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in the Emerald City

◆ CONFERENCE PROCEEDINGS ◆



25TH CONFERENCE ON GIFT ANNUITIES

APRIL 10-12, 2002 • SHERATON SEATTLE HOTEL & TOWERS

PRESENTED BY THE AMERICAN COUNCIL ON GIFT ANNUITIES

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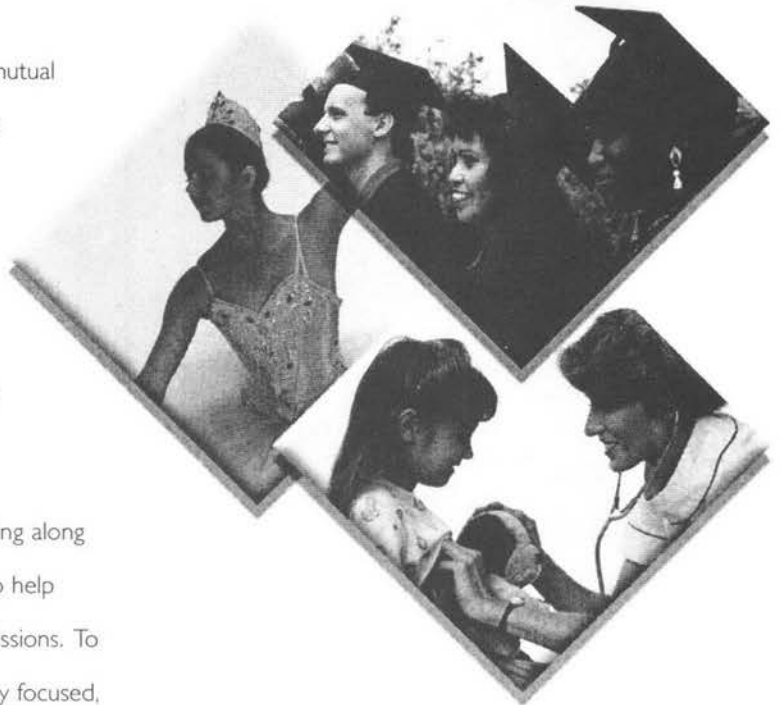
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25TH CONFERENCE ON GIFT ANNUITIES



Sparkling Ideas in the Emerald City!

CELEBRATING 75 YEARS OF SERVICE!

In March 1927, the Federal Council of the Churches of Christ in America approved the appointment of a continuing subcommittee on annuities “to study and recommend the proper range of rates, the form of contracts, the amount and type of reserve funds and the nomenclature to be used, to ascertain and advise as to the legislation in the United States and the various states regarding annuities, their taxability, etc.” In April of the same year 47 delegates assembled in New York City to resolve those very issues. From this simple gathering the Committee on Gift Annuities and its successor, the American Council on Gift Annuities, was born.

Seventy-five years later, the Council still carries out that original mission. Through years of growth, change, turmoil and triumph, that mission remains essentially unchanged. Through the evolution of what we now call “planned giving,” ACGA has been at work providing research and educational services, as well as ethical practice guidance. Through a maze of ever-changing state regulation, the Council strives to keep our nation’s charities informed and in compliance. Through unpredictable economies and donor trends, ACGA’s suggested gift annuity rates have proven to serve the best interests of all parties involved. And, through nearly five years of harsh litigation, the Council, its sponsors, and charities everywhere prevailed.

The 25th Conference on Gift Annuities will be a silver celebration of ACGA’s accomplishments. The oldest planned giving conference in the country continues to grow in attendance and significance. What was once a gathering of less than 50 representatives of religious and church-related organizations has grown to an assembly of more than 800 professionals representing every category of charity in the country. The exciting Emerald City - Seattle, Washington - will serve as a picturesque backdrop for this significant event.



*A Silver Celebration!
A Diamond Jubilee!
Sparkling Ideas...
in the Emerald City!*

2002 CONFERENCE COMMITTEE

Cam Morin Kelly, *Chair*
Joseph O. Bull
Robert L. Coffman
Elaine D’Amours
Lindsay L. Lapole
Betsy A. Mangone
Frank D. Minton
Laurie W. Valentine
Jeffrey K. Wilson

CONFERENCE STAFF

Gloria Kermeen
Tamara Kitchens
Kay Ramsey
Kurt A. Reusze

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◆ CONFERENCE AGENDA ◆



WEDNESDAY, APRIL 10

- 8:00 am – 6:00 pm Registration
- 12:00 Noon Exhibits Open
- 9:00 am – 3:00 pm Basics Course
- ◆ **Fundamentals of Planned Giving Vehicles & Programs**
Presented by: Betsy A. Mangone
- 3:15 pm – 5:00 pm Tax Symposium
- ◆ **Putting the Texas in Taxes: The Bush Tax Agenda and What It Means for Philanthropy**
Moderator: Terry Simmons
Panelists: Jerry McCoy & Wendy Goffe
- 6:00 pm Reception/Gathering in Exhibit Area
- 6:30 pm Opening Dinner
- ◆ **ACGA Chairman's Address**
Clinton A. Schroeder
 - ◆ **Keynote Address**
Ron Sims, County Executive, King County, Washington

THURSDAY, APRIL 11

- 8:30 am – 9:45 am Morning Breakouts
- ◆ **Track I**
Understanding Gift Annuities
Elizabeth Brown
 - ◆ **Track I**
Lead Identification & Qualification in the Internet Age
David M. Lawson
 - ◆ **Track II**
Pitfalls and Possibilities: Case Studies
Robert E. Harding
 - ◆ **Tracks II & III**
Structuring Charitable Gifts of IRAs
Jeremiah Doyle
 - ◆ **Tracks II & III**
Private Foundations vs. Supporting Organizations vs. Donor Advised Funds
David Wheeler Newman
 - ◆ **Tracks II & III**
Investment of Planned Gifts: Protecting the Interests Of All Parties
Eric Swerdlin

THURSDAY, APRIL 11

- ◆ **Track III**
To Outsource Or Not To Outsource: That WAS Our Question
Chris Yates
 - ◆ **Track IV**
Women's Philanthropy: Gender Differences in Planned Giving
Cindy Sterling
- 9:45 am – 10:15 am Refreshment Break in Exhibit Area
- 10:15 am – 11:30 am Repeat Morning Breakouts
- 11:45 am Plenary Luncheon
- ◆ **Gift Annuity Rates and New Developments**
Speaker: Frank Minton
- 1:30 pm – 2:45 pm Afternoon Breakouts
- ◆ **Track I**
Cultivating and Maintaining Long Term Donor Relationships
Joseph O. Bull
 - ◆ **Tracks I & II**
Working With Allied Professionals
Moderated by Clinton Schroeder
Panelists: Judy Courshon, Frank Ellsworth & Malcolm Moore
 - ◆ **Track II & III**
Selecting Planned Giving Officers
Jack Goodner
 - ◆ **Tracks II & III**
Venture Philanthropy
Erin Hemmings
 - ◆ **Tracks II & III**
CRTs – Does This Old Dog Still Hunt?
Emanuel J. Kallina, II
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Investing the Gift Annuity Pool – A Balancing Act
Janice H. Burrill and Paula Blacher
 - ◆ **Track IV**
State Regulation of Gift Annuities
Jim Potter and Edith Matulka
 - ◆ **Track IV**
Planned Giving in Times of Change
Robert F. Sharpe, Jr.
- 2:45 – 3:15 pm Refreshment Break in Exhibit Area
- 3:15 – 4:30 pm Repeat Afternoon Breakouts
- 4:30 – 5:30 pm Diamond Jubilee Reception



◆ CONFERENCE AGENDA ◆

FRIDAY, APRIL 12

7:30 am – 8:45 am **Closing Breakfast**
Speaker, Conrad Teitell

9:00 am– 10:15 am **Morning Breakouts**

- ◆ **Track I**
Lessons Learned From Donors
Katelyn L. Quynn
- ◆ **Tracks I & II**
Leading Donors to the Top
G. Roger Schoenhals
- ◆ **Track II**
The Charitable Lead Trust – Don't Forget the Donor!
Marjorie Houston
- ◆ **Track II**
The Internet: Boom or Bust?
Craig Wruck
- ◆ **Tracks II & III**
Navigating Stock Options and Other Stock Rights: Nuts, Bolts, and Real Life
Bob Lew and Darryl D. Ott
- ◆ **Tracks II & III**
Gift Planning With Real Estate
Philip M. Purcell
- ◆ **Tracks II & III**
Investing Planned Giving Assets: Fiduciary Obligations and Practical Concerns
David Routh
- ◆ **Tracks II & III**
Tips from the Trenches: Proactively Managing Your Bequest Administration Program
Jackie Franey

10:15 am – 10:45 am Refreshment Break in Exhibit Area

10:45 am – 12:00 Noon **Repeat Morning Breakouts**

12:00 Noon **Conference Ends**

ACGA BOARD OF DIRECTORS

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The Merrill Lynch Center for Philanthropy & Nonprofit Management Booth 1 (Princeton, NJ)	SunGard Asset Management Systems Booth 21 (Malvern, PA)
The National Committee on Planned Giving Booth 23 (Indianapolis, IN)	Swerdlin White, A Bank of New York Division ... Booth 12 (West Patterson, NJ)
National Foundation, Inc. Booth 18 (Colorado Springs, CO)	U.S. Trust Booth 19 (Greensboro, NC)
Pentera, Inc. Booth 9 (Indianapolis, IN)	Wells Fargo – Charitable Management Group ... Booth 11 (Los Angeles, CA)



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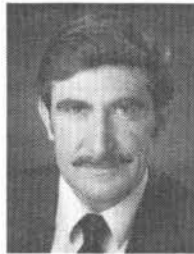
25TH CONFERENCE CHAIR



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

PLENARY SESSION SPEAKERS

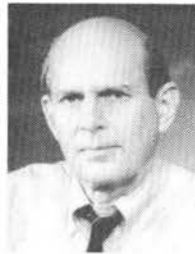
Frank Minton is president of Planned Giving Services, which provides guidance in establishing, administering and marketing planned giving programs by nonprofit organizations. Before entering consulting in 1991, he spent over ten years with the University of Washington, where he served as director of planned giving and executive director of development. Previously he served as senior estate planning officer and field director at Northwestern University, and was a professor at Muskingum College in Ohio. He received M.A. and Ph.D. degrees from the University of Chicago. Dr. Minton has served both as conference chair and president of the National Committee on Planned Giving and received its Distinguished Service Award in 1992. He serves as vice chairman of the board of the American Council on Gift Annuities, directed its survey of gift annuities, was conference chair in 1995, and currently chairs the task force on gift annuity rates. He is a frequent speaker at seminars and conferences, has authored many booklets and articles on planned giving topics, and is co-author of *Planned Giving for Canadians*. He is on the advisory board of *Planned Giving Today*, and is a member of the Seattle Estate Planning Council and the Washington Planned Giving Council.



Clinton A. Schroeder, current Chairman of the American Council on Gift Annuities, is an experienced tax lawyer, Bar Association leader, a Fellow of the American College of Tax Counsel, a former member of the ABA House of Delegates and former Chairperson of the Tax Section of the Minnesota State Bar Association. He chairs the Tax Department of the law firm of Gray, Plant, Mooty, Mooty & Bennett, P.A. in Minneapolis, Minnesota. Schroeder has been a frequent seminar leader at tax institutes at both the state and national

level. He is a past president of both Minnesota and Hennepin County Bar Associations. Schroeder is also very active in community organizations and is a past chair of the board of The Minneapolis Foundation and Fairview Hospital and Health Care. Since 1982, he has served as vice chair of Minnesota Lawyers Mutual Insurance Company.

Ron Sims, King County, Washington Executive, is the chief executive officer for the second-largest government in Washington State and the 11th largest county in the nation. He manages a workforce of nearly 19,000 and a budget of more than \$2.7 billion. Sims has helped foster the region's booming economy, and has provided leadership on issues such as growth management, environmental protection and education. His initiative, "Two Thousand Days to Excel," designed to enable minority students to achieve their full potential, has been widely acclaimed. Sims currently serves as president of the National Democratic County Officials and vice-chair of the Large Urban Caucus of the National Association of Counties. He also served a number of appointments under President Clinton, including the Commission on US-Pacific Trade and Investment Policy and the Intergovernmental Policy Advisory Committee for Trade. Sims is currently a member of the Advisory Board of the Brookings Center on Urban and Metropolitan Policy. In addition to his many civic responsibilities, he also finds time to be actively involved with a number of charitable organizations.



Conrad Teitell is an estate-planning partner in the Connecticut- and Florida-based law firm of Cummings & Lockwood, resident in the Stamford, Connecticut office, and chairs the firm's Charitable Planning Group. He is an adjunct visiting professor at the University of Miami Law School and is also director of the Philanthropy Tax Institute, where he lectures on taxes, philanthropy and estate planning. Teitell writes the monthly newsletter, *Taxwise Giving*.

He is listed in *The Best Lawyers in America* and is a recipient of the Distinguished Service Award from the National Committee on Planned Giving. He is also the recipient of the American Law Institute/American Bar Association's Harrison Tweed Award for Special Merit in Continuing Legal Education. Teitell is counsel to the American Council on Gift Annuities.

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FUNDAMENTALS PROGRAM SPEAKER



Betsy A. Mangone is President of Mangone & Co., a charitable gift planning consulting firm. Prior to opening Mangone & Co. in 1996, she served as Vice President of the University of Colorado Foundation, Inc. Mangone has over 20 years experience in the charitable gift planning field. She serves as a member of the Executive Committee for the American Council on Gift Annuities and is Past President of the National Committee on Planned Giving. She serves as a

member of the Ethics Committee of the National Committee on Planned Giving and as a member of the Editorial Advisory Committee of *The Journal of Gift Planning*. Mangone is an advisor to the Board of Directors of the Colorado Planned Giving Roundtable. She served on the editorial advisory board of the professional publication *Planned Giving Today* and is past chair of the Planned Giving Committee for the Women's Foundation of Colorado. Mangone serves on the faculty of several nationally recognized planned giving training institutes. She is a frequent speaker at national and international conferences, training sessions and seminars. Mangone addresses planned giving and estate planning councils around the country and is the author of numerous articles and booklets on philanthropy, trends in planned giving, emerging donor demographics, ethics and planned giving topics.

TAX SYMPOSIUM PANELISTS

Wendy S. Goffe is a shareholder with the law firm of Graham & Dunn PC in Seattle, Washington. Her practice focuses on estate planning, advising both individuals and charitable organizations concerning planned giving matters, probate and trust administration. Currently, she chairs the Northwest Multiple Sclerosis Planned Giving Committee and is a member of its board of trustees and executive committee. Goffe is an advisory board member for the Northwest Giving Project, a member of the executive committee of the Washington State Bar Association Real Property, Probate and Trust Section, and a member of the acquisition committee of the Tacoma Art Museum. She received her B.A. degree, *cum laude*, and J.D. from the University of Washington.



Jerry J. McCoy is an independent attorney specializing in charitable tax planning, tax exempt organizations and estate planning in Washington, DC. He is a Fellow of the American College of Trust and Estate Counsel, and past chair of its committee on charitable planning and exempt organizations. He is co-founder and co-editor of *Charitable Gift Planning News*, and is a co-author of *The Family Foundation Deskbook*.

Terry Simmons is a partner in the 330 lawyer Dallas-based law firm of Thompson & Knight L.L.P. He represents individual clients, exempt organizations and for-profit entities in complex domestic and international transactions involving nonprofit/for-profit interaction, including related securities and banking issues, intermediate sanctions issues, unrelated business taxable income issues and unrelated debt-financed income issues. He also specializes in the formation and representation of private foundations as well as supporting organizations and all other public charities in all aspects of exempt organization operations. Simmons is one of the most widely-published professionals in the nation on exempt organizations and charitable gift planning, and has given over 200 major presentations on these subjects. He is co-publisher and co-editor of *Charitable Gift Planning News*, a monthly national newsletter on developments in gift planning and exempt organizations. Simmons serves on the board of directors of the American Council on Gift Annuities.



BREAKOUT SPEAKERS



Paula B. Blacher is vice president and senior philanthropic portfolio manager for the Charitable Management Group/Investment Management Group at Wells Fargo Bank in Los Angeles, California. Blacher is responsible for managing specialized charitable trust portfolios. She has 26 years in the financial services field. Prior to joining Wells Fargo, she worked for City National Bank, where she functioned as head of equity research and co-managed equity

common trust funds. Blacher teaches a Chartered Financial Analyst review course in asset valuation and equity analysis co-sponsored by the Los Angeles Society of Financial Analysts in conjunction with the University of Southern California.

Elizabeth A. S. Brown is an attorney and Certified Public Accountant, and serves as assistant general counsel of The Moody Bible Institute of Chicago. Prior to joining Moody in 1983, she was an associate attorney with McDermott, Will & Emery in Chicago. She received her J.D. degree from The University of Chicago, with honors, and has a B.A. in mathematics from North Park College, *summa cum laude*. At Moody, Brown assists donors with estate planning matters, and otherwise provides legal support for Moody's planned giving function. In addition, she oversees Moody's Investment Department. Brown serves on the board of directors of the American Council on Gift Annuities.





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

Gift Annuities, and is a former treasurer of the National Committee on Planned Giving's board. Bull received his J.D. and M.A. from The Ohio State University.

Janice H. Burrill joined Wells Fargo Bank in 1995 as vice president and manager of the Charitable Management Group in Private Client Services, and was named senior vice president and national director in 2000. Prior to joining Wells Fargo, she was director of planned giving at Loyola Marymount University in Los Angeles, after practicing law for several years in Los Angeles. Burrill holds a BS degree in accounting from Loyola Marymount University and a law degree from Loyola Law School. She has served on the board of directors of the National Committee on Planned Giving and currently sits on the boards of several charities in the Los Angeles area. Burrill is an active volunteer and speaker within the nonprofit sector and participated in the first-ever White House Conference on Philanthropy.



Frank L. Ellsworth oversees and coordinates various programs and services to endowments, foundations and other nonprofit institutions for The Capital Group Companies. He is president and chief executive officer of Endowments, a series of mutual funds that are offered exclusively to nonprofits and managed by Capital Research and Management Company. Prior to joining The Capital Group, Ellsworth spent his entire career in higher education. He received his A.B. *cum laude* from Case Western Reserve University, Masters degrees from The Pennsylvania State University and Columbia University in New York, and his Ph.D. from the University of Chicago. For nearly 25 years he combined teaching and administration at Penn State, Columbia University, and Sara Lawrence College, and served as a dean in The University of Chicago's law school. He was also president of Pitzer College in Claremont, California.



Jackie W. Franey is the director of planned giving for the American Heart Association – National Office in Dallas, Texas. For the past eight years she has assisted affiliates in designing, marketing and implementing their planned giving programs, provided technical expertise and training and managed the centralized planned giving marketing program to long-term donors. In addition, she consults with affiliates regarding pro-active bequest administration.

Previously, Franey worked for St. Jude Children's Research Hospital and has been in planned giving for eleven years. She completed the *Certified Specialist in Planned Giving* program in 1998.



25TH CONFERENCE
ON GIFT ANNUITIES

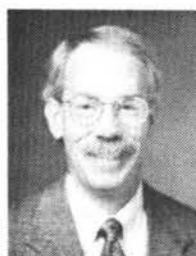
Judy Courshon graduated from Western Washington University with a BA in Business Administration and Computer Science and then earned a Master of Taxation degree from the University of Denver. She has been practicing public accounting for the past 27 years with Deloitte & Touche, PricewaterhouseCoopers and a local firm she founded in 1985. In 2000, Courshon founded Wellspring Group P.S., CPAs, an independent firm that provides personalized

financial management, consulting and tax services to individuals and their families.

Jeremiah W. Doyle, IV is estate planning manager for Mellon Private Asset Management and a first vice president of Mellon Bank in Boston, Massachusetts. He received a LL.M. in banking law and a LL.M. in taxation from Boston University Law School, a J.D. from Hamline University Law School and a B.S. in accounting from Providence College. Doyle has spoken on tax and estate planning topics to numerous organizations and has contributed to many publications in the field. He is the author of several books on tax and estate planning.



Dr. Jack Goodner is president of Carr & Associates in Overland Park, Kansas, and is a counseling psychologist with Arizona State University Tempe. Licensed as a psychologist in Kansas and Missouri, he provides leadership in innovative uses of psychological tools to deal with the strategic process of staffing and developing organizations.



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

member of the Order of the Coif.

◆ CONFERENCE FACULTY ◆



Erin Hemmings is a program manager for Social Venture Partners (SVP) in Seattle, Washington. Modeled after the investment strategies used by venture capitalists, SVP makes grants to nonprofit organizations and leverages those grants with volunteer time and expertise. Hemmings is responsible for administering SVP's grantmaking programs, managing relationships with 25 investees, and implementing SVP's fund development initiative. She also teaches grant

writing at the Evans School of Public Affairs at the University of Washington. Hemmings earned her Bachelor's degree in political science from the University of California, San Diego and Masters degree in public administration from the University of Washington.

Marjorie A. Houston is executive director, gift planning at Brown University in Providence, Rhode Island, where she led the team that developed and implemented the endowment policy and standards for the university. Previously, she was the director of gift planning at the United Way of Southeastern Rhode Island. Houston's articles have appeared in several publications of interest to the philanthropic community and has presented to numerous professional organizations and conferences. She currently serves on the board of directors of the National Committee on Planned Giving and has participated in mentor programs with organizations in the process of developing planned giving programs.



Emanuel J. Kallina, II, a nationally renowned speaker and author on estate planning and charitable giving, is a graduate of Bowdoin College (B.A.), the University of Maryland School of Law (J.D.), and New York University School of Law (Master of Laws in Taxation). While focusing on estate and business tax planning, Kallina practices extensively in the charitable gift planning area, and is heavily involved in legislative and regulatory matters before

Congress and the Internal Revenue Service. He is chairman of the board and president of The James Foundation, a co-founder, vice president and treasurer of the Planned Giving Design Center, a co-founder of the Chesapeake Planned Giving Council, a past member of the board of directors of the National Committee on Planned Giving, and a past chairman of NCPG's Government Relations Committee.

David Lawson began his fundraising career as editor of six editions of *The Foundation 500*, from 1974 to 1981. In 1981 he founded *The Information Prospector*, which produced 300 in-depth financial and biographical profiles monthly. In 1988 he created CDA/Investnet's (now Thomson Financial) Securities MATCH product, created their real estate MATCH



product in 1994, and designed their FACTS Viewer database. In 1997 Lawson founded Prospect Information Network, a firm offering prospect identification services and software to the nonprofit community.

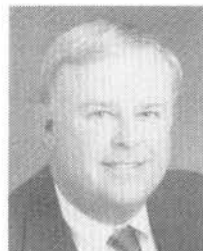
Robert Lew, president and founder of Planning & Financial Advisors, has spent the last twenty years as a financial consultant and planner, specializing in the fields of estate, charitable, insurance and pension planning. His firm counsels corporate executives, business owners, entrepreneurs, families and individuals throughout California on the wealth transfer planning process. He has made numerous presentations to professional organizations and conferences, and writes a column for *The Journal of Gift Planning*. Lew serves on the boards of the National Committee on Planned Giving and the Northern California Planned Giving Council, and is a member of the San Francisco Estate Planning Council, the East Bay Community Foundation's Professional Advisors Council, and the Asian Pacific Fund Professional Advisors Council.



Edie Matulka is an associate with Planned Giving Services, a consulting organization in Seattle, Washington. Among her duties, Matulka has primary responsibility for assisting charities in complying with state regulation for issuance of gift annuities. In addition to the practice of law, her background includes work in government, public and nonprofit settings, and she has served as a board member and planned giving committee member with charitable

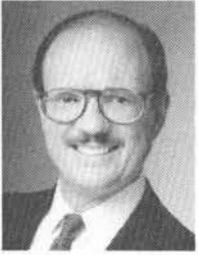
organizations. Matulka earned a B.A. in Political Science from the University of Washington, and graduated from Northwestern School of Law at Lewis and Clark College in Portland, Oregon. She currently serves on the State Regulations Committee of the American Council on Gift Annuities.

Malcolm A. Moore is a partner in the Seattle office of Davis Wright Tremaine, where his practice emphasizes estate planning, probate, wills, trusts, estate, gift and generation-skipping taxation, and income taxation of trusts and estates. He is a past president of the American College of Trust and Estate Counsel and was chair of its Estate and Gift Tax Committee. He has served as chair of the Real Property, Probate and Trust Law Section of the American Bar Association and was a member of the ABA House of Delegates. Moore is a past president of the Seattle Estate Planning Council. He is currently a member of the American College of Tax Counsel, International Academy of Estate and Trust Law, American Law Institute, and a Fellow of the American Bar Foundation. Moore graduated with honors from Princeton University, and received his LL.B. from Harvard University.





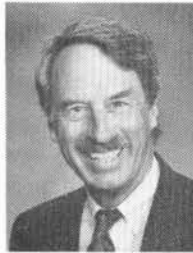
◆ CONFERENCE FACULTY ◆



David Wheeler Newman is a partner with the Los Angeles law firm of Mitchell, Silberberg & Knupp, where he chairs the firm's Charitable Sector Practice Group. He represents tax-exempt organizations with a special emphasis on charitable gift planning. He represents regional and national charities, including colleges and universities, health care providers and social service agencies. Newman is a frequent speaker on the tax and legal aspects of planned giving,

and has addressed national meetings of numerous organizations. He has served on the board of directors of the National Committee on Planned Giving.

Darryl D. Ott, Esq. of Morgan, Miller & Blair in Walnut Creek, California has been involved with wealth transfer planning for high net worth individuals for over 30 years and with charitable gift planning for over 13 years. He has a JD degree from the University of California, Hastings College of the Law, San Francisco, California and is a Certified Specialist of Taxation Law with the California State Bar. Ott is a member of the board of directors and immediate past president of the Northern California Planned Giving Council. He has been a presenter to national and local organizations on a variety of wealth transfer topics.



James B. Potter was a planned giving executive for 20 years with two national charities, the Presbyterian Church (USA) Foundation and the American Lung Association. After five years of part-time consulting work, he became a full-time consultant in 1990, and is currently president of Planned Giving Resources in Alexandria, Virginia. He has served on the board of the American Council on Gift Annuities since 1974 and has chaired their State Regulations

Committee since 1989. Potter was awarded the 1999 Distinguished Service Award by the National Capital Gift Planning Council (then called the Planned Giving Study Group of Washington, DC).



Philip M. Purcell currently serves as director of gift planning for the Central Indiana Community Foundation in Indianapolis, Indiana. He also directs the Planned Giving Resource Center, providing gift planning resources for charitable organizations. Formerly, he served as director of development and planned gifts for the St. Vincent Hospital Foundation in Indianapolis and director of planned giving and development counsel for Rose-Hulman Institute of Technology in Terre Haute, Indiana. Purcell received his BA *magna cum laude* from Wabash College and his JD and MPA degrees with honors from the Indiana University School of Law and School of



Public and Environmental Affairs. He is a member of the Indiana University Center on Philanthropy Fundraising School faculty.

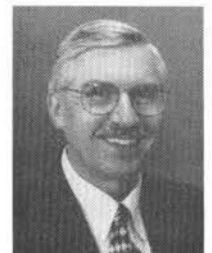
Katelyn L. Quynn is the director of planned and major gifts for the Massachusetts General Hospital in Boston, Massachusetts, where she has worked since 1992. In 1998 she assumed the role of director of planned giving for the Partners Healthcare System, Inc., acting as a consultant to the system's eight affiliate hospitals. Quynn is a past president of the Planned Giving Group of New England and served on the board of directors of the National Committee on Planned Giving. She is a board member of Charitable Accord and testified before Congress for successful passage of the Philanthropy Protection Act of 1995. She was named Planned Giving Professional of the Year by *Planned Giving Today*. Quynn holds a bachelor's degree from Tufts University and a law degree from Boston University School of Law.



David S. Routh is a senior vice president and manager of The Planned Giving Services Group at U.S. Trust Company. In that capacity, he leads a team of planned giving professionals that serve the firm's planned giving clients nationwide. Prior to this, he worked with North Carolina Trust Company (the predecessor of U.S. Trust of North Carolina) and worked extensively with nonprofit clients in connection with their planned giving programs. Routh received his

B.A. from the University of North Carolina at Chapel Hill (Phi Beta Kappa). In 1996, he completed National Trust School at Northwestern University. Routh currently serves as president of the Greensboro Symphony Board and as treasurer of the North Carolina Planned Giving Council.

G. Roger Schoenhals of Edmonds, Washington is the publisher and editor of *Planned Giving Today*, a subscription-based monthly newsletter for gift planning professionals. He also produces *Gift Planning in Canada*, a Canadian publication for PGT subscribers in Canada, as well as a monthly resource guide, *The PGT MarketPlace*. In addition, he has published numerous books and various CDs on planned giving. Schoenhals has advanced degrees from Asbury Theological Seminary and Central Washington State University. He is the former director of Seattle Pacific Foundation and a past president of the Washington Planned Giving Council. Schoenhals has served on various boards and has been a featured speaker at local, regional and national gatherings of gift planners throughout North America.



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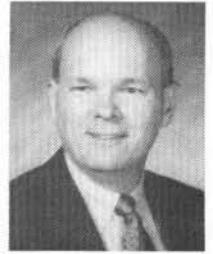
Robert F. Sharpe, Jr. is president of The Sharpe Group, which consults nationwide with a number of leading health, education, social service and religious organizations in implementing their major and planned gift development efforts. A graduate of Vanderbilt University and Cornell Law School, he has in past years practiced law with a major firm specializing in income, estate and gift taxation and corporate planning. Sharpe has authored

many articles and other publications covering numerous gift planning topics. His remarks on the subject have been featured in the *Wall Street Journal*, *The New York Times*, *Newsweek*, *Forbes*, *Smart Money*, *CBS Marketwatch*, *The Chronicle of Higher Education*, *Trusts & Estates* and other national publications. He is a frequent speaker for national gatherings, and, in a survey conducted by *Planned Giving Today*, was named the most popular speaker in America on the topic of charitable gift planning.

Cindy Sterling is a consultant for Washburn and McGoldrick, Inc., a comprehensive development-consulting firm. Her expertise is in gift planning, major gifts and women's philanthropy. She also consults as a personal financial planner. Before consulting, Sterling served as the director of gift planning at Vassar College. A graduate of the University of Pennsylvania in economics (B.A.) and psychological services (M.S.), she also has her Chartered Financial Consultant (ChFC) certification. Sterling is a frequent speaker at educational, financial and gift planning conferences, and recently received the Steuben Apple Award for excellence in public speaking from the Council for Advancement and Support of Education. Sterling has conducted extensive research on women's philanthropy, and published "Gender Differences in Planned Giving: The Way Women Give," in the December 2000 edition of *Planned Giving Today*.



Craig C. Wruck is vice president for Philanthropic and Charitable Services at U.S. Trust Company, where he focuses on the needs of individual donors and charitable organizations. Previously he was vice president of development for The Saint Paul Foundation, one of the ten largest of the more than 500 community foundations in the country. Before that he was with the University of Minnesota Foundation, serving as the director of gift planning. Wruck is past president of the National Committee on Planned Giving, and currently chairs NCPG's Government Relations Committee. He was founding chair of the Minnesota Planned Giving Council and currently serves on its board. He was a founding member of the Editorial Advisory Board of the newsletter *Planned Giving Today*. Wruck holds an MBA from the University of St. Thomas and a bachelor's degree in journalism from the University of Utah.



Chris Yates is the director of gift & estate planning, and associate director of development at the California Institute of Technology (Caltech) in Pasadena, California. Previously, he was senior associate director in the office of planned giving at Stanford University in Stanford, California. Yates received his A.B. degree from Stanford University and his J.D. degree from the University of Chicago Law School. He served on the board of the Northern California Planned Giving Council and was its president for a two-year term. He currently serves as president-elect of the National Committee on Planned Giving, after serving as its secretary in 2001.



Eric Swerdlin is a vice president and the division head of planned giving services at Swerdlin White, A Bank of New York Division, an organization dedicated to providing the nonprofit community with investment services and products designed specifically for planned giving assets. Previously, he spent more than a decade on Wall Street in the financial services industry. Swerdlin has written numerous articles on planned giving and has been published in *The*

Journal of Taxation, *The Journal of Gift Planning* and *The Chronicle of Philanthropy*. He has appeared on CNN, Bloomberg and the Fox News Network on many occasions and has been quoted in *Forbes*, *Worth*, *The Wall Street Journal* and the *Financial Times*. Swerdlin has spoken at numerous planned giving, investment and philanthropic conferences. He has a degree in International Business from The George Washington University.

◆ MODEL STANDARDS FOR THE CHARITABLE GIFT PLANNER ◆

PREAMBLE

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

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

I. PRIMACY OF PHILANTHROPIC MOTIVATION

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

II. EXPLANATION OF TAX IMPLICATIONS

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

III. FULL DISCLOSURE

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

IV. COMPENSATION

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

V. COMPETENCE AND PROFESSIONALISM

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

VI. CONSULTATION WITH INDEPENDENT ADVISORS

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

VII. CONSULTATION WITH CHARITIES

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

VIII. DESCRIPTION AND REPRESENTATION OF GIFT

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

IX. FULL COMPLIANCE

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

X. PUBLIC TRUST

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

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

Your clients and donors
build wealth and accomplish
philanthropic initiatives
using creativity, discipline
and experience. Manage
your charitable assets
using ours.

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UNDERSTANDING GIFT ANNUITIES

Elizabeth A.S. Brown
Assistant General Counsel
Moody Bible Institute
820 N. LaSalle Blvd.
Chicago, IL 60610
(312) 329-4141
FAX (312) 329-4328
ebrown@moody.edu

25TH CONFERENCE ON GIFT ANNUITIES • PRESENTED BY THE AMERICAN COUNCIL ON GIFT ANNUITIES

233 McCREA STREET, SUITE 400 • INDIANAPOLIS, INDIANA 46225 • (317) 269-6271 • FAX: (317) 269-6276 • E-MAIL: ACGA@IUPUI.EDU

I. What is a Gift Annuity?

A. Contract

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

C. General obligation of the Charity

1. Not dependent on charity's earnings.

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

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

D. Not a trust

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

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

E. Gift

1. Emphasize gift rather than investment aspects.

2. Must have donative intent.

II. Types of Annuity Contracts

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

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

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

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

C. Immediate – begins to pay the annuity immediately.

- D. Deferred – payments begin at a specified later date. Although typically the payout date is established at the time the gift is made, there seems to be some flexibility regarding changing the starting date at a later time. See P.L.R. 9743054, where the contract allowed the annuitant to elect the commencement date of the payments at any time after the annuitant reaches age 55. The deduction was based upon the earliest possible start date. Query whether the donor is entitled to a further deduction if he delays the start date.
- E. Cannot have a charitable gift annuity for more than two lives.

III. Annuity Rates

- A. Suggested rates established by the ACGA, based on assumptions regarding:
 - 1. Mortality.
 - 2. Rate of return.
 - 3. Expense load.
 - 4. Residuum. For a long time, this assumption has been 50%. This means that, if Charity's earnings exactly meet assumptions, and the person dies when the actuarial tables say they're supposed to, and the expense assumption is also accurate, then at the annuitant's death the Charity will have 50% of the original gift left. In fact, many charities experience a much higher residuum than 50%. A 1999 survey of charities observed a mean residuum of 97.5%.¹
- B. Most charities follow ACGA rates. 94.6% of charities surveyed say that they either always or usually follow the ACGA rates.²
- C. *Richie v. ACGA et. al.* This class action lawsuit, brought in 1995 and finally dismissed in 1999, alleged that charities following the uniform rates violated antitrust laws. The lawsuit led to legislation which specifically exempts gift annuities from antitrust laws. (See the Charitable Gift Annuity Antitrust Relief Act of 1995 and the Charitable Donation Antitrust Immunity Act of 1997.)
- D. State regulation may affect rates.

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

² *Ibid.*

- E. IRS requires a minimum 10% gift. On occasion, the ACGA rates may not qualify.
- F. Charity individuation. May use higher or lower rates. May have age limits. But there are several reasons for a charity NOT to exceed the ACGA rates:
 - 1. Risk is minimized.
 - 2. More money will remain for charitable work.
 - 3. Charity does not need to hire an actuary and develop its own rate schedule.
 - 4. ACGA rates have credibility with state insurance departments.
 - 5. Focus on the “gift” rather than the “investment” aspects of the annuity.
- G. Ongoing study of methodology for calculation of rates.

IV. Tax effects of gift annuities.

A. Income Tax

- 1. Charitable deduction. Reg. § 1.170A-1(d)(1): “In the case of an annuity...purchased from an organization described in section 170(c), there shall be allowed as a deduction the excess of the amount paid over the value at the time of purchase of the annuity...purchased.”
- 2. Value of the annuity. Reg. § 1.170A-1(d)(2); Reg. § 1.101-2(e)(1)(iii)(b)(2); Reg. § 20.2031-7.
- 3. Taxation of annuity payments – IRC §72.
 - a. Exclusion Ratio – ratio of the “investment in the contract” to the “expected return.” IRC §72(b); Reg. § 1.72-4.
 - b. Expected Return – Reg. § 1.72-5.
 - (1). Single life – calculated by multiplying the annual annuity payment by the multiple shown in Table V of Reg. § 1.72-9 (Called the “expected return multiple.”)

- (2). Two-life – calculated by multiplying the annual annuity payment by the multiple shown in Table VI of Reg. § 1.72-9. (Called the “expected return multiple.”)
- (3). Adjustments required if payments are to be made less frequently than monthly, or if first payment will cover a partial period. See Reg. § 1.72-5(a)(2)(i).
- (4). Note that different tables apply to pre-1986 contracts.

c. Investment in the Contract

- (1). General rule of Reg. § 1.72-6. Investment in the contract is the aggregate amount of premiums or other consideration paid, reduced by any return of premiums or any other amounts received which were excludable from income.
- (2). However, in the case of a gift annuity, the “value of the annuity” (see above) is the investment in the contract. The amount deductible as a charitable contribution is not part of the investment in the contract. See Rev. Rul. 62-137, 1962-2 CB 28, which provides older valuation rules for charitable annuities, and states, “The values prescribed herein will apply for the purpose of determining the aggregate amount of consideration paid for the contract (investment in the contract) for purposes of section 72 of the Internal Revenue Code of 1954.” Also see Rev. Rul. 70-15, 1970-1 CB 20, which states, “The amount in excess of the fair market value of an annuity contract purchased from an organization described in section 170(c) of the Code may not be treated as an ‘investment in the contract’; such amount may be deducted as a charitable contribution.”

d. Exclusion limited to investment; unrecovered investment.

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

- (2). Conversely, if the annuitant dies before the investment in the contract is fully recovered, the unrecovered investment is allowed as a deduction on his final income tax return.
- (3). These rules do not apply to any annuities with a start date before 1986. For those contracts, the exclusion ration remains the same for the life of the contract.

4. Capital Gains implications

- a. Exchange of property for an annuity is considered a bargain sale. See Reg. § 1.170A-1(d)(3) and Reg. § 1.1011-2(a)(4)(i).
- b. The “consideration” received in the bargain sale is the “value of the annuity” (determined in accordance with §2031 and the regulations thereunder.) The “basis” in the property sold is determined by multiplying the donor’s basis in the property exchanged by a fraction whose numerator is the value of the annuity and whose denominator is the face value of the annuity.
- c. Example: Donor transfers appreciated securities to charity in exchange for an annuity that pays \$5,000 per year per life. The fair market value of the securities transferred (and the face amount of the annuity) is \$100,000. The donor’s basis in the property transferred is \$20,000. The value of the annuity is \$59,755, per IRS tables, and the charitable contribution is \$40,245 (\$100,000 minus \$59,755). The donor’s basis in the portion of the property “sold” is calculated as follows:

$$\$20,000 \times \frac{\$ 59,755}{\$100,000} = \$11,951$$

- d. The consideration received for the portion “sold” is \$59,755, and so the gain which must be recognized is \$47,804 (\$59,755 minus \$11,951).
- e. If the annuity is nonassignable, the gain is reported ratably over the period of years measured by the “expected return multiple”, which is equal to the donor’s life expectancy.

- f. Only the donor's life expectancy is considered. The survivor annuitant's life expectancy is not considered.
- g. The maximum capital gain reportable in any year cannot exceed the amount treated as return of investment each year – in other words, the excludible amount.
- h. Upon the death of the annuitant, no further gain must be reported. However, if there is a survivor annuitant, the unreported gain will continue to be reported on the same basis by the survivor annuitant.
- i. In case of two-life annuity funded with joint property, gain is reported over the joint life expectancy.

B. Estate and Gift Tax

1. *Single life annuity established by the donor during his lifetime.* There is nothing to include in the donor's taxable estate, since his right to income terminates with death, and there is no remaining value in the contract.
2. *Annuity established by donor during life with a survivor annuitant.* The value of the survivor's interest is included in the donor's gross estate. IRC §2039. If the survivor is the donor's spouse, the marital deduction is available. IRC §2056(b)(7)(c). With non-spouse survivor annuitant, there may be tax due. Tax would likely be payable out of residuary estate.
3. *Annuity established at death for another beneficiary.* If a testator provides in his will or trust that an annuity should be established for someone else, e.g., a child, niece, etc. the entire amount of the annuity is included in his gross estate, and a charitable deduction is available for the charitable portion (same computation as for income tax.)
 - a. If spouse is the only annuitant, marital deduction is available.
 - b. Beware of two-life annuity established testamentarily for spouse and another beneficiary, e.g., wife, then daughter. There is no marital deduction available for the spouse's interest. Charitable deduction is still available, however.
4. Where donor establishes annuity for another beneficiary inter vivos, there are potential gift tax issues.

- a. If a donor establishes a single life annuity for another beneficiary, e.g., a sister, daughter, niece, etc., a taxable gift has been made. The gift does qualify for the annual exclusion (\$11,000), as it is a "present interest". Face amount of annuity may be more than \$11,000. Compare the non-charitable portion ("value of the annuity") with the exclusion amount.
 - b. If a donor establishes a two-life annuity for himself and a survivor beneficiary, e.g., to donor during his lifetime and then to his daughter, he has made a completed taxable gift to his daughter, and this gift does not qualify for the annual exclusion, because it is not a present interest. Gift tax return would need to be filed, and donor would either pay tax or claim part of his unified credit. Problem can be avoided if donor retains the right to revoke the survivor's interest. Then a completed gift has not occurred, and there is no taxable event for gift tax purposes. However, the survivor's interest will be included in the donor's gross estate at death (see discussion above.)
 - c. Note that gift tax is still an issue, even in 2010 and following.
5. Beware of an income tax issue when annuities are established out of a decedent's estate or a testamentary trust. If the donor's will or trust provides that "10% of my residual estate shall be paid to ABC Charity to establish a single life gift annuity for the benefit of my niece, Susie," then 10% of the income earned by the estate during the period of administration will add to the face value of the annuity. However, someone has to pay the income tax on this income earned during administration. I believe there are three possible results:
- a. If the annuity can be set up immediately (within one month of death?) possibly income can be avoided by back dating the annuity to the date of death.
 - b. If the annuity can be established immediately after the close of the estate's or trust's tax year, the estate or trust could report and pay tax on the income earned in the prior year, withholding the amount of tax due from the share used to establish the annuity. A charitable income tax deduction is available for that portion of the income which represents the charitable portion of the annuity.

- c. If the annuity is established mid-year, the only possible result seems to be that the beneficiary will have to receive a Form 1041-K-1 for the non-charitable portion of the income which is added to the annuity, even though she does not actually receive the income. This is the least desirable result, as Susie will not understand why she has taxable income to report when she has not yet begun to receive the income from the annuity.
 - d. None of these issues exist if the bequest is stated as a specific dollar amount, as specific bequests generally do not benefit from income earned during administration. However, fairness would require setting up the annuity as soon as possible so that the beneficiary begins receiving income as the decedent intended.
- 6. Economic Growth and Tax Relief Reconciliation Act of 2001. (EGTRRA)
 - a. Estate tax is less likely to be an issue in the future. Exemption equivalent is \$1,000,000 in 2002, gradually raised to \$3.5 million by 2009, estate tax is repealed in 2010. In 2011, presumably we go back to a \$1 million exemption unless Congress acts. So annuity is still a valid planning tool from an estate tax standpoint.
 - b. Gift tax - \$1 million exemption, but tax stays in place.
- 7. Possible development for the future – IRA “rollover” into charitable gift annuity. Several proposals have been put forth over the last several years. This is not the law today, but it may be an opportunity for the future.

V. Managing the Annuity Fund

A. Segregation of assets

- 1. There is no general overriding requirement that annuity assets be segregated from the general assets of the charity. The obligation to pay the annuity is a contractual obligation backed by all of the charity's assets, not just the annuity fund.
- 2. State law may require that there be a segregated fund, and may dictate how much must be in the fund.

3. Prudence requires that the charity maintain a separate fund, at least in an accounting sense, designated the "annuity fund." This should be done for the following reasons:
 - a. This may provide greater protection to annuitants, as in some states there may be an argument that these assets are unavailable to general creditors if the charity goes bankrupt. This argument would be based on constructive trust or a similar theory. Although the ultimate success of these arguments is doubtful, bargaining position vis a vis other creditors in a reorganization might be improved. Surely, if the assets are not segregated, they will be gobbled up by general creditors.
 - b. A separate fund facilitates accounting and tracking of performance.
 - c. Charity may wish to employ a different investment strategy with annuity assets than for the general fund or the endowment fund, or it may be required to do so by state regulations. Charity may wish to have the fund, or part of it, professionally managed, or may wish to hire a different investment manager than for its other funds.
 4. In some cases, further segregation within the annuity fund may be desirable. For example, it may be desirable to create a separate sub-fund for California annuities, since that state has rigid investment restrictions. The charity would then be free to invest the remaining annuity funds as it wishes.
- B. How much should be in the annuity fund? Stated another way, when may the charity take its share (the "gift") out of the fund and spend the money for its charitable programs? There are two basic approaches:
1. At a minimum, the charity should keep the required reserves in the annuity fund. This is the amount that, actuarially, will enable it to meet the obligations which it has incurred for all of its annuity contracts.
 - a. If this approach is taken, the charity will likely take some of the face value of the annuity out up front, and will invest only a portion of the funds received from the donor.
 - b. On a periodic basis, (at least annually), the charity will recalculate the required reserve based on the annuity contracts then in effect. If the annuity fund exceeds this

amount, the charity can withdraw funds and add them to its general fund. If the fund is insufficient to meet the required reserves, the charity will have to add money to the annuity fund out of its general fund.

- c. Under this approach, the death of an annuitant will not result directly in funds being made available to the charity. However, the termination of the contract will affect the reserve calculation at the end of the year (or whenever it is done).
2. A key issue is what assumptions are used to calculate the reserves.
 - a. There is one set of actuarial assumptions that are implicit in the IRS tables used to calculate the charitable deduction. These assumptions are not likely to be the ones used for the charity's reserve calculations. For example, a \$100,000 two-life annuity for two 78 year-old annuitants produces a charitable deduction of \$40,734. This does not mean that the charity can immediately take \$40,734 out of the annuity fund.
 - b. There is another set of actuarial assumptions that determine the annuity rates. These assumptions may or may not be the ones the charity wishes to use in its reserve calculations.
 - c. State regulations may dictate a set of assumptions that must be used. (E.g., California.) In that case, the charity must use assumptions which are at least as conservative as the state regulation requires, at least for that portion of the fund. Keep in mind that the charity may choose to use assumptions which are more conservative than state regulation requires.
 - d. It is always best to be conservative in your assumptions, considering the long term of the obligations incurred. However, the assumptions must be reasonable, or the accountants may object.
 3. The other approach is to account for each annuity contract individually.
 - a. Under this approach, the entire face amount of the annuity is invested.

- b. Income earned in the fund is allocated to each contract, and payments are deducted from that contract.
 - c. When an annuitant dies, the amount remaining in that contract is transferred to the general fund.
 - d. In some instances, the contract may even be individually invested, e.g., a \$100,000 Treasury Bond may be purchased to support a \$100,000 annuity. (But note the recent elimination of the 30-year Treasury.)
4. Which approach is right for your charity?
- a. How large is your fund? Are you constantly growing the fund through new contracts?
 - b. Is your actuarial risk diversified?
 - c. How confident are you in your investment performance? Do you regularly beat the assumptions underlying the annuity rates? (Keep in mind that the rates under older annuities were determined under different assumptions.)
 - d. How conservative is your organization?
 - e. What would be the implications if you had to add money to your annuity fund? Would your board and financial officer be able to accept this as a natural consequence of taking the less conservative approach?
 - f. Does your organization have reserve funds that could be used to fund a deficit in the annuity fund?
 - g. Consider hybrid approach. Segregate funds withdrawn from the annuity fund in a separate board-restricted (quasi-endowment) fund up to a certain percentage of the annuity fund. These funds are then available to replenish the annuity fund if needed.

C. Investing the Annuity Fund

1. Objectives

- a. Meet or beat the return assumption which determines the rates. All things being equal, if you beat the assumption,

your residuum will be greater than 50%, and if you do not meet the assumption, it will be less than 50%.

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

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

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

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

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

2. Specific investments

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

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

c. Real estate – In some cases, real estate could be an appropriate investment for the annuity fund. It probably should be income producing, such as a triple net leased commercial property, or apartment building. This may

produce a good long-term return, but there are different risks associated with real estate. And there are management issues, as well. Consider obtaining real estate exposure through REITs as an alternative.

- d. Mortgages and land contracts may also be held in the annuity fund. Again, consider unique risks – default, foreclosure, etc.
 - e. Alternative investments, aka “Absolute return strategies”, aka Hedge Funds. Understand the risks. Diversification is key.
3. Investment Principles to consider
- a. Asset allocation. Determine an asset allocation that is likely to produce the return that you need with a level of risk that you (and your board) are comfortable with.
 - b. Diversification – among asset classes, and within each asset class.
 - c. Discipline. Keep with your strategy for the long term, rebalance periodically.
4. Should you have professional investment management?
- a. In-house expertise?
 - b. Size of portfolio
 - c. Portfolio mix – equities v. fixed income
 - d. Cost
 - e. Use of mutual funds.
 - f. Consider passive investment strategy.
 - g. Charity is still liable to make annuity payments if professional managers do not perform to expectations.
5. Investment issues are far more difficult in the early years of the fund. It is much easier to achieve diversification in a larger fund, and the actuarial risk is less the larger the number of annuitants in the pool. Liquidity is also harder to achieve in a small fund,

because generally, the more liquid, the smaller the return. Consider these issues when deciding whether to take excess out of the fund.

6. Reinsurance

- a. Possibly a way to manage actuarial risk, particularly on a very large contract or when the fund is just starting out.
- b. May be prohibited in some states.
- c. Charity is still liable if insurance company goes under.
 - (1). Check company's rating.
 - (2). Use more than one company?

D. State Regulation

- 1. Do you need to register in your state?
- 2. Do you need to register in other states where your annuitants reside?
- 3. Reserve requirements.
- 4. Investment restrictions.

E. Administrative issues

- 1. Making timely payments. Need a method to produce checks and keep records.
 - a. Checks
 - b. Direct deposit
 - c. ACH
 - d. How do we find out when annuitants die?
- 2. Calculation of charitable deductions, capital gains, etc. Need to inform donor regarding tax matters.
- 3. Calculation of reserves.

- a. Required by state regulation
 - b. For accounting purposes.
 - 4. Tax reporting.
 - a. Annual 1099-R to all annuitants. Magnetic tape to IRS.
 - b. Calculate includible/ excludible portions, and keep track of when the investment in the contract is recovered.
 - c. Capital gains.
 - 5. Software.
 - F. Decisions for your annuity program.
 - 1. Minimum annuity contract.
 - 2. Frequency of payment, or minimum payment allowed.
 - 3. What types of assets will you accept in exchange for an annuity?
 - a. Publicly traded assets are obviously OK.
 - b. What about real estate?
 - 4. Do you want any age limits?
 - 5. Outsourcing.
 - G. Marketing
- VI. Comparing the annuity to other charitable giving vehicles.
- A. Pooled Income Fund
 - 1. PIF has a fluctuating (growing?) income stream.
 - 2. All income is taxable.
 - 3. Capital gains totally avoided on gifts of appreciated property, even if the income recipient is not the donor.

4. Assets are protected from the general creditors of the charity, but there is no guarantee of payments. Charity is only obligated to pay income earned in the trust.
5. Can create PIF for more than two lives.

B. Charitable remainder unitrust

1. Separately invested. Larger amount required to create a CRUT than a gift annuity.
2. Fluctuating income and valuation. In an income-only unitrust, beneficiary receives only income earned in the trust, up to the limitation. In straight unitrust, beneficiary receives a percentage of the fair market value of the trust assets, valued annually. Payment can go up or down.
3. Generally, all payments received are taxable income. There may be distributions of principal which are not taxed in a straight unitrust. Also, a unitrust may invest in tax-exempt securities (but watch out for accumulated capital gains.)
4. Assets in trust protected from general creditors of the charity. Income obligation is not backed by charity's general assets.
5. Complete elimination of capital gains (unless the tier system of income payouts dips into the capital gains layer.)
6. Can create for more than two lives (provided 10% rule is satisfied), or for a term of years up to 20.
7. Can provide for contingent income beneficiaries, or a class of income beneficiaries in a term of years trust.

C. Charitable remainder annuity trust

1. Separately managed trust. Requires larger amount to set up.
2. Annual payment is a fixed amount which does not vary.
3. Initially, complete elimination of capital gains. However, if principal is distributed, capital gains could be carried out under tier system.
4. Payment is not guaranteed by general assets of charity. If trust runs out of money, payments cease.

5. Assets protected from the charity's general creditors.
 6. Can create for more than two lives, or for a term of years.
- D. In general, gift annuity, PIF, and charitable remainder trusts all provide similar, albeit not identical, tax benefits, namely income tax deductions when established inter vivos, estate tax deductions at death, and some shielding from capital gains when funded with appreciated property.

Comparison of Life Income Gifts

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

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WEBSITE: www.nfwbo.org

DESCRIPTION: The National Foundation for Women Business Owners does research for its members and makes it available to the public.

WEBSITE: http://www.irs.gov/tax_stats/index.html

DESCRIPTION: The IRS makes various studies available in PDF, text and Excel formats.

WEBSITE: www.landings.com

DESCRIPTION: Site is designed for plane owners and pilots. Has a free searchable database of plane owners with complete aircraft specifications. The database is compiled by the Federal Aviation Administration

WEBSITE: <http://www.ftc.gov/search>

DESCRIPTION: Federal Trade Commission database of all litigation and news releases. Searchable by keyword.

WEBSITE: <http://pro-net.sba.gov/pro-net/search.html>

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WEBSITE: www.vfinance.com

SEARCH PAGE: <http://www.vfinance.com/news/resultlist.asp>

DESCRIPTION: Searchable database (by company and keyword) of venture capital market back to 1996. Free daily e-mail newsletter of new venture financing.

WEBSITE: www.hispanicbusiness.com

DESCRIPTION: Covers Hispanic owned business and publishes the annual Hispanic Business 500

WEBSITE: www.monster.com

DESCRIPTION: Fully searchable database of job listings by keyword, job type, and company. You can have your search run daily with results sent to you via e-mail.

WEBSITE: <http://openaccess.dialog.com/business/>

DESCRIPTION: Dialog's Openaccess site enables non-member users to search many of its databases at no charge. Non-members pay higher data costs in return for the free searching.

WEBSITE: www.uspto.gov

SEARCH PAGE: <http://164.195.100.11/netahhtml/search-bool.html>

DESCRIPTION: United States Patent & Trademark Office database of patent and trademark owners. Fully searchable by keyword.

WEBSITE: <http://www.bizjournals.com/search.html>

DESCRIPTION: Bizjournals (formerly American City Business Journals) publishes 46 weekly business journals with extensive coverage of private businesses. The site recently began offering a free alert service (Search Watch) to registered users.

WEBSITE: www.corporateinformation.com

DESCRIPTION: Database of over 350,000 business profiles and reports searchable by company name. Has an extensive links collection including international business sites.

WEBSITE: <http://sbs.dnb.com/advFind.asp>

DESCRIPTION: Dun & Bradstreet is making their basic corporate information available in a searchable database. There is no charge. The sales figures are estimates.

WEBSITE: www.newsdirectory.com

DESCRIPTION: Extensive database of news sources ranging from newspapers to television station websites. Also contains link to college and university websites.

WEBSITE: http://yahoo.iplace.com/sales_search.asp

DESCRIPTION: The Home Sales Search database covers ALL 50 STATES. This includes 6 non-disclosure states, where by law, we are unable to show an exact sale price. In these 6 non-disclosure states (IN, KS, MS, NM, UT, WY) you will receive a sale price range rather than an exact sale price. The Home Sales Search database includes sales in over 2,500 counties.

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WEBSITE: www.wsj.com

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WEBSITE: <http://news.ft.com/home/us/>

DESCRIPTION: European and Asian business coverage with a searchable archive. Maintains a global archive with 8.5 million articles from 3,000 sources searchable by keyword, region, and industry.

WEBSITE: <http://nccs.urban.org/990/>

DESCRIPTION: The Urban Institute, in conjunction with GuideStar (www.guidestar.org), has put over 61,000 private foundation 990-PF documents into PDF format for retrieval.

WEBSITE: <http://www.freerisa.com/5500/Search5500.asp>

DESCRIPTION: IRS Form 5500 is a publicly available document covering company pension funds. This site has all 5500 forms in PDF and HTML format, searchable by company name, location, and employer identification number. Individual holdings are not disclosed. Only the number of plan participants and total assets are provided.

Website: www.secinfo.com

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Other Sites: www.sec.gov

www.10kwizard.com

WEBSITE: <http://finance.yahoo.com>

DESCRIPTION: Database of corporate insiders is licensed from Thomson Financial. It contains the last twelve-months of trading activity and has an insider cross-reference feature that shows multiple corporate affiliations. Yahoo also has information from MarketGuide including executive biographies, compensation and option holdings.

WEBSITE(s): www.google.com; www.google.com/advanced_search;
<http://directory.google.com/>

DESCRIPTION: Google has indexed over 2 billion pages which is the most complete (as of September, 2001) indexing of the web available.

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PITFALLS & POSSIBILITIES:

Case Studies in Planned Giving

I. Just Passin' Through: Charitable Gifts with S Corporation Stock and Assets

An S corporation is a separate legal entity for tax purposes. However, it is not normally taxed on its income. Instead, such income passes through ratably to the shareholders and is taxed to them whether or not the corporation actually distributes the income to them. As a result, corporate income distributed to shareholders is subject to only one level of tax. This contrasts sharply with a C corporation, which does pay tax on its net income. If a C corporation distributes its after-tax income to its shareholders in the form of a dividend, they pay a tax on the distribution. Result: two levels of tax.

A. The Situation

1. Dmitri Donor is the sole owner of an S corporation.
2. The corporation owns an apartment complex with a current FMV of \$10,000,000.
3. For simplicity, let's assume the value of Dmitri's S corporation stock is also \$10,000,000. His basis in the shares is \$500,000.
4. The apartment complex is not encumbered by a mortgage. It generates substantial cash flow. The corporation would have depreciation recapture income on a sale of the property.
5. Dmitri is thinking about selling the property and liquidating the corporation, but has not started looking for a buyer yet.
6. He is contemplating some kind of gift to his favorite public charity.

B. Outright Gift of Stock

In 1998, Congress expanded the rules governing permissible S corporation shareholders. Prior to that amendment, a Section 501(c)(3) charitable organization was not a permissible shareholder, so an outright gift of S corporation stock to a charity terminated the S election. In most cases, that would be a very undesirable result. The 1998 amendment makes a charity a permissible S corporation shareholder. However, there is a price to pay. See B.2 below.

1. Benefit to Dmitri
 - a. The stock is long-term capital gain property, and Dmitri would have no ordinary income if he sold it. As a result, his tax benefits will be the normal ones for an outright gift of appreciated long-term capital gain property to a public charity:

- i. The amount of his charitable gift for federal income tax purposes will be the FMV of the stock on the date of the gift. This is apparently true despite the fact that the charity will pay tax on the gain if it later sells the stock, which it almost surely will. See B.2 below.
- ii. The gift is deductible up to 30 percent of Dmitri's federal AGI, with five-year carry-forward.
- iii. If Dmitri will claim a deduction of more than \$10,000 for the gift, he must obtain a "qualified appraisal" of the donated stock within prescribed time limits and must file Form 8283 with his income tax return. Two points are important here. First, an appraisal of stock in a closely held business is expensive. Second, if he gives a minority block of shares, the appraiser will value the gift by applying a minority interest discount of anywhere from 20 to 40 percent.

2. Consequences for charitable donee

- a. Pass-through income: The net income of an S corporation passes through its shareholders for tax purposes whether or not the income is actually distributed to them. IRC § 1366(a). As a result, corporate income which is distributed to shareholders is normally subject to only one level of tax. If a charity is an S corporation shareholder, its share of the S corporation's income is unrelated business taxable income ("UBTI") taxable to the charity at the rates which apply to for-profit corporations. IRC § 512(e)(1)(B)(i).
 - i. The potential risk to the charity is that it will have taxable income with respect to the donated S corporation stock but will not receive a cash distribution from the S corporation to pay the tax.
 - ii. In many cases, the articles, bylaws or shareholder agreement of an S corporation require that it distribute enough cash to its shareholders each year to allow them to pay the tax on the pass-through income. A charity should ask to review these documents before accepting a gift of S corporation stock. If they do not provide for cash distributions to pay tax, the charity will have to decide whether the potential benefits of the gifts outweigh the potential adverse tax consequences.

- iii. In evaluating the potential risk of having taxable income without cash to pay the tax, the charity should also try to determine when it will be able to dispose of the stock and at what price. Obviously, there should be no agreement with the donor, the corporation, or a third-party buyer before the gift occurs. Otherwise there will be a “pre-arranged sale,” and the donor will be taxed on the gain. Nevertheless, the charity can make reasonable inquiries about the prospects for a later sale.
- b. Gain on sale: The other tax consequence for the charity occurs if and when it sells the S corporation stock. It takes a carry-over basis from the donor, which will probably be quite low. As a result, it will most likely realize substantial gain on the sale. Such gain is also UBTI, and is taxable at normal corporate rates. IRC § 512(e)(1)(B)(ii). Note that corporations, unlike individuals, do not have a lower capital gains tax rate. Because of gain on a sale by the charitable donee is UBTI, the benefit of the gift to the charity can be as little as 60 percent of the FMV of the stock. In most cases, this should not matter to the charity because it is not obligating itself in any way. Presumably, an outright gift of any size is always welcome. This discrepancy between the FMV of the gift property and the benefit to the charity will matter only in a case where the donor is fulfilling a pledge for a dollar amount gift. Should the charity value the gift for that purpose at the stock’s fair market value or at the amount of the after-tax proceeds it would receive if it sold the stock at its fair market value on the date of the gift?

C. Funding a CGA with S Corporation Stock

If Dmitri funds a CGA with some of his S corporation stock, the transaction will not terminate the S election because a charity is a permissible shareholder.

1. Benefits for donor: In a sense, a CGA funded with S corporation stock has the same benefits for the donor as a CGA funded with any other kind of appreciated stock held long term. In reality, the tax consequences for the charity mentioned in B.2 above mean that the benefits for the donor will be substantially reduced.

2. Consequences for donee: In a typical case, the charity will sell the S corporation stock soon after receiving it, either back to the corporation in a redemption or to a third-party buyer. In either case, after the charity pays tax on the gain, it will be left with less than the FMV of the stock. If the donor had a zero basis, the charity's after-tax sales proceeds will be only 60 percent of the stock's FMV.
 - a. Given these consequences, a charity would presumably base the annuity rate on the anticipated after-tax sales proceeds it will realize, not on the FMV of the stock on the date the donor funds the CGA. Otherwise, its benefit from the CGA will be substantially less than the benefit which its gift annuity rates are designed to produce.
 - b. There are two consequences for the donor.
 - i. The dollar amount of the annual annuity payment will be lower than if the donor funded the CGA with publicly traded stock of the same value.
 - ii. The capital gain avoidance/capital gain deferral feature of a CGA is effectively nullified.

Depending on the facts, the donor might be better off selling the stock himself and funding the CGA with the after-tax proceeds.

D. S Corporations and CRTs

1. Funding a CRT with S corporation stock: A CRT is not a permissible S corporation shareholder. See IRC §§ 1364(6)(1)(A) and (c)(2). Therefore, transferring S corporation stock to a CRT immediately terminates the S election. Normally this is undesirable:
 - a. Dmitri obviously made the S election because he considered it desirable from a tax point of view. Presumably he doesn't want to terminate it simply to be able to fund a CRT.
 - b. In addition, if he plans to sell the business, he will probably be selling it to another individual, who most likely will wish to continue S corporation status. If he transfers S corporation stock to a CRT before a sale, the S election will terminate and cannot be reactivated for five years without consent of the IRS. A buyer who was expecting to buy S corporation stock will probably discount the offered purchase price substantially if he has to purchase a C corporation instead.

- c. If a C corporation (*e.g.*, a publicly held company) is purchasing Dmitri's corporation, termination of the S election will not be an issue. The S election will terminate in any case when the C corporation purchases the stock.

2. Funding a CRT with S corporation assets:

- a. A corporation is a permissible donor to and income beneficiary of a CRT. PLR 92-05-031. The only restriction is that the CRT must run for a term of years, not for the life of an individual (*e.g.*, the sole shareholder). Thus, Dmitri can cause his S corporation to transfer the apartment building to the CRT in anticipation of a sale. Payments will be made back to the CRT for a fixed term, which must be 20 years or less.
- b. In theory, this arrangement works much like a term-of-years trust funded by an individual with an appreciated asset. There are, however, some limitations and differences.
- c. The charitable contribution resulting from the funding of the CRT flows through to Dmitri. In addition to the normal limits on deduction of charitable gifts (including reduction for potential ordinary income), however, Dmitri's deduction is limited to his basis in his S corporation stock.
- d. Distributions from the CRT to the corporation are taxable income, but such income flows through to Dmitri. If one of two important conditions is satisfied, CRT payments can be distributed to him with only one level of tax.
 - i. Either the CRT must not have any "subchapter C earnings and profits" at the end of the year in which it is funded, or after it is funded no more than 25 percent of its gross income can come from "passive sources". An S corporation will have subchapter C earnings and profits only if it has been a C corporation earlier in its history has earnings and profits remaining from that period. Most likely, distributions from the CRT to the corporation constitute passive income.
 - ii. If neither of these conditions is satisfied, two adverse consequences follow. First, during the initial three years of the CRT, the distributions to the corporation and from it to Dmitri are subject to *two* levels of tax. IRC § 1375. Second, after three years, the S election terminates. IRC § 1362(d)(3).
 - iii. Even if there are subchapter C earnings and profits, these adverse results can be avoided if they are distributed to the shareholder before the end of the year in which the S corporation funds the CRT. Unfortunately, this

distribution is treated as a taxable dividend to the shareholder. IRC § 1368(e)(3). Therefore, if an S corporation has subchapter C earnings and profits, the viability of a “corporate” CRT depends on whether the tax cost of distributing the earnings and profits outweighs the tax benefits of the CRT.

- iv. Even if one of these two conditions is satisfied, there is one situation in which there *may* be two levels of tax. If a C corporation which holds appreciated assets converts to an S corporation and sells those assets within 10 years of the conversion, the sale will be subject to two levels of tax. IRC § 1374. If an S corporation in that situation transfers the appreciated asset to a CRT which later sells it, it is possible that any portion of such gain distributed from the CRT to the S corporation will be subject to two levels of tax. Because the character of income earned by a CRT retains that character if distributed to the CRT’s beneficiary, this may be the result, although there is no authority directly on point.
3. Why doesn’t Dmitri take the building out of the S corporation and transfer it to a CRT for himself? That’s a good question. If that would work, he could set up a one-life CRT instead of a term-of-years version, and he would avoid all of the complications described above regarding subchapter C earnings and profits. The problem is that the distribution of an appreciated asset to an S corporation shareholder is treated like a taxable sale. IRC §§ 1371(a), 311. In effect, all of the gain in the distributed asset (\$9,500,000) will be taxable to Dmitri. Not a good deal.

II. LLCs

A limited liability company or LLC is a business entity which has emerged under state law over the past decade. It is designed to combine the best features of a corporation and a partnership. Owners of interests or units in an LLC are normally insulated from the liabilities of the LLC. Its income flows through to unit holders with only one level of tax. IRC § 701. In many respects, an LLC is like an S corporation in combining limited liability with pass-through of income, but an LLC is somewhat more flexible. In addition, some of the tax consequences of an LLC are more favorable. Charitable gifts are a case in point.

A. The Situation

1. Dmitri’s half-brother, Doug, also wanted to own and run an apartment complex. Unlike his semi-sibling, Doug decides on an LLC as the business entity within which to operate his building.

2. Curiously enough, the building in Doug's LLC has the same FMV as the building in Dmitri's S corporation - \$10,000,000 – even though the buildings are located at the opposite ends of town. Doug also has a \$500,000 basis in his LLC, and the building has no debt on it.
3. Doug's LLC has taken accelerated depreciation deductions with respect to the building and would have depreciation recapture income on a sale.
4. As you've guessed by now, Doug and Dmitri think along similar lines. Doug is also considering some kind of charitable gift.

B. Outright Gift of LLC Units

Assume that Doug gives some of his LLC units to his favorite public charity. What are the tax benefits for Doug, and what are the consequences for the charitable donee?

1. Tax benefits for Doug

- a. The amount of the gift will be the FMV of the donated LLC units decreased by a ratable share of potential recapture income on the partnership property. If an owner of LLC units sells them, the owner will have ordinary income to the extent of the owner's share of potential partnership recapture income and potential ordinary income on other "hot assets" listed in Code Section 751. Note that this is different from the result with Dmitri's S corporation.
- b. In other respects, the benefits are like those for Dmitri. The annual deduction limit and carry-forward rules are the same, as are the qualified appraisal requirements.

2. Tax consequences for charity

- a. A ratable portion of an LLC's income flows through to each of its unit holders. If a charity holds units, its share of LLC income will be taxable UBTI if such income would be UBTI if generated directly by the charity. IRC § 512(c)(1). Fixed cash rent from an apartment building is not UBTI, IRC § 512(b)(3), so Doug's favorite charity does not have to worry about tax liability on LLC income.
- b. Similarly, gain on the sale of a capital asset is not UBTI so if the LLC sells the building, the charity's share of the gain will not be taxable either. IRC § 512(b)(5).
- c. In contrast to a sale of S corporation stock, a sale of LLC units by a charity does not generate UBTI. IRC § 512(b)(5).

C. Funding a CGA with LLC Units

As mentioned above, LLC units held by a charity do not have the special, unfavorable tax consequences of S corporation stock in a charity's hands. As a result, the tax consequences of a CGA funded with LLC units are the same as those of a CGA funded with garden variety long-term capital assets, with one exception. Remember that the amount of Doug's outright gift of LLC units had to be reduced by a ratable share of the potential recapture income on the apartment building. In any of the circumstances listed in B.1.a above, LLC unit holders would have ordinary income on a sale of their units. As a result, the amount of the charitable gift for tax purposes, whether outright, or in exchange for a CGA, must be reduced in an amount to reflect the share of those items attributable to the donated units.

D. LLCs and CRTs

There are three ways Doug can use his LLC to fund a CRT.

1. Funding with LLC units: Doug transfers some or all of his LLC units to a one-life CRT which makes payments back to him. The CRT can later sell the LLC units to a third party. If two strict conditions are satisfied, the CRT could also sell the LLC units back to the LLC itself. Failure to satisfy those conditions would cause the redemption of the LLC units to be an act of self-dealing. See IV.D.3 below.
 - a. Because there is potential recapture income, the amount of Doug's charitable gift will be the present value of the remainder interest in the trust, computed from an amount equal to the FMV of the transferred LLC units minus the potential recapture income.
 - b. Assuming there is no "pre-arranged" sale of the units, neither Doug nor the CRT will be taxed if the CRT later sells those units. As mentioned above, fixed cash rent is not UBTI. As a result, the LLC income received by the CRT will not be UBTI and the CRT will be tax-exempt when it sells the units.
2. Distribution followed by funding: The LLC can distribute an appreciated asset to Doug, who can then transfer it to a one-life CRT for himself. In normal circumstances, the distribution from the LLC to him will not be a taxable event either for him or for the LLC. At this point, we have the familiar case of a donor transferring an appreciated asset to a one-life CRT for himself. Note that because there is potential recapture income in the building Doug's income tax deduction will be reduced.

3. Direct funding by LLC: The LLC can transfer an appreciated asset directly to a term-of-years CRT which makes its payments back to the LLC. This arrangement is similar to the S corporation CRT described above but without some of the complications.
 - a. The charitable gift resulting from the funding of the CRT flows through to Doug. In addition to the usual limits on deductibility, Doug's deduction is limited by his basis in his LLC units. The limit is more favorable than in the case of an S corporation, however. To be able to claim the entire charitable gift, his basis in his LLC units must be at least as great as the portion of the basis in the apartment building allocated to the charitable gift. Rev. Rul. 96-11, 1996-1 C.B. 140.
 - b. Annual distributions pass through the LLC to Doug with only one level of tax. In contrast to the S corporation situation, there are no tax attributes of the LLC which would cause double taxation or which would cause the LLC to cease to be a pass-through entity.

III. Sole Proprietorship

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

A. The Situation

1. Fred Philanthropist operates a construction business as a sole proprietor. He estimates that the FMV of the business is \$1,000,000.
2. The only business asset is "goodwill," *i.e.*, his name and reputation, his client contacts and similar business-generating intangible assets. His basis in these assets is zero.
3. Fred has been talking informally with a potential buyer but has not entered into formal sale negotiations. The buyer has told Fred that he would like to hire him as a consultant for a few years to help him run the business and maximize the value of the business name.
4. The business is not seasonal. Fred has construction projects in the works now and new projects come in on a regular basis.
5. Fred wants to make a charitable gift but also wants to receive lifetime income.

B. Funding a CGA with the Sole Proprietorship

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

C. Funding a CRT with the Sole Proprietorship

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

D. CRT Funded with Stock of Incorporated Business

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

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

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

This plan avoids all of the problems identified with the three preceding alternatives. It does not, of course, avoid tax on the gain on a sale of the goodwill. It does, however, generate an income tax deduction which will partially shelter that gain. Because of the difference between corporate tax rates and individual tax rates on capital gain, it turns out that the difference between this alternative and the plan under D above (assuming all its problems could be solved) is not very great. The increased certainty of the tax consequences and the reduced complexity make this approach worth considering.

IV. CRTs Funded with Business Interests or Assets – Self-Dealing Concerns

Code Section 4941 prohibits certain acts of “self-dealing” between a charitable remainder trust and its “disqualified persons.” Both the definition of “disqualified person” and the list of prohibited acts of self-dealing (and the exceptions) are intricate. The situation is further complicated by the concept of “indirect” self-dealing. **Given this context, every CRT funded with a closely held business interest or an asset used in such a business should be scrutinized carefully ahead of time to see if it presents self-dealing problems.** This section of the outline will deal with several of the most commonly encountered self-dealing issues.

A. Disqualified Persons

For present purposes, four of the categories of disqualified person listed in Section 4946 are important.

1. The donor of the CRT.
2. Certain members of the donor’s family.
3. In the case of a CRT set up by a corporation, partnership or LLC, an owner of more than 20 percent of the voting power (corporation) or profit interest (partnership or LLC) in the donor entity.
4. A corporation, partnership, trust or estate in which disqualified persons have a substantial interest (what counts as substantial depends on the type of entity).

B. Acts of Self-Dealing

The acts of self-dealing most commonly encountered when a CRT is funded with closely held business interests or assets are:

1. Sales, exchanges of leases of property.
2. Loans or other extensions of credit.
3. Payment of compensation.

4. Redemption of business interests by the entity (corporation, partnership or LLC) in question.

C. Indirect Self-Dealing

If a CRT controls a closely held business (*e.g.*, by owning a majority of the voting stock of a closely held corporation), financial transactions between the corporation and disqualified persons are potentially acts of self-dealing. Treas. Reg. § 53.4941(d)-1(b). For example, assume that a donor transfers all of the stock in his closely held corporation to a CRT and that at the time the CRT is funded, the donor also owns a building which he leases to the corporation. Once the trust is funded, the lease is potentially an act of self-dealing.

D. Typical Self-Dealing Issues

To illustrate some common configurations, let's consider a closely held corporation.

1. CRT controls corporation

- a. Donor leases building to corporation: In general, this would be an act of self-dealing. IRC § 4941(d)(1)(A). There is an exception, however, if the lease (the use of the property) is rent-free and the CRT uses the building "exclusively for purposes specified in Section 501(c)(3)." IRC § 4941(d)(2)(C). How this second requirement, which was originally intended to apply to private foundations, applies in the context of a CRT is unclear. Arguably, a rent-free lease of the building to the CRT should be permissible.
- b. Donor is employed by corporation: This is permissible if the donor provides necessary services to the corporation and his compensation is not excessive. IRC § 4941(d)(2)(E).
- c. Loans by a disqualified person to the corporation (including guarantees of third-party loans): Loans and guarantees are generally self-dealing. IRC § 4941(d)(1)(B). There is an exception for an interest-free loan. IRC § 4941(d)(2)(B).

2. Donor controls corporation / CRT holds asset used by corporation: The most common act of self-dealing in this situation is a lease of the building from the CRT to the donor-controlled corporation. This will be an act of self-dealing. Unfortunately, there are no exceptions.

3. Corporation is disqualified person and CRT holds stock: Redemptions are permissible under Section 4941(d)(2)(F) if two conditions are satisfied:

- a. The CRT receives FMV for its shares.

- b. The same offer of redemption is made on the same terms to all holders of the same class of shares.

V. Funding CRTs with Nonliquid Assets – Selected Issues

Funding a CRT with a closely held business interest or other nonliquid asset raises myriad tax issues, some of which we have touched on. Putting a nonliquid asset in a CRT also raises important nontax issues. Two common ones are discussed here.

A. Suiting the Gift Vehicle to the Asset

By definition, a nonliquid asset cannot readily be sold by a CRT to generate cash for reinvestment. Moreover, nonliquid assets do not necessarily generate income. Bare land and closely held stock which pays no dividend are examples. Even with an income producing asset such as rental real estate, the flow of income is not guaranteed. These features of nonliquid assets can lead to awkward problems, or worse, for some types of CRT.

1. Case Study (a/k/a horror story)

- a. Donor funded a CRAT with bare land which he believed was ripe for development. The parcel was appraised at \$4,000,000 when the trust was funded. The trust payout was defined as 7 percent of the initial value of the trust property.
- b. The trust called for quarterly installments. To give the trust cash to make those payments until the property was sold, the charity which was the trustee/remainder beneficiary began purchasing fractional interests from the trust. Both the amount of the quarterly payment and the amount of the fractions being purchased were based on the assumption that the property was worth \$4,000,000.
- c. For 18 months the charity/trustee attempted unsuccessfully to sell the property. The realtor insisted the property was overvalued. The charity decided to test that theory by commissioning two appraisals, and guess what? Both appraisers said the property was worth less than one-third of the \$4,000,000 asking price.
- d. At this point, no one was very happy. The donor had been overpaid, and of course the charity had paid too much for the fractional interests it had purchased. As required by the Treasury Regulations, the charity had to recalculate the initial value of the trust property, recoup overpayments from the donor, and reduce the annual payment going forward to an amount far below the donor's expectations.
- e. Most of these problems could have been solved by selecting a more appropriate gift vehicle.

2. Better alternatives: The main problem with the CRAT in this context is that it has to make the prescribed annual payment by the end of each year whether or not it has cash to do so. If the CRAT is unable to liquidate the gift property, it has only two choices. It can do what the trustee did in our case study or it can make taxable in-kind distributions of fractional interests in the property to the donor. Neither solution is very attractive. Funding a standard CRUT with a nonliquid asset poses roughly the same problem. The solution, of course, is to use a net income with make-up unitrust (“NIMCRUT”) or a flip CRUT. Each has its advantages.
 - a. NIMCRUT: A NIMCRUT has two potential advantages:
 - i. There is a continuing opportunity for make-up of deficits after the gift property is sold. Whether payment of the make-up account is a real possibility, however, depends on conditions in financial markets and the investment acumen of the trustee.
 - ii. After the nonliquid gift property is sold, the trustee can regulate the amount of annual payments to some extent by shifting the trust corpus between growth-oriented and income-oriented investments. Note that the trustee cannot promise ahead of time to follow any particular investment strategy and cannot manipulate trust investment to create a benefit to the income beneficiary at the expense of the remainder beneficiary. To do either would probably disqualify the trust or be an act of self-dealing. Treas. Reg. §1.664-1(a)(3), 53.4941(d)-2(f).
 - b. Flip CRUT: The main advantage of a flip CRUT is that it gives the trustee more investment flexibility once the nonliquid gift property is sold. Once the trust converts to a standard CRUT, the annual payment will not depend on trust income, so the trustee has maximum flexibility to invest for total return.
3. What if the donor insists on an annuity trust? The charity has two choices:
 - a. The charity can refuse to act as trustee, which could mean losing the gift.
 - b. The charity could agree to act as trustee provided that it is very careful to do two things:
 - i. Obtain more than one appraisal of the gift property before agreeing to the arrangement; and

- ii. Make it clear to the donor that until the property is sold, the charity as trustee will make in-kind distributions of fractional interests in the property to the donor to the extent trust income is insufficient to make the required payments. The charity should also be sure the donor understands that these distributions will be taxable in part.

B. Suiting the Gift Vehicle to the Family Situation

1. Case Study

- a. Donor set up four two-life NIMCRUTS, each with himself as initial beneficiary and one of his four children as successor. Each trust was funded with publicly traded securities and one-fourth of the stock in his closely held C corporation. The only asset of the C corporation was bare land located at the edge of a major metropolitan area.
- b. A sale of the corporation (or a sale of the land by the corporation) was more difficult than the donor had anticipated.
- c. The donor died about five years after creating the trusts, leaving each child with a NIMCRUT, roughly half the assets of which were nonliquid and nonincome producing.
- d. The children, who were not thrilled with their father's charitable gift planning to begin with, are now at odds with the charitable beneficiary/trustee. They are irate that they are not receiving the full unitrust percentage each year, and they believe the trustee should have been able to liquidate the corporation by now.

2. The better alternative: Divide the gift plan into three components:

- a. Put all or most of the publicly traded securities into four two-life standard unitrusts, each for the donor and one child.
- b. Put all of the stock into a one-life NIMCRUT or a flip CRUT for the donor.
- c. Use the tax savings from the income tax deductions from the two CRUTS to fund a "wealth replacement" irrevocable insurance trust designed to replace as much as possible of the value of the closely held corporation for the children.

C. Topics Not Covered

Funding an outright charitable gift, a CGA or a CRT with nonliquid assets raise a host of issues beyond the scope of this outline. Two deserve brief mention here even though time and space do not permit a discussion.

1. “Pre-arranged sales”: There are a number of theories under which a donor who uses appreciated property to fund a charitable gift will be taxed on the gain if the charity or charitable trust later sells the gift property. Commentators usually lump those theories under the heading of “pre-arranged sales.”
2. Miscellaneous Non-Tax Issues: These will depend on the particular case. Environmental liability is sometimes an issue if the gift involves real estate or an entity which holds real estate. Other types of legal liability are also an issue. Sometimes a charity does not want to be associated with the particular business activity in question. Obviously, particular gift situations will raise other issues which are impossible to anticipate in the context of a presentation like this one.

VI. Zen and the Art of Planned Giving

The quintessential koan (Zen paradox) is “What is the sound of one hand clapping?”. Today’s koan is more mundane: What kind of deferred gift is not deferred? The answer is the so-called “construction financing CRT.”

A. Overview

In essence, the construction financing CRT is quite simple. The donor funds it with cash or appreciated publicly traded securities. The charity/trustee liquidates the gift property and lends the cash proceeds to itself in exchange for its promissory note. It uses the cash to provide financing for the construction of a building or some other capital project. The trust receives the charity’s interest payments on the note and uses them to make the annual distributions to the donor. When the donor dies, the note is distributed to the charity, and the debt is forgiven. Unlike a conventional loan, the only cost of the borrowed funds to the charity is the annual interest payments. In effect, this is “principal-free” financing, which will be cheaper than commercial financing and may even be less costly than issuance of tax-exempt bonds.

B. Implementation

1. Investment discretion: The charity/trustee *must not promise* that it will liquidate the gift property and lend the cash to itself in exchange for a promissory note. The IRS has interpreted such an ancillary agreement regarding trust investments as an impermissible restriction on the CRT trustee’s investment discretion. *E.g.*, PLR 77-49-033. The IRS has concluded that such an agreement will disqualify the trust.

2. Interest rate: The note must bear interest at the market rate of interest, based on the charity/obligor's credit worthiness and the prevailing interest rates. Accepting a note with too high or too low an interest rate would breach the charity/trustee's fiduciary duty either to itself or to the income beneficiary.
3. Unitrust vs. annuity trust
 - a. An annuity trust works better than a unitrust in this context. The fixed annual payment should be set slightly below the anticipated interest rate on the note. The excess can be used to defray trust expenses. Because the trust payout and the interest payment remained fixed, the arrangement works quite smoothly.
 - b. With a unitrust, the annual payment depends on the annual value of the note, which will vary with prevailing interest rates and the credit worthiness of the charity. If interest rates decline, the value of the note will go up, and the required annual payout will increase. If the annual payout exceeds the interest rate, a fractional interest in the note will have to be distributed to the donor to make up for the difference – obviously an undesirable result.
4. Trust term: A fixed term of 20 years or less works better than a term measured by the lives of the trust beneficiaries. With a fixed term, the charity will be able to calculate its financing costs precisely. With a one- or two-life trust on the other hand, the term is open-ended, and as a result, so is the cost of financing.
5. Self-dealing
 - a. Federal law: As discussed in IV above, CRTs are subject to the prohibitions against self-dealing. A loan from a CRT to a disqualified person is an act of self-dealing. Normally, the trustee of a CRT is a disqualified person, but there is an exception for a Section 501(c)(3) organization. Therefore, if the charity as trustee lends trust assets to itself, no self-dealing occurs for federal tax purposes.
 - b. State law: State trust law generally prohibits a trustee from engaging in financial transactions with the trust. However, the law of most states also permits the trust agreement itself to override that prohibition. Obviously, state law should be consulted on a case-by-case basis, and the CRT agreement should be drafted accordingly.

VII. Some Do's and Don'ts with CLTs

CLTs are less common than CRTs but are worth pursuing because of their potentially enormous benefit to the charity. Because CLTs are primarily a gift and estate tax savings device, they appeal to donors with very substantial estates. As a result, they tend to be quite large, typically funded with at least \$1,000,000. In addition, in contrast to a CRT, a CLT provides a charity with an immediate and ongoing benefit – a sequence of defined payments for a term of years.

A. Refresher Course

Because CLTs are less common than CRTs, a brief review may be helpful.

1. A CLT makes an annuity or unitrust payment to a charity for a defined term of years. At the end of the term, the remaining property is distributed to the donor's family, typically children or grandchildren. Net income variants on a unitrust are not permitted. The trust may run for a fixed term of any length or for the lives of named beneficiaries.
2. With the simpler version of a lead trust ("a nongrantor lead trust"), the donor is allowed no income tax deduction. A gift tax deduction (lifetime CLT) or an estate tax deduction (testamentary CLT) is allowed for the present value of the charity's lead interest. This discussion will focus exclusively on nongrantor CLTs.
3. The trust itself is a taxable entity but is allowed an income tax deduction for any gross income it is required to distribute to the charity each year. Thus, if a lead trust is properly managed, it will be tax-exempt in practice.
4. Lead trusts have two principle transfer tax benefits:
 - a. A lead trust reduces overall gift and estate tax liability because of the gift and/or estate tax charitable deduction for the lead interest.
 - b. If the rate of return on the CLT's assets is greater than the applicable federal rate used to present value the lead interest for charitable deduction purposes, the CLT will provide gift or estate tax "leverage." In other words, the real value of the family's remainder interest will be greater than its tax value. As a result, the tax on the transfer to family members is *actually reduced*.

B. CLT Planning in Light of the New Tax Act

Under the 2001 Tax Act, the unified exemption will increase and there will be no estate tax for those lucky enough (?) to die in 2010. In the unlikely event that Congress extends the estate tax "repeal," there will be no estate tax for those dying in later years either. On the other hand, if the law sunsets at the end of 2010, the prior estate tax law will come back: unified exemption of \$1,000,000 and maximum estate tax rate of 55 percent. Under these circumstances, it is more difficult than ever to predict whether an estate of a given size today will actually

generate estate tax. There are, however, a couple of rules of thumb for lead trusts in this tax environment.

1. A donor should not fund a lifetime CLT with a remainder interest in excess of his or available unified exemption. To do so would result in the payment of gift tax. If it later turns out that there would be no estate tax at the donor's death if he had kept the property (either because of increased exemption or because of estate tax repeal), the gift tax will be wasted.
2. A testamentary lead trust is still very attractive. The donor should, however, revisit his or her estate plan periodically to be sure the trust will still provide estate tax benefits if the donor dies under then current estate tax laws.

C. Diversify! Diversify!

One concern with a CLT, especially if the charitable beneficiary is the trustee, is that the impact of poor investment performance falls primarily on the remainder beneficiaries – children or grandchildren. This risk can be especially great if the donor funds the trust with one or two favorite stocks which the donor believes will grow spectacularly over the term of the trust.

1. Remember that a lead trust is not tax-exempt. Therefore, its ability to sell off the stock and diversify is limited. The higher basis in the gifted stock, the more leeway. In the case of stock with a very low basis, diversification may be virtually impossible.
2. Given the recent shocks in the stock market, donors and charities should know better than to set up CLTs exclusively with low basis stock of a company whose shares are volatile. This presenter has heard of instances of lead trusts funded with tech stocks which have dried up completely over the last two years!

D. Transfer Tax Leverage and the Fed

As explained above, the bigger the spread between the rate of return on lead trust assets and the applicable federal rate used to value the lead interest, the greater the estate tax leverage. Federal interest rates are at historic lows at the moment. The applicable federal rate for February, which is available for gifts in March and April as well, is 5.6 percent. The historical rate of return for the stock market is 10 percent. Subtracting 1 percent for investment management and other fees, that leaves a 9 percent return on trust assets - a substantial spread to work with. A lifetime CLT funded today with the remainder of less than the unified exemption locks in this spread for gift and estate tax purposes.

This outline is based on the federal tax law in effect on the date it was completed: February 15, 2002. It is only a summary of the subject matter it addresses, and it is intended to provide information of a general nature only. It should not be construed as a comprehensive treatment or as legal advice or legal opinion on any specified facts or circumstances. Readers are urged to consult with an attorney concerning their own situations and any specific legal questions they may have.

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Sparkling Ideas...



in the Emerald City

LEAVING RETIREMENT PLAN ASSETS TO CHARITY: SUMMARY OF PRIVATE LETTER RULINGS

Jeremiah W. Doyle IV, Esq.
First Vice President
Mellon Private Asset Management
One Boston Pl. 024-0106
Boston, MA 02108
(617) 722-7420
FAX (617) 722-7916
doyle.j@mellon.com

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**25th Conference on Gift Annuities
American Conference on Gift Annuities**

**Leaving Retirement Plan Assets to Charity:
Summary of Private Letter Rulings**

**Jeremiah W. Doyle IV, Esq.
First Vice President
Mellon Private Asset Management
Boston, MA**

April 11, 2002

PLR 9237020

IRA to CRT

Ruling request:

1. Upon Settlor's death trust will qualify as CRUT.
2. Present value of property transferred to CRT upon settlor's death will qualify for estate tax charitable deduction.
3. If Settlor survives spouse, the establishment of IRA spousal rollover account in the Settlor's name by the trustee of a revocable trust will satisfy 402(a)(7) and 408(d)(3).
4. Consequences to trust from payment of proceeds of Settlor's IRA to CRT.

CRUT f/b/o Settlor's son and son's estate in the event of son's death during the CRT term. The term of the CRUT is the son's life or 20 years, whichever is longer.

Settlor will name CRT as beneficiary of her IRA.

Proceeds of IRA will be IRD.

Held:

1. Instrument qualifies as CRUT. CRUT will be exempt from income taxes unless it has UBTI.
2. The value of the remainder interest passing to charity will qualify for FET charitable deduction under Sec. 2055(a).
3. Establishment of spousal IRA rollover if Settlor survives the Settlor's spouse is hypothetical so IRS won't rule on this issue.
4. IRA classified as IRD. Under 691(a)(1), IRD not properly included in taxable period in which falls the taxpayer's date of death or a prior period shall be included in the gross income, for the taxable year when received, of the person who, by reason of the death of the decedent, acquires the right to receive the amount.

664(b) establishes tier system of taxation.

664(c) provides that a CRUT is exempt from tax unless it has UBTI.

IRS concludes:

Upon Settlor's death, the proceeds of the Settlor's IRA will be IRD under Sec. 691(a)(1)(B).

Because trust will be a CRUT within meaning of Sec. 664(d)(2), the trust will not be taxable on its income, unless it has UBTI.

Character of IRD in hands of CRUT will be considered to have the character that it would have had in the hands of the Settlor if Settlor lived and received such amounts.

Because trust is a CRUT under 664(d)(2), the character of the unitrust amounts payable to the Settlor's son or his estate will be determined under 664(b) and will consist first of ordinary income.

PLR 9253038

Qualified Plan to CRUT

Donor established an 8% NIMCRUT

CRUT will be f/b/o donor during his life and after his death to his wife for such time as she survives him. At death of survivor of donor and wife, the trust will terminate and the trust assets will be distributed to a college and used in such manner as its governing board determines. If college is not described in 170(b)(1)(A), 170(c), 2055(a) and 2522(a) at the time of distribution, the assets will be distributed to another organization which is then so described.

Under terms of qualified plan, if a participant dies before his account balance is distributed or used to purchase an annuity, his beneficiary will be entitled to the full value of his account.

Donor intends to execute a beneficiary designation form, with his wife's consent, under which a portion of his account will be distributed from the plan to the CRUT after his death.

Issue 1

Trust qualifies as CRUT. Thus, under Sec. 664(c) trust will not be subject to any income tax unless it has UBTI.

Issue 2

Trust income payable to spouse after Donor's death will be governed by the CRUT's tier system of taxation.

Issue 3

Interest passing to spouse qualifies for the estate tax marital deduction under Sec. 2056(b)(8). Thus, present value of wife's interest in property passing from the qualified plan to the CRUT as a result of the Donor's death will qualify for the estate tax marital deduction under Sec. 2056(a).

Issue 4

Present value of the charitable interest in property passing from the qualified plan to the CRT as a result of the Donor's death will qualify for the estate tax charitable deduction under Sec. 2055(a).

PLR 9341008

Transfer of IRA assets at death to private foundation.

Designation of private foundation as IRA beneficiary results in estate tax deduction, no taxable income to estate and its beneficiaries and the foundation and no 2% excise tax for the foundation.

T will create private foundation. T will name foundation as the beneficiary of the IRA proceeds upon her death.

Rulings requested:

1. Where private foundation is designated beneficiary of T's IRA, property passing from the IRAs to private foundation at the taxpayer's death will be eligible for a FET charitable deduction under Sec. 2055(a).
2. The estate of the taxpayer will not recognize taxable income upon the distribution of the proceeds of the taxpayer's IRA to the private foundation.
3. The beneficiaries of the estate of the T will not recognize taxable income upon the distribution of the proceeds of the taxpayer's IRA to the private foundation.
4. The private foundation will not recognize taxable income upon receipt of the proceeds of the T's IRA following the death of the T.
5. The private foundation will not be subject to the federal excise tax on net investment income under Sec. 4940(a) when the taxpayer's IRAs pass to the private foundation.

Holding:

A private foundation will not be able to satisfy the requirements of Reg. 1.401(a)(9)-1, D-5 (i.e. the private foundation won't qualify as a designated beneficiary), distributions from an IRA to the private foundation must occur within 5 years after the death of the owner of the IRA (assuming the IRA owner dies before her RBD).

Issue 1 (Estate Tax Charitable Deduction)

Transfer of IRA at death of T to private foundation (defined in §509(a) and is an organization described in §501(c)(3)), will qualify for estate tax charitable deduction.

Issues 2, 3 and 4 (Income in Respect of a Decedent)

If private foundation is named as designated beneficiary of the IRAs, the proceeds will be IRD to the private foundation under Sec. 691(a)(1)(B) when distributed to the private foundation and will not be IRD to the taxpayer's estate nor to the other beneficiaries of the taxpayer's estate.

Issue 5 (Excise Tax on Investment Income)

4940(a) imposes a 2% excise tax on the net investment income of each private foundation exempt from tax under Sec. 501(a).

Sec. 4940(c)(1) defines net investment income as the sum of gross investment income and capital gain net income which exceeds the deductions allowed by Sec. 4940(c)(3).

The statutory scheme of Sec. 4940 envisions a situation in which the private foundation has previously received an asset and is earning income from that particular asset or sells that asset. There is no taxation envisioned when a foundation receives an asset. The revenue rulings in this area deal with situations in which the private foundation has received the asset and the asset is sold or produces some type of income.

Based upon Rev. Rul. 74-404 and 80-118, a private foundation does not realize or recognize income upon receipt of a gift. Income is realized only when the foundation actually receives the income or sells the gift.

Thus, the private foundation will not be subject to the federal excise tax on investment income under Sec. 4940(a) when the T's IRAs pass to the private foundation.

(The author of this private letter ruling indicated that the private foundation would not be subject to the 2% excise tax on net investment income at the time the assets in the IRA are distributed to the foundation. Only the subsequent income generated on the assets distributed and net capital gains on the sale of such assets would be treated as net investment income for excise tax purposes).

The ruling doesn't address the determination of basis for assets of the IRAs (e.g. stock and bonds) distributed to the private foundation. Is the basis the FMV on the distribution date? Or is it the basis of the assets in the IRA prior to distribution? IRS has not addressed this issue. Basis

issues and capital gains can be avoided by selling assets in an IRA and then distributing the cash proceeds to the private foundation.

PLR 9633006

Keogh to private foundation.

Grantor created a private foundation within the meaning of §509(a). The private foundation qualifies for tax-exempt status pursuant to §501(a) as an organization described in §501(c)(3). Grantor is owner of a Keogh plan. The Keogh contains a separate account for the Grantor. Grantor has designated the private foundation as beneficiary of accrued benefit under the Keogh. A's spouse has executed a consent with respect to the designation of the private foundation as beneficiary of the Keogh. At the Grantor's death, the private foundation will receive the entire account balance from the Keogh plan.

Estate Tax Charitable Deduction

IRS held that Grantor's estate will receive a FET charitable deduction under Sec. 2055(a) for the proceeds of the Keogh passing to the private foundation.

IRD

IRS held that Keogh plan proceeds will be IRD to the private foundation and will not be IRD to the Grantor's estate nor to the other beneficiaries of the Grantor's estate.

Income and Excise Tax on Investment Income

The private foundation will receive the proceeds of the Keogh and the amounts in excess of contributions made to the account represent the **receipt of income** to the private foundation. (The estate will not receive the income of the Keogh and will not distribute estate income to the private foundation). Neither the Grantor nor the Grantor's estate will include the Keogh as income.

Based on Rev. Rul. 74-404 and Rev. Rul. 80-118, an exempt private foundation does not realize or recognize income upon receipt of a gift but realizes income only when the foundation actually receives the income or sells the gift.

Because the increase in value of the account is not income of an estate that was subsequently distributed to a private foundation, the exception provided by §53.4940-1(d)(2) of the regulations is not applicable. (That regulation says that in the case of a distribution **from** an estate or a trust described in §4947(a)(1) or (2), such distribution shall not retain its character in the hands of the distributee for purposes of computing the tax under §4940.

The proceeds in excess of the assets contributed to the account are held to be investment income and are subject to the excise tax on investment income under Sec. 4940 because the assets in the account are of the type that produce investment income.

Because the private foundation is exempt from income tax under Sec. 501(a), the private foundation will not recognize income subject to income tax upon receipt of the proceeds of the Grantor's Keogh account following the death of the Donor.

Qualified plan to CRUT

Rulings Requested:

1. No income tax will be payable by H or W or their children, or the trust, upon the distribution of the plan assets to the trust.
2. The present value of the charitable interest in the property transferred to the trust upon H's death will qualify for the estate tax charitable deduction under §2055.

H and W executed a CRUT. The two children of H and W will be the lifetime recipients of the unitrust amount.

H will designate the CRUT as the beneficiary of a qualified retirement plan. Thus, on H's death the proceeds of the plan will be paid in a lump-sum to the trust.

IRS concludes that:

Income from the distribution of the proceeds from H's qualified plan to the CRUT will be IRD.

The income attributable to the retirement plan will be includable in the gross income of the CRUT for the taxable year the distribution is received by the trust as the designated beneficiary of H's retirement plan. The CRUT (provided it is exempt) will not be taxable on its income for that year unless it has UBTI. Neither H nor W will be taxable on the income from the distribution of the retirement plan to the trust.

The character of the income distributed to the children from the CRUT will be ordinary income until the amount of ordinary income attributable to the retirement plan is used up. The income attributable to H's retirement plan will be included as ordinary (1st tier) income.

Provided the CRUT is a qualified CRUT, the present value of the remainder interest in H's retirement plan that is transferred to the CRUT will qualify for the FET charitable deduction under Sec. 2055(a).

Conclusion: Income from distributions of qualified plan assets to qualified CRUT is not taxable to the trust or trust grantors. The beneficiaries of the CRUT are taxable to the extent unitrust amount

distributions are characterized as income from the plan under §664(b).

PLR 9723038

IRA to Charity

Ruling request:

1. Distribution of IRA to Charity 1 and Charity 2 on the death of the survivor of T and S qualifies for estate tax charitable deduction for the FET value of IRA less the excess accumulation tax.
2. An estate tax deduction is allowed under §2053(a)(3) and §2053(c)(1)(B) for the excess accumulation tax.
3. Any distribution from the IRA to Charity 1 or Charity 2 will be included in the income of Charity 1 and Charity 2 as IRD and will not be included in the income of the estate of either T or S.

T and S (his spouse) reside in community property state (California). T funded an IRA with a rollover from a pension plan. The IRA is held in T's name and T has designated S as the primary beneficiary of the IRA. If S doesn't survive T, the two charities will receive the IRA assets when T dies. S consented to the beneficiary designations.

If S survives T, she will make an election under §4980A(d)(5) to defer the excess accumulation tax until S's death. S will designate Charity 1 and Charity 2 as the beneficiaries of the IRA on her death. If S fails to execute a new beneficiary designation form naming Charity 1 and Charity 2 as the IRA beneficiaries, the IRA will be payable to her estate at her death. (We don't know why IRA is payable to S's estate. It could be that the IRA agreement names the estate as a default beneficiary). S has executed a codicil to her will bequeathing the IRA proceeds to Charity 1 and Charity 2.

California Probate Code provides that the excess accumulation tax is imposed on the recipient of the **qualified plan's** assets. T executed a codicil to his will directing the recipient of the **IRA** at his death to pay any excess accumulation tax. The codicil in S's will also provides that any **qualified plan's** excess retirement accumulation tax will be paid by the recipients of the **IRA** assets.

T and S are both over 70 1/2 and have been withdrawing at least the MRD from the IRA.

Held:

1. The estate of the survivor of T and S will be entitled to an estate tax charitable deduction equal to the value of the IRA which passes to Charity 1 and Charity 2 reduced by any FET attributable to the decedent's excess accumulation tax imposed on the IRA.

2. The excess accumulation tax is deductible from the gross estate. Thus, the estate of the survivor of T and S will be able to claim a deduction for the amount of the estate tax attributable to a decedent's excess retirement accumulation.
3. The proceeds of the IRA, or of a successor IRA into which the IRA is rolled over, which would have been items of gross income to T and S if the proceeds had been distributed to them, will be IRD to Charity 1 and Charity 2 (and not to the estate of T or S) when distributed to those organizations.

Points:

1. Notice how T complied with the spousal consent rules under the REA of 1984 when T did the rollover from the pension plan to the IRA. Otherwise, S's rights in the pension plan may carryover to the IRA and, if S exercised her rights, T's desire to leave the IRA to Charity 1 and Charity 2 could have been frustrated.
2. Since the T named S as the primary beneficiary of the IRA, he was able to take MRD based on the joint life expectancy of both he and S. The ruling, however, doesn't indicate whether T was taking the MRD based on the joint life expectancy of he and S, nor does it indicate whether or not he elected to recalculate his and S's life expectancy.
3. Note that if T dies first, S is the primary beneficiary of the IRA. Thus, the IRA will qualify for the marital deduction in T's estate. The IRA can then be paid to S over the remaining joint life expectancy of T and S (assuming T didn't elect to recalculate his life expectancy). Alternatively, S could roll over the IRA into her own IRA, choose a new designated beneficiary and begin a new (and perhaps, longer) distribution period. (Note that if S did a spousal rollover and chose a new designated beneficiary other than the two charities, the T's intent to leave the IRA to the two charities would have been frustrated).

If T outlives S, the IRA can be paid to him over the remaining joint life expectancy of he and S (assuming he didn't elect to recalculate S's life expectancy). When T subsequently dies, the IRA is paid to charity, qualifying for the estate tax charitable deduction in his estate.

4. Notice how the attorney carefully preserved the fiduciary income tax charitable deduction under §642(c) by specifically providing in the codicil to the will that if S didn't execute a designated beneficiary from naming Charity 1 and Charity 2 as the beneficiaries of the IRA, that the IRA, which would then be payable to S's estate, is specifically left to Charity 1 and Charity 2. Thus, the disposition complies with the requirement of §642(c) that (1) the bequest is paid out of gross income and (2) that the bequest is paid pursuant to the terms of the

governing instrument, thus preserving the fiduciary income tax charitable deduction.

5. Notice how the attorney is deferring the excess accumulation tax from T's death to S's death, allowing the IRA to grow unreduced by the excess accumulation tax that would otherwise have been required to be paid when T died first. By leaving the IRA to S and having S elect to defer the excess accumulation tax to her subsequent death, by leaving the IRA to Charity 1 and Charity 2 they can avoid the excess accumulation tax altogether.
6. Notice how the attorney is requiring that the excess accumulation tax be paid out of the IRA, thereby reducing the amount the charity will receive, the amount of the charitable estate tax deduction but not otherwise increasing the estate tax due to the fact that the estate can take an estate tax deduction for the excess accumulation tax. The charities, as tax-exempt entities, can withdraw the money from the IRA to pay the estate tax without causing the withdrawal to constitute a taxable distribution. If the IRA were left to an individual and the individual took a distribution from the IRA to pay the estate tax, the individual would also have to pay income tax on the amount withdrawn to pay the estate tax.

PLR 9818009

IRA and 401(k) to Private Foundation

Taxpayer created a §509 private foundation which qualifies for §501(a) tax-exempt status as a §501(c)(3) organization. Taxpayer owns an IRA and participates in a 401(k). He intends to name the foundation as the beneficiary of the proceeds of the IRA and the 401(k) on his death. Taxpayer's spouse has or will execute any consent required by the Internal Revenue Code or regulations with respect to naming the foundation as the beneficiary of the retirement accounts.

Ruling request:

1. Distribution of IRA and 401(k) proceeds to foundation will be eligible for a federal estate tax charitable deduction.
2. The taxpayer's estate will not recognize taxable income upon distribution of the proceeds to the foundation.
3. The beneficiaries of the taxpayer's estate will not recognize taxable income on receipt of the distribution of the proceeds to the foundation.
4. The foundation will not recognize taxable income upon the receipt of the proceeds following the death of the taxpayer.
5. The foundation will not be subject to the federal excise tax on investment income under §4940(a) at the time the proceeds pass to the foundation.

The IRS concludes:

The Service explained that the value of the IRA and 401(k) will be includible in the taxpayer's gross estate on his death under §2039(a).

The Service ruled that if the foundation is still a §509 private foundation when the taxpayer dies, the taxpayer's estate will be eligible for a federal estate tax charitable deduction under §2055(a) for the proceeds of the IRA and 401(k) assets passing to the foundation.

The Service also ruled that if the foundation is named as the sole beneficiary of the IRA and the 401(k), the proceeds from the IRA and 401(k), which would have been items of gross income to the taxpayer if the proceeds had been distributed to him, will be income in respect of a decedent (IRD) to the private foundation under §691(a)(1)(B) when distributed to the foundation. The Service held that the proceeds from the IRA and the 401(k) will not be IRD to the taxpayer's estate and the beneficiaries of the taxpayer's estate.

The Service did not rule on whether the foundation will recognize income on receipt of the proceeds after the taxpayer's death or whether the foundation will be subject to federal excise tax on investment income at the time the proceeds pass to the foundation. These issues are being considered separately by the IRS.

PLR 199901023

Qualified Plan to CRT

Donor established an inter vivos CRUT. The unitrust was to be funded at the Donor's death. The Donor named the CRUT as the beneficiary of his qualified retirement plan. The qualified plan was payable in a lump sum to the trust. The CRUT was for the benefit of the Donor's two children. The balance in the CRUT upon termination was payable to a foundation.

Held:

1. The proceeds of the qualified retirement plan will be included in the gross income of the CRUT as income in respect of a decedent (IRD) in the year of receipt and will not be includible in the gross income of the Donor's estate
2. The CRUT will not be taxable on the proceeds of the qualified retirement plan unless it has unrelated business taxable income (UBTI).
3. In computing the Section 691(c) deduction, the estate must exclude the charitable deduction resulting from the contribution of the qualified retirement plan to the CRUT.
4. The proceeds of the qualified retirement plan that are IRD are "first tier" income of the CRUT.
5. The Section 691(c) deduction reduces the amount of IRD that the CRUT includes in its "first tier" of income. Thus, the amount of "first tier" income from the IRD is the net of the IRD less the Section 691(c) deduction. The Section 691(c) is not directly made available to the CRUT beneficiaries.

Points:

This is the first ruling that discusses the treatment of the Section 691(c) deduction for IRD payable to a CRUT. Thus, the distribution of the retirement plan proceeds to the CRUT will constitute "first tier" income to the CRUT. Any Section 691(c) deduction must be netted against the first tier income and is not available as a separate item to the CRUT beneficiaries.

The ruling also states that since the retirement plan proceeds are excluded from the gross estate (due to the charitable estate tax deduction), the charitable deduction for the qualified plan proceeds contributed to the CRUT must also be excluded when recomputing the estate tax to determine the Section 691(c) deduction.

PLR 199939039

Qualified Plan and IRA Payable to Foundation

The taxpayer created a private foundation. The taxpayer intended to name the foundation as the beneficiary of some or all of the proceeds of his IRAs and qualified plans upon his death. The taxpayer's spouse agreed to execute any consent required under the Retirement Act of 1984.

Held:

1. The taxpayer's estate will be eligible for a federal estate tax charitable deduction for the proceeds of the IRA and qualified retirement plans passing to the foundation.
2. The proceeds of the IRA and qualified retirement plans passing to the foundation will be income in respect of a decedent (IRD) to the foundation in the year of receipt. In addition, the proceeds of the IRA and qualified retirement plans passing to the foundation will not be IRD to the taxpayer's estate and the beneficiaries of the taxpayer's estate.

Points:

The taxpayer also requested rulings that (1) the foundation will not recognize taxable income upon receipt of the proceeds of the IRA and qualified retirement plans passing to the foundation and (2) that the foundation will not be subject to the federal excise tax on investment income under Section 4940(a). The Service declined the taxpayer's request stating that those issues were being considered separately.

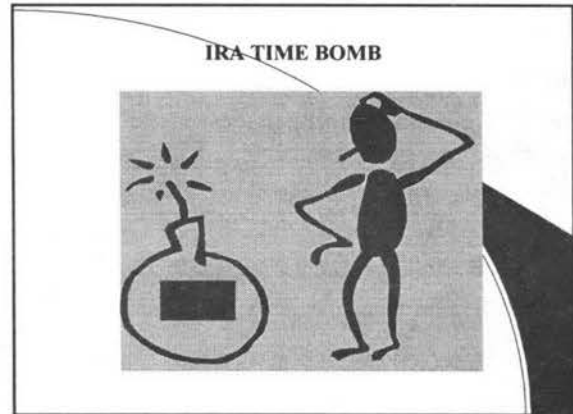
**STRUCTURING CHARITABLE
GIFTS OF IRAs**

25th Conference on Gift Annuities
American Council on Gift Annuities

Jeremiah W. Doyle IV, Esq.
Mellon Private Wealth Management
Boston, MA
April 11, 2002

IRA MAY BE SUBJECT TO:

- Estate Tax
- Income Tax
- Generation-Skipping Tax



FACTS

- John, A Widower, Dies in 2002 At Age 60
- Has \$2 Million IRA
- Estate is Beneficiary Of IRA
- John in Highest Income And Estate Tax Bracket
- Executor Liquidates IRA

HEY - WHERE DID MY IRA GO???
(NO GST)

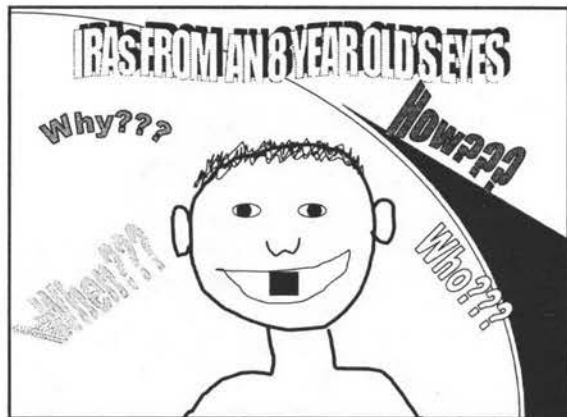
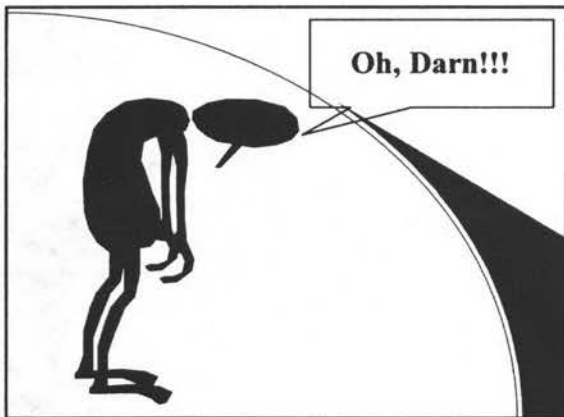
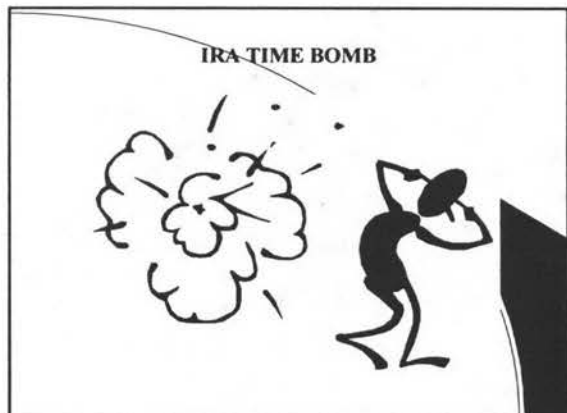
Value of IRA	\$2,000,000
Federal Estate Tax and MA Sponge Tax @ 50%	(\$1,000,000)
Federal and Massachusetts Income Taxes:	
Federal Income Tax: 38.6% x 1,051,200	(\$407,752)
Massachusetts Income Tax: 5.30% x \$2,000,000	(\$106,000)
Balance	\$488,237

Amount Received by Children: \$488,237 i.e. 24 cents on the dollar!!!

HEY - WHERE DID MY IRA GO???
(GST)

Value of IRA	\$2,000,000
Federal Estate Tax and MA Sponge Tax @ 50%	(\$1,000,000)
Generation Skipping Tax	(\$33,333)
Federal and Massachusetts Income Taxes:	
Federal Income Tax: 38.6% x \$717,867	(\$277,078)
Massachusetts Income Tax: 5.30% x \$2,000,000	(\$106,000)
Balance	\$ 283,570

Amount Received by Children: \$283,570 i.e. Less than 14 cent the dollar!!!



- Why???**
- TAX REASONS TO LEAVE IRA TO CHARITY**
- Estate Tax
 - Income Tax
 - Taxed as Ordinary Income When Distributed
 - No "Step-Up" in Basis
 - Cost of Gift Less Than Amount of Bequest
 - Tax Efficient Method of Giving

- TAX CONSEQUENCES OF LEAVING IRA TO CHARITY**
- No Estate Tax
 - Qualifies for FET Charitable Deduction
 - No Income Tax
 - To Donor or Donor's Estate
 - Charity not Taxed on Proceeds
 - Minimum Required Distributions
 - Charity not a "Designated Beneficiary"
 - January, 2001 Changes Made to MRD Rules

WHEN TO LEAVE AN IRA TO CHARITY

- At Death
- During Life
 - Pending Legislation
 - Employee Stock in Qualified Plans
 - 10 yr Averaging if Born Before 1936

WAYS TO GIVE IRA TO CHARITY

- Directly to Charity
 - Name Charity in Beneficiary Form
- To Individual, Followed by Disclaimer to Charity
- To Estate/Trust, Then to Charity
- Income to Individual Beneficiary, Remainder to Charity
 - Qualified Terminable Interest (QTIP) Trust
 - Sec. 2056(b)(7)
 - Sec. 2056(b)(8)
 - Charitable Remainder Trust Sec. 664

WHO TAKES YOUR IRA ?

- The Will Doesn't Control
- The Designated Beneficiary Form Controls

BENEFICIARY OF IRA

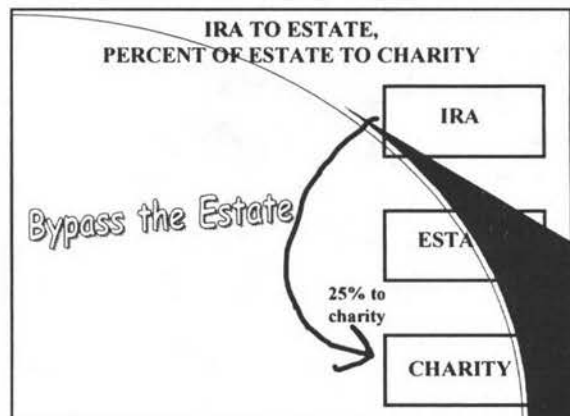
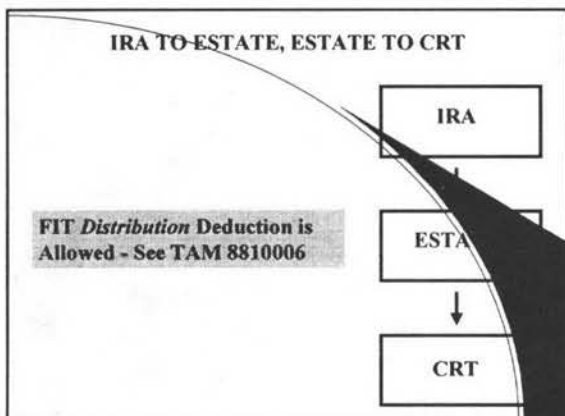
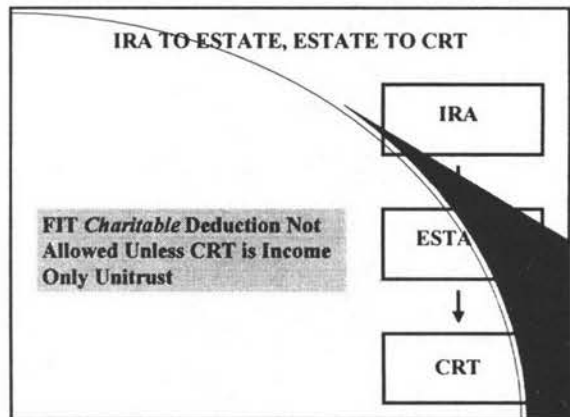
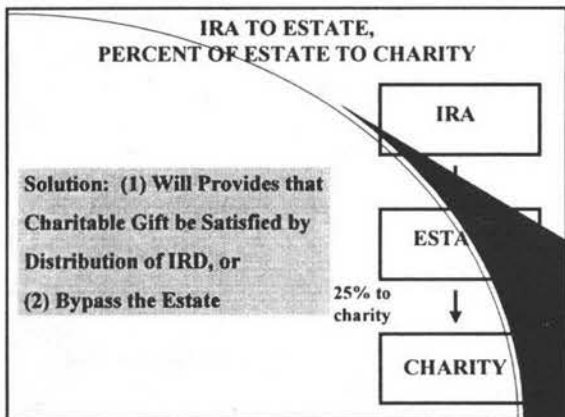
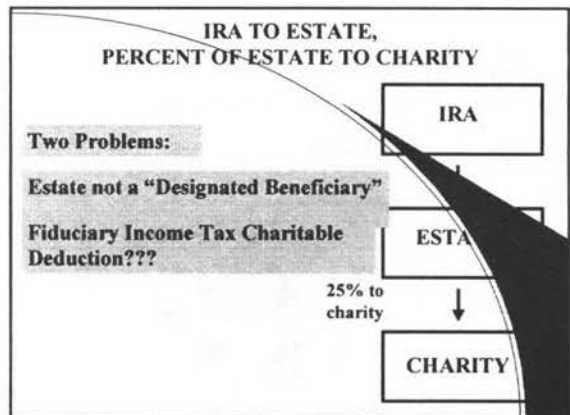
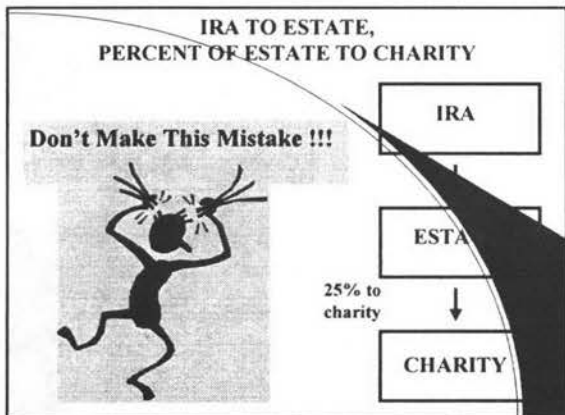
- Named in Beneficiary Form
- Default: See IRA Agreement

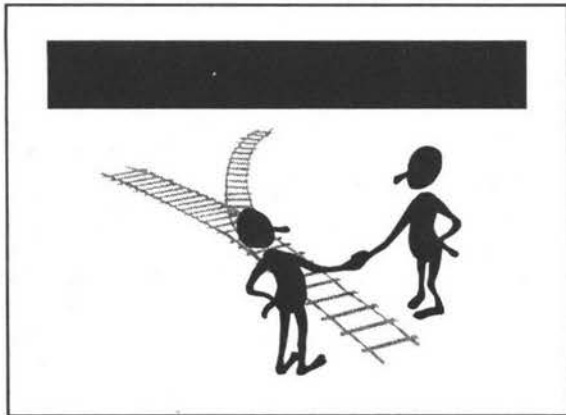
CHARITY AS THE BENEFICIARY OF AN IRA

- Named as Primary Beneficiary
 - IRA owner dies, charity gets the IRA
- Named as Contingent Beneficiary
 - IRA owner dies, primary beneficiary gets it
 - Charity gets nothing
 - Charity gets IRA only if primary beneficiary predeceases the IRA owner
- Example:
 - IRA owner names spouse as primary beneficiary and if spouse survives, agrees to leave IRA to charity

RETIREMENT EQUITY ACT OF 1984

- Applies to Most Qualified Plans
- If Beneficiary of Plan is Other Than Spouse.
 - Waiver Needed
 - Spouse Must Consent to Waiver
- Doesn't Apply to IRAs
 - Be Careful of IRA Rollovers from Qualified Plans





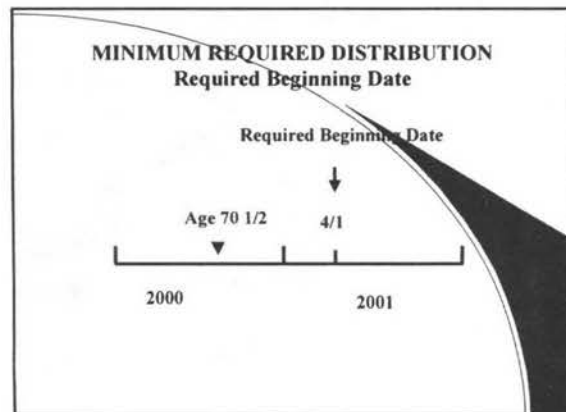
IRA TO SON, STOCK TO CHARITY

	<u>Charity</u>	<u>Son</u>
Stock	500,000	
IRA		500,000
Total Bequest	500,000	500,000
Less: Income Tax on IRA	0	<200,000
Net Bequest	500,000	300,000

IRA TO CHARITY, STOCK TO SON

	<u>Charity</u>	<u>Son</u>
Stock		500,000
IRA	500,000	
Total Bequest	500,000	500,000
Less: Income Tax on IRA	0	0
Net Bequest	500,000	500,000

- MINIMUM REQUIRED DISTRIBUTIONS**
- The Problem**
- Must Begin At 70 1/2
 - Life Expectancy Tables Govern Amount of Distribution
 - Previously, who was named as beneficiary governed amount of the required distribution
 - If "designated beneficiary," favorable distribution
 - If not "DB," less favorable distribution
 - Generally, IRA owners seek to take as little as possible
 - Noncompliance: 50% Penalty




- DESIGNATED BENEFICIARY**
(For MRD Purposes)
- Spouse
 - Children
 - Other Individuals
- But Not:
- Estate
 - Charity
-

**MRD - PRE 2001 REGULATIONS
CHARITY AS BENEFICIARY**

- Lifetime Distributions
 - Based only on IRA owner's life expectancy
- Post-Death Distributions
 - Death Before RBD
 - Distribute within 5 years of IRA owner's death
 - Death After RBD
 - No recalculation: Over IRA owner's LE
 - Recalculation: Distribute by 12/31 of year after death

**MRD - PRE 2001 REGULATIONS
CHARITY AS BENEFICIARY**

Distributions Accelerated



**MINIMUM REQUIRED DISTRIBUTIONS
New Proposed Regs. Issued January, 2001**

- Must Begin At 70 1/2
- Uniform Table Governs *Lifetime* MRD
 - Named Beneficiary Generally **Disregarded**
- *Post Death* MRD Determined by Who is DB
 - "Wiggle room" provided to determine who is the DB after death

**MINIMUM REQUIRED DISTRIBUTIONS
*Lifetime Distributions***

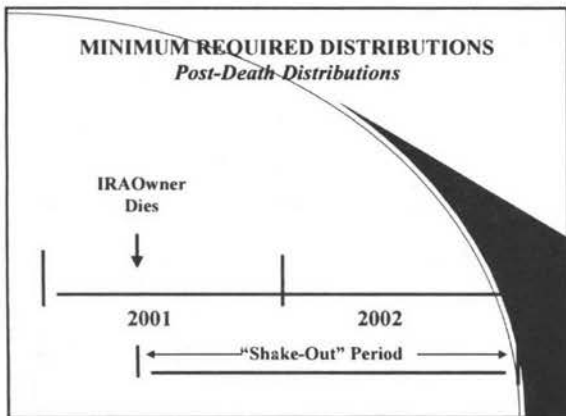
- MRD Not Affected by Who is Named Beneficiary
 - No adverse MRD consequences if *charity* is named
- MRD *always* governed by new "*Uniform Table*"
 - Exception: Where spouse is sole beneficiary and more than 10 years younger than IRA owner
 - Use actual joint LE, recalculated

**MINIMUM REQUIRED DISTRIBUTIONS
New "*Uniform Table*"**

- Calculates MRD based on IRA owner's age and age of beneficiary exactly 10 years younger (*Uniform Table*)
- Results in lower distributions
 - Lower distributions means more left for charity

**MINIMUM REQUIRED DISTRIBUTIONS
*Post Death Distributions***

- Don't have to worry who is DB at RBD or death
- Identity of DB not finalized until 12/31 of the year after death of IRA owner
 - Allows post-mortem "cleanup" by:
 - Separate Accounts
 - Distribution
 - Disclaimer



MINIMUM REQUIRED DISTRIBUTIONS New "Uniform Table" Good News for Charity!!!

Choice of Beneficiary
Can Be Made Without
Concern That Lifetime
Distributions Will Be
Accelerated

MINIMUM REQUIRED DISTRIBUTIONS New "Uniform Table" Good News for Charity!!!

- Lifetime Distributions:
 - If the IRA owner has no DB, it doesn't matter
 - He uses the "Uniform Table" whether he has a DB or not
 - The drawback of naming a charity at the RBD is **TOTALLY ELIMINATED!!!**

MINIMUM REQUIRED DISTRIBUTIONS Charities - Sit up and Take Notice!

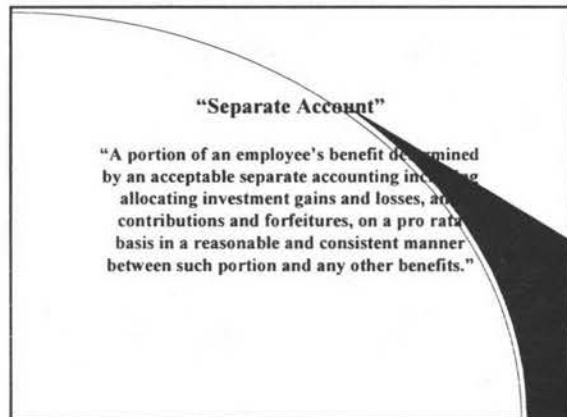
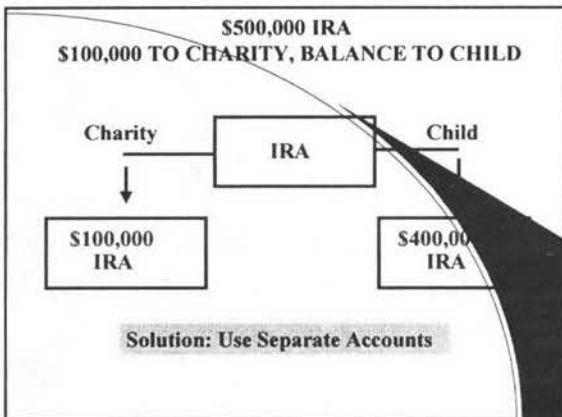
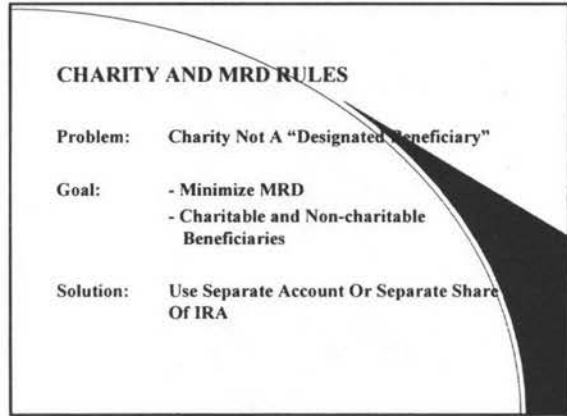
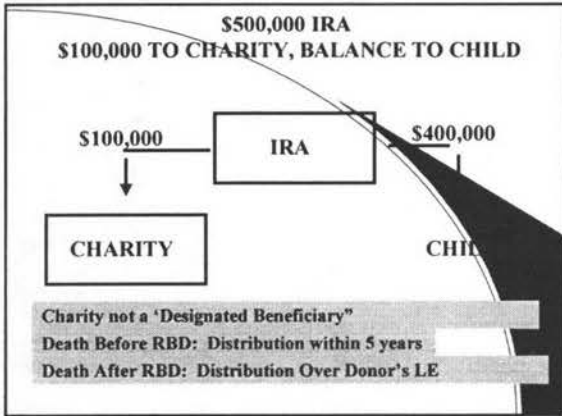
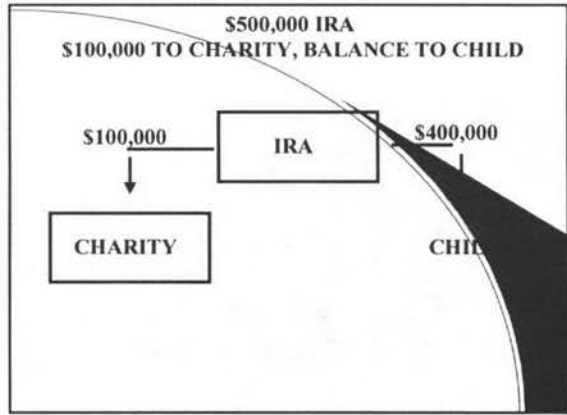
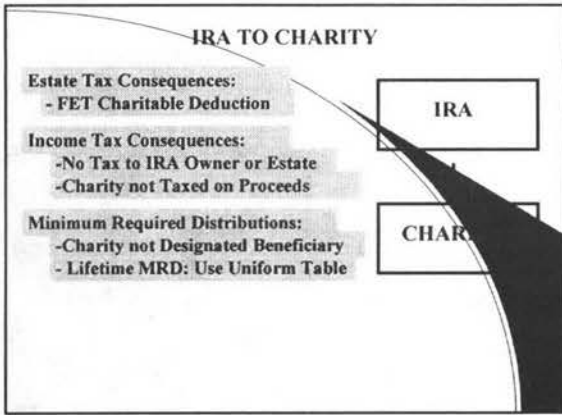
- "Uniform Table" means lower MRD i.e. **there's more for charity!!!**
 - Especially since recalculation of LE is built into the "Uniform Table"

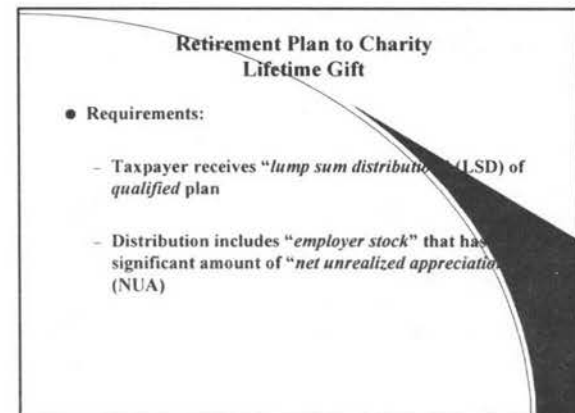
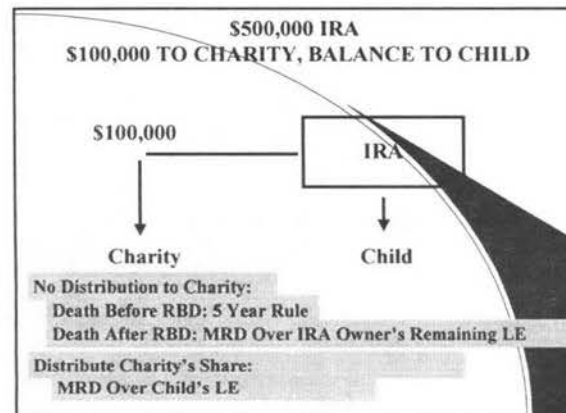
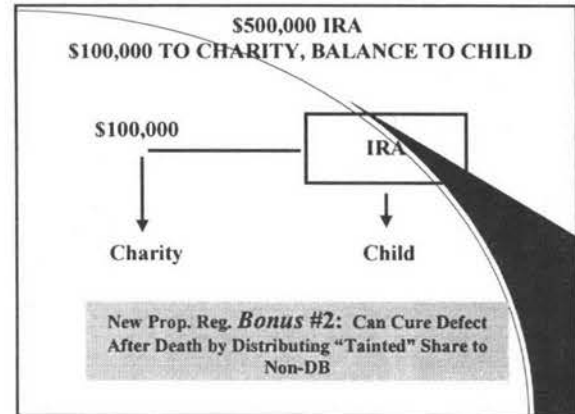
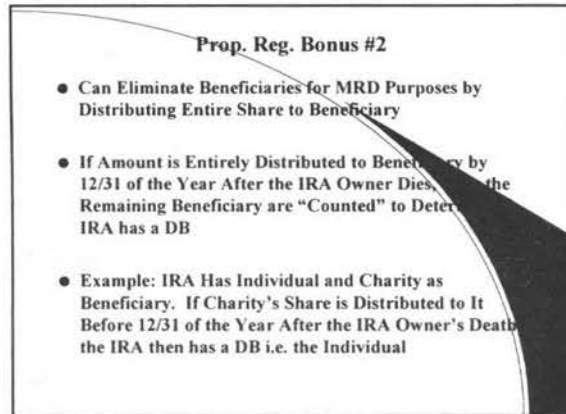
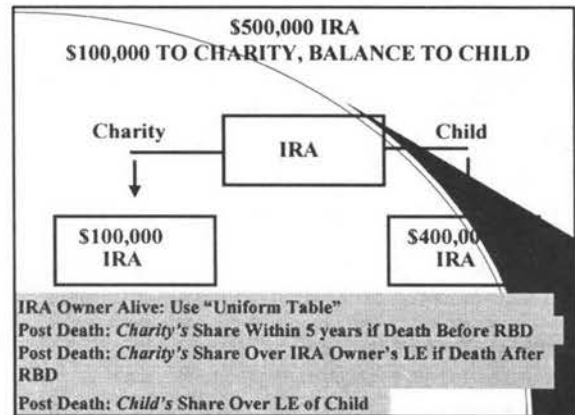
MINIMUM REQUIRED DISTRIBUTIONS Charities - Sit up and Take Notice!

- Advise donors who have named charity as IRA beneficiary they can change to MRD and take less of their IRA

MINIMUM REQUIRED DISTRIBUTIONS Charities - Sit up and Take Notice!

- Donors who want to leave an IRA charity but name DB to lower lifetime MRD should now reassess
 - Now they can name charity as the IRA beneficiary without affecting their lifetime MRD





Retirement Plan to Charity Lifetime Gift

● How It Works:

- Distribution of "employer stock" results in income taxation to the recipient equal to the "cost basis" (not the FMV) of the "employer stock"
- The "NUA" is not taxed on distribution
- When sold the "NUA" in LTCG, regardless of how long the stock is held

Retirement Plan to Charity Lifetime Gift

● How It Works:

- Donor takes LSD of qualified plan
- Retains the "employer stock"
- Pays income tax on "cost basis" of employer stock
- Contributes "employer stock" to CRUT
- Gets charitable deduction for FMV of employer stock value of the retained interest
- CRUT sells stock and pays no capital gains tax
- Proceeds equal to NUA are LTCG under CRUT tier system

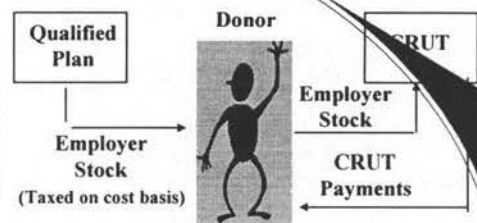
Retirement Plan to Charity Lifetime Gift

● Result:

- Donor takes distribution from qualified plan during life
- Contributes stock to CRUT for his benefit
- At a cost to him of ordinary income tax on the "cost basis" of the employer securities
- Gets assets out of his qualified plan at a low tax cost gives them to charity

This is merely a version of contributing appreciated stock to a CRUT

Retirement Plan to Charity What It Looks Like



Contribution to CRUT based on FMV of Stock

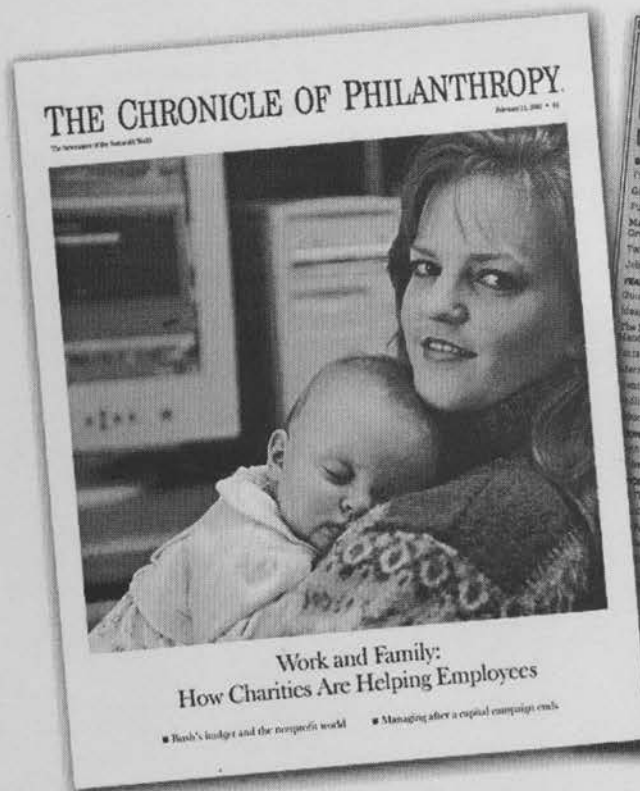
Retirement Plan to Charity Will This Work???



Yes!!!
See PLRs 199919009
200038050 and
200220078 (1/15/02)

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Sparkling Ideas...

in the Emerald City

ALTERNATIVES TO PRIVATE FOUNDATIONS

**David Wheeler Newman
Mitchell, Silberberg & Knupp, LLP
11377 West Olympic Boulevard
Los Angeles, CA 90064
(310) 312-3171
FAX (310) 312-3789
dwn@msk.com**

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Alternatives to Private Foundations

David Wheeler Newman

1. **Private Foundation Defined:** A religious, charitable or educational organization that is not:
 - a. church, school, hospital, government unit or organization receiving substantial support from the government or general public;
 - b. An organization that receives more than one-third of its support from members of the general public and less than one-third of its support from a combination of gross investment income and UBTI;
 - c. A Support Organization; or
 - d. An organization organized and operated for testing for public safety.

2. **What is the Attraction of a Private Foundation?**
 - a. The donor retains maximum **control** over the use of charitable dollars.
 - b. The donor is better able to control the **timing** of tax benefits, since contributions to the foundation need not be precisely matched to expenditures for exempt purposes.
 - c. The foundation provides **name identification** for the donor or his family, linking them to community involvement and philanthropy.

3. **Federal Tax Policy Toward Small Foundations Codified in TRA 69.** The Tax Reform Act of 1969 codified federal tax policy toward private foundations. This legislation sought to:
 - a. Prevent self-dealing between private foundations and contributors;
 - b. Ensure that income and activities of a private foundation are directed toward charitable purposes underlying its tax exemption;
 - c. Limit the ownership and operation of businesses by private foundations; and

d. Ensure that investments of private foundations are not jeopardized by financial speculation.

4. Disadvantages of Private Foundations.

a. **Limitations on Deductions.** Lower limits apply to charitable contribution deductions for gifts to private foundations than those which apply to public charities.

- *Public Charities* General 50% of AGI
 Capital Gain Assets 30%
- *Private Foundations* General 30% of AGI
 Capital Gain Assets 20%

b. **Appreciated Property.** The charitable contribution deduction for gifts to private foundations of appreciated property other than publicly-traded securities is limited to the tax basis in that property.

c. **Excise Taxes:** (see appendix)

- *Self-dealing*
- *Failure to make minimum exempt purpose distributions*
- *Excess business holdings*
- *Investments that jeopardize exempt purpose*
- *Expenditures for lobbying and other political activity*

d. **Tax on Investment Income.** Private foundations pay an excise tax of 2% of net investment income, which may be reduced to 1% if the foundation meets certain minimum distribution standards.

e. **Compliance Requirements.** Private foundations must comply with burdensome record keeping and reporting requirements, most of which result from the 1969 legislation.

5. **Donor Directed Funds.** One private foundation alternative is referred to as a Common Fund, also known as a Donor Directed Fund or an E Fund, formed pursuant to I.R.C. Section

170(b)(1)(E)(iii). In essence, this unique type of private foundation serves as a “pooling vehicle” for the contributions of many donors who retain certain rights to subsequently direct distributions from the Common Fund to specified public charity recipients.

a. **Retention of Control.** Donors who contribute to common funds may determine the ultimate recipients of their philanthropy without the necessity of establishing a separate private foundation to accomplish their purposes.

b. **Solving Timing Problems.** An advantage of the Donor Directed Fund, similar to a private foundation, is that donors may “bank” their contributions by contributing a specific amount to a Donor Directed Fund, and thus obtaining a current income tax deduction for their entire gift, while they select the ultimate recipients of the income and principal of the gift over a subsequent period of time, as the donor determines.

c. **Technical Requirements.** To qualify as a Common Fund under the Internal Revenue Code, the following technical requirements must be satisfied:

- *Affiliation.* The Common Fund must generally be structured as an affiliate of one or more public charities such that, but for the donor control elements, it would qualify as a “support organization” within the meaning of Section 509(a)(3) (see Section 7 below).
- *Distributions.* The Common Fund’s income must be distributed on or before the fifteenth day of the third month following the close of the taxable year in which the income is realized (e.g., if the fund has a December 31 taxable year, all income distributions must be made by March 15 of the following year).
- *Designation of Recipients.* The donor may designate annually the recipients of the income attributable to the donor’s gift. The donor may reserve to his or her spouse the right to make annual designations. **No person other than the donor or spouse may have the right to designate recipients.**
- *Qualified Recipients.* Each income recipient must be a public charity.

- *Distributions of Principal.* The donor must have the authority to direct, during life or through his or her will, the payment of principal attributable to the donor's contribution to one or more public charities. The donor may reserve to his or her spouse the right to designate recipients of principal.
- *Final Distribution.* The principal attributable to the donor's gift must be distributed by the Common Fund to one or more public charities no later than one year following the death of the donor, or the death of his or her spouse, if the donor has reserved to that spouse the right to make post-mortem designations of recipients.

d. **Tax Status.** While Donor Directed Funds have many substantial tax advantages, most prominently the entitlement to a 50% (rather than 30%) contribution base for individual charitable contributions, and the ability to "bank" current charitable contributions for use in subsequent periods, it must be noted that **the Donor Directed Fund itself is a private foundation, and thus is subject to all applicable private foundation rules, including the 2% excise tax on net investment income.**

6. **Donor Advised Funds.** A second alternative to private foundations is the Donor Advised Fund. Unlike the Donor Directed Fund described above, the Internal Revenue Code does not contain any definition of Donor Advised Funds. This vehicle is the product of historical practice which has now been given regulatory blessing (in Treasury Regulation sections 170A-9(e) and 507-2(a)(8)).

a. **Background.** The original concept for the Donor Advised Fund was the establishment by charitably motivated individuals of community trusts (now typically referred to as community foundations) for collecting contributions for the betterment of a community in general. As noted in the Treasury Regulations, "community trusts have often been established to attract large contributions of a capital or endowment nature for the benefit of a particular community or area, and often such contributions have come initially from a small number of donors."

b. **Public Charity Status.** An organization such as a community foundation which sponsors a Donor Advised Fund program is treated as a public charity if it meets the public support tests contained in Code Section 170(b)(1)(A)(vi). Accordingly, a the sponsoring organization will qualify as a public charity if it satisfies the public support test by meeting either the “one-third of support test” or the “ten percent facts and circumstances test.”

- *One-Third of Support Test.* This test requires the organization to normally receive from the government or contributions from the general public at least one-third of its total support.
- *Ten Percent Facts and Circumstances Test.* The organization must seek gifts and bequests from the general public through trust companies, attorneys and other advisors or in other appropriate ways which call attention to the sponsoring organization, provided the organization receives at least 10% of its support from these sources.

c. **Entity-Level Requirements.** Donor Advised Funds are almost exclusively creatures of regulation. The provisions of the applicable regulations (Section 1.170A-(9)(e)(10-13)) must be strictly complied with for contributions to be treated as made to the sponsoring public charity rather than to a separately controlled fund which would be treated as a private foundation. While the sponsoring organization is generally composed of numerous separately endowed component funds, there must be some central organization.

- *Name.* The community foundation or other sponsoring organization must bear a name which conveys the concept of a capital or endowment fund designed to support charitable activities in a relevant community.
- *Common Governing Instrument.* All funds must be subject to a common governing instrument such as a master trust, internal policy statement or uniform instruments of transfer.

- *Governing Body.* The sponsoring organization must also have a common governing body which directs the distribution of funds contributed to it for charitable purposes, and this governing body must have the ultimate fiduciary responsibility for distributions and investments. Powers which must be reserved to the governing body include the powers to:
 - Modify any restriction or condition on the distribution of funds if, in its sole judgment, such restriction or condition becomes, in effect, unnecessary, incapable of fulfillment or inconsistent with charitable needs of the community or area then served;
 - Replace any participating trustee for breach of fiduciary duty; and
 - Replace any participating trustee for failure to produce a reasonable return of net income over a reasonable period of time.

- *Financial Reports.* The organization must prepare and disseminate periodic financial reports concerning the funds which it holds.

d. Component Fund Level Requirements. Favorable tax consequences will result from contributions to a Donor Advised Fund only if the DAF qualifies as a component fund of the sponsoring organization. Failure to qualify will cause the donor's contribution to constitute a separate private foundation subject to the disadvantages described above. A Donor Advised Fund will qualify as a component fund such only if the governing body of the sponsoring organization is not subject to any "material restriction or condition" on assets transferred to the fund. The regulations specify in great detail the significant facts and circumstances which may be considered in determining whether a transfer is subject to a "material restriction or condition." The principal factors include whether the sponsoring organization is the owner of the contributed assets, whether it holds and administers those assets in a manner consistent with its exempt purposes, whether its governing body has the ultimate authority and control over the assets and their income and whether and to what extent its governing body is organized and operated so as to be independent from the donor. The regulations provide that the presence or absence of some

or all of the following “non-adverse” factors will not cause a gift to be treated as being subject to a material restriction or condition:

- *Name.* The provision of a name or designation which memorializes the donor and his or her family.
- *Specified Exempt Purpose.* The specification that the fund’s income and assets are to be used for a designated charitable purpose or for one or more particular public charities (provided that such use is consistent with the exempt purpose of the sponsoring organization).
- *Identified Fund.* The administration of the assets in an identifiable or separate fund where some or all of the principal does not have to be distributed for a specified period.
- *Retention of Property.* The fact that the donor requires the foundation to retain the property if such retention is important to achieve its exempt purposes (for example, the retention of a woodland preserve by a community trust organized for environmental purposes).

e. **Adverse Factors.** The regulations also specify “adverse factors,” the presence of which may indicate the existence of a disqualifying material restriction. Significantly, if the donor reserves the right, directly or indirectly, to name the organization to which the sponsoring organization must distribute his or her gift (other than by designation in the instrument of transfer) or directs the timing of the distributions, then a material restriction or condition may exist. The regulations make it clear that the Internal Revenue Service will examine carefully whether the seeking of advice by the sponsoring organization from, or the giving of advice by, any donor after the assets have been transferred constitutes a reservation of an indirect right to direct distributions, which would in turn constitute a disqualifying material restriction or condition. In making this determination, the following are “good facts”:

- *Independent Investigation.* An independent investigation by the sponsoring organization concerning the consistency of the donor’s advice with the specific charitable objectives of the Community Trust indicates a lack of an inappropriate reserved right.

- *Other Factors.* If the sponsoring organization publishes guidelines with which the donor's advice is consistent, institutes an educational program enumerating specific, consistent charitable needs, distributes funds exceeding those distributed from the donor to the same or similar organizations and provides in its written and oral solicitations that it is not bound by the donor's advice, then there is probably no improper reserved right.

On the other hand, the following are "bad facts," the presence of which suggest that an improper reservation of rights may exist:

- *Marketing Material.* If the written or oral solicitation of funds implies a pattern of conduct or creates an expectation that advice will be followed.
- *Donor's Advice.* The donor's advice is limited to distributions concerning the donor's fund.
- *Independent Investigation.* The sponsoring organization has not independently evaluated the donor's advice or promulgated guidelines concerning its purposes.
- *Sources of Advice.* The sponsoring organization solicits only the donor's advice concerning his or her fund, and there is no procedure for considering advice from others.
- *Pattern of Conduct.* The sponsoring organization follows only the advice of all donors as to their funds substantially all of the time.

The general rule of the material restriction or condition standard is that the sponsoring organization must be able to "freely and effectively" employ the transferred assets or their income in furtherance of the exempt purposes of the sponsoring organization. If this "free and effective" test is met, the standard will be satisfied.

f. Donor Advised Funds that Will Qualify.

- *Consideration of Advice.* The donor's fund may be distributed to other organizations falling within the exempt purpose of the sponsoring

organization, even if the donor's advice is considered in part in making distribution decisions.

- *Instrument of Transfer.* The donor's fund may be distributed as designated by the donor in the instrument of transfer.
- *Field of Interest.* The donor's fund may be distributed among a subset of organizations within "fields of interest" designated in the instrument of transfer, and as to which the donor provides advice.

g. **Who May Advise?** In contrast to the requirements of a Donor Directed Fund described in Section 5 above, **the sponsoring organization is not limited as to the persons from whom it may seek advice concerning distribution of DAFs.** As noted above, only the donor and his or her spouse may direct distributions of income and principal from Donor Directed Funds, and no other person may give such directions. Donors to a Donor Advised Fund, however, may delegate any advisory function to any person or entity, either during lifetime or following the death of the donor, depending on the policies established by the sponsoring organization for these purposes and in light of the provisions of the applicable regulations discussed above. Advice may be solicited by the sponsoring organization from any person, including those whom the donor wishes to provide advice. In fact, unsolicited advice is often received because the general community at large (donors, recipients and the public served by the organization) has an interest in the affairs of the sponsoring organization.

h. **Alternatives to Community Foundations.** As the attractions of donor advised funds as an alternative to private foundations became more widely appreciated, and as community foundation DAF assets continued to grow, financial service firms inaugurated their own DAF programs, allowing their customers to fund a DAF overseen by the company managing their investments rather than by a community foundation. The resources of these companies, combined with their marketing savvy, have propelled the DAF program sponsored by one mutual fund company to become the third largest charity in the United States. There are now a host of commercially-sponsored DAF programs, bearing familiar names such as Schwab, Vanguard and Fidelity.

- More recently, DAF programs have been initiated, or at least considered, by charities such as colleges which run their own programs, as distinguished from community foundations where activities are generally focused on grantmaking to other charities. Many of these operating charities view the DAF not only as a helpful device for their donors to accomplish their philanthropic objectives as conveniently as possible, but also as a vehicle for continuing communications with the donor concerning programs operated by the sponsoring charity with the goal of attracting a larger share of DAF distributions to benefit those programs rather than other charities.
- The result of these trends is not only dramatic growth of assets held in DAFs, but a rapid increase in the number of DAF programs. These increases have not gone unnoticed by the IRS, which has stated that it will scrutinize DAF programs to ensure compliance with all relevant rules.

7. Supporting Organization. An organization that receives little, if any, support from the general public may still qualify as a public charity for tax purposes if it supports other qualified public charities. A supporting organization formed pursuant to Section 509(a)(3) has certain relationships in supporting of other public charities. To qualify under Section 509(a)(3), the supporting organization must satisfy the organizational test, the operational test and the relationship test.

a. **Organizational Test.** A supporting organization must be organized exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified publicly-supported organizations. This organizational test is met by specific provision in the trust agreement or articles of incorporation of the supporting organization.

b. **Operational Test.** The supporting organization must be engaged solely in activities which support or benefit the specified public charity or charities.

c. **Relationship Test.** Supporting organizations must be responsive to the needs of the supported public charity and must constitute an integral part of, or maintain the significant

involvement in the operation of the public charity. This is the most complex of the three tests. However, there is some flexibility in this complexity, since the regulations describe (at length) alternative means of satisfying the test. A supporting organization must either be:

- [Type One] Operated, supervised or controlled by;
(analogous to parent and subsidiary corporations)
- [Type Two] Supervised or controlled in connection with; or
(analogous to parent and subsidiary corporations)
- [Type Three] Operated in connection with one or more public charities.

While these relationships are somewhat similar, there are distinctions which are relevant when structuring the relationship between the supporting organization and the supported public charity or charities. Most supporting organizations used as alternatives to private foundations are structured as either Type One or Type Three.

d. **Control.** A supporting organization may not be controlled directly or indirectly by one or more persons who would be treated as disqualified persons under the private foundation rules (see Appendix).

e. **Type One Supporting Organizations.** The required relationship is established by the fact that a majority of the officers, directors or trustees of the SO are appointed or elected by one or more supported public charities. The Type One SO may support benefit charities designated by class or purpose, so long as those organizations are closely related in purpose to the designated supported charity which controls the SO.

- *Illustration.* Assume that a national environmental organization has the power to appoint a majority of the trustees of an SO, which defines its supported class as environmental organizations with purposes consistent with the national organization which controls the SO board. This designation of the supported charities is adequate to qualify the SO as a Type One.

f. **Type Three Supporting Organizations.** Most Type Three SOs are established as trusts. This is because most SOs that choose to be a Type Three find it easiest to meet the applicable requirements when organized as a trust as opposed to a corporation. The trust agreement governing the SO identifies the specific charities that the SO will support. Typically, a trust agreement for a Type Three SO contains no more than 20 charities that are eligible to receive support from the SO.

- *Distributions.* Once a type 3 SO is funded, distributions must be made each year to one or more of the public charities named in the trust instrument. Distributions do not have to be equal, and distributions do not have to be made each year to every charity on the list. In fact, distributions can be made to only one of the listed charities, so long as the support provided to a charity is sufficient to ensure its “attentiveness” to the operations of the SO. Unlike a private foundation, the minimum amount to be distributed each year by a SO is based on its income - not on its assets. A type 3 SO must generally distribute at least 85% of its net income (excluding capital gains) realized each year. Thus, if the SO holds a portfolio of stocks with a dividend yield of 2%, the SO might be required to distribute a minimum of 85% of this amount, or effectively 1.7% of its assets compared with 5% of a private foundations assets. Of course, an SO may also distribute more than this minimum figure.
- *Attentiveness Test.* The “attentiveness” requirement can be met each year if the SO distributes to one or more of the supported organizations an amount equal to at least 10% of the total support received by the supported organization from all sources. If an entity listed in the trust agreement is a charity that receives a relatively large amount of public support, it will normally be difficult to meet this standard. As a result, the Treasury Regulations governing type 3 SOs provide an alternative manner in which the attentiveness requirement can be met. If the SO distributes to one or more of the supported organizations an amount necessary to fund a significant project or program of the supported organization that would not

otherwise receive sufficient funding the attentiveness test will be satisfied. For distributions to larger charities, a typical SO will have to rely on this alternative. The SO and the supported charity will need to earmark the contributions to be used only for the supported project or program. At least one-third of amounts distributed by the Type Three SO each year must be distributed to, or set aside for the benefit of, the supported charities which meet one of the two attentiveness tests.

- *Illustration.* Assume an SO's total income for tax year 2000 is \$100,000. The SO must, therefore, distribute a total of \$85,000 ($\$100,000 \times 85\%$). In addition, of the \$85,000 being distributed, \$28,333 ($\$85,000 \times 33 \frac{1}{3}\%$) must be paid to one or more of the supported charities that meet the attentiveness test. In other words, \$28,333 must be paid to an organization(s) which receives at least 10% of its total support from the SO or to an organization(s) for an important project or program that would not otherwise receive adequate funding. In addition, the SO must distribute an additional \$56,667 ($(\$100,000 \times 85\%) - \$28,333$) to one or more of the other charities listed on its governing documents. This amount, however, can be distributed in any manner in which the SO's governing board sees fit. For example, the board may give the entire \$56,667 to a single supported charity which meets (or doesn't meet) the attentiveness requirement.
- *DAF as Supported Charity.* One of the few drawbacks of a SO, as compared a private foundation, is the need to identify in advance the public charities that will be supported. Many donors would like to maintain the flexibility (available with a private foundation) to change their minds about which philanthropic endeavors to support. Moreover, the founders' children or grandchildren may take different paths in choosing organizations they would like to support. A very useful way to build flexibility into the public charities designated in SO documents is to name one or more Donor Advised Fund programs as supported public charities. The SO may retain the right to advise the DAF sponsor on

distributions from its fund to a variety of other charities which can be changed from year to year to reflect evolving philanthropic objectives. While the DAF is, of course, the property of the sponsoring organization which has ultimate control over distributions, designation of a DAF program as a supported charity of the Type Three SO comes close to replicating the flexibility of a private foundation, since the DAF program effectively serves as a window on the world of philanthropy beyond the public charities named in the SO trust agreement.

APPENDIX

Private Foundation Excise Taxes

David Wheeler Newman

1. Disqualified Persons.

a. **Substantial Contributors.** Any person who contributes or bequeaths an aggregate amount of more than \$5,000 to a private foundation, if such amount exceeds 2% of total contributions received by the private foundation from inception to date.

- The term includes the creator of a trust.
- Disqualified person status is permanent unless the person has no contact with the private foundation for a period of ten years.

b. **Foundation Manager.**

- Officer, director or trustee of a private foundation.
- Individual with similar powers or responsibilities.

c. **Twenty Percent Owner of Disqualified Person.**

- An owner of more than 20% of the “combined voting power” of a corporation.
- An owner of more than 20% of the “profits interest” of a partnership.
- An owner of more than 20% of the “beneficial interests” of a trust or unincorporated enterprise.

d. **Family Members of Disqualified Persons.**

- Spouse, ancestor, children, grandchildren, great-grandchildren and the spouses of children, grandchildren and great-grandchildren.
- Siblings are not family members for this purpose.

e. Corporations.

- More than 35% of the total combined voting power is owned by substantial contributors, foundation managers, 20% owners or family members.

f. Partnership.

- More than 35% of the profits interest owned by substantial contributors, foundation managers, 20% owners or family members.

g. Trusts and Estates.

- More than 35% of the beneficial interest in the trust or estate is owned by substantial contributors, foundation managers, 20% owners or family members.

h. Private Foundations.

- Only for purposes of the excess business holdings rules.
- To be a disqualified person with respect to another private foundation, a private foundation must be under common control with the other foundation.

i. Government Officials.

- Only for purposes of the self-dealing rules.

2. Self-Dealing.

a. Transactions Between a Private Foundation and One or More Disqualified Persons.

b. Sale or Exchange of Property.

c. Leasing of Property.

- A lease of property by a disqualified person to a private foundation without charge is not an act of self-dealing.

d. Extension of Credit.

- Interest-free loan by disqualified person to a private foundation is not an act of self-dealing if the proceeds of the loan are used exclusively for exempt purposes.

e. Furnishing of Goods, Services or Facilities.

- The foundation may furnish goods, services or facilities to a foundation manager, employee or unpaid worker in exchange for services.

- Goods, services or facilities may be furnished by a disqualified person to a private foundation without charge, if used exclusively for exempt purposes.

- The private foundation may furnish goods, services or facilities to a disqualified person if they are made available to the general public on the same basis. For this exception to apply, a substantial number of the “public” must actually utilize the goods, services or facilities.

f. Compensation.

- The general rule is that payment of compensation by a private foundation to a disqualified person is self-dealing.

- Payment of reasonable compensation to a disqualified person for personal services that are reasonable and necessary to the tax-exempt purpose of the foundation is not self-dealing. This exception does not apply to government officials.

g. Transfer to or Use of Income and Assets.

- The transfer to or use by a disqualified person of the income or assets of a private foundation is generally self-dealing.

- Applies to payments by the private foundation of private foundation excise taxes imposed on a disqualified person.

- Also applies to payment of premiums for liability insurance protecting a foundation manager in connection with the private foundation excise taxes.

- A general exception for indemnification allows the private foundation to indemnify a foundation manager for *costs of defense* in a judicial or administrative proceeding, provided the expenses are reasonable, the manager successfully settles or defends the proceeding and the manager has not acted willfully.

h. Payments to Government Official.

- Any payment of money or other property to a government official generally constitutes self-dealing.

i. Sanctions.

- Initial tax of 5% of the amount involved for each year in the taxable period. The taxable period begins with the date of the transaction and ends on the earlier of a notice of deficiency, assessment of tax or correction of the transaction. This tax is imposed on a disqualified person other than a foundation manager who participated in the act of self-dealing.

- If the initial tax of 5% is imposed on the self-dealing disqualified person, a tax of 2½% is imposed on the participation of any foundation manager in the act of self-dealing, but only if the manager knowingly participated in the act. This 2½% tax may not exceed \$10,000.

- If the initial tax is imposed and the self-dealing act is not timely corrected, an additional tax is imposed of 200% of the amount involved.

3. Mandatory Distributions.

- a. Each year a private foundation must distribute the “distributable amount,” equal to 5% of the value of the non-charitable assets of the foundation (the “minimum investment return”) plus any repayment to the foundation of amounts previously treated as qualifying distributions.

b. Minimum investment return is 5% of the excess of the aggregate fair market value of all assets of the foundation, other than those used in carrying out the foundation's exempt purpose, over the amount of acquisition indebtedness with respect to the assets.

c. Qualifying distributions include:

- Any amount (including administrative expenses) paid to accomplish an exempt purpose other than a contribution to a controlled organization.
- Any amount paid to acquire an asset to be used directly in carrying out an exempt purpose.
- A qualified set-aside.

d. An amount set aside in one year for a specific project for an exempt purpose is a qualifying set-aside if payment for the project is to be made over a period not to exceed five years.

- One type of set-aside meets the "suitability test," which is satisfied when the general set-aside rules are met and the foundation convinces the IRS that the project can be better accomplished through a set-aside than with an immediate payment of funds. An IRS ruling is required.

- The second variety, satisfying the "cash distribution test," may be used only in the early years of the foundation. The test is met when the set-aside rules are met and the foundation actually distributes a lesser, minimum amount during the first four years and distributes the remainder of the set-aside by the end of the fifth year.

e. The sanction imposed for failure to distribute the minimum amount is an excise tax of 15% of the undistributed income of the foundation.

- A subsequent tax of 100% of the undistributed income of the private foundation can be imposed if the condition is not corrected within the correction period.

4. Excess Business Holdings.

a. Generally limited to 20% of a corporation's voting stock or interest in other business enterprise which may be held by a private foundation and all disqualified persons combined.

- If effective control of the corporation is demonstrated to be held by persons other than the foundation and disqualified persons, a 35% limit may be substituted.

- The private foundation must itself hold more than 2% of the voting stock before these limitations apply.

b. Excess business holdings must be promptly disposed of, with certain exceptions.

- A company deriving at least 95% of its income from passive sources is not considered to be a business enterprise which must be disposed of.

- A functionally related business, the conduct of which is substantially related to the foundation's exempt purpose, may be retained.

c. If the excess business holdings are acquired by gift or bequest, the foundation effectively has five years to reduce these holdings to permissible levels. This five-year period may be extended with the permission of the IRS.

d. The restriction on excess business holdings is enforced with an excise tax of 5% of the total value of all excess business holdings.

- If the holdings are not disposed of during the correction period, an additional tax is imposed in the amount of 200% of the value of the excess business holdings. This second-tier tax may be imposed at the end of the "taxable period" beginning with the first day on which there are excess business holdings and ending with the notice of deficiency for the first-tier tax or the date the first-tier tax is assessed.

5. Jeopardizing Investments.

a. A private foundation may not invest any amount in a manner that would jeopardize the carrying out of the foundation's exempt purpose.

- Program-related investments are excluded.

• Jeopardizing investments may include those concerning which the foundation manager failed to exercise ordinary care and prudence under the facts and circumstances.

b. Initial tax is 5% of the amount invested. In addition, a tax of 5% may be imposed on the foundation manager, to a maximum of \$5,000, if the participation is not willful and not due to reasonable cause.

- The foundation manager's participation is willful if it is voluntary, conscious and intentional. His or her action will be considered due to reasonable cause if he or she relies on the advice of legal counsel expressed in a written opinion. The foundation may also rely on the advice of a qualified investment counselor.

- The secondary tax, if the original investment is not removed from jeopardy within the correction period, is 25% of the amount of the investment. In this case, an additional tax of 5% to a maximum amount of \$10,000 with respect to any one investment, may be imposed on the foundation manager. Note that if one foundation manager is liable for an initial or secondary tax, all of the managers are jointly and severally liable.

6. Taxable Expenditures.

a. **Legislative Activities.** Taxable expenditures include amounts paid by a private foundation to carry on propaganda or to influence legislation.

- Non-partisan analysis, study or research, and publication of the results, is allowable.

- Expenditures may also be made to provide technical assistance to the government in response to a written request to the foundation.

- The foundation may incur expenses to communicate with a legislative body regarding any matter affecting the powers, duties or tax-exempt status of the foundation.

b. **Electioneering.** Taxable expenditures include amounts paid to influence the outcome of a specific public election.

c. **Grants to Individuals.** Amounts paid by a foundation as grants to individuals for travel, study or similar purposes are taxable expenditures.

- Such grants will not be taxable expenditures if awarded under a non-discriminatory procedure *approved in advance* by the IRS.
- Special rules apply to grants made by a foundation under an employer-related grant program.

d. **Expenditure Responsibility.** Taxable expenditures include amounts paid by a foundation as a grant, loan or program-related investment to a private foundation (other than an operating foundation) unless the granting foundation exercises expenditure responsibility with respect to the grant.

- No expenditure responsibility is required for grants to a foreign charitable organization if the private foundation determines in good faith that the foreign organization is publicly supported.
- A private foundation exercises expenditure responsibility if it follows procedures to ensure that the grant is spent for the purpose made; obtains complete reports from the grantee regarding expenditure of the funds; and makes a detailed report to the IRS.
- The grant should be preceded by an inquiry to determine that the grantee will use the funds for the stated purpose.
- Each grant subject to the expenditure responsibility rules must be made subject to a written commitment by the grantee to repay any portion of the grant not used for the stated purpose; to submit annual reports of usage of the funds; to maintain adequate records and to make those records available to the grantor; and not to use the funds to carry on propaganda, for electioneering, to make any grant to an individual organization, or to undertake any non-charitable activities.

e. **Non-Charitable Purposes.** An expenditure for an activity that, if a substantial part of the organization's total activities, will cause loss of tax exemption is a taxable expenditure.

- Allowable expenditures include reasonable investments; expenses relating to those investments; payment of taxes; expenses which are deductible in the computation of UBTI; qualifying distributions; deductions which are allowable in calculating the excise tax on investment income; or expenditures arising from program-related investments.

f. **Sanctions.**

- Excise tax of 10% of the amount of the taxable expenditure.
- The foundation manager is subject to tax at 22% if he or she agrees to the taxable expenditure without obtaining advice of legal counsel.
- Additional tax may be imposed if the taxable expenditure is not corrected, at 100% of the amount of the taxable expenditure. This second-tier tax for the foundation manager is 50% of the amount of the taxable expenditure, with a maximum of \$5,000 for any one taxable expenditure and \$10,000 for all taxable expenditures.

7. Investment Income.

- a. Excise tax of 2% on net investment income of private foundations.
- b. Exempt operating foundations are exempt.
- c. The tax is reduced to 1% if the foundation's distributions for charitable purposes are increased by the same amount.

Sparkling Ideas...



in the Emerald City

**INVESTMENT OF PLANNED GIFTS:
PROTECTING THE INTERESTS OF ALL PARTIES**

Eric Swerdlin
Vice President/Division Head
Swerdlin White – A Bank of New York Division
385 Rifle Camp Road
West Patterson, NJ 07424
(800) 557-9373
FAX (973) 247-4670
eswerdlin@bankofny.com

25TH CONFERENCE ON GIFT ANNUITIES • PRESENTED BY THE AMERICAN COUNCIL ON GIFT ANNUITIES

233 McCREA STREET, SUITE 400 • INDIANAPOLIS, INDIANA 46225 • (317) 269-6271 • FAX: (317) 269-6276 • E-MAIL: ACGA@IUPUI.EDU

***Investment of Planned Gifts,
Protecting the Interests of All
Parties***

Eric Swerdlin
Swerdlin White,
A Bank of New York Division
April 11, 2002

SWERDLIN WHITE
A BANK OF NEW YORK DIVISION

**American Council on Gift
Annuities**

SWERDLIN WHITE
A BANK OF NEW YORK DIVISION

The most dangerous phrase on Wall Street

“This time it’s different”

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TEFRA '69

- Codified rules for planned gifts
- Standard CRTs must pay out at least 5% per annum
- Richard Nixon was president
- Woodstock was the music and cultural event
- Ten year constant maturity T-Note (3rd quarter) 7.51%

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Prudent Investor Act

- Must protect purchasing power risk
- Must consider inflation
- Must diversify
- Must consider BOTH parties in a split interest gift

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Charitable Remainder Trusts

- Four tier tax system
- Income to the trust has no relation to payout except in how the payout is taxed
- Purchasing power implies payout + inflation
- Net income trusts should look at REITs, convertibles, and some high yield

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Four Tier Tax System

- Worst in/first out (WIFO)
- Ordinary income
- Capital Gains (short term first and then long term)
- Other income (e.g. tax-free)
- Return of principal

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Charitable Remainder Annuity Trusts

- Fixed payout
- Investment risk is shifted to the remainderman
- Inflation a risk (purchasing power of cash flow)
- Good for income beneficiaries with low risk tolerance
- Risk of exhausting the trust

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Charitable Remainder Unitrusts

- Variable payout
- Investment risk is shared
- Can keep pace with inflation
- Good for income beneficiaries with high volatility tolerance
- Less risk of exhaustion

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Pooled Income Funds

- Variable payout
- Highly correlated to interest rates
- If consistent with governing document, consider REITs and convertible bonds
- Municipal bonds are forbidden
- Short term gains are generally taxable
- New approaches being discussed

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Long Term Interest Rates (30 years)

- Over 10% as recently as 1987
- Under 5% this year
- Now approximately 5½%
- Going out on the yield curve increases risk (bond prices move inversely with interest rates)

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Short Rates (90 day T-Bills and money market)

- T-Bills over 9% in 1988
- T-Bills under 2% this year
- Some money market funds have waived fees to prevent negative returns

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Charitable Gift Annuities

- Fixed payout
- Governed by state insurance commissioners
- Full faith and credit obligation
- Big changes in “toughest” states

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CGA Reserves and Prudent Investing

- This really is different
- Reallocate the investments over a period of time
- Remember reforming NIMCRUTs?

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ACGA Rates Approved April 30, 2001. Effective 07/01/2001.

Age	Rate (%)		
❖55	6.0	❖ 73	7.6
❖56	6.1	❖ 74	7.7
❖57	6.2	❖ 75	7.9
❖58	6.3	❖ 76	8.0
❖59-60	6.4	❖ 77	8.2
❖61	6.5	❖ 78	8.4
❖62-63	6.6	❖ 79	8.6
❖64-65	6.7	❖ 80	8.9
❖66	6.8	❖ 81	9.1
❖67	6.9	❖ 82	9.4
❖68	7.0	❖ 83	9.7
❖69	7.1	❖ 84	10.1
❖70	7.2	❖ 85	10.4
❖71	7.3	❖ 86	10.8
❖72	7.4	❖ 87	11.1
		❖ 88	11.4
		❖ 89	11.7
		❖ 90 and over	12.0

Charitable Lead Trusts

- Low interest rate environment is helpful, especially for annuity trusts

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Estate Tax Confusion!

Year	Top Tax Rate	Unified
Pre-repeal	55%	\$675,000
2002	50%	1,000,000
2003	49%	\$1,000,000
2004	48%	\$1,500,000
2005	47%	\$1,500,000
2006	46%	\$2,000,000
2007	45%	\$2,000,000
2008	45%	\$2,000,000
2009	45%	\$3,500,000
2010	0%	N/A

Implications of Low Interest Rates

- CRAT- harder to qualify, lower deductions
- CGA- beware of deferred contracts
- CLAT- much more effective, just as estate tax ambiguity freezes donors
- PIF- things get worse

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WHAT'S A DONOR TO DO?



- Take advantage of low rates and create a CLAT?
- Grab a CGA at attractive rates?
- Freeze and do nothing?

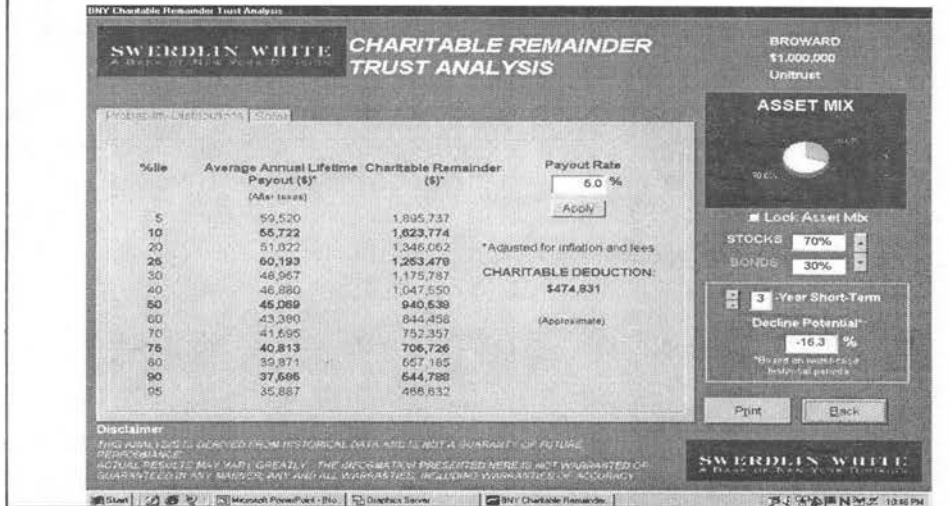
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What's An Advisor To Do?

- Explain the way a planned gift works
- Provide best case/worst case evaluation
- Explain the difference between a fixed payout gift vehicle and a variable payout vehicle

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We Like Using Probability Theory



Full Disclosure

- Always provide full disclosure about best/worst case scenarios
- Discuss the differences between fixed and variable pay gift vehicles
- Make sure they know you invest **in** the market, but do not **control** the markets

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You Raise The Money,
We Do The Rest.

Fiduciary's Planned Giving Program handles the complex details.

With Fiduciary as your Planned Giving partner, you raise the funds from your loyal donors and rest easy. We handle all of the administrative details and provide expert investment services.

There are compelling reasons for this peace of mind.

With over 60 years' experience we're one of the world's largest trust and investment management firms. Our ability to invest globally

is an advantage most competitors don't offer, and our balance sheet has earned us the highest credit rating among all banks.

For more information on how a partnership with Fiduciary will improve your Planned Giving Program results, please call Robert M. Danzig, Assistant Vice President, at 212-632-3051 or write him at 600 Fifth Avenue, New York, NY 10020.

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Sparkling Ideas...



in the Emerald City

**TO OUTSOURCE OR NOT TO OUTSOURCE:
THAT WAS OUR QUESTION**

Chris Yates
Director of Gift & Estate Planning
California Institute of Technology
Mail Code 105-40
Pasadena, CA 91125
(626) 395-6810
FAX (626) 683-9891
chris_yates@caltech.edu

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To Outsource or Not to Outsource: That **Was** Our Question

Chris Yates
Director of Gift & Estate Planning
California Institute of Technology (Caltech)
25th Conference on Gift Annuities
Seattle, Washington
April 10-12, 2002



Why ask the question?

- Growth in planned gift assets may outpace existing systems, capabilities and expertise
- Fiduciary/Liability issues
- Donor Relations
- Efficiency and cost of existing systems
- "Fit" with charity's own goals/mission
- Effective investment of charity's future resources and/or endowment

● ● ● | Major Components in Administration of the Program

- Gift Annuities
- Charitable Remainder Trusts
- Charitable Lead Trusts
- Estates/Revocable Trusts

● ● ● | Assessing Sophistication and Size of Program

- Assessment is critical to understand the program's strengths and weaknesses, and to plan future direction and growth – where are you now, and where are you going?
- Your organization's senior administration needs to understand in order to make good decisions and to properly allocate resources
- Size and sophistication is important to outside management firms, many of which may have minimum requirements

● ● ● | Assessing Sophistication and Size of Program

- Gift Annuities Program
 - Is the program licensed to issue annuities in your state?
 - If so, how many annuities do you administer currently?
 - Total gift annuity assets (\$\$)
 - Do you plan to expand the program significantly in the next 5 years?

● ● ● | Assessing Sophistication and Size of Program

- Charitable Remainder Trusts
 - Does your institution act (or desire to act) as trustee?
 - If so, how many CRTs are you currently administering?
 - Total assets (\$\$) under management?
 - How are the CRT assets invested?
 - How often and by what means do you report to your donors/beneficiaries?




Assessing Sophistication and Size of Program

- Charitable Lead Trusts
 - Does your institution act (or desire to act) as trustee?
 - If so, how many CLTs are you currently administering?
 - Total assets (\$\$) under management?
 - How are the CLT assets invested?
 - How often and by what means do you report to your donors/beneficiaries?




Assessing Sophistication and Size of Program

- Estates and Revocable Trusts
 - Does your institution act (or desire to act) as administrator of estates or revocable trusts?
 - If so, how frequently does this occur?
 - How are the CLT assets invested?
 - How often and by what means do you report to your donors/beneficiaries?




Assessing Your Current Administration Processes

- o Assemble a team
 - Should be representative of all offices involved in accepting and administering life income gifts
 - Planned Giving/Development (THE CUSTOMER)
 - Accounting/Controller's Office
 - Treasurer's Office
 - Gift Processing
 - Real Estate Manager



Assessing Your Current Administration Processes

- o Agree on a Vision/Mission Statement for the Program
 - Investment results in the top quartile of all investment managers
 - Beneficiary payments and tax information distributed in most timely manner possible
 - Streamlined, efficient process
 - Highly satisfied donors who make repeat gifts
 - Flexibility ("change is constant")



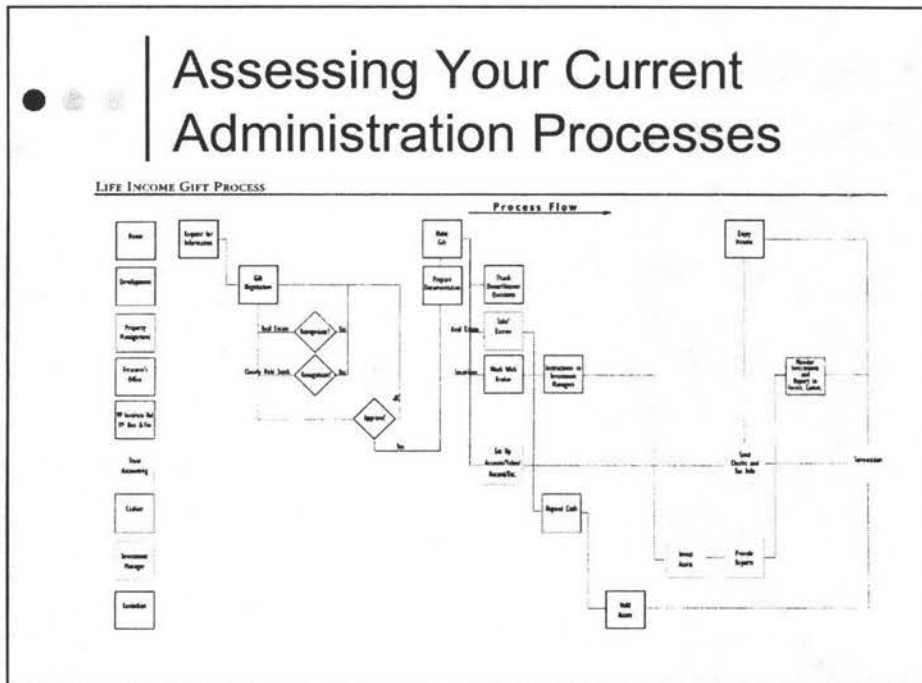
Assessing Your Current Administration Processes

- o Caltech's Mission Statement:
 - *"The mission of Caltech's Planned Giving Program is to attract support for the Institute through life income gifts by providing superior investment returns, timely and accurate reporting, and the highest level of service, consistent with Caltech's fiduciary responsibilities."*



Assessing Your Current Administration Processes

- o Map out the process involved, from initial donor contact about making a life income gift, to termination and distribution to charity.
- o Goal is to understand current process:
 - Number and identity of people involved
 - Sequence of tasks
 - Lines of communication necessary



- ## Assessing Your Current Administration Processes
- o Customer Survey
 - Survey **internal** customers (e.g., trustees, CEO, CFO, other senior administration, program officers, faculty, etc.)
 - Survey **external** customers (donors and beneficiaries)
 - Asks what works and what doesn't work
 - What practices will produce greater customer satisfaction?

● | Assessing Your Current Administration Processes

- Gather “best practices” from other successful programs:
 - Gift acceptance criteria
 - Investment management and performance
 - Administration and accounting
 - Oversight and quality assurance
 - Costs

● | Request for Proposal (“RFP”)

- Provide general background information on your institution
- Provide information about your planned giving program
 - Current method of administration
 - Current investment management
- Require that pricing be included in all proposals
- Name a single point of contact
- Include detailed proposal preparation instructions
- Include a fee proposal worksheet
- Detail process for arranging on-site presentation
- Define process for evaluation and selection




Assessing Your Options

- o Key criteria for evaluating providers
 - Overall Capabilities
 - Ability to meet key service requirements, now or in the future
 - Commitment to high quality, responsive service, and innovation
 - Ability to provide tested, comprehensive services
 - Administration (payments, tax/regulatory filings, accounting)
 - Custody of program assets
 - Investment of program assets
 - Automation: State of the art, flexible, specialized computer systems and software



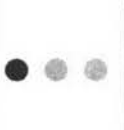
Assessing Your Options

- o Key criteria for evaluating providers
 - Organization/People
 - High quality staff with specialized knowledge of planned giving
 - Organizational depth; succession/backup for key people
 - Excellent reputation – ask for and get references!
 - Can add value to your own efforts



Assessing Your Options

- Key criteria for evaluating providers
 - Investment Management
 - Investment record – historical, preferably including periods of recession
 - Attention to Prudent Investor Rule
 - Offers sufficient diversification
 - Flexibility in portfolios
 - Single Portfolio?
 - Cafeteria style plan?
 - Ability to customize?
 - Assets used in building portfolio
 - Access to Mutual Funds or specialty investments



Assessing Your Options

- Key criteria for evaluating providers
 - Administration
 - What functions, if any, are further outsourced? (e.g., tax reporting)
 - Internal oversight/audit
 - Custody of assets?
 - What kind of oversight reporting is provided to charity, e.g., for Treasurer, Board of Trustees?
 - What kind of reporting is provided to beneficiaries? Is it quarterly, annual?
 - When are 1099's and K-1's delivered?



Assessing Your Options

- o Key criteria for evaluating providers
 - Services/Functions
 - Can payments be made via ACH?
 - Who is the contact for day-to-day questions? Can you reach them throughout the day in your time zone?
 - Who is the relationship manager, and what role do they play in the organization? Level of authority?
 - What sort of online access is available?
 - Who is available to speak directly with donors/beneficiaries/prospects at discretion of the client?



Assessing Your Options

- o Key criteria for evaluating providers
 - Assessment of Impact
 - Will quality and level of services be enhanced from current status?
 - What demands will there be on internal staff?
 - What level of effort will be required to manage the relationship?
 - Are there deficiencies which your staff must help overcome?



Assessing Your Options

- o Key criteria for evaluating providers
 - Assessment of Impact (continued)
 - Importance of relationship to provider
 - If your program is small, will it get the attention it deserves and needs?
 - Culture/level of customer service
 - Can the provider manage the impact of receiving your business?
 - Are they currently taking on a number of new clients?
 - Can they manage special issues or complexities of your particular program?



Assessing Your Options

- o Key criteria for evaluating providers
 - Ability to Work Together
 - Shared goals, common vision
 - Good potential working relationship/chemistry between the internal and external staffs
 - Logistical issues (location, time zone, ability to connect electronically)



Assessing Your Options

- o Key criteria for evaluating providers
 - Cost
 - Identify one-time set-up charges and ongoing periodic charges
 - Wide range of fee structures, often based on size of program and range of services offered
 - Comprehensive services: estimated range 0.50% - 2.00% of assets under management annually
 - Look for "hidden" charges (e.g., mutual fund expenses, tax services)
 - Compare total cost of outside provider to value added to your program, and then weigh this relative to cost of internal management at preferred level of service



Assessing Your Options

- o Internal Administration:
 - Commitment by charity of necessary resources on an **ongoing** basis
 - Ability of all internal players to communicate quickly and effectively
 - Responsibility for oversight
 - Expertise:
 - Accounting, including tax filings
 - Investment management
 - Legal counsel
 - Interface with Donors/Beneficiaries – single contact?



Assessing Your Options

- External Options:
 - Community Foundations
 - Banks and Trust Companies
 - Investment/Brokerage Firms
 - Niche/Specialist Firms
- Outsourcing:
 - Program Administration
 - Program Investments



Assessing Your Options

- Community Foundations
 - Gift Annuity Program – Community Foundation often will already be licensed to issue annuities on behalf of client charity
 - CRT Program – offered by larger, better established Community Foundations
 - Costs vary. Some community foundations will assess a portion of the remainder in addition to an annual fee.
 - Benefits – can offer comprehensive services for small and/or new programs. Charity is its business.
 - Disadvantages – often less direct access to investment managers and trust administrators.



Assessing Your Options

- Banks and Trust Companies
 - Usually provides comprehensive services, but cannot be licensed to issue gift annuities
 - Usually offers trust investment and administrative expertise and infrastructure
 - May offer economies of scale, quality assurances of highly regulated industry
 - Specialty area may have low visibility or priority in big banking operation; bank mergers can be unsettling or disruptive



Assessing Your Options

- Investments/Brokerage Firms
 - Sophisticated investing strategy and options are usually offered
 - Known “name” or reputation may appeal to donors
 - Cannot be licensed to issue gift annuities
 - May not offer administration services
 - Compatibility with core business



Assessing Your Options

- o Niche/Specialist Firms
 - Can provide specialized expertise and comprehensive services tailored to this narrow and esoteric area, with greater accountability
 - May have more flexibility to react to changes in the field
 - Cannot be licensed to issue gift annuities
 - May lack access to systems, products, and personnel for greatest efficiency and value
 - Possibility of acquisition by unrelated entity



Assessing Your Options

- o Sample listing of providers of planned giving services:
 - Local banks and trust companies
 - Local community foundations
 - Fiduciary Trust Company International
 - Fifth Third Bank
 - Kaspick & Company
 - Mellon Private Asset Management
 - Merrill Lynch
 - Northern Trust
 - PNC Bank



Assessing Your Options

- o Sample listing of providers of planned giving services (continued):
 - State Street Global Advisors
 - Swerdlin White (Bank of NY)
 - TIAA/CREF Trust Co.
 - U.S. Trust Co.
 - Vanguard Asset Management & Trust Services
 - Wachovia Charitable Funds Management
 - Wells Fargo Bank



QUESTIONS

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- Janice Burrill, Wells Fargo Bank
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- Anne McMenamin, Manager of Trusts and Bequests, Caltech
- Thomas W. Smith, CFP, Planned Giving Startup

Sparkling Ideas...



in the Emerald City

**WOMEN'S PHILANTHROPY:
GENDER DIFFERENCES IN PLANNED GIVING**

**Cindy Sterling
Consultant
Washburn & McGoldrick, Inc.
250 W. 15th St., Suite 1A
New York, NY 10011
(212) 627-0304
csterling@wash-mcg.com**

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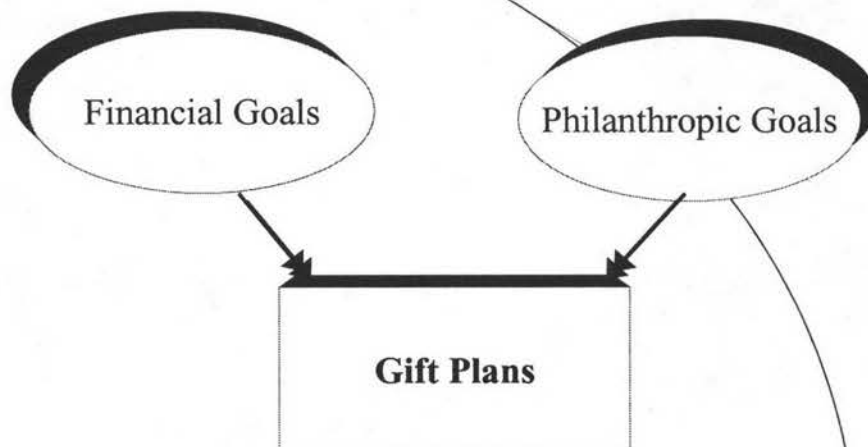
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Women's Philanthropy: Gender Differences in Planned Giving

ACGA Conference
Seattle, Washington
April 10, 2002

Presented By: Cindy Sterling, ChFC
Washburn & McGoldrick, Inc.

Elements of Planned Giving



Market Segmentation

- Do we need to market to women and men differently?



Research on Gender Differences In Planned Giving



Research Population

- Small liberal arts colleges that were or are single sex institutions
- Evaluated planned giving data during capital campaigns completed between 1988 and 1998

Planned Giving

- Income-Producing Gifts
- Mature Bequests

Campaign Totals

<i>Women Donors</i>	<u>Campaign Total*</u>
	Dollars
Bryn Mawr	\$92 million
Mount Holyoke	\$139 million
Smith	\$163 million
Vassar	\$206 million
Wellesley	\$168 million
<hr/>	
<i>Men Donors</i>	
Colgate	\$158 million
Hamilton	\$69.5 million
Williams	\$174 million

*Campaigns Completed 1988-1998; Campaigns lasted 5-7 years.
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Planned Giving Totals

<i>Women Donors</i>	<u>Planned Giving Total*</u>	
	Dollars	% of Total
	Campaign	
Bryn Mawr	\$34 million	37%
Mount Holyoke	\$51 million	37%
Smith	\$46 million	28%
Vassar	\$57 million	28%
Wellesley	\$54 million	32%
<hr/>		
<i>Men Donors</i>		
Colgate	\$14 million	14%
Hamilton	\$25 million	34%
Williams	\$42 million	24%

*Recent Campaigns Completed 1988-1998;
 Includes only life income gifts and matured bequests.
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Planned Giving Total

Women

Mean 32%

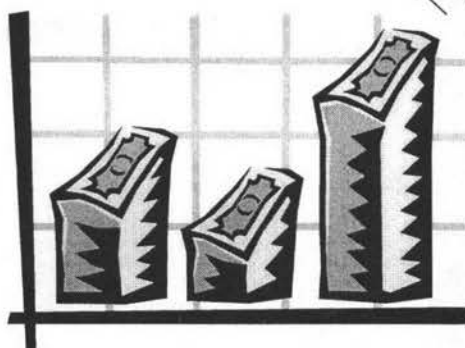
Median 32%

Men

Mean 24%

Median 24%

Income-Producing Gifts



Income-Producing Gifts

Women Donors

	<u>Dollars</u>	<u>% of Total Campaign</u>
Bryn Mawr	\$8 million	9%
Mount Holyoke	\$23 million	17%
Smith	\$14 million	8%
Vassar	\$16 million	8%
Wellesley	\$17 million	10%

Men Donors

Colgate	\$16 million	10%
Hamilton	\$16 million	23%
Williams	\$32 million	18%

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Income-Producing Gifts

Women

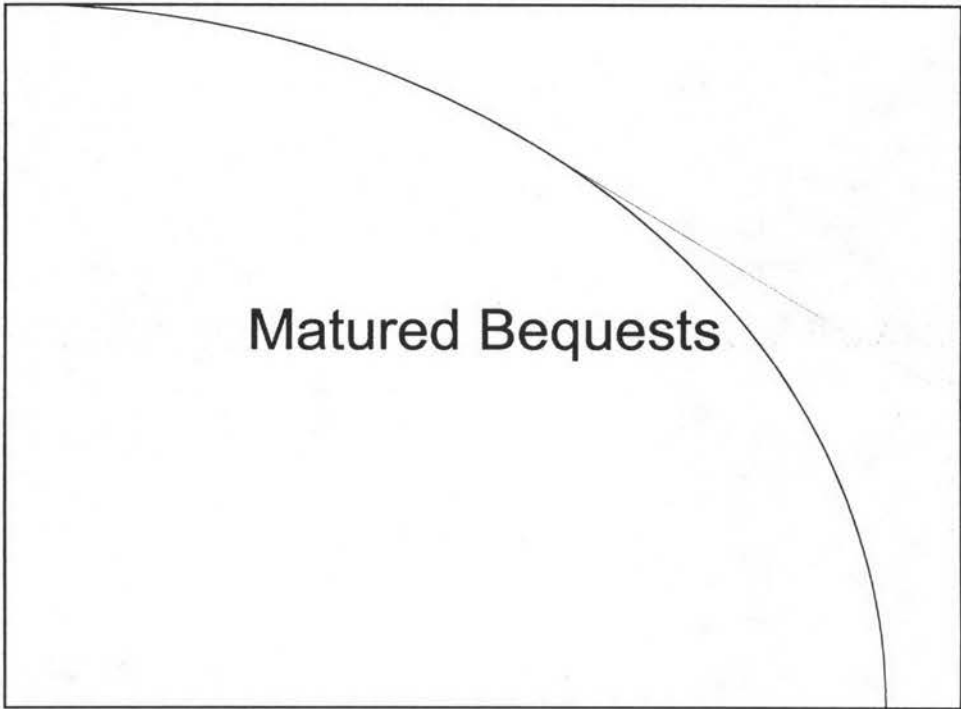
Mean 10.4%

Median 9.0%

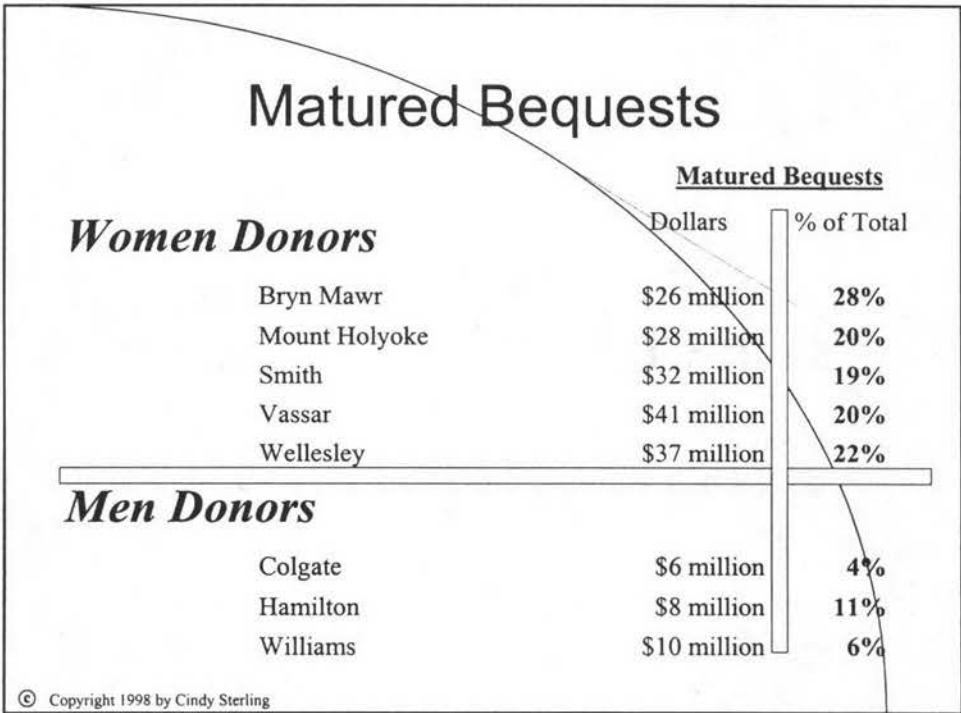
Men

Mean 17%

Median 18%



Matured Bequests



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Matured Bequests

Women

Mean 21.8%

Median 20%



Men

Mean 7%

Median 6%

Recently Completed or Current Capital Campaigns

Campaign completion dates (2001-2004)

Recently Completed or Current Capital Campaigns

Women	<u>Campaign Totals</u>	<u>PG Totals</u>	<u>% of PG</u>
Mt. Holyoke	\$202 million*	\$65 million***	32%
Smith	\$273 million*	\$79 million****	29%
<hr/>			
Men			
Amherst	\$270 million**	\$67 million*****	25%

*As of 12/31/01

** Campaign completed as of 6/30/01

***Does not include \$1.77 million in planned gifts contributed by men.

**** Does not include \$3.03 million in planned gifts contributed by men (mostly spouses.)

*****Does not include \$15.7 million in planned gifts contributed by women (mostly spouses.)

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Income Producing Gifts

Women	Dollars	% of Total
Mt. Holyoke	\$30 million*	15%
Smith	\$19 million**	7%
<hr/>		
Men		
Amherst	\$36 million***	13.3%

* Does not include the \$207,000 given by men

** Does not include \$425,000 given by men (spouses, brothers, sons and male faculty emeritus.)

*** Does not include \$4.9 million given by women (mostly widows and daughters.)

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Matured Bequests

Women

Mt. Holyoke

Dollars

\$35 million*

% of Total

17%

Smith

\$60 million**

22%

Men

Amherst

\$31 million***

11.5%

* Does not include \$1.57 million bequeathed by men.

** Does not include \$2.6 million bequeathed by men (mostly surviving spouses.)

*** Does not include \$10.8 million bequeathed by women (mostly surviving spouses.)

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Current & Past Campaigns

Total % of Campaign

Income-Producing

Bequests

Women

Mean 31.8%

10.6%

21.1%

Median 32%

9%

20%

Men

Mean 24.25%

16%

8%

Median 24.5%

15.5%

8.5%

Other Research



National Committee on Planned Giving Survey 2000*

- Women represent 53% of bequest donors
- Men represent 56% of charitable remainder trust donors

*Planned Giving in United States 2000: A Survey of Donors, National Committee on Planned Giving, 2001.

Bequests for Women & Men* 1995 IRS Estate Tax Data

Women

Educational, Medical and Scientific Institutions	\$1.6 billion	32%
“Other” Institutions	\$1.4 billion	27%
Private Foundations	\$1.17 billion	23%

Men

Private Foundations	\$2 billion	38%
Educational, Medical and Scientific Institutions	\$1.6 billion	31%
“Other” Institutions	\$1.1 billion	22%

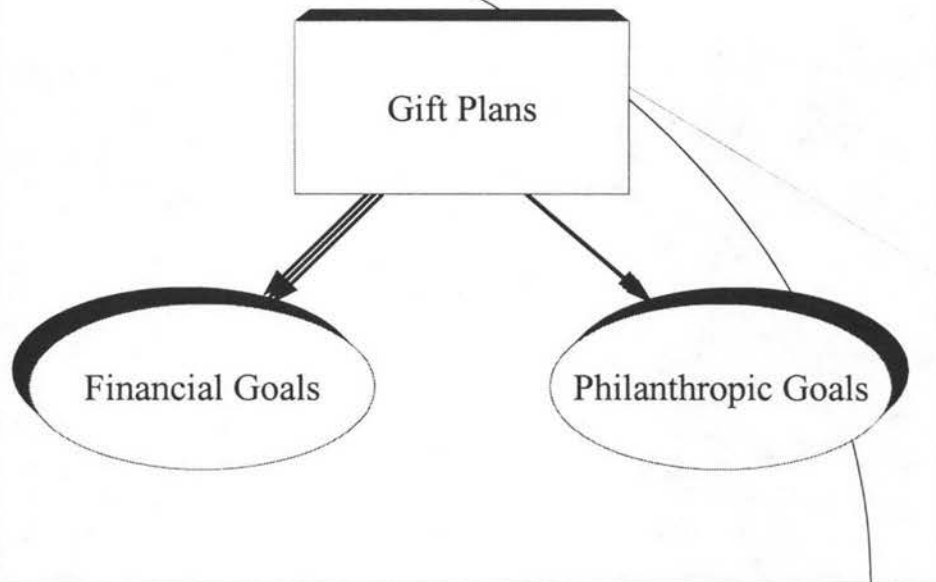
*IRS, Statistics of Income Bulletin, Summer 1999, Publ. 1136(9-99).

Demographics of Charitable Bequests 1995 IRS Estate Tax Data*

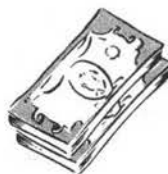
1) Widows (Women)	\$3.7 billion
2) Married Men	\$1.9 billion
3) Widowers (Men)	\$1.6 billion
4) Single Men	\$1.4 billion
5) Single Women	\$860 million
6) Separated/Divorced Women	\$286 million
7) Married Women	\$167 million
8) Separated/Divorced Men	\$123 million

* IRS, Statistics of Income Bulletin, Summer 1999, Publication 1136 (9-99).

Why ... of Women's Philanthropy



What Are Women's Attitudes Towards Money?



Financial Factors Influencing Women's Giving Patterns

- Women earn less than men
- Women live 7 years longer than men
- Women may fear outliving their money ("Bag lady" Syndrome)

Women Retirement Statistics

- 75% of women not entitled to pension benefits because of interrupted work histories
- **70% of female retirees failed to plan for retirement**
- Women's social security benefits are 25% less because of interrupted work histories & earning less income
- 80% of widows who now live in poverty were not considered poor when their husbands were alive.

National Center for Women & Research, 1998.
U.S. Census Bureau

When investing....

- **Men want to beat the market**
- **Women want to avoid big losses**

National Center for Women & Retirement Research, 1998.

When Women Do Invest ...

- Want to be educated about the process ... may take longer to make a decision
- Often buy and hold
- More likely to use professional advisors than men
 - ⇒ Relationship with advisor very important
 - ⇒ Value “trust” more than “performance”

Tracy Longo, “Women Still Lag Men in Retirement Investing,” Financial Planning, 1999.
Nancy Opiela, “What Women Investors Want,” Financial Planning, September, 1998.

Women's Philanthropy ...

...is it really all that different?



Differences in Men's and Women's Giving*

Men

Women

- Visibility
 - Serve as role models
 - More likely to give first, then serve on Board
- Older women less interested in public recognition
 - Often give anonymously
 - More likely to volunteer first, then make a gift

*Andrea Kaminski, "The Hidden Philanthropist: Realizing the full potential of women's giving with gender-sensitive cultivation and solicitation strategies," 1999

*Sondra Shaw and Martha Taylor, *Reinventing Fundraising*, 1995.

Source of Wealth Important*

- Women who create own wealth feel comfortable making charitable giving decisions independently
- Women who are not breadwinners may feel less comfortable making charitable giving decisions

*Altinkemer, Cheryl, "Applying the Rule of Seven to Gift Planning," Gift Planner Digest, September, 2001

*Philanthropy Among Business Women of Achievement, The National Foundation For Women Business Owners Survey , 1999.

What's Important to Women Philanthropists ...



Important Components of Women's Philanthropy*

- **Relationship** with institution is **extremely** important
- Want gift "to make a difference"
- Institutional accountability
- Belief that women should teach each other about philanthropy

*Susan A. Ostrander, Joan M. Fisher, "Women Giving Money, Women Raising Money: What Difference for Philanthropy?" *New Directions for Philanthropic Fundraising*, No. 8 Summer, 1998.

*Sondra Shaw & Martha Taylor, *Reinventing Fundraising*, 1995.

*The UCLA Women and Philanthropy Focus Group, 1992.

Highly Successful Women Business Owners and Executives*

Reason for Giving to Particular Organizations

- Passionate about organization's issue
- Well-run organization
- Focused on population of interest
- Emotional connection
- Organization keeps donor informed

**Philanthropy Among Business Women of Achievement*, The National Foundation For Women Business Owners Survey, 1999.

Highly Successful Women Business Owners and Executives*

Greatest support provided to the following causes

- Education
- Women-related
- Arts
- Health
- Religion

*Philanthropy Among Business Women of Achievement, The National Foundation
For Women Business Owners Survey, 1999.

How to Reach Women Planned Giving Donors

- Realize cultivation may take longer
 - Commit time to develop relationship
- Realize current volunteers may be prospects
 - Pursue and enhance these relationship
- Focus on impact gift will have on organization
 - Have details ready

How to Reach Women Planned Giving Donors Continued

- Create consistent, on-going, “user friendly” marketing materials that feature giving by women donors
 - Always include bequest options
- Educate on gift plans in context of overall financial planning
- Conduct Seminars on Women’s Financial/Gift Planning

Sparkling Ideas...



in the Emerald City

CULTIVATING AND MAINTAINING LONG TERM DONOR RELATIONSHIPS

Joseph O. Bull
Director of Planned Giving
The Ohio State University
2400 Olentangy River Road
Columbus, OH 43210-1027
(614) 688-5699
FAX (614) 688-3503
Bull.5@osu.edu

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Who: The Cast of Characters in Long Term Relationships

- ☞ Donors**
 - Family of Donors
- ☞ Advisors to Donors**
 - Executors
- ☞ Internal Peers**

Paraeto's Principle

- ☞ 80-20 Rule**
- ☞ Is it now 80-10?**
- ☞ Top 1% of donors = 57%**
- ☞ Ohio State's experience**
- ☞ How do you spend your time?**

What: Defining a Long Term Relationship

- ☞ **Relationship Marketing**
- ☞ **Lessons from Academic Research**
- ☞ **Isn't it nice that business and academe are just learning what PG professionals have known for decades?**

Research on Behaviors Which Influence Long Term Relationships

- ☞ **Salespeople's Behaviors**
 - Customer Orientation
 - Customer Trust
 - Pro-active behaviors
- ☞ **Relationship Enhancing Behaviors**
 - Customer's Positive Attitude
 - Mutual Goals
- ☞ **Relationship Threats**
 - Lack of Freshness
 - Balance of Professionalism and Friendship
 - Unreasonable Demands

What Buyers Want Most From Salespeople

- ☞ Expertise**
- ☞ Contribution**
- ☞ Representation**
- ☞ Trustworthiness**
- ☞ Compatibility**

When: How Long is Long Term?

- ☞ Economic power of “seniors”**
- ☞ \$150 M from 101**
- ☞ NCPG’s Survey of Donors 2000**
- ☞ Ohio State’s Probate Statistics**

Where: Sites Where the L-T Relationship Can Flourish

- ☞ **Based on Donor's circumstances and comfort level**
- ☞ **My Place or Yours?**
- ☞ **Non-traditional sites**

Why: Isn't All This L-T Stuff Much Ado About Nothing?

- ☞ **Most PG's are *NOT irrevocable***
- ☞ **Competition**
- ☞ **Additional gifts**
- ☞ **Lessons from kindergarten**

How: The Process of Nurturing L-T Relationships

☞ **Micro: dealing with individuals**

☞ ***The One Minute Sales Person***

- **The Wonderful Paradox**
- **Selling on Purpose**
- **Before the Sale**
- **During the Sale**
- **After the Sale**

How: The Process of Nurturing L-T Relationships

☞ **Micro: dealing with individuals**

☞ ***The One Minute Sales Person***

- **The Wonderful Paradox**
- **Selling on Purpose**
- **Before the Sale**
- **During the Sale**
- **After the Sale**

How: The Process of Nurturing L-T Relationships

- ☞ Micro: dealing with individuals**
- ☞ Macro: systems and processes**
 - Acknowledgements and Condolences
 - Publicity
 - Gift Recognition Society
 - Events
 - Multiple Prospect Managers?
 - Gift Management and Tracking
- ☞ Return to Pareto**

Bringing Together the Essential Elements for Planned Giving

- Sophisticated Asset
Management

- High Quality Gift
Administration

- Expert Consulting on
Policies and Practices

- Comprehensive
Reporting

- Demonstrated
Knowledge
and Expertise



MANAGING \$2 BILLION OF
PLANNED GIFT ASSETS FOR CHARITIES NATIONWIDE



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Sparkling Ideas...



in the Emerald City

WORKING WITH ALLIED PROFESSIONALS

Moderator:

Clinton A. Schroeder
Gray, Plant, Mooty, Mooty & Bennett P.A.
3400 City Center
33 So. 6th Street
Minneapolis, MN 55402
(612) 343-2832
FAX (612) 333-0066
clinton.schroeder@gpmlaw.com

Panelists:

Judy Courshon
President
Wellspring Group CPAs
10900 NE 4th, Suite 920
Bellevue, WA 98004
(425) 462-8220
FAX: (425) 462-8218
judy@wellspringgroup.net

Dr. Frank L. Ellsworth
President
Endowments,
Capital Research &
Management Co.
333 South Hope Street
Los Angeles, CA 91711
(213) 486-9560
FAX (213) 615-0219
fle@capgroup.com

Malcolm A. Moore
Partner
Davis Wright Tremaine
2600 Century Square
1501 Fourth Avenue
Seattle, WA 98101
(206) 622-3150
FAX (206) 628-7699
malcolmmoore@dwt.com

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WORKING WITH ALLIED PROFESSIONALS

Panel members:

**Judy Courshon
Frank Ellsworth
Malcolm Moore**

Moderator:

Clinton A. Schroeder

I. HOW TO DEAL WITH DONOR'S LAWYER OR CPA

- A. Avoiding conflicts
- B. Avoiding unauthorized practice of law
- C. When is dual representation okay? Is written consent needed?
- D. How can undue influence be avoided?
- E. Should charities ever draft documents like trust agreements or Wills for donors?
 - 1. Does it make a difference if the donor's own counsel reviews the documents?

II. HOW TO DEAL WITH OTHER PROFESSIONAL ADVISORS?

- A. Types
 - 1. Financial planners
 - 2. Insurance sales person
 - 3. Bank trust officer
- B. Is it ever okay for a charity to pay a commission to the financial planner?
- C. Is it okay to promise to sell assts received from donor through his broker?
 - 1. How about promising to "keep the trust account with that broker?"

III. COMMUNITY FOUNDATIONS AND NATIONAL FOUNDATIONS OR INVESTMENT COMPANIES

- A. Should we prefer one over the other?
- B. Is a charitable fund sponsored by a family of mutual funds the same as a national community foundation?
 - 1. Is it okay for a broker to get fees, such as Sec. 12(b)(1) (service fee charge) or an up-front commission?
 - 2. Should a charitable gift fund ever invest in load funds?
- C. Is there any problem with national foundations paying commission to financial planners or brokers for placing CGA's with them?
- D. Is it legal or ethical for charities to make contracts with financial planners or their parent companies?
- E. Are "enduring relationships" between charities and commercial organizations?

Sparkling Ideas...



in the Emerald City

**SELECTING PLANNED GIVING OFFICERS:
WHO IS THE MOST LIKELY TO SUCCEED?**

**Dr. Jack Goodner
President
Carr & Associates
10880 Benson, Suite 2330
Overland Park, KS 66210
(913) 451-9220
FAX (913) 451-9228
jack@carrassessment.com**

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SELECTING PLANNED GIVING OFFICERS - WHO IS THE MOST LIKELY TO SUCCEED?

Separating The Wheat From The Chaff A Systematic Approach to Selecting Planned Giving Officers

The Salvation Army is no newcomer to Planned Giving as a method to fund the bulk of its ministry.

- In 1865 the founder, William Booth encouraged the solicitation of gifts by will.
- In 1927 The Salvation Army was a founding organizer of the Committee on Gift Annuities (American Council on Gift Annuities).
- 1973 saw the first Territorial Planned Giving Director in the Salvation Army
- In 1978 the National Advertising Program began
- In 1980 the Southern Territorial initiated funding to encourage a full-time director in each division and installed standard reporting and production standards
- 1985 saw the first multiple staff hired in divisions
- 1995 was the first year the systematic selection system was in place and the first year in which annual production exceeded \$100,000,000

The current staff is made up of 25 full-time Planned Giving Associates, 9 Division Planned Giving Directors, and a Territorial Director who has been in that role for fifteen years. The nine divisions are governed by Territorial/Divisional Policy. They present a unified approach to potential donors.

This paper will address some of the history of one of those territories – The Salvation Army-Southern Territory currently under the direction of Lindsay Lapole. The study it describes was intended to look back over the development, design, and results of the selection process used to employ Planned Giving Associates and to evaluate its contribution to the success of The Salvation Army-Southern Territory.

The impetus for the development of a systematic approach to selection began in the summer of 1993. The Salvation Army-Southern Territory and Carr & Associates had cooperated on facets of employee selection for many years. Carr has had a long-term involvement with a number of national and international organizations in the measurement of candidates and/or employees for selection, promotion, and

Selecting Planned Giving Officers

developmental assessment. It is made up of a staff headed by psychologists armed with psychometric and measurement expertise, an understanding of the work setting and worker characteristics required in particular work situations, and a research orientation.

The Salvation Army selection practices in place in 1993 called for candidates to be surfaced (often from personal contacts and relationships), interviews conducted, and a selected candidate to be sent Carr & Associates assessment materials for completion. Unless major disqualifiers were uncovered, the candidate was hired. Results achieved by the hired candidates were mixed.

A visit between Carr's psychologists the Territorial Planned Giving Director, Lindsay Lapole, brought the problem into focus. Lindsay brought with him a clear idea of who among his Planned Giving Associates were producing and who were not. He had a simple request –

“We want more of the former and fewer of the latter.”

Since Carr had amassed considerable data across organizations and industries on individual candidates for management, sales, and professional positions, it was decided to use this database to see how plentiful these stars were among general applicants for such positions.

Salvation Army planned giving “stars” were described by the measured characteristics identified when they were hired. The five highest producers were found to be remarkably similar. In particular, they were distinguished by a high level of assertiveness (a likely contributor to their ability to make sales) and a high level of compliance (a likely asset within The Salvation Army organizational philosophy).

The characteristics found in the high performers were compared against Carr's research database of over 10,000 candidates measured on a wide variety of characteristics. The question we asked –

If we considered the 10,000 cases as the applicant pool, how many would match the characteristics of the high producers in the Southern Territory.

The shocking answer we found was that only 70 cases were identified as matches to our “star” profile. Only 70 of 10,000 high level candidates met the proposed requirements for Planned Giving Associates, Southern Territory.

It might have been tempting at this point to decide the profile was wrong... or the right people were just too difficult to find. However, armed with a clear picture of the high performers in his organization and the reality of the difficulty in finding others like them, Lindsay attacked the real problem.

All of the testing and interviewing available do not improve the quality of the candidate in front of you. If the process of setting a target, building a

Selecting Planned Giving Officers

candidate pool, carefully processing the pool, and making timely, accurate decisions is flawed, the chance of finding that next “star” are about 70 in 10,000 – basically, a needle in a haystack.

By the summer of 1994, Lindsay had elevated the discussion about selection problems to the Southern Territorial Planned Giving Steering Committee. With the blessing of this group, Lindsay and Carr were encouraged to devise a systematic program to improve the process of finding and selecting Planned Giving Associates.

By the beginning of 1995 the program was in place. The final process recognized and took advantage of the strength of a two-tier management system in place within The Salvation Army.

Territorial management provided continuity by identifying basic competencies required to assure a culture and image appropriate to representing The Salvation Army. Because of the scale of operation, Territory management centralized technical resources, training and a dual supervisory relationship. In addition, Territorial Management provided seed money to the nine Divisions to offset the start-up costs of a new Planned Giving Associate.

Divisional management provided the implementation steps. They could target those characteristics that best fit the local needs. Day to day supervision was delegated to the Division Planned Giving Director. Ultimately the selection decisions were assigned to Divisional Management subject to approval of the Territorial Planned Giving Steering Committee.

Since 1995 the selection process has been modified but the fundamental steps have remained the same. The steps are relatively straightforward:

1. Target
2. Source
3. Screen
4. Select

The strength is based upon the recognition that selection is a process and if steps are skipped, errors will happen. The following describes how The Salvation Army and Carr have operationalized the process.

Targeting

Possibly the most important but frequently overlooked step in selection is targeting. The Salvation Army/Carr program requires the decision-makers to meet in one place, at one time, and build a Selection Criteria to be used as a blueprint for the target. This is a process used by Carr to focus on observables and glean out the rhetoric. Although this step is sometimes

Selecting Planned Giving Officers

resisted, it is essential because it produces a quantifiable, weighted set of specific selection criteria. This Selection Criteria will

- tell those who source where to look,
- it will help to design the position announcement,
- it will assist in screening, and finally,
- it will expedite the most difficult step in any search, the final selection decision.

Sourcing

Previous experience made several things about sourcing very evident.

- The sourcing net must be very broad.
- It should gather candidates simultaneously.
- It should assume candidates are qualified until objective evidence says they are not.

In other words, all potential candidates should be encouraged to apply. Leave the screening until later.

Screening

Since the applicant pool is usually sizable, it became important to collect and analyze candidate data promptly. The objective is to spend the bulk of the time with those candidates who most likely fit the position requirements. The screening phase includes collecting a resume, application, and preliminary psychological data. Based upon this information as compared to the previously established quantifiable Selection Criteria, a group of applicants are passed on to a chemistry interview. Successive screening is used to move candidates who are most likely to succeed to the hiring point.

Selecting

Selecting takes place at the end of the process, not at the front. Typically 100-150 applicants have responded. The first screening takes these down to 15-20 and recommends 6-8 to go forward. At this point decision-makers conduct the interviews. They are aided by a more depth look at psychological characteristics. As the field is narrowed to 2-3, finalists complete psychological assessment in Carr's offices. The position is offered and orientation begins.

It is this process that has been installed, tuned when necessary, but retained in order to improve the quality of Planned Giving Associates in the Southern Territory. It is under this program that the current staff of twenty-five Planned Giving Associates and nine

Selecting Planned Giving Officers

Division Directors has been assembled. The Salvation Army and Carr are proud of the team that has been assembled.

In an attempt to understand the differences between the current staff and associates selected under less systematic procedures, an analysis of available data on those hired before and after the 1995 establishment of a systematic process for targeting, sourcing, screening, and selecting Planned Giving Associates for The Salvation Army-Southern Territory was undertaken. Seventy-nine individuals who were hired between 1977 and 1995 were identified. Thirty-two individuals hired under the revised selection system were also identified. Attempts were made to collect all psychometric and demographic information that was available at the time of hire. The results highlighted what was known about new employees on the day of hire.

In addition, we were also interested in learning about differences in post-hire results. Two broad types of performance data, were examined:

- Activity - Defined by field contact information. Data available on a quarterly basis for each Planned Giving Associate since 1990.
- Achievement- Defined by production in terms of both number and value of gifts. Data available since date of hire for all Planned Giving Associates.
- Efficiency- Defined by the interaction between contact information and production information with adjustment made for lost gifts.
- Turnover- Defined by length of tenure. Emphasis was placed on gathering and analyzing information about reasons for terminating employment with The Salvation Army and subsequent employment.

Of particular interest was the predictive value of pre-hire information. The relationship between information available on the day of hire and subsequent performance was examined. The predictors consisted of:

- results of psychometric assessments including scores on a variety of measures and scales
- demographic information including work history, education, and professional designations.

Post-hire results (described above) were used as performance criteria. Since analyses found no differential prediction, results for the entire group will be discussed.

Selecting Planned Giving Officers

An examination of the effectiveness of the three-step screening process was also undertaken. Characteristics of the selection pool were represented by those completing the first level of assessment (approximately 700). This was compared to those who successfully passed the chemistry interview and were asked to complete the second level of assessment (approximately 250), to those who successfully passed a depth interview and were asked to complete a third level of assessment (approximately 50), and to those hired.

Finally, we were interested in a comparison between the costs/benefits of no systematic selection procedures, the earlier procedures, and the revised program for The Salvation Army-Southern Territory. Lindsay Lapole assisted in determining both tangible and intangible costs and benefits of finding the right Planned Giving Associate.

Results of the above analyses will be discussed. Support for a systematic approach to selection will be offered. Proposed changes revealed by the analyses will be described. Relevance to other organizations will be highlighted.

Selecting Planned Giving Officers

A special thank you to:

Paula Felchner, our Associate at Carr whose skill and tenacity in wading through over 25,000,000 data points produced the statistical analyses described above.

Lindsay Lapole, Territorial Planned Giving Director, and the Officers of The Salvation Army, Southern Territory whose commitment to excellence makes it possible to objectively focus on good programs and make them even better.

Sparkling Ideas...



in the Emerald City

VENTURE PHILANTHROPY AND NEW GIVERS

Erin Hemmings
Associate Director
Social Venture Partners
1601 Second Avenue, Suite 605
Seattle, WA 98101
(206) 374-8757
FAX (206) 728-0552
erinh@svpseattle.org

25TH CONFERENCE ON GIFT ANNUITIES • PRESENTED BY THE AMERICAN COUNCIL ON GIFT ANNUITIES

233 McCREA STREET, SUITE 400 • INDIANAPOLIS, INDIANA 46225 • (317) 269-6271 • FAX: (317) 269-6276 • E-MAIL: ACGA@IUPUI.EDU

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Presenter: Erin Hemmings, Associate Director, Social Venture Partners
1601 Second Avenue, suite 605, Seattle, WA 98101
erinh@svpseattle.org; (206) 374-8757
www.svpseattle.org

Venture Philanthropy and New Givers

I. Introduction

- A. Overview of Philanthropic Landscape
- B. Goals for presentation
 - 1. Profile and Giving Style of "New Givers"
 - 2. Venture Philanthropy overview
 - 3. Case study of Social Venture Partners
 - 4. What does this mean for gift planners? Can you approach new givers the same old way?

II. Overview of the philanthropic landscape

- A. Prospect of inter-generational wealth transfer
 - 1. \$41-\$136 Trillion dollars transferred over next 55 years
- B. Era of unprecedented wealth accumulation (despite downturn)
- C. Increase in volume of philanthropic giving (not as percentage of income)
- D. Proliferation of organized giving vehicles
 - 1. Donor advised funds
 - 2. Private family foundations
 - 3. Giving Circles
 - 4. Venture Philanthropy funds
 - 5. Supporting organizations
 - 6. CRT, CLT, etc.
- E. Emergence of new cohort of donors
- F. Growth in academic, philanthropic, and media interest in new givers and their philanthropic potential

III. Profile and Giving Style of New Givers

- A. Profile
 - 1. Young
 - a. Ages 25-45 (not 55-75)
 - b. Single, recently married, parents of very young or school-aged children
 - 2. Newly Wealthy
 - a. Rapid ascendancy into ranks of the wealthy
 - b. Wealthy early in their professional careers

3. New to Philanthropy
 - a. New wealth enables philanthropy at a new level
 - b. Raised in largely middle and working class families without clear family traditions of philanthropy
 - c. Lack clear or large-scale philanthropic role models
 4. Non-uniform areas of Interest
 - a. Tendency to favor Education, Children's programs, Environment, and International causes
 - b. Because of age and life experiences, unlikely to have immutable giving areas of interest
 - c. "Accelerated learning curve" for moving from affiliation to engagement or mission-oriented giving
 5. Unclear about magnitude of their wealth
 - a. Face complex wealth management issues
 - b. Difficult to determine "how much will you need for the rest of your life?"
- B. Giving Style/Tendencies of New Givers
1. Hands-On, Engaged, and personally involved in their giving
 2. Bottom-line, Results-oriented
 3. Interested in supporting strategic or systemic change not charity
 4. Hopeful about application of "business smarts" to nonprofit setting
 5. Likely to restrict or target their gift
 6. Attracted to idea of leverage or scalability
 7. High expectation
 8. Attracted to idea of innovation and social enterprises
 9. "Ready, Aim, Fire"

IV. Venture Philanthropy Overview

- A. No uniform definition of Venture Philanthropy (V.P.)
 1. Very broadly defined, often misused or overused
 2. Often juxtaposed with "traditional philanthropy"
 3. Not a better approach, just a different approach
 4. Often used to describe philanthropic approach of new givers and entrepreneurs
- B. V.P. seeks to apply the principles of Venture Capital investing to philanthropy
 1. Close Relationships between the Funder and Investee
 2. Infuse financial capital and human capital
 3. Offer managerial advice and oversight
 4. Long-term Commitments to funding relationship
 5. Focus on Organizational Capacity and Infrastructure-building
 6. Focus on outcomes
- C. The Players
 1. 30-50 V.P. groups in the US and Canada
 2. Lots of philanthropists adopting elements of V.P.
 3. Variety of organizational models
 4. Can use almost any form of giving vehicle as organizational model

V. Social Venture Partners Seattle- A Case Study

A. Background

1. Formed in 1997 in Seattle by technology entrepreneur Paul Brainerd
2. Brainerd wanted to create a philanthropic model that would appeal to emerging cohort of new givers
3. SVP's mission: promote philanthropy and volunteerism to achieve positive social change. Using Venture Capital approach as a model, SVP is committed to giving time and expertise to help nonprofit organizations
4. 1997: Started with group of 30 committed individuals, \$5k to a pool fund
5. 2002: 300 Partners, 25 Investees, average grant of \$50k, average lifecycle 3-7 years.
6. SVP now replicated in 20+ US and Canadian cities
7. Each SVP started by a core group of committed individuals, all locally- driven and locally-focused.

B. How it Works

1. Each Partner contributes \$5500 to the fund annually
2. Funds are pooled and invested by Partner-led grant committees through competitive grant selection process
3. Once funds are committed, Partners volunteer their time and expertise to the Investees
4. Majority of volunteer projects are capacity-focused and designed to further the capability of the agency, not just the program
5. Funding can be program-specific, general operating, or infrastructure-focused
6. Typically take on 3-5 projects in year 1 as we develop trust and a good working relationship
7. About 70% of Partners volunteer in some capacity within SVP
8. In addition to grantmaking and volunteer work, SVP also has a curriculum of educational events designed to catalyze philanthropy and educate philanthropists

C. Who are the Partners?

1. Average age- 76% under 45, 95% under 55
2. 42% of wealth from high-tech sector, 58% from other business and entrepreneurial sectors, plus a few inheritors
3. Working professionals and early retirees
4. Range of philanthropic experience

D. What's the appeal of SVP among new givers?

1. Opportunity to "give back" and make a difference
2. Opportunity to leverage professional skills and feel a direct connection to nonprofit organizations
3. Ability to do more than could be done individually
4. Promotes ability to work and learn with peers- create community
5. Opportunity to learn about philanthropy, "test drive" and apply skills to other philanthropic endeavors
6. Opportunity to learn about local nonprofits and issues
7. Basic conceptual framework of SVP's venture philanthropy approach make sense to them

VI. Can you approach donors the same old way?

- A. Despite difference in profile, style, and tendencies of new givers, most of the principles of effective fundraising are the same:
 - 1. "The more things change, the more things stay the same"
 - 2. It's about relationships
 - 3. Mission, Mission, Mission
 - 4. Willingness to ask
- B. Things that new donors are likely to look for:
 - 1. Ability to demonstrate results
 - 2. Clear focus and strategic direction
 - 3. Innovation
 - 4. Efficiency
 - 5. Growth
 - 6. Savvy Leadership
 - 7. Opportunity for Involvement
- C. Challenge for Planned Giving and Fund Raising
 - 1. Doing good work is no longer good enough
 - 2. Competition
 - 3. Finding ways to involve donors and manage involvement
 - 4. Let donors be architects of charitable endeavors but don't chase dollars that aren't right for your organization
 - 5. Changing from demand-side to supply-side fundraising
- D. Additional tips for approaching new donors
 - 1. Timing and pacing- gifts are likely to be incrementally larger
 - 2. Increased patience- don't be cynical about new donors
 - 3. Emphasize broader, systemic, community change versus how the money will help an individual project or organization needs
 - 4. Set expectations up front
 - 5. Make it fun

The most resourceful nonprofits don't have a penny in the bank.

As a principal or officer of a nonprofit organization, your financial challenges are diverse and, unless carefully managed, can outpace resources or limit ongoing programs. Through our Center for Philanthropy & Nonprofit ManagementSM, Merrill Lynch offers financial management and fiduciary services that are designed specifically for nonprofit organizations. Our services include:

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National Philanthropic Consulting Team

Richard Slutzky
Princeton, NJ 609-627-4066

Jennifer Tisthammer
Ft. Lauderdale, FL 954-713-6252

Michael Wagschal
Newport Beach, CA 949-553-7465

Barbara Washington
Princeton, NJ 609-627-4372

Your dedicated Merrill Lynch Financial Advisor, together with the Center for Philanthropy & Nonprofit Management, can help you find cost-efficient financial solutions for your nonprofit organization's unique needs. Call us today.



Sparkling Ideas...



in the Emerald City

**THE CRT:
DOES THIS OLD DOG STILL HUNT?**

**Emanuel J. Kallina, II
Kallina & Ackerman, LLP
6507 York Road
Baltimore, MD 21212-2115
(410) 377-2170
FAX (410) 377-2179
administrator@kallacker.com**

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1) Introduction – Below are numerous IRS rulings, notices, positions, cases and new regulations spanning the last three years which directly relate to charitable remainder trusts. This outline is broken down into four parts, the first one dealing with the definition of fiduciary income as used within CRTs. The second part of the outline focuses on rulings which assist us as planners. The third part concerns fixing one's mistakes, including reformations, rescissions, scrivener errors, disclaimers, and settlement agreements. Obviously, these tools can also be used in a proactive sense from a planning perspective. Lastly, the fourth part of the outline deals with miscellaneous rulings. The speech itself will highlight specific rulings, notices, positions, cases and the new regulations in an effort to analyze "if this old dog will still hunt."

2) Definition of Fiduciary Income

a) TAM 9825001 -Variable Annuity in NIMCRUT

i) Role of TAMs in IRS Hierarchy

- (1) Private letter rulings apply to specific taxpayers only, and are generally issued at a low level of the National Office of the Internal Revenue Service ("IRS" or "Service").
- (2) On the other hand, a TAM is an opinion of the National Office, typically requested by a local district office. It often involves decisions by policy makers at the highest levels of the Service.

ii) Facts of the TAM

- (1) Insurance agents wanted to save money, so they did not employ skilled professionals in the design or investments of the NIMCRUT.
- (2) In 1990, husband and wife ("H & W") created an 8% NIMCRUT:
 - (a) No special language in NIMCRUT.
 - (b) Not an approved insurance company.
- (3) H & W made a gift of closely held stock to the NIMCRUT in 1990. H & W appointed an independent special trustee ("IST"), but this was the only precaution taken. The closely held stock was sold in 1991 to an independent third party. Proceeds from the sale were reinvested in 2 annuities on life of the H & W. H & W were payees of the annuities and not the Trustee of the NIMCRUT! Fortunately, it was a deferred annuity, with annuity payments delayed to age 80 (H & W were in their mid-60s). In 1997, H & W assigned all rights which they owned in the deferred annuities to the NIMCRUT.

iii) Three Legal Issues

(1) Legal Issue #1 - Did Naming the Husband and Wife as Payees of the Annuity Constitute an Act of Self-Dealing?

(a) Was there a property right?

(b) Was there a transfer of property rights to a disqualified person?

(c) Did a disqualified person receive a benefit?

(2) Holdings on Legal Issue #1

(a) Yes, there was a property right.

(b) Yes, there was a transfer to a disqualified person.

(c) But, there was no self-dealing because the H & W never received anything (no "current benefit" received).

(3) Legal Issue #2 - Did the Purchase of an Annuity Constitute an Act of Self-Dealing? As a corollary issue, did the IST Manipulate the Assets of the NIMCRUT for the Personal Benefit of the Husband, "by furthering his [the Husband's] income, retirement & tax planning goals"?

(a) The IRS in the TAM revealed additional facts: The contributed asset was closely held stock in a family company. The Husband had entered into a 5 year employment and non-competition agreement with the buyer, which meant he had no current need for income. The IST was the family attorney (who also happened to be the nephew of H & W). The attorney resigned after sale of closely held stock and the purchase of annuities. The Husband, who was the donor and one of the income beneficiaries, became sole successor trustee from 1/15/92 to the present.

(b) The IRS expressed its position: "There was a concern that the transaction as a whole; the purchase of a deferred annuity, the failure to make withdrawals from the annuity policies, and the intention to subsequently make unitrust payments to [the Husband] under the make-up provisions of the Trust; could be construed as an act of self-dealing under section 4941(d)(1)(E)..."

(4) Holding on Legal Issue #2 - the TAM stated:

- (a) "In as much as [husband], a disqualified person, is entitled to receive the income interest from the trust, it is difficult to argue that the disqualified person receives an inappropriate benefit by deferring the income interest, particularly where such deferral is permitted under section 664 of the Code."
- (b) "Inherently, any investment decision regarding the trust assets that increases or decreases the amount of payout of this income interest is a use for the benefit of the disqualified person."
- (c) "Accordingly, these uses must be permitted under the income exception of 4947(a)(2)(A) unless the disqualified person controls the investment decision and uses this control to unreasonably affect the charitable remainder beneficiary's interest."
- (d) "Since charitable remainder trusts by their intrinsic nature provide for a continuous use by the disqualified person of the entire corpus, we conclude that the presence of an unreasonable affect [sic] on the charitable remainder interest distinguishes a permissible use of trust assets from an impermissible use."
- (e) "In addition to failing to show harm to the charitable remainder interest, the facts of this case do not clearly show control by the disqualified person."
- (f) "...the facts are insufficient to demonstrate that [husband] usurped control from "the trustee... Instead, the trustee merely took into consideration the particular financial needs of [husband] before reinvesting the proceeds from the sale of the trust assets."

(5) Legal Issue #3 - Does the Withdrawal Provision in the Annuity Result in Income to the NIMCRUT Within the Meaning of Section 643(b) of the Code?

- (a) The local District Office argued that the NIMCRUT had income because it had the right to receive cash.
- (b) According to the National Office, the NIMCRUT's requirement to pay out a fixed percentage of "income" refers to "fiduciary income," as that term is defined under state law.
- (c) "The applicable state law, the Uniform Principal and Income Act of [X], appears ambiguous on whether a trust's right to receive money is income to the trust..."

(d) "The implication from the sections that define income and principal, however, is that a trust does not realize either [income or principal] until the trust actually receives possession of money or other property."

(6) Holding on Legal Issue #3 - the TAM stated:

(a) "Therefore, the Trust's right to receive either the cash value or the surrender value of the contracts does not create trust accounting income under section 643(b) of the Code."

(b) Where Do We Go From Here?

iv) Questions to be Asked:

(1) Is an IST required at all times? At the time of the gift of the closely held stock? At the time of the purchase of the annuities? Thereafter?

(2) Is damage to the charitable remainder the key?

(3) How about other assets inside of NIMCRUTs, such as partnerships?

(4) What happens if the trust instrument does not define fiduciary income? Are we to assume that the Revised Uniform and Uniform Principal & Income Acts of the various states per se allow the deferral of income unless there is cash?

(5) Let us assume that, without cash, there is no fiduciary principal or income. If the trust instrument is silent and fails to quantify fiduciary income, does that mean that the appreciation in value of the annuity is allocable to fiduciary income?

(6) What will happen under the Proposed Regulations?

(7) When issued, will these regulations be proposed or final?

(a) Will they follow the approach of the TAM?

(b) Will they clarify issues created by the TAM or those not addressed by the TAM?

(c) Will they clarify issues created by the TAM, or those not addressed by the TAM?

b) LTR 199907013 - Discretionary Allocation of Post-Gift Gain

- i) **SUMMARY:** A established a net income with make-up charitable remainder trust ("Trust") for the benefit of B for B's life. A intends to contribute appreciated securities to the Trust, which provides that the trustee may reasonably allocate to the income of the Trust some or all of the post-contribution capital gains realized by the Trust on the sale of any stock, bond, or other security that produced limited or no income during the period owned by the Trust.
- ii) Under local law, if the Trust gives the trustee discretion in crediting a receipt or charging an expenditure to income or principal or partly to each, no inference will be made that the trustee has acted improperly because he or she has made an allocation contrary to a provision of local law. Accordingly, the Service held that trust income may include the appreciation in certain Trust assets that occurred since the Trust held those assets, and that the Trust's provision giving the trustee discretion over the allocation of some or all of the post-contribution gain to fiduciary income will not prevent the Trust from qualifying as a charitable remainder trust under section 664.
- iii) **POINTS TO PONDER:** This is a great Ruling. Since December 10, 1998 and the issuance of the Final Regulations, an allocation of post-contribution gain to fiduciary income was clearly permissible. Practitioners have wondered whether providing the trustee with discretion in allocating gain to income may create administrative inconsistencies or provide too much control to the donor or income beneficiary.
- iv) The IRS has determined that the flexibility to allocate some or all of the post-contribution gains to fiduciary income is valid. Of course, this determination will provide trustees with greater control over the timing of trust income and the distribution to the income beneficiary. Is the next step permitting the spigot trust with any investment?

c) LTR 199952035 - NIMCRUT Fiduciary Income

- i) **SUMMARY:** Settlor established a net income with make-up charitable remainder unitrust which is intended to qualify under Section 664(d)(2) of the Code ("Trust"). The primary asset in the Trust is stock in Corporation. Corporation intends to convert to a real estate investment trust ("REIT") and must distribute its pre-REIT accumulated earnings and profits to be eligible for such a conversion. In order to accomplish this requirement, Corporation proposes to distribute to its shareholders a percentage of its earnings and profits through a cash dividend and the remaining percentage of its earnings and profits in a non-cash consent dividend under Section 565 of the Code. The trustee of the Trust represents that it will agree to the consent dividend only if the consent dividend made to the Trust is pro rata when compared with the aggregate consent dividends made to the other shareholders in the Corporation. Neither the Trust nor other shareholders in the Corporation will have the

option to receive additional common stock or notes of Corporation as part of the distribution of Corporation's earnings and profits.

- ii) The trustee of the Trust represents that the amounts treated as consent dividends will be included in the Trust's gross income described in Section 664(b)(1) of the Code and that under the laws of the state, a trust generally does not have either income or principal until the trust receives money or property. In addition, the trustee represents that under the terms of the governing document of Trust and the laws of the state, all distributions from a REIT to Trust, other than distributions made from ordinary income, are principal. As such, the trustee represents that all distributions by Corporation after it is a REIT to Trust, other than distributions of the REIT's ordinary income, will be allocated to principal by the trustee and therefore will never be distributed to Settlor as part of the unitrust amount. Based on these facts and representations, the Service concluded that the amounts treated as consent dividends are included in Trust's gross income for purposes of characterizing distributions under Section 664(b)(1) Code, but do not constitute trust fiduciary accounting income under Section 643(b) of the Code for purposes of Section 664(d)(3)(A) of the Code
- iii) POINTS TO PONDER: This technique avoids the NIMCRUT distribution requirement on the distribution of earnings and profits from a personal holding company ("PHC") and reduces the tax at the PHC level. What if the entire PHC distribution constitutes a consent dividend?

d) Proposed 643(b), 664 and 642 Regulations

- i) SUMMARY: The proposed regulations will amend the definition of income under Regulation Section 1.643(b)-1 to take into account certain state statutory changes to the concepts of income and principal. However, amounts allocated between income and principal pursuant to applicable state law will be respected if state law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, taking into account ordinary income, capital gains, and, in some situations, unrealized appreciation. In addition, an allocation of capital gains to income will be respected if directed by the terms of the governing instrument and applicable local law. Further, the proposed changes to the regulations will permit trustees to implement a total return investment strategy and to follow the applicable state statutes designed to treat the income and remainder beneficiaries impartially.
- ii) The proposed regulations affect, in part, pooled income funds and charitable remainder trusts:
 - (1) Pooled Income Funds. The proposed regulations amend Regulation Section 1.642(c)-2(c) to address capital gain issues with respect to pooled income funds and provide that no net long-term capital gain will qualify for the charitable deduction if, under the terms of the governing instrument and applicable state law,

income may be a unitrust amount or may include an equitable adjustment with respect to unrealized appreciation in the value of the trust assets.

(2) Charitable Remainder Trusts. The proposed regulations will amend Regulation Section 1.664-3(a)(1)(i)(b) to provide that income under the terms of the governing instrument and applicable local law may not be determined by reference to a fixed percentage of the annual fair market value of the trust property. If the applicable state law defines income as a unitrust amount, the governing instrument of a net income charitable remainder unitrust must provide its own definition of trust income. In addition, the proposed regulations provide that capital gains attributable to appreciation in the value of assets after the date contributed to the trust or purchased by the trust may be allocated to income under the terms of the governing instrument and applicable local law. Such an allocation, however, may not be discretionary with the trustee. The Regulations under Section 664 already prohibit the allocation of pre-contribution gains to income.

iii) The full text of the Proposed Regulations is attached as "Exhibit A".

iv) NCPG's comments on the Proposed Regulations are attached as "Exhibit B".

3) Planning Techniques

a) LTR 9817010 - Rollover to Second CRT

i) SUMMARY: Trustee proposed to create a second CRUT identical in terms to the current CRUT and to fund the second trust using assets from the original trust. Additionally, the grantor, who is also the income beneficiary, proposed to transfer his entire income interest in the second trust to the charitable beneficiary. The goal, through the merger doctrine, was to terminate that portion of the original trust and transfer immediately the assets to charity.

ii) The IRS held that this proposal would not adversely affect the qualification of the original trust.

b) TAM 9831004 - CRAT Income to Second Trust

i) SUMMARY: The IRS authorized a charitable remainder annuity trust to pay income to a second trust, which existed for the benefit of the donor's incompetent daughter.

ii) POINTS TO PONDER: This position of the National Office of the IRS is consistent with recent published opinions.

- c) LTR 9839024 - CRT Unitrust Interest Payable to Grantor Trust
- i) **SUMMARY:** In this Ruling, the IRS concludes that a trust created under a court-supervised guardianship administration for an incompetent individual will not fail to qualify as a charitable remainder unitrust where the unitrust interest is payable for the incompetent individual's life to a grantor trust established by the guardianship court for such incompetent individual.
 - ii) **POINTS TO PONDER:** This Ruling is in accord with the recent TAM 9831004 and other recent published opinions.
- d) LTR 9851006 - CRT Split into Two CRTs
- i) **SUMMARY:** In this Ruling, the IRS holds that two charitable remainder unitrusts created pursuant to the division of an existing inter vivos charitable remainder unitrust will not fail to qualify under Code Section 664. Because of the donors' divorce, they proposed to divide their interests in the original unitrust into two separate equal unitrusts.
 - ii) **POINTS TO PONDER:** Does this Ruling offer a solution to a problem that might not otherwise be solved by including qualified contingency provisions in a charitable remainder trust? This Ruling does not highlight the significance of a testamentary right to revoke an income interest as in LTR 9403030.
- e) LTR 9901023 - QRP to CRT
- i) **SUMMARY:** In this Ruling, the IRS finds that a charitable remainder unitrust's receipt of the proceeds from a donor's qualified retirement plan at the donor's death would be income in respect of a decedent includible in the gross income of the unitrust in the year of receipt under Code Section 691(a)(1)(B). The IRS notes that the unitrust will not be taxed unless it has unrelated business taxable income in that year. Because the proceeds would be includible by the unitrust, they would not be includible by the donor's estate.
 - ii) Under the ordering rules of Code Section 664, the proceeds will retain the ordinary income classification in the hands of the unitrust that the proceeds would have had if payable to the donor. The charitable deduction allowed to the estate for the payment of the proceeds to the unitrust must be excluded in calculating the hypothetical estate tax for purposes of the deduction under Code Section 691(c)(1)(A) because the plan proceeds are excluded from the estate's income.
 - iii) Finally, the IRS notes that the Code Section 691(c)(1)(A) deduction would not be available directly to the unitrust beneficiaries. The donor created the unitrust during his lifetime, naming his two children as the noncharitable beneficiaries. The unitrust is

the designated beneficiary of the donor's qualified retirement plan and will receive the proceeds in a lump sum at the donor's death.

iv) **POINTS TO PONDER:** This Ruling expands on the issues discussed in LTR 9818009 and LTR 9838028.

f) LTR 9903001 - CRAT Payments to Special Needs Trust

i) **SUMMARY:** In this Ruling, the IRS holds that an outright gift of one-half of the decedent's personal residence to a charity founded by the decedent and a gift of a remainder interest in the other half of the residence to that charity will qualify for estate tax charitable deductions.

ii) A special needs trust established for the decedent's disabled child was the holder of the life estate in the latter one-half of the residence. The IRS states that the decedent's request that the charity and the special needs trust enter into a "use agreement" providing which portion of the property the life estate beneficiary may use does not disqualify the remainder interest for the charitable deduction because the use agreement would be entirely voluntary. Therefore, the decedent's request does not make the charitable gift of the remainder interest subject to a condition or power.

iii) Finally, the IRS holds that the payment of the annuity interest from a testamentary charitable remainder annuity trust established by the decedent to the special needs trust for the disabled child's lifetime will not disqualify the charitable remainder annuity trust under Code Section 664. The trustee of the special needs trust has sole discretion to distribute income and principal to the child. Citing Revenue Ruling 76-270, the IRS observes that the trustee of the special needs trust will hold and administer the annuity payments for the child and the special needs trust will be includible in the child's estate because the child has a general power of appointment over the trust assets.

iv) **POINTS TO PONDER:** This Ruling highlights how charitable planning may be combined with planning for disabled family members. The donor in this Ruling funded at her death a charity (created by the donor) with an outright gift of a one-half undivided interest in her personal residence, a remainder interest in the other one-half undivided interest in the personal residence and a remainder interest in a testamentary charitable remainder annuity trust, while providing a disabled child with a residence and an income stream for the child's life.

g) LTR 199915045 - CRT Owns Life Insurance Policy

i) **SUMMARY:** Grantor proposed to create a charitable remainder unitrust with a bank being the trustee ("Trust"). Under the governing instrument of the Trust, the trustee is to pay quarterly installments to the grantor's stepdaughter, who is the sole income beneficiary of the Trust. The grantor intends to purchase an insurance policy on her spouse's life, fund the policy with enough cash so that no additional premiums are

expected to be due, and then assign ownership of the policy to the Trust. Upon the death of the stepdaughter, the trustee will distribute all of the then principal and income of the Trust to charities that qualify as organizations described in sections 170(b)(1)(a), 170(c), 2055(a), and 2522(a) of the Code.

- ii) Taking note that the insurance policy is irrevocably payable for a charitable purpose, the Service held that neither the existence or exercise of the trustee's power to pay the annual premiums on the insurance policy will disqualify the Trust as a charitable remainder trust. Additionally, the Service held that (i) the grantor will be entitled to an income tax charitable contribution deduction for the present fair market value of the remainder interest in the insurance policy, (ii) the grantor will be allowed a gift tax charitable deduction under 2522(a) of the Code for the present value of the remainder interest in the Trust, and (iii) the Trust will not be included in the gross estate of either the grantor or his wife because neither retained any interest in or power over any of the property transferred to the Trust and that under the terms of the Trust neither will possess any interest or power with respect to the Trust corpus.
- iii) POINTS TO PONDER: Could the donors have contributed appreciated securities with the policy to the CRT to fund the premium payments, with the same tax consequences?

h) FSA 1999-923 - Stock From QTIP to CRT

- i) SUMMARY: In this Field Service Advice, the IRS advised that (x) although a surviving spouse's initial transfer of stock from a QTIP trust to the charitable remainder beneficiary of the trust was a transfer of a non-qualified split interest under Code Section 2522, the facts were not favorable for litigation over the charitable gift tax deduction; and (y) more facts would be needed to determine if the surviving spouse's actual life expectancy on the dates of the gifts justified use of the IRS actuarial tables.
- ii) The surviving spouse gave a portion of the stock in the QTIP trust which had been created by her late husband to the charity on one date, while retaining an interest in the trust. At a later date, she gave the remainder of the stock to the charity. She was suffering from incurable cancer at the time of both gifts and died a few days after the second gift. Noting that state law provides that the surviving spouse had no legal or equitable interest in the individual assets of the QTIP trust but only a right to enforce the payment of her income interest for life, the IRS advised that the first gift must be considered an assignment of an income interest from an undivided portion of the trust corpus as a whole and not an assignment of an income interest in any specific asset. However, the IRS indicated that a charitable gift tax deduction is allowable for the second gift because the second gift did not constitute a split interest transfer.
- iii) The IRS concluded that the charitable gift tax deduction issue with respect to the first gift should not be litigated in this case because it would be difficult to demonstrate that

any actual abuses of the type that originally led to the adoption of the split interest rules occurred during the months between the two gifts.

iv) POINTS TO PONDER: What kind of things might the IRS view as split interest abuses appropriate for litigation?

i) LTR 199919039 - IRA to CRUT

i) SUMMARY: Taxpayer was the President and CEO of Corporation A, which merged into Corporation B in 1997. At the time of the merger, each corporation had only one class of stock in its authorized capital. On January 2, 1998, Corporation A merged its Plan X, a qualified plan under the Code, with Corporation B's Plan Y, a profit-sharing plan with a cash or deferred arrangement, which is also a qualified plan under the Code. One hundred percent of Taxpayer's account balance in Plan X was in the form of Corporation A's stock, which upon the merger was exchanged for stock of Corporation B. Taxpayer proposes to rollover a portion of his plan to his IRA and to distribute the balance as a lump sum. Taxpayer will then contribute a portion of such stock to a CRUT.

ii) The Service concluded that the distribution from Plan Y which was not rolled-over to the Taxpayer's IRA qualifies as a taxable "lump sum distribution" under the Code. However, because the distribution consisted of securities of the employer corporation (B), it qualifies as an exception to the general taxation rule under section 402(a)(1) of the Code and the built-in gain of the stock is therefore excluded from Taxpayer's gross income (See, section 402(e)(4)(b)). In addition, with respect to the CRUT, the Service held that: (i) Taxpayer will not recognize any gain or loss from contributing the stock received from the qualified plan to the CRUT; (ii) Taxpayer will receive an income and gift tax charitable deduction for the contribution of the non-rollover shares to the CRUT; (iii) the stock transferred to the CRUT will retain Taxpayer's cost basis and holding period for purposes of any subsequent sale by the CRUT; (iv) the four-tier system for characterizing the tax consequences to the income beneficiaries will apply; and (v) the gain from any subsequent sale by the CRUT of the non-rollover stock will be exempt from taxation to either the CRUT, the Taxpayer or Taxpayer's spouse.

iii) POINTS TO PONDER: This Ruling highlights the fact-sensitive and highly technical nature of tax law conclusions. Generally, a taxable event occurs upon the distribution of assets from a retirement plan. However, in this Ruling, a unique set of circumstances provides an exception to the general rule of taxability on the distribution of retirement plan assets. Such circumstances provide an increased benefit to the donor, which promotes the consummation of a significant gift to charity. Another interesting and beneficial feature of this particular charitable gift plan is that a capital gains tax is incurred on the ultimate sale of the stock by the CRUT, as opposed to ordinary income on the distribution from the plan.

j) LTR 199952071 - Mortgaged Property in CRT Solution

- i) SUMMARY: A limited liability company, which is treated as a partnership for federal tax purposes ("Company"), proposes to contribute appreciated real property encumbered by debt to a limited partnership ("Partnership") for units in the Partnership ("Units"). The general partner of the Partnership is a non-public real estate investment trust which is intended to qualify as a real estate investment trust under Section 856 of the Code ("REIT"). The Partnership uses an interim-closing-of-the-books allocation method with a semi-monthly convention for allocating partners' varying shares in partnership items. It is anticipated that when debt-encumbered property is contributed to the Partnership, the Partnership will almost immediately pay the debt and close its books on the 15th day of each month. Pursuant to the Partnership's agreement, debt-encumbered property can only be contributed during the first half of each month, and charitable donations of the interests in the Partnership can be made only during the second half of each month.
- ii) The Partnership agreement provides that limited partners of the Partnership may not convert its Units to shares of common stock in the REIT for a period of two years from the date the limited partner acquires its Units. If the limited partner is a non-profit or charitable remainder trust and receives the Units for less than full consideration, the two-year period will be calculated from the date that the donor of the Units acquires the Units.
- iii) Company anticipates holding the Units for two years and then transferring them to a charitable remainder trust ("Trust"), which may in turn exchange the Units for common stock in the REIT to hold either as an investment or for future sale. The Trust will pay a unitrust amount to Company for 20 years and the remainder to a charitable organization described in Sections 170(b)(1)(A), 170(c), 2055(a), and 2522(a) of the Code. The unitrust amount will initially be the lesser of trust income or six percent of the net fair market value of the Trust's assets, and will flip to a fixed percentage payout of six percent upon the sale or exchange of interests in the Partnership, or REIT stock, for marketable assets.
- iv) POINTS TO PONDER: The IRS should always be applauded when its representatives assist donors in placing a charitable gift. This Ruling represents a significant planning opportunity for a vexing donor problem - avoidance of all the problems associated with a gift of encumbered property to a CRT, including grantor trusts, self-dealing, and UBIT issues.

k) LTR 199952086 - Debt-Financed Property Not UBIT to CRT

- i) SUMMARY: M, a net income with makeup charitable remainder unitrust, proposes to create and provide funds for N, which will be a foreign corporation wholly owned by M. M will not incur debt to fund N. N will be treated as a corporation for U.S.

income tax purposes, the status of N and its assets will be separate from M and its assets, and N will not act as the agent for M or M's trustee.

- ii) The trustee of M anticipates that N will purchase an interest in a U.S. partnership ("Fund"). The Fund anticipates the use of debt financing to partially fund its acquisition of investment assets, which will include a diverse portfolio of primarily below investment-grade securities. The debt-financed income will be distributed to N, which may in turn make distributions to M. M states that it has four business purposes for establishing N: (i) flexibility in disposing of interests in the Fund, (ii) additional limited liability protection, (iii) avoiding unrelated business taxable income, and (iv) management of additional investments to be made by M.
- iii) The Service stated that because the income will arrive at M indirectly through N, which will pay dividends to M, such dividend income is not taxable under Section 512(b)(1) of the Code. In addition, M has not itself incurred debt in financing its interest in N, therefore, such dividend income is not debt-financed income described in Section 514 of the Code. Accordingly, the Service ruled that, (i) N's distributive share of the Fund's income and gains under Section 704 of the Code will not constitute unrelated business taxable income to M, (ii) the amounts distributed by the Fund to N will not constitute unrelated business taxable income to M, and (iii) the amounts distributed by N to M will not constitute unrelated business taxable income to M.
- iv) POINTS TO PONDER: What an interesting PLR! The foreign corporation may provide multiple benefits to the CRT: (i) additional asset protection and (ii) avoid UBIT on debt financed property. Will the foreign corporation pay tax on its receipt of the income from the Fund?

1) LTR 200002011- Testamentary Gift of Nonstatutory Stock Options

- i) SUMMARY: Taxpayer founded a corporation and has been employed by the corporation since its inception. He is currently chairman of the board of directors for the corporation. During the course of employment, he elected to defer receipt of certain amounts to which he was entitled, including (i) compensation which he elected to defer receipt of pursuant to Corporation's deferred compensation plan and (ii) shares of stock in the corporation payable to him as a result of his exercise of compensatory stock options and as to which he elected to defer receipt of pursuant to the corporation's deferred stock option plan. In addition, the corporation will provide a death benefit to the taxpayer's estate or his designated beneficiaries upon his death. Collectively, these three items are referred to as "Deferred Compensation." Taxpayer plans to name one or more charitable organizations as the designated beneficiaries of the Deferred Compensation.
- ii) Taxpayer also has certain rights to purchase shares of the corporation's stock at specified option prices ("Options"). No option price was less than the fair market value of the stock to which it applied on the date the Option was granted. Taxpayer has

represented that the Options are the type of options commonly known as "nonstatutory options" because they do not meet the requirements for special income tax treatment under Sections 421 through 424 of the Code. It is further represented that at the time of their grant, the Options did not have a readily ascertainable fair market value. Taxpayer plans to transfer the Options by will to one or more charitable organizations.

- iii) First, the Service concluded that the Deferred Compensation and the value of the Options will be includible in the taxpayer's gross estate under Section 2033 and 2039(a) of the Code and the taxpayer's estate will be eligible for a federal estate tax deduction under Section 2055(a) of the Code for such amounts passing to charitable organizations. In addition, the Service noted that the proceeds from the Deferred Compensation that would have been items of gross income to the taxpayer, if the proceeds had been distributed to him before his death, will be income in respect of a decedent ("IRD") to the charitable beneficiaries pursuant to Section 691(a)(1)(B) of the Code when distributed to the charitable organizations. As a result, the proceeds from the Deferred Compensation will not be IRD to the taxpayer's estate.
 - iv) As to the taxpayer's bequest of the Options to charitable organizations, the Service observed that this is governed by Regulation Section 1.83-1(d), which provides that if substantially nonvested property has been transferred in connection with the performance of services and the person who performed the services dies while the property is still substantially nonvested, any income realized on or after such death with respect to the property under Regulation Section 1.83-1(d) is IRD to which the rules of Section 691 of the Code apply. Even though the Service noted that Regulation Section 1.83-7 is silent on the treatment of non-arm's-length transfers of nonstatutory options, it Service concluded that any income realized by the charitable organizations after the taxpayer's death by exercise of the options is IRD to the charitable organizations under Section 691(a)(11)(C) and such income will not be IRD to the taxpayer's estate.
 - v) POINTS TO PONDER: This is a significant ruling with great planning potential. What testamentary charitable planning opportunities does this ruling open up for nonstatutory stock options? May this ruling apply to a split-interest gift?
- m) LTR 200052026 - CRT Qualifies Despite Prohibited Contribution
- i) SUMMARY: H & W created a charitable remainder unitrust, naming themselves as trustees and income beneficiaries. Later H & W made a second contribution to the unitrust in violation of the CRUTs governing instrument. The proceeds of the second contribution were not used in calculating unitrust payments and H & W did not take a charitable contribution deduction for the second contribution. H & W offered to return the second contribution to themselves and amend their individual tax returns for years 1 and 2 to reflect the capital gains and dividend income on the X stock while it was held in the account of the unitrust.

- ii) The IRS ruled that the second contribution of X stock would be ignored for federal tax purposes and would not cause the unitrust to be disqualified under Code Section 664(d)(2) so long as the husband and wife amended their tax returns to reflect the capital gains and dividend income from the X stock while it was held by the unitrust. The IRS observed that the second contribution was a nullity under state law because the husband and wife had acted without legal authority when they accepted the second contribution.
- n) LTR 200052035 – CRAT Modified to allow current distributions to Charity
- i) SUMMARY: Decedent created a charitable remainder annuity trust paying A for life an annuity equal to 5% of the initial fair market value of the trust's assets. At A's death, the remainder of the trust was to go to qualified charities. The trustees sought to modify the trust to authorize the trustees to pay income and principal to qualified charities during A's life if the fair market value of the trust's assets exceeds a certain amount at the time of distribution. These charitable distributions would not be made if they would endanger A's annuity. The trustees obtained the consent of A and the state attorney general and petitioned for a court order to modify the trust.
 - ii) The IRS ruled that the proposed modification of the trust would not disqualify it as a charitable remainder annuity trust under Code Section 664.
 - iii) POINTS TO PONDER: Would charitable deductions be available for amounts distributed from the trust to charity during A's lifetime?
- o) Martin v. The Ohio State University Foundation– Malpractice
- i) SUMMARY: In *Martin v. The Ohio State University Foundation*, 2000 Ohio App. LEXIS 4824 (Ohio App., 10th App. Distr., 2000), H&W owned real estate that they had been unable to sell for several years. An insurance agent/financial and estate planner ("Agent") recommended that they consider creating a charitable remainder unitrust and transfer the real estate to the unitrust. Agent also suggested that they purchase an insurance policy to provide money for their children after their deaths. Over the course of the discussions, Agent and Lawyer #1 used financial planning software to create several plans and financial projections for H&W. The projections indicated that the unitrust would create sufficient cash flow for H&W to pay the premiums on the insurance policy and make the mortgage payments on a retirement home in Florida.
 - ii) H&W and Agent decided to name the Ohio State University Foundation ("OSUF") as trustee of the unitrust. They met with the Planned Giving Officer ("PGO") for OSUF. Ultimately, H&W decided to create the unitrust and to purchase a \$1,000,000 vanishing premium policy on the life of W. Although the projections had originally contemplated a unitrust with an 8% payout, PGO convinced the parties that a 7%

payout was more realistic. Agent directed Lawyer #2 to prepare the unitrust. H never spoke to Lawyer #2 at any time before the unitrust was executed.

- iii) After executing the unitrust in 1990, H&W claimed that they made initial payments on the insurance policy and the Florida home because they believed they would receive payments from the unitrust immediately. The trustee did not sell the real estate until 1992. H&W did not receive a unitrust payment until 1993 and at no time before trial did they receive more than a 5% payment. H&W let the insurance policy lapse because they were unable to make the premium payments. H alleged that he and his wife were never told that there would be no payment of income to them from the unitrust until the real estate was sold. He claimed that they were never told that the percentage payout was not guaranteed. Mr. Martin also said that he did not see the unitrust agreement until the date it was executed. H&W sued OSUF, its treasurer, Agent and Agent's insurance company alleging fraud, negligent misrepresentation, breach of contract and breach of fiduciary duty. OSUF and its treasurer settled with H for \$675,000 prior to trial.
 - iv) The lower court ruled in favor of Agent and his insurance company and H appealed. After reviewing the elements of fraud and finding that fraud could be present in this case, the appeals court reversed the lower court and remanded the case for a new trial.
 - v) POINTS TO PONDER: What steps should advisors and others involved in the charitable gift planning process take to ensure that they are not likely to be at risk of committing fraud or negligence in rendering advice or giving projections to donors?
- p) LTR 200107019 – Palmer/Blake/Greene and Assignment of Income
- i) SUMMARY: The IRS analyzed case law and applied the law to a situation where a couple transferred a claim in litigation to a charitable trust prior to the expiration of appeals in the case.
 - ii) The Service, in an unusual ruling, held that the couple was "not required to include the proceeds of the judgment in income under the assignment of income doctrine because such claims are contingent and doubtful in nature."
 - iii) POINTS TO PONDER: Is this position consistent with other positions of the IRS, or with the IRS' refusal for last several years to grant favorable ruling on Palmer/Blake/Greene factual scenarios?!
- q) LTR 200108035 – Less than a 5% CRUT?!
- i) SUMMARY: The donors to a proposed 7% standard, charitable remainder unitrust, which would be funded with publicly traded stock, asked the IRS of the trust would qualify under Code Section 664 where the unitrust amount will be paid as follows:

50% to individual D, for D's life; 35% to Charity for five years (or termination of the trust if earlier) and then to D for D's life; and 15% to Charity for D's life.

- ii) The donors also wished to confirm how to compute the federal gift tax charitable deduction for the present value of the lead income interests transferred to Charity. The Service ruled that the trust satisfied all tax-qualification requirements under Code Section 664, assuming it was a valid trust under state law. The 15% unitrust amount distribution to Charity for the life of D and the 35% distribution to Charity for five years, or the death of D both qualify as unitrust interests under Regulation Section 25.2522(c)-3(c)(2)(vii). Consequently, their present value, to be determined under the valuation methodology described in Section 25.2512-5T(d)(2)(i) of the Temporary Gift Tax Regulations and Section 1.664-4T(e) of the Temporary Income Tax Regulations, will qualify for a gift tax charitable deduction under Code Section 2522.
 - iii) Additionally, the Service ruled that no additional income tax charitable contribution deduction is allowed for the share of the unitrust amount paid to Charity during the term of the trust (in the case of Charity's fifteen percent share) or during the initial five year term (in the case of Charity's interest in the thirty-five percent share).
 - iv) POINTS TO PONDER: What about the 5% rule?! We have always wondered what would happen if part of the income interest passed to charity, and whether or not that could cause a CRT to drop below 5% minimum payout. Also, why no income tax deduction?
- r) LTR 200117016 - Stock Redemption from CRTs Avoids Self-Dealing Taint; Palmer/Blake and Greene Revisited; Personal Holding Companies
- i) SUMMARY: Three charitable remainder unitrusts were established for the three children of H and W and funded with the common stock of a personal holding corporation ("PHC"). The PHC was created by H and owned by H, W, all three of their children, the children's CRTs and certain of their living trusts. Its assets consisted primarily of publicly traded stock and the stock in a subsidiary corporation.
 - ii) The PHC offered to redeem all outstanding shares of its common stock from all persons and entities who owned it (including the CRTs) for cash and at fair market value. The IRS determined that the PHC would be a disqualified person with respect to each CRT and that the redemption of its stock from the CRTs would constitute a prohibited act of self-dealing unless the special exception of Code Section 4942(d)(2)(F) could be found to apply.
 - iii) Consequently, the structure of the redemption plan fit within this exception to the self-dealing rules and the IRS ruled that the parties appeared to have accomplished this goal. To that end, the redemption offer was solely for cash and solely for the fair market value of the shares as determined by an independent qualified appraiser.

- iv) In addition, the redemption plan passed Section 4942(d)(2)(F) muster because: (1) it consisted of a bona fide offer made with respect to all of the PHC's stock; (2) it applied the same terms to all of the stock owned by all of the PHC's shareholders; (3) it was being offered to all shareholders of the PHC with respect to all of its outstanding stock; and (4) the PHC had only one class of stock outstanding. The IRS did not guarantee that it would agree with the fair market appraised value of the stock as made by the qualified appraiser; however, the Service did believe that the parties were attempting to make a good faith effort to determine fair market value.
 - v) Of additional importance was the lack of any prearranged sales agreement with the CRTs. That is, no CRT was required to tender any of its shares for redemption, and the trustee clearly had the fiduciary obligation not to do so if it determined that the amount received in the redemption would be less than fair market value. The Service ruled additionally that the actual redemption of shares by some shareholders will not constitute a direct or indirect transfer, for purposes of Code Section 4941(d)(2)(F), of their respective assets or income to any shareholder who does not accept the redemption offer, because the same terms and conditions regarding the redemption of shares applied to all shareholders.
 - vi) POINTS TO PONDER: Once again, is the IRS relenting on the Palmer/Blake/Greene scenario? Also, this is a good example of how to go "by the book" to qualify for the special self-dealing exception for redemptions of common stock from a CRT by a redeeming corporation that is a disqualified person. Finally, this is a good example of why and PHCs should never really have to face the accumulated holdings tax.
- s) LTR 200120016 - IRS Approves Division of One CRUT into Two CRUTs incident to Divorce
- i) SUMMARY: H&W executed a marital property settlement agreement after a final dissolution of marriage decree was entered. While married, A established a charitable remainder unitrust ("CRUT#1"), naming himself the current income recipient and B, the successor income recipient if she survives him. Incident to their divorce, they intend to divide the trust corpus into two equal shares and transfer half to a new trust ("CRUT#2") with terms identical to the original one, except that the order of the income recipients' interests will be reversed in CRUT #2 and each immediate income recipient will have the right to designate the charitable beneficiaries of his or her separate charitable remainder trust.
 - ii) With respect to the tax aspects of this proposed plan, the IRS ruled that:
 - (1) The division of CRUT#1 will not cause it nor CRUT#2 to run afoul of tax-qualification requirements because the total unitrust amount to be paid annually will not change; A and B will each receive an amount equal to that which A would

have received absent the trust division; and the remaindermen will still receive their initial entitlements;

- (2) The *cost basis* of the assets in both trusts will be the same as they were in CRUT #1 immediately before the asset division because the asset transfer to CRUT #2 is not a gift, bequest or devise and the cost basis will carryover and remain unchanged, per Code Section 1015(b) and Treasury Regulation Section 1.1015-2(a)(1);
 - (3) The *holding periods* of the assets in both trusts will be the same as they were in CRUT #1 immediately before the asset division because Code Section 1223(2) calls for a tacking of holding periods in situations where there will be a cost basis carryover from CRUT #1 to CRUT#2;
 - (4) No *gift tax* consequences arise because the final divorce decree was entered well within two years after the property settlement agreement was signed, thus satisfying the Code Section 2516 rule that transfers of property incident to a divorce and written property settlement agreement are deemed to be 'for adequate and full consideration', rendering them gift tax-exempt if divorce occurs within three years from the date one year before such agreement was executed; and
 - (5) No *income tax* consequences arise because no gains or losses are recognized on transfers of property from an individual to (or in trust for the benefit of) a spouse, or former spouse if the transfer is incident to a divorce (Code Section 1041(a)).
 - (6) POINTS TO PONDER: Is divorce the only context where such a division of one CRUT into two CRUTs is permissible, or can it be done in other scenarios?
- t) LTR RUL. 200124010 - Acceleration of CRUT Remainder Interest Approved
- i) SUMMARY: The Service has ruled an individual can accelerate the remainder interest of a charitable remainder unitrust during his lifetime without adversely affecting the qualification of the trust. The trust's governing instrument provides that during trustor's lifetime, he shall have the power to assign any portion or all of the principal of the trust to any one or more of the charitable remaindermen, provided they are qualified at the time of distribution.
 - ii) The trustor wishes to terminate the trust by assigning its principal to three of the four named charitable remainder beneficiaries. The Service ruled the proposed plan will not adversely affect the trust's qualification as a charitable remainder unitrust under section 664.

u) LTR 200127023 – Collapsing a CRT

i) SUMMARY: An individual created a 20 year CRUT, naming himself as the noncharitable income beneficiary. The individual, the trustee, and the charitable beneficiary have agreed to terminate the trust by having the trustee distribute the actuarial value of the income interest to the individual and the actuarial value of the remainder interest to the charitable beneficiary.

ii) The Service ruled:

- (1) the termination of the trust is not a distribution of the unitrust amount;
- (2) the individual will be treated as disposing of his interest in the trust in exchange for money and property;
- (3) the termination will not be an act of self-dealing under section 4947;
- (4) the individual will realize from the sale of his interest in the trust the amount of money and the fair market value of the property;
- (5) Under section 1001(e)(1), the uniform basis assigned to the individual's interest in the trust is zero, and the individual has no basis in his interest in the trust; and
- (6) the individual must recognize the entire amount realized from the disposition of his interest under section 1001(c).

v) LTR 200140027 - Partition of CRT followed by Acceleration of Partial Remainder Interest

i) SUMMARY: H&W created a charitable remainder unitrust naming themselves as life income recipients. One spouse has died and the surviving spouse proposes to divide the trust 85% (Trust A)/15% (Trust B) into two new trusts, each identical to the first and allocating the basis in the original trust's assets on a representative basis.

ii) The surviving spouse then intends to irrevocably designate a charity as the remainderman of Trust B and assign his remaining income interest to the charitable remainderman, thereby accelerating payment of the remainder interest.

iii) Trust B will terminate and pay over its entire corpus to the remainderman. Trust A will continue to operate for the balance of its measuring term.

- iv) The Service ruled:
- (1) the surviving spouse will be entitled to an income tax deduction under section 170 for the value of the unitrust payment (i.e., the present value of the income interest as valued on the date of transfer) transferred to charity;
 - (2) the surviving spouse will be entitled to gift tax deduction under section 2522 in the same amount; and
 - (3) the gift of the unitrust interest in Trust B will have no effect on the qualification of Trust A.
- v) POINTS TO PONDER: A taxpayer's ability to accelerate the entire remainder interest of a charitable remainder trust to charity has its basis in Rev. Rul. 86-60. Variations on this theme can be found in Ltr. Ruls. 8805024, 9529039, 9550026, and 9817010.
- w) LTR RUL. 200143028 - Division of CRUT Upon Divorce Approved
- i) SUMMARY: H&W created a charitable remainder unitrust naming themselves as joint and survivor income recipients. Separately, each reserved the power, exercisable by will, to terminate the other's right to their one-half survivorship income interest. H&W are getting divorced and propose to split the trust into two identical trusts of equal value, naming each as the sole income recipient and trustee.
 - ii) The Service ruled the split will not deny the two new trusts qualification under section 664 nor violate the private foundation excise tax rules.
 - iii) Note that reasonable legal and other expenditures incurred by the trust to effect the proposed division of the trust will not be self-dealing under section 4941 nor a taxable expenditure under section 4945.
- x) LTR RUL. 200150019 - Service Approves Five Life NIMCRUT
- i) SUMMARY: For several years now, the Service has discontinued issuing rulings on the qualification of one or two-life charitable remainder trusts. In this ruling, the Service approves a five-life NIMCRUT with both joint-and-survivor and consecutive income recipients and provides the deduction factor.
 - ii) The trust will pay income to B and C for their joint lives and then to the survivor of them; after which, income will continue in equal shares to D, E and F in equal shares for their lives and in equal shares among the survivors or to the survivor of them.
 - iii) Although the relation of income recipients to one another was not disclosed, it is common for such trusts to be established for the joint lives of husband and wife with a

consecutive income interest paid to children. In such cases, it is important to remember that unless the husband and wife are the sole income recipients, upon the first death, the income interest passing to the surviving spouse will not qualify for the estate tax marital deduction under section 2056(b)(8). This can result in double estate taxation of the income interests. Although not stated in the ruling, the trustors presumably retained the right exercisable by will to revoke the non-spouse trustors' income interests as provided in Reg. section 1.664-3(a)(4), thereby making transfers to the trust incomplete for gift tax purposes. Transfers would then be complete for estate tax purposes upon the death of the survivor of B and C.

iv) Finally, although this trust passed the 10% minimum remainder interest test as required by section 664(d)(2)(D), the income recipients would have to be of advanced age to meet this test even using the minimum five-percent payout rate.

y) LTR RUL. 200152018 - Transfer of Unitrust Interest for Gift Annuity Deductible

i) **SUMMARY:** Taxpayer established a five percent standard payout charitable remainder unitrust reserving for himself a life income. The charitable remainderman is in need of current building funds; therefore, the taxpayer proposes to transfer his entire life income interest to the remainderman as consideration in exchange for a charitable gift annuity.

ii) The Service ruled as follows:

- (1) The transfer produces both income tax and gift tax charitable deductions to the extent the present value of the taxpayer's income interest exceeds the present value of the annuity.
- (2) To the extent the charitable remainder trust has undistributed capital gains from prior years, the transfer will not cause such gains to be included in the taxpayer's gross income in the year of transfer.
- (3) For purposes of calculating gain realized on the purchase of the annuity under the bargain sale rules, the taxpayer's basis in the unitrust interest will be determined by allocating his adjusted basis in the property when it was originally transferred to the charitable remainder trust between the unitrust and annuity interests on the date the unitrust interest is transferred in exchange for the gift annuity.

iii) Income Tax Deduction

- (1) In general, under of IRC 170(f)(3)(A), in order for a charitable contribution to be deductible for income tax purposes, the donors must transfer their entire interest in the contributed property. This is commonly referred to as the "partial interest rule."

- (2) There are limited exceptions to this rule. Among these exceptions are transfers of income and remainder interests in qualified trusts; however, the regulations prohibit a deduction where the property in which a partial interest exists is itself divided. In essence, the contribution of the taxpayer's interest in the unitrust payments will be deductible only if he transfers his entire interest in such payments. Because this occurred, the transfer was deemed deductible.
- (3) With respect to the amount of the deduction, the regulations provide that a deduction is allowed for the excess of the amount paid over the value of the annuity at the time of purchase. In this case, the amount paid in exchange for the gift annuity is equal to the present value of remaining unitrust payments. It is determined by calculating the present value of the remaining income interest from the charitable remainder trust based on the fair market value of the trust, age of the income recipient, and the Charitable Federal Midterm Rate under section 7520, all applicable to the date of transfer. The deduction is then determined by subtracting the present value of the annuity payments from this amount.

iv) Reduction Rules and Applicable Percentage Limitation

- (1) Section 170(e)(1)(A) provides that taxpayers must reduce their income tax charitable deductions by the amount of gain that would not have been long-term capital gain (i.e., ordinary income) had the contributed property been sold. In addition, certain contributions of tangible personal property are limited to the donor's cost basis.
- (2) The courts have ruled that a life interest in trust is a capital asset. Also, because an interest in a trust is not tangible personal property, the reduction rules do not apply. The resulting deduction will be subject to the 30% annual deduction limitation.

v) Gift Tax Deduction

- (1) In determining whether the transfer would be deductible by the taxpayer for gift tax purposes, the Service first cited Rev. Rul. 86-60 which permits both income and gift tax deductions in situations where taxpayers contribute their entire life annuity interest from a charitable remainder annuity trust to the charitable remainderman.
- (2) Second, citing Rev. Rul. 80-281, which permits a gift tax deduction for an exchange of a sum of money for an annuity paid from a charity's general funds, the Service ruled that a gift tax deduction would be allowed, calculated in the same manner as for the income tax charitable deduction as previously discussed.

vi) Bargain Sale Issues

(1) Nonrecognition of Gain on Transfer

- (a) Without explanation, the Service ruled that undistributed capital gains realized by the trustee from prior years would not be included in the taxpayer's income by virtue of the transfer of the income interest to the charity.
- (b) This conclusion may be based on the rules applicable to other transfers of capital gain property to charity in exchange for an annuity under Reg. section 1.1011-2(a)(4)(ii). This section provides that gain that is recognized from the bargain sale of appreciated property may be reported ratably over the life expectancy of the annuitant provided: 1) the transfer qualifies for an income tax charitable deduction under IRC 170; 2) the donor is at least one of the annuitants; and 3) the annuity is non-assignable except to the issuing organization. This case met those conditions; however, what makes this issue distinguishable is the fact the gain referenced here is internal gain of the trust as compared to gain attributable to the income interest itself, discussed next.

(2) Basis in Contributed Property

- (a) Section 1001(e)(1) provides that in determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to Sections 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.
- (b) Under Section 1001(e)(2), a "term interest in property" includes an income interest in a trust. Accordingly, the adjusted basis in the contributed property for purposes of determining the taxation of annuity payments will be deemed to be zero.

vii) POINTS TO PONDER: The applications of this ruling have in essence created a new form of planned gift similar in concept to the Life Estate/Bargain Sale/Gift Annuity transaction. See also Ltr. Rul. 8806042. The applications of this ruling are significant:

- (1) Capital Campaigns. This ruling offers a new source of funds to organizations from existing major donors. It is fairly common for donors to make charitable remainder trusts gifts to organizations with which they have a short giving history or a record of making only modest outright gifts. In addition, the financial needs and circumstances of existing CRT donors may have changed since they created their trusts, placing them in the position to make an additional contribution. Organizations that have cultivated strong ties with these donors may be in a position to share this new opportunity.

(2) A Solution for Problem CRTs.

- (a) Even after the close of the Flip Unitrust reformation window, how many net income unitrusts still exist that in today's low interest rate and declining stock market environments have not come close in recent years to producing enough trust accounting income to satisfy their payout obligations? Fixed annuity payments that are guaranteed by the issuing charity could be an attractive alternative to the dissatisfaction and uncertainty many donors have experienced with their net income unitrusts.
 - (b) Furthermore, net income unitrusts that do not include capital gains in their definition of trust accounting income can distribute only ordinary income which is taxed at the highest rates. Under the proposed scenario, provided the gain attributable to the unitrust income interest is considered long-term capital gain, payments from the gift annuity will consist of a combination of long-term capital gain and ordinary income. The annuitant should be able to report gain ratably over his lifetime provided the annuity satisfies the three-part test discussed earlier.
 - (c) Taking into account the tax savings from the income tax charitable deduction, the higher annuity rates available to older annuitants, and the favorable taxation of payments, the net after-tax benefits of this plan may be very attractive.
 - (d) A related question not addressed in the ruling deals with the tax character of the income interest itself. If the income interest is a capital asset with a zero basis, is it short or long-term capital gain property? We refer you to Treas. reg. section 1.1223-1 which suggests the taxpayer's holding period in the income interest of the trust is the same as his holding period in the assets he contributed originally. Again, this issue was not addressed in the ruling.
- (3) Sharing the Wealth. In this ruling, the trustor transferred his income interest to the charitable remainderman of the trust. However, could he have chosen an organization other than the remainderman? Although Rev. Rul. 86-60 is based on the income interest being transferred to the remainderman of the trust, it does not state that this is a requirement. If the income interest could be transferred to a different qualified organization, the discounted remainder interest would be accelerated immediately to the original remainderman with a new organization issuing and benefitting from the gift annuity. This would mean that all existing CRT donors are potential new donors to any organization that issues gift annuities! The time-value of money considered, the original remainderman loses nothing; in fact, it benefits by receiving the remainder interest sooner and putting it to use for its charitable purposes. This split transaction might also be attractive to organizations that do not issue gift annuities and, therefore, cannot consummate such transactions alone.

z) LTR 200202078 – Profit-Sharing Plan Distribution to CRUT

- i) SUMMARY: An individual participated in a profit sharing plan through his employer, and upon retiring had his retirement benefits distributed to him in the form of company stock. Some of the stock he rolled into an IRA, with the balance of the stock paid directly to him. This balance of company stock was contributed by him to a CRUT.
- ii) The IRS ruled that the entire distribution was considered a lump sum distribution under section 402(e)(4)(D)(i). Further, the Service held that the individual won't recognize ordinary income on the portion of the shares representing the net unrealized appreciation which eventually went to the CRUT. Gain on the sale on the CRUT shares would be treated as capital gain income to the extent of the original net unrealized appreciation. Finally, the Service ruled that the CRUT qualifies under section 664, the individual won't recognize immediate taxable income or capital gain or loss from contributing stock to the CRUT.

iii) PGDC Commentary:

- (1) To review the benefits of this and two prior rulings, an individual can take a lump-sum distribution which includes employer stock and not realize any Net Unrealized Appreciation (NUA) attributable to it at the time of receipt or upon its subsequent transfer to a charitable remainder trust. Furthermore, because the NUA is considered long-term capital gain regardless of the distributee's holding period (See IRS Notice 98-24), the distributee can transfer it immediately to a charitable remainder trust and generally calculate an income tax charitable deduction based on its full value.
- (2) The distributee will realize ordinary income in an amount equal to the plan's basis in the stock at the time of distribution. This amount becomes the distributee's basis and, therefore, is included in the value of the stock for charitable deduction computational purposes. If, however, the distributee holds the stock for less than one year before transfer to the CRT, any additional appreciation will be considered short-term capital gain. Under the reduction rules of section 170(e)(1)(A), a deduction for that component of the gain is not allowed.
- (3) Planning Tip: The distributee will realize ordinary income at the time of receipt in an amount equal to the plan's basis in the stock. Because the charitable deduction can be used to offset all forms of income, the distributee/trustor can utilize the deduction to offset this amount and may be able to shelter additional plan distributions as well (subject to the percentage deduction limitation rules).
- (4) In addition to the trustor receiving a substantial current income tax charitable deduction, the trust's income recipient(s) can receive favorable tax treatment on

the unitrust or annuity distributions. Because all NUA is considered long-term capital gain property, a subsequent sale of the stock by the trust will cause the NUA to fall into the LTCG tier under the four-tier accounting system. Depending on how the proceeds of the sale are reinvested, a significant portion of trust distributions may be characterized as long-term capital gains.

(5) Compare the CRT scenario to the simple rollover of the stock into an IRA. An IRA rollover produces no current income tax deduction and causes all subsequent IRA distributions (including the NUA) to be taxed as ordinary income when distributed. Taking this further, consider the potential net after estate tax and IRD income tax cost of naming family members as beneficiaries of the IRA and the net after-tax opportunity cost of the charitable gift to heirs can be very low.

(6) For further reading, see Ltr. Ruls. 200038050 and 199919039.

4) Fixing What's Broken: Reformations, Rescissions, Scrivener Errors, Disclaimers, and Settlement Agreements

a) LTR 9816002 - Reformation

- i) SUMMARY: A testamentary non-qualifying charitable trust which paid 50% of the income to one individual with the remaining 50% divided among three individuals. Income was paid to each beneficiary for life with a proportionate part of the trust assets going to charities upon death.
- ii) The estate sought to reform the trust into two trusts: 50% into a trust for the first individual, remainder to charity, and 50% into a second trust which would distribute its income for the other three beneficiaries for life, with a proportionate portion of the trust assets to charity upon the death of each one. The IRS approved this reformation.

b) LTR 9816030 - Rescission ab initio

- i) SUMMARY: Wife asserted that she had failed to understand the restrictions applicable to a CRT and successfully brought suit to rescind the trust, which the court held void ab initio.
- ii) The IRS held that the return of the trust assets did not constitute an act of self-dealing, a taxable expenditure under section 4945, or a taxable foundation termination under section 507.

c) LTR 9822041 - Scrivener - IOCRUT to SCRUT

- i) SUMMARY: A court modification to a charitable remainder unitrust due to scrivener's error will not disqualify the CRT. The donors created an "income only" CRUT and contributed low dividend paying stock to it. However, the donors had documentation

to prove that a standard CRUT was intended. The donors propose to request a judicial reformation to cure this defect.

- ii) The Service held that: (1) The proposed judicial modification of the CRUT will not violate Code Section 664 or the Regulations thereunder and will not disqualify the CRUT; and (2) the transfers to the CRUT will qualify for charitable gift tax purposes. These rulings are contingent on the issuance of a court order requiring the proposed modification.
 - iii) POINTS TO PONDER: Do the applicable reformation rules under Code Section 2055(e)(3) apply when scrivener's error is involved?
- d) LTR 9826021 - Scrivener - Public to Private
- i) SUMMARY: The IRS ruled that the reformation of an inter vivos charitable remainder unitrust to allow the charitable remainder beneficiaries to include private foundations will not disqualify the trust under Code Section 664. The taxpayers presented evidence that the provision in the governing instrument limiting the remainder beneficiaries to public charities was the result of a drafting error.
 - ii) A husband and wife created a charitable remainder unitrust and funded it with publicly traded securities. X was named as initial trustee. The husband and wife have the power to remove X and name successor trustees. The unitrust amount is to be paid to the husband and wife, or the survivor of them. At the death of the survivor of them, the remaining trust assets are to be distributed in equal shares to three charities designated in the instrument or to such charities as the husband and wife, or the survivor, may designate. The governing instrument specifies that if any one of the recipients named in the governing instrument or subsequently designated by the couple is not qualified under Code Sections 170(b)(1)(A), 170(c), 2055(a) and 2522(a), then the property that would go to such organization would go instead to the other organizations then entitled to receive shares or otherwise to one or more charities qualified under Code Sections 170(b)(1)(A), 170(c), 2055(a) and 2522(a) as the trustee may select.
 - iii) The couple represent that reformation is necessary to correct a drafting error making it impossible to designate a private foundation as a remainder beneficiary. They submitted to the IRS an affidavit from the representative who advised them on the creation of the trust which indicates that the couple told him it was their intent to create a private foundation and name it as the remainder beneficiary of the trust. The representative referenced his own failure to note the limitation in the governing instrument which excluded private foundations as permissible beneficiaries.
 - iv) The charitable deduction claimed by the husband and wife was less than twenty percent of their adjusted gross income and so would not exceed the applicable percentage limitations after the reformation. In addition, the publicly traded stock

used to fund the trust qualified under the exception in Code Section 170(e)(5) and so the couple's charitable deduction would not have to be reduced pursuant to Section 170(e)(1)(B)(ii).

- v) The husband and wife represent that state law allows reformation of an irrevocable trust to carry out the parties' true intent and that non-vested charitable remainder beneficiaries and the state's attorney general would have the right to object to the reformation.
- vi) The proposed reformation will not violate Code Section 664 or the regulations thereunder and will not adversely affect the couple's charitable income tax deduction under Code Section 170.
- vii) POINTS TO PONDER: This ruling gives us hope that the IRS might be liberalizing its views on reformations. As we noted with respect to LTR 9818027 earlier this year, perhaps the IRS will consider reformation of other types of charitable remainder trust provisions as long as the donor's intent is clear at the creation of the trust. Will a representative's affidavit always constitute proof of the donor's intent?

e) LTR 9827008 - Disclaimer and Reformation

- i) SUMMARY: The IRS ruled that an estate will be entitled to a charitable deduction for the present value of the remainder interest in a trust provided that the non-charitable beneficiaries of the trust validly disclaim their powers to invade corpus and provided that judicial reformation proceedings are commenced within the appropriate time frame.
- ii) A decedent's will provides that the residue of her estate is to be held in trust, with the income to be paid to her niece for life. The niece has the power to invade corpus for extraordinary medical expenses. At the niece's death, the income is to be paid equally to two friends for their lives and then to the survivor of the friends. The two friends also have the power to invade corpus for extraordinary medical expenses. At the death of the survivor of the niece and the two friends, the remainder of the trust is to be divided among four charities. If any charity loses its non-profit status, such charity's share will be distributed to the other charities.
- iii) The estate cannot take a charitable estate tax deduction under Code Section 2055 for the value of the remainder interest that will pass to charity because the trust does not qualify as a charitable remainder trust under Code Section 664. The estate proposes to have the niece and the two friends disclaim their powers to invade corpus pursuant to Code Section 2518 and to reform the trust so that the niece and the two friends will receive, respectively, a unitrust amount equal to 7.4 percent of the net fair market value of the trust assets valued annually. The charities would have to be qualified under Code Sections 2055 and 170(c). The reformation would be effective as of the decedent's death.

- iv) According to the IRS, the difference between the actuarial value of the charitable interest prior to the reformation and after the reformation will not exceed 5 percent of the actuarial value of the reformable interest. The interests of the niece and two friends after the reformation will terminate at the same time that these interests would have terminated prior to the reformation.
 - v) Provided that the judicial proceedings to reform the trust are commenced before the 90th day after the last date for filing the decedent's estate tax return (including extensions) and the disclaimers are qualified under Code Section 2518 and the regulations thereunder, the estate will be entitled to a charitable deduction for the present value of the remainder interest in the trust under Code Section 2055.
 - vi) POINTS TO PONDER: It appears likely that the decedent in this ruling did not contemplate creating a qualified charitable remainder trust when she signed her will. Charitable remainder interests are often created in a haphazard fashion during the estate planning process. This ruling demonstrates that it can pay to consider using the charitable trust reformation provisions in some situations where no one thought of setting up a qualified charitable trust during the original planning stage.
- f) LTR 9827010 – Reformation
- i) SUMMARY: The IRS ruled that an estate will be entitled to a charitable deduction for the present value of the remainder interest in a trust and for the present value of a guaranteed annuity in a trust provided that the non-charitable trust beneficiary validly disclaims his right to receive consumer price index adjustments in the amount of his annuity and provided that a court rules that the trust must be reformed. The IRS held that the portion of the annuity amount going to two charities after the reformation would constitute a guaranteed annuity under Code Section 2055(e)(2)(B) and the related regulations.
 - ii) Decedent's will provides that the residue of her estate is to be held in trust, with the sum of \$52,000 to be paid to a non-charitable beneficiary on an annual basis. This sum is to be adjusted each year in accordance with the consumer price index but is never to be less than \$52,000. Any remaining trust income is to be paid in equal quarterly installments to two charities. At the death of the non-charitable beneficiary, the remainder is to pass in equal shares to the two charities.
 - iii) The estate instituted a judicial proceeding to reform the trust into a charitable remainder annuity trust. The estate proposes to have an annuity of 5 percent paid each year. Of this 5 percent amount, 12.8 percent will go to the non-charitable beneficiary and 87.2 percent will go to the two charities. The remainder of the trust will pass to the two charities at the non-charitable beneficiary's death. The reformation will be effective as of the decedent's death.

- iv) The IRS noted that the difference between the actuarial value of the charitable interest prior to the reformation and after the reformation will not exceed 5 percent of the actuarial value of the reformable interest. The non-charitable beneficiary's interest after the reformation will terminate at the same time that it would have terminated if the trust was not reformed.
 - v) The trust will be a charitable remainder annuity trust after the reformation assuming it is a valid trust under local law. The trust will be exempt from income taxes each year that it continues to meet the requirements of Code Section 664 unless it has unrelated business taxable income. The estate will be entitled to a charitable deduction under Code Section 2055 for the present value of the remainder interest in the trust and for the present value of the portion of the annuity to be paid to the charities. The IRS noted that these rulings are expressly contingent upon the issuance of a court order requiring the proposed reformation.
 - vi) POINTS TO PONDER: In this ruling, it is not clear why the decedent's will did not include a formal charitable remainder trust. Although reformation is available in certain cases, it is important to keep the rules of Code Section 2055 in mind when drafting estate planning documents.
- g) LTR 9833008 & LTR 9833010 - Scrivener - Post-Gift Appreciation Allocation to Income
- i) SUMMARY: In each of these rulings, the taxpayer asserted that a provision allocating post-gift appreciation to income was omitted from a net-income with make-up charitable remainder unitrust because of a scrivener's error. The IRS rules that a judicial modification of the trust to correct the error will not disqualify the trust as a charitable remainder unitrust so long as the court determines that the omission was in fact a scrivener's error.
 - ii) POINT TO PONDER: These rulings are additional examples of the broad latitude that the IRS is exhibiting with respect to modifications of charitable remainder trusts.
- h) TAM 9845001 - Reformation
- (1) SUMMARY: Based on the legislative history to Code Section 2055(e)(3), the IRS rules that the retroactive amendment of an inter vivos trust to qualify as a charitable remainder unitrust is permissible under the law. The trust was amended to include the required provisions concerning (i) payment of death taxes, (ii) testamentary transfers and (iii) calculation of the unitrust amount when additional contributions are made. The IRS also noted that there are several issues with respect to the prior administration of the trust. First, the noncharitable beneficiaries are required to reimburse the trust for excess distributions made to them in prior years and these excess payments create questions about self-dealing. Second, the trust's investment in a limited partnership may have generated unrelated business taxable income. Finally, the gain on the sale of stock originally

transferred to the trust may have been understated so the trust's accumulated capital gains account may need to be adjusted even if the trust was tax-exempt during the years of the sales.

ii) POINTS TO PONDER: Is the IRS showing more leniency towards poorly-drafted charitable remainder trusts these days? Does the IRS take a lenient approach towards charitable remainder trust administration issues in this Ruling?

i) LTR 9845015 - Settlement Agreement CRT

i) SUMMARY: In this Ruling, the IRS holds that a trust created pursuant to a settlement agreement between a decedent's estate and his non-U.S. citizen surviving spouse qualifies as a charitable remainder unitrust under Code Section 664(d)(2). The decedent's surviving spouse is the noncharitable beneficiary of the trust and her interest in the trust is designed to qualify as a qualified domestic trust for marital deduction purposes.

ii) The IRS finds that the transfer of assets to the trust via the settlement agreement will not constitute a gift from the surviving spouse because the distribution to the trust represents a good faith settlement of an enforceable claim. The Ruling indicates that no part of the trust will be includible in the surviving spouse's estate at her death. Finally, the IRS concludes that the payment made to the surviving spouse to compensate her for the delay in the funding of the trust will be treated as a distribution of trust income for purposes of Code Section 2056A(b)(3) so no additional estate tax would be imposed.

iii) POINTS TO PONDER: When might a charitable remainder trust be used to resolve other estate controversies? Note companion Ruling 9845016 below.

j) LTR 9845016 - Settlement Agreement

i) SUMMARY: This companion Ruling to Ruling 9845015 similarly holds that the trust created under the settlement agreement is a qualified charitable remainder trust and that the trust's accrued income payment will be not be subject to the additional estate tax under Code Section 2056A(b)(1)(A).

ii) In addition, this Ruling holds that the decedent's estate is entitled to a marital deduction for the value of the surviving spouse's interest in the trust and to a charitable deduction for the value of the charity's interest in the trust.

iii) POINTS TO PONDER: When should parties contemplating a settlement agreement consider asking the IRS to rule on the tax consequences as the taxpayers in Rulings 9845015 and 9845016 did?

k) LTR 9903015 - Reformation

- i) **SUMMARY:** This Ruling holds that the proposed reformation of several trusts created under a decedent's will would be qualified reformations under Code Section 2055(e)(3). As a result, the estate will be entitled to charitable estate tax deductions for the present value of the remainder interests in the trusts.
- ii) The IRS notes that the trusts were intended to be charitable remainder unitrusts but did not meet all the technical requirements under Code Sections 2055(e) and 664. In addition, the IRS rules favorably notwithstanding that the charitable remainder beneficiary was not an approved public charity on the date of the death of the decedent.
- iii) **POINTS TO PONDER:** Despite the increased leniency towards charitable remainder trust reformation that the IRS exhibits in this Ruling and a number of other recent rulings, what factors might prevent the IRS from approving a reformation in a given case? When will the IRS begin issuing FLIP trust reformation rulings?

l) LTR 199929033 - Reformation

- i) **SUMMARY:** Trust is a charitable remainder annuity trust described in section 664(d)(1) of the Code whose governing instrument provides that Trustee is to pay an amount equal to five percent of the initial fair market value of Trust property ("annuity amount") to X for life from Trust income, and to the extent Trust's income is insufficient, from principal. Trust income in excess of the annuity amount is paid to Charity, a nonprofit organization described in section 170(c) of the Code. Because Charity has received only nominal payments of income from Trust, the Trustee, X, and the Trust propose to amend the governing instrument to provide that Trustee may distribute up to a specifically stated dollar amount from Trust principal to Charity each year during X's lifetime if the principal amount of Trust is at least a specific dollar level after each distribution. Noting that it was represented that (i) state law allows non-judicial resolution agreements to grant trustees powers not inconsistent with the provisions or purposes of the trust and (ii) X will not claim a deduction under sections 170 or 2522 of the Code for any distribution to Charity, the Service held that the proposed reformation of Trust will not violate section 664 of the Code and will therefore not disqualify the charitable remainder annuity trust.
- ii) **POINTS TO PONDER:** Is the annuity amount paid by the CRAT reduced during the trust term by the amended trust provision?

m) LTR 20012204 – Reformation

- i) The attempted reformation of a CRT was not permitted because the unitrust provisions didn't satisfy the requirements of Section 664.

- ii) POINTS TO PONDER: Why the hard line, in light of earlier flexibility? What doesn't the text of this ruling tell us?!
- n) LTR 200127038 – Reformation
- i) SUMMARY: The Service has ruled that the reformation of a trust is a qualified reformation under section 2055(e)(3), and that the reformed trust qualifies as a charitable remainder annuity trust under section 664.
 - ii) Some of the assets of a trust, funded by an individual's estate, will be distributed to two individuals. The remainder of the assets are to be held in trust to benefit the widow and to pay her a monthly annuity, and additional amounts from principal or income in the trustee's sole discretion for her medical care or support in reasonable comfort. On her death, the balance of the trust will pass to a charity.
 - iii) The widow filed an election in probate court to take her elective share of the decedent's estate, and also filed a complaint seeking a declaratory judgment that she is entitled to her elective share. The parties settled and divided the trust into two trusts, a noncharitable trust and a charitable trust. The noncharitable trust holds assets in an account and will terminate after distributing them to the individuals. The charitable trust will pay the widow an annuity equal to 5 percent of the initial net fair market value of the trust, provided that the payout doesn't exceed the percentage that would result in a 5 percent probability that the trust would be exhausted before the death of the widow. On the widow's death, the remaining trust assets will be distributed to charity.
 - iv) The Service ruled that the charitable trust qualifies as a charitable remainder annuity trust under section 664(d)(1), the value of the charity's interest in the charitable trust is deductible by the decedent's estate under section 2055(e), and the value of the widow's interest in the charitable trust is deductible by the estate under section 2056(b)(8).
- o) LTR 200142011 – Pre-1969 CRT denied Tax Benefits
- i) SUMMARY: A trust was created and funded before October, 1969 when the Tax Reform Act of 1969 came into being. The taxpayer (probably a bank trustee) proposed to modify the trust and to re-calculation net income to be distributed to the last surviving beneficiary of the trust.
 - ii) The trustee requested rulings that (a) any amount of the trust's gross income set aside and deducted under section 642(c) in Year 1 and prior tax years wouldn't be disallowed due to the modification, and (b) for years after Year 1, the modified trust would be treated as having been created before October 1969, would be allowed a deduction under section 642(c) of the amount of its gross income set aside, and the gross income set aside would be treated as income earned on amounts contributed before October 1969.

iii) The Service denied all rulings, since the amounts set aside under the trust, as modified, had more than a remote chance of not being used for a purpose described in section 1.642(c)-2(b)(1).

p) LTR 200052026 - CRT Qualifies Despite Prohibited Contribution

i) SUMMARY: H & W created a charitable remainder unitrust, naming themselves as trustees and income beneficiaries. Later H & W made a second contribution to the unitrust in violation of the CRUT's governing instrument. The proceeds of the second contribution were not used in calculating unitrust payments and H & W did not take a charitable contribution deduction for the second contribution. H & W offered to return the second contribution to themselves and amend their individual tax returns for years 1 and 2 to reflect the capital gains and dividend income on the X stock while it was held in the account of the unitrust.

ii) The IRS ruled that the second contribution of X stock would be ignored for federal tax purposes and would not cause the unitrust to be disqualified under Code Section 664(d)(2) so long as the husband and wife amended their tax returns to reflect the capital gains and dividend income from the X stock while it was held by the unitrust. The IRS observed that the second contribution was a nullity under state law because the husband and wife had acted without legal authority when they accepted the second contribution.

q) LTR 200052035 – CRAT modified to allow current distributions to Charity

i) SUMMARY: Decedent created a charitable remainder annuity trust paying A for life an annuity equal to 5% of the initial fair market value of the trust's assets. At A's death, the remainder of the trust was to go to qualified charities. The trustees sought to modify the trust to authorize the trustees to pay income and principal to qualified charities during A's life if the fair market value of the trust's assets exceeds a certain amount at the time of distribution. These charitable distributions would not be made if they would endanger A's annuity. The trustees obtained the consent of A and the state attorney general and petitioned for a court order to modify the trust.

ii) The IRS ruled that the proposed modification of the trust would not disqualify it as a charitable remainder annuity trust under Code Section 664.

iii) POINTS TO PONDER: Would charitable deductions be available for amounts distributed from the trust to charity during A's lifetime?

r) LTR 200105059 - CRAT Reformation

i) SUMMARY: A testamentary trust was drafted to provide six individuals with net income for 10 years with the remainder interest passing to seven charities. The income

interests were divided in various percentages among the income recipients, and the remainder interest was also divided among the named charities. If an income recipient died before the end of the 10-year term, his or her share of the income was to be added to principal. If all income recipients died before the end of the 10-year term, the Trust was to terminate at the last death.

- ii) The Trust did not meet the requirements for an estate tax charitable deduction. However, the IRS held that the proposed judicial reformation, when granted, will reform Trust into a deduction-qualifying, 10-year, charitable remainder annuity trust with the following main characteristics: (1) a fixed percentage annuity amount of 6.8%; (2) if any income recipient predeceased the decedent or dies prior to the termination of the 10-year annuity period, his or her share of the annuity amount must be reapportioned, in equal shares, among the remaining individual recipients; (3) annuity distributions must be made at the end of each tax year; (4) the annuity payments to the individual recipients must terminate upon the first of the following events to occur: (a) the expiration of the 10-year period commencing on the decedent's date of death, or (b) the death of all of the individual recipients; (5) when the trust terminates, the principal and any undistributed net income must be divided into seven equal shares, to be held and administered separately, for the benefit of the seven charitable organizations the decedent designated as the remainder beneficiaries; and (6) the appropriate private foundation excise tax rules will apply to the reformed trust.

 - iii) The IRS stated the reformation is a qualified reformation within the meaning of Code Section 2055(e)(3)(B) because: (1) the difference between the actuarial value (determined as of the date of decedent's death) of the qualified interest and the actuarial value (as so determined) of the reformable interest does not exceed 5 percent of the actuarial value (as so determined) of the reformable interest; (2) the nonremainder interest, i.e., the interest of the individual beneficiaries, terminates at the same time both before and after the qualified reformation; and (3) the reformation is effective as of the date of Decedent's death.
- s) LTR 200122045 – Reformation
- i) SUMMARY: The attempted reformation of a CRT was not permitted because the unitrust provisions didn't satisfy the requirements of Section 664.
 - ii) POINTS TO PONDER: Why the hard line, in light of earlier flexibility? What doesn't the text of this ruling tell us?!
- t) LTR 200127038 – Reformation
- i) SUMMARY: The Service has ruled that the reformation of a trust is a qualified reformation under section 2055(e)(3), and that the reformed trust qualifies as a charitable remainder annuity trust under section 664.

- ii) Some of the assets of a trust, funded by an individual's estate, will be distributed to two individuals. The remainder of the assets are to be held in trust to benefit the widow and to pay her a monthly annuity, and additional amounts from principal or income in the trustee's sole discretion for her medical care or support in reasonable comfort. On her death, the balance of the trust will pass to a charity.
 - iii) The widow filed an election in probate court to take her elective share of the decedent's estate, and also filed a complaint seeking a declaratory judgment that she is entitled to her elective share. The parties settled and divided the trust into two trusts, a noncharitable trust and a charitable trust. The noncharitable trust holds assets in an account and will terminate after distributing them to the individuals. The charitable trust will pay the widow an annuity equal to 5 percent of the initial net fair market value of the trust, provided that the payout doesn't exceed the percentage that would result in a 5 percent probability that the trust would be exhausted before the death of the widow. On the widow's death, the remaining trust assets will be distributed to charity.
 - iv) The Service ruled that the charitable trust qualifies as a charitable remainder annuity trust under section 664(d)(1), the value of the charity's interest in the charitable trust is deductible by the decedent's estate under section 2055(e), and the value of the widow's interest in the charitable trust is deductible by the estate under section 2056(b)(8).
- u) LTR 200201026 – Reformation
- i) SUMMARY: The decedent's will transferred the residue of the estate to a trust for the benefit of the son, income to be paid quarterly, with NO principal invasions being allowed. At the son's death, the trust is to be divided into two equal shares for charitable purposes. Decedent's estate obtained a court order allowing it to reform the trust into a charitable remainder unitrust under section 664(d)(2). As reformed, the son will be entitled to a unitrust amount equal to 7.6 percent of the net fair market value of the assets of the trust, remainder as before to charity.
 - ii) The Service ruled that the charitable trust qualifies as a CRUT under section 664(d)(1). Accordingly, the present value of the charities' interests are deductible by the estate, limited however by the permissible amount which would have been allowable for the reformable interest but for section 2055(e)(2).
- v) LTR 200204022 – Disclaimer
- i) SUMMARY: H&W created a CRUT with income payable to the couple or the survivor for life. On the death of the survivor of H&W, the unitrust amount is payable to S or D. H&W reserved the right to revoke the interest of any unitrust recipient. W has died, and the CRUT trustees propose to divide the CRUT into two equal CRUTs. S & D intend to disclaim in full their rights pursuant to Sec. 2518, and H intends to disclaim any rights and powers he possesses under the CRUTs.

- ii) The Service held there was no completed gift of the unitrust successor interest until W's death. The Service ruled that if the son and daughter file a disclaimer within nine months of the wife's death that the disclaimer will be valid and the son and daughter will be presumed to have predeceased the creation of the CRUT. Thus, the corpus of the new CRUT will pass directly to the charitable remainderman on H's death. The Service also ruled that if the disclaimers are qualified, that H will be the sole noncharitable beneficiary of the new CRUT for federal estate tax purposes.
 - iii) If the new CRUT otherwise qualifies as a CRUT under section 664, the value of the charitable remainder interest in the new CRUT will qualify for the federal estate tax charitable deduction under section 2055 and the value of the unitrust interest passing to H will qualify for the estate tax marital deduction under section 2056(b)(8).
- w) Additional CRT Reformation LTR 9823037; LTR 9829017; LTR 9832037; LTR 9851023; LTR 9853014; LTR 199923013; LTR 199924029; LTR 199927040.

5) Miscellaneous

a) LTR 9827017 - Incomplete Gifts

- i) SUMMARY: Two trusts qualified as valid charitable remainder unitrusts under Code Section 664(d)(2) despite the fact that all interests in the trusts are incomplete gifts for federal gift tax purposes.
- ii) A husband and wife each established a trust. The husband's trust provides that a unitrust amount of 11% will be paid to him semi-annually. At his death, the unitrust amount will be paid to the wife and at her death, the unitrust amount will be paid to another individual. At the death of the survivor of the three individuals, the remainder of the trust will pass to three charities. The husband is trustee of his trust and an independent trustee is appointed to value assets that do not have ascertainable values. The husband retains the power exercisable only by his will to revoke or terminate the successive interests of the wife and the other individual. The husband also reserves the power to add or substitute other charitable beneficiaries and/or to change the percentages to be received by each charity. If any charity is not qualified under Code Section 170(b)(1)(A), 170(c), 2055(a) and 2522(a), then the trustee is to distribute such charity's share to one or more charities which are so qualified.
- iii) The wife's trust is substantially similar to the husband's trust except that the wife receives the initial unitrust amount from her trust, she is the initial trustee of her trust and she retains the testamentary power to revoke the interests of her husband and the other individual beneficiary. We assume that the wife also retained the power to change the charities or the percentages going to the charities under her trust. (There are some apparent typographical errors in the ruling as it pertains to the provisions of the wife's trust.)

- iv) The husband and wife made incomplete gifts via their respective trusts. The trusts qualify as charitable remainder unitrusts for purposes of Code Section 664(d)(2) with respect to transfers made to them prior to July 28, 1997. The IRS did not rule on qualification with respect to any transfers after that date (for transfers after July 28, 1997, the value of the remainder interest in a charitable remainder trust must be equal to at least 10% of the value of the assets transferred to the trust).
- v) POINTS TO PONDER: If the interest of the non-spouse individual beneficiary is not revoked, then in all likelihood, the unitrust interest passing from the deceased spouse's trust to the surviving spouse at the death of the first spouse to die will not qualify for the federal estate tax marital deduction. Perhaps the plan contemplated is for the non-spouse individual beneficiary to disclaim his or her interest in the trust created by the spouse who dies first but keep his or her interest in the trust created by the spouse who dies last. This scenario would avoid gift taxes and postpone the estate taxes until both spouses are gone and would avoid estate taxes with respect to only one charitable remainder trust. How would the new 10% test for charitable remainder trusts impact this type of planning?

b) LTR 9833011 - Charitable Contributions

- i) SUMMARY: In response to a request by a Code Section 501(c)(3) community center regarding possible solicitations for gifts of artwork, the IRS rules as follows: (i) Contributions of artworks to the community center will be charitable contributions if substantiation requirements are met. (ii) The donors' charitable contributions will not be reduced under Code Section 170(e)(1)(A), which relates to reductions for gain that would not have been long-term capital gain if the property had been sold for its fair market value, as long as the artwork is long-term capital gain property in the hands of the donors. (iii) The donors' charitable contributions will not be reduced under Code Section 170(e)(1)(B)(i), which relates to reductions for tangible personal property put to an unrelated use, as long as the donors establish that the artwork is not put to an unrelated use or reasonably assume that it will not be.
- ii) POINTS TO PONDER: Consider the viability of a gift of an undivided interest in the artwork or the consequences of a loan of the artwork. What constitutes a "related use"?

c) LTR 199915053 - Qualified Appreciated Stock

- i) SUMMARY: Taxpayer is a principal shareholder of a corporation ("Company") who also established a private grant-making charitable foundation as a nonprofit corporation to receive charitable gifts from Taxpayer and others ("Foundation"). Foundation is currently seeking a ruling from the IRS that it is a private foundation described in section 509(a) of the Code.

- ii) Company has two classes of voting common stock, Class A which is listed on NASDAQ, and Class B which is not listed on any established securities market. Class B shares are convertible into Class A shares at any time on a share-for-share basis at the option of the holder pursuant to the Company's restated certificate of incorporation. Taxpayer contributed shares of Class B stock to Foundation and signed an agreement that he would not sell any shares of Company common stock such that it would restrict the ability of Foundation to sell or otherwise dispose of its shares of stock.
 - iii) Taking note that section 170(e)(5) and its legislative history do not directly discuss whether "qualified appreciated stock" includes stock that is convertible to stock for which market quotations are readily available on an established securities market," the Service held that the contributed shares of Class B stock were not "qualified appreciated stock" under section 170(e)(5)(B), because price quotations for the convertible Class B stock were not available on an established securities market.
 - iv) POINTS TO PONDER: Do "convertible shares" also constitute "Unmarketable Assets" under the new CRT Regulations? If contributed, would the capital gain on the sale of the stock by the Foundation be imputed back to the donor?
- d) Notice 99-17 - Capital Gain Distributions
- i) SUMMARY: Notice 99-17 modifies in two respects Notice 98-20, which the IRS issued to provide guidance on the ordering of capital gain distributions made on or after January 1, 1998, from a charitable remainder trust under Code Section 664(b)(2).
 - ii) First, for taxable years ending after December 31, 1997, the section of Notice 98-20 dealing with pre-effective date capital gains should be ignored.
 - iii) Second, in Notice 98-20's example illustrating the ordering and character rules, the 28% group is changed to gains on collectibles (such as art and coins). These modifications put the IRS's guidance in sync with Code Section 1(h)(13)(D) as added by the Tax and Trade Relief Extension Act of 1998.
 - iv) POINTS TO PONDER: Does this Notice constitute the guidance planned for 1999 on the treatment of capital gains taken into account by charitable remainder trusts mentioned in the IRS and Treasury's 1999 Business Plan Guidance.
- e) LTR 199918046 - Term-of-Years CRT
- i) SUMMARY: Generally, pursuant to Rev. Proc. 99-3, the IRS does not issue rulings concerning whether a charitable remainder trust that provides for unitrust payments for one or two measuring lives satisfies the requirements described in section 664 of the Code. However, because the proposed trust provides for unitrust payments for a term of years, the request for a ruling is not subject to section 4.01(39) of Rev. Proc. 99-3.

- ii) In their request for a ruling, the grantors noted that the proposed trust contains provisions which differ from the model language contained in Rev. Proc. 90-30. Accordingly, the IRS agreed to rule on whether said provisions disqualify the trust under section 664 of the Code. The provisions differ from the model language (i) in that the unitrust amount is to be paid to the recipients for a term of years rather than for the lives of the recipients, (ii) in providing for contingent beneficiary designations if one or both of the recipients should fail to survive the unitrust term, (iii) in providing for the unitrust amount to be paid to the recipients no later than the close of the taxable year for which the payment was due, and (iv) in designating multiple and alternate charitable remaindermen and providing for the appointment of a successor trustee.
 - iii) The IRS held that the proposed trust will meet the requirements of a charitable remainder unitrust under section 664 of the Code, provided that it is a valid trust under local law.
 - iv) POINTS TO PONDER: The results of this Ruling are not surprising. One interesting aspect, however, may be procedural. If a donor desires to engage in a sophisticated CRT arrangement and obtain LTR approval of the CRT, a term-of-years trust will at least provide the IRS with the legal authority to favorably rule on the qualification issue under section 664.
- f) LTR. RUL. 200150040 - Gifts in Exchange for Priority Admission to Nursing Home Permitted
- i) SUMMARY: A supporting organization that exists for the benefit of two nursing homes wanted to market a program that provides priority admission to the nursing home or assisted living facility for donors who enter into charitable gift annuity agreements with the organization or name it as beneficiary of a charitable remainder trust.
 - ii) The Service held that neither the supporting organization nor the nursing facilities will incur any costs in connection with the program and donors will receive no measurable economic benefit as a result of the arrangement. Consequently, the IRS reasoned the benefit will not be treated as an additional consideration issued in exchange for property within the meaning of section 514(c)(5). (Failure of the Service to reach this conclusion would have meant that the any income from such program would be unrelated debt-financed income to the charity.
- g) LTR 200203034 – CRT doesn't qualify
- i) SUMMARY: H proposes that his S corporation will create a CRUT under section 664, funding it with marketable securities. The unitrust amount will be paid to the corporation for 19 years and then to H&W for life. On termination the CRUT remainder will pass to charity.

- ii) Noting that the corporation's gratuitous transfer to the trust is only partially for a business purpose, and that a portion of the transfer will be for the benefit of the couple, the IRS ruled a portion of the securities contributed will be treated as constructively distributed to H who will be treated as making a gratuitous transfer of the property to the trust.
- iii) Both H and the corporation will be the grantors of the trust, and they will share in the profits from the joint investment of their assets. Citing Reg. Section 301.7701-4(a) and (c), the Service ruled that the arrangement cannot be classified as a trust and so doesn't meet the definition of a CRUT under section 664(d)(2).

Note: The author has drawn liberally from www.pgdc.net and its daily tax alerts. Please review this site for the precise text of the above rulings and cases.

Exhibit A

[4830-01-P]

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 20, 25, and 26

[REG-106513-00]

RIN 1545-AX96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations revising the definition of income under section 643(b) of the Internal Revenue Code to take into account changes in the definition of trust accounting income under state laws. The proposed regulations also clarify the situations in which capital gains are included in distributable net income under section 643(a)(3).

Conforming amendments are made to regulations affecting ordinary trusts, pooled income funds, charitable remainder trusts, trusts that qualify for the gift and estate tax marital deduction, and trusts that are exempt from generation-skipping transfer taxes. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by May 18, 2001. Outlines of topics to be discussed at the public hearing scheduled for June 8, 2001 must be received by May 18, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG-106513-00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG-106513-00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.ustreas.gov/tax_regs/regslst.html. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Bradford Poston at (202) 622-3060 (not a toll-free number); concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy R. Traynor, 202-622-8452 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 643(b) provides a definition of the term income for purposes of subparts A through D of part I of subchapter J of the Internal Revenue Code (Code). The term income, when not modified

by any other term, means the amount of income of the trust or estate determined under the terms of the governing instrument and applicable local law. Section 1.643(b)-1 further provides that trust provisions that depart fundamentally from the concepts of local law in determining what constitutes income will not be recognized.

These statutory and regulatory provisions date back to a time when, under state statutes, dividends and interest were considered income and were allocated to the income beneficiary while capital gains were allocated to the principal of the trust. Changes in the types of available investments and in investment philosophies have caused states to revise, or to consider revising, these traditional concepts of income and principal.

The prudent investor standard for managing trust assets has been enacted by many states and encourages fiduciaries to adopt an investment strategy designed to maximize the total return on trust assets. Under this investment strategy, trust assets should be invested for total positive return, that is, ordinary income plus appreciation, in order to maximize the value of the trust. Thus, under certain economic circumstances, equities, rather than bonds, would constitute a greater portion of the trust assets than they would under traditional investment standards.

One of the concerns with shifting trust investments toward equities and away from bonds is the potential adverse impact on the income beneficiary. Based on the traditional concepts of income and principal, the income beneficiary is entitled only to the dividends and interest earned by the trust assets. The dividend return on equities as a percentage of their value traditionally has been substantially less than the interest return on bonds.

To ensure that the income beneficiary is not penalized if a trustee adopts a total return investment strategy, many states have made, or are considering making, revisions to the definitions of income and principal. Some state statutes permit the trustee to make an equitable adjustment between income and principal if necessary to ensure that both the income beneficiary and the remainder beneficiary are treated impartially, based on what is fair and reasonable to all of the beneficiaries. Thus, a receipt of capital gains that previously would have been allocated to principal may be allocated by the trustee to income if necessary to treat both parties impartially. Conversely, a receipt of dividends or interest that previously would have been allocated to income may be allocated by the trustee to principal if necessary to treat both parties impartially.

Other states are proposing legislation that would allow the trustee to pay a unitrust amount to the income beneficiary in satisfaction of that beneficiary's right to the income from the trust. This unitrust amount will be a fixed percentage, sometimes required to be within a range set by state statute, of the fair market value of the trust assets determined annually.

Questions have arisen concerning how these state statutory changes affect the definition of income provided in section 643(b) and the other Code provisions that rely on the section 643(b) definition of income. This definition of income affects trusts including, but not limited to, ordinary trusts, charitable remainder trusts, pooled income funds, and qualified subchapter S trusts.

In addition, trusts that qualify for the gift or estate tax marital deduction must pay to the spouse all the income from the property. All the income is considered paid to the spouse if the effect of the trust is to give the spouse substantially that degree of beneficial enjoyment of the trust property that the principles of trust law accord to a person who is unqualifiedly designated as the life beneficiary of a trust. Section 25.2523(e)-1(f) of the Gift Tax Regulations and section

20.2056(b)-5(f) of the Estate Tax Regulations. Questions have arisen whether the spouse is entitled to all the income from the property in a state that permits equitable adjustments or unitrust payments.

Similarly, questions have arisen as to whether an otherwise exempt trust which uses equitable adjustments or unitrust payments will be subject to the generation-skipping transfer tax provisions of chapter 13 of the Code.

Explanation of provisions

Definition of Income

The proposed regulations will amend the definition of income under section 1.643(b)-1 to take into account certain state statutory changes to the concepts of income and principal. Under the proposed regulations, trust provisions that depart fundamentally from traditional concepts of income and principal (that is, allocating ordinary income to income and capital gains to principal) will generally continue to be disregarded, as they are under the current regulations. However, amounts allocated between income and principal pursuant to applicable state law will be respected if state law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, taking into account ordinary income, capital gains, and, in some situations, unrealized appreciation. For example, a state law that provides for the income beneficiary to receive each year a unitrust amount of between 3% and 5% of the annual fair market value of the trust assets is a reasonable apportionment of the total return of the trust. Similarly, a state law that permits the trustee to make equitable adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is a reasonable apportionment of the total return of the trust.

In addition, an allocation of capital gains to income will be respected under certain circumstances. Such an allocation will be respected if directed by the terms of the governing instrument and applicable local law. Similarly, if a trustee, pursuant to a discretionary power granted to the trustee by local law or by the governing instrument (if not inconsistent with local law), allocates capital gains to income, the allocation will be respected, provided the power is exercised in a reasonable and consistent manner.

The proposed changes to the regulations will permit trustees to implement a total return investment strategy and to follow the applicable state statutes designed to treat the income and remainder beneficiaries impartially. At the same time, the limitations imposed by the proposed regulations ensure that the Code provisions relying on the definition of income under section 643(b) are not undermined by an unlimited ability of the trustee to allocate between income and principal.

Pooled Income Funds

A special rule is proposed to be added to the regulations covering pooled income funds to address the problems arising from the potential application of the new state statutes to these funds. A pooled income fund as defined in section 642(c)(5) is a split-interest trust created and maintained by certain types of charitable organizations. Noncharitable beneficiaries receive the income from the commingled fund during their lives and the charitable organization receives the remainder interests. The income that is to be paid to the noncharitable beneficiaries is income as defined in section 643(b), section 1.642(c)-5(i).

A pooled income fund is a trust subject to taxation under section 641. It is entitled to a distribution deduction under section 661 for income distributed to the noncharitable beneficiaries. In addition, it receives a charitable deduction under section 642(c)(3) for any amount of net long-term capital gain which pursuant to the terms of the governing instrument is permanently set aside for charitable purposes. A pooled income fund is taxed on any net short-term capital gain that is not required to be distributed to the income beneficiaries pursuant to the terms of the governing instrument and applicable local law.

Under traditional principles of income and principal, ordinary income would be paid to the income beneficiaries. Any net long-term capital gain would be allocated to principal to be held for the ultimate benefit of the charitable remainderman and therefore would qualify for the charitable deduction under section 642(c)(3).

If a pooled income fund were to pay the income beneficiaries a unitrust amount in satisfaction of their right to income, as provided by proposed state statutes, long-term capital gains would no longer qualify for the charitable deduction. Any net long-term capital gain not required to be distributed during the current year would be added to principal. However, the amount of the gain would not be permanently set aside for charitable purposes because this amount may be used in the future to make the unitrust payment to the income beneficiaries. A similar situation arises if the trustee is permitted under state law to make equitable adjustments with respect to unrealized appreciation in the value of the trust assets. A portion of any subsequently realized capital gain may already have been treated as distributed to the income beneficiaries in accordance with an equitable adjustment distribution.

The proposed regulations will amend section 1.642(c)-2(c) to address these issues for pooled income funds. Thus, no net long-term capital gain qualifies for the charitable deduction if, under the terms of the governing instrument and applicable state law, income may be a unitrust amount or may include an equitable adjustment with respect to unrealized appreciation in the value of the trust assets.

Charitable Remainder Unitrusts

A charitable remainder unitrust is a split-interest trust that provides for a specified distribution to one or more noncharitable beneficiaries for life or a term of years, with an irrevocable remainder interest held for the benefit of a charitable organization. Under section 664(d)(2), the amount distributed to the noncharitable beneficiaries is a fixed percentage (not less than 5% and not more than 50%) of the annual fair market value of the trust assets. Alternatively, under section 664(d)(3), the unitrust amount may be the lesser of this fixed percentage amount or trust income (with or without a make-up amount). For this purpose, trust income means income as defined under section 643(b) and the applicable regulations. section 1.664-3(a)(1)(i)(b).

Under proposed state statutes, trust income could be a fixed percentage of the annual fair market value of the trust assets, and the fixed percentage may be less than 5%. A net income charitable remainder unitrust using such a state statutory definition of income would in substance be a fixed percentage unitrust with a percentage less than the 5% required by section 664(d)(2). Therefore, the proposed regulations will amend section 1.664-3(a)(1)(i)(b) to provide that income under the terms of the governing instrument and applicable local law may not be determined by reference to a fixed percentage of the annual fair market value of the trust property. If the applicable state law defines income as a unitrust amount, the governing instrument of a net income charitable remainder unitrust must provide its own definition of trust income. In addition, the proposed

regulations will provide that capital gains attributable to appreciation in the value of assets after the date contributed to the trust or purchased by the trust may be allocated to income under the terms of the governing instrument and applicable local law. Such an allocation, however, may not be discretionary with the trustee. The section 664 regulations already prohibit the allocation of pre-contribution gains to income.

Capital Gains and Distributable Net Income

Section 643(a)(3) provides that gains from the sale or exchange of capital assets are excluded from distributable net income to the extent that these gains are allocated to corpus and they are not either paid, credited, or required to be distributed, to a beneficiary during the year, or paid, permanently set aside, or to be used for a charitable purpose. The circumstances in which capital gains are considered paid or credited to a beneficiary during the year, and therefore included in distributable net income, are not entirely clear. In addition, the revisions to state law definitions of income have precipitated additional questions in this area. The question arises, for example, whether realized capital gains are included in the unitrust amount distributed to the income beneficiary under local law, if the unitrust amount exceeds the trust's ordinary income.

The proposed regulations will amend section 1.643(a)-3(a) to clarify the circumstances in which capital gains are includible in distributable net income for the year. In general, capital gains are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument or local law, or pursuant to a reasonable and consistent exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by the governing instrument or local law): allocated to income; allocated to corpus but treated by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or allocated to corpus but utilized by the fiduciary in determining the amount which is distributed or required to be distributed to a beneficiary. As is the case under the current regulations, capital gains that are paid, permanently set aside, or to be used for the purposes specified in section 642(c) are included in the distributable net income. Capital losses are netted at the trust level against any capital gains, except for a capital gain that is utilized in determining the amount that is distributed or required to be distributed to a particular beneficiary.

Under the proposed regulations, capital gains will be included in distributable net income under certain circumstances that are directed by the terms of the governing instrument and applicable local law. Thus, any capital gain that is included in the section 643(b) definition of income is included in distributable net income. Similarly, any capital gain that is used to determine the amount or the timing of a distribution to a beneficiary is included in distributable net income.

Capital gains are also included in distributable net income if the fiduciary, pursuant to a discretionary power granted by local law or by the governing instrument (if not inconsistent with local law), treats the capital gains as distributed to a beneficiary, provided the power is exercised in a reasonable and consistent manner. Thus, if a trustee exercises a discretionary power by consistently treating any distribution in excess of ordinary income as being made from realized capital gains, any capital gain so distributed is included in distributable net income.

The provisions of sections 643(b) and 643(a)(3) are further intertwined when consideration is given to the new state statutory provisions defining income. If, under the terms of the governing instrument or applicable local law, realized capital gains are treated as income to the extent the unitrust amount or the equitable adjustment amount exceeds ordinary income, capital gains so treated are included in distributable net income. A similar result is achieved for capital gains

consistently allocated to income by the fiduciary pursuant to a discretionary power. In any other situation, capital gains will be excluded from distributable net income and will be taxed to the trust.

Distributions in Kind

The proposed regulations will clarify the consequences of certain distributions of property in kind for purposes of the distribution deductions under sections 651 and 661. Thus, if property is distributed to a beneficiary in satisfaction of the beneficiary's right to income, the trust will be treated as having sold the property for its fair market value on the date of distribution.

Trusts Qualifying for Gift and Estate Tax Marital Deduction

Certain transfers of property in trust for the benefit of the spouse qualify for the marital deduction for gift and estate tax purposes. These transfers include a life estate with a general power of appointment described in sections 2523(e) and 2056(b)(5) and qualified terminal interest property described in sections 2523(f) and 2056(b)(7). One of the requirements of these provisions is that the spouse must be entitled for life to all the income from the trust property. The rules for determining whether the spouse is entitled to all the income from either a life estate with a general power of appointment trust or a qualified terminable interest trust are set forth in section 20.2056(b)-5(f) of the Estate Tax Regulations and section 25.2523(e)-1(f) of the Gift Tax Regulations. These rules provide that if an interest is transferred in trust, the spouse is entitled for life to all the income from the entire interest or a specific portion of the entire interest if the effect of the trust is to give the spouse substantially that degree of beneficial enjoyment of the trust property during the spouse's life which the principles of the law of trusts accord a person who is unqualifiedly designated as the life beneficiary of a trust.

The proposed regulations will provide that a spouse's interest satisfies the income standard set forth in sections 20.2056(b)-5(f) and 25.2523(e)-1(f) if the spouse is entitled to income as defined under a state statute that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of section 1.643(b)-1(a). As the examples under Section 1.643(b)-1(a) make clear, reasonable apportionment can be accomplished through a unitrust definition of income or by giving the trustee the power to make equitable adjustments between income and principal. In addition, a conforming amendment is made to section 20.2056A-5(c)(2) providing rules regarding distributions of income from a qualified domestic trust.

Trusts Exempt From Generation-Skipping Transfer Tax

In general, under the effective date rules accompanying the generation-skipping transfer (GST) tax statutory provisions, a trust that was irrevocable on September 25, 1985, is not subject to the GST tax provisions, unless a GST transfer is made out of corpus added to the trust after that date. Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (TRA), Public Law 99-514 (100 Stat. 2085, 2731), 1986-3 (Vol. 1) C.B. 1, 634. The regulations provide guidance on when certain changes made to the terms of an exempt trust will not be treated as causing the trust to lose its exempt or grandfathered status. One safe-harbor in section 26.2601-1(b)(4)(i)(D) is for modifications that will not shift a beneficial interest in the trust to a lower generation beneficiary or increase the amount of a GST transfer.

Under the proposed regulations, the administration of a pre-September 25, 1985 trust in conformance with a state law that defines income as a unitrust amount, or permits equitable

adjustments between income and principal to ensure impartiality, and that meets the requirements of section 1.643(b)-1(a) will not be treated as a modification that shifts a beneficial interest to a lower generation beneficiary, or increases the amount of a generation-skipping transfer.

Proposed Effective Date

The regulations are proposed to apply to trusts and estates for taxable years that begin on or after the date that final regulations are published in the Federal Register.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) and comments sent via the Internet that are submitted timely to the IRS. The IRS and Treasury request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying. A public hearing has been scheduled for June 8, 2001, in the IRS Auditorium, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Owing to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by May 18, 2001. A period of 10 minutes will be allotted to each person making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

Various personnel from offices of the IRS and the Treasury Department participated in the development of these proposed regulations.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 20

Estate taxes, Reporting and recordkeeping requirements.

26 CFR Part 25

Gift taxes, Reporting and recordkeeping requirements.

26 CFR Part 26

Estate taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1, 20, 25, and 26 are proposed to be amended as follows:

PART 1 -- INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In section 1.642(c)-2, paragraph (c) is amended by adding a sentence after the first sentence to read as follows:

Section 1.642(c)-2 Unlimited deduction for amounts permanently set aside for a charitable purpose.

* * * * *

(c) * * * No amount of net long-term capital gain shall be considered permanently set aside for charitable purposes if it is possible, under the terms of the fund's governing instrument or applicable local law, that the income beneficiaries' right to income may, at any time, be satisfied by the payment of either an amount equal to a fixed percentage of the annual fair market value of the trust property or any amount based on unrealized appreciation in the value of the trust property. * * *

* * * * *

Par. 3. Section 1.643(a)-3 is revised to read as follows:

Section 1.643(a)-3 Capital gains and losses.

(a) In general. Except as provided in section 1.643(a)-6 and in paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

(b) Capital gains included in distributable net income. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and consistent exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by local law or by the governing instrument, if not inconsistent with local law) --

(1) Allocated to income;

(2) Allocated to corpus but treated by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but utilized by the fiduciary in determining the amount which is distributed or required to be distributed to a beneficiary.

(c) Charitable contributions included in distributable net income. If capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

(d) Capital losses. Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See section 1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

(e) Examples. The following examples illustrate the rules of this section:

Example 1. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has \$5,000 of dividend income and \$10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the \$10,000 capital gain to principal. During the year, Trustee distributes to A \$5,000, representing A's right to trust income. In addition, Trustee distributes to A \$12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the \$10,000 of capital gain is taxed to the trust.

Example 2. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the \$10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.

Example 3. The facts are the same as in Example 1, except that pursuant to the terms of the governing instrument (in a provision not inconsistent with applicable local law), capital gains realized by Trust are allocated to income. Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the \$10,000 capital gain is included in Trust's distributable net income for the taxable year.

Example 4. The facts are the same as in Example 1, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is \$10,000, rather than \$12,000. Because Trustee will consistently use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the \$10,000 capital gain is included in Trust's distributable net income for the taxable year.

Example 5. Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Example 6. Under the terms of Trust's governing instrument, all income is to be paid to A during the Trust's term. When A reaches 35, Trust is to terminate and all the principal is to be distributed to A. All capital gains realized in the year of termination are included in distributable net income. See section 1.641(b)-3 for the determination of the year of final termination and the taxability of capital gains realized after the terminating event and before final distribution.

Example 7. The facts are the same as Example 6, except Trustee is directed to distribute only one-half of the principal to A when A reaches 35. Trust assets consist entirely of stock in corporation M. If Trustee sells one-half of the stock and distributes the sales proceeds to A, all the capital gain attributable to that sale is included in distributable net income. If Trustee sells all the stock and distributes one-half of the sales proceeds to A, one-half of the capital gain attributable to that sale is included in distributable net income.

Example 8. The facts are the same as Example 6, except Trustee is directed to pay B \$10,000 before distributing the remainder of Trust assets to A. No portion of the capital gains is allocable to B because the distribution to B is a gift of a specific sum of money within the meaning of section 663(a)(1).

Example 9. State law provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the annual fair market value of the trust assets in full satisfaction of that beneficiary's right to income. State law provides that this unitrust amount shall be considered paid first from ordinary income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under State law. Trustee makes the unitrust election under State law. At the beginning of the taxable year, Trust assets are valued at \$500,000. During the year, Trust receives \$5,000 of dividend income and realizes \$80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A \$20,000 (4% of \$500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of \$15,000 is allocated to income pursuant to the State law ordering rule and is included in distributable net income for the taxable year.

Example 10. The facts are the same as in Example 9, except that neither State law nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire \$80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment with respect to all realized capital gains.

Example 11. The facts are the same as in Example 9, except that neither State law nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves

such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary income. Trustee evidences this treatment by including \$15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary income.

Par. 4. Section 1.643(b)-1 is revised to read as follows:

Section 1.643(b)-1 Definition of income.

For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Internal Revenue Code, income, when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal, that is, allocating ordinary income to income and capital gains to principal, will generally not be recognized. However, amounts allocated between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary income, capital gains, and appreciation. For example, a state law that provides for the income beneficiary to receive each year a unitrust amount of between 3% and 5% of the annual fair market value of the trust assets is a reasonable apportionment of the total return of the trust. Similarly, a state law that permits the trustee to make equitable adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. These adjustments are permitted when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of income and principal is unable to administer the trust impartially. In addition, an allocation of capital gains to income will be respected if the allocation is made either pursuant to the terms of the governing instrument and local law, or pursuant to a reasonable and consistent exercise of a discretionary power granted to the fiduciary by local law or by the governing instrument, if not inconsistent with local law.

Par. 5. In section 1.651(a)-2, paragraph (d) is added to read as follows:

Section 1.651(a)-2 Income required to be distributed currently.

* * * * *

(d) If a trust distributes property in kind as part of its requirement to distribute currently all the income as defined under section 643(b) and the applicable regulations, the trust shall be treated as having sold the property for its fair market value on the date of distribution. If no amount in excess of the amount of income as defined under section 643(b) and the applicable regulations is distributed by the trust during the year, the trust will qualify for treatment under section 651 even though property in kind was distributed as part of a distribution of all such income.

Par. 6. In section 1.661(a)-2, paragraph (f) is revised to read as follows:

Section 1.661(a)-2 Deduction for distributions to beneficiaries.

* * * * *

(f) Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e).

Par. 7. In section 1.664-3, paragraph (a)(1)(i)(b)(3) is revised to read as follows:

Section 1.664-3 Charitable remainder unitrust.

(a) * * *

(1) * * *

(i) * * *

(b) * * *

(3) For purposes of this paragraph (a)(1)(i)(b), trust income generally means income as defined under section 643(b) and the applicable regulations. However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property. If applicable state law provides that income is a unitrust amount, the trust's governing instrument must contain its own definition of trust income. In addition, capital gain attributable to appreciation in the value of a trust asset after the date it was contributed to the trust or purchased by the trust may be allocated to income pursuant to applicable local law and the terms of the governing instrument but not pursuant to a discretionary power granted the trustee.

* * * * *

PART 20 -- ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Par. 8. The authority citation for part 20 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 9. Section 20.2056(b)-5 is amended by adding a new sentence to the end of paragraph (f)(1) to read as follows:

Section 20.2056(b)-5 Marital deduction; life estate with power of appointment in surviving spouse.

* * * * *

(f) * * * (1) * * * In addition, the surviving spouse's interest shall meet the condition set forth in paragraph (a)(1) of this section, if the spouse is entitled to income as defined by a state statute that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of section 1.643(b)-1 of the this chapter.

* * * * *

Par. 10. Section 20.2056(b)-7 is amended by adding a new sentence to the end of paragraph (d)(1) to read as follows:

Section 20.2056(b)-7 Election with respect to life estate for surviving spouse.

* * * * *

(d) * * * (1) * * * A power under applicable state law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries that meets the requirements of section 1.643(b)-1 of this chapter will not be considered a power to appoint trust property to a person other than the surviving spouse.

* * * * *

Par. 11. Section 20.2056(b)-10 is amended by adding a new sentence at the end of the section to read as follows:

Section 20.2056(b)-10 Effective dates.

* * * In addition, the rule in the last sentence of section 20.2056(b)-5(f)(1) and the rule in the last sentence of section 20.2056(b)-7(d)(1) regarding the spouse's right to income if the state statute provides for the reasonable apportionment between the income and remainder beneficiaries of the total return of the trust are applicable with respect to trusts for taxable years that begin on or after the date that final regulations are published in the Federal Register.

Par. 12. Section 20.2056A-5 is amended by adding a new sentence in paragraph (c)(2) after the third sentence to read as follows:

Section 20.2056A-5 Imposition of section 2056A estate tax..

* * * * *

(c) * * *

(2) * * * However, distributions made to the surviving spouse as the income beneficiary in conformance with applicable state law that defines the term income as a unitrust amount, or permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries, will be considered distributions of trust income, if the state statute provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of section 1.643(b)-1 of this chapter. * * *

* * * * *

Par. 13. Section 20.2056A-13 is revised to read as follows:

Section 20.2056A-13 Effective dates.

Except as provided in this section, the provisions of sections 20.2056A-1 through 20.2056A-12 are applicable with respect to estates of decedents dying after August 22, 1995. The rule in the fourth sentence of section 20.2056A-5(c) regarding unitrusts and distributions of income to the surviving spouse in conformance with applicable state law that provides for the reasonable apportionment between the income and remainder beneficiaries of the total return of the trust is applicable with respect to trusts for taxable years that begin on or after the date that final regulations are published in the Federal Register.

PART 25 -- GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 14. The authority citation for part 25 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 15. Section 25.2523(e)-1 is amended by adding a new sentence to the end of paragraph (f)(1) to read as follows:

Section 25.2523(e)-1 Marital deduction; life estate with power of appointment in donee spouse.

* * * * *

(f) * * * (1) * * * In addition, the spouse's interest shall meet the condition set forth in paragraph (a)(1) of this section, if the spouse is entitled to income as defined by a state statute that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of section 1.643(b)-1(a) of this chapter.

* * * * *

Par. 16. Section 25.2523(h)-2 is amended by adding a new sentence to the end of the section to read as follows:

Section 25.2523(h)-2 Effective dates.

* * * In addition, the rule in the fourth sentence of section 25.2523(e)-1(f)(1) regarding the spouse's right to income if the state statute provides for reasonable apportionment between the income and remainder beneficiaries of the total return of the trust is applicable with respect to trusts and estates for taxable years that begin on or after the date the final regulations are published in the Federal Register.

PART 26 -- GENERATION-SKIPPING TRANSFER TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1986

Par. 17. The authority citation for part 26 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 18. Section 26.2601-1 is amended as follows:

1. Paragraph (b)(4)(i)(D)(2) is amended by adding a new sentence to the end of the paragraph.
2. Paragraph (b)(4)(i)(E) is amended by adding Examples 11 and 12.
3. Paragraph (b)(4)(ii) is revised to read as follows.

The additions and revisions read as follows:

Section 26.2601-1 Effective dates.

* * * * *

(b) * * *

(4) * * *

(i) * * *

(D) * * *

(2) * * * In addition, administration of a trust in conformance with applicable state law that defines the term income as a unitrust amount, or permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries, will not be considered to shift a beneficial interest in the trust, if the state statute provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of section 1.643(b)-1 of this chapter.

(E) * * *

Example 11. Conversion of income interest to unitrust interest under state statute. In 1980, Grantor, a resident of State X, established an irrevocable trust for the benefit of Grantor's child, A, and A's issue. The trust provides that trust income is payable to A for life and upon A's death the remainder is to pass to A's issue, per stirpes. In 2002, State X amends its income and principal statute to define "income" as a unitrust amount of 4% of the fair market value of the trust assets valued annually. For a trust established prior to 2002, the statute provides that the new definition of income will apply only if all the beneficiaries who have an interest in the trust consent to the change within two years after the effective date of the statute. The statute provides specific procedures to establish the consent of the beneficiaries. A and A's issue consent to the change in the definition of income within the time period, and in accordance with the procedures, prescribed by the state statute. The administration of the trust, in accordance with the state statute defining income to be a 4% unitrust amount, will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

Example 12. Equitable adjustments under state statute. The facts are the same as in Example 11, except that in 2002, State X amends its income and principal statute to permit the trustee to make equitable adjustments between income and principal when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of income and principal is unable to administer the trust impartially. The provision permitting the trustees to make these equitable adjustments is effective in 2002 for trusts created at any time. The trustee invests and manages the trust assets under the state's prudent investor standard, and pursuant to authorization in the state statute, the trustee allocates receipts between the income and principal accounts in a manner to ensure the impartial administration of the trust. The administration of the trust in accordance with the state statute will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

(ii) Effective dates. The rules in this paragraph (b)(4) are applicable on and after December 20, 2000. However, the rule in the last sentence of paragraph (b)(4)(i)(D)(2) of this section regarding the administration of a trust in conformance with applicable state law providing for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust is applicable with respect to trusts for taxable years that begin on or after the date that final regulations are published in the Federal Register.

* * * * *

Robert E. Wenzel
Deputy Commissioner of Internal
Revenue

Exhibit B

PROPOSED IRC §§642, 643(b) and 664 REGULATIONS

Presented by

National Committee on Planned Giving

Scott Blakesley, President

with recognition for the efforts of

Craig C. Wruck, Chair, Government Relations Committee

And

Emanuel J. Kallina, II, Esq., Jonathan D. Ackerman, Esq.

and Steven R. Bone, Esq.

May 18, 2001

The National Committee on Planned Giving (NCPG) is a federation of over 110 local councils. NCPG's planned giving councils have more than 12,000 members nationwide whose work includes developing, marketing and administering charitable planned gifts. The National Committee on Planned Giving is the largest association of gift planning professionals in the country. This group includes charitable development staff, accountants, attorneys, financial planners, fundraising consultants, trust administrators and insurance professionals.

The mission of NCPG is to facilitate, coordinate and encourage the education and training of the planned giving community and to facilitate effective communication among the many different professionals in this community. NCPG is dedicated to improving the quality and quantity of planned gifts through the systematic education of professionals, donors and government officials across the country.

NCPG applauds the Treasury and the IRS in promulgating regulations in proposed form regarding §643 of the Internal Revenue Code of 1986, as amended (Code) and other related Sections of the Code, in attempting to deal with state law changes to the definitions of principal and income, federal tax provisions and the economic realities of the investment environment. The Proposed Regulations are intended to clarify issues regarding the nature and uses of increasingly popular "income exception" charitable remainder unitrusts (CRUTs) and traditional pooled income funds (PIFs), both of which are of significant benefit to charity.

Background

NCPG understands that the proposed update to the Code §§ 643(b) regulations and others affected by it was precipitated specifically by the following types of state law changes to definitions of fiduciary accounting income that generally permit the trustee of any type of trust to:

- (1) make an "equitable adjustment" between income and principal if necessary to ensure that both the income beneficiary and the remainder beneficiary are treated impartially, based on what is fair and reasonable to all of the beneficiaries;
- (2) pay a fixed percentage of the annual fair market value of the trust property (akin to a "unitrust amount" in a standard CRUT) to the income beneficiary in satisfaction of that beneficiary's right to the income from the trust.

State law provisions such as these are applicable to income exception CRUTs and PIFs by virtue of the Code §643(b) definition of trust income. This definition adopts *by reference* the applicable state law definition of fiduciary accounting income. Existing Treasury Regulation §1.643(b)-1 adds the caveat that trust provisions that depart fundamentally from the concepts of the applicable local law in determining what constitutes income will not be recognized. Historically, this definition of fiduciary income has worked well, and the flexibility it provides has been much appreciated by those who utilize split-interest charitable trusts. Nevertheless, the definition works only so long as the states do not promulgate definitions of fiduciary accounting income that directly interfere with other provisions of the Code that define how split-interest trusts like PIFs and income exception CRUTs are required to work for tax-qualification purposes.

Since state law provisions such as the two noted above could create interference with the intended operation and function of income exception CRUTs and PIFs, Treasury believes it is now necessary to modify the Regulations to: (1) clarify that defining fiduciary income in terms of a “unitrust amount” for income exception CRUTs will be impermissible if such trusts are to be tax-qualified under Code § 664; (2) allow the allocation of realized gains attributable to post-gift or post-purchase asset appreciation to fiduciary income pursuant to applicable local law and the terms of the trust’s governing instrument, but only if such allocations are non-discretionary by the trustee; and (3) provide a new limitation on the deductibility of net long-term capital gains permanently set aside by a PIF for charitable purposes, in situations where it is possible under the terms of the fund’s governing instrument or applicable local law that the PIF could satisfy the income beneficiaries right to income by allocating a fixed percentage of the annual fair market value of the fund’s assets to income or basing the income payment on unrealized appreciation in the value of the fund’s property.

These comments address each provision of the Proposed Regulations dealing with income exception CRUTs and PIFs with commentary and suggested considerations.

1. Income Exception CRUTs

A. NCPG supports the IRS and Treasury in attempting to curb any potential abuse in an income exception CRUT by applying a state law definition of income to include a “unitrust amount;” however, requiring a trust’s governing instrument to contain its own definition of fiduciary income will be overly burdensome and reach beyond the scope of the IRS’ and Treasury’s concern.

NCPG understands and agrees with Treasury’s reasons for prohibiting a “unitrust amount” definition of fiduciary accounting income with respect to an income exception CRUT. An income exception CRUT pays out the lesser of (i) a percentage (not less than 5%) of the annual fair market value of the trust’s assets, or (ii) the trust’s income. The definition of income in (ii) in the formula above is based upon Code §§643(b) and the Regulations thereunder (trust income). Under a state statute that sanctions trust income to be defined as a fixed percentage of the annual fair market value of the trust’s assets, the trustee of an income exception CRUT could allocate a fixed 3% unitrust percentage to trust income and essentially convert an income exception CRUT into a standard CRUT paying out less than the 5% required payout rate.

For example, if the CRUT owns \$100 of assets and earns no trust income (such as, interest, dividends or post-contribution capital gains, as it may be defined in the CRUT governing

instrument), the trustee could nevertheless allocate 3% (or \$3) to the income beneficiary as sanctioned under state law. Such a result is clearly inconsistent with Code §§664 and the Regulations thereunder.

Treasury's solution to this problem is stated in the Proposed Regulations, as follows:

“.....However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property. If applicable state law provides that income is a unitrust amount, the trust's governing instrument must contain its own definition of trust income.”

If state law permits trust income to be defined as a unitrust amount, the Proposed Regulations would require a trust's governing instrument to contain its own definition of trust income. Such a requirement is likely to create unnecessary uncertainty in the charitable gift planning community and unnecessarily complicate the drafting of income exception CRUTs. For instance, state law rarely mandates that trust income be defined in any fashion, and ordinarily provides absolute deference to the definition of trust income under the terms of the trust's governing instrument. In addition, if the trust is required to contain its own definition of trust income, drafters of income exception CRUTs will be required to address all aspects of what is, and is not, trust income in the governing instrument. Lastly, a complicated array of rules would need to be established to consider the fate of existing CRUTs in states where the law changes, i.e., will such trusts be “grandfathered” from these regulations or will a reasonable time period be established for a qualified reformation?

Since the IRS' and Treasury's concern relates to the conversion of an income exception CRUT into a less than 5% standard CRUT, the first sentence as proposed, with the modification reflected below, should be sufficient to curb any potential abuse.

“.....However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any provision in applicable state law to the contrary.”

Under this provision, trust income may not be determined based upon a unitrust amount, even if state law permits such an allocation. Therefore, an income exception CRUT cannot be converted into a standard CRUT based upon such a state law definition of trust income. Considering the fact that the above provision entirely eliminates this IRS and Treasury concern, requiring a definition of trust income in the trust's governing instrument, with its attendant complications, becomes unnecessary.

B. NCPG supports the position of the IRS and Treasury to permit the allocation of post-contribution and post-acquisition realized appreciation to trust income in an income exception CRUT.

IRS and Treasury have again voiced their support for the allocation of post-contribution and post-acquisition realized appreciation (Post-Gift Gain) to trust income. However, the IRS and Treasury now desire to prohibit the trustee of an income exception CRUT from being granted the discretion to allocate Post-Gift Gain to trust income, as follows:

“.....In addition, capital gain attributable to appreciation in the value of a trust asset after the date it was contributed to the trust or purchased by the trust may be allocated to income pursuant to applicable local law and the terms of the governing instrument but not pursuant to a discretionary power granted the trustee.”

In attempting to narrow the scope of its concern, the IRS and Treasury may perceive that a discretionary power granted the trustee to allocate Post-Gift Gain to trust income provides too much flexibility to the trustee to allocate receipts of trust income to the detriment of the charitable remainderman. Since only Post-Gift Gain can be allocated to trust income, NCPG does not think there is any risk to the charitable remainderman. The charitable deduction is based upon the fair market value of the assets contributed to the trust. If only Post-Gift Gain can be allocated to trust income, the charity will always receive at least the projected value of its remainder interest in the trust, and thus, the integrity of the calculation of the charitable deduction remains intact.

Nevertheless, the IRS and Treasury address this perceived potential risk by prohibiting the trustee from being granted this discretionary power either under state law or in the governing instrument. Existing income exception CRUTs and state law (especially with respect to the “equitable adjustment” right) may currently grant such a discretionary power to the trustee. Thus, the governing instruments of income exception CRUTs will have to be amended to clarify that the trustee is not granted this discretionary right, notwithstanding state law to the contrary. NCPG is concerned that the necessity to modify (or grandfather) existing CRUTs will be overly burdensome.

In addition, treating the income and remainder beneficiaries fairly and reasonably is the underlying rationale for the equitable adjustment theory. It is easy to imagine circumstances in which an “all or nothing” allocation of Post-Gift Gain to trust income would be less advantageous to the charitable remainderman, even though the pre-contribution gain remains intact for its benefit, and inconsistent with the donors/income beneficiaries desires.

For these reasons, NCPG respectfully opposes the position of the IRS and Treasury to prohibit the trustee of an income exception CRUT from being granted the discretion to allocate Post-Gift Gain in one taxable year to trust income in that taxable year.

2. Pooled Income Funds

NCPG respectfully opposes the proposal by the IRS and Treasury to disallow the charitable deduction for long-term capital gains permanently set aside for charity in a pooled income fund (PIF) where it is possible to satisfy the income beneficiaries’ right to income by the payment of either a unitrust amount or any amount based on unrealized appreciation.

The income that is paid out to the non-charitable income beneficiaries of a PIF is trust income as defined in Code Section 643(b) and the Regulations thereunder. Any amount of net long-term capital gain that, pursuant to the terms of the governing instrument, is permanently set aside for charitable purposes is eligible for a charitable income tax deduction to the PIF. Traditional principles of trust income limit the allocation of trust income to receipts from ordinary income-type investments.

Such limitation has essentially eliminated the PIF as an arrow in a gift planner's quiver. Under current market conditions and an increased awareness and acceptance of total return investing, charities are expending time and resources attempting to determine how best to terminate their PIFs, rather than revive them.

The IRS and Treasury have stated two legitimate concerns should the applicable state law ever be amended to treat trust income as a unitrust amount or permit the right to equitably adjust trust receipts between trust income and principal. First, if trust income can be defined as a unitrust amount, long-term capital gains realized in one year could be distributed in a subsequent year. Second, if the trustee has the right to equitably adjust trust receipts, an amount based upon unrealized appreciation could be allocated to trust income and distributed.

However, the Code refers to trust income as the amount that is distributed to a PIF's income beneficiaries, and absent statutory change, no regulatory limitation can be placed on the payout from a PIF. In addition, PIF governing instruments would be required to be amended (or grandfathered). Lastly, alternatives must be found that permit (i) total return investing in the PIF and (ii) the trustee, pursuant to the terms of the governing instrument, to allocate realized gains to trust income for distribution to the income beneficiaries. Under those circumstances, the charitable deduction should be available for any realized gains not otherwise distributed, and the PIF can be revitalized.

NCPG respectfully requests that the IRS and Treasury promote charitable giving by considering alternative means for more fully utilizing PIFs, taking into account current market conditions and the changing state laws.

3. Interpretation of the Proposed Regulations

NCPG desires that these Proposed Regulations clearly state the concerns of the IRS and Treasury and address them directly and narrowly.

Informal discussions with the IRS regarding the application of these Proposed Regulations have raised concerns in two major respects. First, apparently the IRS is requiring that the precise definition of trust income and principal used in a document must be drawn verbatim from a state statute; and second, that an allocation of Post-Gift Gain to trust income must be limited to 3%—5%.

A literal reading of the Proposed Regulations does not require that the definition of trust income, as stated in the governing instrument, identically track the specific definition of trust income under a particular state's principal and income act. Current Treasury Regulations under Code §§664, 642(c) and 643(b) recognize that the governing instrument plays a pivotal role in the definition of trust income. An IRS interpretation of these Regulations requiring a state statute to specifically authorize the definition of trust income as contained in a governing instrument would be inconsistent with these current Regulations and a literal reading of the Proposed Regulations.

In addition, such an interpretation would require substantive changes in a massive number of existing documents, including potentially all income exception CRUTs, marital deduction trusts under wills, various grantor retained income trusts, etc.

In addition, these Proposed Regulations do not limit the amount of Post-Gift Gain that can be allocated to trust income. To the contrary, these Regulations currently contemplate that all Post-Gift Gain (not subject to a discretionary power granted to the trustee) may be allocated to trust income. An interpretation of these Regulations to somehow limit the amount of Post-Gift Gains that can be allocated to trust income has no basis in law, would be inconsistent with the literal language of the Proposed Regulations and would create administrative problems as mentioned above in terms of re-writing many existing documents.

NCPG would be pleased to present any additional materials, documentation or analysis with respect to any of the issues raised in these comments and appreciates the opportunity to be heard.

Sparkling Ideas...



in the Emerald City

**INVESTING THE GIFT ANNUITY POOL:
A BALANCING ACT**

Janice H. Burrill
Senior Vice President
& National Director
Wells Fargo Bank
Private Client Services
Charitable Management Group
333 S. Grand Avenue, Suite 540
Los Angeles, CA 90071
(800) 930-4264
FAX (213) 680-4109
janiceb@wellsfargo.com

Paula B. Blacher, CFA
Vice President & Senior
Philanthropic Portfolio Manager
Wells Fargo Bank
Private Client Services
Charitable Management Group
333 S. Grand Avenue, Suite 540
Los Angeles, CA 90071
(800) 930-4264
FAX (213) 680-4109

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~ Investing the Gift Annuity Pool ~

A Balancing Act

by

Janice H. Burrill, J. D., Senior Vice President & National Director
Paula B. Blacher, CFA, Vice President & Senior Philanthropic Portfolio Manager
Wells Fargo Bank
Private Client Services
Charitable Management Group

"I advise you to go on living solely to enrage those who are paying your annuities. It is the only pleasure I have left." -Voltaire

I. Introduction – The Balancing Act

- ✓ At least 3 “Balls” in the air when making decisions on investing the gift annuity pool:
 1. The Charitable Environment
 2. The Federal and State Regulatory Environment
 3. The Economic and Investment Environment
- ✓ Other balls to juggle?

II. Ball One: The Charitable Environment

- ✓ Charitable Gift Annuities (“CGAs”) Mechanics:
 - Pay fixed income for life to one or two beneficiaries
 - Tax deduction and taxation of payments determined by IRS rules
 - Gift annuity rates are generally derived from the ACGA tables and *usually* exceed long term predictions of investment return
- ✓ Basic and Important Premise: CGAs are a general obligation of the issuing charity, which means the annuity payments are backed by the general assets of the nonprofit (donors like this if the charity is financially secure)

- ✓ The CGA investment scenario will vary depending on the structure that the charitable organization has adopted for managing CGAs. There are several common scenarios for handling CGA investments once the Planned Giving Office closes the CGA:
 1. Planned Giving Office hands over assets to Finance/Treasurer's Office to handle investments in-house.
 2. Planned Giving Office is actively involved in the investment policies internally.
 3. Planned Giving Office and/or Finance Office transfers assets to an outside service provider (typically a financial services institution).¹

- ✓ Regardless of the scenario followed, it is important to establish clear oversight responsibility between:
 - Planned Giving Office
 - Finance/Treasurer's Office
 - Board and/or investment committee

- ✓ There is not necessarily a "best" scenario, but it is important that the planned giving professional be involved and knowledgeable to speak to donors about the CGA payout rates and the assumptions upon which those payout rates are based.

- ✓ A quick review of several of the assumptions from ACGA for setting their rates (as of July, 2001):
 1. A total investment return of 6.5%²
 2. At the death of the annuitant(s), a residuum to the charity of at least 50% of the original contribution.
 3. The cumulative costs of administering the program (including investment of assets) will be 75 basis points per year.

- ✓ Example – Why it is important to understand these assumptions.

- ✓ Whether the charity handles CGA administration internally with its Finance Office or externally with a financial institution, communication between the Planned Giving Office and the Finance Office is vital for donor relations and future gifts!

¹ According to the ACGA 1999 Survey of Charitable Gift Annuities, more charities are outsourcing the investment and administration of CGAs. From 1994 to 1999, the percentage of charities outsourcing all investment responsibilities more than **tripled** from 16.3% to 56.2%.

² According to the same ACGA Survey, "Charities that retain outside investment managers consistently realize higher returns than charities that handle the investing internally."

Period	Annual Amount by which external managers exceed internal investors
Past year	80 basis points
Past five years	140 basis points
Past ten years	150 basis points

Thus, with external managers, a charity may have better results even after paying investment management fees."

III. Ball Two: The Regulatory Environment:

A. State Regulations (or not): Where you or your donors live is what you get

- ✓ A charity may be subject to *more than one* state's regulations: important to remember that if a charity is issuing gift annuities to donors in various states, you must check with each state where your donors reside regarding any regulatory requirements.
- ✓ State regulations concerning CGAs vary considerably:
 - Some states mandate reserve requirements and strictly define investment limitations for those reserves
 - e.g. California (see sample provisions), New Jersey
 - Some states mandate reserve requirements but allow greater investment latitude for those reserves (e.g. prudent investor standard)
 - e.g. Washington, Arizona, Florida, New York (recent change in New York – see sample provisions)
 - Some states are completely silent regarding gift annuities
 - e.g. Delaware, Rhode Island, West Virginia
 - The majority of states address gift annuities but do not specifically address reserve requirements and/or investments
- ✓ For a summary of state regulations on CGAs, see website:
www.pgresources.com

B. Uniform Prudent Investor Act (1994) – see Exhibit “A”

- ✓ Background on genesis of UPIA
- ✓ Standard of prudence applied to *entire* portfolio—all trust assets (not individual investments)
- ✓ Risk/return tradeoff is central consideration
- ✓ Diversification
- ✓ No category restrictions
- ✓ Delegation of fiduciary duty permitted

IV. **Ball Three: The Economic and Investment Environment**

A. Overview

- ✓ Investment Basics -- Considerations that apply regardless of the economic/financial market environment
- ✓ Investment Lessons of 2000/2001; Investment Environment 2002
- ✓ Themes for the new millennium – thinking large

B. Asset Allocation (stock/bond/cash mix) drives investment returns

- ✓ Over 90% of investment return amount, and variability of returns across time, stems from asset allocation decision (*Ibbotson & Kaplan, Financial Analysts Journal, Jan/Feb 2000*).
- ✓ Expected returns of different portfolio mixes (based upon current interest rates and 10 year historical equity returns)
 - 60% bonds/30% equities/10% cash: 6.3%
 - 50% bonds/40% equities/10% cash: 8.0%
 - 40% bonds/50% equities/10% cash: 9.0%

C. Balancing Act: Investing Gift Annuities Conceptual Overview

- ✓ Balancing investments (assets) with annuity payments (liabilities)
- ✓ Balancing growth with income
 - May be constrained by state regulations
 - Over time, will impact residuum
- ✓ Balancing risk (portfolio volatility) with return
 - Efficient frontier – the greater the expected return, the greater the risk (variability) of returns
 - Goal: For any given level of risk, the largest return or, conversely, for any given return, the least amount of risk
- ✓ Balancing through diversification of assets
 - May be constrained by state regulations or preferences
 - Adding asset classes with returns that are less than perfectly correlated will lower risk; the lower the correlation, the greater the risk reduction
 - For example, small-capitalization or international equities to a large capitalization portfolio will lower risk
 - Adding bonds to an equity portfolio will lower risk more because the correlation between stocks and bonds is low

D. Balancing (Diversifying) the Pool's Equity Segment

- ✓ Active vs. Passive
 - Actively managed vs. index or exchange traded funds
 - Index funds have low cost structures but cannot be customized to meet individual organization's needs
 - Exchange traded funds (ETFs) trade like stocks but beware of liquidity
 - Top down vs. Bottom Up
 - Analyzing the economy, industry, and then picking stocks vs
 - Picking stocks that meet the manager's specific investment criteria
- ✓ Style Investing
 - Growth vs. Value; Blend
 - The two dominant styles in the U.S. equity market
 - They tend to be negatively correlated (when one performs well, the other does not...)
 - Sector investing (e.g., technology, health)
- ✓ Capitalization choices (US Markets)
 - Large cap, mid-cap, small cap
- ✓ Alternative markets (typically through mutual funds)
 - International, world regional, emerging markets, real estate, hedge

E. Balancing (Diversifying) the Pool's Fixed Income Segment

- ✓ Active vs Passive
 - Total return vs. laddered maturities
- ✓ Governments, Agencies, Corporates, Mortgages
 - Short, intermediate, long term
- ✓ Alternative markets
 - High yield ("junk"), international bonds

F. Back to the Future: Investment Lessons of 2000 & 2001 - Living with Volatility

- ✓ Diversification reduces risk
 - 2 types of risk
 1. System risk: Affects all stocks
 - ❖ Market risk, purchasing power risk, political/event risk, interest rate risk
 2. Non-System risk: Affects groups of specific stocks
 - ❖ Industry/sector risk
 - ❖ Company risk

- ✓ Stocks don't always go up
 - Worst back-to-back 2 year period in 25 years
 - But then neither do bonds! (e.g., 1999)
- ✓ Volatility is a **VERY** important issue
 - Annuity payments must be paid regardless of the financial market environment
- ✓ Economic environments can change
 - Financial markets react
 - Low interest rate/low inflation
- ✓ 9/11 ramifications
- ✓ Goal: Match investment pool with annuity payments while providing for growth
- ✓ Have an appropriate long-term strategy and stick with it: *When the going gets tough – the tough take a long-term view!*

G. Investment Environment 2002: US Economy

- ✓ Growth
 - Recession appears to have been relatively mild
 - Consensus: Growth to resume during second half 2002
 - Inventory rebuilding will aid growth; consumer is 2/3 of US economy
- ✓ Inflation
 - Expected to remain mild (businesses have very little pricing power) although higher levels of government spending could cause prices to rise
- ✓ Interest rates
 - Began 2002 at 40 year lows with short-term “real” (inflation adjusted) rates below zero
 - As the economy improves will the Fed become less accommodative? Watch the yield curve
- ✓ Earnings
 - Remain vulnerable as economy emerges from 2001's recession/slow down.
 - Earnings “comps” much easier in second half
- ✓ Valuations
 - Earnings are key; It is earnings that drive stock prices higher. However, inflation and interest rates also play an important role in valuation. (Best of all possible worlds (1) Earnings improve and (2) valuations, for example price/earnings multiples, expand)
- ✓ 9/11's legacy: Event risk will always be with us and, therefore, expect volatility

H. Looking Forward: Long Term Investment Themes

- ✓ Economic “Triple Crown”
Moderate inflation, moderate to low interest rates, fiscal stimulation
- ✓ Worldwide “boomers” are graying
Retirement investments; Healthcare
- ✓ Productivity gains
Drive earnings; dampen inflation
- ✓ Globalization
Governments move to open market economies; expanding trade agreements;
capital flows more freely, lowering its costs; manufacturing “portability” favors
efficient producers

I. Balancing Needs for the Long Term: Developing an Investment Strategy

The Role of the Investment Committee:

- ✓ Adopt investment policies appropriate to the unique needs of gift annuities
- ✓ Establish investment objectives
- ✓ Hire consultants/managers and/or invest in a diversified mix of index funds
- ✓ Exercise oversight on a regular basis
 - Not more than quarterly; not less than annually
- ✓ Rebalance portfolio when asset classes diverge from normal mix

V. Conclusions: Balancing all the Balls at Once

It is important to bring all these factors together for a viable and successful gift annuity program:

- ✓ Procedure to handle assets once gift closes
- ✓ Competent and experienced investment management
- ✓ Investment Policy Statement
- ✓ Stewardship of donors
- ✓ Establish clear oversight responsibility

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UNIFORM PRUDENT INVESTOR ACT

PREFATORY NOTE

Over the quarter century from the late 1960's the investment practices of fiduciaries experienced significant change. The Uniform Prudent Investor Act (UPIA) undertakes to update trust investment law in recognition of the alterations that have occurred in investment practice. These changes have occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as "modern portfolio theory."

This Act draws upon the revised standards for prudent trust investment promulgated by the American Law Institute in its Restatement (Third) of Trusts: Prudent Investor Rule (1992) [hereinafter Restatement of Trusts 3d: Prudent Investor Rule; also referred to as 1992 Restatement].

Objectives of the Act. UPIA makes five fundamental alterations in the former criteria for prudent investing. All are to be found in the Restatement of Trusts 3d: Prudent Investor Rule.

(1) The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term "portfolio" embraces all the trust's assets. UPIA § 2(b).

(2) The tradeoff in all investing between risk and return is identified as the fiduciary's central consideration. UPIA § 2(b).

(3) All categorical restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing. UPIA § 2(e).

(4) The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing. UPIA § 3.

(5) The much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards. UPIA § 9.

Literature. These changes in trust investment law have been presaged in an extensive body of practical and scholarly writing. See especially the discussion and reporter's notes by Edward C. Halbach, Jr., in Restatement of Trusts 3d: Prudent Investor Rule (1992); see also Edward C. Halbach, Jr., Trust Investment Law in the Third Restatement, 27 Real Property, Probate & Trust J. 407 (1992); Bevis Longstreth, Modern Investment Management and the Prudent Man Rule (1986); Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U.L. Rev. 52 (1987); John H. Langbein & Richard A. Posner, The Revolution in Trust Investment Law, 62 A.B.A.J. 887 (1976); Note, The Regulation of Risky Investments, 83 Harvard L. Rev. 603 (1970). A succinct account of the main findings of modern portfolio theory, written for lawyers, is Jonathan R. Macey, An Introduction to Modern Financial Theory (1991) (American College of Trust & Estate Counsel Foundation). A leading introductory text on modern portfolio theory is R.A. Brealey, An Introduction to Risk and Return from Common Stocks (2d ed. 1983).

Legislation. Most states have legislation governing trust-investment law. This Act promotes uniformity of state law on the basis of the new consensus reflected in the Restatement of Trusts 3d: Prudent Investor Rule. Some states have already acted. California, Delaware, Georgia, Minnesota, Tennessee, and Washington revised their prudent investor legislation to emphasize the total-portfolio standard of care in advance of the 1992 Restatement. These statutes are extracted and discussed in Restatement of Trusts 3d: Prudent Investor Rule § 227, reporter's note, at 60-66 (1992).

Drafters in Illinois in 1991 worked from the April 1990 "Proposed Final Draft" of the Restatement of Trusts 3d: Prudent Investor Rule and enacted legislation that is closely modeled on the new Restatement. 760 ILCS § 5/5 (prudent investing); and § 5/5.1 (delegation) (1992). As the Comments to this Uniform Prudent Investor Act reflect, the Act draws upon the Illinois statute in several sections. Virginia revised its prudent investor act in a similar vein in 1992. Virginia Code § 26-45.1 (prudent investing) (1992). Florida revised its statute in 1993. Florida Laws, ch. 93-257, amending Florida Statutes § 518.11 (prudent investing) and creating § 518.112 (delegation). New York legislation drawing on the new Restatement and on a preliminary version of this Uniform Prudent Investor Act was enacted in 1994. N.Y. Assembly Bill 11683-B, Ch. 609 (1994), adding Estates, Powers and Trusts Law § 11-2.3 (Prudent Investor Act).

Remedies. This Act does not undertake to address issues of remedy law or the computation of damages in trust matters. Remedies are the subject of a reasonably distinct body of doctrine. See generally Restatement (Second) of Trusts §§ 197-226A (1959) [hereinafter cited as Restatement of Trusts 2d; also referred to as 1959 Restatement].

Implications for charitable and pension trusts. This Act is centrally concerned with the investment responsibilities arising under the private gratuitous trust, which is the common vehicle for conditioned wealth transfer within the family. Nevertheless, the prudent investor rule also bears on charitable and pension trusts, among others. “In making investments of trust funds the trustee of a charitable trust is under a duty similar to that of the trustee of a private trust.” Restatement of Trusts 2d § 389 (1959). The Employee Retirement Income Security Act (ERISA), the federal regulatory scheme for pension trusts enacted in 1974, absorbs trust-investment law through the prudence standard of ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a). The Supreme Court has said: “ERISA’s legislative history confirms that the Act’s fiduciary responsibility provisions ‘codif[y] and mak[e] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts.’” *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 110-11 (1989) (footnote omitted).

Other fiduciary relationships. The Uniform Prudent Investor Act regulates the investment responsibilities of trustees. Other fiduciaries – such as executors, conservators, and guardians of the property – sometimes have responsibilities over assets that are governed by the standards of prudent investment. It will often be appropriate for states to adapt the law governing investment by trustees under this Act to these other fiduciary regimes, taking account of such changed circumstances as the relatively short duration of most executorships and the intensity of court supervision of conservators and guardians in some jurisdictions. The present Act does not undertake to adjust trust-investment law to the special circumstances of the state schemes for administering decedents’ estates or conducting the affairs of protected persons.

Although the Uniform Prudent Investor Act by its terms applies to trusts and not to charitable corporations, the standards of the Act can be expected to inform the investment responsibilities of directors and officers of charitable corporations. As the 1992 Restatement observes, “the duties of the members of the governing board of a charitable corporation are generally similar to the duties of the trustee of a charitable trust.” Restatement of Trusts 3d: Prudent Investor Rule § 379, Comment *b*, at 190 (1992). See also *id.* § 389, Comment *b*, at 190-91 (absent contrary statute or other provision, prudent investor rule applies to investment of funds held for charitable corporations).

UNIFORM PRUDENT INVESTOR ACT

SECTION 1. PRUDENT INVESTOR RULE.

(a) Except as otherwise provided in subsection (b), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this [Act].

(b) The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.

Comment

This section imposes the obligation of prudence in the conduct of investment functions and identifies further sections of the Act that specify the attributes of prudent conduct.

Origins. The prudence standard for trust investing traces back to *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830). Trustees should “observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.” *Id.* at 461.

Prior legislation. The Model Prudent Man Rule Statute (1942), sponsored by the American Bankers Association, undertook to codify the language of the *Amory* case. See Mayo A. Shattuck, *The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century*, 12 Ohio State L.J. 491, at 501 (1951); for the text of the model act, which inspired many state statutes, see *id.* at 508-09. Another prominent codification of the *Amory* standard is Uniform Probate Code § 7-302 (1969), which provides that “the trustee shall observe the standards in dealing with the trust assets that would be observed by a prudent man dealing with the property of another”

Congress has imposed a comparable prudence standard for the administration of pension and employee benefit trusts in the Employee Retirement Income Security Act (ERISA), enacted in 1974. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a), provides that “a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a

prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims”

Prior Restatement. The Restatement of Trusts 2d (1959) also tracked the language of the *Amory* case: “In making investments of trust funds the trustee is under a duty to the beneficiary . . . to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived” Restatement of Trusts 2d § 227 (1959).

Objective standard. The concept of prudence in the judicial opinions and legislation is essentially relational or comparative. It resembles in this respect the “reasonable person” rule of tort law. A prudent trustee behaves as other trustees similarly situated would behave. The standard is, therefore, objective rather than subjective. Sections 2 through 9 of this Act identify the main factors that bear on prudent investment behavior.

Variation. Almost all of the rules of trust law are default rules, that is, rules that the settlor may alter or abrogate. Subsection (b) carries forward this traditional attribute of trust law. Traditional trust law also allows the beneficiaries of the trust to excuse its performance, when they are all capable and not misinformed. Restatement of Trusts 2d § 216 (1959).

SECTION 2. STANDARD OF CARE; PORTFOLIO STRATEGY; RISK AND RETURN OBJECTIVES.

(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

- (1) general economic conditions;

- (2) the possible effect of inflation or deflation;
 - (3) the expected tax consequences of investment decisions or strategies;
 - (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
 - (5) the expected total return from income and the appreciation of capital;
 - (6) other resources of the beneficiaries;
 - (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and
 - (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.
- (d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.
- (e) A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act].
- (f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

Comment

Section 2 is the heart of the Act. Subsections (a), (b), and (c) are patterned loosely on the language of the Restatement of Trusts 3d: Prudent Investor Rule § 227 (1992), and on the 1991 Illinois statute, 760 § ILCS 5/5a (1992). Subsection (f) is derived from Uniform Probate Code § 7-302 (1969).

Objective standard. Subsection (a) of this Act carries forward the relational and objective standard made familiar in the *Amory* case, in earlier prudent investor legislation, and in the Restatements. Early formulations of the prudent person rule were sometimes troubled by the effort to distinguish between the standard of a prudent person investing for another and investing on his or her own account. The language of subsection (a), by relating the trustee's duty to "the purposes, terms, distribution requirements, and other circumstances of the trust,"

should put such questions to rest. The standard is the standard of the prudent investor similarly situated.

Portfolio standard. Subsection (b) emphasizes the consolidated portfolio standard for evaluating investment decisions. An investment that might be imprudent standing alone can become prudent if undertaken in sensible relation to other trust assets, or to other nontrust assets. In the trust setting the term “portfolio” embraces the entire trust estate.

Risk and return. Subsection (b) also sounds the main theme of modern investment practice, sensitivity to the risk/return curve. See generally the works cited in the Prefatory Note to this Act, under “Literature.” Returns correlate strongly with risk, but tolerance for risk varies greatly with the financial and other circumstances of the investor, or in the case of a trust, with the purposes of the trust and the relevant circumstances of the beneficiaries. A trust whose main purpose is to support an elderly widow of modest means will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth.

Subsection (b) of this Act follows Restatement of Trusts 3d: Prudent Investor Rule § 227(a), which provides that the standard of prudent investing “requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.”

Factors affecting investment. Subsection (c) points to certain of the factors that commonly bear on risk/return preferences in fiduciary investing. This listing is nonexclusive. Tax considerations, such as preserving the stepped up basis on death under Internal Revenue Code § 1014 for low-basis assets, have traditionally been exceptionally important in estate planning for affluent persons. Under the present recognition rules of the federal income tax, taxable investors, including trust beneficiaries, are in general best served by an investment strategy that minimizes the taxation incident to portfolio turnover. See generally Robert H. Jeffrey & Robert D. Arnott, *Is Your Alpha Big Enough to Cover Its Taxes?*, *Journal of Portfolio Management* 15 (Spring 1993).

Another familiar example of how tax considerations bear upon trust investing: In a regime of pass-through taxation, it may be prudent for the trust to buy lower yielding tax-exempt securities for high-bracket taxpayers, whereas it would ordinarily be imprudent for the trustees of a charitable trust, whose income is tax exempt, to accept the lowered yields associated with tax-exempt securities.

When tax considerations affect beneficiaries differently, the trustee's duty of impartiality requires attention to the competing interests of each of them.

Subsection (c)(8), allowing the trustee to take into account any preferences of the beneficiaries respecting heirlooms or other prized assets, derives from the Illinois act, 760 ILCS § 5/5(a)(4) (1992).

Duty to monitor. Subsections (a) through (d) apply both to investing and managing trust assets. "Managing" embraces monitoring, that is, the trustee's continuing responsibility for oversight of the suitability of investments already made as well as the trustee's decisions respecting new investments.

Duty to investigate. Subsection (d) carries forward the traditional responsibility of the fiduciary investor to examine information likely to bear importantly on the value or the security of an investment – for example, audit reports or records of title. E.g., *Estate of Collins*, 72 Cal. App. 3d 663, 139 Cal. Rptr. 644 (1977) (trustees lent on a junior mortgage on unimproved real estate, failed to have land appraised, and accepted an unaudited financial statement; held liable for losses).

Abrogating categoric restrictions. Subsection 2(e) clarifies that no particular kind of property or type of investment is inherently imprudent. Traditional trust law was encumbered with a variety of categoric exclusions, such as prohibitions on junior mortgages or new ventures. In some states legislation created so-called "legal lists" of approved trust investments. The universe of investment products changes incessantly. Investments that were at one time thought too risky, such as equities, or more recently, futures, are now used in fiduciary portfolios. By contrast, the investment that was at one time thought ideal for trusts, the long-term bond, has been discovered to import a level of risk and volatility – in this case, inflation risk – that had not been anticipated. Accordingly, section 2(e) of this Act follows Restatement of Trusts 3d: Prudent Investor Rule in abrogating categoric restrictions. The Restatement says: "Specific investments or techniques are not per se prudent or imprudent. The riskiness of a specific property, and thus the propriety of its inclusion in the trust estate, is not judged in the abstract but in terms of its anticipated effect on the particular trust's portfolio." Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment f, at 24 (1992). The premise of subsection 2(e) is that trust beneficiaries are better protected by the Act's emphasis on close attention to risk/return objectives as prescribed in subsection 2(b) than in attempts to identify categories of investment that are per se prudent or imprudent.

The Act impliedly disavows the emphasis in older law on avoiding "speculative" or "risky" investments. Low levels of risk may be appropriate in

some trust settings but inappropriate in others. It is the trustee's task to invest at a risk level that is suitable to the purposes of the trust.

The abolition of categoric restrictions against types of investment in no way alters the trustee's conventional duty of loyalty, which is reiterated for the purposes of this Act in Section 5. For example, were the trustee to invest in a second mortgage on a piece of real property owned by the trustee, the investment would be wrongful on account of the trustee's breach of the duty to abstain from self-dealing, even though the investment would no longer automatically offend the former categoric restriction against fiduciary investments in junior mortgages.

Professional fiduciaries. The distinction taken in subsection (f) between amateur and professional trustees is familiar law. The prudent investor standard applies to a range of fiduciaries, from the most sophisticated professional investment management firms and corporate fiduciaries, to family members of minimal experience. Because the standard of prudence is relational, it follows that the standard for professional trustees is the standard of prudent professionals; for amateurs, it is the standard of prudent amateurs. Restatement of Trusts 2d § 174 (1959) provides: "The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill." Case law strongly supports the concept of the higher standard of care for the trustee representing itself to be expert or professional. See Annot., Standard of Care Required of Trustee Representing Itself to Have Expert Knowledge or Skill, 91 A.L.R. 3d 904 (1979) & 1992 Supp. at 48-49.

The Drafting Committee declined the suggestion that the Act should create an exception to the prudent investor rule (or to the diversification requirement of Section 3) in the case of smaller trusts. The Committee believes that subsections (b) and (c) of the Act emphasize factors that are sensitive to the traits of small trusts; and that subsection (f) adjusts helpfully for the distinction between professional and amateur trusteeship. Furthermore, it is always open to the settlor of a trust under Section 1(b) of the Act to reduce the trustee's standard of care if the settlor deems such a step appropriate. The official comments to the 1992 Restatement observe that pooled investments, such as mutual funds and bank common trust funds, are especially suitable for small trusts. Restatement of Trusts 3d: Prudent Investor Rule § 227, Comments *h, m*, at 28, 51; reporter's note to Comment *g*, *id.* at 83.

Matters of proof. Although virtually all express trusts are created by written instrument, oral trusts are known, and accordingly, this Act presupposes no

formal requirement that trust terms be in writing. When there is a written trust instrument, modern authority strongly favors allowing evidence extrinsic to the instrument to be consulted for the purpose of ascertaining the settlor's intent. See Uniform Probate Code § 2-601 (1990), Comment; Restatement (Third) of Property: Donative Transfers (Preliminary Draft No. 2, ch. 11, Sept. 11, 1992).

SECTION 3. DIVERSIFICATION. A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

Comment

The language of this section derives from Restatement of Trusts 2d § 228 (1959). ERISA insists upon a comparable rule for pension trusts. ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C). Case law overwhelmingly supports the duty to diversify. See Annot., Duty of Trustee to Diversify Investments, and Liability for Failure to Do So, 24 A.L.R. 3d 730 (1969) & 1992 Supp. at 78-79.

The 1992 Restatement of Trusts takes the significant step of integrating the diversification requirement into the concept of prudent investing. Section 227(b) of the 1992 Restatement treats diversification as one of the fundamental elements of prudent investing, replacing the separate section 228 of the Restatement of Trusts 2d. The message of the 1992 Restatement, carried forward in Section 3 of this Act, is that prudent investing ordinarily requires diversification.

Circumstances can, however, overcome the duty to diversify. For example, if a tax-sensitive trust owns an underdiversified block of low-basis securities, the tax costs of recognizing the gain may outweigh the advantages of diversifying the holding. The wish to retain a family business is another situation in which the purposes of the trust sometimes override the conventional duty to diversify.

Rationale for diversification. "Diversification reduces risk . . . [because] stock price movements are not uniform. They are imperfectly correlated. This means that if one holds a well diversified portfolio, the gains in one investment will cancel out the losses in another." Jonathan R. Macey, *An Introduction to Modern Financial Theory* 20 (American College of Trust and Estate Counsel Foundation, 1991). For example, during the Arab oil embargo of 1973, international oil stocks suffered declines, but the shares of domestic oil producers and coal companies benefitted. Holding a broad enough portfolio allowed the investor to set off, to some extent, the losses associated with the embargo.

Modern portfolio theory divides risk into the categories of “compensated” and “uncompensated” risk. The risk of owning shares in a mature and well-managed company in a settled industry is less than the risk of owning shares in a start-up high-technology venture. The investor requires a higher expected return to induce the investor to bear the greater risk of disappointment associated with the start-up firm. This is compensated risk – the firm pays the investor for bearing the risk. By contrast, nobody pays the investor for owning too few stocks. The investor who owned only international oils in 1973 was running a risk that could have been reduced by having configured the portfolio differently – to include investments in different industries. This is uncompensated risk – nobody pays the investor for owning shares in too few industries and too few companies. Risk that can be eliminated by adding different stocks (or bonds) is uncompensated risk. The object of diversification is to minimize this uncompensated risk of having too few investments. “As long as stock prices do not move exactly together, the risk of a diversified portfolio will be less than the average risk of the separate holdings.” R.A. Brealey, *An Introduction to Risk and Return from Common Stocks* 103 (2d ed. 1983).

There is no automatic rule for identifying how much diversification is enough. The 1992 Restatement says: “Significant diversification advantages can be achieved with a small number of well-selected securities representing different industries Broader diversification is usually to be preferred in trust investing,” and pooled investment vehicles “make thorough diversification practical for most trustees.” Restatement of Trusts 3d: Prudent Investor Rule § 227, General Note on Comments *e-h*, at 77 (1992). See also Macey, *supra*, at 23-24; Brealey, *supra*, at 111-13.

Diversifying by pooling. It is difficult for a small trust fund to diversify thoroughly by constructing its own portfolio of individually selected investments. Transaction costs such as the round-lot (100 share) trading economies make it relatively expensive for a small investor to assemble a broad enough portfolio to minimize uncompensated risk. For this reason, pooled investment vehicles have become the main mechanism for facilitating diversification for the investment needs of smaller trusts.

Most states have legislation authorizing common trust funds; see 3 Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 227.9, at 463-65 n.26 (4th ed. 1988) (collecting citations to state statutes). As of 1992, 35 states and the District of Columbia had enacted the Uniform Common Trust Fund Act (UCTFA) (1938), overcoming the rule against commingling trust assets and expressly enabling banks and trust companies to establish common trust funds. 7 Uniform Laws Ann. 1992 Supp. at 130 (schedule of adopting states). The Prefatory Note to the UCTFA explains: “The purposes of such a common or joint investment fund are to diversify

the investment of the several trusts and thus spread the risk of loss, and to make it easy to invest any amount of trust funds quickly and with a small amount of trouble." 7 Uniform Laws Ann. 402 (1985).

Fiduciary investing in mutual funds. Trusts can also achieve diversification by investing in mutual funds. See Restatement of Trusts 3d: Prudent Investor Rule, § 227, Comment *m*, at 99-100 (1992) (endorsing trust investment in mutual funds). ERISA § 401(b)(1), 29 U.S.C. § 1101(b)(1), expressly authorizes pension trusts to invest in mutual funds, identified as securities "issued by an investment company registered under the Investment Company Act of 1940"

SECTION 4. DUTIES AT INCEPTION OF TRUSTEESHIP. Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this [Act].

Comment

Section 4, requiring the trustee to dispose of unsuitable assets within a reasonable time, is old law, codified in Restatement of Trusts 3d: Prudent Investor Rule § 229 (1992), lightly revising Restatement of Trusts 2d § 230 (1959). The duty extends as well to investments that were proper when purchased but subsequently become improper. Restatement of Trusts 2d § 231 (1959). The same standards apply to successor trustees, see Restatement of Trusts 2d § 196 (1959).

The question of what period of time is reasonable turns on the totality of factors affecting the asset and the trust. The 1959 Restatement took the view that "[o]rdinarily any time within a year is reasonable, but under some circumstances a year may be too long a time and under other circumstances a trustee is not liable although he fails to effect the conversion for more than a year." Restatement of Trusts 2d § 230, comment *b* (1959). The 1992 Restatement retreated from this rule of thumb, saying, "No positive rule can be stated with respect to what constitutes a reasonable time for the sale or exchange of securities." Restatement of Trusts 3d: Prudent Investor Rule § 229, comment *b* (1992).

The criteria and circumstances identified in Section 2 of this Act as bearing upon the prudence of decisions to invest and manage trust assets also pertain to the prudence of decisions to retain or dispose of inception assets under this section.

SECTION 5. LOYALTY. A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.

Comment

The duty of loyalty is perhaps the most characteristic rule of trust law, requiring the trustee to act exclusively for the beneficiaries, as opposed to acting for the trustee's own interest or that of third parties. The language of Section 4 of this Act derives from Restatement of Trusts 3d: Prudent Investor Rule § 170 (1992), which makes minute changes in Restatement of Trusts 2d § 170 (1959).

The concept that the duty of prudence in trust administration, especially in investing and managing trust assets, entails adherence to the duty of loyalty is familiar. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B), extracted in the Comment to Section 1 of this Act, effectively merges the requirements of prudence and loyalty. A fiduciary cannot be prudent in the conduct of investment functions if the fiduciary is sacrificing the interests of the beneficiaries.

The duty of loyalty is not limited to settings entailing self-dealing or conflict of interest in which the trustee would benefit personally from the trust. "The trustee is under a duty to the beneficiary in administering the trust not to be guided by the interest of any third person. Thus, it is improper for the trustee to sell trust property to a third person for the purpose of benefitting the third person rather than the trust." Restatement of Trusts 2d § 170, comment *q*, at 371 (1959).

No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries – for example, by accepting below-market returns – in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause. See, e.g., John H. Langbein & Richard Posner, *Social Investing and the Law of Trusts*, 79 *Michigan L. Rev.* 72, 96-97 (1980) (collecting authority). For pension trust assets, see generally Ian D. Lanoff, *The Social Investment of Private Pension Plan Assets: May it Be Done Lawfully under ERISA?*, 31 *Labor L.J.* 387 (1980). Commentators supporting social investing tend to concede the overriding force of the duty of loyalty. They argue instead that particular schemes of social investing may not result in below-market returns. See, e.g., Marcia O'Brien Hylton, "Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market, 42 *American U.L. Rev.* 1 (1992). In 1994 the Department of Labor issued an Interpretive Bulletin reviewing its prior analysis of social investing questions and reiterating that pension trust fiduciaries may invest only in conformity with the prudence and loyalty standards of ERISA §§ 403-404. Interpretive Bulletin 94-1, 59 *Fed. Regis.* 32606 (Jun. 22, 1994), to be codified as 29 CFR § 2509.94-1. The Bulletin reminds fiduciary investors that they are prohibited from "subordinat[ing]

the interests of participants and beneficiaries in their retirement income to unrelated objectives.”

SECTION 6. IMPARTIALITY. If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.

Comment

The duty of impartiality derives from the duty of loyalty. When the trustee owes duties to more than one beneficiary, loyalty requires the trustee to respect the interests of all the beneficiaries. Prudence in investing and administration requires the trustee to take account of the interests of all the beneficiaries for whom the trustee is acting, especially the conflicts between the interests of beneficiaries interested in income and those interested in principal.

The language of Section 6 derives from Restatement of Trusts 2d § 183 (1959); see also *id.*, § 232. Multiple beneficiaries may be beneficiaries in succession (such as life and remainder interests) or beneficiaries with simultaneous interests (as when the income interest in a trust is being divided among several beneficiaries).

The trustee’s duty of impartiality commonly affects the conduct of investment and management functions in the sphere of principal and income allocations. This Act prescribes no regime for allocating receipts and expenses. The details of such allocations are commonly handled under specialized legislation, such as the Revised Uniform Principal and Income Act (1962) (which is presently under study by the Uniform Law Commission with a view toward further revision).

SECTION 7. INVESTMENT COSTS. In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.

Comment

Wasting beneficiaries’ money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs.

The language of Section 7 derives from Restatement of Trusts 2d § 188 (1959). The Restatement of Trusts 3d says: “Concerns over compensation and

other charges are not an obstacle to a reasonable course of action using mutual funds and other pooling arrangements, but they do require special attention by a trustee. . . . [I]t is important for trustees to make careful cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio.” Restatement of Trusts 3d: Prudent Investor Rule § 227, comment *m*, at 58 (1992).

SECTION 8. REVIEWING COMPLIANCE. Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee’s decision or action and not by hindsight.

Comment

This section derives from the 1991 Illinois act, 760 ILCS 5/5(a)(2) (1992), which draws upon Restatement of Trusts 3d: Prudent Investor Rule § 227, comment *b*, at 11 (1992). Trustees are not insurers. Not every investment or management decision will turn out in the light of hindsight to have been successful. Hindsight is not the relevant standard. In the language of law and economics, the standard is *ex ante*, not *ex post*.

SECTION 9. DELEGATION OF INVESTMENT AND MANAGEMENT FUNCTIONS.

(a) A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

(1) selecting an agent;

(2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and

(3) periodically reviewing the agent’s actions in order to monitor the agent’s performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

(c) A trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.

(d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State.

Comment

This section of the Act reverses the much-criticized rule that forbade trustees to delegate investment and management functions. The language of this section is derived from Restatement of Trusts 3d: Prudent Investor Rule § 171 (1992), discussed *infra*, and from the 1991 Illinois act, 760 ILCS § 5/5.1(b), (c) (1992).

Former law. The former nondelegation rule survived into the 1959 Restatement: "The trustee is under a duty to the beneficiary not to delegate to others the doing of acts which the trustee can reasonably be required personally to perform." The rule put a premium on the frequently arbitrary task of distinguishing discretionary functions that were thought to be nondelegable from supposedly ministerial functions that the trustee was allowed to delegate. Restatement of Trusts 2d § 171 (1959).

The Restatement of Trusts 2d admitted in a comment that "There is not a clear-cut line dividing the acts which a trustee can properly delegate from those which he cannot properly delegate." Instead, the comment directed attention to a list of factors that "may be of importance: (1) the amount of discretion involved; (2) the value and character of the property involved; (3) whether the property is principal or income; (4) the proximity or remoteness of the subject matter of the trust; (5) the character of the act as one involving professional skill or facilities possessed or not possessed by the trustee himself." Restatement of Trusts 2d § 171, comment *d* (1959). The 1959 Restatement further said: "A trustee cannot properly delegate to another power to select investments." Restatement of Trusts 2d § 171, comment *h* (1959).

For discussion and criticism of the former rule see William L. Cary & Craig B. Bright, *The Delegation of Investment Responsibility for Endowment Funds*, 74 *Columbia L. Rev.* 207 (1974); John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1976 *American Bar Foundation Research J.* 1, 18-24.

The modern trend to favor delegation. The trend of subsequent legislation, culminating in the Restatement of Trusts 3d: Prudent Investor Rule, has been strongly hostile to the nondelegation rule. See John H. Langbein, *Reversing the Nondelegation Rule of Trust-Investment Law*, 59 *Missouri L. Rev.* 105 (1994).

The delegation rule of the Uniform Trustee Powers Act. The Uniform Trustee Powers Act (1964) effectively abrogates the nondelegation rule. It authorizes trustees “to employ persons, including attorneys, auditors, investment advisors, or agents, even if they are associated with the trustee, to advise or assist the trustee in the performance of his administrative duties; to act without independent investigation upon their recommendations; and instead of acting personally, to employ one or more agents to perform any act of administration, whether or not discretionary” Uniform Trustee Powers Act § 3(24), 7B Uniform Laws Ann. 743 (1985). The Act has been enacted in 16 states, see “Record of Passage of Uniform and Model Acts as of September 30, 1993,” 1993-94 Reference Book of Uniform Law Commissioners (unpaginated, following page 111) (1993).

UMIFA’s delegation rule. The Uniform Management of Institutional Funds Act (1972) (UMIFA), authorizes the governing boards of eleemosynary institutions, who are trustee-like fiduciaries, to delegate investment matters either to a committee of the board or to outside investment advisors, investment counsel, managers, banks, or trust companies. UMIFA § 5, 7A Uniform Laws Ann. 705 (1985). UMIFA has been enacted in 38 states, see “Record of Passage of Uniform and Model Acts as of September 30, 1993,” 1993-94 Reference Book of Uniform Law Commissioners (unpaginated, following page 111) (1993).

ERISA’s delegation rule. The Employee Retirement Income Security Act of 1974, the federal statute that prescribes fiduciary standards for investing the assets of pension and employee benefit plans, allows a pension or employee benefit plan to provide that “authority to manage, acquire or dispose of assets of the plan is delegated to one or more investment managers” ERISA § 403(a)(2), 29 U.S.C. § 1103(a)(2). Commentators have explained the rationale for ERISA’s encouragement of delegation:

ERISA . . . invites the dissolution of unitary trusteeship. . . . ERISA’s fractionation of traditional trusteeship reflects the complexity of the modern pension trust. Because millions, even billions of dollars can be involved, great care is required in investing and safekeeping plan assets. Administering such plans—computing and honoring benefit entitlements across decades of employment and retirement—is also a complex business. . . . Since, however, neither the sponsor nor any other single entity has a comparative advantage in performing all these functions, the tendency has been for pension plans to use a variety of specialized providers. A consulting actuary, a plan administration firm, or an insurance company may oversee the design of a plan and arrange for processing benefit claims. Investment industry professionals manage the portfolio (the largest plans spread their pension investments among dozens of money management firms).

John H. Langbein & Bruce A. Wolk, *Pension and Employee Benefit Law* 496 (1990).

The delegation rule of the 1992 Restatement. The Restatement of Trusts 3d: Prudent Investor Rule (1992) repeals the nondelegation rule of Restatement of Trusts 2d § 171 (1959), extracted supra, and replaces it with substitute text that reads:

§ 171. Duty with Respect to Delegation. A trustee has a duty personally to perform the responsibilities of trusteeship except as a prudent person might delegate those responsibilities to others. In deciding whether, to whom, and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising agents, the trustee is under a duty to the beneficiaries to exercise fiduciary discretion and to act as a prudent person would act in similar circumstances.

Restatement of Trusts 3d: Prudent Investor Rule § 171 (1992). The 1992 Restatement integrates this delegation standard into the prudent investor rule of section 227, providing that “the trustee must . . . act with prudence in deciding whether and how to delegate to others” Restatement of Trusts 3d: Prudent Investor Rule § 227(c) (1992).

Protecting the beneficiary against unreasonable delegation. There is an intrinsic tension in trust law between granting trustees broad powers that facilitate flexible and efficient trust administration, on the one hand, and protecting trust beneficiaries from the misuse of such powers on the other hand. A broad set of trustees’ powers, such as those found in most lawyer-drafted instruments and exemplified in the Uniform Trustees’ Powers Act, permits the trustee to act vigorously and expeditiously to maximize the interests of the beneficiaries in a variety of transactions and administrative settings. Trust law relies upon the duties of loyalty and prudent administration, and upon procedural safeguards such as periodic accounting and the availability of judicial oversight, to prevent the misuse of these powers. Delegation, which is a species of trustee power, raises the same tension. If the trustee delegates effectively, the beneficiaries obtain the advantage of the agent’s specialized investment skills or whatever other attributes induced the trustee to delegate. But if the trustee delegates to a knave or an incompetent, the delegation can work harm upon the beneficiaries.

Section 9 of the Uniform Prudent Investor Act is designed to strike the appropriate balance between the advantages and the hazards of delegation. Section 9 authorizes delegation under the limitations of subsections (a) and (b). Section 9(a) imposes duties of care, skill, and caution on the trustee in selecting the agent, in establishing the terms of the delegation, and in reviewing the agent’s compliance.

The trustee's duties of care, skill, and caution in framing the terms of the delegation should protect the beneficiary against overbroad delegation. For example, a trustee could not prudently agree to an investment management agreement containing an exculpation clause that leaves the trust without recourse against reckless mismanagement. Leaving one's beneficiaries remediless against willful wrongdoing is inconsistent with the duty to use care and caution in formulating the terms of the delegation. This sense that it is imprudent to expose beneficiaries to broad exculpation clauses underlies both federal and state legislation restricting exculpation clauses, e.g., ERISA §§ 404(a)(1)(D), 410(a), 29 U.S.C. §§ 1104(a)(1)(D), 1110(a); New York Est. Powers Trusts Law § 11-1.7 (McKinney 1967).

Although subsection (c) of the Act exonerates the trustee from personal responsibility for the agent's conduct when the delegation satisfies the standards of subsection 9(a), subsection 9(b) makes the agent responsible to the trust. The beneficiaries of the trust can, therefore, rely upon the trustee to enforce the terms of the delegation.

Costs. The duty to minimize costs that is articulated in Section 7 of this Act applies to delegation as well as to other aspects of fiduciary investing. In deciding whether to delegate, the trustee must balance the projected benefits against the likely costs. Similarly, in deciding how to delegate, the trustee must take costs into account. The trustee must be alert to protect the beneficiary from "double dipping." If, for example, the trustee's regular compensation schedule presupposes that the trustee will conduct the investment management function, it should ordinarily follow that the trustee will lower its fee when delegating the investment function to an outside manager.

SECTION 10. LANGUAGE INVOKING STANDARD OF [ACT]. The following terms or comparable language in the provisions of a trust, unless otherwise limited or modified, authorizes any investment or strategy permitted under this [Act]: "investments permissible by law for investment of trust funds," "legal investments," "authorized investments," "using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital," "prudent man rule," "prudent trustee rule," "prudent person rule," and "prudent investor rule."

Investment Policy Statements: Considerations Checklist

- ✓ State philosophy, mission, and/or organizational objectives
- ✓ Relate objectives to gift annuity pool
- ✓ Create investment policy & guidelines. Consider:
 - Income needs
 - Risk tolerance
 - Time horizon
 - Return expectations
 - State regulatory constraints
- ✓ Define asset allocation ranges & targets
- ✓ Create benchmarks for performance evaluation
- ✓ Hire outside advisors or choose mutual funds to implement
- ✓ Review guidelines annually
 - Update as necessary
- ✓ Monitor outside advisors annually
- ✓ Rebalance diligently



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NEW YORK

New Investment Rules for Annuity Reserves

(Passed NY Legislature June 24, 2001, becomes law upon Governor's signature)

New York State Senate Bill #3770 was filed in the NY State Senate on 03/22/2001 and passed the New York State legislature about June 24, 2001. It has been sent to Governor Pataki for his signature and will become law effective immediately upon his signing the measure.

The Bill changes the INVESTMENT RESTRICTIONS for Gift Annuity Reserves found in Section 1, Subsections (b) and (c) of section 1110 of the NY Insurance law . . . to be invested ... from a very restrictive list of acceptable investments (mostly U.S. Treasuries) to those investments made ...

" . . . in accordance with the prudent investor standard as defined in section 11-2.3 of the estates, powers and trusts law and shall not be subject to the investment limitations set forth in this chapter. Such assets shall be segregated as separate and distinct funds, independent of all other funds of such corporation or association, and shall not be applied to pay its debts and obligations or for any purpose except the aforesaid annuity benefits."

(c) No such corporation or association organized under the laws of another state shall be permitted to make such annuity agreements in this state unless it complies will all requirements of this section imposed upon like domestic corporations or associations, except that it may invest its reserve and surplus funds in securities permitted by the laws of the state where it was organized.

Subsection (f) of Section 1110 of the NY Insurance Law is repealed.

This act shall take effect immediately.

NOTE: The following is part of the "memo of explanation" sent to the legislature by the Bill's sponsor, Senator James L. Seward:

"Justification: A charitable gift annuity is a contract under which a charity, in return for a transfer of cash or other property, agrees to pay a fixed sum of money for the life of the donor and upon the death of the donor, the charity would use the remainder of the gift for its charitable purposes. Currently, New York's laws governing the investment of reserves by charities issuing charitable gift annuities are the strictest in the nation. For example, among other restrictions, under current New York law, investments in stocks or equity based mutual funds are limited to ten percent of the charity's admitted assets. These overly restrictive investment requirements cause charities operating in New York to have lower returns than charities operating in other states, leaving less money available for charitable purposes. These requirements also

put New York State charitable organizations at a competitive disadvantage to organizations in other states.

This bill would subject charities issuing charitable gift annuities to the prudent investor standard, thereby protecting their assets while ensuring that charities in New York State are able to realize a reasonable return on their investments so that more money is available to further the organization's charitable purposes."

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This page last updated July 1, 2001.

Click here to see the **Master Set of 6 Gift Annuity Agreements** (offered by Planned Giving Resources, Inc.) that will work in all 50 states (with the addition of the "Extra Wording" state specific "disclosure language" that is now required by 24 states.)

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INSURANCE CODE

SECTION 11520-11524

11520. The following organizations and persons may receive transfers of property, conditioned upon their agreement to pay an annuity to the transferor or the transferor's nominee, after obtaining from the commissioner a certificate of authority so to do:

(a) Any charitable, religious, benevolent or educational organization, pecuniary profit not being its object or purpose, after being in active operation for at least 10 years; provided, nevertheless, that 10 years of active operation shall not be required in case of:

(1) A nonprofit corporation organized and controlled by a hospital licensed by the State Department of Health Services as a general acute care hospital pursuant to Chapter 2 (commencing with Section 1250) of Division 2 of the Health and Safety Code; and

(2) An incorporated educational institution offering courses of instruction beyond high school, organized pursuant to Section 94757 of the Education Code, and which is, and for at least one year has been, qualified pursuant to Chapter 7 (commencing with Section 94700) of Part 59 of the Education Code to issue diplomas or degrees as defined in Sections 94724 and 94726 of that code;

(b) Every organization or person maintaining homes for the aged for pecuniary profit.

This section applies to organizations subject to and operating under Chapter 10 (commencing with Section 1770) of Division 2 of the Health and Safety Code.

(c) This section shall become operative on January 1, 1997.

11520.5. No person shall transact in this state the business described in this chapter without first procuring a certificate of authority from the commissioner for such purpose. Application for such certificate shall be made on a form prescribed by the commissioner accompanied by a filing fee of one thousand seven hundred seventy dollars (\$1,770). Such certificate shall not be granted until the applicant conforms to the requirements of this chapter and the laws of this state prerequisite to its issue. After such issue the holder shall continue to comply with the requirements of this chapter and the laws of this state. Where a hearing is held under this section the proceedings shall be conducted in accordance with Chapter 5 (commencing with Section 11500) of Part 1, Division 3, Title 2 of the Government Code, and the commissioner shall have all of the powers granted therein.

Subject to the annual fee provisions herein, every certificate of authority issued or held under this chapter shall be for an indefinite term and, unless sooner revoked by the commissioner, shall terminate upon occurrence of any of the following:

(a) Upon the holder's ceasing to exist as a separate entity.

(b) Upon the winding up or dissolution, or expiration or forfeiture of the corporate existence of a corporate holder thereof.

(c) Upon winding up or dissolution of a holder not a corporation.

(d) In any event upon surrender by the holder of its certificate of authority and cancellation of the same by the commissioner. The commissioner shall not cancel a surrendered certificate of

authority until he is satisfied by examination, or otherwise, that the former holder has discharged its annuity liabilities to residents of this state or satisfactorily reinsured the same.

Notwithstanding the preceding provisions for a certificate of authority of indefinite term, each holder of a certificate of authority under this chapter shall owe and pay in advance to the commissioner in lawful money of the United States an annual fee of fifty-eight dollars (\$58) on account of such certificate of authority until its final termination or revocation. Such fee shall be for annual periods commencing on July 1st of each year and ending on June

30th of each year and shall be due on each March 1st and shall be delinquent on and after each April 1st.

Each holder of a certificate of authority shall also be subject to the payment in advance of the following fees, as appropriate:

(1) One hundred eighteen dollars (\$118) for each amended certificate of authority caused by a change of the name of the holder.

(2) Eighty-nine dollars (\$89) for the services and expenses of the commissioner in connection with the filing of amended articles by a holder.

(3) Three hundred fifty-four dollars (\$354) for all services and expenses of the commissioner in connection with the withdrawal of a holder of a certificate of authority under this chapter.

11520.6. (a) Before granting a certificate of authority or amended certificate of authority as a grants and annuities society to any applicant, the commissioner shall consider the qualifications of the applicant with respect to the following subjects:

- (1) Minimum net worth and working capital.
- (2) Lawfulness and quality of investments.
- (3) Financial stability.
- (4) Reinsurance agreements.
- (5) Competency, character, and integrity of management.
- (6) Ownership and control.
- (7) Fairness and honesty of methods of doing business.
- (8) Risk to the public.

(b) Upon consideration of all relevant qualifications, the commissioner shall issue a certificate of authority to an applicant, unless the commissioner finds that the applicant is materially deficient with respect to one or more of the subjects set forth in subdivision (a).

11521. Upon granting to such organization or person a certificate of authority to receive such transfers, the commissioner shall require it to establish and maintain a reserve fund adequate to meet the future payments under its outstanding annuity contracts and in any event not less than an amount computed as follows:

(a) In the case of annuities payable under agreements made prior to January 1, 1950, in accordance with the standard of valuation based upon McClintock's table of mortality among annuitants, with interest assumption at 3 1/2 percent per annum.

(b) In the case of annuities payable under agreements made on and after January 1, 1950, in accordance with the standard of valuation based upon the 1937 Standard Annuity Table, with interest assumption at 21/2 percent per annum, or other table of mortality derived from recent annuity experience, with interest assumption not higher than is currently yielded on safe securities, as may be prescribed by the commissioner.

For any failure on its part to establish and maintain such reserve fund, the commissioner shall revoke its certificate of authority.

11521.1. (a) The funds and other property, together with interest and dividends thereon and proceeds therefrom, conditioned upon issuance of the certificate holder's contracts to pay annuities, shall be maintained under a separate trust agreement for reserves held for the benefit of California annuitants and shall be held legally and physically segregated from the other assets of the certificate holder. The amendments to this subdivision enacted during the 1993 portion of the 1993-94 Regular Session shall apply to any organization that is issued a new certificate of authority on or after January 1, 1994. Any grants and annuities society that holds a certificate of authority on January 1, 1994, and that is not in compliance with this subdivision as of that date, shall comply with these amendments by January 1, 1998.

(b) Nothing in subdivision (a) shall prevent the certificate holder from withdrawing from time to time, pursuant to an appropriate resolution of its board of trustees, that amount or amounts as are determined, in a manner which is satisfactory to the commissioner, to be excess over and above its reserve required to be maintained under the provisions of Section 11521.

(c) If the grants and annuities society will manage and direct investment of the reserve funds required under Section 11521, the California reserves may be held under a declaration of trust stating that the grants and annuities society will hold the funds in trust and invest funds or property held in trust in accordance with the requirements of this code. If a bank will manage or direct the investment of the California reserves fund, a trust agreement shall be executed with that institution that will act as a trustee.

* 11521.2. (a) The reserve required by the table of commensurate values for each annuity contract issued must be invested in investments specified in Sections 1170 through 1182 except that a certificate holder may invest in securities listed and traded on the New York Stock Exchange, the American Stock Exchange or regional stock exchanges or the National Market System of the Nasdaq Stock Market or successors to such exchanges or market having the same qualifications, to the extent of the lesser of net worth (assets over liabilities and reserves) of the certificate holder or 10 percent of such general investments. This section does not permit investment in options or commodity exchanges.

(b) The certificate holder may invest in such other investments as permitted by and subject to the written consent of the commissioner.

11521.3. (a) Prior to admission each applicant shall file with the commissioner an accurate and complete financial statement consisting of a balance sheet and income and expense statement, showing the current condition of the applicant and sworn to by the officer of the applicant having the responsibility for preparing the statement.

(b) If the applicant is already transacting a grants and annuities business in another state, an accurate and complete financial statement showing the condition of the present grants and annuities business, sworn to by the officer having the responsibility for preparing the statement, shall be submitted.

(c) One hundred and twenty days after the end of their fiscal year, every certificate holder shall make and file with the commissioner an accurate and complete financial statement, consisting of a balance sheet and income and expense statement, showing the current condition of the certificate holder's grants and annuities

operation on a form prescribed by the commissioner.

11521.4. The commissioner may, in his discretion and after hearing, require the disposal of any investment made in violation of the provisions of this chapter; pending disposal pursuant to such order, no value shall be allowed for such investment in any financial statement or report required to be filed with the commissioner and purporting to show the financial condition of the owner thereof for the purpose of determining whether such owner is solvent or insolvent.

11521.5. The commissioner may adopt reasonable rules and regulations as may be necessary to carry out the provisions of this chapter pursuant to the provisions of Chapter 3.5 (commencing with Section 11340) of Part 1 of Division 3 of Title 2 of the Government Code. Pursuant to these provisions, the commissioner may also amend or repeal the rules and regulations.

11521.6. Nothing contained in Section 11521.1, 11521.2, or 11521.4 shall apply to any grants and annuities certificate holder that also holds a certificate of authority pursuant to Article 3 (commencing with Section 699) of Chapter 1 of Part 2 of Division 1.

11522. Every organization or person holding a certificate of authority to receive transfers under this chapter shall file with the commissioner a copy of each agreement entered into between the permit or certificate holder and the transferor, and that organization or person shall pay a basic fee to the commissioner for the filing of each agreement. The basic fee as provided in this section shall be established by rules and regulations adopted by the commissioner pursuant to Section 11521.5 for each agreement filed by the organization or person where up to 10 agreements are filed within any calendar quarter. Thereafter, within each calendar quarter, the fee for each agreement shall be as follows: 50 percent of the basic fee for 11 to 20 agreements filed; 20 percent of the basic fee for 21 to 30 agreements filed; 10 percent of the basic fee for 31 to 40 agreements filed; and 5 percent of the basic filing fee for 41 or more agreements filed.

The fees as provided herein shall be paid with the filing of the agreements by the organization or person.

11523. Such annuity agreement must show:

- (a) The value of the property transferred.
- (b) The amount of annuity agreed to be paid to the transferor or his nominee.
- (c) The manner in which, and the intervals at which, such annuity is to be paid.
- (d) The age, in years, at or nearest the date of such agreement, of the person during whose life the annuity is to be paid.
- (e) The reasonably commensurate value, as of the date of such agreement, of the benefits thereby created. This value shall not exceed by more than 15 percent the net single premium for such benefits, determined in accordance with that standard of valuation set forth in subdivision (a) or (b) of Section 11521 which is applicable to such agreement as the minimum standard of valuation.

11523.5. Any person holding a certificate of authority under this chapter may reinsure its total liability under an annuity agreement (as defined in Section 11523) with an admitted insurer for a single premium. In such event, such certificate holder may take credit for such reinsurance in reduction of the amount of the reserve fund it is required to maintain under the provisions of Section 11521, subject to the following conditions:

(a) Such certificate holder shall file with the commissioner a copy of the reinsurance contract specifying which annuity agreement previously filed pursuant to Section 11522 is thereby reinsured.

(b) Such certificate holder shall enter into a written agreement with the annuitant and the reinsurer agreeing that if it should for any reason be unable to continue the making of the annuity payments required by its annuity agreement, the annuitant shall receive payments directly from the reinsurer and that such reinsurer shall be credited with all such direct payments in the accounts between it and such reinsurer.

(c) Any commission granted by the reinsurer on the reinsurance shall be payable only to the certificate holder which shall pay no commission directly or on account of such reinsurance.

11523.6. No grants and annuities society applying for admission to this state, or transacting in this state, the business described in this chapter shall transact or be authorized to transact a variable annuity business as described in Section 10506.

11524. Except as prescribed in this chapter, such organization or person shall be otherwise exempt from the provisions of this code and other insurance laws of this state, except the provisions of Sections 730 to 736, inclusive, Sections 790 to 790.10, inclusive, Section 1011, Sections 1012 to 1044, and Sections 1056.5 to 1061. The cost and expense of examining such organization or person shall be paid as prescribed in Section 736.

CALIFORNIA CODES
INSURANCE CODE
SECTION 1170-1182

1170. Domestic incorporated insurers may invest their assets in the purchase of any of the securities specified in this article, or in loans upon such securities, if such purchase or loan conforms to all the following conditions:

(a) Such securities are not in default as to principal or interest at the date of investment.

(b) In the case of a purchase, the purchase price does not exceed the market value of the securities at the date of investment.

(c) In the case of a loan not governed by the provisions of section 1176, the amount loaned does not exceed eighty-five per cent of such market value at the date of investment.

1171. Such insurers may invest in obligations of the United States or obligations for which the faith and credit of the United States are pledged for payment of principal and interest.

1171.5. Such insurers may invest in obligations of the United States Postal Service.

1172. Such insurers may invest in obligations of the Dominion of Canada, or the Commonwealth of Puerto Rico, or of any province of the Dominion of Canada, or of any political subdivision of the Commonwealth of Puerto Rico, or obligations for which are pledged the faith and credit either of the dominion, or the commonwealth, or of any province of the dominion, or of any political subdivision of the commonwealth, for the payment of principal and interest, if within 10 years immediately preceding the investment such province or such political subdivision was not in default for more than 90 days in the payment of principal or interest upon any legally authorized obligation issued by it.

1173. Such insurers may invest in obligations issued under authority of law by any county, municipality, or school district in this State or in any other state, or in any province of the Dominion of Canada or in any political subdivision of the Commonwealth of Puerto Rico, if the obligor has not within two years next preceding the investment defaulted for more than 90 days in the payment of any part of either principal or interest upon any legally authorized obligation issued by it, and the obligations of the state or province or political subdivision in which it is located are legal for investment under the provisions of Sections 1172 or 1174.

1174. Such insurers may invest in obligations of this State or those for which the faith and credit of this State are pledged for the payment of principal and interest, and in obligations of any other State in the United States, if within ten years immediately preceding the investment such State was not in default for more than ninety days in the payment of any part of principal or interest of

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any debt duly authorized by the Legislature of such State to be contracted by such State since the first day of January, 1878.

1175. Such insurers may invest in bonds of any permanent road division in this state, or any district organized under the laws of this state, when such bonds are legal **investments** for savings banks of this state, or have been certified as legal **investments** for savings banks pursuant to Division 10 (commencing with Section 20000) of the Water **Code**, or when the statutes or laws providing for the issuance of such bonds provide that such bonds shall be entitled to the same force or value or use as bonds issued by any municipality, or such law specifically states that such bonds shall be legal **investments** for either savings banks, **insurance** companies, all trust funds, state school funds or any funds which may be invested in bonds of cities, counties, cities and counties, school districts, or municipalities in the state, or when such bonds have been investigated and approved by a commission or board now or hereafter authorized by law to conduct such investigation and give such approval when such law specifies that upon that approval the bonds are legal **investments** for insurers, or which the commissioner approves in writing as legal for investment of the funds of insurers.

The commissioner in determining whether to approve any bonds as legal **investments** which do not otherwise qualify as such pursuant to any part of this **code**, shall, at the expense of any insurer requesting approval, make an adequate independent investigation of such bonds and the security therefor. A copy of the data secured in such investigation and the resulting opinion of the commissioner shall be furnished to the insurer.

1175.5. Such insurers may invest in bonds of any county water district operating under Division 12 of the Water **Code**.

1176.5. Such insurers may make, invest in or purchase loans which are guaranteed by the United States or any agency thereof pursuant to the provisions of the "Servicemen's Readjustment Act of 1944" or any act of Congress supplementary or amendatory thereof.

1176.6. None of the provisions of the **Insurance Code** limiting or restricting loans by insurers or prescribing the security therefor shall apply to any loans which are fully guaranteed by the United States or any agency thereof pursuant to the provisions of the "Servicemen's Readjustment Act of 1944" or any act of Congress supplementary or amendatory thereof; and in any case in which payment of a portion of any loan is guaranteed by the United States or any agency thereof pursuant to the provisions of the "Servicemen's Readjustment Act of 1944" or any act of Congress supplementary or amendatory thereof, the guaranteed portion of such loan shall not be deemed a part of said loan for the purposes of any provision of the **Insurance Code** limiting the amount which may be loaned by an insurer upon the security of real property or improvements thereon shall be applicable to such loan.

1177. Such insurers may invest in notes or bonds secured by mortgage guaranteed as to payment by a policy of mortgage **insurance**, and mortgage participation certificates issued by a mortgage insurer in accordance with the provisions of this **code**.

1178. Such insurers may invest in collateral trust bonds or notes, secured by any of the following:

(a) A deposit of obligations authorized for investment by this article or Articles 4, 5, or 6 of this chapter having a market value at least fifteen per cent in excess of the par value of the collateral trust bonds or notes issued.

(b) A deposit of obligations authorized for investment by this article or Articles 4, 5, or 6 of this chapter, together with other securities, the combined market value of the deposit being at least twenty per cent in excess of the par value of the collateral trust bonds or notes issued, with the par value of the collateral trust bonds or notes not exceeding the market value of the deposited obligations which are authorized for investment by this article or Articles 4, 5, or 6 of this chapter.

(c) A deposit of obligations authorized for investment by this article, or Articles 4, 5, or 6 of this chapter, together with other securities, and conforming to the following requirements:

(1) The combined market value of the deposit is at least thirty per cent in excess of the par value of the collateral trust bonds or notes issued.

(2) The par value of such collateral trust bonds or notes issued does not exceed the market value of deposited obligations authorized for investment by this article.

(3) The deposited collateral consists of obligations authorized for investment by this article, or Articles 4, 5, or 6 of this chapter, having a market value of at least seventy-five per cent of the par value of such collateral trust bonds or notes issued.

1179. Such insurers may invest in farm loan bonds, consolidated farm loan bonds, collateral trust debentures, consolidated debentures, or other obligations issued under the Federal Farm Loan Act, approved July 17, 1916, as amended (Title 12 U.S.C. Sections 636 to 1012 inclusive, and Sections 1021 to 1129 inclusive), and the Farm Credit Act of 1933, as amended (Title 12 U.S.C. Sections 1131 to 1138f inclusive), and the Farm Credit Act of 1971 (Title 12 U.S.C. Sections 2001 to 2259 inclusive). Under this section such insurers

may invest in farm loan bonds and consolidated farm loan bonds issued by federal land banks, consolidated collateral trust debentures and all other debentures issued by federal intermediate credit banks, debentures issued by the Central Bank for Cooperatives and consolidated debentures issued by banks for cooperatives.

1180. Such insurers may invest in bonds issued under the "Home Owners' Loan Act of 1933"; bonds, debentures and notes issued by any federal home loan bank, or consolidated federal home loan bank notes, bonds and debentures issued by the Federal Home Loan Bank Board in accordance with the provisions of the Federal Home Loan Bank Act, and mortgage, mortgage participation, pass-through or trust certificates, or obligations or other securities issued or guaranteed by the Federal Home Loan Mortgage Corporation, pursuant to Section 305 or Section 306 of the Federal Home Loan Mortgage Corporation Act (12 U.S.C. Secs. 1454, 1455), by the Government National Mortgage Association, pursuant to Section 306 or Section 313 or Title III of the National Housing Act (12 U.S.C. Secs. 1721, 1723(e)), or by the Federal National Mortgage Association pursuant to 12 U.S.C. Sections 1717-1719.

1181. Such insurers may also invest in registered warrants of this

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State, issued pursuant to law.

1182. Domestic incorporated insurers may invest in an account or accounts in one or more banks or savings and loan associations to the extent the account or accounts are insured by an agency or instrumentality of the federal government. As used in this section, an account may include a certificate of deposit.

BIOGRAPHIES

JANICE H. BURRILL

Senior Vice President & National Director, Wells Fargo's Charitable Management Group

Janice joined Wells Fargo in 1995 as Vice President & Manager of the Charitable Management Group in Private Client Services, and was named Senior Vice President & National Director in 2000. Prior to coming to Wells Fargo, Janice was Director of Planned Giving for five years at Loyola Marymount University in Los Angeles. She also practiced law for several years in Los Angeles and London with both Shearman & Sterling and Graham & James. Janice holds a Bachelor of Science degree in Accounting (magna cum laude) from Loyola Marymount University and a law degree (cum laude) from Loyola Law School. From 1996 to 1999, Janice was on the Board of Directors of the National Committee on Planned Giving, and chaired NCPG's Public Affairs Committee, which oversees the "Leave a Legacy" national initiative. She is also past president of the Planned Giving Roundtable of Southern California and former chair of the Western Regional Planned Giving Conference. Janice currently sits on the Boards of the Los Angeles Women's Foundation, Ramona Convent Secondary School, the Center for Healthy Aging and Holy Family Services. She is also a member of Trust & Estates magazine's Philanthropy Committee, and the Planned Giving Councils of the University of California, Irvine, Barlow Hospital Foundation and Mount St. Mary's College. She is an active volunteer and speaker within the nonprofit sector and participated in the first-ever White House Conference on Philanthropy.

PAULA B. BLACHER, CFA

Vice President & Senior Philanthropic Portfolio Manager

In her position as Vice President and Senior Philanthropic Portfolio Manager for the Charitable Management Group, Paula manages portfolios for non-profit organizations, including charitable gift annuity pools, charitable remainder and charitable lead trusts. She has 28 years experience in the financial services field. Prior to joining Wells Fargo, she worked for City National Bank where she acted as head of equity research, with responsibility for supervising the research process and co-managing equity common trust funds. Paula also worked for 15 years at Provident Investment Counsel, an institutional growth-style manager. There she managed a listed growth mutual fund for Smith Barney, as well as assets for large and medium sized institutions, high-net worth individuals, and endowments for non-profit organizations. Paula holds an Executive MBA from the Peter F. Drucker Graduate Management Center, Claremont Graduate University, is a Chartered Financial Analyst and a Certified Investment Management Consultant. Paula currently teaches a Chartered Financial Analyst review course in asset valuation and equity analysis co-sponsored by the Los Angeles Society of Financial Analysts in conjunction with the University of Southern California. She is an executive board member of Women at Work, a member of the Fulfillment Fund's Financial Advisory Council, the National Committee on Planned Giving, and the California Institute of Technology Associates. Paula enjoys public speaking; in addition to addressing civic organizations she has spoken to national professional organizations on investment policy issues.

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STATE REGULATION OF CHARITABLE GIFT ANNUITIES

James B. Potter
President
Planned Giving Resources
P.O. Box 8300
Alexandria, VA 22306-8300
(703) 799-8300
FAX (703) 799-8318
jimbpotter@aol.com

Edith Matulka, J.D.
Vice President
Planned Giving Services, Inc.
3147 Fairview Avenue E., #200
Seattle, WA 98102-3019
(206) 329-8144
FAX (206) 329-8230
ematulka@plannedgivingservices.com

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233 McCREA STREET, SUITE 400 • INDIANAPOLIS, INDIANA 46225 • (317) 269-6271 • FAX: (317) 269-6276 • E-MAIL: ACGA@IUPUI.EDU

Introduction

While the degree to which states regulate issuance of charitable gift annuities varies substantially, the purpose behind each state's law is undoubtedly protection of the interests of the residents of the particular state. If a charity is offering gift annuities to donors in multiple states, it must comply with the law of each of those states, not just the state in which the charity is domiciled. Depending on the state, a charity may find it needs to meet certain criteria (years-in-operation, minimum amount of unrestricted net assets), or that it must hold the annuity reserve assets in a specific manner and submit a detailed annual reporting to the state. Before deciding whether to issue gift annuities in a particular state, a charity is wise to consider the range of issues and determine whether it meets, or wants to subject itself to, the requirements of a particular state.

State Categories

State regulation concerning the issuance of charitable gift annuities may be separated into three categories:

- **Certification**
Ten states (Arkansas, California, Hawaii, Maryland, New Jersey, New York, North Dakota, Oregon, Washington, and Wisconsin) require charities to apply for and receive certification in order to issue gift annuities to residents of that state. Charities must maintain segregated reserve funds, in some states subject to investment restrictions, and an annual reporting must be submitted to maintain certification.
- **Exemption**
Thirty-four states offer either a blanket or conditional exemption for the issuance of gift annuities. To qualify for the exemption, the charity must meet the applicable statutory criteria and, in certain states, comply with such requirements as including disclosure or other state mandated language in annuity agreements (in 28 states) and/or providing notification to the state insurance or securities commission of their intent to issue annuities (in 17 states).
- **Silent**
Six states (Delaware, Montana, Ohio, Rhode Island, West Virginia, and Wyoming) and the District of Columbia are currently silent regarding gift annuities.

See Appendix 1 for a map reflecting these categories and Appendix 2 for a state-by-state listing.

The **certification** process involves a formal application which includes the forms of annuities to be offered, the proposed rate schedule, and other supporting documentation addressing the structure and financial status of the organization.

The **exemption** states include those that require notification to a state agency regarding issuance of gift annuities and those that do not. When notification is required, it typically is a simple one-time filing, indicating compliance with the statutory requirements.

- **Notification (17 states)**

Alabama, Alaska, Connecticut, Florida, Georgia, Idaho, Iowa, Minnesota, Mississippi, Missouri, Nevada, New Hampshire, New Mexico, North Carolina, Oklahoma, Tennessee, and Texas.

- **No notification (17 states)**

Arizona, Colorado, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maine, Massachusetts, Michigan, Nebraska, Pennsylvania, South Carolina, South Dakota, Utah, Vermont, and Virginia.

The **silent** states have no specific statutory provisions governing charitable gift annuities, either through a certification process or by providing for an exemption. Issuance of annuities in these states, therefore, may be covered by either insurance or securities laws, requiring charities to comply with the same registration and reporting requirements as any issuer of insurance or securities. Charities find such requirements to be prohibitive, and many make the decision to issue gift annuities in these states without such registration. While silent states do not appear to be actively enforcing insurance or securities laws against charities, it is unclear whether this is because they do not have the resources to do so, or because they view the laws as not applicable to charities.

Registration Issues

As mentioned previously, there are certain statutory requirements that may affect a charity's ability to offer gift annuities in a particular state. The charity may be unable to satisfy a particular condition (e.g., has not existed for the requisite number of years), or it may prefer not to subject its gift annuity program to a certain requirement (e.g., limitation on investment of reserve assets). The issues to be considered are set out in the following pages, without necessarily making reference to all states' requirement in a given area. For a one-page overview of state-specific requirements, see Appendix 3.

Years-in-operation

Thirty-four states require a charity issuing gift annuities to have been in operation for a certain period of time. Three years is the most common (21 states), but the required time period can be as high as 20 years. There are two particular concerns which arise in meeting the "years-in-operation" criteria: one pertains to specific states, and the other pertains to charities which do not meet the time period, but which were created from, or in support of, charities which do.

While in general it is a matter of the charity having been in existence for the requisite time, there is an in-state component to the years-in-operation requirement for Maryland and Oregon. Both states have different categories under which a charity registers to issue gift annuities. In Maryland a charity must show proof of the type of activity related to the applicable category (religious or educational). Recruiting prospective students, mailing newsletters to state residents, or fundraising activity is not sufficient.

Oregon has more categories, not all of which have a years-in-operation requirement. For instance, private colleges and universities must have been in existence for 20 years, but need not show a presence in Oregon. Religious and national health organizations have no specific years requirement, but must have an in-state presence (e.g., churches, or an affiliate office). Graduate schools and colleges and museums must have operated in Oregon for 20 years, while for general non-profit organizations it is 10 years. For out of state charities in these categories, proof of "operation" in Oregon is shown by indicating when the charity registered to do business as a foreign corporation. Whether a charity has already done so, and whether it has done so long enough to meet the time requirement, may depend on what types of other activity or solicitation it has been conducting within Oregon.

In many instances the charity issuing gift annuities is a foundation specifically created to handle fund-raising activity. While the underlying charitable organization may meet the years-in-operation requirements, the foundation itself may have been established more recently. The question arises whether such a foundation (or any other similarly situated charity) can rely on the years of existence of the main organization. Among the certification states, Arkansas, Maryland, and New Jersey allow such "piggybacking" (at least in most circumstances), while California, Hawaii, New York, Oregon, Washington, and Wisconsin do not. Among the exemption states, the most frequent statutory phrasing requires a charity to have had a certain number of years of "continuous operation" or to be "a successor or affiliate of a charitable organization that has been in continuous operation" for the required time period, which has been interpreted to include a foundation. However, in other states there is no mention of successors or affiliates, or the requirement is otherwise phrased differently. Charities that find themselves needing to rely on another organization's years in existence should look closely at the statutory language for the states in which they wish to issue gift annuities.

Unrestricted Assets

Another requirement found in a large number of states (21) is that the charity have a minimum amount of unrestricted assets, ranging from \$100,000 to \$2 million. While again the statutory language varies, the most common definition is "unrestricted cash, cash equivalents or publicly traded securities, exclusive of the assets funding the annuity." These are general assets of the charity and do not need to be segregated from other assets or placed in a reserve fund. Since annuity payments are backed not only by the annuity assets but also by all assets of the charity, this requirement is designed to insure that charities issuing gift annuities have adequate financial resources. The unrestricted designation is to ensure that

the assets are available to make annuity payments if needed and not restricted to other purposes (such as an endowment, scholarships, building fund, etc.)

It is predominantly exemption states that have a specified dollar amount, and charities affirm that they meet that amount when they submit their notification. However, certification states review the financial status of a charity even when there is no stated minimum. This is one reason why audited financial statements are a part of the application process, and may be required as part of the annual reporting. The permit to issue gift annuities would likely be suspended or revoked if the state became concerned about a charity's financial status. In exempt states, where there is no annual reporting, a charity on its own should stop issuing gift annuities if its unrestricted assets drop below the required amount.

Segregated Reserve Fund

While the years-in-operation and unrestricted asset requirements may determine whether a charity even starts a gift annuity program, the requirements concerning a segregated reserve fund have an ongoing impact on the program and may affect whether a charity elects to issue gift annuities in certain states.

Thirteen states require a charity to establish an annuity reserve fund: Arkansas, California, Florida, Hawaii, Maryland, New Hampshire, New Jersey, New York, North Dakota, Oregon, Pennsylvania, Washington, and Wisconsin. Since most charities retain 100% of the annuity contribution until the annuity terminates, regardless of any state requirement, establishment of the fund is not of particular concern (although some charities would prefer not to have to create a fund separate from other assets of the organization). Rather, restrictions on how the fund is invested, and in some cases the minimum amount that must be in the fund, cause the greatest concern.

Hawaii, North Dakota, Oregon, and Pennsylvania all say nothing about the composition of the reserve fund. Maryland, New Hampshire, New York, and Washington require investment in accordance with a "prudent investor" standard, with the latter two states mandating a 10% surplus on top of the calculated reserve amount. Even with the surplus, the amount required to be held in reserve is less than the entire annuity contribution.

Florida does have investment limitations, but they are imposed only on reserves held by Florida-based charities. Out-of-state charities may invest in accordance with the requirements of their state of domicile. Florida also mandates a 25% surplus, but this is misleading because the methodology referenced in Florida's statute is fundamentally different than that used by other states and usually results in a smaller calculated reserve. Reserves calculated to meet Florida's requirement, even with the 25% surplus, normally do not exceed those required in other states unless the CMFR is quite low.

The remaining four states, Arkansas, California, New Jersey, and Wisconsin, also place limitations on how the segregated reserve fund is invested, and these limitations are imposed on all charities issuing gift annuities in their state. While the specific restrictions vary

among the states, investment in stocks or in mutual funds is extremely limited. California requires a segregated fund holding only the reserves for annuities issued to California residents. While from an administrative standpoint this may be cumbersome, it has the affect of minimizing the impact the investment restrictions have on a charity's gift annuity reserves as a whole. In contrast, the restrictions imposed by Arkansas, New Jersey, and Wisconsin apply to the reserves held for annuities from all states. A charity operating a national gift annuity program would have two segregated funds, one for California and one for all other states. The second fund would need to be invested so as to comply with the investment limitations of Arkansas, New Jersey, and Wisconsin, even if the vast majority of the charity's gift annuities were issued to residents of other states. The amount subject to the limitations is the actuarially calculated reserve plus a surplus, which for New Jersey is the greater of 10% or \$100,000. For some charities this necessitates transferring into the reserve fund assets beyond those contributed for gift annuities.

If a charity elected not to issue gift annuities in New Jersey, it would have the option of creating state-specific funds for Arkansas and Wisconsin. While again adding some administrative complexity, as with California the investment restrictions apply only to reserves held for donors in the applicable state. However, both states require the reserve fund to be at a minimum level - \$50,000 for Arkansas and \$100,000 for Wisconsin - which, depending on the value of the gift annuity contributions for that state, may result in a need to transfer other assets into the fund. Thus a charity issuing gift annuities in all states but New Jersey would have four reserve funds, one each for Arkansas, California and Wisconsin, and the fourth for all other states.

A second option available in Wisconsin is to propose an investment plan for your reserve fund as a whole that differs from the statutory requirements. (Again this makes sense currently only if annuities will not be issued in New Jersey.) If approved, this would remove the need for a Wisconsin-only fund. If the charity also decided not to issue gift annuities in Arkansas, only two reserve funds would be needed: a California-only fund, subject to that state's investment restrictions, and a second fund invested in accordance with the Wisconsin approved plan.

Acceptance of Real Estate

While New York now allows the Annuity Reserves to be invested for Total Return under its Prudent Investor Act (as of November 1, 2001), other rules must be followed if a charity is located in New York or has a New York Gift Annuity Certificate/Permit. For instance, New York prohibits the acceptance of any assets except cash and negotiable securities for a gift annuity. Real property may not be accepted, even if the charity, the donor and the real estate are outside of New York, if the charity holds a New York Permit. While other states allow acceptance of real estate, there may be restrictions as to its being held in the reserve fund. For example, New Jersey limits real estate to ten percent of reserve assets, which may from a practical standpoint mean it cannot be held in the reserve fund. A charity wishing to retain the real estate, however, could place other equivalent assets into the reserve fund.

Other State Filings

A full discussion of state laws regulating charitable solicitations is beyond the scope of this presentation. However, certain states require registration with other agencies in order to obtain certification to issue gift annuities or in order to qualify under the exemption. In addition to the initial registration, this can result in annual filings and/or fees.

Five states (Florida, Maine, New Jersey, Oklahoma, Oregon, and South Dakota) require registration to do business in the state. Generally this filing is with the Secretary of State's office, with fees ranging from \$25 to \$300. Registration may also be required with the agency charged with monitoring charitable activity within the state, often the Attorney General's office, although in some cases there are exemptions for certain types of charities. Included in the states requiring this charitable registration are New Jersey and Oregon, along with Kentucky, New Hampshire, and Pennsylvania.

Timing of Registration

Once the decision has been made whether or not to issue gift annuities in a particular state, the question becomes when to register. With certification states, the statutes require obtaining a permit before issuing gift annuities, with one exception. In New York, a charity need not apply for a permit until its required segregated reserve amount on outstanding annuities for all states (not just New York annuities) exceeds \$500,000. In fact, while a charity could submit a permit application prior to meeting the threshold amount, the Department of Insurance will only conduct a preliminary review and will not issue a permit until the threshold is exceeded and the charity has provided updated financial and reserve information.

If a charity is less likely to issue annuities in a particular state, it may prefer to wait to obtain its permit so as not to be subject to restrictions on the reserve fund or to annual filing requirements and then apply once interest is shown by a particular donor. The disadvantage to this approach is asking the donor to wait during the pendency of the application, but typically review by the state takes from six weeks to four months. The noticeable exceptions are California and New York, where the review can take up to a year.

Of the exemption states requiring notification, Alabama requires a charity to apply for and receive the exemption prior to issuing gift annuities in that state. In other states the filing can be done concurrently with a charity entering into its first annuity with a resident of the state. However, because the exempt states do not impose restrictions on the reserve fund or require a detailed annual reporting, a charity may prefer to complete the notifications for all applicable states at the same time. By doing so, the charity need not be concerned when completing a specific annuity whether a filing still needs to be made in that donor's state. Because of the minimal filing requirements for notification states, the process is generally complete upon submission, with occasional requests for further information or clarification. Alabama requires more supporting documentation, but even there the review is generally complete within a matter of weeks rather than months.

Oops - We've Already Issued Annuities

Many charities have been issuing annuities in regulated states without a permit or without submitting the required notification. What happens when they seek to bring themselves into compliance? Most states have not been fining charities for their prior activity. This has been true whether the state becomes aware of the activity and issues a cease and desist order, or whether the charity comes forward on its own. It appears that the states prefer not to deter charities from bringing themselves into compliance, perhaps in recognition of insufficient resources to actively seek out those charities issuing gift annuities in violation of the statutes.

However, in 2000 Washington State began imposing fines consisting of a \$100 penalty, plus \$25 per year since issuance of the first Washington annuity and \$5 per existing Washington agreement. The per year and per agreement fees are based on the annual fees required once a charity has received its permit, so most of the fine involves a charity paying what it would have paid if it had registered as required. In addition to the fine, a stipulation and order outlines the charity's violation of the statute and indicates that a fine is being imposed in lieu of refusal to grant the permit.

If a charity does not meet the criteria of a particular state in which it has issued, and therefore cannot obtain a permit or qualify for the exemption, it should cease issuing future annuities to residents of that state. While still running the risk of a fine, the charity is on its own initiative complying with what would likely be the state's first action, the issuance of a cease and desist letter. A charity that has issued gift annuities in a state but elects not to register because of specific requirements of the state should similarly cease future activity, although again the risk of fines remains.

Conclusion

Complying with state regulation governing issuance of gift annuities is not always easy, and doing so can impact a charity's administration of its gift annuity program, especially when investment restrictions are involved. Nevertheless, a charity issuing gift annuities should be aware of, and in compliance with, the regulations of the states in which it is conducting gift annuity activity. As more charities begin issuing gift annuities, states are likely to become increasingly aware of the activity and concerned about protecting their residents. This brings with it the possibility of stricter enforcement. A charity that is in compliance in the states in which it is issuing annuities removes the risk of fines or legal action, and the resultant negative publicity which could follow, and can comfortably respond to donors' questions should they ask about regulations governing gift annuities.

State Regulations of Charitable Gift Annuities								(as of 02-11-2002)
No.	State	Contact State for Permit / Notice	Disclosure Wording	Effective Date of Law	State Contacts			
====	====	=====	=====	=====	Contact Name	Phone Number	Ext.	
====	====	=====	=====	=====	=====	=====	=====	
1	AL	Notice	Yes	4/9/97	Rena Davis	334-242-2984		
2	AK	Notice	Yes	10/1/01	Janice Stamper	907-269-7905		
3	AR	Permit	No		John Shields	501-371-2766		
4	AZ		Yes	4/9/97				
5	CA	Permit	Yes		Carol Harmon	415-538-4420		
6	CO	No	Yes	1995				
7	CT	Notice	Yes	1/1/00	Nancy Monahan	860-297-3804		
8	DE			[Silent State]				
9	DC			[Silent State]				
10	FL	Notice	Yes	5/15/96	Jan Hamilton	850-413-2446		
11	GA	Notice	Yes	7/1/00	Monica Wolfe	404-655-9205		
12	HI	Permit	No		Paul Yuen	808-586-2790		
13	IA	Notice	Yes	7/1/01	James Thornton	515-281-4271		
14	ID	Notice	Yes		Carol Anderson	208-334-4309		
15	IL	No	No	1995	[See web site]			
16	IN	No	No		[Blanket Exemption]			
17	KS	No	No		Steve Wassom	785-296-3307		
18	KY	No	No		[Blanket Exemption]			
19	LA	No	No		[Blanket Exemption]			
20	MA	No	No		[Blanket Exemption]			
21	MD	Permit	Yes	9/30/95	Howard Max	410-468-2205		
22	ME	No	No		[Blanket Exemption]			
23	MI	No	No		[Blanket Exemption]			
24	MN	Notice	No	1996	Diane Walters	651-296-4973		
25	MO	Notice	Yes	8/28/01	Aleecia McIntire	573-751-3497		
26	MS	Notice	Yes	7/1/01	Kathy French	888-236-6167		
27	MT			[Silent State]				
28	NC	Notice	Yes	11/1/98	Carolyn Thomas	919-733-5060	345	
29	NE	No	No	1996	[Blanket Exemption]			
30	NV	Notice	Yes	10/1/99	Guy Perkins	775-681-7660		
31	NH	Notice	Yes	5/28/99	Karen Jensen	603-271-3591		
32	NJ	Permit	No		Adelaide Phelan	609-292-5427	50328	
33	NM	Notice	Yes		Diana Bonal	505-827-4561		
34	NY	Permit	Yes	5/13/99	John Lucchesi	212-480-4778		
35	ND	Permit	Yes	1998	Leona Ziegler	701-328-3328		
36	OH			[Silent State]				
37	OK	Notice	Yes	7/21/98	John Beers	405-521-3996		
38	OR	Permit	Yes	11/14/95	Donna Bleiler	503-947-7275		
39	PA	No	Yes	12/16/96				
40	RI			[Silent State]				
41	SC	No	No		[Blanket Exemption]			
42	SD		Yes	7/1/01				
43	TN	Notice	Yes	6/12/01	Sandra Smith	615-741-1633		
44	TX	Notice	Yes	9/1/95	John Carter	512-305-7722		
45	UT	No	No		[Blanket Exemption]			
46	VA	No	Yes	3/31/96				
47	VT	No	Yes	7/1/01				
48	WA	Permit	Yes		James Tompkins	360-407-0537		
49	WV			[Silent State]				
50	WI	Permit			Steve Caughill	608-267-2049		
51	WY			[Silent State]				
Totals		10	17	28	11	[Full details at: http://www.acga-web.org/regs.html]		
						[Please e-mail any changes to: jimbpotter@aol.com]		

STATE REGULATORY CATEGORIES
Charitable Gift Annuities

I. STATE LAW REQUIRES CERTIFICATION, RESERVE AND ANNUAL FILING (10):

State	Years in operation	Board resolutn.	Disclos. in agrmt.	Reserve required	Annual filing	Investment limitations	Notes:
AR	5	yes	---	yes ¹	yes	less strict ¹	¹ May elect to segregate AR annuitants
CA	10	yes	---	yes ²	yes	strict ²	² CA annuitants only
HI	10 in HI	---	---	yes	yes	---	Law requires \$5 million of assets in Hawaii
MD	10 in MD	---	yes	yes	yes	---	³ Prudent investor standard
ND	---	---	---	yes	yes ⁴	---	⁴ Submission of audited financial statements
NJ	10	yes	---	yes	yes	strict ⁵	⁵ Rules apply to reserves for all states
NY	10	yes	---	yes	yes	---	⁶ Prudent investor standard
OR	0-20 ⁷	---	yes	yes	yes	---	⁷ Depends on the type of charity
WA	3	---	---	yes	yes	---	⁸ Prudent investor standard; \$500,000 net assets
WI	10	---	---	yes ⁹	yes	less strict ⁹	⁹ May elect to segregate WI annuitants

II. STATE LAW PROVIDES FOR BLANKET OR CONDITIONAL EXEMPTION (34):

State	Years in operation	Board resolutn.	Disclos. in agrmt.	Reserve required	Notice to state	Avail. Assets	Notes:
AL	---	---	yes	---	yes	---	Exemption granted by Securities Dept.
AK	3	---	yes	---	yes	\$300k	
AZ	---	---	yes	---	---	---	
CO	3	---	yes	---	---	---	
CT	3	---	yes	---	yes	\$300k	
FL	5	---	yes	yes	yes	---	Investment limitations in some cases
GA	3	---	yes	---	yes	\$300k	
ID	3	---	yes	---	yes	\$100k	
IL	20 ¹⁰	---	---	---	---	\$2 mil. ¹⁰	¹⁰ Waived if annuities reinsured
IN	---	---	---	---	---	---	
IA	3	---	yes	---	yes	\$300k	
KS	---	---	---	---	yes ¹¹	---	¹¹ Voluntary filing w/ Securities Dept.
KY	---	---	---	---	---	---	Certain charities must file copy of Form 990
LA	---	---	---	---	---	---	
ME	5	---	---	---	---	---	Must be qualified as a foreign corporation
MA	---	---	---	---	---	---	
MI	---	---	---	---	---	---	
MN	3	---	---	---	yes	\$300k	Exemption granted by Securities Dept.
MS	3	---	yes	---	yes	\$300k	
MO	3	---	yes	---	yes	\$100k	
NE	3	---	---	---	---	---	
NV	3	---	yes	---	yes	\$300k	
NH	3	---	yes	yes	yes	\$300k	Annuity rates must not exceed ACGA recomnd.
NM	3	---	yes	---	yes	\$300k ¹²	¹² Either in unrestricted assets or reserve fund
NC	3	---	yes	---	yes	\$100k	
OK	3	---	yes	---	yes	\$100k	Annual submission of audited fin. statement
PA	3	---	yes	yes	---	\$100k	Must comply with PA char. solicit. law
SC	5	---	---	---	---	---	
SD	10	---	yes	---	---	\$500k	Must be qualified as a foreign corporation
TN	3	---	yes	---	yes	\$1 mil. ¹³	¹³ \$300,000 for TN colleges or universities
TX	3	---	yes	---	yes	\$100k	
UT	---	---	---	---	---	---	
VT	3	---	yes	---	---	\$300k	
VA	3	---	yes	---	---	\$100k	



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25TH CONFERENCE ON GIFT ANNUITIES • PRESENTED BY THE AMERICAN COUNCIL ON GIFT ANNUITIES

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I. Introduction.

A. Fund raising in America is undergoing a period of unprecedented change.

1. Demographic shifts.
2. Economic fluctuations.
3. Tax changes.
4. Social change.
5. Unprecedented numbers of organizations raising funds.

B. Challenge is to preserve philanthropy as an American institution in the midst of this change.

1. Individual organizations must pursue this goal.
2. Group efforts will also be required.
3. Nonprofits must sometimes act together.
4. Some efforts must cross sectors and include the for profit planning community.

C. "Planned Giving" incorporates the elements necessary to balance various perspectives.

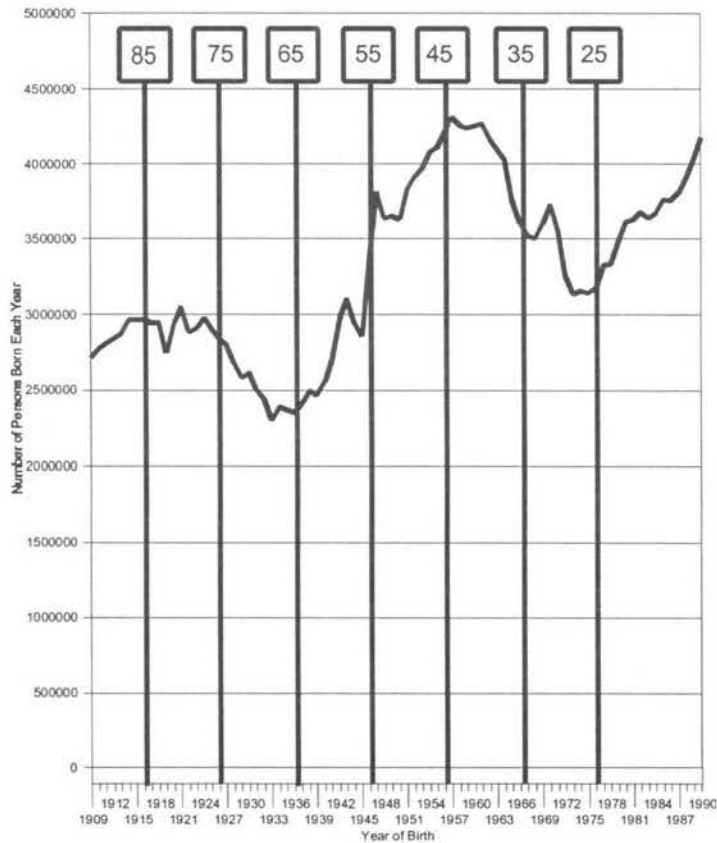
1. The perspective of the charitable recipient.
2. The perspective of the donor.
3. The perspective of the advisor.
4. The perspective of the government.

II. There are Broad Environmental Influences Affecting Philanthropy at the Turn of the Century.

A. Demographic changes.

1. Uneven skew of population due to changes in birth rates as a result of Depression and World War II.

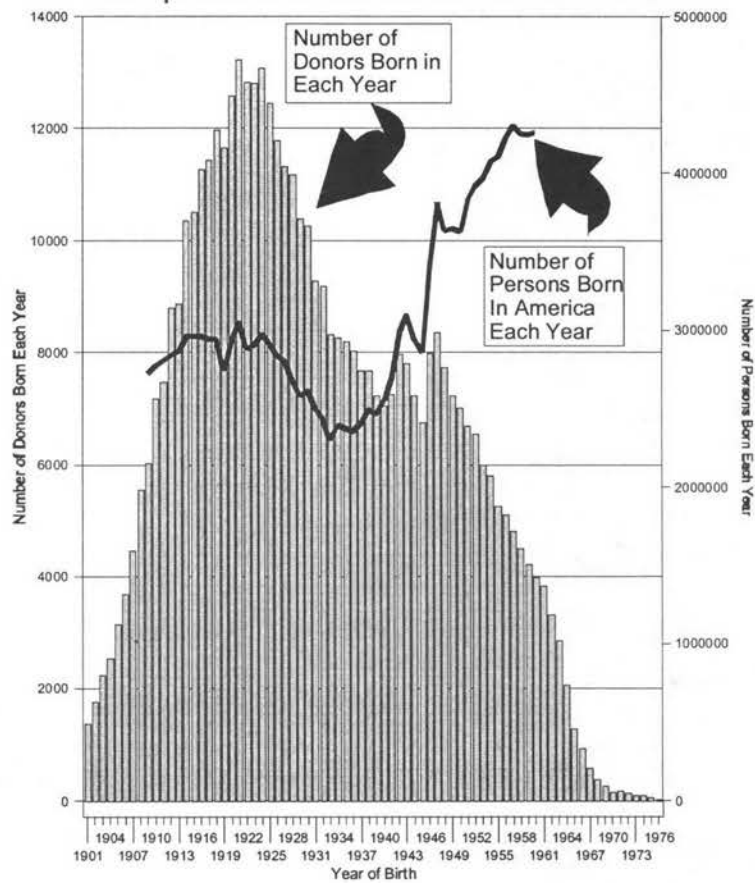
Number of Live Births In America
For Period 1909-1990



- a. Has resulted in shortage of donors in key age ranges for many organizations.
- b. Fewer persons in mid 60s than any other age range.

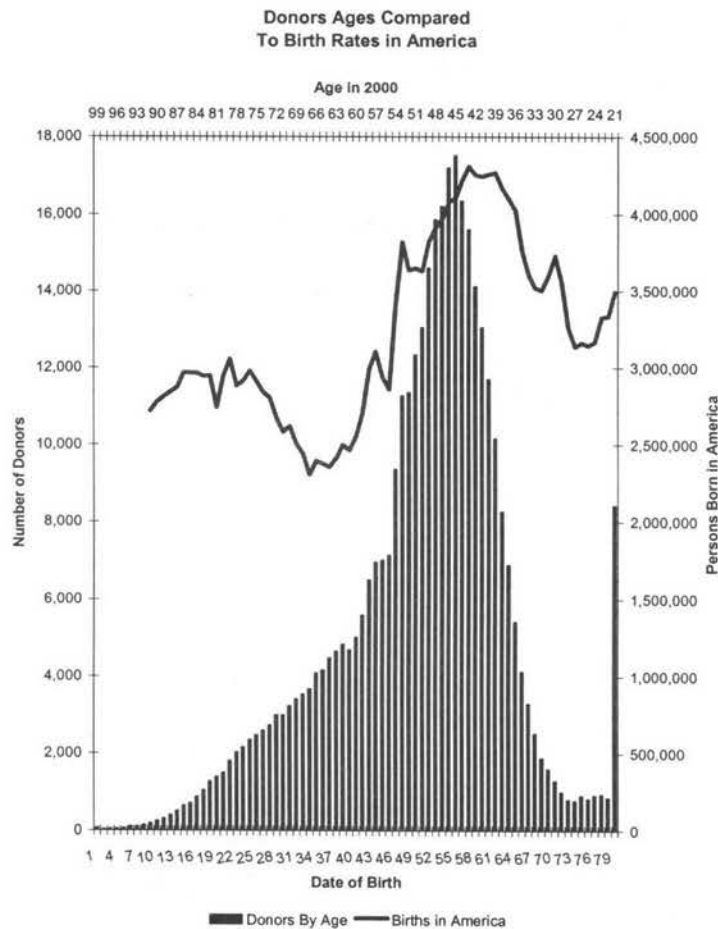
- c. Over 70 million persons passing the age of 65 over next twenty years.
- d. This is already reflected in the donor bases of many organizations.

**Distribution of Donors by Year of Birth
Compared to Birth Rate from 1909-1960**



- (1) Organizations like this one are having difficulty acquiring new donors.
- (2) Experiencing drops in acquisition of 20% or more over the past few years.
- (3) Putting increased pressure on bequests and other planned gift income.

2. Baby boomers not yet "taking up the slack" for most organizations.
 - a. Charities must compete with children and other interests.
 - b. Exceptions for organizations that appeal to the concerns of persons in this age group.

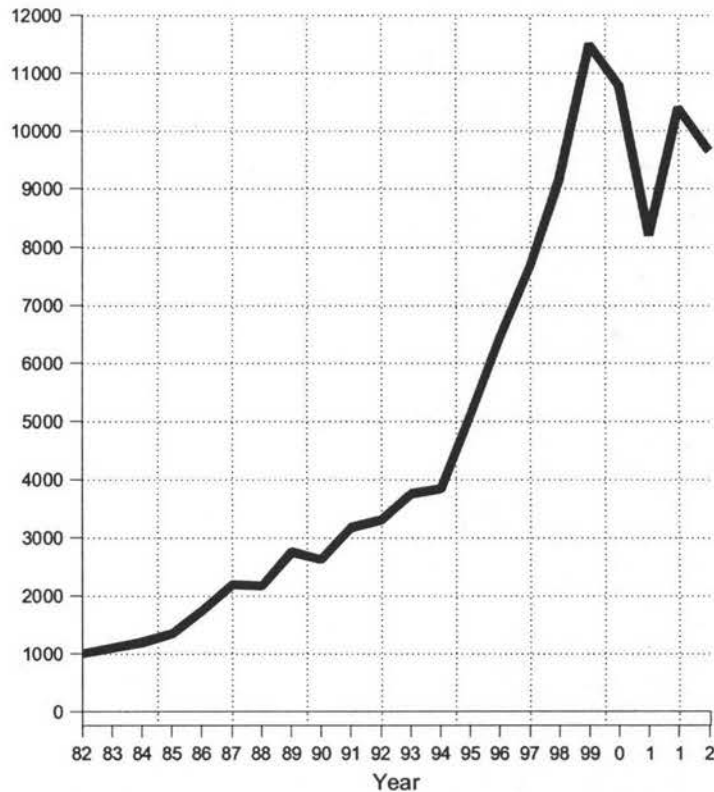


- (1) Life expectancy of 50 year old couple is 40 years.
- (2) Census bureau estimates that 40% of women who reach age 50 this year will live to be 100 years old.
- (3) Emphasis in gift planning will gradually shift from gifts that are only completed at the death of one or more persons, but that yield useable funds in less than forty or fifty years.

B. Economic influences are also a factor in major and planned gift development.

1. Long-term growth in equity markets has resulted in tremendous gains in wealth for top 20% of population. Recent downturns have created an atmosphere of uncertainty.

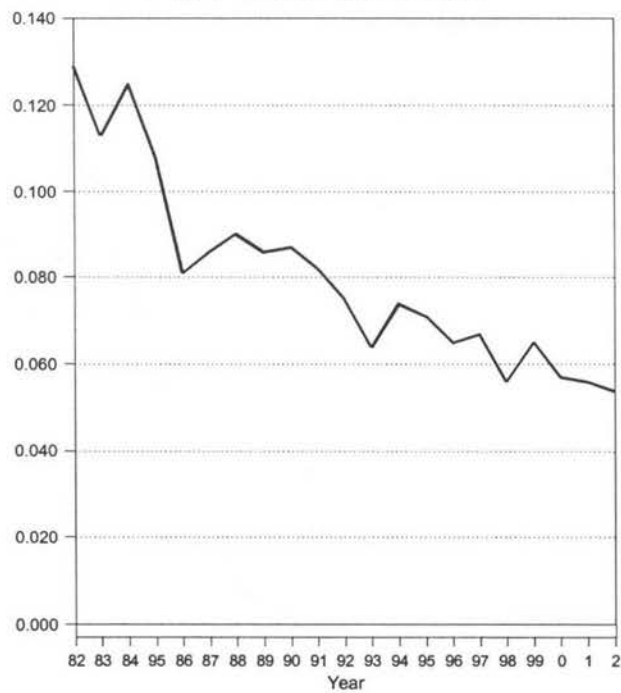
Dow Jones Industrials Average For Period 1982-2002



2. Much of the wealth created in investment markets over past two decades is owned by older Americans.
3. Many investors would like to “cash in” and enjoy income from their investments.
4. This involves payment of capital gains tax for the privilege of doing so.

5. If they cash out, lower interest rates await them.
Note trend in government security interest rates.

Trend in Long-Term Treasury Yields For Period 1982-2002



- II. A Closer Look at Social Policy as Reflected in Tax Law Changes.
- A. The changes brought about The Economic Growth & Tax Relief Reconciliation Act of 2001 (EGTRRA) will affect taxpayers very differently depending on various factors.
1. Marital status of donor.
 2. Whether donor has children.
 3. Age of donor.
 4. Wealth level of donor.

B. Where planned giving is concerned, wealth levels and age will be the primary factors that determine how EGTRRA will influence donors and their advisors as they plan charitable gifts.

1. The wealthier a person is, the more likely they will have to consider estate and gift taxes as they plan.

**ESTATE TAX
PHASEOUT SCHEDULE**

Year	Exempt Amount	Maximum Rate
2002	\$1,000,000	50%
2003	\$1,000,000	49%
2004	\$1,500,000	48%
2005	\$1,500,000	47%
2006	\$2,000,000	46%
2007	\$2,000,000	45%
2008	\$2,000,000	45%
2009	\$3,500,000	45%
2010	Tax Repealed*	0%

2. Note that 51% of those who are were subject to tax in 2001 are now exempt since the exemption rose to \$1,000,000 in January 2002. While a "sunset provision" may restore current law in 2011, keep in mind that will mean a "return" to a \$1,000,000 exemption which would have been in place in any event by 2006 under current law so that will be the "current law" that is returned to.

Estates	Value of Estates	Cumulative Exempt	Cumulative Percentage
49,705	650,000-1,000,000	49,705	50.79%
36,419	1,000,000-2,500,000	86,124	88.00%
7,689	2,500,000-5,000,000	93,813	95.86%
2,665	5,000,000-10,000,000	96,478	98.58%
944	10,000,000-20,000,000	97,422	99.54%
446	over 20,000,000	97,868	0.46%
97,868		97,868	100%

3. The older a person is, the more likely it is that they must plan their estate anticipating the need to pay estate taxes.
4. Younger persons, regardless of wealth, may tend to take a “wait and see” attitude and be less likely to plan their estates with the assumption that their estates will owe estate taxes. The net result may be to quell planning by younger persons that requires the irrevocable transfer of significant amounts of property today in order to eliminate estate tax and/or “replace” assets that would otherwise be lost to taxes. On the other hand, those who sell products where youth is a planning advantage will be reminding these persons of the risks their heirs face if they are wrong.
5. In any event, considering the impact of estate and gift tax changes on various age groups will be important in determining the correct communications strategies to pursue with each group.

	YOUNGER	MIDDLE-AGED	OLDER
WEALTHY	A1	B1	C1
MODERATE MEANS	A2	B2	C2
LIMITED MEANS	A3	B3	C3

- C. Some planning vehicles are primarily age-sensitive.
1. Bequests via wills, trusts, life insurance, retirement plans or other means.
 2. Gift annuities.
 3. Charitable remainder trusts for life.
 4. Life estates in homes.
 5. Pooled income funds.
- D. These plans can be arranged according to the age ranges of primary appeal. Wealth is also a factor to some extent.

AGE-BASED GIFT PLANS

	-50 YOUNGER	50-70 MIDDLE-AGED	70+ OLDER
WEALTHY	A1	B1	C1 Bequests Charitable Trusts for Life Bequests Life Estate Gifts Gift Annuities Retirement Plans & Insurance
MODERATE MEANS	A2	B2 Charitable Trusts for Life Pooled Income Funds	C2 Bequests Charitable Trusts for Life Pooled Income Funds Gift Annuities Retirement Plans & Insurance
LIMITED MEANS	A3	B3	C3 Bequests Gift Annuities Retirement Plans & Insurance

1. The impact of tax law changes can be considered in this context.
2. The older donors are, the less likely various plans are to be affected.

E. The use of other planning tools is indicated primarily based on the wealth of an individual.

1. Charitable lead trusts.
2. Term of years remainder trusts.
3. Charitable remainder trusts for life of others.
4. Charitable remainder trusts with income assignments.
5. Outright gifts of property.

F. These plans can be arranged in the gift planning matrix based primarily on wealth with age as a secondary consideration.

WEALTH-BASED GIFT PLANS

		-50 YOUNGER	50-70 MIDDLE-AGED	70+ OLDER
WEALTHY	A1	Gifts of Cash Gifts of Appreciated Property Charitable Lead Trusts Term of Years Trusts Life Income Gifts for Others	Gifts of Cash Gifts of Appreciated Property Charitable Lead Trusts Term of Years Trusts Life Income Gifts for Others	Gifts of Cash Gifts of Appreciated Property Charitable Lead Trusts Term of Years Trusts Life Income Gifts for Others Life Income Gifts for Donor
MODERATE MEANS	A2	Gifts of Cash	Gifts of Cash Gifts of Appreciated Property Term of Years Trusts	Gifts of Cash Gifts of Appreciated Property Term of Years Trusts Life Income Gifts for Donor
LIMITED MEANS	A3	Gifts of Cash	Gifts of Cash	Gifts of Cash

G. All of the plans will claim a constituency in one or more of the "boxes."

AGE AND WEALTH-BASED MATRIX

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

Some plans have limited appeal based on both wealth and age.

- a. Testamentary charitable lead trusts.
- b. Large charitable gift annuities.

H. Impact of tax changes on charitable bequests.

1. Most bequests in terms of numbers come from estates that are not subject to tax under today's laws.
2. Approximately 50% of the dollar value of bequests comes from non-taxable estates. Of the amounts being left to charity from taxable estates, 80% or more of those estates will no longer be subject to estate tax over the next few years.

Example:

Mary G. is a widow, age 75, with no children. She owns the following assets:

Home	\$350,000
Investments	450,000
Other	<u>200,000</u>
Total	\$1,000,000

During a meeting with her tax advisor in 2001, she was told that the federal taxes on her estate could be over \$120,000 if she died in that year and left everything to her nieces and nephews. Her assets would have been distributed as follows:

Family	\$880,000
Approximate tax	<u>120,000</u>
Total	\$1,000,000

Mary decided she would like to leave \$100,000 of her estate to fund scholarships in memory of her husband, and the remainder to her nieces and nephews. Under 2001 estate tax laws, this would have been the approximate tax consequences:

Value of estate	\$1,000,000
Charitable gifts	<u>100,000</u>
Taxable estate	\$900,000
Approximate tax	\$ 83,250

Her assets would thus have been distributed in the following way:

Family	\$816,750
Charity	100,000
Taxes on family portion	<u>83,250</u>
Total	\$1,000,000

Because of the need to pay taxes on the amount left to her nieces and nephews, the combined cost of taxes and her request to charity would have been \$183,250.

Mary was pleased to learn that beginning January 1, 2002, the amount she can leave to anyone through her estate has increased to \$1 million. As a result, she can still leave the \$100,000 she had planned to fund scholarships, and her loved ones will now receive more than they would have before, even if no bequest had been made, as no tax will be due on the portion they receive.

Family	\$900,000
Charity	100,000
Taxes on Family Portion	<u>-0-</u>
Total	\$1,000,000

She can thus decide to keep her charitable bequests at the same amount as previously planned or increase them somewhat if desired, with her nieces and nephews still receiving more than before.

Alternatively, she could increase her bequest from \$100,000 to as much as \$183,250, while her family would still enjoy the same amount she had planned for them to receive prior to the 2001 tax act.

3. IRS data for estates of persons who died in 1998 reveal that just under 17% of approximately 97,000 persons who die with taxable estates now make charitable gifts and use the estate tax deduction. This amounts to about 16,000 persons per year from among the approximately 2,377,000 deaths each year. The cost to the families of these persons can be as much as 45% of the amounts donated via the estate.
 - a. These persons are contributing in the range of \$10.8 billion each year.
 - b. Treasury economic models predict that if estate taxes are eliminated, charitable giving via estates will decline by \$6 billion per year, or approximately 60% of the amount currently being left to charity by persons with taxable estates.

This analysis ignores the strength of the donative intent. Of an estimated 225,000 estates that included gifts to charity in 1998, as noted above only 16,000 enjoyed estate tax savings. That means that for over 90% of persons leaving funds to charity via their estates, the cost is currently 100%.

4. Recently released surveys of the very wealthy reveal that such persons appear to be leaning toward directing a significant portion of their tax savings toward charitable purposes after assuring that their families are adequately provided for. The respondents to this survey conducted by Paul Schervish, of Boston College for Bankers Trusts Company had a median net worth of \$39 million.

Estate Planning

Not surprisingly, nearly all (89%) of the respondents have a written estate plan. They by-and-large expect their assets to pass on to their heirs and to go for taxes, with a smaller portion going to charity. If they had their way, most would allocate more money to charity and less to taxes, though not all the wealth holders were in favor of eliminating estate taxes altogether.

Expected and desired distribution of estates

	<i>Expected Distribution</i>	<i>Desired Distribution</i>
Children and grandchildren	42%	58%
Other heirs	5%	6%
Taxes	37%	9%
Charity	16%	26%
Other	0%	1%

Source: Bankers Trust Private Banking – "Wealth with Responsibility – Study 2000"

Example:

Harold Schmidt has amassed an estate of \$10,000,000. His estate would have paid taxes at a rate as high as 55% under pre-2002 tax law on amounts over \$3,000,000. As part of a capital gift development effort, he made a binding estate commitment of \$2,500,000. Mr. Schmidt has two children, and he decided he wanted them to share the balance of his estate amounting to approximately \$1,700,000 each at his death.

Note the approximate cost of this gift to his family net of the combination of estate taxes and the gift, assuming various estate tax rates from 2001 forward:

Gross Estate	Charitable Bequest	Taxable Estate	Maximum Tax	Tax Paid	Net To Family	Percent To Family	"Price" To Family
\$10,000,000	\$ 2,500,000	\$ 7,500,000	55%	\$ 4,125,000	\$ 3,375,000	34%	66%
\$10,000,000	\$ 2,500,000	\$ 7,500,000	50%	\$ 3,750,000	\$ 3,750,000	38%	63%
\$10,000,000	\$ 2,500,000	\$ 7,500,000	45%	\$ 3,375,000	\$ 4,125,000	41%	59%
\$10,000,000	\$ 2,500,000	\$ 7,500,000	40%	\$ 3,000,000	\$ 4,500,000	45%	55%
\$10,000,000	\$ 2,500,000	\$ 7,500,000	35%	\$ 2,625,000	\$ 4,875,000	49%	51%
\$10,000,000	\$ 2,500,000	\$ 7,500,000	30%	\$ 2,250,000	\$ 5,250,000	53%	48%
\$10,000,000	\$ 2,500,000	\$ 7,500,000	25%	\$ 1,875,000	\$ 5,625,000	56%	44%
\$10,000,000	\$ 2,500,000	\$ 7,500,000	20%	\$ 1,500,000	\$ 6,000,000	60%	40%
\$10,000,000	\$ 2,500,000	\$ 7,500,000	15%	\$ 1,125,000	\$ 6,375,000	64%	36%
\$10,000,000	\$ 2,500,000	\$ 7,500,000	10%	\$ 750,000	\$ 6,750,000	68%	33%
\$10,000,000	\$ 2,500,000	\$ 7,500,000	5%	\$ 375,000	\$ 7,125,000	71%	29%
\$10,000,000	\$ 2,500,000	\$ 7,500,000	0%	\$ -	\$ 7,500,000	75%	25%

Upon learning of the scheduled repeal of estate taxes and the impact of that on his children's inheritance, he decided that he would rewrite his will in such a way that the bequest would remain in his will following estate tax repeal and actually be increased somewhat, as he could now "afford" to do so while his children would actually receive more.

5. Some persons who are in their late 70s to early 80s who will be adjusting their estates as a result of tax law changes will still be planning in terms of the possibility of significant taxes due on a larger estate. If they have bequests in their current wills, they now have them there at a cost to their noncharitable heirs. That cost will fall under the new law. If they are not now subject to tax, there is no reason to think they will change the charitable dispositions in their estates because they are still not subject to tax. There is now even less likelihood that they will be subject to estate tax in the future.

I. Impact of tax law changes on gift annuities.

1. Gift annuity activity should remain strong.
2. Evidence that average age of gift annuitants is getting older as "supply" of persons in the 70 to 80 age range begins to fall.
3. To the extent gift annuitants are motivated by estate tax savings, most of them are in the age range when they enter into gift annuities that they will not be seriously contemplating elimination of the tax during their lifetime.

4. Most persons who make gifts in the form of gift annuities are strongly motivated by income and capital gains tax planning considerations and other economic motivations.

J. Retirement plan gifts under the terms of the new tax law.

1. Legislation that would allow outright gifts from retirement plans or rollover into split interest gift vehicles, while still alive in Congress, did not make it into the final versions of EGTTRA.
2. Retirement plans will nevertheless continue to be tremendous growth source for charitable gifts as G. I. Bill generation passes away.
3. As estate taxes are reduced or eventually eliminated, retirement plans will still be a desirable "pocket" from which to make gifts at death, as these funds will still be subject to income tax if left to heirs.

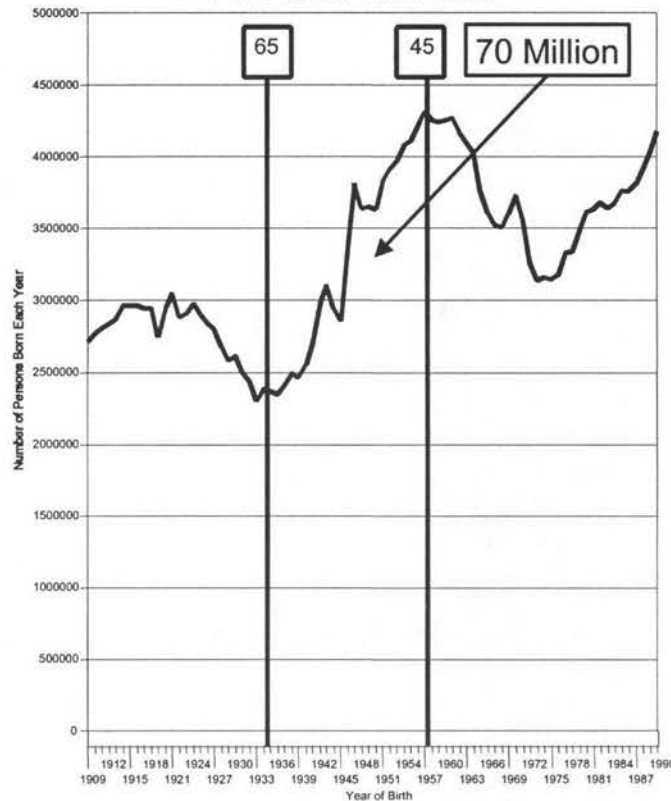
K. Outlook for gifts of life insurance.

1. Large amounts of wealth in the form of life insurance.
2. Can be an excellent "bequest substitute."
3. Many persons own large amounts of life insurance to provide for liquidity should their estates be subject to tax.
4. To the extent there is a windfall in an estate due to reduction or elimination of estate taxes, it may be realized in the form of "excess" life insurance proceeds. It may be wise to encourage donors and their advisors to engage in contingency planning that results in life insurance that is not needed for the payment of taxes being directed to charitable purposes.
5. Insurance will still be purchased to replace wealth for heirs, but will be much more difficult to show heirs "coming out ahead" if no estate taxes are due in a "do nothing" or "sell and reinvest" scenario. Wealth replacement will continue to be attractive to persons who are making large charitable gifts and wish to take steps to minimize the impact of their gift on the amounts left to their loved ones.

L. Charitable remainder trusts and the new tax act.

1. Average age of CRT donors is late 60s.
 - a. Most unitrust donors are couples who are either already retired or who are approaching retirement years.
 - b. Charitable remainder annuity trust donors have traditionally been older and female, more likely to match the profile of the typical gift annuitant.
2. Over 70 million persons will reach the age of 65 over the next twenty years.

Number of Live Births In America
For Period 1909-1990



3. Demographic shifts will be such a tremendous impetus to the growth of charitable remainder trusts, it may be difficult to ascertain impact of tax law changes looking backward from a vantage point in time ten years hence.

4. CRTs with wealth replacement may be more common as younger donors can gain more leverage using this technique. Long life expectancies combined with uncertainties concerning long-term investment performance may lead more and more people to consider higher payout annuity trusts for terms of years.
5. NCPG survey indicates that while desire to make gifts is the primary motivator of charitable remainder trust donors, the desire to plan for tax savings is a much higher motivator than in the case of charitable bequests.

Reasons for Making A Charitable Remainder Trust



6. As estate tax is eliminated or threshold increased, and at the same time there are income and asset limits on social security and medicare benefits, seniors may be looking for ways to increase security and protect assets in later years.
7. There are a number of motivators for charitable remainder trusts, pooled income funds, and gift annuities apart from estate tax savings that fall into the category of “long-range estate/financial planning issues” listed above.
 - a. Predictable income.
 - b. Capital gains tax savings that results in more income potential from appreciated assets.
 - c. Tax-free investment diversification.
 - d. Income tax savings.
 - e. Tax-free growth of assets.
 - f. Professional asset management.
 - g. Protection of assets.

8. The financial planning community and charities should in many cases encourage charitably-motivated donors to act during their lifetime when all of the above advantages can be achieved, rather than making a gift at their death that may result in no tax savings for them or their heirs.
9. Charitable lead trusts.
 - a. Lead trusts will remain attractive in lower interest rate environment.
 - b. Will perhaps be more attractive to baby boomers with younger children as a tax-efficient way to delay inheritances.
 - c. As estate taxes are reduced or eliminated, charitably-minded persons may appreciate freedom to structure lead trusts with much greater freedom and find lead trusts to be an excellent way to minimize taxes that may still be due on their estates.
 - d. As gift taxes will be retained for transfers during lifetime in excess of \$1 million even after planned repeal of the estate tax, the lead trust will continue to hold attraction for persons who wish to make significant charitable gifts but who also wish to minimize taxes that MIGHT otherwise be due on inter vivos gifts to loved ones.
- M. Gifts of remainder interests in real property.
 1. Attractive to those who may not be subject to estate tax but who would like to make a significant gift to charity at death and enjoy tax benefits today.
 2. Attractive to wealthy donors who expect to be subject to estate tax and would like to reduce the impact of those taxes and also enjoy tax benefits today.
 3. As in the case of charitable lead trusts, lower interest rates make such gifts especially attractive.

III. Examples of Ways to Use Gift Planning Tools to Attain Multiple Goals.

A. Using deferred gift annuities to plan for long term economic security.

George and Mary Sparks, both age 70, have recently retired from successful careers. They enjoy investment income in excess of \$150,000 per year. This amount is more than adequate to sustain their standard of living. In addition to this income, they will be required to withdraw \$100,000 from their retirement plan in the coming year. Their home is paid for and they have few income tax deductions available to them other than their charitable gifts. They are in the 35% tax bracket on each additional dollar of income. The Sparks' children are in their 40s and are very well off financially, having inherited significant amounts from their grandparents.

The Sparks have decided that they would like to leave a portion of their estates to charity, and are considering a bequest of at least \$100,000 to one of their interests.

Upon review of a number of options shown them by the charity and their advisors, the Sparks indicate that they think the balance of their retirement plans might be the best "pocket" from which to make their charitable bequests, as this is the asset that will yield the least for their children after estate and income taxes that must be paid on any amounts left to them from their retirement plans.

The Sparks have several hundred thousand dollars worth of securities that have increased greatly in value since they have owned them but yield little income. They have been shown how they could increase their income from these assets using a charitable remainder trust, but they have decided that additional income is not a high priority currently. A charitable gift annuity that pays a fixed rate of 6.6% for life doesn't interest them either.

Why don't the Sparks just make a current gift to offset the withdrawal from their pension plans rather than pay tax on money they otherwise plan to leave to charity in any event? The primary concern that keeps the Sparks from making larger current gifts or an irrevocable charitable commitment at this point is the fear that they may need more income in their final years of life, perhaps age 85 to 95 or older. Mrs. Sparks mother is still alive at age 94.

In their situation, the Sparks might wish to make use of a deferred payment gift annuity. A deferred gift annuity at their ages, both 70, with payments deferred until age 85, would result in payments at that time (using the American Council on Gift Annuities 2001 suggested rates) of 19.9% of today's gift amount. Their charitable deduction would be approximately 68%.

If they were to withdraw \$100,000 from their retirement plan, they would pay some \$35,000 in federal income tax, leaving them \$65,000 to invest for their future economic security.

Given these facts, the Sparks might wish to withdraw the \$100,000 from their retirement plan and enter into a deferred payment gift annuity in the amount of \$85,000 with the following results:

Additional reportable income	\$100,000
Deduction for deferred gift annuity	(\$57,800)
Amount taxable	\$42,200
Tax liability	\$14,770

From a cash flow standpoint, this is what happens:

Withdrawal	\$100,000
Less amount donated for deferred annuity	(\$85,000)
Less tax paid	(\$14,770)
Net cash	\$230

The Sparks have thus reduced the tax on their withdrawal from \$35,000 to \$14,770, a savings of over \$20,000, which represents a nearly 60% reduction in the amount of tax they would otherwise owe on the withdrawal. They have set aside \$85,000 to grow for their benefit 15 years hence, rather than the \$65,000 that would have remained after-tax if they had made no gift.

When they reach age 85, they will enjoy income of 19.8% of \$85,000 or \$16,830 per year, hence the term "deferred annuity rate." If they were to complete a similar gift each year for a number of years, they would be building a significant "secondary retirement plan" for increased comfort in later years. In the meantime, they are free to enjoy the fruits of a lifetime of labor knowing they have assured a future income if required.

It might also be wise to use their most highly appreciated, lowest yielding securities to fund the deferred gift annuity. This would result in partial avoidance and partial delay of the capital gains tax that would be due on a sale. The net cash remaining from the retirement plan fund withdrawal after taxes could then be used to purchase a new, more highly diversified portfolio of securities.

In sum, they have avoided some \$20,000 in income tax at the time of withdrawal, avoided as much as \$18,000 in federal capital gains taxes, and as much as \$32,500 in federal estate taxes on the \$65,000 that would have been remaining after their withdrawal.

If they both die prior to the commencement of the annuity payments, they have made the significant "bequest" they had planned to make, while accelerating tax benefits from the "bequest" into an income tax deduction in the current tax year. If they wish, they could still leave any amounts remaining in their retirement accounts at death for charitable use.

As an added benefit, even if all of their other assets are exhausted, they will have the comfort of knowing that they may enjoy a future income stream that will be backed by all of the available assets of the organization that issued the gift annuity.

If the underlying funds earn 8% per year during the deferral and payout period, here is the anticipated result.

Reserve at time payments begin	\$269,634
Payment Amount	\$ 16,830
Payment as Percent of Reserve	6.2%

Note that the payment amount represents just 6.2% of the amount of the annuity reserve fund at the time the payments begin and 5% of the value of the reserve fund at the end of the anticipated payment period. Thus the level of risk to the charity is minimal and diminishes with the growth of the reserve fund over time.

The deferred gift annuity will typically have a present value that is very high relative to the amount contributed for the annuity. Note the present value in the case of this example if we discount the anticipated value of the remainder of the annuity reserve at 5%:

Reserve at time payments begin	\$275,979
Payment Amount	\$ 16,830
Anticipated Payment Period	10 years
Anticipated remainder	\$338,311
Present Value at 5% Discount	\$ 99,904

This gift may thus be attractive to a 70 year old couple that would like to make a meaningful gift while providing for a "secondary retirement income" that will be available if they should live to advanced years.

If they die before receiving payments from the annuity, they have accelerated tax benefits from a future bequest to the current tax year. Each spouse also enjoys the knowledge that should they predecease the other, the entire endowment of the charitable recipient stands behind the payment of a substantial future income.

Consider the impact on future economic security for the Sparks if they were to complete such a gift each year between ages 70 and 75.

B. Combining outright and deferred gifts to fund a large gift over a period of years.

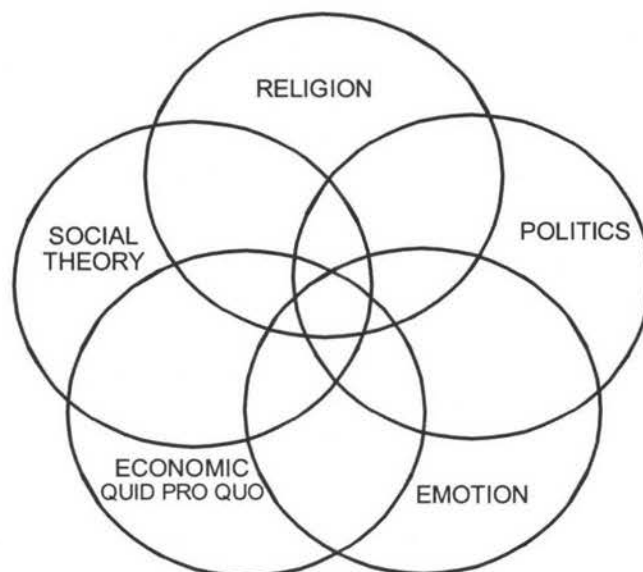
George and Elizabeth Harper, age 65 and 62 have been long term supporters of a number of charities, particularly those that focus on learning disabilities in children. Mrs. Harper is on the board of a particular charity that has evidenced a desire to begin a state of the art facility aimed at supplementing other educational opportunities that are available in the community for children with severe learning disabilities. While there are programs designed for such children in the local school systems, the Harpers have a child now in his 40s whom they believe could have benefited immensely had there been such a center available when he was a child. He is currently unable to support himself and the Harpers provide for his economic well being.

Mr. Harper is the chief executive officer of a very successful corporation he founded over 30 years ago. It is common knowledge that he has stock in the company valued at over \$15,000,000. The total value of their other assets is in the range of \$6,000,000.

He and Mrs. Harper are very conservative politically and would like to see significant tax cuts and reduction in government spending. They believe, however, that investment in social infrastructure is essential to the smooth functioning of a civilized society and believe strongly that they have a duty to “give something back” to society.

The Harpers have two other children who are in their mid 30s. They are doing well financially. The Harpers have expressed a desire to take care of their disabled son for life and leave the bulk of their assets to their other children, with as little paid in estate taxes as possible. To date they have made periodic gifts to their children and their spouses utilizing the annual exclusion from gift tax of \$11,000 per donor per donee. They have also used all of the estate and gift tax exemption that was available to them prior to the 2001 tax act (\$1,350,000). They were pleased to learn that as of January 1, 2002, they can give an additional \$650,000 (\$325,000 each) to their heirs tax free during lifetime or at their death. They are interested in utilizing this amount in the most effective way possible.

Consider the various elements that make up the intentions underlying the Harper’s gifts:

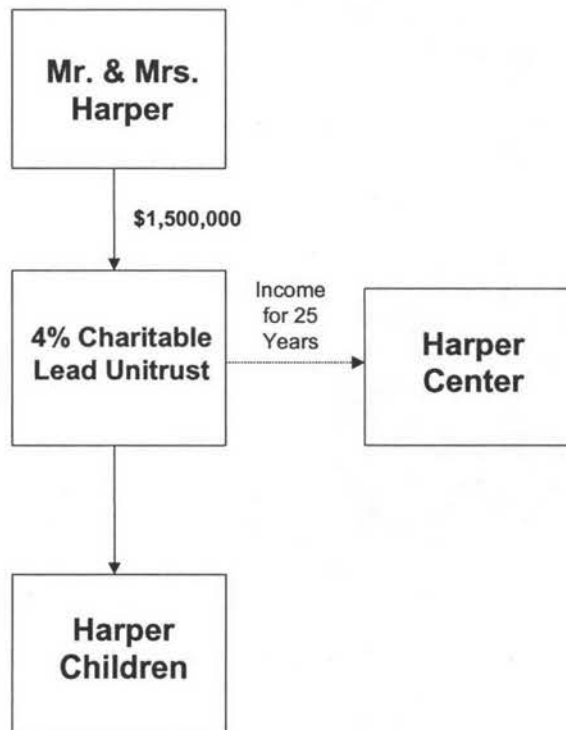


They have expressed a desire to leave assets to charity at death but they would really like to see some of their wealth put to work today funding programs they wish to support, rather than just at their death.

How might the Harper's wishes be carried out using a variety of charitable planning techniques?

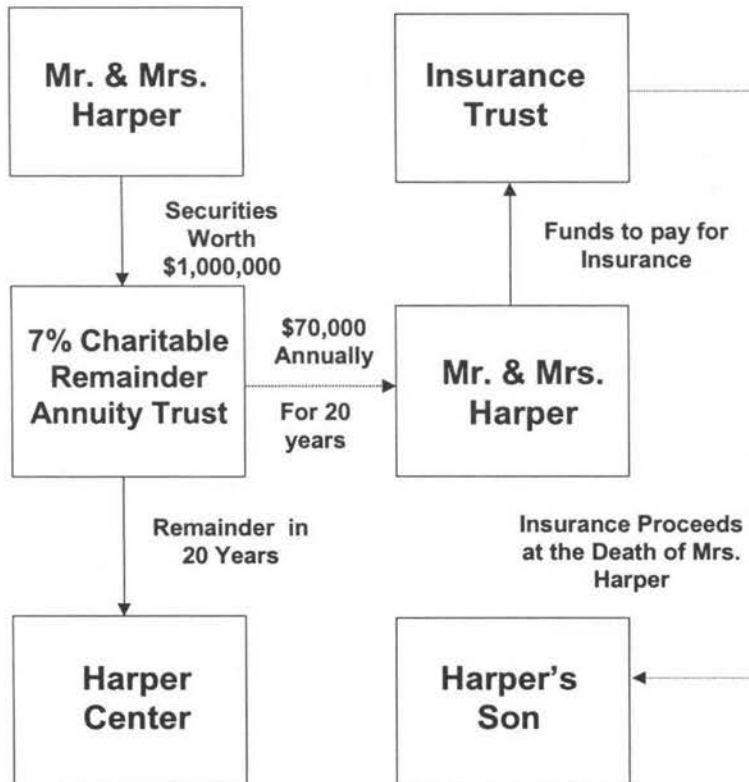
Here is how the Harper Childhood Development Center was funded. First, the Harpers made an outright gift of \$500,000 worth of very low basis stock in his corporation for use in the acquisition of land for the construction of the facility. This was the lead gift in a \$1,500,000 campaign for funds to supply the physical plant needed for the operation of the facility. This capital need is urgent in that the center cannot function without capital facilities.

Second, The Harpers established a \$1,500,000 charitable lead unitrust with a payout rate of 4%, or \$60,000 the first year. If the trust earns a total return of 7%, then the payments will increase over time. The payments from this trust will be used to substantially underwrite the salary of a director of the center with upward adjustments expected each year. The lead trust amounts to a "temporary endowment" that will provide assurance to a prospective new director that the fund will be available for at least 25 years to assure a large portion of the salary required for the position.



The Harpers will be entitled to a gift tax deduction of \$943,000, leaving a taxable gift of \$557,000 to their children. This amount can be offset against the additional \$650,000 lifetime gift tax exemption amount available to them as of January 1, 2002. The children will receive the remainder of the trust when they are in their late 50s. If it earns 7% per year and pays income tax on the amount earned in excess of the payout amount, they should receive approximately \$2,400,000 at the termination of the trust.

Third, the Harpers decide to create a \$1,000,000 charitable remainder annuity trust that will make a fixed payment to them each year of \$70,000 for a period of 20 years.

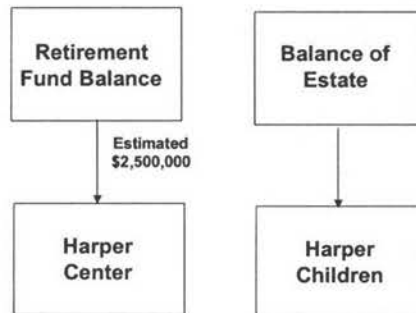


At the end of the 20 year period the remainder of the trust will be transferred as permanent endowment for the Center. For a period of five years, the Center will have the benefit of both the lead trust and the remainder from the CRAT.

The Harpers plan to use very low basis stock to fund the CRAT. If the trust earns a total return of 7%, comprised of 3% in ordinary income and the remainder in capital gains, then the majority of the income from the trust will be taxed as capital gain under the tier structure of income reporting. The Harpers plan to use the tax savings and after-tax income from the trust to purchase a large amount of life insurance owned outside their estates on the life of Mrs. Harper that is payable to a trust for the benefit of their disabled son. In this manner they assure a significant sum is available to support their son while also providing additional endowment for the Harper Center that will be available in 20 years no matter how long they live.

Finally, the Harpers provide that at their death the balance of their qualified retirement plans, anticipated to be some \$2,500,000, be paid to the Center to fund a permanent endowment.

The balance of their estate will be left to the two children who have not otherwise been provided for in trusts. It is anticipated that the amount that each child will receive will equal or exceed the amount left to the disabled son, not counting the amount that they will receive at the termination of the charitable lead trust.



Through careful planning, the Harper Childhood Center will be established with a new physical plant, an executive director whose salary is largely funded for 25 years with a means of adjustment for inflation, a permanent endowment of \$1,000,000 or more available at the end of 20 years and a long-term commitment of \$2,500,000 or more to be received at the death of the donors.

It would be most unusual if donors like the Harpers did not continue to make regular gifts to the Center each year for the remainder of their lives, given the substantial "investment" they have already made now and over the coming years. Did the Harpers make a major gift, a leadership gift, a capital gift, an endowment gift, a special gift, a deferred gift, an annual gift, or a planned gift?

IV. Conclusion.

- A. Demographics, economics, tax changes, and other factors may well usher in a “golden age” of planned giving.
 - 1. Charitable entities can help older generations transfer their wealth.
 - 2. Can also help younger generation inherit and manage it well.
- B. Tax laws will play an important role.
 - 1. Strategies may change.
 - 2. Basic fairness will always dictate that Americans not be taxed on wealth that is voluntarily devoted to charitable use.
- C. Despite demographic, legislative, economic and social change, the future is bright for those organizations and institutions that are meeting vital needs in society.
 - 1. The form of gifts may change.
 - 2. The timing of gifts may change.
 - 3. Motivations are complex, but are ultimately rooted in aspects of human nature that are timeless.

Sparkling Ideas...



in the Emerald City

LEADING DONORS TO THE TOP

G. Roger Schoenhals
Publisher
Planned Giving Today®
100 Second Ave. So., Suite 180
Edmonds, WA 98020
(425) 744-3837
FAX (425) 744-3838
roger@pgtoday.com

25TH CONFERENCE ON GIFT ANNUITIES • PRESENTED BY THE AMERICAN COUNCIL ON GIFT ANNUITIES

233 McCREA STREET, SUITE 400 • INDIANAPOLIS, INDIANA 46225 • (317) 269-6271 • FAX: (317) 269-6276 • E-MAIL: ACGA@IUPUI.EDU

Leading Donors to the Top

By G. Roger Schoenhals

Note: This nontraditional session compares planned gift development with the adventure of guiding donors up the trail of a grand mountain. Picturesque photos and the personal experiences of the speaker will illustrate the needed techniques to bring donors from the lowlands of annual giving all the way to the top where ultimate gifts are made.

Introduction

- A. Mountains and Nonprofits
- B. Pyramids of Development
- C. The Ultimate Trip

I. Planning the Trip

- A. Personnel
- B. Route
- C. Logistics

II. Meeting at the Trailhead

- A. Initial Contact
- B. Final Preparations
- C. Setting Out

II. Walking the Gentle Lowlands of Annual Giving

III. Hiking the Steeper Slopes of Special Giving

IV. Along the Way

- A. Hazards of Hiking
 - 1. Falling Rocks
 - 2. Bad Weather

3. Obstructions
4. Physical Problems
5. Other Dangers

B. Enroute Advice

C. Stops and Snacks

D. Elevation Factors

E. Delightful Vistas

V. Climbing the Final Stretch to Ultimate Giving

A. The Pace

B. Perseverance

C. Arrival Sensations

1. Exaltation

2. Expansion

3. Achievement

4. Ownership

5. Exclamation

VII. Coming Down

Conclusion

Sparkling Ideas...



in the Emerald City

THE CHARITABLE LEAD TRUST

Marjorie A. Houston
Executive Director, Gift Planning
Brown University
Box 1893
Providence, RI 02912
(401) 863-1459
FAX (401) 863-3301
marjorie_houston@brown.edu

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**The Charitable Lead Trust
Marjorie A. Houston**

April 10, 2002

The Charitable Lead Trust

Abstract

During the past twelve months we have seen the IRS monthly discount rate drop to 4.8%, making this a favorable climate for charitable lead trusts. We have also seen the advent of dramatic changes in the estate and gift tax law that could impact the importance of the charitable lead trust in a person's long term financial and philanthropic planning. Even with the tax law changes, the lead trust remains a good vehicle for the right donor to satisfy charitable intentions, and at the same time, pass along assets to the next generation at minimal gift tax cost. The lead trust, however, is not as much about saving taxes as it is about the family. The donor is giving up something to make the gift, so also is the family. Helping the donor to understand the concept is important; listening to the needs and concerns of the donor is even more so. In the end, the donor will be the one who closes the gift.

What Is a Charitable Lead Trust and How Does It Work?

A lead trust is an irrevocable trust, created during life or at death, that gives charity the first or leading interest – rather than the remainder interest – in the trust, and thereafter passes to or continues in trust for others, such as children or grandchildren. It is a separately invested trust created by transferring cash, marketable securities, or income-producing property to a trustee you select.

The trustee may be one or more individuals, a bank, the charity, or a combination of these. You designate charity as the beneficiary of income for a specified period of years, or for a period measured by a person's lifetime. Upon completion of that period, the assets revert to beneficiaries you have designated in the trust instrument.

A unique feature of a charitable lead trust is that you may tailor charity's income interest. A charitable lead unitrust pays an annual income equal to a percentage of the value of the principal, as valued annually. You select the percentage pay-out when you create the trust. A charitable lead annuity trust pays a fixed amount annually to charity. You specify the fixed dollar amount when you establish the trust.

How Can You Benefit from the Charitable Lead Trust?

The gift and estate tax law provides for a deduction for the present value of the lead interest in the trust committed to charity. Your gift or bequest, in the form of the lead trust, is equal only to the remainder value of the trust assets that pass to the non-charitable beneficiaries after the lead trust ends. The value of the remainder interest passing to the beneficiaries is subject to gift or estate tax at the time the trust is created. (In 2010, the estate tax is repealed. A testamentary charitable Lead trust established in a decedent's estate in 2010 only, will not be subject to estate or generation skipping transfer taxes. Without the estate tax and GSTT liability, outright gifts to children and grandchildren will be preferable from a purely tax savings point. In 2011 the estate and gift tax exemption return to those in effect before the law was signed in 2000, therefore making good testamentary planning difficult.)

The value of the taxable gift is determined by subtracting the value of the interest committed to charity from the fair market value of the property at the time it is transferred to the charitable lead trust. At this time any available unified credit, which increased to one million dollars in 2002, is applied to offset any gift tax obligation.

Briefly, three components influence the charitable lead trust: the amount paid to charity, the length of time the trust is established, and the prevailing IRS discount rate at the time the trust is established. The discount rate is the percent at which the government determines money will grow over time, based on the mid-term government bond rate. The rate fluctuates monthly. The combination of the three rates determines the value of the gift to the beneficiaries, and therefore the amount of gift or estate tax to be paid.

Can You Arrange a Charitable Lead Trust So That the Gift or Estate Tax is Zero?

Through a charitable lead annuity trust, you can equalize the charitable deduction and the entire value of the property transferred to the trust. In this case, the taxable gift or bequest made upon creating the charitable lead annuity trust is zero, and no gift or estate tax is assessed.

For example, on a trust established for fifteen years, with a 6 percent pay-out rate you would pay tax on 40 cents of each dollar given to your children, assuming that the portfolio has an annual total return of at least the charitable pay-out. If your asset doubles in that time period, you effectively will have paid tax on 20 cents or less on a future value. Moreover, based on certain of the foregoing assumptions (e.g., the trust growth is significantly greater than the IRS discount rate), you could almost certainly pass more to your family than if the asset were passed directly during lifetime or at death.

The chart below demonstrates the portion of a dollar subject to gift tax when placed in a charitable lead trust.

Percent income earned on trust	Term of Trust		
	10 years	15 years	20 years
5%	0.62	0.50	0.40
6%	0.48	0.40	0.29
7%	0.48	0.30	0.17
8%	0.40	0.20	0.05
9%	0.33	0.10	0.0
10%	0.25	0.01	0.0

Based on 5.6% Discount Rate

Will You Be Subject to a Capital Gains Tax?

The most significant benefit of the charitable lead trust is that the asset is removed from your taxable estate. The gift tax is due when the trust is established, and can be paid from either the stock used to fund the trust, or other assets. If the trust is funded with a non-income-producing asset, the trustee must sell some shares annually to make the annuity payment, and the trust pays a capital gains tax for the sale. However, a corresponding tax deduction for the trust is applied because the trust is making payments to a charitable entity. The taxes paid are offset, therefore, essentially nullifying the tax effect to the trust.

Can You Serve as Trustee for Your Charitable Lead Trust?

If you fund a charitable lead trust, you can either specify the charity or charities that receive payments from the trust or leave the selection up to the trustees each year. If the charity or charities are selected annually by the trustee of the lead trust, you cannot be a trustee solely holding that power or else the lead trust property can be included in your gross estate. You have, however, the unqualified right to remove or replace an independent trustee or give that power to your spouse or other related person. This gives you enormous influence over the operation of a charitable lead trust.

Is a Charitable Lead Trust Right for You?

Because of the administrative and start-up costs involved in setting up a charitable lead trust, you should not consider establishing a trust for less than \$250,000. If you wish to give charity the income stream from assets for a set period of time, but want the capital value of marketable or income-producing assets to remain in your family, then a charitable lead trust may be right for you. If you wish to pass assets to your children or other persons at a discounted value and a reduced gift tax liability, then a charitable lead trust may be right for you. If you want to remove assets from your taxable estate, but still have them pass to your heirs during your lifetime or at death, then a charitable lead trust may be right for you. (Before the recent tax reconciliation Act of 2000 came into effect, one could establish a CLT on the life of a person

who was unrelated. This provided opportunity for misuse by using the life expectancy of a person who was likely to die sooner than the life expectancy. The new law requires that the person on whose life the trust is set be related to the grantor in some manner.)

Most Frequently Asked Questions of Interest to Donors

1. How do I determine the right number of years for my charitable lead trust?

The term is based on how soon you want your heirs to receive the assets and how much gift or estate tax you are willing to pay. A proven rule is to establish the trust for ten, fifteen, or twenty years if the assets at the end of the term are to benefit your children. If the assets are going to grandchildren, a twenty or twenty-five year term is appropriate.

2. Is it still possible to zero out the remainder going to charity?

There are several planning issues to consider, such as the availability of your unified credit. While it is still possible, alternative strategies should be reviewed – such as the step charitable lead annuity trust or setting a higher pay-out rate to charity over the term of the trust.

3. What investment issues should I consider?

You should have confidence in your managers to be able to produce a 10 percent average annualized return over the life of the trust. The trust must be actively managed with the goal to have the total return beat the discount rate.

4. Are there risks I should consider?

You should have a degree of comfort that some or all of the charitable pay-out will be taken from the trust's capital gain or principal, particularly if the funding asset either does not appreciate as anticipated or the portfolio is subject to market corrections.

5. What type of asset should I consider in funding the charitable lead trust?

Ideally, the lead trust is funded using a single appreciated security with high potential for growth over time, a diversified stock and bond portfolio, or an asset that is considered grossly undervalued. The ideal asset is income producing real estate.

6. What kind of results can I expect?

In most cases, the lead annuity trust can provide more for the children than doing nothing or leaving your assets in your estate. The lead annuity trust also produces more for children than an equivalent outright gift to children coupled with an outright gift to charity.

7. How do I know if a lead trust is right for me?

If you have an estate valued at more than five million dollars, have children or grandchildren, and you and your family do not need immediate access to the principal, a charitable lead trust may prove an effective tool for you to make a charitable gift and satisfy some family-planning issues. You will want to consider a minimum trust of \$250,000 and fund it with an asset that is likely to appreciate over time. The exemption from gift tax will be \$1 million in 2009. The unified credit for estate tax purposes is increased to \$3.5 million. In 2010 the estate and generation skipping transfer tax is repealed but the gift tax remains. On estates over \$5 million capital gains tax at death comes into play. All these factors need to be considered when evaluating whether a charitable lead trust makes sense.


Conclusion

The repeal of the estate tax, coupled with the retention of the gift tax, the changes in the step-up in basis rules for assets passed at death change the dynamics for gift planners. The charitable remainder trust will become the lead option of choice for all donors. The charitable lead trust and private foundation, often used to achieve estate tax savings, may no longer be needed for that purpose, particularly if the estate tax repeal becomes law after 2010. However, the gift tax is still with us and will be even if the estate tax repeal takes effect. The CLT will continue to be an effective way to provide lifetime gifts to children and grandchildren while avoiding federal taxes. In fact, in this pre-repeal environment of low discount rates this might be a great time for elderly donors to consider a CLT for grandchildren.

**The Charitable Lead Trust
- Don't Forget the Donor!**

**Marjorie A. Houston
25th Conference on Gift Annuities
April 10, 2002**

Introduction



- ⌘ Timing Is Everything!
- ⌘ Learning What Works
- It's about the donor understanding

The Genie in the Bottle...A Donor's Perspective

- ⌘ Your donor is 65 years old and you are discussing a \$2,000,000, 8% charitable lead annuity trust for 20 years
- ⌘ 80% of donor's net worth is in one low yielding, highly appreciated asset, which he wants to pass to his children
- ⌘ Donor has used lifetime exemption
- ⌘ Assume 2002 estate and gift tax rate structure

The Big Picture of the Lead Trust


- ⌘ The potential to channel future appreciation in personal assets to heirs, free of gift or estate tax liability
- ⌘ An estate tax freeze mechanism
- ⌘ Low cost to heirs of making a gift to charity

The Charitable Lead Trust

- ⌘ A taxable entity
- ⌘ An irrevocable split-interest trust
 - has an income interest which goes to charity
 - has a remainder interest which goes to family members

Three Components of a Lead Trust

- ⌘ Rate of Return
- ⌘ Duration of Trust
- ⌘ Discount Rate*
 - *The rate at which future earnings are discounted is the discount rate. It is based on the rate available on investments that bear NO RISK. This so called risk free rate of return is generally the rate available on mid-term Treasury Bills.

Mirror, Mirror on the Wall 


- ⌘ There is no 5% minimum limitation on amount of income paid to charity
- ⌘ The donor (grantor) to the trust does not usually get a charitable deduction for the income payments to charity
- ⌘ The trust is a taxable entity and activity in the trust is subject to general tax rules that govern all trusts

Confident...You Show the Donor the Numbers!



- ⌘ The Charitable Lead Annuity Trust
- ⌘ Term of Years 20
- Principal \$2,000,000
- ⌘ Income rate 8%
- ⌘ Annual to Charity \$160,000
- ⌘ Gift Tax Deduction \$1,896,300
- ⌘ Taxable Gift \$103,700
- ⌘ Gift Tax Due \$42,517
- ⌘ Benefit to Charity \$3,200,000
- ⌘ Benefit to Heirs \$4,253,132
- ⌘ Assumed growth rate 10%
- ⌘ IRS Discount rate 5.6%

...and the Donor responds



- ⌘ "So I Get an Income Tax Charitable Deduction of \$160,000 Every Year for Twenty Years?"
- ⌘ Answer: NO WAY!

Explaining the Taxes

- ⌘ The Income Tax...the trust's, not the donor's
 - The trust receives an unlimited charitable deduction for the amount paid to charity
 - The trust is not subject to the 30% or 50% limit on deductions
 - If trust does not distribute all of its earned income to satisfy charitable payments, then balance is taxed at compressed trust income tax rates.


Explaining the Taxes, cont'd...

- ⌘ Don't trip over the capital gains tax
 - If trustee sells property in the trust, the gain is taxed in the trust and paid from trust assets. (What happens if income to charity paid in-kind?)
 - Appreciation in property distributed to heirs from trust not subject to gift or estate tax
 - The appreciated property does not receive a step-up in basis, as it would if it passed at death

The Gift and Estate Tax

- ⌘ The Gift and Estate tax rates are exactly the same until 2010
- ⌘ Each individual may give away \$1,000,000 of assets during lifetime starting in 2002
- ⌘ Estate tax death transfer exemption gradually increases until 2010-when it is eliminated
- ⌘ The marginal gift and estate tax rate gradually decrease through 2010
- ⌘ In 2010 top individual gift tax rate is the top individual income tax rate in effect at that time.

Donor asks, "Why Am I Doing This?"




- ⌘ Donor asks that you make it simple to explain to family
- ⌘ Can you put it into three steps or less
- ⌘ Donor doesn't understand why he has a gift tax deduction

Undaunted, You Return to the Office



Make It Simple



- ⌘ Most donors use the lead trust to reduce or eliminate the tax cost of transferring wealth to children or grandchildren

“Zeroing Out the Gift Tax”

Payout to Charity	Value of Gift to Charity Years			
	10	15	20	25
6%	0.45	0.60	0.71	0.8
7%	0.52	0.7	0.83	0.93
8%	0.6	0.8	0.95	100
9%	0.67	0.9	100	100
10%	0.75	100	100	100

IRS Discount Rate 5.6%

“Gift Tax Paid Today Much Less Than Estate Tax Paid at Death”

(except in 2010!)

Gift Tax example:

- \$2,000,000 in 8% CLAT for 20 years; total return 10%
- 8% income payout rate (\$160,000)
- Assume 50% tax bracket and lifetime exemption not available
- Gift tax due is about \$42,517
- Benefit to children after 20 years is \$4,253,132

Estate Tax at Death

- ⌘ Assume donor holds \$2,000,000 and asset has an appreciation of 10%
- ⌘ After 20 years the asset would equal about \$9,723,475
- ⌘ Estate tax rate of 50% would generate an estate tax of approximately \$4,861,737
- ⌘ Benefit to children is \$4,907,738

THE POINT IS...



⌘ The donor can give away \$3,200,000 to his favorite charity for a cost of approximately \$654,606 to his family

Now the Rest of the Story

⌘ Consider the following:

- Parents contribute \$1.5M to an entity in exchange for a 5% income stream
- Entity is for 10 years
- Value of gift to children is approximately \$1,300,000
- Parents apply \$1.3M exemption and pay no gift tax
- The appreciation of the asset in the entity will not be taxed in parents' estate

...And Further



- ⌘ Assume the asset appreciates 7.2% per year, at the end of 10 years the asset will have doubled in value
- ⌘ Parents removed approximately \$3M from estate
- ⌘ What have the parents established?

The Possibilities...The Grantor Retained Annuity Trust



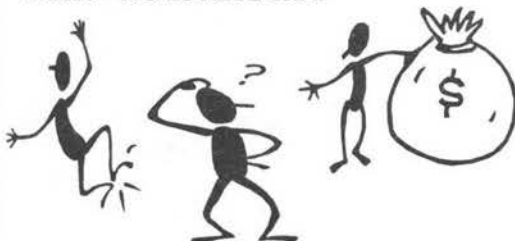
- ⌘ The GRAT (Grantor Retained Annuity Trust) is a trust in which the grantor receives a set annual dollar amount for a fixed term of years
- ⌘ Principal of trust goes to others, such as children
- ⌘ Grantor must survive the term of the trust
- ⌘ All trust principal will be excluded from grantor's estate for tax purposes

Or... The Family Limited Partnership

- ⌘ A Family Limited Partnership...must have a business purpose such as managing or developing real estate
- ⌘ Used to provide for a smooth succession and control of family assets
- ⌘ Provides for a smooth economic arrangement among family members to maintain partnership assets in the family

The Economic Tax and Reconciliation Act of 2001

⌘2010 - NO ESTATE TAX!



Merging Potentially Convergent Views

- ⌘ Have the donor tell advisor why making the gift is important
- ⌘ Acknowledge to advisor you are aware of other ways donor can pass assets to children
- ⌘ Share all information with advisor



Most Important...

- ⌘ Listen to the Donor
- ⌘ Be an objective party for the donor
- ⌘ It will be the donor who will close the gift





Tax Facts

A Charitable Financial and Tax Newsletter

Areas That Could Have an Impact on Charitable Gifts

- Income tax rates lowered
- More individuals could be impacted by Alternative Minimum Tax
- Estate and generation-skipping tax repealed
- Gift tax modified



For additional information:
 Marjorie A. Houston P'00
 Executive Director
 The Office of Gift Planning
 110 Elm Street
 Box 1893
 Providence, RI 02912
 401.863.9119
 Fax 401.863.3301
 Gift_Planning@Brown.edu

The Economic Growth and Tax Relief Reconciliation Act of 2001

The long-debated and much-anticipated tax bill has been passed by Congress and signed into law. While the provisions offer some immediate relief for taxpayers, most of the provisions are phased in gradually, and some do not take effect until the middle or end of the decade. Realistically, we will have two Presidential elections during that period, and Congress could change hands multiple times as well. Coupled with changing economic conditions, we could see revised provisions before all the current ones are fully phased into effect.

In 1981, Congress passed Ronald Reagan's tax-cut plan, only to spend the next several years repealing many of the provisions as the budget deficit began to swell. The current tax bill is being written in an environment when the federal government is expected to post a \$5.6 trillion budget surplus over the next decade. These budget projections are subject to keeping the rate of growth in federal spending at a historically low level. Ultimately, the fate of the tax provisions will depend on who controls Congress over the next decade.

Income Tax Rates Lowered

The first phase of the decrease in income tax rate will result in taxpayers receiving a credit in the tax year 2001. The maximum credit will be \$300 in the case of a single individual, \$500 for a head of household, and \$600 for married couples filing jointly. Most taxpayers will receive this credit in the form of a check issued by the Department of the Treasury.

Income Tax Rate Changes

Calendar Year	28% Rate Reduced To	31% Rate Reduced To	36% Rate Reduced To	39.6% Rate Reduced To
2001*-2003	27%	30%	35%	38.6%
2004-2005	26%	29%	34%	37.6%
2006-2010	25%	28%	33%	35%

* effective 7/1/2001

Effect on Charitable Gifts

The tax savings (or benefit) from a charitable contribution correlates to the rates at which the donor pays income tax. The lower the income tax rate, the smaller the tax savings. Since tax savings are not the primary motivation for making charitable gifts, the lower income tax rate structure should not have any significant impact on charitable donations over the long haul. However, one way to take advantage of the drop in the income tax rates is to accelerate deductions, making them this year rather than in future years.

(Continued on page 4)

**The Estate and Generation-Skipping Tax Repealed**

Initially, the repeal of the Estate and Generation-Skipping Tax (GST) would appear to provide enormous relief. However, since the gift tax remains for transfers during a person's lifetime, and the capital gains tax imposed on the sale of appreciated property is alive and well, the "relief" promised looks more like an invitation to "throw Momma from the train..." in 2010. To understand the impact of the changes, look at the current estate and gift tax rules.

Under Present Law

A gift tax is imposed on lifetime transfers, and an estate tax is imposed on transfers at death. The gift tax and the estate tax are unified, so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. The unified estate and gift tax rates begin at 18 percent on the first \$10,000 of cumulative taxable transfers, and reaches 55 percent on cumulative taxable transfers over \$3 million. In addition, a 5-percent surtax is imposed on cumulative taxable transfers between \$10 and \$17 million, which has the effect of phasing out the benefit of the lower graduated rates. Thus, these estates are subject to a top marginal rate of 60 percent. Estates over \$17,184,000 are subject to a flat rate of 55 percent on all amounts exceeding the amount exempt from transfer tax, as the benefit of the graduated rates is phased out.

Gift Tax Annual Exclusion

Individuals may make gifts during their lifetime of \$10,000 of a present interest in property to any person during the taxable year. The annual exclusion is indexed for inflation; the inflation-adjusted amount for 2001 remains at \$10,000. If the nondonor spouse consents to split the gift with the donor spouse, then the annual exclusion is \$20,000. Unlimited transfers between spouses are permitted without the imposition of a gift tax.

Unified Credit

In addition to annual gifts, Uncle Sam also provides a credit for assets transferred as gifts during one's lifetime and at death. Under current law, the unified credit amount effectively exempts from tax transfers totaling \$675,000 in 2001, \$700,000 in 2002 and 2003, \$850,000 in 2004, \$950,000 in 2005, and \$1 million in 2006 and thereafter. The benefit of the unified credit applies at the lowest estate and gift tax rates. For example, in 2001, the unified credit applies between the 18 to 37 percent estate and gift tax rates. Thus, in 2001, transfers by gift or through an estate over \$675,000, are effectively subject to estate and gift tax rates beginning at 37 percent.

From 2002 through 2011, the estate and gift tax rates are as follows:

Calendar Year	Estate tax death time transfer exemption	GST tax death time transfer exemption	Gift Tax Unified Credit	Highest estate and gift tax rates
2002	\$1 million	\$1,060,000	\$1 million	50%
2003	\$1 million	\$1,060,000	\$1 million	49%
2004	\$1.5 million	\$1.5 million	\$1 million	48%
2005	\$1.5 million	\$1.5 million	\$1 million	47%
2006	\$2 million	\$2 million	\$1 million	46%
2007	\$2 million	\$2 million	\$1 million	45%
2008	\$2 million	\$2 million	\$1 million	45%
2009	\$3.5 million	\$3.5 million	\$1 million	45%
2010	N/A (taxes repealed)	N/A (taxes repealed)	\$1 million	top individual income tax rate under the bill (gift tax only)
2011	\$675,000	\$1,060,000	\$675,000	55%



Rules Moving Forward: Phase Out and Repeal of Estate and Generation-Skipping Transfer Taxes

Under the *Economic Growth and Tax Relief Reconciliation Act of 2001*, the estate tax is gradually repealed and the unified credit for gifts during lifetime is increased. To better understand the planning challenges associated with this change, consider the following highlights:

- In 2002, the 5-percent surtax (on transfers between \$10 million and \$17 million) and the rates in excess of 50 percent are repealed.
- Also in 2002, the unified credit or the amount effectively exempt from transfer tax (for both estate and gift tax purposes) is increased to \$1 million.
- In 2003, the estate and gift tax rates in excess of 49 percent are repealed.
- In 2004, the estate and gift tax rates in excess of 48 percent are repealed, and the unified credit for estate tax purposes is increased to \$1.5 million.
- The unified credit for gift tax purposes remains at \$1 million as increased in 2002.
- In 2004, the family-owned business deduction is repealed.
- In 2005, the estate and gift tax rates in excess of 47 percent are repealed.
- In 2006, the estate and gift tax rates in excess of 46 percent are repealed, and the unified credit for estate tax purposes is increased to \$2 million.
- In 2007, the estate and gift tax rates in excess of 45 percent are repealed.
- In 2009, the unified credit for estate tax purposes is increased to \$3.5 million.
- In 2010, the estate and generation-skipping transfer taxes are repealed.
- In 2010, the present law rule providing for a step-up in basis on appreciated property received from a decedent is repealed.

In 2011, the estate and gift tax exemptions return to those in effect before the law was signed.

Perfect Planning May Not Be Possible

If you die this year, the first \$675,000 is exempt from the estate tax and the top tax rate is 55 percent on amounts over \$3 million. If you die next year, the amount exempt from tax will be \$1 million, a savings of \$125,500 in taxes. In 2009, the exemption rises to \$3.5 million, and those fortunate enough to make funeral plans for 2010 will pay no estate tax on the transfer of their assets. However, on January 1, 2011, the estate tax is resurrected and returns to the rates in effect on January 1, 2001.

Even the best laid plans will not eliminate taxes entirely for the heirs. Heirs enjoyed a step-up in basis for assets passed at death before the new tax changes. After the repeal of the estate tax, the new law will allow \$4.3 million of capital gain property to pass tax free to a spouse and \$1.3 million to other heirs. Anything above those amounts will be subject to capital gains tax when these assets are sold.

Modifications in the gift tax law may make lifetime gifts less appealing. In 2002, the amount exempt from gift tax is increased from \$675,000 to \$1,000,000. In 2010, when the estate and generation-skipping transfer taxes are repealed, the top gift tax rate will be the top individual income tax rate as provided under the bill. Except as provided in the IRS Regulations, a lifetime gift over \$1 million to an individual(s), other than a spouse, either outright or in trust will be treated as a taxable gift.

Impact of Changes for Charitable Gifts

Bequest income to higher education institutions increased by 22 percent in 1999 to a record \$2.1 billion. The increase from 1997 to 1998 of \$377 million was more than the total amount of \$374 million received by institutions of higher education in 1981. This illustrates the importance of estate distributions to the overall goals of the charitable sector. The estate tax is to be resurrected after December 31, 2010, so tax-wise planning will become a challenge. As the axiom goes, death and taxes are inevitable. While we know Congress cannot predict the first, we can be confident they will change the latter.

(Continued on page 4)



Impact of Changes for Charitable Gifts

(Continued from page 3)

However, the basics will remain the same. What differentiates those who actually put charity in their plans from those who simply consider doing so is charitable motivation. According to a survey of donors completed by the National Committee on Planned Giving, both for-profit advisors and representatives of charitable organizations are catalysts in 35 percent of charitable bequest donor decisions, and in 76 percent of those donors establishing Charitable Remainder Trusts.

For charitable organizations, the tax-law changes provide numerous opportunities:

- First, the importance of the mission becomes even more important. Bequests will always be an important source of income, and most bequest gifts are not motivated by the tax benefits.
- Second, although the estate taxes will be either diminished or repealed entirely, the impact of capital gains tax will be increased. Individuals will be looking for ways to shelter themselves and their heirs from the impact of capital gains tax. The Charitable Remainder Trust, already a major player in estate planning, will take on a more important role.
- Third, **Donor Advised Funds** and **private foundations** will play a larger role as individuals struggle with the issues of children and the passage of wealth. The new tax law will put greater control of wealth in the hands of the parents and greater capacity to influence children on ways to use the wealth. Charitable organizations should illustrate how they can best serve the individual donor's need in developing charitable strategies.
- Fourth, women traditionally outlive men and they will have greater control over disposition of the family wealth. Charitable organization can focus marketing materials on how to help women address their financial decisions.

Alternative Minimum Tax Rules and Their Effect on Charitable Gifts

The relatively narrow spread between the top regular tax rate (38.6 percent in 2001) and the Alternative Minimum Tax (AMT) rate of 26 percent or 28 percent, along with the broad scope of the AMT base, may impose the AMT on many taxpayers. When a taxpayer is subject to the AMT, the tax benefit of a charitable deduction may be less than anticipated (or take longer to realize). Although the bill provides some relief from the AMT, it is estimated that by the year 2010, 18 million additional individuals who pay income tax would be affected by the AMT.

Planning Issues

If you have a donor who is subject (or may be subject) to the AMT, planning is essential. The scheduled timing of charitable contributions is essential in order to realize the maximum current benefit of the charitable deduction. A donor who makes large gifts and whose tax position moves between the regular tax and the AMT may have difficulty determining the actual tax benefits of charitable gifts, and when those benefits will be realized. This does not preclude the donor from making a pledge, but Brown may want to be sensitive to the amount given in any single tax year to pay off the pledge.

Income Tax Rate Lowered Effect on Charitable Gifts

(continued from page 1)

For example, someone in the top bracket could accelerate a 5-year pledge and pay it in full this calendar year. In addition, donors could make a large gift to their Donor Advised Fund to take advantage of the tax savings provided by the higher income tax rate.

Tax Fact is a periodic newsletter produced by Brown University's Office of Gift Planning. It is for informational purposes only and not meant to be used as legal or tax advice. Please consult with your advisor on how this information applies to your personal situation.

Sparkling Ideas...



in the Emerald City

THE INTERNET: BOOM OR BUST?

Craig C. Wruck
Vice President,
Philanthropic and Charitable Services
U.S. Trust Company
730 Second Avenue South
Minneapolis, MN 55402
(612) 336-1424
FAX (612) 336-1388
cwruck@ustrust.com

25TH CONFERENCE ON GIFT ANNUITIES • PRESENTED BY THE AMERICAN COUNCIL ON GIFT ANNUITIES

233 McCREA STREET, SUITE 400 • INDIANAPOLIS, INDIANA 46225 • (317) 269-6271 • FAX: (317) 269-6276 • E-MAIL: ACGA@IUPUI.EDU

The Internet: Boom or Bust?

Friday, April 12, 2002: 9:00 – 10:15 and 10:45 – 12:00

Craig C. Wruck
Vice President,
Philanthropic and Charitable Services
cwruck@ustrust.com

U.S. Trust Company
730 Second Avenue South
Minneapolis, MN 55402
(612) 336-1424

OVERVIEW

The “Internet,” the “net,” the “information superhighway,” the “World Wide Web.” Whatever the term, they all refer to the global network of computers that has grown over the last 30 years to the point where today you can easily visit the Library of Congress, chat with friends in Boston and Pretoria simultaneously, and watch live video from the latest space shuttle – all without leaving your desk ... or your living room. Truly, there is no more “there” – it’s all “here.”

In this session we will begin with a brief overview of the fascinating history of the Internet. Next we will present a short explanation of the workings of the network – just the concepts, nothing too technical.

Then we will dig into the real revolution that has been triggered by the Internet: the explosion of easy and cheap access to information. We will make the argument that it is this free access to complete information that is changing forever the way in which individuals make charitable gifts. Finally, we will consider how the Internet can become a powerful tool to improve your planned giving and development program and take a look at some of the current offerings.

Expect this session to be interactive and come prepared with your observations and questions. Technicians and computer geeks might be disappointed with this session, but the rest of us will leave with a better understanding of these forces that are changing the world in which we live. Like the Internet itself: no one is an expert here, but we can all learn from one another.

WARNING: *You are entering a nonexistent universe. Consider the consequences. This is an unreal universe, a tissue of nothingness. While the Internet beckons brightly, seductively flashing an icon that says “knowledge-is-power,” this non-place lures us to surrender our time on earth. A poor substitute it is, this virtual reality where frustration is legion and where – in the names of Education and Progress – important aspects of human interactions are relentlessly devalued.*

Clifford Stoll, *Silicon Snake Oil, Second Thoughts on the Information Highway*

WHAT THIS SESSION IS NOT ABOUT...

- the “Internet”
- how to design snappy web pages
- “dot com” or “e” anything

WHAT THIS SESSION IS ABOUT...

- the explosion of cheap and instant access to information
- how the behavior of generous individuals is changing in this environment
- how charitable gift planners must change to face this new reality

A BRIEF HISTORY OF THE INTERNET

Today hundreds of thousands of computer networks are themselves connected together to allow tens of millions of computers all over the planet nearly instantaneous and free communication with one another. But it all started over 30 years ago because the Department of Defense needed a computer network tough enough to suffer a nuclear attack and keep on working.

- **“Arpanet”** – The original “internet” was created in 1969 by the Advanced Projects Research Administration of the Department of Defense which was trying to create a way to communicate between computers that was capable of surviving enemy attack.
- **“TCP/IP”** – The rules that govern the Internet, Transmission Control Program / Internet Protocol requires that all computers connected to the network be allowed to communicate on a peer to peer basis, that data be sent in standard “packets,” and that the responsibility for completing communications lies with the communicating computers, not the network
- **“packet switched network”** – The internet is a “packet switched network” as opposed to a circuit switched network. Think of the Post Office versus the Phone Company.
- Who runs the Internet? Who pays for it?

In an ironic twist 20 some years after the creation of the Arpanet, during the Gulf War the Iraqi command and control network proved nearly impossible to knock out despite some of heaviest bombing in military history. The Iraqi network was based upon TCP/IP protocols and used commercially available hardware and software.

THE “NEW” ENVIRONMENT...

- information
 - very inexpensive with nearly instant access
 - quality is still questionable, but improving
- transactions
 - 24/7/365 is a reality
 - costs, security, and privacy concerns are now manageable

THE “OLD” APPROACH TO FUNDRAISING...

- successful fund raising involves persuasion
- ethical persuasion requires true and accurate information
- but effective persuasion relies on managing the flow of information
- controlling the order in which facts are presented is key

IMPLICATIONS FOR FUNDRAISING...

- allows access to individuals at the exact moment when and in the exact place where they are motivated to give
- low entry cost (and therefore low penalty for failure) encourages experimentation and risk taking by charitable organizations and donors
- encourages “hyperagency” (proliferation of new organizations and structures to create social change)
- rapid and two way communication means “have-nots” will know how much is available from the “haves”
- donors can become loyal to a cause rather than an organization
- encourages “disintermediation” of charitable giving which is already affecting United Ways and community foundations
- immediate results may take priority at the expense of systemic solutions

THE NEW BOTTOM LINE FOR CHARITABLE GIVING...

- the old game is no more, the new game is collaboration
- the new environment demands change from charities, fund raisers, and advisors
- real life indicators...
 - the Columbine High School fund, September 11 Telethon for America
 - databases (like Guidestar), transaction services (like DonorNet)
 - technical resources (like Planned Gift Design Center)
 - true integrated services and “analytical tools” are just emerging

E-mail is far and away the most popular use of the Internet. A researcher mailed 100 postcards and sent 100 e-mail messages, one each day, from Buffalo, New York to Berkeley, California. The postcards took an average of 2.7 days to arrive while the e-mail messages averaged 11 minutes. However while 100 of the postcards eventually arrived only 92 of the e-mail messages made it.

APPLICATIONS AND EXAMPLES...

The key is to always remember: It's still all about communications. The message must be crafted and delivered with the audience in mind. The mere fact that the channel is a web page does not change the need to carefully develop and follow a communications strategy for each and every message. Consider the following to examples:

In this example the audience is individuals who may visit the charity's web site:

Luminaria Society: Make a Planned Gift

Luminaria Society honors individuals who have included Our Charity in their estate planning. Planned gifts of any size and type ensure the future of Our Charity by building its endowment fund. Planned gifts also provide a useful and effective tool for reducing tax liability and assuring future income for those who include charitable giving in their financial planning.

There are two primary types of planned gifts:

- **Testamentary Gifts** – The most common testamentary gift is a bequest, through which a contributor can name Our Charity as a charitable beneficiary in a will or living trust. Gifts to charitable beneficiaries are subtracted before estate taxes are computed, which sometimes makes it possible to reduce the rate at which other estate assets are taxed.
- **Life Income Gifts** – These versatile planned gifts have many advantages. There are several types of charitable trusts, most of which allow the transfer of assets to a trust with Our Charity as beneficiary. Charitable trusts provide an immediate charitable tax deduction, deferred capital gains taxes, and trust income for the rest of the contributor's life.

There are many more planned giving options available. Before making any decisions on charitable giving, you should consult with a financial planner, tax accountant, or lawyer to see which option best suits your financial situation. Our Charity also has several planned giving advisors who are professional consultants available to assist you. For more information on planned giving, please contact the Development Office at 651-555-1212, or email plannedgiving@ourcharity.org.

This charity's web page is managed by an outside "web master" who coordinates with the foundation grant writer. The text for this particular page was written by the grant writer after talking to the planned giving officer. It is, no doubt, accurate, but does it communicate?

By contrast, consider the following web page, which is addressed to a different audience, professional advisors:

For Professional Advisors: We Can Help

By working with a community foundation, your clients can achieve their charitable purposes and at the same time meet a broad range of tax, business, and estate planning objectives. The Foundation is a logical place to turn to when you are advising clients on the best way to realize these goals at maximum tax advantage and convenience.

There are several tasks and financial events that can motivate a client to seek professional advice that might contain a charitable opportunity:

- Creating an estate plan
- Approaching retirement
- Disposing of long-term capital gain property
- Minimizing the tax impact of a financial windfall
- Ownership transitions in closely-held companies
- Managing an inheritance

A call to our development office will bring a prompt and confidential response that is customized to your client's needs.

Resources for Attorneys, Estate Planners and Professional Advisors

printed materials <link> – We have extensive printed materials that you can share with clients who are charitably inclined. Many are available through the Publications section of this site, which you can access for free. You can use these to bring up the subject of philanthropy with your clients, or to address their specific needs.

charitable planning news <link> – With breaking news and important reminders, our Tax Faxes provide timely advice of interest to your clients and colleagues. Please e-mail us to be added to our fax distribution list, or you can click on this link.

financial illustrations <link> – For your estate planning clients, we can provide a free deferred gift illustration customized to their circumstances.

seminars <link> – Periodically, we offer up-to-the-minute tax and estate planning seminars for professional advisors and their clients. To be included on the invitation list, please e-mail us or click on this link.

For details, or to discuss any questions, please call our, Vice President of Development at (612) 555-1212.

Note that this page begins with clear and strong communication: It gets right to the point and tells the reader in a clear voice what is in it for him or her. Also note this page understands that the reader is already web savvy and so uses common web tools such as embedded links and, most importantly, makes materials available at the click of a mouse.

As these examples illustrate, content is key. Merely “having a planned giving web page” is not likely to produce much in the way of new planned gifts. However, the web can be a very cost-effective way to deliver well organized campaign to communicate your planned giving messages.

YOU DON'T HAVE TO DO IT YOURSELF...

Marketing and Communication...

Fortunately, there are a number of excellent providers of planned giving web services, and the cost is quite reasonable. The services offered range from highly complex and very customized to simple and very standardized. In addition, some offer a full array of planned giving services while others focus on the marketing and communications aspects.

For examples, visit the following:

- Stelter Company (www.stelter.com)
- Virtual Giving (www.virtualgiving.com)
- The Capital Alliance (www.capitalalliance.com)

Calculations on the Web...

The ability to offer a customized illustration of a planned gift, or to allow a prospective donor to “play” with a gift scenario is a powerful tool. Once you have established a planned giving web site, it’s an easy step to add the ability to “web calcs.” The vendor of your planned giving software may be able to provide this service. Usually it is a simple matter of adding a link to your planned giving web site.

However, be sure to be clear about your objective: Do you really want to provide free calculations to anyone in the world? If your objective is to secure more planned gifts for your organization, then you should build in the ability to track inquiries and to offer additional information so that you have the chance to follow-up with potential donors.

For examples, see the following:

- PG Calc (www.pgcalc.com)
- Crescendo (www.crescendointeractive.com)

Advisor Services...

Charitable organizations have long cultivated professional advisors through the use of newsletters, seminars, and other services designed to get information on charitable giving in the hands of advisors. As professional advisors become more web savvy, the ability to provide electronic newsletters and on-line reference services is becoming an important cultivation tool. The time and technical resources to provide such a service is beyond all but the very largest charitable organizations. The Planned Gift Design Center (www.pgdc.net) was among the first to offer a service that charitable organizations may sponsor to make available to professional advisors.

What matters is not the reality of the internet revolution, but rather the public impressions that it creates. Public reaction is influenced by the intuitive plausibility of an idea. This plausibility is ultimately influenced by the ease with which examples come to mind. If we are regularly spending time on the internet, then these examples will come to mind very easily.

Robert J. Shiller, *Irrational Exuberance*

WHAT MIGHT BE NEXT...

- Imagine a generous person who can obtain information directly from a needy individual or cause, act spontaneously to transact a gift (from any financial resource using any charitable gift plan) on the spot, and, later, receive verification that the gift has been well used.
- Now, imagine a “decision engine” like the ones used by Amazon to sell books or by Schwab to sell mutual funds, but this one designed to help generous individuals select charitable causes.
- Then, consider what it would be like if we find ourselves in an environment of fewer, or perhaps no tax incentives (repeal of the estate tax, loss of the charitable deduction).

QUESTIONS AND MORE QUESTIONS...

- In this new world where any generous person can have easy access to inexpensive and complete information, will donors become more or less generous?
- If donors are able to act spontaneously, on balance will they make better gifts or worse? What can we learn from the experience of charitable giving in the aftermath of September 11th?
- Should we encourage experimentation and spontaneity by donors? Do we have any choice?
- What is the role of the charitable gift planner in a world where anyone can easily access the tools of planned giving? Is the role different for the nonprofit gift planner than the for profit gift planner?
- Will the immediacy of it all lead to an emphasis on current and narrowly restricted gifts at the expense of systemic solutions?

- If donors can precisely control and restrict their giving, who will pay for the infrastructure of charitable organizations (there might be no unrestricted annual fund)?
- In a world where we are all connected to one another, who will represent the donor and who will represent the charity?

"My dear, we live in an age of transition."

Adam (said to Eve upon being expelled from the Garden of Eden)

CONCLUSION...

There is no doubt that the internet is here to stay, and that successful fund raisers will learn to use this new and powerful communication tool. Internet giving is increasing, but slowly. Among the 60% of the population who had internet access, 12 % said they went online to find information about charitable contributions and 6% said they made a contribution via a web site. (Independent Sector survey, 11/01).

Making effective use of a web site for planned giving or any other fund raising program is not so much a question of technology, but rather communications and marketing strategy. A good web page will have all of the characteristics of a good publication, and it will offer the visitor both ways to become involved, and reasons to do so.

The larger question is how the explosion of information will affect the way people make charitable decisions. Charitable organizations will have to redouble their efforts to demonstrate not only their needs, but their worthiness of support. In this new world there is no where to hide.

Innovations do not create change. Innovations that aim to change society, or the market, or customer always fail. The innovations that succeed do so by exploiting change rather than forcing it.

Peter F. Drucker, *Management*



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Sparkling Ideas...



in the Emerald City

NAVIGATING STOCK OPTIONS AND OTHER STOCK RIGHTS: NUTS, BOLTS AND REAL LIFE

Robert Lew
President
Planning & Financial Advisors
690 Market Street, Suite 826
San Francisco, CA 94104
(415) 675-2930
FAX (415) 675-2949
rlew@pfadvisor.com

Darryl D. Ott, Esq.
Morgan, Miller & Blair
1676 No. California Boulevard,
Suite 200
Walnut Creek, CA 94596
(925) 937-3600
FAX (925) 943-1106
dott@mmlaw.com

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233 McCREA STREET, SUITE 400 • INDIANAPOLIS, INDIANA 46225 • (317) 269-6271 • FAX: (317) 269-6276 • E-MAIL: ACGA@IUPUI.EDU

NAVIGATING STOCK OPTIONS AND OTHER STOCK RIGHTS *NUTS, BOLTS* AND REAL LIFE

A. *NUTS AND BOLTS*

1. INTRODUCTION

The purpose of this paper is to provide assistance to charitable gift planners and other professional advisors in understanding the very complex income tax rules and the other legal requirements of incentive stock options, non-qualified stock options and restricted stock. In addition, it is important for charitable gift planners to be exposed to some specific case studies which illustrate the means of integrating charitable planned gifts with these important wealth building tools and for them to understand how options and other stock rights fit into the overall wealth transfer planning for these very important potential donors.

First, this paper will set out definitions for incentive stock options, non-qualified stock options and restricted stock. Then the paper will discuss in detail the income tax effects at various stages of the legal lives of the stock options, e.g. at grant, exercise and disposition, and of the restricted stock. Then it will discuss any special circumstances and post mortem planning opportunities for these stock rights. Finally the paper will briefly discuss various gift planning and tax strategies for dealing with stock options and restricted stock.

There is one assumption that underlies the entire discussion in this section of the paper regarding the options. The assumption is that on the date of the exercise of the option the fair market value of the stock of the company is greater than the exercise price specified in the option. While there may be some circumstances when a grantee of an option might want to exercise a stock option if the exercise price is greater than the then fair market value of the stock, it is extremely unlikely.

Second, this paper will set out the facts of six "real life" detailed case studies, two of which involve incentive stock options, three of which involve non-qualified stock options and one of which involves restricted stock. Each of these case studies involves charitable gift planning techniques, and each will be analyzed carefully to reflect the relative benefits of each of these techniques with respect to the charitable beneficiaries and to the donors and their family members. All of the techniques provide substantial benefits for both the charities and the donors and their families. The numeric results in each of the examples will be discussed thoroughly.

All references herein to "the Code" or to "Section" and "§" are to the Internal Revenue Code of 1986, as amended, unless otherwise specifically designated. The reference to "IRS" is to the Internal Revenue Service unless otherwise designated. Also, all references in this paper to specific tax and legal

requirements for the stock options and the restricted stock are limited to those required by federal laws. The tax and legal requirements for any state should be referred to specifically. Unless the context clearly indicates otherwise, the terms “donor” and “client” will be used interchangeably throughout the paper.

2. DEFINITIONS

2.01 ALTERNATIVE MINIMUM TAX The calculation of “alternative minimum tax income” (“AMTI”) is entirely distinct and apart from the calculation of taxable income for regular income tax purposes. AMTI is computed in the same way as taxable income for regular tax purposes but (i) certain items of income and deductions used in the regular taxable income are adjusted and (ii) certain items of preference are added back to the taxable income to arrive at AMTI. The tentative “alternative minimum tax” (“AMT”) is equal to 26% of the alternative minimum tax base up to \$175,000 and 28% of the alternative minimum tax base over \$175,000. The alternative minimum tax base is the AMTI reduced by various exemption amounts. The AMT so calculated is then compared to the taxpayer’s regular income tax, and if the AMT is greater, the AMT is the amount that must be paid for that taxable year. Most importantly for purposes of this paper, the amount by which the fair market value of the shares acquired at the time of the exercise of an incentive stock option exceeds the exercise price is an item of tax preference which must be included in AMTI. See the discussion set forth in Section 3.03 below.

2.02 CODE SECTION 83(b) ELECTION A “Code Section 83(b) election” is made with respect to restricted stock and in some very special circumstances might be made as of the date of the exercise of an incentive stock option to attempt to limit the alternative minimum tax. The election, which must be filed with the IRS for the taxable year during which the employee first receives the transfer of the restricted stock, allows the employee to report a lesser amount of ordinary compensatory income during this year of receipt of the stock with the hope that in future years when the employee sells the stock at a higher value the employee will then be able to report this appreciation as capital gain income rather than as ordinary compensatory income. See Article 5 below.

2.03 COMPENSATORY STOCK OPTIONS AND COMPENSATORY RESTRICTED STOCK The terms “compensatory stock options” and “compensatory restricted stock” mean any options for the acquisition of stock of a company granted either to an employee, such as incentive stock options, or to employees, directors and consultants, such as non-qualified stock options and any restricted stock issued to employees of a company as a form of compensation. These terms are very generic. These compensatory stock options must be distinguished from “investment options” such as those traded on the Chicago Board of Options Exchange since the income tax effects with investment options are very different from those with compensatory options.

2.04 DISPOSITION DATE Same as “Sale Date”. See Section 2.16 below.

2.05 DISQUALIFYING DISPOSITIONS See Section 3.05 below.

2.06 EXERCISE DATE The “exercise date” of the option is the date of the delivery of the exercise of the option. See Section 2.07 below.

2.07 EXERCISE OF OPTION The “exercise of the option” is generally a written notification to the company by the grantee of the option of her intention to acquire a specified number of the shares of the stock of the company pursuant to the grant of the option.

2.08 EXERCISE PRICE The “exercise price” is the price that the grantee must pay to the company on the exercise date to acquire the stock of the company. The exercise price must be specified in the grant of the option. See Section 2.10 below. Same as “Strike Price”.

2.09 GRANT DATE The “grant date” is the date that the company gives (grants) the option to purchase stock in the company, whether an incentive stock option or a non-qualified stock option, to the grantee. The rights of the grantee to acquire the stock are governed by the terms of the grant of the option. See Section 2.10 below.

2.10 GRANT OF OPTION The “grant of the option” is generally a written document given to the grantee of the option which specifies all of the terms of the option such as the exercise price, the term of the option, the vesting schedule, the number of shares of the company’s stock which may be acquired, whether or not the option is transferable, if it is transferable to whom it may be transferred and whether or not the option may be exercised by a designated beneficiary after the date of the grantee’s death.

2.11 INCENTIVE STOCK OPTIONS See Section 3.01 below.

2.12 NON-QUALIFIED STOCK OPTIONS See Section 4.01 below.

2.13 NON-STATUTORY OPTIONS Same as “Non-Qualified Stock Options”. See Section 4.01 below.

2.14 OPTION The term “option” as used in this paper is the right of an individual to purchase for a stated price a specified number of shares of the stock from a company by virtue of an offer of the company which continues for a stated period of time.

2.15 RESTRICTED STOCK See Section 5.01 below.

2.16 SALE DATE The “sale date” is the date that the owner of the stock of the company (whether as a result of the exercise of an option or the acquisition of restricted stock) actually sells the stock and disposes of her interest in the stock. Same as “Disposition Date”.

2.17 STATUTORY OPTIONS Same as “Incentive Stock Options”. See Section 3.01 below.

2.18 STRIKE PRICE Same as “Exercise Price”. See Section 2.08 above.

2.19 2 AND 1 RULE The “2 and 1 Rule” is a rule that only relates to incentive stock options and which is applicable only after the incentive stock option has been exercised and the grantee-employee is the owner of the stock of the employer. In order for the grantee-employee to be able to report the gain on the sale of the stock as capital gain and not as ordinary compensatory income, the 2 and 1 rule requires the grantee-employee to own the stock prior to the sale for a period which is the longer of either 2 years after the date of the grant of the incentive stock option or 1 year after the date of the exercise of the incentive stock option. This rule has very important implications for the ability of the grantee-employee to use any planned giving tools. Moreover, the 2 and 1 rule is no longer applicable after the death of the grantee-employee (see Section 3.07 below).

2.20 VESTING “Vesting” is the point in time when the grantee of an option (pursuant to the terms of the grant of the option) or the owner of restricted stock (in accordance with the terms of the restricted stock agreement) becomes indefeasibly entitled to acquire (with an option) or to retain ownership of (with restricted stock) the stock of the company. The vesting is generally spread out over a period of years at increasing percentages, but there are no particular legal requirements as to how quickly the rights to the stock must vest.

3. INCENTIVE STOCK OPTIONS (“ISOS”)

3.01 INCENTIVE STOCK OPTIONS DEFINED An incentive stock option (“ISO”) is an option issued pursuant to a plan adopted by the employer corporation which conforms to all of the statutory

requirements of Code Sections 421 through 424 when granted. Some of the basic requirements are that: (i) the shareholders must approve the plan; (ii) the ISO must be granted to an employee of the company (not a director or consultant) and, basically, the individual must remain an employee through the date of the exercise; (iii) the exercise (strike) price for the stock must equal or exceed the fair value of the company's stock as of the date of the grant; (iv) an option must be granted within 10 years of the date of the adoption of the plan and must be exercised within 10 years of the date the option is granted; (v) the fair value of the ISO stock that is first exercisable during a year cannot exceed \$100,000 based on the value of the company's stock as of the date of the grant; and (vi) an individual already owning more than 10% of the company's stock must pay at least 110% of the fair value as the exercise (strike) price and the option must expire within 5 years as compared to 10 years for lesser shareholders. In accordance with the provisions of Code Section 422, an ISO is not transferable. Due to all of these requirements and restrictions (and some others which will be discussed in Sections 3.04 and 3.05 below), ISOs themselves (as opposed to the stock acquired by the exercise of the ISO) do not lend themselves to much, if any, prior wealth transfer planning, income tax planning or charitable gift planning.

3.02 INCOME TAX EFFECTS AS OF THE DATE OF THE GRANT There are no income tax consequences to the grantee-employee of the option as of the date of the grant of the option.

3.03 INCOME TAX EFFECTS AS OF THE DATE OF THE EXERCISE Generally there are no regular income tax effects with ISOs as of the date of the exercise of the option by the grantee-employee. However, the difference as of the date of the exercise of the ISO between the fair value of the stock as of the date of the exercise and the strike price for the stock is an item of preference for purposes of the alternative minimum tax ("AMT") calculations. See the definition of AMT in Section 2.01 above. The possibility of the imposition of the AMT can create a very difficult cash management situation for the grantee-employee after the exercise of the ISO and therefor after the acquisition of the stock because she may have AMT to pay to the IRS as a result of her exercise of the ISO but may not have any cash with which to pay the AMT. An obvious solution to this cash dilemma is to sell some of the stock acquired by the exercise of the ISO at least up to an amount that creates regular tax equal to the AMT. But such sales of too much of the stock would then lead to other adverse income tax consequences. See Section 3.05 below.

3.04 INCOME TAX EFFECTS OF QUALIFYING DISPOSITIONS One of the other requirements of an ISO to enable the grantee-employee of the ISO (and now owner-employee of the stock of the company) to obtain long term capital gain treatment upon a sale of the stock is the "2 and 1 Rule". See Section 2.19 above. The 2 and 1 Rule will permit the owner-employee to report the gain on the sale of the stock as capital gain if, after the exercise of the ISO, the stock is not sold within 2 years of the date of the grant of the ISO or not within 1 year of the date of the exercise. A disposition (whether a sale, exchange, gift or other transfer of legal title) of the stock which occurs after the expiration of the 2 and 1 Rule time periods is referred to as a qualifying disposition.

3.05 INCOME TAX EFFECTS OF DISQUALIFYING DISPOSITIONS A disqualifying disposition is a reverse application of the 2 and 1 Rule. If, after the exercise of the ISO, the stock is sold, exchanged, gifted or otherwise transferred within 2 years of the date of the grant of the ISO or within 1 year of the date of the exercise of the ISO, the employee must report the "gain" (the difference as of the sale date between the sales proceeds and the strike price) as ordinary compensation income and not as capital gain. The difference in the income tax rates between those for ordinary income and those for capital gains can be quite significant. In California, the difference in the combined rates for federal and California income taxes can be as much as 19%. Needless to say, if the owner-employee needs the cash to pay the AMT or otherwise is just wanting to diversify or simply feels that the stock has reached its peak in value, the owner-employee's advisers, including gift planners, must understand and be able to explain the difference in the income tax treatment to the owner-employee. There are a few limited exceptions to the disqualified disposition rules, such as the transfer of the stock by a decedent by bequest or other form of inheritance.

However, it is this 2 and 1 Rule that causes the owner-employee of the stock to report any gain as ordinary income on a transfer by gift of her ISO-created stock to a charitable remainder trust before the satisfaction of the 2 and 1 Rule.

3.06 SPECIAL METHODS OF EXERCISE OF AN ISO There are now a multitude of methods related to the exercising of an ISO that in some instances provides some income tax and cash flow assistance to the grantee-employee in the exercise of the ISO and the ownership of the stock of the company resulting from the exercise of the ISO. These methods are generally variations that provide financing assistance to the grantee-employee. A detailed explanation or analysis of these methods is clearly beyond the scope of this paper. Some of the methods are: (i) using stock of the employer to pay for the exercise of the ISOs; (ii) under certain limited circumstances exchanging ISO stock for similar company stock; (iii) granting a "reload" option when company stock is used to pay for the exercise price for the company stock then being acquired, (iv) providing tandem stock appreciation rights (SARs) so long as the SARs meet certain requirements and (v) providing financing through a broker for a "cashless exercise" of the ISOs.

3.07 EFFECT OF THE DEATH OF THE OPTION HOLDER AND ESTATE TAX TREATMENT

Following the death of the grantee-employee, if the ISO plan permits the beneficiaries of the grantee-employee to exercise the ISO, then as long as the option was an ISO as of the date of the grantee-employee's death, the beneficiaries of the ISO will receive the same tax treatment on the exercise of the option as would have been realized by the grantee-employee. The transfer of the ISO to the beneficiaries or the transfer of the stock of the employer to the beneficiaries which has not yet satisfied the 2 and 1 Rule (see Section 2.19 above) is not a disqualifying disposition of the stock. Moreover, the estate or heir who receives the ISO does not have to comply with the 2 and 1 rule at all with respect either to ISO stock received by the beneficiaries from the grantee-employee or stock received by the beneficiaries following their exercise of the ISO. The death of the grantee-employee eliminates the need to comply with any of the ISO holding period requirements. However, the date of death of the grantee-employee will be the starting date for the measurement of the capital gain holding periods that will be used to determine whether any post-death appreciation is either short term or long term capital gain. In addition the ISOs receive a full step-up in basis just like any other asset of a decedent, and no ordinary income or capital gain will be reportable on the stepped-up basis portion on a later exercise of the ISOs or disposition of the ISO stock by the beneficiaries. Also, due to this step-up in basis of the ISO, the death of the grantee-employee eliminates the occurrence of any AMT on the subsequent exercise of the ISO by the beneficiaries, at least with respect to the pre-death bargain element in the ISO. The fair market value of the ISO as of the date of the death of the grantee-employee is an asset that will be includable in the taxable estate of the grantee-employee. The fair market value of an ISO is basically the difference between the fair value of the stock of the company as of the date of the death of the grantee-employee and the strike price. Generally, the plans for the ISOs permit the recipient from the grantee-employee to exercise the ISOs in the same manner as the grantee-employee and to receive the same income tax treatment on exercise and on any subsequent disposition as would have applied to the grantee-employee if she would have lived. If the deceased grantee-employee was employed by the employer as of the date of her death, there is no statutory requirement that the recipient must exercise the ISO within three months of the grantee-employee's death.

3.08 TESTAMENTARY PLANNING CONSIDERATIONS Even though a transfer of an ISO upon the death of the grantee-employee is permitted by the statutes and is not a disqualifying disposition and even though the recipient of the ISOs following the death of the grantee-employee is entitled to the special income tax reporting rules discussed above as would have been available to the grantee-employee, the recipient is also still subject to the same reporting requirements as would have applied to the grantee-owner. And, in addition, the ISOs still are not otherwise transferable by the recipient. So the limitations on the planning possibilities for the recipient and on the transfer of the ISOs to charities still apply. Again, it is only after the exercise of the ISO and the ownership of the underlying stock itself that traditional gift planning possibilities will arise. In fact, the net effect of all of the post-death rules for

ISOs is that the ISO stock is to be treated by gift planners no differently from any other asset in an estate of a decedent.

4. NON-QUALIFIED STOCK OPTIONS (“NQSOS”)

4.01 NON-QUALIFIED STOCK OPTIONS DEFINED A non-qualified stock option (“NQSO”) is an option to acquire stock of a company that does not, for any one of a number of reasons, satisfy all of the Code requirements for incentive stock options. See Section 3.01 above. Unlike the incentive stock options, the issuance of a NQSO is not limited just to employees of the company, but they may be granted to employees, directors and consultants to the company. Also unlike the requirements for incentive stock options, NQSOS can be transferable at any time, either before or after exercise of the option if the plan adopting the NQSOS or the grant of the option permits the transfer. This transfer possibility does provide some additional planning opportunities for allied professionals and charitable gift planners. Code Section 83 is the Internal Revenue Code Section that is involved in the analysis of the income tax effects of non-qualified stock options.

4.02 INCOME TAX EFFECTS AS OF THE DATE OF THE GRANT Generally, the grantee of the NQSOS will not recognize taxable income on the date of the grant of the option. The tax reason why the grantee does not recognize taxable income is simply that, pursuant to the provisions of Section 83 of the Code, the option does not have a “readily ascertainable fair market value”. In effect, the compensatory aspects of the option are held “open” until the option is exercised. Since at the time of the grant of the NQSO there is not a tax event, the income tax effect in the future is to treat the appreciation in the value of the property underlying the option between the date of the grant and its exercise as compensation income, and not capital gain. Under these circumstances the grantee of the NQSO would generally want to treat the value of the option as of the date of its grant as compensation income at that time rather than later as of the date of the exercise of the option. The reason for this preference is that the amount of the ordinary compensation income which would be reportable as of the date of the grant would generally be less than the reportable ordinary compensation income as of the date of the exercise of the option. And therefore the ultimate capital gain that would be reported upon the eventual sale of the stock would be greater. However, the Code specifically and purposefully makes it difficult, for this very reason, for the grantee of the NQSO to report any ordinary compensation income as of the date of the grant of the NQSO. If a NQSO is not actively traded on an established market (which is highly likely), then Code Section 83 has four rigorous tests that must be met for the NQSO to have a readily ascertainable fair market value. The effect of these requirements is to force the taxation of the value of the NQSO to the date of its exercise. However, from a non-tax standpoint a NQSO is still a very attractive compensation device for executives and employees of a company. The options are generally granted without requiring the grantee to make any payment for it as of the date of the grant; the income tax effects are delayed; and the NQSOS also offer significant upside if the company “takes off” as is generally expected.

4.03 INCOME TAX EFFECTS AS OF THE DATE OF THE EXERCISE On the date of the exercise of the NQSO, the grantee will be required to recognize ordinary compensation income in an amount equal to the excess of the fair market value of the stock as of the date of the exercise over the exercise (strike) price paid for the stock on such date. There are issues from the company’s standpoint concerning the company’s obligations to report this inclusion of income by the grantee to the government and therefore the obligation of the company to withhold income taxes from the grantee as of the date of the exercise of the NQSO. These issues are beyond the scope of this paper.

4.04 INCOME TAX EFFECTS OF DISPOSITIONS Unlike incentive stock options, there is not any concept of a “qualifying” or “disqualifying” disposition of the stock. Following the exercise of the NQSO and therefore the acquisition of the stock of the company and, additionally, the reporting of the ordinary compensation income at such time, the stock will be treated in the same manner as any other investment

stock of the grantee-owner. The holding period for the determination of future capital gain recognition (more than 12 months) commences as of the date of the exercise of the NQSO. The basis of the stock acquired by the exercise of the NQSO is the amount paid by the grantee for the stock (the strike price) plus the amount of the ordinary compensation income reported by the grantee as of the date of the exercise. As a result, the basis of the stock is generally its full fair market value as of the date of the exercise of the NQSO. So on a future disposition of the stock by the grantee-owner, any increase in value of the stock over its value as of the date of the exercise of the NQSO will be taxed as capital gain income. And if the disposition occurs more than 12 months after the date of the exercise of the NQSO, then the appreciation will be treated as long term capital gain and will qualify for taxation at the lower capital gain income tax rates.

4.05 SPECIAL PLANNING OPPORTUNITIES WITH TRANSFERS Due to the fact that NQSOs can be transferred if the plan adopting the NQSOs or the grant of the option permits the transfer, this possibility opens up some charitable and non-charitable planning opportunities. Most importantly for the planned giving community, the IRS in PLR 200002011 (and subsequently reinforced in PLR 200012076) reached several favorable conclusions concerning a transfer by a decedent of NQSOs to a charitable organization at the time of her death. The IRS concluded that the decedent's estate will be entitled to a full charitable deduction for the fair market value of the NQSOs passing to the charity and that when the charity exercises the NQSOs the charity and not the estate of the decedent will be required to report the income. Also in this PLR, the IRS concluded that the transfer of the NQSOs and the reporting of the income upon the exercise of the NQSOs was "income in respect of a decedent" which is the same conclusion used for the disposition of qualified retirement plan accounts and individual retirement accounts. See Section 6.03 and Case Study No. 3 below for a discussion of the gift planning possibilities with testamentary transfers of NQSOs. There is a different tax result, however, with lifetime, non-arms length transfers of NQSOs. In PLR 9722022, the grantee transferred her NQSOs to an irrevocable trust for the benefit of her family members. The IRS concluded that the transfer of the NQSOs to the trust did not cause the grantee to recognize income as of the date of the transfer and, most importantly, that upon the subsequent exercise of the NQSOs by the trust the grantee and not the trust would recognize taxable compensation income equal to the excess of the fair market value of the shares received as of the date of the exercise (determined as of the exercise date) over the option price paid for the shares. The word "charity" could be substituted for the word "trust" in PLR 9722022 with a similar result and with a further conclusion that the grantee would receive a charitable income tax deduction as of the date of the exercise of the NQSOs by the charity in the same amount as the amount of the taxable compensatory income to be reported by the grantee as of such date. See Section 6.04 and Case Study No. 4 below for a discussion of the gift planning possibilities with lifetime transfers of NQSOs.

4.06 EFFECT OF THE DEATH OF THE OPTION HOLDER AND ESTATE TAX TREATMENT Following the death of the grantee-employee, if the NQSO plan permits the beneficiaries of the grantee-employee to exercise the NQSO and if the NQSO was not taxed at the date of the grant thereof, then the NQSO will pass to the beneficiaries of the grantee-employee with the potential taxation of the compensation income element left open. So after the date of the death of the grantee-employee when the beneficiaries engage in a transaction that "closes" the option transaction (an exercise of the option) it will be the beneficiaries who will report the ordinary compensation income. See IRS Treasury Regulations §§1.83-1(c) and (d). The "open" income tax treatment of this asset applies the same rules with the same income tax effects as with any other assets which involve "income in respect of a decedent" ("IRD"). Most notably, these rules and the tax treatment are the same as those involved with qualified retirement plans and individual retirement accounts. These IRD rules provide planning opportunities for gift planners which will be discussed in more detail in Section 6.05 and Case Study No. 5 below. The fair market value of the NQSO as of the date of the death of the grantee-employee is an asset that will be includable in the taxable estate of the grantee-employee. The fair market value of a NQSO is basically the

difference between the fair value of the stock of the company as of the date of the death of the grantee and the strike price.

4.07 TESTAMENTARY PLANNING CONSIDERATIONS The possibility for testamentary planning with NQSOs is much better than with ISOs. As discussed in Sections 4.05 above and in Sections 6.03, 6.04 and 6.05 and Case Studies Nos. 3, 4 and 5 below there are many more “pre-exercise” planning opportunities with NQSOs than are available for ISOs. Please refer to these Sections and Case Studies for the further discussions.

5. RESTRICTED STOCK

5.01 RESTRICTED STOCK DEFINED The area of “compensatory” transfers of property using restricted stock is governed by Code Section 83. For purposes of this paper, the term “property” will mean stock of the employer’s company. When an employer “transfers” stock that is “restricted” and that is subject to a “substantial risk of forfeiture” to an employee “in connection with the performance of services” then the analysis of the income tax effects to the employee are not too dissimilar to those discussed above with respect to incentive stock options and non-qualified stock options. Perhaps the best way to explain “restricted stock” is by way of an example. On July 1, 2000, Dotcom Corporation transfers 1,000 shares of its common stock to its employee, Ms. Technonerd who does not pay anything for the stock. On the date of the transfer the shares have a value of \$1.00 per share. The agreement between Dotcom and Ms. T specifies that if Ms. T leaves the employ of Dotcom before July 1, 2002, she will forfeit all rights to the stock which must then be returned to Dotcom without Ms. T receiving any payment for the stock. In addition, Ms. T is prohibited by the employer’s restricted stock plan from transferring the stock during the period that the “substantial risk of forfeiture” (the employment condition) continues to apply other than on her death or to a limited class of permitted transferees such as her family members and charities. A legend to this effect is stamped on Ms. T’s stock certificate. Assume that the value of the stock on July 1, 2002 (which is after Dotcom’s IPO) will be \$50.00 per share. Assume also that Ms. T remains in the employ of Dotcom past July 1, 2002. For purposes of the following discussion, July 1, 2000 is the date of the “transfer” of the “property” (the stock), and July 1, 2002 is the date that the stock is transferable and no longer subject to the substantial risk of forfeiture.

5.02 INCOME TAX EFFECTS AS OF THE DATE OF THE TRANSFER Contrary to the rules discussed above with respect to incentive stock options and non-qualified stock options as of the date of the grant of the options, the date of the “transfer” of the restricted stock to the employee is significant. Depending upon what course of action the employee takes on the date of the transfer, the employee may not or may have an income tax reporting event as of that date. In the example set forth in Section 5.01 above, Ms. T will not have any income to report if she does nothing because the stock that she received is subject to a “substantial risk of forfeiture”. However, see Section 5.03 below for the income tax effects to Ms. T as of the date the stock is no longer subject to the substantial risk of forfeiture if she does nothing as of the date of the transfer. The effects later will be quite severe. Ms. T does, however, have a choice as of the date of the transfer of the property, July 1, 2000 in our example. Ms. T can file a Code Section 83(b) election (see Section 2.02 above) with the IRS. If she does file this election, then Ms. T will be required to report as ordinary compensatory income the value of the stock as of the date of its transfer to her, July 1, 2000. In our example, this amount will be \$1.00 times the 1,000 shares or only \$1,000 of ordinary income. Her basis in the stock will be \$1,000, and the holding period for capital gain considerations will commence as of the date of the transfer of the stock to her (July 1, 2000 in our example). Then on July 1, 2002 when the substantial risk of forfeiture expires, Ms. T will not have any further income to report to the IRS. And even more importantly, if Ms. T were to sell the stock on July 2, 2002, the \$49 of appreciation realized after July 1, 2000 will be reportable by Ms. T as capital gain.

5.03 INCOME TAX EFFECTS AS OF THE DATE OF THE RELEASE OF THE RESTRICTIONS The income tax effects as of the date that the stock is no longer subject to the substantial risk of forfeiture depends on the course of action that the employee took as of the date of the transfer of the stock to her by the employer. See Section 5.02 above for the income tax effects to the employee as of the date of the transfer of the stock. If the employee did nothing as of the date of the transfer of the stock (which means that the employee did not file a Code Section 83(b) election and did not report any income to the IRS in year 2000) then the employee will have to report as ordinary compensatory income in the year that the substantial risk of forfeiture lapses, the full value of the stock as of such date. So in our example, by doing nothing on July 1, 2000 and reporting no income to the IRS in year 2000, Ms. T will have to report to the IRS as ordinary compensatory income for year 2002 (the year that the substantial risk of forfeiture expires), \$50.00 times 1,000 shares or \$50,000. Her basis in the stock will be \$50,000, and her holding period for capital gain considerations will commence as of the date that the substantial risk of forfeiture lapses (July 1, 2002 in our example). So Ms. T will have to wait until July 2, 2003 to sell the stock if she wants to report any further appreciation in value as long term capital gain. If the employee does file a Code Section 83(b) election when she receives the restricted stock, then in the later year when the substantial risk of forfeiture lapses, the employee will not have any further income to report to the IRS. In our example, if Ms. T files the Code Section 83(b) election then on July 1, 2002 she will not have any further income to report. Her next tax event will be when she sells the stock. If the employee fails to satisfy the condition of the restrictions and therefor the substantial risk of forfeiture actually occurs, the employee will lose the ownership of the stock, and the company will regain the ownership of the stock. Regardless of whether or not the employee has filed a Code Section 83(b) election, there will not be any income tax effect to the employee on the forfeiture and transfer of the stock back to the company, i.e., the employee will not be able to report a taxable loss of any nature on the transfer of the stock back to the company.

5.04 INCOME TAX EFFECTS OF DISPOSTIONS BEFORE THE REPORTING OF THE COMPENSATORY ORDINARY INCOME Before the employee has reported the income to the IRS with respect to the transfer of the stock (which means that the employee did not file a Code Section 83(b) election at the time of the transfer of the stock to her and the substantial risk of forfeiture has not yet lapsed), a disposition of the stock by the employee (which can occur by reason of the employee's death and by reason of any other disposition so long as the substantial risk of forfeiture remains in effect) will create rather complex income tax results to the employee. In an arm's-length disposition such as a sale, the employee reports the amount realized through the disposition as compensation income, and Code Section 83 has no further application to the transaction. If, however, the stock is disposed of in a non-arm's length transaction (such as a gift to a family member or to a charity), there are two potential tax events to the employee – the disposition and the lapse of the restrictions. The disposition does not terminate the application of Code Section 83 to the employee, rather Code Section 83 continues to apply until the restrictions lapse. If the employee is not paid anything for the stock as of the date of the disposition (in a true gift situation), then there will not be any income for the employee to report at that time. And then on the lapse of the restrictions, the employee (not the transferee) will report the same amount of ordinary compensatory income at that time as if the stock had not been previously disposed of by the employee. If the non-arm's length disposition is to a charity and if the disposition occurs before the restrictions lapse, then the employee-donor will report the compensatory ordinary income and receive a charitable income tax deduction only in the year that the restrictions lapse.

5.05 INCOME TAX EFFECTS OF DISPOSTIONS AFTER THE REPORTING OF THE COMPENSATORY ORDINARY INCOME After the employee has reported the income to the IRS with respect to the transfer of the stock, either as of the date of the transfer (by filing a Code Section 83(b) election) or as of the date that the restrictions lapse (by previously not filing a Code Section 83(b) election), the ownership of the stock for income tax purposes will be treated in exactly the same manner as the ownership by any individual of similar stock which was not previously restricted stock. The

primary issue will then be whether or not, on a later sale of the stock, the owner will be entitled to report any further appreciation as long term capital gain. The planning choices for gift planners will also then be the same as with any other stock investments based primarily on whether or not the stock is a long term capital gain asset. There is, however, one significant remaining non-tax issue if the stock is disposed of before the substantial risk of forfeiture lapses even if the employee has filed the Code Section 83(b) election. That issue is that if the forfeiture condition occurs (in our example if Ms. T's employment terminates before July 1, 2002), the transferee (the family member or the charity) will no longer be the owner of the stock and, generally, will not be paid anything for the stock as of the date of the forfeiture.

5.06 SPECIAL PLANNING OPPORTUNITIES WITH TRANSFERS Currently, there do not appear to be many planning opportunities, if any, to assist the employee-donors to avoid the imposition of the ordinary compensatory income during their lifetimes with restricted stock. There is one testamentary planning opportunity with restricted stock that is discussed in Sections 5.08 and 6.06 and Case Study No. 6 below.

5.07 EFFECT OF THE DEATH OF THE STOCKHOLDER AND ESTATE TAX TREATMENT If the employee's death occurs after the transfer of the stock and before the restrictions lapse and if the restricted stock plan of the employer permits a transfer to the deceased employee's family members or other beneficiaries without a triggering of the forfeiture restriction, then the employee's death itself does not close the compensation element of the transaction. The IRS Treasury Regulations in §1.83-1(d) specify that the compensation element in the restricted stock that remains unreported as of the date of the employee's death is to be considered as "income in respect to a decedent" ("IRD"). This is the same treatment which is imposed upon any balances remaining in any qualified retirement plans (like §401(k) plans) and individual retirement accounts (IRAs). Hopefully, at this time most gift planners are becoming familiar with the severe tax (both estate tax and income tax) consequences that these assets are subjected to upon the death of the employee. Hopefully, also, most gift planners will also be familiar now with the testamentary planning consideration that are available with IRA accounts and charitable remainder trusts. The testamentary planning considerations for restricted stock are discussed below in Sections 5.08 and 6.06 and in Case Study No. 6. The fair market value of the restricted stock as of the date of the employee's death will be includable in the employee's taxable estate for federal estate tax purposes. In determining the fair market value of the restricted stock, the existence of the substantial risk of forfeiture must be considered.

5.08 TESTAMENTARY PLANNING CONSIDERATIONS As discussed initially in Section 5.07 above, the open compensation element in restricted stock as of the date of the death of the employee will be treated as "income in respect of a decedent" ("IRD") under the Code. By analogy to the Private Letter Rulings which permit the testamentary transfer of IRD assets contained in qualified retirement plans and individual retirement accounts ("IRAs") to charitable remainder trusts following the death of the participant-donor, it seems appropriate, if the employer's restricted stock plan permits transfers, for the employee-donor to transfer the restricted stock (for which no Code Section 83(b) election was filed and which is still subject to the substantial risk of forfeiture) to a charitable remainder trust for the benefit of the members of the employee-donor's family and for the benefit of the donor's favorite charities. This planning opportunity will be discussed briefly in Section 6.06 below and will be illustrated in detail in Case Study No. 6 below.

6 GIFT PLANNING STRATEGIES FOR STOCK OPTIONS AND RESTRICTED STOCK

6.01 TRANSFER OF ISO STOCK TO A CHARITABLE REMAINDER TRUST The first gift planning strategy involves a transfer of the stock acquired through the exercise of an incentive stock option as contrasted with a transfer of the incentive stock option itself. After the donor has exercised the incentive stock option and after the donor has satisfied the 2 and 1 Rule (see Section 2.19 above), the donor establishes a charitable remainder trust, gifts the shares of the ISO stock to the CRT and then the CRT

sells the stock. This strategy provides nothing new or unusual from a planned giving standpoint except for the emphasis on the fact that the donor had owned the stock long enough to satisfy the 2 and 1 Rule. This strategy is illustrated in more detail in Case Study Number One below.

6.02 TRANSFER OF ISO STOCK TO A CHARITABLE LEAD TRUST This gift planning strategy also involves a transfer of the stock acquired through the exercise of an incentive stock option as contrasted with a transfer of the incentive stock option itself. The donor has exercised the incentive stock option and currently owns the stock. The donor wants to establish a charitable lead trust to benefit her favorite charity. She can establish the charitable lead trust and transfer the ISO stock to the CLT only after she has owned the stock long enough to satisfy the 2 and 1 Rule (see Section 2.19 above). The strategies discussed in Section 6.01 above and this Section illustrate two planning principles involving ISOs: (1) the inability to provide any planning suggestions or opportunities with regard to the incentive stock options which by the very terms of the enabling Internal Revenue Code Sections are non-transferable and (2) the need for the donor to satisfy the 2 and 1 Rule before any gift planning strategies are implemented. This strategy is illustrated in more detail in Case Study Number Two below.

6.03 TRANSFER OF NQSO'S TO A CHARITY This gift planning strategy is simply an illustration of the fact situation found in PLR 2000020110. In this situation, the employer's plan for its non-qualified stock options allows the options to be transferred prior to their exercise to family members and to charities. The grantee-donor therefore transfers, at her death, some of her NQSOs to her favorite charity before the options are exercised. After her death and after the receipt of the options by the charity, the charity exercises the NQSOs and, becomes the owner of the stock. The charity then sells the stock to obtain the cash. The income tax and estate tax effects on the donor's family are illustrated in more detail in Case Study Number Three below.

6.04 TRANSFER OF NQSO'S TO A CHARITABLE LEAD TRUST This gift planning strategy is an extension of the facts considered by the IRS in PLR 9722022. The donor during her lifetime establishes a charitable lead trust and transfers a portion of her options into the CLT. The plan established by the donor's employer for the NQSOs allows such a transfer prior to the exercise of the options. The income tax and estate tax effects on the donor and the donor's family are illustrated in more detail in Case Study Number Four below.

6.05 TESTAMENTARY TRANSFER OF NQSO'S TO A CHARITABLE REMAINDER TRUST This gift planning strategy is believed to be more innovative and relies on the IRS Treasury Regulations which require the beneficiaries of the deceased grantee-employee to report the compensation income in the NQSOs as "income in respect of a decedent" ("IRD") when they, the beneficiaries, exercise the NQSOs after the grantee-employee's death (see Section 4.06 above). This IRD characterization and the prior IRS Private Letter Rulings which allow the IRD from qualified retirement plans and IRAs to be "transferred" to a charitable remainder trust following the death of the IRA participant seem also to be applicable to NQSOs. After the donor's death, the donor's will (or living trust document) simply requires that a charitable remainder trust is to be set up following the donor's death and that the NQSOs or some part of them are to be transferred to the CRT. (Obviously it is imperative that the employer's plan for the NQSOs allows such a transfer.) The CRT then exercises the NQSOs, and the CRT reports the IRD rather than the donor's estate or the donor's estate beneficiaries. The income tax and estate tax effects on the donor and the donor's family are illustrated in more detail in Case Study Number Five below.

6.06 TESTAMENTARY TRANSFER OF RESTRICTED STOCK TO A CHARITABLE REMAINDER TRUST This last gift planning strategy is similar to the strategy discussed above in Section 6.05 except that it involves the testamentary transfer of restricted stock rather than NQSOs. See also Sections 5.07 and 5.08 above. In this strategy, the employer's restricted stock plan allows the restricted stock to be transferred following the death of the employee subject to the continuing restrictions. Since IRS Treasury Regulation §1.83-1(d) categorizes the compensation element in the restricted stock after the employee's

death to be “income in respect of a decedent” (“IRD”), the deceased employee-donor can direct that following her death the restricted stock is to be transferred to a charitable remainder trust. The existing IRS Private Letter Rulings which allow the IRD from qualified retirement plans and IRAs to be “transferred” to a charitable remainder trust following the death of the IRA participant seem also to be applicable to restricted stock. The income tax and estate tax effects on the donor and the donor’s family are illustrated in more detail in Case Study Number Six below.

B. REAL LIFE

7. CASE STUDIES AND SPECIFIC APPLICATIONS FOR STOCK OPTIONS AND RESTRICTED STOCK

The six Case Studies that follow hopefully will provide insights into some of the alternative ways that gift planners can assist their potential donors who are the owners of stock options with the structuring of gift transactions that provide, in each case, significant benefits for the donors or their families and for the charities of their choice. Three of the Case Studies involve charitable remainder trusts; two involve charitable lead trusts; and one involves a direct transfer to the charity. Two of the Case Studies involve incentive stock options; three of them involve non-qualified stock options; and one involves restricted stock. Each of the applications for these tools will be discussed in detail. The goal of these Case Studies is to encourage additional thoughts from and discussion among all of us and to increase everyone's understanding of how charitable gift planning techniques can be utilized in connection with stock options.

In the paper entitled Navigating Charitable Lead Trusts: Nuts and Bolts and Real Life prepared by the authors for the 1997 National Conference for the National Committee on Planned Giving and in the paper entitled Navigating Retirement Plan Distributions: Nuts and Bolts and Real Life prepared for the 1998 National Conference for the National Committee on Planned Giving, the financial analyses in the Real Life sections of those papers were prepared to minute mathematical accuracy. In the Real Life section in the paper entitled Navigating Closely Held Businesses: Nuts, Bolts and Real Life prepared for the 1999 National Conference for the National Committee on Planned Giving and in the Real Life section of this paper, the approach is different. While the mathematical analysis in each Case Study in these latter two papers is accurate, the emphasis in these two papers is more to explore the overall structuring of the charitable gift plans and the overall financial effect on the donors and their families and on the charities without getting totally buried in the financial detail.

In each of the six following Case Studies, the assumptions set forth below have been used with additional assumptions being stated in each particular Case Study itself when necessary.

Assumptions:

Description	Assumption	Description	Assumption
7520 Interest Rate	7.0%*	Present Value Interest Rate (Inflation)	2.5%
Combined Federal and State Ordinary Income Tax Rate	40%	Before Tax Total Rate of Investment Return	8%
Combined Federal and State Capital Gain Tax Rate	28%	Federal Estate and Gift Tax Exemption Equivalents	Used; all transfers are taxable
Federal Estate and Gift Tax Rate	50%		

* This assumed 7520 Interest Rate (or the Charitable Mid-Term Rate {"CMFR"}) is the average over the last three years of the 7520 Rates.

7.01 CASE STUDY NUMBER ONE STOCK FROM INCENTIVE STOCK OPTIONS; AFTER THE SATISFACTION OF THE TWO AND ONE RULE; CHARITABLE REMAINDER TRUST. Case Study Number One is actually quite simple. In spite of her age, Ms. Technonerd has had a very important position with Dotcom Corporation for many years. In fact Dotcom Corporation was one of the first Silicon Valley start-ups. During the past several years, Dotcom even has had steadily increasing earnings. As one of its ever increasing employee benefits, Dotcom granted its key employees incentive stock options (“ISOs”). Ms. T was one of those employees.

Ms. T exercised her ISOs more than two years ago. She has therefor satisfied the 2 and 1 Rule. Even though Ms. T’s salary from Dotcom has increased significantly, she and her husband are interested and would welcome some additional income for their retirement years. The donors have also been very active with their local charities, and one of the planned giving officers of one of these charities has explained to them the benefits of a charitable remainder trust. Mr. and Ms. T decide to set up a charitable remainder uni-trust for their joint lifetimes with a payout rate of 8%. They then transfer some of Ms. T’s stock in Dotcom valued at \$2,000,000 to the CRUT. The stock has an income tax basis of \$200,000 which was the exercise price of the ISOs.

So what are the financial results to the Ms. T, her husband and child and to the charity? See the Financial Results Table below.

Additional Assumptions for Case Study Number One

Additional Assumptions:

Description	Assumption	Description	Assumption
Fair Market Value of Stock	\$2,000,000	Exercise Price/Income Tax Basis in the Stock	\$200,000
Ages of the Donors	65 and 63	Term of the CRUT	Joint Lives/23 Years
CRUT Payout Rate	8%		

Table For Case Study Number One

Financial Results:

Description	No Planning and Death at Life Expectancy	Charitable Remainder Uni-Trust for Benefit of Donors	Charitable Remainder Uni-Trust and a Wealth Replacement Trust
Sales Price Now	\$2,000,000	\$2,000,000	\$2,000,000
Total Income Taxes	\$486,000	\$0	\$0
After Tax Sales Proceeds Held for the Benefit of the Donors	\$1,514,000	\$2,000,000	\$2,000,000
Income Tax Deduction	\$0	\$353,060	\$353,060
Income Tax Savings	\$0	\$141,224	\$141,224*
First Year After Tax Income and Tax Savings	\$72,672	\$237,224	\$96,000
Subsequent Annual After Tax Income	\$72,672	\$96,000	\$96,000
Cumulative Annual After Tax Income Paid Through Life Expectancy	\$1,671,456	\$2,445,224	\$2,208,000
Life Insurance Death Benefit	\$0	\$0	\$770,509
Net After Tax Wealth Received by the Family of the Donors	\$757,000	\$0**	\$770,509**
Benefit to Charity	\$0	\$2,000,000	\$2,000,000

Footnotes To Case Study Number One

* In this situation, the \$141,224 of income tax savings are used to purchase a single premium, second-to-die life insurance policy on the lives of the donors. The insurance policy was designed to perform under adverse conditions including a 10% reduction from the current earning rate.

** In the interests of simplicity, these figures ignore the opportunity and the strong likelihood that the donors will be able to re-accumulate a significant amount of wealth over their lifetimes by using the CRT alternative due to the fact that they will receive a significantly higher after-tax income stream from the CRT for a very long time.

7.02 CASE STUDY NUMBER TWO STOCK FROM INCENTIVE STOCK OPTIONS; AFTER THE SATISFACTION OF THE TWO AND ONE RULE; CHARITABLE LEAD TRUST. The charitable gift planning tool and the charitable gift planning technique utilized in Case Study Number Two are, similarly to Case Study Number One, also quite straight forward. Mr. PropellerHead (“PH” for short) is an employee of a corporation, WebSite Corporation, which is a “less mature” business entity than Dotcom Corporation. However, WebSite has just recently successfully completed its IPO, and the future for WebSite looks very promising. In fact, some of PH’s stock in WebSite that has a current value of \$2,000,000 and that he acquired just over 2 years ago from the exercise of some of his incentive stock options, is expected to be valued ten years from now at \$8,000,000.

PH and his wife have two very young children who seem destined to Harvard and to Stanford in several years. Mr. and Mrs. PH have listened to the planned giving officer at their college alma mater and are ready to set up a charitable lead trust with a portion of the WebSite stock. The charitable lead annuity trust will have a term of ten years (to tie in to when their oldest child will be ready for college) and their alma mater will be the recipient of the annual “lead” payments from the CLAT which will be set at \$90,000 (4.5% times \$2,000,000) for the full 10 years.

The financial results shown in the Financial Results Table assume that PH and his wife both die in the 10th year following the establishment of the CLAT so that an overall comparison of the alternatives can be properly evaluated. In fact, however, PH and his wife actually live long and healthy lives, enjoy being with their family and since they had such a positive experience with this first CLAT, they actually become significant philanthropists in their community.

See the Financial Results Table below for the comparative analysis of this Case Study.

Additional Assumptions for Case Study Number Two

Additional Assumptions:

Description	Assumption	Description	Assumption
Fair Market Value of Stock Today	\$2,000,000	Fair Market Value of Stock in Ten Years	\$8,000,000
Exercise Price/Income Tax Basis in the Stock	\$200,000	Charitable Lead Annuity Trust Payout Rate	4.5%
Charitable Lead Annuity Trust Term	10 Years		

Table For Case Study Number Two

Financial Results:

	Description	No Planning - Gift in 10 years at Death	Gift Now and Death in 10 Years	Gift Now Through a 10 Year Charitable Lead Annuity Trust
A	Value of Stock Today and at Date of the Gift	\$2,000,000	\$2,000,000	\$2,000,000
B	Reportable Taxable Gift Today	\$0	\$2,000,000	\$1,367,876
C	Gift Tax Paid Today by Donors	\$0	\$1,000,000	\$683,938
D	Adjustments Due to Early Payment of Gift Tax	\$546,512*	(\$252,554)**	--
E	Annual Gross/After Tax Dividends	\$90,000/\$54,000	\$90,000/\$54,000	\$90,000/\$90,000
F	Cumulative After Tax, Invested Value of Dividends	\$672,900	\$672,900	\$0
G	Dividends Paid to Charity over 10 Years	\$0	\$0	\$900,000
H	Value of Stock in 10 Years	\$8,000,000	\$8,000,000	\$8,000,000
I	Income Tax Basis for Stock	\$200,000	\$200,000	\$200,000
J	Income Taxes on Long Term Capital Gains Paid in 10 Years	\$0	(\$2,184,000)	(\$2,214,800)
K	Subsequent Federal Estate Taxes	(\$3,244,450)	\$0	\$0
L	Net After Tax Wealth Received by the Family of the Donors	\$5,974,962 (D+F+H+K)	\$6,236,346 (D+F+H+J)	\$5,785,200 (H+J)
M	Benefit to Charity	\$0	\$0	\$900,000

Footnotes To Case Study Number Two

* This adjustment is the gift tax of \$683,938 paid in the charitable lead trust example invested at 4.8% after tax for 10 years which is then reduced by 50% for the estate tax that otherwise would be payable.

** This adjustment is the difference between the \$1,000,000 of gift tax paid in the Gift Now example and the \$683,938 of gift tax paid in the Charitable Lead Trust example invested at 4.8% after tax for 10 years which is then reduced by 50% for the estate tax that otherwise would be payable.

7.03 CASE STUDY NUMBER THREE NON-QUALIFIED STOCK OPTIONS; TRANSFER OF THE OPTIONS AT DEATH AND PRIOR TO EXERCISE DIRECTLY TO A CHARITY. The gift planning option illustrated in Case Study Number Three involves the following facts and strategy. In addition to receiving her incentive stock options from Dotcom Corporation, Ms. Technonerd also was granted an even greater number of non-qualified stock options (“NQSOs”) in Dotcom. These NQSOs actually form a very significant portion of Ms. T’s overall wealth. The various tranches of the options, all of which are now vested, are exercisable over differing periods of time at different prices. The top echelon at Dotcom are actually very enlightened, and they have amended all of their NQSO plans to allow the options to be transferred to members of the families of the grantee-employees or trusts for their benefit and to charities.

During one of Ms. T’s conversations with her favorite planned giving officer at her favorite local charity (who had just returned from the National Committee on Planned Giving’s National Conference in Orlando, Florida), Ms. T came to understand the devastating income tax and estate tax effects on her family after her death when her family exercises her NQSOs. Ms. T believes that she can provide a very significant gift to her favorite charity at a very low “cost” to her family by amending her living trust to make a gift at her death of some of her NQSOs directly to the charity. Ms. T does make that amendment to her living trust. Her gift includes the NQSOs and enough cash for the charity to be able to exercise the options after the charity receives the options.

The financial analysis of this gift planning strategy is set forth in the Financial Results Table below.

Additional Assumptions for Case Study Number Three

Additional Assumptions:

Description	Assumption	Description	Assumption
Fair Market Value of Option	\$1,800,000	Exercise Price for the Stock	\$200,000

Table For Case Study Number Three

Financial Results:

Description	No Planning and Death Now	Direct Gift at Death of the Non-Qualified Stock Option to Charity
Fair Market Value of Option at Death	\$1,800,000	\$1,800,000
Additional Cash for Exercise of the Option	\$200,000	\$200,000
Total Assets for Family or Charity	\$2,000,000	\$2,000,000
Total Estate Taxes	\$640,000	\$0
Total Income Taxes on IRD	\$720,000	\$0
Net After Tax Wealth Received by the Family of the Donors	\$640,000	\$0
Benefit to Charity	\$0	\$2,000,000

7.04 CASE STUDY NUMBER FOUR NON-QUALIFIED STOCK OPTIONS; TRANSFER OF THE OPTIONS DURING LIFETIME AND PRIOR TO EXERCISE TO A CHARITABLE LEAD TRUST.

The planning option illustrated in Case Study Number Four is a little more complex than the earlier Case Studies. WebSite Corporation has been very interested in retaining its valued employees. So, in addition, to the adoption of incentive stock option plans, WebSite has also created a number of non-qualified stock option (“NQSO”) plans. Mr. PropellerHead (“PH”) is one of the employees who now owns vested NQSOs. The plans for these NQSOs allow the options to be transferred to members of the families of the grantee-employees or trusts for their benefit and to charities.

Since PH and his wife had such success with the charitable lead annuity trust that they established to provide for their children’s education in Case Study Number Two, they also immediately establish a second CLAT with a more long-range view for their children. And instead of funding the CLAT with stock, PH and his wife transfer some of the NQSOs to the CLAT instead. The NQSOs that are transferred to the CLAT have a relatively small value at the time of the transfer, and the exercise price for the NQSOs is very insignificant. Mr. and Mrs. PH understand, however, that they must also transfer enough cash to the CLAT, in addition to the NQSOs, so that the CLAT will have the liquidity to make the payments to their college over the 10 year term of the CLAT. PH again expects the value of the stock to be \$8,000,000 at the end of the term of the CLAT. After the end of the 10 year term of the CLAT, the trust does not immediately distribute to the children, but the assets in the trust are then held for the benefit of the children for a number of years,

As in Case Study Number Two, the financial results shown in the Financial Results Table below assume that PH and his wife both die in the 10th year following the establishment of the CLAT, but, as before, they continue to live a long, full and philanthropic life. See the Table below for the financial results.

Additional Assumptions for Case Study Number Four

Additional Assumptions:

Description	Assumption	Description	Assumption
Fair Market Value of Option Today	\$200,000	Fair Market Value of Stock in Ten Years	\$8,000,000
Exercise Price/Income Tax Basis in the Stock in the 10th Year	\$0 (Nil)	Charitable Lead Annuity Trust Payout Rate	6.0%
Charitable Lead Annuity Trust Term	10 Years		

Table For Case Study Number Four

Financial Results:

	Description	No Planning and Death in 10 Years; Option Exercised Just After Donors' Death	Gift Now of the Option Through a Charitable Lead Annuity Trust; Option Exercised Just After Donors' Death
A	Value of Option Today	\$200,000	\$200,000
B	Additional Liquid Assets Transferred to the Charitable Lead Trust	--	\$200,000
C	Adjustment Due to Transfer of Additional Assets to the Charitable Lead Trust	\$159,813*	--
D	Reportable Taxable Gift Today	\$0	\$231,433
E	Gift Tax Paid Today by Donors	\$0	\$115,717
F	Adjustment Due to Early Payment of Gift Tax	\$92,466**	--
G	Value of Option in 10 Years	\$8,000,000	\$8,000,000
H	Total Estate Taxes	(\$2,400,000)	\$0
I	Total Income Taxes at Ordinary Income Tax Rates	(\$3,200,000)	(\$3,200,000)***
J	Adjustment for Donor Estate's Payment of the Income Taxes After Death in the Charitable Lead Trust	\$1,600,000****	--
K	Value of Additional Assets Remaining in the Charitable Lead Trust	--	\$20,560
L	Net After Tax Wealth Received by the Family of the Donors	\$4,252,279 (C+F+G+H+I+J)	\$8,020,560 (G+K)
M	Benefit to Charity	\$0	\$240,000

Footnotes To Case Study Number Four

* This adjustment is the additional assets of \$200,000 paid into the charitable lead trust invested at 4.8% after tax for 10 years which is then reduced by 50% for the estate tax that otherwise would be payable.

** This adjustment is the gift tax of \$115,717 paid in the charitable lead trust example invested at 4.8% after tax for 10 years which is then reduced by 50% for the estate tax that otherwise would be payable.

*** This figure is the ordinary income tax at a rate of 40% of \$3,200,000 paid in the charitable lead trust example by the donor's estate after her death.

**** This adjustment is the income tax of \$3,200,000 paid in the charitable lead trust example by the donor's estate which is then reduced by 50% for the estate tax that otherwise would be payable.

7.05 CASE STUDY NUMBER FIVE NON-QUALIFIED STOCK OPTIONS; TRANSFER OF THE OPTIONS PRIOR TO EXERCISE BUT FOLLOWING THE DEATH OF THE OPTION HOLDER TO A CHARITABLE REMAINDER TRUST. In Case Study Number Five, Ms. Technonerd wants also to provide some benefits for her children following her death from some more of her Dotcom Corporation vested non-qualified stock options and ultimately for her favorite local charity. The same planned giving officer mentioned in Case Study Number Three also suggests the following gift planning strategy to Ms. T. Ms. T and her husband think that this strategy is so significant and so powerful for their family and the charity that, without any further coaxing, they immediately make an appointment with their equally enlightened attorney who immediately makes the appropriate amendments to their estate planning documents.

The estate planning documents for Ms. T and her husband are amended to provide that following both of their deaths, a charitable remainder uni-trust will be established for the lifetime of their daughter who is now 35 years of age. The CRUT will provide for a payout rate to their daughter of 6%. The CRUT will be funded after both of their deaths with some of the NQSOs of Dotcom which have a value of \$1,800,000 and a strike price of \$200,000. The gift to the CRUT includes cash of \$200,000 so that the CRUT will be able to exercise the NQSOs without diminishing the principal of the CRUT.

This gift planning strategy provides significantly greater benefits for Ms. and Mr. T's daughter over her lifetime than if the NQSOs were simply transferred to her by Ms. and Mr. T after their deaths primarily due to the imposition of the income tax on the "income in respect of a decedent" which their estate would be required to pay if the NQSOs are transferred directly to their daughter. This strategy and its financial results are very similar to those expected from a testamentary transfer of assets in qualified retirement plans and individual retirement accounts to a charitable remainder trust. The financial results are set forth in the Financial Results Table below.

Additional Assumptions for Case Study Number Five

Additional Assumptions:

Description	Assumption	Description	Assumption
Fair Market Value of Option Today	\$1,800,000	Exercise Price/Income Tax Basis in the Stock	\$200,000
Age of the Donors' Child	35	Child's Life Expectancy and Term of the Charitable Remainder Trust	42 years
CRUT Payout Rate	6%		

Table For Case Study Number Five

Financial Results:

Description	No Planning and Death Now	Gift of the Option at Death to a Charitable Remainder Uni-Trust
Fair Market Value of Option at Death	\$1,800,000	\$1,800,000
Additional Cash for Exercise of the Option	\$200,000	\$200,000
Estate Tax Deduction	\$0	\$215,280
Total Estate Taxes	\$540,000	\$892,360
Total Income Taxes on IRD	\$720,000	\$0
Adjustment Due to the Exercise Price and the Estate Tax Being Paid from other Assets in the Charitable Remainder Trust Example	\$546,180*	--
After Tax Amount Available for Investment	\$1,086,180	\$2,000,000
Annual After Tax Income (Range)	\$52,137	\$72,000-\$162,158
Cumulative Annual After Tax Income Paid Through Life Expectancy	\$2,189,739	\$4,670,080
Present Value of the Cumulative Income Stream	\$1,346,200	\$2,616,046
Present Value of Invested Principal	\$385,034	--
Present Value of Net After Tax Wealth Received by the Family of the Donors	\$1,731,234	\$2,616,026
Present Value of Benefit to Charity	\$0	\$215,260

* This adjustment is the exercise price of \$200,000 and the estate tax of \$892,360 paid from other assets in the charitable remainder trust example which are then reduced by 50% for the estate tax that otherwise would be payable.

7.05 CASE STUDY NUMBER SIX RESTRICTED STOCK; TRANSFER OF THE STOCK PRIOR TO LAPSE OF RESTRICTIONS BUT FOLLOWING THE DEATH OF THE STOCKHOLDER TO A CHARITABLE REMAINDER TRUST.

The gift planning strategy illustrated in Case Study Number Six is actually quite similar to the strategy shown in Case Study Number Five except that the asset used to fund the 6% charitable remainder uni-trust for the benefit of Ms. and Mr. T's daughter is restricted stock rather than non-qualified stock options.

Again, the top management of Dotcom Corporation is to be commended. One of the restricted stock plans that Dotcom adopted (and of which Ms. T is a participant) creates "substantial risks of forfeiture" of the stock based on earnings performance goals for the company rather than the more usual restrictions based on the continued employment of the employee-owner of the restricted stock. The plan also allows the restricted stock to be transferred to members of the families of the owner-employees or trusts for their benefit and to charities.

So when Ms. T and her husband visit their attorney to amend their estate plan to provide for the creation of the charitable remainder trust following their deaths for some of the non-qualified stock options as described in Case Study Number Five, they also include provisions for the establishment of another but similar charitable remainder trust which will be the recipient of a portion of the restricted stock. The restricted stock has a value today of \$2,000,000. And, in fact, after the deaths of Ms. and Mr. T and the receipt of the stock by the CRUT, Dotcom achieves its earnings goals specified in the restricted stock plan and the stock is no longer restricted.

Since at the time of Ms. and Mr. T's deaths, the restrictions on the stock had not yet lapsed, the compensation income element "built in" to the restricted stock is considered as "income in respect of a decedent" which is potentially taxable to their daughter at ordinary income tax rates. Similarly as in Case Study Number Five, this gift planning strategy provides significantly greater benefits to their daughter when compared simply to allowing their daughter to receive the restricted stock directly. And, of course, there is ultimately a significant benefit to the favorite charity of Ms. and Mr. T. The financial results are set forth in the Financial Results Table below.

Additional Assumptions for Case Study Number Six

Additional Assumptions:

Description	Assumption	Description	Assumption
Fair Market Value of Restricted Stock Today	\$2,000,000	Age of the Donors' Child	35
Child's Life Expectancy and Term of the Charitable Remainder Trust	42 years	CRUT Payout Rate	6%

Table For Case Study Number Six

Financial Results:

Description	No Planning and Death Now	Gift of the Restricted Stock at Death to a Charitable Remainder Uni-Trust
Fair Market Value of Restricted Stock at Death	\$2,000,000	\$2,000,000
Estate Tax Deduction	\$0	\$215,280
Total Estate Taxes	\$600,000	\$892,360
Total Income Taxes on IRD	\$800,000	\$0
Adjustment Due to the Estate Tax Being Paid from other Assets in the Charitable Remainder Trust Example	\$446,180*	--
After Tax Amount Available for Investment	\$1,046,180	\$2,000,000
Annual After Tax Income (Range)	\$50,217	\$72,000-\$162,158
Cumulative Annual After Tax Income Paid Through Life Expectancy	\$2,109,099	\$4,670,080
Present Value of the Cumulative Income Stream	\$1,296,624	\$2,616,046
Present Value of Invested Principal	\$370,855	--
Present Value of Net After Tax Wealth Received by the Family of the Donors	\$1,667,479	\$2,616,026
Present Value of Benefit to Charity	\$0	\$215,260

*This adjustment is the estate tax of \$892,360 paid from other assets in the charitable remainder trust example which is then reduced by 50% for the estate tax that otherwise would be payable.

C. CONCLUSION

The use of sophisticated charitable giving techniques is "coming of age" in a big way with a broad spectrum of innovative non-profit development officers and allied professional advisers who are forward thinking and who are connecting with donors that are open to planning techniques which create true win-win situations for the donors, their families and the ever more needy charities. The limitations imposed in recent years on other tax deferral techniques, the power available in today's computers and an ever increasing responsibility upon the private sector to assist charities with the human issues concerning our society are continuing to combine to create significant opportunities for the individual donors and the charities. Officers of the charities and allied professional advisers working closely together can provide immense assistance to their donors by first helping them develop a family financial philosophy which is the doorway to a better understanding of the importance of all of the planned giving tools. These tools provide a broad spectrum of very powerful planning options which have been available for some time but which can now be better analyzed, understood and applied for the mutual benefit of the donors and the charities. Planned giving professionals, attorneys, certified public accountants, insurance professionals and financial planners will now all be called upon to develop new uses for these sophisticated techniques and to find more and more applications that create new and substantial opportunities for the donors and the charitable recipients.

Incentive stock options, non-qualified stock options and restricted stock are now a source of significant wealth for many potential donors. While the gift planning strategies discussed in this paper may have fairly limited application, they are also very powerful. And even though the application of the strategies may be seen as fairly narrow, the opportunity to meet with and to start to build a strong and obviously very beneficial mutual relationship between the potential donors and the innovative charity can perhaps open other avenues and assets to charitable giving.

The opportunities available for the charities, the allied professionals and, most importantly, the donors to use the planned giving tools to assist with the succession planning and tax reduction for their options and restricted stock are immense. The reasons are at least twofold – the amount of the wealth involved with the options and restricted stock in our country is ever increasing, and these sophisticated charitable giving techniques are extremely powerful. As planners, all of us must continue to expand our knowledge of these techniques, to emphasize their use and to encourage all of the donors that we advise to use them for their benefit and for the benefit of their favorite charities.

D. PRESENTATION OVERHEADS

The presentation overheads used in the actual presentation of this paper to the 25th Conference on Gift Annuities presented by the American Council on Gift Annuities in Seattle, Washington are attached.

If you have any questions or comments about the material presented in this paper or the case studies, please feel free to contact either:

Darryl D. Ott, Esq.
Morgan, Miller & Blair
Professional Corporation
1676 N. California Blvd., Suite 200
Walnut Creek, CA 94596
Voice: (925) 937-3600
FAX: (925) 943-1106
E-Mail: dott@mmlaw.com

Robert Lew
Planning and Financial Advisors
690 Market Street, Suite 826
San Francisco, CA 94104
Voice: (415) 675-2930
FAX: (415) 675-2949
E-Mail: rlew@pfadvisor.com

Navigating Stock Options & Other Stock Rights

Presented to:
25th Conference on Gift Annuities

Robert Lew
Planning and Financial Advisors

Darryl Ott
Morgan, Miller & Blair

Scope of Presentation

- ◆ What are ISO, NQSO, RS and how do they work?
- ◆ How are ISO, NQSO, RS taxed?
- ◆ Planning Solutions

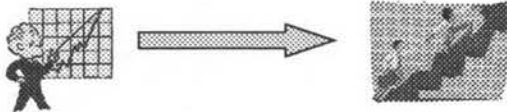
What is an Option?

A stock option is the right, but not the obligation, to buy a fixed number of shares of stock at a specified price for a specific period of time.

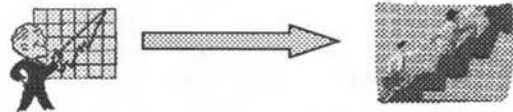
Alphabet Soup

- ◆ ISO - Incentive Stock Option
 - » Statutory Stock Option
 - » Qualified Stock Option
- ◆ NQSO - Non-Qualified Stock Option
 - » Non-Statutory Stock Option
 - » Non-Qualified Options
- ◆ RS - Restricted Stock
 - » Stock Bonus Programs
 - » Restricted Stock Grants

Incentive Stock Option

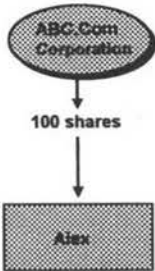


Incentive Stock Option



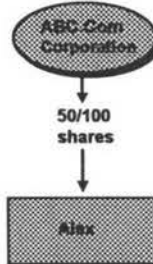
- ◆ Important terms
 - ◆ Grant
 - ◆ Vested
 - ◆ Exercised
 - ◆ Sell
- ◆ Why ISO?
 - ◆ Tax benefit
- ◆ Why Not?
 - ◆ Restrictions and Limits

ISO – The Grant



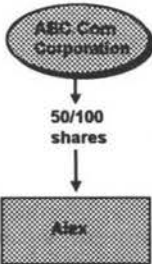
- ◆ Alex is granted 100 shares:
 - ◆ to vest at 10 shares a year
 - ◆ which can be purchased for \$5.00 a share
- ◆ There is no tax due when the ISO is granted.

ISO – Vesting



- ◆ Vested – In year five, 50 shares can be purchased for \$250.00.
- ◆ There is no tax due when the ISOs are vested.

ISO – Exercising

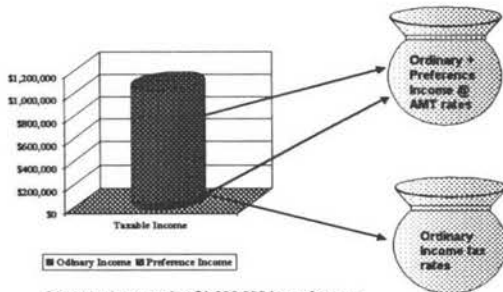


- ◆ There is generally no ordinary income tax due when the ISOs are exercised.
- ◆ The basis will be the exercise price
- ◆ There may be AMT tax due when the ISOs are exercised.

AMT

Value of Stock	\$1,250
Strike Price	<u>\$ 250</u>
Subject to AMT	\$1,000

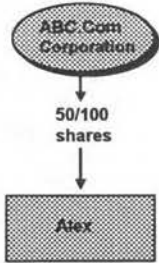
Alternative Minimum Tax



ISO – Tax Upon Sale

- ◆ Sell stock within two years of grant or a year of exercise - pay ordinary income tax on the gain. Non-Qualified Disposition
- ◆ Sell after two years of grant and one year of exercise - pay long term capital gains tax on the gain. Qualified Disposition

ISO – Upon Death



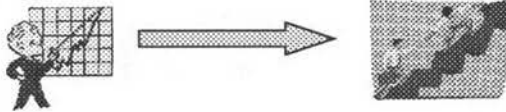
- ❖ Upon death, previously exercised shares will have a basis “step up” to FMV.
- ❖ The difference between the FMV and the exercise price is included in the estate.
- ❖ No 2/1 rule.

Timing of Taxes

	Grant	Vest	Exercise	Sell
ISO	Non-Tax Event	Non-Tax Event	AMT	Ordinary Income Tax Rate

- ☐ Non-Tax Event
- Ordinary Income Tax Rate
- Ordinary or LTCG Tax

Non-Qualified Stock Option



❖ Important terms

- ❖ Grant
- ❖ Vested
- ❖ Exercised
- ❖ Sell

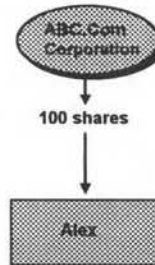
❖ Why NQSO?

- ❖ Flexible
- ❖ Transferable

❖ Why Not?

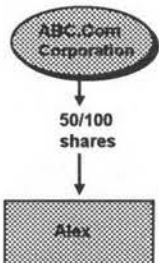
- ❖ Fewer tax benefits

NQSO – The Grant



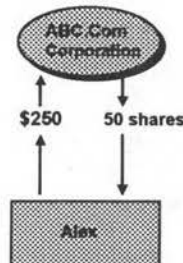
- ❖ Alex is granted 100 shares:
 - ❖ to vest at 10 shares a year
 - ❖ which can be purchased for \$5.00 a share
- ❖ There is no tax due when the NQSO is granted.

NQSO – Vesting



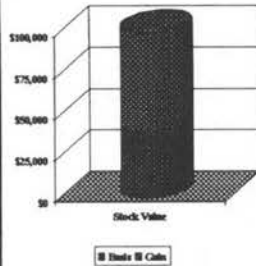
- ❖ In year five, 50 shares can be purchased for \$250.00.
- ❖ There is no tax due when the NQSO is vested.

NQSO – Exercising



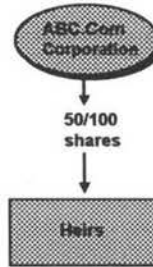
- ❖ Taxes are due on the difference between FMV and what is paid when the option is exercised.
- ❖ Alex pays \$250 for shares worth \$1,250 and owes ordinary income tax on \$1,000.
- ❖ *Compensation*

NQSO – Tax Upon Subsequent Sale



- ◆ Basis will be the fair market value of the stock as of the date of exercise.
- ◆ Tax will be due on the difference (gain) between the basis and the sale price.
- ◆ LTCG if held for more than one year after exercise.

NQSO – Upon Death



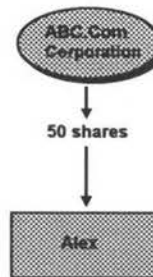
- ◆ Options exercised after death triggers ordinary income tax less a deduction for estate taxes paid.
- ◆ The difference between the FMV and the exercise price is included in the estate.

Restricted Stock



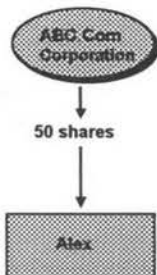
- | | |
|---|---|
| <ul style="list-style-type: none"> ◆ Important terms <ul style="list-style-type: none"> ◆ Issuance ◆ Vested ◆ Restrictions lapse ◆ Sale | <ul style="list-style-type: none"> ◆ Why RS? <ul style="list-style-type: none"> ◆ Simple ◆ Why Not? <ul style="list-style-type: none"> ◆ No tax advantage |
|---|---|

RS – The Issuance



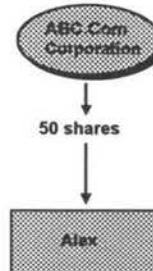
- ◆ If Alex does a good job and stays for five years, he will be allowed to keep 50 shares of stock.
- ◆ There is no tax due when the RS is issued.

RS – Restrictions Lapse



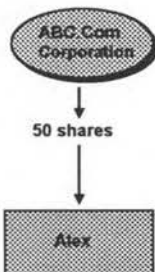
- ◆ Restrictions Lapse – In year five, Alex will be allowed to keep 50 shares.
- ◆ Lapse is automatic and ordinary income taxes are due immediately.
- ◆ *Compensation*

RS – Tax Upon Sale



- ◆ Basis will be the fair market value of the stock as of the date the restrictions lapsed.
- ◆ Tax will be due on the difference (gain) between the basis and the sale price

RS – Tax Upon Death



- ❖ Upon death, the basis of restriction lapsed shares (shares owned) are “stepped up.”
- ❖ The FMV of lapsed and non-lapsed shares are included in the estate.
- ❖ The non-lapsed shares are considered IRD.

ISO - Planning Giving Before Exercise

- ❖ From a planned giving point of view, what can a donor do with options from an ISO before exercising?
- ❖ During life, nothing. Options cannot be transferred!!
- ❖ At death, option can be given to a charity by the estate or by the heirs at fair market value.

ISO - Planned Giving After Exercise

- ❖ From a planned giving point of view, what can a donor do with the stock from an ISO after exercising?
- ❖ The 2/1 rule may limit what the donor can do.

Planned Giving with the 2/1 Rule

After 2/1 rule met, donor can:

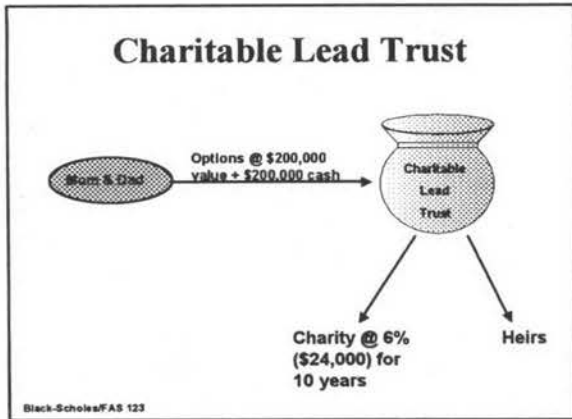
- ❖ Outright gift to reduce taxes
- ❖ CRT to sell without LTGC taxes
- ❖ CLT to pass assets to heirs at a discount

NQSO - Planned Giving Before Exercise

- ❖ From a planned giving point of view, what can a donor do with the NQSO before the option is exercised and while alive?
- ❖ Deduction may be limited to basis (\$0) until sold by the charity. Then gain and deduction may offset. Reg. 1.170(e)(1)(F)(ii)
- ❖ Give the option to a Charitable Lead Trust.

Client Assumptions (Case study 4)

Value of option	\$200,000
Cash	\$200,000
Stock value in 10 Years	\$8,000,000
AFR	7%
Gross Earning Rate	8%
Income Tax Rate	Flat 40%
Estate Tax Rate	Flat 50%



Charitable Lead Trust

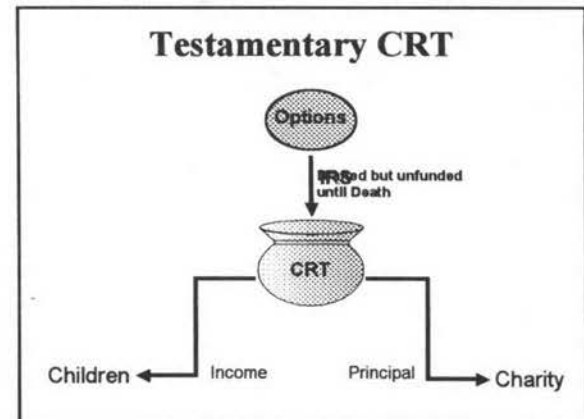
	No Planning	CLAT
10 th Year Value	\$8,000,000	\$8,020,560
Income Tax	\$3,200,000	\$3,200,000
Estate /Gift Tax	\$2,400,000	\$115,717
Children	\$4,252,279*	\$8,020,560
Charity	\$0	\$240,000

*Includes adjustment of \$200,000 + \$115,717 growing at 8% taxable and \$1,600,000 net of taxes on \$3,200,000 paid by grantor of the CLAT

Special "grantor" rule

NQSO - Planning Giving @ Death

- ◆ From a planned giving point of view, what can a donor do with the NQSO before the option is exercised but after the death of the optionee?
- ◆ Testamentary gift of options to charity who in turn exercises the options. (PLR 200002011) (Case study 3, IRD planning)
- ◆ NQSO can be donated to a testamentary CRT.



Client Assumptions (Case study 5)

FMV of Stock @ Death	\$2,000,000
Exercise Value	\$200,000
Age of Child	35
CRT Term	Life (42 years)
Payout Rate	6%
Inflation Rate	2.5%
Gross Earning Rate	8%
Income Tax Rate	Flat 40%
Estate Tax Rate	Flat 50%

Testamentary CRT

	No Planning	CRT
Value @ Death	\$2,000,000	\$2,000,000
IRD	\$720,000	\$0
Estate Tax	\$540,000	\$892,360
Opportunity Cost	\$546,180	N/A
Annual After Tax Income	\$52,137	\$72,000 --- - \$162,158
Present Value to Children	\$1,731,234	\$2,616,046
Present Value to Charity	\$0	\$215,280

NQSO - Planned Giving After Exercise

- ◆ What can a donor do with stock from a NQSO after exercising?
- ◆ Any planned giving tool including:
 - ◆ Outright Gift
 - ◆ Charitable Remainder Trust
 - ◆ Charitable Lead Trust
 - ◆ Charitable Gift Annuities
 - ◆ Pool Income Fund

RS - Planned Giving Before Restrictions Lapse

- ◆ From a planned giving point of view, what can a donor do with RS before the restrictions lapse?
- ◆ Nothing to charity while alive.
- ◆ Testamentary outright gift or to a Charitable Remainder Trust. (Case study 6)

RS - Planned Giving After Restrictions Lapse

- ◆ What can a donor do with the RS after the income taxable event?
- ◆ Any planned giving tool including:
 - ◆ Outright Gift
 - ◆ Charitable Remainder Trust
 - ◆ Charitable Lead Trust
 - ◆ Charitable Gift Annuities
 - ◆ Pool Income Fund

	Grant/Issue	Vest	Exercise/Lapse	Sell
ISO				Non-Tax Event
NQSO	Testamentary Gift - Outright or to CRT	Outright Gift to CRT		Ordinary Income Tax Rate
RS	Testamentary Gift - CRT	Gift		Ordinary or LTCG Tax

☐ Non-Tax Event
 ■ Ordinary Income Tax Rate
 ■ Ordinary or LTCG Tax

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Planning and Financial Advisors

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Sparkling Ideas...



in the Emerald City

CHARITABLE GIFTS OF REAL ESTATE

Philip M. Purcell, J.D., CFRE
Director of Gift Planning
Central Indiana Community Foundation
615 N. Alabama
Indianapolis, IN 46204
(317) 634-7497
FAX (317) 637-7021
philp@cicf.org

25TH CONFERENCE ON GIFT ANNUITIES • PRESENTED BY THE AMERICAN COUNCIL ON GIFT ANNUITIES

233 McCREA STREET, SUITE 400 • INDIANAPOLIS, INDIANA 46225 • (317) 269-6271 • FAX: (317) 269-6276 • E-MAIL: ACGA@IUPUI.EDU

Charitable Gifts of Real Estate

I. Prospective Realty: The Potential of Real Estate Gifts.

- A. The upcoming inter-generational wealth transfer holds unprecedented potential for philanthropy.
1. 1993 Study (Wealth and Inheritance) by Robert B. Avery and Michael S. Rendall of Cornell University. By the year 2040, they forecast a transfer of \$10.4 trillion (1989 dollars), coming in 115 million bequests with a mean value of \$90,167.
 2. 1999 Study updates this analysis and forecasts a transfer of \$40 to \$100 trillion. See *"Wealth and the Commonwealth: New Findings on the Trends in Wealth and Philanthropy"* and *"Millionaires and the Millennium: The Forthcoming Transfer of Wealth and the Prospects for a Golden Age of Philanthropy"*, John Havens and Paul Schervish, Boston College Social Welfare Research Institute, 1999. Low-range estimate: \$41 trillion will transfer from 1998 to 2052, and the actual figure may double or triple that amount.
- B. Real estate as a component of individual wealth. Sources: *Statistical Abstract of the United States* (1997); *Prudential Resources Management* (1995).
1. 64.7% of families (including one person units) own their primary residence.
17.5% of families own investment real estate.
 2. Median value of primary residence: \$90,000.
Median value of investment real estate: \$50,000.
 3. Mean net worth of families who own their primary residence: \$295,400.
Median net worth of families who own their primary residence: \$102,300.
 4. 75% of individuals over age 65 own one or more homes. Total value of the homes owned by those over age 65 equals approximately \$1 trillion. 83% of individuals over age 65 have no debt on their real estate.
 5. Approximately 50% of individual wealth is held in real estate. Estates over \$10 million have less than 50% of value in real estate per Bruce Bigelow, Connecticut Planned Giving Conference, September 1998.
 6. Total value of land and buildings included in farm real estate: \$859 trillion at \$890 per acre.
 7. Website for real estate data: USTrust.com.
- C. Many gift planning techniques are available to tap the potential of real estate gifts if your organization is willing to lay the groundwork.

II. Understanding Real Estate Interests.

- A. What is Real Estate?
1. A definition: Real estate or real property is land and generally whatever is erected or growing upon or affixed to land. Also, rights issuing out of, annexed to, and exercisable within or about land (e.g., water or mineral rights, oil/gas interests, etc.).
 2. Examples of real estate or real property are numerous. Definitions and regulations may vary pursuant to state and/or federal law. Here are a few examples: personal residence, undeveloped land, permanently attached fixtures to land, agricultural land, commercial property (e.g., industrial buildings, hotels, entertainment facilities, etc.), investment property (e.g., apartments, shopping centers/malls, office buildings, etc), natural resources (e.g., oil/gas interests, timberland, mineral rights, water/water rights, etc.), development land (unimproved, improved), and easements (permitting or prohibiting a use).
 3. Real property is not personal property. Personal property is generally all property other than real estate. Personal property is divisible into tangible (corporeal) and intangible (incorporeal) personal property.
 - a. Types of Tangible Personal Property: art, antiques, jewelry, collectibles, animals, yachts, vehicles, cut crops and timber, etc.
 - b. Types of Intangible Personal Property: stocks, bonds, patents, copyrights, life insurance, partnership interests, LLC units, trademarks, etc.
- B. There are many different types of real property ownership and/or interests. The charity and the donor must

fully understand the donor's interest prior to completion of a gift. *Note: Donors may be unaware of their actual legal ownership/interest.* Legal counsel should be consulted with a review of the donor's legal documents. Types of real estate ownership and interests are subject to state law.

Whole Interests:

1. **Fee Simple Absolute.** The owner is entitled to the entire property with unconditional power of disposition during his/her life and descending to his/her heirs at death. Unlimited in duration, disposition and descendibility.
2. **Fee Simple Conditional.** The owner is entitled to the property on condition that something be done or not done.
3. **Fee Simple Defeasible.** The owner's interest may end upon the happening of a specific event.
4. **Fee Simple Determinable.** The owner's interest automatically expires on occurrence of a stated event.
5. **Fee Tail.** The property ownership is limited to the children (and their subsequent issue) of the owner.

Partial Interests:

6. **Partial Interest.** Property concurrently held by more than one owner, each sharing a portion of ownership in some legal manner at the same time or consecutively. For example, a life estate by one followed by a remainder interest held by another; each owns a partial interest.
7. **Undivided Interest.** The interest owned by one of two or more tenants in common or joint tenants before partition. Held by the same title by two or more persons, whether their rights are equal (i.e., value or quantity) or unequal. The undivided interest is a fractional interest whereby each owner co-owns each and every right to the same property at the same time in their relative proportions.
8. **Life Estate (consecutive ownership).** The property is owned for the lifetime of the owner (or another). Upon the death of the life estate owner, the property passes to the owner of the remainder interest. It is possible to have a term of years estate followed by a remainder. See PLR 8305075.
9. **Joint Tenancy (Concurrent ownership).** Two or more persons whose interest in property is fee simple, fee tail, life estate, for years or at will. Joint tenants have one and the same interest; each owns an undivided interest in the whole with a right of survivorship. Joint tenants have one and the same interest, accruing by one and the same conveyance, commencing at one and the same time, and held by one and the same undivided possession. A joint tenant cannot transfer his/her share to another by bequest; the right of survivorship prevails.
10. **Tenancy by the Entirety (Concurrent ownership).** Ownership between husband and wife by which together they hold title to the whole with the right of survivorship so that, upon the death of either, the other takes the whole. Used in approximately six states.
11. **Tenancy in Common (Concurrent ownership).** More than one owner where each holds an undivided interest in the whole property. Unlike a joint tenancy or a tenancy by the entirety, the interest of a tenant in common does not terminate upon his/her death, i.e., there is no right of survivorship. Upon the death of a tenant in common, his/her interest passes to his/her heirs or estate, even if the other tenant(s) in common are not heirs. Tenants in common may transfer their share (unless otherwise agreed to).
12. **Community Property (Concurrent ownership).** Property owned in common by husband and wife each having an undivided one-half interest by reason of their marital status. Eight community property states: Louisiana, Texas, New Mexico, Arizona, California, Washington, Idaho and Nevada. The rest of the states are common law jurisdictions except Wisconsin that has marital property (similar to community property). In most common law states, each spouse owns what he/she earns. In community property states, one-half the earnings of each spouse is considered property of the other spouse.

Other Interests:

13. **Tenancy.** An interest in real estate allowing possession or occupancy of land or premises under the terms of a lease (e.g., landlord may retain right to enter to demand rent or to make repairs). Also known as a leasehold estate. A leasehold may be donated. See PLR 9014033

(regarding transfer of a lease into a charitable remainder trust). Types of leaseholds:

- **Tenancy for year(s).** One who has temporary use and possession, but not permanent ownership, for a determinate time period.
 - **Tenancy from year to year (periodic tenancy).** One who has temporary use and possession for an uncertain time period, but an annual rent is reserved.
 - **Tenancy at will.** One who has temporary use and possession at the will of the owner for an uncertain time period.
14. **Cooperative.** A cooperative is a corporation or association organized for rendering economic services, without gain to itself, to shareholders or members. In addition, cooperative may connote an apartment building in which the owner (e.g., a corporation) holds title to all premises and grants rights of occupancy to particular departments by means of proprietary leases. The board of directors of a cooperative may need to approve a transfer of any ownership/shares of the cooperative.
15. **Condominium.** An undivided interest in common in a portion of a parcel of real property together with a separate interest in space in a residential, industrial or commercial building as such real property. Such an interest may be (1) a perpetual (inheritable) estate, (2) life estate, or (3) an estate for years, such as a leasehold transferred by deed.
16. **Partnership Interests (Intangible Personal Property which may represent an indirect interest in real estate).** A partnership is an association of two or more persons to carry-on a business as co-owners. Partnership income, gains and losses, etc., flow to the individual partners and are reported on their personal income tax returns. General partnership interests carry all the liabilities, debts, etc. of the partnership. The limited partnership interests have very limited exposure to debts and liabilities - and minimal management involvement. Partnership interests may be donated but charity (legal counsel) should first review the applicable partnership agreement documents for potential liabilities and unrelated business taxable income (UBI).
17. **Limited Liability Corporations (LLC) (Intangible Personal Property which may represent an indirect interest in real estate).** Offers a hybrid legal structure between partnerships and corporations. Taxed generally like a partnership (avoiding corporate double taxation) while offering limited liability similar to the corporate form. Units of ownership in a LLC may be donated. These LLC units may represent ownership interests in real estate, from which income may be paid (similar to partnership interests). The charity may receive LLC units but should note that liabilities, debts, unrelated business income, etc., may also result from acceptance of these units (similar to partnership interests).
- Note:* In **PLR 200134025**, a single member LLC was established for each parcel of real estate donated. IRS held LLC will qualify as a 501(c)(3), but with no need for a 1023 application or annual 990. The LLC limits liability under state law, but ignored for income tax purposes. IRS did not rule on whether gift to LLC qualifies for a tax deduction; this issue is pending.
18. **Real Estate Investment Trusts (REITs).** These trusts (or in some cases corporations) primarily own real estate. Shares or certificates which represent ownership in the REIT may be donated to charity.
19. **Qualified Personal Residence Trust (QPRT) and Personal Residence Grantor Retained Income Trust (GRIT).** A person may transfer his/her home to the trust retaining the right to live in it for a set period of time. When the period ends, the home transfers to children (or others). Gift taxes are paid during life upon the transfer, saving potential estate taxes had the residence been transferred through the estate at death.
20. **Other Trusts.** With the great popular interest in revocable living trusts as an opportunity to avoid probate, many individuals have transferred some or all of their real estate to such trusts. Other types of trusts may also hold real estate (e.g., testamentary trusts which become activated upon death, irrevocable trusts, etc.). The trustee holds title to any real estate owned in the name of the trust. The income and remainder beneficiaries hold equitable (potentially legally enforceable) interests in the trust. If a donor is trustee of his/her revocable living trust and wishes to donate real estate held by the trust, then the trustee/donor should likely retitle

the real estate into his/her personal name before making the gift. In the alternative, the trust document must allow the trustee to transfer/donate trust property (i.e., real estate) to another person or entity such as your charity.

21. **Share-Cropped agricultural property.** Owner and tenant(s) proportionately share income, expenses, profits, etc.

III. Charitable Giving Strategies with Real Estate

A. Outright Gifts and General Considerations.

1. Outright gifts.

- a. Income and gift tax charitable deduction equal to full fair market value (FMV), if held for more than 12 months and subject to a reduction for potential depreciation recapture. No gift tax. IRC Sec. 2522(a).
- b. The 1997 Taxpayers Relief Act (TRA) also enacted a 25% capital gains rate for certain depreciated real estate. Gifts of this depreciated real estate may be attractive. **Note:** The income tax deduction for a gift of appreciated real estate is reduced for the ordinary income portion but not the long-term capital gain portion. IRC Sec. 1245 provides that only the excess of accelerated depreciation deductions over straight-line deductions is treated as ordinary income. Straight-line depreciation is a uniform depreciation amount over the useful life of the asset. There are several methods for accelerating or taking more than a uniform method in the early years of the depreciated period. If real property has been depreciated using an accelerated method, then the excess of the accelerated over the straight-line depreciation will be recoverable as ordinary income.
- c. No capital gains tax on appreciation. **Note:** Pursuant to the 1997 Taxpayers Relief Act, a taxpayer is able to exclude from federal income tax up to \$250,000 of the gain from the sale of a principal residence. Married couples filing jointly get to exclude \$500,000. The exclusion is allowed each time someone who meets the eligibility requirements sells a primary residence, but not more than every two years. To be eligible, one would have to have owned and occupied the home as a primary residence for at least two of the five years before the sale. Beginning in 2010, a decedent's estate, heir, or qualified revocable trust will be permitted to exclude the gain on the sale of the decedent's principal residence up to \$250,000, provided the decedent had owned and occupied the property as a principal residence for at least two of the five years preceding the sale. [IRC Sec. 645]
- d. Gift reduces taxable estate for estate tax purposes IRC Sec. 642(c).
- e. Due to gift of appreciated property, the income tax deduction is limited to 30% of adjusted gross income (AGI), with the five-year carryover for excess deduction. If a donor is not able to use the full deduction, consider these alternatives:
 - (1) Donate partial interests (e.g., 25% partial interests for four years).
 - (2) Elect a 50% AGI deduction limit by reducing the size of the gift by the amount of appreciation. The 50% limit allows a faster write-off that may permit more gifts!**Note:** Gifts of appreciated real property to private non-operating foundations are deductible up to only 20% of AGI. The amount of the deduction is reduced to the lesser of donor's basis or the property's FMV, whichever is less.
- f. Gifts by C corporations are deductible for FMV up to 10% of taxable income. Deductions for gifts by S corporations, partnerships and LLC's accrue to shareholders.
- g. **Ordinary Income Property.** If real estate is held by a donor less than 12 months prior to gift, or if it is subject to depreciation recapture (e.g., due to use of accelerated depreciation), then the deduction amount is reduced to the donor's cost basis - or by the amount of the recapture.
 - (1) **Note:** A donor's principal residence is specifically excluded from the

- recapture rules.
- (2) Inventory Property. All inventory property held in the course of a donor's trade or business is also ordinary income property. For example, land lots or homes owned by a real estate developer. Thus a deduction for a gift of such inventory real estate by the donor is limited to his/her tax or cost basis.
- h. **Right of First Refusal.** Review legal documents/abstract prior to donation to see if a third party has a right of first refusal that could prevent the gift. See *Mericle v. Wolf*, 562 A. 2d 364 (1989). **Repurchase Option.** If donor gives property subject to a repurchase option, there is no gift until option expires. TAM 9828001.
- i. **Pre-Arranged Sale.** While buyers waiting in the wings may be helpful, charities and donors must be careful to avoid the step-transaction doctrine, which would collapse the gift (and subsequent sale) to the donor. Avoid a sham, quid pro quo, binding legal contract (oral or written), etc. which suggests a pre-arranged sale. See *Palmer v. Comm.*, 62 T.C. 684 (1974). *Blake v. Comm.*, 42 T. C. M. 1336 (1981), 697F2d473 (1982); Rev. Rul. 78-197.
- j. **Bequest gifts.** Real estate donated by bequest should be inspected prior to acceptance. Another reason to review bequest language.
- k. **UBIT.** Beware unrelated business (taxable) income from donated property that generates commercial income from unrelated (nonexempt) activities. Specific exclusions from UBI exist for most investment income (e.g., interest, dividends, rent from real estate, capital gains, royalties, etc.). See IRC Sec. 511-513; IRS Form 990-T.
- l. **Like-Kind Exchange.** Pursuant to IRC Sec. 1031, a person may trade his/her property for property of a similar kind and defer any recognition of capital gain. Like-Kind property is liberally defined (e.g., city land for a farm, unimproved or improved). The transaction must be completed with 180 days of the disposition of the old property. Planned giving opportunities are tow-fold.
- (1) If the new property to be invested in is less in value than the old, then gain is recognized for the excess. Solution: Gift an undivided interest to a CRT.
- (2) Incremental 1031 exchanges combined with a CRT or gift annuity may transfer property at no gain if donor does not wish to do all at once.
2. **Establishing Value. Caution:** Donors may have predetermined opinions (sometimes emotional) about the value of their real estate. Lay your groundwork with donors by carefully explaining the rules and procedures of valuation early in the donation process (but not too early to scare a donor away!). You should do this to avoid any disappointment that may hinder the gift, as well as to help the donor understand the protocol.
- a. **Beware of Prior Agreements.** The charity must have complete freedom to select the buyer and negotiate price of donated real estate. While a donor may suggest interested buyers, the donor and/or charity should not enter into any binding contract of sale prior to donation. In such a case, the IRS may attribute to the donor the gain on the sale (i.e., capital gains tax liability). Thus, be careful of written letters, memos, contracts, etc. - or even oral statements - which may be construed as pre-gift binding agreements. Once again, be certain to so advise donors of this important protocol very early in the donation process. Donors may believe they are doing your charity a favor by locating a buyer. Keep your communication lines with the donor open at all times!
- b. **Qualified Appraisals.** All donations of real estate of \$5,000 or more require a qualified appraisal. Reg. Sec. 1.170A-13(c). If the recipient charity disposes of the real estate within two years of receipt, it must notify the IRS of the sale price using IRS Form 8282. The donor must complete and file IRS form 8283 (the appraisal summary) with the income tax return on which the charitable deduction is made. Individuals, S Corporations, closely held corporations and partnerships must comply. C corporations must file a partial appraisal summary.
- (1) **Appraisal Fees.** Appraisal fees are income tax deductible by the donor as

an expense to calculate tax liability (not as part of the charitable gift), subject to the limitations on miscellaneous itemized deductions.

- (2) **Time Requirement.** The appraisal must be made not earlier than 60 days before the date of contribution, and before the filing of the tax section on which the deduction is first claimed.
- (3) **Procedures for Appraisers.** In determining value, appraisers primarily use three standards:
 - (a) reproduction or replacement cost,
 - (b) capitalization of income from the property, and/or
 - (c) sale of comparable property. Other factors may be considered: zoning, surrounding neighborhood/area, condition of structures, etc. See IRS Publication 561, *Determining the Value of Donated Property*.
- (4) **Qualified Appraiser.** To be a qualified appraiser, an individual must so hold him/herself out to the public, or perform appraisals on a regular basis, and have qualifications to make appraisals on the type of property being donated. Consult applicable state law governing appraisers in the State where the property is located. To locate a qualified appraiser in other states or cities, consider using national real estate firms (e.g., Prudential, etc.) that have a resident office near your charity as a source of contact and reliability. Another avenue is to contact professional appraisal associations (e.g., American Institute of Real Estate Appraisers or the Society of Real Estate Appraisers). A qualified appraiser may *not* be the donor, a party to the gift transaction (e.g., the charity's employees) and/or a person not sufficiently independent of the donor or donee who would not provide a fair value. See Reg. Sec. 1.170A-13(c)(5).

Directories/associations of qualified appraisers:

- American Society of Appraisers (real and personal property).
- National Association of Independent Fee Appraisers.
- Real Estate section of the National Association of Realtors.
- Appraisal Institute (merger of American Institute of Real Estate Appraisers and the Society of Real Estate Appraisers). Phone: (312) 335-4100.

These associations may maintain their own appraiser classifications. For example, classifications by the Appraisal Institute include MAI for commercial, residential, industrial property as well as real estate investment and SRA for residential. Per Title IX of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, the **Appraisal Subcommittee** was formed to monitor state certification requirements for appraisers, review appraisal regulations set by federal regulatory agencies, and review the procedures and of The Appraisal Foundation. The Appraisal Subcommittee maintains a national registry of state certified and licensed appraisers. The **Appraisal Foundation** (Phone: (202) 347-7722), has two independent boards, the Appraisal Standards Board (ASB) and the Appraiser Qualifications Board (AQB). The ASB promulgates the generally accepted standards of the appraisal profession, the Uniform Standards of Professional Appraisal Practice (USPAP). The AQB establishes minimum experience, education, and examination criteria for state licensing of appraisers and recommends such criteria for state licensing of appraisers.

- (5) **Appraisal's Contents.** The regulations specify what must be in the appraisal:
 - Description of property.
 - Date of contribution.
 - Terms of any agreement relating to use (e.g., disclosure of planned

gift arrangement).

- Name, address, etc. of appraiser.
- Appraiser's qualifications.
- The specific standard(s) of valuation used. See (3) above. See Reg. Sec. 1.170A-13(c)(3).

(6) **Appraisal Summary.** A summary of the appraisal is incorporated into Section B of the 8283 form. This summary must be completed and signed by the donor, donee and appraiser. Of course, the 8283 forms is attached and submitted with the tax return that claims the charitable deduction. Failure to submit the completed 8283 form and the appraisal will result in denial of the deduction.

c. **Encumbrances.** If real estate subject to a mortgage, debt or encumbrance is donated, the gift is a bargain sale. The encumbrance is considered an amount realized on the sale with the donor taxed on the gain allocated to the sale portion. The donor's tax or cost basis is allocated between the sale and the gift, increasing the taxable portion.

(1) The charitable contribution is reduced by the amount of outstanding debt, regardless whether the charity assumes the debt, and even if the donor agrees to pay off the debt after the gift. However, if a donor continues to pay off the debt following the gift, these payments may be deductible gifts for the use of the charity.

(2) **Debt - Financed Income.** Unless the charity puts the encumbered real estate to a related use, it will likely have debt-financed income. IRC Sec. 514. The charity will have to pay UBIT on net income and capital gains tax if sold. This becomes an important consideration in deciding whether to accept encumbered property.

Exceptions: The debt-financing rules do not apply for the first 10 years after receipt if received by bequest/devise. However, the charity cannot agree to pay off the debt. Also, if the property is received while the donor is alive, the debt-financing rules do not apply for 10 years, but the donor must have owned the real estate for more than 5 years and the debt

must have been placed more than 5 years prior to the gift.

B. Gifts of Partial Interest.

The Partial Interest Rule is one of the most important in planned giving in general - and especially so with real estate gifts. Close attention must be paid in order to avoid violation. In general, the Partial Interest Rule prohibits a charitable deduction (income, gift and estate tax) for a gift of a contribution of less than the donor's entire interest in the property (i.e., a split interest gift). The exceptions are tightly construed.

1. **Violations.** Examples of gifts that violate the Partial Interest Rule:

- a. A gift of the right to only use property while the legal ownership is not transferred to the charity (e.g., no-rent charged, use for specified time period, etc.).
- b. Rent-free loan. If the use by charity is *not* legally enforceable, no gift tax is owed. See Revenue Ruling 70-477.
- c. If a donor retains *substantial* rights to the property (e.g., minerals, oil, timber), then the partial interest rule is violated. See Revenue Ruling 76-331.

2. **Exceptions.** A charitable deduction is allowed if a donor contributes a partial interest that represents his/her entire interest in the property. See Reg. Sec. 1.170A-7(a)(2)(I). The specific exceptions to the Partial Interest Rule include:

- a. A qualified charitable remainder unitrust, annuity trust or pooled income fund. See IRC Sec. 664 and 642(c) further discussed below.
- b. A gift of all or a portion of the income interest from a qualified charitable remainder

trust. See Rev. Rul. 86-60. *Note:* A donor cannot *deliberately* separate his interests in property and then claim a deduction for a gift of one of the interests. Reg. Sec. 1.170 A-7(a)(2)(I).

- c. A qualified charitable lead trust. See IRC Sec. 170(f)(2)(B).
- d. A remainder interest in a personal residence or farm. See below.
- e. An undivided portion (not in trust) of the donor's entire interest in the property. See below.
- f. A limited partial interest in real property for conservation purposes. See below.
- g. *Note:* A donor can segregate his/her property into different interests and claim a charitable deduction for donating all the separate interests to charities. Reg. Sec. 1.170A-7(a)(2)(ii).

C. Remainder Interest in a Personal Residence or Farm.

1. This is a gift to and not for the use of a charity, allowing a 30% deduction limit. Reg. Sec. 1.170 A-8(a)(2). Same for remainder interest in CRT. Exception: If the property is held in trust for the charity's benefit after termination of the prior estate, then entire gift is for use of charity subject to 20% limitation. The charitable deduction is allowed when a donor gives (by warranty deed) the remainder interest to charity but retains a life estate for himself/herself. See Reg. Sec. 1.170A-7(b)(3) and (4); Sec. 170(f)(2). See discussion below about policies.
 - a. Personal residence includes the principal residence, a vacation home, condominium, and stock in a cooperative apartment (See Reg. Sec. 20-2055-2(e)(2)(ii)). The cooperative must be used by the donor as his/her personal residence.
 - b. Household furnishings are not included. See Rev. Rul. 76-165. Fixtures are included.
 - c. A farm consists of land used to produce crops, agricultural products or livestock sustenance. It includes barns, farmhouse, and improvements.
 - d. The remainder should be in the residence or farm, not the proceeds from the sale thereof.
2. The remainder value is determined using the value of the land and improvements, but must be reduced by the value of the life use of the property by the donor (and spouse).
 - a. The remainder value must also be discounted to reflect straight-line depreciation (or depletion) of the improvements during the life use. Salvage value of the property is also factored. Reg. Sec. 1.170A-12(b).
 - b. *Note:* The income tax deduction is increased to the extent more value is attributed to the non-depreciable portion of the property (i.e., land).
3. **Effect of Debt.** Little authority on point. In PLR 9329017, the arrangement was considered a bargain sale. The donor was entitled to a deduction for the present value of the remainder interest in the difference between the FMV and the debt amount. Future principal payments would provide additional deductions measured by the value of the remainder interest in each principal payment.
4. If the donor decides to move (e.g., to a nursing home), the donor may give the remaining life estate and receive an additional deduction.
 - a. This alternative must *not* be preplanned. Thus, be careful with pre-gift documentation. Also, avoid a gift of the life estate soon after the arrangement is set up, avoiding the appearance of pre-planning. Of course, health issues may cause a sudden move.
 - b. The donor may lease the property to a third party (to the extent of the life estate) to receive income.
 - c. The donor may sell the life estate to a third party, or a joint sale with charity and split the proceeds.
 - d. **Lifetime Income.** The life estate interest may be contributed to a CRUT, or

exchanged for the life income in a CRUT or a gift annuity. See discussion in *Life Estate Reserved*, Crescendo Software by Comdel, Inc., Charles Schultz (1998).

5. **Additional Income.** The remainder interest may be donated in exchange for a gift annuity income. The rates of return would be negotiated. The donor's and charity's legal counsel, accountant, business office, etc., should carefully review such an arrangement prior to acceptance. Many factors would need to be considered (e.g., age of donor/life estate holder, long-run value of property, etc.). The income to fund such an annuity may come from the charity's operating budget, endowment or a reverse mortgage with a bank (i.e., a current loan based on the value of the remainder interest). Another option for lifetime income (e.g., in states where a gift annuity for real estate is prohibited) is for the donor to hold a mortgage with the charity paying interest and the principal being forgiven at the end of the mortgage period.
6. The charitable remainder must be of the entire property, not just part. Rev. Rul. 76-544. Also, donors are typically required to give their entire remainder interest, but a deduction for an undivided fraction of the remainder is allowed. See Rev. Rul. 87-37.
7. See discussion below regarding policies concerning an agreement with donor with regard to life estate responsibilities.
8. A current gift of a remainder interest in household furnishings, crops, farm equipment, etc. (tangible personal property) is a nondeductible future interest on current income taxes. See PLR 8316037. Estate tax deduction is available. No current gift tax charitable deduction.

D. Gift of an Undivided Portion (not in trust).

1. An undivided interest consists of a fraction or percentage of every substantial right that the donor has in property. See Rev. Rul. 89-90. Usually results in a discount of the FMV of the property.
 - a. A gift of an undivided interest is deductible for income, gift and estate tax. See IRC Sec's. 170(f)(3)(B)(ii), 252(c)(2), 2055(e)(2).
 - b. The gift must be for the entire term the donor owns, or is entitled to use the property (e.g., life or term of years).
 - c. The gift carries all proportional rights of use and possession of the property
 - d. Gifts of undivided interests are helpful in cases where if the donor gave all the property at once, the deduction would far exceed his/her limitations.
2. *Example:* Donor owns 20 acres of land and donates an undivided 30% remainder interest to charity. See Rev. Rul. 87-37.

E. Land for Conservation Use.

1. A gift of a lease, an option to purchase, or an easement as to real estate granted in perpetuity qualifies for the charitable deduction so long as the gift is made exclusively for conservation purposes. See Reg. Sec. 1.170A-14; IRC Sec. 170(f)(3)(B)(ii)., Excellent resource: *Doing Deals: A Guide to Buying Land for Conservation*, by Land Trust Alliance and Trust for Public Land (1995).
 - a. A deduction is permitted for an outright gift of a remainder interest in real estate granted for conservation purposes. See IRC Sec. 170(f)(3)(B)(iii).
 - b. A deduction is permitted for a gift of a donor's entire interest in real estate other than the right to subsurface minerals. See IRC Sec. 170(h).
 - c. Computing the charitable deduction.
 - (1) The value of the easement is its FMV on the date of gift. If there is no available meaningful record of marketplace sales, then the value of the easement and deduction equals the difference between the pre-gift FMV and post-gift FMV of the entire property (even if easement is only on a portion thereof). See Rev. Rul. 73-339 and Rev. Rul. 76-376.
 - (2) A qualified appraisal is necessary to substantiate a deduction value in

- excess of \$5,000.
- (3) The appraiser may consider such factors as:
 - The property's current use.
 - Likelihood and potential value of property development without the restriction.
 - Effect of other restrictions.
 - (4) No deduction is allowed if the grant may have *no* material effect on the property's value or may enhance, rather than reduce, the property's value. See Reg. Sec. 1.170A-14(h)(3)(ii).
 - (5) The basis amount that is allocable to the qualified conservation interest bears the same ratio to the property's total basis as the FMV of the qualified interest bears to the FMV of the property before the gift. Reg. Sec. 1.170A-14(h)(3)(iii).
2. Important Qualifications.
- a. Definition. A qualified conservation contribution is the contribution of a *qualified* real property interest to a *qualified* organization exclusively for conservation purposes, protected in perpetuity. See Reg. Sec. 170A-14(a). Also, consult applicable state law (e.g., Uniform Conservation Easement Act).
 - b. A qualified real property interest consists of one of three interests:
 - (1) An entire interest in real property. Even if the donor retains a qualified mineral interest (i.e., right of access to subsurface oil, gas, minerals). Minor interests (right-of-ways, etc.) may be transferred before the gift so long as they do not interfere with the conservation purpose. See Reg. Sec. 1.170A-14(b)(1).
 - (2) A remainder interest in real property.
 - (3) A perpetual (in perpetuity) conservation restriction. This includes an easement or other similar state law provisions (e.g., restrictive covenant).
 - c. A qualified organization includes governments and publicly supported charities. The donor's deed must prohibit the charity from transferring the easement unless the conservation purpose is continued. See Reg. Sec. 1.170A-14(c)(1).
 - d. Conservation purposes mean: (1) preserving land areas for outdoor recreation by the general public, or for its education; (2) protecting a relatively natural habitat of fish, wildlife, plants, or similar ecosystem; (3) preserving open space (including farmland and forestland); or (4) preserving a historically important land area or certified historic structure. The regulations contain specific requirements to be met for each category of purpose. Reg. Sec. 1.170A-14(d)(1).
3. If mortgaged property is donated, the mortgagee must subordinate its rights to the charity's right to enforce the conservation uses in perpetuity. Reg. Sec. 1.170A-14(g)(2).
 4. If the property unexpectedly becomes impossible to fulfill the conservation use, the charity may extinguish the restrictions by court order. The charity must use the proceeds from a sale of the land for consistent conservation purposes. Reg. Sec. 1.170A-14(g)(6)(i).
 5. Idea: Consider asking the donor to make a separate gift to establish an endowment fund at the charity to provide annual income to assist maintenance costs on donated conservation property.
 6. TRA '97 added IRC Sec. 2031(c) to allow a tax break in addition to the charitable deduction taken during life (per Sec. 170(h)) or at death (per Sec. 2055(f)) for gifts of land with a conservation easement. The exclusion is subject to a cap that will rise from \$100,000 for the estates of decedents dying during 1998 to \$500,000 for the estates of decedents dying after 2001.
 - a. The conservation easement charitable deduction is allowed for the reduction in the FMV of the property caused by the conservation easement. Therefore, the burdened property comes into the estate tax calculation already reduced in taxable value by that amount. IRC Sec. 2031(c) allows the executor to elect to exclude from estate tax up to 40% of the value of the land subject to the easement. Without this provision, the estate tax cost may

cause the forced sale of the property, to the possible detriment of the conservation purpose as well as the heirs. The up-to-40% exclusion is, in reality, equal to the lesser of (1) a dollar amount specified in IRC Sec. 2031(c)(3), or (2) a sliding percentage that starts at 40% and varies downward depending on the value of the easement.

- b. The IRC Sec. 2031(c) reduction does not apply to the value of any retained development right (unless every person in being having an interest in the land agrees to extinguish the right before the estate tax return is filed). New Sec. 2031(c)(9) allows the easement decision to be made after death by the receiving heirs or trustee.
- c. Qualified conservation easement. Not every type of conservation easement that would qualify under IRC Sec. 170(h) will qualify under IRC Sec. 2031(c):
 - The former geographic restrictions are now eliminated, effective for estates of decedents dying on and after January 1, 2001
 - The land must have been owned by the decedent or a member of the decedent's family for the three years preceding death. If it is held by a trust, partnership, or corporation, at least 30% of the entity must be held by the decedent.
 - The easement purposes that qualify include preservation for education, noncommercial outdoor recreation, protection of natural habitat or ecosystem, and preservation of open space (either for scenic enjoyment of the general public or pursuant to established governmental policy). Unlike IRC Sec. 170(h), the purposes do *not* include historic preservation.
 - The easement must have been placed on the property by the decedent, either during his or her life or by will, or by a member of the decedent's family or a trustee holding the land, after death, by the time the estate tax election is filed on the return.

F. Charitable Remainder Trusts.

- 1. Real estate may be donated to a charitable remainder unitrust (CRUT) or annuity trust (CRAT). Income paid is taxed per a four-tier system. No charitable deduction is allowed if the charitable remainder interest is less than 10% of the initial trust value. The payout rate may range from 5% to 50%.
 - a. The primary concern is whether the real estate will produce income to sustain the income interest. Further, the real estate may not be readily marketable to produce proceeds to be reinvested to create an income flow. A CRT receiving UBI in any tax year will not be tax exempt for that year. UBI is income from an unrelated trade or business and does not include most investment income (e.g., rental income) or capital gain unless income is debt-financed. Reg. Sec. 1.664-1(c). IRC Sec. 512.
 - b. An income-only with a make-up feature will allow for the income to wait until the property is sold. This type of CRUT also allows additions to cover any real estate carrying costs.
 - c. CRAT or CRUT payments may be made with an undivided interest (in kind distribution) until property is sold. These distributions are treated as if the trust sold the undivided interest and distributed the proceeds. Part of the distribution is taxed as a capital gain and the recipient will take a cost basis in the undivided interest equal to its then FMV. Alternatively, donors may make additional gifts to the CRUT (not CRAT) to cover the income payments until the sale. A CRAT is usually not the best arrangement for real estate for several reasons:
 - (1) The property must be sold to fund the income obligation. The proceeds may not equal the FMV on gift date, creating a scenario that may deplete the charitable residual.
 - (2) Additions cannot be made to the CRAT to cover sale costs.
 - (3) Note: A testamentary CRAT may allow some delay in funding to allow time to sell the property during estate administration.

- (4) A CRAT may be considered for a gift of tax/exempt bonds issued by charity to fund construction, etc.
- d. A depreciation reserve is required for an income-only CRUT funded with real estate. PLR 8931019.
- e. Since S corporation stock may not be given to a CRT without loss of the S corporation qualification, an S corporation may donate some of its real estate instead, or the donor may consider a gift annuity. See *Charitable Gifts of Subchapter S Stock: How to Solve the Practical and Legal Problems* by Christopher Hoyt, *The Journal of Gift Planning*, Vol. 2. No. 1 (1998).
2. **Flip Trusts.**
- a. Definition. The flip trust initially is a net income CRUT to which unmarketable real estate (or other assets) is donated. Upon sale of the property, the trust flips to a regular fixed percentage CRUT.
- b. Final Regulation 1.664-3(a)(1)(I) would allow a flip unitrust funded with unmarketable assets if all the following requirements are met:
- The flip event must be stated in the governing trust instrument. The flip event must be triggered on a specific date or by a single event whose occurrence is not discretionary with or within the control of any person.
 - The flip to the standard unitrust must occur at the beginning of the following year after the triggering event.
 - The Final Regulations provide ten examples of permissible and impermissible triggering events. The sale of an unmarketable asset (as defined for purposes of appraising unmarketable assets) such as the donor's former personal residence is permissible. Other permissible triggering events include when the income beneficiary reaches a certain age, when the donor gets married, when the donor divorces, when the income beneficiary's first child is born, and when the income beneficiary's father dies. The impermissible events relate to the occurrences that are within the discretion of the trustee. A request by the income beneficiary or by the income beneficiary's financial advisor will likewise not be permissible events.
 - Following the sale of the unmarketable assets, the CRUT operates exclusively using the fixed percentage method (i.e., a straight unitrust).
 - The fixed percentage method does not contain a make-up provision and any make-ups before the conversion are forfeited.
- c. These provisions apply to trusts created on or after December 10, 1998. However, a noncompliant flip trust or a net income unitrust could convert to a flip unitrust so long as the reformation proceeding was initiated by June 8, 1999. The triggering event under the reformed governing instrument could not occur in the year prior to the year in which the court issued the order reforming the trust.
- d. A make-up provision for a Flip Trust would be limited to the initial period prior to its flip.
3. Real property with debt. Funding a CRT with encumbered property is not advisable. Alternatives may be considered, such as shifting the debt from the real estate to be donated to other non-gift assets. Five significant issues.
- a. Loss of tax exemption. A CRT that receives debt-financed income (UBI) loses its tax-exempt status and becomes fully taxable on all income received during years of debt-financed income. Reg. Sec. 1-664-1(c). See above regarding exceptions to debt-financing rules.
- b. Self-dealing. An act of self-dealing may be deemed to have been made with an excise tax under IRC Sec. 4941 imposed. No self-dealing will occur if the debt was placed on the property more than 10 years before the gift, or only the initial funding of the trust was accomplished with mortgaged property. Reg. Sec. 53-4942(d)-1(a).
- c. Bargain Sale. The transfer will be treated as part sale and part gift with the donor taxed on the gain realized by the transfer of the debt. A partial deduction for the remainder interest

portion of each mortgage payment is possible if the donor agrees to make direct mortgage payments (principal and interest) to the debt holder.

- d. Grantor Trust. A CRT may lose qualification if it is deemed to be used to make payments on the grantor's debts. Thus, the grantor is treated as owner of the trust assets. See Reg. Sec. 1.667(a)-1(d). See PLRs 9015049 and 8931023.
- e. Prohibit Payment. Authorized payments by a trustee of a CRT are limited to payments for annuity or unitrust amounts and charitable distributions. Payments on debts may be prohibited and not considered a form of investment. Reg. Sec. 1.664-2(a)(4).

Ideas: A portion of the property may be sold to pay off debt. Also, mortgage may be converted to a personal debt.

4. An undivided interest may be donated to a CRT. In one case, the donor donated one undivided interest to a CRT and the balance was a bargain sale with charity. See PLR 8042142. *Caution:* Potential self-dealing for a gift of an undivided interest to a CRT if family members share undivided interests. See PLR 9114025.
5. Self-dealing. Real estate donated to a CRT may not be sold, rented or exchanged to a disqualified person, i.e., the donor or member of his/her family (i.e., spouse, ancestor, lineal descendant or spouse of lineal descendant). IRC Sec. 4941.
6. *Valuation.* On December 10, 1998, Treasury issued final regulations that provide that the trust's unmarketable assets must be valued by an independent trustee, or by a qualified appraisal from a qualified appraiser. The final regulations define unmarketable assets as assets other than cash, cash equivalents, or assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stock, and unregistered securities for which there is no available exemption permitting public sale. 63 Fed. Reg. 68188 (December 10, 1998).

G. Pooled Income Funds.

1. Similar to CRAT's, the key issue is whether the property will produce any or sufficient income. Also, if the property is sold for less than the FMV when first put in the pooled fund, a number of problems ensue:
 - a. The pooled fund's unit value is distorted.
 - b. The income flow to the fund's other beneficiaries is also distorted.
2. A depreciation reserve is required if real estate is donated to a pooled income fund. Rev. Rul. 90-103 and 92-81.
3. *Idea:* A new pooled fund could be established and marketed for the purpose of attracting gifts to help build an income-producing building such as a college dormitory. An agreement would specify the payment of income (rent) produced by the building to the pooled fund. *Caution:* The income production from the land/building should be secure and steady over the long-term to avoid problems in meeting any established donor expectations.

H. Charitable Gift Annuity.

1. The donor may transfer all his/her interest in real estate to the charity that in turn contracts to make income payments to him/her for life. Technically, this is not a split-interest gift. Beneficiaries limited to one or two persons. The payments are treated just like commercial annuities: a portion is deemed tax-free return of principal. To determine this portion, one must apply the exclusion ratio that is the investment in the contract divided by the expected return. The investment in the contract is the present value of the gift annuity on the starting date (i.e., cost of a comparable commercial annuity). The expected return is the amount that the annuitant is expected to receive. The excess of each payment over this tax-free amount (other than capital gain as explained below) is taxed as ordinary income. Reg. Sec. 1.170A-1(d)(2).
2. The rate of return negotiated between the donor and charity may be discounted to reflect carrying costs, taxes, etc. which the charity must bear until the property is sold. *Important:*

Carefully consider the marketability of the land and whether charity can carry the income payment in the event the real estate is not sold.

3. A deferred payment gift annuity may allow for time to sell the property. Pursuant to PLR 9743054, the IRS approved a gift annuity with a beginning date deferred to some future date to be selected by the annuitant. Idea: Consider an annual payment gift annuity to allow time to sell the property.
4. **Important:** Check state *registration requirements* and *regulation* of gift annuities. For example, New York prohibits the transfer of real estate for a gift annuity. If a charity offers gift annuities in New York, NY state law prohibits any real estate in any state in the gift annuity pool. Resources for state law summaries: www.ncpg.org or Jim Potter @ www.pgresources.com.
5. The donor's cost basis is allocated proportionally between the gift and sale elements (i.e., a bargain sale). The sale portion is the present value of the income interest. The gain allocated to this sale portion is spread proportionally over the beneficiary's life expectancy (as long as annuity is non-assignable to other individuals). Reg. Sec. 1.011-2(a)(4)(ii). Several authorities suggest taxation of this income at the 20% rate until further clarification by IRS.
6. If appreciated real estate is donated for a gift annuity, the gain is spread proportionally over the donor's life expectancy.
7. The income tax deduction is generally equal to the difference between the FMV of the land and the present value of the annuity payments. Reg. Sec. 1.170A-1(d)(2).
8. Caution: Potential gift tax implications for joint and/or survivor annuities involving persons who are not married.
9. Resource: Charitable Gift Annuity for Real Estate by James E. Connell, Phone (717) 272-3243. Provides an evaluation model using a computer spreadsheet or Word Perfect table. Allows several assumptions to be compared, quantifying risks and costs. It converts the net cash received to the return needed to support the payments.

I. **Bargain Sale.**

1. When real estate is sold to charity below FMV, the difference is a tax-deductible gift. The donor's cost basis is allocated proportionally between the sale and gift portions. Reg. Sec. 170-4(c)(2)(ii).
 - a. Advantage: Current tax deduction to wash all or a portion of capital gains tax on sale portion.
 - b. Advantage: Cash to reinvest.
2. Caution: The donor must intend to make a gift to charity.
 - a. The intention should be well documented (e.g., by separate letter, in the offer of sale, in the deed of transfer, etc.).
 - b. FMV should be independently substantiated. See above.
3. Gift Property Subject to Debt. When real estate subject to debt is donated, it is treated as a bargain sale for the amount of the debt, regardless if charity agrees to pay the debt. Reg. Sec. 1.101102(a)(3).
 - a. The gift equals the difference between the FMV of the property and the debt amount.
 - b. If donor pays on the debt, he/she receives income tax charitable deductions as made.
4. Capital Gains Tax. In a bargain sale, the cost basis must be allocated between the gift and sale portions.
 - a. The basis allocated to the sale is the total basis multiplied by the ratio of the bargain sale price to the FMV.
 - b. The basis allocated to the sale is then subtracted from the bargain sale price to determine the gain realized upon which capital gains tax is owed.
5. **Installment Bargain Sale.**
 - a. Sales price is paid by the charity in installments for a set period of years as negotiated between donor and charity.
 - b. Advantages:

- (1) Capital gains tax owed is spread over payment period.
 - (2) Charitable deduction in year of bargain sale for the gift portion.
 - (3) Charity receives property up front.
 - (4) Gift annuity only available for one or two lives.
- c. Procedure of the installment bargain sale.
- (1) The gain reported for any tax year is the installment payment for the year times a fraction equal to (1) the total gain to be reported under the contract over (2) the total contract price.
 - (2) The property's basis is allocated between the gift and the sale.
 - (3) A portion of each principal payment will be treated as nontaxable return of principal (basis allocated to sale divided by principal).
 - (4) The interest rate called for by the note must be no less than the imputed interest rate of IRC Sec. 483. While a high rate will avoid problems with IRC Sec. 483, too high a rate will increase the value of the note beyond its face amount. Thus, setting the interest rate correctly is important.
Suggestion: consider current mortgage rates with the monthly AFR discount rates as a minimum.
- d. **Limitation on use of installment method.** The installment method is generally unavailable for stock in trade, inventory, property held primarily for sale to customers in the ordinary course of business, or stock regularly traded on an established market. Special rules for real property sold by a nondealer impose an interest charge on the tax deferred unless the property is used in farming, is a time-share or residential lot on which interest on deferred tax is being paid under the installment method, or is personal use property (such as a personal residence). These rules generally apply only if the taxpayer has outstanding installment obligations in excess of \$5 million at the end of the year.
- e. **Unrelated business income.** The resale of bargain sale property may be subject to UBIT as unrelated debt-financed income under IRC Sec. 514. You should consult your legal counsel. If the charity chooses to lease or rent the property instead, it may also have unrelated business income. Normally, the investment income of exempt organizations is excluded from taxation but, if income derives from debt-financed property, it will be taxable. **Debt-financed property** is property held to produce income that is subject to acquisition indebtedness. **Acquisition indebtedness** is broadly defined as the outstanding principal debt incurred before, during, or after the acquisition of the property. If the debt would not have been incurred but for the acquisition, and the debt was reasonably foreseeable when the property was acquired, the property is debt-financed. Exceptions can take the property out of IRC Sec. 514. For example, property used by an exempt organization to further its exempt purposes is not treated as debt-financed property. In addition, there is also a ten-year grace period if neighborhood land is acquired with the intent to use it for an exempt purpose within the ten-year period. Debts incurred by certain qualified organizations for acquiring or improving real property may not be considered acquisition indebtedness. Therefore, income or gain from the property will not be taxable as unrelated debt-financed income. Qualified organizations include IRC Sec. 170(b)(1)(A)(ii) educational organizations and their affiliated support organizations, certain pension trusts, and IRC Sec. 501(c)(25) title-holding companies.
6. **Application of Bargain Sales/Installment Bargain Sales.**
A bargain sale (or installment bargain sale) may be useful when a gift annuity or charitable remainder trust are not possible or practical:
- a. If donor wishes to live in the home or sell it to a disqualified person (i.e., self-dealing violations for a CRT).
 - b. If a term of years income is desired (i.e., not allowed for gift annuity).
 - c. Installment bargain sale for real estate in New York (State where a gift annuity for land is impermissible). Note: Installment bargain sales also avoids other state

- regulations pertaining to gift annuities, e.g., rates, reserves, investments, timing of payments, insurance regulations, etc.
- d. A term of years income greater than 20 years (disallowed for a CRT).
 - e. Payments may vary from year to year (e.g., deferred payments, increase payments over time to account for inflation, large up-front payment to buy a new home, etc.). Subsequent beneficiaries may be named.
 - f. Charity may obtain desired real estate (e.g., contiguous property) at a discounted price.
 - g. A bargain sale could be offered for a portion of desired land, while the remaining portion is exchanged for a gift annuity or donated to a charitable remainder trust. The bargain sale may allow receipt of up-front cash while the CRT or gift annuity would provide additional income and tax savings.
7. Resource: *Bargain Sales and Retained Life Estate* by Bruce Bigelow, 1998 Conference on Gift Annuities.

J. Charitable Lead Trusts.

1. A donor may contribute real estate to the qualified no grantor CLT. Important: The real estate should produce income, which is paid to charity during the trust term. Gift tax is paid on the remainder interest for children/grandchildren.
2. Ideally, the real estate in the CLT appreciates in value, so that the gift tax paid on the initial funding is a significant savings on potential future transfer taxes.
3. Income tax deduction available for annual gifts of income. See IRC Secs. 170(f)(1)(B), 2055(e)(2)(B), 2522(c)(2)(B).
4. Since CLT is not tax exempt, a sale of the real estate may produce taxable gain to CLT.

K. Gifts of Natural Resources.

1. Examples: oil, gas, timber, timberland, timber rights, minerals, mineral rights, water, waterways, water rights and other objects of the earth subject to depletion.
2. State and federal laws apply varied rules as to their characterization as real property, tangible or intangible personal property, etc.
3. Consult an attorney specialist in the state where the potential gift is located.
4. Some Considerations:
 - a. Oil and gas may be held as follows: in fee, undivided interest, partnership, lease, royalty, etc. Tax results and gift planning would vary accordingly.
 - b. Water rights are likely subject to governmental control.
 - c. Mineral and mining interests include: claims to production, patents, surface/subsurface rights, leases.
 - d. Timber can include: cut timber (tangible personal property), rights to cut timber (contract), timberland (real property). Excellent resource: *Timber, Timberland and Charitable Planning*, 10th NCPG Proceedings, Nancy J. Brucker (1997).
 - e. Caution: Beware violating the Partial Interest Rule and an impermissible split interest gift when a donor does not give all of his/her interest in a natural resource/real estate.

IV. Preventing Civil War: Establishing Effective Policies and Procedures.

A. Creating the Real Estate Gifts Team.

1. The process of drafting, approving and implementing a thorough policies and procedures manual can be an effective mechanism for the institutional approval and ultimate success of your charity's real estate gifts program. Ideally, this manual will cover all aspects of development and planned giving, of which real estate gifts is an important part.

- a. Initial considerations include whether or not the charity will accept real estate.
 - b. Secondly, what gift arrangements are acceptable: outright, bargain sale, CRTs, gift annuities, etc.
 - c. Thirdly, whether real estate will be accepted from outside your city, county, state, region, etc.
2. An initial draft may be prepared by the planned giving officer with initial reviews for comment by other development officers.
 - a. Share a draft with the business office, alumni office (if appropriate), legal and accounting counsel. Be ready for much discussion, amendments, etc.!
 - b. Share a draft with a professional or real estate gifts volunteer advisory committee (attorneys, accountants, real estate professionals).
 - c. When a final draft is ready, present to the CEO and, if appropriate, Development or Planned Giving Committee of the Board of Trustees/Directors. Upon ratification, submit the manual for approval by the full Board upon recommendation of its sub-committee.

B. Important Policies and Procedures: Environmental Review.

1. Overview. The 1980 federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA, aka Superfund law) can make any owner (including charity) of real estate liable for hazardous waste clean-up and damages even if the charity, or the donor, did not cause the substance to be on the property. 42 U.S.C. Sec. 9601 et. seq. Many states have similar laws also imposing liability for cleaning up and remediating the site. Note: A charity may be able to obtain a current list of CERCLA sites from the state or federal EPA.
 - a. Liability is joint and several, i.e., the owner of a part of a superfund site (current or in the historical chain of title) may have to pay to clean up the *whole* site.
 - b. Liability is strict, i.e., there are few defenses.
2. Defenses to protect charity.
 - a. Act of God or war.
 - b. CERCLA does not impose liability on a charity which may own the property after the hazardous waste was deposited - but which no longer holds title to the land (gap owner). Does not apply if (1) the contaminants were released while the gap owner was in possession, regardless of gap owner's knowledge of the leak, or (2) the gap owner knew of the hazardous substance and did not disclose the fact at the time of sale. Note: State law may not protect a gap owner.
 - c. Two kinds of innocent landowners allow a defense pursuant to SARA (Superfund Amendments and Reauthorization Act of 1986). 42 U.S.C. Sec. 9601(35A).
 - (1) A landowner who acquires the contaminated property by inheritance or bequest so long as the owner takes due care to prevent further environmental damage after learning about it. The release was caused solely by a third party (not an employee or other contracted relationship).
 - (2) A person not knowing, or having reason to know, of the previous disposal. Requirements:
 - The release was caused solely by a third party (not an employee or other contracted relationship)
 - Upon acquisition, must take due care.
 - Before acquisition, must have conducted all appropriate inquiry into the previous ownership and uses of the property with good commercial or customary practice in an effort to minimize liability. Inquiry: What is appropriate inquiry? CERCLA does not specify. However, per CERCLA, a court must take into account:
 - Specialized knowledge or experience of the owner (e.g., prior gifts of real estate).
 - Commonly known or reasonably ascertainable information.
 - Obviousness of the problem, or likely presence of waste

- (e.g., known industrial site).
 - Ability to detect through appropriate inspection.
- d. Liability of an estate or trust is limited to estate or trust assets. The fiduciary (trustee, executor, etc.) of the estate or trust is not personally liable unless negligent. See CERCLA and RCRA (Resource Conservation and Recovery Act, 42 U.S.C. Sec. 9601 et. seq.).
- e. Several states have set up assistance funds to assist property owners who may have environmental issues (e.g., loans, grants, etc.).
- f. In 1995, the U. S. EPA approved its new Guidance on Agreements with Prospective Purchasers of Contaminated Property and Model Prospective Purchaser Agreement (PPA). 60 FR 34792. The goal is to broaden the range of Brownfields development (i.e., contaminated property) to enhance community development. Specific criteria are required in order to establish a PPA that may include a covenant not to sue.
3. Environmental Site Assessment.
- a. American Society of Testing Materials (ASTM) has attempted to establish national standards with ASTM E 1527-97 AStandard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process: (i.e., Phase I). A Phase I Review is now standard for nonresidential real estate transactions. ASTM has also established an initial Transaction Screen questionnaire which is a pre-Phase I assessment. Cost: approximately \$500.
- b. The environmental professional will prepare a written report based on the following:
- *Records review*, including permits and operating records of the facility, national and state environmental computer data bases, real property records (abstract, chain of title, etc.), agency files, aerial photographs and, as necessary, other records related to past and current uses of the property and surrounding properties.
 - *Site reconnaissance*, physically visiting and visually observing the property for potential environmental conditions such as indications of past spills or the presence of tanks, PCB-containing equipment, or asbestos-containing material.
 - *Interviews with current and, to the extent possible, prior owners and occupants* regarding potential environmental conditions and use of the property.
 - Interview with local government officials.
- c. If possible contamination is detected, a Phase II should be recommended. In a Phase II, actual samples of soil, water, etc. are tested. Phase III will involve more extensive testing, research, and suggestion of remediation.
- d. If a Phase I results in a clean bill of health, charity is likely an innocent landowner. Therefore, policies should require that acceptance of real estate gifts (at least for nonresidential property) be delayed and conditioned on the successful completion of a Phase I. Note: Failure to pass a Phase I may also hinder the future marketability of the land.
- e. Qualified Environmental Professionals may be found by contacting local government (e.g., state/federal EPA, city engineer), real estate professionals (appraisers, attorneys, etc.) or other charities. Be certain to confirm their credentials particularly in light of any applicable state law standards. Also, confirm their liability as well as errors and omissions insurance coverage in the event of a negligent or faulty report. Name charity as an additional insured. A Phase I assessment may cost from \$500 (residential) to thousands (industrial).
- f. A charity may ask the donor to provide a signed disclosure and *indemnification* statement in the event of liability, clean-up, etc. Consult legal counsel. Problems include alienating the donor - as well as the viability of a donor being able to account for all the liability in any event!
- g. The EPA and state agencies may provide written assurance to a charity that it will relieve the charity of liability for pre-existing contamination.
- h. Some charities utilize separate corporations to accept real estate gifts. Options

include a title-holding company (a tax exempt entity under IRC Sec. 501(c)(2)) or a corporation exempt under IRC Sec. 501(c)(3).

- (1) Courts may be willing to pierce this veil to hold the primary charity liable, especially if the other corporation is not truly separate (i.e., a separate management, etc.).
 - (2) A Sec. 501(c)(2) title holding company has many limitations as to the property accepted (e.g., for debt-financed property), and including the fact that the parent charity's liability is less insulated since the real estate must be titled to the parent charity for the donor to receive a deduction.
4. Some Charities establish *supporting organizations or LLCs* to accept real estate gifts to insulate potential liability, or if real estate is not an appropriate investment. IRC Sec. 509(a)(3).
 5. **Personal Residences.** While an environmental review may not be necessary, consider an inspection by an engineer, etc., to detect structural defects, asbestos, lead paint, etc.

C. Other Important Policies and Procedures.

1. **Valuation.** The charity may encourage the donor to assume the costs of the independent qualified appraisal. This allows the donor to have first-hand observation of valuation - particularly helpful if the value is lower than anticipated. However, the charity may wish to independently confirm value. The charity must have a staff member conduct a review of the site prior to receipt to observe condition.
2. **Receipts.** Donors of gifts of \$250 or more must receive a receipt to substantiate the deduction. See Reg. Sec. 1.170A-13. A receipt must include:
 - a. Description of the real estate. Note: Receipt need not state value of donated real estate.
 - b. Statement whether any goods or services were given in consideration by charity.
 - c. Description and good faith estimate of value of any goods/services given donor.
3. **Property Subject to Debt.** As a general policy, the charity may require donors to satisfy all debts, mortgages, encumbrances, etc., on property donated outright or in a deferred arrangement (CRT, etc.). This may avoid many complications, as discussed above.
4. **Payment of Transfer Costs:** As a general policy, donors should be encouraged to pay for some or all of the transfer costs. Any expenses paid by charity must be allocated to its interest, or else taxable income may be imputed to the donor. PLR 8204220. The expenses include: real estate taxes, insurance (earthquake, flood, etc.), management and broker's fees, title insurance, maintenance costs, environmental review, title search (abstract, payment of utilities, liens, landowner/homeowner association dues/fees, surveys, inspections (termites, contractor, etc.), re-zoning, necessary repairs (to sell or comply with codes), etc. **Caution:** Donors may naturally consider these the charity's costs, especially for major real estate gifts. Negotiate carefully. **Ideas:** Charity could reimburse donor for some transfer costs upon completion of gift.
5. **Marketability.** As a general policy, only real estate which is readily marketable should be accepted. See above discussion regarding problems with donor signing pre-gift sales agreements. However, an assessment can be made of marketability using professional advice. For example, a title review by an attorney may reveal potential problems such as liens (financial), encumbrances (non-financial), restrictive easements, covenants (e.g., for housing developments, condominiums, etc.), encroachments, etc. A local real estate broker/appraiser can assess the current real estate market in the area and the potential for a quick and reasonable sale and/or appreciation. Other professionals can assess the condition of the property for sale (perc test, contractor review of buildings, termites, etc.). **Note:** If land that is held by charity is not used for its exempt purpose, then real estate or ad valorem taxes will be assessed.
6. **Title Transfer.** Policies should require representation by local counsel where the property is located to assure compliance with state law regarding transfer of good and marketable title. The policies should require a warranty deed. A *warranty deed* conveys good clear title. A *quitclaim deed* conveys whatever the donor owns, but without warranty that the donor's title

is valid. A *tax deed* is issued by the government to a buyer following forfeiture for failure to pay taxes. A *Sheriff's deed* follows sale of property following forfeiture for failure to pay loans, judgements, etc. A *contract for deed* is an agreement whereby seller delivers a deed when conditions are met. A *trust deed* is an indenture by which property is transferred to trust.

7. *Remainder Interest Gift Agreement.* Policies should require that the donor maintain responsibility for taxes, insurance, utilities, maintenance and repairs, etc., during his/her life estate. Significant capital improvements may require joint approval. For a sample agreement form, see *Charitable Giving and Solicitation* by Sue Stern Stewart, et. al. at page 40,111. Similar agreements will be necessary if a charity is co-owner with a partial or undivided interest.
8. *Governmental Regulation.* Transfer of real estate should be conditioned by your policies upon successful review of applicable governmental regulatory concerns such as:
 - Housing codes.
 - Zoning (Is it zoned in a way that enhances appropriate marketability?).
 - Applicability of conservation acts.
9. *Charitable Remainder Trusts.* Idea: Charity may consider serving as trustee only after the real estate is sold, thus keeping it out of the chain of title and protecting against potential liability. An independent trustee or the donor as trustee may serve in this role until the property is sold. Charity may further be protected by funds escrowed by the donor or a hold harmless, release and/or indemnity clause or agreement.
10. *Gift Annuities.* All policies should require review and compliance with the state registration requirements and other regulations for gift annuities. See discussion above. Particular staff may be authorized to negotiate rates upon full disclosure of property values, costs, etc.
11. *Bargain Sale.* Consider a bargain sale ratio (e.g., 50%) threshold that will allow staff to negotiate gifts within accepted parameters.
12. *Public Relations.* Consider the "PR" issues associated with a real estate gift (e.g., substandard rental property, property subject to controversy due to its use, etc.).
13. *Legal Counsel.* Charity's legal counsel should always be informed/involved with real estate gifts. Legal counsel in other states may be needed. References: Martindale-Hubbel Attorney directories (@ public library), state, local bar associations, etc.

V. Cultivating Fertile Tara: Establishing Strategy for Marketing Real Estate Gifts.

- A. Resource - *Planned Giving in the United States: A Survey of Donors* (1993, NCPG). Survey sent to a randomly selected sample of 150,000 households.
 1. Real estate is the second most common type of non-cash gift (22.2%), preceded by collectibles/antiques/artwork (23.2%). Less common is closely held stock (17.5%), public stock and other investments (14.4%) and automobiles (5.2%). **Query:** Given the magnitude of real estate holdings, should it not be more commonly donated?
 2. Fewer non-cash donors (22.2%) are below age 45 than for bequest or life income donors. The most non-cash donors are ages 45 - 59 (29.9%), followed by ages 60 - 69 (25.3%) and ages 70+ (22.7%). Non-cash donors are more likely than the national average to have household incomes in the highest bracket (\$75,000 and over). **Target Market:** Donors at peak income ages who may use the deduction. Also, consider donors who are in retirement who wish to simplify their life by divesting multiple real estate holdings (e.g., "snowbirds").
 3. The majority of non-cash donors (59.4%) making non-cash gifts over \$5,000 credit themselves with the idea. **Red Flag:** Is your organization doing all it can to promote real estate gifts?
 4. The most common donor affiliation was that of "member" (30.9%). **Note:** Churches, museums and other "member" organizations should particularly encourage such gifts, especially if the non-cash gift may be of direct use by the charity (e.g., for a building campaign).
 5. Non-cash donors identify themselves as neighbors/community residents and directors/trustees twice as often as do bequest or life income donors. **Focus:** Consider marketing your real

estate gifts program close to home!

6. The amount of time the non-cash asset was held by the donor prior to the gift does not vary significantly by the type of gift asset, *except* for real estate. 77.8% of the gifts of raw land had been held for six years or more. **Conclusion:** Appreciate the value of appreciation. **Good news:** Donor is likely to be aware of any drawbacks (e.g., environmental hazards) to the land.
7. Only 12.6% of non-cash donors had tried to sell the asset prior to gift. However, of this 12.6%, the majority (62.5%) were real estate gifts. **More good news:** Your organization is likely to receive land which is not being given away as a "last resort".
8. Most non-cash donors (71.2%) are unsure of the amount of appreciation on the donated asset. **No surprise:** Most non-cash gifts have been held for several years prior to donation. However, of those donors who remember the percentage of appreciation, 68.8% indicated that appreciation comprised *more than* 50% of the asset's current value. **Emphasis:** Market the concept of saving capital gains tax!
9. Approximately one-half (54.2%) of non-cash donors did not care what the charity did with the gift. **Bonus:** Charities need unrestricted gifts!
10. Approximately one-third (35.9%) said the charity sold the gift with 79.7% of those indicating that the asset had been sold for more than or about the same amount they had claimed as a charitable deduction. Only 8.7% said that the asset had been sold for less than they had claimed as a deduction, and none of those reported that this had caused any tax problems. Respondents were uncertain of the outcome of the sale in 11.6% of the cases. **Tell your Trustees:** Most gifts of real estate are not "losers"! Valuable and marketable real estate is usually given, simplifying the administrative costs and time associated with such gifts.
11. One-third (32%) of the respondents said they made non-cash gifts of \$5,000 or more to more than one charity. 56.5% made gifts of differing values, saying they were influenced to do so by the needs of the specific charities. **Important Lesson:** Promote the mission, programs and needs of your organization! Also, do not take your donors for granted by ignoring their potential for real estate gifts... other charities may not make this mistake!

B. Appreciate donor motivation.

1. **Promote your charitable mission.** 92.1% of the respondents cited desire to support the charity as the primary reason for their non-cash gift.
2. **Consider real estate gifts for specific needs.** 67% cited the ultimate use by the charity as the reason for the non-cash gift - which might have a greater relevance for non-cash gifts such as collectibles and art as opposed to real estate, except for real estate used for a building, expansion purposes, conservation, etc.
3. **Stress Capital Gains Tax Savings.** 46.4% indicated that avoiding capital gains tax was important. This was much more important for donors whose income exceeded \$75,000.
4. **Encourage Memorial Gifts.** 36.5% of the respondents indicated their non-cash gift was made to create a lasting memorial for oneself or a loved one. 50% of those over age 70 cited this reason as important.
5. **Appeal to Financial/Estate Planning Goals.** Long-range estate/financial planning issues were significant to 29.9% of the non-cash donors. The opportunity to enhance income was also important (19.3%).
6. **Repeat Gifts.** Prior planned or "asset" gift donors, familiar with the processes and advantages of these gifts, may be very likely to consider real estate gifts. Also, consider repeat real estate gifts (outright to planned).

C. Marketing Strategy Caveats.

1. Donors may be as uncertain in making real estate gifts, as your organization may be in accepting them! Donors may not think you want real estate gifts, or that you cannot even accept such gifts. Further, donors may be apprehensive about all the work to process such a gift - by the charity as well as by the donor. Once you are comfortable with accepting such gifts, you can encourage and explain the process to donors with confidence.

2. Donors may have emotional attachments to real estate which may favor charitable donation rather than a sale or estate liquidation upon death.
3. Once your internal policies and procedures are in place for accepting real estate gifts, be prepared for another significant outreach effort to encourage donors to consider real estate gifts!
Excellent Resource: Marketing Strategies to Real Estate Owners, Developers and Investors by Lynda S. Moerschbaecher, The Journal of Gift Planning, Vol. 1 No. 1 (1997).

VI. *Tara-ific Techniques: Successful Strategies for Marketing Your Real Estate Gifts Program.*

- A. General considerations:
 1. Marketing real estate gifts deserves more emphasis. While cash and non-cash gifts of appreciated securities (outright or with planned gifts) receive the bulk of the typical marketing budget, real estate should not be ignored. Typically, a gift of real estate will be of "major" gift value proportions.
 2. Real estate can experience rapid appreciation, even more so than an individual's stock portfolio. A gift to avoid capital gains tax may be attractive. Further, planned gifts of real estate can transform a non-income producing asset into an income generating gift arrangement.
 3. Real estate can be easily woven into the marketing of cash and stock gifts.
- B. Successfully integrating your real estate gifts program with other planned giving and development programs.
 1. Coordinated mailing schedules of promotional materials.
 2. Education of entire staff (Development, Business Office, etc.) and volunteers (Class agents, Board of Trustees, etc.).
 3. Written policies and procedures. See above.
 4. Prospect reports/checklists.
 5. Pledge card notification and other suggestions of real estate gifts in annual giving mailings.
 6. Utilize alumni surveys or target mailings with surveys.
- C. Personal Visits.
 1. Cultivation:
 - a. Who to visit?
 - (1) Self-identified; Loyal annual givers; Major givers.
 - (2) All ages. Family size (single or no children). Include spouses in communications.
 - (3) Health care concerns may delay major giving. However, moves to retirement homes may lead to gifts of the homestead.
 - (4) Widows are approximately 70% of the population over age 85.
 - (5) Net wealth and valuable assets.
 - (6) "Snowbirds" with multiple residences.
 - (7) Farmers; Commercial Business Owners; Real Estate Developers/Agents.
 - b. Real Estate gifts may occur after the following events:
 - (1) Changes in tax law.
 - (2) After marriage or divorce.
 - (3) Following a change in estate value, or rapid appreciation of real estate.
 - (4) When children or grandchildren move away from home.
 - (5) Relocation to a new State.
 - (6) Retirement.
 - (7) Death of spouse or children.
 - (8) Move to a retirement facility or nursing home.
 - (9) Following sale of a business.
 - c. Prospect Research: Data (e.g., tax records, owner's name/address, mortgage information, etc.) is available on real estate holdings through local government (e.g., county recorder, treasurer, plat mapping) and local abstract company. Also, newspapers carry real estate transactions in classified ads.
 2. Education.

- a. Educate prospective donors about your charity. Keep donors informed and involved.
- b. Educate prospective donors about gift/estate planning:
 - (1) Why not to procrastinate one's estate planning.
 - (2) Tax advantages of real estate gifts (capital gains tax savings, income tax deduction, etc.).
 - (3) Special issues or problems to avoid.
 - (4) How to locate an estate planning/real estate attorney (Bar Association referral, Martindale-Hubbell, etc.)
- 3. Solicitation. Similarities/differences from annual/major giving of cash and stock.
 - a. Be sensitive to the personal nature of the estate planning process (e.g., emotional ties to property).
 - b. Considering a gift of real estate may take time.
- 4. Recognition and Stewardship are essential!
 - a. Consider a real estate gifts recognition society, as a separate recognition or as part of a comprehensive planned gift recognition.
 - b. Consider integrating real estate gifts with other outright gifts into annual and/or cumulative recognition levels.
- D. Market in cyberspace with the Worldwide Web and Internet.
 - 1. Include real estate gifts program information on your web page.
 - 2. Update information with new tax news, announcements of gifts (matured bequests, etc.).
 - 3. Include your e-mail address.
- E. Planned giving software.
 - 1. Create easy-to-read personalized illustrations.
 - 2. Share illustrations usually after you have established excellent rapport with the prospective donor.
- F. Broaden your audience and facilitate understanding with brochures, newsletters and seminars.
 - 1. Brochures. Purchase or produce in-house.
 - a. Easy-to-read with pleasing lay-out, art, photos, clear print, etc. Coordinate design, colors, etc. among brochures and newsletter.
 - b. Use testimonials or examples but avoid "heavy" tax analysis. Save detailed analysis for a personal visit and illustration. However, promote key benefits of real estate gifts: avoid capital gains tax, increase income, etc. Also, use emotional appeal.
 - c. Distribute effectively by target mailings, brochure cases in your office or near recognition plaque, follow-up to newsletters, etc. Consider a sequence of brochures on various themes (values, memories, vision, etc.). Timing may be selected to coordinate with a reunion or special event.
 - d. Inquire with local and state bar association for general public estate planning or real estate transfer brochures.
 - e. Provide estate planning quizzes, checklists, estate size and tax estimators, financial inventory booklets, etc.
 - 2. Newsletters. Purchase or produce in-house.
 - a. Easy-to-read suggestions same as with brochures.
 - b. Provides an excellent format for more detailed testimonials by donors with their stories, photos, how real estate gifts work, etc.
 - c. Can include a variety of information: other types of planned giving and development vehicles, news about your charity, legal and tax news, etc.
 - d. Mail regularly: 2-3 times per year. Consider including individuals at least age 45 and older on the mailing list.
 - e. Three-hole punch for future reference.
 - f. Reprints from respected journals.
 - g. Use reply cards.
 - 3. Seminars.
 - a. Estate and gift planning seminars may be held at your charity in conjunction with other special events. Consider a "traveling" seminar which may include dinner, news from your charity by other representatives, etc.

- b. Share information about charitable and non-charitable aspects of estate planning, including real estate. Do not make it a "solicitation" event.
 - c. Invite (as appropriate) other professionals (attorneys, financial, real estate professionals, etc.) to join in the presentation.
 - d. Offer private consultations.
- G. Videotapes can offer a personalized presentation for the busy audience.
- 1. May be expensive to produce well.
 - 2. Excellent for testimonials from donors.
 - 3. Videotapes are available from professional advisors (financial, insurance, etc.). Always review before distributing and provide disclaimers.
 - 4. Follow-up videotapes with phone calls to assess effectiveness, answer questions, etc.
- H. Advertisements.
- 1. Can be used most effectively in your organization's publications.
 - 2. May use catchy (but not trite) phrases. May consider a sense of humor but do not lose the sense of importance associated with a gift and estate planning.
 - 3. Consider professional art work and layout for fresh and innovative ideas.
- I. Educating and working with professional advisors.
- 1. Participate in your local NCPG and estate planning councils with other professionals, e.g., real estate brokers, lawyers, casualty insurance agents, real estate managers, etc.
 - 2. Offer continuing education programs at your organization to educate about gift planning with real estate.
 - 3. Include on planned giving newsletter mailing list, etc.
 - 4. Invite onto a Real Estate Gift Advisory Committee.
 - 5. Provide gift/estate planning references with specific mention of real estate gifts (e.g., estate/gift planning guides available from vendors, *Arthur Anderson's Tax Economics of Charitable Giving*, 12th Edition, etc.).
- J. Donor Prospecting.
- 1. Your mailing list can be screened to find matches with certain real estate information. For example, see www.prospectinfo.com
 - 2. Monitor geographic areas where property values are high or are rising. Consider target mailings/contact with constituents in those areas.

VII. Conclusion.

Is your organization doing all that it can to facilitate gifts of real estate?

After all...tomorrow is another day!

Real Estate Gift Consideration Checklist

Prospective Donor: _____

Location of Property: _____

Type of Property (personal, residence, farm, commercial, etc.): _____

Proposed Gift Arrangement: ___ Outright ___ Estate ___ CRT ___ GA ___ Remainder ___ BS ___ Other: _____

Proposed Date of Gift: _____

1. Ownership

- _____ Title – Donor’s current ownership interest
- _____ Warranty Deed
- _____ Quitclaim Deed
- _____ Sheriff’s Deed
- _____ Other (specify) _____
- _____ Copy of Deed in File: ___ yes ___ no
- _____ Warranty Deed prepared on behalf of charity: ___ yes ___ no
- _____ Current Updated Abstract: ___ yes ___ no
- _____ Title Insurance owned by donor: ___ yes ___ no Copy in file: ___yes ___no
- _____ New Title Insurance to be purchased by Donor: ___ yes ___ no

2. Environmental Review

Types of Review to be conducted

- _____ Personal Inspection by Staff: date _____
- _____ Inspection by qualified home inspector: date _____ Copy in file: ___yes ___no
- _____ Pre-Phase I Review: date _____ Copy in file: ___yes ___no
- _____ Phase I EA: date _____ Copy in file: ___yes ___no
- _____ Phase II EA: date _____ Copy in file: ___yes ___no
- _____ Phase III EA: date _____ Copy in file: ___yes ___no

3. Marketability

- _____ Current Qualified Appraisal ___ yes ___ no Date: _____ Copy in file: ___yes ___no

_____ New Qualified Appraisal to be completed by date _____

_____ Describe recent efforts to dispose of property (eg. Efforts to sell, donate, etc.):

_____ Name all listing agents used for property within the last two years: _____

_____ Any current mortgage, lien, debt, encumbrance, on property : _____

_____ Current zoning classification/description of property: _____

_____ Describe condition of property: _____

_____ Describe surrounding neighborhood, properties, etc: _____

_____ Are property taxes paid to date: ___ yes ___ no (Amount owed: \$ _____)
(Approximate annual property tax liability: \$ _____)

_____ Property insurance currently on property: ___ yes ___ no
(Approximate annual coverage amount: \$ _____)

4. Counsel

_____ Charity Legal Counsel for transfer: _____

_____ Donor Legal Counsel for property transfer: _____

_____ Charity Listing Agent for property: _____

Sparkling Ideas...



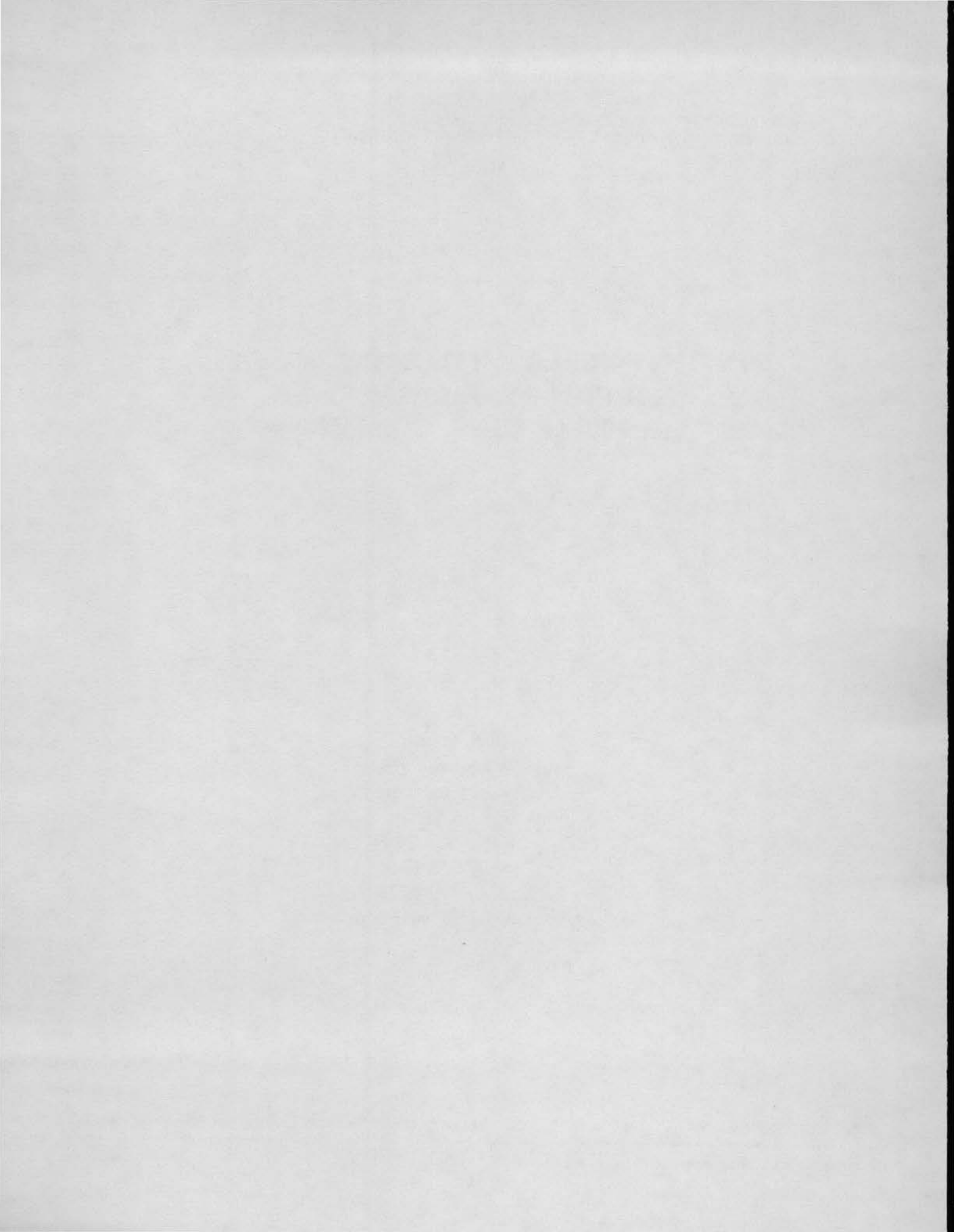
in the Emerald City

**INVESTING PLANNED GIVING ASSETS:
FIDUCIARY OBLIGATIONS
AND PRACTICAL CONCERNS**

David S. Routh
Senior Vice President
U.S. Trust Company
301 N. Elm Street
Greensboro, NC 27401
(336) 272-5100
FAX (336) 230-1725
david_routh@ustrust.com

25TH CONFERENCE ON GIFT ANNUITIES • PRESENTED BY THE AMERICAN COUNCIL ON GIFT ANNUITIES

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Investing Planned Giving Assets: Fiduciary Obligations and Practical Concerns

The American Council on Gift Annuities – 25th Conference on Gift Annuities

April 10-12, 2002

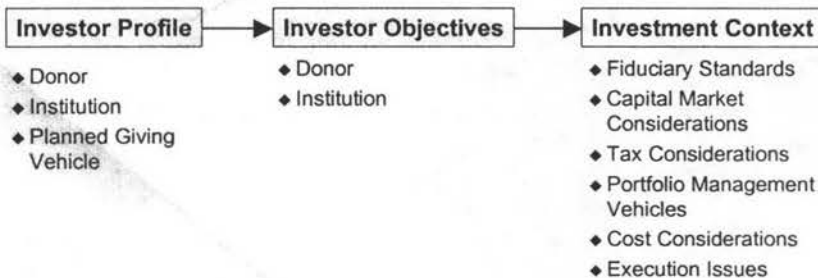
DAVID S. ROUTH
Senior Vice President
Manager, *The Planned Giving
Services Group*
U.S. Trust Company

MICHAEL C. SHOLTZ, J.D., LL.M.
Senior Vice President
Senior Trust Officer, *The Planned Giving
Services Group*
U.S. Trust Company

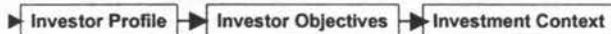
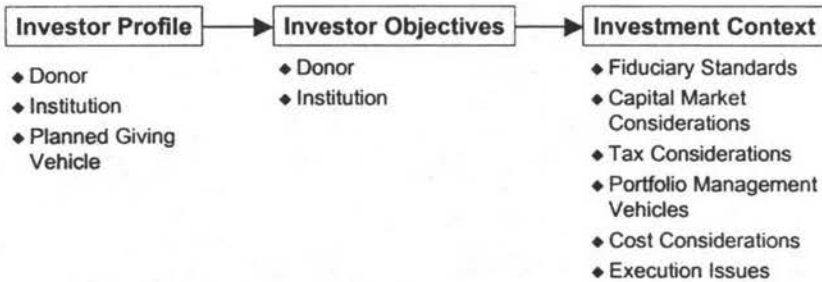
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Investing Planned Giving Assets: Fiduciary Obligations and Practical Concerns

Overview of Investment Planning for Planned Giving Programs



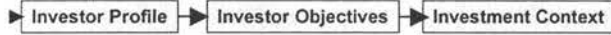
Overview of Investment Planning for Planned Giving Programs



Who is the Investor?

Donor/Income Beneficiary

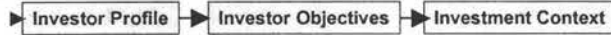
- ◆ Age
- ◆ Risk tolerance
- ◆ Tax bracket
- ◆ Access to integrated planning
- ◆ Other income



Who is the Investor?

Institution

- ◆ Stakeholders
 - ◆ Board
 - ◆ Planned Giving Officers
 - ◆ Administrative Staff
 - ◆ Investment Staff
- ◆ Size of program
- ◆ Risk tolerance



Who is the Investor?

Planned Giving Vehicle

- ◆ Size
- ◆ Type
 - ◆ Gift Annuity
 - ◆ CRAT
 - ◆ CRUT
 - ◆ NIMCRUT
- ◆ Payout rate
- ◆ Tax characteristics of vehicle

▶ Investor Profile → Investor Objectives → Investment Context

Who Bears the Risk?

Gift Annuity

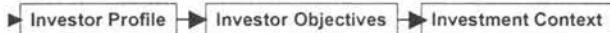
- ◆ Fixed dollar payout to Donor
- ◆ General obligation of the Institution
- ◆ Who bears the risk?
 - ◆ Market risk – Institution
 - ◆ Reinvestment risk– Institution
 - ◆ Inflation risk – Donor primarily, but also Institution
 - ◆ Payment volatility risk – No
 - ◆ Tax risk/uncertainty for Donor - No

▶ Investor Profile → Investor Objectives → Investment Context

Who Bears the Risk?

Charitable Remainder Annuity Trust

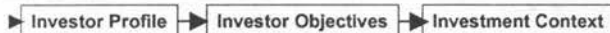
- ◆ Fixed dollar payout to Donor
- ◆ Who bears the risk?
 - ◆ Market risk – Institution
 - ◆ Reinvestment risk– Institution
 - ◆ Inflation risk – Donor primarily, but also Institution
 - ◆ Payment volatility risk – No
 - ◆ Tax risk/uncertainty for Donor - Yes



Who Bears the Risk?

Charitable Remainder Unitrust

- ◆ Fixed percentage of annual value paid to Donor
- ◆ Who bears the risk?
 - ◆ Market risk – Shared between Donor and Institution
 - ◆ Reinvestment risk– Shared between Donor and Institution
 - ◆ Inflation risk – Shared between Donor and Institution
 - ◆ Payment volatility risk – Yes
 - ◆ Tax risk/uncertainty for Donor - Yes

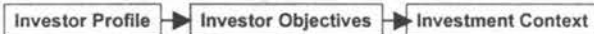
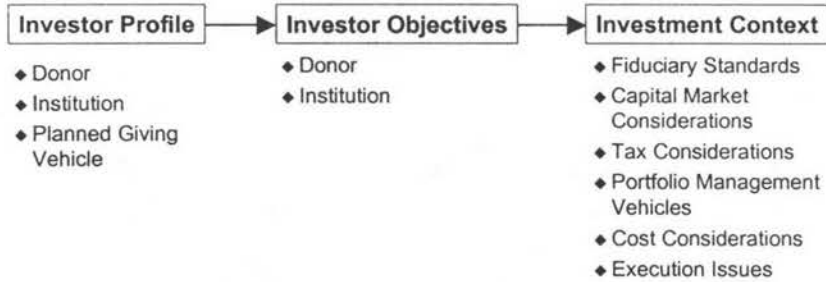


Who Bears the Risk?

NIMCRUT

- ◆ Payout to Donor equals net income of trust
- ◆ Who bears the risk?
 - ◆ Market risk – Institution
 - ◆ Reinvestment risk– Primarily the Donor
 - ◆ Inflation risk – Shared between Donor and Institution
 - ◆ Payment volatility risk – High over long term
 - ◆ Tax risk/uncertainty for Donor - Yes

Overview of Investment Planning for Planned Giving Programs

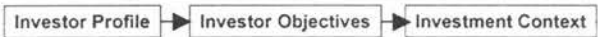


Who is the Investor?

Donor/Income Beneficiary

- ◆ High current income
- ◆ Growth of income
- ◆ Predictability of income
- ◆ Growth of remainder to fulfill charitable intent
- ◆ Preservation of charitable deduction (execution issue)

Investing Planned Giving Assets: Fiduciary Obligations and Practical Concerns



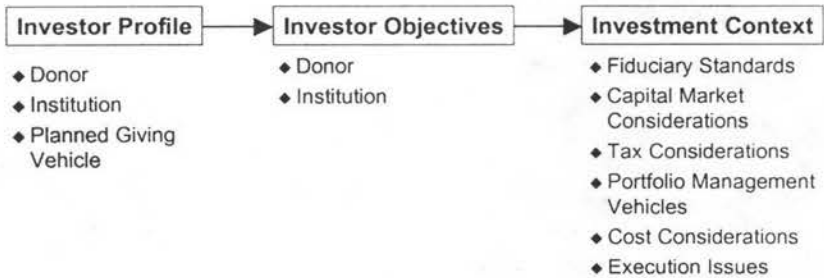
Who is the Investor?

Institution

- ◆ Donor satisfaction
- ◆ Maximize remainder interest
- ◆ Preserve and enhance overall image of the Institution
- ◆ Stakeholder voices
 - ◆ Board
 - ◆ Planned Giving Officers
 - ◆ Investment Staff
 - ◆ Administrative Staff

Investing Planned Giving Assets: Fiduciary Obligations and Practical Concerns

Overview of Investment Planning for Planned Giving Programs



Endowment vs. Planned Giving Programs

	Endowment	Planned Giving Program Donor
Time Horizon	Perpetual	Finite-Donor's Life Expectancy
Tax Status	Tax-Exempt	Taxable
Unrelated Business Income	Allowed (w/in IRS limits)	Prohibited
Pay Out Rate	One Rate/Spending Policy	Rates Vary by Vehicle and by Donor
Risk Tolerance	Institution's Risk Tolerance	Varies by Vehicles and by Donor
Assets	One Large Pool	Many Small Pools
Liquidity Requirements	Unique to Institution	Varies by Vehicle
Return Requirement	Institution's Requirement	Varies by Vehicle and by Donor
Investment Policy	One Policy	Policy for Each Trust and Separate Pool



Fiduciary Standards

Duties of Trustee – Common Law

- ◆ Duty to administer trust in accordance with its terms
- ◆ Duty to exercise care, skill, and prudence in administering trust
- ◆ Duty of loyalty to beneficiaries
- ◆ Duty to secure and safeguard trust estate
- ◆ Duty to segregate and identify trust assets
- ◆ Duty to account
- ◆ Duty to invest and make trust property productive

Investor Profile → Investor Objectives → Investment Context

Fiduciary Standards

Uniform Prudent Investor Act – Codified in 30+ States

- ◆ "A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution."

- ◆ Codifies Modern Portfolio Theory: "A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of the overall investment strategy having risk and return objectives reasonably suited to the trust."
 - ◆ Duty to monitor risk and return in total portfolio
 - ◆ No "per se" imprudent investments

Investor Profile → Investor Objectives → Investment Context

Fiduciary Standards

Prudent Investor Act

- ◆ Circumstances to be considered by trustee in making investment and management decisions
 - ◆ General economic conditions
 - ◆ Possible effect of inflation or deflation
 - *◆ Expected tax consequences of investment decisions
 - ◆ Role each investment plays within overall trust portfolio
 - ◆ Expected total return from income and appreciation of capital
 - *◆ Other known resources of the beneficiary
 - ◆ Needs for liquidity, regularity of income, and preservation or appreciation of capital
 - ◆ An asset's special relationship or special value, if any, to the purposes of the trust or to one of more of the beneficiaries



Fiduciary Standards

Other Duties and Permitted Acts of Fiduciaries Under Prudent Investor Act

- ◆ Duty to diversify trust investments -- unless trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying
- ◆ Duty of impartiality among beneficiaries
- ◆ Duty to secure investment services at reasonable cost
- ◆ Duty to use special skills -- a trustee who has special skills, or who is named trustee upon a representation thereof, has a duty to use those special skills or expertise.
- ◆ Authority to delegate investment management duties

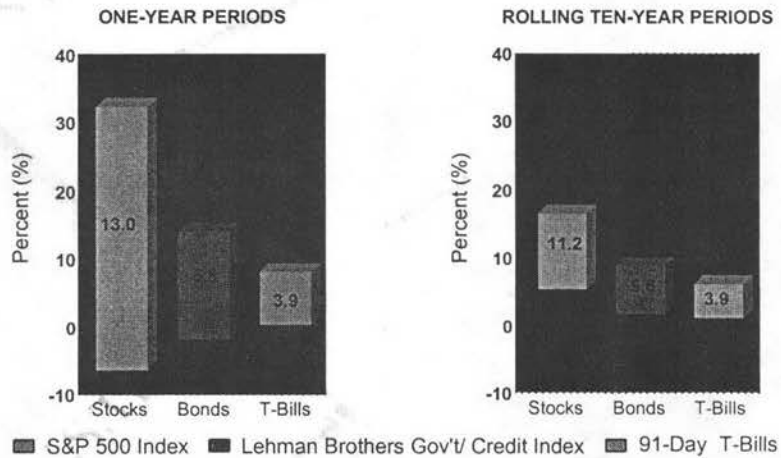


Capital Market Considerations

Overview

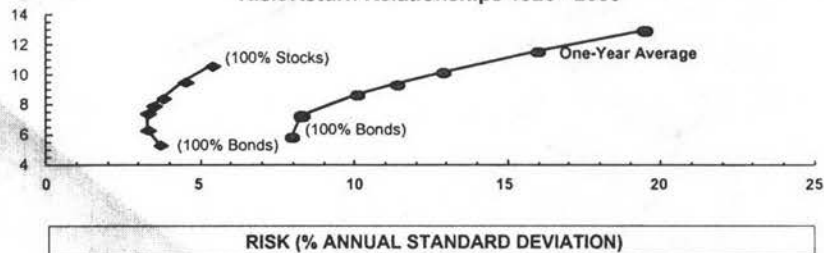
- ◆ Asset classes
- ◆ Impact of inflation
- ◆ Risk and return relationships
- ◆ Benefits of diversification
- ◆ Benefits of asset class combinations

The Influence of Time Risk/Return Relationships 1926 - 2000



Asset Class Combinations – Stocks and Bonds

Risk/Return Relationships 1926 - 2000



Ten-Year Rolling Average			One-Year Average		
Bonds/Stocks	Return	Risk (±1)	Bonds/Stocks	Return	Risk (±1)
(0/100)	11.2%	5.6%	(0/100)	13.0%	20.2%
(20/80)	10.3%	4.5%	(20/80)	11.5%	16.5%
(40/60)	9.3%	3.6%	(40/60)	10.1%	12.9%
(50/50)	8.8%	3.3%	(50/50)	9.4%	11.3%
(60/40)	8.2%	3.1%	(60/40)	8.7%	9.8%
(80/20)	6.9%	3.0%	(80/20)	7.3%	7.4%
(100/0)	5.6%	3.4%	(100/0)	5.8%	6.7%

Investment Volatility Impacts Donor and Institution

Assumptions

- ◆ \$1,000,000 Initial Amount
- ◆ Payout – 7% Unitrust
- ◆ Management Fee -- 50 Basis Points

Asset Allocations Analyzed

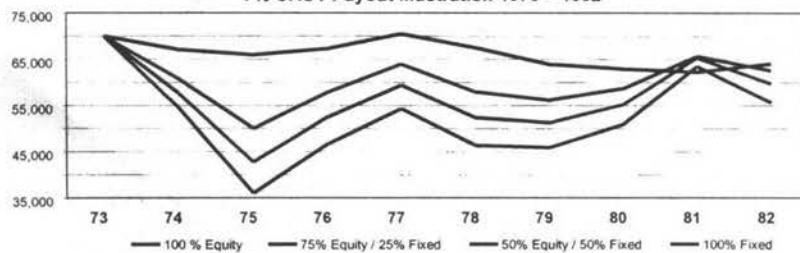
- ◆ 100% Equity
- ◆ 50% Equity / 50% Fixed
- ◆ 75% Equity / 25% Fixed
- ◆ 100% Fixed

Time Periods Analyzed

- ◆ 1973-1982 – Challenging Equity Market
- ◆ 1973-1992 – Improving Equity Market
- ◆ 1959-1978 – Worst 20-year Period
- ◆ 1980-1999 – Best 20-year Period

Investment Volatility Impacts Donor and Institution

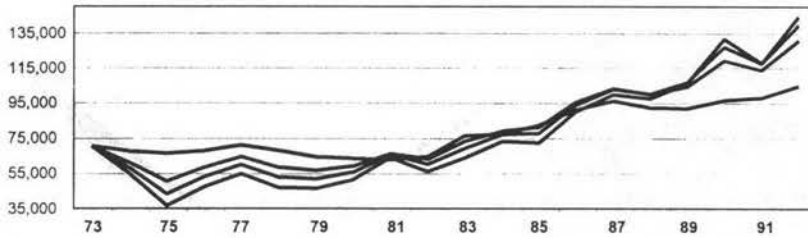
7% CRUT Payout Illustration 1973 – 1982



	100% Equity	75/25	50/50	100% Fixed
Target Payment	\$70,000	\$70,000	\$70,000	\$70,000
High	\$70,000	\$70,000	\$70,000	\$70,000
Low	\$36,084	\$42,799	\$50,018	\$62,192
Largest Negative Change	(\$18,455)	(\$14,874)	(\$10,789)	(\$3,632)
Ending Value to Charity	\$903,349	\$981,083	\$1,037,763	\$1,083,575

Investment Volatility Impacts
Donor and Institution

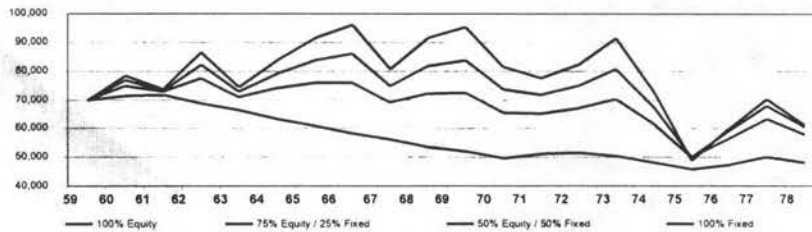
7% CRUT Payout Illustration 1973 – 1992



	100% Equity	75/25	50/50	100% Fixed
Target Payment	\$70,000	\$70,000	\$70,000	\$70,000
High	\$143,857	\$139,052	\$130,183	\$104,264
Low	\$36,084	\$42,799	\$50,018	\$62,192
Ending Value to Charity	\$2,057,806	\$1,986,603	\$1,857,583	\$1,484,029

Investment Volatility Impacts
Donor and Institution

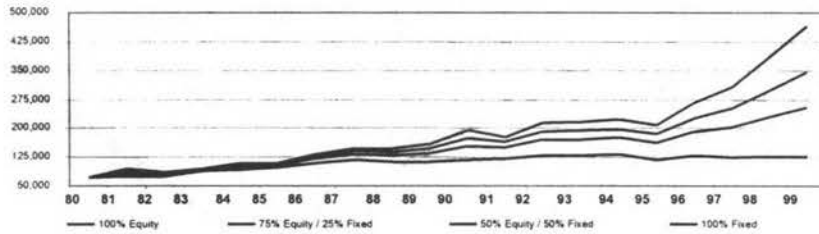
7% CRUT Payout Illustration 1959 – 1978



Results:	100% Equity	75/25	50/50	100% Fixed
Target Payment	\$70,000	\$70,000	\$70,000	\$70,000
High	\$96,179	\$85,963	\$77,616	\$71,645
Low	\$48,943	\$50,135	\$49,986	\$45,975
Largest Negative Change	(\$24,051)	(\$17,520)	(\$11,585)	(\$3,133)
Ending Value to Charity	\$795,573	\$779,101	\$737,831	\$600,871

Investment Volatility Impacts Donor and Institution

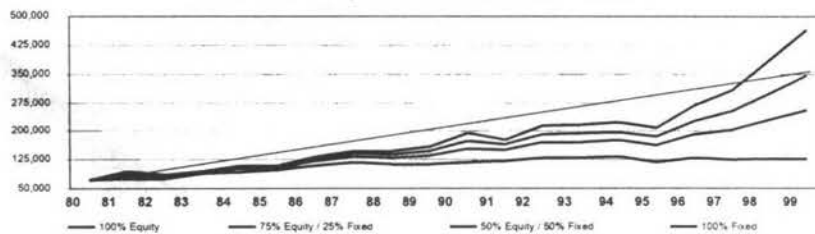
7% CRUT Payout Illustration 1980 – 1999



Results:	100% Equity	75/25	50/50	100% Fixed
Target Payment	\$70,000	\$70,000	\$70,000	\$70,000
High	\$466,147	\$346,796	\$253,065	\$130,536
Low	\$70,000	\$70,000	\$70,000	\$70,000
Largest Negative Change	(\$16,704)	(\$12,965)	(\$13,091)	(\$12,313)
Ending Value to Charity	\$7,121,346	\$5,028,308	\$3,472,541	\$1,538,726

Investment Volatility Impacts Donor and Institution

7% CRUT Payout Illustration 1980 – 1999



Results:	100% Equity	75/25	50/50	100% Fixed
Target Payment	\$70,000	\$70,000	\$70,000	\$70,000
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Ending Value to Charity	\$7,121,346	\$5,028,308	\$3,472,541	\$1,538,726

Investor Profile → Investor Objectives → Investment Context

Tax Considerations

Issues

- ◆ Donor's after-tax results are driven by Institution's investment strategy
- ◆ In general, commingling planned giving assets with endowment assets, ignores the tax ramifications to Donor or Institution
 - ◆ Donor - Taxable
 - ◆ Institution - Tax exempt
 - ◆ How can you reconcile?

Investor Profile → Investor Objectives → Investment Context

Tax Considerations

Issues - Continued

- ◆ In order to maximize the results, you must know:
 - ◆ Donor/income beneficiary's tax bracket
 - ◆ Four-tier tax structure (CRTs) – four “buckets”
 - Ordinary income “bucket”
 - Long-term capital gain “bucket”
 - Tax-exempt income “bucket”
 - Principal “bucket”

Why Does Tax-Efficiency Matter in CRTs?

The Four Tier Tax System

TIER I Ordinary Income
TIER II LT Capital Gains
TIER II Tax Free Income
TIER IV Principal

Implications

- ◆ Distributions to beneficiaries are taxed on a "Worst-in-First-Out" basis
- ◆ If the ordinary income "bucket" is not managed carefully, the capital gain can be "locked-in" the CRT

Why Does Tax-Efficiency Matter in CRTs?

Initial Gift of Appreciated Asset

Ordinary Income
LT Capital Gains <i>LT Capital Gains from Original Gift</i>
Tax Free Income
Principal <i>Tax Basis from Original Gift</i>

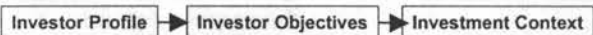
CRT Year 1 - End of Trust

Ordinary Income ◆ Dividends ◆ Bond Interest ◆ ST Capital Gains } <i>From Investment Activity</i>
LT Capital Gain <i>LT Capital Gain from Original Gift and LT Capital Gain from Investment Activity</i>
Tax Free Income <i>Tax Free Income from Investment Activity</i>
Principal <i>Principal from Original Gift</i>

**Investment Context:
Example of Tax Impact on Donor**

Facts/ Assumptions	Size: \$1,000,000	Bond Coupon: 6%
	Type: CRAT	Dividend Yield: 2%
	Payout: 8%	Donor Federal Tax Bracket: 39.6%
	Asset Allocation: 70% Equity/30%Fixed	

Bond Interest Income	\$18,000	\$18,000
Dividend Income	14,000	14,000
Total Interest and Dividends	32,000	32,000
Management Fee	(10,000)	(10,000)
Ordinary Income (Net of Fee)	22,000	22,000
Additional Distribution Amount Needed	58,000	58,000
Total Donor Payout	80,000	80,000
Donor Taxes		
• Ordinary Income Tax	9,741	9,741
• ST Capital Gains Tax	0	25,682
• LT Capital Gains Tax	14,314	0
Total Tax	24,055	35,423
Net to Donor	\$55,945	\$44,576



Portfolio Management Vehicles

Vehicles

- ◆ Mutual funds
- ◆ Bank common trust funds
- ◆ Pooled endowment funds
- ◆ Individually managed portfolio

Issues

- ◆ Control of
 - ◆ Asset allocation decisions
 - ◆ Diversification decisions
 - ◆ Tax implications of trading strategy
 - ◆ Costs
- ◆ Adherence to investment policy set for each trust



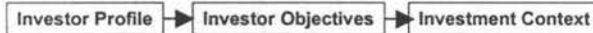
Cost Considerations

Costs

- ◆ Investment management fees - All forms
- ◆ Transaction fees
 - ◆ Investment related
 - ◆ Administrative
- ◆ Tax compliance fees
- ◆ Cost of internal administrative staff, if appropriate

Issues

- ◆ Fiduciary duty to obtain services at reasonable cost
- ◆ Cost structure can become competitive advantage or disadvantage

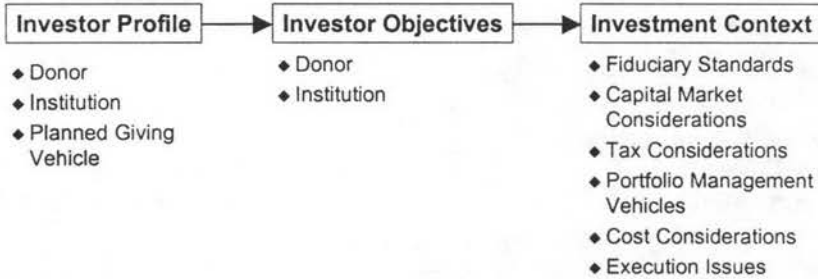


Cost Matters

Assumptions	Beginning Balance: \$1,000,000 CRUT Payout: 7%	Annual Return: 3% Income, 7% Growth Time Period: 20 Years
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Impact	50 Basis	100 Basis	150 Basis
Total to Donor (before tax)	\$1,781,840	\$1,689,011	\$1,602,028
Total to Charity	\$1,627,462	\$1,465,684	\$1,319,261

Overview of Investment Planning for Planned Giving Programs



Bringing Order to this Investment Planning Chaos

The Challenge

- ◆ Multiple investor profiles
- ◆ Multiple and often conflicting objectives
- ◆ Multiple tax considerations
- ◆ Demanding fiduciary standards
- ◆ Uncertain capital markets
- ◆ Portfolio management vehicles - Some appropriate, others are not
- ◆ Execution / Administrative issues

Bringing Order to this Investment Planning Chaos

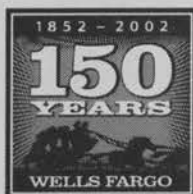
The Solution

- ◆ Multiple asset allocation options at individual trust level
- ◆ Tax-intelligent investing is critical
- ◆ Administrative perfection
 - ◆ Timeliness
 - ◆ Accuracy
- ◆ Carefully study alternative cost structures
- ◆ Understand investment vehicle options

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**TIPS FROM THE TRENCHES:
PROACTIVELY MANAGING YOUR BEQUEST
ADMINISTRATION PROGRAM**

Jackie W. Franey
Director of Planned Giving
American Heart Association – National Center
7272 Greenville Avenue
Dallas, TX 75231-4596
(214) 706-1589
FAX (214) 706-5230
jackie.franey@heart.org

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I. INTRODUCTION

Bequest administration is the process of reviewing documents when an individual who has named a charity in his/her estate plan has died. The goal of bequest administration is to ensure that the charity receives all that it's entitled to under the decedent's estate plan, as quickly as possible. In order to accomplish this, you must know what documents to review, what information must be monitored and have a general understanding of the probate and trust administration legal processes.

II. OVERVIEW

The following is a list of the documents that we are entitled to receive from the personal representative of an estate when the decedent has named a charity as a beneficiary under the Last Will and Testament. The documents are listed in the order in which they are normally received. In your state, the documents may be called something else, but the purpose may be very similar.

Notice of Administration

The typical progression of an estate begins with notification from the personal representative or the decedent's attorney. A copy of the Last Will and Testament usually accompanies the notification. If you do not receive a copy of the Last Will and Testament, then one should be requested.

In a trust administration, there may not be a formal notification. Instead, your charity may receive correspondence from an attorney for the trustee, or the trustee, indicating that you have been named as a beneficiary in the trust.

Last Will and Testament

The *Last Will and Testament* tells what type of bequest has been given to your charity. There are different types of bequests: specific, residuary and contingent.

Specific: These bequests are paid after all claims against the estate have been met and before the residual beneficiaries are paid.

Residuary: These bequests are paid after specific bequests, taxes and expenses have been paid. A partial distribution may be made once the residual interest is finalized. In most cases, we ask the executor to make a partial distribution of the residual interest.

Contingent: These bequests are contingent on a future event such as the death of a primary beneficiary, or the death(s) of surviving heir(s). There is always a possibility that the contingent beneficiary will receive something, although remote.

Trusts

There are three main types of *trusts*: testamentary (the trust is established at the death of the decedent through his Last Will and Testament, revocable (living trust arrangements) and irrevocable. A charity can learn the terms of the testamentary trust by having a copy of the decedent's Will. Information on revocable trusts is normally confidential until they become irrevocable; while a charity may or may not learn the terms of a charitable remainder trust. In many cases, the donor retains the right to change the remainder beneficiaries.

Charitable Remainder Trusts: If a charity is an irrevocable remainder beneficiary in the trust, income must be recorded once the net present value of the future gift is known. While it may be many years before the remainder beneficiary receives the gift, the "future interest" needs to be tracked, using the age and gender of the income beneficiaries.

Inventory

In most states, a detailed inventory and valuation must be filed after the personal representative for the estate has been appointed. The Inventory lists all the assets of the decedent as of date of death and places a value on them. Everything from money in bank accounts, stocks, bonds, real estate, etc. can be reflected on the Inventory. If a charity is a residual beneficiary, then it's entitled to a copy of the Inventory.

The length of the estate administration process can be predicted using the Inventory. If the estate is valued at over \$1,000,000 during 2002-03 (increasing to \$3,500,000 by 2009) it usually takes 16-18 months to administer the estate due to the filing of an estate tax return. On average, most estates take about nine months to a year to complete.

The Inventory also allows a charity to estimate the value of the bequest when there is a residual interest in an estate. If the gift is a remainder or residual gift, review the Inventory for noncash assets. It might be helpful to request to the attorney that the assets are liquidated and cash is distributed, rather than inheriting an interest in real estate, for example. Different types of assets can result in potential problems for your charity. After the Inventory is received, calendar about 6-8 months for receipt of the Final Accounting and distribution of all funds.

Estimating the Value of a Bequest

If a charity is named to receive a specific bequest, you can assume you will receive that specific amount. If, however, the assets of the estate are insufficient to pay all the specific bequests, then the gifts are usually reduced proportionally. Check the statutes in your state for the process of abating the gift and gift reductions.

Determining the remainder or residual gift is sometimes more art than science. A good rule of thumb is to determine the net value of the estate from the Inventory, or from the trust asset statement. Allow a certain percentage (we use 10%) of the net value of the estate to be allocated for services provided by the personal representative and/or attorney for the estate as well as payment of claims to creditors of the estate (i.e., funeral, miscellaneous bills, etc.). After this computation is made, subtract all specific bequests. The remaining figure represents the residual portion of the estate. You can then multiply this figure by the percentage of the residual assets stated in the Last Will and Testament to calculate the expected amount of the bequest.

Develop a relationship with your business office/finance department and understand the accounting rules that pertain to bequest administration. The bequest administrator must work closely with the accountant who will be booking these gifts as income to assure that the estimated amount is supportable, the time frame for receiving the income is reasonable and any restrictions are properly classified.

Final Accounting and Petition for Discharge

The Final Accounting and Petition for Discharge is due twelve months unless an estate tax is due and the Personal Representative has filed a Notice of Estate Tax Due (which automatically extends close due date to twelve months from due date of 706). Within thirty days from the date of service of the Final Accounting and Petition for Discharge, the personal representative should (and in some states must) distribute the estate. In some states with the thirty-day requirement, the thirty-day waiting period may be waived if all interested parties consent to waiver. In addition, the Final Accounting should be reviewed for Personal Representative and attorney fees and estate expenses.

During trust administration, due to the absence of court related processes (such as the need to file an Inventory with the court); it can be more challenging to determine when the gift will be distributed. On average, it can take 8-12 months for gifts to be distributed; due primarily to the tax filing requirements that must be fulfilled by the trustee. Accounting rules dictate at what point you must include on the general ledger the value of a trust interest. Variables in this determination include the type of trust, the terms of the trust and the valuation information. In addition, you should request a final trust accounting or statement.

III. ADMINISTRATION OF BEQUEST FILES

Developing a good calendar system is essential to proactive bequest administration. It is imperative that all estates be regularly monitored to ensure that all funds due your organization are received in a timely manner and that no complications occur which could jeopardize the gift or your charity. (e.g. inheriting contaminated real property). It is also recommended that a good working relationship be developed and maintained with other nonprofits. Estate and trust complications can more easily be resolved if all the beneficiaries work together.

The following outlines normal practices with regard to managing bequest files from the time of first notification until final distribution from the estate or trust is received.

Initial Correspondence

After a Notice of Administration is received from the personal representative or his/her attorney, write a letter thanking them for the notification. Request that all future correspondence be sent directly to the Bequest Administrator and provide information on the complete legal name, address and tax identification number. Include an IRS W-9 form and IRS Tax Exempt Letter (501(c)(3) letter): most attorneys and trustees will request this information. If necessary, also request a copy of the Last Will and Testament and/or Trust Agreement at this time. (We also ask for a copy of the death certificate) Make a notation on your calendar or use a database tracking system to follow-up with the personal representative or his/her attorney to confirm that requested information was received (30 days is a good estimate).

If an attorney is unwilling to provide a copy of the Last Will and Testament, go to the courthouse to obtain a copy or explain to the attorney that the exact wording of the language of the decedent is needed. It may be helpful to inform the attorney that the reason you would like the language is to ensure that the wishes of the deceased are followed regarding the use of the funds. In some cases, informing the attorney that your auditors regularly review bequest files for accuracy of information related to bequest administration may assist in securing the necessary language.

If an attorney or trustee is reluctant to provide a copy of the trust (since a trust is not filed with the court), then discuss with the trustee that your charity is a beneficiary and is entitled to information regarding the gift. (Often this is the law). If the trustee wants, he/she can block out the other gifts in the trust. Be careful, however, that you understand all the terms of the trust that relate to your gift. For example, if the attorney sends you information that you have a 25% remainder interest in the trust after specific bequests are made, you need to know the total amount of the specific bequests in order to determine the true value of your gift.

Upon notification of an estate or trust, a paper file is opened. It may be helpful to use a legal document checklist to ensure that the proper documents are placed in the file. At a minimum all files should contain:

- Copy of Decedent's Last Will and Testament, codicils and/or trust
- Copy of the Inventory and Appraisalment
- Written information regarding the value of the trust (preferably a list of assets)
- Copy of all accountings if charity has a remainder interest
- Copies of all checks received
- Copies of all correspondence sent to and received from the personal representative or his/her attorney

If there are complications in an estate, you may want to separate out those physical files from the other files to monitor them more closely. Regularly review the status of all legal matters on a monthly basis. Establish a tracking system using the following guidelines:

If a specific bequest: calendar 9-12 months for review

If a residuary interest: calendar 4-5 months to receive a copy of the Inventory or asset statement, which shows the total value of the decedent's estate. Then calendar approximately 4-6 months to follow-up that the estate is closing.

If a residuary interest in an estate or trust exceeding \$1,000,000: calendar 16-18 months for final distribution or follow-up. Make a note in your file that an IRS form 706 (Federal tax filing) is required.

If a remainder interest and the Inventory show that there is real estate to be sold: notify the personal representative or his/her attorney that you would like to receive an all cash distribution

If the remaining asset is a tax reserve, find out how long a tax reserve can be held in your state and calendar for that amount of time to then review the file. Most estates and trusts withhold a tax reserve to pay for the final taxes and miscellaneous expenses of the estate/trust after the bulk of the funds have been distributed.

Open files: Open files should be separated into two types, "active" and "inactive". Active files are those estates or trusts where we can predict when and how much we will receive. Inactive files involve either funds to be received at a later, undeterminable date, or contingent interests where funds are not definite.

Restricted gifts: The two most common types of restrictions are: 1) when the decedent requests that the money be used for a specific purpose only, or 2) when the decedent requests that the money be used only in a specific geographical area. You will need to properly account for all restricted gifts for audit purposes. If a restriction is designated by the donor that you cannot fulfill, you may need to decline the gift.

Throughout the Administration of the Estate

Throughout the administration of the estate, acknowledge correspondence from the personal representative or his/her attorney in writing. Determine who will be the primary contact for the personal representative or his/her attorney and at what point in time the planned giving staff person may cultivate the donor's heirs/family and the executor and/or other advisors. In some cases, the planned giving staff person will already have a relationship with the attorney – how will you communicate between the role of the attorney as executor and the attorney as donor advisor?

As the processing of bequests becomes an established routine, there should be certain policies or general guidelines that must be established. Examples of these are: 1) distributions for a bequest should be in cash rather than in-kind whenever possible, 2) in those states where applicable, do not sign off on attorney and/or personal representative fees before the administration of the estate is complete.

Distributions from the Estate

Upon receipt of distributions from the estate, write the personal representative and/or his attorney a thank-you letter. Acknowledge other heirs and family members as appropriate and work closely with planned giving staff so they can steward heirs, family members and advisors connected with the estate. If appropriate, share with the family how the funds will be used to further the mission of the organization. Carefully review the receipting language before signing off on a distribution because you may be waiving an accounting, stating you've received full distribution, etc.

Keep track of perpetual and charitable remainder trusts separately and work closely with your business office/finance department and the planned giving staff. The planned giving staff can steward those donors that have irrevocably named your charity as a remainder beneficiary and build relationships with the advisor(s) before the death of the donor and/or income beneficiaries. If you are aware of a charitable remainder trust where the donor(s) retained the right to change the remainder beneficiaries, then it is critical for the planned giving staff to steward the donors to remain as a beneficiary.

Perpetual trusts last forever and under accounting rules, the income received from them, as well as the charity's percentage share of the principal must be accounted for in the audit. Perpetual trusts payout income only, with the principal remaining untouched. Obtain a copy of the trust's accounting each year, as close to June 30th (end of charity's fiscal year) as possible in order to have the most current fair market value information.

Closing the File

When the Final Accounting and Petition for Discharge are received, review them prior to the hearing set by the court to confirm the estate has been administered properly. If the Final Accounting and Proposed Distribution appear to be in order, calendar thirty days for receipt of funds, and in those states where applicable, sign the Receipt of Petition for Discharge and Accounting and Consent to Distribution. Upon receipt of the final distribution, the estate file is closed.

Closed files: Closed files can be organized by fiscal year. At the end of the fiscal year and after the audit is complete, closed files can be separated out and placed in storage. Determine records retention procedures for closed files. The current guideline is that bequest administration documents must be retained for the life of the corporation, although miscellaneous correspondence might not have to be retained that long.

Generally speaking, it takes 6-18 months to close an estate (from receipt of original notice of death to all funds distributed). With trusts, since the court is not involved, the timetable can be much shorter. Sometimes, we will learn of the death of the decedent and receive the funds at the same time.

Audit procedures: Audit approaches do vary since they are dependent on the auditor's assessment of controls in place over bequest administration as well as their knowledge of the bequest process. Be prepared for the auditors to select a random sample of bequest receivables open at year-end, as well as the largest expectancies. They will want to review the calculation for the amount you expect to receive, your logic for the date(s) you expect to receive distribution(s) and copies of the wording, which indicates any donor restrictions.

The auditors will be interested in looking at any bequests that have stipulated or unusual payout periods. They will also want to see trust statements related to perpetual trust and documents to support the premise that the trusts were set up into perpetuity. In addition, if you have received any non-cash distributions, they will want to understand how you arrived at the value used to record the gift and understand any liabilities associated with the asset.

IV. WHEN TO CALL AN ATTORNEY

Often situations arise in estate and trust administration when an attorney needs to be contacted in order to protect your charity's interest. Confirm the timeline for filing a response – often times you have twenty days or less to respond or you lose your right to contest. Determine procedures for when to call an attorney and the standard maximum percentage of a gift that will be spent on attorney's fees. For example, you could set a maximum of five percent of any gift – therefore for a potential distribution of \$100,000 – you would be setting a ceiling of \$5,000 in discussing a fee structure with the attorney.

The common scenarios described should be viewed in conjunction with your own internal legal department requirements.

- You've written and called the executor/trustee to request appropriate information, and your telephone calls and letters have gone unanswered.
- You've been served a Summons and Complaint, or been notified of a legal challenge to a will or trust. For example, someone is challenging the validity of the will.
- You've reviewed a pleading and found something unusual.
- You've received a document and you've exhausted resources to try to understand it (a volunteer, board member, another nonprofit beneficiary).

- You've noticed that your organization is misidentified in a will or trust—name or address is incorrect. You've tried, through correspondence to and/or telephone calls with the estate/trust attorney to clarify matters, and more documentation is required. A pleading/affidavit may need to be filed with the court to resolve it.
- The executor/trustee is delaying closing the estate/trust past a reasonable amount of time.

You will need to share with your business office/finance department a list of all estates in litigation, the issues involved, the likelihood of settlement, and the amount of bequest income at stake, the names of the attorneys representing your organization who are involved, and a projected timeframe for settlement. This information is particularly important if the value of a recorded bequest receivable could be impaired by the litigation.

V. WHAT TO KNOW ABOUT NON-CASH ASSETS

Distributions for a bequest should be in cash rather than other assets whenever possible. Sometimes, as a beneficiary, your charity might be asked to accept real estate (land, homes, condominiums, etc.), personal property and furnishings (jewelry, artwork, mobile homes, etc.), vehicles, stock, bonds, certificates of deposit, notes receivable (mortgages), royalties or mineral rights. You can always disclaim an asset because you do not want it or have concerns about accepting it.

In some states, the personal representative is allowed to follow the intention of the will verbatim and the decedent's wishes can be followed whether or not you agree with the distribution. If you accept non-cash assets, provide your business office/finance department with a list of these assets and a reasonable market value for each. If a reasonable market value cannot be determined, they will determine the amount to record (e.g. \$1.00) so that ownership of the asset will not be forgotten.

Let your business office/finance department know of any liabilities assumed in accepting the asset, e.g. with real property – real estate taxes, maintenance costs, etc. If you do retain securities, they will need to know any interest or dividends earned subsequent to the date of receipt, since this income will be accounted for as investment income and not as bequest income.

Most importantly, work on procedures for disposing of the assets, preferably before accepting non-cash assets. Advise your business office/finance department of any contracts signed for the sale of these assets. If real estate is sold for an amount different from the amount recorded as the fair market value when the gift was accepted, the gain or loss is not bequest income but gain or loss on the sale of an asset, and will be treated differently for income purposes.

Here is a brief listing of the relevant information needed to monitor various types of non-cash assets:

- **Real estate:** the type of property (e.g. residential or commercial), the property address, as well as whether the property is income producing, any liens or toxic problems. The appraised value should be provided by the attorney for the estate/trust. It is also important to note whether (and when) the property is sold for payment of taxes.
- **Insurance:** the insured name and address, owner name, company name and premium payments.
- **Promissory Notes:** the principal amount, interest rate, maturity, whether current, foreclosure or secured and any terms.
- **Royalties:** the date the interest was received (e.g. oil/gas leases), the county and state location (if applicable) and a description of the royalty interest.
- **Securities:** the name and type of stock, number of shares, the value on the date of transfer and date and value when sold.

VI. PARTNERING WITH THE BUSINESS OFFICE/FINANCE DEPARTMENT

Accounting standards require that all receivables must be recorded as income. Distributions from bequests are regarded as receivables, and accordingly, must be entered into the General Ledger by accounting. An expectancy should be recorded after the will is declared valid by probate, no uncertainties as to the likelihood of receiving the gift exist and the amount of the bequest can be determined. Bequests that are conditioned upon future or uncertain events should not be recorded until the conditions are substantially met.

The business office/finance department will need a listing of bequest receivables that indicate the expected date of receipt. They will separate those bequests to be received within the fiscal year from those to be received after the end of the fiscal year. Additionally, the business office/finance department will need to have available how the amounts due were calculated, how the expected distribution date was determined and language from bequest documents that indicate donor imposed restrictions. If the distribution from an estate is less than the amount expected and the amount estimated was recorded by the business office/finance department as a bequest receivable, you must advise them. The amount, which will not be received, will probably be written off as a loss of an asset.

At the end of a fiscal year, the auditors will be looking for a roll-forward of bequest receivables. You may be asked to prepare this. The schedule would show all bequest receivables recorded as of June 30 (end of charity's fiscal year) of the previous year, less cash received during the year, plus or minus all adjustments to expected receipts to arrive at the balance as of the end of the current fiscal year (June 30th).

If you receive statements periodically from trustees, you should perform several clerical checks. First make sure the beginning balance of the statement ties to the ending balance of the last statement you received. Expect to see trustee's and accountant's fees. The

trustee's fees should be in line with the statutory rates or normal rates charged by the bank or investment house administering the trust.

With the help of your bequest records, you should be able to quickly compare the list of beneficiaries and validate that disbursements to these were made appropriately. Review the disbursements made from the trust for any unusual items. If any other disbursement looks unusual or you do not understand the description, call the trustee and ask for an explanation. If you need further clarification, discuss the issue with your CFO or other staff person in a position to assist with bequest issues.

If the trust is a perpetual trust or one that will be active for a long period of time, you may want to ask the trustee what percentage is being invested in stock versus in fixed instruments. You may want to review this mix with someone with financial expertise to determine if the mix makes sense. If 80% is in equities, or 100% is in fixed income, you may need to ask the trustee to alter the composition of the investments to better address the market risk and growth of principal.

VII. PLANNED GIVING: BUILDING THE CASE FOR SUPPORT THROUGH YOUR BEQUEST ADMINISTRATION PROGRAM

For many organizations, a gift from an individual's estate plan represents one of the largest sources of income on an annual basis. For the American Heart Association, "estate settlement" dollars represent approximately twenty percent of our annual income. But this income didn't just "happen" – planned giving represents the relationship we have with donors as they fulfill their philanthropic goals to support the organizations and missions that are important to them and bequest administration represents our responsibility to fulfill their philanthropic goals. Both sides carry equal weight in the equation – securing the gift commitment and securing the gift dollars.

A pro-active bequest administration process enables an organization to learn what a typical "planned giving donor" looks like:

- Was this person male or female?
- What was the age of this person at death?
- What relationship did this individual have with our organization: a long-term donor from direct mail, a volunteer or board member, a family member of a long-term donor or volunteer or a person who had experience with cardiovascular diseases or stroke?
- Was the bequest a specific, percentage or residual gift?
- How many charities were included in the will?

In addition, information such as the average size bequest and number of gifts from bequest administration will enable us to determine if we are "growing" our program. While it is important to track the total dollar amount – how many estates does this figure represent?

How many “large” gifts does this figure represent? We track the number of gifts in excess of \$500,000 to determine the percentage of large estates that comprise the annual income.

This analysis of information through the bequest administration process provides us with insight on how to market our program, both internally to volunteers and staff and externally to donors and advisors. For example, is our exact legal name being used, or are we still known as the Heart Fund? Another example would be our working relationship with executors and trustees – providing excellent customer service through the bequest administration process could lead to building a relationship with an advisor who is assisting a donor to support cardiovascular or stroke research or specifically, the American Heart Association.

The analysis also enables us to determine how many gifts are coming to fruition from long-term donors and donors that have been cultivated by planned giving staff. We share throughout the Association cultivation and relationship building for planned gift commitments that come to fruition. Most recently, we also “bump up” our gifts from a donor’s estate against our direct mail file to determine if there was ever an existing relationship. The story of a \$5 or \$10 direct mail donor that included us in the will and never shared that information is then shared across the Association. In addition, we track life-income gift donors to determine how many of these individuals also include us in revocable gifts.

In conclusion, this type of information helps to “build the case for support” for pro-active bequest administration and investing in a planned giving program. *As you manage your bequest administration process, think about the opportunities to build your planned giving program!* Use these steps to proactively manage your bequest administration program and deepen the commitment to planned giving:

- Educate management on the difference between planned gift commitments and bequest administration
- Provide excellent customer service to executors and trustees
- Thank, thank, thank and cultivate heirs
- Analyze donors including your organization in their estate plans
- Track number and size of estates on an annual basis
- Track the average size of a bequest and whether specific, residual or percentage
- Implement a tracking mechanism to proactively manage the process

GLOSSARY OF TERMS

Abandoned Funds - Assets of a decedent that are unclaimed. Sometimes discovered by companies called Asset Locators or Heir Finders.

Accounting - This document must be filed with the court in a probate matter and in a trust administration matter, the beneficiaries can request one. If the charity has a remainder interest, this document should be reviewed. The accounting lists all financial transactions of the executor or trustee from date of death to a final date near when distribution is to occur.

Administrator – Person or corporation appointed by a court to settle the estate (i.e., pay taxes, bills, and distributed property to *heirs*) of a deceased person if no valid *will* can be found. See also *personal representative*.

Affidavit – Written statement of fact voluntarily signed and sworn to before a person having authority to administer an oath.

Amendment - A change or addition to a trust. Trust may be completely restated or only modified in an amendment.

Ancillary Administration – Process of putting through *probate* property owned by a deceased person in the state where he or she owned it, not in the state in which he or she lived.

Assets – Money and *real* and *personal property* owned by a person or organization.

Beneficiary – Person who is named to receive some benefit or money from a legal document such as a *trust*, life insurance policy or *will*. Can also be referred to as legatee.

Bequest – Gift provided through a will.

CRT - Charitable Remainder Trust (See also **Trust, Remainder Interest, Residuary Interest**)

Closed File - All funds due the charity have been received.

Codicil - An additional statement or change to a person's will. Used in conjunction with a will.

Community property – Property acquired during marriage that was not a gift to or inheritance of one spouse or specifically kept separate.

Consent - Agreement to a procedure. Note: Silence (not signing or filing an objection) is construed in some states as consent.

Contested Will or Trust - See **Will contest**.

Contingent interest - This occurs when the gift is conditioned upon another event, which may or may not occur.

Credit estate tax – State tax on the assets of someone who has died. Applies only to estates that are required to pay federal estate taxes. Estates do not pay double taxes but instead, by paying a credit estate tax, “rebate” part of the federal estate tax owed back to the state.

Creditor – Person or corporation to whom money is due.

Decedent – Person who has died and left property to be administered.

Devise - Interchangeable term for bequest; gift made through a will.

Discharge - Release of duty or liability; entered by the court at the close of a legal process.

Disclaimer - If accepting an asset of the estate goes against charity’s policy or would be dangerous, (within strict time elements) the charity can disclaim the portion of the estate comprised of the unacceptable assets. This course of action requires filing with the court.

Distributee – Person who inherits; an *heir*.

Distribution - Payment (may be full or partial) of bequest/devise.

Domicile Rule - the domicile of the decedent is the place where (s)he lived at the time the will was executed (signed). This is the appropriate location for distribution of the bequest.

Donor – Person or corporation who gives a gift or confers a power to another; creator of a *trust*.

Executor – Person or corporation appointed in a *will* or by a court to settle the estate of a deceased person. (Female version of executor is “executrix.”) See also *administrator* and *personal representative*.

Federal estate tax – Federal tax assessed against the assets of a person who has died if the value exceeded \$1,000,000 (\$1,500,000 in 2004/05, \$2,000,000 in 2006-08, \$3,500,000 in 2009). Filed on IRS form 706.

Final Distribution - The last portion of the payment/benefit to an organization or person, “in full.”

501 (c)(3) - IRS form letter recognizing an organization's tax exemption status.

Guardian – Person or corporation appointed by a court to handle the affairs or property of another who is unable to do so because of incapacity or because he/she is under the age of majority.

Heir – Person or corporation designated to inherit property from someone who has died.

Homestead exemption – State law that allows the head of the family to keep certain property (i.e., a home) safe from *creditors*.

Inactive File - Funds are due to the charity, but it is difficult to determine the date of receipt. These are files that require less regular review. Examples of inactive files would be: Files with only tax reserves left or future remainder or contingent interests.

Intestate – Dying without a valid *will*.

Inventory – Detailed accounting of articles of property with their estimated value, required by the court to settle most estates.

Irrevocable Trust - A trust that cannot be revoked. Revocable trusts usually become irrevocable at death.

Issue – Offspring descended from a common ancestor (children, grandchildren, great-grandchildren, etc.)

Joint tenancy with the right of survivorship – Form of ownership in which property is equally shared by all owners and is automatically transferred to the surviving owners if another dies.

Letters testamentary – Court documents obtained by the *personal representative* that confirms his or her authority to settle a deceased person's estate. Also known as Letters of Administration.

Life Estate - A benefit that passes to one for his or her lifetime.

Living Trust Agreement - Created by an individual during his/her life that sets for how assets are to be administered during his/her life and distributed at his/her death. This type of trust involves transferring assets of the trust or to the trust.

Newly Discovered Assets - Assets not known of at the time an estate was originally opened and in probate.

Notice – Information about certain facts. For example, the *personal representative* is usually responsible for informing (serving notice to) all interested parties that the estate of the deceased is open for probate.

Notice of Administration/

Notice of Petition to Administer an Estate - The first document filed by an attorney to begin probate of a decedent's will and/or any codicils.

Open File - A bequest file where information has been received and money is still due the charity, or additional information is needed to determine if there are any funds due the charity.

Order – Written command or direction by a judge or court clerk; may outline a decision of the court, direct or forbid an action, or may be the final decision of the court.

Partial Distribution - a part or percentage of the full benefit to which the person or organization is entitled.

Perpetual trusts - Trusts which last forever or until the principal of the trust is too small to justify a trust.

Per Stirpes - refers to one's direct lineage of inheritance by law.

Personal property – Property other than land and fixtures.

Personal representative – Person named in a will or appointed by a court to settle an estate. See also *administrator* and *executor*.

Petition to Determine Homestead Status - asks the Court to determine how real estate should be transferred through an estate (whether it qualifies as Homestead property.)

Petition to Discharge - asks the Court to release the liability of the person administering the estate, based on demonstrated filings, etc., that the person's duties have been fully performed.

Petition to Extend Time - asks the Court to grant additional time (beyond the statutory deadline) to file required documents.

Petition to Reopen Estate - asks the Court to reopen the probate administration of the estate after it has already been closed (usually when an asset has been newly discovered).

Pleadings - Documents prepared by an attorney (or a person acting as their own attorney) filed with the court. Includes caption which contains the court's name, case number and parties involved.

Principal - The originating value of the trust or a promissory note. "Interest" or income is what is earned based on the value of the principal.

Probate – Legal process of establishing the validity of a deceased person's last will and testament. Commonly used to mean process and laws for settling an estate. A will goes through probate, a trust does not. In addition, assets that pass via a beneficiary designation (ira, insurance, etc) typically are not included in probate.

Real Property/Real Estate – Land, including building(s) on it and its natural assets.

Remainder Interest - Usually the interest that remains in an estate or trust, after it has continued for the benefit of another - sometimes for their lifetime.

Reserve Distribution - Usually a distribution that comes from a reserve fund maintained for an IRS clearance, or remaining income that was earned in the process of closing out a trust.

Resident Agent – Person living in a state who is authorized to accept legal documents on behalf of another.

Residuary Estate – That part of the estate remaining after all *bequests* have been made and claims satisfied.

Residuary Interest - A gift of the "residue" of decedent's will or trust is what's left after other gifts, if any (called Specific Gifts or "Special" Gifts), have been made. Is sometimes interchanged with "remainder" gifts.

Small Estate Administration – Simplified process for probating estates that are less than a specified dollar limit set by state law. Also known as Summary Administration.

Specific Bequests - A gift, which is not a residuary gift but is specifically described.

Statements - Accounting of assets on-hand, income, expenses and activities transacted.

Stock Power Form - Form used to transfer ownership of stock, usually requires "medallion signature".

Tenancy By Entirety – Form of spousal ownership in which property is equally shared and automatically transferred to the surviving spouse. While both spouses are living, ownership of the property can be altered only by divorce or mutual agreement.

Testamentary Trust - A trust created within a will.

Testate – Leaving a valid *will*.

Testator/testatrix - The person who wrote a testamentary document, or a will.

Trust – Legal document that transfers money or property for the benefit of another.

Trustee (co-trustees) - Person(s) or entity (e.g. bank trust department) that is administering a trust for the benefit of another. The Trustee has a fiduciary duty to the beneficiaries of the trust.

Trustor(s) - Person(s) who create a trust. Also known as the Donor(s).

W-9 - IRS form used for tax-filing purposes.

Waiver - Agreement to forego future information, a process requirement, or right.

Waiving an Accounting - In estate or trust matters an attorney may request that you waive the filing requirement of an accounting. An accounting shows all financial transactions of the estate/trust from the death of the decedent to the present. It is not recommended that an accounting be waived if the charity has a residuary interest. If the charity has a specific bequest it is fine to waive an accounting.

Will - Legal document declaring how a person wishes to dispose of his or her property to *heirs* or *beneficiaries* after death. A will can be changed at any time. The most recent Will is the controlling document. An amendment to a will is called a codicil.

Will contest - Challenge of a *will* by a person who believes the will is unfair, invalid, or that one or more of its provisions does not accurately reflect how the deceased person wanted his or her property distributed.

Witness - Person who is present at an event or at the signing of a document such as a will, real estate closing document, stock power form, beneficiary receipt, etc.

First Letter
Requesting Copy of Will

April 2, 2002

Mr. John W. Smith
Law Offices of John W. Smith
P. O. Box 12345
Anytown, USA 12345-7090

RE: *Jane Doe Estate*

Dear Mr. Smith:

Thank you for your recent correspondence regarding the estate of Jane Doe. We are extremely grateful for Mrs. Doe's generosity in providing for the American Heart Association in her estate and enabling us to continue our mission to fight cardiovascular diseases and stroke.

For your convenience, we have enclosed a completed W-9 form indicating our Tax Identification Number, our status, and our correct address for your records. This is the appropriate address for all future correspondence regarding any estate or trust, since the supervision of gifts to the American Heart Association in the state of XXX is centralized at this office in ABC City. We have also enclosed an IRS 501(C)(3) letter.

In order to complete our records and meet our audit requirements, we would appreciate the following information:

- A copy of the Will (or pertinent page[s] thereof)
- A copy of Mrs. Doe's Death Certificate
- An estate Inventory, when available
- The name and address of appropriate family member(s) to whom we may extend our condolences and express our appreciation.

If you have any questions, please feel free to contact me at (800) 555-1212. I look forward to working with you and appreciate your efforts in the administration of this estate.

Sincerely,

Ms. Mary Jane Heart
Bequest Administrator

Distribution Follow-up Letter

April 2, 2002

Mr. John W. Smith
Law Offices of John W. Smith
P. O. Box 12345
Anytown, USA 12345-7090

RE: *Jane Doe Estate*

Dear Mr. Smith:

During a recent review of our trust and bequest files, a distribution that has been expected for some time from the estate of Mrs. Jane Doe has not been received. In addition, we have no record of receiving a response from you to our inquiry letter dated XXXX (copy enclosed).

The purpose of this letter is to request an update on the status of this estate's distribution schedule. Please provide us with any information for our files that would be useful to adjust our accountings to reflect an accurate date to anticipate receipt of the final distribution from this estate.

Please respond to the address indicated above, since the supervision of gifts to the American Heart Association in the state of XXXX is centralized at this office in ABC City. We appreciate your attention to this matter and look forward to hearing from you soon.

Sincerely,

Ms. Mary Jane Heart
Bequest Administrator

Enc.

Thank You Letter to Family Member

April 2, 2002

Mr. John W. Doe
123 Main Street
Anytown, USA 12345-7090

Dear Mr. Doe:

On behalf of the American Heart Association please accept our deepest sympathy on the death of your mother, Mrs. Jane Doe. We appreciate her philanthropic support in our fight against heart disease and stroke.

Your mother's generous gift to the American Heart Association helps us to continue our life saving research of America's number one killer - heart disease. For over 70 years the American Heart Association has been working to reduce disability and death from cardiovascular diseases and stroke.

We know that mere words cannot console you at a time of such great loss, but we hope you will find comfort in the knowledge that your mother's generous contribution will continue to affect countless lives in the years to come.

Sincerely,

Ms. Mary Jane Heart
Bequest Administrator

AMERICAN COUNCIL ON GIFT ANNUITIES
233 McCREA STREET, SUITE 400 • INDIANAPOLIS, INDIANA 46225
PHONE: (317) 269-6271 • FAX (317) 269-6276
E-MAIL: ACGA@IUPUI.EDU • WEB: WWW.ACGA-WEB.ORG