Using Charitable Contribution Planning Opportunities with Family Business Succession Planning

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Charitable gifts are not part of everyone’s estate and business succession planning. Some clients simply have no interest in charities, while others would like to give but feel the need to devote all of their resources to their families. Sooner or later, though, you’ll have to discuss charitable giving with a client. Maybe you’ll initiate the conversation as part of an annual review or a discussion of specific tax or financial objectives; maybe the client will. In either case, you need a level of familiarity with the sometimes bewildering array of giving options available, each with its own tax, financial and practical consequences. Complexity abounds. The income tax deduction provision alone—originally a single sentence in the 1917 federal tax act—has grown to occupy 16 pages in a paperback edition of the current Internal Revenue Code. That single provision is now interpreted by over 100 pages of Treasury Regulations, scores of revenue rulings, and countless private letter rulings and court decisions.

Anyone seeking to navigate the maze of charitable giving rules must realize the risks involved. As the mythical Murphy said, “If something can go wrong, it will.” Slight variations in the gift form may mean the difference between a tax deduction for the full value of the donation, a deduction for only the donor’s cost basis, and no deduction at all. Failure to plan and analyze adequately also can result in practical problems both for the charity and for the donor and any other individual beneficiaries.

The good news is that you can deal effectively with potential donors without becoming an expert in all the arcane rules of charitable giving. What you need is a basic understanding of how the type of property donated and the nature of the charitable recipient will affect the gift. You also should be generally familiar with the various forms in which federal tax laws allow donors to receive immediate benefits despite having given away only part of their interest in the property. This outline does not purport to list all of the planning possibilities and issues that you may encounter. Instead it highlights several popular planned giving techniques and explores some common problems that can develop. By becoming aware of them in this context, you may be better equipped to help clients take advantage of the possibilities while avoiding the problems.

I. Why Give? — A Brief Reminder about the Goals of Charitable Giving

A. Essential Charitable Motivation. The primary reason to make a gift to any charity is that the donor believes in the organization and the work it is doing. Once a donor has decided to make a gift, however, he or she should keep in mind the other benefits that may be available.
B. **Tax Deductions.** Immediate income, estate and gift tax deductions are available for charitable gifts (although donors must itemize deductions in order to claim an income tax deduction). For a partial interest gift, the deduction is based upon the value of the property, discounted pursuant to IRS actuarial tables for the time that non-charitable beneficiaries retain an interest.

C. **Increased Income Yield Without Immediate Capital Gain.** If the gift property is to be sold, the proceeds will not be reduced by capital gains tax. The full amount will be available for reinvestment, potentially at a higher rate than the gift property had been paying to the donor.

D. **Continued Income Or Use.** A partial interest gift will enable a donor not only to support a charity during lifetime but also to guarantee that the donor, surviving spouse or some other individual can receive income from the gift property or continue to use it even after the gift.

E. **Access To Built-up Equity.** A life income gift can allow a donor to unlock equity that has built up over the years in a home or other illiquid asset, without having to sell the asset and incur a capital gain tax liability.

F. **Corporate Tax Avoidance.** A gift of stock of a closely-held business and subsequent redemption by the corporation can enable the owner to remove assets from the business without tax at the corporate level.

G. **Augmented Retirement Income.** Through contributions to charitable remainder unitrusts or gift annuities, donors may be able to set aside retirement income beyond the amounts that federal income tax law allows as “qualified plan” contributions.

H. **Assured Income Stream.** Life income gifts allow donors to guarantee an income stream for college funding or to providing a degree of financial security for a friend, relative, or faithful employee.

I. **Larger Charitable Gift.** Deferred gifts may enable donors to make larger gifts than they otherwise could afford to make from current income and disposable assets.

J. **Succession Planning.** Donors can use lead trusts and other deferred gifts to transfer family business or farm interests to the next generation at a greatly reduced estate or gift tax cost.

K. **Pledge Funding.** Planned gifts can ensure that a charitable pledge will be completed even if the donor die or suffer financial reverses.

L. **Other.** Combinations of charitable gifts using various assets can meet many other combinations of personal and financial needs.
II. Where to Give? — Type of Charitable Recipient

A. Statutory Framework. The universe of organizations exempt from federal income tax under IRC § 501(c)(3) (called “charities” in this outline) is divided into sub-categories, each with special characteristics that can affect a donor’s gift.

1. Reasons For Multiple Categories. Certain charities do not have to depend on the public for continuing support because they were funded by one individual or corporation, a family, or some other small group. Congress worried that they might be more likely to use their resources to advance their donors’ private agendas than to benefit the public. Originally, the only penalty that the IRS could impose on such charities was revocation of tax-exempt status. Congress wanted an intermediate sanction that would deter abuses without costing a charity its exemption. It also wanted a standard that was uniform and easy to apply.

2. Resulting Categories. Charities now are divided into two main categories: “private foundations” (PFs) and non-private foundations, more often called “public charities” (PCs). PFs generally are subject to excise taxes, operational restrictions, reporting requirements and other burdens that do not apply to PCs. Some charities that ordinarily would be PFs may be classified in intermediate sub-categories that enjoy some — but not all — of the advantages of PC status. These include “private operating foundations”, “exempt operating foundations”, “conduit foundations” and “donor-directed funds”. Other entities such as non-exempt trusts and split-interest trusts, which are not entirely charitable, may nevertheless be treated as PFs for some purposes.

B. Identification of Public Charities. Every charity is presumed to be a PF. It will be classified as a PC only if it satisfies one of five PC tests.

1. Per Se PCs. Churches and their conventions or associations, educational institutions with regular faculties and curricula and regularly-attending student bodies, hospitals and their associated medical research organizations, foundations that raise public contributions for state colleges and universities, and political subdivisions of governments automatically are entitled to PC status.

2. Organizations Supported by Public Contributions. A charity will be a PC if it “normally” receives at least one third (and in some cases, as little as 10%) of its financial “support” from government units and public contributions.

   a) “Normally” means the charity receives the required level and mix of support for the four years immediately preceding the year in question. The test applies to the four-year period in the aggregate. If met, it qualifies the charity as a PC for the year in question and the following year.

   b) “Support” does not include the charity’s total revenue. In particular, it excludes capital gains, receipts from the performance of exempt activities and certain grants that are unusual or unexpected in size. In determining how much of its support has come from the public, the charity generally must ignore contributions from a donor (or group of related donors) to the extent they exceed $5,000 and 2% of its total
support during the four-year measuring period.

c) A charity with a support fraction of one third or more is automatically a PC, while one with a support fraction of less than 10% is automatically a PF. Others will be classified as PCs only if they meet a facts-and-circumstances test designed to confirm that they are so organized and operated as to attract new and additional public or governmental support on a continuous basis.

3. **Organizations Supported by Public Payments.** A charity will be a PC if it “normally” receives (i) more than one third of its “support” from public contributions and receipts from performing its exempt activities and (ii) not more than one third from gross investment income and after-tax income from taxable businesses.

   a) “Normally” again means the test is applied to aggregate support over a four-year period, and qualification for a particular year also causes the charity to be classified as a PC for the following year.

   b) “Support” is defined more broadly than under the public contributions test, in that it also includes the charity’s receipts from performing its exempt activities.

   c) In determining the proportion of countable public support, the charity must ignore all payments from officers, directors, substantial contributors, individuals and entities related to them, and other “disqualified persons” (DPs). Contributions from non-DPs generally are countable in full, but payments from non-DPs for goods and services must be ignored to the extent they exceed $5,000 or 1% of the charity’s total support received through the end of that year. There is no facts-and-circumstances test for a charity whose public support fraction is less than one third.

4. **Organizations That Support Certain PCs.** A charity automatically is a PC, regardless of its sources of financial support, if it exists to support the activities and purposes of one or more PCs. The PC may be the sole member or sole shareholder of the charity, or the two entities may be under the common control of a third PC. As an alternative, the charity may show that it is “operated in connection with” a PC. In that case its organizational structure must include an overlap of officers or directors or other features that give the PC a significant voice in directing the use of the charity’s income and assets. It also must either (i) conduct on the PC’s behalf activities that the PC otherwise would conduct itself or (ii) pay substantially all of its income to or for the benefit of the PC and show that the amount is sufficient to assure that the PC will be attentive to its operations. The charity also must not be controlled by its substantial contributors or certain other DPs.

5. **Public Safety Organizations.** A charity that is organized and operated exclusively for testing for public safety is a PC.

6. **Community Foundations and Donor-Advised Funds.** A community foundation usually is an “umbrella” charity established to attract large capital or endowment contributions for the benefit of a particular area or community, with initial
funding coming from a small group of donors. Donor-advised funds are component parts of a community foundation, in which the donor has retained a right to advise — but not direct — the community foundation as to grants to other charities from the fund. Community foundations and donor-advised funds do not comprise a separate statutory category of PCs. Instead, a community foundation generally must qualify as a publicly-supported charity under the public contributions test described in Item 2 above, and a donor-advised fund must contain no restrictions that would prevent it from being considered part of the community foundation.

C. Effects of Private Foundations Status. PFs, unable to qualify as PCs under the tests described above, are subject to an array of taxes, operational restrictions, reporting requirements and deduction limits that do not apply to PCs.

1. Investment Tax. The net investment income of PFs is subject to a 2% excise tax, which may be reduced to 1% once the PF establishes a pattern of making additional charitable grants beyond the minimum distribution requirements summarized below.

2. Required Annual Distributions. A PF must track the average annual value of assets not used directly in its charitable activities each year and must make “qualifying distributions” of roughly 5% of that amount by the end of the following year.

   a) Distributions that count toward the 5% payout target include (1) the PF’s expenditures (including administrative expenses) for its own direct charitable activities, (2) grants and contributions (and related administration expenses) to PCs and to certain PFs not controlled by DPs and (3) amounts set aside with IRS permission for specific long-term charitable projects. Excess qualifying distributions in any year can be carried over and applied against the distribution requirement in succeeding years.

   b) Any shortfall without advance IRS approval will cause the PF to incur an excise tax equal to 15% of the undistributed amount. If that amount remains undistributed at the end of the next year, a second tax of 100% is imposed.

3. Self-Dealing Restrictions. A PF is prohibited from engaging in certain “self-dealing” transactions with DPs, even if objective evidence shows that the transaction would benefit the PF.

   a) DPs include (i) officers, directors, trustees and others with similar powers, (ii) substantial contributors whose gifts total more than $5000 and more than 2% of the total contributions the PF has received, (iii) those individuals’ close relatives, (iv) owners of more than a 20% interest in any entity that is a substantial contributor, (v) entities in which any of the foregoing own more than a 35% interest and (vi) government officials.

   b) With limited exceptions, PFs and DPs are prohibited from engaging in any of these transactions:
i. Sale, exchange or leasing of property;

ii. Lending of money or other extension of credit, except an interest-free loan to a PF to be used exclusively to carry out its exempt purposes;

iii. Furnishing of goods, services or facilities, except those furnished without charge by a DP to a PF for use in its exempt activities and those furnished to a DP by a PF on a basis no more favorable than that on which the PF makes them available to the general public;

iv. Payment of compensation or payment or reimbursement of expenses by a PF to a DP unless the amounts are not excessive, are not paid to a government official, and are for personal services that are reasonable and necessary to carry out the PF's exempt purposes;

v. Transfer of the PF's income or assets to, or their use by or for the benefit of, DPs except through a liquidation, merger, redemption, recapitalization or other corporate adjustment or reorganization of a DP corporation in which all securities of the same class as that held by the PF are subject to the same terms and those terms provide for the PF to receive no less than fair market value; and

vi. Payments of money or property to government officials by a PF, except certain prizes, awards, scholarship and fellowship grants, domestic travel expenses reimbursements, retirement payments and small gifts.

c) A DP who violates these rules will be liable for an excise tax equal to 5% of the amount involved in the transaction. Foundation managers who participated, knowing the transaction was an act of self-dealing may also be liable, jointly and severally, for excise taxes. The parties also must correct the self-dealing violation by returning property, repaying loans or compensation, or otherwise undoing the transaction and putting the PF in as good a position as if the DP had been acting according to the highest fiduciary standards. If the transaction is not corrected promptly, the DP will incur a second excise tax equal to 200% of the amount involved, and foundation managers also may be personally liable for additional taxes.

4. **Limits on Excess Business Holdings.** A PF generally may not acquire or hold more than a 2% interest in any business entity unless the aggregate holdings of the PF and all substantial contributors and other DPs do not exceed 20% of the business. The ceiling on aggregate holdings increases to 35% if the PF can show that non-DPs control the business.

   a) If the aggregate holdings of the PF and all DPs exceed permissible limits at the end of its taxable year in which its interest first becomes an excess business holding, the PF will incur an excise tax equal to 5% of the value of its largest excess business holding during that year. If its actual holdings are not reduced to 2% or less or the aggregate holdings are not reduced to the 20% (or 35%) ceiling by the end of its next taxable year, it will incur an additional excise tax equal to 200% of the
value of the holding.

b) Certain holdings that exceed the 2% threshold and the 20% (or 35%) aggregate limit do not immediately become excess business holdings. For example, if a PF’s holdings change other than by purchase, any additional holdings it acquires as a result will not be treated as excess business holdings for five years after the acquisition. This five-year grace period applies to interests acquired by gift or bequest from any source or by redemption by a corporate DP. For an interest acquired pursuant to the terms of a will or trust, the five-year period does not begin to run until the PF actually receives the interest or, if sooner, until the end of a reasonable period for estate or trust administration.

5. **Prohibition Against Jeopardizing Investments.** A PF may not make or retain certain types of investments that might jeopardize its ability to achieve its charitable goals. No category of investment is prohibited *per se*; instead the IRS will examine such factors as the expected return, the risk of rising and falling values and the need for portfolio diversification.

a) An investment is not prohibited if it satisfies a “prudent man” standard when made. The prohibition also does not apply to “program-related investments”, which are intended primarily to accomplish a charitable purpose and do not have significant investment purposes.

b) A PF that makes a jeopardizing investment will incur a 5% excise tax. If it fails to dispose of the investment promptly and reinvest the proceeds in non-jeopardizing form, it will incur an additional 25% excise tax.

6. **Expenditure Restrictions.** A PF must refrain from making five types of expenditures that are inconsistent with its charitable purposes.

a) A PF may not attempt to influence the outcome of any specific public election or carry on, directly or indirectly, any voter registration drive.

b) A PF may not engage in most lobbying activities unless relating to legislation that would affect its existence, powers and duties, or tax-exempt status or the deductibility of donors’ contributions. The prohibition does not apply to nonpartisan analysis, study or research published generally, technical advice or assistance requested by a government entity or examining and discussing broad social, economic or similar problems without dealing with the merits of specific legislation.

c) A PF may not make grants to individuals for travel, study or similar purposes unless the IRS has approved its grant-making procedures in advance. This prohibition does not interfere with a PF’s ability to make other types of grants to deserving individuals.

d) A PF may not make grants to another PF or a non-501(c)(3) entity unless it exercises “expenditure responsibility” for the grants. To do so, the PF must establish adequate procedures to assure that the grantee spends the grant funds
solely for their intended purpose. As part of the process it also must compile and retain
detailed pre- and post-grant reports from the grantee and make detailed annual reports to
the IRS.

e) A PF may make grants only for exempt purposes.

7. Reduced Income Tax Deductions. Individual donors are entitled to
less favorable income tax deductions for contributions to most PFs than for comparable
contributions to PCs.

a) The annual deduction limit for aggregate contributions of
cash and ordinary income property to non-PFs is 50% of the donor's contribution base
(roughly equivalent to AGI). The corresponding limit for PFs cannot exceed 30% of
AGI, and it is reduced dollar-for-dollar to the extent contributions to non-PFs exceed
20% of AGI. Likewise, the non-PF and PF limits for contributions of long-term capital
gain property are 30% and 20% (or less), respectively.

b) If contributions to charities exceed the annual percentage
limits, the excess can be carried forward for up to five years, subject to corresponding
percentage limits in each year. Contributions to non-PFs, however, are applied in those
future years before contributions to PFs. As a result, donors who continue to make
substantial charitable contributions may find that they cannot use their full deductions for
PF contributions during the five-year carryover.

c) Donors who make non-cash gifts to non-PFs generally can
claim deductions for the current market value, subject to annual percentage limits. Gifts
of property other than “qualified appreciated stock” to PFs, however, generate deductions
equal to only the donor's cost basis if that is less than market value.

8. Special Termination Requirements. A PF may change its status or
distribute its assets to another organization only by following strict statutory
requirements. Deviation from these requirements will result in a termination tax equal to
the lesser of (a) the aggregate tax benefit that the PF and all of its substantial contributors
have derived from its tax-exempt status since its creation, plus interest, or (b) its entire
net asset value. A PF may terminate its status by:

a) going out of business after distributing its assets to one or
more PCs that have had that status continuously for at least sixty months immediately
before the distribution, or

b) converting itself into a PC by satisfying the public support
test for PC status for a continuous period of at least sixty months. The transition period
does not begin, however, until the beginning of the PF’s next taxable year after it notifies
the IRS that it intends to become a PC.

9. Additional Reports. PFs must file annual IRS information returns
on Form 990-PF, which is more detailed than the Form 990 that PCs file. A PC may
remove donor information from the copy of its information return that it makes available
for public inspection. A PF, however, may not delete any information about donors who are substantial contributors. Many states also require PFs to file copies of their returns with the Attorney General or other state official.

10. **Advantages of PF Status.** Despite the statutory burdens imposed, PFs status may be attractive to donors who have particular charitable and family goals.

   a) Although subject to more burdens than PCs, PFs still are tax-exempt, and contributions to them are tax-deductible.

   b) PFs can set their own charitable projects, investment policies and grant-making procedures and generally can function autonomously within the statutory framework.

   c) Donors and their families can comprise the entire board of a PF and make all decisions relating to it. Thus an individual or family can retain effective control of donated funds for years after receiving a full tax deduction for the gift.

D. **Entities Relieved of Some—But Not All—PF Burdens.** The PF rules apply in modified form to other types of entities.

1. **Private Operating Foundations.** A PF that conducts its own active charitable programs, rather than merely making grants to other organizations, is subject to all of the PF rules **except that** it need not make distributions to other charities each year and can offer donors the same income tax deductions as non-PFs. To qualify as such a “private operating foundation”, the charity must satisfy an “income test” and either an “assets test”, an “endowment test”, or a “support test”, all designed to confirm that it is using its income and assets to run its own direct charitable projects.

2. **Exempt Operating Foundations.** A special category of POFs also is exempt from the 2% excise tax on net investment income and can receive grants from other PFs without triggering the expenditure responsibility rules for the grantor PF. A POF will qualify if (i) it has been publicly supported for ten years or was a POF on January 1, 1983, (ii) its governing body is broadly representative of the general public and no more than 25% of the members are DPs, and (iii) none of its officers is a DP.

3. **Conduit Foundations.** Donors may claim income tax deductions for contributions to a PF under the more liberal annual deduction limitations applicable to PCs if, by the 15th day of the third month after the end of the PF's taxable year in which it receives the contributions, the PF distributes to unrelated PCs principal equal to 100% of the total value of all contributions it has received during the year and it has no remaining undistributed income for that year.

4. **Donor-directed Funds.** Donors likewise may claim deductions under the more liberal PC rules for contributions to certain common funds that allow each donor who is a substantial contributor (or the donor's spouse) to determine annually which of certain specified PCs will receive the income generated by that donor's
contribution and to designate (by deed or will) which of the PCs ultimately will receive the principal attributable to the contribution.

5. **Non-exempt Charitable Trusts.** A trust that is not tax-exempt will nevertheless be treated as a PF if it is devoted entirely to charitable or other purposes described in IRC § 501(c)(3) and if it includes amounts for which a charitable contribution deduction has been allowed.

6. **Split-interest Trusts.** A trust in which some, but not all, of the interests qualify for charitable contribution deductions—such as a charitable remainder trust, lead trust or pooled income fund—is generally subject to the PF rules *except that* it is not liable for the 2% excise tax on net investment income or subject to the 5% annual distribution requirement. A remainder trust or pooled income fund also is exempt from the excess business holdings and jeopardizing investments prohibitions, and a lead trust likewise is exempt if the value of the income interest does not exceed 60%.

E. **Determination of a Charity’s Status.** When it files an exemption application (IRS Form 1023), an exempt organization must submit at least a full year’s financial data or three years’ projected budgets, along with other information about whether it satisfies one of the tests for non-PF status.

1. **Definitive Ruling.** If the applicant has completed a fiscal year of at least eight months or if it is claiming supporting organization status, the IRS will include a definitive ruling on its non-PF status in the same letter that recognizes its IRC § 501(c)(3) status.

2. **Advance Ruling.** An applicant that claims to be a publicly supported organization may seek a provisional “advance ruling” allowing it to be treated as a non-PF for its first five fiscal years. To avoid being retroactively re-classified as a PF at the end of the five-year period, the applicant must promptly submit financial data showing that it did satisfy one of the two public support tests for that period. If the applicant has not completed a fiscal year of at least eight months, the IRS will not issue a definitive ruling on publicly-supported status. Even if an applicant has completed one or more fiscal years, it may choose to seek an advance ruling. The extra time may enable it to secure enough public funding to satisfy a public support test that it could not satisfy initially.

3. **Reconfirmation of Status.** Once classified, a supporting organization will remain a non-PF for as long as it maintains its formal ties to another non-PF. A publicly-supported organization, however, must submit financial data each year to confirm that it has satisfied one of the public support tests for the four-year period ending with the immediately preceding year.

III. **How to Make the Gift? — Charitable Giving Vehicles and Techniques**

The Internal Revenue Code offers tax deductions for the value of property contributed outright to charities, subject to the annual percentage limitations and value reduction rules outlined above. A donor also may generate deductions for giving less
than his or her entire interest in property; but when the donor (or a designated beneficiary) retains an interest in the gift property, the gift must be made in one of nine specific formats authorized by the Code.

A. Undivided Portion of a Property Interest. A gift of a fraction or percentage of the donor's entire interest in property, including a proportionate share of each right he or she possesses, lasting for the entire term of his or her interest. In the case of a work of art or a vacation home, for example, the donor and the charity each must have the right to possess and control the asset for portions of the year corresponding to their respective interests, although a court has ruled that the charity does not actually have to exercise its right by taking possession each year.

B. Gift of Art Work or Copyright. The owner of both a work of art and its copyright may receive an income tax deduction for transferring them to a charity. The owner also may receive estate and gift tax deductions—but not an income tax deduction—for transferring either interest by itself.

C. Remainder Interest in Personal Residence or Farm. A gift of a remainder interest in the donor's personal residence or farm, reserving rights for the donor (and spouse) to use it for life, after which the charity becomes outright owner.

D. Qualified Conservation Contribution. A gift to charity of a remainder interest in, or perpetual restriction on the use of, land for conservation purposes such as public recreation, historic preservation, protection of the ecosystem or preservation of open spaces.

E. Bargain Sale. A sale of property to a charity for less than its fair market value. The transfer is treated for tax purposes as two transactions: (i) a sale of part of the donor's interest in return for the value of cash and property received from the charity and (ii) a gift of the rest of the property's fair market value. The donor's cost basis in the gift property must be prorated between the sale and gift portions for purposes of calculating capital gain if the transfer involves appreciated property.

F. Charitable Gift Annuity. A bargain sale to a charity in return for its promise to pay a fixed amount at least annually to one or more beneficiaries for life. No separate trust is established; instead, the charity becomes outright owner of the property immediately, and the donor (or another designated annuitant) becomes an unsecured creditor of the charity. The annuity amount usually is based upon recommendations published periodically by the American Council on Gift Annuities, a not-for-profit organization. Annuity agreements with donors in other states or annuities payable to beneficiaries in other states may trigger additional registration, reporting and disclosure obligations, reserve requirements and investment restrictions for the charity under those states' laws.

G. Charitable Remainder Trust. An irrevocable tax-exempt trust established by the donor to pay stated amounts at least annually to individual beneficiaries for life or a term of not more that 20 years and then to transfer the entire
trust fund to a charity. The required annual payment may be between 5% and 50% of the trust value, and the actuarial value of the charitable remainder at the time of the gift cannot be less than 10% of the value of the gift property.

1. **Unitrust.** Payments must be expressed as a fixed percentage (not less than 5%) of the net value of trust assets, recalculated each year. A unitrust may pay the percentage from income and, if necessary, from principal; or it may limit payments to the amount of the trust’s actual net income or may provide that any shortfall will be made up from excess income in future years. It also may start in either of the income-only formats and then “flip” to a straight percentage payment on the happening of a specified event. Additional contributions are allowed.

2. **Annuity Trust.** Payments must be either a stated sum or a percentage of the initial value of trust assets (but, in either case, not less than 5% of the initial fair market value of the trust fund). Payments may not be limited to trust income. Additional contributions are not allowed.

**H. Pooled Income Fund.** An irrevocable trust established by a charity to hold cash or property (other than tax-exempt securities) as one fund and pay a proportionate share of income for the lives of one or more beneficiaries, with remainder to the charity. Additional contributions are allowed. Only a few larger charities currently make such trusts available to their donors.

**I. Charitable Lead Trust.** An irrevocable taxable trust established by the donor to pay a stated amount of income to a charity for a specified time and then to convey the trust fund to individuals whom the donor has designated. A lead trust may be either a grantor trust or a non-grantor trust and may use the unitrust or annuity trust format.

**J. Exception for Donor’s Entire Interest.** A partial interest gift other than one of the nine types described above nevertheless will be deductible if the gift is of the donor’s entire interest in the property. For example, a gift of a life interest not in trust or an interest for a period of years would not be deductible normally; but if that is the donor’s only interest in the property, he or she may claim a deduction for giving it to a charity.

**K. Examples of Non-deductible Gifts.** The foregoing rules render non-deductible certain transfers that clearly convey value to a charity. Examples include interest-free or below-market loans to charities, rent-free use of office space or other property, and gifts through non-qualifying trusts.

**IV. What to Give? — Property to be Transferred to Charity**

**A. Publicly Traded Securities.** Publicly traded stocks and bonds are among the easiest assets to use in charitable giving. They are appropriate for use with all of the gift vehicles described above, except that a pooled income fund may not accept tax-exempt securities. No appraisal is required to substantiate the donor’s deduction; instead the value is the average of the high and low (or bid and asked) prices on the date of the
gift. Gifts of appreciated stock held for more than one year will be subject to the 30% and 20% aggregate annual limits for gifts to PCs and PFs, respectively; but the higher 50% and 30% limits will apply to gifts of any donor who elects under IRC § 170(b)(1)(C) to deduct only cost basis and forgo any additional deduction for appreciation. Certain situations, however, are governed by additional or different rules:

1. **Impending Redemption or Sale.** Donors may try to make charitable gifts of appreciated securities that are about to be redeemed or sold, in order to avoid tax on the gain. At some point before the stock actually is redeemed or sold, however, the transaction will have progressed too far for the donor to be able to avoid the gain. For example, in a sale, the donor and buyer may have agreed on the price and all other significant terms. In a tender offer, the donor may irrevocably have tendered the stock. In a liquidation, the directors and shareholders may have voted to approve the plan.

2. **Liquidation of Taxable Subsidiary.** If a taxable corporation transfers at least 80% of its assets to charities or certain other exempt organizations in a liquidation, merger or conversion, the corporation must recognize the gain or loss it would have realized if the assets had been sold. The gain recognition rule will not apply, however, if the charity uses the assets in a taxable trade or business.

3. **Restricted Stock.** Stock that is not readily marketable under Rule 144 of the Securities Act of 1933 or is subject to similar restrictions may not be treated as publicly-traded stock. The stock therefore may not be valued solely by reference to public sale prices. Instead, the donor is likely to need a qualified appraisal to substantiate a contribution deduction that exceeds $10,000. The stock also may not be “qualified appreciated stock”, and a donor who gives it to a PF may be able to deduct only the cost basis.

B. **Stock in Closely-held C Corporation.** A donor who claims a deduction of more than $10,000 for a charitable gift of closely-held stock must substantiate the deduction through a qualified appraisal. The appraisal must take into account all relevant factors, including whether the interest is a minority and whether it is readily marketable. The corporation subsequently may be able to redeem the stock for its market value without tax consequences to the donor if the charity was not legally obligated to present the stock for redemption. If the charity is a PF, however, the corporation must offer to redeem all shares of the same class on like terms in order to qualify for an exception from the self-dealing rules. A PC also may sell donated stock to members of the donor’s family, so long as it receives fair market value so as not to violate the intermediate sanctions rules. A PF, however, generally may not sell donated stock to the donor’s family or related entities because of the self-dealing rules.

C. **S Corporation Stock.** Until 1996, giving S Corporation stock to a charity would render the corporation ineligible for S status. Charities now are eligible S Corporation shareholders, although split-interest entities such as charitable lead and remainder trusts and pooled income funds still are not. Such eligibility, however, comes at a price.
1. **Tax Consequences to Charity.** All S Corporation income allocated to the charity, whether or not distributed, is treated as income from an unrelated trade or business. It therefore is taxable even if it consists of dividends, interest, rents, royalties or other items that a charity normally can receive tax-free. Capital gain on a charity’s sale of S Corporation shares likewise is taxable to the charity. A charity organized as a corporation may have more after-tax income from holding S Corporation stock, as S Corporations are not subject to the compressed ordinary income tax brackets that apply to the income of trusts. A charity organized as a trust may be the preferred recipient of S Corporation stock that will be sold promptly, as trusts are subject to lower capital gain tax rates than corporations.

2. **Effect on Donor’s Deduction.** A donor of S Corporation stock may not be able to deduct the full market value. Rules like those applicable to partnerships (relating to such items as unrealized receivables, depreciation recapture and appreciated inventory) will reduce the available deduction by the amount of gain that would not have been long-term capital gain if the corporation’s assets had been sold.

**D. Gifts of Corporate Property.** If a C corporation itself gives a corporate asset to charity, it may deduct the value of the contributed asset up to the current annual limit of 10% of the corporation’s taxable income (computed without regard to the charitable contribution deduction). In contrast, if an S Corporation makes a charitable gift of a corporate asset, the resulting deduction flows directly through to the shareholders in proportion to their interests and is subject to each shareholder’s individual contribution limits. Such a contribution reduces the cost basis of each shareholder’s shares. A contribution may not reduce basis below zero, however, so any excess will not be deductible currently. Instead, it may be carried forward and deducted in future years to the extent that capital contributions or future S Corporation earnings increase the shareholder’s basis. Deductions of more than $10,000 must be supported by qualified appraisals.

**E. Partnerships and Similar Interests.** Charities usually will not accept gifts of general partnership interests due to concerns about the accompanying liability and the potential effects on their tax-exempt status. In contrast, a limited partnership interest may be transferred to charity if the applicable partnership agreement permits. A deduction of $5,000 or more must be substantiated by a qualified appraisal.

1. **Other Consequences to Donor.** The donor may recognize income if the transfer releases him from partnership liabilities that exceed his tax basis in the partnership interest. Even without a negative basis, a partnership interest donor may recognize gain under the bargain sale rules. The donor’s deduction may be reduced by minority interest and lack of marketability discounts, and it may have to be reduced further to reflect the presence of unrealized receivables, substantially appreciated inventory and other items that would generate ordinary income if the interest had been sold rather than contributed. In certain instances, the donor also may have to recapture a portion of a previously-claimed investment credit or may lose certain suspended passive losses.
2. **Issues for Charity.** A charity must be fully aware of all the obligations that it will assume by accepting a limited partnership interest. The tax law will treat it as conducting directly any activity carried on by the partnership. Consequently it should examine the partnership's operations and finances to determine whether any activity is an unrelated trade or business or whether any partnership asset is debt-financed, as either case will result in taxable income for the charity regardless of whether the partnership makes a distribution to it. This analysis is particularly important for a charitable remainder trust since, under current law, any unrelated business taxable income will cause the trust to lose its tax-exempt status. As a result, all of the trust’s income will be subject to tax at regular rates; and, if taxable income is realized in the year of the donation, the contribution will not qualify for income or transfer tax deductions.

**F. Real Estate.** Real estate may be particularly useful for charitable giving, whether outright or in one of the partial-interest vehicles described above. A charity accepting a real estate interest must understand the financial and practical consequences, including potential environmental or tort liability, specialized management needs, income-producing potential, marketability, and costs of taxes, insurance, maintenance and similar items. Deductions generally are available for the fair market value, unless depreciation must be recaptured or the property is not considered a capital asset because the donor is, e.g., a real estate developer and the property is part of inventory.

1. **Mortgaged Property.** If the contributed property is subject to a mortgage, the donor’s contribution deduction will be reduced by the outstanding amount, whether the charity assumes the debt or takes the property subject to it. Relieving the donor from a mortgage debt also will trigger the bargain sale rules, causing the donor to recognize some capital gain on the transfer. Unless the charity uses the property in its exempt activities, moreover, property contributed subject to a mortgage will generate unrelated debt-financed income. As in the case of partnership interests, mortgaged property can disqualify a charitable remainder trust.

2. **Option on Property.** The owner may give a charity an option to purchase property at a price below its fair market value within a specified time. Granting an option may convey value to the charity, but it does not result in a charitable contribution deduction. When the charity exercises the option, however, the donor will have made a charitable contribution equal to the amount by which the exercise price exceeds the property value.

3. **Remainder Interest Gifts.** A donor may give a farm or personal residence to charity, reserving for the donor or another beneficiary an estate for life or a specified term of years. The deduction will be determined actuarially, based on the property value, applicable federal interest rates, the duration of the intervening estate(s) and expected depreciation of the improvements during the term. The donor must use the residence, but it need not be the donor’s principal residence; a vacation home will qualify. Likewise, a condominium unit, stock in a cooperative housing corporation or a house boat may qualify. Under most states’ laws, a charitable gift of a remainder interest will not affect the donor’s obligation to pay regularly recurring expenses such as annual real estate taxes, insurance premiums, utilities, repairs and normal maintenance costs.
G. Life Insurance. No lifetime gift results from naming a charity as the beneficiary of a donor-owned life insurance policy, even if the designation is irrevocable. A donor can make a deductible contribution, however, by irrevocably designating the charity as owner of the policy. Because the sale of a policy would generate ordinary income, the donor’s deduction is limited to the lesser of the policy value or the donor’s basis in the policy. The gift therefore qualifies for the 50% annual contribution limit, rather than the 30% limit applicable to gifts of capital assets. Read literally, the valuation regulations require the donor to obtain a qualified appraisal from someone other than the issuing company or agent if the claimed deduction exceeds $5,000. If a gift policy is not paid up, the donor’s future premium payments on the charity’s behalf will generate additional deductions.

H. Retirement Benefits. Individual retirement accounts, 401(k) plans, HR-10 plans and similar retirement arrangements generally are not good sources of lifetime gifts to charity because the owner cannot transfer any portion without first including it in personal taxable income. The transaction therefore will be at best a “wash” and may actually generate taxable income if deduction reduction rules or applicable percentage limitations prevent the donor from claiming a current deduction for the entire amount withdrawn. Such retirement balances, however, are among the best sources of charitable gifts at the owner’s death. Not only are they subject to estate tax but, unlike most other assets, they do not receive a basis step-up at the owner’s death and therefore are subject to income tax when distributed to non-charitable beneficiaries. Each beneficiary is allowed a partial income tax deduction for federal (but not state) estate tax attributable to the retirement assets, but combined estate and income taxes nevertheless can absorb more than 75% of the value of retirement assets when the donor is in the highest estate tax bracket and the beneficiaries are in the highest income tax brackets. Donors may be able to defer or reduce this tax burden by use of spousal rollovers, distributions over younger beneficiaries’ life expectancies, and similar techniques. At the same time, recent changes in retirement plan distribution rules have made it easier to leave part of a retirement balance to charity without causing adverse tax consequences for other individual beneficiaries.

I. Tangible Personal Property. A donor’s deduction for a gift of tangible personal property is limited to the lesser of fair market value or cost basis unless the charity is a PC, the property would have generated long-term capital gain if sold and the charity can reasonably be expected to use the property in its exempt activities. In addition to obtaining a qualified appraisal if the claimed market-value deduction exceeds $5,000, the donor must furnish proof that the charity used the property in its exempt activities or that it was reasonable to anticipate that the charity would do so when the gift was made. If the charity plans to sell or otherwise dispose of the property or use it in an unrelated trade or business, only the lesser deduction is available. Special rules allow deductions exceeding cost basis for certain gifts by corporations, including inventory used to aid the ill, the needy or infants, gifts of scientific research equipment and gifts of certain computer equipment and software to schools.
J. Other Examples of “Problem” Gift Assets.

1. Property that the donor has negotiated to sell. At some point, negotiations may have proceeded so far that the donor will be deemed to have sold the property even though all documentation has not been completed. The donor cannot then avoid the resulting capital gain by a last-minute charitable transfer.

2. Property donated for a specific use. In addition to the charitable deduction limitations described above, problems can arise if the donor and the charity have different understandings of how the charity intends to use the property, how long conditions or restrictions will last, and under what circumstances they can be modified or eliminated.

3. Business interests. Certain business interests may be subject to buy-sell agreements or other transfer restrictions that effectively prevent their owners from giving them to charity.

4. Oil and gas interests. Working interests may generate unrelated business taxable income for the charity, as may certain non-working interests that are subject to debt financing.

5. Promissory notes. A donor’s own promissory note generates no deduction until paid; it is merely a promise to make a future gift. A gift of a third party’s note may be deductible, subject to appraisal requirements.

6. Installment obligations. A charitable transfer of an installment obligation generally will be a disposition, triggering recognition of deferred income that may substantially offset any resulting charitable contribution deduction.

7. U. S. savings bonds. Savings bonds cannot be transferred to charity during the owner’s lifetime; instead, the owner must cash them and include the untaxed interest component in taxable income for the year of the gift.

8. Augmented estate property. If a married donor makes a gift of more than $10,000 within five to six years of death and does not adequately provide for the surviving spouse, Virginia law allows the spouse to claim a share of the shortfall from all other beneficiaries, including charities.

V. Then What? — Contribution Substantiation Requirements

A. Receipts. A statement accompanying the donor’s return must identify the charity, describe the property, and state when and how the donor acquired it, the cost basis, the fair market value, the date of contribution, and the terms of any agreement or understanding between the donor and the charity about the use or disposition of the property.

1. Gifts of $250 or More. For all gifts of at least $250, the donor also must obtain a receipt from the charity before filing a return claiming the resulting
deduction; a canceled check no longer is sufficient to substantiate the deduction. The receipt must state the amount of cash contributed and describe (but not value) any property contributed. It also must either state that the charity has furnished no valuable benefits in return for the contribution or, as noted below, describe and value whatever the donor received.

2. *Quid Pro Quo* Contributions. If the charity furnishes goods or services to a donor in return for a contribution of more than $75, it must provide a written statement that describes the goods or services, provides a good-faith estimate of their value and reminds the donor that the tax deduction is limited to the amount by which the value of the contributed property exceeds the value of the goods or services received.

**B. Appraisal Rules.** Regulations for charitable contributions of property (other than publicly-traded securities) require detailed appraisals if the value of the property, when added to the value of all similar items given to charity in the same year, exceeds $5,000 (or $10,000 in the case of nonpublicly-traded securities).

1. **Qualified Appraisal.** To be acceptable, the appraisal report must be made by an independent qualified appraiser and must include a description of the property, the fair market value and an explanation of the method by which it was determined, a statement that the appraisal was prepared for income tax purposes, a list of the appraiser’s qualifications, the appraiser’s signature and tax identification number, and any other information that the IRS may require.

2. **Qualified Appraiser.** The applicable regulations define a “qualified appraiser” as an individual who performs appraisals on a regular basis, is qualified to appraise the type of property at issue and is not closely affiliated with a party to the gift transaction. Generally excluded as qualified appraisers are (i) the donor, (ii) the charity, (iii) parties to the transaction in which the donor acquired the property, (iv) employees of any of the foregoing, (v) certain close relatives of any of the foregoing and (vi) appraisers who do not perform a majority of their appraisals in a taxable year for persons other than the donor, the charity or a party to the donor’s acquisition. In situations involving many specialized assets, this restrictive definition disqualifies the individuals most likely to be familiar with the property and readily able to value it.

**C. Forms 8283 and 8282.** In addition to cost basis and holding period information, the donor’s income tax return must include an appraisal summary report (IRS Form 8283) signed by both the appraiser and a representative of the charity. If the charity disposes of the contributed property (by selling, consuming, discarding or any other means) within two years after the date of contribution, it must file Form 8282 to advise the IRS of the disposition price, if any, and disposition date.

**VI. Selected Pitfalls and Planning Opportunities**

**A. Self-dealing by Split-interest Trusts.** Many ordinary transactions with the trustee of a charitable remainder trust, lead trust or pooled income fund will violate the PF self-dealing rules if the other party is the donor, a member of the donor’s family,
an entity in which the donor or family member owns a substantial interest, or some other DP. Examples include:

1. Allowing a DP to live in or otherwise use property contributed to the trust.

2. Allowing a DP to purchase property from the trust, even if the price paid clearly represents or exceeds fair market value.

3. Leasing office space or equipment or purchasing supplies from a DP.

4. Assuming a DP's debt on contributed property or taking the property subject to the debt.

5. Allowing a corporate DP to redeem contributed stock unless the DP offers to redeem all other outstanding securities of the same class on the same terms.

B. Unspecified Charitable Remainderman. A donor's contribution to a charitable remainder trust will be subject to the lower PF income tax deduction limits if there is any possibility that the named charitable remainder beneficiary or a successor will be a PF, even if the only charity named in the trust instrument is a PC. IRS model CRT forms contain this trap.

C. Estate Termination. Estates generally are not subject to the PF rules; but an estate that pours over to a PF will become subject to those rules at the end of whatever the IRS considers a reasonable period for estate administration, regardless of whether the estate has been closed for state probate purposes.

D. Donors' Grants through PFs or Donor-Advised Funds. Donors who make grants through their PFs may engage in acts of self-dealing if, for example, the grant satisfies a legally binding pledge of the donor or the donor accepts benefits on account of the PF's contribution. The same problem arises with a quid pro quo contribution even if the PF pays only the deductible part and the donor pays the non-deductible part and accepts the benefits. A donor's receipt of similar benefits in connection with a grant from a donor-advised fund could constitute private investment that jeopardizes the grantor charity's exemption or an excess benefit transaction that subjects the donor to intermediate sanctions.

E. Effect of Resource Sharing between Company and PF. Companies often wish to furnish office space, employees, equipment or other resources to their PFs. Resources furnished without charge to the PF generally present no tax exemption problems. If the PF reimburses the company for any part of the cost, however, it will have engaged in an act of self-dealing that will obligate the company to pay an initial excise tax and to return the payment to the PF.

F. Grants to Non-PFs with Advance Rulings. Large grants by individual or corporate donors may cause a non-PF with an advance ruling to fall into PF status at
the end of the advance ruling period. Grants from non-PF charities classified as supporting organizations can have the same effect. An “unusual grant” exclusion may preserve non-PF status in certain cases.

G. **Adverse Effects of Successful Fundraising.** A PC that accumulates a large endowment and reduces its fundraising activity may become a PF if its countable public contributions drop below the one-third or 10% thresholds. Moreover, a donor can become a substantial contributor — and thus a DP for purposes of the public support tests and PF restrictions — with a much smaller contribution in the early years of a charity, since the threshold for substantial contributor status is 2% of the total contributions received through the end of the year in which the gift is made. To avoid substantial contributor status, donors whose contributions are significant, but not so much larger than all others as to disqualify the donors automatically, should consider postponing part or all of their contributions to later years, when others’ gifts will have raised the 2% threshold.

H. **PC Status for Company-Related Foundation.** When a charity is formed by a for-profit company that provides the majority of its funding and appoints its board of directors, the charity might seem to be a classic PF. If employees who are not owners of the company and are not related to each other contribute more than one third of the charity’s total support, however, the charity can qualify for PC status under the one-third-of-support test. The company’s control of the charity board — and thus of the grantmaking process — will not prevent that result.

I. **Opportunity to Change Status Temporarily.** Once an entity is classified as a PF, it can become a PC only by completing a 60-month transition or becoming a supporting organization for a PC. It can obtain many of the benefits of PC status for a particular year without becoming a PC, however, if it either meets the POF requirements or makes distributions sufficient to qualify it as a conduit foundation. The former can be met in the aggregate for the four years ending with the year in question or for any three years during that four-year period. The latter is determined on the basis of a single year and the following 2-1/2 months.

J. **Importance of AFRs.** The deduction for certain partial-interest gifts must be determined by an actuarial calculation that uses, among other factors, the “Applicable Federal Rate”. Remainder trusts, lead trusts, gift annuities, and real estate remainders (but not pooled income funds) all are AFR-sensitive. All-time low AFRs last summer increased the deductions associated with lead trusts and real estate remainders, reduced the deductions for most other partial interests, and prevented some donors from using particular gift forms. For example certain younger donors could not create remainder trusts for their lifetimes because the remainder value would have been less than the 10% minimum. Recent AFR increases have reduced this effect.

K. **Choice of AFR.** A donor who makes a partial-interest gift that is AFR-sensitive may calculate the resulting deduction on the basis of the AFR for the month of the gift or for either of the two immediately preceding months. For gifts made later in the month after IRS has published the next month’s AFR, the donor can choose the most advantageous of four rates — for the current month, either of the two preceding months
or the next month (if the donor postpones the gift until that month). The donor can utilize another month's rate, however, only by making an affirmative election on the tax return where the deduction is claimed.

L. Beneficial Combinations. Charitable gift vehicles that work well alone may provide even more benefits when used in combination. A charitable lead trust that reduces estate and gift taxes can pay income to a PF controlled by the donor's family, and a companion charitable remainder trust can generate an immediate income tax deduction while providing income to the family until they receive the lead trust principal. A gift of a remainder interest in a personal residence will generate only a tax deduction; but transferring the remainder interest in return for a charitable gift annuity also can generate income that will help the donor pay living expenses. A charitable remainder unitrust for life will provide income with potential inflation protection and will result in a transfer to charity at the beneficiary's death, while a combination of a short-term charitable remainder annuity trust and a flip unitrust may provide a steady initial annuity income, generate a larger income tax deduction, allow time for the unitrust principal to grow and still permit the charity to receive part of the ultimate gift during the donor's lifetime.

M. Limiting Effect of Generalizations. The greatest impediment to effective charitable gift planning is lack of knowledge about available gift vehicles and applicable rules; but reliance on preconceptions about particular types of donors or gift situations may be almost equally limiting. For example, younger donors creating remainder trusts generally prefer the unitrust format; but an annuity trust may be a better fit for a relatively young donor seeking a temporary income stream until a pension or other income source becomes available. Donors tend to choose the highest available AFR; but a lower AFR produces higher deductions for residence remainder and lead trust gifts. The highest available AFR also may not be appropriate for a gift annuity donor who is concerned more about the tax-free portion of each annuity payment than about the size of the initial income tax deduction. An effective gift planner must analyze the totality of each donor's individual situation in order to recommend charitable gift vehicles that will provide the best combination of benefits for the donor and the charity.