More Problem Solving with Planned Gifts

PG Calc Webinar

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Introduction

In Problem Solving with Planned Gifts (a PG Calc Webinar presented on July 31, 2014), we noted that planned giving marketing tends to focus on specific gift instruments or arrangements such as bequests, gift annuities, charitable remainder trusts, and the Charitable IRA Rollover. However, in our meetings with donors we are confronted with information about their aspirations, financial situation, and family dynamics, and our challenge is to find a solution that meets their objectives while benefiting our charity.

This paper presents additional case studies designed to stimulate thought as to which planned gift or combination of gifts might be appropriate in a given situation. The cases could be summarized as follows:

Case One addresses questions that are commonly raised about how to determine the charitable deduction for gifts of life insurance policies.

Case Two is about donors who want a charitable remainder trust for a combination of life and a term of years, and it discusses permissible and impermissible trust durations.

Case Three concerns a donor who wants the charity to serve as trustee of a charitable remainder trust that has a higher payout rate than the charity's policies allow and suggests a different approach in setting policies.

Case Four, which is based on an actual situation with changes in names, amounts, and the charity to protect anonymity, is quite complicated, but it provides an opportunity to discuss a number of issues including a pledge for a naming opportunity, a gift of an income interest, timing of an appraisal, and trust management.

Case Five describes an alternative way of making a capital campaign gift and then mentions a variation to that alternative.

Case Six shows how to structure an annuity so that the donor has totally tax-free income and increases annual giving.

Case Seven deals with a gift of an interest in a Limited Liability Company, important because commercial real estate is often held by such a company.

Case Eight presents a number of ways to design gifts of retirement fund assets and contends that these gifts can be pursued despite not knowing the fate of the Charitable IRA Rollover.

Case Nine is about a common ethical dilemma that gift planners face, namely how close is too close when it comes to friendships with donors.

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CASE ONE

Problem

Bill has a paid-up life insurance policy of which he is the owner and insured. The face value is $100,000, the cash surrender value of the policy is $80,000, and the premiums he has paid total $60,000. There are no outstanding policy loans, and no dividends have been distributed to him. The "cost of insurance" charges collected by the insurance company are $12,000. (This is the cumulative cost of insuring each year what the company has at risk, namely the death benefit less the policy's cash value. In other words, it is essentially the cost of the "term" insurance benefit while the policy has been in force.)

If Bill surrenders the policy to the company for cash, he will have ordinary income of $20,000, which is the cash value minus the following:

- Total premiums paid
- Outstanding policy loans
- Dividends distributed
- Any other distributions

Since Bill has received no distributions of any kind from the policy, the ordinary income is simply the cash value minus total premiums paid. The component of premiums representing "cost of insurance" is not a factor in calculating the amount of gain taxed as ordinary income when a policy is surrendered to the insurance company for cash.

Bill has been approached by a company that specializes in the purchase of existing life insurance policies, and this company offers to pay him $88,000 for transferring ownership of the policy to it. In the case of a sale of a policy to a third party the "cost of insurance" must be taken into consideration in determining the adjusted cost basis of the policy, so the adjusted cost basis would be $60,000 - $12,000 = $48,000. The total gain is $40,000 ($88,000 - $48,000), and the IRS applies the "substitute for ordinary income doctrine" to hold that the amount of the total gain that would be ordinary income is the ordinary income that would be realized if the policy had been cash surrendered. Hence, the sale would result in $20,000 of ordinary income and $20,000 of long-term capital gain.

Suppose that Bill offers to transfer ownership of the policy to your charity. What would be the tax consequences?

Solution

Since a gift of a life insurance policy is an "other distribution" analogous to a sale of the policy, the "cost of insurance" must also be taken into consideration when determining the adjusted cost basis. Thus, for a charitable gift, as for a sale, the adjusted cost basis of Bill's policy would be $48,000. However, the charitable deduction is reduced only by the amount that would be ordinary income (See IRC Sec. 170(e)(1)(A).) In the case of a contribution of a long-term

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appreciated capital asset (other than "unrelated" tangible personal property), a donor is allowed a deduction for the full fair market value, and does not reduce the deduction by the amount of long-term capital gain. Bill must reduce his deduction by $20,000, the portion that is ordinary income, so his deduction would be the value of the policy minus $20,000.

In the case of a paid-up policy, the value of the policy is the replacement value, which could be more or less than the cash surrender value. In the event that the insured's health has deteriorated, it could cost more than the cash value to purchase an equivalent policy. On the other hand, if life expectancies and/or interest rates have increased, it might be possible to purchase an equivalent policy for less than the cash value. However, an appraiser should be able to argue successfully that a policy should not be worth less than the amount of cash the charity would receive from a surrender of the policy.

In the case of a policy on which premiums are still being paid, the value of the policy is "the interpolated reserve value," which takes into consideration prepaid premiums and prorated cash value increases. This is normally very close to the cash surrender value, but it could vary to some degree. Again, whatever amount would be ordinary income if the policy were cash-surrendered, must be subtracted from the value of the policy to determine the deduction.

For an explanation of the IRS position see Rev. Rul. 2009-13. You may also want to look at Rev. Rul. 2009-14. The latter was prompted by the life settlement market and concerned third party individuals who purchase life insurance as an investment, but it did not supersede Rev. Rul. 2009-13.

Following is a summary of the tax consequences when a person transfers ownership of a life insurance policy to a charity:

1. Even though all pertinent information might be available from the insurance company, an appraisal of the policy is required if the deduction to be claimed will exceed $5,000. The appraiser must be independent of the donor, the charity, and the insurance company. The appraised value will be reported on Form 8283 filed with the tax return on which the deduction is claimed. The appraisal could be advantageous to the donor, for it might demonstrate that the value of the policy is greater than the cash surrender value.

2. The charitable deduction will be reduced by the amount that would be taxed as ordinary income if the policy were cash-surrendered. To determine the deduction, subtract from the cash surrender value total premiums paid plus dividends distributed plus outstanding policy loans plus any other withdrawals.

3. If premiums are still owing to keep the policy in force, the donor can either make contributions to the charity, which it uses to pay the premiums, or it can pay premiums directly to the company. If it does the latter, the charity will issue a donation receipt upon confirmation that the premium was paid. The payment must be in cash, and it will be subject to a deduction limit of 30% of adjusted gross income because the gift is considered to be "for the use of" the charity rather than to the charity. If the contribution is to the charity, the donor could give long-term appreciated securities, thereby getting a double benefit: a deduction for fair market value and avoidance of tax on the capital gain. The disadvantage of giving the charity long-term appreciated securities instead of cash is being subject to the lower 30%-of-adjusted-gross-income limit.

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4. If a life insurance policy with capital gain, as well as ordinary income, is contributed for a gift annuity, some of the gain reported on Form 1099-R will be taxed as ordinary income and part as long-term capital gain. The initial deduction will be the adjusted cost basis, not reduced by the "cost of insurance" allocated to the gift element.

5. You may be approached by a company offering to purchase certain of the policies that have been given to your charity. In many instances, the offering price will be higher than the cash surrender value. Remember that there is a reason for offering a premium price, so this may or may not be a good deal for the charity. One factor is the expectations of the donor. Ordinarily, you would not want to sell a policy if the donor is counting on the death proceeds establishing a named endowment. Whether or not you decide to surrender, sell, or alter a policy, you should periodically do a review of your policies to assess what you have and determine if any action is warranted.

CASE TWO

Problem

Steve and Wendy, ages 73 and 72, would like to contribute some highly-appreciated stock for a charitable remainder unitrust. They want to assure payments for as long as either is alive, but in the event that they, like their parents, do not live beyond their 70s, they would like for the payments to continue to their daughter, age 49, at least for a certain number of years. Further, they inquire whether their grandson, age 23, might receive payments for a period of time if their daughter predeceases them or does not live for very long following their deaths. What beneficiary arrangements are possible?

Solution

It is possible for payments to be made to Steve and Wendy, then to the survivor of them, and then to their daughter for the balance of her life. However, the charitable deduction would be relatively small, and the gift to the charity would likely be long delayed. The charity very possibly would be unwilling to serve as trustee because the daughter is younger than its minimum age for a life beneficiary. Depending on the size of the trust, it may be possible and practical to establish such a trust using a commercial trustee.

Even if they could solve the trustee problem, it would not be possible to have three generations of life beneficiaries – payments to Steve and Wendy for life, then to their daughter for life, and then to their grandson for life. That is because the present value of the trust remainder would be less than 10% of the amount contributed, resulting in the trust's not being qualified.

Here is a beneficiary arrangement that is permissible and probably would satisfy the charity's condition for serving as trustee:

The trust would pay income to Steve and Wendy jointly and then to the survivor of them for life. If both Steve and Wendy die before the end of 20 years, the trust will make payments to their daughter for the shorter of her life and the balance of a 20-year period beginning on the date the trust was established. In the unlikely event that Steve, Wendy, and their daughter all die within

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20 years, the trust payments would be made to the grandson for the shorter of his life or for the balance of a 20-year period beginning on the date the trust was established.

With this arrangement, Steve and Wendy are assured of not outliving their payments. However, if they die within the next few years, they will have provided a benefit to heirs. The charity will receive the remainder of the trust at the end of Steve and Wendy's life if they live beyond 20 years but no later than 20 years after the inception of the trust in the event that neither Steve nor Wendy lives for 20 more years.

When deciding what beneficiary arrangements are permissible. It is important to keep in mind that payments from a charitable remainder trust can be:

- For the life of certain beneficiaries alive at the creation of the trust,
- For a term not exceeding 20 years,
- For the life of certain beneficiaries alive at the creation of the trust or for 20 years, whichever is shorter,
- For the life of certain beneficiaries alive at the creation of the trust, then for the life of certain additional beneficiaries alive at the creation of the trust or for 20 years, whichever is shorter, or
- For the life of certain beneficiaries, but if they do not live for 20 years then to other named beneficiaries for the balance of a 20-year period beginning with the establishment of the trust.

The proposed solution satisfies the fifth condition. See Reg. Secs. 1.664-2(a)(5) and 1.664-3(a)(5).

The following beneficiary arrangements are not possible:

- To A for life and then to B for 20 years. (The trust period would not be measured either by the life of named beneficiaries or by a term nor exceeding 20 years.
- To A and B for life and then to their children for life with no requirement that a child beneficiary be alive at the time the trust was created. However, if the trust is for a term of years, the beneficiaries could include children not yet born.

A charitable remainder trust may terminate upon the occurrence of a qualified contingency. For example, payments could be made to Bridget for her life except that they would terminate upon her remarriage.

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CASE THREE

Problem

Jim, a sprightly and well-informed widower, age 80, has done well with his investing, and announces to Jane, the planned giving officer of his alma mater, that he is prepared to contribute $2 million of highly-appreciated securities to fund a charitable remainder unitrust with his college as the sole remainder beneficiary. He proceeds to explain that he wants to assure a high level of income to pay for his world travels. He adds that he would like for the college to serve as trustee and electronically deposit his quarterly checks in his bank account so that the money is accessible wherever he is. After a flush of excitement, Jane starts asking him for the pertinent information, and she is dismayed to learn that he insists on an 8% payout rate.

She replies, "In the late 1990s, when stocks were generating double-digit returns year-after-year, a number of charitable remainder unitrusts with high payout rates were established. In the first decade of this century, the assets of many of these trusts declined in value with a corresponding decrease in income paid to beneficiaries. Now, our college, like many other charities, strongly recommends a conservative payout rate, which not only preserves a significant charitable gift but also increases the probability that trust income will rise over time, keeping pace with the inflation rate. A conservative rate also generates a larger charitable deduction. For all of these reasons, our college has decided not to serve as trustee of any charitable remainder trust with a payout rate higher than 6%."

Jim responds, "I understand the college's position, but the deduction from an 8%-payout-rate unitrust will be sufficient for my needs, and it will not unduly diminish what remains for the college, especially if it manages the trust well. While I prefer to make the gift to my alma mater, if it won't budge on its 6% maximum payout rate, I intend to check on the policies of some other charities that are also important to me.

Should the college (1) stand firm and not agree to serve as trustee if the payout rate is higher than 6%, (2) make an exception to its policy in view of the large amount being offered, or (3) change its policy about payout rates?

Solution

If Jim had approached the college, offering to contribute $200,000 for the unitrust and agreeing to a 5% payout rate, the college would have agreed to serve as trustee without hesitation. The present value of the college's remainder interest would have been $135,546, based on the 2.2% July 2015 CMFR ("Charitable Mid-Term Federal Rate" described in IRC Sec. 7520).

However, the college was hesitant to serve as trustee of an 8%-payout-rate unitrust funded with $2,000,000, although the present value of the remainder interest was $1,099,760. Presumably, the college also would have been unwilling to be trustee of a 10-year-term unitrust with a 10% payout rate, even though the present value of the remainder interest would have been $707,880.

Suppose that Jim lives another 15 years, which is beyond his life expectancy, and suppose that the constant return of the unitrust, net of expenses, is a mere 4%. How much would be left for the charity at the end of Jim's life?

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Trust funded with $200,000, 5% payout rate - $172,012
Trust funded with $2,000,000, 8% payout rate - $1,084,173

This analysis demonstrates that a charity's decision whether to serve as trustee should not be based on some arbitrary one-size-fits-all maximum payout rate, but rather on the value of the gift to the charity. Instead of setting a maximum payout rate, the charity could require that the present value of the remainder interest be a minimum dollar amount or a minimum percentage of the contribution, whichever is larger. While the charity would still negotiate payout rates, explaining to donors how the rate affects future income, the charitable deduction, and the benefit to the charity, the payout rate the charity ultimately accepts would depend on the amount contributed, the age(s) of the beneficiary(ies) or duration of the trust if for a term of years, and the type of trust (whether a unitrust or an annuity trust).

Adhering inflexibly to a maximum payout rate would preclude a charity's serving as trustee of a charitable remainder trust to cover the college expenses of a student, or of any other short-term trust where a donor wants to provide large payments for just a few years. Basing its willingness to serve as trustee on the value of the gift enables the charity to take all relevant factors into consideration. There could be instances when the charity would agree to serve as trustee when its share of the remainder interest is less than 50% provided the vested gift value meets its minimum requirement.

CASE FOUR

Problem

Ronald and Julia, ages 75 and 74, want to name the new wing of the hospital where their deceased daughter was treated. Their most available funding assets is an historic waterfront home where they once lived and which has been rented since they moved. They believe the property is worth about $4 million, but the estimation of value from various realtors whom they have consulted varies from $3 million to $4.75 million. The wide variation is due to the fact that there are certain issues that could limit the ability to modify or replace the existing structure on this very choice site. They have not had the property appraised because they fear that an appraiser would fail to appreciate this very unique property and thus underestimate what someone would be willing to pay for it.

This is inherited property, owned a long time, with a very low basis, so Ronald and Julia would incur large federal and state capital gains taxes if they sold it. The charitable deduction from a gift of a portion of the sales proceeds would reduce their taxes somewhat, but their taxes would still be significant. Their stated objectives, other than naming the hospital wing for their daughter, are avoid taxation of the capital gains, reduce their income tax over the next few years, and increase cash flow in order to have a high quality of life during retirement To achieve their cash flow objectives, they insist that the trust have a 7.5% payout rate.

The hospital board decided that a gift of $1,500,000 payable over a period not exceeding five years would be required to name the wing. Ronald and Julia asked if they could meet the naming requirement with a portion of the remainder interest of a charitable remainder unitrust. (The couple had previously established a unitrust with another rental property, so they were familiar with the instrument.)

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The hospital's planned giving director, after conferring with the hospital administration and board chair, informed them that the hospital would agree to name the wing for their daughter if it received 75% of the required amount ($1,125,000) within the next five years plus whatever percentage of the remainder interest of the unitrust that would have a present value of at least $375,000.

One possibility was to have the property appraised and then satisfy the $1,125,000 near-term contribution requirement by giving the hospital outright a fractional interest of the property that would have a value of $1,125,000. For example, if the property appraised for $4 million, a 28.13% fractional interest would be contributed outright to the hospital, and a 71.87% fractional interest would be contributed to the unitrust, with a vested portion of the remainder interest going to the hospital.

The hospital rejected this option for two reasons. First, it did not want to be on the chain of title, considering the complicated issues with the property. Second, it was concerned that the property might sell for substantially less than the appraised value, in which case its share of the proceeds would fall short of the $1,125,000 required as a near-term contribution.

Actually, Ronald and Julia want to serve as trustee until the property is sold because they know this unique property very well, and they believe they can secure a better price than an external trustee might be able to do. Following the sale, it is their intention to resign as trustee and appoint the hospital. This is fine with the hospital, which prefers not to be trustee of any charitable remainder trust while it is holding real estate, and especially not of a trust owning this particular property. Ronald and Julia would like some portion of the trust remainder to go to other charities whose missions they admire and to which they regularly contribute.
How might this gift be structured to meet the donors' objectives and satisfy the hospital's concerns?

Solution

After conferring with their attorney, Ronald and Julia have a trust agreement drafted with these provisions:

- The trust is a NIMCRUT that will convert to a straight charitable remainder unitrust as of January 1 following the year the property is sold.

- The payout rate of the trust is 7.5%.

- Trust payments will be made to Ronald and Julia jointly as long as both are alive and then to the survivor of them for life.

- The two of them, together, will serve as trustee, but they reserve the right to name a successor trustee. If they fail to do so and neither is able to serve, the hospital becomes the default trustee and will agree to serve provided the real estate has been sold.

- The hospital is named as remainder beneficiary of the trust. However, the donors acting together, while living and legally competent, or one of them acting alone, if only one of them

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is both living and legally competent, may add or substitute other charitable beneficiaries, provided that in no event shall the hospital be designated as a beneficiary of less than 50% of the remainder interest.

The property is transferred to the trust on July 9, 2015, and immediately thereafter the donors, in their capacity as trustee, list the property for sale.

We will assume that a sale of the property closes on December 18, 2015 and that the net proceeds paid to the trust are $3,700,000. As of January 1, 2016 the NIMCRUT "flips" to a straight unitrust. The trustee holds the proceeds in cash during the few remaining days of the year, so on January 1, 2016 (the annual valuation date) trust assets are still $3,700,000. Ronald and Julia will receive in 2016 payments totaling $277,500 (7.5% x $3,700,000).

Following the sale, they order an appraisal of the property, and the appraiser is instructed to value the property as of July 9, 2015 when they contributed it. (When an appraisal is done subsequent to a gift, it must be an historical appraisal indicating the value on the gift date based on information available at that time.) The appraiser determines that on that date the property was worth $3,600,000. Based on this gift value and the July 2015 CMFR of 2.2%, their charitable deduction is $1,236,132, and they will have up to six years (the year of the gift plus five carry-forward years) to use it.

On December 31 of 2016, when the fair market value of trust assets is $3,607,500 they contribute to the hospital 48.7968% of their income interest, which has a value of $1,125,000 (based on their ages at that time and a presumption that the CMFR remains at 2.2%). Since the hospital is beneficiary of the remainder interest, the 48.7968% of the income interest merges with that percentage of the remainder interest, and the hospital receives a distribution of $1,125,000 cash from the trust.

At the beginning of 2017, the trust has $2,482,500 of assets, and Ronald's and Julia's payments for that year total $186,187 (7.5% x $2,482,500) which, though diminished from the 2016 amount, is still more than adequate for their needs. The gift of the income interest results in another charitable deduction of $1,125,000. Although they will be unable to use both deductions in the allotted time, they will substantially reduce their income tax over the next few years.

Following the distribution of the $1,125,000 to the hospital, which satisfies the near-term required gift amount, Ronald and Julia resign as trustee and appoint the hospital as successor trustee. They also exercise their right to name other charities as beneficiaries of whatever remains in the trust at the second death.

Assuming that one or the other lives another 20 years (which is beyond their joint life expectancy) and assuming that the net return on trust assets is a constant 6%, the trust balance at termination would be $1,834,906, and the hospital's 50% share would be $917,453. Discounted at 4%, the present value of this remainder would be $418,714, which exceeds the required present value of $375,000 for this portion of their total gift.

The actual present value of the hospital's future gift depends, of course, on the longevity of the donors, the year-by-year return on trust assets, and the discount rate used. Although that present value cannot be determined in advance, it appears that it would at least come close to $325,000, even with conservative assumptions.

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In summary:

- Ronald and Julia name the wing of the hospital for their deceased daughter.
- They avoid taxation of capital gain when the property is sold.
- They receive a large charitable deduction.
- They significantly increase cash flow during retirement.
- They are able to benefit other charities for which they have affection.
- The hospital avoids the potential liability of owning an interest in the property.
- There is no guesswork as to how much the hospital will receive in the near term. The donors have agreed to contribute outright $1,125,000, and if they don't do this with other assets, they will contribute whatever fraction of their income interest has a value of $1,125,000.
- The actual amount the hospital receives upon termination of the trust is close to $1,000,000.

Questions:

1. Why would the donors not contribute a larger share of their income interest and thus cover the entire pledge in the near term, without covering part of it with the remainder interest? Answer: This would have further decreased their income which was unacceptable to them.
2. Why should the gift of the income interest occur over a year after creation of the trust? (See IRC Sec. 1001(e).)
3. Why should the income interest not be contributed until the NIMCRUT has converted to a straight unitrust?
4. When a person makes a gift of all or a portion of the income interest in a charitable remainder trust, why is it necessary to have an independent appraisal of that interest? After all, the value of the income interest can easily be determined using planned giving software.

CASE FIVE

Problem

On behalf of an arts organization for which you work, you have asked David and Nancy for a $1 million gift to your capital campaign, and you have explained that they can either pay this amount in a lump sum before the end of the year or pledge it and pay it in installments over the

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next five years. They agree to make the gift but explain that they are in a dilemma as to the timing. On the one hand, they could certainly use a large charitable deduction this year because of a spike in income resulting from a bonus paid to David and the exercise of some stock options. On the other hand, they would like to retain as much of their capital for as long as they can because they believe they can earn a high return on it. They ask whether they can pay $125,000 per year over eight years. Extending the pledge period raises these concerns:

- The present value of the gift is diminished.
- The donors might not fulfill the pledge obligation, though you don't expect that to be a problem in this instance.
- The donors might die before the pledge is fully paid. If it is structured as an enforceable pledge, any amount due at the death of the surviving donor could be a claim against his or her estate.

Notwithstanding these concerns, your campaign leadership, eager to secure a principal gift from these donors, agrees to an eight-year pledge, but you wonder if there might be an alternative that is better for both the donors and your charity.

Solution

You suggest to David and Nancy that they contribute $1 million of David's cash bonus to a grantor charitable lead annuity trust with a term of eight years and a 12.5% payout rate. Payments of $125,000 would be made to your charity each calendar year for the next eight years, whereupon the trust would terminate, and the remaining trust assets would be paid to David and Nancy. The two of them, together, would serve as trustee. Following is a financial illustration of this gift arrangement:

Amount contributed to the lead trust	$1,000,000
Total payments to the charity	1,000,000
Income tax charitable deduction, CMFR of 2.0%	915,690
Income tax savings (39.6% rate)	362,613 [1]
After-tax earnings on tax savings over seven years	173,132 [2]
Amount paid to donors at trust termination (7% annual return on trust assets)	435,711
Estimated tax donors pay on trust income	160,000 [3]
Net cost of $1,000,000 campaign gift ($1,000,000 + $160,000 – 435,711 – 362,613 – 173,132)	188,544

[1] The actual income tax savings and the earnings on those savings, depend on the donors' combined federal and state tax rate, whether any of their charitable deduction will be lost because of their level of income, and how quickly they can use the deduction. In the case of a cash contribution to a lead trust, the deductible limit per year is 30% of adjusted gross income.

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[2] The tax savings are presumed to be invested in a securities portfolio, so most of the income is taxed as capital gains and dividends.

[3] The donors are personally taxed on interest, dividends and realized capital gain on trust assets, but not on distributions of capital.

This arrangement is attractive to the charity because it has an irrevocable right to the trust payments, which is preferable to depending on the donors to perform in a timely manner on pledge payments.

It is appealing to the donors because they receive an up-front charitable deduction almost as large as if they had contributed the $1 million outright, they retain investment control, and the higher the return they can realize, the more of the trust assets will be returned to them.

While this example is for an eight-year trust, the trust term could be five years in order to coincide with the normal pledge period. Some donors would prefer to have a financial institution or the charity serve as trustee.

Bottom line: In this environment with a very low AFR, a grantor charitable lead annuity trust can be an excellent vehicle for high-income individuals to use for a capital campaign gift.

VARIATION OF CASE FIVE

Suppose that David and Nancy like front-loading their charitable deduction but not personally paying tax on trust income that they do not receive. Instead of investing their $1 million cash contribution in a growth-oriented portfolio, they purchase shares in a municipal bond fund paying tax-exempt interest of 3%. Since the interest is far short of the required annual payment to the charity, they must annually liquidate some shares, and if those shares have appreciated in value, they will be taxed on the capital gain, but any capital losses could offset capital gains.

Assuming that net capital gains are negligible, and that the interest paid on the bond fund shares remains at 3% for eight years, the value of shares remaining at the end of eight years would be $155,228, compared to the $435,711 returned to them if a growth-oriented portfolio had generated a 7% net annual return. They would have avoided the estimated $160,000 in taxes paid during the eight years, but even so they come out better by choosing taxable investments with a higher return. Of course, for any given period, the results could be different, depending on actual returns.

CASE SIX

<u>Problem</u>

You represent a social service charity and you are meeting with Wanda, age 76, who has been regularly contributing $1,500 per year to your charity. During the visit she complains about the low interest she is earning on her CDs and bonds and the 33% tax rate to which the interest is subject. She remarks that she is thinking of using $50,000 from a maturing CDF to purchase shares in a municipal bond fund that is currently paying an interest rate of 3%. You ask her if she

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would be interested in a plan that would provide larger tax-free payments for the rest of her life expectancy, generate a charitable deduction, increase her current annual support for the charity, and assure that contributions in her name would continue indefinitely.

Solution

Having gotten her attention, you propose this plan:

- Contribute the $50,000 from the maturing CD to your charity for a gift annuity.
- Receive each month the portion of the gift annuity payment that is tax-free.
- Authorize the charity to retain, as a contribution, the taxable portion of each gift annuity payment. The charitable deduction from the contribution will offset the taxable income from the annuity. The charity will issue a Form 1099-R for the taxable portion and a donation receipt for the same amount.
- Create with the residuum of the annuity a named endowment, the income from which will continue her annual gifts indefinitely

The financial illustration of the plan:

Contribution		$50,000
Gift annuity payment		
Tax-free	$2,298 *	
Taxable	702	
	3,000	3,000
Charitable deduction		22,869 *
Amount paid to Wanda tax-free each year		2,298
Tax-free amount as a percentage of the contribution		4.6 %
Additional charitable contribution each year		702

* The charitable deduction and the taxation of payments are based on a 2.2% CMFR.

At the end of Wanda's life, the residuum of the gift annuity would be combined with any other gifts so designated for a named endowment. The income from the endowment would continue Wanda's annual support.

If Wanda had used the $50,000 to purchase municipal bonds, her tax-free income would have been $1,500 per year. With the gift annuity she receives tax-free $2,298.

If Wanda lives beyond her life expectancy, her payment ceases to be tax-free. At that point, she could advise the charity to send her the entire $3,000 gift annuity payment so that money would be available for taxes.

Besides tax-free payments for the duration of her life expectancy, Wanda will be entitled to an income tax charitable deduction of $22,869, which saves $7,547 in income tax.

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You may be able to invent a catchy name by which to market this plan. For example, you might call it the "Tax-free Annuity and Gift Plan."

The key feature of this plan is paying just the tax-free portion of annuity payments to the donor and having the taxable portion retained as a contribution. The plan can appeal to donors because in most cases, at least in this low-interest environment, they would receive tax-free payments larger than the interest from either taxable or tax-exempt investments, a charitable deduction, and the satisfaction of supporting the charity at a higher level.

CASE SEVEN

Problem

Kristin, the planned giving officer of an environmental charity, was excited when John said he was interested in funding a charitable remainder trust with an apartment building, which he judged to be worth between $5 and $6 million. One of the first questions she asked was whether the property was indebted, and she was relieved when John said the mortgage was paid off last year. She then inquired about ownership of the property and learned that the title was held by a Limited Liability Company ("LLC") and that there were four members of the LLC – John who owned a 60% interest, his brother who had a 20% interest, and Tim and Charles, non-family members, who each owned a 10% interest.

John said that all of the partners, who were getting on in years, wanted to dispose of the property, but that he was the only one interested in a charitable gift. Aside from benefiting Kristin's charity, he wanted to avoid the hefty capital gains tax he would realize upon the sale, and he hoped for a stream of reliable income without management responsibility during his retirement years. The other partners simply wanted a lump sum of cash from the sale even though their share would be diminished by the tax they would pay on their share of the capital gain. How might Kristin structure this gift?

Solution

Kristin proposed that John contribute his LLC interest to a NIMCRUT that would convert to a straight unitrust following the sale of the property owned by the LLC. Before making this proposal, she had to ascertain that the operating agreement would permit a transfer of an LLC interest to a charitable remainder trust.

John secured an appraisal of his LLC interest to substantiate the charitable deduction he intended to claim, and the appraiser applied a fractional interest discount in determining the value. Within a 60-day period following the appraisal, John transferred his LLC interest to the NIMCRUT, naming himself as trustee and continuing in his role as manager of the LLC. Pursuant to a decision by all members, the property was then listed for sale by the LLC. A few months later another LLC purchased the property, and the sales proceeds were distributed to the members according to their respective interests. Then the LLC was terminated.

It is fortunate that the apartment building was owned by an LLC rather than by an S corporation. John could have made an outright contribution of some or all of his S corporation shares, but he

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could not have contributed them to a charitable remainder trust because it is not a qualified shareholder of S stock.

The property owned by John's LLC generated only passive rental income, and it was not subject to a mortgage. If an LLC has debt-financed income, the trust's portion will be unrelated business taxable income ("UBTI"), and it will be subject to a 100% tax. The tax exemption of a charitable remainder trust does not extend to UBTI.

If a portion of an LLC's assets consist of ordinary income property, the deduction allocated to the ordinary-income assets would be limited to the cost basis of those assets. There is no reduction of the charitable deduction if it holds just capital assets that generate passive income. In summary, when an individual inquires about making a gift of real estate, first determine who owns the property. Unless it is a personal residence of the donor, it is likely to be owned by a C corporation, a partnership, an S corporation, or an LLC. If the property is owned by an LLC determine the following:

- The interest owned by the donor.
- Whether the donor is thinking of an outright gift or a life income plan.
- Who are the other owners and what they want to do with their interests.
- Whether the LLC is actively engaged in a business or receives only passive income from rental property.
- Whether the LLC operating agreement permits a charity or charitable remainder trust to own an interest and, if not, whether it is possible to amend the operating agreement to make ownership by one of these entities possible.
- The marketability of the property of the LLC interest.
- Any expenses that might be payable by the owner of the LLC interest and what net income is being distributed to that owner.

An LLC interest can be suitable for either an outright gift of for a charitable remainder trust, but the gift will be more complicated than if the property in the LLC were individually owned.

CASE EIGHT

Problem

Joe and Keith, both planned giving officers and members of the local PPP council, report that some of their donors have been asking whether they can make charitable gifts from their IRAs, and they are discussing whether to advise donors to proceed to make a transfer now, even though the renewal of the Charitable IRA Rollover for 2015 is not a certainty.

With regard to legislation pertaining to the Rollover, there are three possibilities:

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The ideal is enactment of legislation that would both expand the Rollover and make it permanent. The Charitable IRA Initiative, a 501(c)(4) organization, is seeking passage of stand-alone legislation that would allow a rollover not only for outright gifts but also for gift annuities and charitable remainder trusts. Other organizations would like for it to be possible to make outright rollover gifts for donor advised funds.

If a stand-alone expanded and permanent bill is not approved, Congress might once again include the Rollover for outright gifts as part of the Extenders package, which has typically been adopted near the end of the calendar year. Unfortunately, by that late date some individuals, who might have made a rollover gift that would have counted towards their required minimum distribution, have already taken the required distribution in cash in order to avoid a penalty.

The worst-case scenario is that the Charitable IRA Rollover is not approved this year, either as a stand-alone bill or as part of the Extenders' package.

In view of these possible outcomes, what should Joe and Keith, and indeed all gift planning officers, be advising donors to do?

The potential for gifts from retirement funds is enormous. In the first quarter of 2015 assets in IRAs totaled $7.6 trillion, and there was another $4.7 trillion in 401(k) plans. While the focus is on IRAs because they hold the largest share of retirement assets and because of the favorable legislation that has been in effect from 2006-2014, gift planners will want to show how gifts can be made from other retirement plans as well.

<u>Solution</u>

Keith and Joe decide that when donors inquire about the status of the Charitable IRA Rollover, they will tell them that, although the legislation has not been renewed, they probably have little to lose by advising their IRA administrator to make a transfer now. If the legislation is subsequently enacted retroactive to January 1, 2015, the amount transferred would not be added to taxable income and would count towards the minimum distribution requirement. If the legislation is not enacted, the amount transferred would be added to taxable income, but a deduction for an equivalent amount would be allowed. For most donors, the tax consequences for a taxable distribution and deductible contribution would be the same as for a tax-free, non-deductible transfer. The latter would be better if adding the distribution to income would subject the donor to the 3.8% healthcare surtax or if the entire contribution could not be deducted because of the contribution limits. These possible consequences should, of course, be mentioned.

Even if the Charitable IRA Rollover were in effect, it is not necessarily the best alternative. If the donor has some highly-appreciated stock, it may be better to take a cash withdrawal, contribute stock with a value approximately the same as the cash withdrawal, and then use the cash either to repurchase the stock or to buy shares in another company. The deduction from the contribution of the stock will offset the taxable distribution (assuming all of the deduction can be used), and the donor will get a stepped-up basis in his shares. The donor would want to make sure the entire deduction can be used, given the lower 30% of adjusted-gross-income limit applicable to gifts of long-term appreciated stock.

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A cash withdrawal combined with either a cash contribution or a contribution of stock is possible for anyone over age 59½, and the withdrawal does not have to be from an IRA. It could be from another defined contribution plan such as a 401(k) or 403(b). The withdrawal should be after age 59½ to avoid the 10% penalty tax.

Often people inquire of Keith and Joe about using money in an IRA for a gift annuity or charitable remainder trust. They cannot afford to make an outright gift of IRA assets and forever forfeit the income from them, but they would be willing to commit some of their retirement assets to charity if they could continue to receive income from them. An expanded IRA Rollover permitting tax-free rollovers for a life income plan would be ideal, and that is one of the objectives of the Charitable IRA Initiative, the 501(c)(4) organization mentioned above. Meanwhile, the following are possible:

- Take a withdrawal from an IRA or other defined contribution plan, withhold enough to cover taxes, and contribute the balance to a pooled income fund or for a gift annuity or charitable remainder trust. Pooled income funds now generate a very high deduction, so the tax on the withdrawal could be substantially offset if the contribution were to a pooled income fund. The deduction from a contribution for a gift annuity is not as large, but when cash is contributed a high percentage of the payments will be a tax-free return of capital. Although this alternative could make sense for donors, it will probably never be popular because it is more complicated to explain.

- Establish a gift annuity for a survivor with funds remaining in an IRA or any defined benefit plan where proceeds are payable to a named beneficiary. The charity would be named as a beneficiary of the retirement fund, and while the donor is living he or she would execute a gift annuity agreement under which the charity would agree to pay an annuity to a survivor equal to the amount the charity receives multiplied by the applicable rate for a person of the age of the survivor at the time of the donor's death. (See PLR 200230018.)

- Establish a charitable remainder trust for a survivor with funds remaining in an IRA or any defined contribution plan where proceeds are payable to a named beneficiary. In this case, the trust, not the charity, would be named as beneficiary. A number of private letter rulings have been issued pertaining to such trusts.

If Keith and Joe are talking to someone interested in doing a Roth IRA conversion and who might also consider a larger gift, perhaps in connection with a capital campaign or to establish an endowment, they could suggest that the gift be made in the same year as the Roth conversion. Then the deduction could fully or substantially offset the tax on the rollover. They would want to make sure that the usable deduction would be approximately equal to the amount added to income. The gift could be outright, or it could be stock or real estate, perhaps to fund a charitable remainder trust.

Finally, of course, Keith and Joe can continue what they have long done, namely to suggest naming their charity as a beneficiary of the remaining funds in an IRA or defined befit plan, explaining why this is such a tax-efficient gift.

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As these examples demonstrate, Keith and Joe can talk about all kinds of ways to make a gift involving retirement funds while the fate of the Charitable IRA Rollover is being decided.

CASE NINE

Problem

While working for a certain university you became very friendly with Mrs. Chalmers, and she established two annuities with the university and also included a $500,000 bequest to it in her will. The university is her alma mater.

You leave the university and become Director of Planned Giving for a nearby hospital foundation. A few months after your move, Mrs. Chalmers contacts you and asks you to visit her. During the visit she tells you that she intends to change her will, removing the $500,000 bequest previously designated for the University and substituting the hospital foundation where you now work. You remind her that she had wanted to support her alma mater, and you suggest that she give this more thought. She replies that she is grateful to the hospital because she was once a patient there, and that she is not pleased with some of the changes implemented by the new president of the university. However, you suspect that the primary reason she is taking this action is to perpetuate her relationship with you and assure that you continue to visit her. What would you do?

Solution

Here are possible actions you might take:

- When she asks you to visit her, politely decline, telling her that she should now deal with the person who has replaced you as Director of Planned Giving at the university. You hesitate to do this because you know that she values her friendship with you and would be crushed if you were to end it.

- You visit her and encourage her to retain the bequest to the university, which was obviously very important in her life. Then you call the new planned giving director at the University, tell him what has happened, and suggest that he schedule an appointment with her as soon as possible. While this is the collegial thing to do, it seems to you like a betrayal of her confidence. She certainly never expected you to tell anyone at the university about your conversation.

- You suggest to her that, in view of her relationship with both the university and the hospital, she consider dividing the bequest, leaving one-half to the university and one-half to the hospital foundation, or, if she is able, that she leave the university bequest intact and add a bequest to the hospital foundation. Suppose she protests, saying that she can afford to give only $500,000 to charity and that she is quite sure she wants it all to go to the hospital foundation.

- You respect her wishes and provide the necessary bequest language that she can give to her attorney. You rationalize, “I took no initiative to take the bequest away from the

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> university and direct it to my new employer. She acted totally on her own, and a donor has a right to dispose of her property however she wishes."

Which, if any, of these alternatives would you follow? A larger question is to what extent you should allow friendships to develop between you and donors. It is inevitable that you and some of your donors will have great chemistry and share common interests. They may also invite you to stay at their home or join them on social occasions. Inasmuch as people give to people as well as to causes, your friendships may facilitate large gifts. Yet your colleagues may resent the perks you get as a result of the friendship and see you as a "wanna be" member of a social class to which you don't naturally belong. They may also question the independence of your judgment. In the case of an elderly, lonely donor like Mrs. Chalmers, you have nothing to gain from the friendship (unless she wants to make a personal gift to you), but you genuinely like her and have empathy for her because she is lonely with no close family members.

How do you keep friendships and professionalism in the proper balance?

CONCLUDING WORD

The foregoing solutions utilize many of the planned giving instruments, and they concern gifts of various kinds of assets. They also address questions that are commonly asked. The suggested solutions are innovative adaptations and combinations of existing gift instruments. In other words, they are about doing old things in new ways.

As Henry David Thoreau said, "The world is but a canvas to the imagination." Gift planners, like artists, writers, and inventors, have an opportunity to be creative. Not only can creativity serve our donors well, but it can also be fun.

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