Philanthropy in Estate Planning: Opportunities and Pitfalls

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Philanthropy/Charitable Giving: Why?

- Further worthwhile causes
- Reduce burden on government
- Establish legacy
  - Family engagement
- Tax benefits
  - Income
  - Gift
  - Estate

Charitable Giving Basics: General Types of Gifts

- Immediate Gifts
  - Cash
  - Appreciated Property
  - Bargain Sales
  - Charitable Lead Trusts
- Deferred Gifts
  - Charitable Gift Annuities
  - Charitable Remainder Trusts
  - Life Insurance

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What/who are the typical charitable donees?

- Donor Advised Funds
- Private Foundations
- Supporting Organizations
- Public charities (e.g., churches, universities, museums, United Way, etc.)
- Charitable Remainder Trusts
- Charitable Lead Trusts

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What/who are the typical charitable donees?

- Donor Advised Funds
  - Local options include Deseret Trust Company and the Community Foundation of Utah. Nationally, Fidelity Donor Advised Fund is largest. Many large financial institutions also have programs.
  - Sponsor is public charity and administers the fund. Donor need not file returns, do accounting, etc.
  - No donor “control”
  - Be aware of Pension Protection Act provisions

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What/who are the typical charitable donees?

- Private Foundations
  - Requires formation of entity and application for exemption
  - Annual administration requirements
  - Beware of private foundation rules
  - Primary benefit: Donor and family maintain control

What/who are the typical charitable donees?

- Supporting Organizations
  - Less favored entities since mid 2000's
  - Public charity status because of "support" for one or more other public charities
  - Since PPA, more rules applicable to SO's
  - More difficult to get IRS approval
  - Primary benefit: single family support, but public charity benefits

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What/who are the typical charitable donees?

- Public charities (e.g., churches, universities, museums, United Way, etc.)
  - Best benefits
  - Generally, must have 1/3 of their support from the general public
  - Usually operating entities
  - May be formed and controlled by smaller group (e.g. donor and family)
  - DAF sponsors are public charities

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What/who are the typical charitable donees?

Split Interest vehicles

- Charitable Remainder Trusts
  - Allows donor to retain an interest (income, unitrust or annuity payment)
  - Donor receives a deduction based on value of remainder
  - Remainder goes to charity (public or private)
- Charitable Lead Trusts
  - Depending on how structured, donor provides income or annuity to charity for period of years
  - Remainder goes to donor's beneficiaries (e.g., family members, trust, etc.)
  - Donor may derive certain tax benefits

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Donation Issues: Charitable Deductions

- IRC Section 170 governs deductibility of donations for income tax purposes
- Common issues/questions
  - Services are not deductible
  - Rent free use of property is not deductible
  - Charity auctions – only gift above FMV is deductible
  - Failure properly to document gift/comply with rules
  - Donations of closely held assets
    - LLC interests (UBIT from income or "hot assets")
    - S corporation stock (UBIT from sale of stock)
    - IRS Form 8283
    - Appraisals
    - Gift Substantiation
- Advice: Consult with tax advisors early (and often)

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Donation Issues: Charitable Deductions

- IRC Section 170
  - Substantiation
    - “Contemporaneous written acknowledgment”
    - Donations to DAF’s require donor receive special acknowledgement that sponsoring charity donor advised fund has “exclusive legal control over the assets contributed….” IRC Sec. 170(f)(18).
    - Donor must establish value of contributed asset
    - Complex asset valued more than $5,000 must be appraised
    - The appraisal must be prepared by a “qualified appraiser” who has earned a designation from a recognized professional organization.
      See Mohamed v. Commissioner, T.C. Memo 2012-152
      (no deduction without compliance)

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Donation Issues: Charitable Deductions

- IRC Section 170
  - Substantiation
    - Appraisal must include: description of the property transferred, date of contribution, any terms or conditions put on the property transferred, information on the qualified appraiser, the basis for the valuation, the appraiser's signature, and date of appraisal
    - The appraisal cannot have been made more than 60 days prior to the date of the contributions but may be done after the gift.
    - If the contribution value is over $500,000, the full appraisal must be attached to the return.
    - IRS Form 8283 must be signed by the appraiser and the donee and attached to the tax return.

Donation Issues: Donor Intent

- Charity is required to follow donor conditions
  - Endowment funds
  - Must follow provisions of donor intent
- Doctrine of "Cy Pres" can be invoked but takes court order and court approval
  - Unilateral action by the charity can be a problem
- Pitfall avoidance
  - Work with to structure the intent broadly
  - Clear written agreement is a must, give charity appropriate flexibility
- Note: Many charities have gift acceptance policies

Additional Issues in Gifting Complex Assets: Deduction Issues

- IRC Section 170
  - Donee classification makes a difference
    - Private Foundation
      - Contributions generally limited to 30% of AGI (cash and publicly traded securities)
      - Complex assets (e.g., private stock) – <u>deduction also limited to donor's basis</u> and AGI cap is 20%
    - Public Charity
      - Complex assets – deduction allowed at FMV of asset but limited to 30% of AGI

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Additional Issues in Gifting Complex Assets: Deduction Issues

- IRC Section 170
  - Special Issues: Arts and Collectibles
    - 170(e)
      - Who is the donor? What if the artist? What if the donor received the art as a gift from the donor? Art dealer?
      - Will property be put to related use?
      - Donor should get certification of charity's intent
      - Be aware of fractional interest issue
      - Relinquishment of art is important

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Additional Issues in Gifting Complex Assets: UBIT

- Unrelated Business Income Tax ("UBIT")
  - UBIT creates "tax erosion"
    - Net gift is lower than FMV
  - Most donors and many advisors are completely unaware of UBIT implications
  - Common types of UBIT include
    - Acquisition indebtedness
    - S corporation
    - "Hot assets" and operating businesses

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Additional Issues in Gifting Complex Assets: UBIT

- Acquisition indebtedness under IRC Section 514
  - Debt used for acquisition of investment property
  - Beware of pass-through entities (e.g., gift of LP interest of private equity fund that uses leverage for some of its investments)
  - Ratio of debt to basis creates taxable amount
    - Average acquisition indebtedness during last 12 months over basis

Additional Issues in Gifting Complex Assets: UBIT

- S corporation gifts
  - IRC Section 512(e):

    (1) If an organization described in section 1361(c)(2)(A)(vi) or 1361(c)(6) holds stock in an S corporation:

    (A) such interest shall be treated as an interest in an unrelated trade or business, and

    (B) notwithstanding any other provision of this part—**(i)** all items of income, loss, or deduction taken into account under section 1366(a), and **(ii)** any gain or loss on the disposition of the stock in the S corporation,

    shall be taken into account in computing the unrelated business taxable income of such organization.

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Additional Issues in Gifting Complex Assets: UBIT

- Operating companies and “hot assets”
  - Gain from sale of partnership interest generally treated as sale of capital asset. See IRC Sec. 741.
  - The presence of “hot assets” in the partnership affects the character of gain recognized from a sale as well as the allowable amount of a charitable contribution of the interest
    - “Hot assets” include receivables, inventory, and depreciation recapture items
  - Charity recognizes UBIT on “hot assets” as part of sale, and donor must reduce deduction by the amount of ordinary income that would have been realized if property had sold on contribution date
  - Income received by charity during holding period may be subject to UBIT

Additional Issues in Gifting Complex Assets: UBIT

- Charitable Remainder Trusts
  - Are subject to private foundation rules (e.g. self-dealing)
  - Are not qualified S corporation shareholders
  - UBIT in CRT is taxed at 100%. See IRC 664(c)
  - Thus, CRTs are not good charitable gifting vehicle for complex assets with UBIT consequences unless the asset will be immediately sold.
    - UBIT amount may be insignificant in relation to capital gains
    - Must run the numbers

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Additional Issues in Gifting Complex Assets: Excess Business Holdings

- IRC Sec. 4943
  - Applicable to DAFs, Supporting Organizations and Private Foundations
  - Excise tax of 10% of any "excess business holdings"
    - Permitted holdings are 20% of all "voting stock" reduced by the percentage of "voting stock" held by all "disqualified persons" (defined below).
    - However, if the private foundation and all disqualified persons own less than 35% of the "voting stock" and effective control of a corporation is held by one or more persons other than disqualified, then 35% is substituted for 20% defining.
    - Voting stock includes profit interests in partnership entities.

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Additional Issues in Gifting Complex Assets: Excess Business Holdings

- IRC Sec. 4943
  - Exceptions:
    - Entities that earn 95% of revenues from “passive sources” (look through to underlying assets)
    - Program-related investments
    - *De minimis* rule (less than 2% charity ownership)
    - Five-year disposition if charity acquired by gift or bequest (which may be extended another 5 years)

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Additional Issues in Gifting Complex Assets: Other Excise Tax Issues

- IRC Sec. 4941
  - Donated property subject to debt
  - Other self dealing issues
- IRC Sec. 4942
  - Needs cash to make 5% payout
- IRC Sec. 4958
  - Automatic excess benefits for SOs and DAFs
    - Compensation, reimbursement, loans, etc.

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Additional Issues in Gifting Complex Assets: Asset Liquidity

- Charities do not like illiquid assets
- Thus, gifts usually must have a liquidity option in the “near future”
- Assignment of Income Doctrine
  - How close is too close in terms of timing of gift and timing of sale transaction?
  - 90 days, 45 days, 1 day?
  - Key question: At the date of a gift is the charitable donee legally bound to complete a previously negotiated sales transaction or can it, renegotiate, change the terms, or walk away from the transaction altogether without legal recourse?

Final Thoughts

- Philanthropy can play a significant role in estate and gift planning
  - Tax and other benefits are available
  - However, to achieve the desired benefits, proper compliance with legal requirements is essential
  - Additionally, charitable planning usually involves irrevocable instruments and transactions
    - As the saying goes "Measure twice, cut once"