Thought Leadership Article

Doing Good While Doing Well: Charitable Planning With the Closely Held Business

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Closely held business owners often arrive in the office of their advisers with a puzzle, a challenge, and an opportunity. The puzzle is nontax business succession planning. The challenge is planning to reduce income and transfer taxes. And, the opportunity is the client's philanthropic plans. An estate plan incorporating charitable gifts of the closely held business ownership interest can solve the puzzle, meet the challenge, and seize the opportunity—maximizing valuation discounts, minimizing taxes, and effecting the client's succession and charitable goals. To create a successful plan, advisers should anticipate the unique tax and nontax implications of the charitable gift for the donor, the charity, and the business. This discussion provides an overview of the issues underlying charitable giving, closely held businesses, and estate planning. This discussion also summarizes some interesting applications of an integrated approach to estate, business succession, and charitable planning.

Overview of Applicable Income and Transfer Tax Laws

Charitable Giving: General Tax Treatment

Income Tax—Individuals

The Internal Revenue Code promotes a general public policy of encouraging charitable giving. To this end, the Code contains several statutes providing for income or transfer tax deductions for charitable contributions.

With respect to income taxes, Section 170(b)(1)(A) provides that gifts of cash or unappreciated property made "to" public charities (but not to private foundations) are deductible up to 50 percent of the donor's contribution base. The contribution base is similar, although not identical, to the donor's adjusted gross income. Public charities, therefore, are referred to as "50 percent organizations."

Organizations that are private foundations (i.e., organizations not publicly supported) and that are not "operating foundations" are referred to as "30 percent organizations." Gifts of cash or ordinary income property "to" 30 percent organizations or "for the use of" 50 percent organizations are deductible up to 30 percent of the donor's contribution base.[1]

Capital gain property is treated differently than cash or ordinary income property. Capital gain property is any capital asset, the sale of which at its fair market value at the time of contribution, would have resulted in long-term capital gain, as the property had been held for more than one year.[2]

Gifts of capital gain property (e.g., real estate, closely held business ownership interests, etc.) to a 50 percent organization are deductible up to 30 percent of the donor's contribution base.[3] Gifts of capital gain property to a private foundation are deductible up to 20 percent of the donor's contribution base.[4]

In the case of a gift to a 50 percent organization, however, a donor can elect to use the 50 percent limitation instead of the 30 percent limitation. This election is available as long as the donor reduces the value of the gift by the amount of gain which would have been long-term capital gain had the

contributed property been sold.[5] This is known as "election out."

This example applies these rules: let's suppose a donor gives $500,000 in appreciated property to 50 percent organization. The donor has a basis of $300,000 in the donated property. For the year of the contribution, the donor's contribution base (i.e., the AGI, more or less) is $200,000.

In this example, the donor has two tax deduction options.

First, under the 30 percent limitation, the donor can deduct the entire $500,000 contribution. The 30 percent of the donor's contribution base of $200,000 equals $60,000. And, that amount is the limit on what the donor can take as an income tax deduction in the year of the gift. The remaining $440,000 can be taken as a deduction over the next five years. This deduction is subject to the limit in each of those five years of 30 percent of the donor's contribution base for that year.

Second, the donor can elect out of the 30 percent limitation. Instead, the donor can deduct 50 percent of their contribution base in the year of the gift (i.e., $100,000). And, the donor can deduct an additional $200,000 over the next five years (subject to the limit in each of those five years of 50 percent of the donor's contribution base for that year).

In this second option, the total deductions are limited to $300,000. This is because the price of electing out of the 30 percent limitation is that the gift is reduced by the amount of long-term capital gain that would have been realized if the property had been sold.

In this example, the long-term gain is $200,000, the difference between (1) the $500,000 fair market value and (2) the donor's basis of $300,000.

The five-year carryover for contributions that exceed the donor's contribution base for the year of the contribution is codified at: (1) Sections 170(d)(1)(A) and 170(b)(1)(C)(ii) for contributions subject to the 50 percent/30 percent limitation, and (2) Sections 170(b)(1)(B) and 170(b)(1)(D)(ii) for contributions subject to the 30 percent/20 percent limitation.

It is noteworthy that, generally, depreciated property should be sold. And, the proceeds of the sale should be given to charity, rather than give the property directly to charity. This procedure preserves a loss deduction under Section 165.[6]

For private foundations, the contribution deduction is further limited to the donor's basis.[7] There is an exception to this limitation, however, for gifts of "qualified appreciated stock" (i.e., stock for which market quotations are readily available on an established securities market). Contributions of qualified appreciated stock to private foundations are deductible at the full fair market value of the stock (instead of only at the donor's basis in the stock).[8]

Gifts of ordinary income or short-term capital gain property with a low cost basis are not tax-favored. This is because the charitable deduction for gifts of property which, if sold or exchanged, would not produce long-term capital gain, is reduced by the amount of the non-long-term gain.[9]

In other words, the charitable deduction for non-long-term capital gain property is limited to basis only (i.e., fair market value, less potential non-long-term capital gain). Examples of property that will not produce long-term capital gain upon sale include: inventory, crops, dealer property, and works created by the donor.

One exception to the above rule applies to personal property with Section 1245 recapture potential. For such property, both the capital gain and ordinary income rules apply. Therefore, for such property, the deduction may be more than the tax basis. This is because the deduction would be basis plus the potential capital gain, but without potential recapture income.[10]

There must, however, be a bona fide business in order for this exception to hold.[11]

Income Tax—Trusts

Section 642(c) provides for an income tax charitable deduction for amounts of gross income paid or set aside for charitable purposes.

Estate Tax

The estate tax Code sections encourage charitable giving. Generally, Section 2055 permits an unlimited deduction from a decedent's gross estate for bequests and other transfers to qualifying recipients for public, charitable, religious, and other similar purposes.

The estate tax charitable deduction is reduced by the amount of any death taxes that are, either by the terms of the will or by local law, assessed against an otherwise deductible bequest or other transfer. The amount of the deduction may not be more than the value of the transferred property that is required to be included in the gross estate.

Therefore, property that funded a lifetime charitable contribution is deductible for estate tax purposes only if the property is included in the gross estate. By the same logic, the testamentary exercise of a special power of appointment in favor of a charity is not deductible. This is because property subject to the special power is not includible in the gross estate.

There are additional, rather specific limitations to the general rule of Section 2055. No deduction is allowed for a transfer to or for the use of an organization or trust described in Sections 508(d) or 4948(c)(4), subject to the conditions specified in those sections. Further, where an interest in property is split between a charitable and a noncharitable recipient, special rules must be followed. Otherwise, the tax deduction will not be allowed.

To be eligible for the estate tax charitable deduction, a remainder interest must be in the form of a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. And, an income interest must be in the form of a guaranteed annuity, or it must be a fixed percentage of the fair market value of the property, determined yearly.

These requirements, however, do not apply (1) to a remainder interest in a personal residence or farm or (2) to an undivided portion of a decedent's entire interest.

Gift Tax

Likewise, the gift tax code also encourages charitable giving. Generally, Section 2522 allows an unlimited gift tax deduction for lifetime transfers to qualifying recipients for public, charitable, religious, and other similar purposes. In effect, the deduction operates as an exclusion.

Subject to minor exceptions, the definition of eligible recipients and qualifying transfers are identical to those used for federal estate tax purposes. Except for gifts made before August 5, 1997, a donor need not file a gift tax return if the entire value of the donated property qualifies for a gift tax deduction.[12]

Generation-Skipping Transfer Tax

Under Section 2642(a), charitable gifts are essentially left out of the equation for calculating generation-skipping transfer tax (GST). This is because, in determining the inclusion ratio, the denominator of the fraction is reduced by "any charitable deduction allowed under Section 2055 or 2522 with respect to such property."

Valuation and Substantiation—Generally

Noncash charitable gifts are valued at "fair market value." In a charitable deduction case, as in most valuation disputes, the donor has the burden of proof.[13]

Use of Actuarial Factors and the Section 7520 Tables in Valuation

When a gift is made in the form of a split interest, rather than outright, actuarial factors are used to value the gift. Applications of actuarial factors include determining the present value of an annuity, a life interest, or a remainder or reversionary interest. For federal estate, gift, and certain income tax purposes, the actuarial factors are based on two components:

1. the life expectancy of a designated individual or individuals (the "mortality component")
2. the assumed rate of return (the "interest rate component")

Under Section 7520, the value of an annuity, interest for life or for a term of years, or remainder or reversionary interest for valuation dates occurring on or after May 1, 1989, is determined under tables that are prescribed by the Secretary of the Treasury.[14]

If an income, estate, or gift tax charitable contribution is allowed for any part of the property transferred, the taxpayer may use the federal midterm rate for the month of the transfer, or, usefully, for either of the two months preceding the month in which the valuation date falls.

In the case of transfers of more than one interest in the same property, each interest must be valued on a basis consistent with the valuation of all other such interests. For instance, if a taxpayer transfers property to a charitable remainder trust in October

the taxpayer may use an interest rate based on the federal midterm rate for August, September, or October. However, the taxpayer must use the same rate for both the noncharitable lead interest and the charitable remainder interest.

Regulations provide that the Section 7520 tables apply to "ordinary" beneficial interests. A "restricted" beneficial interest, in contrast, is an interest that is subject to one or more additional conditions, powers, or restrictions. These limitations may be imposed by the governing instrument, or they may exist based on surrounding circumstances.

Restricted beneficial interests are valued based on all relevant facts and circumstances, rather than the standard actuarial tables. This is true even though the tables may be one useful fact in valuing such interests.[15]

If the individual who is a measuring life is terminally ill at the time of the transaction, the standard tables are not available.[16]

The standard actuarial table cannot be used to value an income interest if (1) the assets upon which the interest is based do not produce a reasonable amount of income, and (2) the beneficiary cannot compel the trustee to make them productive.[17]

Appraisals and Expert Witnesses; Overvaluation Penalties

Except when valuation of a charitable gift is straightforward (e.g., gifts of cash or publicly traded stock not inside a partnership or LLC), an appraisal is required. Revenue Procedure 66-49[18] provides that the minimum information in a competent appraisal report prepared for income tax purposes should include the following:

1. a summary of the appraiser's qualifications,
2. a statement of the value and the appraiser's definition of the value concluded
3. the bases on which the appraisal was made, including any restrictions, understandings, or covenants limiting the use or disposition of the property
4. the date as of which the property was valued
5. the signature of the appraiser and the date the appraisal was made.[19]

There are additional "qualified appraisal" requirements for charitable gifts over $5,000 (not including the value of cash or publicly traded securities). With respect to those gifts, the donor must (1) obtain a qualified appraisal and (2) attach a summary (Form 8283) to his or her return if the claimed value of donated property (other than cash or publicly traded securities). For closely held stock, however, the threshold is $10,000.

The penalty for noncompliance with the qualified appraisal rules is the complete disallowance of a charitable deduction.[20]

To be a qualified appraisal:

1. the appraisal must be made not earlier than 60 days before the date of the contribution,
2. the appraisal document must be prepaid, signed, and dated by a "qualified appraiser," and
3. generally, the fee for the appraisal must not be based upon a percentage of the appraised value.[21]

These qualified appraisal and qualified appraiser rules apply to individuals, partnerships and corporations.

If a value over $500,000 is claimed for the appraised contributions, then the qualified appraisal itself must be attached to the taxpayer's return.

The Section 170(f)(11)(E) definition of a "qualified appraiser" was tightened by the Pension Protection Act of 2006 ("PPA 2006"). PPA 2006 created a civil penalty under Section 6695A for any person who prepares an appraisal that results in a substantial or gross valuation misstatement in value.[22]

The PPA 2006 also lowered the thresholds for overvaluation penalties. With respect to returns filed after August 17, 2006, a 20 percent income tax penalty can be imposed if an individual has an underpayment of income tax attributable to a substantial valuation misstatement.

A substantial valuation mistatement is where the value of any property or its adjusted basis claimed on a return is 150 percent or more of the amount determined to be correct.[23]

The penalty increases from 20 percent to 40 percent in the case of gross valuation misstatements. A gross valuation misstatement is reporting the value of any property or its adjusted basis at 200 percent or more of the correct amount.[24]

No penalty is imposed with respect to an underpayment relating to a substantial valuation misstatement if it is shown that (1) there was reasonable cause and (2) the taxpayer acted in good faith.[25] The reasonable cause exception does not apply to gross valuation misstatements.

For valuation penalty purposes, fair market value is generally defined as the price at which the property would change hands between a willing seller

and a willing buyer, the buyer being under no compulsion to buy and having reasonable knowledge of the relevant facts.

Substantiation Requirements for Gifts Over $250

Unless the taxpayer substantiates the contribution with a contemporaneous written acknowledgement of the contribution by the donee organization, a taxpayer is not allowed a deduction for any charitable contribution of $250 or more. Acknowledgement may be provided for each contribution of $250 or more, or may be provided on a periodic basis (i.e., quarterly or annually).

The acknowledgement must include the amount of cash and a description (but not value) of any property (other than cash) contributed. If the donee provides any goods or services in consideration for such contribution, such fact also must be acknowledged, along with a description and a good faith estimate of the value of such goods or services.

If such goods or services consisted solely of "intangible religious benefits" (a benefit exclusively for religious purposes generally not sold in a commercial transaction outside the donative context) that also must be acknowledged.

The acknowledgement is considered contemporaneous if it is received on or before the date the applicable tax return is filed or the due date for such return (including extensions).[26]

A single payroll deduction over $250 can be substantiated by combining the donor's pay stub or Form W-2 and a pledge card that otherwise meets the statutory notice requirements under Section 170 (f)(8).[27]

It is noteworthy that this rule applies to gifts to private foundations—even to trust-form private foundations of which the donor is the sole trustee. In those instances, compliance with the rule requires the donor as trustee to give a receipt to himself or herself.

With respect to charitable gifts by S Corporations or partnerships, the entity itself is treated as the taxpayer for substantiation purposes. This means that the shareholder or partner is not required to obtain any additional substantiation for his or her share of the contribution.[28]

Although the receipt requirement applies to transfers to pooled income funds, it does not apply to gifts to charitable remainder trusts.[29]

If property to which the qualified appraisal rules apply (e.g., property other than cash or marketable securities) is sold or otherwise disposed of by the donee charity within three years of the contribution, the disposition (and the proceeds, if any) must be reported to the Service and to the donee on Form 8282.[30]

Private Foundation Rules and Requirements

Wealthier clients commonly include a family foundation as a component in their estate plans.

The foundation advantages include independence and flexibility, control, and a separate philanthropic identity within the community. The foundation disadvantages include penalty taxes, relatively complex compliance and procedural requirements, and less favorable income tax treatment.

Notwithstanding these tradeoffs, foundations are still used to allow clients who wish to support charitable activities to do so with greater facility and flexibility, and sometimes even to increase charitable contributions. Private foundations are also used to create a permanent, ongoing charitable endowment.

Tax Characteristics of a Private Foundation

Under Section 509, a private foundation is a tax-exempt charitable organization described in Section 501(c)(3), which is not:

1. a so-called 50 percent organization (church, school, et. seq.),
2. a publicly supported organization which meets the objective tests as to support sources and which has limited endowment income,
3. a "satellite" organization that exists solely to support an organization that is not a private foundation, or
4. an underwriters laboratory or public safety testing organization.

In addition to less generous deductions for their supporters, private foundations are subject to a series of excise taxes in various situations. Except for the tax on net investment income under Section 4940, each of the penalty excise taxes provides for a two-level tax structure. An initial tax is imposed at a relatively low level, supplemented by a more severe tax that applies if the foundation fails to correct the violation that gives rise to the initial tax liability.[31]

Dealings between the foundation and its substantial contributors, foundation officials, and related persons (known as "disqualified persons") that are self-dealing are prohibited under Section 4941. Examples of prohibited transactions include: selling or leasing of property or making of loans between the foundation and a disqualified person.

The prohibition on self-dealing is absolute (the Service lacks equitable authority to excuse harmless

violations). This strictness often causes unexpected difficulties.

Under Section 4942, foundations also pay tax if they fail to make an annual minimum distribution equal to 5 percent of investment assets. The tax is 30 percent of the amount of income undistributed at the beginning of the next year. Further, if the distribution deficiency is not corrected within the taxable period, the penalty increases to 100 percent.

One exception to this general rule is that a foundation can treat amounts set aside for a specified charitable project as having been distributed, even though payment is not made until a later year. Advance Service approval of the project is required.[32]

Foundation excess business holdings are taxed under Section 4943, a provision designed to restrict foundation involvement in the ownership and operation of businesses. Generally, business holdings are excess if (1) disqualified persons own 20 percent or more of the voting stock of incorporated business, and (2) the private foundation owns at least 2 percent of the business. Like other Chapter 42 excise taxes, the tax is two-tier, with tier one being 10 percent, and tier two being 200 percent.

A private foundation has five years within which to dispose of excess holdings, absent an extension of up to five additional years which can be granted for good cause shown.[33] Nevertheless, caution is advised when funding a private foundation with ownership interests in a closely held business.

Investments that jeopardize the foundation's exempt purpose are taxed under Section 4944. The tier one tax is 10 percent on the foundation manager and the foundation. The tier two tax is 5 percent on the foundation manager, and 25 percent on the foundation.

Expenditures for noncharitable purposes, including those for lobbying and propagandizing, influencing elections or conducting voter education, making grants to certain individuals (unless approved by the Service in advance), making grants to organizations other than public charities (unless the foundation monitors grantee's use), and making grants for noncharitable purposes are taxed under Section 4945. There is a two-tier tax of 20 percent (and then 100 percent) on the foundation, and 5 percent (and then 50 percent) on the foundation manager.

Tax is imposed on the termination of a foundation under Section 507. The termination tax equals the aggregate benefits of the foundation's exempt status or the net value of its assets. See Section 507(c). However, this tax can be avoided in several ways.

Foundations pay a 2 percent tax on investment income. See Section 4940. This tax can be reduced to 1 percent, but not if the foundation was liable for tax for failure to distribute income under Section 4942 during the base period. "Investment income" includes:

1. income from sources "similar to" dividends, rent, interest, royalty, and
2. net capital gain from any property which produces "gross income."

Use of loss carrybacks is limited, in addition to a limit on use of loss carryovers. There is tax on capital gain from a Section 1031 like-kind exchange of "exempt use" property that has been used for exempt purposes for at least one year.

Foundations as Beneficiaries of Charitable Lead Trusts

For families with sufficient wealth, family foundations may be used with one or more charitable lead trusts to minimize transfer taxes on large transfers to younger generations. The lead trust offers tax-saving characteristics, while the amounts distributed are paid to the foundation, through which family members can influence, if not control, the ultimate application of funds.

Treasury Regulation Section 53.4942(a)-2(c)(2)(iii) takes the position that a private foundation that is the beneficiary of a charitable lead trust must take into account for minimum distribution purposes the lesser of (1) the income distributions from the lead trust or (2) five percent of the trust assets.

This regulation, however, was invalidated by *Jackson Family Foundation v. Commissioner*,[34] where a private foundation disregarded taking into account the assets of the trust or the annuity distributions received from the trust in determining its minimum investment return.

Charitable lead trusts that make payments to a foundation in which the creator of the trust has an influential role present risks of estate inclusion under Section 2036. This is particularly true when the donor and decedent had the power to direct (or even only participate in designating) the recipients of foundation grants.[35]

Foundations as Beneficiaries of Charitable Remainder Trusts

A private foundation cannot receive the remainder interest in a charitable remainder trust if the trust

instrument requires that the remainder beneficiary be an organization described in Section 170(b)(1)(A). On the other hand, unless the instrument so provides, the settlor's income tax charitable deduction for the transfer to the trust will be subject to the lower percentage limitations applicable to contributions to private foundations.

For purposes of the beneficiary/foundation's minimum distribution requirement, the foundation's future interest in the charitable remainder trust will not be taken into account until all intervening interests in the trust have expired.[36]

If a donor does not wish to create a "stand by" foundation to receive eventual distributions from a charitable remainder trust, it is possible for the charitable remainder trust's terms to provide that the trust will continue as a grant-making entity after the death of the noncharitable beneficiaries.

Probate Exception to Self-Dealing Rules

Under limited circumstances, the probate exception to the self-dealing rules allows many transactions that otherwise would not be allowed between (1) a private foundation and (2) a disqualified person.

Treasury Regulation Section 53.4941(d)-1(b)(3) provides that the term, "indirect self-dealing" will not include a transaction with respect to a private foundation's interest or expectancy in property (whether or not encumbered) held by an estate (or revocable trust, including a trust which has become irrevocable on a grantor's death), This is true regardless of when title to the property vests under local law, if certain conditions are met.

Corporate Adjustment Exception to Self-Dealing Rules

The corporate adjustment exception under Section 4941(d)(2)(F) exempts transactions between a private foundation and a corporate disqualified person in any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization from the self-dealing rules. This statement is true if the foundation receives fair market value in the transaction, and all classes of stock held before the transaction are subject to the same terms.

The terms of the redemption must be identical with respect to all shareholders. For instance, where other shareholders receive cash and the foundation receives debentures, the exception likely will not apply. Interestingly, however, the Service ruling position is that the exception applies even where it is anticipated and all but certain that only the foundation will be redeemed.[37]

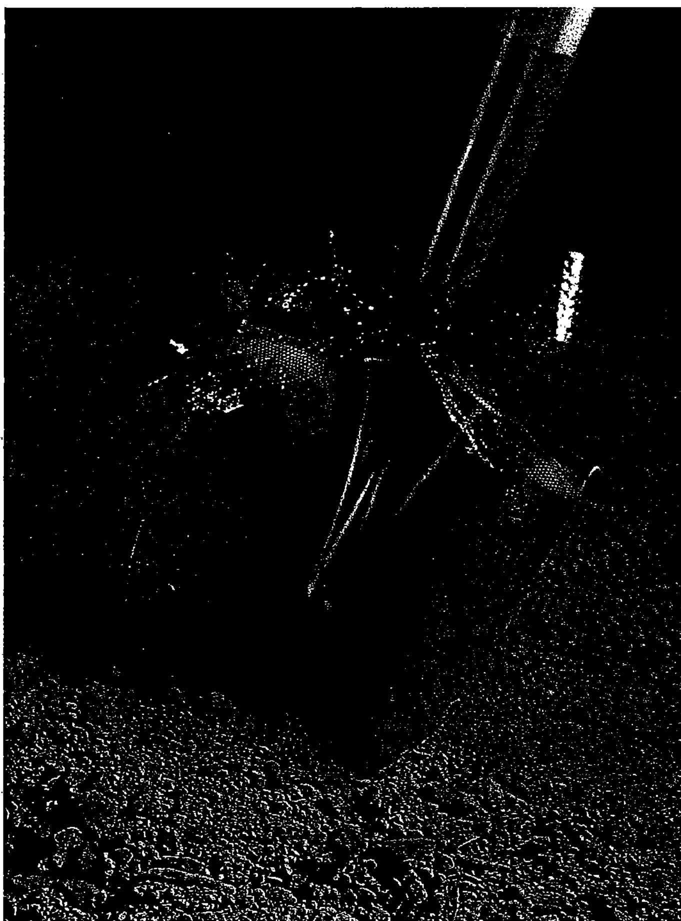
Exit Strategies to Terminate a Private Foundation

If a family does not wish to continue operating its own separate foundation, it has several options. First, it can pay the termination fee under Section 507. Because this normally means disgorging all of the foundation's net assets to the government, this alternative is seldom used voluntarily.

Second, the foundation can pay over all the foundation's net assets to one or more public charities in accordance with Section 507(b)(1). Terms and conditions may be placed on such transfers to provide for family's continuing recognition or involvement.

Third, the foundation can convert into a form of public charity (including a supporting organization) and operate continuously in that form for at least 60 months.

Finally, the foundation can merge with another foundation in accordance with Section 507(b)(2) and the regulations thereunder.



Alternatives to the Private Foundation

Donor-Involved (Advised or Philanthropic) Funds

These are funds created by public charities (i.e., 50 percent organizations). The donor contributing to the fund or former trustees of a transferor private foundation (or others designated by the donor or trustees) provide advice or recommendations concerning distributions from the fund. The public charity, however, must have ultimate control over distribution decisions.

To prevent the fund being treated as a private foundation (causing the donor's deduction to be limited accordingly), the fund must be operated as a "component fund" of the public charity.

PPA 2006 codified the definition of what is (and what is not) a donor-advised fund at Section 4966. And, PPA 2006 included several other provisions that significantly affected the formation and operation of donor advised funds.

A donor advised fund is defined by Section 4966 as any fund or account (1) which is owned and controlled by a "sponsoring organization" (which generally includes most public charities) that is separately identified by reference to contributions of a donor or donors; and (2) with respect to which a donor or person appointed by the donor ("donor adviser") has advisory rights with respect to investments or distributions.

PPA 2006 also imposes excise taxes on donor-advised funds (Sections 4966 and 4967), expands the application of intermediate sanctions with respect to such funds, and applies the excess business holding rulings for private foundations to such funds.

Taxable Distributions

If distributions from donor-advised funds to individuals or to any entity are not for charitable purposes, they will result in the imposition of penalty taxes on the persons who recommended and approved such distributions. As discussed below, distributions to "disqualified supporting organizations" are also subject to penalty taxes, unless expenditure responsibility is exercised.

Permitted Distributions

A donor-advised fund may make distributions to any charitable organization described in Section 170(b)(1)(A) (other than a "disqualified supporting organization," discussed below). Accordingly, churches, educational organizations, hospitals and medical organizations, publicly supported organizations, governmental units, and private operating foundations may receive distributions.

Other permissible distribution recipients include the sponsoring organization of the donor-advised fund, and other donor advised funds.

Distributions Requiring Expenditure Responsibility

Expenditure responsibility entails a pre-grant inquiry, a detailed grant agreement, obtaining reports from the grantee, and taking action to recover any diverted grant funds. Expenditure responsibility must be exercised in order for a donor advised fund to make distributions to several types of organization, including: a private nonoperating foundation, a "disqualified supporting organization,"[38] or an organization not described in Section 170(b)(1)(A).

Prohibited Benefits

PPA 2006 also provided for penalties if, based on the advice of a donor, donor adviser or related party, a distribution is made from a donor-advised fund and a donor, donor adviser or related party receives a "more than incidental benefit" as a result of such distribution. See Section 4967.

The penalty is 125 percent of the amount of the benefit and can be imposed on the person who recommended the distribution or the person who received the benefit. In addition, fund managers who approve such distributions are subject to a penalty tax of 10 percent ($10,000 maximum) if they knew the distribution would result in the benefit.

Excess Benefit Transactions

PPA 2006 also prohibited any "grant, loan, compensation, or other similar payment" from a donor-advised fund to a donor, donor adviser or related party.[39]

If such a payment or loan is received from a donor-advised fund, a 25 percent penalty tax is imposed on the recipient based on the amount involved, and any amount repaid as a result of correcting an excess benefit transaction must be repaid to the sponsoring organization but not held in any donor-advised fund.

Compensation of Investment Advisers

PPA 2006 prohibited a sponsoring organization from paying excessive compensation to anyone providing

investment advice with respect to donor-advised funds.[40]

Application of Excess Business Holdings Limitations

PPA 2006 applied the private foundation excess business holdings limitations to assets held by donor-advised funds.[41]

Accordingly, the combined holdings of a donor-advised fund and its donors, donor advisers, and related parties are generally limited to 20 percent of the voting stock of a corporation (or equivalent ownership of a partnership or other entity).

Charitable Deduction Requirements

PPA 2006 altered certain charitable contribution rules for contributions to donor-advised funds. Donors are denied an income, gift or estate tax deduction for contributions to a donor-advised fund held by a Type III supporting organization that is not "functionally integrated."

All donor-advised fund gift acknowledgments to donors must indicate to donors that the sponsoring organization has exclusive legal control over the assets contributed to a donor-advised fund. If such acknowledgement is not provided, a donor could be denied a charitable deduction.

Supporting Organizations

Supporting organizations are a category of public charity that need not be (and generally is not) publicly supported. Conceptually, the supporting organization is indirectly responsive to the public by reason of its relationship to one or more public charities that it supports.

Examples of supporting organizations include religious organizations connected with churches, trusts organized and operated for the benefit of a school (and controlled by, or operated in connection with, the school), university presses, or similar organizations.

PPA 2006 included several provisions that significantly affect the organization and operation of supporting organizations. Some provisions applied to all supporting organizations. These included an expansion of the application of intermediate sanctions, the definition of a disqualified person, and certain disclaimer requirements.

Comparing Supporting Organizations and Private Foundations

Supporting organizations have several potential advantages over private foundations.

First, they pay no 2 percent excise tax on the investment income.

Second, contributions of any type of long-term appreciated property to a supporting organization, including closely held stock, are deductible to the extent of 30 percent of the donor's "contribution base."

Third, contributions of cash to a supporting organization are deductible to the extent of 50 percent of the donor's contribution base.

Supporting organizations may offer more flexibility in business planning, because they can hold a significant interest in any business, including the donor's business.

In addition, transactions between the supporting organization and the donor or related parties (including entities controlled by the donor) are permissible, provided that transactions are at arm's length and are reasonable. For instance, a corporation controlled by the donor could redeem stock owned by a supporting organization.

In addition, a supporting organization may purchase stock from the donor's estate, and may sell stock to members of the donor's family.

If one or more public charities assume administrative responsibility for operation of a supporting organization, its operating costs may be reduced below those of a private foundation. A supporting organization's investment activities are less restricted than those of a private foundation.

A supporting organization controlled by one or more public charities may accumulate income for a reasonable period for future charitable projects, and there are no specific annual payout requirement.

Applications of Charitable Planning in Estate and Business Succession Planning

Contribution of C Corporation Stock and the "Charitable Bailout"

One technique that can accommodate the donor's charitable objectives, avoid capital gains tax, avoid long-term reduction in an owner's ownership position in a C corporation, and allow tax-free distribution of excess cash accumulated in the C corporation is to for the donor to make a charitable gift of C corporation stock, followed by a redemption of the donated stock by the corporation.

This plan is sometimes referred to as a "charitable bailout." This is because both the charitable gift and the subsequent redemption would be

completely income tax free. And, the corporation would be able to "bail out" its accumulated cash.

If the charitable donee is a private foundation or charitable remainder trust, normally the redemption would constitute impermissible self-dealing. However, the "corporate adjustment" exception discussed above permits redemptions in certain circumstances.

May the redemption occur for a note? Loans by a foundation to a corporate disqualified person are an impermissible act of self-dealing. Is a redemption for an installment note a loan? In PLR 9347035, the Service held that it was not, but reversed its original ruling in PLR 9731034, citing Treasury Regulation Section 53.4941(d)-3(d)(2).

It is noteworthy, however, that if the redemption for a note occurs as part of the probate exception to self-dealing (discussed above), self-dealing may be avoided.[42]

Even if the probate exception is available, however, it is uncertain whether payments on the note will be self-dealing. Considering the spirit of the rulings, the best answer should be "no."

What if the note already exists in the estate such that no probate exception is available? Service guidance indicates that self-dealing encompasses receipt by a foundation of notes made by disqualified persons through gift or bequest.[43]

Charitable Gifts of Partnership (or LLC) Interests

Charitable gifts of interests in partnerships or limited liability companies can present tax consequences to donors or donees that are sometimes surprising and unfavorable.

Donor Issues

The gift may cause phantom ordinary income for the donor, through the realization of ordinary income if the partnership has unrealized receivables or appreciated inventory, or if there is any investment tax credit subject to recapture.[44] The gift could also accelerate any unrecognized installment gain in the partnership.[45]

Another potential risk to the donor is phantom capital gain income to the donor, arising from application of the "bargain sale rules" which apply to gifts of interests in partnerships with outstanding indebtedness, even if the indebtedness is nonrecourse and unsecured. The partner is treated as having received payment for his or her entire share of partnership liabilities.[46]

Valuation and substantiation requirements apply to gifts of partnership or LLC ownership interests.

Generally, a charitable gift of an interest in a partnership or LLC is treated as a gift of a capital asset. Consequently, if made to a public charity, the gift generally would qualify for a full fair market value deduction.

With some justification, however, the Service has claimed that the same valuation discounts promoted by donors of noncharitable gifts also apply to charitable gifts. Consequently, the appraised value of the interest transferred generally would be 10 percent to 50 percent less than the undiscounted value (i.e., the value of the underlying assets in the partnership or LLC).

Gifts of partnership and LLC interests are subject to the "qualified appraisal" rules. If the charitable donee is given rights to liquidate the partnership or LLC immediately (or after a short period of time), and if the charity is also allowed to transfer the interests, valuation discounts may be significantly reduced (increasing the charitable deduction for the gift).

The principles underlying many of the reported cases and rulings on prearranged sales or redemptions of stock should logically apply to gifts of partnership or LLC ownership interests.

Donee Issues

The principal issue affecting donee organizations receiving gifts of partnership or LLC interests is unrelated business taxable income (UBTI). However, there are other potential risks. A charitable donee may wish to consider requesting an indemnity from its donor with respect to any of the potential liabilities discussed below.

Unrelated Business Taxable Income (UBTI)

Tax-exempt organizations, including private foundations, pay tax on their UBTI.[47] UBTI is income from activities that:

1. are regularly carried on,
2. rise to the level of a trade or business, and
3. are substantially unrelated to the organization's exempt purposes.[48]

UBTI does not include passive income such as dividends, interest, most rents from real property and gains from the sale of property (other than dealer property).[49]

In contrast to the situation of tax-exempt organizations holding S corporation shares, a tax-exempt partner's share of partnership income and gain is not necessarily treated as UBTI. Instead, there is a type of "look through" rule. The charitable organization must include in its UBTI only its share of the

partnership's income attributable to the partnership's unrelated trade or business activities.[50]

In other words, for purposes of this rule, the exempt partner is treated as engaged in the same activities of the partnership. The tax-exempt partner's share of the partnership's dividends, interest, rents, royalties, and other "passive" income retains its tax-free character.

Rent is not passive income excluded from UBTI if it represents a portion of the tenant's net income or profit.[51] Some commercial leases (including many shopping center leases) provide for both a fixed minimum rent and an additional percentage rent.

The UBTI exclusion for passive activity income is limited when the property giving rise to the income is financed by "acquisition indebtedness." Acquisition indebtedness is (1) indebtedness incurred to purchase or improve the property or (2) indebtedness incurred before or after a purchase or improvement that would not have occurred but for such purchase or improvement.[52]

Where property is acquired (including by gift or bequest) subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien is considered acquisition indebtedness, even though the organization does not assume or agree to pay such indebtedness.[53]

There is an exception, however, if the property is acquired by bequest or devise from a deceased donor—in that instance, the indebtedness is not treated as acquisition indebtedness during the 10-year period following the date of acquisition.[54]

A similar exception applies to property acquired by gift from a living donor. In that instance, the indebtedness is not treated as acquisition indebtedness during the 10-year period following the date of acquisition if:

1. the mortgage was placed on the property more than five years before the date of the gift and
2. the donor owned the property for more than five years before the date of the gift.[55]

Further, the acquisition indebtedness rule does not apply to the extent that the organization uses the mortgaged property in a way that is substantially related to the organization's exempt purposes.[56]

Payments of Income Tax

The charitable partner may be subject to income tax on its share of partnership UBTI without regard to actual distributions from the partnership. To avoid a phantom income problem for the charitable partner, it is important that the partnership agreement or LLC operating agreement require the entity to make distributions in an amount sufficient to pay any unrelated business income tax.

Capital Assessments

Generally, limited partners and members of LLCs generally are liable for partnership debts and expenses only to the extent of their investment. The terms of the partnership agreement or operating agreement, however, can require partners or members to make additional capital contributions or other payment.

Before accepting a gift, the charitable donee should carefully consider these and other cash flow issues.

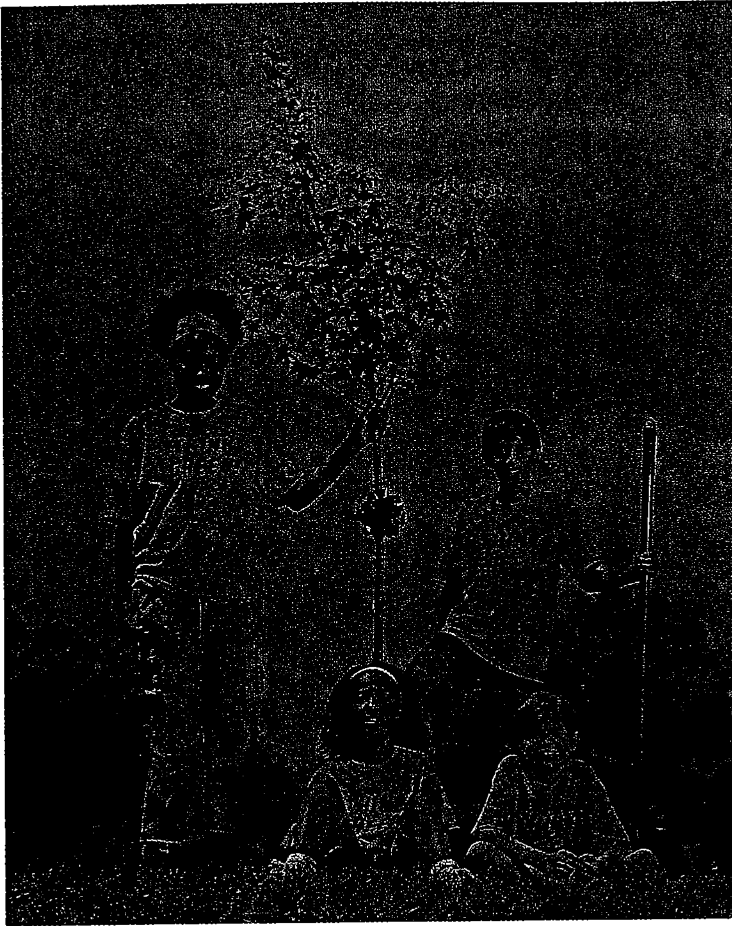
Environmental Liabilities

Because the interest of a limited partner or a member of an LLC is personal property (even if the entity itself owns real property), a partner or member should not constitute an "owner" within the mean of federal and state environmental laws.

In some instances, however, the partner or member could be deemed an "operator" of property. A prudent charitable organization should undertake at least limited environmental due diligence before accepting an interest in any entity operating real property.

Private Foundation Issues

When a disqualified person gives debt-encumbered property (or an interest in a partnership that owns debt-encumbered property) to a private foundation, it is important to consider whether the rules on whether the transaction is a "sale or exchange" for income tax purposes also indicate a "sale or exchange" under the self-dealing rules.



Generally, for purposes of computing gain from the disposition of property, the amount realized includes the amount of liabilities from which the transferor is discharged.[57]

If disposed property secures a liability, the transferor is considered to be discharged from the liability—even if the transferee takes the property subject to the liability, and does not assume the liability.[58]

A disposition of property includes a gift of the property.[59] The amount realized is the amount of the loan encumbering the property.[60]

Along similar lines, a gift of debt-encumbered property to a charity is a bargain sale, and the amount realized by the donor includes the liability—even if the transferee does not agree to assume or pay it.[61]

If the disposition is of a partnership interest, the liabilities from which the transferor is considered to be discharged include the transferor's share of the partnership's liabilities.[62]

Under this analysis, when a charity receives a gift of a partnership interest in a partnership owning encumbered property, the charitable donor is discharged from an amount of liability equal to the donor's share of the partnership's liabilities.[63] Presumably, the discharge of the liability can be negated if the donor assumes primary responsibility for the liability.

A special rule in Section 4941(d)(2)(A) provides that for purposes of defining self-dealing, a sale or exchange includes the transfer of real or personal property by a disqualified person to a private foundation, if the property:

1. is subject to a mortgage or similar lien which the foundation assumes, or
2. is subject to a mortgage or similar lien which a disqualified person placed on the property within 10 years of the date of the transfer.[64]

If debt was placed on partnership property by either the partnership or a partner within ten years of the charitable gift to the foundation, it is necessary to determine whether the partnership or the partner is a "disqualified person" with respect to the foundation.

The issue turns on whether the partner or partnership is a disqualified person at the time the property is contributed to the foundation, rather than whether the partner or the partnership was a disqualified person at the time that he, she or it placed the debt on the property.[65]

A partner is a disqualified person if the partner is a foundation manager or a substantial contributor to the foundation (or if certain family members or related entities are substantial contributors). If disqualified persons own more than 35 percent of the profits interest in the partnership, then the partnership itself is a disqualified person.[66]

Under the "one bite rule" that provides an exception to this general analysis, self-dealing does not include a transaction between a private foundation and a disqualified person where the disqualified person status arises only as a result of the transaction.[67]

Distributions from Estates to Private Foundations and Self-Dealing Issues

Interesting planning issues are presented when partnership interests pass to the private foundation at the partner's death (where debt was placed on partnership property by a disqualified person within ten years of the bequest).

In these instances, the estate of the partner is not necessarily a disqualified person. The private foundation rules discussed above provide flexibility in many cases.

An estate has a separate identity from the decedent. Even if the decedent is a disqualified person with respect to the foundation, the estate itself is not automatically a disqualified person.[68] Further, an estate is not a disqualified person merely because its executor is a disqualified person.[69]

Although an estate will become a disqualified person if it is a substantial contributor to the foundation, the "one bite rule" will apply at the time of the estate's initial funding of the foundation. Afterwards, the estate will be a disqualified person, but this may not matter, because the estate is likely to terminate, and will not need to have any further dealings with the foundation.

The estate will be a disqualified person if more than 35 percent of its beneficial interest is held by disqualified persons.[70] Therefore, if the decedent is a substantial contributor to the foundation during his lifetime, then he and certain family members are disqualified persons.

By extension, if more than 35 percent of the estate passes to the family, then the estate itself is also a disqualified person. And, there would be self-dealing when the estate distributes the partnership interest to the foundation.

One way to mitigate this problem is for the deceased partner to leave not more than 35 percent of his estate to his family, which will cause the estate not be a disqualified person.[71] Predictably, this mitigation approach may be unattractive to the decedent or his family.

Another option is that if the foundation receiving distributions from the estate is a "fresh foundation," then the deceased will not be a substantial contributor to the foundation, with the result that he and his family will not be disqualified persons. Therefore, the family may receive more than 35 percent of the estate, without the estate itself becoming a disqualified person.

Co-Ownership by Private Foundations and Disqualified Persons

Self-dealing issues can arise when a private foundation and a disqualified person own interests in the same partnership.

The Service has ruled that liquidation of a private foundation's limited partnership interest in a real estate limited partnership was not an act of self-dealing.[72]

It is an unresolved issue whether or not a shift of relative beneficial interest in a partnership occurring when a partnership makes a capital call, but either a foundation or a disqualified person does not make the required capital contribution, is a sale or exchange that constitutes self-dealing.

Self-dealing can occur even without a sale or exchange if a disqualified person uses or benefits from the income or assets of a private foundation.[73]

Special Rules Applicable to Gifts of S Corporation Stock

Charitable organizations are permissible S corporation shareholders.[74] A donor may give or sell S corporation stock to charitable organizations (particularly gifts of appreciated stock) or charitable lead trusts that make an Electing Small Business Trust (ESBT) election under Section 1361(e), or as consideration for a charitable gift annuity.

S corporations present certain unique issues in valuing the charitable gift. Specifically, the donor's deduction will be reduced from the appraised value of the stock by ordinary income items internal to the S corporation including unrealized receivables, appreciated inventory,[75] depreciation recapture under Sections 1245 or 1250, and an extensive list of particular assets that produce ordinary income rather than long-term capital gain upon sale.[76]

The income tax (but not transfer tax) rules pertaining to partnership sales and distributions are applied to gifts of S corporation stock by Section 170(e)(1).

Taxation of S Corporation Stock Owned by a Charity

All of the charity's earnings with respect to its S Corporation stock will be UBTI, subject to tax (UBIT).[77] UBIT is payable without regard to whether the corporation has made any cash or other distributions which might enable the charity to pay the UBIT.

As discussed more fully above, to avoid phantom income problems, the charity should consider a distribution and/or indemnity agreement with the corporation and/or donor, as applicable, as a condition of acceptance of the gift.

Sale or Redemption of the S Corporation Stock

Capital gain on the sale or redemption of the S corporation stock itself is also taxed as UBTI.[78] It is noteworthy that this general result differs from the treatment of virtually any other asset held by the charity.

There is an exception to the general rule if all of the stock is sold in a transaction (e.g., sale to a

public company) that terminates the S election. In such case, the election is deemed terminated on the day before the sale. No UBTI results from the transaction, because there is no gain on the sale of C corporation stock.

When the donor anticipates that a sale to a public company or other event that will terminate the S election is fairly certain to occur shortly after the charitable gift, it may be advisable to voluntarily terminate the S election before the charitable gift is made.

This will avoid UBTI to the charity, and may also avoid Section 751 treatment to the charity and other shareholders. The donor will also avoid reduction of his deduction by Section 751 items. It is noteworthy, however, that the assignment of income issues discussed below may apply.

Use of Supporting Organizations to Hold S Corporation Stock

As discussed above, charitable organizations owning S corporation stock are subject to unrelated business income tax on the organization's share of corporate income and any gains realized on sale. Consequently, advisers often consider the "best" way to minimize any income taxes, particularly whether it would be better to organize the charity in trust form, or corporate form.

Charitable corporations and charitable trusts are now subject to income tax at roughly the same top marginal rate, but trusts reach the top bracket much quicker (at taxable income of approximately $10,000). Charitable trusts, however, pay the same maximum rate on capital gain income as individual taxpayers.

In contrast, corporations must pay income tax on capital gain at the usual rates. The conventional wisdom, therefore, is that a charitable trust is preferable if the stock will be sold relatively soon, but otherwise, it is usually better to use a corporation.

Charitable Corporations

A corporate-form supporting organization could be formed to acquire, hold, and sell S corporation stock. The corporate form may provide limited liability benefits. Further, Section 512(b)(10) permits a tax-exempt organization receiving UBTI to take a deduction for charitable contributions (i.e., to another charitable organization other than itself) of up to 10 percent of its UBTI. This provision can effectively reduce the overall rate of income tax.[79]

One option, then, is for the supporting organization make "upstream" grants to the "parent," effectively reducing the overall tax rate by about 10 percent.

Charitable Trusts

The income tax charitable deduction available to charitable trusts receiving UBTI is much different than the rule for charitable corporations. Under Section 512(b)(11), tax-exempt charitable trusts receiving UBTI are entitled to the same income tax charitable deduction afforded individual taxpayers (i.e., for cash gifts to public charities is 50 percent of adjusted gross income).

This means that a trust-form supporting organization making "upstream" grants to its charitable "parent" can reduce the effective overall tax rate on UBTI by up to 50 percent.

Charitable Lead Trusts

While a charitable lead trust may be an ESBT if its only potential current beneficiary is a charity.[80] Tax-exempt trusts and QSSTs are not qualified to be ESBTs, but CRTs are not similarly disqualified.[81]

Although the charitable lead trust (CLT) may hold S corporation shares, income tax treatment of charitable lead trusts owning S corporation shares and taxed as ESBTs is disadvantaged.

Specifically, the CLT will not be allowed any deduction for its payments of the charitable annuity or unitrust amount, except with regard to income from non–S corporation assets of the trust.[82]

This result is not changed by Section 1366(a)(1)(A), which merely operates to pass through to the ESBT the deductions which would have been allowable to the S corporation, if the S corporation were a true taxpayer.[83]

The charitable deduction is only for amounts paid to charity by the S corporation from its gross income, not amounts paid to charity by the trust itself.

Although the result above appears negative, it is no worse than a comparable situation for a charitable lead trust owning C corporation stock. Let's consider Exhibit 1, which assumes for simplicity's sake (1) that top individual and corporate rates are both 40 percent and (2) that the CLT is the sole shareholder in each instance.

As Exhibit 1 indicates, the results for the C corporation and the S corporation are substantively the same. In each instance, if the corporation distributes less of its earnings, a cash flow shortfall occurs.

Charitable Gifts by the Business Entity

Usually, clients and advisers focus on charitable gifts of interests in closely held businesses. Sometimes, however, it makes sense to consider a charitable contribution by the business entity.

Charitable Gifts by C Corporations

Charitable contributions by C corporations are deductible up to only 10 percent of the corporation's taxable income.[84]

In contrast, individual taxpayers generally may deduct charitable contributions up to 30 percent or 50 percent of adjusted gross income.

Charitable Gifts by S Corporations

Since 1982, charitable contributions by S corporations are deductible proportionately by the S corporation shareholders.[85] The deductible amount (fair market value or basis) is determined at the S corporation level, based on the type of property donated and the status of the donee. Any percentage or other limitations are then determined at the shareholder level, based on the shareholder's overall income.

Under the general rule of Section 1366(d)(1), however, the shareholder's charitable deduction is limited to the shareholder's basis in the S corporation stock and any corporate indebtedness to the shareholder. This means that an S corporation shareholder owning low basis shares may not be able to deduct his or her entire share of the S corporation's charitable contributions.

Charitable Gifts by Partnerships and LLCs

As with S corporations, charitable gifts by partnerships or LLCs are deductible proportionately by the partners or members.[86] Although the general rule is similar to the rule for S corporations, there are certain subtle differences with significant results.

The charitable deduction is not covered by the Section 704(d) rule limiting the partner's deduction for the partner's distributive share of partnership loss to the partner's basis. Consequently, it appears that a partner should be able to deduct the partner's entire proportionate share of a partnership gift without regard to basis.

In Revenue Ruling 96-11,[87] the Service ruled that a partner deducting his or her proportionate share of a partnership gift must reduce his or her basis in the partnership only to the extent of the partnership's basis in the property donated.

Exhibit 1
Charitable Lead Trust (CLT)
C Corporation Assets Versus S Corporation Assets

	C corporation	S corporation
Assets in the CLT	$1m	$1m
Annuity	$70,000 (7 percent)	$70,000 (7 percent)
Corporate earnings	$200,000	$200,000
Corporate tax paid	$80,000	$0
Corporate distributions to the CLT	$70,000	$150,000
CLT distribution to charitable beneficiary	$70,000	$70,000
Deduction by the CLT per § 642(c)	$70,000	$0
CLT taxable income	$0	$200,000
Tax owed and paid by the CLT	$0	$80,000
Net amount remaining to the CLT	$0	$0

Revenue Ruling 2004-05,[88] provides that a trust that is a partner will benefit from a charitable contribution made by the partnership, even if the trust itself has no charitable beneficiaries.[89]

Effect of Section 337

Corporations making large charitable contributions must be careful not to violate Treasury Regulation Section 1.337(d)-4, which continue the repeal of the "General Utilities Doctrine." Under these regulations, a taxable corporation is required to recognize gain or loss upon the transfer of "all or substantially all of its assets to one or more tax-exempt entities."[90]

With certain exceptions, the rule also applies to "a taxable corporation's change in status to a tax-exempt entity."[91] The regulation specifically applies to transfers to charitable remainder trusts.[92]

The determination of whether a corporation has transferred "substantially all" its assets is based on all the facts and circumstances under the general rules of Section 368(a)(1)(C).

Contributions to Charitable Remainder Trusts

Charitable gifts of highly appreciated but underproductive assets can be particularly effective, whether made:

1. outright to a charitable organization or

2. to a charitable remainder trust of which the business entity is remainder beneficiary.

Based on the very broad definition of "person" contained in Section 7701(a)(1), the Service has ruled that charitable remainder trusts may be established by C corporations (PLR 9205031), S corporations (PLR 9340043), or partnerships (PLR 9419021).

With an S corporation gift, the charitable deduction would flow through to the shareholders (as with any other charitable contribution by an S corporation). The CRT can then sell the contributed appreciated assets with no capital gains cost.

Contribution of Intellectual Property to Private Foundation

PLR 200715015 illustrates the strategy of contributing intellectual property to a private foundation. In that ruling, a corporation formed a limited partnership and contributed to it exclusive ownership of certain trademarks and other intellectual property. The other partner was the owner of the corporation, who contributed cash.

The partnership granted the corporation a license to use that property, in exchange for a royalty based on the corporation's net sales. The corporation then contributed the limited partnership units to a private foundation (created and managed by the owner).

The ruling held that because the limited partnership would receive 95 percent or more of its gross income from passive sources (e.g., royalties), the partnership units would not be an excess business holding for the foundation.

In addition, as passive income, the royalties would not be UBTI for the foundation.

Charitable Lead Trusts

Charitable lead trusts (CLTs) have been one of the most useful planning structures available for wealthier individuals who wish to give to charity, but WHO also want to provide for the continued affluence of family members.

The CLT may be most advantageous where the donor and his or her family (1) have no immediate need for all of the income that they currently enjoy and (2) are willing to forego some current benefit in exchange for the prospect of long-term capital appreciation.

CLT Basic Structure

Conceptually, a charitable lead trust (CLT) is the reverse of a CRT. With a CLT, a fixed or variable annuity is paid to charity for a determinable period.

The charity should qualify under Sections 170, 2055, and 2522, which govern the type of deduction associated with the creation of the CLT. The CLT need not specify a particular charitable recipient; this designation can be left to the trustees and can be changed by the trustees from year to year. There is no minimum or maximum payout requirement and no limitation on the number of years that the annuity can be paid to charity.[93]

The period may be measured in a variety of ways: (1) in years, (2) by the life or lives of individuals living when the CLT is created, (3) a measuring life plus a term of years, or even (4) by the shorter of a term of years or a measuring life plus a term of years.[94]

The basic requirement is that the term is ascertainable when the CLT is created. The remainder passes outright or in trust to one or more noncharitable beneficiaries. The remainder beneficiary may be one or more individuals, partnerships, corporations, estates or trusts.

Two separate gifts are made when the CLT is created. The first is a gift of a current interest to one or more charitable beneficiaries. The second is a gift of the remainder interest to one or more noncharitable beneficiaries. Upon funding the CLT, the donor is liable for gift tax on the present value of the noncharitable remainder interest.

Transfer Tax Advantages

The CLT's primary tax advantage is the transfer tax deduction for the present value of the charitable interest.

The trust property (and any appreciation on that property) are removed from the donor's estate, unless the donor retains any powers that could lead to its inclusion in his or her estate under Sections 2036 or 2038.

Income Tax Status of CLT

A qualified CLT is a trust that meets the various statutory definitions that qualify a donor's transfer to the CLT for one or more tax deductions.[95] To be qualified, the CLT must pay the charitable lead interest in the form of a fixed annuity or unitrust amount.

There are two basic varieties of qualified CLTs: (1) qualified nongrantor CLTs and (2) qualified grantor CLTs. Qualified nongrantor CLTs are created

inter-vivos or at death, and are treated as separate taxpayers.

Qualified grantor CLTs are created inter vivos, and the grantor is treated as the owner of the CLT's income for income tax purposes. Another variation is a nonqualified nongrantor CLT created during life.

Charitable Lead Annuity Trust

A charitable lead annuity trust is an irrevocable trust under which a sum certain is to be distributed periodically to one or more charitable beneficiaries not less often than annually for a term of years, or during the life or lives of one or more individuals who are living when the trust is created.

If trust income is insufficient to satisfy the annuity, the principal of the trust must be used. Annuity payments may be set at varying amounts, as long the payments are determinable when the CLT is created.[96]

It is noteworthy that, however, a charitable lead interest will not qualify as a guaranteed annuity interest if the trustee has the discretion to commute and prepay the charitable interest prior to the expiration of the specified annuity term.[97]

In general, no amounts may be paid for private purposes from the charitable lead annuity trust until the expiration of the charitable annuity term.[98]

Unlike the rules governing charitable remainder annuity trusts, there is no explicit prohibition against making additional contributions to a charitable lead annuity trust.[99]

Additional contributions, however, do not generate additional estate or gift tax deductions, because the amount of the annual guaranteed annuity payment must be determinable at the inception of the trust.[100]

Charitable Lead Unitrust

A charitable lead unitrust is an irrevocable trust under which a fixed percentage of the net fair market value of its assets (valued annually) is to be distributed not less often than annually to one or more charitable beneficiaries for a term of years, or during the life or lives of one or more individuals who are living when the trust is created.

If trust income is insufficient to satisfy the annuity, the principal of the trust must be used to satisfy the unitrust amount. Unlike charitable remainder unitrusts, a net income limitation is not available.[101] The unitrust amount may not vary over the term of the CLT.[102]

In computing fair market value of the trust, all assets and liabilities are taken into consideration, without regard to whether particular items also are taken into account in determining trust income. The same valuation date and method should be used each year.

If these details are not specified in the trust, then the trustee must select the date and method on the first income tax return that the trust is required to file.[103]

Additional Considerations

A clause that "saves" the trust from violating any applicable rule against perpetuities will not disqualify the trust, even if the term of the trust is shortened as a result.[104]

After the Tax Court's decision in *Boeshore Estate v. Commissioner*,[105] the Service issued final regulations acknowledging that a noncharitable interest in the form of qualifying annuity or unitrust interest can precede a charitable lead interest.[106]

Reformation

Even if the noncharitable trust interests are clearly separable, the transfer of a partial interest to a charity generally will not qualify for a deduction unless the trust interest is a qualified annuity or unitrust interest.[107]

"Reformation" rules permit the amendment of certain charitable trusts which otherwise would not qualify for a charitable contribution deduction.[108]

Tax Consequences to the Donor

Lifetime Transfers

Generally, no immediate income tax deductions are available to the donor upon funding the CLT if the CLT is treated as a taxpayer separate and apart from the donor.[109]

A current income tax deduction is allowable only if the trust is a qualified grantor CLT, causing the donor to be treated as the owner of the property.[110]

A gift tax deduction is allowed based on the present value of the charitable interest.[111] The remainder interest does not qualify for the gift tax annual exclusion. This is because the gift is incomplete. For the gift tax deduction to apply to the charitable interest, the gift must be complete. Accordingly, the donor must retain the power (directly or indirectly) to affect the charitable recipient.[112]

It appears the donor may be an officer or director of the charitable recipient.[113] The charity's governing documents, however, should include provisions that prevent the donor from having control over the property received from the CLT he or she created.[114]

Testamentary Transfers

The charitable interest in a CRT is eligible for the estate tax charitable deduction.[115] If a grantor retains a reversionary interest in a lifetime CLT that exceeds 5 percent of the corpus, and the grantor dies during the term of the trust, a portion of the value of the CLT will be included in the grantor's estate.[116]

Valuing the Charitable Interest

The present value of an annuity is determined by multiplying the amount of the annuity by factors dependent on the applicable rate under Section 7520.[117]

To determine the present value of a unitrust interest, the present value of the remainder interest is subtracted from the present value of the remainder interest from the value of the property contributed to the CLT.[118]

Generation-Skipping Transfer Tax

For GST purposes, a CLT and its charitable beneficiaries are non-skip persons.[119]

Consequently, neither the creation of a CLT nor distributions to its charitable beneficiaries during the annuity or unitrust term will result in any GST tax consequences.

Upon termination of the charitable interests in a CLT, however, a GST tax may be imposed if the remainder beneficiaries are "skip persons" with respect to the donor of the CLT. Generally, GST tax is paid from the remainder interest.[120]

A GST exemption may be allocated to shield part or all of the remainder interest from GST tax. The effect of allocating a portion of the donor's GST exemption upon creation of a charitable lead annuity trust cannot be determined until the charitable lead interest terminates.

GST is allocated to the CRT by an "adjusted GST exemption formula," which "adjusts" the donor's initially allocated GST exemption to a projected future value as of the date the charitable lead interest actually expires, using the discount rate applied under the valuation methods provided by the Service in effect at the time the trust was created.[121]

The amount of GST exemption a donor should allocate to a charitable lead annuity trust is based on the following:

1. the term and payout rate of the charitable lead interest
2. the projected rate of return on trust property (i.e., the donor's best estimate of the future value of the trust when the charitable lead interest expires)
3. the discount rate provided by the Service in effect when the trust is created[122]

Taxation of the CLT and its Beneficiaries

A nongrantor CLT is taxed as a complex trust.[123] Any trust income in excess of the income tax deduction relating to the charitable payout is taxed to the trust. The trust receives an unlimited charitable income tax deduction for items of gross income that, pursuant to the terms of the governing instrument, are paid during the taxable year to a qualified charity.[124]

The deduction is not limited by percentage limitations applicable to individuals. The CLT's charitable deduction is reduced, however, by any UBTI realized by the CLT during the year to the extent the UBTI exceeds the percentage limitations attributable to individuals under Section 170(b)(1)(A).[125]

The deduction is limited to the extent capital gains or tax-exempt income is deemed distributed.

The best practice is for the governing CRT instrument to provide for a hierarchy of sources of payments, in order to maximize the income tax benefits of the charitable payouts. For example, the hierarchy can provide first for distributions from ordinary income (including short-term capital gains), then from capital gains, then from UBTI, then from tax-exempt income, and only last from principal.[126]

Rules regarding estimated tax payments apply to CLTs.[127]

Usually, the CLT's taxable year will be the calendar year.[128] There is an exception for wholly charitable trusts exempt from taxation under Section 501(a).[129]

This exception does not apply to CLTs, however, because CLTs are not described in section 501(a). Therefore, all CLTs report on a calendar year basis. CLTs report income on Forms 1041, 1041-A, and 5227. A Schedule K-1 is provided to the charitable beneficiary.[130]

To avoid forced sales or adverse tax consequences to the trust, the trust should realize a sufficient level of cash flow to satisfy the regular payment of the annuity or unitrust interest. If there is insufficient cash to satisfy a given annuity or unitrust interest, the sale or distribution of appreciated property will result in the CLT realizing capital gain.

Borrowing may be a more favorable short-term alternative. However, it is not economically feasible over the long term. Further, the trustee must be careful to avoid creating UBTI.[131]

If possible, a draftsperson will want to allocate items taxed at higher rates to the charitable

beneficiaries. Similarly, a draftsperson should consider allocating expenses to income.[132]

CLTs and Private Foundation Rules

The CLT is considered to be a private foundation for purposes of the private foundation restrictions discussed above.[133]

Thus, the CRT can be subject to the taxes on self-dealings (see Section 4941), excess business holdings (see Section 4943), investments jeopardizing charitable purposes (see Section 4944), and taxable expenditures (see Section 4945).

Although the private foundation limitations may apply automatically to the trust under state law, but if they do not, the limitations must be spelled out in the governing trust instrument.[134]

The taxes on acts of self-dealing and taxable expenditures will apply in all events. The taxes on excess business holdings and jeopardizing investments, however, do not apply if, at inception, the value of the charitable income interest is 60 percent or less of the initial value of the entire trust property.[135]

The regulations define "income interest" to include a guaranteed annuity or a unitrust amount.

Although its ruling appears incorrect in light of Treasury Regulation Section 53.4947-2(b)(2), the Service has ruled that this "60 percent exception" is not applicable unless all of the trust's income is payable to charity, even income in excess of the annuity or unitrust amount.[136]

In instances where the present value of all charitable income interests (without regard to whether any deduction is allowed) exceeds 60 percent of the aggregate value of the net assets of the annuity lead trust computed on the date of valuation, the trust's governing instrument must prohibit not only the acquisition, but also the retention, of property, the acquisition of which would give rise to a tax under Section 4944.[137]

Grantor CLTs

If the grantor would benefit from a current income tax charitable contribution deduction, a CLT can be created that is taxed as owned by the grantor under the grantor trust rules. The result of such a CLT is that the CLT's income would be taxed to the grantor ("Qualified Grantor CLT").[138]

Although there are several ways to cause a trust to be treated as a grantor trust, most of the options cause undesirable results with respect to the requirements for a qualified CLT annuity or unitrust interest.

Section 673 taxes the grantor on trust income if the grantor has a reversionary interest with value greater than 5 percent of the value of the trust assets at the time assets are transferred to the trust. If the reversion is held by grantor's spouse, the same result obtains.[139]

Commentators generally conclude that retaining a reversion is the preferred way to secure grantor trust treatment for a CLT.

If a CLT is a qualified grantor CLT, an income tax deduction is available for the present value of all distributions payable to charity.[140] The gift is considered "for the use of" the charity, so the 30 percent or 20 percent limits apply.[141]

For each year thereafter, the grantor will be taxed on all items of income attributable to the trust.

Determining whether the grantor tax treatment of the CLT is desirable is a matter of comparing the value of the current deduction to the deferred income tax liabilities during the term of the trust.

One option is to have the trust invest in nontaxable assets so that the trust would have no net taxable income, avoiding problems from the mismatch of all trust income being taxed to the grantor, even though the income would be distributable to the charity, not the grantor.

If the trust ceases to be a grantor trust due to the grantor's death or otherwise, there is a recapture of the excess deduction taken over the deduction that would have been allowed had the trust term been clearly known.

The grantor is treated as having received, as of such date, income equal to the amount of any deduction that was previously allowed less the discounted value of all amounts that were required to be, and actually were, paid to charitable beneficiaries.[142]

Instead of defining the charitable interest as a qualifying annuity or unitrust interest, a CLT can provide that charity will receive "all net income." With this type of nonqualifying, nongrantor CLT, the grantor is not entitled to an income or gift tax charitable contribution deduction. This is because the charitable interest is not qualified.

However, the trust's income is not taxed to the grantor and the trust qualifies for an unlimited income tax deduction for the full amount passing to charity.[143] The result is that the grantor gets the benefit of an unlimited charitable deduction.

In addition, the CLT will not be subject to the private foundation rules.[144] The ability of the nonqualified nongrantor CLT to avoid application of the private foundation rules may make this trust a

useful option when the excess business holdings rules present problems.

Operating a CLT as the Family's Charitable Pocketbook

A grantor can authorize the trustee of a CLT to sprinkle the lead interest among qualifying charitable beneficiaries.[145] As discussed in PLR 200240027, this flexibility offers interesting applications.

In PLR 200240027, the donors (a husband and wife) created three irrevocable charitable lead unitrusts. At the end of the charitable terms, the trusts were to continue for the benefit of each of their three children. They appointed one of their children as the initial trustee of each trust.

Assuming there was no understanding, express or implied between the donors and the trustee regarding the disposition of the amounts received by the trusts, the Service concluded that no portion of the assets of the trusts will be included in either grantor's gross estate for federal estate tax purposes.

CLTs: Funding Family Foundations; Application of Self-Dealing Rules to CLTs

Until further guidance is given, income distributions received by a private foundation from a nongrantor charitable lead trust will not be included in determining the private foundation's distributable amount for the year the amount is received.[146] This provides flexibility with respect to private foundation minimum distribution requirements.

In PLR 200124029, the Service ruled that funding a CLT with a promissory note was not self-dealing. Specifically, the eventual receipt and holding of a promissory note by the CLTs, and the subsequent payment of principal and interest on the note by disqualified persons would not constitute acts of self-dealing under Section 4941(d).

Further, the continued operation of the real estate business that was supporting payment of the note by family members also would not constitute acts of self-dealing.

In PLR 200018062, the Service evaluated the participation of a CLT as a limited partner in a limited partnership in which other family members and trusts connected to the grantor of the CLT were also partners.

The Service ruled that the CLT's retention of an interest and investment in the partnership was not a direct or indirect act of self-dealing, as defined in Section 4941(d)(1).

Further, payments by the CLT to the partnership for investment management and advisory services, and the reimbursement of the corporate general partner for costs and expenses paid as the general partner would not constitute direct or indirect acts of self-dealing by the CLT, as defined in Section 4941(d)(1), or taxable expenditures, as defined in Section 4945(d)(5).

In addition, the CLT's limited partnership interest in the partnership would not constitute an excess business holding, as defined in Section 4943(c).

In PLR 200232033, the Service ruled that a delay in funding a CLT caused by protracted litigation was not self-dealing. Because of the litigation, the CLTs had not been funded, and the decedent's estate lacked sufficient liquid assets to fund the CLTs. Given the delay in funding, the CLTs owed substantial amounts to the charitable beneficiary.

The estate sought to fund the CLTs with property including certain related-party promissory notes that would be transferred to the charity to make up the arrearages.

The Service ruled that the proposed transaction to make up the arrearages met the estate administration exception described in Treasury Regulation Section 53.4941(d)-1(b)(3), and therefore, would not be an act of self-dealing.

PLR 199952093 involved a 20-year inter-vivos charitable lead annuity trust. The CLT had originally been funded with closely held bank stock. The bank was later acquired by a public company.

After the acquisition, the CLT had liquid assets, and the grantor, the trustees of the CLT, the foundation managers of the family foundation, and the four remaindermen all wanted to pay the CLT, in one lump sum, the remaining amount due to the CLT, without discount.

The Service ruled that prepayment of the entire remaining charitable interest without discount to the family foundation as the sole charitable beneficiary of CLT would not constitute the termination of the private foundation under Section 507, or an act of self-dealing under Section 4941. This is because the foundation was not a disqualified person. In addition, prepayment would not be a taxable expenditure under Section 4945.

Back-Loaded Charitable Lead Annuity Trusts, aka Shark-Fin CLATs

In Revenue Procedure 2008-45,[147] and Revenue Procedure 2008-46,[148] the Service issued sample inter vivos and testamentary charitable lead trusts with annotations.

These forms do not impose any particular requirements on the annuity payout schedule. This flexibility allows a CLT to be constructed with back-loaded payments.

In annuity trusts, back-loaded payments are desirable, conceptually, because so long as a dollar remains in the CLAT, any amounts earned in excess of the Section 7520 rate are captured for the remainder beneficiaries rather than the charitable beneficiaries.

As an illustration, let's assume a Section 7520 rate of 3.2 percent. A trust funded with $1,000,000 that paid $1,000 per year for 19 years to charity, followed by a payment at the end of the 20th year of $1,852,000 would "zero out."

If total annual return on the CLAT assets is 5.45 percent, the entire original $1,000,000 will remain at the end of the 20-year period. If the rate of return were 7 percent then almost $2,000,000 would remain.

Longer periods will yield striking results. For example, a 50-year trust funded with $1,000,000 may need to pay $4,800,000 in the 50th year, in addition to minimal payments in each of the first 49 years. Such a trust that grew at 5.45 percent could have $9,000,000 remaining after all payments were made.

The financial consequences of such long terms, however, may be unpredictable. Let's suppose a charity with the right to receive $1,000 per year for 49 years and $4,800,000 in year 50 were approached by a buyer acting independently of the original donor, to conduct an arm's-length negotiation and potential transaction.

If such a charity were conservative, and anticipated earning only 5 percent a year, on average, over the 50-year term, the charity might consider selling its annuity interest for $420,000, plus a reasonable profit.

Let's consider whether the remainder beneficiaries of such a trust would be interested in purchasing the annuity interest for something in the range of $420,000 to $450,000.

As suggested by the example above, Shark-Fin CLATs may be quite attractive for charitably disposed clients who want to shift assets to remainder beneficiaries without paying gift taxes.

Assignment of Income Issues and Prearranged Redemptions

As mentioned briefly above, considerable care should be taken to avoid any "prearranged redemptions" resulting in taxation to the donor of any capital gain realized on the redemption.

In *Palmer v. Commissioner*,[149] the Tax Court held that a taxpayer's gift of stock in a closely held corporation to a private foundation, followed by a redemption of the stock, would not be characterized as a sale or redemption between the taxpayer and the corporation followed by a gift of the redemption proceeds to the foundation. This is because the foundation was not legally obligated to redeem the stock at the time it received the shares.

In Revenue Ruling 78-197,[150] the Service announced that it would treat the proceeds of a stock redemption under facts similar to those in the *Palmer* case as income to the donor only if the donee is legally bound or can be compelled by the corporation to surrender the shares for redemption.

Revenue Ruling 78-197 was also applied in *Rauenhorst, et ux. v. Commissioner*.[151] In that case, the government unsuccessfully argued that the "bright-line" rule of Revenue Ruling 78-197 was not controlling.

The Tax Court noted that "the Commissioner's revenue ruling has been in existence for nearly 25 years, and it has not been revoked or modified. No doubt taxpayers have referred to that ruling in planning their charitable contributions, and, indeed, petitioners submit that they relied upon that ruling in planning the charitable contributions at issue. Under the circumstances of this case, we treat the Commissioner's position in Revenue Ruling 78 197, 1978 1 C.B. 83, as a concession."

Following the *Rauenhorst* decision, the government reiterated its intention, generally, to follow its own rulings in litigation.

Likewise, PLR 200321010 also found favorably for the taxpayer (a retired officer of a corporation intending to give shares of the corporation to a CRUT). This is because there was no legally binding obligation between the trust and the corporation to redeem the stock.

Accordingly, the Service concluded that the transfer of the stock to the CRUT, followed by any subsequent redemption of the stock, would not be recharacterized for federal income tax purposes as a redemption of the stock from the CRUT grantor, followed by a contribution of the redemption proceeds to the CRUT.

It found that the same principles would apply if the stock were sold by the CRUT, rather than redeemed by the corporation, as long as there was no prearranged sale contract.

Any redemption proceeds or sales proceeds received by the CRUT for the stock would not be treated as taxable income received by the CRUT grantor.[152]

Disclaimer to a Charitable Fund

The estate tax charitable deduction is allowed for an amount that becomes (or is added to) a charitable bequest or transfer as a result of a "qualified disclaimer" under Section 2518. Where the disclaimer is described by a formula, significant tax savings may be achieved as well as a form of "audit insulation."

This issue was litigated to a taxpayer-favorable result in *Estate of Helen Christiansen v. Commissioner*,[153] a reviewed Tax Court opinion that was affirmed by the Eighth Circuit on November 13, 2009.[154]

Mrs. Christiansen died leaving everything to her only child, Christine Hamilton. Any amounts Christine Hamilton disclaimed would go 75 percent to a charitable lead annuity trust and 25 percent to a private foundation.

Ms. Hamilton disclaimed a fraction of the estate the numerator of which was the fair market value of the estate, before payment of debts, expenses, and taxes, less $6,350,000, and the denominator of which was the fair market value of the estate, before payment of debts, expenses, and taxes.

The government argued that the disclaimer to the foundation should generate an estate tax charitable deduction only for the amount originally set forth on the estate tax return, not the amount agreed to after audit. The Court disagreed.

The government first argued that the increased amount passed as a result of a contingency—the Service audit increasing the value of the estate—but the Court noted that merely because "the estate and the Service bickered about the value of the property being transferred doesn't mean the transfer itself was contingent in the sense of dependent for its occurrence on a future event."

The government also argued public policy, *Procter* like, grounds for disallowing an increased charitable deduction. The majority opinion in the Tax Court rejected that contention holding: "This case is not *Procter*. The contested phrase would not undo a transfer, but only reallocate the value of the property transferred among Hamilton, the Trust, and the Foundation."

The Circuit Court also emphatically rejected the argument that fixed-dollar-amount partial disclaimers interfered with the ability to audit estates. Instead, the Circuit Court found that allowing these sorts of disclaimers supported the broad public policy of encouraging charitable donations.

The idea of creating a charitable fund controlled by descendants has long been used in planning for the wealthiest families. Recently, refinements in the idea have made the idea useful for families of more moderate wealth.

The issue for the parent and the descendant is: Would the descendant be better off with a charitable fund, unreduced by estate or gift taxes, or with a personal fund from which estate or gift taxes have been paid?

Let's consider this illustration that assumes a combined 50 percent federal and state bracket for both estate and generation-skipping tax. A parent must begin with $200,000 in order to set aside $100,000 for a child's use. Is the child better off with a charitable fund of $200,000 or a personal fund of $100,000?

Similarly, in order to generate $100,000 in a personal trust for a grandchild, a grandparent must begin with about $300,000 in order to pay estate tax of about $150,000 and generation skipping tax of about $50,000 (on a tax-exclusive basis).

Would the grandchild be better off with a charitable fund of $300,000 or a personal fund of $100,000?

The economic circumstances of the descendants are the most important variable in answering these questions. If the child or grandchild will inherit only the assets in question, then a personal fund will almost certainly be more desirable.

In contrast, if the assets in question are only a small part of the total inheritance, then a charitable fund becomes more attractive. Other factors to consider include the position of the descendant in the community, the family situation of the child or grandchild, and (perhaps) the economic circumstances of the spouse of the child or grandchild.

Older generations are often very concerned that descendants be treated fairly. Where one descendant, or group of descendants, may like a charitable fund but another would not, a charitable fund is often not created. This "lowest common denominator" estate planning can be combated through a charitable fund created by disclaimer.

Under this approach, a parent or grandparent provides for a sum to be set aside for the child or grandchild that will bear its own estate and generation skipping taxes (if any).

If the child or grandchild disclaims the sum, the sum passes into a charitable fund (perhaps named for the child or grandchild), the income from which can be "used" on an annual basis for charitable giving.

The child or grandchild has a choice: accept the sum as a bequest or disclaim it into a charitable fund (or disclaim only part). If the child or grandchild disclaims, then the amount disclaimed passes

into the charitable fund free of estate or generation-skipping tax.

If the child or grandchild accepts the bequest, then all applicable estate and generation skipping taxes are paid from the bequest.

Each child or grandchild may make his or her own decision and each decision affects only such child or grandchild. To insulate the strategy—to some degree—against failure to follow disclaimer formalities, it may be prudent to establish a specific sum as to which the disclaimer may apply—the child or grandchild may receive income from the general assets of the estate during the initial nine-month period without jeopardizing the disclaimer.

The charitable fund may be created either in a private foundation or as a donor-advised fund in a community foundation.[155] In most instances, the donor-advised fund is preferable.

The Service has required that the disclaiming party not vote as a member of the board of the community foundation on any distribution from the charitable fund created with the disclaimed assets.[156]

Conclusion

By remaining mindful of the income and transfer tax framework for charitable giving, advisers will increase the value they provide for clients owning closely held businesses. Although the governing statutes and regulations are complex, they offer many opportunities to integrate client objectives for philanthropy, business succession, and minimizing transfer taxes.

At present, interest rates are near historic lows—a condition that may not last. Many of the strategies discussed in this outline (particularly gifts to split-interest trusts) are more attractive in a low interest rate environment. For that reason, now is a particularly opportune time for integrated business succession, charitable, and tax planning.

Notes:

1. Section 170(b)(1)(A)-(B).
2. Section 170(b)(1)(c)(iv); Section 1221.
3. Section 170(b)(1)(C).
4. Section 170(b)(1)(D).
5. Section 170(b)(1)(C); Section 170(e)(1)(B).
6. See *Commissioner v. Withers*, 69 T.C. 900 (1977).
7. Section 170(e)(1)(B)(iii); Treas. Regs. § 1.170A-4(a)(2)-(3).
8. Section 170(e)(5).
9. Section 170(e).
10. Treas. Reg. § 1.170A-4(d) (ex. 2).
11. For instance, in *Ford v. Comm'r*, T. C. Memo 1983-556, a partnership owned an underwater craft, the Aegir, the contribution of which to charity would have created no income tax deduction because it was fully depreciated ordinary income property. The partnership created a corporation (with one share of stock, owned by the partnership), transferred the Aegir to the corporation and, the same day, gave the share of stock to charity. The court found there was no business purpose for the corporation but rather it was a sham and conduit for tax avoidance purposes.
12. Section 2522(d).
13. *Welch v. Halvering*, 290 U.S. 111 (1933); Lamphere, 70 T.C. 391 (1978). See also *Holtzman*, 40 T.C.M. 350 (1980).15.
14. Treas. Regs. § 1.7520, § 20.7520, § 25.7520. See IRS Publication 1457, *Actuarial Values, Alpha Volume* and IRS Publication 1458, *Actuarial Values, Beta Volume*. With respect to the interest rate component, the § 7520 valuation tables are based on the interest rate that the Service announces monthly in a news release and publishes in the *Internal Revenue Bulletin*. This rate is 120 percent of the applicable federal midterm rate compounded annually (rounded to the nearest two-tenths of one percent) in effect under section 1274(d)(1) for the month in which the valuation date falls.
15. Treas. Regs. §§ 1.7520-3(b)(1)(ii)-(iii), 20.7520-3(b)(1)(ii)-(iii), 25.7520-3(b)(1)(ii)-(iii).
16. An individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within one year. An individual who survives for eighteen months after a transfer is presumed not to have been terminally ill at the time of the transfer, "unless the contrary is established by clear and convincing evidence." Treas. Regs. §§ 1.7520-3(b)(3), 20.7520-3(b)(3), 25.7520-3(b)(3).
17. Treas. Regs. § 20.7520-3(b)(2)(v) (Exhibits 2 and 3).
18. 1966-2 C.B. 1257 (modified by Revenue Procedure 96-15, infra).
19. See also Treas. Reg. § 20.2031-6(a) (IRS not required to accept expert appraisals); IRS Pub. No. 561 (Rev. Dec. 88) (IRS may reject valuation of taxpayer's appraiser); *Estate of Roberts v. Commissioner*, 28 T.C.M. 40, 47 (1969) (opinion of taxpayer's appraiser upheld where appraiser highly qualified as to nature of paintings and object d'art in question); *Isbell v. Commissioner*, 44 T.C.M. 1143 (1982) (the opinion of taxpayer's appraiser discounted where appraiser not expert in appraising property in question (Han dynasty ceramic jar) and whose description of property not supported by facts); *Weil v. Commissioner*, 26 T.C.M 388 (1967) (the expert called by taxpayer knew little about painting or painter in question and, therefore, his testimony was discounted); *Posner v. Commissioner*, 35 T.C. Memo. 943 (1976) (IRS Art Advisory Panel valuation relied on where large discrepancy in appraisers' valuations.); *Furstenberg v. United States*, 595 F.2d 603 (Cl. Ct. 1979) (the credibility of art appraisers discussed, particularly one associated with IRS Art Advisory Panel).
20. Some taxpayers have successfully argued substantial compliance (see, e.g., *Bond v. Commissioner*, 100 T.C. 32 (1983)), but most of the reported decisions have required strict compliance. See, e.g., *Hewitt v. Commissioner*, 109 T.C. 258 (1997), aff'd 166 F.3d

332 (4th Cir. 1998); *D'Arcangelo v. Commissioner*, T.C. Memo. 1994-572 (1994).

21. Treas. Regs. § 1.170A-13(c).
22. The penalty is equal to the greater of $1,000 or 10 percent of the understatement of tax resulting from such a misstatement, up to a maximum of 125 percent. The penalty will not apply if the appraiser establishes that it was "more likely than not" that the appraisal was correct.
23. Section 6662(e).
24. Section 6662(h).
25. Section 6664(c).
26. Section 170(f)(8).
27. Treas. Regs. § 1.170A-13(f)(11).
28. Treas. Reg. § 1.170A-13(f)(15).
29. Treas. Reg. § 1.170A-13(f)(13).
30. Section 6050L.
31. In addition, if the person liable has previously been liable for a Chapter 42 tax, or if the transgression is both willful and flagrant; § 6684 imposes a penalty equal to the applicable tax. Effectively, when it applies, § 6684 doubles the applicable penalty.
32. Section 4942(g)(2)(B).
33. Section 4943(c)(7).
34. 15 F.3d 917 (9th Cir. 1994), aff'g 97 T.C. 534 (1991) (reviewed).
35. Rev. Rul. 72-552, 1972 2 C.B. 525; see also PLR 7929002; *Rifkind v. U.S.*, 5 Cl. Ct. 362 (1984).
36. See Treas. Regs. §53.4942(a) 2(c)(2)(i).
37. See, e.g., PLR 9108030, 9108036, 9101021, 9338046., 200720021, and 200521028.
39. "Disqualified supporting organizations" include Type III supporting organizations that are not "functionally integrated"; and Type I and Type II supporting organizations and "functionally integrated" Type III supporting organizations if a donor, donor advisor or related party controls a supported organization of such supporting organization; or the Secretary of the Treasury determines by regulation that a distribution to such a supporting organization is "inappropriate."
40. Section 4958(c)(2).
41. Section 4958(f)(1)(F); § 4958 (f)(8).
42. Section 4943(e).
43. See, e.g., PLR 9312024, 9042030, 9108024, 9112012, and 9350038.
44. See GCM 37731 and 37037; PLRs 8521122. In contrast, however, PLR 200635017 approved a transaction in which notes were contributed to a limited liability company that were then purchased through a transaction approved through the probate exception involving option agreements.
45. See, e.g., Sections 47-50; 751(a).
46. See, e.g., Rev. Rul. 60-352, 1960-2 C.B. 208.
47. See, e.g., § 752; Treas. Reg. § 1.752-1(d); Rev. Rul. 75-194, 1975-1 C.B. 80.
48. Section 511.
49. Sections 512, 513.
50. Section 512(b).
51. Section 512(c).
52. Section 512(b)(3)(B)(ii).
53. Sections 514(a), 514(c)(1).
54. Section 514(c)(2)(A).
55. Section 514(c)(2)(B).
56. Section 514(c)(2)(B).
57. Section 14(b)(1)(A).
58. Treas. Reg. §1.1001-2(a)(1).
59. Treas. Reg. § 1.1001-2(a)(4)(i).
60. Treas. Reg. § 1.1001-2(a)(4)(iii).
61. Treas. Reg. § 1.1001-2(c) Ex. (6).
62. Treas. Reg. § 1.1011-2(a)(3).
63. Section 752(d); Treas. Reg. §1.1001-2(a)(4)(v).
64. Rev. Rul. 75-194.
65. See, e.g., PLR 9241064; Rev. Rul. 78-395; PLR 8932042.
66. See, e.g., *Gershman Family Foundation*, 83 TC 217 (1984), where the foundation was created after the lien was placed on the gifted property.
67. Section 4946(a)(1)(F).
68. Treas. Reg. § 53.4941(d)-1(a).
69. GCM 39445.
70. Treas. Reg. § 53.4941(d)-1(a).
71. Section 4946(a)(1)(G).
72. The 35 percent analysis should be undertaken conservatively. It is unwise to rely on delaying funding of the foundation until after family bequests are paid, or to rely on the existence of funded inter vivos revocable trusts to shelter assets passing to the family.
73. PLR 200724023.
74. Section 4941(d)(1)(E).
75. Section 1361(b)(1)(B); § 1361(c)(6).
76. It is unclear clear whether the rule covers all appreciation (§ 751(a)), or merely "substantially appreciated" inventory (§ 751(b)), inventory with a market value more than 120 percent greater than its basis.
77. Section 751(c).
78. I.R.C. Section 512(e).
79. I.R.C. Section 512(e)(1)(B)(kk).
80. See, e.g., Treas. Reg. § 1.512(b)-1(g)(3).
81. Section 1361(e)(1)(A)(k)(III).
82. Section 1361(e)(1)(B).
83. Section 641(d)(2)(C).
84. See Treas. Reg. § 1.641(c)-1(d).
85. I.R.C. Section 170(b)(2). Computed without regard to certain special deductions for corporations under §§ 241, 243-247, and 249, any net operating loss carrybacks (§ 172), and any capital loss carryback (§ 1212(a)(1).
86. Section 1366(a)(1).
87. Section 702(a)(4).
88. 1996-1 C.B. 140.
89. 2004-3 IRB 295.
90. This ruling does not state how the trust came to be a partner, and it leaves open the question whether a trust with no charitable beneficiaries may become a partner in a partnership which allows charitable contributions without the consent of the trust partner.
91. Treas. Reg. § 1.337(d)-4(a)(1).
92. Treas. Reg. § 1.337(d)-4(a)(2).
93. Treas. Reg. § 1.337(d)-4(c)(2).
94. Section 170(f)(2)(B); Treas. Reg. § 1.170A-6(c)(2)(i) (A).

95. Treas. Regs. §§ 1.170A-6(c)(2); 20.2055-2(e)(2); 25.2522(c)-3(c)(2); Rev. Rul. 85-49, 1985-1 C.B. 330; PLR 1997-21006.
96. Sections 170(f)(2), 2055(e)(2)(B), 2522(c)(2)(B).
97. Treas. Regs. §§ 1.70A-6(c)(2)(i); 20.2055-2(e)(2)(vi) and 25.2522(c)-3(c)(2)(vi).
98. *Crown Income Charitable Fund v. Comm'r.*, 98 T.C. 327 (1992) aff'd, 8 F.3d 571 (7th Cir. 1993) pro; see also Rev. Rul. 88-27, 1988-1 C.B. 331; PLR 9734057.
99. Treas. Regs. §§ 1.170A-6(c)(2)(i)(E) and 1.170-A-6(c)(2)(ii)(D).
100. But see PLR 1993-04020.
101. Treas. Regs. §§ 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi)(a) and 25.2522(c)-3(c)(2)(vi)(a).
102. Rev. Rul. 77-300, 1977-2 C.B. 352; PLR 7918102.
103. Treas. Regs. §§ 1.170A-6(c)(2)(ii)(A), 20.2055-2(e)(2)(vii)(a) and 25.2522(c)-3(c)(2)(vii)(a).
104. Treas. Regs. §§ 1.170A-6(c)(2)(ii); 20.2055-2(e)(2)(vii) and 25.2522(c)-3(c)(2)(vii).
105. PLR 8104213; PLR 9721006.
106. 78 T.C. 523 (1982).
107. T.D. 9068 (July 3, 2003).
108. Rev. Rul. 77-97, 1977-1 C.B. 285.
109. Sections 170(f)(7), 2055(e)(3) and 2522(c)(4).
110. Section 170(f)(2)(B); Treas. Reg. § 1.170A-6(c).
111. Sections 671-678.
112. Section 2522(c)(2)(B).
113. Treas. Reg. § 25.2511-2(b)-(c).
114. PLR 8130033.
115. See PLRs 200138018; 200108032, 200030014. Payments to a donor advised fund operated by the charitable recipient are discussed in PLRs 200010036 and 200009048.
116. Section 2055(e)(2)(B).
117. I.R.C. Section 2037.
118. See IRS Pub. 1457.
119. Treas. Regs. §§ 1.170A-6(c)(3); 20.2055-2(f)(2) and 25.2522(c)-3(d)(2).
120. Section 2651(f)(3).
121. Section 2603(a)(2).
122. Section 2642(e).
123. PLR 200107015, which concerned an assignment of an interest in a charitable lead annuity trust, illustrates the difficulties and risks of using a CLAT to benefit grandchildren.
124. Section 661.
125. Section 642(c)(1).
126. Sections 681 and 512(b)(11).
127. Rev. Rul. 71-285, 1971-2 C.B. 2487.
128. Section 6654(1).
129. Section 644.
130. Section 644(b).
131. The returns are filed on or before April 15th of the year following the year with respect to which the returns are filed.
132. Treas. Reg. § 1.514(c)-1(a)(1)(iii).
133. But see Rev. Rul. 74-19, 1974-1 C.B. 155.
134. Sections 508(d)(2) and 4947(a)(2).
135. See Rev. Rul. 75-38, 1975-1 C.B. 161 and Treas. Regs. § 508-3(d).
136. Section 4947(b)(3).
137. PLR 8241098.
138. Treas. Regs. §§ 1.170A-6(c)(2)(i)(D), 20.2055-2(e)(2)(vi)(e) and 25.2522(c)-3(c)(2)(vi)(e).
139. Sections 671-679.
140. Section 672(e).
141. Section 170(f)(2)(B).
142. Section 170(b)(1)(B)(i).
143. Section 170(f)(2)(B); Treas. Reg. § 1.170A-6(c)(4).
144. Section 642(c).
145. Section 4947(a)(2)(A).
146. Note, however, that if the power is held by the grantor or the grantor's spouse the grantor may be treated as the owner for income tax purposes. § 674(a). If the grantor retains the power, the value of the CLT will be included in the grantor's estate for estate tax purposes. §§ 2036(a)(2); 2038(a)(1).
147. Notice 2004-36, C.B. 2004-19 at 889. See also Notice 2004-35, C.B. 2004-19 at 889.
148. 2008-30 IRB 224.
149. 2008-30 IRB 238.
150. *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.
151. 1978-1 C.B. 83.
152. *Rauenhorst, et us. v. Commissioner*, 119 T.C. No. 9 (2002).
153. See also PLR 200821024.
154 *Estate of Helen Christiansen v. Commissioner*, 130 T.C. No. 1 (2008).
155. 2009 WL 3789908.
156. The latter mechanism is more flexible. This is because of the disclaimer-related rule that the disclaiming party may not direct the ultimate disposition of the disclaimed funds. The child or grandchild who has disclaimed assets that then pass to a charitable foundation must ensure that he or she does not control the distribution of the assets or the income from them. The Service discussed the limited role the disclaiming party may play in PLR 9320008.
157. See PLR 200518012; PLR 9532027.

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