positive note, the final regulations provide for a new type of CRT which is a hybrid of a Standard CRUT and a NIMCRUT called a FLIPCRUT. The final regulations also liberalized the valuation rules on unmarketable assets.

C. CRT Requirements

1. Charitable Remainder Annuity Trust Only or Charitable Remainder Unitrust Only— No combining

The trust must be in the form of either a Charitable Remainder Annuity Trust (CRAT) or a Charitable Remainder Unitrust (CRUT) but not a combination of the two. Combining the characteristics of a CRAT and a CRUT will **disqualify** a CRT. Regs. § 1.664-1(a)(2).

2. Irrevocability

The trust instrument must be irrevocable. See, e.g., Regs § 1.664-1(a)(1)(i). However, certain individuals may retain the right to change charitable remainder organizations if such power is allowed under the terms of the trust instrument. Rev. Rul. 76-8. In addition, if language in the trust instrument permits, the trust may be amended (under limited circumstances) to bring the instrument into compliance with the requirements of IRC § 664.

3. CRT Payout

Must be at least 5% (Minimum Payout) but not more than 50% (Maximum Payout). See IRC § 664(d)(1)(A) (for CRATs); IRC § 664(d)(2)(A) (for CRUTs).

4. Non-Charitable Beneficiary

A CRT must have at least one non-charitable income beneficiary (called the "Recipient" in the Regulations).

5. CRT - Trust Term Alternatives

(a) Life or lives of non-charitable beneficiary(ies).

(b) Term of years (not to exceed 20)

(c) Some combination of a and b.

6. Charitable Remainder

(a) At the end of the trust term, any property remaining in the trust must be distributed to one or more public charities and/or private foundations.

(b) Grantor can designate in the trust instrument how the charity should use the remainder interest (e.g. scholarships, endowment fund, etc.).

(c) Trust instrument must include a provision that if a designated charity does not exist or is not qualified at the time the remainder is distributed, one or more alternative qualified charities will receive the share of the disqualified or no longer existing charity.

(d) The value of the CRT remainder interest is determined under IRC § 7520 which provides tables for valuing the charitable remainder using the applicable federal rate (AFR) in effect for the month of the gift to the CRT. The Grantor may also elect to use the AFR for either of the two preceding months. Additional contributions to a unitrust are valued at the time of the addition.

7. Tax Exempt Trust

A qualified CRT is a tax-exempt entity. There is typically no capital gain incurred by the Grantor upon the transfer of appreciated property to a CRT or its subsequent sale by the CRT trustee. **CAVEAT:** A CRT is fully taxable as a complex trust in any year in which it has unrelated business income as defined in IRC § 512. IRC § 664(c).

8. Restriction on Investments

A trust is not a qualified CRT if the trust instrument includes a provision which restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. Regs. § 1.664-1(a)(3).

9. Trust Must be a CRT from Time of its Creation

In order for a trust to be a qualified CRT, it must meet the definition of and function exclusively as a CRT from the date of creation of the trust. Regs. § 1.664-1(a)(4).

10. Governing Instrument Provisions

All CRT trust instruments must include certain **mandatory provisions** required by the IRS in order to be a qualified CRT. In 1989 and 1990 the IRS issued its current model forms for *inter vivos* and testamentary CRTs. (Rev. Procs. 89-20, 89-21, 90-30, 90-31 and 90-32). These model forms contain both mandatory and optional provisions. A CRT will be disqualified for failing to include a mandatory provision. The IRS has a no-rule position on issues covered by the model forms. The IRS announced in Notice 2000-37 that it would be revising its model forms to take into consideration recent statutory and regulatory changes. As of the date of this outline, only the annuity trust forms had been published. See Rev. Procs. 2003-53 through 2003-60.

11. Must Not Be Grantor Trust

In order to be a qualified CRT, the trust must not be treated as a grantor trust under IRC §§ 671-678. Regs. § 1.664-1(a)(4).

12. Private Foundation Prohibitions

CRTs are subject to the private foundation rules prohibiting self-dealing (IRC § 4941) and taxable expenditures (IRC § 4945). CRTs with a charity as one of the income beneficiaries are also subject to the prohibitions on excess business holdings (IRC § 4943) and jeopardy investments (IRC § 4944).

13. Unrelated Business Taxable Income

Certain types of assets generate unrelated business taxable income (UBTI) when owned by a CRT. In any year in which a CRT has UBTI, the trust is fully taxable. This is a problem particularly if the CRT has UBTI in the year in which the low basis asset funding the CRT is sold.

14. Permissible Non-Charitable Beneficiaries

(a) Individuals

(b) Trusts and Estates. Payment to a trust must be limited to a twenty (20) year term except that a CRT for the benefit of an incapacitated individual is not subject to the twenty (20) year term limitations but may be payable over the incapacitated person's lifetime. Rev. Rul. 76-270. For financially incapacitated person, see Rev. Rul. 2002-20.

(c) Corporations, Partnerships and LLCs (limited to twenty (20) year term).

(d) No Pets Allowed

15. Who Can Act As Trustee of a CRT?

(a) The Grantor (under most circumstances)

(b) The Remainder Organization

(c) An Independent Trustee (may be necessary with a retirement NIMCRUT or retirement FLIPCRUT)

16. CRT Reformation

Under certain circumstances a nonqualified CRT can be reformed to make it qualified. IRC § 2055(e)(3). In recent years, the IRS has issued several private letter rulings approving the judicial reformation of CRTs that do not meet the IRC § 2055(e)(3) reformation requirements under the theory of "Scrivener's Error." See, e.g., PLRs 200002029 and 200218008.

17. Valuation of Unmarketable Assets

If unmarketable assets are transferred to or held by a CRT, in order to be a qualified CRT, valuation must be performed exclusively by an independent trustee or determined by a qualified appraisal from a qualified appraiser. Unmarketable assets are assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents (e.g., real property, closely-held stock, tangible personal property). Regs. § 1.664-1(a)(7).

D. Income, Gift and Estate Tax Consequences

1. Income Tax Charitable Deduction (IRC § 170)

(a) The Grantor is entitled to an income tax charitable deduction equal to the present value of the charitable remainder interest. The income tax charitable deduction must be at least 10% of the fair market value of the property contributed to the CRT (the 10% minimum remainder test). Income tax deduction is run off of cost basis rather than fair market value for certain types of property (ordinary income and tangible personal property) as well as for transfers of property that is not Qualified Appreciated Stock where a private foundation can be named as a remainder organization.

(b) Charitable Contribution Percentage Limitations

i. *CRT Limited to Public Charity Remainder Organization.* If the trust instrument provides that only public charities can be named as remainder organizations, the Grantor's income tax charitable deduction will be limited to 30% of AGI for gifts of appreciated property held long-term and 50% of AGI for gifts of cash, with a 5 year carryforward for any unused deduction.

ii. *CRTs with Ability to Name Private Foundations as a Remainder Organization.* If the CRT trust instrument allows private foundations to be named as charitable remainder organizations, the Grantor's income tax charitable deduction will be limited to 20% of AGI for gifts of appreciated property held long-term and 30% of AGI for gifts of cash, with a 5 year carryforward for any unused deduction. Under certain circumstances, the income tax charitable deduction will be calculated on the Grantor's basis in the contributed property rather than the fair market value (i.e., any property which is not considered "Qualified Appreciated Stock" when contributed to a private foundation). IRC § 170(e)(5)(D). Qualified Appreciated Stock includes stock and mutual funds for which market quotations are available on an established securities market.

2. Income Taxation of Non-Charitable Beneficiaries

Although the CRT itself is tax-exempt, the non-charitable beneficiaries' payments are taxed under a system unique to CRTs known as the 4 Tier System. IRC § 664(b); Regs. § 1.664-1(d). It is a worst-in-first-out system taxation. Non-charitable beneficiary payments are taxed as follows:

(a) First - Ordinary income to the extent of the CRT's ordinary income for the year and any undistributed ordinary income for prior years (Tier 1);

(b) Second - Capital gain to the extent of the CRT's capital gain for the year or any undistributed capital gain for prior years (Tier 2);

(c) Third - Tax-exempt income to the extent of the CRT's tax-exempt income for the year and any undistributed tax-exempt income for prior years (Tier 3); and

(d) Fourth - Tax-free return of principal (Tier 4).

For example, assume a CRT is funded with cash and in a given year that the trust has $1,000 of dividends, $3,000 of undistributed capital gains from prior years and $1,000 of municipal bond interest. The Trustee distributed $6,000 to the grantor. Under the Tier System, $1,000 is dividend income, $3,000 is capital gains, $1000 is tax-free municipal bond interest and $1000 is tax-free return of capital. Where the CRT is funded with highly appreciated assets, it is unlikely that Tier 3 or Tier 4 income will come into play because the large unrealized capital gain from the sale of the funding asset will be part of Tier 2.

Note: CRTs can be invested in a manner to minimize Tier 1 income.

(e) Distributions in Kind. The unitrust or annuity amount may be paid in cash or in other property. If a distribution is made in property, the amount paid is considered an amount realized by the trust from the sale or other disposition of property. The basis of the property in the hands of the recipient is its fair market value at the time it was paid. Regs. § 1.664-1(d)(5).

3. Gift Tax Consequences

(a) Transfers to a qualified CRT are entitled to a gift tax charitable deduction for the present value of the charity's interest. **CAVEAT:** The unlimited marital deduction is only available when one or both spouses are the only non-charitable income beneficiaries.

(b) Where there is an income beneficiary other than the grantor, there is a gift by the grantor to the other non-charitable beneficiary (other than a spouse) equal to the actuarial value of the other non-charitable beneficiary's interest. It is possible for the grantor (as long as the grantor is the initial beneficiary) to avoid gift tax by reserving the right exercisable only by Will to revoke only the other non-charitable beneficiary's interest.

4. Estate Tax Consequences

(a) *Estate Tax Marital Deduction - IRC § 2056(b)(8)* - A CRT only qualifies for the unlimited estate tax marital deduction if there is no non-charitable beneficiary other than the Grantor's spouse (except the Grantor).

Examples:

(i) Grantor and spouse as only non-charitable beneficiaries does qualify for the marital deduction.

(ii) Grantor and spouse and children as non-charitable beneficiaries does **not** qualify for the marital deduction.

(b) *Mandatory CRT Estate Tax Payment Provision* - In order to be a qualified CRT, the trust instrument must include a provision that no estate taxes attributable to the CRT shall be paid out of the trust assets. Rev. Rul. 82-128.

E. Other CRT Issues

1. CRT Tax Filings

(a) *Federal Form SS-4* - Application for a Taxpayer Identification Number

(b) *Federal Form 709* - Gift Tax Return for any year there is a contribution to the CRT, unless CRT provides for ability to change charitable remainder organizations, resulting in an incomplete gift.

(c) State Gift Tax Return - if applicable

(d) *Federal Form 8283* - Valuing the gift

Note: With certain funding assets a qualified appraisal may be required. See Regs. § 1.170A-13(c).

(e) *Schedule A of Federal Form 1040* - Taking income tax charitable deduction

(f) *Federal Form 5227* - Annual CRT Information Return

(g) *Federal Form 1041*-A - Trust Accumulation of Charitable Amounts (filed annually unless all net income is required to be distributed currently)

(h) *Federal Forms 1041 and 4720* in any year where there is UBTI

(i) *Federal Form K-1* to income beneficiaries

2. *CRT Trustee's Obligations*

(a) *Duty To Be Impartial* - CRT Trustee has an obligation to act impartially with respect to the interests of the charitable and non-charitable beneficiaries and may not invest in a manner that favors the non-charitable beneficiaries.

(b) *Duty To Diversify* - CRT Trustee has a duty to diversify trust assets in a manner consistent with state law.

(c) *Duty To Properly Administer CRT - In Estate of Atkinson v. Commissioner*, (CA-11) No. 1-16530, 10/16/02, The Eleventh Circuit upheld the Tax Court decision which disqualified a CRT where the Trustee failed to make the annuity payments.

3. *Multiple Grantor CRTs*

Multiple Grantors to a CRT other than spouses may disqualify a CRT as a taxable association. See PLRs 9547004 and 200203029.

4. *Substantiation Rules*

The substantiation rules for certain charitable contributions under IRC § 170(f)(8) do not apply to CRTs.

5. *Wealth Replacement Trust*

A wealth replacement trust is an irrevocable insurance trust created at the same time as the CRT to replace for the family the asset ultimately passing to charity. A portion of the after-tax CRT income is used to pay the premiums for the insurance owned by the wealth replacement trust. At the end of the CRT trust term (usually the death of the survivor of the grantor and his or her spouse) the assets in the CRT pass to charity and the assets in the wealth replacement trust pass to the grantor's children and/or grandchildren free of estate taxes.

6. Reasons for Establishing a CRT

(a) Most Grantors, particularly after the Tax Reform Act of 1997, and capital gains tax reduction to 15% under the 2003 tax reform act, need a certain amount of charitable intent.

(b) Tax-efficient diversification out of a concentrated low basis asset position.

(c) Increase cash flow on a low or no dividend asset.

(d) Estate Tax minimization using wealth replacement trust.

(e) Supplemental retirement planning using Retirement NIMCRUT or FLIPCRUT.

(f) Business Succession Planning.

(g) Income Tax Charitable Deduction.

II. CRATS

A. CRAT-Defined (IRC § 664(d)(1))

1. An irrevocable trust;
2. From which a sum certain (which is not less than 5% nor more than 50% of the initial net fair market value of all property placed in trust);
3. Must be paid, at least annually;
4. To one or more persons (at least one of which is not a charity);
5. For the life or lives of such individual or individuals or for a term of years (not to exceed 20);
6. Which upon the termination of the trust term, the remainder interest must be distributed to, or for the use of, a qualified charitable organization as defined in IRC § 170(c); and
7. The value of the charitable remainder interest (determined under IRC § 7520) must be at least 10% of the initial net fair market value of all property placed in the trust. IRC § 664(d)(2)(D).

B. Additional CRAT Restrictions (Not Applicable to CRUTS)

1. 5% Probability Test of Rev. Rul. 77-374

   CRATS are subject to a special rule which requires that there must not be more than 5% probability that the non-charitable beneficiary (or beneficiaries) will survive the exhaustion of the trust assets.

2. No Additional Contributions

   A CRAT cannot be qualified unless its governing instrument provides that no additional contributions may be made to the trust after the initial contributions. Regs. § 1.664-2(b).

III. CRUTS

A. Standard CRUT - Defined (IRC § 664(d)(2))

1. An irrevocable trust;

2. From which a fixed percentage (which is not less than 5% nor more than 50%) of the net fair market value of the trust assets **as revalued annually**;

3. Is to be paid, at least annually;

4. To one or more persons (at least one of which is not a charity);

5. For the life or lives of the individual beneficiary or beneficiaries or for a term of years (which does not exceed 20);

6. Which upon the termination of the trust term, the remainder interest must be distributed to, or for the use of, a qualified charitable organization as defined in IRC § 170(c); and

7. The value of the charitable remainder interest (determined under IRC § 7520) must be at least 10% of the initial fair market value of all property placed in the trust. IRC § 664(d)(2)(D).

B. Other CRUT Issues

1. Additional Contributions are allowed to any type of CRUT at any time.

2. There are 3 other types of CRUTs besides the STANDARD CRUT -- the NICRUT, the NIMCRUT and the FLIPCRUT (all discussed below).

C. Net Income Only Unitrust -- No Makeup (NICRUT) - IRC § 664(d)(3)

1. The non-charitable income beneficiary is entitled to the lesser of (i) the stated percentage in the trust instrument or (ii) actual trust income. If the trust's actual income as defined in IRC § 643(b) is less than the stated percentage in the trust instrument, the income beneficiary only receives the actual trust income. Any deficiencies in distributions are lost, even if the trust's income exceeds the stated percentage in a subsequent year.

D. Net Income with Makeup Unitrust (NIMCRUT) - IRC § 664(d)(3)

1. The non-charitable income beneficiary is entitled to the lesser of (i) the stated percentage in the trust instrument or (ii) actual trust income. If the trust income for the year is less than the stated percentage, the Trustee pays the income beneficiary only the actual trust income as defined in IRC § 643(b). The difference between the actual income distributed and the stated percentage is made up in later years, if trust income exceeds the stated percentage.

2. Proceeds from the sale or exchange of any assets contributed to the trust by the Grantor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of contribution.

3. Post contribution capital gain can be allocated to income if the trust instrument so provides. According to the IRC § 643(b) regulations, allocation must be mandatory, not at the discretion of the Trustee.

E. FLIPCRUT - Regs. § 1.664-3(a)(1)(i)(c)

1. The 1998 final regulations provide for an additional type of CRUT called the "combination of methods" unitrust or the FLIPCRUT. A FLIPCRUT is a trust that starts out as either a NICRUT or a NIMCRUT. As of the first day of the calendar year following the occurrence of the "triggering event" defined in the trust instrument the trust switches to a STANDARD CRUT.

2. The "triggering event" may be (i) a specific date, (ii) the sale of unmarketable securities held by the trust, or (iii) a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other person (IRS examples include marriage, divorce, death, or birth of a child).

F. CRAT vs. CRUT

1. The CRAT lets the charitable remainder beneficiary reap the benefit of all the appreciation in the trust (along with all risk of loss) while ensuring a fixed annual payment to the income beneficiary.

2. The CRUT allows the non-charitable beneficiary to participate in any appreciation (or reduction in value), since the unitrust amount will either be increased or decreased each year depending upon the performance of the trust investments.

3. Because the CRAT payment is fixed, it is most appropriate for elderly individuals (75 or older) who will not live long enough to see their purchasing power from the trust dramatically reduced. There is also not much possibility for creative CRT planning with a CRAT since payments never change.

G. Which Type of CRUT to Choose

1. *STANDARD CRUT* - usually individuals 50 or older who want to (a) diversify out of a low basis concentrated publicly-traded security, (b) increase income and/or (c) do some estate planning.

2. *NIMCRUT* - With the introduction of the FLIPCRUT in 1998, NIMCRUTS are now primarily used for income deferral purposes such as supplemental retirement planning.

3. *FLIPCRUT* - Used when CRT is funded with real estate, closely-held stock, tangible personal property, as well as for supplemental retirement planning.

IV. FUNDING CRTS WITH DIFFICULT ASSETS

A. In General

Traditionally, CRTs have been funded primarily with publicly traded marketable securities. This is changing. With the recent stock market declines and the introduction of the Flip Charitable Remainder Unitrust (FLIPCRUT) in 1998, more CRTs are being funded with what could be called "difficult assets," such as real estate, closely held business interests and even tangible personal property. These assets are "difficult" because they can result in a number of unanticipated tax problems for the creator of a CRT that rarely arise for trusts funded with cash or marketable securities--including onerous private foundation excise taxes, reduction or denial of the expected charitable deduction, gift tax and even full taxation of the gain on the property used to fund the trust.

B. Difficult Asset Tax Traps

1. The Prearranged-Sale Problem

In contrast to sales of publicly traded securities, sales of difficult assets generally are privately negotiated. If the CRT grantor entered into an informal agreement or understanding to sell the appreciated property to a buyer prior to transferring it to the CRT and the property is ultimately sold by the trust to that buyer, the Internal Revenue Service may recharacterize the transaction as a sale by the grantor personally rather than a sale by the CRT. This means not only that the gain would be taxable instead of being a tax-free sale by the CRT, but also that the grantor would have to pay the full capital gains tax out of his or her own pocket and could not use trust assets to pay the tax. See *Palmer v. Commissioner*, 62 T.C. 684 (1974); Rev. Rul. 78-197; and *Rauenhorst v. Commissioner*, 119 T.C. 157 (2002) for situations favoring the taxpayer. But see *Blake v. Commissioner*, 697 F.2d 473 (2d Cir. 1982) and *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999) for cases favoring the IRS. For much greater detail, see Laura Peebles' outline, "How Late is Too Late," included with these materials.

2. Private Foundation Prohibitions

In 1969 Congress enacted the private foundation excise taxes to discourage perceived abuses. Certain of the private foundation excise taxes are applicable to CRTs.

CRTs are subject to the private foundation excise tax rules prohibiting self-dealing (IRC § 4941) and taxable expenditures (IRC § 4945). CRTs with a charity as one of the income beneficiaries also are subject to the prohibitions on excess business holdings (IRC § 4943) and jeopardy investments (IRC § 4944).

(a) *Self-Dealing.* Contributions of difficult assets commonly raise self-dealing concerns. Under the self-dealing rules, most transactions between a disqualified person and a CRT are strictly prohibited regardless of whether they are fair and beneficial to the CRT.

i. *General Rule.* The general rule is that the self-dealing rules prohibit all transactions between a private foundation and a disqualified person ("DP"). Specifically, there can be *no* (1) sale or exchange, (2) leasing, (3) lending, (4) extension of credit, (5) furnishing of goods, services or facilities, (6) payment of compensation or (7) transfer to or use by or for the benefit of a DP of a the income or assets of a private foundation.

ii. *Definition of Disqualified Person.* DPs include (1) the creator of the trust; (2) substantial contributors to the trust; (3) trustees, directors, officers and other foundation managers; (4) persons holding more than a 20% interest in corporations, partnerships and trusts that are substantial contributors; (5) family members of the foregoing (i.e., ancestors, descendants and spouses); (6) corporations, partnerships and trusts in which any of the foregoing hold more than a 35% voting, profits or beneficial interest. Family attribution rules apply to determine holdings in a corporation, partnership or trust.

(iii) Certain Exceptions to Self-Dealing.

(A) *Interest Free Loans.* A DP can make an interest-free loan to a private foundation if the loan proceeds are used entirely for the private foundation's charitable purposes.

(B) *Goods and Services.* A DP can provide goods, services and/or facilities to a private foundation as long as provided at no cost and used exclusively for the private foundation's charitable purposes. A private foundation can provide goods, services and/or facilities to a DP if on a basis no more favorable than that on which the goods, services and/or facilities are made available to the general public (e.g., if a private operating foundation runs a public park, a DP can visit the park on the same basis that other members of the general public can do so).

(C) *Compensation*. DPs can receive compensation for administrative services (accounting, legal, investment advisory and certain banking services). Compensation and reimbursement for expenses must be for services and expenses that are reasonable and necessary to carrying out the private foundation's exempt purposes and must not be excessive.

(D) *Redemptions*. If a corporation is a DP, any liquidation, merger, redemption, recapitalization or other corporate adjustment, organization or reorganization is not self-dealing if all securities of the same class as those held by the private foundation are subject to the same terms and the terms provide for receipt by the private foundation of no less than fair market value. See PLR 200117016.

iv. *Definition of Indirect Self-Dealing*. Self-dealing includes not only direct transactions between the private foundation and DPs but also transactions between an entity controlled by the foundation and DPs. Therefore, if a private foundation controls a corporation or other entity, then transactions between the corporation and the donor, the donor's family and entities controlled by the donor or his family can be self-dealing. For example, suppose a private foundation owns 90% of the voting stock of a family corporation and the corporation leases its headquarters building from its founder, who happens to be the grantor of the CLT. Such lease would be an act of self-dealing.

v. *Definition of "Control" for Indirect Self-Dealing Purposes*. In the case of a transaction between a corporation or other entity controlled by a private foundation and a DP, the private foundation is deemed to control the corporation for indirect self-dealing purposes if such DP, together with one or more persons who are DPs by reason of their relationship to such DP (e.g., family members of the DP), may, only by aggregating their votes or positions of authority with that of the private foundation, require the corporation to engage in a transaction that would be self-dealing if engaged in between the private foundation and the DP directly. The regulation provides that the corporation will be considered to be controlled by the private foundation or by the private foundation and DPs if such persons are able, in fact, to control the corporation (even if their aggregate voting power is less than 50 percent of the total voting power of the corporation's governing body) or if one or more of such persons has the right to exercise veto power over the actions of the corporation relevant to any potential acts of self-dealing. Regs. § 53.4941(d)-1(b)(5). Consider the following examples:

(A) Foundation owns 90% of voting stock of ABC Corporation. The foundation controls the corporation for purposes of the indirect self-dealing rules.

(B) Foundation owns 20%, DP#1 owns 16% and DP#2 owns 15% of the voting stock of ABC Corporation. The Foundation controls the corporation for purposes of the indirect self-dealing rules because, by aggregating their votes, the Foundation, DP#1 and DP#2 can cause the corporation to engage in acts that would be prohibited acts of self-dealing if engaged in by the Foundation directly. On the other hand, if the Foundation owns 35% of ABC Corporation and DPs together own 65%, the Foundation does not control the corporation for purposes of the indirect self-dealing rules, because the DPs do not need to aggregate their votes with those of the Foundation in order to be in a position of control. Rev. Rul. 76-158, 1976-1 C.B. 354.

(C) Foundation owns only nonvoting stock in ABC Corporation. DPs own 100% of voting stock. Foundation should not be deemed to control ABC for purposes of the indirect self-dealing rules.

vi. Self-Dealing Penalties.

(A) *First-Level Tax*. The first-level tax on the DP is 5% of the amount involved in the act of self-dealing. For how to determine the amount involved, see IRC § 4941(e)(2) and Regs. § 53.49419e)-1(b). In addition, a foundation manager (e.g., a CRT trustee) who knowingly participates in the act of self-dealing must pay 2-1/2% of the amount involved-- up to $10,000-- unless his or her participation is not willful and is due to reasonable cause.

(B) *Second-Level Tax*. The second-level tax imposed on the DP is 200% of the amount involved, and applies if the act is not corrected by the earlier of the date a deficiency notice is mailed by the IRS or the tax is assessed. The second-level tax on the foundation manager is 50% of the amount involved-- up to $10,000-- and is imposed if the manager does not agree to part or all of the correction. Where a foundation manager is also a DP (other than in his capacity as a foundation manager), he or she is liable for all the taxes in both capacities. Regs. §53.4941(a)-1(a).

vii. Example. Fulfillment of an individual's existing binding pledge by creating a charitable remainder trust is self-dealing because the trust assets are being used to benefit the donor-- a DP-- in violation of Regs. § 53.4941(d)-2(f)(1). PLR 9714010.

3. *Unrelated Business Taxable Income*

When the current federal income tax was first enacted, charitable organizations enjoyed a complete exemption from the tax. Over the years, an increasing number of charities took advantage of the blanket tax-exemption by purchasing and operating for-profit businesses without having to pay any corporate income tax. Concerned about the loss of tax revenue and the unfair competitive advantage that tax-exempt businesses had over for-profit competitors, Congress, in 1950, enacted the unrelated business income tax ("UBIT") to tax the unrelated business taxable income (UBTI) of tax-exempt organizations.

A broad range of organizations and gifts are subject to the tax. The tax does not distinguish between direct investments by charities and assets received as charitable gifts. Also, the UBIT rules apply not only to outright gifts to public charities but also to gifts to private foundations, charitable remainder trusts and non-grantor charitable lead trusts. Common examples of charitable gifts to which UBIT can apply include gifts of mortgaged real estate, margined securities, many hedge fund and private equity fund interests, S corporation stock, limited liability company interests and limited partnership interests.

Income is subject to UBIT only if the income is from 1) an activity which constitutes a trade or business; 2) the trade or business is regularly carried on; and 3) the activity is not substantially related to the organization's exempt purposes. Most passive income, such as rents, royalties, dividends, interest and annuities, is not subject to UBIT. Passive income will be subject to UBIT to the extent it is derived from "debt-financed property."

Debt-financed property generally means any property held to produce income (including gain from the sale of such property) for which there is "acquisition indebtedness" at any time during the year (or during the 12-month period before the date of the property's disposal, if it was disposed of during the year.)[2] The amount of UBTI is proportionate to the debt on the property.[3] Most of the UBIT issues that arise in the area

---

[2] Acquisition indebtedness is the unpaid amount of debt incurred under the following circumstances: (1) when acquiring or improving the property, (2) before acquiring or improving the property if the debt would not have been incurred except for the acquisition or improvement, or (3) after acquiring or improving the property if: (a) the debt would not have been incurred except for the acquisition or improvement, and (b) incurring the debt was reasonably foreseeable when the property was acquired or improved. The facts and circumstances of each situation determine whether incurring a debt was reasonably foreseeable.

[3] The computation of the charitable organization's debt-financed income is as follows. For each debt-financed property, the unrelated debt-financed income is a percentage (not over 100%) of the total gross income derived during a tax year from the property. This percentage is the same percentage as the average acquisition indebtedness with respect to the property for the tax year is of the property's average adjusted basis for the year (the debt/basis percentage). When only part of the property is debt-financed property, proper allocation of the basis, debt, income,

of charitable giving stem from debt-financed property concerns. There are limited exceptions to the debt-financed property rules for certain types of mortgaged property.

For example, if property subject to a mortgage is acquired by gift, bequest, or devise, the outstanding principal debt secured by the mortgage is not treated as acquisition indebtedness for a 10-year period beginning on the date the property is received by the charity, if the mortgage was placed on the property more than five years before the date of the gift and the donor held the property for more than five years before the date of gift.[4]

4. *Section 170(c) Drafting Trap:*

If the CRT trust instrument allows a private foundation to be named as one of the charitable remainder organizations, the grantor's income tax deduction will be subject to the more restrictive adjusted gross income limitations applied to gifts to private foundations rather than the more generous limitations applied to gifts to public charities. In addition, the grantor's income tax deduction will be calculated by reference to the grantor's basis in the contributed property rather than the property's fair market value. This basis limitation does not apply if the grantor gives "qualified appreciated stock" to the CRT. Qualified appreciated stock generally means stock in a publicly traded company, subject to the limitations of section 170(e)(5).

If the grantor has no intention of ever naming a private foundation as one of the remainder organizations and the trust is funded with difficult assets, the trust instrument should always include a provision limiting the charitable remainder organizations to public charities as described in section 170(b)(1)(A). Under most circumstances, this will guarantee that the charitable deduction will be computed based on the contributed asset's fair market value rather than its basis. Note that the IRS-approved forms of CRTs (other than the notes to the new CRAT forms) do *not* contain a specific reference to section 170(b)(1)(A); accordingly, practitioners using the IRS-approved forms may unwittingly cause their clients to receive a lower charitable deduction.

5. *Mortgaged Property Problem*

Funding a CRT with mortgaged property is very difficult to accomplish in a tax-efficient manner because of the following concerns:

(a) *Grantor Trust*. Regs. § 1.664-1(a)(4) provides that a CRT is created as soon as neither the grantor nor any other person is treated as the owner of the trust. If the grantor remains liable on the debt, the CRT is treated as a grantor trust for income tax purposes. That means it is not a tax-qualified CRT, and the grantor loses the income and gift tax charitable deductions, plus, the trust loses its tax-exempt status. The grantor will be liable for any capital gains taxes generated when any appreciated trust asset is sold.

---

and deductions with respect to the property must be made to determine how much income or gain derived from the property to treat as unrelated debt-financed income. For example, suppose X, a charitable organization, owns, as an investment, an office building that is debt-financed property. The building produced $10,000 of gross rental income last year. The average adjusted basis of the building during that year was $100,000, and the average acquisition indebtedness with respect to the building was $50,000. Accordingly, the debt/basis percentage was 50% (the ratio of $50,000 to $100,000). Therefore, the unrelated debt-financed income with respect to the building was $5,000 (50% of $10,000).

[4] This exception does not apply if an organization assumes and agrees to pay all or part of the debt secured by the mortgage or makes any payment for the equity in the property owned by the donor or decedent (other than a payment under an annuity obligation excluded from the definition of acquisition indebtedness). Whether an organization has assumed and agreed to pay all or part of a debt in order to acquire the property is determined by the facts and circumstances of each situation. Exceptions to debt-financed property also exist if substantially all of the use of the property is related to the charitable organization's exempt purpose or if a charitable organization acquires real property with the intention of using the property for exempt purposes within 10 years and such property is in the neighborhood of other property that the organization uses for exempt purposes.

(b) *UBTI.* Mortgaged property can create a UBTI problem because of the debt-financed property rules in section 514, unless the narrow exception of section 514(c)(2)(B) applies.

(c) *Bargain Sale.* When a CRT is funded with mortgaged property, the transaction is treated as a bargain sale for income tax purposes under IRC § 1011(b). This forces the grantor to recognize gain on some portion or all of the outstanding mortgage value. This rule applies regardless of whether the mortgage is recourse or non-recourse and regardless of whether the grantor continues to pay the mortgage.

(d) *Self-Dealing.* It would appear that a donor is prohibited from transferring a mortgaged asset to fund a CRT if the mortgage was placed on the property within 10 years of the transfer. IRC § 4941(d)(2)(A). However, the self-dealing prohibition may not apply to the initial transfer of mortgaged property to a CRT. Regs. § 53.4941(d)-1(a) provides that "[t]he bargain sale of property to a private foundation is not a direct act of self-dealing if the seller becomes a disqualified person only by reason of his becoming a substantial contributor as a result of the bargain element of the sale." If, however, the loan principal remains outstanding once the donor becomes a DP, the IRS has privately ruled that a new act of self-dealing occurs in each year in which the loan remains uncorrected. PLR 9530032 (revoking PLR 9343033).

C. Specific Difficult Assets

The extent to which any of the tax traps discussed above will arise in a given CRT depends, in part, on the type of asset involved.

1. Real Estate

A gift of real estate to a CRT typically presents substantial, though often solvable, tax problems, including the following:

(a) *The mortgaged-property problem.* The single biggest problem with gifts of real estate to a CRT is the mortgaged-property problem described above. A gift of mortgaged property is treated as a bargain sale, may cause the trust to have UBTI, may cause the CRT to be treated as a grantor trust, thus losing its tax-exempt status, and raises self-dealing concerns. Our advice to clients is simple: Get rid of the mortgage before funding the CRT.

(b) *Prearranged sale.* The grantor should not be subject to a binding obligation to sell the property before it is contributed to the CRT. Therefore, the practitioner should ensure that no sale contract or option has been signed prior to the contribution to the CRT.

(c) *Private foundation excise taxes.* A gift of unmortgaged residential real property to a CRT poses possible self-dealing problems under section 4941. For example, if the grantor continues to reside--even for one second--in the residence after it is contributed to the CRT, the CRT is deemed to have conferred a direct benefit on the grantor, thereby subjecting the trust and the grantor to the excise tax. The self-dealing tax cannot be avoided by having the grantor lease the property from the trust after the property has been contributed to the CRT. Treas. Reg. 53.4941(d)-2(b); Rev. Rul. 76-357, 1976-2 C.B. 285. Accordingly, the grantor must move out of the residence *before* it is contributed to the CRT.

There is a certain amount of confusion regarding whether a CRT can be funded with an undivided interests in property where the donor keeps another interest in the same property. In PLR 9114025, the IRS approved of three unitrusts funded with undivided interests in a limited partnership. The partnership's main asset was a shopping center. Originally, the donors had planned to fund the CRTs with undivided interest in the shopping center, but the IRS warned that the trusts would not qualify, apparently due to self-dealing problems. See Blattmachr, "Something Pretty Scary: Application of

Certain Private Foundation and UBTI Rules in Estate Planning and Administration," 26 University of Miami Institute on Estate Planning, Ch. 10 (1992). But see PLR 7751033.

(d) *UBTI.* We discussed the UBTI problem in connection with mortgaged real estate above. However, note that the UBTI problem is not limited to mortgaged real estate. UBTI can sometimes result if the real estate is subject to a lease. Generally, rent payments qualify for the passive income exception to UBIT. However, if the lease payments look more like an active trade or business and less like the passive collection of rent by the CRT, then the exception does not apply. This could be so if, for example, a commercial lease contains provisions in which the rental payments are tied in some way to the profits of the tenants.

(e) *Depreciation Recapture.* If the real estate, whether owned outright or indirectly through a pass-through entity by the CRT, was subject to accelerated depreciation that may be recaptured upon a later sale, the charitable deduction must be reduced by the amount of recaptured depreciation. IRC §§ 1245 and 1250. If the amount of recapture income is greater than the income tax charitable deduction, the CRT may have UBTI upon sale of property by CRT. Regs. §§ 1.1245-6(b) and 1.1250-1(c)(2).

(f) *Option on Mortgaged Real Estate.* In PLR 9501004, the IRS ruled that a CRT would not be qualified when a donor funded the CRT with an option to buy real estate (rather than the property itself) in order to avoid the mortgaged property concerns.

2. S Corporation Stock

(a) A CRT is not permitted to be an S corporation shareholder. A gift of S corporation stock to a CRT will cause the corporation to lose its subchapter S status and be taxed thereafter as a C-corporation.

(b) It is possible to have the S corporation create the CRT itself, contribute some of its assets to the trust and be the trust beneficiary. See PLR 9340043. But see PLR 200203034 (CRT created by S corporation giving successor unitrust interest to corporation's shareholder and spouse would be taxed as an association and therefore would not be a valid CRT). If this approach is used, the term of the CRT cannot exceed 20 years. IRC § 664(d)(2)(A).

(c) The issues of mortgaged property, prearranged sale, self-dealing and UBTI described above in connection with gifts of real estate are equally applicable to an S corporation's gift of assets to a CRT. In particular, all of the CRT's income from the S corporation will be treated as UBTI. However, there are two additional tax traps that are unique to S corporation gifts.

  i. First, if the S corporation contributes appreciated assets, IRC § 1366(d) limits the shareholders' charitable deduction to the shareholders' basis in the stock.[5]

  ii. Second, if the S corporation contributes substantially all of its assets to the CRT, then the corporation may recognize gain under section 337(d).[6]

---

[5] The shareholders' bases in the S stock would be reduced by the amount of the charitable deduction. See IRC § 1367(a)(2)(B), cited in PLR 9340043.

[6] According to the IRS Exempt Organizations CPE Text For Fiscal Year 2000, Chapter U, "Treas. Reg. Sec. 1.337(d)-4 And Exempt Organizations, "if an S corporation had been a Subchapter C corporation within ten years of the disposition, it could trigger a corporate-level "built-in gains" tax. Sec. 1374."

3. *C-corporation Stock*

Closely held C-corporation stock may be an appropriate funding asset in some circumstances. The typical situation involves the owner of a closely held business organized as a C-corporation who is contemplating a liquidation of his or her interest, either through a sale to a third party or a redemption by the corporation itself. The issues presented here are numerous, and include the following:

(a) *Prearranged sale.* This is the most common issue we see in connection with gifts of closely held C-corporation stock to a CRT. Often, the grantor's estate and charitable planning advisers are not consulted regarding personal tax and estate planning until after a deal to sell the business has been negotiated. Depending on the particular facts, a CRT will not be effective to shelter the gain on the subsequent sale of the business. The prearranged sale issue should not be a problem if the stock is to be redeemed by the corporation rather than purchased by a third party, provided that the trustee of the CRT is under no binding obligation to offer the stock for redemption after the transfer to the trust. Rev. Rul. 78-197, 1978-1 C.B. 83. See *Rauenhorst*, 119 T.C. 157 (October 7, 2002) in which the Tax Court held that Internal Revenue Service could not disavow its own favorable-to-taxpayer 1978 ruling on whether stock sale was prearranged. And IRS's Chief Counsel (apparently in response to *Rauenhorst*) reminded its attorneys not to take a position inconsistent with published Internal Revenue Service guidelines. IRS Chief Counsel Notice CC-2002-043, 2002 Tax Notes Today 206-13 (October 24, 2002).

(b) *Private foundation excise taxes.* The sale of C-corporation stock or assets by a CRT to a third party should not trigger the private foundation self-dealing excise tax unless the third party is a "disqualified person." Thus, a sale of the CRT's stock or assets to the grantor's child who expects to take over the family business from the grantor would be a prohibited act of self-dealing because the child is a DP. In contrast, a redemption of the CRT's stock by the corporation, rather than a sale to a third party, would not result in a self-dealing tax if the offer to redeem is at fair market value and is made to all shareholders holding the same class of stock. IRC § 4941(d)(2)(F); PLRs 9015055, 9338046 and 9347035. In order to qualify for this exception, it may be advisable to structure the gift to the CRT as a separate class of stock held only by the CRT. Then, the corporation can redeem only the CRT's stock while still qualifying for the redemption exception to the self-dealing rules.

(c) *UBTI.* Gifts of C-corporation stock generally do not raise UBTI problems because the trade or business income of the corporation is taxed at the corporate level. However, if the CRT owns more than 50% of the voting power and more than 50% of the equity in the C-corporation, then any interest, annuity, royalty or rent (but not dividends) paid from the corporation to the CRT will constitute UBTI under section 512(b)(13).

(d) *Other C-corporation gift problems.* If a CRT is not able to sell the C-corporation stock, it may have to sell the C-corporation assets. The sale of C-corporation assets by the CRT followed by liquidation of the C-corporation inside of the CRT results in a tax at the corporate level under section 337(d). This dramatically reduces the benefits of the CRT.

4. *Partnerships and LLCs*

(a) *UBTI.* Hedge funds and other "alternative" investments often are structured as limited partnerships or LLCs. In connection with their investment strategies, these entities frequently utilize debt or derivative products that may look more like debt than equity. Alternatively, if the fund is a venture-capital fund, it may invest directly in operating businesses that are not C-corporations. As a result, the primary problem presented by gifts of partnership or LLC assets to a CRT is UBTI. If a CRT owns an interest in a partnership or an LLC that operates an active trade or business or has debt-financed property, the CRT will have UBTI because the tax attributes of a partnership or LLC flow through to its partners or members. As a consequence, the CRT will lose its tax exemption for the year. This result often can be avoided by having the CRT's investment in the partnership or LLC structured through a C-corporation or controlled foreign corporation that "blocks" the UBTI from ever reaching the CRT. See PLR 199952086. Many hedge funds and alternative investment funds have established such "blocker" corporations, either domestically or offshore, for the express purpose of attracting tax-exempt investors such as CRTs. Alternatively, it may be possible for the CRT to create its own blocker corporation through which to make such investments. See PLR 200315028; 200315032; 200315034; and 200315035.

(b) *Self-dealing.* The self-dealing rules may make the day-to-day management of the partnership or LLC difficult when a CRT is a partner or member because any transaction between the LLC or partnership and the CRT must be scrutinized to determine whether or not it violates the self-dealing rules.

i. See, e.g., PLR 200326039. In that ruling an S corporation operated a condominium, and transferred several of the units to an LLC in return for a 98% membership interest in the LLC. The remaining 2% of the LLC was owned by a management company controlled by the son-in-law of the S corporation's controlling shareholder. The S corporation created a term of years CRUT to be funded with its 98% interest in the LLC. The IRS ruled that the LLC was controlled by the CRUT for purposes of the indirect self-dealing rules but that a management agreement between the LLC and the management company was not self-dealing because the services provided by the management company qualified for the "personal services" exception. The management agreement specifically excluded

(c) *Other issues.* The IRS currently has a no-rule position on Net Income with Makeup Unitrusts funded with partnership interests due to a concern over the ability to manipulate the timing of distributions of income from the CRT. Rev. Proc. 2003-3, 2003-1 I.R.B. 113.

5. Tangible Personal Property

Tangible personal property--such as paintings, sculpture and jewelry--can sometimes be an appropriate asset with which to fund a CRT. While the general tax traps described above must all be considered in the case of a tangible personal property gift, there are three additional tax problems specific to such gifts. First, the grantor's income tax deduction is *delayed* until the property is actually sold by trustee because the transfer to the CRT is considered a charitable contribution of a future interest in tangible personal property. IRC § 170(a)(3). Second, the grantor should be informed that his or her income tax deduction for the remainder interest will be based on the lesser of the property's fair market value or its cost basis under section 170(e)(1)(B). Third, if the property has been subject to accelerated depreciation (e.g., farm equipment) then the charitable deduction may be further reduced.

In PLR 9452026, a donor planned to fund a CRT with an appreciated musical instrument. The donor was not in the business of dealing in musical instruments and had not depreciated the property. The IRS ruled that an income tax deduction would be allowed under IRC § 170(a)(3) when the trustee sells the instrument. The IRS stated that because the instrument would be sold, the gift to the CRT would be deemed an unrelated use and the deduction would be limited to basis. Finally, the IRS ruled that any gain on the sale of the instrument would not be attributable to the donor.

V. CLT FUNDAMENTALS - A QUICK OVERVIEW

A. Charitable Lead Trust ("CLT") Vocabulary[7]

1. *"Charitable Remainder Trust in Reverse"*

A CLT is often referred to as a charitable remainder trust in reverse because the usual roles of charitable and non-charitable beneficiaries are reversed. In a CLT, charity "leads off" by receiving an income interest for a certain period of time, after which non-charitable beneficiaries receive the remaining trust principal.

2. *"Lead Interest"*

The **lead interest** in a CLT is charity's right to receive payments from the trust for a certain term. That right may take the form of the right to receive an annuity payment or a unitrust payment.[8] An **annuity payment** is the right to receive a specified amount from the trust each year that does not change from year to year. A **unitrust payment** is the right to receive a specified percentage of the trust assets each year which necessarily will vary as the value of the trust changes from year to year.

3. *"Term"*

The **term** of a CLT is the length of time over which charity is to receive its annuity or unitrust payments. The term may be the life or lives of a permitted individual or individual or a term of years or a combination of the two.[9] In contrast to a charitable remainder trust, if the term of a CLT is measured by a term of years, that term need not be limited to 20 years.

4. *"Remainder Interest"*

The "**remainder interest**" is the right of the non-charitable remainder beneficiaries to receive the remaining principal of the trust at the expiration of the charitable term. The remainder beneficiaries may be the grantor or other non-charitable beneficiaries.

B. Types of CLTs

1. *Qualified CLT*

A **qualified CLT** is a CLT that meets various Code requirements for deductibility of the lead interest for federal estate, gift and/or income tax purposes.

A qualified CLT may be either a charitable lead annuity trust ("CLAT") or a charitable lead unitrust ("CLUT"). A charitable lead annuity trust is a CLT in which charity is to receive a guaranteed annuity

---

[7] The Internal Revenue Code ("Code") provisions relating to CLTs are found at sections 2055(e)(2)(B) [estate tax]; 2522 (c)(2)(B) [gift tax]; and 170(f)(2)(B) [income tax] and the Treasury Regulations thereunder.

[8] In rare instances, the lead interest may simply be the right to receive the income from the trust. However, this type of lead interest does not create a tax-qualified charitable lead trust and, therefore, is not discussed in this outline.

[9] The permissible measuring lives are limited to the grantor, her spouse, and/or a lineal ancestor or the spouse of a lineal ancestor of the remainder beneficiaries. Regs. §§ 1.170A-6(c)(2)(i)(a) and (ii)(a); 20.2055-2(e)(2)(vi)(a) and (vii)(a); 25.2522(c)-3(e)(2)(vi)(a) and (vii)(a).

payment during the term of the trust. A charitable lead unitrust is a CLT in which charity is to receive a guaranteed unitrust interest during the term of the trust.

A qualified CLT may be either inter vivos or testamentary. An inter vivos charitable lead trust is a CLT created during the donor's lifetime. A testamentary charitable lead trust is a CLT created under the donor's Will. An inter vivos CLT provides gift tax advantages and in some cases may also produce an income tax benefit. A testamentary CLT generally provides only estate tax advantages.

Unlike a charitable remainder trust, a CLT is not exempt from federal income tax. The manner in which trust income is taxed depends upon whether the CLT is a "grantor" CLT or a non-grantor CLT. A grantor charitable lead trust is a CLT of which the donor (or "grantor") is treated as the owner for federal income tax purposes because of certain powers that the grantor or parties related to the grantor retain over the trust. The donor is taxed on all of the income of a grantor CLT regardless of the fact that the income is never distributed to the donor. A non-grantor charitable lead trust is taxed as a standard "complex" trust for income tax purposes meaning, generally, that the trust is taxed on all of its net undistributed income and on all capital gains. However, a non-grantor CLT does generally receive a charitable income tax deduction for the annuity or unitrust payments made to charity each year. A grantor CLT does not receive such a deduction.

2. Non-Qualified CLT

A **non-qualified charitable lead trust** is an irrevocable trust providing an income interest to charity that does not meet IRC requirements for estate, gift or income tax deductibility. A non-qualified CLT generally is taxed as a complex trust for income tax purposes.

VI. BENEFITS

A. To Charities

A lead trust can enable a charity to "lock in" an immediate and possibly sizable gift. Charitable lead trusts tend to be used only by wealthy donors. Because the trust is a highly complex technique involving fairly significant legal and administrative costs, it generally is not cost-effective unless funded with a large amount of assets--in our office we generally advise against a lead trust with anything less than $1,000,000 in initial funding. Moreover, the trust agreement is irrevocable and, in contrast to a charitable remainder trust, often provides immediate payments to the charity.

B. To Donors

In addition to providing a means for benefiting a favorite charity, a properly designed lead trust will produce an estate or gift tax deduction for the donor for the value of that portion of the trust designated for charity. In addition, if the lead trust is structured as a "grantor" trust for income tax purposes, the donor is permitted to take an immediate income tax deduction for the value of charity's interest in the trust. However, the benefit of the income tax deduction may be diluted by two factors: First, the donor will be subject to tax on all of the trust's income during the charitable term. Second, if the donor dies or the trust otherwise loses its grantor trust status during the charitable term, then the benefit of the charitable income tax deduction is "recaptured" at that time.

C. To Family Members

A donor is considered to have made a taxable gift to a lead trust equal to the initial value of the assets contributed to the trust less the value of charity's interest in the trust. The value of charity's interest in the trust is computed by reference to a discount rate promulgated each month by the Treasury under section 7520 of the

Code. If the assets in the lead trust perform at a rate greater than the section 7520 rate, the family will receive assets in excess of that which was reported to the IRS as a taxable gift.

Example I-1: In July 2003, when the assumed discount rate is 3%, Donor contributes $1,000,000 to a 20-year charitable lead trust paying an annuity of $67,216 per year. The value of charity's interest in the trust would be $1,000,000, meaning that the taxable gift to the remainder beneficiaries would be zero. If the trust assets perform at a rate of less than 3% per year for the 20-year term, there will be nothing left in the trust for the remainder beneficiaries. However, if the trust assets perform at a rate better than 3%, then the remainder beneficiaries will receive such excess appreciation.

These benefits are magnified if the trust can be designed to eliminate or reduce generation-skipping transfer tax. However, at least in the case of a charitable lead *annuity* trust, structuring the trust to avoid application of the generation-skipping transfer tax is problematic.

D. To Business Owners

A donor owning stock in a closely held business may be concerned that the business would have to be sold at death to pay estate taxes. One way of significantly reducing the estate tax attributable to the business would be for the donor to create a lead trust under her Will to which a significant portion of nonvoting stock in the business would be bequeathed. The donor's estate would receive a charitable deduction for the value of charity's interest in the trust, thereby reducing the estate tax payable at the donor's death to a more manageable level and possibly avoiding the need for a forced sale of the business. There may be significant disadvantages to placing a business in a lead trust, however, including application of onerous private foundation excise tax provisions, loss of control over the business and cash flow, and other issues. Some of the private foundation excise tax problems can be addressed by ensuring that the value of charity's interest in the trust does not exceed 60%. Recapitalizing the business into voting and nonvoting stock and transferring only nonvoting stock to the lead trust can sometimes solve the control issue. The question whether there will sufficient cash flow within the business to fund the payments to charity is not easily solved. If the business is structured as an S corporation, a non-grantor lead trust may produce significant negative income tax results.

VII. ESTATE AND GIFT TAX DEDUCTIBILITY

A. Denial of Deduction for Gifts to "Split Interest" Trusts

IRC Sections 2055(e)(2) and 2522(c)(2) generally deny a gift or estate tax charitable deduction for gifts to trusts in which charity has only a partial interest. These code sections were enacted in 1969 in response to certain perceived abuses concerning charitable trusts. For example, under a pre-1970 charitable trust, a donor might provide for all of the trust income to be paid to charity for a certain period of years, with the remainder payable to her children. Prior to 1970, the law would have permitted a charitable deduction for the value of charity's income interest at fixed assumed discount rate. However, the Trustee would be free to invest the trust in such a way as to produce income less the assumed discount rate, with the result that the charitable deduction would be overvalued and the taxable gift to the children undervalued. In response, sections 2055(e)(2) and 2522(c)(2) deny a deduction for such "split interest" trusts unless charity's interest in the trust takes the form of a guaranteed payment, i.e., either a guaranteed annuity interest or a guaranteed unitrust interest.

B. Guaranteed Annuity Interest

Sections 2055(e)(2)(B) and 2522(c)(2)(B) of the Code and the Regulations thereunder[10] set forth the following requirements in order for an interest to qualify as a guaranteed annuity interest:

1. Charity must have the irrevocable right, granted under the governing instrument, to receive a fixed amount payable at least annually.

2. The annuity amount can be described as a percentage of the assets initially contributed to the trust. Treas. Reg. §§ 20.2055-2(e)(2)(vi); 25.2522(c)-3(c)(2)(vi). This method of describing the annuity amount can be particularly useful for hard-to-value assets, such as real estate or closely held stock because the annuity amount automatically adjusts if the value of the contributed property is adjusted in an IRS audit.

Example III-1: Donor contributes closely held stock appraised at $1,000,000 to a 20-year charitable lead trust directing the payment of an annuity of 6.7216% of the value of the assets initially contributed to the trust "as finally determined for federal gift tax purposes." Using the July 2003 discount rate of 3% and the appraised value of the trust assets, the annuity amount would be $67,216 per year and the value of charity's interest in the trust would be $1,000,000, resulting in a zero taxable gift to the remainder beneficiaries. On audit, the valuation of the property contributed to the CLAT is adjusted to $2,000,000. If the annuity amount were described simply as "$67,216 per year" then the taxable gift to the children would increase to $1,000,000, possibly generating an unexpected federal gift tax. However, because the annuity is described as a set percentage of the initial value of the trust assets as finally determined for federal gift tax purposes, the result of the valuation adjustment on audit is simply an increase in the annuity amount from $67,216 to $134,432 and a corresponding increase in the charitable deduction to $2,000,000. The taxable gift would remain at zero.

3. Under Treas. Reg. §§ 20.2055-2(e)(2)(vi) and 25.2522(c)-3(c)(2)(vi), the annuity interest must be a guaranteed annuity interest "in every respect." Accordingly, the trust agreement cannot provide that charity is to receive a payment equal to the lesser of a sum certain or a fixed percentage of the net fair market value of the trust assets. However, it is permissible for the trust agreement to provide for a varying annuity amount as long as the amounts to be paid are ascertainable on the date of the initial transfer to the trust. Assuming that the value of the trust assets is likely to appreciate over the life of the trust, it is advantageous to the trust remainder beneficiaries for the annuity payments to charity to be "end-loaded" such that the annuity payments in the early years of the trust are small and the annuity payments in later years are much larger. In this way, more of the trust assets are invested to produce returns for the remainder beneficiaries than is the case with a "straight" lead trust.

4. The governing instrument may permit any income in excess of the annuity amount to be paid to charity, but this will not increase the amount of the charitable deduction. Treas. Reg. §§ 20.2055-2(e)(2)(vi)(d) and (vii)(d); 25.2522(c)-3(c)(2)(vi)(d) and (vii)(d). Otherwise, the governing instrument generally should prohibit payments to anyone other than the charitable beneficiaries during the charitable term.

C. Guaranteed Unitrust Interest

Sections 2055(e)(2)(B) and 2522(c)(2)(B) of the Code and the Regulations thereunder[11] set forth the following requirements in order for an interest to qualify as a guaranteed unitrust interest.

1. Charity must have the irrevocable right, granted under the governing instrument, to receive a fixed percentage of the fair market value of the trust assets valued on the same day (or the average of several

[10] Treas. Reg. §§ 20.2055-2(e)(2)(vi) and (vii); 25.2522(c)-3(c)(2)(vi) and (vii).

[11] Treas. Reg. §§ 20.2055-2(e)(2)(vi) and (vii); 25.2522(c)-3(c)(2)(vi) and (vii).

days) each year, provided that the same valuation date or dates are used each year. Where the governing instrument does not specify the valuation date or dates, the trustee must select the date or dates on the first form 1041 that the trust is required to file. Treas. Reg. §§ 20.2055-2(e)(2)(vii); 25.2522(c)-3(c)(2)(vii).

2. Under Treas. Reg. §§ 20.2055-2(e)(2)(vii); 25.2522(c)-3(c)(2)(vii), the unitrust interest must be a guaranteed unitrust interest "in every respect." Accordingly, the trust agreement cannot provide that charity is to receive a payment equal to the lesser of a sum certain or a fixed percentage of the net fair market value of the trust assets.

3. The governing instrument may permit any income in excess of the unitrust amount to be paid to charity, but this will not increase the amount of the charitable deduction.[12] However, in the case of a charitable lead unitrust, payment of excess income to the charity actually reduces the charitable deduction because the diversion of income to charity in excess of the unitrust amount is deemed to reduce the base of assets upon which the unitrust payment is computed for future years. Rev. Rul. 78-183, 1978-1 C.B. 302.

4. The opportunity to transfer appreciation to non-charitable remainder beneficiaries is not as great with a unitrust as with an annuity trust because the unitrust creates what is in effect a partnership between the charitable and non-charitable beneficiaries while the annuity trust "freezes" charity's interest at a particular value and assigns all appreciation beyond that value to the non-charitable remainder beneficiary.

5. The unitrust payment must be made regardless of whether or not trust income is sufficient; a "net income with makeup" variety is not available. Rev. Rul. 77-300, 1977-2 C.B. 352.

D. Term of the Lead Interest[13]

1. The term of a lead trust can be a term of years, with no twenty-year maximum, a life or lives in being at the creation of the trust, or a life or lives in being plus a term of years. For example, in Rev. Rul. 85-49, 1985-1 C.B. 330, the IRS approved a CLT with a term of three lives plus a term of years. It is unclear whether lead interest for the shorter of a life in being or a term of years would be permitted.

2. New Regulations Relating to Term of CLTs.

   (a) Prior to April 4, 2000, neither the Internal Revenue Code nor the regulations relating to charitable lead trusts required that a CLT's measuring life be a grantor or remainder beneficiary of the trust. As a result, some taxpayers selected as a measuring life an individual who is seriously ill but not so ill as to cause the section 7520 valuation tables to be inapplicable.[14] Accordingly, the valuation of the charitable interest would be based on the actuarial tables under section 7520. These tables set forth the average life expectancy of all individuals the same age as the individual who is the measuring life; however, due to her illness, such individual is not likely to survive to the average date. If the seriously ill individual died prior to the average date, the amount charity received could be significantly less than the amount on which the gift or estate tax charitable deduction was based. Likewise, the amount transferred to the noncharitable remainder beneficiaries could be much greater than the section 7520 valuation tables would indicate.

   (b) Based on the belief that "this kind of adverse selection of an unrelated measuring life to artificially inflate the charitable deduction is contrary to Congressional intent," the IRS issued proposed regulations providing, in substance, that the permissible term for guaranteed annuity interests and

---

[12] Treas. Reg. §§ 20.2055-2(e)(2) (vii)(d); 25.2522(c)-3(c)(2) (vii)(d).

[13] See Treas. Reg. §§ 20.2055-2(e)(2)(vi)(a) and vii(a); 25.2522(c)(2)(vi)(a) and (vii)(a).`

[14] See Treas. Regs. §§ 20.7520-3(b)(3) and (4); 25.7520-3(b)(3) and (4).

unitrust interests is either a specified term of years or the life of "certain" individuals living at the date of the transfer." These regulations were finalized on February 5, 2001. T.D. 8923, 2001-6 I.R.B. 485 (2/5/2001). Under the regulations, the individuals who may be used as measuring lives are:

i. The donor;

ii. The donor's spouse; and/or

iii. An individual who, with respect to all remainder beneficiaries (other than charities) is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries.

(c) Therefore, under the regulations, appropriate remainder beneficiaries for a CLT would include children, step-children, grandchildren and step-grandchildren of the individual who is the measuring life. Nieces and nephews and other collateral heirs would not qualify. Note, of course, that if a term of years CLT, rather than a CLT whose term is measured by the life of an individual, is used, then anyone can be a remainder beneficiary.

(d) When the regulations were first proposed, commentators expressed concern that a standard "family disaster" clause providing for payment of the CLT remainder to specified beneficiaries in the event of the premature death of the presumptive remainder beneficiaries could cause a disqualification of the CLT. In an effort to remedy this issue, the final regulations provide that the requirement that all noncharitable remainder beneficiaries are lineal descendants of the individual whose life measures the term-- or of that individual's spouse-- is satisfied as long as there is a less than 15% probability that individual who are not lineal descendants will receive trust corpus.

(e) The regulations are effective for inter vivos charitable lead trusts made on or after April 4, 2000. They are effective for testamentary lead trusts where the decedent dies on or after April 4, 2000 unless either:

i. If the decedent dies on or before July 3, 2001 without having republished her Will or amending her revocable trust, as the case may be; or

ii. If on April 4, 2000 the decedent was under a mental disability to change the disposition of her property and either (1) does not regain competence before the date of death or (2) dies prior to the later of (a) 90 days after the date on which she does regain competence or (b) July 3, 2001 without having republished her Will or amending her revocable trust, as the case may be.

(f) The IRS will not disallow the charitable deduction for a CLT whose measuring life does not comply with the proposed regulations if the CLT is reformed into a lead interest payable for a specified term of years.

i. The term of years to be used is computed by identifying the factor for valuing the annuity or unitrust interest for the named individual's measuring life and then identifying the term of years (rounded up to the nearest whole year) that corresponds to the equivalent term of years factor for an annuity or unitrust interest. For example, in the case of an annuity interest payable for the life of an individual age 40 at the time of the transfer, assuming an interest rate of 7.4% under section 7520, the annuity factor from column 1 of Table S(7.4) contained in IRS Publication 1457, Aleph volume, for the life of an individual age 40 is 12.0587. Based on Table B(7.4) of Publication 1457, the factor 12.0587 corresponds to an annuity for a term of years between 31 and 32 years. Accordingly, the annuity interest must be reformed into an interest payable for a term of 32 years.

ii. The judicial reformation must be commenced before the later of July 3, 2001 or the date prescribed by IRC §2055(e)(3)(C)(iii). That section provides that a judicial proceeding must be commenced not later than the 90th day after the last date (including extensions) for filing an estate tax return or, if no estate tax return is required, the last date (including extensions) for filing the trust's first income tax return. Any judicial reformation must be completed within a reasonable time after it is commenced.

iii. A non-judicial reformation is permitted if effective under state law, provided it is completed by the date on which a judicial reformation must be commenced. In the alternative, if a court, in a proceeding that is commenced on or before July 3, 2001, declares null and void *ab initio* any transfer made under a Will or revocable trust where the decedent dies on or after April 4, 2000, and on or before March 6, 2001, then IRS will treat those transfers in a manner similar to those described in IRC §2055(e)(3)(J). That section provides that if the trust has been declared void *ab initio*, no deduction shall be allowed for any transfer to the trust and any transactions entered into by the trust prior to being declared void shall be treated as entered into by the transferor or donor.

(g) The regulation also clarifies the status of rule against perpetuities "savings" clauses in CLTs. Under the regulations, an interest payable for a specified term of years can qualify as a guaranteed annuity or unitrust interest even if the governing instrument contains a savings clause intended to comply with the relevant rule against perpetuities provided that the savings clause utilizes a vesting period of 21 years after the deaths of measuring lives who are selected to maximize, rather than limit, the term of the trust. The proposed regulations do not indicate the appropriate interest rate to be used in valuing the respective interests of the charity and the non-charitable remainder beneficiaries in the event the trust is so terminated.

E. Private Foundation Prohibitions

1. The governing instrument must prohibit certain transactions described in the private foundation excise tax provisions of the Code as follows:

2. *Self-Dealing* under section 4941. Self-dealing is defined generally to mean certain transactions between a CLT and a disqualified person ("DP"). Acts of self-dealing include the following:

   (a) Any sale, exchange or lease of property between the CLT and a disqualified person, except (a) certain general stock redemptions for fair market value and (b) a lease from a disqualified person to the CLT at no charge.

   (b) Any loan or extension of credit between a CLT and a disqualified person, except that a disqualified person may make interest-free loans to the CLT. However, interest-free loans to the CLT to enable the CLT to pay charity its annuity or unitrust interest will disqualify the CLT.

   (c) Any furnishing of goods, services or facilities between the CLT and a disqualified person, except that a disqualified person may furnish such items to a CLT at no charge.

   (d) Any payment of compensation by the CLT to a DP, except for reasonable and necessary services such as compensation of trustees, lawyers, investment advisers and banks. It is less clear whether or not payments to disqualified persons for brokerage or management fees with respect to commercial real estate owned by the CLT will be excepted from self-dealing treatment.

   (e) Any transfer by the CLT of its income or assets to or for the benefit of a disqualified person.

3. *Taxable expenditures* under section 4945.

4. In general, the trust agreement must prohibit the trust from holding *excess business holdings* as defined in section 4943. A CLT will be deemed to have excess business holdings if the CLT, together with all of its

disqualified persons, owns more than 20% of the voting stock of a corporation or an equivalent interest in a non-corporate entity engaged in a trade or business.

(a) A CLT with excess business holdings is granted five years to reduce the holdings (of the CLT and all disqualified persons combined) to no more than 2%.

(b) The excess business holdings prohibition does not apply if the value of the charitable interest in the trust is less than 60% of the total value of the trust and if no property is distributable to charity at the end of the charitable term.

5. In general, the trust agreement must prohibit the trust from retaining or investing in *investments that jeopardize the charitable purpose of the trust* under section 4944.

(a) The jeopardy investment prohibition does not apply if the value of the charitable interest in the trust is less than 60% of the total value of the trust and if no property is distributable to charity at the end of the charitable term.

F. Combined Charitable and Private Interests

The governing instrument generally should prohibit payments to anyone other than the charitable beneficiaries during the charitable term. However, payments to non-charitable beneficiaries may be permitted in the following circumstances:

1. Payment of Annuity Amount to Both Charitable and Non-Charitable Beneficiaries

The trust can pay amounts concurrently to both charitable and non-charitable beneficiaries if either of the following two tests is met:

If the separate share rule applies. The separate share rule applies if (1) the trust requires that payments to the non-charitable beneficiary be made from a segregated group of assets devoted exclusively to the non-charitable beneficiary's use; (2) the trust is required to account separately for items of income and deduction attributable to each of the segregated amounts; and (3) the trust can be treated as two separate trusts, one whose income and remainder interests are devoted exclusively to non-charitable purposes and one that is considered a charitable trust under section 4947(a)(1) or (2) of the Code.

Even if the separate share rule does not apply, the trust nonetheless may permit payments to both charitable and non-charitable beneficiaries if the trust agreement provides for the payment of a guaranteed annuity or unitrust amount to both charitable and non-charitable beneficiaries. Treas. Regs. §§ 20.2055-2(e)(2)(vi)(f); 25.2522(c)-2(c)(2)(f).

2. Preceding Private Interest

Suppose a donor transfers $1,000,000 to a CLT to pay $115,000 per year to an individual for five years followed by an annuity of $115,000 per year to a charity for the next five years. Under the estate and gift tax regulations the charitable annuity would not qualify as a guaranteed annuity interest. Treas. Regs. §§ 20.2055-2(e)(2)(vi)(f); 25.2522-2(c)(2)(f). However, the estate tax version of these regulations was held invalid in Estate of Boeshore, 78 T.C. 523 (1982). The IRS acquiesced in the result of Boeshore. IRB 1987-24, 4.

3. *Revised Regulations*

Final regulations effective July 7, 2003 embrace the Boeshore result. Under the regulations, a charitable deduction for a guaranteed annuity or unitrust interest will not be disallowed solely because it is preceded by a noncharitable annuity or unitrust interest in the same trust. Treasury Decision 9068.

G. Other Governing Instrument Requirements

1. *Commutation*

The governing instrument should prohibit prepayment (sometimes called "commutation") of the lead interest. Rev. Rul. 88-27, 1988-1 C.B. 331 (charitable lead annuity trust); PLR 9734057 (charitable lead unitrust). The rationale for disqualification has to do with the trustee's ability to manipulate the value of charity's interest if interest rates change between the date the trust is funded and the date of the prepayment. For example, if a prepayment were based on one interest rate while the market interest rate was lower, the charitable organization, upon investing the prepaid amount at the market interest rate, would receive less than the amount that was implicit in valuing the prepayment amount. GCM 39676.

2. *Rule Against Perpetuities*

Although not a "governing instrument requirement" from the standpoint of federal law, the trust should have a rule against perpetuities savings clause as a matter of state law if the trust is established under the laws of a state that still follows the rule. Although the IRS has approved a rule against perpetuities savings clause privately, PLR 8033091, query whether or not the clause might be deemed an impermissible commutation power under the rationale of Rev. Rul. 88-27 and GCM 39676. The proposed regulations described at section III.D(e), supra, appear to provide a safe harbor for a rule against perpetuities saving clause, provided that the vesting period chosen must be 21 years after the deaths of measuring lives "who are selected to maximize, rather than limit, the term of the trust." As an example, the explanation to the proposed regulations recites that an annuity or unitrust interest that will terminate on the earlier of 30 years or 21 years after the death of the last surviving of the descendants of any grandparent of the donor living at the creation of the interest will be treated as payable for the specified term of years.

3. *Death Taxes*

In the context of charitable remainder trusts, the IRS has ruled that the governing instrument must contain provisions mandating that any death taxes be borne by the non-charitable beneficiaries. Rev. Rul. 82-128, 1982-2 C.B. 71. Although there is no similar revenue service ruling applicable to charitable lead trusts, prudence dictates that the governing instrument of a CLT contain provisions exempting the charitable interest from the payment of any death taxes attributable to the trust. If death taxes were payable from the charitable interest, the taxes could jeopardize the payment of the annuity in the case of a CLAT and would reduce the size of the unitrust amount in the case of a CLUT. For this reason, it is likely that the IRS would impose a death tax governing instrument on CLTs similar to that imposed upon charitable remainder trusts. See PLR 9348012 for an example of such a governing instrument provision.

4. *Additions*

It is well known that post-creation additions to a charitable remainder annuity trust are prohibited while post-creation additions to a charitable remainder unitrust are permitted. Treas. Reg. § 1.664-2(b). Are similar rules applicable to CLATs and CLUTS?

CLATs. The CLT regulations are silent as to whether additions to CLATs are permitted or prohibited. An early private ruling, as well as an authoritative commentator, initially concluded that additions to a CLAT should be prohibited. PLR 8213127; Teitell, *Charitable Lead Trusts* 1-15 (1990). However, a more recent technical advice memorandum indicates that post-creation additions to a CLAT are permissible. TAM 9506001. However, an addition to a CLAT would not generate an additional tax deduction because the addition could not act to increase the size of the annuity amount payable to charity.

CLUTs. The CLT regulations are silent as to whether additions to CLUTs are permitted or prohibited. However, the charitable remainder unitrust regulations permit additions and provide a scheme for determining the additional resulting charitable deduction. Moreover, at least two private rulings from the IRS have approved CLUTs with governing instruments permitting additions and providing for calculation of the additional charitable deduction in a manner consistent with the charitable remainder trust regulations. PLRs 8043077; 7938099.

H. Incomplete Gift to a CLT

If the lead trust permits the trustee to sprinkle the lead payments among various charities the donor should not be a trustee. This will avoid incomplete gift treatment. Treas. Reg. § 25.2511-2(b) and (c); Rev. Rul. 77-275, 1977-2 C.B. 346. Similarly, if the donor's private foundation is the recipient of the lead interest and the donor serves as a trustee of the private foundation, incomplete gift status may result as well. PLR 1999-08-002; PLR 1999-03-045. However, the donor's private foundation can be named as the lead recipient notwithstanding the donor's status as a trustee of the foundation if the governing instrument of the foundation provides that funds paid to it by the CLT are to be segregated into a separate account in which the donor-trustee will have no distribution authority. PLR 200108032. It apparently is permissible for the donor's *spouse* to serve as an officer or director of a private foundation which is the recipient of a charitable lead interest. PLR 200043039.

VIII. INCOME TAX DEDUCTIBILITY

A. In General

1. The donor of a qualified charitable lead trust is generally entitled to a charitable income tax deduction only if (1) the trust meets the guaranteed annuity or unitrust interest and governing instrument requirements described above *and* (2) the trust is a grantor trust for income tax purposes. IRC §170(f)(2)(B); Treas. Regs. § 1.170A-6(c).

2. Deductibility ceilings; carryforward.

   If the lead interest is held by a public charity, the income tax deduction generally is subject to the 30% deductibility ceiling and a five-year carryforward.

   If the charitable interest is held by a private foundation, then the 20% deductibility ceiling generally applies. The IRS has ruled privately that the five-year carryforward is not available for a CLT benefiting a private foundation, PLR 8824039, but this result has been roundly criticized by leading commentators.

B. Obtaining Grantor Trust Status

1. IRC §§ 671 through 679 treat the grantor as the owner of that portion of the trust over which the grantor or certain related parties hold an interest or power. It is possible for a trust to be treated as a grantor trust for income tax purposes without being included in the grantor's estate for estate tax purposes.

2. Examples of powers that might be included to cause grantor trust status are as follows:

   (a) Design the trust with a non-adverse party trust having the power to sprinkle lead payments among various charities and include a power in a non-adverse party to add beneficiaries to the trust. This power should cause the trust to fail to meet any of the exceptions to grantor trust status contained in

IRC § 674. Of course, there should be no power to add non-charitable beneficiaries during the lead term.

(b) Design the trust with a power in the trustees to sprinkle the lead payments among charitable beneficiaries and intentionally name trustees in a manner that will cause the trust to fail one of the following three exceptions:

i. None of the trustees is the grantor or the grantor's spouse (in other words, naming the spouse as a trustee will cause the trust to fail this exception);

ii. At least half of the trustees are persons who are not related or subordinate parties subservient to the wishes of the grantor (in other words, naming trustees where a majority are close relatives of the grantor (within the meaning of section 672(c) of the Code will cause the trust to fail this exception); or

iii. No person who is not a trustee is required to consent to the trustee's distribution decisions (for example, giving some trusted individual a veto power over trustee decisions and an inter vivos power of appointment over the trust remainder would cause the trust to fail this exception).

(c) Include a power for a person who is neither a fiduciary nor a person with an adverse interest a power, exercisable in a non-fiduciary capacity, to acquire the trust property by substituting other property of equivalent value. This power should cause grantor trust status under IRC § 675(4). However, a number of IRS rulings have indicated that the mere inclusion of such a power in the trust document is not itself sufficient to cause grantor trust status; rather, it must be shown that the power is exercisable in a non-fiduciary capacity, a question of fact. See PLRs 9407014; 9810019; 9648045; 9416009; 9352007; 9352004; 9253010; 9248016. Therefore, it probably is not safe to rely on a reacquisition power alone to cause grantor trust status. Moreover, the grantor and any disqualified person should not hold the reacquisition power, as an acquisition of the trust assets by a disqualified person would violate the self-dealing rules of section 4941 of the Code.

IX. INCOME TAXATION OF THE CHARITABLE LEAD TRUST

A. Grantor Trusts

1. Unlike a charitable remainder trust, a CLT is not a tax-exempt entity.

2. istribution of appreciated property in satisfaction of annuity or unitrust amount will be treated as if the property had been sold and then distributed to the charity, thereby causing the grantor to recognize gain. *Kenan v. Comm'r*, 114 F. 2d 217 (2d Cir. 1940); *Suisman v. Eaton*, 115 F. Supp. 113 (D. Conn. 1935), aff'd per curiam 83 F.2d 1019 (2d Cir. 1936), cert. den., 299 U.S. 573 (1936).

3. Recapture trap. If grantor trust status ceases prior to the end of the lead term, then the grantor will be forced to recognize income in an amount equal to the difference between

(a) The total deduction the grantor received upon creating the trust; *minus*.

(b) The present value--on the date of the trust's creation--of all amounts that were required to be, and actually were, paid to the charitable organization pursuant to the terms of the trust before grantor trust status ceased. IRC § 170(f)(2)(B); Treas. Reg. § 1.170A-6(c)(4).

B. Non-Grantor Trusts

1. Unlike a charitable remainder trust, a CLT is not a tax-exempt entity. A non-grantor CLT is generally taxed under the usual rules for the taxation of income of complex trusts, with certain exceptions.

2. Unlike a typical complex trust, a non-grantor CLT will not receive a distribution deduction under section 661. Treas. Reg. § 1.663(a)-2.

3. However, the CLT does receive a deduction for amounts of gross income that are paid to charity, but only to the extent that such payments are made pursuant to the terms of the governing instrument. IRC § 642(c); *Rebecca K. Crown Income Charitable Fund*, 8 F.3d 571 (7th Cir. 1993), aff'g 98 T.C. 327 (1982).

    (a) To the extent a lead payment is not made out of gross income, it is not deductible.

    (b) There is no requirement that payment be made from current year's gross income. Treasury regulations permit deduction for "an amount paid during the taxable year in respect of gross income received in a previous taxable year, but only if no deduction was allowed for the amount so paid." Treas. Reg. § 1.642(c)-1(b).

    (c) The deduction may be claimed either in the year the lead payment was made or, if the trustee so elects, in the year following the year of payment. IRC § 642(c); Treas. Regs. § 1.642(c)-1(b).

4. Denial of IRC § 642(c) deduction for UBTI.

    (a) Section 681 of the Code generally disallows a charitable income tax deduction to the extent that a payment to charity consists of unrelated business taxable income (UBTI). Treas. Regs. § 1.642(c)-3(d).

    (b) will be deductible to the extent it does not exceed deductibility ceilings applicable to individuals. The deductibility ceilings are applied against the UBTI, not the trust's entire income. IRC § 512(b)(11).

5. Sourcing *rules can result in lower than expected deductibility*. See PLR 9750020, in which IRS ignored provisions of a CLT allocating distributions first to ordinary income, then to net short term capital gain, then to net long term capital gain, then to UBTI, then to tax-exempt income and then to corpus. This ruling does not appear to have any basis in the language of IRC § 642(c).

6. Distribution of appreciated property in satisfaction of annuity or unitrust amount will be treated as if the property had been sold and then distributed to the charity, thereby causing the trust to recognize gain. *Kenan v. Comm'r*, 114 F.2d 217 (2d Cir. 1940); *Suisman v. Eaton*, 115 F. Supp. 113 (D. Conn. 1935), aff'd per curiam 83 F.2d 1019 (2d Cir. 1936), cert. den., 299 U.S. 573 (1936). However, the trust will be entitled to a section 642(c) deduction with respect to this gain. Rev. Rul. 83-75, 1983-1 C.B. 114.

X. GENERATION-SKIPPING TRANSFER TAX

A. General Rules

See IRC §§ 2601 *et seq*.

1. The generation-skipping transfer tax (GST tax) is a 55% tax on property transferred to skip persons (persons at least two generations below the donor, e.g., grandchildren and their descendants).

2. A CLT is not subject to GST tax until the charitable lead interest expires. When charity's interest terminates, any trust property passing to a skip person is subject to the GST tax unless the trust is exempt.

3. Each donor has a $1,030,000 exemption from the GST tax to allocate to transfers during life or at death. An allocation of exemption either makes the entire trust exempt from GST tax or reduces the applicable GST tax rate to less than 55%.

B. Annuity Trust vs. Unitrust

1. *Allocation of GST exemption to a CLUT.* If on funding of a CLUT the donor allocates GST exemption to the CLUT equal to the gift tax value of the remainder interest, the CLUT thereafter is exempt from GST tax, regardless of the amount of property remaining in the CLUT at the termination of the charitable interest.

2. Allocation *of GST exemption to a CLAT.* A donor cannot allocate GST exemption to a CLAT on funding and know whether or not the CLAT will be exempt from GST tax at the termination of the charitable interest. Any GST exemption allocated to the CLAT grows at the IRS discount rate used to value the charitable gift at the time the CLAT was created. This is known as the "adjusted GST exemption." When the charitable interest terminates, if the adjusted GST exemption is less than the then value of the trust property, property distributed from the trust to skip persons will be subject to GST tax at a rate equal to the GST tax rate then in effect (currently 55%) multiplied by a fraction, the numerator of which is the CLAT's adjusted GST exemption amount and the denominator of which is the value of the CLAT at the end of the charitable term. IRC § 2642(e); Treas. Regs. § 26.2642-3. Moreover, if the trust property grows at a rate lower than the IRS discount rate used to value the charitable gift, then the amount of GST Exemption allocated will be greater than the value of the trust. However, the excess exemption is not restored to the grantor. Treas. Reg. § 26.2642-3(c).

3. Some planners have suggested that it may be possible to avoid Treas. Reg. §25.2542-3(c)'s special GST Exemption allocation rule by creating a CLAT in which the remainder interests are vested and then having the remaindermen gift or sell their interests to a generation-skipping exempt trust. This approach has been rejected by the IRS, at least for gifts of a vested remainder interest, in LTR 200107015 (November 14, 2000).

XI. COMPUTING THE CHARITABLE DEDUCTION

A. In General

The charitable deduction is for the present value of the charitable interest computed under the rules of, and using the discount rate promulgated under, IRC § 7520. The discount rate under section 7520 is a rate equal to 120% of the federal midterm rate under section 1274(d)(1) of the Code for the month of transfer or, if the donor or the donor's executors so elect, either of the two months preceding the month of transfer. IRC § 7520.

B. Terminally Ill Measuring Life

The section 7520 tables and valuation method may not be used if the death of that individual is imminent. Under Treas. Reg. §§ 1.7520-3(b)(3), 20.7520-3(b)(3) and 25.7520-3(b)(3), the section 7520 tables will not apply if the individual has an incurable illness or other deteriorating physical condition that causes there to be at least a 50% probability that the individual will die within one year. If the individual survives for 18 months or longer after the creation of the CLT, then there is a presumption against terminal illness.

C. Limitations on Value of Charitable Interest

1. If the value of charity's interest exceeds the value of the property contributed to the trust, then the value under section 7520 will be limited to the value of the property contributed to the trust. Treas. Reg. § 1.7520-3(b)(2)(i), 20.7520-3(b)(2)(i), 25.7520-3(b)(2)(i).

2. In addition, under Rev. Rul. 77-454, 1977-2 C.B. 351, if the charitable term is measured by reference to the life of an individual and payment of the annuity would exhaust the trust fund prior to the expiration of the charitable term if the trust fund produced a rate of return equal to the assumed section 7520 discount rate, then the value of the annuity will be limited to an annuity for the shorter of the measuring life or the term of years over which the trust could be expected to make the annuity payments if the trust produced a rate of return equal to the assumed section 7520 discount rate. The Rev. Rul. 77-454 rules do not apply to CLUTs.

XII. CLT DIFFICULT ASSET TAX TRAPS

A. UBIT

The unrelated business income tax generally presents fewer problems for CLTs than it does for CRTs.

1. If the CLT is structured as a grantor trust, the existence of UBTI is largely irrelevant since all of the trust's income is taxed to grantor in all events.

2. Even for a non-grantor CLT, UBTI is not the tax disaster that it is for a CRT. In a CRT, the presence of even one dollar of UBTI causes the trust to lose its income tax-exempt status for that year. A non-grantor lead trust is not tax-exempt in any event. Rather, as noted above, it is taxed as complex trust with a deduction against its income under section 642(c) of the Code for required distributions to charity. UBTI does dilute the tax efficiency of the trust, however, in that the trust's income tax deduction for distributions to charity attributable to UBTI is subject to the deductibility percentage limitations applied to individuals. The deduction for distributions attributable to UBTI applies only with respect to distributions to domestic charities.

B. Private Foundation Rules

Some private foundation excise tax rules apply both to CLTs and CRTs and some apply only to CLTs.

1. *Self-Dealing*. The self-dealing prohibition applies to both CLTs and CRTs. Here is a list of the acts of self-dealing detailed in IRC § 4941, and how they might apply in the CLT context.

   (a) *Sale or Exchange*. Any sale, exchange or lease of property between the CLT and a disqualified person, except (a) certain general stock redemptions for fair market value and (b) a lease from a disqualified person to the CLT at no charge. The sale or exchange prohibition can often be implicated if a CLT is funded with a difficult asset, such an interest in an operating business or real estate, as shown in the following examples:

      i. A sale of stock owned by the CLT to a DP.

      ii. A redemption of CLT's stock by a corporation which is a DP. The corporation will be a DP is more than 35% of its voting stock is held by DPs. Even if the corporation is a DP, a redemption will not be self-dealing if all securities of the same class as that held by the CLT are subject to the same terms and those terms provide that the CLT shall receive no less than fair market value for its stock. IRC § 4941(d)(1)(F).

         (A) *Caveat*: The corporation should not fund the redemption with a note. Although the redemption is excepted from the definition of self-dealing, the note may be a separate act of self-dealing under IRC § 4941(d)(1)(B).

         (B) *Planning note*: If a redemption pursuant to IRC § 4941(d)(1)(F) is contemplated, consider having the corporation issue a separate class of stock prior to the gift to the CLT. The grantor can then use that stock as the subject of all gifts to the CLT (or other charitable entities subject to the private foundation excise taxes). This will narrow the class of owners of stock subject to the section 4941(d)(1)(F) general redemption rule.

iii. *Mortgaged Property.* In general, the sale or exchange of property between a CLT and any DP constitutes a taxable act of self-dealing under IRC § 4941. When mortgaged property is contributed to a CLT, the transfer will be treated as a sale or exchange for section 4941 purposes if the CLT assumes the mortgage or if the mortgage was placed on the property within 10 years and the CLT takes its interest subject to the mortgage. Regs. § 53.4941(d)-2(a). Notwithstanding the statement in the Regulations that a transfer of mortgaged property to a CLT constitutes self-dealing, the IRS has privately ruled that a transfer of property to a CLT was not a section 4941 sale or exchange where the property transferred was an interest in a partnership whose underlying asset was real estate subject to a mortgage placed on the property within 10 years. PLR 9402026. The rationale for the IRS ruling was Regs. § 4941(d)-1(a), which creates an exception to the self-dealing rules for transactions in which a party's DP status arises only as a result of the transaction. In the CRT context, the IRS has ruled privately that if the loan remains outstanding after the gift, then a new act of self-dealing occurs in each year in which the loan remains outstanding. See PLR 9530032 (revoking PLR 9343033).

iv. *Indirect Self-Dealing.* Self-dealing includes not only direct sales, exchanges or leases of property between the CLT and DPs but also any such sale, exchange or lease between an entity controlled by the CLT and DP. Therefore, if a CLT controls a closely-held business, then theoretically any sale, exchange or lease of property between the business and the donor, the donor's family and entities controlled by the donor or his family will be self-dealing. For example, suppose a CLT owns 90% of the voting stock of a family corporation and the corporation leases its headquarters building from its founder, who happens to be the grantor of the CLT. Such lease would be an act of self-dealing.

(b) *Loans.* Any loan or extension of credit between a CLT and a disqualified person, except that a disqualified person may make interest-free loans to the CLT. However, interest-free loans to the CLT to enable the CLT to pay charity its annuity or unitrust interest will disqualify the CLT.

i. The prohibition on extensions of credit can present a significant trap for CLTs owning stock in a corporation which is a disqualified person. If the corporation redeems the CLT's stock in the corporation pursuant to the general redemption exception of section 4941(d)(1)(F) but does so in exchange for a promissory note, the note constitutes an extension of credit which may be a separate act of self-dealing not covered by the section 4941(d)(1)(F) exception. Even if the original issuance of the note is covered by the section 4941(d)(1)(F) exception, any subsequent modification or forgiveness of the note would constitute a separate act of self-dealing.

ii. In the case of a testamentary CLT, the trap may be avoided if stock earmarked for the CLT is redeemed from the testator's estate for a note and the note is transferred to the CLT in lieu of the stock. The IRS has privately approved such a strategy where (1) the note was secured by the transferred property, (2) the interest rate was equal to or greater than the applicable federal rate under IRC § 1274 for the month of the sale, (3) a state probate court approved the transaction, and (4) the transaction was completed during the normal estate administration period. PLR 200124029. See also PLR 200024052. Both rulings are based on Regs. § 53.4941(d)-1(b)(3), which contains an exception to the indirect self-dealing rules for certain transactions completed during a reasonable period of estate administration.

(c) *Furnishing Goods or Services.* Any furnishing of goods, services or facilities between the CLT and a disqualified person, except that a disqualified person may furnish such items to a CLT at no charge.

(d) *Compensation*. Any payment of compensation by the CLT to a disqualified person, except for reasonable and necessary services such as compensation of trustees, lawyers, investment advisers and banks. Regs. § 53.4941(d)-2(e). It is less clear whether or not payments to disqualified persons for brokerage or management fees with respect to commercial real estate owned by the CLT will be excepted from self-dealing treatment. See PLR 200241048 (Reasonable management fees paid by CLT funded with real estate partnership to an S corporation which is a DP with respect to the CLT were not self-dealing where activity was necessary to carrying out CLT's purposes.) But see PLR 9438045 (payments to DPs for management of CLT's commercial real estate were acts of self-dealing).

(e) *Use of CLT Assets by DP*. Any transfer by the CLT of its income or assets to or for the benefit of a DP is a prohibited act of self-dealing. For example, the use of CLT funds to satisfy a DP's charitable pledge is self-dealing. This is the case regardless of whether the pledge was made before or after the CLT was funded.

2. *Taxable Expenditures*. Section 4945 of the Internal Revenue Code applies to prohibit taxable expenditures by a charitable lead trust. Taxable expenditures include distributions for non-charitable purposes, as well as transfers to private foundations unless the transferring trust exercises expenditure responsibility. In an IRS private ruling, a charitable lead trust was *required* to make payments to a private foundation. The service ruled that no expenditure responsibility was required because the distribution was more in the nature of a gift by a donor rather than a grant to the foundation. See PLR 1999 52093. It is unclear whether the rationale of this ruling would be applicable to a charitable lead trust in which a foundation was merely one of several charities over which the trustee had discretion to distribute lead payments.

3. *Excess Business Holdings*. The proscription against excess business holdings applies only to CLTs (and CRTs that have a charity as one of the annuity or unitrust beneficiaries).

(a) A CLT can prevent application of the excess business holdings rule if the value of the charitable interest is less than 60% of the total value of the trust and if no property is distributable to charity at the end of the charitable term.

(b) If the excess business holdings rules do apply and the business is a DP, then the business cannot redeem stock from the CLT unless the redemption falls within the exception to self-dealing for redemptions offered to all holders of stock in the same class as that held by the CLT, on the same terms and for the same value. Accordingly, before funding a CLT with stock in a closely held business, it may be wise to recapitalize the business to create a class of stock to be used solely to fund the CLT. This would limit the class of shareholders to whom a redemption must be offered to those holding stock used to fund the CLT.

(c) For a testamentary CLT, the excess business holdings rule may also be avoided by having the stock earmarked for the CLT redeemed out of the estate in exchange for a note. The note would then be distributed to the CLT. See PLRs 200124029 and 200024052, discussed in connection with self-dealing above.

4. *Jeopardy Investments*. Under IRC § 4944, an excise tax is imposed if the CLT invests in any manner which could jeopardize the trust's charitable purpose.

(a) Although no investment is a jeopardizing investment, *per se*, the Regulations list several examples of investments that will be closely scrutinized under the jeopardy investment rules, including "trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of 'puts' and 'calls' and 'straddles,' the purchase of warrants and selling short. Regs. § 53.4944-1(a)(2). This rule can be avoided if the value of charity's interest in the CLT is limited to 60% or less of the total value of the trust.

(b) In the discussion of self-dealing and excess business holdings above, we noted that stock earmarked for a testamentary CLT could be redeemed from the testator's estate for a note, and the note distributed to the CLT in lieu of the stock. PLRs 200124029 and 200024052. In those cited rulings, the charitable interest exceeded in 60%. The taxpayer in PLR 200124029 apparently did not seek a ruling on whether the note was a jeopardy investment for purposes of IRC § 4944. However, in PLR 200024052, the IRS ruled that the retention of the note would not be a jeopardy investment provided that the note provided the CLT with an investment that was at least as liquid as the assets the CLT would have received from the estate and the other requirements of Regs. § 53.4941-1(d)-1(b)(3) (i.e., probate court approval, note is distributed prior to end of normal estate administration period) are satisfied.

C. Special Problems Where S Corporation Stock Is Held by a CLT.

1. A grantor CLT is a permitted S corporation shareholder because it is a grantor trust. IRC § 1361(c)(2). A non-grantor CLT can also be a permitted S corporation shareholder provided that the trustee elects to treat the trust as an electing small business trust under section 1361(e) of the Code. This produces highly undesirable income tax results, however, because:

   (a) The CLT will be taxed on S corporation income at the highest marginal rates for trusts, IRC § 641(c)(2)(A); and

   (b) The CLT will be denied a section 642(c) deduction for distributions of lead payments to charity each year. IRC § 641(c)(2)(A), flush language; Regs. §§ 1.641(c)-1(g)(4); 1.641(c)-1(*l*), Ex. 4.

2. As with a gift of any business interest, a gift of S corporation stock may raise multiple private foundation excise tax issues, including direct and indirect self-dealing and excess business holdings, as discussed above. In connection with our discussion of excess business holdings and self-dealing above, we suggested a technique whereby the corporation could effect a general redemption to solve the excess business holdings problem while at the same time avoiding application of the self-dealing rules to the redemption itself. We suggested use of a separate class of stock to be held by the CLT alone in order to minimize the cash flow impact of the redemption on the corporation. It may be more difficult to utilize this planning opportunity with an S corporation because an S corporation is generally not permitted to have more than one class of stock (although two classes have been approved where the only difference between them was with respect to voting rights, PLR 200026011).

3. The IRS has privately ruled that an S corporation may be the grantor of a non-grantor CLT. PLR 9512002.

.StmLibl:1049969.1 3/23/2004

Charitable Lead Trusts: The Sleeping Giants of Gift Planning

American Council on Gift Annuities
26th Conference on Gift Annuities

May 7, 2004

Jonathan D. Ackerman, Esquire
Law Office of Jonathan Ackerman, LLC
6 Park Center Court, Suite102
Owings Mills, Maryland 21117
410.363.1187
410.581.0123 fax
jonathan@ackermanlaw.net
www.ackermanlaw.net

Charitable Lead Trusts:
The Sleeping Giants of Gift Planning

American Council on Gift Annuities
26th Conference on Gift Annuities
May 7, 2004

I. Charitable Lead Trusts (CLT)

a. Character – As it relates to the payout, a charitable lead trust works in an inverse fashion as the charitable remainder trust. For instance and in general, a CLT pays the lead interest to charity for a period of years or the life of an individual with the remainder either reverting back to the donor or to or for the benefit of another private individual.

b. Types

1. Non-Grantor - In a non-grantor CLT, the donor is not subject to income tax on the income and gain incurred by the CLT. Correspondingly, the donor is not entitled to an income tax deduction. The trust is a taxpaying entity, but receives a charitable income tax deduction for the lead payments to charity. The present value of the remainder interest in the CLT is treated as a gift for gift tax purposes.

2. Grantor - In a grantor CLT, the donor is subject to income tax on all income and gain incurred by the CLT. Correspondingly, the donor is entitled to a charitable income tax deduction. The present value of the lead charitable interest is the amount the donor will be entitled to as a charitable income tax deduction. This deduction, however, will have to be recaptured for income tax purposes on a pro rata basis if the donor dies during the term of a term-of-years CLT. The trust is a tax nothing and does not receive a charitable income tax deduction for the lead payments to charity.

3. Super-Grantor – The super-grantor CLT is a hybrid and special creature. It is essentially a defective grantor trust for income and estate and gift tax purposes. In other words, the donor is subject to all of the income and gain incurred by the trust (a grantor trust for income tax purposes), but the CLT assets are not includable in the gross estate of the donor. Thus, the donor can implement income and estate tax planning into his or her philanthropic planning.

4. Ghoul CLT – Don't Try This At Home! Several years back, the IRS informed us that a promoter was touting a CLT based upon the life of an individual who was seriously ill, but not "terminally ill" under the Section 7520 rules. Even worse, this sick individual would receive some type of payment in return for using his or her life as the measuring life in a CLT. A "terminally ill" person, under the technical rules, has a 50% probability of dying within one year, and if such person lives beyond 18 months, he or she is presumed not terminally ill. The potential for abuse was clear. If a CLT is created using the life expectancy (let's say 15 years) of someone who is very sick, but not "terminally ill", and the calculation of the lead interest for income, gift or estate tax charitable deduction purposes is based upon annual payments being made to charity for 15 years. But in reality, the individual lives for only 5 years – charity is only receiving 5 payments - and the balance is being distributed to the non-charitable remainder prematurely. The charitable deductions have been artificially inflated. Although there is no account of anyone actually creating such a CLT, Treasury heard about the abuse and reacted by amending the income, estate and gift tax Regulations. Basically, only one or more of the donor, the donor's spouse and lineal ancestors of all remainder beneficiaries may be used as the measuring life in a CLT. In other words, the distribution from a CLT should be, in essence, a substitute for a testamentary disposition. Thanks to a promoter of a ghoulish application of a legitimate planned giving vehicle, a donor cannot create a CLT for the benefit of a step daughter, a partner in a common law marriage or a life partner, without violating these rules, which have been effective since April, 2000.

c. CLAT v CLUT (& GSTT)

1. A charitable lead annuity trust (CLAT) pays out an annuity amount to the charitable lead beneficiary. Thus, a specific dollar amount or a percentage of the net fair market value of the assets contributed to the CLAT determined on the date of contribution may represent the amount paid out to the charity. The annuity amount will be fixed on the date of creation and not change.

2. A charitable lead unitrust (CLUT) pays out a unitrust amount to the charitable lead beneficiary. Thus, a percentage of the net fair market value of the assets contributed to the CLAT determined on the date of contribution and revalued each year will represent the amount paid out to the charity. The unitrust amount is similar to the unitrust payout from a standard charitable remainder unitrust. The net income only payout (available to NIMCRUTs, for instance) is not available to CLTs.

3. As a general rule, the CLUT will likely be used where a CLT is created with generation skipping planning, i.e., where a grandchild will be

the recipient of the remainder interest at the termination of the CLT. This is so because under Section 2642 of the Internal Revenue Code of 1986, as amended ("Code", or simply referencing a "Section" of the Code, unless the context otherwise indicates), the amount of the GST tax imposed on distributions from a CLT is determined by the application of an "inclusion ratio" which takes into account the amount of the property transferred, the amount of the GST exemption allocated to the transfer, the death taxes paid, and any estate or gift tax charitable deduction allowed. The inclusion ratio is determined by subtracting the applicable fraction from 1. To prevent the avoidance of the GST tax by using a CLAT to zero out all gift tax and GST tax, Congress enacted Code Section 2642(e), which forces the applicable fraction to be determined at the end of the charitable term using the value of the assets then in the trust. Treas. Reg. Section 26.2642-3(a) further delineates that, in determining the applicable fraction with respect to a CLAT, the numerator is the adjusted GST exemption and the denominator is the value of the trust property immediately after the termination of the charitable lead interest. The adjusted GST exemption is the allocated GST exemption, increased by an amount equal to the interest that would accrue at the rate used to value the estate or gift tax charitable deduction, compounded annually, for the trust term. Under current law, it is impossible to have any assurance that a timely allocation of GST exemption at the creation of the CLAT will prevent the imposition of the GST tax. If the trust assets grow at a rate faster than is assumed in computing the value of the remainder interest, GST distributions from the trust will be subject to GST tax; if the trust assets grow at a slower rate, a portion of the GST exemption will be wasted. Suffice it to say, this area is very complex, and although there may be some saving actions that can be taken (like, make a late allocation of the GST exemption), a CLUT should be used where generation skipping planning is involved. A CLUT is not subject to Code Section 2642(e), and a GST exemption allocation made at the time of funding will be effective for the date of funding values.

d. Testamentary v Inter Vivos

1. A CLT may be created at the death of the donor or during the donor's life. A testamentary CLT is created upon the death of the donor; therefore, it is hard to advise the donor what the payout and the term of the trust should be to maximize the estate tax charitable deduction. The IRS has liberally permitted donors to provide flexibility in the establishment of the different terms of the CLT at such time when the donor passes. For instance, various private letter rulings indicate the flexibility that donors have to establish, based upon a formula, the CMFR, term, amount to be contributed and payout of a CLT at death, *See*, PLRs 9118040, 9128051 and 9631021. In addition, if the assets remain a part of the donor's gross estate, they will be includable in his or her gross estate and subject to estate tax; however, those assets will receive a stepped-up

basis at death and the appreciation during the donor's life will cause a larger estate tax charitable deduction.

2. A CLT may also be created during the donor's life. In that regard, the donor can experience the benefit of watching the charitable dollars at work during his or her life and take advantage of either estate tax planning and/or income tax planning (by the use of a grantor CLT). In the case of a nongrantor CLT, these assets will be removed from the donor's gross estate, if properly structured, at the price of a potential gift tax for the present value of the remainder interest at the creation of the CLT. Of course, the applicable exemption amount ($1.5 Million in 2004 and rising) can be reduced to reflect the present value of the remainder interest in the year of the gift.

II. Fundamental Concepts

a. Estate & Gift and Income Tax Regimes

1. The estate and gift tax regime is separate and apart from the income tax regime. The estate and gift tax regime taxes the transfer of wealth, whereas the income tax regime taxes the earning of income. Although the two regimes may overlap in the charitable gift planning arena, they remain separate and must be independently considered in structuring a CLT. For instance, a nongrantor CLT is generally created to minimize the estate and gift taxes on a transfer of a remainder interest to the donor's heirs. Whereas a grantor CLT is generally created to maximize the donor's income tax planning.

b. Present Value

1. The concept of present value is critical to the understanding of the benefits of creating a CLT. For instance, the present value of the income interest in a grantor CLT is the amount of the charitable income tax deduction, and the present value of the remainder interest in a nongrantor CLT is the gift to the donor's heirs on the date of the creation of the CLT. An understanding of present value is crucial. Conceptually, present value reflects the fact that receiving one dollar today is worth more than receiving one dollar ten years from today, because the negative impact of inflation reduces the dollar over time. Present value is calculated using special charitable gift planning software and the three basic elements are an amount (one dollar), timing (10 years from today) and an interest factor (Charitable Midterm Federal Rate - CMFR). For purposes of calculating the present value of the remainder interest in a CLT, the interest factor is a given – Treasury has accepted a floating rate, published monthly, based upon the applicable federal rate, called the CMFR. The donor can choose

the CMFR from the month of the gift or for the last two months (whichever is most favorable), *See* the economic projections in IV below, for an analysis of the favorable impact of the current low CMFR.

c. Income Taxation of Trusts & CLTs

1. The administration of a CLT can be tricky, because the CLT is not a tax-exempt entity, like a CRT. The concept that applies to the income taxation of a CLT is "somebody's paying the taxes". For instance, in a non-grantor trust, if the trust earns $100 of taxable income and distributes $100 to the income beneficiary, the trust pays no tax and the beneficiary pays tax on the $100. If in the same scenario the trust earns $200 and distributes $100, the beneficiary again pays tax on its receipt of $100 and the trust pays tax on the $100 not distributed – someone is paying the taxes!

2. However, in the case of a grantor trust, no matter what the trust earns in taxable income and how much is distributed to the income beneficiary, the grantor will pay the taxes on the taxable income of the trust.

3. These rules are the same with a grantor and non-grantor CLT; however, a CLT is entitled to a charitable income tax deduction. Thus, a non-grantor CLT which incurs $100 of income and makes a charitable distribution of $100 will have a tax wash ($100 of income and a $100 charitable deduction). If the non-grantor CLT incurs more in income than the income payout to charity, though, the trust will be required to pay tax on the excess income – so, don't put in an appreciated asset that would be required to be sold and an immediate gain incurred during the term of the trust, *See* Section III, a, 2 below, relating to the impact of UBIT on a CLT.

d. CLT v CRT

1. A CLT payout is the inverse of a CRT payout. The income beneficiary is a charitable organization and the remainder beneficiary is a non-charitable beneficiary. Since there is no approved form for a CLT, like the CRTs, many practitioners believe that portions of the CRT Regulations under Section 664 and governing instrument requirements relate to the drafting of a CLT document. It is good news that the IRS in Notice 2003-39 requested comments regarding the creation and publication of charitable lead trust sample forms. This program is very important to the planned giving community, because the publication of CLT forms by the IRS will further legitimize, and hopefully increase the use of, this valuable planned giving vehicle.

III. Technical Issues Relating to CLTs

a. Unrelated Business Income Tax ("UBIT")

1. Character of Tax - A public charity is generally not subject to income tax, *See*, Section 501(a). Likewise, a CRT is generally not subject to income tax, *See*, Section 664(c). However, a substantial exception to this "tax-exempt" status applies to both a charity and a CRT (and in effect, a CLT) where such entity has unrelated business income. UBIT will apply to the activities of a public charity if three (3) factors are present: (i) income is derived from a trade or business, (ii) which is regularly carried on by the charity and (iii) the conduct of which is not substantially related to the charity's performance of its tax-exempt function, *See*, Section 512(a) and Treas. Reg. Section 1.513-1(a). Section 513 specifically addresses unrelated trade or business activity and defines it as, "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501..." There are a variety of activities which can be conducted by a charity and not rise to the level of an "unrelated trade or business", such as where the charity's activity is "primarily for the convenience of its members, students, patients, officers, or employees....", *See*, Section 513 (*i.e.*, college cafeteria and book shop). Under Section 511(a), the amount of income subject to UBIT (which includes debt-financed income, as discussed below) will be taxed under the corporate rates under Section 11.

2. Applications of Tax - It should be noted that the impact is different if a charity, a CRT or a CLT incurs UBIT. For instance, a charity will pay tax only on its unrelated business income, and the incurrence of UBIT will generally not otherwise adversely affect the charity. However, a charity may lose its tax-exempt status if the revenue generated from "unrelated" sources is substantial (one-half of the charity's annual revenues, *See*, GCM 39108) or if the operation of the unrelated trade or business is not in furtherance of its tax-exempt purposes and the charity is operated for the primary purpose of carrying on a trade or business. Whereas a CRT will lose its tax-exempt status for all purposes in any taxable year in which it incurs UBIT, *See*, Sections 511 and 664(c). A non-grantor CLT loses, on a dollar for dollar basis, its charitable income tax deduction under Sections 642(c) and 681. A charity, CRT or CLT may incur UBIT even if it indirectly owns a business activity. For instance, a limited partner, member of an LLC, or member of another non-corporate entity will have attributed to it UBTI of the enterprise as if it were a direct recipient of its

share of the entity's income which would be UBTI if it were itself carrying on the business of the entity, *See*, Section 512(c), Revenue Ruling 79-222, 1979-2 C.B. 236 and *Service Nut & Bolt Co. Profit Sharing Trust v. Commissioner,* 724 F.2d 519 (6th Cir. 1983). In addition, applying the aggregate view of partnerships, the IRS National Office in TAM 9651001 advised that an interest in a partnership that holds debt financed property is effectively an interest in the partnership's underlying assets and liabilities. Thus, the charity received debt financed income from the sale of its partnership interests, But *See*, PLR 9414002 where the charity's sale of stock in a subsidiary corporation whose real estate was leveraged did not incur debt financed income as a corporation was a separate taxpaying entity. The incurrence of any debt by a CLT generally is dangerous. For instance, no investments (even marketable securities) should be acquired through the incurrence of "margin" debt.

3. Debt Financed Income - Unrelated business income is not restricted to income from operations but also applies to gains from the disposition of debt financed property. Notwithstanding the exclusions for rent, capital gains and interest from UBTI discussed below, UBIT applies if debt financed income is generated. Under Section 514, certain income that would otherwise be excluded from the scope of UBIT must be included in UBIT because such income is incurred with respect to debt financed property. Section 514(b) defines "debt-financed property" as any property which is held to produce income and with respect to which there is "acquisition indebtedness" at any time during the year. Property held to produce a capital gain upon disposition, as well as property which produces a recurring income stream, is "held to produce income" for purposes of this definition, *See*, Treas. Reg. Section 1.514(c)-1(a)(1). The gain from the sale of such property is also subject to tax as UBIT. Keep in mind also that the sale of debt financed property within twelve (12) months of mortgage satisfaction will trigger this tax, *See*, Treas. Reg. Section 1.514(b)-1(a). In order to have a DFP, the property must be subject to "acquisition indebtedness". As stated in Treas. Reg. Section 1.514(a)-1(a)(1)(v), "acquisition indebtedness" means the outstanding amount of -- (i) the principal indebtedness incurred by the organization in acquiring or improving such property; (ii) the principal indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and (iii) the principal indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement. Treas. Reg. Section 1.514(a)-1(a)(1)(v) describes the method to calculate the taxable portion of the gain generated upon the sale of DFP, as follows: If debt-financed property is otherwise sold or disposed of, there shall be included in computing unrelated

business taxable income an amount with respect to such gain (or loss) derived from such sale or other disposition as - (a) the highest acquisition indebtedness with respect to such property during the 12 month period, preceding the date of disposition, is of (b) the average adjusted basis of such property.

4. Exceptions to Tax - Aside from the type of activities excepted from UBIT, Congress has recognized that the nature of the income arising from certain activities should be considered in determining whether the income should be treated as unrelated business income and taxable.

A. 512(b) exceptions - For instance, dividends and interest (Section 512(b)(1)), royalties (Section 512(b)(2)) and certain rents from real property (Section 512(b)(3)) are all excepted from UBIT, because such income is passive in nature. However, great care must be exercised in considering these technical qualifications of each exception. For instance, "rents from real property" is a term of art and generally requires that the rental of real property be fixed in amount and on a triple net basis and the landlord is prohibited from providing substantial services (as is more explicitly described under the real estate investment trust rules). Another significant exception to UBIT is gains on the sale of property (Section 512(b)(5)), unless such property is "inventory" (as discussed below in III.g. under "Dealer Issues") or is "debt-financed property" (as discussed above).

B. Holding Rule DFP Exception - An exception to the DFP rule is provided under Section 514(c)(2)(B) where, among other things, the encumbrance is placed on the property more than 5 years before the date of the gift.

C. Special School DFP Exception for Real Property - A substantial exception to the DFP acquisition indebtedness rules is described in Section 514(c)(9). Debt which is incurred in the acquisition of property by certain "qualified organizations" will not be treated as acquisition indebtedness, so long as such organizations do not violate certain statutory prohibitions. This exception applies only to schools (and their affiliated supporting organizations) and Section 501(c)(25) organizations.

b. Excess Business Holdings Tax

1. Character of Tax – In order to discourage private foundations from holding investments in business enterprises, Congress enacted Section 4943, which basically subjects a private foundation to a two-tier excise tax for its "excess business holdings". In enacting this Section, Congress was

concerned that private foundation managers would focus their attention on the success of a business enterprise and away from the charitable purposes for which the private foundation was created. In addition, such enterprise, as owned by a tax-exempt entity, could unfairly compete with another similarly situated enterprise which was owned by a taxable entity. The excise tax imposed under Section 4943 is 5% of the highest value of the holdings in a business enterprise in excess of the "permitted holdings". A harsh second-tier excise tax equal to 200% of such excess business holdings may apply if (i) the 5% tax is imposed and (ii) the private foundation still has excess business holdings at the close of the earlier to occur of (A) the date of mailing of a notice of deficiency by the IRS relating to such holdings or (B) the date on which the 5% tax is assessed by the IRS, *See*, Sections 4943(b) and (d)(2), *Also See*, Section 6684 for a possible third-tier tax. "Permitted holdings" means 20% of the voting stock in an incorporated business enterprise, or 20% of the profits or beneficial interest in a non–incorporated enterprise, reduced by the percentage such interests owned by all disqualified persons (as defined in Section 4946(a)) ("Disqualified Persons", who are generally substantial contributors to, and trustees of, the private foundation, and any person related by family to such individuals and entities significantly owned by such individuals), *See*, Section 4943(a)(1) and (2). Once the permitted holdings have been determined, the permitted holdings are subtracted from the percentage held by the foundation to determine the amount of "excess business holdings", *See*, Treas. Reg. Section 53.4943-3(d). The net effect of these formulas is to assure that the combined holdings of all Disqualified Persons and the private foundation in a business enterprise are not more than 20%. Any readjustment of the assets (*e.g.*, a recapitalization, redemption, merger) may also impact the excess business holdings rules, *See*, Treas. Reg. Section 53.4943-7(d).

2. Exceptions to Tax - If the excess business holdings tax applies, there are several methods by which the "private foundation" (a CLT, in this case) can limit the impact of, or altogether avoid, such tax.

A. Five-year period - The private foundation is given a five-year period beyond the date of the gift to dispose of the business holdings in excess of the combined 20% permitted holdings, *See*, Section 4943(c)(6). The law treats the business holdings as being held by Disqualified Persons for such five-year period. Thus, the private foundation is not deemed to own any business holdings for such period. There are, however, exceptions to this favorable rule. These exceptions basically attempt to prohibit an end run around this rule, *i.e.*, transfer from the private foundation to another commonly controlled or related private foundation, a purchase by an entity effectively controlled by a Disqualified Person or the private foundation or a Disqualified Person's plan to purchase during the five-year period additional holdings in the same business enterprise held by the private foundation, *See*, Treas. Reg. Section 53.5953-6(c).

B. Effective control exception - Under certain circumstances, the permitted holdings may be increased from 20% to 35%, *See*, Section 4943(c)(2)(B). Such an increase is permitted if (i) persons other than the private foundation and Disqualified Persons have "effective control" of the enterprise and (ii) the private foundation establishes to the satisfaction of the Commissioner that effective control is in one or more persons (other than the private foundation itself) who are not Disqualified Persons. Effective control means the power to direct or cause the direction of the management and policies of a business enterprise, whether through the ownership of voting stock, the use of voting trusts, or contractual arrangements, or otherwise. For example, the effective control test is met if individuals holding a minority interest, none of whom is a Disqualified Person, have historically elected a minority of the corporation's directors. The key is to prove that another person or group of persons do control the company, not that the Disqualified Persons don't control the company, *See*, Revenue Ruling 81-111, 81-1 CB 509.

C. Passive source exception - The third possible method of avoiding the Section 4943 tax is the passive source exception. The definition of a "business enterprise" includes the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services, *See*, Section 4943(d)(3)(B). If 95% or more of the gross income of a business enterprise is "passive", the entity will not be deemed to be a business enterprise. The definition of what is passive is a term of art and basically includes dividends, interest, payments with respect to securities loans, annuities, royalties measured by production of income from the property, rents from real property (unless taxable as unrelated business income) and gains or losses on sales and exchanges of property (other than inventory and property held for the sale to customers), *See*, Section 4943(d)(3). This concept is consistent with the Congressional intent in attempting to discourage foundation managers from spending too much time on the business enterprise, *See*, PLR 9211067. If the activity is passive, by definition, the managers would not be spending time on the business enterprise.

D. Extension of initial five-year period - The IRS has the statutory power to extend the initial five-year period (discussed in

(i) above), for unusually large gifts or bequests of diverse holdings or holdings with complex corporate structures, for up to an additional five years, Section 4943(c)(7). The private foundation must prove to the Secretary of the Treasury that it has made diligent efforts to dispose of such holdings during the initial period, and a disposition of such holdings within the initial period has not been possible (except at a price substantially below fair market value) due to the size and complexity or diversity of such holdings. The private foundation must submit a plan with the Secretary and the state official having the authority over the foundation's affairs (usually the Attorney General's Office) for disposing of the excess during the extended period. This plan may be accepted by the Secretary if it can be reasonably expected to be carried out during the extension period.

E. De minimis rule - A de minimis rule is provided in which Disqualified Persons may retain any percentage of holdings, so long as the private foundation holds no more than 2% of the voting stock (or profits or beneficial interest) or 2% by value of all outstanding shares, *See*, Section 4943(c)(2)(C).

F. 90-day grace period - A private foundation will have at least 90 days from the date of the gift to dispose of the excess business holdings without incurring this excise tax, *See*, Treas. Reg. Section 53.4943-2(a)(1)(ii). This 90-day period is extended to include the period during which a private foundation is prevented by federal or state securities laws from disposing of such excess business holdings, *See*, Treas. Reg. Section 53.4943-2(a)(1)(iii).

3. Applications of Tax – Although Section 4943 deals with a private foundation and not a CLT, Section 4947(a)(2) and (b)(3)(A) cause the excess business holdings tax to apply to a CLT where the aggregate value of the charitable lead interest exceeds 60% of the fair market value of the property contributed to such trust.

c. Jeopardy Investment Tax

1. Character of Tax - Section 4944 subjects a private foundation and a manager of the private foundation (*i.e.*, a trustee) to a two-tier excise tax for *making investments* in such a manner as to jeopardize the carrying out of the private foundation's exempt purposes. If such a jeopardizing investment is made, Section 4944(a)(1) imposes on the private foundation a tax of 5% of the amount of the investment for each year or part thereof in the "taxable period" (defined below), and Section 4944(a)(2) imposes a similar 5% tax on any foundation manager who knowingly and willfully

participated in making such investment. However, the tax on the foundation manager is limited to $5,000 per investment. The second tier tax of 25% of the investment is imposed whenever (i) an initial tax is imposed pursuant to Section 4944(a)(1) on the making of a jeopardy investment and (ii) the investment is not removed from jeopardy within the "taxable period", Section 4944(b)(1). The "taxable period" is the earlier to occur of (A) the date of mailing of the deficiency notice by the IRS, (B) the date on which the 4944(a)(1) tax is imposed or (C) the date on which the amount so invested is removed from jeopardy, Section 4944(e)(1). A foundation manager is liable for an additional tax equal to 5% of the amount invested, only if an additional tax has been imposed on the foundation and the manager has refused to agree to part or all of the removal from jeopardy of such investment. This second-tier tax on the foundation manager is likewise limited to $10,000 per investment (Also *See*, Section 6684 for a possible "third-tier" tax where the private foundation or manager had been liable for the Section 4944 tax in a prior year and became liable for the same tax in a subsequent year or where the act or failure to act giving rise to the excise tax is both willful and flagrant).

2. Exceptions to Tax

A. Gratuitous Transfer - The tax under Section 4944(a)(1) is imposed on the private foundation if it "invests" any amount in such a manner as to jeopardize its tax-exempt purpose, *See*, Treas. Reg. Section 53.4944-1(a). Although neither the Code nor the legislative history address the application of this tax to gifted property, Treas. Reg. Section 53.4944-1(a)(2)(ii)(a) provides that Section 4944 shall not apply to an investment made by any person which is later gratuitously transferred to a private foundation. This Regulation Section further provides that, if such foundation furnishes any consideration to such person upon the transfer, the foundation shall be treated as having made an "investment" in the amount of such consideration. One commentator describes this Regulation Section as follows, "Property received as a gift or bequest is not a jeopardizing investment regardless of how imprudent it might be if purchased by the foundation", Bittker & Lokken, *Federal Taxation of Income Estates and Gifts*, Second Edition, 1993, ¶101.7.3, p.101-111. Thus, it appears clear that the *receipt* by way of gift of a speculative asset by a private foundation cannot be described as an "investment", causing the private foundation to be subject to the tax under Section 4944. However, what is less clear is the ability of the foundation to *retain* such asset without incurring the jeopardy investment tax. In fact, another commentator has indicated that an implied duty to dispose of highly speculative property, even if acquired by gift, can arguably be read into Section 4944, *See*, Chiechi and Maloy, 338-3rd T.M., *Private Foundations - Section 4940 and Section 4944*, p. A-17 ("Chiechi"). However, two private letter rulings which relate directly to CLTs, and as recognized by Chiechi, indicate a contrary and favorable taxpayer result, *See*, PLRs 8125038 and 8038180, *Also See*, PLR 8135040 and 9320052. The IRS, however, adds the following qualification to that conclusion: the trust does not change the form or terms of such investment. Treas. Reg. Section 53.4944-1(a)(2)(iii) provides in effect that if a private foundation changes the form or terms of an investment (including property gratuitously transferred to a private foundation), the trust will be considered to have entered into a new investment which will be judged at the time of such change as to whether that investment carries out the organization's exempt purposes. Thus, a change in the form or terms of an investment triggers a reapplication of the jeopardy investment standard.

3. Applications of Tax – Although Section 4944 deals with a private foundation and not a CLT, Section 4947(a)(2) and (b)(3)(A) cause the jeopardy investment tax to apply to a CLT where the aggregate value of the charitable lead interest exceeds 60% of the fair market value of the property contributed to such trust.

A. Jeopardy Investment Defined - Treas. Reg. Section 1.4944-1(a) states the general trustee standard to be applied in determining when an investment is a "jeopardy investment" under Section 4944, as follows: when the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investments, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. This standard as established in the legislative history has been described as a "prudent trustee" approach, *See*, S. Rep. No. 91-552, 91st Cong., 1st Sess. 45 (1969), 1969-3 C.B. 423, 453, and reaffirmed as such by the IRS in Revenue Ruling 74-316, 1974-2 C.B. 389. As provided in Treas. Reg. Section 53.4944-1(a), the managers may, in the exercise of the requisite standard of care and prudence, take into account the expected return (including both the income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return). In addition, the determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of the foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole. Such Regulation Section also provides that no category of investments shall be treated as a *per se* violation of Section 4944. However, this Regulation does cite certain investments which will be closely scrutinized, as follows: trading on margin, trading in commodity futures, investments in working interests in oil and gas wells, purchase of puts, calls and straddles, purchase of warrants and selling short. The determination whether the investment of any amount jeopardizes the carrying out of a foundation's exempt purposes is to be made as of the time that the foundation makes the investment and not subsequently on the basis of hindsight. Therefore, once it has been ascertained that an investment does not jeopardize the carrying out of such purposes, the investment shall never be considered to jeopardize the carrying out of such purposes, even though as a result of such investment, the foundation subsequently realizes a loss, *See*, Treas. Reg. Section 53.4944-1(a)(2).

B. Self-Dealing Tax

1. Character of Tax - Section 4941 imposes an excise tax (from 5% to 200%) on a private foundation for direct or indirect acts of "self-dealing" between a private foundation and a Disqualified Person, including any direct or indirect: sale or exchange, or leasing, of property; and lending of money or other extension of credit; and furnishing of goods, services, or facilities; and payment of compensation (or reimbursement of expenses); and transfer to, or use by or for the benefit of, a Disqualified Person of the income or assets of a private foundation. Note that the definition of a Disqualified Person does not include a charity defined under Section 509(a)(1), (2) or (3).

2. Application of Tax - There are two persons upon whom the Section 4941 self-dealing excise tax can be imposed, the Disqualified Person and the foundation manager (*i.e.*, Trustee). The self-dealing excise tax has two tiers, the (a)(1) and (2) tier and the (b)(1) and (2) tier. Each tier's tax is imposed during the taxable period, *See* Sections 4941(a) and (b). The taxable period begins upon the act of self-dealing and ends upon the earlier of (i) the date of the mailing of the notice of deficiency, (ii) the date on which the tax imposed under (a)(1) is assessed, or (iii) the date on which the correction of the act of self-dealing is completed, *See*, Section 4941(e)(1). The taxable period may otherwise close on any particular act of self-dealing if the statute of limitations for the assessment of the excise tax arising thereunder expires. These self-dealing rules apply to a CLT as if such trust was a private foundation, *See*, Section 4947(a)(2), *Also See*, Section 6884 for a possible third tier tax.

3. Exceptions to Tax - Even if a transaction would constitute self-dealing, no excise tax will be imposed if the transaction satisfies one of the following overall exceptions.

A. Furnishing of Goods, Services or Facilities on Same Basis as to Public - The furnishing of goods, services, or facilities by a private foundation to a Disqualified Person where such goods, services, or facilities are made available to the general public on at least as favorable a basis as they are made available to the Disqualified Person is exempt from the self-dealing tax, Section 4941(d)(2)(D).

B. Compensation for Certain Personal Services - The payment of compensation (or the payment or reimbursement of expenses) by a private foundation to a Disqualified Person (other than a government official) for the performance of personal services which are reasonable and necessary to carry out the exempt purposes of the private foundation is not self-dealing, as long as such compensation (or payment or reimbursement) is not excessive, Section 4941(d)(2)(E).

C. Corporate Transactions - A transaction between a private foundation and a corporation which is a disqualified person and which is pursuant to a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization is not self-dealing so long as all of the securities of the same class as that held (prior to such transaction) by the foundation are subject to the same terms and such terms provide that the foundation will receive no less than fair market value, *See*, Treas. Reg. Section 4941(d)(2)(F).

D. Self-Dealing Corrective Act - The correction of a previous act of self-dealing is not self-dealing, *See*, Treas. Reg. Section 53.4941(e)-1(c)(1).

E. Initiation of Disqualified Person Status - A transaction between a private foundation and Disqualified Person where the Disqualified Person's status arises only as a result of the transaction at issue is not self-dealing, *See*, Treas. Reg. Section 53.4941(d)-1(a).

F. Certain Indirect Transactions - Certain specific transactions, not directly involving a private foundation as a party but involving an organization, estate, or trust in which the private foundation owns an interest are excluded from self-dealing. For example, indirect self-dealing does not include certain transactions with respect to a foundation's interest or expectancy in property held by an estate (or revocable trust) where the transaction is approved by the probate court having jurisdiction over the estate or trust, *See*, Treas. Reg. Section 53.4941(d)-1(b)(3). The IRS has approved the use of this exception to self-dealing in several instances, including a disqualified person's purchase of a private foundation's interest in corporate stock (PLR 8901039), a private foundation's interest in a deed of trust and the related note receivable (PLR 9127052) and a private foundation's remainder interest in nonresidential real property (PLR 9112012).

IV. Economic Illustrations of a CLT

a. Impact of the current CMFR – the lower the CMFR, the larger the charitable income, estate and gift tax deduction upon the creation of a CLT, *See* the illustration attached as Exhibit A (#'s 1 – 4).

b. Impact of using discountable assets in CLT – by using assets whose fair market values are discounted, such as FLP or LLC interests or a promissory note, a higher stated payout rate can be used, causing a CLT to terminate earlier and distribute the assets to the donor's heirs sooner, *See* the illustration attached as Exhibit A (#'s 5 – 9).

Exhibit A
Charitable Lead Trust Calculations

	Contributed Amount	Annual Payment	Timing	Discount Rate	Taxable Portion	Tax
#1 CLAT	$1M	$70,000	15 Years	10%	$467,570	$210,406
#2 CLAT	$1M	$70,000	15 Years	4%	$221,710	$99,769
#3 CLAT	$1M	$70,000	21.75 Yrs	4%	$0	$0
#4 CLUT	$1M	$70,000	15 Years	4%	$351,620	$158,229

Charitable Lead Trust Calculations - Discount Planning

	Contributed Amount	Annual Payment	Timing	Discount Rate	Taxable Portion	Tax
#5 CLAT	$700K	$49,000	15 Years	4%	$155,197	$69,838
#6 CLAT	$700K	$70,000	15 Years	4%	$0	$0
#7 CLAT	$700K	$70,000	12 Years	4%	$43,043	$19,369
#8 CLAT	$700K	$70,000	9 Years	4%	$179,529	$80,788
#9 CLAT	$700K	$70,000	13.25 Yrs	4%	$0	$0

26th Conference on Gift Annuities

Leaving Retirement Plan Assets to Charity: Summary of Private Letter Rulings

Jeremiah W. Doyle IV, Esq.
Senior Director
Mellon Financial Corporation
Private Wealth Management
Boston, MA

May 7, 2004

PLR 9237020

IRA to CRT

Ruling request:

1. Upon Settlor's death trust will qualify as CRUT.
2. Present value of property transferred to CRT upon settlor's death will qualify for estate tax charitable deduction.
3. If Settlor survives spouse, the establishment of IRA spousal rollover account in the Settlor's name by the trustee of a revocable trust will satisfy 402(a)(7) and 408(d)(3).
4. Consequences to trust from payment of proceeds of Settlor's IRA to CRT.

CRUT f/b/o Settlor's son and son's estate in the event of son's death during the CRT term. The term of the CRUT is the son's life or 20 years, whichever is longer.

Settlor will name CRT as beneficiary of her IRA.

Proceeds of IRA will be IRD.

Held:

1. Instrument qualifies as CRUT. CRUT will be exempt from income taxes unless it has UBTI.

2. The value of the remainder interest passing to charity will qualify for FET charitable deduction under Sec. 2055(a).

3. Establishment of spousal IRA rollover if Settlor survives the Settlor's spouse is hypothetical so IRS won't rule on this issue.

4. IRA classified as IRD. Under 691(a)(1), IRD not properly included in taxable period in which falls the taxpayer's date of death or a prior period shall be included in the gross income, for the taxable year when received, of the person who, by reason of the death of the decedent, acquires the right to receive the amount.

   664(b) establishes tier system of taxation.

   664(c) provides that a CRUT is exempt from tax unless it has UBTI.

IRS concludes:

Upon Settlor's death, the proceeds of the Settlor's IRA will be IRD under Sec. 691(a)(1)(B).

Because trust will be a CRUT within meaning of Sec. 664(d)(2), the trust will not be taxable on its income, unless it has UBTI.

Character of IRD in hands of CRUT will be considered to have the character that it would have had in the hands of the Settlor if Settlor lived and received such amounts.

Because trust is a CRUT under 664(d)(2), the character of the unitrust amounts payable to the Settlor's son or his estate will be determined under 664(b) and will consist first of ordinary income.

PLR 9253038

Qualified Plan to CRUT

Donor established an 8% NIMCRUT

CRUT will be f/b/o donor during his life and after his death to his wife for such time as she survives him. At death of survivor of donor and wife, the trust will terminate and the trust assets will be distributed to a college and used in such manner as its governing board determines. If college is not described in 170(b)(1)(A), 170(c), 2055(a) and 2522(a) at the time of distribution, the assets will be distributed to another organization which is then so described.

Under terms of qualified plan, if a participant dies before his account balance is distributed or used to purchase an annuity, his beneficiary will be entitled to the full value of his account.

Donor intends to execute a beneficiary designation form, with his wife's consent, under which a portion of his account will be distributed from the plan to the CRUT after his death.

Issue 1

Trust qualifies as CRUT. Thus, under Sec. 664(c) trust will not be subject to any income tax unless it has UBTI.

Issue 2

Trust income payable to spouse after Donor's death will be governed by the CRUT's tier system of taxation.

Issue 3

Interest passing to spouse qualifies for the estate tax marital deduction under Sec. 2056(b)(8). Thus, present value of wife's interest in property passing from the qualified plan to the CRUT as a result of the Donor's death will qualify for the estate tax marital deduction under Sec. 2056(a).

Issue 4

Present value of the charitable interest in property passing from the qualified plan to the CRT as a result of the Donor's death will qualify for the estate tax charitable deduction under Sec. 2055(a).

PLR 9341008

Transfer of IRA assets at death to private foundation.

Designation of private foundation as IRA beneficiary results in estate tax deduction, no taxable income to estate and its beneficiaries and the foundation and no 2% excise tax for the foundation.

T will create private foundation. T will name foundation as the beneficiary of the IRA proceeds upon her death.

Rulings requested:

1. Where private foundation is designated beneficiary of T's IRA, property passing from the IRAs to private foundation at the taxpayer's death will be eligible for a FET charitable deduction under Sec. 2055(a).

2. The estate of the taxpayer will not recognize taxable income upon the distribution of the proceeds of the taxpayer's IRA to the private foundation.

3. The beneficiaries of the estate of the T will not recognize taxable income upon the distribution of the proceeds of the taxpayer's IRA to the private foundation.

4. The private foundation will not recognize taxable income upon receipt of the proceeds of the T's IRA following the death of the T.

5. The private foundation will not be subject to the federal excise tax on net investment income under Sec. 4940(a) when the taxpayer's IRAs pass to the private foundation.

Holding:

A private foundation will not be able to satisfy the requirements of Reg. 1.401(a)(9)-1, D-5 (i.e. the private foundation won't qualify as a designated beneficiary), distributions from an IRA to the private foundation must occur within 5 years after the death of the owner of the IRA (assuming the IRA owner dies before her RBD).

Issue 1 (Estate Tax Charitable Deduction)

Transfer of IRA at death of T to private foundation (defined in §509(a) and is an organization described in §501(c)(3)), will qualify for estate tax charitable deduction.

Issues 2, 3 and 4 (Income in Respect of a Decedent)
If private foundation is named as designated beneficiary of the IRAs, the proceeds will be IRD to the private foundation under Sec. 691(a)(1)(B) when distributed to the private foundation and will not be IRD to the taxpayer's estate nor to the other beneficiaries of the taxpayer's estate.

Issue 5 (Excise Tax on Investment Income)
4940(a) imposes a 2% excise tax on the net investment income of each private foundation exempt from tax under Sec. 501(a).

Sec. 4940(c)(1) defines net investment income as the sum of gross investment income and capital gain net income which exceeds the deductions allowed by Sec. 4940(c)(3).

The statutory scheme of Sec. 4940 envisions a situation in which the private foundation has previously received an asset and is earning income from that particular asset or sells that asset. There is no taxation envisioned when a foundation receives an asset. The revenue rulings in this area deal with situations in which the private foundation has received the asset and the asset is sold or produces some type of income.

Based upon Rev. Rul. 74-404 and 80-118, a private foundation does not realize or recognize income upon receipt of a gift. Income is realized only when the foundation actually receives the income or sells the gift.

Thus, the private foundation will not be subject to the federal excise tax on investment income under Sec. 4940(a) when the T's IRAs pass to the private foundation.

(The author of this private letter ruling indicated that the private foundation would not be subject to the 2% excise tax on net investment income at the time the **assets** in the IRA are distributed to the foundation. Only the subsequent income generated on the assets distributed and net capital gains on the sale of such assets would be treated as net investment income for excise tax purposes).

The ruling doesn't address the determination of basis for assets of the IRAs (e.g. stock and bonds) distributed to the private foundation. Is the basis the FMV on the distribution date? Or is it the basis of the assets in the IRA prior to distribution? IRS has not addressed this issue. Basis issues and capital gains can be avoided by selling assets in an IRA and then distributing the cash proceeds to the private foundation.

PLR 9633006

Keogh to private foundation.

Grantor created a private foundation within the meaning of §509(a). The private foundation qualifies for tax-exempt status pursuant to §501(a) as an organization described in §501(c)(3). Grantor is owner of a Keogh plan. The Keogh contains a separate account for the Grantor. Grantor has designated the private foundation as beneficiary of accrued benefit under the Keogh. A's spouse has executed a consent with respect to the designation of the private foundation as beneficiary of the Keogh. At the Grantor's death, the private foundation will receive the entire account balance from the Keogh plan.

Estate Tax Charitable Deduction

IRS held that Grantor's estate will receive a FET charitable deduction under Sec. 2055(a) for the proceeds of the Keogh passing to the private foundation.

IRD

IRS held that Keogh plan proceeds will be IRD to the private foundation and will not be IRD to the Grantor's estate nor to the other beneficiaries of the Grantor's estate.

Income and Excise Tax on Investment Income

The private foundation will receive the proceeds of the Keogh and the amounts in excess of contributions made to the account represent the **receipt of income** to the private foundation. (The estate will not receive the income of the Keogh and will not distribute estate income to the private foundation). Neither the Grantor nor the Grantor's estate will include the Keogh as income.

Based on Rev. Rul. 74-404 and Rev. Rul. 80-118, an exempt private foundation does not realize or recognize income upon receipt of a gift but realizes income only when the foundation actually receives the income or sells the gift.

Because the increase in value of the account is not income of an estate that was subsequently distributed to a private foundation, the exception provided by §53.4940-1(d)(2) of the regulations is not applicable. (That regulation says that in the case of a distribution **from** an estate or a trust described in §4947(a)(1) or (2), such distribution shall not retain its character in the hands of the distributee for purposes of computing the tax under §4940.

The proceeds in excess of the assets contributed to the account are held to be investment income and are subject to the excise tax on investment income under Sec. 4940 because the assets in the account are of the type that produce investment income.

Because the private foundation is exempt from income tax under Sec. 501(a), the private foundation will not recognize income subject to income tax upon receipt of the proceeds of the Grantor's Keogh account following the death of the Donor.

PLR 9634019

Qualified plan to CRUT

Rulings Requested:

1. No income tax will be payable by H or W or their children, or the trust, upon the distribution of the plan assets to the trust.

2. The present value of the charitable interest in the property transferred to the trust upon H's death will qualify for the estate tax charitable deduction under §2055.

H and W executed a CRUT. The two children of H and W will be the lifetime recipients of the unitrust amount.

H will designate the CRUT as the beneficiary of a qualified retirement plan. Thus, on H's death the proceeds of the plan will be paid in a lump-sum to the trust.

IRS concludes that:

Income from the distribution of the proceeds from H's qualified plan to the CRUT will be IRD.

The income attributable to the retirement plan will be includable in the gross income of the CRUT for the taxable year the distribution is received by the trust as the designated beneficiary of H's retirement plan. The CRUT (provided it is exempt) will not be taxable on its income for that year unless it has UBTI. Neither H nor W will be taxable on the income from the distribution of the retirement plan to the trust.

The character of the income distributed to the children from the CRUT will be ordinary income until the amount of ordinary income attributable to the retirement plan is used up. The income attributable to H's retirement plan will be included as ordinary (1st tier) income.

Provided the CRUT is a qualified CRUT, the present value of the remainder interest in H's retirement plan that is transferred to the CRUT will qualify for the FET charitable deduction under Sec. 2055(a).

Conclusion: Income from distributions of qualified plan assets to qualified CRUT is not taxable to the trust or trust grantors. The beneficiaries of the CRUT are taxable to the extent unitrust amount distributions are characterized as income from the plan under §664(b).

<u>PLR 9723038</u>

IRA to Charity

Ruling request:

1. Distribution of IRA to Charity 1 and Charity 2 on the death of the survivor of T and S qualifies for estate tax charitable deduction for the FET value of IRA less the excess accumulation tax.

2. An estate tax deduction is allowed under §2053(a)(3) and §2053(c)(1)(B) for the excess accumulation tax.

3. Any distribution from the IRA to Charity 1 or Charity 2 will be included in the income of Charity 1 and Charity 2 as IRD and will not be included in the income of the estate of either T or S.

T and S (his spouse) reside in community property state (California). T funded an IRA with a rollover from a pension plan. The IRA is held in T's name and T has designated S as the primary beneficiary of the IRA. If S doesn't survive T, the two charities will receive the IRA assets when T dies. S consented to the beneficiary designations.

If S survives T, she will make an election under §4980A(d)(5) to defer the excess accumulation tax until S's death. S will designate Charity 1 and Charity 2 as the beneficiaries of the IRA on her death. If S fails to execute a new beneficiary designation form naming Charity 1 and Charity 2 as the IRA beneficiaries, the IRA will be payable to her estate at her death. (We don't know why IRA is payable to S's estate. It could be that the IRA agreement names the estate as a default beneficiary). S has executed a codicil to her will bequeathing the IRA proceeds to Charity 1 and Charity 2.

California Probate Code provides that the excess accumulation tax is imposed on the recipient of the **qualified plan's** assets. T executed a codicil to his will directing the recipient of the **IRA** at his death to pay any excess accumulation tax. The codicil in S's will also provides that any **qualified plan's** excess retirement accumulation tax will be paid by the recipients of the **IRA** assets.

T and S are both over 70 1/2 and have been withdrawing at least the MRD from the IRA.

<u>Held:</u>

1. The estate of the survivor of T and S will be entitled to an estate tax charitable deduction equal to the value of the IRA which passes to Charity 1 and Charity 2 reduced by any FET attributable to the decedent's excess accumulation tax imposed on the IRA.

2. The excess accumulation tax is deductible from the gross estate. Thus, the estate of the survivor of T and S will be able to claim a deduction for the amount of the estate tax attributable to a decedent's excess retirement accumulation.

3. The proceeds of the IRA, or of a successor IRA into which the IRA is rolled over, which would have been items of gross income to T and S if the proceeds had been distributed to them, will be IRD to Charity 1 and Charity 2 (and not to the estate of T or S) when distributed to those organizations.

Points:

1. Notice how T complied with the spousal consent rules under the REA of 1984 when T did the rollover from the pension plan to the IRA. Otherwise, S's rights in the pension plan may carryover to the IRA and, if S exercised her rights, T's desire to leave the IRA to Charity 1 and Charity 2 could have been frustrated.

2. Since the T named S as the primary beneficiary of the IRA, he was able to take MRD based on the joint life expectancy of both he and S. The ruling, however, doesn't indicate whether T was taking the MRD based on the joint life expectancy of he and S, nor does it indicate whether or not he elected to recalculate his and S's life expectancy.

3. Note that if T dies first, S is the primary beneficiary of the IRA. Thus, the IRA will qualify for the marital deduction in T's estate. The IRA can then be paid to S over the remaining joint life expectancy of T and S (assuming T didn't elect to recalculate his life expectancy). Alternatively, S could roll over the IRA into her own IRA, choose a new designated beneficiary and begin a new (and perhaps, longer) distribution period. (Note that if S did a spousal rollover and chose a new designated beneficiary other than the two charities, the T's intent to leave the IRA to the two charities would have been frustrated).

   If T outlives S, the IRA can be paid to him over the remaining joint life expectancy of he and S (assuming he didn't elect to recalculate S's life expectancy). When T subsequently dies, the IRA is paid to charity, qualifying for the estate tax charitable deduction in his estate.

4. Notice how the attorney carefully preserved the fiduciary income tax charitable deduction under §642(c) by specifically providing in the codicil to the will that if S didn't execute a designated beneficiary from naming Charity 1 and Charity 2 as the beneficiaries of the IRA, that the IRA, which would then be payable to S's estate, is specifically left to Charity 1 and Charity 2. Thus, the disposition complies with the requirement of §642(c) that (1) the bequest is paid out of gross income and (2) that the bequest is paid pursuant to the terms of the

governing instrument, thus preserving the fiduciary income tax charitable deduction.

5. Notice how the attorney is deferring the excess accumulation tax from T's death to S's death, allowing the IRA to grow unreduced by the excess accumulation tax that would otherwise have been required to be paid when T died first. By leaving the IRA to S and having S elect to defer the excess accumulation tax to her subsequent death, by leaving the IRA to Charity 1 and Charity 2 they can avoid the excess accumulation tax altogether.

6. Notice how the attorney is requiring that the excess accumulation tax be paid out of the IRA, thereby reducing the amount the charity will receive, the amount of the charitable estate tax deduction but not otherwise increasing the estate tax due to the fact that the estate can take an estate tax deduction for the excess accumulation tax. The charities, as tax-exempt entities, can withdraw the money from the IRA to pay the estate tax without causing the withdrawal to constitute a taxable distribution. If the IRA we left to an individual and the individual took a distribution from the IRA to pay the estate tax, the individual would also have to pay income tax on the amount withdrawn to pay the estate tax.

PLR 9818009

IRA and 401(k) to Private Foundation

Taxpayer created a §509 private foundation which qualifies for §501(a) tax-exempt status as a §501(c)(3) organization. Taxpayer owns an IRA and participates in a 401(k). He intends to name the foundation as the beneficiary of the proceeds of the IRA and the 401(k) on his death. Taxpayer's spouse has or will execute any consent required by the Internal Revenue Code or regulations with respect to naming the foundation as the beneficiary of the retirement accounts.

Ruling request:

1. Distribution of IRA and 401(k) proceeds to foundation will be eligible for a federal estate tax charitable deduction.
2. The taxpayer's estate will not recognize taxable income upon distribution of the proceeds to the foundation.
3. The beneficiaries of the taxpayer's estate will not recognize taxable income on receipt of the distribution of the proceeds to the foundation.
4. The foundation will not recognize taxable income upon the receipt of the proceeds following the death of the taxpayer.
5. The foundation will not be subject to the federal excise tax on investment income under §4940(a) at the time the proceeds pass to the foundation.

The IRS concludes:

The Service explained that the value of the IRA and 401(k) will be includible in the taxpayer's gross estate on his death under §2039(a).

The Service ruled that if the foundation is still a §509 private foundation when the taxpayer dies, the taxpayer's estate will be eligible for a federal estate tax charitable deduction under §2055(a) for the proceeds of the IRA and 401(k) assets passing to the foundation.

The Service also ruled that if the foundation is named as the sole beneficiary of the IRA and the 401(k), the proceeds from the IRA and 401(k), which would have been items of gross income to the taxpayer if the proceeds had been distributed to him, will be income in respect of a decedent (IRD) to the private foundation under §691(a)(1)(B) when distributed to the foundation. The Service held that the proceeds from the IRA and the 401(k) will not be IRD to the taxpayer's estate and the beneficiaries of the taxpayer's estate.

The Service did not rule on whether the foundation will recognize income on receipt of the proceeds after the taxpayer's death or whether the foundation will be subject to federal excise tax on investment income at the time the proceeds pass to the foundation. These issues are being considered separately by the IRS.

PLR 199901023

Qualified Plan to CRT

Donor established an inter vivos CRUT. The unitrust was to be funded at the Donor's death. The Donor named the CRUT as the beneficiary of his qualified retirement plan. The qualified plan was payable in a lump sum to the trust. The CRUT was for the benefit of the Donor's two children. The balance in the CRUT upon termination was payable to a foundation.

Held:

1. The proceeds of the qualified retirement plan will be included in the gross income of the CRUT as income in respect of a decedent (IRD) in the year of receipt and will not be includible in the gross income of the Donor's estate

2. The CRUT will not be taxable on the proceeds of the qualified retirement plan unless it has unrelated business taxable income (UBTI).

3. In computing the Section 691(c) deduction, the estate must exclude the charitable deduction resulting from the contribution of the qualified retirement plan to the CRUT.

4. The proceeds of the qualified retirement plan that are IRD are "first tier" income of the CRUT.

5. The Section 691(c) deduction reduces the amount of IRD that the CRUT includes in its "first tier" of income. Thus, the amount of "first tier" income from the IRD is the net of the IRD less the Section 691(c) deduction. The Section 691(c) is not directly made available to the CRUT beneficiaries.

Points:

This is the first ruling that discusses the treatment of the Section 691(c) deduction for IRD payable to a CRUT. Thus, the distribution of the retirement plan proceeds to the CRUT will constitute "first tier" income to the CRUT. Any Section 691(c) deduction must be netted against the first tier income and is not available as a separate item to the CRUT beneficiaries.

The ruling also states that since the retirement plan proceeds are excluded from the gross estate (due to the charitable estate tax deduction), the charitable deduction for the qualified plan proceeds contributed to the CRUT must also be excluded when recomputing the estate tax to determine the Section 691(c) deduction.

PLR 199939039

Qualified Plan and IRA Payable to Foundation

The taxpayer created a private foundation. The taxpayer intended to name the foundation as the beneficiary of some or all of the proceeds of his IRAs and qualified plans upon his death. The taxpayer's spouse agreed to execute any consent required under the Retirement Act of 1984.

Held:

1. The taxpayer's estate will be eligible for a federal estate tax charitable deduction for the proceeds of the IRA and qualified retirement plans passing to the foundation.

2. The proceeds of the IRA and qualified retirement plans passing to the foundation will be income in respect of a decedent (IRD) to the foundation in the year of receipt. In addition, the proceeds of the IRA and qualified retirement plans passing to the foundation will not be IRD to the taxpayer's estate and the beneficiaries of the taxpayer's estate.

Points:

The taxpayer also requested rulings that (1) the foundation will not recognize taxable income upon receipt of the proceeds of the IRA and qualified retirement plans passing to the foundation and (2) that the foundation wil not be subject to the federal excise tax on investment income under Section 4940(a). The Service declined the taxpayer's request stating that those issues were being considered separately.

STRUCTURING CHARITABLE GIFTS OF IRAs

26th Conference on Gift Annuities

Jeremiah W. Doyle IV, Esq.
Mellon Financial Corporation
Private Wealth Management
Boston, MA
May 7, 2004

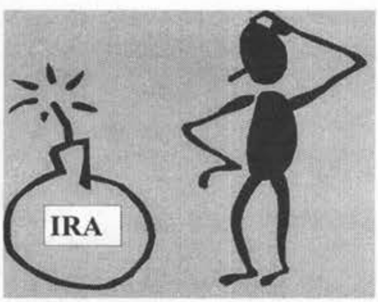
Agenda

- Set the stage
- Why Leave IRA to Charity
- When to Leave the IRA to Charity
- How to Leave the IRA to Charity
- Who Takes the IRA
- Tax Efficient Gift of IRA
- Speed Bumps
  - REA of 1984
  - Trust or Estate as IRA Beneficiary
  - Minimum Required Distribution Rules
- Using a Charitable Remainder Trust
- Lifetime Gift of IRA to Charity
- Convert IRA at Death to Charitable Gift Annuity
- How Separate Share Rule Affect §642(c) Deduction

IRA MAY BE SUBJECT TO:

- Estate Tax
- Income Tax
- Generation-Skipping Tax

IRA TIME BOMB



FACTS

- John, A Widower, Dies in 2004 At Age 65
- Has $2 Million IRA
- Estate is Beneficiary Of IRA
- John in Highest Income And Estate Tax Bracket
- Executor Liquidates IRA

HEY - WHERE DID MY IRA GO???
(NO GST)

Value of IRA	$ 2,000,000
Federal Estate Tax @ 48%	($ 914,800)
Massachusetts Estate Tax	($ 180,800)
Federal and Massachusetts Income Taxes:	
Federal Income Tax: 35% x $979,200	($ 342,720)
Massachusetts Income Tax: 5.30% x $2,000,000	($ 106,000)
Balance	$ 455,680

Amount Received by Children: $455,680 i.e. 23 cents on the dollar!!!

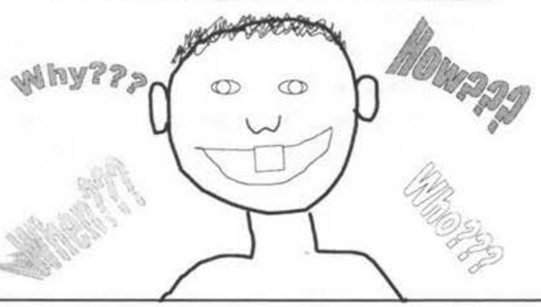
HEY - WHERE DID MY IRA GO???
(GST)

Value of IRA	$2,000,000
Federal Estate Tax @ 48%	($ 914,800)
Massachusetts Estate Tax	($ 180,800)
Generation Skipping Tax	($ 293,319)
Federal and Massachusetts Income Taxes:	
Federal Income Tax: 35% x $685,881	($ 240,058)
Massachusetts Income Tax: 5.30% x $2,000,000	($ 106,000)
Balance	$ 265,023

Amount Received by Grandchild: $265,023 i.e. 13 cents on the dollar!!!

IRA TIME BOMB

CHARITABLE GIFTS OF IRAs FROM AN 8 YEAR OLD'S EYES



Why???

TAX CONSEQUENCES OF LEAVING IRA TO CHARITY - 9 PLRs

- No Estate Tax
  - Qualifies for FET Charitable Deduction
- No Income Tax
  - To Donor or Donor's Estate
  - Charity not Taxed on Proceeds
- Tax Efficient gift – for a cost of roughly 25% to the heirs, 100% of IRA can be devoted to a charitable purpose

When???

WHEN TO LEAVE AN IRA TO CHARITY

- At Death
- During Life
  - Take Distribution, Pay Income Tax
  - Pending Legislation
  - Employer Stock in Qualified Plans
  - 10 yr Averaging if Born Before 1936

How???

WAYS TO GIVE IRA TO CHARITY

- Directly to Charity
  - Name Charity in Beneficiary Form
- To Individual, Followed by Disclaimer to Charity
- To Estate/Trust, Then to Charity
- Income to Individual Beneficiary, Remainder to Charity
  - Qualified Terminable Interest (QTIP) Trust
    - Sec. 2056(b)(7)
    - Sec. 2056(b)(8)
  - Charitable Remainder Trust Sec. 664

Who???

WHO TAKES YOUR IRA ?

- The Will Doesn't Control
- ***The Designated Beneficiary Form Controls***

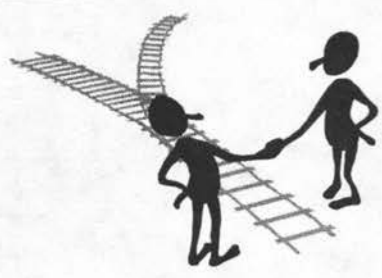
BENEFICIARY OF IRA

- Named in Beneficiary Form
- Default: See IRA Agreement
  - Estate?
  - Spouse?

CHARITY AS THE BENEFICIARY OF AN IRA

- Named as Primary Beneficiary
  - IRA owner dies, charity gets the IRA
- Named as Contingent Beneficiary
  - IRA owner dies, primary beneficiary gets the IRA
  - Charity gets nothing
  - Charity gets IRA only if primary beneficiary predeceases the IRA owner
- Example:
  - IRA owner names spouse as primary beneficiary and if spouse survives, agrees to leave IRA to charity

STRUCTURING A TAX EFFICIENT GIFT



IRA TO SON, STOCK TO CHARITY

	Charity	Son
Stock	500,000	
IRA		500,000
Total Bequest	500,000	500,000
Less: Income Tax on IRA	0	<200,000>
Net Bequest	500,000	300,000

IRA TO CHARITY, STOCK TO SON

	Charity	Son
Stock		500,000
IRA	500,000	
Total Bequest	500,000	500,000
Less: Income Tax on IRA	0	0
Net Bequest	500,000	500,000

Speed Bumps

- Retirement Equity Act of 1984
- Estate or Trust as beneficiary of retirement plan
- Minimum Required Distribution Rules

RETIREMENT EQUITY ACT OF 1984

- Applies to Most Qualified Plans
- Spouse has Rights in Qualified Plan
- If Beneficiary of Plan is Other Than Spouse:
  - Waiver Needed
  - Spouse Must Consent to Waiver
- Doesn't Apply to IRAs
  - Be Careful of IRA Rollovers from Qualified Plans

IRA TO ESTATE, PERCENT OF ESTATE TO CHARITY

Don't Make This Mistake !!!

IRA

↓

ESTATE

25% to charity ↓

CHARITY

IRA TO ESTATE, PERCENT OF ESTATE TO CHARITY

Two Problems:

Estate not a "Designated Beneficiary"

Fiduciary Income Tax Charitable Deduction???

IRA

↓

ESTATE

25% to charity ↓

CHARITY

IRA TO ESTATE, PERCENT OF ESTATE TO CHARITY

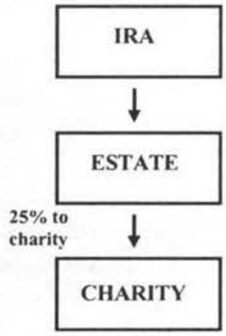
Solutions:

(1) Qualify for §642(c) Deduction

(2) "Assign" IRA to Charity

(3) Pay the Charity Last

(4) Bypass the Estate

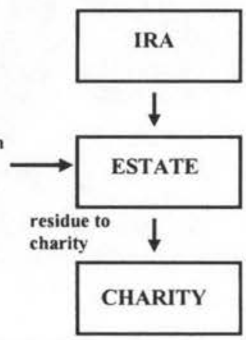


QUALIFY FOR §642(C) DEDUCTION

- **2 Requirements for Fiduciary Income Tax Deduction:**
  - **Paid out of gross income**
  - **Paid pursuant to the governing document**
    - **Important: Estate or trust should have language that charitable gift can be satisfied by distribution of IRD**

IRA TO ESTATE, PERCENT OF ESTATE TO CHARITY

PLR 200336020 – IRA distribution included in gross income of estate but qualified for fiduciary income tax charitable deduction.



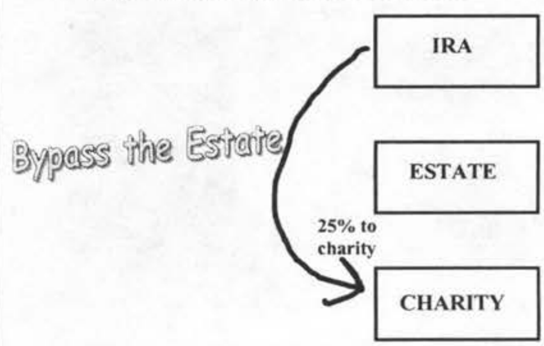
"Assign" IRA to Charity - PLR 200234019 FACTS

- **D named estate as beneficiary of IRA**
- **D's will left percent of estate to various charities**
- **Will authorized non-pro rata distributions**
  - **Rev. Rul. 69-486 - no tax on non-pro rata distribution if allowed by inst or state law**
- **IRS says executor could "assign" IRA to charity**
- **Result: (1) No taxable income to estate or individual beneficiaries, (2) IRA not included in estate's DNI and (3) No taxable income to charity**
- **Reason: Regs. say if IRD is transferred to specific or residuary legatee, only the recipient must report such income**

Pay Charity Last - PLR 200221011 FACTS

- **D's will leaves specific bequests to individuals, residue to charity**
- **Estate named as beneficiary of IRA**
- **Year 1 - Executor pays administration expenses and all specific bequests to individuals**
  - **Charity only remaining bene at end of Year 1**
- **Year 2 - estate receives IRA proceeds**
- **Result: IRS says *estate* is entitle to charitable "set aside" deduction that would offset the inclusion of the IRA proceeds in gross income**

IRA TO ESTATE, PERCENT OF ESTATE TO CHARITY



MINIMUM REQUIRED DISTRIBUTIONS

What Are MRD?

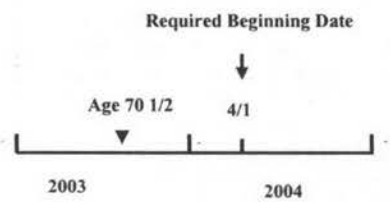
- **MRD Rules Dictate:**
  - **When Distributions Commence**
  - **Once Begun, How Fast Must Distributions Be Made**
  - **Who is a "Designated Beneficiary"**

MINIMUM REQUIRED DISTRIBUTIONS

The Problem

- **Must Begin At 70 1/2**
- **Life Expectancy Tables Govern Amount of Distribution**
- **Previously, who was named as beneficiary governed the amount of the required distribution**
  - **If "designated beneficiary," favorable distribution**
  - **If not "DB," less favorable distribution**
- **Generally, IRA owners seek to take as little as possible**
- **Noncompliance: 50% Penalty**

MINIMUM REQUIRED DISTRIBUTION
Required Beginning Date



MINIMUM REQUIRED DISTRIBUTIONS

The Problem

- **Lifetime distributions - will naming a charity as bene affect how much the IRA owner must withdraw during life?**
- **Distributions after death - what is the effect of having multiple beneficiaries, one of which is a charity?**
  - **Objective: Allow individual beneficiary to spread IRA distributions over his/her life expectancy**

DESIGNATED BENEFICIARY
(For MRD Purposes)

- **Spouse**
- **Children**
- **Other Individuals**

But Not:
- **Estate**
- **Charity**

Multiple Beneficiary Rule: Valid DB only if all benes are DB

MRD - PRE 2001 REGULATIONS
CHARITY AS BENEFICIARY

Distributions Accelerated

MINIMUM REQUIRED DISTRIBUTIONS
Final Regs. Issued April 16, 2002

- If entire IRA goes to charity – no issue
  - Lifetime distributions governed by Uniform Table
  - Post-death distributions go 100% to charity
- If charity is one of multiple beneficiaries
  - Lifetime distributions governed by Uniform Table
  - Post-death distributions to individual beneficiary

may be accelerated!!!

MINIMUM REQUIRED DISTRIBUTIONS
Final Regs. Issued April 16, 2002

- Must Begin At 70 1/2
- Uniform Table Governs *Lifetime* MRD
  - Named Beneficiary Generally **Disregarded**
- *Post Death* MRD Determined by Who is DB
  - "Wiggle room" provided to determine who is the DB after death
  - Post-Death, No Drawback to Leaving Entire Retirement Benefits to Charity

MINIMUM REQUIRED DISTRIBUTIONS
Lifetime Distributions

- MRD Not Affected by Who is Named Beneficiary
  - No adverse MRD consequences if *charity* is named
- MRD *always* governed by new "*Uniform Table*"
  - Exception: Where spouse is sole beneficiary and is more than 10 years younger than IRA owner
    - Use actual joint LE, recalculated
      - Results in less being distributed than under the "Uniform Table"

MINIMUM REQUIRED DISTRIBUTIONS
Lifetime Distributions
New "Uniform Table"

- Calculates lifetime MRD based on IRA owner's age and age of beneficiary exactly 10 years younger (MDIB table)
- Results in lower distributions
  - Lower distributions means more left for charity

		Uniform Table			
Age	Factor	Age	Factor	Age	Factor
70	27.4	85	14.8	100	6.3
71	26.5	86	14.1	101	5.9
72	25.6	87	13.4	102	5.5
73	24.7	88	12.7	103	5.2
74	23.8	89	12	104	4.9
75	22.9	90	11.4	105	4.5
76	22	91	10.8	106	4.2
77	21.2	92	10.2	107	3.9
78	20.3	93	9.6	108	3.7
79	19.5	94	9.1	109	3.4
80	18.7	95	8.6	110	3.1
81	17.9	96	8.1	111	2.9
82	17.1	97	7.6	112	2.6
83	16.3	98	7.1	113	2.4
84	15.5	99	6.7	114	2.1
				115	1.9

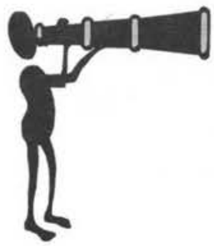
MINIMUM REQUIRED DISTRIBUTIONS
New "Uniform Table"
Good News for Charity!!!

Choice of Beneficiary Can Be Made Without Concern That Lifetime Distributions Will Be Accelerated

MINIMUM REQUIRED DISTRIBUTIONS
New "Uniform Table"
Good News for Charity!!!

- **Lifetime Distributions:**
  - **If the IRA owner has no DB, it doesn't matter**
  - **He uses the "Uniform Table" whether he has named a DB or not**
  - **The drawback of naming a charity at the RBD is *TOTALLY ELIMINATED*!!!**

MINIMUM REQUIRED DISTRIBUTIONS
Charities - Sit up and Take Notice!



- **"Uniform Table" means lower MRD i.e. there's more left for charity!!!**
  - **Especially since recalculation of LE is built into the "Uniform Table"**

MINIMUM REQUIRED DISTRIBUTIONS
Charities - Sit up and Take Notice!

- **Donors who want to leave an IRA to charity but named a DB to lower lifetime MRD should now reassess**
  - **Now they can name charity as the IRA beneficiary without affecting their lifetime MRD**

MINIMUM REQUIRED DISTRIBUTIONS
Post Death Distributions

- **Distributions after death depend on beneficiary**
  - **Not as favorable as Lifetime Distribution rules**
  - **Problem: Multiple Beneficiaries, One Being Charity**
- **Don't have to worry who is DB at RBD or death**
- **Identity of DB not finalized until 9/30 of the year after death of IRA owner**
  - **Allows post-mortem "cleanup" by:**
    - **Separate Accounts**
    - **Distribution**
    - **Disclaimer**

MINIMUM REQUIRED DISTRIBUTIONS
Death Before RBD

- **If there is a DB:**
  - **DB can be determined by 9/30 of the year after death**
  - **Distribute over DB's remaining LE**
    - **Spouse - recalculation**
    - **Non-spouse - term certain**
- **If there is no DB:**
  - **5 year rule applies**

Remember the Multiple Beneficiary Rule

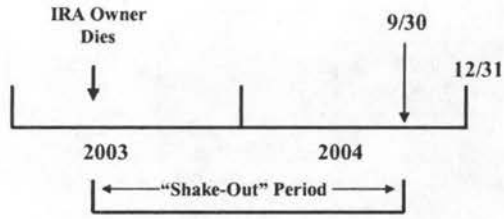
MINIMUM REQUIRED DISTRIBUTIONS
Death After RBD

- **If there is a DB:**
  - **DB can be determined by 9/30 of the year after death**
  - **Distribute over DB's remaining LE**
    - **Spouse - recalculation**
    - **Non-spouse - term certain**
- **If there is no DB:**
  - **Distribute over *IRA owner's* remaining LE (term certain basis)**

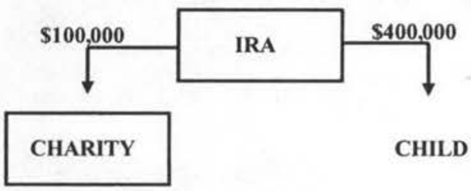
Remember the Multiple Beneficiary Rule

MINIMUM REQUIRED DISTRIBUTIONS
Charity as One of Multiple Beneficiaries
Post-Death Distributions

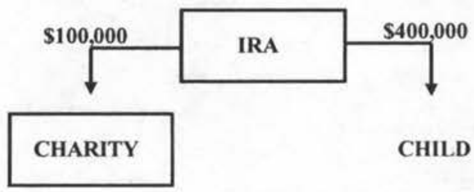
MINIMUM REQUIRED DISTRIBUTIONS
Post-Death Distributions



$500,000 IRA
$100,000 TO CHARITY, BALANCE TO CHILD

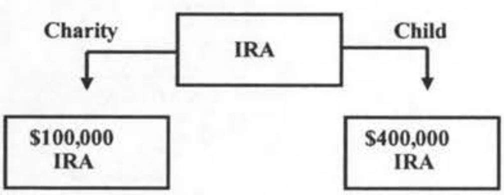


$500,000 IRA
$100,000 TO CHARITY, BALANCE TO CHILD



Charity not a 'Designated Beneficiary"
Death Before RBD: Distribution within 5 years
Death After RBD: Distribution Over Donor's LE

$500,000 IRA
$100,000 TO CHARITY, BALANCE TO CHILD

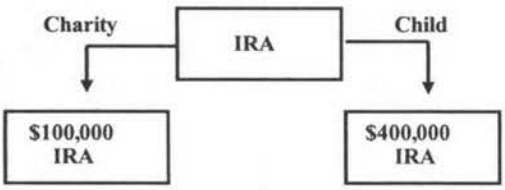


Solution: Use Separate Accounts

"Separate Account"
Reg. 1.401(a)(9)-8, A-3

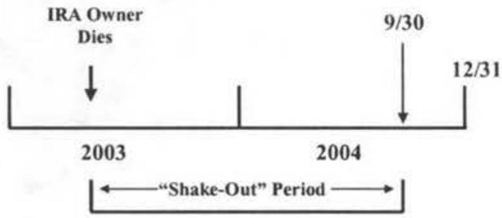
"...separate portions of an employee's benefit reflecting the separate interests of the employee's beneficiaries under the plan as of the date of the employee's death for which separate accounting is maintained. The separate accounting must allocate all post-death investment gains and losses, contributions and forfeitures, for the period prior to the establishment of the separate accounts on a pro rata basis in a reasonable and consistent manner among the separate accounts."

$500,000 IRA
$100,000 TO CHARITY, BALANCE TO CHILD

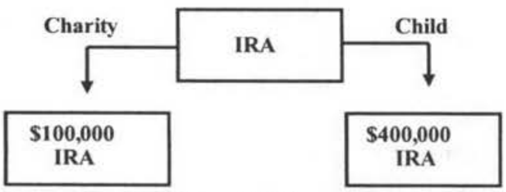


Final Reg. *Bonus #1*: Can Set up Separate Accounts Anytime Before 9/30 of the Year After the IRA Owner Dies

MINIMUM REQUIRED DISTRIBUTIONS
Post-Death Distributions



$500,000 IRA
$100,000 TO CHARITY, BALANCE TO CHILD

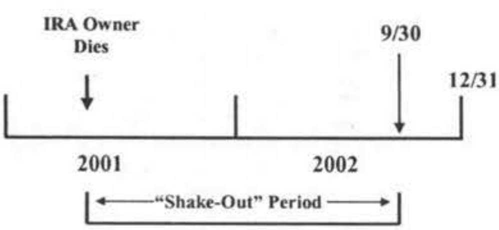


IRA Owner Alive: Use "Uniform Table"
Post Death: *Charity's* Share Within 5 years if Death Before RBD
Post Death: *Charity's* Share Over IRA Owner's LE if Death After RBD
Post Death: *Child's* Share Over LE of Child

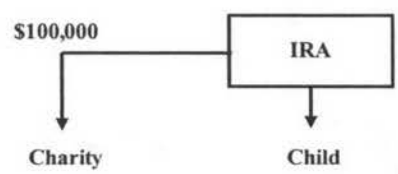
Final Reg. Bonus #2

- **Can Eliminate Beneficiaries for MRD Purposes by Distributing Entire Share to "Tainted" Beneficiary**
- **If Amount is Entirely Distributed to Beneficiary by 9/30 of the Year After the IRA Owner Dies, Only the Remaining Beneficiary are "Counted" to Determine if IRA has a DB**
- **Example: IRA Has Individual and Charity as Beneficiary. If Charity's Share is Distributed to It Before 9/30 of the Year After the IRA Owner's Death, the IRA then has a DB i.e. the Individual**

MINIMUM REQUIRED DISTRIBUTIONS
Post-Death Distributions



$500,000 IRA
$100,000 TO CHARITY, BALANCE TO CHILD



New Final Reg. *Bonus #2*: Can Cure Defect After Death by Distributing "Tainted" Share to Non-DB

$500,000 IRA
$100,000 TO CHARITY, BALANCE TO CHILD

$100,000

IRA

Charity

Child

No Distribution to Charity:
- Death Before RBD: 5 Year Rule
- Death After RBD: MRD Over IRA Owner's Remaining LE

Distribute Charity's Share:
- MRD Over Child's LE

IRA TO CRT

IRA

↓

CRT

↓

Payments to Individual
Remainder to Charity

ADVANTAGES OF IRA TO CRT

- FET Charitable Deduction for PV of Remainder
- CRT Tax-Exempt - No Federal Income Tax
  - Receipt of IRA Distribution is Tax -Free
  - Assets Retained in CRT Grow Tax-Free
  - 100% Available to Reinvest
- Tax Spread Over CRT Payment Period
- CRT Provides Stream of Income to Beneficiary

DISADVANTAGES OF CRT

- Not a Designated Beneficiary
- Fixed Payments
- No Access to Principal
- No "pass-thru" of Sec. 691(c) deduction
- Estate or trust to CRT - no §642(c) deduction

DISADVANTAGES OF CRT - PLR 199901023

<u>WIFO Tier System of Taxation</u>

IRA Proceeds ⟶ Tier One - Ordinary Income

Tier Two - Capital Gain

Tier Three - Tax-Exempt Income

691(c) ⟶ Tier Four - Return of Corpus

What Really Happens: Section 691(c) Deduction
Reduces the IRA Proceeds in Tier One Income

IRA TO ESTATE,
PERCENT OF ESTATE TO CHARITY

IRA

↓

ESTATE

25% to charity ↓

CRT

Charitable v.
Distribution Deduction
from Estate to CRT

Retirement Plan to Charity
Lifetime Gift

- **Requirements:**
  - **Taxpayer receives "*lump sum distribution*" (LSD) of *qualified* plan**
  - **Distribution includes "*employer stock*" that has a significant amount of "*net unrealized appreciation*" (NUA)**

Retirement Plan to Charity
Lifetime Gift

- **How It Works:**
  - **Distribution of "employer stock" results in income taxation to the recipient equal to the "*cost basis*" (not the FMV) of the "employer stock"**
  - **The "NUA" is not taxed on distribution**
  - **When sold the "NUA" is LTCG, regardless of how long the stock is held**

Retirement Plan to Charity
Lifetime Gift

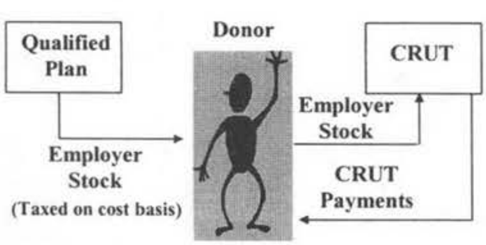
- **How It Works:**
  - **Donor takes LSD of qualified plan**
  - **Retains the "employer stock"**
  - **Pays income tax on "cost basis" of employer stock**
  - **Contributes "employer stock" to CRUT**
  - **Gets charitable deduction for FMV of employer stock less the value of the retained interest**
  - **CRUT sells stock and pays no capital gains tax**
  - **Proceeds equal to NUA are LTCG under CRUT tier system**

Retirement Plan to Charity
Lifetime Gift

- **Result:**
  - **Donor takes distribution from qualified plan during life**
  - **Contributes stock to CRUT for his benefit**
  - **At a cost to him of ordinary income tax on the "cost basis" of the employer securities**
  - **Gets assets out of his qualified plan at a low tax cost and gives them to charity**

This is merely a version of contributing appreciated stock to a CRUT

Retirement Plan to Charity
What It Looks Like



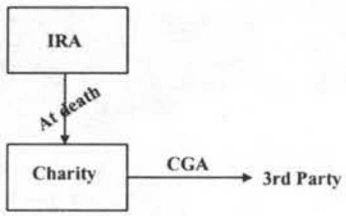
Contribution to CRUT based on FMV of Stock

Retirement Plan to Charity
Will This Work???

Yes!!!

See PLRs 199919039, 200038050, 200202078 (1/15/02), 200215032 (4/12/2002) 200302048 and 200335017

Testamentary Gift Annuity Funded with IRA PLR 200230018



Testamentary Gift Annuity Funded with IRA PLR 200230018

- **Ruling 1: IRA proceeds not UBTI to charity, T/E ok**
- **Ruling 2: IRA included in decedent's taxable estate**
- **Ruling 3: FET charitable deduction equal to value of IRA less present value of annuity**
- **Ruling 4: IRA proceeds are IRD to charity, not to decedent's estate**
- **No ruling: Annuitant's "investment in contract" is value of IRA less FET charitable deduction**
  - **absent ruling, appears entire amount of each annuity payment is taxable to the annuitant as ordinary income**

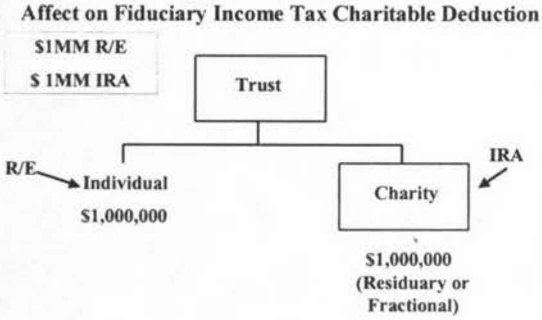
Separate Share Rule Result

A distribution will carry out DNI only to the extent there is DNI properly allocated to the beneficiary's separate share

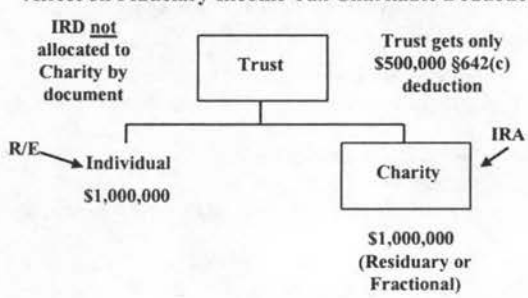
Issue: Application of Separate Share Rule to IRD Reg. 1.663(c)-2(b)(3)

- **Final separate share regs provide that IRD "is allocated among the separate shares that *could potentially be funded* with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law."**
- **"The amount of gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts."**
- **Result: Allocation of IRD could shift income tax liabilities to trusts protected from Federal estate tax or GST. *Docs should state that, to extent possible, applicable exclusion amount and GST exemption should be funded with non-IRD assets.***

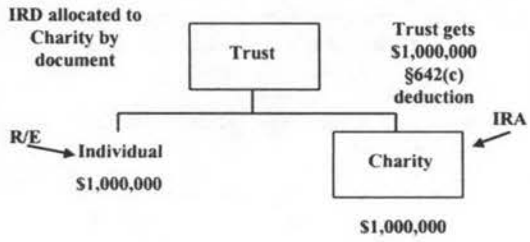
IRD Payable to an Estate or Trust Affect on Fiduciary Income Tax Charitable Deduction



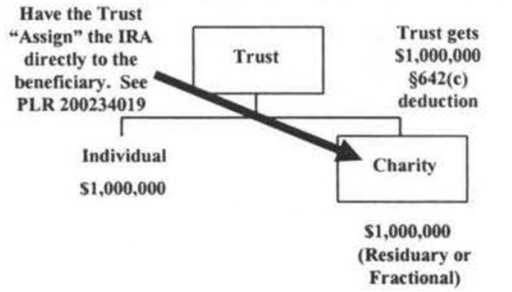
IRD Payable to an Estate or Trust Affect on Fiduciary Income Tax Charitable Deduction



IRD Payable to an Estate or Trust
Affect on Fiduciary Income Tax Charitable Deduction



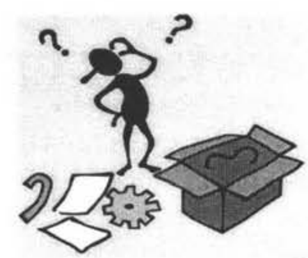
IRD Payable to an Estate or Trust
Alternative - How to Avoid the Separate Share Rule



Conclusion

- Set the stage
- Why Leave IRA to Charity
- When to Leave the IRA to Charity
- How to Leave the IRA to Charity
- Who Takes the IRA
- Tax Efficient Gift of IRA
- Speed Bumps
  - REA of 1984
  - Trust or Estate as IRA Beneficiary
  - Minimum Required Distribution Rules
- Using a Charitable Remainder Trust
- Lifetime Gift of IRA to Charity
- Convert IRA at Death to Charitable Gift Annuity
- How Separate Share Rules Affects the §642(c) Deduction

Don't Try This At Home



MRD - PRE 2001 REGULATIONS
CHARITY AS BENEFICIARY

- Lifetime Distributions
  - Based only on IRA owner's life expectancy
- Post-Death Distributions
  - Death Before RBD
    - Distribute within 5 years of IRA owner's death
  - Death After RBD
    - No recalculation: Over IRA owner's LE
    - Recalculation: Distribute by 12/31 of year after death

Investing Assets for Charitable Gift Annuities

Thomas K. Anderson, CFA
Principal and Portfolio Manager
State Street Global Advisors
Charitable Asset Management Group

Agenda

1. Trends, Issues and Observations
2. The Basics
3. The Risks
4. State Regulations/Challenges
5. Investment Theory
6. Measuring Success
7. Looking Ahead

Trends, Issues, and Observations

Charitable gift annuities are the leading planned gift vehicle today. In 2003, they represented approximately 90% of the gift activity and more than 80% of the dollar activity for the clients with whom State Street works.

Not surprisingly, gift annuities have become the "go-to" planned giving vehicle for development staff. Gift annuities are generally easier and faster to open, requiring only a one- or two-page contract. They are certainly easier for the donor to understand—with a guaranteed payout for life that is higher than any other income generating alternatives. After the weak stock market performance of 2000-2002, donors seem happy to let the charities bear the investment risk and opportunity.

However, for many of these same reasons, gift annuities can cause considerable concern for the investment and finance staff at many charities. The high payout rates are a dramatic departure from the typical payouts from endowments. The concept of eroding principal to achieve the 50% residuum seems even more foreign. Lastly, charitable gift annuity payments are a general obligation of the charity, backed by assets of the charity. Yet gift annuity programs sometimes live under the radar screen of investment committees and finance staff.

The Basics

As a starting point, let us review some charitable gift annuity basics. Charitable gift annuities offer a fixed payment (annuity) for life to one or two beneficiaries. They represent an irrevocable gift, for which the donor receives a tax deduction. The payments are taxable for the income beneficiary, although typically at less than full income tax rates. Most charities follow the rates provided by the American Council on Gift Annuities (ACGA).

The rates set by the ACGA do change over time, based on changes in market expectations and life expectancies. The current rates follow several assumptions, meant to achieve a remainder value of 50% of the original gift for a donor that lives to her life expectancy. The specific assumptions are:

- 50% target residuum of the original contribution
- Annuity 2000 Table, female lives, plus 1.5 year "set back" for increased life expectancy of charitable donors
- 1% expenses for administration and investment management
- Allocation of 35% Equities, 60% Fixed Income, 5% Cash
- Average annual return of 6.0% (5.0% after expenses)

In general, we find that the assumptions the ACGA makes are reasonable. In practice, most of our clients see remainder values higher than the 50% target residuum. One reason for this is that most programs have asset allocations with higher equity weights than in the ACGA assumptions, and over the long term this has led to higher returns than in the assumptions. We believe the assumptions for projected returns the ACGA uses are sensible, as are the expense levels.

The Risks

As we mentioned, investment and finance staff find much to worry about with gift annuity programs, primarily because of several risks that are outside of their control. In some ways, the convenience of gift annuities makes it easy to overlook some of these risks.

- Market risk is the simplest risk that applies to investments—the risk that an investment will decline in absolute value—even as payouts remain constant
- Interest rate risk is important because typically, 35-100% of a gift annuity portfolio is dedicated to fixed income assets. Interest rate risk relates to bonds and the fact that prices on existing bonds move in the opposite direction to interest rates. So, if interest rates rise—as they are likely to over the next few years—the bonds in a gift annuity portfolio could deliver weak or negative returns.
- Inflation Risk is another risk primarily linked to bonds, meaning the risk that an investment will not keep pace with inflation, reducing purchasing power over time.
- Timing risk concerns the impact of weak or negative investment returns in the early years, making it difficult to recover market value (especially with continuing payouts)
- Payout risk addresses the risk that the guaranteed payouts become too high, especially if market value of gift annuity declines
- Actuarial risk is a blanket term for several specific risks. Longevity risk is the risk that income beneficiaries outlive life expectancies, especially as people live longer and medical care advances. Individual contract risk refers to the risk that individual contracts "go negative," as payouts exhaust gift value and leave no remainder value. This is a particular concern for unusually large or illiquid gifts relative to overall gift annuity assets.

State Regulations and Challenges

Managing gift annuities seems complicated enough just worrying about the high payouts, increasing life expectancies, and vagaries of the investment markets. But, just to make sure we do not become complacent, some state governments have added another layer of complexity. The state requirements are intended to provide a level of protection for income beneficiaries by restricting investment choices and requiring charities to set aside reserve funds to meet payout liabilities.

Several states require gift annuity programs to set aside reserves, which are calculated by determining the present value of the payment liability using discount rates provided by the states or determined by an actuary. Among these states, New Jersey, New York, and Washington use the prudent investment standard to govern the investment of reserves. Several other states also restrict the allowable investments, including California, Florida, Wisconsin, and Arkansas.

California

- 6% discount rate to determine reserve requirement for liabilities
- Only 10% of reserve may be invested in corporate securities (bonds or stocks)
- Typical asset allocation: 25% equities/75% bonds (typically U.S. Treasury and Agency securities)

Florida

- State mandated discount rates (based on year of gift) to determine reserve requirement for liabilities
- Only 50% of reserve may be invested in equities
- Typical asset allocation: 50% equities/50% bonds

Wisconsin

- Actuary determines discount rate to determine reserve requirement for liabilities
- Only 20% of reserve may be invested in equities
- Typical asset allocation: 25% equities/75% bonds

Arkansas

- Actuary determines discount rate to determine reserve requirement for liabilities
- Only 10% of reserve may be invested in corporate securities (bonds or stocks)
- Typical asset allocation: 25% equities/75% bonds

For an investment manager, investment restrictions can limit our flexibility and the restrain the potential investment returns. Typically, limiting the percentage that can be invested in equities will result in lower investment returns over the long term.

Investment Theory

To describe the approach used in managing gift annuity assets, we will make several assumptions.

- The first is that no state restrictions apply, meaning that we are developing a portfolio that is not governed by California, Florida, Arkansas, or Wisconsin's guidelines.
- Secondly, we assume that our portfolio is guided by the Prudent Investor Act. Under this philosophy, the investment manager is required to invest assets as a prudent investor would and to adopt an overall investment strategy that addresses risk and return considerations. Asset allocation becomes paramount, with an emphasis on diversification and a total return philosophy.
- Thirdly, the charity contributes all of the gift value into the gift annuity fund; they do not withdraw any surplus assets.

In developing the portfolio, asset allocation is the key investment decision. Research demonstrates that approximately 90% of the variability of returns is attributable to asset allocation. How much is allocated to specific asset classes, such as stocks or bonds, drives differences in performance. To diversify risk and increase potential return, we want to make sure that the portfolio is represented in all of the major asset classes—large cap stocks, small cap stocks, international equities, and high-grade bonds. For programs with a comfort level with even broader diversification, it can make sense to include emerging market equities, high yield (junk) fixed income, and real estate investment trusts (REIT) funds as well.

In determining the appropriate asset allocation, the primary considerations are the level of liabilities, the time horizon, and the risk tolerance of the charity. Once a strategic asset allocation is developed, the portfolio is rebalanced regularly to maintain the strategic asset allocation. The asset allocation itself should be reviewed periodically to ensure that it still applies.

Consider some sample asset allocations:

Conservative

- 30% Large Cap Equity
- 5% Small Cap Equity
- 5% International (MSCI EAFE benchmark) Equity
- 50% High Grade Fixed Income
- 10% High Yield Fixed Income

Balanced

- 30% Large Cap Equity
- 10% Small Cap Equity
- 10% International (MSCI EAFE benchmark) Equity
- 45% High Grade Fixed Income
- 5% High Yield Fixed Income

Growth
- 40% Large Cap Equity
- 10% Small Cap Equity
- 10% International (MSCI EAFE benchmark) Equity
- 5% Emerging Markets Equity
- 30% High Grade Fixed Income
- 5% High Yield Fixed Income

A charity's asset allocation choice would depend on several things:
- the age of the program and asset size of the gift annuity program
- the financial health of the charity and size of their endowment
- the diversification of the pool of gift annuity donors—is it broadly diversified by gift size and beneficiary characteristics, or is the pool dominated by a few large gifts
- investment policy of the charity—aggressive or conservative

The most important thing is getting the asset classes right. Interestingly, that asset allocation is the most important decision, the lion's share of the attention seems to focus on manager selection—choosing which funds will be included within an asset class. It remains very difficult to find active managers who can consistently beat benchmarks (and active management fees) over all time periods and market conditions. It seems that the biggest differences among most investment managers are expenses and marketing, and that over the long term the investment returns are less differentiated.

At State Street Global Advisors, our investment philosophy for gift annuity portfolios could be summarized as follows:
- Diversify, diversify, diversify
- Use core investment strategies to capture asset class returns—avoid a growth or value bias
- Use benchmark-oriented vehicles with strong risk controls, especially for large-cap equities and high-grade bonds.
- Take active risk in least efficient asset classes—international equities and small cap equities.
- Use funds with reasonable fees. If possible, avoid mutual funds and use institutional pooled funds.

Measuring Success

The ultimate question for a gift annuity program is "Are we achieving the 50% residuum?" If your program is not hitting this target, then the program is not meeting the assumptions used in setting the ACGA rates. To achieve the 50% residuum, you need to:
- Pay ACGA rates or less—the vast majority of programs pay ACGA rates; some actually put caps on the highest rates, or discount the rates below ACGA levels.
- Meet the return requirement of 6% (5% net of fees)—this generally has not occurred over the past 3-5 years, but is generally true over longer time periods.
- Have donors that do not outlive life expectancy (at least on average), which is largely a matter of chance or of having a large enough pool of donors.

For most charities, in the late 1990s it was not uncommon to achieve 100% of gift value or more. Today, we generally see remainder values in the range of 60-90% of original gift value, depending on the program's asset allocation and the timing of the gift. Only a small percentage of contracts are currently valued below 50% of the original gift value. The contracts that are at the greatest risk are those written in 1998, 1999 and 2000.

Looking Ahead

The past four years have humbled many investment managers. The unwinding of the stock market "bubble" of the late 1990s resulted in a "double whammy"—at the same time that equity values were plummeting, interest rates were falling, leading to lower discount rates. Lower discount rates resulted in higher liabilities for gift annuity programs—and actually required some charities to contribute funds to meet reserve requirements.

State Street Global Advisors is one of the leading managers of pension assets. Many of our pension clients suffered from the same problem—declining pension assets, increasing pension liabilities, and the need to contribute funds at the least opportune time. As a result, we have been conducting research to help our clients address the mismatch between the duration of their liabilities and their assets. This research for pension programs has considerable application for gift annuity programs.

In our view, a new philosophy may emerge for gift annuity investment management. Rather than simply setting a strategic asset allocation and rebalancing to that allocation, this new approach could involve setting a strategic policy to govern the asset allocation.

At the simplest level, the strategic policy could be similar to the guidelines set by several of the states—using a discount rate to determine the required reserve to be held in fixed income securities, with any surplus invested in equities. The fixed income assets could be matched in duration to the liabilities, to ensure that any changes in rates will not negatively impact the portfolio.

At more sophisticated levels, the strategic policy could involve setting a minimum target surplus level. For example, the charity and its investment manager might determine that an appropriate minimum surplus level is 15%, meaning that the portfolio should at all times hold assets equivalent to the 115% of present value of its liabilities. Then, after considering a number of factors—current assets, projected cash flows and contract terminations, and anticipated investment returns—the investment manager could use sophisticated modeling techniques to determine the asset allocation that would provide a reasonable probability of maintaining that 15% minimum surplus level.

It would not be surprising to see charities fall into two camps—risk minimizers and return maximizers. The risk minimizers would have a more conservative bias, unwilling to risk any probability of falling below the target surplus level. The return mazimizers—most likely the charities with the strongest financial positions—would be willing to take on more risk for the opportunity to grow the portfolio's assets.

Creativity in a Changing World

26th Conference on Gift Annuities
May 5-7, 2004

When Planned Giving is Not the Only Hat You Wear

Presented by Betsy A. Mangone
Mangone & Co.
12687 W. Cedar Drive, Suite 210
Lakewood, CO 80228
303-980-0800
www.Mangoneandco.com

When Planned Giving Is Not the Only Hat Your Wear

Introduction

Many, many successful planned giving programs in this country are initiated and managed by development staff with responsibility for other areas of development. It takes discipline and commitment when adding planned giving to your responsibilities, but it will be rewarding personally and it will be rewarding professionally.

It is important to remember that planned giving programs, like other areas of development do not take place in a vacuum. For example, attendees at annual and other special events tend to feed the annual fund pipeline; annual fund donors tend to become leadership gift candidates; leadership gift donors tend to become major gift candidates; and major gift donors often are planned giving donors. So, planned giving is just an extension of your current development program, and managing the program is likewise just an extension of your current responsibilities.

Why Even Consider a Planned Giving Program When You Are Busy with Current Gifts?

Planned giving is a method of charitable giving that provides benefits to both the donor and the organization. Planned gifts are created during the donor's lifetime, but typically, the actual principal of the gift is only available to the charitable organization after the donor's lifetime. There are many types of planned gifts offering a variety of benefits. Some provide immediate or deferred lifetime income to the donor while the ultimate gift goes to the charity, and some pay immediate income to the charity and the gift principal goes back to the donor or individuals designated by the donor. Bequests offer more intangible benefits, such as lifetime control of one's assets, while still providing a gift to charity after the donor's lifetime. Almost every planned gift is a gift of estate assets. Therefore, it is a gift that requires consideration and planning in the context of the donor's overall estate plan.

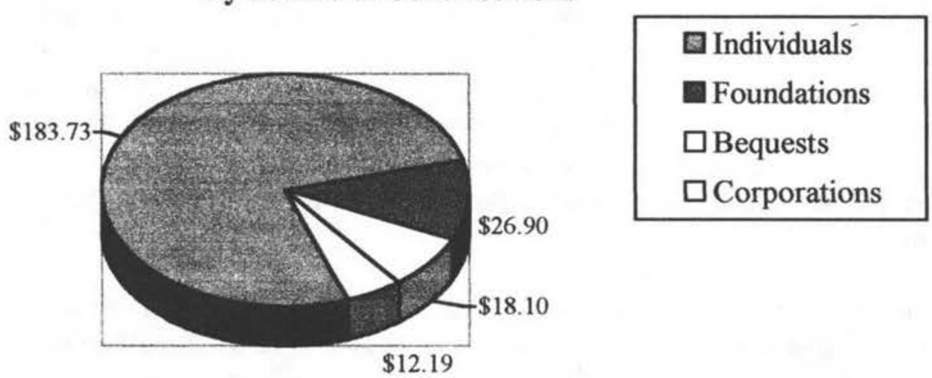
According to the most recent statistics gathered by the American Association of Fund-Raising Counsel Trust referenced below, of the $240.92 billion given for charitable causes in the United States in 2002, individuals contributed 76% with the remainder coming from corporations, foundations, and bequests. Gifts from individuals include life-income arrangements such as charitable gift annuities, charitable remainder trusts, and pooled income contributions, and these planned gifts have been increasing at a faster rate than individual gifts as a whole.

Revenue from bequests and other estate gifts have also been growing, increasing by 7.8% in 1998 and 10% in 1997.[1]

From 1929 to 2002, there have been quantifiable records of private philanthropy by Americans (in current dollars).

Year	Philanthropic Giving
1929	In spite of the economic climate, charitable giving totaled $1.28 billion
1950	Americans' philanthropic generosity tripled to $4.55 billion
1960	Gifts donated for philanthropic purposes more than doubled to $10.4 billion
1970	At the beginning of this decade, the 1960 figure had almost doubled to $19.2 billion
1980	Increasing dramatically from an already significant base, private giving rose to $48 billion
2002	$241 billion—76.3% from individuals[2]

2002 Contributions: $240.92 Billion
By Source of Contributions



In addition, recent research initiated at Cornell and continued by numerous sources across the country points to the enormous transfer of generational wealth, at least $41 trillion[3], poised to begin in the next few years. The planned giving prospect base, in both people

[1]Giving USA 2000/AAFRC Trust for Philanthropy
[2] American Association of Fund Raising Counsel Trust, *Giving USA*, 2002.
[3] Millionaires and the Millennium: New Estimates of the Forthcoming Wealth Transfers and the Prospects for a Golden Age of Philanthropy, Havens and Schervisn, October 19, 1999, Social Welfare Research Institute

and dollars therefore, is growing dramatically and is expected to continue to do so. Charities are aggressively positioning their planned giving programs to capture gift opportunities through this transfer.

Further studies are concluding that the new generation of philanthropists will be more interested in the *process* of giving than the actual institution that benefits from the gift. To be successful in attracting these donors and their gifts, institutions must demonstrate state-of-the-art planned giving options and expertise. They must prepare to strategically address these new trends to attract future planned giving prospects who, while philanthropically motivated, will care very much about the scope of planned giving options and expertise an institution can offer.

Seven Critical Reasons for a Planned Giving Program

1. The importance of individual giving
2. Planned gifts are attractive to prospective donors of wealth
3. Planned gifts attract a new generation of donors
4. Planned gifts will enhance other components of your fundraising efforts
5. Planned gifts will enhance public awareness of your organization
6. Planned gifts will eventually be responsible for a significant portion of your total annual fundraising revenue
7. Your donors are being solicited for planned gifts by other charities

Elements of a Successful Planned Giving Program

1. A board of directors who understands the deferred nature of planned giving
2. Supervisory personnel who understand the deferred nature of planned giving
3. A staff person who can devote several hours a week to the planned giving program (most effectively if the hours are at the same time each week)
4. Staff with knowledge of planned giving vehicle *concepts,* and knowledge of the tax and legal *concepts*
5. Available technical resources
6. Staff with an understanding of the basic steps of development
   - Identify the prospect
   - Interest the prospect
   - Involve the prospect
   - Solicit the prospect
   - Steward the prospect
7. An organizational strategic plan and a sense of how planned giving will fit into the overall development structure and plan
8. Staff ability to engender trust and build long-term relationships
9. A sense of the priorities of a planned giving program
10. A planned giving action plan
11. Establishment of goals and a format for measuring and evaluating success

What About The Board?

It is important that the board be aware of your planned giving efforts for several reasons.

1. The board has a fiduciary responsibility for all aspects of your organization, and planned giving vehicles can carry a liability
2. The board should understand the deferred nature of gift revenue
3. Board members are typically good planned gift candidates
4. Board members can assist you with stewardship activities

What About Supervisory Personnel?

It is important that the development program manager be familiar with the characteristics of a planned giving program.

1. The supervisor needs to understand the long-term relationships needed before planned gifts are made
2. The supervisor needs to understand the deferred nature of gift revenue, as well as the future potential of the revenue
3. The supervisor must approve of your time spent in the program
4. The supervisor must approve the budget and other resources for the program

How Much of Your Time Will It Take?

Planned giving programs in the start-up stage require little of your time…as little as two to three hours a week. It is best to allocate the same time frame every week if possible. As you become familiar with the activities necessary to grow the program, you will be able to anticipate the time allocation needed.

To What Extent is Staff Knowledge of Planned Giving Concepts Important?

This is a tricky area as education is so important in working with planned gifts. This is true because you are talking with donors about gifts that can potentially impact their entire estate and financial planning process. Liability for charities can be high and here are some of the concerns.

1. When the planned giving officer gives advice, not information
2. When the planned giving officer encourages a gift that is not appropriate for the donor or his/her family
3. When a planned giving officer gives misinformation
4. When a planned giving officer does not use disclaimer language

The best answer is to educate yourself in the basics as soon as possible and then continue your education with one planned giving conference per year. Also, have a planned giving consultant or professional advisor on retainer so that you can easily obtain the information you need. And do not hesitate to use this resource. Prospective donors will always understand when you say you need to get more information and get back to them.

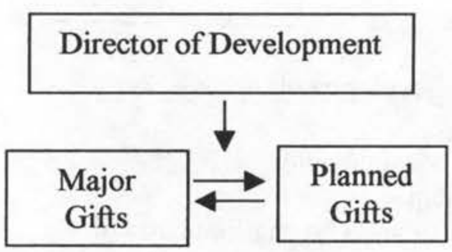
What is an acceptable level of knowledge? At the very least you should be acquainted with the concepts in Attachment A "Planned Giving Overview." You can also subscribe to planned giving publications that provide planned giving information such as Planned Giving Mentor and Planned Giving Today. You may also subscribe to the Journal of Gift Planning if you are a member of the National Committee on Planned Giving.

What About a Strategic Plan and Organizational Structure?

It is important that you have a sense of how planned giving will integrate with the comprehensive development plan. For example, if the strategic goal is to evolve from an organization largely dependent on foundation and corporate support into one that is individual donor driven, a planned giving program will focus you in exactly the right direction. If the development effort is focused on developing an emphasis on endowment building, a planned giving program will be a tremendous help because planned giving donors like to give to endowment. If the strategic plan is to concentrate on growing the major gift program, the planned giving effort will assist because most planned gifts are major gifts.

Structurally, planned giving is often tucked under the major gift program. Certainly the program can stand along side the major gift program without being a component of it, but a planned giving program that is completely separate from major gifts is usually found in larger organizations with established planned giving programs.

Possible organizational structures typically look like either of the following:



Why is Building Long Term Relationships Important?

The ability to build long-term relationships is important because most planned gifts come as a result of these relationships. Planned gifts are built on trust. Think about it…we are asking our prospective donors to make an investment in our organizations…would they make an investment in a stock when they did not trust their broker, would they make an investment when they did not trust the company they were investing in? Therefore, the characteristics of sincerity, good listening skills and the ability to follow up and follow through are hallmarks of successful planned giving officers.

What are the Priorities?

Here are some *initial* priorities to consider if both you and the program are new.

Priority	Time Allocated
Education	25%
Prospect Development	25%
Marketing	25%
Stewardship	10%
Negotiating and Closing Planned Gifts	5%
Prospect Management	5%
Allied Professional Development	5%

After 12 Months, or for existing programs, the priorities might look like the following.

Priority	Time Allocated
Prospect Development	25%
Marketing	25%
Prospect Management	10%
Stewardship	10%
Negotiating and Closing Planned Gifts	10%
Education	10%
Allied Professional Development	10%

What Does a Planned Giving Action Plan Look Like?

Suggested 12 Month Planned Giving Action Plan

Activity	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7	Month 8	Month 9	Month 10	Month 11	Month 12
Create and have board approve Gift Acceptance Policies and Procedures												
Identify Planned Gift donors and prospects												
Establish revenue and non-revenue goals												
Create Recognition Society *(name, benefits, etc.)*												
Prepare and produce Bequest & Recognition Society Brochure												
Create program marketing plan												
Create additional program marketing material and correspondence												
Create infrastructure, codes for tracking, procedures for bequests, and benchmarks for program performance												
Recognition Society Event												
Design and unroll Life Income Gift program												
Create and unroll Professional Advisor program												
End-of-Year mailing												
Evaluate areas for increased planned giving visibility and/or new program initiatives *(print media, website, Donor Advised Funds, etc.)*												

Why Establish Goals?

Determining accountability is critical in a planned giving program because of the deferred nature of the majority of revenue. And, despite the deferral of revenue, it is possible to establish concrete goals and provide measurements of success in reaching those goals.

First we look at establishing firm dollar goals. For planned giving programs that are very new, dollar goals need to be established, but the caveat is that actual revenue will not be expected for approximately 36 months from the beginning of the program marketing. This is because it typically takes this long for someone who has created a bequest or other planned gift, to pass away. After the initial 36 month period, most programs try to grow program revenue by 5-7% per year.*

In addition to cash goals, we have non-revenue goals, which are comprised of the activities we must undertake in order to generate gift revenue. The activities of the non-revenue goals can be found in our action plans.

Basically, revenue and non-revenue performance goals contain the following categories

1. Number of cultivation contacts per week/month
2. Number of stewardship contacts per week/month
3. Number of proposals or solicitations per week/month
4. Number of gifts secured per month/year
5. Number of refusals
6. Dollars secured per year

* Depends on economic and political conditions.

ATTACHMENT A

PLANNED GIVING OVERVIEW

I. WHAT IS PLANNED GIVING?

Planned giving (or charitable gift planning) refers to the process of making a charitable gift of estate assets to one or more non-profit organizations, a gift that requires consideration and planning in light of the donor's overall estate plan.

Such gifts usually include legal documents and often require the assistance of a qualified professional advisor to complete. Because of the size and potential impact of such gifts, a donor should always consult with his or her professional advisors before completing the process.

Planned gifts are usually deferred, meaning they are arranged now and fulfilled later. For example, a person could include a provision in his or her will to make a bequest to ACGA. That arrangement would be a planned gift.

Planned giving is also a method of fundraising that provides services to both the institution and the donor. Planned gifts work as an alternative to cash and/or current gifts, and they are the fastest growing method of philanthropy in this country.

- Gifts of cash often compete with other needs, such as the support of loved ones and the donor's own financial security. Planned gifts do not compete with family priorities; in fact, planned gifts can enhance personal planning objectives.

- A planned gift often allows a donor to make a larger gift than would be possible through a current cash gift.

- America is an aging society; planned giving prospects are generally older people with appreciated assets.

- Tax reform has done nothing but enhance the estate planning techniques and tax relief offered by planned giving vehicles.

Recent research initiated at Cornell and continued by numerous sources across the country points to the enormous transfer of generational wealth, at least $41 trillion[4], poised to begin in the next few years. Charities are aggressively positioning their planned giving programs to capture gift opportunities through this transfer. Additional studies are concluding that the new generation of philanthropists will be more interested in the *process* of giving than they will be in the actual institution that benefits from the gift. Therefore, the planned giving prospect base, in both people and dollars, is growing dramatically. Institutions successful in attracting these gifts will have positioned themselves with state-of-the-art planned giving options and expertise. Institutions not taking these strategic planning steps will not be as prepared and thus not as attractive to future planned giving prospects who, while philanthropically motivated, will care very much about the scope of planned giving options and expertise an institution can offer.

II. METHODS OF GIVING

A. OUTRIGHT

B. BEQUESTS

C. LIFE INCOME

- Charitable Gift Annuity
- Charitable Remainder Annuity Trust
- Charitable Remainder Unitrust

D. LEAD INCOME

- Charitable Lead Trust

E. RETAINED LIFE ESTATE

F. LIFE INSURANCE

G. GIFTS OF RETIREMENT PLAN ASSETS

[4] Millionaires and the Millennium: New Estimates of the Forthcoming Wealth Transfers and the Prospects for a Golden Age of Philanthropy, Havens and Schervisn, October 19, 1999, Social Welfare Research Institute

OUTRIGHT

- Immediately available to benefit ACGA and its constituents and programs

- Can provide the donor with recognition during his or her lifetime

- Current year charitable income tax deduction

    - Deductible to 50% of adjusted gross income (AGI) if cash
    - Deductible to 30% of AGI if appreciated securities

- Possible estate tax deduction as determined by the Economic Growth and Tax Relief Reconciliation Act of 2001 which included a phase-in repeal of estate taxes by 2010

- Irrevocable

BEQUESTS

- Donor controls distribution of assets through will

- Possible estate tax deductions based upon phase-in repeal of estate taxes by 2010

- Gift deferred until death of donor

- No current charitable income tax deduction

- Revocable

LIFE INCOME

Gift Attributes

- Immediate charitable income tax deduction

    - Deduction based on present value of future interest of gift to ACGA and donor age(s).
    - Deductible to 50% of AGI if cash.

  - Deductible to 30% of AGI if appreciated property

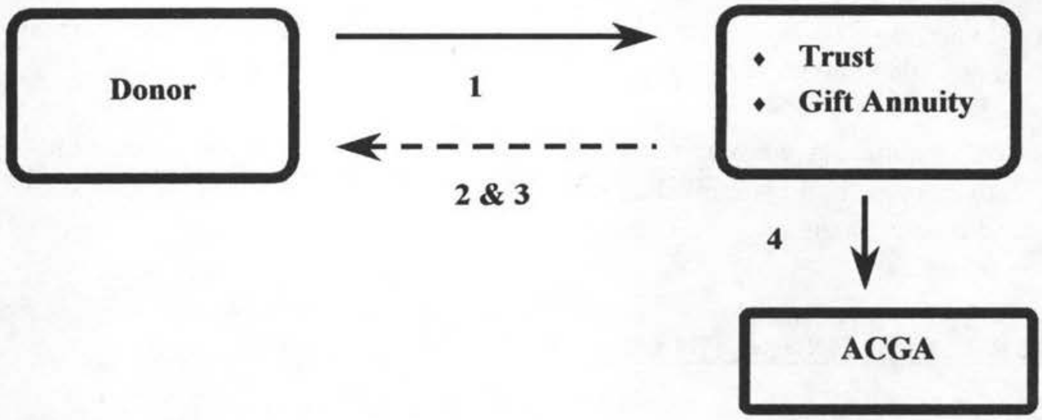
- ➢ Possible estate tax deduction
- ➢ Elimination of capital gains tax liability
- ➢ Annual income for life
- ➢ Expert fund management
- ➢ Irrevocable

LIFE INCOME

Benefits to Donor

- ➢ May increase annual income for lifetime
- ➢ Eliminates capital gains tax liability
- ➢ Immediate charitable income tax deduction
- ➢ Diversifies investments
- ➢ Expert money management
- ➢ Removes asset to decrease estate taxes where applicable

LIFE INCOME GIFTS



1. **Donor gifts assets to charitable trust or gift annuity.**
2. **Annual income for lifetime.**
3. **Income, capital gains, & estate tax benefits.**
4. **Meaningful future gift for ACGA.**

CHARITABLE GIFT ANNUITIES

IMMEDIATE PAYMENT CHARITABLE GIFT ANNUITY

Cash or securities can be transferred to ACGA in return for an annuity that pays a fixed income for life to the donor and/or donor's spouse or other designated beneficiaries.

The annual payment is a fixed sum, the amount of which is based on the size of the gift and the number and ages of the beneficiaries. Rates of return under a charitable gift annuity are lower than the rates offered by commercial insurance companies so that a significant residuum will remain for ACGA. Part of each annuity payment will be taxed as ordinary income, part may be considered tax free income, and/or part may be taxed as capital gain income if the gift is funded with appreciated securities.

The preliminary minimum amount for a gift annuity agreement is $10,000. Agreements shall be limited to two lives with a minimum age of 60 for the annuitants.

DEFERRED PAYMENT CHARITABLE GIFT ANNUITY

The receipt of payments from an annuity may be deferred for a specified term of years. An effective retirement planning tool, the deferred payment charitable gift annuity entitles the donor to an immediate charitable deduction at a time when his/her current income tax bracket may be higher than it might be in the future. Receiving income may be postponed until the donor retires when his/her income tax bracket may be lower.

The preliminary minimum amount for a deferred payment gift annuity agreement is $10,000. Agreements shall be limited to two lives with a minimum age of 50 for the annuitants and income beginning at age 60.

CHARITABLE REMAINDER TRUSTS

TRUSTS

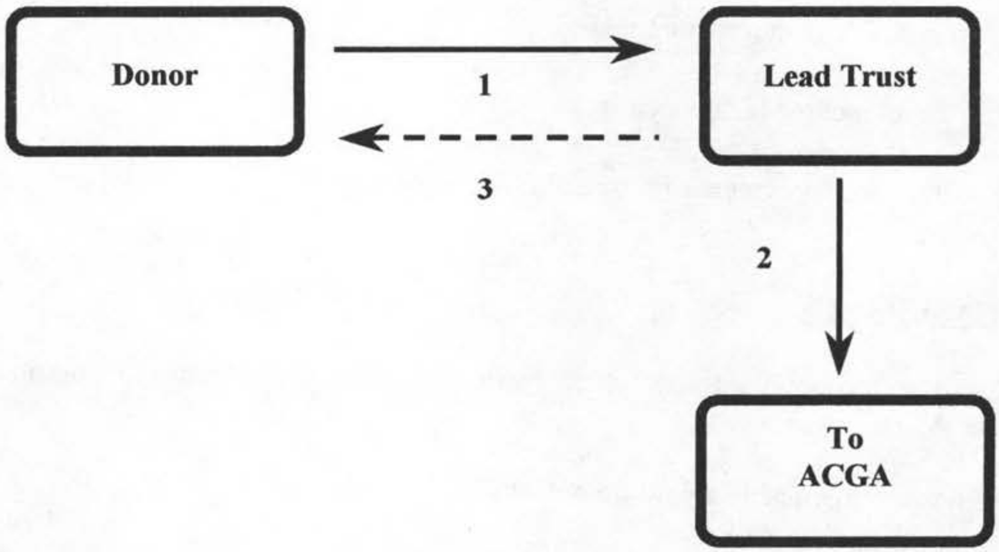
- Annuity Trust
  - Fixed dollar payment each year for life of trust
- Unitrust
  - Fixed percentage of market value of trust
  - Trust assets revalued each year

CHARITABLE LEAD TRUSTS

- Current income for ACGA
- The ability to provide a multi-year gift to ACGA
- The ability to transfer assets back to donor or to other generations
- Potentially significant gift and estate tax savings
- Possible charitable income tax deduction

LEAD INCOME

INCOME TO ACGA
REMAINDER TO DONOR OR ANOTHER PERSON



1. **Donor gives assets to charitable lead trust.**
2. **Trust provides income to ACGA.**
3. **After trust's term, principal reverts to donor or distributes to one or more persons designated by donor.**

RETAINED LIFE ESTATE

A donor can contribute a primary personal residence, second home, or farm to ACGA and continue to occupy the property until death. This is known as transferring a remainder interest in a property while retaining a right to a life estate.

Benefits

- Irrevocable commitment to ACGA
- Current income tax deduction
- Continued enjoyment of property for lifetime

LIFE INSURANCE

There are various methods by which a life insurance policy may be contributed to ACGA. A donor may:

- Assign irrevocably a paid-up policy
- Assign irrevocably a life insurance policy on which premiums remain to be paid as long as ACGA is owner and beneficiary
- Name ACGA as successor beneficiary of the proceeds
- Establish a new life insurance policy with ACGA as the owner and beneficiary

Benefits

Depending on how a policy is gifted, the following may occur:

- Ability to make a gift with low-cost asset or modest out-of-pocket cost
- Potential current income tax deduction

Safety Valve

Should the circumstance occur, ACGA has the option to determine if it is more beneficial to pay policy premiums or surrender the policy for cash value.

RETIREMENT PLAN ASSETS

There are a variety of ways to make a planned gift of retirement plan assets. Currently, lifetime transfer of retirement plan assets cannot escape the income tax window, however, current legislation to allow charitable rollover (CARE Act (S. 476) and the Charitable Giving Act (H.R. 7)) is pending in Congress.

- Designate ACGA as full or partial beneficiary of plan.

  In cases where retirement plan assets are sizable, there can be exposure to multiple layers of taxation. In this instance, it may be more tax-wise to bequeath estate assets that are less tax-burdened to the family and designate the more tax-exposed retirement plan assets to charity.

- IRA to charitable remainder trust

  A testamentary transfer to a qualified charitable remainder trust with a spouse as the income recipient allows the spouse's income to qualify for the estate tax marital deduction. The donor's estate receives a charitable deduction.

- IRA to community foundation or ACGA to create a donor advised fund

  The donor directs that upon death the IRA funds go to a specific community foundation or ACGA to create a named donor advised fund. The estate receives the charitable estate tax deduction in the year of the donor's death. Donor reserves the right for family members to make annual recommended distributions from the fund so family philanthropy can continue.

- IRA to charitable gift annuity

  The Internal Revenue Service has just ruled (PLR 200230018) that a testamentary gift annuity may be funded with an IRA. This ruling pertained to a donor with an IRA at a brokerage firm. The donor will complete an IRA beneficiary form that provides that, if the annuitant survives the donor, then, when the donor dies, the proceeds of the IRA will be transferred to charity – in exchange for the charity's promise to pay the annuitant an annuity for the remainder of his/her life.

American Council on Gift Annuities
233 McCrea Street, Suite 400 • Indianapolis, Indiana 46225
Phone: (317) 269-6271 • Fax (317) 269-6276
E-mail: acga@acga-web.org • Web: www.acga-web.org