CHARITABLE PLANNING COMPROMISE OPTIONS

Donor Advised Funds, Private Foundations and Charitable Lead Trusts

Scott Blakesley

Spencer Fane LLP
1000 Walnut, Suite 1400, Kansas City, Missouri 64106
Phone: (816)292-8268 -- E-mail: sblakesley@spencerfane.com

ACTEC
Heart of America Fellows Institute

November 29, 2018

I. INTRODUCTION

A. Importance of Having the Charitable Discussion with Clients.

1. Estate Planning should involve all aspects of a person's situation, including any charitable activity or intent.

2. Sometimes clients won't initiate the discussion about their charitable intent – and sometimes they do not even understand what this means until the right questions are asked. Consequently, charitable planning is often overlooked as a topic of discussion because the advisor may not be comfortable with the area and would prefer to avoid the whole subject.

3. Similarly the planned giving side of charitable giving is often not addressed by the person responsible for charitable fundraising, because the focus is so often on current giving and current needs.

4. Discussion with the client needs to be more than simply asking the question: "Do you want to include a bequest to charity in your Will/Trust?" It should develop as part of the overall discussion of what the client wants or needs to have happen with respect to financial matters and the future division and disposition of assets.

5. Not all clients will include provisions for charity as part of their estate plans, but more will do so than might be expected -- if given the right opportunity.

B. Not Always a "Choice" Between Family and Charity.

1. Often, an estate planning attorney will consider the inclusion of charitable bequests in a Will or Trust as a choice the client must make between giving to family or giving to charity.

2. Although sometimes it is a choice, often the charitable provisions can be seen by the client as a way to coordinate the desire to provide financial benefit to family members with a feeling that they would like to "make a difference" in the world, and be remembered after they are gone.

3. These materials discuss three alternatives to include charitable benefits in the plan while maintaining the involvement of family members.

C. The Question of How Much is "Enough" for the Family?

1. Sometimes, the motivation to leave assets to charity is not driven by charitable intent as much as by a fear of leaving too much to the family – and the client begins asking the question "how much is enough?"

2. People are starting to realize that there is a responsibility for how wealth is left to the next generation. Often, there is concern that giving descendants "too

much" will spoil them, and result in the family members not having any motivation to provide for their own support.

3. In situations like this, the charitable provisions may be a "default" alternative to leaving the assets directly for the family.

4. The techniques covered by these materials can be an effective way to accomplish these goals of keeping the family engaged but not financially spoiled.

5. Of course, the determination of how much is "enough" or "too much" varies from family to family, and person to person. The specific amount is not as important to understand as the general idea that there may be such a limit.

4. When the "charity" involved with an estate plan is a Private Foundation or Donor Advised Fund, the charitable bequest may be viewed by the client in a new light. The client may see this as a nice compromise, because the charitable bequest does not take the assets away from the family, but merely "earmarks" some portion of the assets for charitable purposes, to be determined in the future by the family.

II. DONOR ADVISED FUNDS

A. General Description.

1. A Donor Advised Fund is a charitable fund established with a public charity. Usually the public charity is a Community Foundation, but more recently other types of non-profit and for-profit entities have started to sponsor donor advised funds (such as Charitable Funds established by Fidelity, Vanguard, Merrill Lynch and other investment companies). [For purposes of these materials, the entity that is managing the Donor Advised Fund will be referred to as the Sponsoring Charity.]

2. The IRS defines a Donor Advised Fund as "a separately identified fund or account that is maintained and operated by a section 501(c)(3) organization, which is called a sponsoring organization. Each account is composed of contributions made by individual donors. Once the donor makes the contribution, the organization has legal control over it. However, the donor, or the donor's representative, retains advisory privileges with respect to the distribution of funds and the investment of assets in the account." [Quoted from IRS web site at www.irs.gov.]

3. It is important to remember that a contribution to a Donor Advised Fund is actually a contribution to the Sponsoring Charity, and the assets then belong to and are officially controlled by the Sponsoring Charity.

4. However, the arrangement between the donor and the Sponsoring Charity is such that the donor (or other members of the donor's family, as designated) have the right to make recommendations as to how distributions will be made from the Fund for charitable purposes.

5. Although the recommendations are not legally binding on the Sponsoring Charity, they will almost always be followed (if reasonable) because this will encourage others to establish Donor Advised Funds with the Sponsoring Charity.

6. Some of the financial institutions that provide Donor Advised Funds will sometimes blur the legal status of the Fund and approach the arrangement as if the donor (or other designated advisors) have the right to direct the distributions to charity, but this fact has not seemed to cause any serious issues for the IRS.

B. **Tax Characteristics.**

1. For income tax and estate tax purposes, contributions to a Donor Advised Fund are generally treated the same as a contribution to a public charity.

2. Contributions during lifetime will permit a donor to claim a charitable income tax deduction based on the same rules and limitations as are applicable to other donations to a public charity (whereas Private Foundations have different rules applicable, as described below).

3. One exception to this general rule is in the case of a Charitable IRA Rollover under IRC §408(d)(8). The charitable rollover option is not available for a contribution from an IRA to a Donor Advised Fund.

4. Under current law, a Donor Advised Fund has no minimum annual distribution requirements and is not subject to the list of special limitations that apply to Private Foundation (such as self-dealing and excess business holdings, as further described below).

5. A Donor Advised Fund is not subject to the tax on net investment income that applies to Private Foundations. However, in almost every situation, a Donor Advised Fund will be charged an administrative fee by the Sponsoring Charity.

6. Traditionally, a Donor Advised Fund could not be used to satisfy an obligation of the donor, including the satisfaction of any prior charitable pledge. This was deemed as an improper personal benefit to the individual donor (satisfying a legal obligation). However, on December 4, 2017, the IRS released a Notice that describes proposed guidance being considered to permit such distributions if (i) the Sponsoring Charity makes no reference to the existence of any charitable pledge when making the distribution from the Donor Advised Fund (although references to the name of the person who advised on the distribution are permitted); (ii) no donor/advisor receives, directly or indirectly, any other benefit that is more than incidental on account of the distribution; and (iii) the donor/advisor does not claim a charitable contribution deduction for the distribution. [The Notice provides that donors and Sponsoring Charities may currently rely on the guidance in this Notice relating to fulfillment of pledges.]

C. Planning Considerations.

1. A Donor Advised Fund can be a cost effective method for funds (large or small) to be set aside for charitable purposes without significant legal or administrative costs that are normally associated with a Private Foundation (see below).

2. A Donor Advised Fund can usually be established in a very short period of time and does not involve complex documents, tax filings or legal or accounting fees.

3. A Donor Advised Fund does not require an annual income tax return to be filed by the Fund (the financial activities of the Fund are included in the annual tax filing done by the Sponsoring Charity.

4. Although a Donor Advised Fund is not subject to all the special rules or limitations applicable to Private Foundations, it can act very much like a Private Foundation for most families – when the only intention is to make future contributions to one or more existing public charities.

5. A Donor Advised Fund may not be the best choice if the donor intends for one or more family members to be directly employed by the Fund (in which case, a Private Foundation may be more desirable).

6. A Donor Advised Fund also may not be the best choice if the donor intends for the charity to initiate direct charitable activities and/or large fund-raising events. For example, a Donor Advised Fund is not designed to operate a food bank, sponsor educational travel, or provide scholarships (other than to support existing scholarship programs at educational institutions).

7. Sometimes clients will decide not to us a Donor Advised Fund simply because they don't want to give up legal control of the assets or decisions – even though the Sponsoring Charity will assure them that their wishes will be carried out in the Donor Advised Fund.

8. It is important to remember that, once the assets are in a Donor Advised Fund, they cannot be moved into a Private Foundation (while assets held in a Private Foundation can be moved into a Donor Advised Fund at a later date).

9. When a Donor Advised Fund is to be used and the client specific intentions as to how the funds are used or not used, such limitations (and other important provision) need to be incorporated into the documentation for the Fund – rather than simply relying on the "standard" version of these documents that may be provided by the Sponsoring Charity.

III. PRIVATE FOUNDATIONS

A. General Description.

1. Essentially, any charitable entity that does not qualify for some other status under the Internal Revenue Code will be treated as a Private Foundation. If a charitable organization cannot meet the "public support" tests under the Internal Revenue Code and Treasury Regulations, it will be treated as a Private Foundation. [The "public support" rules are beyond the scope of these materials.]

2. A Private Foundation is a trust or corporation that is operated exclusively for charitable purposes and/or to make distributions to established public charities.

3. If the Private Foundation is a trust, a Trust Agreement will govern the ongoing operation of the Private Foundation.

4. If the Private Foundation is a corporation (or an LLC treated as a corporation), Articles of Incorporation and Bylaws (or Operating Agreement, in the case of an LLC) will govern the ongoing operation of the Private Foundation. A corporation will also be subject to any specific state laws that may be applicable to not-for-profit corporations.

5. A Private Foundation may be subject to certain registration and compliance requirements under the laws of any state in which it is operating – and this is especially true if the Private Foundation will be involved in fund-raising efforts (although, usually, a Private Foundation does not solicit contributions from others outside the immediate family).

B. Tax Characteristics.

1. For purposes of the estate tax charitable deduction, a Private Foundation is treated like any other charitable organization.

2. For income tax purposes, contributions made to a Private Foundation are subject to special rules and limitations that don't apply to public charities (or Donor Advised Funds).

(a) The income tax charitable deduction for gifts of cash to a Private Foundation is limited to 30% of the donor's Adjusted Gross Income (AGI) for the year. [This is compared to a 60% AGI limitation for cash contributions to the other types of charitable entities.]

(b) The income tax charitable deduction for gifts of other assets is limited to 20% of the donor's AGI. [This is compared to a 30% AGI limitation for non-cash gifts to the other types of charitable entities.]

(c) The income tax charitable deduction for a contribution to a Private Foundation of an asset other than cash is limited to the income tax cost basis of the asset contributed, unless the asset is marketable securities. [Contributions to the other types of charitable entities are generally deductible up to the full fair market value of the asset contributed (regardless of cost basis).]

3. For any donation made a Private Foundation (including donations made by the person who created the Foundation and/or is acting as Trustee or Director), the Private Foundation should issue a receipt indicating that no goods or services were provided in exchange for the donation. Otherwise, the donor will not be allowed a charitable income tax deduction.

4. Private Foundations are subject to a 1% or 2% tax on net investment income (the actual rate depends upon the extent of charitable donations made during the year). IRC §4940.

5. A Private Foundation must file an annual tax return (From 990PF) to report the assets of the Private Foundation, the amount of income subject to the tax on net investment income, and to provide other compliance information to the IRS.

6. In order to have the IRS confirm the tax exempt status, a Private Foundation must file Form 1023 with the IRS. The Form 1023 is due within 27 months after the Private Foundation is created. Meanwhile, the Private Foundation can continue operating as an IRC §501(c)(3)charity, and the eventual determination by the IRS is retroactive to the date of creation.

7. A Private Foundation cannot be used to satisfy an obligation of the donor, including the satisfaction of any prior charitable pledge. [The more lenient rules applicable to Donor Advised Funds have not been made applicable to Private Foundations.]

C. Other Special Rules Applicable to Private Foundations.

1. Private Foundations are subject to additional rules and limitations that don't apply to public charities (including Donor Advised Funds). Most of these rules are imposed in the form of significant excise taxes which make compliance with the limitations essentially mandatory.

2. Assets maintained in Private Foundations are subject to the self-dealing rules of IRC §4941. Generally, transactions are not allowed between the Private Foundation and any "disqualified person" (substantial contributor, family member, Trustee, etc.). A "self-dealing" transaction is disallowed even if the transaction is "fair" to the Foundation – or even if it is a "good deal" for the Foundation. There is an important exception for reasonable compensation paid for services rendered.

3. Private Foundations must make a minimum distribution to or for charitable purposes of at least 5% each year. IRC §4942. [This rule is designed to require Private Foundations to pay out the annual income, rather than accumulating it.

The 5% number is established as an arbitrary determination of the "income" of the Private Foundation, and the actual income of the Private Foundation is not relevant for this purpose.]

4. Private Foundations are subject to the "excess business holdings" rules of IRC §4943, which generally prohibit a Private Foundation from holding more than 20% of the voting rights over any entity, when combined with interests held by all disqualified persons.

5. A Private Foundation cannot make any investment in a manner that jeopardizes the carrying out of any of its exempt purposes. IRC §4944.

6. An excise tax is imposed on any Private Foundations that makes a "taxable expenditure." IRC §4945. For this purpose, a taxable expenditure includes any grant to an organization that is not a public charity, supporting organization or private operating foundation <u>unless</u> the Private Foundation exercises "expenditure responsibility" with respect to the grant, (i) to see that the grant is spent solely for the purpose for which it is made; (ii) to obtain full and complete reports from the grantee on how the funds are spent; and (iii) to make full and detailed reports to the IRS regarding such grants.

D. Planning Considerations.

1. A Private Foundation cannot receive a distribution from an estate or trust as a result of a disclaimer by a beneficiary unless the beneficiary also disclaims the right to be a Trustee or Director of the Private Foundation. Under IRC §2518, a person making a valid disclaimer cannot control the distribution following the disclaimer. [A distribution to a Donor Advised Fund is not subject to this disclaimer limitation even though the disclaiming beneficiary is an advisor to the Donor Advised Fund – because the beneficiary can have is no legal control over the Donor Advised Fund.]

2. A Private Foundation can provide compensation to a family member for services provided. This provides a planning opportunity for a client who wants a child to run the Private Foundation as such child's job (which can balance a situation where another child is paid for running the family's for-profit company).

3. A Private Foundation can redeem shares of stock held by the Private Foundation even if the Company is a disqualified person under the Private Foundation rules. The redemption can be done so long as the same redemption opportunity is provided to all other shareholders at the same time and subject to the same price and terms (even if none of the other shareholders decide to exercise the right).

4. Reasonable expenses of administering the Private Foundation are allowed, and can even be counted toward the 5% requirement minimum distribution each year. This provides an opportunity for a family to cover the costs of an annual meeting of the Trustees/Directors of the Private Foundation to discuss distributions and other administrative or policy matters. However, it is important that such expenses are reasonable and relate to the administration of the Private Foundation – rather than simply a substitute for a family vacation.

IV. CHARITABLE LEAD TRUSTS

A. General Overview.

1. A Charitable Lead Trust ("CLT") is an irrevocable Trust which provides an "income interest" to a charity for a period of years, after which the remainder passes to the non-charity beneficiaries. It is basically the opposite of a Charitable Remainder Trust (a subject being covered by other materials in this Institute), and it is important to realize that the tax consequences are significantly different.

2. The "income interest" in a CLT must be in the form of either (a) a fixed dollar amount ("Annuity Trust" or "CLAT") or (b) a fixed percentage of the assets valued each year ("Unitrust" or "CLUT").

3. The term of the a CLT can be either for a term of years (the usual situation) or for the life of a designated individual.

4. Usually, a CLT is created at death (through the provisions of a Will or Revocable Trust), although it is possible to create a CLT during lifetime (in the form of an irrevocable trust agreement).

5. <u>Example</u>: Fred's Revocable Trust Agreement includes a distribution of $1,000,000 to be held in a Charitable Lead Trust that provides for a 5% annual payment to XYZ Charity for a period of 15 years. At the end of the term, the remaining assets in the CLT are to be distributed to Fred's descendants (or could be continued in trusts for the benefit of Fred's descendants).

B. Income Tax Aspects.

1. A CLT is NOT a tax-exempt entity. The income tax rules applicable to CLTs are the same as the rules applicable to any other irrevocable trust. Even though the CLT is not tax-exempt, under the trust income tax rules of IRC §642(c), the CLT can claim an income tax charitable deduction for the amounts paid to charity each year.

2. Generally there is no income tax deduction for amounts contributed to a CLT. However, if the CLT is a "Grantor Trust" for income tax purposes, (i) the Grantor can claim an initial income tax deduction for the present value of the payments to be made to charity during the Term; and (ii) all future income of the CLT is taxable to the Grantor, and no further charitable income tax deductions are allowable.

4. For capital gain tax purposes, (a) if the CLT is created at death, the assets in the trust will have a new cost basis for income tax purposes; and (b) if the CLT is created during lifetime, the assets contributed to the CLT will continue with the same cost basis as in the hands of the Grantor. **The sale of appreciated assets in a CLT <u>does not</u> avoid the capital gains tax** (compare this to the rules for a Charitable Remainder Trust, which is income tax-exempt and can postpone or avoid such capital gains taxes for assets sold within the trust).

5. If any annuity or unitrust payment is satisfied with an asset other than cash (i.e. appreciated securities), the distribution is a taxable event for the CLT, just as if the CLT sold the asset to the charity for the amount of the distribution. [In most cases the income to the CLT will be offset by the income tax charitable deduction for making the distribution.]

C. Gift Tax Consequences of a CLT.

1. If the CLT is established during the Grantor's lifetime, there is a gift tax charitable deduction for the present value of the payments to be made to charity during the Term.

2. However, the present value of the remainder interest (passing to non-charitable beneficiaries) is a taxable gift on the date the CLT is created -- unless the remainder beneficiary is the Grantor.

3. The gift to the remainder beneficiary does <u>not</u> qualify for the gift tax annual exclusion, so the Grantor will be making a taxable gift equal to the value of such remainder interest (using part or all of the Tax Exempt Amount, with gift tax due on any excess amount).

D. Estate Tax Consequences of a CLT.

1. If the CLT is created during lifetime (and the Grantor is not the remainder beneficiary), the value of the CLT is not included in the Grantor's estate for federal estate tax purposes, which results in a reduction of estate taxes payable at the Grantor's death.

2. If the CLT is created at the Grantor's death, the Grantor's estate can claim a charitable estate tax deduction for the present value (at the Grantor's death) of the payments to be made to charity during the Term.

3. The value of the deductible portion of a CLT is affected by the length of the term and the Applicable Federal Rate ("AFR"). For both CLATs and CLUTs, the longer the Term, the greater the value of the charitable interest (which means a lower taxable remainder). The AFR makes little or no difference in the value of a CLUT, but can make a significant difference in the value of a CLAT -- when the AFR is lower, the value of the remainder interest (the taxable part of the transfer) is also lower.

4. With the right number of years, it is possible to "zero out" the value of the remainder interest in a CLAT, so that the remainder interest is at or close to $0; if the payout rate is high enough and/or the Term is long enough. Although you can't reach "zero" on a CLUT, you can get fairly close.

E. Planning Considerations with a CLT.

1. When the client's children have other sources of support, or when other portions of the estate are being (or have been) left to the children – a CLT can be

useful for some or all of the assets eventually intended to benefit grandchildren (or children in their post-retirement years).

2. A CLT can be considered a "compromise" for a donor/client who wants to benefit charity at death, but is not sure he/she is ready to remove the assets from the family permanently. The CLT provides an opportunity to let charity "borrow" the assets for a period of years, which are then continued for the benefit of the family.

3. A CLT is commonly used to benefit charity while providing for future appreciation to pass to family members, especially through the use of an Annuity Trust. The value is based on the value at the time of creation, and most of the future appreciation will generally pass to family members without additional transfer taxes.

4. A CLT can be particularly useful for assets that are already discounted for estate and gift tax purposes, such as a family business interest or investment limited partnerships (or LLC). Although the transfer tax value of the business interest is discounted, the underlying asset value has not changed. The charitable deduction is based on the discounted value, but the underlying assets will still generate an investment return without regard to the valuation discount.

<u>Example</u>: Assume a CLUT is funded with Limited Partnership interests, which may be discounted by 25% (or more) for estate tax purposes. The "real" value of the CLT assets may be $1,000,000, but the discounted value is only $750,000. If the payout rate is 10%, this is applied against the discounted value to require an annual payment to charity of $75,000. When this payment is compared with the "real value" of the trust assets, the $75,000 annual payment will only require a 7.5% rate of return.

5. CLTs are well-suited for Generation Skipping planning where the general goal is to provide for some future benefit to family members. The client can provide an immediate benefit to charity in the form of initial payments from the CLT while the balance of the assets in the CLT will pass to descendants in the future, when the need is expected to be greatest. However, it is important to remember the following distinction in allocating the GST Exemption (currently $11,180,000) to a CLT:

a. When a Charitable Lead <u>Unitrust</u> is created, the GST Exemption can be allocated immediately to the taxable portion of the trust (after deducting the present value of the charity's "income" interest).

b. When a Charitable Lead <u>Annuity Trust</u> is created, the GST Exemption is allocated initially to the taxable portion of the trust (after deducting the present value of the charity's "income" interest). <u>However</u>, the impact of allocating the GST Exemption will not be known until after the end of the Term. Each year of the CLAT, the amount of the GST Exemption allocated to the trust is increased by the same percentage rate as was used to value the CLAT initially. At the end of the Term, this adjusted Hypothetical GST Exemption is applied against the actual value of the CLAT assets to determine the GST exempt portion of the trust. It is unlikely that the value of the CLAT assets at the end of the Term will exactly match the Hypothetical GST

Exemption, and the result will either be a waste of GST Exemption or a trust that is part exempt and part non-exempt for Generation Skipping Tax purposes.

c. Consequently, it is almost always better to use a CLUT (rather than a CLAT) when GST planning is involved.

6. When considering a CLT for tax planning purposes, always consider the alternative of an outright charitable bequest equal to the estate tax charitable deduction that would be allowed through the use of the CLT. The estate tax consequences are the same, and the family and the charity may be able to avoid the "complications" associated with the creation and administration of a CLT.